MALVERN CAPITAL MANAGEMENT

MCM

Quarterly Commentary and 2021 Market Outlook

January 2021

Fourth Quarter 2020 Review

2020 – What a year! It was a year most people would likely want to forget. For the equity markets the year started out pretty well, continuing the positive trend from 2019. Early on it looked like we were headed for back-to-back years of double-digit gains. But all of a sudden, a mysterious virus, named Covid-19, emerged. The whole world changed. What was a promising "sure thing" continuation of the "bull" market turned quickly into a "bear" market in March, recording a loss on the S&P 500 of some 34% in just about a month. An economy that was humming along reversed course and we fell into a recession. As we moved through the year, the recession reversed course and the economy rebounded. Some, including many economists, calling it a "V"-shaped recovery. The markets also recovered and bounced back rather nicely. Surprisingly, we ended the year with those double-digit returns from the S&P 500 Index as well as other popular indices.

For the 4th quarter 2020, the S&P 500 Index rose 12.15%. In our 3rd quarter 2020 version of the "Market Outlook" we wrote about our expectation that we may begin to see "value" stocks out-perform "growth" stocks with the ending of a multi-year run of "growth" stocks out-performing "value" stocks. We did indeed see that shift into "value" stocks which we believe is more than a short-term event. The Russell 1000 Value Index returned 16.25% while the Russell 1000 Growth Index rose by 11.39% for the quarter. Small company stocks performed the best in the quarter as the Russell 2000 Index (an index of U.S. small companies) appreciated by 31.37% in the 4th quarter. Small company stocks have lagged larger company stocks for many years. We are confident that this trend of small company stocks out-performing large company stocks is going to continue beyond the 4th quarter.

Index Performance

Category	Representative Index	Dec. 2020	4th Qtr 2020	2020	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	3.41	10.73	9.72	9.90	14.65	12.97
Broad US Large Companies	S&P 500 Index	3.84	12.15	18.40	14.18	15.22	13.88
US Small Cap Companies	Russell 2000 Index	8.65	31.37	19.96	10.25	13.26	11.20
US Mid Cap Companies	Russell Mid Cap Index	4.68	19.91	17.10	11.61	13.40	12.41
Largest 100 NASDAQ Companies	NASDAQ 100 Index	5.11	13.09	48.88	27.59	24.27	20.63
Large "Value" Stocks	Russell 1000 Value Index	3.83	16.25	2.80	6.07	9.74	10.50
Large "Growth" Stocks	Russell 1000 Growth Index	4.60	11.39	38.49	22.99	21.00	17.21
Developed International	MSCI EAFE Index	4.65	16.05	7.82	4.28	7.45	5.51
Emerging Markets	FTSE All Emerging Markets	6.15	17.58	15.12	6.21	12.36	3.43
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	0.14	0.67	7.51	5.34	4.44	3.84
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	1.88	6.45	7.11	6.24	8.59	6.80
Commodities	Bloomberg Commodity	4.97	10.19	-3.12	-2.53	1.03	-6.50
Total US Market (all cap stocks)	Russell 3000 Index	4.50	14.68	20.89	14.49	15.43	13.79
Real Estate Investment Trusts	Wilshire US REIT Index	2.78	10.62	-7.90	3.30	4.25	8.27
Cash	US T-Bill 90 Day	0.01	0.02	0.36	1.45	1.12	0.59

** 3 year, 5 year and 10 year returns are annualized. All periods ending December 31, 2020.*
All returns include the reinvestment of dividends.

The bond market also did well in the 4th quarter, especially lower quality junk bonds. Generally, lower quality bonds do well when coming out of a recession as we in fact did. We also saw commodities perform well in the 4th quarter as most commodities have done poorly for the past several years. Is this positive performance signaling some underlying inflation?

In the 4th quarter we had the November elections which came and went without any real impact on the markets. The elections did leave some unfinished business resulting in a special election in January to fill two senate seats from Georgia. Covid-19 cases and fatalities accelerated in the quarter resulting in more "lock downs" across the country. The "lock downs" resulted in layoffs and businesses shutting down. We'll have to wait and see if there is another resulting recession.

As we move into the new year, all eyes will be on the new administration's proposals, new Covid-19 cases, the Fed, the economy and corporate earnings. Nonetheless, it is certainly great to be finished with 2020.

Continued Monetary Stimulus

In response to the plunging Gross Domestic Product (GDP) rate as a result of the Covid-19 pandemic, the Federal Reserve lowered the Fed Funds rate to 0 - 0.25% in an attempt to stimulate the economy in March 2020. Further, the Fed has said it will keep interest rates at this low level at least until 2023. In addition to the lower interest rates, the Fed embarked on what has been referred to as "Quantitative Easing 4" or "QE4" (QE1, QE2, QE3 and Operation Twist were implemented by the Federal Reserve following the financial crisis in 2008). The QE programs are essentially bond buying programs whereby the Fed increases its balance sheet by buying U.S. Treasury securities, mortgage-backed securities and other loans. QE4 would do just that by buying such securities. These programs are intended to increase the money supply and stimulate economic activity. Currently the Fed has added a total of $3.2 trillion to its balance sheet for a total balance sheet at the end of 2020 of $6.4 trillion. Prior to the pandemic's response, the Fed had been gradually reducing its balance sheet since 2015.

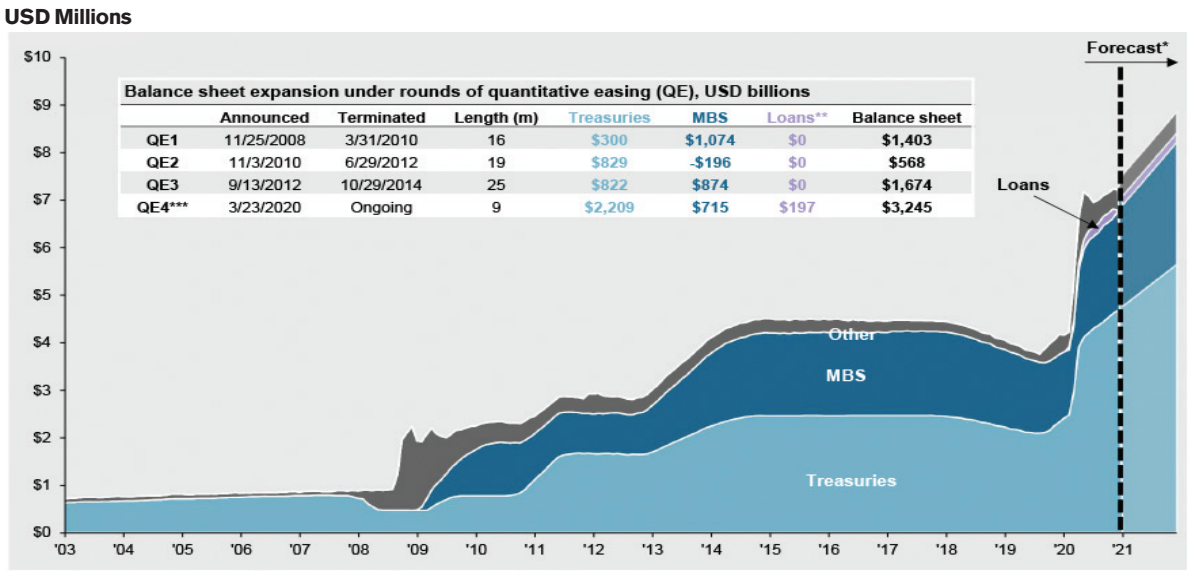
We want to point out that the Fed's low interest rate policy only directly affects the Fed Funds rate and not market-oriented rates such as the yields on Treasury bills, notes and bonds. We have seen a rise since August in market-oriented interest rates. For example, the yield on the 10-year U.S. Treasury note rose from its August low of .504% to end the year at .917%. The yield has continued to rise beyond year-end.

The Fed also has said that it will allow inflation to increase beyond its stated target rate of 2% until the jobs market improves. A stable inflation rate is a primary objective of the Fed as well as maximum employment and low long term interest rates.

It is important to note that not just the United States' central bank launched a QE program in response to Covid-19 but other central banks around the world did as well including the Bank of Japan and the European Central Bank.

This massive liquidity pumped into the global economies has been largely responsible for the rise in equity prices since the March 2020 equity market bottom. This liquidity will continue into 2021 which we believe will further fuel the equity markets in 2021.

The Federal Reserve Balance Sheet



Balance sheet expansion under rounds of quantitative easing (QE), USD billions

	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4***	3/23/2020	Ongoing	9	$2,209	$715	$197	$3,245

Source: FactSet, Federal Reserve, J.P. Morgan Investment Bank, J.P. Morgan Asset Management.
Currently, the balance sheet contains $4.4 trillion in Treasuries and $2.0 trillion in MBS. The end balance sheet forecast is $5.4 trillion in Treasuries and $2.5 trillion in MBS by December 2021. *Balance sheet forecast assumes the Federal Reserve maintains its current pace of purchases of Treasuries and MBS through December 2021 as suggested in the December 2020 FOMC meeting. **Loans include liquidity and credit extended through newly established corporate credit facilities in March 2020. Loan figures shown are max usage over the QE period referenced and are not growth of loan portfolio over the period. Other includes primary, secondary and seasonal loans, repurchase agreements, foreign currency reserves, and maiden lane securities. ***QE4 is ongoing and the expansion figures are as of the most recent Wednesday close as reported by the Federal Reserve.
Guide to the Markets – U.S. Data are as of December 31, 2020.

J.P.Morgan Asset Management

Additional Fiscal Stimulus

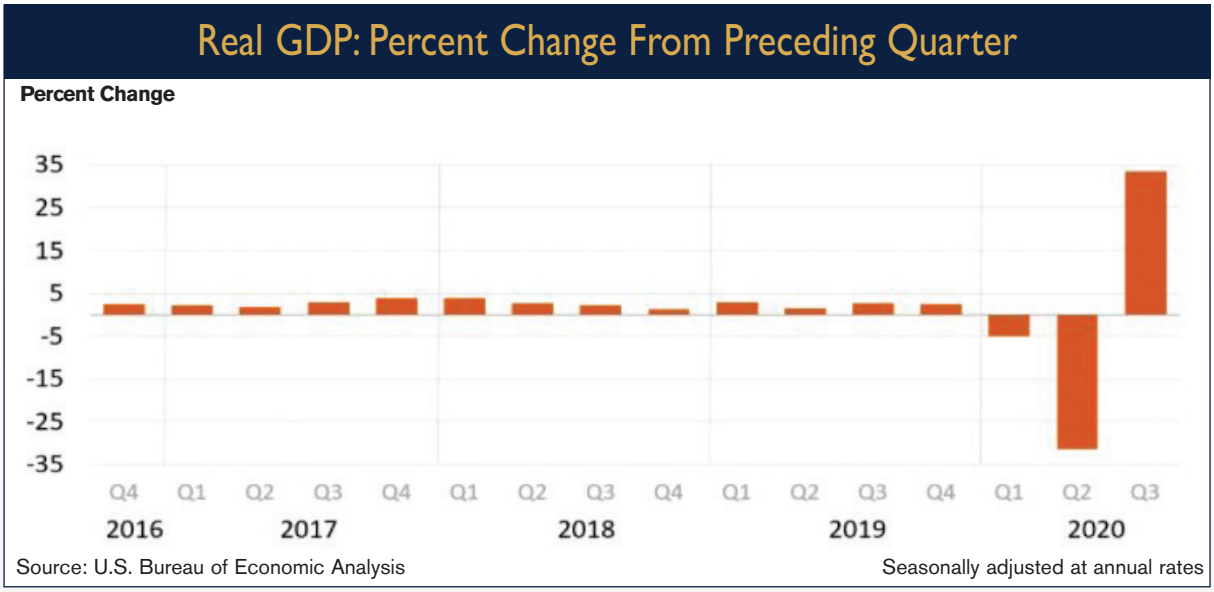
Americans received significant fiscal stimulus from the CARES Act earlier in 2020. Such stimulus included direct checks to taxpayers from the government, enhanced unemployment benefits and the Paycheck Protection Plan (PPP). Further, additional stimulus in the form of direct checks to many Americans began being paid out toward the end of 2020.

We have a new presidential administration with Joe Biden. Biden will have both the House and Senate of his same party which should allow him to pass his agenda into law. It is expected that he will propose an infrastructure bill which could potentially result in massive government spending. Such spending would be very stimulative to the economy. As such, it would also be very positive for the equity markets. Although the Biden administration proposes tax increases primarily on the wealthy and corporations, those tax increases (even if enacted in full) will likely fall short of paying for any infrastructure initiatives as well as the rest of his agenda. Thus, much of the spending will probably come from borrowing the money which in the short-term will also be very stimulative. At some point, deficit spending will be a problem, and inflationary, but it doesn't look like it will be an issue in the near-term.

The Economy

After dropping by 31.4% in the 2nd quarter 2020, investors eagerly awaited the release of the 3rd quarter 2020 real Gross Domestic Product (GDP) number. The "third" release of the real GDP annualized growth rate for the 3rd quarter 2020 was announced in late December, 2020 and it showed that real GDP had grown 33.4% for the quarter. This was further evidence of the so-called "V" shaped recovery that we and others were predicting for the economy. This sharp recovery of GDP was largely the result of the parts of the economy which had previously been closed re-opening in the quarter.

Real GDP acceleration came from increases in personal consumption expenditures (PCE), private inventory investment, exports, nonresidential fixed investment and residential fixed investment. These increases were partly offset by decreases in federal, state and local government spending.



Jobs had been created in the first two months of the 4th quarter but in December we recorded a loss of 140,000 jobs for the month. The unemployment rate ended the year at 6.7%, quite elevated from the pre-pandemic rate of 3.5% but the rate was down substantially from its peak in April 2020 at 14.7%.

Despite additional regional shut downs in late November and December, we believe the economy will gradually improve primarily due to the aforementioned liquidity being pumped into the financial system.

Corporate Earnings Outlook

Earnings estimates for the S&P 500 Index for the full year 2020 are projected to come in at $120.24 per share according to analysts from Standard & Poor's. At the end of last quarter (September 30, 2020) those same analysts projected the full year earnings to only be $113.84. Analysts have increased their earnings estimates for the full year 2020 which is a positive sign despite a "lock down" of the economy in many parts of the country.

Looking beyond 2020 into this year, we are seeing projected earnings of $164.41 for the full year 2021. This represents a year-over-year increase in earnings of 36.7% from 2020 to 2021. This sharp increase in earnings would correspond with the rebound in the economy. If we achieve the forecasted earnings of $120.24 for 2020, it will represent a decline of 23.5% from the full year 2019 to the full year 2020. The S&P analysts' earnings estimates for 2021 are likely assuming reopening of the economy as we see vaccines for Covid-19 come to market.

Corporate earnings are an important driver of equity prices. The improvement in the estimates for 2020 and 2021 will further support our view that equity markets will continue higher.

Current Market Valuation

There are a number of market valuation indicators we look at to help us ascertain whether or not the equity markets are over-valued, under-valued or fair-valued. They include the Q ratio, the Cyclically Adjusted

Price-Earnings (CAPE) ratio, the "Buffett Indicator" and an evaluation of the current forward and trailing price-earnings (P/E) ratios to historically average P/E ratios. At this time, all of these indicators suggest that the equity markets are over-valued.

The Q Ratio stands at 2.64 and is at its highest level ever going back to 1900. The CAPE Ratio is currently 33.8 which is at the highest level since December 1999 when it reached a reading of 44.2 prior to the tech company melt-down.

The Buffet indicator, named after investor Warren Buffet, is a simple calculation of the market value to nominal quarterly GDP. Buffett claims that "it is probably the best single measure of where valuations stand at any given moment." Looking at its current reading, we see that it is at 176.6% which is the highest reading going back to 1951 which is the earliest date it can be calculated since Quarterly GDP numbers only go back that far.

With the current earnings on the S&P 500 Index assumed to be $120.24 per share, the trailing P/E ratio is 31.24. The forward P/E ratio is 22.85 (the ratios are calculated using the year-ending price of the S&P 500 Index at 3756.07). To put these ratios into perspective, the 25-year average trailing P/E ratio is 19.89 (the average of the quarter-ending P/E ratios). The 25-year average forward P/E ratio is 16.56 (according to JP Morgan).

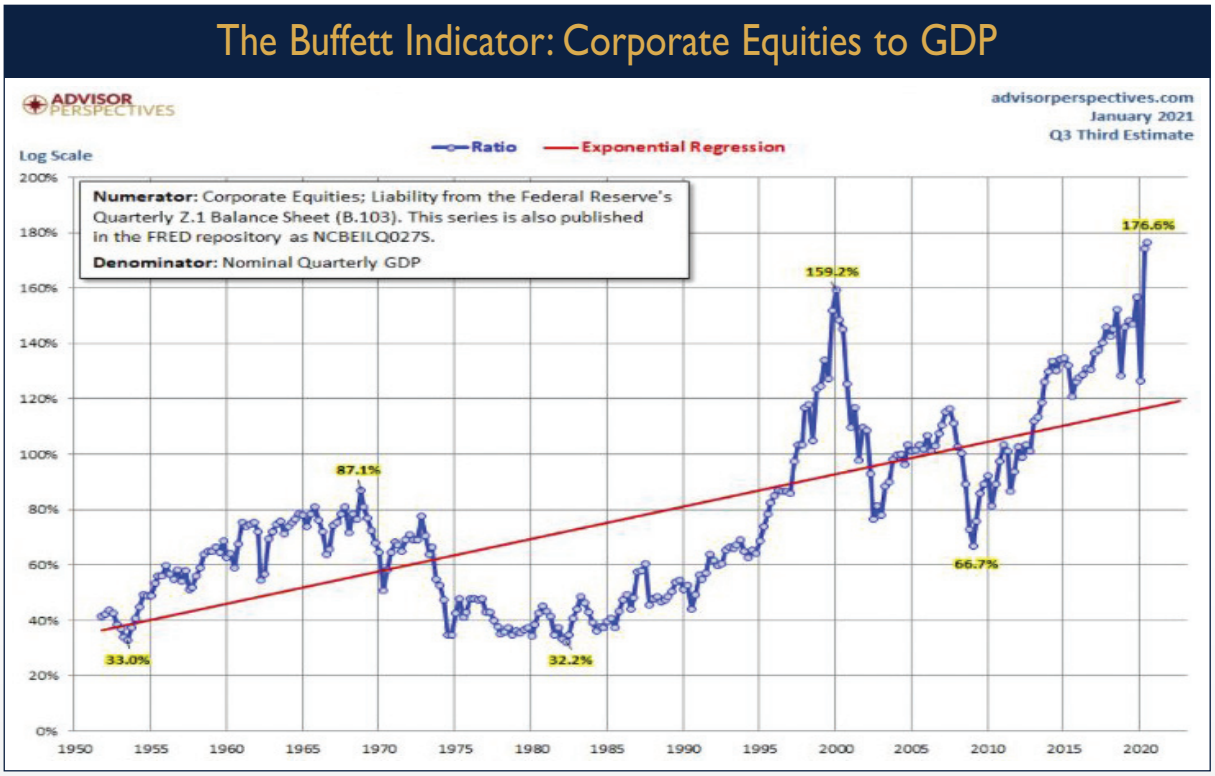
With these valuation measures in mind, do we suggest that investors sell out of the equity markets? Although caution is in order, the fact that interest rates are historically low, the Fed is buying bonds within the QE4 program and the Federal government is sending money to its taxpayers and will most likely be embarking on massive government spending programs, we have to look at things differently. The tremendous amount of liquidity pumped into the financial system actually may make equities look more reasonably valued. We continue to suggest cautious optimism toward the markets at this time and we want to stay fully invested.

As such, we project a total return (including reinvested dividends) from the S&P 500 Index of 9.9% for 2021. Our projection considers the full year estimate for earnings of $164.41 and applies a trailing P/E ratio (a lower P/E multiple than we currently see) of 24.75. The 24.75 P/E ratio is the same ratio the S&P 500 Index had at the end of June and would represent a more reasonable multiple than the 31.24 P/E ratio we show now.

Think Small

Small capitalization stocks are considered to be companies trading with a market capitalization as little as $300 million up to companies with a market capitalization of $2 billion. Small capitalization stocks appear to be coming back into favor after a number of years of trailing in returns to larger capitalized companies. At the end of the 3rd quarter 2020, the large cap S&P 500 Index had returned 8.93% versus the small cap Russell 2000 Index's returning 4.93%; a 400-basis point difference. At the end of the 3rd quarter 2020, the three-year average annualized return of the S&P 500 Index was 12.28% versus the Russell 2000 Index at 1.77%, a staggering 1051 annualized basis point difference between large cap and small cap. Looking at the five-year annualized difference, the S&P 500 Index returned 14.10% versus the Russell 2000 Index's 8.0% at the end of the 3rd quarter 2020. However, in the 4th quarter 2020, the Russell 2000 Index reversed course and returned 31.37% versus the S&P 500 Index returning 12.15%, an out-performance of small cap stocks by 1,922 basis points. Are we seeing the start of a new trend or was this one-quarter out-performance simply a blip? We believe in the former.

There may be reasons to be optimistic toward small cap stocks. Small cap stocks tend to do well when the economy is coming out of a recession. We are certainly coming out of the Covid-19 induced recession. Small



cap stocks generally suffer worse during recessions and the latest recession was no exception. Small cap stocks also typically lead the market when it starts a new "bull" run. In March 2020, we suffered through a short, but deep "bear" market, a "bear" market defined as a drop of 20% or more in a market index. From the short "bear" market of March 2020, we have entered a new "bull" market. Thus, we should see small cap stocks lead us forward as they usually do when entering a new "bull" market. Also, small cap stocks can find more meaningful impact from friendly fiscal policy which the Federal government is providing. It should be noted that small cap stocks can benefit more from rising interest rates than do larger cap stocks. Although the Fed is keeping the Fed Funds rate low, we have seen market-oriented rates such as the yield on the 10-year U.S. Treasury note rise in recent months.

The stage seems to be set for a positive run from small cap stocks. Within a diversified portfolio, some exposure to small cap stocks is warranted.

Value Stocks Shine

We have been quite positive toward "value" stocks versus "growth" stocks. Growth stocks have been out-performing value stocks since December 2006 except for a few short periods of under-performance. In the 4th quarter 2020, the Russell 1000 Value Index outperformed the Russell 1000 Growth Index by 486 basis points, or 16.25% versus 11.39% respectively (growth did out-perform in the month of December, 4.60% for growth versus 3.83% for value). The Russell 1000 Index is the top 1000 largest companies traded in the United States. That index is further divided between those stocks classified as value stocks versus those stocks classified as growth stocks.

Like small cap stocks, value stocks do better in the recovery stage of the economic cycle. It should also be noted that value will do better when interest rates are on the rise and inflation picks up. Are we suggesting

that we are seeing inflation? Although the government calculations are not showing much inflation, most consumers would probably disagree.

Conclusion

Despite suffering through a "bear" market, albeit a very short "bear" market in 2020, equity markets performed well for the year. In particular the 4th quarter was quite good for equities especially small cap equities. Small capitalization stocks are looking attractive right now and the environment in which they perform best is upon us. We also believe we have been seeing the start of a new trend of "value" stocks out-performing "growth" stocks.

The presidential election is behind us as well as the Georgia special elections. The incoming Biden administration promises huge tax increases on the wealthy and corporations while also promising massive government spending. In addition to the fiscal stimulus from the Federal government, we expect continued monetary stimulus coming from the Federal Reserve in the form of Quantitative Easing 4 and low historical interest rates. In contrast to the low Fed Funds rate, market-oriented rates have been rising.

Corporate earnings have been improving after taking a hit in the early part of 2020 as a result of the country effectively shutting down. Likewise, the economy has improved from the recession of 2020. It looks like the so-called "V" shaped recovery although we are not quite back to where we were. The employment situation is also much better now than earlier in 2020.

Certain indicators of market valuation would suggest that the markets are extremely over-valued. However, given the high level of liquidity pumped into the financial system from the Federal Reserve and the Federal government, perhaps these current valuations are much more reasonable and justified. We are confident that current market valuations reflect fair-value.

We are positive toward the upcoming year and we believe that further advances in the equity markets will be seen this year but will take diligence to find those investment pockets of growth.

As such, we are here to listen, counsel and provide direction to all of our clients.

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