Investor Insights & Outlook

July 2021 2nd Quarter Concorde Investment Management

Domestic Economic Overview

A Message from Concorde Investment Management

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In our last letter we discussed infection rates falling off a cliff given vaccinations and previously acquired immunity from natural infection. As of this writing, the CDC reversed course on their mask recommendations and the US is going through another wave, this time with the Delta variant. The Delta variant tends to be much more contagious than the initial strain mainly due to the viral load associated with it. It replicates faster and an infected individual sheds more virus, making it more contagious. Looking at other countries with similar vaccination rates, the Delta wave should spike and recede more quickly than previous waves and thus not materially impacting the economy. It should be noted that hospitalizations and deaths have not followed case increases this time and the fear from the Delta spread is overblown, in our opinion.

The economy is continuing to grow and posted GDP is 6.5% in real terms for Q2 2021. Less than what was expected but still a robust number. There is also continued stimulus being spent by the government, with pre-refunded child tax credits being deposited monthly beginning July 15th, totaling $100 Billion. The main discussion being had amongst the public obviously is more around inflation and whether it is transitory or going to be around for some time. May and June's CPI numbers were the largest gains in 13 years, likely higher than they would be otherwise given the low baseline comparisons from May and June 2020. Supply constraints combined with pent up demand are driving these numbers from a short-term perspective. But unsurprising to our clients, we've been expecting and waiting for alarm bells to sound on inflation for quite some time. Looking at year over year statistics on the cost of goods and services is more likely to be waived away by economists given last year we had a total collapse in prices versus

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Domestic Economic Overview (continued)

standing back and looking at the money supply and how it has increased over time. More money in circulation will mean goods and services will cost more in nominal terms. USD supply has quadrupled in 20 years, Japan has increased 50%, the Euro has quadrupled, and China has gone from $2T in circulation to $35T! Another way to look at it is through your own eyes. If any readers that have been on vacation this summer have noticed, there are help wanted signs everywhere. The only way to fill those jobs are to offer more money than the business next door (and the federal government). For a local business to be able to stay profitable if they are having to pay higher wages to attract workers, they have to raise prices. Nonfarm job openings are at the highest on record at 9.3 million and 48% of small business firms have 1 or more jobs unable to be filled, also an all-time high. The US is getting supply chain disruption inflation and wage inflation at the same time. So, what does that mean? Well, if an individual has capital and owns assets, not much. Those assets should retain real value and increase in nominal terms if invested properly. Cash, on the other hand, will decline in real terms. If an individual makes money by the hour, has no savings, and no assets, they are watching their standard of living decrease. This has been going on a while and the pandemic is only exacerbating the effects. We expect the balance of 2021 to continue to provide growth given the focus on people going back to work and the economy reasserting itself from the pandemic and we continue to be watching inflation pressure and deficit spending.

International Economic Overview

As of June, every developed country, excluding Japan, has a purchasing manager's index above 50, indicating expansion. Not unlike the inflation numbers, baseline effect and supply issues are driving the PMI. Any company doing manufacturing is trying to catch up from a collapse in demand to an acceleration. This is part of the inflationary pressure we discussed in the Domestic section. Vaccine rates elsewhere in the world continue to lag western countries however populations do not have the luxury of not working and continue to live. Stimulus via direct checks is not a possibility in other countries.

Economic impact from the pandemic going forward is going to be limited given the necessity of individuals to get back to work. One note on the Delta variant as it relates to international infection. The Delta variant was previously known as the Indian variant given that is where the strain originated. In India, the spike of their wave peaked on May 7th when India reported 414k new infections. As of July 22nd, daily cases were down 90%. From the start of the rise to the collapse lasted about 2 months. That timing should feed into expectations for the rest of the globe on that variant's infection curve.

Equity Markets

Domestic and international markets continued to climb in the second quarter, adding to the recovery from the market lows in March 2020. Under the surface there were divergences in both style and geography as investors gained some clarity on the nature and likely speed of the economic recovery from the pandemic related shutdowns and consumer activity. In the U.S., value oriented cyclical stocks continued recent strength, however growth stocks outperformed in this quarter as investors started to look past the burst that is getting the economy closer to "normal". Value stocks have had one of their best extended performance periods over the last 10 years. It can likely be stated that the easy money has been made in many cyclical stocks, but they remain attractive going forward even assuming trend growth after 2021-2022.

The majority of international markets have lagged domestic performance since the pandemic lows and this seems logical to us as the recovery has been slower and the near term has more uncertainty with regards to returning to normal. Disruption in China and the impact their economy has on many regions is also influencing this weakness.

Although selectivity is becoming more important as markets rise, fundamental growth in earnings and cash flow are supporting a significant amount of the rally. Our strategy at this time stays the same: invest in quality value-oriented businesses that should have advantages beyond the recovery phase and where valuations permit, invest in very high quality, primarily large growth companies already exhibiting strong earnings and free cash flow. We are limiting exposure to international markets to revenue coming from world class multinational operators with significant U.S business. Despite these limitations and screening with our fundamental criteria, we still find an adequate number of investments that are worthy of holding or investing in considering our long-term investment perspective.

YTD @ 6/30/21		
S&P 500	U.S. Large Cap	15.3%
Russell 2000 Growth	U.S. Small Cap Growth	9.0%
Russell 2000 Value	U.S. Small Cap Value	26.7%
MSCI EAFE	Developed Market Large Cap	9.2%
MSCI EM	Emerging Markets	7.4%
MSCI ACWI x U.S.	Broad Int'l Markets x U.S.	9.4%
MSCI China	Broad China	1.9%

Fixed Income

The domestic credit markets exhibited confusing trends during the quarter. Ten-year U.S. Treasury yields, the benchmark for risk free bonds, steadily dropped to around 1.35% after peaking at 1.75% in late March. Shorter term Treasury yields remained mostly flat except for a modest spike in June. Spreads between Treasuries and other riskier instruments including corporates and asset backed securities remained very low, implying little concern from investors about ultimate default risk. The largest quandary is why the longer bond yields are remaining this low while the economy is recovering strongly and inflation is briskly rising. Admittedly the inflation spike is likely just that, although the ultimate run rate will likely be equal to or higher than the pre pandemic period. However, even if inflation settles at a 2-3% range a year or two out, these current yield levels don't make sense. The demand side is what many could be underestimating. We know that the Fed is still providing support in the market and explains part of this, but these purchases are likely to be tapered soon. Also, this artificial demand did not keep yields from rising significantly from the low point in the spring of 2020 through this March. The other part of demand that could be stronger than expected is from international buyers of all types as the appeal of the U.S. dollar and economic stability may have been enhanced by the pandemic and the lingering economic uncertainty for many large international economies. Remember that the credit markets tend to look ahead just as equity markets. One more disconcerting explanation for the current drop in yields is that Treasury market investors expect a more severe lower growth and inflation environment in the U.S. after the bounce back recovery is complete. Whatever the ultimate conclusion, Treasury and investment grade corporate yields are very important as they drive business and real estate valuations to a large degree. We still expect overall longer term yields to rise over the next 2 years and are investing in primarily high-quality credits that will be resistant to damage from that scenario.

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