Davenport Asset Management Quarterly Update | Q3 2021

September 30, 2021

We are three-quarters of the way through 2021, and stocks are holding onto meaningful gains. As of September 30, the S&P 500® Index was up 15.9% year-to-date while the Russell 2000® Index had gained 12.4%. The third quarter itself was a bit more subdued, with the S&P up 0.6% and Russell down 4.4%. We were pleased to see solid relative performance from our portfolios as market conditions became more tumultuous. Stocks initially powered through headwinds associated with the Delta variant, but weakened late in the quarter alongside fears surrounding supply chain disruptions, waning economic stimulus and rising interest rates. In fact, the S&P was down 4.7% for the month of September. We think such a breather may be healthy given the torrid pace of gains through August, when the S&P seemed on pace for a record number of new highs in a year.

COVID was a factor during the quarter. Early on, cyclical and so-called "reopening" plays lagged the broader market as the Delta variant evoked fears of renewed caution on the part of consumers and a setback to our economic recovery. More recently, however, this dynamic has reversed as vaccination rates have improved and case counts appear to be peaking. While there is always the threat of a new virus strain, we are hopeful the worst is behind us and continue to believe there is tremendous pent-up demand for various travel and leisure activities. Indeed, we have already witnessed very encouraging signs from various holdings in the hotel, concert, theme park and casino industries.

Market Returns	Q3 2021	YTD
U.S. Large Caps	0.6	15.9
U.S. Mid Caps	-0.9	15.2
U.S. Small Caps	-4.4	12.4
International Developed Markets	-0.4	8.3
Emerging Markets	-8.1	-1.2
Intermediate Term Bonds	0.0	-0.9

Source: Morningstar Direct. Please see last page for index definitions.

Inflation has remained a hot topic. Supply chain disruptions, shortages of various commodities, port congestion, and labor constraints have prompted meaningful price increases for many finished goods. Rising energy prices, partially driven by the transition to clean energy, are also a factor. These are issues not only for consumers, who are paying up for seemingly everything, but also many manufacturing companies that are seeing input costs rise dramatically or even a scarcity of raw materials. We've recently seen numerous well-known companies reduce near-term earnings expectations (sometimes twice in one quarter!) given supply constraints and pressure on profit margins. This phenomenon may prove to be transitory. Nonetheless, it reminds us of the importance of investing in companies with pricing power that can offset inflationary pressures.

This brings us to the Fed. Understandably, policymakers are under a microscope given the threat of inflation. Fed Chairman Powell and his colleagues recognize that price increases could be temporary and are in no rush to significantly tighten monetary policy via higher interest rates. It's also worth noting that tighter policy would do little to address supply chain disruptions (the primary source of inflation at the moment), and could prematurely stifle our recovery. Still, the economy is recovering nicely from COVID and there is clearly less need for aggressive policy support. Hence, while we do not expect any sudden or unexpected policy change that is typically associated with major market disruptions, we do expect policy will gradually become less accommodative.

The bigger challenge may be waning support from Congress. We will soon lap the extraordinary fiscal stimulus offered during the course of the pandemic (checks to consumers, etc.) and a large infrastructure bill seems to face political headwinds. At a minimum, another large spending bill could be the last we see for a while. Then there is the issue of paying for all of this extraordinary stimulus. There's already a movement afoot to raise individual and corporate tax rates. Tax increases look like they will be more moderate than initial proposals and should be manageable, but could still be a headwind for corporate profits and stock prices. In the meantime, we are also sure to get a healthy dose of partisan politics and chicanery that has become commonplace in Washington D.C. We are currently seeing this as leaders bicker over raising our country's debt ceiling.

Up until very recently, the market has largely brushed aside the aforementioned concerns as well as others, including winds of change in China. As we enter the home stretch, it will be interesting to see if markets take a pause or stocks continue to be supported by the "TINA" thesis (i.e. "there is no alternative" to stocks given paltry interest rates). We continue to argue that valuations are full with the S&P trading at roughly 20x 2022 earnings estimates, but not unreasonable in the context of low interest rates. While there may not be much room for continued valuation expansion, stocks may be able to appreciate at a rate commensurate with mid-to-high single digit earnings in coming years. This would be in keeping with our expectation for more moderate returns than what investors have enjoyed in recent years. Bear in mind, the S&P 500 is up over fivefold since the financial crisis, implying annual returns nicely above historical norms. So, while returns can still be attractive, in our opinion it seems logical to expect some reversion to the mean.

The third quarter had no shortage of market moving headlines. Domestically, investor sentiment was challenged by inflation, continued supply chain disruptions, debt ceiling and stimulus debate gridlock, a hawkish Fed pivot, and the waning but still present COVID delta variant. Internationally, geopolitical tensions rose with the U.S.'s Afghanistan exit, and China growth concerns were highlighted when Evergrande (Chinese real estate developer) missed two debt payments in late September. With $300 billion in outstanding company debt, contagion fears surfaced with the Lehman Brothers bankruptcy cited as a reference point illustrating the potential far reaching financial and economic impact.

Looking ahead, the question of reflation or stagflation has surfaced. The recent spike in energy prices and ongoing supply shortages begs the question of whether "transitory" headline and core inflation will prove stickier. Global growth and relations have shown pockets of weakness, domestic safety nets are expiring and central banks are pivoting from highly accommodative posturing.

Relative Value

The relative value table and heat map illustrate two important insights. First, Treasury rates moved higher as inflation concerns persist. Second, high yield bonds and leveraged loans performance illustrated continued reach for yield into speculative market segments that trade at rich levels and don't seem to price in a default rate uptick.

Comparative Total Returns

Oct 1, 2021	Short-Term Cumulative Returns						Annualized Returns			
	YTD	WTD	1Mo	3Mo	6Mo	1yr	2yr	3yr	5yr	10yr
US										
Treasury	-2.34%	-0.12%	-0.85%	0.51%	1.94%	-3.22%	2.24%	5.12%	2.32%	2.32%
High Grade Corp.	-0.73%	-0.32%	-0.72%	0.55%	3.25%	2.19%	4.90%	7.61%	4.71%	4.96%
High Yield Corp.	4.66%	-0.29%	-0.05%	0.82%	3.53%	11.26%	6.80%	6.55%	6.35%	7.29%
Leveraged Loans	4.62%	0.13%	0.63%	1.12%	2.69%	8.75%	5.02%	4.33%	4.78%	5.16%
Municipals	0.97%	-0.55%	-0.72%	-0.40%	1.26%	3.03%	3.39%	5.17%	3.31%	4.00%
Convertibles	6.84%	-1.44%	-0.92%	0.04%	2.26%	27.91%	34.55%	22.80%	19.78%	15.87%
Preferreds	2.20%	-0.32%	-0.33%	0.19%	2.88%	6.19%	5.51%	7.20%	5.53%	6.79%
Mortgage Markets										
Mortgage Master	-0.62%	0.12%	-0.16%	0.34%	0.51%	-0.27%	2.00%	4.00%	2.24%	2.44%
US Equity Market										
S&P 500	17.24%	-2.19%	-3.59%	1.20%	9.14%	30.77%	23.76%	16.27%	17.14%	16.74%

Source: CreditSights, BofA/ML, S&P/LSTA, Bloomberg.
Treasury=G0Q0, HG=C0A0, HY=H0A0, LL=SPBDPL, Muni=U0A0, Convert=V0S0, Pref=P0P1, Mortgages=M0A0, S&P 500=SPX

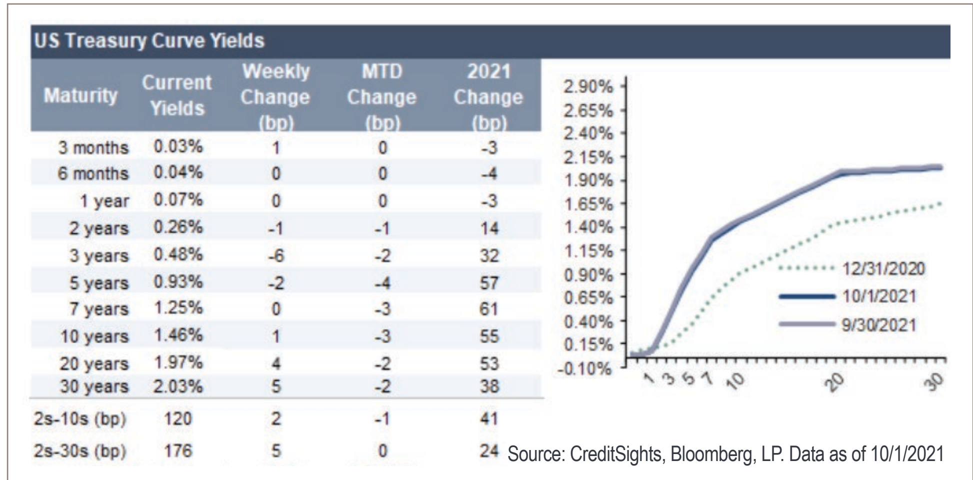
Annual Relative Total Return Ranking - USD Markets

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
S&P 500 15.8%	US Gov't 9.1%	US Gov't 14.0%	High Yield 57.5%	High Yield 15.2%	Munis 11.2%	EM Sov 18.3%	S&P 500 32.4%	S&P 500 13.7%	Munis 3.6%	High Yield 17.5%	S&P 500 22.3%	Munis 1.0%	S&P 500 31.5%	S&P 500 18.4%	S&P 500 17.2%
High Yield 11.8%	Mtges 7.0%	Mtges 8.3%	Loans 52.5%	S&P 500 15.1%	US Gov't 9.8%	S&P 500 16.0%	High Yield 7.4%	Munis 9.8%	Mtges 1.5%	S&P 500 12.0%	EM Sov 10.0%	Mtges 1.0%	High Yield 14.4%	High Grade 9.8%	High Yield 4.7%
EM Sov 10.6%	EM Sov 6.4%	Munis -4.0%	EM Sov 27.2%	EM Sov 12.5%	EM Sov 8.2%	High Yield 15.6%	Loans 5.4%	High Grade 7.5%	S&P 500 1.4%	Loans 10.4%	High Yield 7.5%	US Gov't 0.8%	EM Sov 14.3%	US Gov't 8.2%	Loans 4.6%
Loans 6.9%	S&P 500 5.6%	High Grade -6.8%	S&P 500 26.4%	Loans 10.4%	High Grade 7.5%	High Grade 10.4%	Mtges -1.4%	EM Sov 7.3%	US Gov't 0.8%	EM Sov 9.5%	High Grade 6.5%	Loans 0.6%	High Grade 14.2%	High Yield 6.2%	Munis 1.0%
Mtges 5.3%	High Grade 4.6%	EM Sov -10.2%	High Grade 19.8%	High Grade 9.5%	Mtges 6.1%	Loans 9.8%	High Grade -1.5%	Mtges 6.1%	EM Sov 0.6%	High Grade 6.0%	Munis 5.4%	High Grade -2.2%	Loans 8.7%	Munis 5.3%	Mtges -0.6%
Munis 5.0%	Munis 3.3%	High Yield -26.4%	Munis 14.5%	US Gov't 5.9%	High Yield 4.4%	Munis 7.3%	Munis -2.9%	US Gov't 6.0%	Loans 0.1%	Mtges 1.7%	Loans 4.6%	High Yield -2.3%	Munis 7.7%	EM Sov 4.8%	High Grade -0.7%
High Grade 4.4%	High Yield 2.2%	Loans -29.3%	Mtges 5.8%	Mtges 5.7%	S&P 500 2.1%	Mtges 2.6%	US Gov't -3.3%	High Yield 2.5%	High Grade -0.6%	US Gov't 1.1%	Mtges 2.4%	S&P 500 -4.4%	US Gov't 7.0%	Mtges 4.1%	EM Sov -2.3%
US Gov't 3.1%	Loans 2.0%	S&P 500 -37.0%	US Gov't -3.7%	Munis 2.3%	Loans 1.5%	US Gov't 2.2%	EM Sov -5.8%	Loans 1.8%	High Yield -4.6%	Munis 0.4%	US Gov't 2.4%	EM Sov -4.6%	Mtges 6.5%	Loans 3.5%	US Gov't -2.3%

Source: CreditSights, BofA/ML, S&P/LSTA, Bloomberg.
EM Sov is USD EM Soverign BBB & lower index. YTD calculated as of Oct 01, 2021

Treasury Markets

The Treasury curve steepened in the third quarter. A tighter monetary policy tone pushed short rates up. Longer rates moved higher incorporating inflationary concerns. While the curve is still at historically low levels, a 30 year 2% rate coupled with duration of 22 years duration isn't too enticing. If that 2% moved 100 basis points higher to 3%, the Treasury bond's market value would fall approximately 22%. We see greater value in the 5 year Treasury bond which offers a rate slightly above 1% and 1/5th the price sensitivity (duration) of the 30 year long bond.



US Treasury Curve Yields

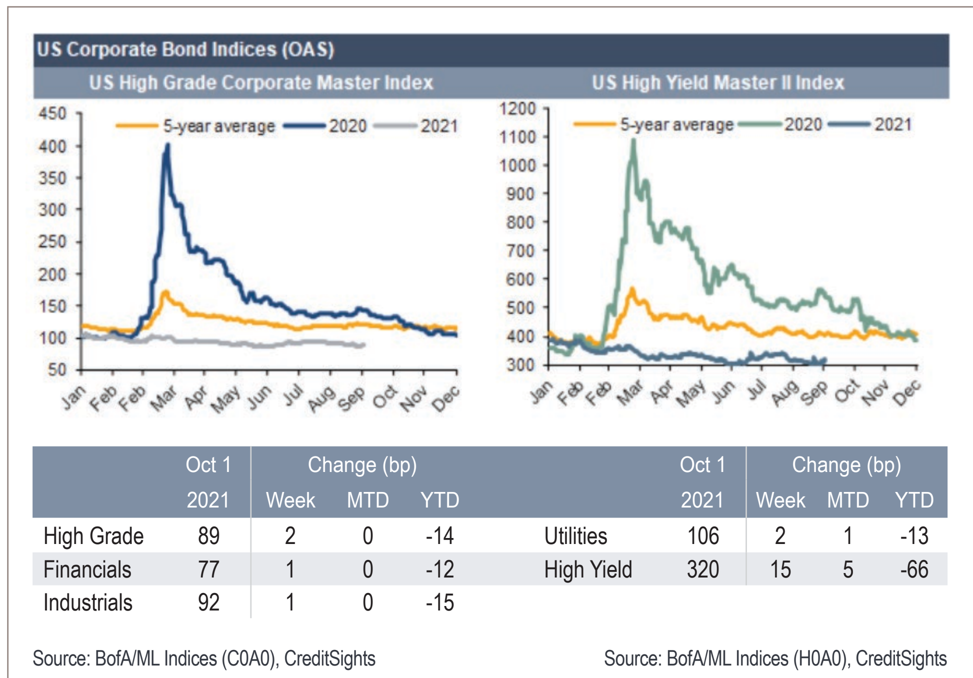
Maturity	Current Yields	Weekly Change (bp)	MTD Change (bp)	2021 Change (bp)
3 months	0.03%	1	0	-3
6 months	0.04%	0	0	-4
1 year	0.07%	0	0	-3
2 years	0.26%	-1	-1	14
3 years	0.48%	-6	-2	32
5 years	0.93%	-2	-4	57
7 years	1.25%	0	-3	61
10 years	1.46%	1	-3	55
20 years	1.97%	4	-2	53
30 years	2.03%	5	-2	38
2s-10s (bp)	120	2	-1	41
2s-30s (bp)	176	5	0	24

Source: CreditSights, Bloomberg, LP. Data as of 10/1/2021

Credit Markets

Credit spreads remain tight, but we see pockets of value through careful credit selection. This is more the exception than the norm, thus we continue to also see value in high rated credits positioned to withstand eventual spread widening. The new issue market remains robust ($1.2 trillion YTD) with new deals pricing at minimal concessions due to ample domestic fund manager cash and continued international buyer presence. Issuance continues to favor long paper to lock in low borrowing costs. This does create a supply challenge for investors looking to invest in shorter maturities to manage duration (interest rate) risk.

Corporate yields remain at compressed levels. The recent incremental move higher in yields was attributable to a US Treasury selloff as credit spreads generally held up but have begun to show signs of fatigue. While many companies have taken out high coupon debt over the past 18 months, the few outstanding high coupon bonds come with extremely high prices. This creates two challenges – buying high & selling low (as bonds naturally drop in price, falling to par at maturity) and less liquidity for premium priced bonds. We are compelled to look for bonds that trade at a discount, although it is slim pickings. Through fundamental and sector work, there is a chance to find a mispriced bond trading at a discount that will mature at par. The caveat to "dumpster diving" is to ensure the discount bond isn't a value trap but rather has a legitimate "rising star" thesis.



	Oct 1 2021	Change (bp) Week	MTD	YTD		Oct 1 2021	Change (bp) Week	MTD	YTD
High Grade	89	2	0	-14	Utilities	106	2	1	-13
Financials	77	1	0	-12	High Yield	320	15	5	-66
Industrials	92	1	0	-15					

Source: BofA/ML Indices (C0A0), CreditSights

Source: BofA/ML Indices (H0A0), CreditSights

US IG Corporate Yield to Worst (%) by Rating, Tenor

Yield t	AAA	AA	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3	B1	B2	B3
Index	1.93	1.83	1.86	1.84	2.00	2.27	2.30	2.50	2.77	3.24	3.54	4.05	4.51	4.72
3Y	0.52	0.55	0.71	0.74	0.82	0.91	0.98	1.31	1.95	2.15	2.69	3.62	3.84	3.63
5Y	1.09	1.24	1.39	1.45	1.49	1.56	1.64	2.05	2.46	2.78	3.41	3.89	4.29	5.09
7Y	1.68	1.71	1.89	1.96	1.99	2.08	2.20	2.51	2.83	3.44	3.83	4.38	4.92	4.99
10Y	1.84	2.00	2.11	2.22	2.28	2.40	2.53	2.86	3.15	3.61	4.09	4.39	4.89	4.94
30Y	2.63	2.86	3.00	2.95	3.06	3.26	3.43	3.83	3.90	4.57	5.59	4.82	4.49	5.70

Source: CreditSights, BofA 9/30/2021

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