Strategic Asset Allocation Committee

Winter 2021

DAVENPORT ASSET MANAGEMENT 1863

Summary
The stock market has been incredibly resilient in recent years and able to shrug off a continuing barrage of bad news. In recent months, there seem to have been five primary factors driving the stock market:

1. Inflation expectations related to supply chain disruptions and increased commodity prices
2. Movement in interest rates tied closely to those inflation expectations
3. Anticipation of less stimulative Federal Reserve policies (and other central banks around the globe) that could include Fed Funds rate increases and tapering of asset purchases
4. Strong earnings growth and increased expectations
5. Recent developments in China that include government regulations on several industries that seemingly go against the capitalistic economy they were striving for and a potential real estate bubble and defaults of several large real estate developers

Despite changes in the market and economy over the past several years, our recommendations have remained fairly consistent for the long-term investor. Broadly speaking, we would be overweight to stocks with a tilt toward smaller market cap and value stocks, a bit of commodities, and elevated cash at the expense of traditional fixed income investments. In our base case scenario, we expect a slow increase in interest rates to account for inflation levels above the 2% level to which we have become accustomed. If that happens, bond returns may be low but we don't expect large losses as some have called for and believe that bonds should hold up in times of market shock. Extended outlook for lower bond returns could continue to push more money into stocks and particularly dividend stocks in a search for more yield. Commodities may continue to perform relatively well but returns should likely be below the 50%+ we've seen over the past year. Small cap stocks may rebound from recent volatility (they had declined over 10% from earlier high). All of these factors should benefit more cyclical "value" sectors like financials, energy, and industrials. If inflation remains higher and longer lasting than expected, it is likely that a market pullback could occur as the market and Federal Reserve digest and react to higher inflation, with an inordinate impact on high valuation growth stocks. More detail on each of these points is below:

Overweight	Underweight
Stocks	Bonds
Value	Growth
Small	Large
Commodities	REITs
Corporate Credit	Treasuries
Short Term Bonds	Long Term Bonds

Source: Morningstar Direct

The outcome of inflation will affect everything:
Will it be transitory or long-lasting? Our base case is somewhere in between as we expect fears of 1970's style inflation to be overblown but that we may experience mildly higher than normal inflation. The well-publicized supply chain shortages could remain for some time, but are likely to subside over time as demand wains, more supply comes on line, and people find other alternatives to expensive products. Additionally, we believe that over the longer term, inflation may have to compete with deflationary forces that include an aging population, ever increasing automation, and less government stimulus that could ultimately shorten the duration of any inflationary pressures. To use history as a guide, we looked at 2 periods that include the 8 year period between 1972 and 1979 and the 8 calendar years since 1980 in which inflation spiked but ultimately proved benign. The table below summarizes asset class returns during those periods.

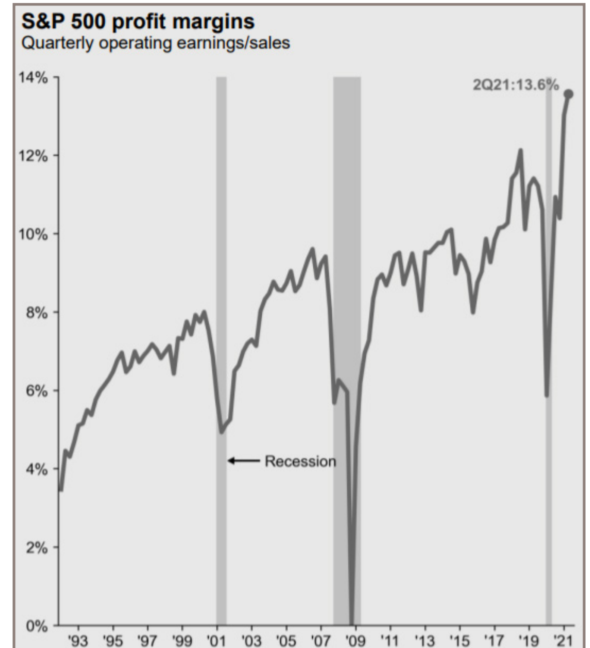
- **Persistent Inflation:** In the 1970's, large stocks were able to muster mid-single digit gains despite having 3 down years in 8 years; stocks declined in years that inflation spiked (1973, 1974, 1977) but did well when it began to ease (1975, 1979); overall, small cap stocks, gold and commodities did well and bonds lost a bit of principal as the result of higher interest rates (both Fed Funds rate and the 10 year Treasury yield).

- **"Transitory" Periods:** We looked at the 8 years since 1979 in which inflation spiked but ultimately proved to be temporary. We found that inflation rose by about 1.8% then slowed in the following year; on average the 10 year Treasury bond yield began to move during the year that inflation spiked but the Federal Reserve did not raise rates until the following year; most risk assets outperformed bonds; small stocks lagged in the year inflation spiked but outperformed as inflation slowed; gold, commodities and real estate investment trusts (REITs) posted strong returns.

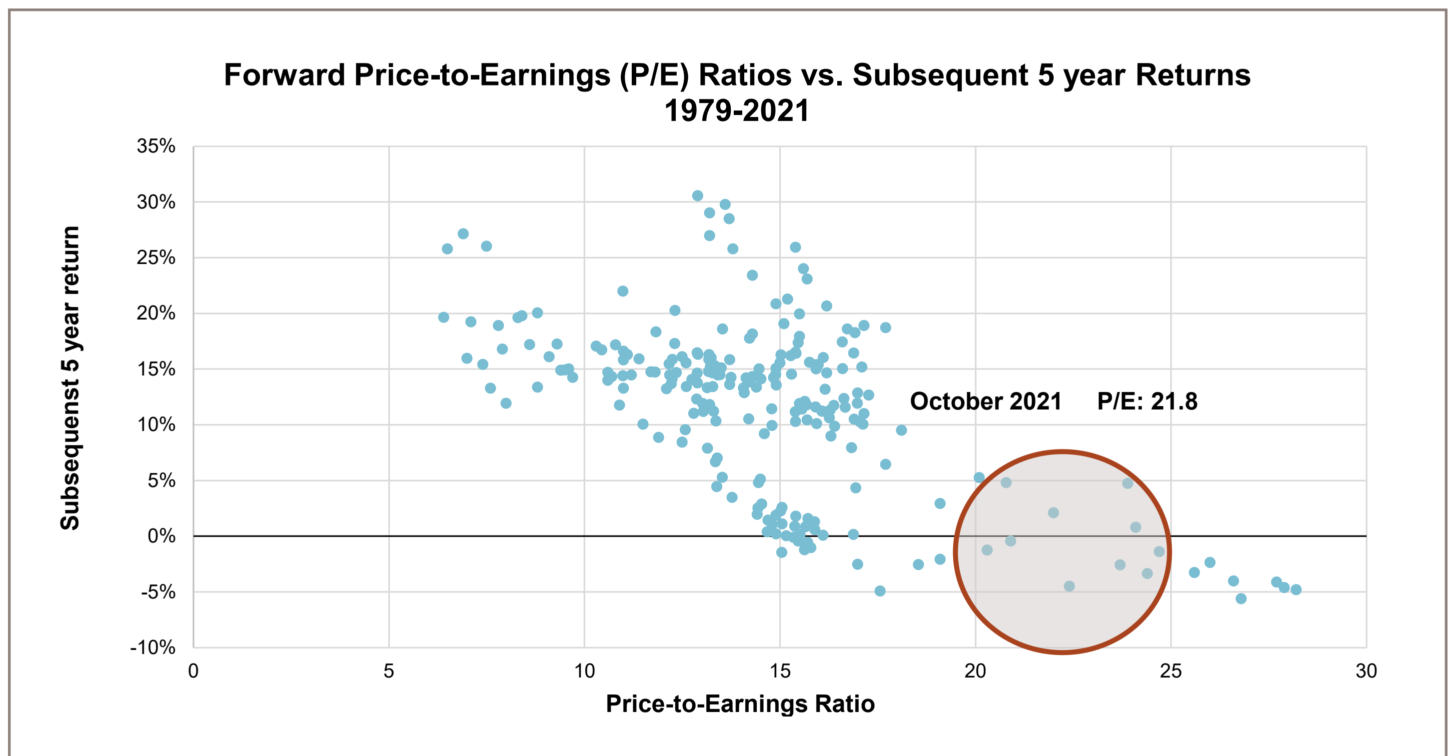
	Transitory Period (1979-2020)		Persistent Period (1972-1979)
	Years of Rising Inflation	Following Year	All Years
Inflation and Interest Rate Data			
US Inflation Rate	3.5%	3.7%	8.1%
Rise in Inflation from Prior Year	1.8%	0.5%	-
Change in Fed Funds Rate	-0.4%	1.2%	1.2%
Change in 10 year Treasury Rate	0.4%	0.6%	0.5%
Asset Class Returns			
Large Cap Stocks	10.9%	8.6%	5.1%
Small Cap Stocks	7.8%	15.2%	15.1%
International Developed Markets	10.0%	5.7%	9.3%
REITs	2.8%	14.6%	4.8%
Gold Price	12.2%	19.9%	13.2%
Broad Commodities	20.9%	11.0%	22.1%
Implied Principal Gain/Loss on Bonds	-0.4%	2.4%	-1.9%

Source: Morningstar; years with rising inflation defined as those when inflation increased more than 1% from prior year; all returns are annualized.

We remain overweight to stocks over bonds for long term investors:
We recognize the massive gains for stocks over the past several years and feel as though returns are likely to be below average going forward. However, we think that continued economic growth, historically low (albeit rising) interest rates, and higher corporate profitability could drive further gains. The chart at right supports our thesis that stocks are likely to generate more moderate returns than we have seen over the past 10-15 years given that stock valuations remain high relative to their historical averages. However, in light of historically low bond yields, we think these valuations are supported. Additionally, the makeup of the S&P 500® Index has changed over time to favor more efficient and more profitable companies as indicated by the chart below that shows a steady increase in profitability among the country's largest companies over the past thirty years. Although we recognize that spiking inflation and above average stock valuations could create short-term volatility, we believe that stocks could provide better returns than bonds over the long term.

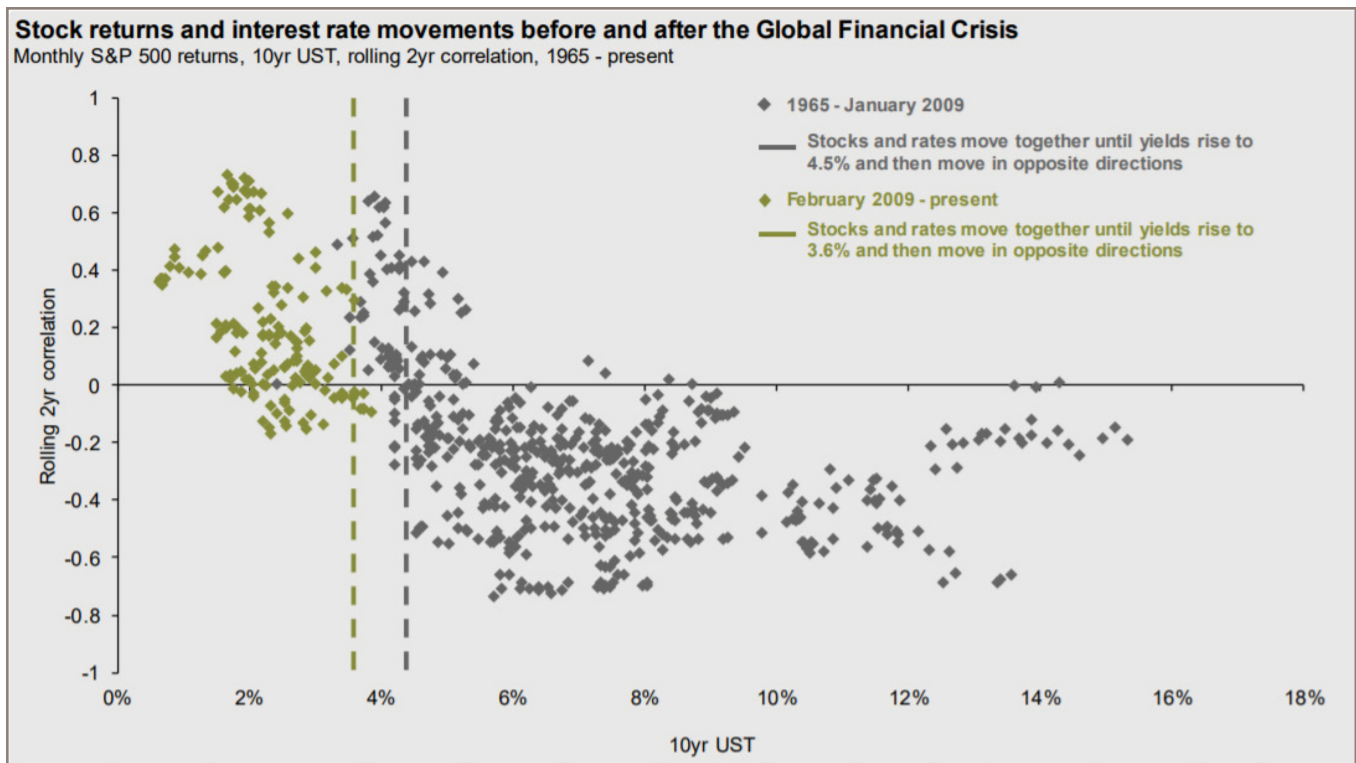


Source: JPMorgan Guide to the Markets, BEA, Compustat, FactSet



Source: Bloomberg, Morningstar, Davenport Asset Management; P/E is price divided by consensus analyst earnings estimates over the next 12 months reported by Bloomberg. 5 year returns are annualized

Rising interest rates have not always been bad for stocks, but eventually they become a hindrance
The chart below from JPMorgan shows that historically, stocks have been able to move higher with interest rates until the 10 year yield reaches about 3.5%-4.5% depending on the time period. In recent years (2009-present), a 10 year Treasury yield of 3.6% or higher has resulted in declining stock prices. As of October 31, the 10 year Treasury yield stood at 1.56%.



Source: FactSet, J.P. Morgan Asset Management. X-intercept for each data set is calculated using a quadratic regression where interest rates are the independent variable and the rolling 2-year correlation of stock returns and interest rate movements is the dependent variable. Guide to the Markets - U.S. Data are as of September 30, 2021.

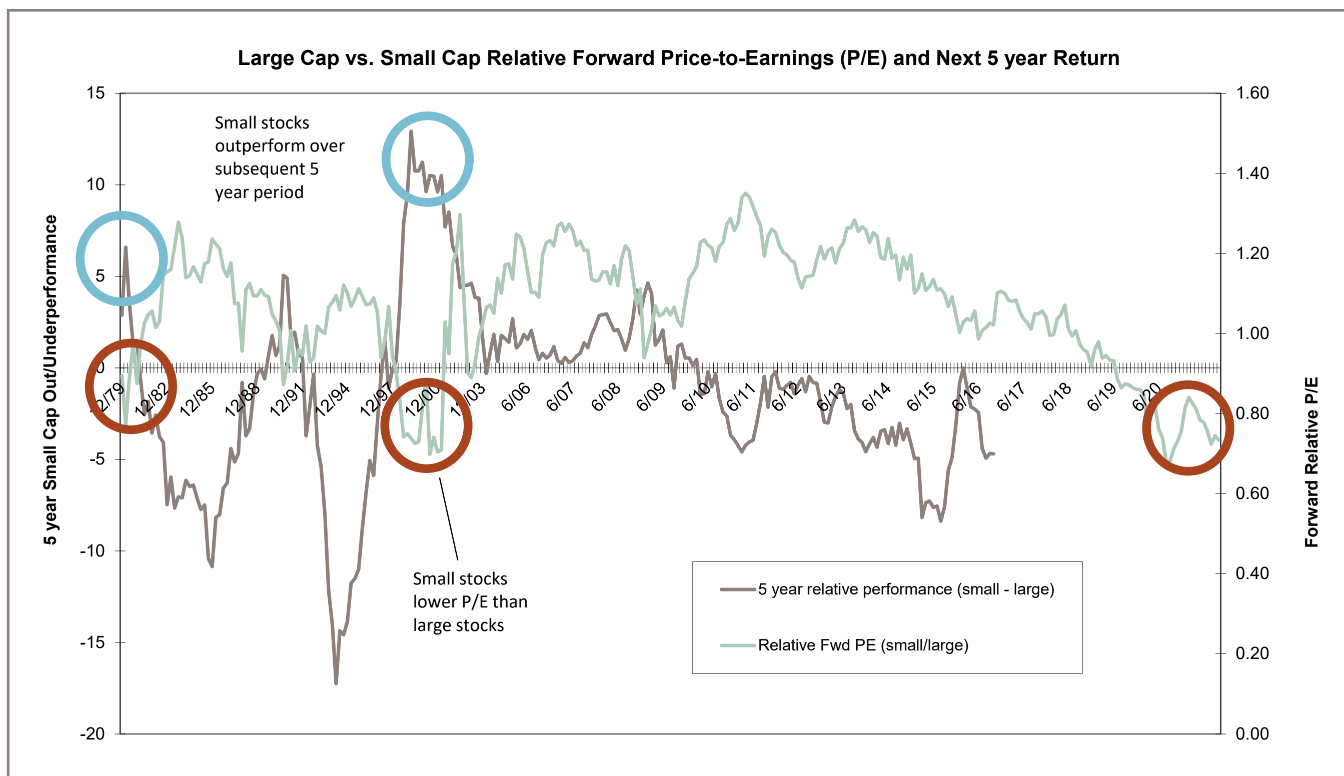
"Cheaper" asset classes might do better, although they may also add volatility
The table below shows that most equity categories are trading at higher valuations than they have over the past 15-20 years. Small cap stocks, emerging markets stocks and value stocks appear to be the most attractive from a valuation standpoint relative to their longer term averages.

Price-to-Earnings (P/E) Ratio (1990 to Present)

	Large Cap Stocks	Mid Cap Stocks	Small Stocks	Developed Int'l Stocks*	Emerging Market Stocks*	Value Stocks	Growth Stocks
Average P/E	16.9	16.1	16.9	13.9	11.6	14.6	20.2
Current P/E	21.8	20.3	16.4	15.6	12.5	16.4	31.1

*Source: Bloomberg, *Int'l and Emerging Markets data starts in 2005*

Small stocks in particular can continue to do well
The recent market has been dominated by the largest market cap companies in the world. Going forward, we think that smaller companies may provide the best opportunities to outperform. From periods of similar valuations historically, when small stock price-to-earnings (P/E) ratio is below that of large cap stocks, they typically outperform over the next five years as indicated in the chart below. Improving economic conditions, low interest rates, increased innovation could favor small cap stocks. This valuation data is for companies with positive earnings so we would recommend using an actively managed fund or an exchange traded fund (ETF) that aims to own the stocks of higher quality companies. For a list of those instruments, please contact your Davenport Financial Advisor.

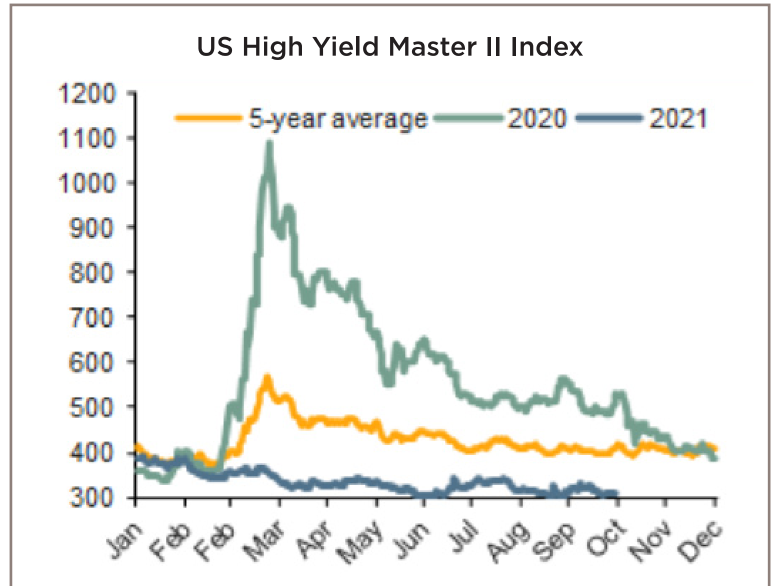


Source: Return data from Morningstar Direct; Valuation data from Bloomberg

Commodities can continue to do well but gold being hurt by cryptocurrencies
As noted above, commodities could continue to do well in a milder inflationary environment and did remarkably well during the persistent inflation of the 1970's. We would not expect a repeat of the nearly 50% return over the past 12 months but think returns could remain strong moving forward given newfound supply discipline. This can be a difficult category to gain quality exposure to, so we recommend consulting your Davenport Financial Advisor before you purchase. Gold has typically been thought of as a store of value and has done well in the inflationary environments that we observed. However, this time the price of gold has declined and may have been temporarily replaced by cryptocurrencies for this purpose. Our next bear market may result in a reversion toward gold but in the meantime, we think a broader commodity index is the best protection against higher inflation.

We recommend keeping bonds positioned for safety given the potential for higher interest rates and the relatively low yields on more risky bonds, particularly if remaining overweight stocks

- **Bonds for safety:** bonds are unlikely to provide much return but should still hold up well in the event of a market downturn
- **Stay short-term:** interest rates remain at a historically low level and could increase as the result of more fiscal stimulus and threats of inflation; short-term bonds are less sensitive to movements in interest rates
- **Underweight Treasuries:** Treasury bonds are the most sensitive to the potential for higher interest rates, which means they are most likely to lose value when rates rise
- **Stay high quality Overweight Quality Corporates:** the chart to the right shows that average credit spread (the compensation you receive on a corporate bond above risk free Treasury rates) for high yield bonds is well below the 5 year average, meaning you may not be getting compensated for the amount of risk associated with lower quality issues



Source: BofA/ML Indices (H0A0), Credit Sights

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Investors' risk in emerging market economies can include political instability, domestic infrastructure programs, currency volatility, and illiquid equity.

Index Definitions:
The **S&P 500 Index** is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market. The **S&P GSCI Gold Index**, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark tracking the COMEX gold future. The index is designed to be tradable, readily accessible to market participants, and cost efficient to implement. Standard & Poor's Financial Services LLC, a division of S&P Global, is the source and owner of the registered trademarks related to the S&P 500 Index. The **Russell 1000® Value Index** measures the performance of the Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The **Russell 1000® Growth Index** measures the performance of the Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The **Russell 2000® Index** measures the performance of the 2000 smallest companies in the Russell 3000® Index. The Russell Top 200® Index is a market capitalization weighted index of the largest 2000 companies in the Russell 3000®. London Stock Exchange Group PLC and its group undertakings (collectively, the "LSE Group"). © LSE Group 2021. FTSE Russell is a trading name of certain LSE Group companies. "Russell®" is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote/sponsor/endorse the content of this communication. The **Merrill Lynch US High Yield Master II Index (H0A0)** is a commonly used benchmark index for high-yield corporate bonds. The Master II is a measure of the broad high yield market, unlike the Merrill Lynch BB/B Index, which excludes lower-rated securities.

An index is not available for direct investment; therefore its performance does not reflect the expenses, fees and taxes generally paid with the active management of an actual portfolio.