CCT
ASSET MANAGEMENT

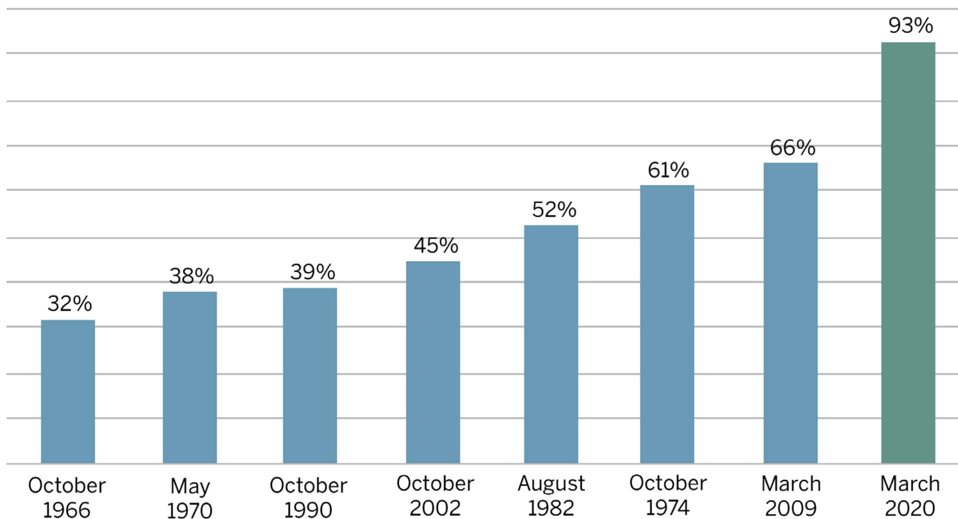
Investment Update — October 2021

This is a quarterly update of economic conditions and investment strategy.

Finding Balance in A Rapidly Changing Market

Due to choppiness in the last two weeks of September, the S&P 500 Index ended the third quarter roughly flat. Nonetheless, the Index has delivered a strong, 16% total return year to date. It is now almost double its pandemic-driven low and more than 25% above its pre-pandemic high. This rebound has been the largest and fastest post-recession recovery in the last 80 years.

S&P 500 Price Change in 553 Days from Bottom



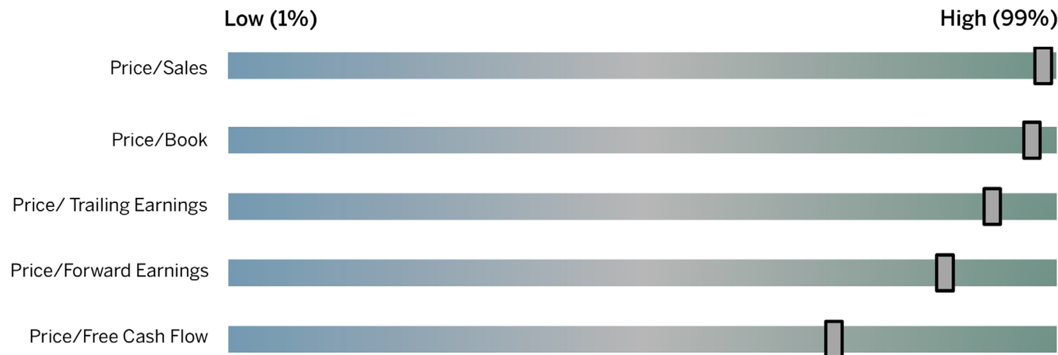
Note: 553 days chosen to capture pandemic-related low through September 30, 2021
Source: Bloomberg and Standard & Poor's

There are several reasons for these strong returns, including robust economic and profit growth, plentiful liquidity supplied by the world's largest central banks, interest rates near record lows, and healthy consumer balance sheets. All these factors suggest a recession is unlikely to unfold within the next 12 months. Since bear markets typically occur alongside recessions, investors have felt comfortable buying during the occasional shallow dips.

While we understand the optimism driving the market higher, there are also reasons to worry:

- **Economic growth may not meet now-lofty expectations.** Very high GDP growth in the second quarter prompted analysts to lift economic and profit expectations for the rest of this year and 2022. If economic growth reverts to good, but not great, levels, disappointing earnings growth or negative earnings revisions may follow.
- **Valuations are very high by almost any metric.** Whether one compares stock prices to earnings, sales, book value or free cash flow, equity markets are expensive. Disappointing results that lower earnings expectations typically lead to larger corrections when valuations are high.

S&P 500 Valuation: Current Percentile Ranking Relative to History



As of September 30, 2021
Source: Strategas and Center for Research in Securities Prices

- **Elevated inflation may persist longer than expected.** This is perhaps the risk we worry about most. High inflation is typically associated with high interest rates and low inflation with low interest rates. Currently, inflation is high, but interest rates are low. This disconnect is because many investors are betting that after a short bump due to economic reopening, inflation will fall rapidly and remain subdued thereafter. If, however, the currently high levels of inflation do not decline as expected, interest rates may climb. This scenario would be particularly troublesome for Growth stocks because higher rates would reduce the present value of their often-distant future cash flows.

Short, Sharp Intra-Market Rotations

Interest rates are at extremely low levels; therefore, even small interest rate moves are leading to big changes in equity market performance. The correlation between equities and the 10-year U.S. Treasury Bond yield has never been higher. Over the past four quarters, this has resulted in shorter, yet sharper, equity market movements and rapid rotations between Growth and Value stocks.

- During the fourth quarter of 2020 and the first quarter of 2021, interest rates rose sharply, and Value stocks outperformed Growth. From September 30, 2020, to March 31, 2021, the 10-year U.S. Treasury yield rose from 0.68% to 1.74% and the Energy sector of the S&P 500 rose 67%, while the Growth-heavy Technology sector only increased 14%. After several very difficult years, Value stocks were finally having their day in the sun.
- These glory days were short lived. From March 31, 2021, to August 4, 2021, the 10-year U.S. Treasury yield declined from 1.74% to 1.12%, and Growth stocks outperformed again. During that period, the Technology Sector outperformed the Energy Sector by 16%.
- Then, in the last few weeks of September, 10-year U.S. Treasury yields moved sharply higher again, rising from 1.30% to 1.54% in just four trading sessions. If this continues, another period of Value outperformance is likely.

We expect these short, sharp rotations to continue until there are clearer indications of the future rate of economic growth over the next decade. Unfortunately, this isn't likely any time soon. The unprecedented economic shutdown during the pandemic and subsequent reopening of the global economy make analyzing trends in economic data extremely difficult, and many variables may still affect the economy's direction.

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We believe the most likely outcome is that economic growth remains robust for the next few quarters as more of the globe reopens and consumers continue to spend the fiscal stimulus distributed during the pandemic. However, we do not think rapid growth will last long, as even moderately higher interest rates are likely to have a negative impact on both the real economy and financial markets.

Portfolio Positioning

Rapidly changing market leadership is difficult for even the nimblest portfolio managers, and capital gains tax and trading expenses make it costly to try to catch every zig and zag. Thus, short-term trading has never been our approach. We're long-term investors.

In this difficult market, we have positioned client portfolios to be well-balanced between Growth and Value stocks. As a result, our model portfolio has lower valuations relative to its benchmark than at any time in the last eight years, while maintaining above-market rates of earnings growth.

We hold our Value and more cyclical stocks primarily in our **End of Disinflationary Tailwinds** and **Next Generation Automation** themes, and to a lesser extent, our **Crisis Beneficiaries** theme. Many of these stocks have strong current cash flows and dividend yields. If inflation remains relatively high, we think interest rates will rise further, and stocks such as these will outperform. Given the deep discounts at which Value stocks are trading, these holdings are likely to pay off in the short term even if inflation is only marginally higher than expected.

Growth stock holdings dominate our **Molecular Medicine**, **Heterogeneous Computing**, and **Wealth Concentration** themes. A large free cash flow stream that can grow at an above-market rate is indeed valuable, especially if we're right about economic growth slowing in 2022. Our Thematic investment approach seeks to identify such stocks, emphasizing those that other investors do not yet fully appreciate.

We believe our current balanced approach is well suited to the times.

Significant Portfolio Actions in the Third Quarter

Delivery Hero SE

We exited our position in Delivery Hero, an online restaurant delivery company headquartered in Germany with a presence in major urban markets globally. Delivery Hero was a holding in our Global Wealth Concentration theme. We believed the company would be able to leverage its technology platform in densely populated urban environments, using a disciplined strategy of focusing only on cities where it could be the market leader.

Our thesis was that consolidating in rational markets while exiting competitive ones would lead the company to achieve profitability on a somewhat accelerated timeframe. However, over the course of the last year management changed their strategy and began re-entering very competitive markets, launching thin-margin businesses and investing simply for market share. The change in strategy is likely to lead to an elevated cash burn rate and further push out the timeline for achieving profitability.

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