COLONIAL TRUST *Quarterly*

3RD QUARTER | 2021

EST. 1913
COLONIAL TRUST
COMPANY

Investment Management

Trust & Estate Administration

Financial Advisory Solutions

LEADERSHIP

LOCATIONS

Spartanburg Office
359 S. Pine Street
Spartanburg, SC 29302
(864) 582-3356

Greenville Office
101 E. Washington St., Ste 200
Greenville, SC 29602
(864) 370-0737

Columbia Office
6 Calendar Ct, Suite 1
Columbia, SC 29206
(803) 782-7646

Charleston Office
578 East Bay Street, Suite B
Charleston, SC 29403
(843) 577-0444

ColonialTrust.com

In The Spotlight

Kathryn Smith, *Financial Planner*

Kathryn Smith joined Colonial's team in April of 2021. She brings a background in public accounting and financial planning to lead Colonial Trust's financial planning efforts. In public accounting, Kathryn's time was focused on high net worth individuals, estate, trust, and gift tax compliance as well as planning. She has also worked as a financial strategist with a wealth management group, guiding clients through retirement preparedness and planning. At Colonial, she leads a planning team of credentialed CFP® Professionals and CFA Charterholders with over one hundred years of combined experience. She is passionate about helping clients to define and achieve their goals. The financial planning process provides clients with the confidence and clarity to make lifestyle decisions, knowing that their financial needs will be met. She earned a Master of Accountancy and Certificate of Financial Planning from Appalachian State University and graduated with a Bachelor of Science in Business Administration from Lees-McRae College. In addition to being a CERTIFIED FINANCIAL PLANNER™ (CFP®), she is also a Certified Public Accountant (CPA) and a Personal Financial Specialist (PFS).

Kathryn grew up in Greenville and works in Colonial's Greenville office. She is a dedicated member of the cycling community and also enjoys running, yoga, and being active. On the weekends she can be found bikepacking or catventuring with her two cats. She also enjoys travel, dining, wine, and gardening.

Kathryn fills a strategic need for our firm. Colonial considers planning as a cornerstone in the development of an appropriate investment strategy. Our process utilizes industry-leading software suites to provide goals and cash flow-based planning for clients. The planning process considers both a comprehensive examination of a client's financial situation and their personal objectives and expectations to develop a thorough financial plan. Incorporating a client's financial situation and understanding their values are essential in developing a financial plan to provide a financial roadmap.

The financial planning process begins with a discovery interview with Kathryn and your advisor. From there a financial planning packet is shared with the client. This packet is designed to assist a client in categorizing assets, sources of income, liabilities, and other information to help prepare a full financial picture. Once completed, Kathryn along with your investment advisor will begin to model the plan. There may be multiple conversations to fine-tune the facts and assumptions, followed by a meeting to review the results of the plan. Once a baseline plan is established, there will be opportunities to examine additional scenarios or changes in circumstance.

If you are interested in learning more about Kathryn and financial planning, please reach out to your advisor. Initiating the planning process begins with an engagement agreement to provide transparency around timing, expectations, and fees.

MARKET COMMENTARY

The broad equity market posted its fifth consecutive positive quarter, with the S&P 500 returning 8.6%. The large cap index outperformed the Russell 2000 small cap index, which returned 4.3%. International equities were positive, with the MSCI EAFE developed market index returning 5.4% and MSCI Emerging Markets index returning 5.1%. Bonds reversed their negative first quarter performance, with the Bloomberg Barclays US Agg. Bond index returning 1.8%.

During the first quarter, technology stocks lagged the market as investors focused on the economic reopening and higher interest rates. In 2Q, investors returned to technology stocks and the tech-heavy Nasdaq returned 9.7%, besting the S&P 500. The five "Megacap" tech stocks of Apple, Google, Microsoft, Amazon, and Facebook had an average quarterly return of 15.0%.

Certain "reopening" areas of the market also fared well, with the real estate sector posting 13.1% returns, while energy stocks showed continued strength, up 11.3%. Oil prices rose 24.2% for the quarter and are now up 53.5% on the year. Other "reopening" sectors underperformed the market, with industrials, materials, and consumer discretionary sectors returning 4.5%, 5.0%, and 6.9%, respectively. Of the 11 sectors in the S&P 500, only utilities were in the red for the quarter, with a -0.4% return.

The tenor of the market changed during the quarter with a rotation in market leadership. From March through September 2020, the market was led by technology stocks during the lockdowns. As vaccines and the economic reopening were on the horizon last fall, the market's strength broadened out and more cyclical areas took the reins from technology through the end of 1Q. The second quarter saw several sectors rotate in and out of favor, although the broad trend was higher.

The churning under the surface in the equity markets coincided with changes in interest rates during the quarter. The high water mark for the benchmark 10yr treasury yield for the year was 1.74% on March 21st. Yields fell during April and climbed back to 1.70% on May 12th. During this period, cyclical stocks performed well. From May 12th through quarter-end, rates fell to 1.47%, reversing a portion of the runup seen in March. The May 12th reversal in bond yields marked the quarterly low for the Nasdaq. The move lower in rates bolstered the returns of these higher valuation growth stocks through quarter-end.

As we consider the direction of the economy and markets, we are reminded of the saying, "it's a market of stocks, not a stock market." The underlying fundamentals for many firms were fantastic based on first quarter financial results, with overall S&P 500 quarterly revenues and earnings increasing 9.5% and 143.1% from 2020 levels according to S&P™. Energy companies returned to profitability on higher oil prices and banks posted record profits as far fewer loans soured than expected a year ago. Large technology companies, like Apple and Google, far surpassed analyst expectations for revenue and earnings. Companies across the market increased their forecasts for the rest of the year, announced share buybacks, and increased their dividends.

While these strong fundamentals impacted share price performance at times in the quarter, the largest influence on asset prices continues to be monetary policy and interest rates. The S&P 500 experienced three days of greater than 1% declines during the quarter, and each was caused by concerns about inflation and monetary policy. We believe the path of least resistance for equity prices is higher, so long as interest rates remain at historically low levels.

In our humble opinion, forecasting the path of capital markets for the next twelve months is highly dependent on the path of interest rates. The path of rates will be determined by economic activity and the Fed's reaction function to the economy. We will spend the remainder of this letter unpacking these concepts to provide our assessment of markets for the balance of 2021 and into 2022.

The first week in July brought markets the June jobs report where 850,000 new jobs were created. This brings us to 3.26 million jobs created in 2021; however, we remain 6.8 million jobs below our February 2020 level. This deficit is dwarfed by the 9.3 million job openings in the US and demand for labor is putting pressure on wages, which rose 3.6% in June over the prior year. We have all heard stories of restaurants operating at half capacity or closing early because of the lack of labor. The Conference Board survey regarding jobs availability shows the tightest labor market in two decades. Economists expect the labor shortages to moderate as emergency unemployment benefits expire and children go back to school in the fall. In the meantime, we expect wage growth to be elevated for the next few months until labor supply returns in the fall.

Manufacturing has rebounded sharply and measures of activity point to a continuation into the second half of the year. The ISM Purchasing Managers Index remains firmly in expansionary territory at 60.6 and the year-over-year change in industrial production for April was 16.3%, which is the highest reading since the 1950s; however, the base effects of last year's level explain a portion of this increase. New orders for durable goods rose sharply off the lows of last year and point to robust capital spending. While activity is robust, a sharp rebound in demand and crippled supply chains have led to record long lead times for raw materials and inventory shortages, which are driving prices higher. According to ISM, lead times for electronic components have increased from 16 weeks to 52 weeks. This is driving prices higher for manufactured goods and creating scarcity for certain products. Autos are perhaps the epicenter of this issue as chip shortages have caused production delays, resulting in empty new car lots and higher prices for used cars. Re-establishing global supply chains and increasing productions will take time and put upward pressure on prices; however, the profit motive of capitalism will solve these shortages.

The housing market has been red hot, with the April Case-Shiller home price index up 14.9% over the prior year. Existing home sales peaked in October 2020 and have fallen 14% through May. New home sales peaked in January and have fallen 23% through May. Permits and starts for new homes rebounded from last spring's low levels but both peaked in the first quarter and have fallen 10% and 8%, respectively. Low interest rates and changing consumer preferences about where to live are driving housing demand; however, the supply of new and existing homes is not keeping up with demand, driving prices higher. The supply curve has not shifted to meet demand due to higher input costs. Lumber has been widely cited as the largest contributor, with lumber futures rising 287% from June 2020 to May 7, 2021. Since that day, lumber futures have fallen 57% but remain 64% higher than a year ago. The fall in lumber has not manifested in OSB board, which is priced 373% higher than a year ago and at all-time highs. The price rise in raw materials is compounded by a lack of skilled workers, driving wages higher. Higher prices are impacting affordability and beginning to slow the housing market through demand destruction. The resolution of higher input costs will require increased production. Lumber is a prime example, where production reached a 14yr high in April, and lumber futures have fallen as supply increased.

The consumer enters the second half of the year in good shape. The Fed's report of household balance sheets shows assets and net worth at all-time highs. The US savings rate has moderated from the stimulus inflated level of March, but at 12.4% of income is more than double pre-pandemic levels. OpenTable reservations are largely back to 2019 levels and May retail sales are up 28% over the prior year. TSA check-ins approached 2019 levels in June and hotel occupancy rates are at their highest level since October 2019. Demand is returning quickly, and consumers have record high asset values and plenty of excess savings. Bank deposits and money market funds have increased around 26% since February 2020, creating $4.5 trillion of additional savings. As COVID continues to fade, we believe the consumer will increase spending across a variety of categories.

Strong manufacturing, strong housing, and a strong consumer are increasing economic activity. GDP growth in 1Q was 6.4% and the median forecast from Bloomberg is 10% for second quarter. The challenges with labor, raw materials, and supply chains are impacting economic activity and manifesting through prices. Annual CPI reached 5.0% in May, the highest reading since 2008. Producer prices are rising quicker than consumer prices and PPI is up 8.7% in May over the prior year. Areas where these challenges are more acute are seeing sharp price increases, with used cars and gasoline up 30% and 56% from 2020. The heuristic used by CPI to measure housing costs posted a 2.2% increase in May, which does not reflect real home price data. This has brought inflation to the forefront for markets and consumers. A Google news search for inflation yields 52.8 million results and Google Trend shows searches about inflation have increased sharply over the last three months – hitting a crescendo on the week of May 12th.

This brings us to the Fed's reaction function and possible changes to Fed policy. The timetable for a change in policy was pulled forward during the second quarter. During the Fed meeting in June, Chairman Powell acknowledged the strength in the economy and improving fundamentals. While he highlighted that employment remains below pre-pandemic levels, the Fed Governors signaled they would begin discussing a reduction in their monthly bond purchases of $120 billion. Chairman Powell's press conference included questions on the current monetary stimulus in the face of rising prices. The Fed remains committed to the idea that inflation is transitory and due to the base effects of depressed prices last year due to lockdown and supply chain disruptions. Their firm belief is the reopening of the economy caused demand to return quicker than supply. They contend that over the next few quarters, the economy will see an increase in the supply of labor, goods, and raw materials resulting in either lower prices or slower price appreciation. This belief is predicated on employees re-entering the labor market in the fall, increased production of goods as supply chains are repaired, and the resolution of shipping bottlenecks.

Whether inflation is transitory or secular is the most important question facing the markets. We will not rehash our last newsletter, where the word inflation appears 21 times. In that missive, we discussed the economic reasons we believe 2021 is not the early 1980s to justify why we concur with the Fed on the transitory nature of inflation. Rather, we will take this opportunity to highlight what the market believes about inflation going into the second half of 2021.

The market expresses its forecast for economic growth and inflation through the yield curve, the price of borrowing for different time periods. In its June 16th meeting, the Fed hinted it was considering reducing its accommodative policy and the bond market's reaction was a flattening of the yield curve. Yields on 3yr treasury bonds rose 16bps, while yields on 30yr bonds fell 12bps between the Friday before and after this meeting. This flattening of the curve, where short rates move higher and long rates move lower, is a signal the bond market believes the Fed will raise short-term rates, but that slower growth and lower inflation will be the story for the long-term. The bond market is signaling the inflation we are seeing is transitory and the forces of higher sovereign debt levels and aging demographics will reduce economic growth after the reopening surge and result in lower inflation. Moreover, the current shortages in labor and supply chain disruptions will be remedied by time and higher productivity, which ticked up in the most recent quarter.

It is anathema to logic that a $5 trillion increase in federal debt and a $4 trillion increase in the Fed's balance sheet would not lead to inflation. But this debt level serves as a weight around the neck of the economy and reduces the speed limit of future economic growth. This does not portend disaster ahead, simply a reality where growth is slower and pricing power less evident than we see today.

In the near term, growth will be robust. Earnings growth for the S&P 500 for 2Q is projected to be 65% and 53% for the full year. Valuation measures for the broad equity market remain elevated in this low interest rate environment but have moderated from the levels seen in January. The year-to-date return of the market has been fueled by earnings growth rather than valuation expansion, as was the case in 2020. According to FactSet, the 14.4% increase in the S&P 500 through June was the result of a 19.7% increase in earnings and a 5.3% reduction in valuation multiples. In our January newsletter, we stated in 2020 the market outperformed the economy and in 2021 we expected the economy to outperform the market. This appears to be unfolding as expected.

As we move into the second half of 2021, we expect this trend to continue. We believe inflation will be prevalent, but the 5.0% CPI reading in May could be the highpoint of the year. We believe economic and earnings growth will be spectacular in the 2nd quarter and will moderate from these levels into year end. We expect the Fed will lay the groundwork for taking the training wheels off the economy and markets, first through reducing its bond purchases and eventually raising the Fed Funds rate in 2022. We expect earnings growth and low interest rates to provide support for equity prices in the second half of 2021; however, volatility will increase as the Fed begins to change its stance. We will reiterate that we expect economic fundamentals to outperform equity prices for the remainder of the year.