Morris Capital Advisors, LLC

Investment Commentary
March 31, 2021

The Stock Car Experience

Several years ago my wife, Anne, bought me "The Stock Car Experience" for my birthday. It was the opportunity to drive a 600 horsepower modified stock car for 10 laps at Pocono International raceway, reaching speeds of 160 miles per hour. As I prepared for my opportunity to drive, I stood on pit row in a flame retardant racing suite and crash helmet. Looking down the long homestretch into the highly-banked first turn, I saw skid marks on the track. They did a sort of double circle straight into the wall. As I climbed into the car and strapped in, I remember thinking, "I don't want to be like THAT guy"!

Some may say that the financial markets resemble that 600 horsepower super charged race car these days. As measured by the S&P 500, stocks were up almost 6% during the first quarter of 2021, up more than 55% over the past year, and up an incredible 77% from the market lows of last year. The move, fueled by unprecedented fiscal stimulus and Fed liquidity was led by the mega-cap tech stocks like Apple, Amazon, and Google. These stocks have been market leaders since the advent of quantitative easing by the Fed following the great financial crisis in 2008.

Despite the move, analysts seem to be in uniform agreement that the economic rebound will continue and that it will further support the equity markets. Analyst estimates for Gross Domestic Product (GDP) growth range as high as 9.5% next quarter, 8.3% in Q3, and 6.3% for the full year of 2021. The estimates are based on expectations of the effectiveness of the Covid vaccine, leading to a reopening of the economy releasing pent-up demand, and massive fiscal stimulus. These analysts project that stocks will maintain their upward trajectory, supported by continued earnings growth, lofty market valuations, and continued investor enthusiasm. Of course, all of this is dependent on continued fiscal stimulus, facilitated by the Fed.

The federal government sought to offset the impact of economic shutdowns by passing the $2 trillion CARES Act and another $900 billion stimulus package in 2020, combined they represent more than 13% of GDP prior to the shutdowns. Add another $1.9 trillion American Rescue Act currently under consideration by Congress, and the total comes to more than 22% of GDP as of the end of 2019. Funded entirely by debt, this deficit spending pushed total federal debt to GDP from 79% at the end of 2019, to more that 108% now, and is projected to exceed 112% by the end of 2021. Debt to GDP levels exceeding 100% are considered excessive, and could constrain economic growth. Financing this debt is entirely dependent on the Fed and its outright purchase of government debt, referred to as "quantitative easing". These purchases, continuing at $180 billion per month, swelled the Fed balance sheet from $4.1 trillion to $7.7 trillion over the past year alone. This spending, borrowing, and Fed liquidity far exceed anything envisioned when these policies first began, and could be impossible to unwind without losing control. The results this year might seem impressive, but this financial engineering powered the economic and stock market engine at high speed down the straightaway without much thought of how it might handle a sudden sharp corner.

The financial markets present their most difficult challenge when analyst and investor thinking is uniformly positive or negative, creating a feedback loop and complacency, especially in a bull market. Current analyst bullishness may be overlooking some important factors. The economic rebound is real, and the likelihood of further stimulus is high, but we are beginning to observe employment, inflation, and valuation warning signs. Employers are finding it difficult to attract qualified employees, despite the fact that there are more than 8.4 million fewer people working than a year ago. Stimulus checks may have juiced retail spending, but the economic impact will be fleeting if those 8.4 million people remain unemployed. The economic rebound has also strained supply chains and commodity pricing. Computer chips are in short supply, slowing production of autos and electronics. Home builders are facing higher lumber costs and shortages of building materials. Higher food and fuel costs hurt consumers, especially those with lower incomes. Finally, equity valuations are well above historical norms. The price earnings ratio (PE) of the S&P 500 is over 22 compared to the historical average of 16.5. This PE may be consistent with interest rates at current levels, but if inflation concerns push yields higher, stocks could experience difficulty, especially those popular momentum names with unsustainable valuations.

We believe that the recent shift in leadership towards value stocks could continue as interest rates and valuations revert to historical levels. We believe that our focus on high-quality well-managed companies with proven earnings, reasonable debt levels, and strong free-cash flow should position us to take maximum advantage of this shift. The best drivers know that it is not how fast you go into a corner, but how fast you can come out that matters. It all depends on anticipation and positioning. Combined with client driven investment allocations, our conservative growth-oriented approach should enable us to drive through those sharp market turns and emerge safely on the other side.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

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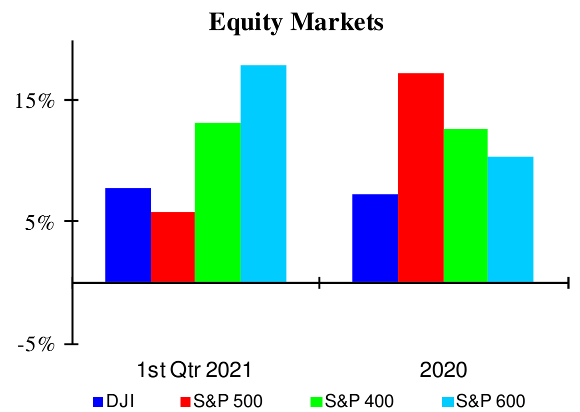
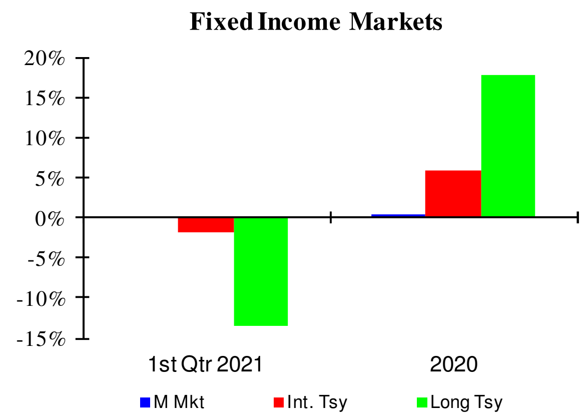
Market Summary
March 31, 2021





Equity markets in the first quarter of 2021 were treated with repeated doses of good news: rapid rollouts of COVID-19 vaccines, declining infection rates, and rebounding economic activity. At the same time, Democratic control of the White House and both houses of Congress led to the rapid passage of another enormous stimulus package, with the promise of more of the same in coming quarters. The Federal Reserve promised to keep monetary policy extremely loose for the foreseeable future, effectively underwriting the federal spending spree.

The only fly in the ointment, from the perspective of stock market investors, was a large increase in longer-term bond yields. The combination of rapidly improving economic conditions and rising interest rates promoted massive sector rotation. Economically sensitive, value oriented stocks outperformed, while high growth tech names suffered modest P/E compression from very high levels. Small cap stocks boomed, far outperforming large cap stocks, and speculative activity by individual investors drove exceptional volatility in issues that had been heavily shorted by professional investors, leading to high profile losses in many hedge funds.

Longer-term bond yields moved sharply higher throughout 2021's 1st quarter, re-establishing levels last seen before the COVID lockdown crisis erupted in February 2020. Short-term rates, however, traded barely above the zero bound for most of the quarter, reflecting extremely loose monetary policy. As a result, the Treasury yield curve has steepened dramatically.

Given that most economic indicators suggest that a robust economic recovery is underway, a steepening of the curve is to be expected. What remains uncertain, however, is whether the accompanying rebound in inflation pressures is temporary or permanent. Certainly ongoing supply chain disruptions are contributing to price spikes in many commodities markets, but these may subside as kinks are worked out. However, accelerating price appreciation in residential real estate, and a speculative frenzy in cryptocurrency markets, raise the specter of a sustained rebound in inflationary pressure fed by overly accommodative monetary policy.

As a result, longer-dated paper posted double digit declines in total return in the quarter, far underperforming the equities markets.