Morris Capital Advisors, LLC

Investment Commentary
June 30, 2021

Speed Blurs

Last quarter the theme for the investment commentary was my experience as I prepared to drive a 600 hp stock car at Pocono International Raceway. I described my trepidation as I awaited my turn to drive this high-powered machine at incredible speeds. But the professional instructors understood that a novice like me could not just jump in and hit max speed, they had to gradually increase the speed each lap, ultimately hitting a top speed that did not seem that much faster (or riskier) than those initial laps. As they say, speed blurs.

I thought of this as I reviewed market action from the pandemic lows of last year, and the impact of fiscal and monetary policy on market performance. The steady upward trend, driven by fiscal and monetary stimulus, created complacency among policy-makers, analysts, and investors that everything is under control, and that the markets will continue to move higher. Speed blurs.

The stock market rose 8.5% during the second quarter of 2021, as measured by the S&P 500 index. The move was driven by a rebound in large-cap stocks, especially among the familiar tech names that have attracted so much attention over the past few years (FaceBook, Apple, Amazon, Microsoft, Google). The performance of these stocks contributed to an overall shift in leadership to growth stocks and away from the value names that outperformed last quarter. The move pushed the S&P 500 to all-time highs, up 15.2% for the year, and up more than 96% from the lows last year, but also pushed valuation measures to lofty levels. The price to earnings ratio of the S&P 500 index (a common measure of stock valuations) was 21.4 at quarter-end, well above the 25-year average of 16.6. Corporate earnings are expected to grow over the next several years as the economy rebounds, but that growth may not support these valuations.

Fixed income markets also rose during the quarter. Yields on 10-year US Treasury notes fell from 1.75% at the beginning of the quarter to 1.50% by quarter end. This decline in rates, coupled with strong performance from Corporate and High Yield bonds as credit spreads tightened, contributed to the strong results. The drop in rates during the quarter occurred despite concerns about rising inflation and uncertainty regarding fiscal and monetary policy. Declining yields on longer-term maturities and short-term Fed Fund rates near zero offer little room for error, and may not be consistent with continued strong economic growth and higher inflation.

Lofty stock market valuations and interest rates at or near historical lows indicate that the financial markets have become increasingly reliant on external support in the form of fiscal and monetary stimulus. Since the beginning of the pandemic Congress passed more than $5.1 trillion in fiscal stimulus, and the Biden administration is pushing for an additional $1.8 trillion (all of it funded by debt). At the same time, the Fed has continued to expand its balance sheet, spending $120 billion per month to purchase US Treasury and agency mortgage backed securities. Investors should be careful not to allow all of this external stimulus to blur their vision of market risks.

At some point the financial markets will need to transition away from reliance on external support. There are indications that we have reached peak levels of fiscal and monetary stimulus, economic growth, and earnings growth. If that is the case, the stock market will face additional headwinds caused by the economic recovery: labor constraints, higher interest rates, rising inflation, and the possibility that the Fed may tighten earlier than expected. It may all be reliant on the ability of the Fed to manage their role. The Fed must decide when to tighten monetary policy by first taking their foot off the gas pedal (tapering the quantitative easing program) and next by hitting the brake (raising interest rates). The historical record of the Fed in managing these types of transitions is not promising. The Fed raised uncertainty earlier this year when they discussed accelerating the timeline for their move to a less accommodative stance. The reaction was even more pronounced when the Fed reduced liquidity injections in the 4th quarter of 2018, triggering a stock decline of 20%, affectionately known as the “Taper Tantrum”.

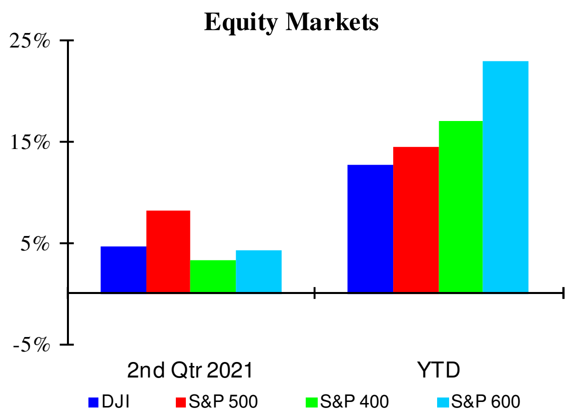
History demonstrates that the past year is the exception for the stock market, rather than the rule. Stocks do not move up in a straight line forever, and, at some point, fiscal and monetary support will no longer be the primary determinants of market performance. The shift to value based stocks in the first quarter of this year was an early, albeit short-lived, indication that this transition may be approaching.

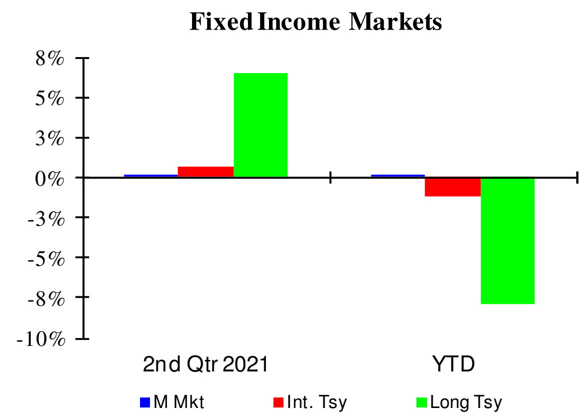
As the markets grapple with economic headwinds, valuation constraints, and reduced stimulus, investors will be well-served to focus on traditional investment fundamentals. We believe that our focus on high-quality well-managed companies with proven earnings, reasonable debt levels, and strong free-cash flow should position us to take maximum advantage of this shift. Professional drivers and investors know that it is important to remain focused and avoid complacency. Our focus on conservative growth-oriented companies with attractive valuations should enable us to manage through this transition and continue safely down the road.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

Market Summary
June 30, 2021





Equity markets generated solid performance during 2021's second quarter, despite some potentially troubling developments. The various measures of inflation significantly exceeded expectations, generating concern that the Federal Reserve was much closer to debating a tapering of monthly bond purchases than had been assumed earlier in the year. At the same time, various economic indicators began to show early signs of decelerating rates of growth (from very high levels), leading investors to wonder whether the economy has already reached peak growth rates. These concerns were reinforced as long-term bond yields began to recede from the highs established in the previous quarter. "Stagflation" replaced "reflation" as the trade du jour.

While equity markets seemed to take these developments in stride, under the surface there was considerable turmoil. Growth stocks sharply outperformed value stocks, and large cap stocks bested small cap names. Stable growth favorites reemerged as the place to hide, while cyclically-oriented stocks almost completely retraced their spectacular first quarter gains.

Longer-term bond yields moved steadily lower during 2021's 2nd quarter, unable to sustain the high levels achieved in the 1st quarter. Although the headline inflation numbers seemed to confirm investors' worst fears, the consensus seemed to accept Fed assurances that those reported inflation rates were transitory. Even so, various Fed officials began to publicly express discomfort with those headline numbers, thus markets began to discount an earlier start to the process of ramping down the large monthly purchases of treasuries and mortgage backed securities. Employment and other data also seemed to hint at an emerging slowdown in the blistering rate of growth the US economy has enjoyed since the recovery from the pandemic shutdowns began last summer.

By quarter's end, long-term bond yields had retraced about half of the sizeable upward move experienced in the 1st quarter. As a result, longer bonds enjoyed total returns that rivaled the stock market. Shorter duration bond performance was roughly flat.