BROOKMONT CAPITAL MANAGEMENT

Summary

- S&P 500 returned 0.58% in the 3rd quarter of 2021, Value underperformed Growth by 1.94%
- In September, the 10 year US Treasury Rate rose 6.8%
- Supply chain issues are prevalent in the economy but the demand for the affected goods is likely to be delayed and not destroyed
- Increasing vaccination rates and effectiveness to prevent hospitalizations will drive a more relaxed COVID policy from governments
- Political uncertainty will lead to heightened market volatility as the market tries to assess the risk of higher taxes and regulation
- With supply chain disruptions and an inefficient labor market, we expect inflation to stay above the Federal Reserve's 2% target through 2022 and into 2023.

COVID-19 and Supply Chain Issues

The COVID pandemic and associated supply chain disruptions, continue to drive near and intermediate term market performance. This is attributable in part to the majority of highly impacted products (i.e. automobiles and consumer electronics) are in categories where demand is delayed rather than destroyed. This is an important distinction when evaluating expected financial performance as we exit global shutdowns. For example a grocery store shopper looking for chicken that is out of stock will use a substitute protein source and as chicken is restocked that consumer will not purchase more once chicken supplies normalize. In contrast, a car or smartphone consumer delays a purchase if inventory is in short supply or prices are escalated, however once supplies normalize that pent up demand will be realized thus only delaying demand rather than destroying it. As we evaluate the impact of supply chain disruptions, we adjust our expectations to this concept of permanent vs temporary demand and its financial implications.

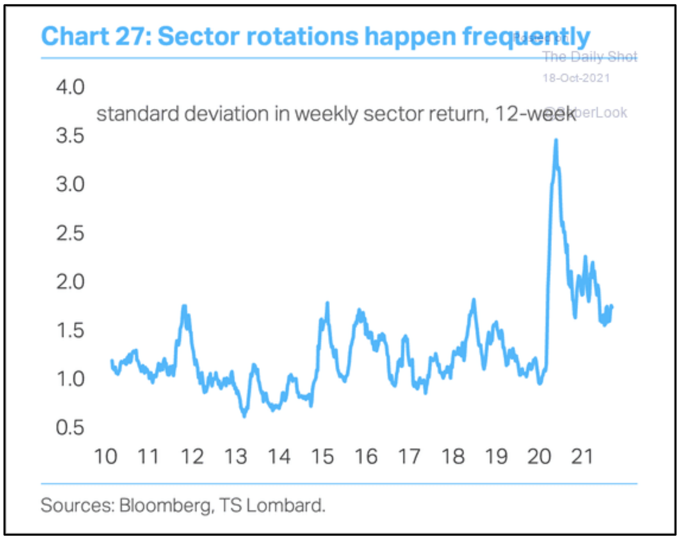
Daily COVID cases rose in various regions throughout the quarter, with major increases experienced in the United States, Vietnam, and Malaysia, to name a few. The spike in the United States resulted in a slowdown in travel- and leisure-related spending, showing the continued sensitivity of the average US consumer to COVID. There was additional evidence of this in the September Employment Situation report, where the number of people not looking for work because of COVID increased by 107,000 from August to September, the first increase reported since January.

The COVID spikes in Vietnam, Malaysia, and other key emerging markets with large global manufacturing footprints has driven further tightness in the global supply chain as governments implemented various restrictions which hampered manufacturing and export volumes.

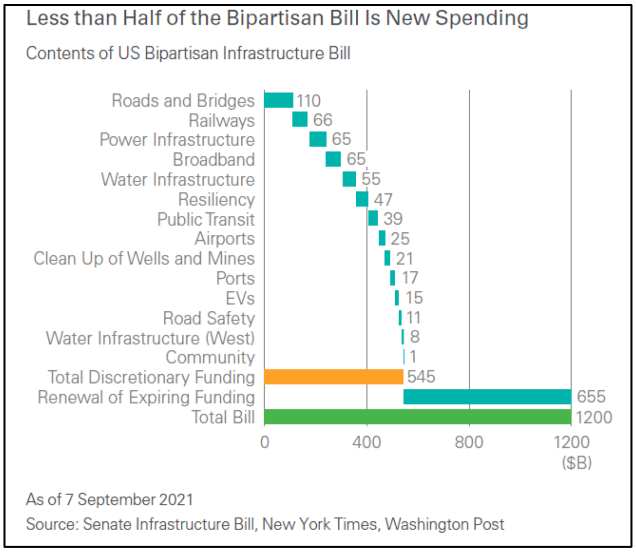
We expect that the COVID pandemic will effectively transition to endemic COVID entering 2022. This is driven by increasing vaccination rates globally, which we view as significant not to COVID case counts as much as hospitalizations and case outcomes. The primary stated motivation behind lockdowns and mobility restrictions implemented globally since the start of the pandemic has been to ensure that hospital capacity is not exceeded. With current data suggesting that COVID vaccines are over 99% effective at preventing hospitalizations, we expect that both individuals and governments will continue shifting towards a more accommodative approach to COVID. The normalization of individual sentiment should drive the continued recovery of services spending within developed markets, particularly within the travel and leisure industries. The shift in governments' COVID responses should help provide a more stable environment for supply chains to recover.

Washington's near-term impact on Markets

The risk in an unchecked Democratic executive and congressional branch is the public sector spending and higher taxes leading to increased risk of real inflation. Congress has modified the debt limit 14 times since 2001. There is little risk that the US will hit a technical default in December as law makers reach a compromise on the spending package and infrastructure bill. The compromises will result in smaller programs and marginally higher corporate tax rate of 26.5% as opposed to the proposed 28% by the administration. Senator Joe Manchin (D-WV, Chair of Energy Committee) has said publicly that he will not vote for a spending bill that is over $1.5 trillion so it is unlikely that the final bill will be close to the proposed $3.5 trillion. There are many areas of negotiation in the spending bill and changing regulatory environment that could have sector specific implications, resulting in higher sector volatility during negotiations, resulting in elevated equity sector rotations as illustrated in the above graph. For example, ending the fossil fuel energy tax breaks is in the proposed package, however we believe it will likely not make it to the final bill. Senator Manchin is against ending those tax breaks because West Virginia receives about 90% of its power from coal burning plants. The current bill would take away tax breaks from coal burning, natural gas, and other fossil fuel plants and Senator Manchin is proposing to include Carbon Capture measures in the bill so that fossil fuel power sources can qualify for tax breaks and other clean energy incentives.

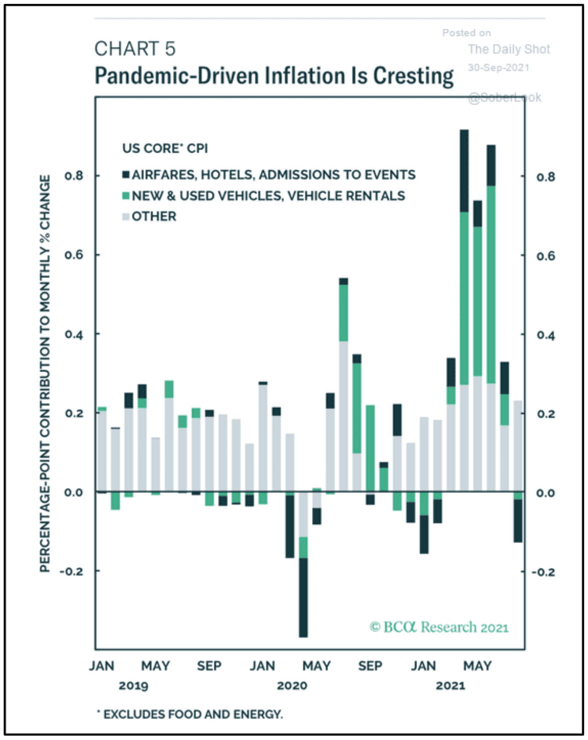


The proposed Infrastructure Bill is $1.2 trillion with 55% of that spending for continuing existing programs (see Graph). Speaker Pelosi has maintained her stance that she wishes to have the infrastructure bill passed by October 31 but there is push back from the progressive side of the party. The progressives are holding the infrastructure bill hostage until a deal is reached on the spending bill that includes the measures that progressives want, including universal childcare, free community college, and significant green energy investment. With Presidential polling numbers declining, the UN Climate Change Conference, and midterms quickly approaching, President Biden is under pressure to get a deal done quickly which will lead to a more compromises. The large amount of uncertainty from the Federal Government and these bills will likely result in heighted market volatility. We do not expect the packages, if passed, to result in short-term inflation spikes. The spending is spread out such that it will take 3–5 years to affect the US economy.

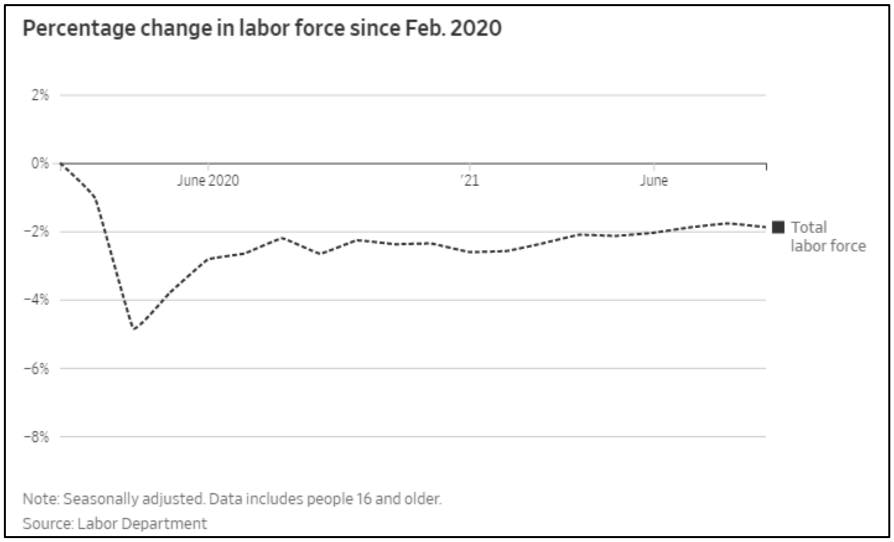


Inflation & Labor Market

Inflation has exceeded the Federal Reserve's projections through 2021 as the August PCE rose 4.3% from a year earlier. The sustained increase in inflation has started to have larger impacts on the cost of living as there has been a 5.9% increase in Social Security benefits which is based on the exaggerated measurement, CPI. This broad impact has had some impact at the Federal Reserve as policy makers have started to admit that inflation was not as "transitory" as they thought even though most of the price pressures are still derived from transportation delays, semiconductor shortages, and rising energy prices. These sources touch on every level of the economy which has led to 46% of small businesses planning on raising prices in the next 3 months.

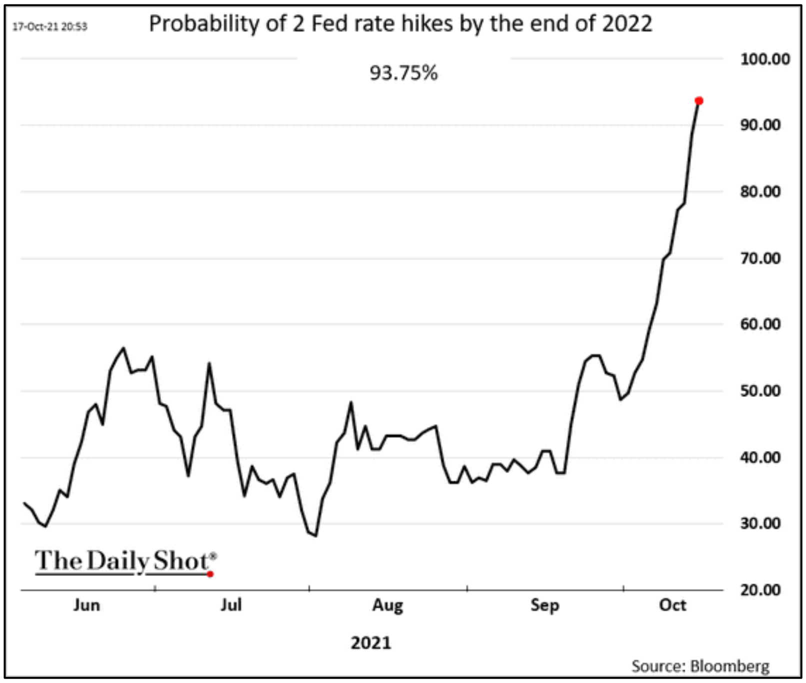


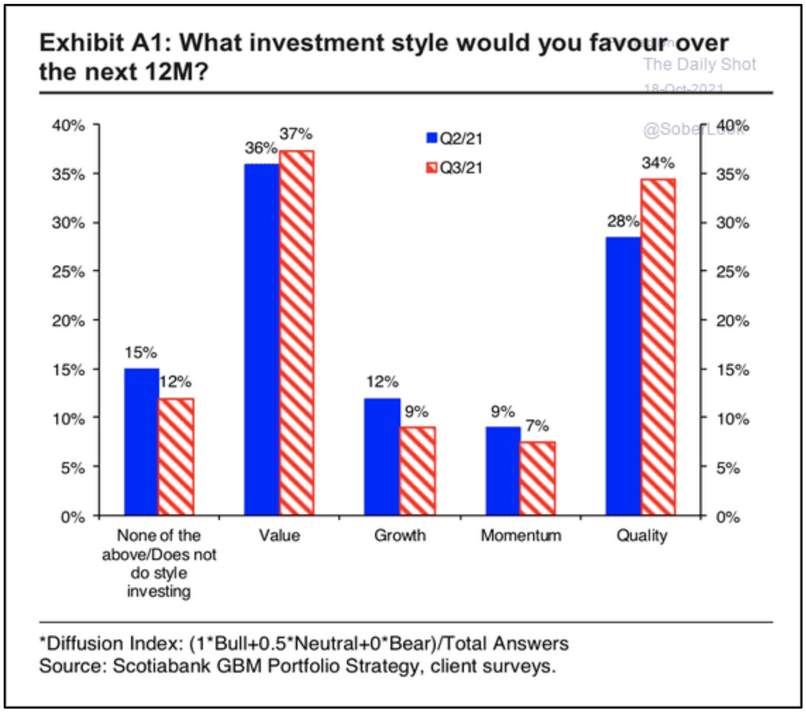
Inflation tends to be a self-fulling force which leads to households demanding higher wages as they accept higher prices for goods. The hourly pay for the average worker has risen 4.6% over the last year but a lot of that wage pressure also stems from an inefficient labor market where the US has 10.9 million unfilled positions and 8.3 million unemployed workers (as of July). In August, quit rates among the US labor market shot up to an all-time high of 2.9%. The phenomenon is being driven in part by workers who are less willing to endure inconvenient hours and poor compensation and who are quitting instead to find better opportunities. The industries most affected by the record quit rates were the Healthcare, Restaurants and Bars, Child Care, and Hotel Industries. Employment at restaurants and bars was down 7.6% in September from February 2020 and hourly pay for those workers was up 12.7% at the same time. To combat margin contractions caused by supply chain disruptions and labor shortages, restaurants have increased meal prices by 7.3%



On the other side of the labor market, early retirement for workers 55-64 have increased over the course the pandemic as retirement balances and home values have soared. Many Americans chose to retire early instead of re-entering the labor market which has also contributed to the labor shortage that US is experiencing. With supply chain disruptions and an inefficient labor market, we expect inflation to stay above the Federal Reserve's 2% target through 2022 and into 2023. The inflation caused from transportation delays, semiconductor shortages, and rising energy prices has started to minimally bleed into the labor market as evidenced by wage growth in truck drivers, port workers, and restaurant workers but we believe that run-away inflation isn't something to worry about until we see this type of wage growth in all sectors of the labor market.

Moving Forward





The economy is in a peculiar spot with supply chain issues causing demand delay, an inefficient labor market where job openings outcast unemployment by 24% and a pandemic that is slowly being treated as an endemic by world governments. Even with all this uncertainty, the US economy is experiencing record corporate profits in part due to a dovish Federal Reserve. This has led to the overall equity market making all-time highs and the discussion of tapering asset purchases by the Fed have begun and been exacerbated by persistent inflation. The Federal Reserve has come out with a plan to start tapering asset purchases by reducing asset purchases by $15 billion per month. This timeline would result in the Federal Reserve being done with purchases in July of 2022 and it is expected that the monetary policy makers will take a short break to gauge the economy and then start to slowly raise rates. Many economists expect two rate hikes by the end of 2022. This rising rate environment naturally favors value stocks over growth stocks. Growth Stocks are currently at historical highs in terms of an inverse correlation to the 10 Year US Treasury Rate. With the rising rate environment, supply chain issues, persistent inflation, and a complex labor market, we expect not just value stocks to perform well but more importantly quality stocks to perform well. Quality stocks with sustainable business models, strong management teams, and strong pricing power will be able to better navigate the complex market the US in experiencing as we emerge from a pandemic driven world.

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The Brookmont Dividend Growth Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Dividend Growth Strategy Composite is measured against the Russell 1000 Value Index. The Russell 1000 Value Index measures the performance of the large-cap segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbaised barometer for the large-cap value segment. There is no representation that this index is an appropriate benchmark for such comparison. You cannot invest directly in an index, which also does not take into account trading commissions and costs. The Volatility of this index may be materially different from the performance of the strategy.

The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, included those accounts no longer with the firm. Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow of at least 15% of portfolio assets. The temporary removal of such account occurs at the beginning of the month in which the significant cash flow occurs and the account re-enters the composite at the beginning of the month which follows the cash flow by at least 30 days. Additional information regarding the treatment of significant cash flows is available upon request.

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Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Net-of-fees performance was calculated using actual management fees. Additional information regarding the policies for calculating and reporting returns is available upon request.

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