Rate and Vaccination Volatility Brings Buying Opportunities

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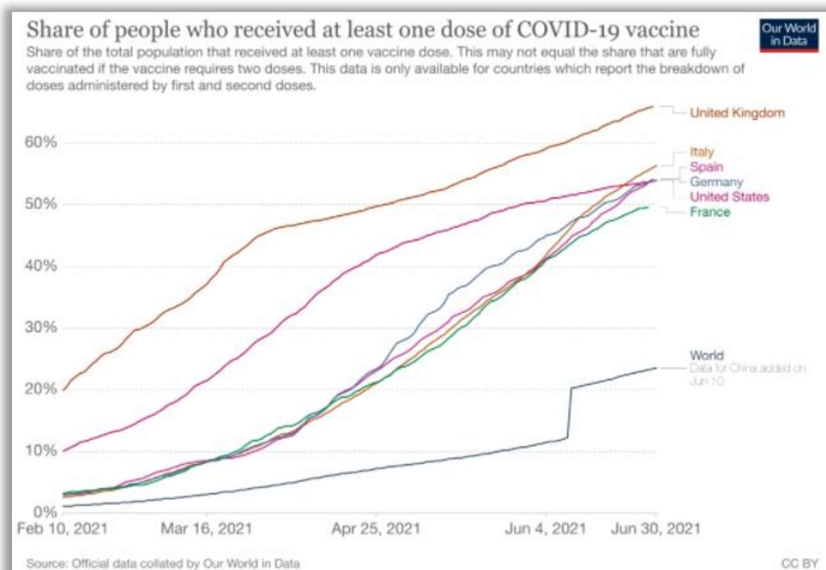
- S&P 500 returned 5.94% in the 2nd quarter of 2021. From June 30, 2020 to May 31, 2021, Value outperformed Growth by 10% but the rally in mega cap tech names brought that difference to just 1% for the quarter.
- Inflation fears and stalling unemployment led to a volatile market, presenting buying opportunities for quality companies.
- Fragmented global reopenings contribute to supply chain disruptions and idiosyncratic inflation.
- Facebook, Apple, Amazon, Microsoft, and Google (FAAMG) stocks rose sharply in June, accounting for over half of the Index's returns since May 12th, leading the S&P 500 to all-time highs.

Divergent Global Vaccination Rates lead to Fragmented Global Reopenings

Expectations for US real GDP growth increased steadily through the quarter, with the average forecast for Q4 2021 growth increasing 10% in June from the projection in March. Investors were pensive about inflation entering Q2, concerned that excess liquidity and a Biden infrastructure plan could overheat the economy. Inflation fears peaked on May 12, after headline April CPI came in significantly above estimates—growing 4.2% Y/Y. On the same day, the US 10-year yield spiked to 1.70% and yield-sensitive sectors plunged, with Tech declining 2.86% and consumer discretionary declining 3.28%. Inflation fears have eased since mid-May, with most investors buying into the Fed's "transitory" inflation narrative.

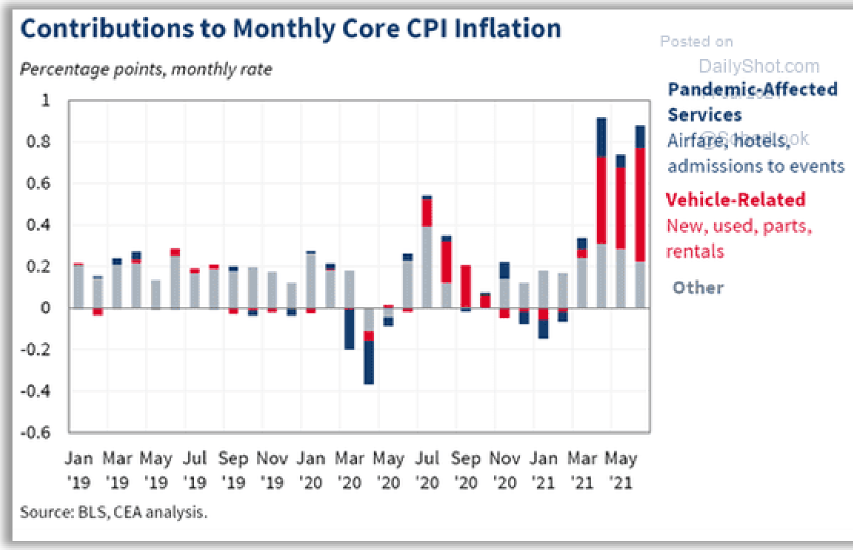
Following the initial surge and peak in US daily vaccinations in April, the US vaccination effort has slowed. Americans that want the vaccine have now already received it. This creates a new and more challenging issue, as daily vaccinations are no longer limited by dose manufacturing or logistical constraints, but rather a lack of demand from citizens—a problem that does not seem to have any straightforward solution. The US has now plateaued at 54% and is expected to take another 5 months to reach 75% of the population to be vaccinated (Dec-21). The EU is expected to reach the 75% threshold in 2 months (Sep-21). This is a reversal of where we began the quarter, when US vaccinations were outpacing the rest of the world. Developing countries are still behind the developed world because of a lack of financing, infrastructure, and access. The developed countries are debating waiving the intellectual property



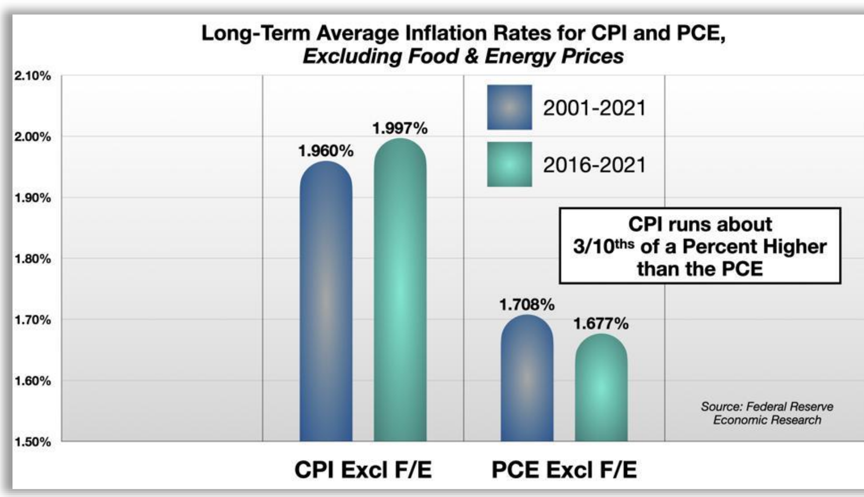
rights of vaccine makers. This would provide greater access as production could be expanded; however, opponents say that this would lead to lower quality vaccines which could present future problems. Either way, the lack of demand from the US, increased EU vaccination rates, and vaccine access amongst the developing world has led to a fragmented global reopening which contributes to the supply chain disruptions and idiosyncratic inflation.

Inflation is less that what meets the eye?

The June Year over Year non-seasonally adjusted Headline CPI came in at 5.49% which was a 4.99% increase from the previous month but this large increase in Headline CPI comes with several caveats. The first is that over two thirds of the 5.49% increase in the year over year comparison was in the Vehicle Related goods and Pandemic Affected Services. The pandemic has caused supply chain disruptions as orders were cancelled due to lack of demand in the height of the pandemic. The United States runs on a lean supply chain system based on just-in-time principles. While this has benefits with inventory management, it can also cause problems when these efficient supply chains are disrupted. These disruptions will be resolved in due time as regional unfilled orders and delivery times are already starting to revert to the mean.

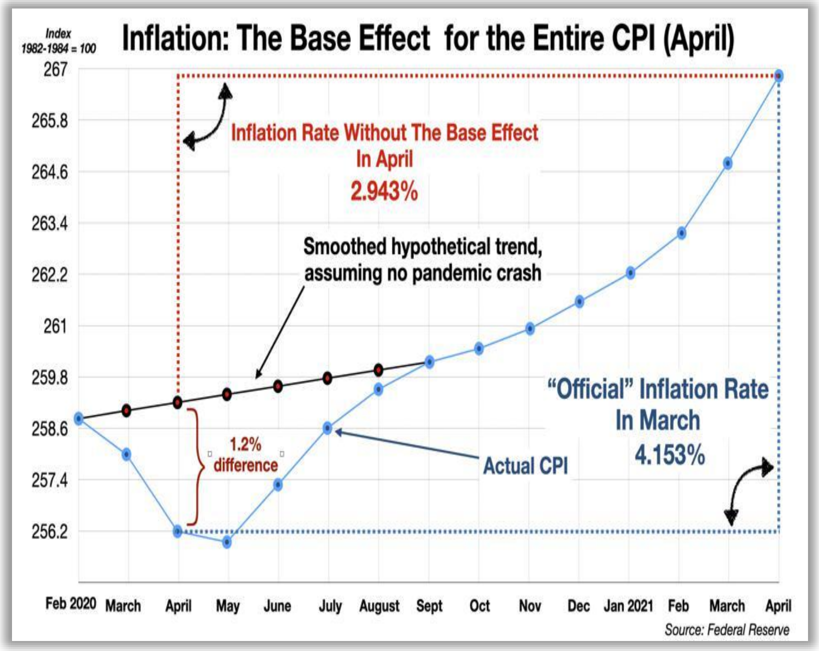


Second, Policy makers do not rely on the Consumer Price Index to tailor their monetary policy but rather the Personal Consumption Expenditure Index (PCE) which on a long-term average runs about 30 bps below the CPI. For example, In May CPI inflation was at 4.9% year over year while Core PCE inflation, which excludes the volatile food and energy categories was at 3.4%. This was still the fastest increase in Core PCE since 1992. The differences between the CPI and the PCE are based in the basket of goods that are used to measure price increases. CPI is based on what households are buying while



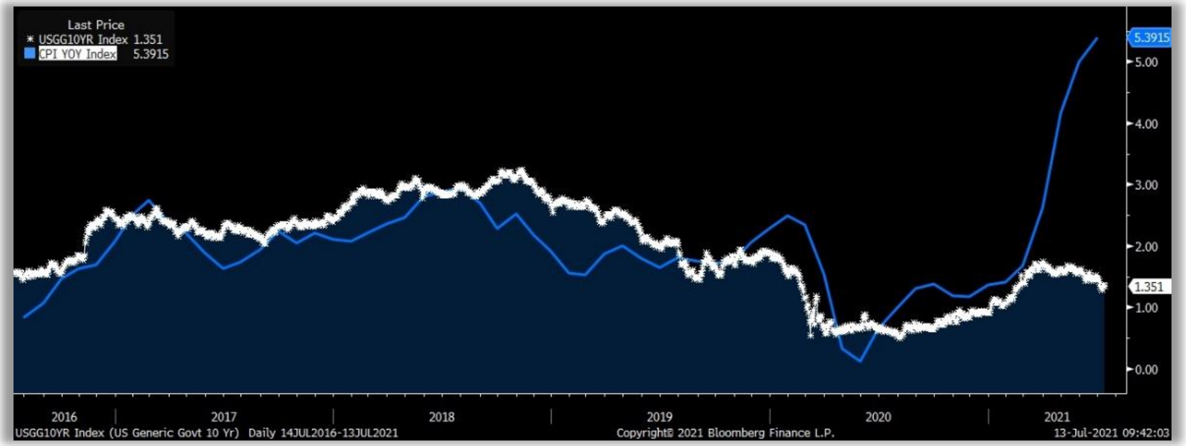
the PCE is based on what businesses are selling. Another difference is that the CPI is based only on out-of-pocket expenses like food and gas while the PCE includes other expenditures like medical care paid for by employer-provide insurance. The last major difference is that the PCE considers the substitution effect and elasticity of a good. For example, if the price of beef increases then consumers might turn to chicken or turkey, The PCE would adjust the basket of goods to reflect that beef now makes up less of what the business is selling.

The third caveat of the 5.49% year over year Headline CPI is the fact that it is comparing this year's inflationary numbers to last year's inflationary numbers. As you can see by the graph, last June the US Economy was still shut down and prices dropped due to lack of demand for goods and services. This year over year comparison is called "The Base Effect" which result in an overstated headline CPI number. It can be expected that this base effect will dwindle this fall as the actual CPI comes back to the hypothetical CPI trend if there were no pandemic crash. These caveats represent the more nuanced considerations policy makers use when setting monetary policy. Over the past year, the United States has seen a 20% increase in M2 money supply which historically led to long term inflation. Inflation usually takes about 2 years from the time that the money supply is increased. Given the unique circumstances, only time will tell if the Federal Reserve is wrong about inflation being transitory.



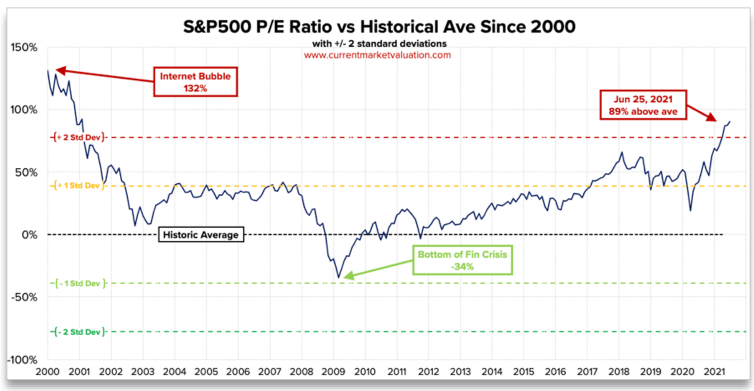
Quality Companies Provide Best Option during a Volatile Market

The debate over whether inflation is transitory or long term was the big headline for the 2nd Quarter of 2021. This led investors to question the duration in growth stocks as they are more sensitive to rate changes. In June, growth stocks outperformed value stocks as investors seemed to think inflation was transitory as unemployment increased from the month prior which translated to the dovish Federal Reserve likely not raising rates until 2023. The Federal Reserve has made it clear that unemployment numbers are what they prioritize over inflation numbers, and therefore we saw the decoupling of inflation and interest rates (see Graph Next Page).



Blue Line = CPI Index White = 10-year US Treasury Rate

Over the past year (6/30/2020 – 6/30/2021) Value stocks have outperformed growth stocks by 1%, but before June 2021 that number was 10%. The growth names that drove the June performance were the Facebook, Apple, Amazon, Microsoft, and Google (FAAMG) stocks. These names accounted for over half of the 7.6% gain in the index and now make up 27% of the index. That heavy weighting has put index investors at as the S&P 500 P/E ratio is above 2 standard deviations from the historical averages. Also, the S&P 500 real earnings yield is now at -2%. Earnings growth has driven the returns in the market this year. The headlines will still be dominated by discussions on rates and its impact on growth stock valuations, but quality companies should outperform during rate uncertainty and an evolving tax regulatory environment. Brookmont looks to bring value to investors through investing in companies with durable business models, strong pricing power to protect margins from inflation, and valuations that are less vulnerable to tax/regulatory changes.



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