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Investment Review and Outlook

As the pace of vaccination improved, accompanied by the reopening of additional sectors of the economy, equity investors celebrated by bidding prices higher during the second quarter. And despite the reacceleration of the economy, fixed income securities performed rather well after a bruising sell-off earlier in the year. Financial market participant behavior seems to suggest that we are in a "Goldilocks" economy, in which growth is healthy, but not too strong. We do not expect this confluence of positive dynamics to herald a new era of healthy economic growth without inflation. But we are finding investment ideas that can benefit from the current growth while protecting portfolios from certain emerging risks.

Continued fiscal stimulus from Washington seems to be a foregone conclusion. The Biden administration is angling for a number of additional spending programs to address a wide variety of infrastructure deficiencies as well as social policy imperatives. Meanwhile, the Federal Reserve is signaling a slight change in the timing of its expected unwinding of the unprecedented quantitative easing and zero interest rate policy. But no worries - the Fed still expects to tighten policy at a glacial pace. They are now expecting as many as two interest rate hikes in 2023. Our conclusion is that low interest rates will continue to encourage borrowing and spending for the foreseeable future. But it also gives us reason to keep a watchful eye on the pace of inflation. We will be especially interested in the inflation figures later this year as comparisons to the price levels in the early days of the economic shutdown are in the rearview mirror.

We will continue to focus on investments that we expect to perform well in an environment of slowly rising inflation and interest rates. We believe we have reached an inflection point where investors can no longer just buy any stock at any price and "the rising tide of the bull market will lift all boats."

Resurrection of a Dinosaur

Look what sector of the stock market is outperforming the averages this year: the hapless energy sector. With the advent of a concerted global effort to eliminate fossil fuels, many investors exited this sector in the past few years. But since late 2020, energy stocks have been surging. Even industry titan **ExxonMobil's (XOM $61.35)** shares have nearly doubled in price from the multi-year low set last October. So, if fossil fuels are going the way of the dinosaur, how are oil and gas exploration and production companies performing so well?

There are several possible explanations. First, perhaps investors have been overly pessimistic about the future of the industry and sold many stocks indiscriminately. Second, the acceleration in the economy has caused a sharp rebound in demand for oil and gas. Consumption levels are approaching pre-Covid levels faster than many expected. Third, many public policy decisions intended to limit future production of fossil fuels is causing concern that future supplies will not be sufficient during the transition to alternative fuels. Finally, an increasing number of oil and gas companies are adopting more conservative policies with regard to capital allocation. We expect fewer dollars to be allocated to large capital expansion projects. At the same time, shareholder returns, in the form of stock buybacks and dividends, could grow meaningfully in the years ahead.

We have maintained an overweight allocation to energy stocks and plan to remain so. Despite the rally in these shares, they still appear cheap vis-à-vis the market. Moreover, they could provide a hedge against the economy overheating. Finally, sector dividend yields are more attractive than virtually every other market sector – and we expect those dividends to continue to grow for some time. Not a bad dynamic for investors who are hard pressed to find attractive yields in today's markets!