GAMBLE JONES
CAPITAL MANAGEMENT
A Divison of Gamble Jones Investment Counsel

April 1, 2021

Only in the mercurial world of the stock market would good news be greeted with such turbulence. While the prospects for economic and corporate earnings growth have become much rosier in recent months, this optimism has been accompanied by an increase in long-term interest rates that has created some additional market volatility.

Coming off a year in which the Covid-19 pandemic resulted in the biggest economic contraction in the U.S. since 1946, the economy is well positioned for a strong rebound. To be sure, the recovery to date is far from complete as there are still nine million fewer jobs today than at the outset of the pandemic and many areas of the service sector remain impaired due to virus-related restrictions. However, the combination of steady progress in the rollout of vaccines, the recent passage of an additional $1.9 trillion in fiscal stimulus, and a year of pent-up demand is anticipated to propel the economy to its fastest growth in nearly forty years. The strong economic expansion is expected to translate into a robust increase in corporate earnings, with S&P 500 companies now forecasted to post EPS growth of 25% for the year.

A natural result of the better outlook for the economy has been a steady rise in long-term interest rates, with the 10-year U.S. Treasury note now yielding more than 1.7%, up from an all-time low of .52% in August and .92% to start the year. Long-term rates tend to climb when investors anticipate economic improvement since greater growth often leads to higher inflation, which reduces the value of returns from fixed-income investments. Having been depressed for more than a decade, inflation is expected to pick up this year as the economy recovers. However, with many of the long-term forces that have kept prices subdued for years still at work (including globalization, technological advances, and an aging population), it is unlikely that inflation will reach runaway levels anytime soon. As such, interest rates, which have so far simply retraced their path back to pre-pandemic levels, are not likely to soar in the near future either, particularly with the Federal Reserve steadfastly committed to maintaining an extremely loose monetary policy until the economy reaches full employment. However, with rates still at historically low levels, it would not be surprising if they were to gradually move higher in the near term as the economy accelerates.

Given the significant role that the low interest rate environment has played in boosting stock valuations over the last dozen years, it is logical that an increase in bond yields has injected some additional volatility into the market. Still, in spite of its choppy trading in recent weeks, the S&P 500 has continued to move higher as the positive impact from the improving outlook for the economy and corporate earnings has so far outweighed the negative impact from rising rates. This trend can continue so long as the rise in interest rates remains gradual and orderly. We would, however, expect the market's historically high valuation following the 75% surge in the S&P 500 over the past year to serve as an impediment to a significant rally from here.

While the market has continued to climb, many of the names leading the charge have changed. Improved economic prospects have led to a rotation in leadership from technology stocks and other growth areas of the market that have performed so well throughout the pandemic to the more economically sensitive cyclical sectors of the market that had been laggards but that should now be the biggest beneficiaries of a strong economic recovery. This rotation has been further driven by the rise in long-term rates, which reduces the value in today's dollars of the large profits expected well into the future from high-growth companies and encourages investors to instead prioritize the near-term profits likely to be generated by cheaper, cyclical companies.

We would not be surprised if the market were to remain volatile as investors continue to process this year's expected mix of higher growth, inflation, and interest rates. Over the long run, an increase in interest rates driven by stronger economic growth is generally positive for the market. In this case, it is a sign that things are gradually returning to normal after the unprecedented shock caused by the pandemic. It is also healthy that the rally in stocks has now broadened to include a number of different sectors of the market and is no longer completely reliant on technology stocks to lead the way. Though healthy, these market shifts generally come with some turbulence. We don't mind market volatility as it can often provide investors with good long-term opportunities. We do, however, take steps to minimize portfolio volatility by investing in a diversified mix of quality companies and adding uncorrelated assets such as fixed-income investments, gold, and cash where appropriate. Our primary focus remains centered on owning great companies trading at reasonable valuations, regardless of whether they are classified as growth or value, cyclical or non-cyclical. While there will be times when even great investments are out of favor, the market will recognize their true value over the long run.

Sincerely,

Gamble Jones Capital Management

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