Palouse Capital Management, Inc.
2021 Commentary
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2021 Recap and Analysis

At the beginning of 2021 the focus of equity investors was squarely on the Covid-19 pandemic and all of its economic impacts. 2020 was a really good year for equity markets despite those impacts and most investors probably wondered if that could continue in light of terrible Covid-19 case and death count reports early in 2021. The bright spot on the horizon was the prospect of vaccines and that helped equity markets stay where they were despite an otherwise ugly news backdrop. Earnings expectations turned south in a hurry during the early stages of the pandemic, but they had improved markedly by the end of 2020. The big market's forward P/E ratio was about 22x to begin 2021, a high number in the historical context, which showed a good deal of confidence in the market's recovery.

The winter 2020/2021 Covid-19 spike was scary, yet investors seemed to worry about it much less than the original spike in the Spring of 2020; despite the lack of vaccines, it seemed like the healthcare system was much more effective at handling the pandemic than in the past and that gave investors a reason to be optimistic. Case counts peaked early in 2021 and then tailed off quickly as overall immunity developed and vaccines began to roll out. By the beginning of the summer, case counts had dropped off to what seemed like manageable levels and that reinforced investor optimism; the big market was up about 15% year to date through June, supported by a good earnings expectations trend, a couple of good earnings seasons and consistent trading multiples. The big market's forward P/E ratio remained in the 21x to 23x range for the first half of 2021.

While the delta variant of Covid-19 was discovered in late 2020 and the first US cases were detected in the Spring of 2021, it did not start to fuel a new American Covid-19 spike until later in the Summer of 2021. The delta wave continued on for months, peaking in September or October of 2021. By the beginning of September, the big market was up about 22% since the beginning of the year; equities then pulled back that month, at least partially due to worries about the delta variant. After that, markets finished the year strongly due to continued solid earnings performance and, eventually, declining Covid-19 cases.

The S&P 500® Index ("SPX") returned about 28% in 2021, better than the 18% return in 2020 but less than the very strong 31.5% return achieved in 2019. The SPX doubled between the end of 2018 and the end of 2021 for a compound annual return of 26%. For comparison, the SPX provided a compound annual return of about 16% since the end of 2008.

In 2021 the S&P 500® Growth Index ("SGX") outperformed the S&P 500® Value Index ("SVX") by a wide margin for the second year in a row and also the ninth time in the past 13 years. The SPX dramatically outperformed small cap stocks (i.e. the Russell 2000® Index) in 2021 after trailing small caps slightly in 2020; before that, one has to go back to 2016 to find a period when small cap stocks outperformed large caps. Large cap growth has dominated the equity performance landscape since the end of the "Great Recession" and the ugly bear market that spanned the second half of 2008 and the beginning of 2009.

All sectors were up solidly – ranging from 14.6% to 55.4% - in 2021. The worst sector last year was utilities[1]. The best sector was energy, which was up 55.4% on a 55% move up in crude prices. Before the Covid-19 lockdowns began, US oil production was running at about 13.1 million barrels per day, a record level. When the pandemic took hold, production dropped dramatically to 9.7 million barrels per day by the end of the Summer of 2020. The

[1] All sector data here refers to our 1,000 stock model.

price of crude dropped from about $63 per barrel to about $12 per barrel during the Spring and Summer of 2020[2] due to lockdowns and the pandemic-induced economic malaise plaguing the nation at that time. As one would expect, oil exploration also dropped off the table at that time; the US total rig count went from a relatively healthy 792 rigs to a low of 244 rigs, by far the lowest level since data has been collected for this series, during the pandemic lockdowns.

The price of crude eventually worked its way back to about $40 per barrel by the late Spring of 2020 and then moved sideways through the Fall of that year. While US production came back up to around 11 million barrels per day by the Fall of 2020, it is even now still far off pre-pandemic levels. While improving, rig counts have also remained at historically very low levels. Anemic production growth, a restoration of energy demand and very low exploration activity have all contributed to a doubling of crude prices between November of 2020 and the date of writing; this has driven an impressive move in energy stocks.

A particularly important development in the equity market construct is the return of very high rates of price inflation, which is largely due to surging energy prices (i.e. crude oil, natural gas, gasoline, fuel oil, aviation fuel, propane). Before the pandemic began, non-core inflation was running at about 2.5% annually. After initially dropping during the early stages of the pandemic, non-core inflation has now risen to the 7% annual range – by far the highest level reached since 1982 (on the way down) and 1978 (on the way up). Inflation in this range has a profound impact on consumers, businesses and the economy as a whole - and it therefore will, potentially, materially affect equity markets in the near future. I use the qualifier "potentially" here because markets have so far largely shaken off the current surge in inflation as a transitory phenomenon.

Tied in with inflation, current interest rate levels and potential/likely Federal Reserve monetary policy action are very hot topics for equity investors right now. The debate revolves around, among other things, the Fed's expected response to the current inflation situation. Equity markets are, as always, sensitive to anything the Fed says about interest rates and monetary policy, but that phenomenon is more pronounced right now given the current inflation situation. Many market watchers have used the term "transitory" to describe the inflation situation through most of the surge. Fed Chairman Jay Powell commented in his testimony on January 11th that core inflation has been caused by a shift in consumer spending patterns away from spending on things like travel to spending on consumer durables (like household appliances) and vehicles, effectively blaming the pandemic for transitory core inflation. The implication is that, over time, the situation will correct itself. The Fed might well be correct on this, but only time will tell.

The Fed has had a very accommodative stance for a long time; except for the period of December 2015 to March of 2020, the Fed funds lower bound target rate has been zero since 2008. During most of that time the Fed has also been using a quantitative easing strategy to stimulate the economy and keep longer term interest rates low. Largely as a result of the Fed's actions, all interest rates are currently extremely low in the historic context and there is essentially nowhere to go but higher. Faced with high rates of inflation (among other things), the Fed will make monetary policy changes this year; the timing and extent of it are the two major unknowns.

It would be easy to say that a period of rising interest rates would be generally bad for equity markets. After all, the current value of any financial asset can be seen as the present value of future cash flows (i.e. in the case of equities, the potential sale price). Therefore, an increase to

[2] Note that the price of crude actually went negative for a short time in April of 2020.

interest rates can increase the discount rate and therefore decrease the present value of any asset. It is a good theory, but theories do not always work out in the real world of investing. While interest rates have been generally declining for decades, which makes analyzing the long term effect of interest rate movements on equities difficult, there have been periods of increasing interest rates in the recent past in which equities did just fine. I would postulate that corporate earnings, which are in many instances not materially affected by the level and changes of interest rates, are a far better determinant of the level and direction of equity prices over time.

Market Model and Outlook

Our market upside model, which is based only on average sell side target prices, now suggests a 15.6% one year upside potential to the all cap market, an attractive number in the historical context. I am calculating the market's forward P/E multiple at 20.5x, in line with the lower end of the recent range. About 93% of the Top 1,000 are showing positive upside to target prices, which is above average.

Equity markets largely shook off the effects of the delta surge and, so far, the same thing appears to be happening with omicron. I am hearing news stories about hospitals being overwhelmed, but it seems like that was also the case through most of the delta surge. Our healthcare system is much better able to handle the surges now; it is not like the original surge when the government had to do things like invoke the Defense Production Act to manufacture ventilators and mobilize huge hospital ships into major US ports. It seems highly unlikely that the federal or state governments will impose business shutdowns again, unless things get much worse from here.

Based on the trend over the past year or so, 4Q21 earnings season will probably be constructive for stocks. I am calculating expected annual earnings growth for the Top 500[3] at 9.3%, which I think is a positive factor in the overall equity market construct at this point in the cycle. As long as earnings and guidance keep up with expectations through earnings season then I think stocks are generally quite attractive right now.

Going back to March of 2009 there have been a few intense corrections including the nasty but short Covid-19 correction in the Spring of 2020 – but there has not been what most investors would consider a bear market since the one that ended in the Spring of 2009. Some might speculate that 2022 could see the end of the bull market given what is shaping up on the monetary policy front (among other things). While interest rates are sure to rise this year, they are starting from a very low level and it seems unlikely that the market is going to slam on the brakes any time soon. While continuing jitters and a correction seem likely this year, barring some catastrophe I do not think that we are close to heading into a bear market. As value investors, we would probably see a correction as a buying opportunity. All investing should be seen as a long term endeavor and equities have been a great place to invest over long periods of time.

Weekly Report, Conference Call and Podcast

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[3] The Top 500 is a subset of the Top 1,000 – the largest 500 companies (by market cap) in the Top 1,000.

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All analysis in this report was provided by Bryn Harman, CFA, PCM's Chief Executive Officer and Chief Investment Officer. Mr. Harman can be reached directly at 509-220-4253 or bharman@palousecap.com.

If readers have any questions about anything mentioned in this report please feel free to contact us any time at 800-624-3833. Readers can also refer to our website, www.palousecap.com, for more information and can email PCM's Chief Investment Officer directly at bharman@palousecap.com with any questions. Readers should not assume that any investments in the securities mentioned in this program were or will be profitable or will continue to be held in the future. Pursuant to Rule 206(4)-1(a)(2)(A) we will provide a list of all trades made on behalf of clients in the past year upon request.

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The PCM market model examines the universe of the 1,000 largest actively traded equities trading in the United States (referred to as the "Top 1,000"). The "Price to Earnings Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total estimated net income (from sell side estimates) for the respective market capitalization range or sector. The "Price to Book Value Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total last reported shareholder's equity for the respective market capitalization range or sector. "Upside to Target" is calculated using float adjusted market capitalization weightings and the one year upside potential to the average sell side target price for each security.

"Market cap" means market capitalization.

"LCV" refers to PCM's Large Cap Value Strategy.

"TR" means our Large Cap Total Return Strategy.

"SMID" means Small to Mid Capitalization and also refers to our Small/Mid Cap Value Strategy in certain contexts.

"ACT" means our All Cap Tilt Strategy.

"DI" means our Diversified Income Strategy.

"SPX" refers to the Standard & Poors® 500 Index ("S&P® 500"). The Standard and Poor's 500 Index is a free-float capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic equity market. The S&P 500 equal weighted index is the equal weighted version of the SPX. The S&P® High Dividend Yield Index measures the performance of 80 high dividend yield equities within the SPX. The S&P SmallCap 600® index is a capitalization weighted index that measures the performance of 600 small capitalization stocks.

The Russell 3000® Index is a float-adjusted, market capitalization weighted index comprised of equities of the 3000 largest domestic companies. The Russell 2500® index is a subset of the Russell 3000 index comprised of the 2500 smallest cap equities in the Russell 3000 and represents the SMID segment of the domestic equity market. The Russell® 2000 Index is a subset of the Russell 3000 index comprised of the 2000 smallest cap equities in the Russell 3000 index and represents the small cap segment of the domestic equity market.