BRIAN D. LOWDER, INC.

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INSIDE THIS ISSUE

FINANCIAL MARKET OVERVIEW

Once again, the stock market produced another unexpected and lopsided performance, but this time, we had a reversal of leadership in quarterly stock performance during the second quarter of 2021. During the 4th quarter of 2020, ***Value stocks*** led the advance and this leadership continued into the first quarter 2021: large-company value stocks were up over 10%, mid-size value stocks up nearly 13% and small-company value stocks up over 21%. During the second quarter of 2021, ***Growth stocks*** were up over 10% and value stocks up less than 5%. Year-to-date, all three major stock indexes are up nearly 13% to 15% and have set new records.

As stated in our previous newsletters, this rotation away from growth to value stocks during the fourth quarter 2020 and first quarter 2021 was good news and made sense. We were crawling out of the pandemic shutdown and the expectation was value or traditional/everyday companies would come back to life, not just a small group of darling stocks. During the previous three months, growth stocks have regained the spotlight and once again, the risk appetite for short-term trading in whatever stocks are going up is back in vogue.

The technology stock index was up over 11% during the second quarter compared to an 8% return on the total stock market. International stocks delivered slightly lower returns compared to the U.S. – up about 4% during the second quarter. Emerging markets (smaller-country international stock indexes) had slightly lower returns as well – up about 3.4%. Once again, energy stocks had a third consecutive quarter of superior returns up over 9% during the second quarter after earning nearly 30% during the first quarter and nearly 25% return during the fourth quarter of 2020. Investment real estate performed well – up 8% during the first quarter and up over 10% during the second quarter while home prices continued soaring. Water utility stocks were varied – some located outside California were up between 4%-7%, California water utilities posted negative returns as a drought is expected this Summer after a relatively light snow pack last winter. The price of Gold reversed course during the second quarter posting a 3.5% gain after falling 10% during the first quarter.

Fixed income or bond prices for short-term maturities were down for the second quarter in a row. Short-term Treasuries were down 0.10% while intermediate-term Treasuries posted a 2.27% positive return after falling more than 5% during the first quarter (down 3.72% year-to-date). Our previous newsletters have warned conservative investors that fixed income PRICES will continue to fall as interest rates rise. Interest rates offered on 10-year Treasuries jumped from 0.9% at the beginning of this year to 1.7% by March 31, 2021. The rate has dropped slightly during the second quarter from 1.7% to 1.5%. We will remind conservative investors again: Interest rates will continue to rise as the recovery advances. Expect negative returns for fixed income/bonds the foreseeable future.

The following chart displays sample returns of various asset categories during the second quarter of 2021 and calendar year-to-date:

Year-To-Date 2021	2nd Qtr. 2021	Index Return (***includes dividends reinvested***)
+ 12.73%	+ 4.61%	**Dow Jones Industrial Average (^DJI)**
+ 14.50%	+ 8.02%	**Standard & Poor's 500 Index (^GSPC)**
+ 14.48%	+ 7.80%	**DJ U.S. Total Stock Market (VTI)**
+ 12.58%	+ 11.70%	**Large-company stock-Growth (IWF)**
+ 16.01%	+ 4.67%	**Large-company stock-Value (IWD)**
+ 10.28%	+ 10.92%	**Mid-Size Stocks – Growth (IWP)**
+ 18.58%	+ 5.20%	**Mid-Size Stocks – Value (IWS)**
+ 8.72%	+ 3.65%	**Small-company stock- Growth (IWO)**
+ 25.82%	+ 3.97%	**Small-company stock- Value (IWN)**
+ 8.11%	+ 3.97%	**International (EFA)**
+ 6.74%	+ 3.39%	**Emerging Markets (EEM)**
+ 19.80%	+ 10.77%	**Real Estate Investment Trusts (VNQ)**
		Fixed Income (includes appreciation)
- 0.25%	- 0.10%	**Short-term U.S. Treasury (SHY)**
- 3.72%	+ 2.27%	**Intermediate U.S. Treasury (IEF)**
		Alternative Investment Category
- 7.14%	+ 3.54%	**Gold (GLD)**

**All returns calculated using adjusted historical quotes from finance.yahoo.com*

Continued on page 2

Continued from page 1

FINANCIAL MARKET OUTLOOK

Investors' appetite for taking risk in stocks, real estate, Bitcoin, etc. continues to rise (although Bitcoin has lost nearly half its value since March 31, 2021). The primary explanation: There is simply nowhere else to go (invest) when interest paid on conservative fixed income (bonds) investments are below 2% and short-term bonds and certificates of deposit pay less than 1%.

Stock prices, residential home values, commodities (metals, lumber, etc.) are up and continue to rise for two main two reasons. First, interest rates are so low, investors – especially conservative investors, are investing more funds into stocks because they receive next to zero interest income from investing in fixed income/bonds or bank accounts and after considering inflation, their ***real return*** is negative.

Second, our country (and the world) is coming out of the biggest economic shutdown in over 50 plus years. The demand for goods and services has been unleashed (now that the COVID virus appears to be in check) – yet the supply of goods has been cut to a bare minimum because businesses cut back and were in survival mode through the COVID shutdown. Retail inventories are at their *lowest level* since 1992.

Residential Home Prices have been surging for a year. Buyers are routinely offering $30,000 to $150,000 above asking price. The price jump in April (14.6% annual gain) was the highest rate in over 30 years – in San Diego alone, the price annual increase was 21.6%. The National Association of Realtors reported that the median existing-home price for all housing types in MAY 2021 have increased 23.6% since MAY, 2020.

Why has home prices jumped so much in just one year and will it continue? The primary reason for the price jump is ultra-low interest (mortgage) rates. Earlier this year, buyers who qualify have been able to secure a home loan at a 2.75% - 3% fixed interest rate for 30 years. The average home mortgage rate prior to 2020 has averaged around 4% since 2012 and between 5% and 6% from 2003 to 2012.

A simple 1% lower home mortgage interest rate on an $800,000 loan (assumes a 1 million purchase price with a 20% down payment and a 2.75% interest rate compared to a 3.75% mortgage rate) results in a savings of $439 per month or $5,260 per year. Alternatively, a buyer can choose to **pay $100,000 more** or a 1.1 million purchase price for a new home with a $100,000 larger loan ($900,000) and *still have the same monthly mortgage payment* compared to a $800,000 loan at 3.75%. What would you do?

The reason for the recent 20% plus gain in home prices certainly is not because most families became wealthier during the COVID crisis. How much longer can home prices increase or alternatively, when will home prices stabilize or begin to fall? Answer: <u>When interest rates begin to rise</u>. Are rising interest rates likely? Yes – continue reading.

Stock Prices have been rising substantially since 2019 – even during the dreaded 2020 COVID year and into 2021. Stocks were up about 30% in 2019 and last year, anything related to work-at-home, electric cars, and a few dominant companies (Apple, Microsoft, Amazon, Alphabet - formerly known as Google, and Facebook) performed very well and the overall stock market was up more than 15%. In 2021 the overall stock market is up 14% through June. Keep in mind, a few very large companies are mostly responsible for the gain as the average stock is up less than one-half of these figures.

Even under the worst of economic circumstances related to the COVID crisis, the S&P 500 has gained for 5 consecutive quarters in a row AND has gained more than 5% each time for five quarters in a row. This has only happened one other time since 1945.

So, after 2 ½ years of stellar stock price performance, is change coming that will cause a pause, a temporary decline or reversal of fortune for stocks and if so, what will cause a correction and when?

Investors need to reflect on the reasons for the recent above-average stock market performance and more importantly, assess whether the market climate will allow for further gains <u>in the future</u>. Certainly, the COVID crisis and all of the extraordinary measures our government took to calm and support the economy and financial markets are OVER and won't repeat.

Rising interest rates are a certainty. COVID checks will soon be ending. Higher personal and corporate tax rates are a near-certainty and other tax benefits may soon be lost as well (no more step-up in cost basis to fair market value on the date of death).

More importantly, investors need to understand that the overall stock market is an anticipatory machine. The stock market moves well-ahead of today's reality – the recent annual returns already reflect very high expectations that the economy will be far better off in a year or so than it is today.

In addition to very low interest rates, we are more knowledgeable about how to effectively treat the COVID virus and jobs are available everywhere. ***An inevitable rise in the inflation rate*** is coming – it is actually already underway.

The Federal Reserve Chairman and our President are trying gallantly to assure the public and investors that the inevitable increase in interest rates is not near (sometime after 2022) and that inflation will only be a temporary blip once our companies get back to full production and our economy adjusts to the enormous increased demand for goods and services. In just three months (March compared to June)

Continued on page 3

Continued from page 2

time, their story has changed. The Fed stated or estimated that short-term borrowing rates for corporations and the government would be 0% to 0.25% until the end of 2023. Three months later in June, their forecast suddenly changed – forecasting the same borrowing rate to be 2.4% by the end of 2023.

Simply observe the current prices for everyday goods as evidence for rising inflation. Many items cannot be found or ordered and received in a reasonable time: Chlorine and pumps for pools, lumber, freon for air conditioning, gasoline is hovering around $5 per gallon, restaurants are charging a 15% or more surcharge on your bill, try getting a rental car at any National Park, Hawaiian Islands etc. for less than $100 per day, clothing, grocery store items, home prices, etc. and the list goes on and on.

Price increases have already started and more are on the way. As prices increase, so do interest and inflation rates. Do you think wages can stay the same under higher home and rent prices as well as all of the items mentioned above? If wages don't go up, then employees/workers have less buying power with the same payroll check. Rising interest and inflation rates are coming - we can debate how much of an increase and for how long at another time. At the very least, it seems sensible and more probable to assume inflation will remain elevated and rise compared to its recent history under COVID …… at least until the end of 2022.

There's more. Our government debt is staggering and growing (resulting in an inevitable impact on interest rate increases). Our Government Debt is now equal to 100% of what we produce – Gross National Product. That's right – we have already borrowed as much as our country produces in a year. And, there's no end in sight as a new Budget and "Infrastructure" Spending Bill is currently estimated at 3 trillion dollars. The only positive with this topic is that Americans are ***currently*** only paying 2% or less (via income taxes and other fees our government collects from us) interest on this debt – forget about actually paying it off. When I came into this field in the mid-1980's, the interest rate or cost was 14%. You can easily imagine what happens to your quality of life when your personal debt cost rises from less than 2% - certainly a low point - to somewhere between 5% and the highest rate of 14% during my lifetime.

So, the headwinds are: high probability of rising interest and inflation rates, higher income tax rates, higher home prices, larger government debt and 3 trillion more debt that our Congress and White House wish to spend, the unknown impact (if any) from the new Delta Variant of the COVID virus, and a stock market that has already performed exceptionally well over the previous 2.5 years in spite of a nearly closed economy and the COVID virus.

And how about this as a final observation just to emphasize the willingness of a growing group of investors to take on excessive and growing levels of risk without much consideration for looking forward. **Robinhood** – the online company that allows quick trading in stocks, stock options and Cryptocurrencies at no commission cost – is going public in an Initial Public Offering.

Robinhood was just levied a RECORD 70 million dollar fine by the Financial Industry Regulatory Authority for giving false or misleading information to customers and for operating an online platform so unreliable, that it repeatedly falters or shuts down at key moments (rapid and large trading in one security) and not to mention the more than 50 lawsuits pending from customers damaged by trading halts. Robinhood boasts that is has over 18 million customer accounts compared to Charles Schwab who has 32 million active accounts. The difference: The average account size at Robinhood is $5,000 and median account size is $240. Small account sizes for primarily day traders and high risk "investing". Further, 88% of Robinhood's revenue comes from options and Cryptocurrency trading.

So, investors need to consider and assess whether or not the financial markets are reasonably priced going forward and whether excessive risk and optimism in the face of upcoming challenges discussed above are greater than the perceived rewards.

Investment Outlook and Recommendations

The stock market will continue exhibiting more daily and weekly volatility; however, the uncertainty and risks have changed. Attention is now refocusing away from COVID, political elections and a shutdown economy to an accelerating economy, inevitable rising interest and inflation rates, and higher tax rates. The stock market has continuously set new records every week under the expectation that economic growth can only get better than where we were just six months to one year ago.

Stocks do have an equal probability of continued advancement. The best advice/suggestion is look away from the glamour stocks of last year (electric vehicles, stay-at-home products and services and big tech). Traditional "value" stocks – every day companies that have been around for many years are very cheap on a comparable basis. This category is much safer than growth and tech stocks plus many of these companies pay 2% to 5% dividend income. This category is very attractive from a future price gain perspective, is fairly valued and a good source to pursue higher income that clients are losing in the low interest rate fixed income category.

Besides rising interest and inflation rates, another relevant risk is delays and poor/slow execution by our politicians in leading this country forward. The COVID card has already been played and any slow execution will adversely affect the "already priced in" expectations of stocks. Honestly, in today's environment, it doesn't matter which party is "in

Continued on Page 4

Continued from page 3

control" of the Presidency or Congress. The object of their game is to bash and prevent the "other side" from accomplishing anything. The only difference now is the two parties have changed seats and now one side will try and prevent the other from succeeding.

International stocks are also an attractive asset class as most countries are well behind the U.S. in "getting back to normal" and their stock prices have not advanced anywhere near as much as the U.S. The international stock market is a better buy on a relative basis (to the U.S) – normally, it's the opposite.

Recently, the biggest change or shift in our clients' asset allocation was the addition of Treasury Inflation Protected Securities or TIPS. TIPS are indexed to inflation in order to protect investors from a decline in the purchasing power of their money. As inflation rises, TIPS adjust in price to maintain its real principal value the fixed income.   Since we do not favor most fixed income investments at this time, TIPS are a welcome addition to the fixed income asset class. TIPS are issued by the U.S. Government and basically go up in value in step with inflation. As stated earlier, rising inflation and interest rates are a nearly certain, the only unknown is when and how fast will these rates rise.

The other addition to client portfolios was metals – specifically the gold metal itself and gold mining stock companies for the same reasons: expected higher interest and inflation rates. We have added at least a 5% to 10% allocation to metals and up to twice that percentage amount in Treasury Inflation Protected Securities. It is likely additional increases to metals and TIPS will occur during the third quarter.

We will maintain our current asset allocation (proportional exposure to stocks, fixed income, etc.) for most client portfolios for now. An allocation increase is likely for international stocks, value stocks, metals and TIPS.

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