PARKSIDE INVESTMENTS

Market Review and Outlook

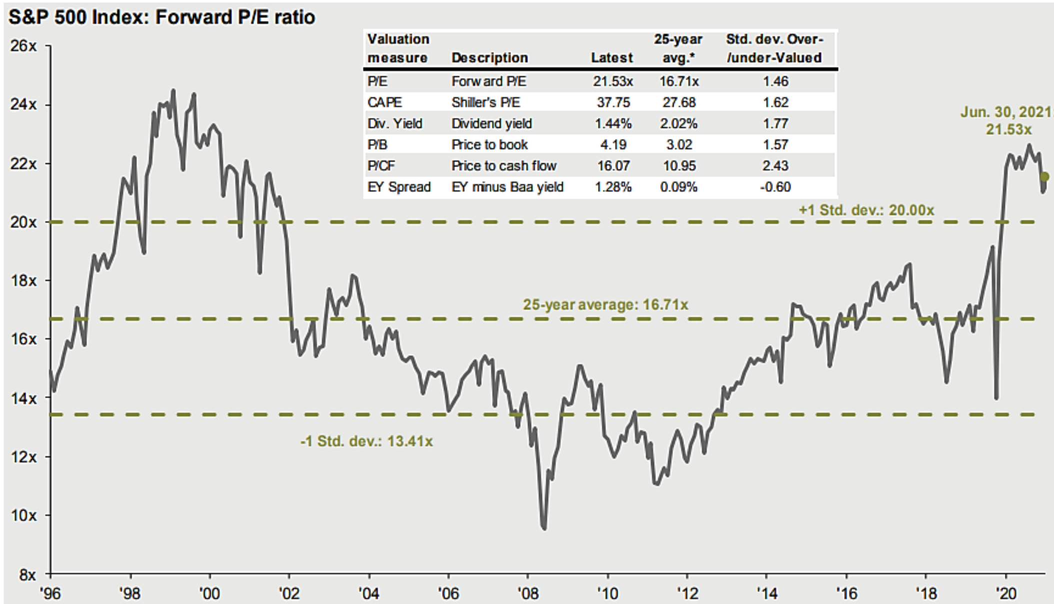
Global equity markets delivered another batch of positive returns in the second quarter, with investors emboldened by continued economic improvement and a rapid recovery in corporate earnings. Domestic stocks led the rally and closed at a new market high, as the S&P 500 posted a second-quarter total return of 8.6% (+15.3% YTD)—marking its fifth consecutive quarter of gains. Overseas, the story was similar; developed international equities (EAFE) closed the quarter up another 5.4% (+9.2% YTD), while emerging markets (EM) reported a second-quarter gain of 5.1% (+7.6% YTD).

The combination of widespread vaccine distribution, sustained government stimulus, and the general population's desire to resume pre-lockdown activities is spurring accelerated economic expansion. Current consensus U.S. gross domestic product (GDP) projections for 2021 have been increased to a multi-decade high of 6.6% (up an additional 2.5% since the start of the year). Actual GDP growth could ultimately surpass that figure by year end, as excess slack in the economy leaves room for further improvement. For instance, while the U.S. unemployment rate has fallen from a high of 14.8% in April 2020 to 5.9% in June 2021, labor shortages (particularly in leisure and hospitality) are preventing many businesses from fully reopening. Short-term supply chain bottlenecks in construction, transportation, semiconductor production and agriculture are also holding back economic expansion. Assuming time helps to ease supply chain constraints in the coming months, and labor force participation increases ahead of the September expiration of generous federal unemployment benefits (with 25 states ending benefits even earlier), the economy could continue to advance at an accelerated pace through the balance of the year.

A byproduct of robust economic growth, however, is increased inflationary pressure. Inflation became a hot-button issue during the quarter and a source of market volatility after the Fed's preferred measure of inflation, the Core Personal Consumption Expenditure (PCE) Index, increased by more than 3.0% year-over-year in April (and May)—the highest reading since 1992. Investors have persistent concerns that higher inflation will force the Federal Reserve to stop buying assets or even raise interest rates sooner than expected. The Fed tried to temper those fears at its June 16th meeting, reiterating its belief that inflationary pressures are "transitory" and that no rate hikes are likely until at least 2023. While a reduction in the Fed's bond purchasing activity will precede that, perhaps as early as late this year or early next year, dialing back crisis-level monetary support would be a necessary and constructive response if the economy continues to grow.

Over the medium term, we believe the economy can continue to expand at a healthy pace while keeping inflation at or near the Fed's 2.0% "average" target. Temporary surges above that threshold are possible, but a damaging and protracted inflation spiral seems unlikely in our view. Globalization and technological advances—the two most important secular forces that have kept inflation in check the past couple decades—are unlikely to reverse anytime soon. These influences, coupled with the Fed's mandate to ensure stable prices, should keep the risk of crippling inflation at bay.

Given this supportive economic backdrop, the corporate profit outlook is as bright as it has been in a long time and continues to strengthen. Based on FactSet estimates, S&P 500 earnings are now expected to increase 37% in 2021 (vs. the 22% growth forecast at the start of year), followed by 12% earnings growth in 2022. The improved earnings outlook has pulled the market's forward P/E multiple down to 21.5x (from a post-pandemic peak of 24.0x), but stock valuations remain quite high by almost all measures (except against interest rates).



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.53x	16.71x	1.46
CAPE	Shiller's P/E	37.75	27.68	1.62
Div. Yield	Dividend yield	1.44%	2.02%	1.77
P/B	Price to book	4.19	3.02	1.57
P/CF	Price to cash flow	16.07	10.95	2.43
EY Spread	EY minus Baa yield	1.28%	0.09%	-0.60

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, JP Morgan Asset Management

In isolation, above-average market valuations are not overly concerning (at least near term). Longer term, we believe market returns will be tempered by today's elevated valuations, but the combination of excess liquidity and the TINA ("there is no alternative") effect could continue to propel equities higher in the coming months. The froth and speculation permeating certain parts of the market, however, is worrisome. For instance, the so-called "meme" (or fad) stocks, such as GameStop and AMC Entertainment, are being driven by social sentiment rather than grounded underlying fundamentals. There's a danger that these pockets of euphoria are starting to spread to the broader market as well, which could potentially lead to unsustainable, bubble-like conditions.

We continue to keep a watchful eye on the risks posed by rising interest rates, inflation, stretched market sentiment, and the emergence of new COVID-19 variants. With valuations near historic highs, equities do not have much of a safety margin and could be vulnerable to a correction. The S&P 500 hasn't experienced a 5% correction in more than 8 months (October 2020)—versus the historical average of every 3.5 months—so a modest pullback is seemingly overdue. That said, we still believe the most prudent course for equity market participants is to remain broadly invested to capture the benefits of global reopening. By actively selecting those companies with high-quality business models, sensible balance sheets, and reasonable valuations, we believe our carefully-constructed equity portfolio can continue to generate value as the cycle progresses.

Core Portfolio

During the quarter, we purchased (repurchased) Discovery Communications.

Discovery is a media company that traditionally used cable operators to broadcast its non-scripted content, but has more recently entered the streaming landscape with the launch of Discovery+. We've long believed the market significantly underappreciated the value of Discovery's content and its ability to remain relevant amidst the secular trend in cord cutting. We had previously been multi-year owners of the stock, but sold our original stake in the company in March after the shares had more than tripled from their October 2020 lows and reached a valuation level that we felt fully priced in Discovery's medium-term growth prospects. Almost immediately after our first-quarter exit, Discovery shares cratered when one of its largest shareholders (Archegos Capital Management) became insolvent. The insolvency caused a forced liquidation of shares held by Archegos and the investment banks that served as its prime brokers. This sent the stock price careening back well below our long-term fair value estimate for the company, so we took the opportunity to reinvest in Discovery at what we think will prove to be a substantial/temporary discount to its intrinsic value.

We exited our position in Box Inc. during the second quarter.

Box provides cloud-based enterprise collaboration software enabling users to manage, share, and store content in a secure ecosystem. With the secular growth outlook for cloud-based computing and remote working, we saw a huge opportunity for Box to capitalize on these trends with its collaboration solutions. Although the company competes in the cloud services market against well-capitalized companies like Microsoft and Alphabet, we believed its software provided unique capabilities that enterprise customers would value. That thesis increasingly came under pressure, however, as Box consistently delivered underwhelming execution in terms of both customer growth and profitability. In addition, the company recently announced a financing deal with an outside investor that we viewed as unnecessary and dilutive to existing shareholders. As a result, we decided to sell our holding in the company, using the proceeds to fund more compelling investment opportunities.

Fixed Income

The 10-year Treasury yield, which began 2021 at 0.93% and spiked to a 14-month high of 1.74% by the end of March, closed the second quarter at 1.45%. Despite being up for the year, the recent drop in the 10-year yield indicates that bond investors expect inflationary pressures to remain benign and the Fed to maintain its accommodative policies. The bond market is often viewed as a more dependable barometer of future economic growth and inflation expectations than the erratic stock market. Nonetheless, current long-dated treasury yields appear to offer little protection (let alone upside) in an improving economic climate. Investors will eventually demand compensation for the rising risk of inflation and higher interest rates if sustained economic growth persists. This suggests interest rates are much more likely to move higher (as opposed to lower) over the medium term. Against this backdrop, we maintain our cautious view on longer duration bonds and continue to seek safety over yield by investing in securities at the shorter and intermediate portion of the interest rate curve.

Final Thoughts

As always, thank you for your continued support and confidence. Please do not hesitate to reach out to us with questions or to stop by and see us at one of our two offices (both of which are now open).

Parkside Investments, LLC

July 8, 2021

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Benchmark performance shown for various market indices is shown with interest and dividends reinvested and gross of all fees and expenses. An investor's individual performance would include interest and dividends reinvested, but would be net of all fees and expenses incurred from transactions and management of their portfolio. No one can invest directly in a benchmark.

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