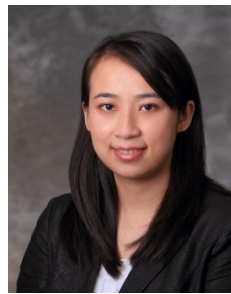




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## **MBI Quarterly Commentary 2021 Q2**

*“When things go badly, people become cautious. Then their caution causes things to go well, and when things go well, they become incautious. I think that’s a forever cycle.”*  
- Howard Marks

We hope all is well with you and your family and you are enjoying the summer. As always, we will share our commentary regarding the important events that happened this quarter and share our current ideas and concerns. From the market perspective, value-oriented sectors, such as financial services, industrials and basic materials, continued to outperform other sectors in the 2<sup>nd</sup> quarter of the year. However, we observed a significant increase in investor interest in growth-oriented sectors, such as technology and consumer discretionary stocks, closer to the end of the quarter.

Higher than average inflation, and the potential for additional increases in the near future, remains one of the main discussion topics in the financial media and with our clients. We will outline our thoughts on the prospects of higher inflation and strategies that can help in such an environment in this commentary. Overall, the economy and financial markets remain at a comfortable, but perhaps elevated levels, with overall sentiment favoring more risky types of investments. We expect to see more market volatility over the next several months.

The table on the following page summarizes the performance of various domestic equity categories over the past 3-month, year-to-date (YTD) and 3-year periods.

3 Month Return % as of 6-30-2021				YTD Return % as of 6-30-2021				3 Yr. Annualized Return % as of 6-30-2021									
3.82%	7.86%	15.42%	9.20%	Large Cap	14.34%	12.95%	14.58%	14.47%	Large Cap	11.36%	18.96%	24.95%	19.89%	Large Cap			
4.19%	6.75%	11.33%	7.17%		Mid Cap	22.12%	16.15%	9.52%		15.75%	Mid Cap	9.12%	15.77%		24.79%	16.93%	Mid Cap
5.41%	2.52%	4.79%	4.23%			Small Cap	27.99%	17.65%		4.34%		16.34%	Small Cap		8.48%	10.63%	
4.03%	7.20%	13.90%	8.37%		US Market		17.03%	13.15%		14.60%	14.88%	US Market			10.76%	17.89%	26.24%
Value	Core	Growth			Value	Core	Growth			Value	Core	Growth					

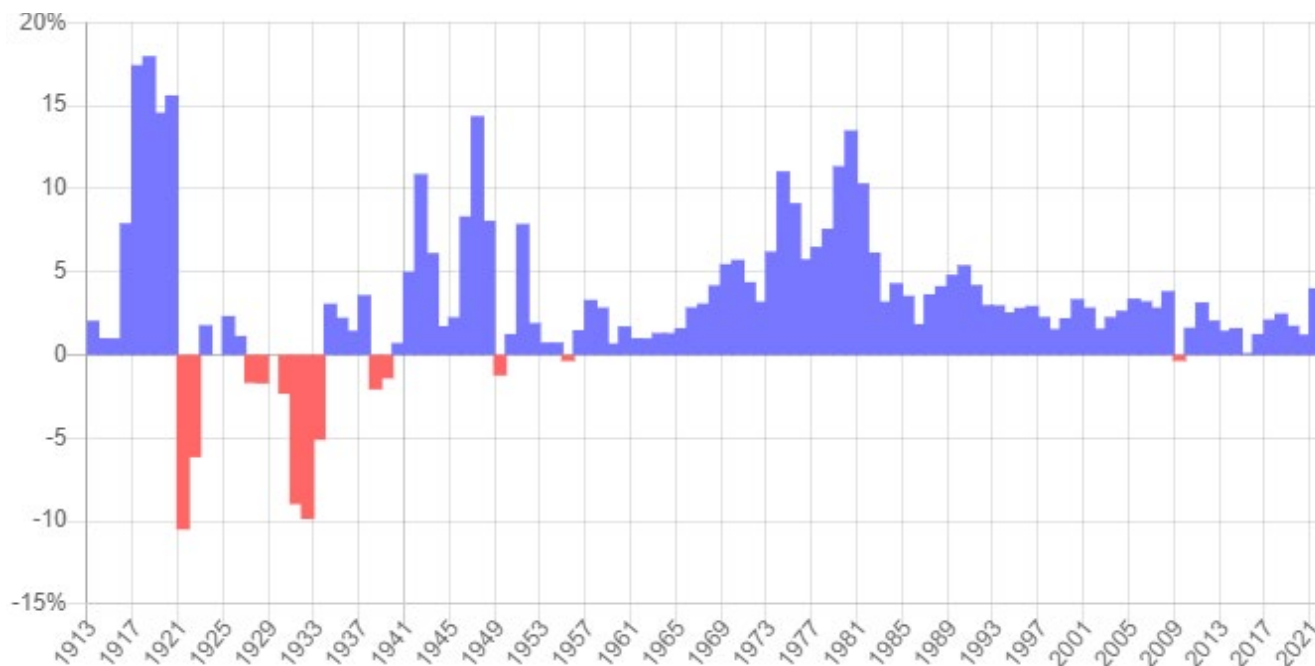
Source: Morningstar

The U.S. stock market continued to outperform the equities of most major developed and developing countries in the 2<sup>nd</sup> quarter and YTD. Developed markets, as measured by the MSCI EAFE Index, were up +5.23% and +8.89% for the quarter and YTD, respectively. Emerging markets, as a group, increased by +5.16% and +8.91% for the same time periods as reported by the FTSE Emerging Markets (EM) Index. Stocks of Chinese companies that represent the majority of most emerging market indices increased by +2.16% for the quarter and only +1.65% YTD. We note a significant portion of positive performance in the emerging markets category can be explained by the commodity driven economies such as Brazil, Russia and South Africa.

The investment returns of most domestic fixed income investments have improved in the 2<sup>nd</sup> quarter of the year. The yield on the 10-Year Treasury, which is considered to be one of the most important benchmarks for overall interest rates, declined from +1.75% to +1.44% throughout the quarter (decrease of -18%). As a reminder, the yield almost doubled in the first quarter of the year. There is a strong negative correlation between interest rates and bond prices (i.e. they tend to move in the opposite direction). One of the reasons for the decline is lowered expectations for the size and continuation of the fiscal and monetary stimulus over the next several quarters. As a result, the economic expansion may peak in the summer and cool down closer to the end of the year. This may also result in lower overall inflation and, therefore, reduce the probability of interest rate increases by the Federal Reserve Bank.

As we discussed in our previous market commentary, our overall preference is to underweight the allocation to fixed income investments and/or match it with each client's specific portfolio cash needs. Bonds and other fixed income investments continue to be an important asset class from the perspectives of portfolio risk management and diversification. However, based on the current market conditions, some of the bond categories simply do not provide the risk/reward characteristics that would make them sensible investments. This is particularly true for those of our clients who have more flexibility when it comes to their portfolio cash needs. Many traditional bond categories offer only a few percentage points of yield that would be entirely offset by even moderate inflation.

As we mentioned earlier in this commentary, inflation and related questions have been some of the most heavily discussed topics over the past several months. The Consumer Price Index (CPI) rose to 5.0% year-over-year (YOY) in May of this year. The previous YOY figure was at 4.2%. Both are significantly higher than the 1.4% rate we experienced in December and even lower throughout the entire year 2020. Overall, we would expect to see more inflation when the economy is recovering or expanding at a much higher rate than on average. What investors are particularly concerned about is so-called "run-away" inflation that was last experienced in the late 1970s and early 1980s in the U.S. There are relatively few policies that can be effectively utilized in such environment, at least in the short-term. The effects of such scenarios can be quite devastating, especially for those who live on fixed income. The table on the following page summarized the annual inflation rates in the U.S. since 1913.



Source: BLS.com

There are two major ways of thinking about inflation and its near-term prospects. One idea, regularly promoted by the Fed Chairman Jerome Powell, is that most of current inflation is “transitory” and can be explained by the pent-up demand for goods and services that were under-consumed in 2020 due to the Coronavirus related restrictions. Once the initial demand has been satisfied, the overall economic growth and, as a result, inflation will go back to the normal or target level of approximately 2.0% per year. There are other factors that would impact this way of thinking, but the overall idea is that the level of inflation we are currently experiencing is temporary. There is certainly some strong basis for this thought process given the unprecedented restrictions and economic decline we experienced last year.

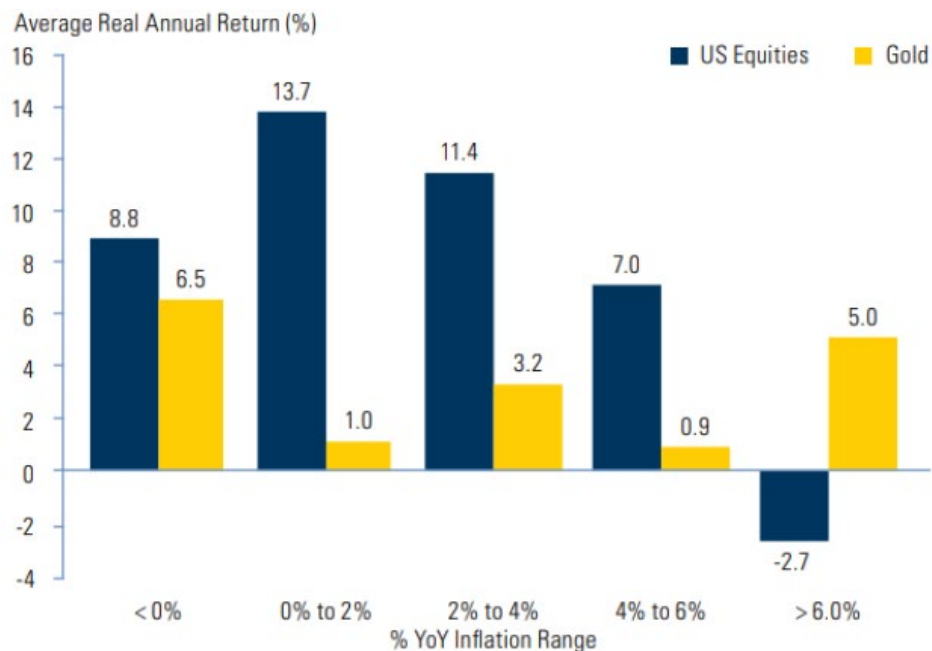
The contrary way of analyzing our current situation is that this is just the “beginning” and we will experience even higher levels of inflation throughout the year that would likely spill into 2022 and even beyond. This thesis is supported by the incredible amounts of liquidity that is being injected into the financial system by the Fed (i.e. “helicopter money”). The Biden administration is working on multiple stimulus packages that are designed to stimulate the economy even further and will likely have inflationary effects in either short- and/or intermediate-term. This is in

addition to the record-high national debt-to-GDP ratio of more than 120% (this ratio was at 35% in 1980 and 57% in 2020). Some of the articles and white papers that we reviewed on this perspective paint a truly dramatic picture.

Our perspective on the subject is somewhere in between these two drastically different viewpoints. Some of the inflation caused by the pent-up demand for goods and services will likely dissipate over the next several months or quarters. The demand for travel and durable goods is a good example of “transitory” effects of post-pandemic recovery. There is only but so many trips we can take or refrigerators we need at any given time period. Some of the shortages are caused by the disruption in global supply chains and will take longer to be resolved (e.g. semi-conductors and other computer parts). We are more concerned about the labor market deficiencies and structural changes that are happening in the post-Covid environment. As an example, there is a nation-wide shortage of skilled blue-collar laborers that even worsened due to Covid. Those who possess such skills have significant negotiating power over their compensation packages. Once a certain level of pay is achieved and expected, it would be challenging for employers to adjust the salaries once the demand for the services declines. This may result in higher levels of structural inflation and for longer periods.

Regardless of your personal perspectives on inflation, we believe it is prudent to take proactive steps to increase the probability of adequately protecting your portfolio against inflation. There are multiple ways of accomplishing this goal and we will briefly outline some of the ideas in this commentary.

When appropriate, based on your personal risk tolerance and portfolio cash needs, we believe that increasing your allocation to equities will provide significant protection against inflation. The performance of certain sectors, such as financials, has a strong positive correlation with rising inflation. Other types of companies that can pass their increased costs to the end consumers, such as the Real Estate Investment Trusts (REIT), are also good inflation hedges. Gold is a traditional “go-to” investment for those who want to protect the purchasing power of their portfolio. However, as you can observe on the chart on the following page, domestic equities tend to provide more protection in most moderate inflation scenarios.



Source: Data from 1926 to 2020, Goldman Sachs, Bureau of Labor Statistics, Bloomberg, Ibbotson

In terms of the interest rate updates, we experienced a minor market “scare” when the Fed indicated that the economy is expanding at an acceptable pace and there is a possibility of interest rate increases in 2022. Prior to this announcement, it was widely accepted that the Fed rate will remain at the current level, 0% to 0.25%, at least until 2023. It is also possible that the central bank will begin to taper down its monthly \$120 billion bond purchase in the fall. We believe Chairman Powell has been consistent and timely with the policy announcements and adjustments, especially in March of last year. Nevertheless, any discussions regarding potential interest rate hikes and deceleration of bond purchases will likely result in market volatility.

For the economic updates, the Fed’s forecast for the U.S. gross domestic product (GDP) increased to +7.0% for the year. The previous forecast that was released in March pointed to an increase of +6.5% for the year. For the 2<sup>nd</sup> quarter, the GDP is expected to increase by as much as 10%. However, as we indicated earlier in this commentary, many economists predict the growth to peak over the summer months and slow down closer to the end of the year.

As of June, the unemployment rate in the U.S. remained at a relatively high rate of 5.9%. This figure indicates a significant improvement when compared to the unemployment rate we experienced at the end of 2020, 6.7%. However, the official figure actually increased when compared to the previous period, 5.8% in May 2021. The unemployment situation will likely improve once the enhanced unemployment benefits are either eliminated or re-directed toward other purposes (e.g. one-time bonus for those who find jobs in certain industries). We note that the Fed's objective is to "conduct the nation's monetary policy to support the goals of *maximum employment*, stable prices, and moderate long-term interest rates." As a result, it is entirely possible that no significant policy changes will be made until the overall employment situation has been improved.

We expect the market volatility to increase over the summer months. There are several reasons why we believe in such possibility. First, we haven't experienced a "true" market correction for more than fifteen months since March of last year. The valuations of some of the equity categories, such as mid- and small-cap domestic stocks, appear to be elevated and we normally expect at least one or two market corrections each year. Second, as we indicated earlier, investors are becoming more sensitive to any hawkish updates from the Fed. Third, the Delta variant of Covid-19 appears to be more aggressive than originally expected and may have significant impact on the economic recovery, especially in the regions that have lower vaccination rates. Finally, the overall market sentiment appears to be even more bullish compared to where we were in the previous quarter. When such sentiment changes, the markets tend to react quite rapidly to any news that are not only negative, but perhaps simply not as good as originally expected.

As always, we strongly believe that the best approach to any market circumstances is to have a plan in place that would allow you to *take advantage* of the potential market volatility. As many of you know, we fully rebalance our managed accounts at least semi-annually to adjust the allocations based on each specific investment policy and our market outlook.

In addition to the ideas discussed earlier in this commentary, some of the adjustments we plan to make include reducing the allocations to mid- and small-cap domestic stocks, especially

those in the “value” category. These types of investments tend to be more cyclical and perform best when the economy is expected to rapidly improve (i.e. earlier parts of the business cycle). We will also adjust our international stock allocations with the goal of increasing the percentage allocated to developed markets, specifically European stocks. These markets are still in the early stages of the recovery and will likely benefit from the massive stimulus efforts by the European Central Bank (ECB) and other government entities. It is worth mentioning that any of these adjustments would be made in conjunction with the specific goals and risk tolerance of each client and portfolio.

For those of you who are interested in our most recent market ideas, please consider our next webinar titled “**Quarterly Investment Update and Financial Considerations**” (Tuesday, July 27, at 12:00 pm EST). You may also be interested in our financial planning webinar on “**Maximizing Social Security Benefits and Avoiding Mistakes**” (Thursday, July 22, at 11:00 am EST). [Click here to register](#) and receive updates about these webinars.

Thank you and stay safe and healthy!



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