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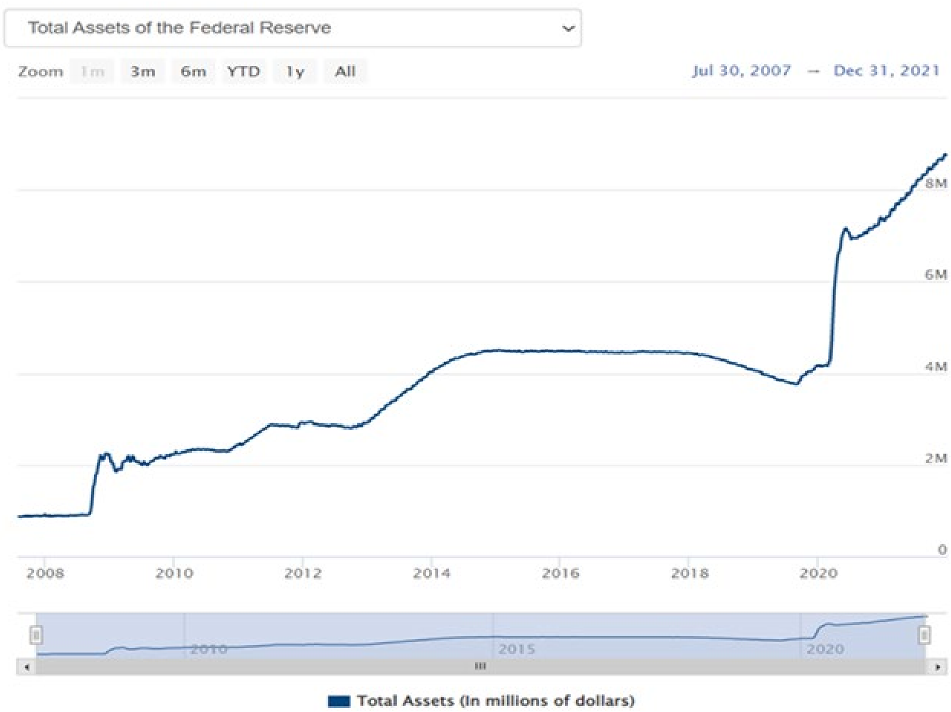
Prospector Partners Quarterly Commentary

Current Market Environment

Don't Fight The Fed

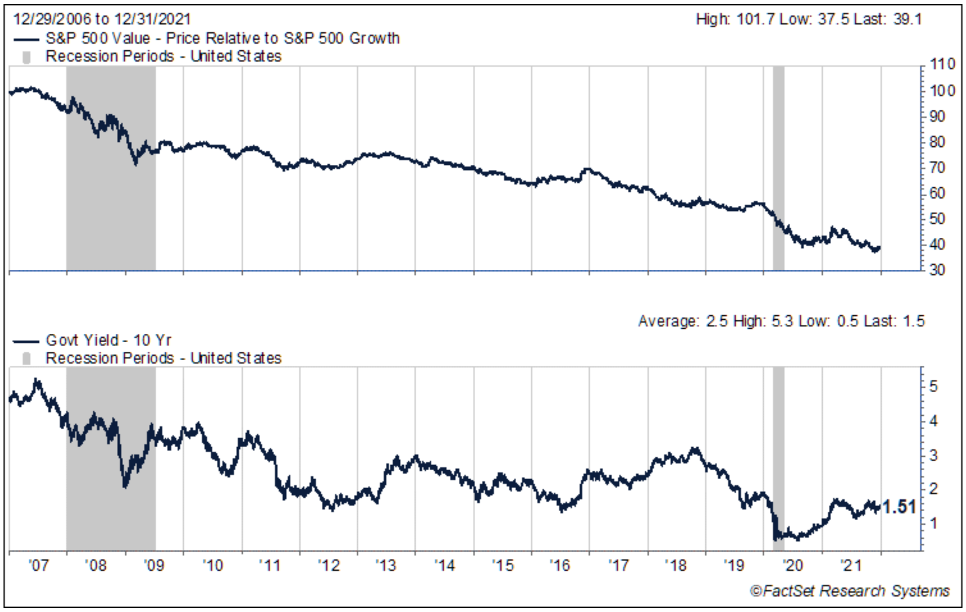
2021 began with a hopeful optimism of a soon-to-be vaccinated world, and our being able to put the COVID-19 pandemic in the rearview mirror. As the year progressed however, the reality was less sanguine, and a rollercoaster ride of setbacks, followed by incremental positives, followed by more setbacks ensued. An initially disjointed vaccine rollout gained momentum in the spring, but the take rate in the U.S. has been behind other industrialized nations. Additionally, by late summer it became apparent that COVID-19 was likely to become endemic, as the virus went through various mutations and the Delta variant caused a spike in infections – including reinfections and so called "breakthrough" cases of vaccinated individuals (although the vaccines remained highly effective against hospitalizations). Then, as we celebrated Thanksgiving, South Africa broke the news of the even more contagious Omicron variant, which would soon cause another, even worse spike. As of this writing, the U.S. is experiencing record daily cases and hospitalizations.

Despite these new variants, and other pandemic-related setbacks (e.g., supply-chain disruptions, worker shortages, and corresponding goods and services inflation), as well as non-COVID related concerns (e.g., the debt default of Chinese property developer Evergrande), the stock market climbed each of these proverbial "walls of worry" and the benchmark S&P 500 gained 28.7% for the year, setting 70 record highs along the way. Putting this march higher into further context: the benchmark closed the year fully 40% above its pre-pandemic high. While the multi-trillion dollar fiscal stimulus packages helped the U.S. consumer manage through the pandemic, this effort has been dwarfed by super-dovish Fed policy. In addition to holding interest rates low, the Federal Reserve has injected almost $5 trillion dollars into the economy via Quantitative Easing (see below chart for context), and is surely to thank for much of the market's ebullience.



Source: U.S. Federal Reserve

Given the Fed is now tapering asset purchases, and stands ready to raise interest rates in the upcoming months, this raises the inevitable question as to whether a more hawkish Fed will be bad for stocks. History is inconclusive when it comes to the overall market's behavior during a period of Fed tightening. And, while there certainly will be stocks which are directly impacted by a higher Fed Funds Rate, we feel that focusing on Fed tightening alone would be missing the forest for the trees. More important in our minds, is the overall level of longer-term interest rates. A defining characteristic of the stock market over the past decade-plus has been the dominance of growth stocks over their value brethren. As can be seen in the following chart, this trend has had a very high correlation with ever-declining long-term bond yields during that period.

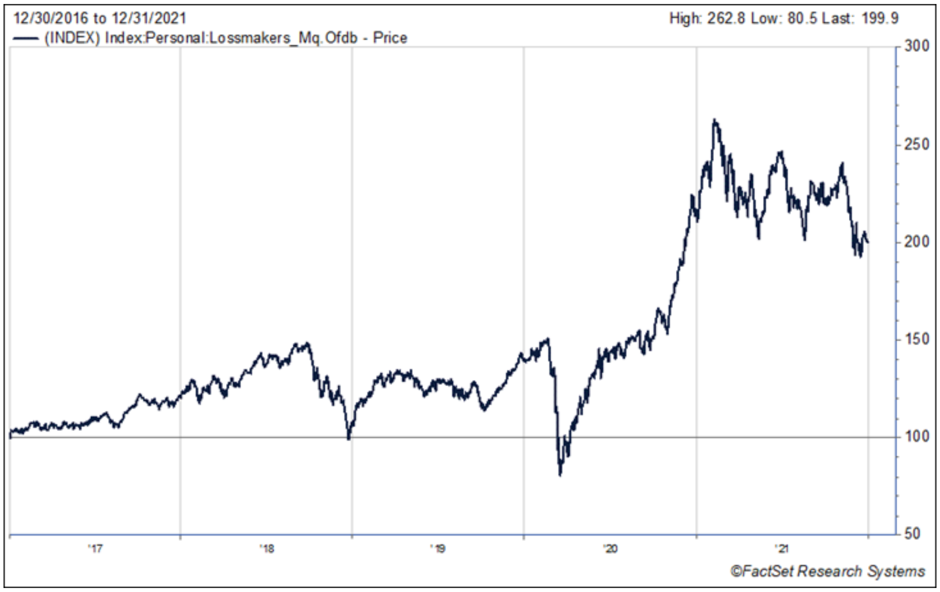


Whether long-term bond yields will continue higher depends on a number of factors: the economy's continued strength, the persistence of inflation, and whether the Fed acts too soon to name a few. On the latter point, we take the Fed at their word that they are willing to let inflation "run hot" for a bit, rather than act too soon – seemingly having learned a lesson from hiking rates too early following the Great Financial Crisis. While it remains to be seen how a less accommodative Fed will impact the overall stock market, as we've stated in past communications…we are much more comfortable with the risk / reward prospects of the value stocks held in your portfolio – especially when compared to the more richly-valued growth names which have been market favorites for so long, or the mega-cap technology stocks which dominate the S&P 500 Index.

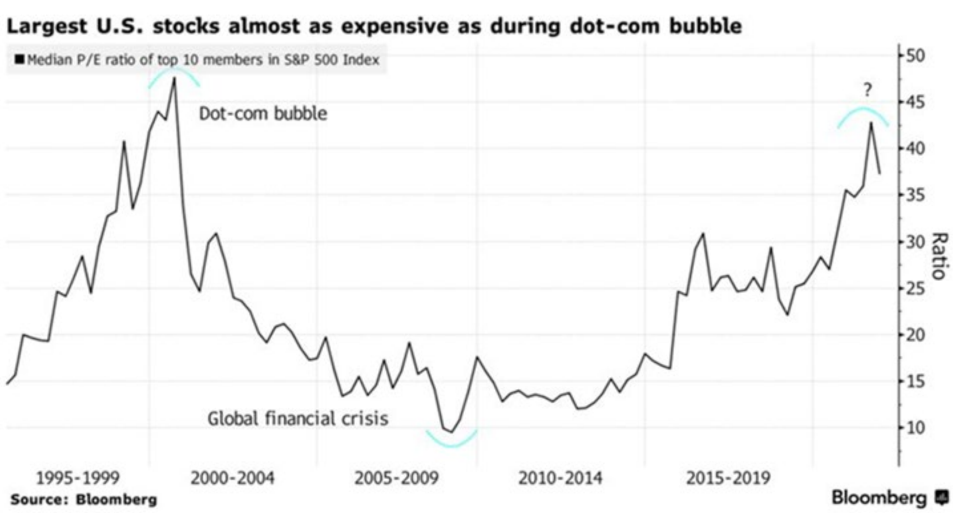
Valuations Matter

Furthering that thought, it is also worth noting that notwithstanding the S&P 500's stellar 2021 returns, many stocks are already in bear market territory. As discussed in our 1Q21 market commentary, loss-making companies and so-called "meme stocks" led the market during the early part of the year. Reminiscent of the "Dotcom Bubble," these stocks traded to nosebleed multiples of revenues, with market commentators opining that traditional valuation metrics should be ignored – growth should be bought at any cost. As the year progressed, the air began to come out of the most speculative stocks. By way of example, the chart below is a composite of companies within the Russell 2000 Growth Index (small-cap growth stocks) which had negative earnings over the trailing twelve months. Contrary to the strong returns of the S&P 500 and other major market indices, the median return for these stocks for the full year 2021 was a decline of over 20% - but what is striking is how loved these stocks were during the preceding rally.

Composite of 517 companies in the Russell 2000 Growth Index with negative earnings:



Time will tell, but it's possible the selloff of speculative small-cap stocks is a so-called "canary in the coal mine." Indeed, as 2022 has begun, we have seen a significant rotation from growth to value across market caps. This has even included the mega-cap technology stocks, which continue to command a heavy weighting in the S&P 500, accounting for most of the top ten largest companies in the index. Additionally, as can be seen below, these stocks have been afforded lofty valuations. Ultimately, we believe that as has been the case with small-cap speculative stocks, so too with the mega-cap tech darlings...valuations will matter.



Outlook

2022 is setting up to be a pivotal year. Much will depend on how successful the Federal Reserve is at transitioning from an ultra-stimulative posture, to a less accommodative one. The U.S. consumer remains resilient, with healthy balance sheets following trillions in fiscal stimulus. While COVID-19 infection rates and hospitalizations remain high, immunity from prior infections, increasing vaccinations, and release of anti-virals should help further the reopening of our economy.

While interest and mortgage rates have lifted, they are coming off historically low levels. We are seeing reinflation in many areas of the economy, and are watching this closely given the historically high levels of government spending here and around the world. Unemployment has shown significant improvement, but labor continues to be an issue, as the participation rate continues to be low and labor shortages are impacting many industries.

In our estimation, overall equity valuations remain at elevated levels. The high valuations of a small number of enormous technology companies certainly exert upward pressure to the overall averages. Treasury and high-grade corporate bond yields look unattractive. In any case, value investing is ripe for a period of outperformance, and the bargains inherent in your portfolio should attract acquirers and other investors over time. Meanwhile, we still believe equities represent a superior asset allocation alternative to bonds over the longer term.

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