PROSPECTOR PARTNERS

John D. Gillespie
Portfolio Manager

Kevin R. O'Brien
Portfolio Manager

Jason A. Kish
Portfolio Manager

Steven R. Labbe
Portfolio Manager

Q2
2021

Prospector Partners Quarterly Commentary

Current Market Environment

Transitory. Anyone following the markets during the second quarter heard the word bandied about ad nauseam, and the question of whether inflation would serve to be temporary (transitory) or more permanent drove the daily movements of the market. Indeed, the quarter began with a Consumer Price Index (CPI) reading that showed heightened levels of inflation, with March CPI jumping 2.6%, fueled by an economy that was rapidly expanding due to increased vaccination rates, reopening of businesses, and continued stimulus. The debate over "transitory or not" quickly heated up, with every economic reading being scrutinized as to whether it was indicative of more persistent inflation. If inflationary, then the 10-year Treasury would sell off, value stocks would lead growth, and vice versa. The April CPI reading jumped again, this time to 4.2%, followed by 5.0% for May and June's 5.4% -

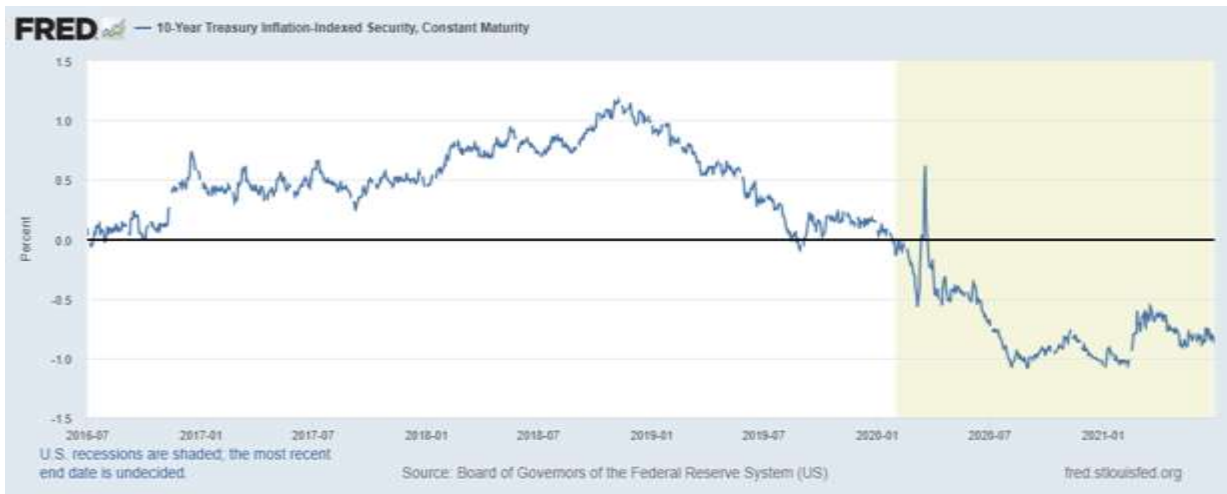
the highest reading since August 2008. Despite these readings, the markets seemed to vote "transitory" as long-term bond yields came off the late March highs, and the yield curve began to flatten. This was exacerbated when Fed chairman Jay Powell indicated during the June meeting that they would expect to raise rates earlier than previously planned (albeit not until 2023), eliciting fears of a prematurely hawkish Fed pouring cold water on the current economic expansion. The 10-year yield, which ended March at 1.74%, sank to 1.47% at June 30, and the yield curve flattened considerably. This also caused investors to pile back into growth stocks and sell interest-rate sensitive stocks (for example, banks and other financials) as a consensus developed that we were poised to be in a persistently low interest rate environment. As discussed in previous writings, lower long-term yields tend to favor higher-growth companies as future earnings are discounted at lower rates. So, is the market right? Will inflation serve to be transitory despite the rapid economic expansion and unprecedented stimulus, and thus are we destined for a semi-permanent low-interest rate future? Before a conclusion is reached, we believe the following additional questions will likely need to be answered:

What will be the long-term impact of materials, goods and labor shortages?

By this point, we have all likely experienced some impact from recent shortages of products, materials or labor. If you were looking to build a deck, or a similar project, you surely noticed the impact as lumber prices soared to over $1,600 per thousand board feet from under $400 a year prior. In the market for a car? You've likely had trouble finding one, and / or noticed the sky-high prices of what is actually available. A confluence of pandemic-related events has led to shortages of lumber, autos (due largely to a lack of semiconductor supply), and many other products. When the pandemic hit, manufacturers shut down plants, sawmills, etc., laying off workers in the process. In a normal recovery, these plants and mills slowly come back online as the economy gradually improves. However, during this unprecedented v-shaped recovery, supply has been unable to recover as quickly as demand – creating these product shortages. Additionally, this has been compounded by a labor shortage despite continued high levels of unemployment. Whether because out of work individuals are reluctant to go back to work due to ongoing COVID-19 concerns, the lack of child care, or the ongoing stimulus payments they are receiving, many companies are finding it hard to re-staff their factories, shops, restaurants, etc. Many restaurants have been forced to open on a limited schedule due to staffing shortages.

While many of these shortages will work their way through the system, proving to be temporary (e.g., lumber prices are back to just under $600 as mills have come back online or ramped up production), it remains to be seen how much will last longer term. Prices are increasing on products as companies attempt to keep up with input cost pressures, and businesses are being forced to raise wages to entice new employees. Will these price increases reverse as supply chains stabilize and will wage pressures abate as enhanced unemployment benefits roll off in the fall, causing some unemployed Americans to start looking for jobs again? And not to be overlooked, given rents make up about one third of CPI – will the July 31st end to the moratorium on evictions, enabling landlords to adjust leases, cause a significant rise in rents? Only time will tell.

Are interest rates artificially low due to Fed asset purchases?



As can be seen in the chart above, we've been in a persistently negative real rate environment since the beginning of the pandemic, with rates staying persistently low despite the economy's rapid recovery. We do not purport to be economists, but one macro-economist we respect suggests this may be partially the result of Fed asset purchases, and thus may lead to a rise in rates as asset purchases abate. Mike Darda, of MKM Securities, points out in recent notes that the real yield of 10-year inflation-protected securities has averaged about 25 basis points over a long period. According to Darda, assuming inflation expectations of about 2% hold steady (recall, the Fed has indicated a willingness to allow inflation to go over 2% for a period), "that would mean the 10-year yield would climb to 2.3% or so." Adding some weight to this theory, JP Morgan recently noted, "…from the start of 2021 through May 2021, the Federal Reserve's Treasury purchase of $80B per month has totaled $400B YTD, or roughly equal to the total net issuance of Treasury securities of $415B. As of May, the Fed held 24% of total Treasuries outstanding and up from 15% in February 2020 (pre-pandemic)." Should the Fed begin to limit asset purchases, it seems plausible yields will rise in response.

Will we get more stimulus in the form of an infrastructure bill?

As referenced earlier, we have already flooded the economy with unprecedented stimulus. To date, an estimated $5 trillion has been injected into the economy by the U.S. government, equal to 24% of GDP. This compares to $1.6 trillion during the Great Financial Crisis, or 11% of GDP, of which a large portion was aimed at stabilizing the financial system versus directly stimulating the economy. This is in contrast to the pandemic-induced stimulus program, of which much went directly into consumer pockets (via checks, school lunch aid, unemployment insurance, etc.) and to small businesses (PPP Program, Economic Injury Disaster Loans, etc.). This stimulus has unquestionably aided the current "v-shaped" recovery.

An infrastructure bill could add an additional boost to an already rapidly expanding economy, and while President Biden announced a bipartisan agreement on a $1.2 trillion infrastructure deal on June 24th, we would not cast aspersions at those who are dubious any such agreement will pass. However, if a bipartisan deal doesn't pass, the likelihood increases that a Democrat simple-majority

bill is pushed through via the budget reconciliation process. Should this occur, it's more than likely the package would be much larger than a bipartisan deal, potentially in the multiple trillions. While controversial in a gridlocked Washington, where more and more gets pushed through via executive orders, and via the budget reconciliation process, a larger infrastructure deal would surely add more fuel to the economy, and raise the specter of increased inflation.

Will a COVID strain break through the vaccine, causing a major resurgence?

Even if the aforementioned scenarios all point in the direction of rising interest rates, the wildcard will be if we see a resurgence of COVID-19. Recently, concerns over the "Delta" COVID-19 variant have weighed down the market and contributed to the rally in Treasuries, further depressing interest rates. There have also been reports of a "Lambda" variant, that has hit some South American countries and even Canada, and is anecdotally more severe than even the Delta variant. Should one or more of these variants cause the vaccines to prove ineffective, we could see slowdown, or even a double-dip recession. More than likely however, this would lead to another flood of government stimulus, and just delay the expansion as vaccine boosters effective against the new strains are developed. The added stimulus and continued ballooning of the U.S. balance sheet would further stack the deck in favor of an inflationary period and increased rates down the road, albeit delayed by the virus.

So, what does this all mean for us? While we believe significant portions of our portfolios would benefit from any rise in interest rates and steepening of the yield curve, that is not a main thesis for portfolio holdings or sector bets. The same could be said as it relates to inflation. For example, our bank holdings would surely benefit from rising interest rates and a steeper yield curve (as net interest margins would expand). However, we feel there are multiple other "ways to win" with our bank holdings…including a significant capacity to grow loans as the economy continues to expand, the potential to return material amounts of capital to shareholders or be acquired, as well as continued multiple expansion.

In fact, focusing on individual holdings or sectors is missing the forest for the trees, in our view. The biggest factor in a rising interest rate environment is likely to be a rotation out of highly-valued growth stocks, which have enjoyed a decade plus of outperformance and valuation expansion, and into value stocks. In our view, investors who are overweight these growth companies are making an implicit bet that the low-interest rate environment will last for the foreseeable future - especially (as can be seen from the chart on the next page) given the valuation gap between growth and value is near the widest it has been since the dotcom bubble. While, admittedly, we've been waiting for Godot (in the form of a rotation to value stocks) for quite some time, we are steadfastly continuing our process of bottom-up research, finding attractively-valued investments, while always considering the potential downside first.

Exhibit 9: MSCI USA Value/Growth – 12M Fwd P/E

Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Outlook

2021 looks to be a transitional year. We are clearly in the early stages of a new economic cycle, following the coronavirus-induced recession of 2020. Continued progress on vaccinations will allow the U.S. economy to continue returning to more familiar footing with the resumption of dining out, air travel for business and pleasure, and large group gatherings. The recent United States elections, although closely contested, have ushered in a change in administration with attendant changes in the agenda around stimulus, spending, taxes, and trade. The razor-thin margins in Congress are likely to temper any radical policy shifts. Importantly the volatility emanating from the executive branch should ease.

While interest and mortgage rates have lifted, they are coming off historically low levels. We are seeing early signs of reinflation, however consensus expectations for inflation over the longer term remain relatively subdued despite the historically high levels of government spending here and around the world. We are carefully monitoring aggregate corporate debt levels (especially BBB- debt which is a single notch above junk status), currently above pre-2008 crisis levels and loom as a potential problem absent continued aggressive Fed support. Unemployment has shown significant improvement, but continues to be an issue.

In our estimation, overall equity valuations remain at elevated levels, due to the sharp rebound in equities. The high valuations of a small number of enormous technology companies certainly exert upward pressure to the overall averages. Recovery in aggregate earnings will take time as certain industries such as hospitality, entertainment, and travel are tied to the success of a vaccine rollout plan, and will take longer to return to pre-coronavirus levels. Treasury and high-grade corporate

bond yields look unattractive after the dramatic flight to safety rally during 2020. 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.

WWW.PROSPECTORPARTNERS.COM
370 Church Street, Guilford, CT 06438
203-458-1500

The views described herein do not constitute investment advice, are not a guarantee of future performance, and are not intended as an offer or solicitation with respect to the purchase or sale of any security. Investing involves risk, including loss of principal. Investors should consider the investment objective, risks, charges and expenses of a Fund carefully before investing. Please review the offering memorandum or prospectus of a Fund for a complete discussion of the *Fund's risks which include, but are not limited to: possible loss of principal* amount invested; stock market risk; value risk; interest rate risk; income risk; credit risk; foreign securities risk; currency risk and derivatives risk.

Nothing contained in this document constitutes investment, legal, tax, or other advice nor should be relied upon in making an investment or other decision. Any projections, outlooks or estimates contained herein are forward looking statements based upon specific assumptions and should not be construed as indicative of any actual events that have occurred or may occur.