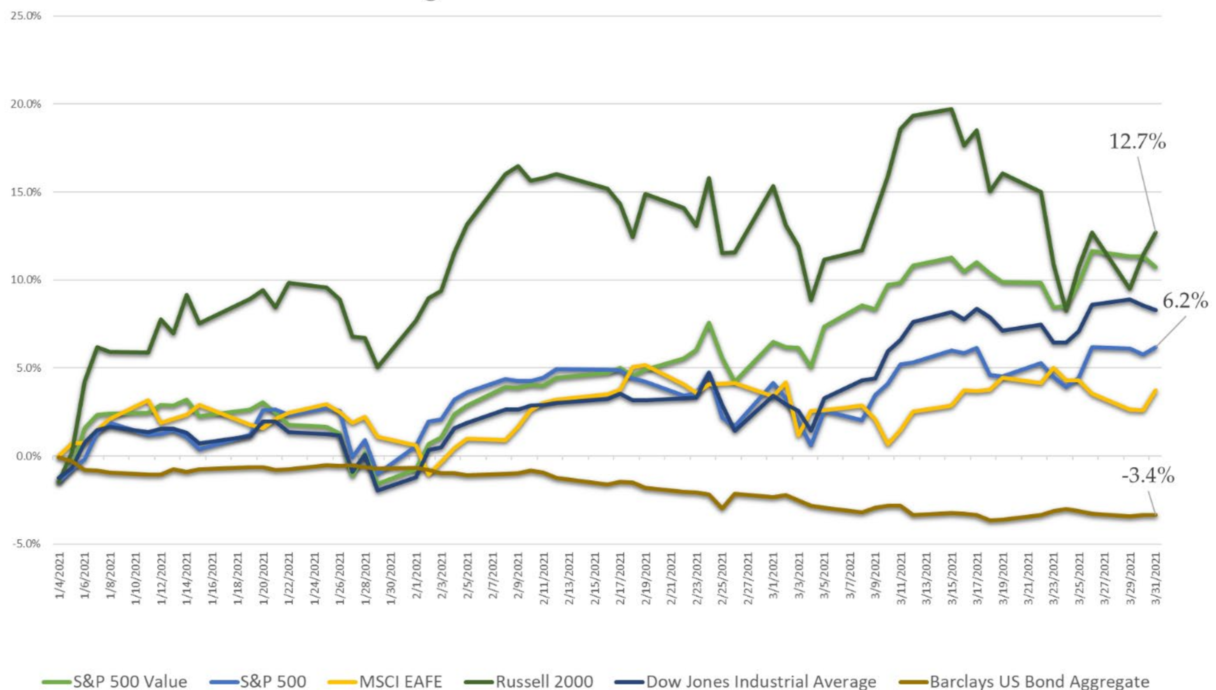
Dear Turtle Creek Client,

The global economy extended its swift recovery through the first quarter as COVID-related economic headwinds continued to recede and historic monetary and fiscal stimulus measures remained firmly in place. Market performance reflected this dynamic, with distressed and smaller company assets handily outperforming their higher-quality and growth-oriented peers during the quarter. Interest rates also continued to rise steadily, pressuring returns on safe-money asset classes like investment grade bonds and cash.

Forward-looking indicators currently signal strong and accelerating growth in corporate profits for at least the next several years, a forecast that implies we have officially exited from the COVID economic crisis. Investors must now analyze a very different mix of potential risks and rewards including new stock market leadership, Biden Administration proposals ranging from infrastructure spending to a new tax code, and the longer-term inflationary implications of ongoing and unprecedented government stimulus.

Amidst this backdrop, we have not changed our view that risk assets such as equities will drive portfolio returns over the near-term, while safer assets such as bonds and cash will require careful handling until the larger interest rate backdrop stabilizes.

Investors should also analyze first quarter stock market performance critically with an eye to longer cycles. Current stock market leadership reflects in many cases a repricing of lower quality business that recently faced insolvency, but now are valued as going concerns. While the short-term performance related to these recovery trades can be eye-popping, over the longer-term such low-quality investments have usually delivered relatively poor results.



Source: Bloomberg

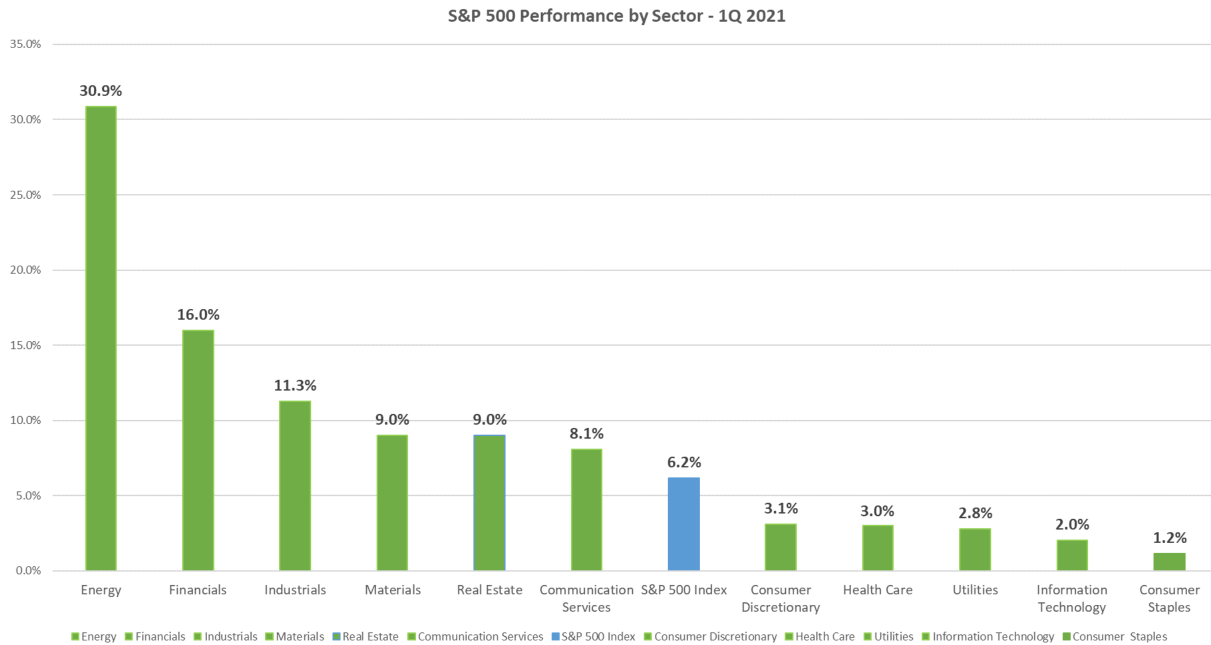
Turtle Creek Management, LLC | 3838 Oak Lawn Ave | Suite 1650 | Dallas, Texas 75204 | 214-468-0100 | 214-468-0106 fax |
turtlecreekdallas.com

First Quarter Stock Market Performance

The U.S. stock market delivered broad gains during the quarter with the S&P 500 index advancing 6.2% overall and every economic sector posting positive results. The market continues to be lead by economically sensitive companies benefitting from the global economic recovery. The Energy sector posted an outsized 31% return during the quarter while Financial, Industial, and Materials companies also posted gains in excess of the overall market.

Market laggards during the quarter include the formerly high-flying Technology and Consumer Discretionary sectors as well as Health care, Utilities, and Consumer Staple stocks. Technology and Consumer Discretionary stocks had been the clear market leaders both before and through the COVID crisis and were driven to elevated valuation multiples in that process. While these companies continue to feature attractive fundamentals and superior growth prospects, their valuations were pressured during the quarter as investors migrated to other sectors posting stronger relative financial results.

Consumer Staple and Utilities companies by contrast grappled with the same interest rate concerns plaguing the bond market. These companies are often called "Bond Proxies" due to their mature, steady financial results and the fact that they reward investors more through dividend payments than capital appreciation. Similar to bonds, their market valuations are more heavily influenced by interest rates and the rising rate backdrop pressured their share prices during the quarter.



Source: Bloomberg

From a fundamental perspective, market leaders during the quarter featured distinctly low-quality characteristics. Financial economists define the concept of a "quality stock" as a mix of above average, sustained profitability and minimal financial leverage. By those measures, market leaders were indeed low-quality. The top 10% of S&P stocks in terms of total return during the quarter featured profit margins and returns on capital well below the S&P 500 average and greater financial leverage. The bottom 10%, by contrast, exhibited profitability well in excess of the overall index and much less financial risk as compared to market leaders.

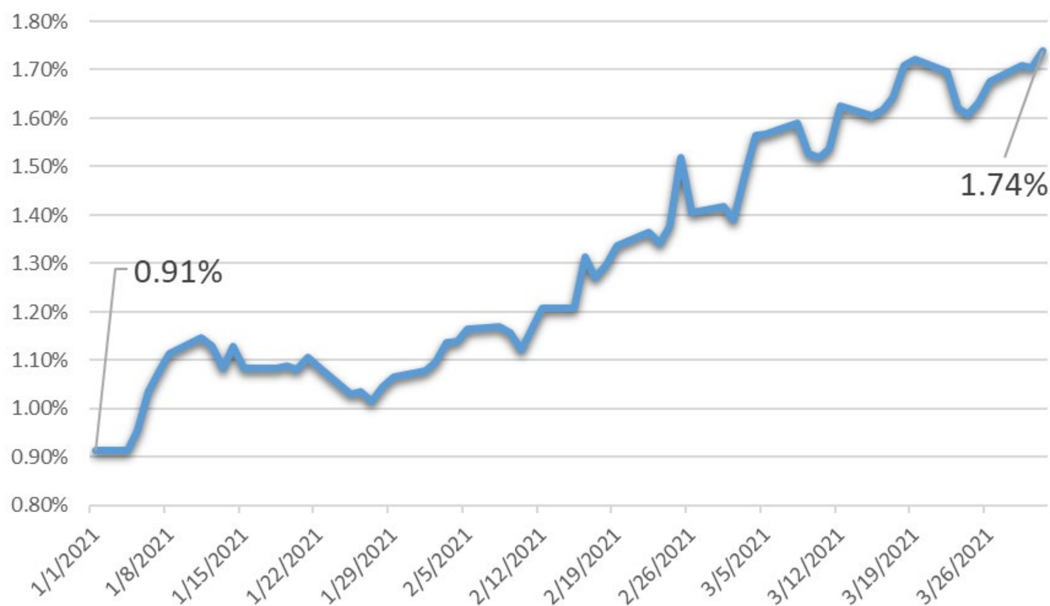
Fundamental Comparison - Top and Bottom Decile of S&P 500 Stocks - 1Q 2021

	Total Return - 1Q 2021	Return on Equity	EBITDA Margin	Debt/Equity
Top 10% - Best Performing Stocks	**36.4%**	**14.1%**	**8.4%**	**160.4%**
S&P 500 Index	**6.1%**	**26.7%**	**16.9%**	**119.8%**
Bottom 10% - Worst Performing Stocks	**-8.1%**	**29.7%**	**26.9%**	**123.9%**

Source: Bloomberg

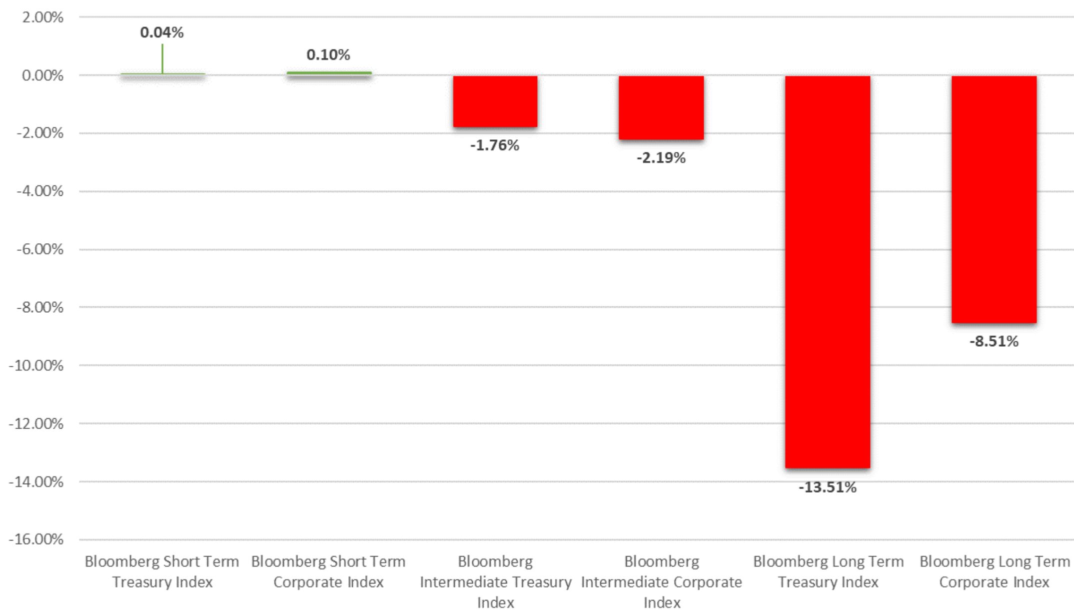
Fixed Income and Cash Markets

The benchmark 10-Year Treasury yield ground steadily higher throughout the quarter, reflecting increasing optimism over longer-term economic growth and a potential resurgence in inflation. The upward shift in yields was significant with the 10-Year yield jumping nearly a full percentage point. Despite this dramatic shift, the ongoing rate reversal still appears to be in the early stages by our analysis. Treasury yields continue to trade below pre-COVID levels and the increasingly positive economic outlook and ongoing government stimulus all point to higher rates over the near-term.



Source: Bloomberg

The impact of rising rates on bond returns ranged from negligible to painful depending on the duration (or time to maturity) of your bond holdings. As we have described before, bond prices move inversely to rates and shift to a greater degree depending on the length of their maturities. During the quarter, shorter maturity bonds were largely undisturbed as the Federal Reserve kept a tight leash on short-term rates. Longer-term bonds, by contrast, posted steep losses. The Bloomberg Long-Term Treasury Index lost more than 13% during the quarter.



Infrastructure, Stimulus, and the Shifting Tax Code

The newly installed Biden Administration wasted no time in introducing twin stimulus proposals during its first months in office, building on the already sizeable stimulus measures enacted by the Trump administration. The "American Rescue Plan" was approved by Congress in early March, providing ongoing jobless benefits and temporary but sizeable anti-poverty measures. The "American Jobs Plan" was announced during the quarter as well. This bill asks for comprehensive infrastructure investments targeting the overhaul of decaying traditional infrastructure as well as sizeable investments in green energy, public transportation, high-tech manufacturing, enhanced broadband, and a modernized electrical grid.

Economists generally agree that infrastructure investment is urgently needed, and that other historical periods of infrastructure spending have translated to enhanced economic growth and job creation. Industries including automotive manufacturers, transportation, logistics, construction, machinery, and mining would all see a multi-year surge in demand should the Biden proposal be enacted as it stands.

The question remains as to how these significant outlays will be financed, and hikes in both corporate and personal income taxes seem the likeliest outcomes. Specific proposals to date have focused entirely on adjustments to the corporate tax code. President Biden and Treasury Secretary Janet Yellen have in recent weeks outlined plans to reverse Trump-era reductions in corporate income tax rates and eliminate offshore tax exemptions for American corporations. While there have been no specifics on proposed changes to personal income tax rates, a key plank of the Biden campaign focused on a boost to income tax rates for high-earners and an increase in capital gains tax.

We see both pros and cons in the Biden proposals. The early stages of economic recovery in 2009 were marked by global austerity, deflationary trends, and highly conservative corporate spending which translated to a sluggish, decade-long crawl back to average GDP growth and employment. Today's significant fiscal support measures should help to avoid those policy mistakes. Over the longer-term, we do believe the economic benefits from infrastructure spending are tangible. Hikes in corporate tax rates are a net negative for the intrinsic value of your equity investments unless accompanied by accelerated earnings growth in the years ahead.

The Inflationary Impact of Deficit Spending and Monetary Stimulus

One of the most feverishly debated topics during the first quarter was the potential for an unanticipated and sustained boost to inflation due to the currently historic nature of government spending and monetary stimulus. Certain investors analyzed the rising interest rate environment and mounting deficits and saw bubbling inflationary forces rather than a natural step back from an abnormal rate environment.

The concept of inflation risk has largely faded from investors' minds and for understandable reasons. Once reliable inflation models such as the Phillips Curve began to misfire starting in the 1980s. Milton Friedman's famous proclamation that "inflation is always and everywhere a monetary phenomenon" has also lost favor. Central Bankers all over the world have pumped enormous sums of money into their economies for more than a decade with little or no impact on consumer prices. This accumulating data has shifted Central Banker thinking, resulting in the current Federal Reserve approach that will allow the economy to "run hot" before any adjustment to the currently accommodative monetary policy is considered, a once unthinkable stance.

Runaway inflation, should it materialize, is not something to be taken lightly. It inflates input costs and crimps profit margins for corporations. It reduces the real return on your assets and pressures market valuations. The only known method to extinguish inflationary trends is to tip the economy into recession through monetary tightening which impacts both stocks and bonds negatively.

While such a scenario should not be discounted entirely, we do believe it to be only a remote possibility. Massive structural changes to the global economy have introduced multiple shock absorbers against traditional 20th Century inflation sources. Labor costs have been tamed due to offshoring and the global integration of workforces. Once tight commodity markets now feature significant supply. Digital disruption from online commerce vendors has shrunk prices for goods the world over.

It is also important to note that the inflation threat remains theoretical. The CPI Index, one of the most common measures of U.S. inflation, expanded only marginally during the quarter to 1.7% which remains below long-term average and Federal Reserve targets.

Investment Strategy

The themes highlighted in this letter – rising rates, accelerating corporate profits, broader sources of economic demand compared to years past – all point to the equities portion of your portfolio driving returns over the near-term. Cash yields will continue to be negative in real terms until the Federal Reserve steps back from its current stimulative, zero-rate policy. Bonds will also remain under pressure if the current rising rate environment persists. Because of this, we continue to favor a short-duration high credit quality stance for the fixed income allocation of your portfolio.

The greatest attention should be focused on the underlying mix of equity assets to ensure your portfolio both captures emerging growth opportunities and is adequately hedged against the remote but relevant risk of above-trend inflation. High-quality cyclical stocks and inflation-resistant industries have more relevance than ever in this new, Post-COVID world.

As always, we hope are eager to discuss these topics or any other question or concerns and look forward to speaking with you soon.

Sincerely,

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA