Palouse Capital Management, Inc.
3Q21 Commentary
October 2021

3Q21 Recap and Analysis

Large cap equities were generally flat in 3Q21, although that was not the case for the entire quarter. The S&P 500® Index ("SPX") continued on its strong trajectory through the end of August before turning down for the last month of the quarter; large caps were down about 5% in September. Market participants continued to worry about, among other things, inflation, supply chain issues, infrastructure legislation and the delta variant of the Covid-19 virus although the market showed a good amount of resiliency to these issues for most of the quarter. 2Q21 earnings season (i.e. for April, May and June quarters) was another good one and fresh earnings expectations seemed to provide investor comfort in July and August. The September move was probably more of a "steam release" than anything else. A market change of 5% is not what most investors would call a correction. In fact, a 5% downward move seems very normal given the strength of the market since the Spring of 2020; large caps returned about 97% between March 23, 2020 and September 30, 2021 (non-annualized).

Small caps materially underperformed large caps in 3Q21 for the second quarter in a row. Small caps and large caps performed about the same coming out of the pandemic correction until the fall of 2020. After that, small caps did much better than large caps until the spring of 2021 and the discrepancy might have been caused by the significantly higher weight of financials in the small cap indexes. Financials did really well in the post-pandemic correction rally as interest rates rose materially from the summer of 2020 through the spring of 2021.

Growth stocks outperformed value stocks for the second quarter in a row in 3Q21. Value did much better than growth coming out the correction, which again might have had something to do with financials, which generally trade at lower multiples than other sectors of the market. Growth has outperformed value by about 600 basis points since the spring of 2021. Growth has dominated equity markets for at least a decade.

There were seven sectors up and four down in 3Q21, indicating a fairly disjointed market. The best sector in 3Q21 was financials, which was up about 2.7%. The worst sector in 3Q21 was industrials, which was off over 4%. The relative softness of industrials probably had to do with that sector's exposure to inflation and supply chain issues.

Inflation and the prospect of rising interest rates are still front and center in the equity market construct. Anyone who buys groceries or drives an internal combustion vehicle can attest to the presence of inflation. Prices of crude oil, natural gas, propane and gasoline have risen so much that people are now referring to the situation as an "energy crisis". Prices of many other commodities like sugar, flour, milk, coffee, steel and copper have increased dramatically in the past year. A lot of this seems to do with supply chain disruptions associated with the Covid-19 pandemic. In the case of the energy sector, rig counts have improved but are still historically very low after cratering in the Spring of 2020. I wonder if labor shortages are to blame for low drilling activity.

Any time the inflation and interest rate issues arise investors always think about the Fed and the employment situation. The employment situation improved in 3Q21, but not as much as economists were expecting. The unemployment rate is now 4.8%, which looks like a good number considering where it was during the Covid-19 lockdowns; however, there are still over 7.7 million unemployed people in the US, which is curious considering that there are over 10 million job openings.

As of the time of writing, 3Q21 earnings season was just getting started although there have been 135 of the Top 1,000 (i.e. the 1,000 largest domestic companies) announce results for quarters ended in July, August or September of 2021. Of those reports, 90% were positive

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surprises, normal for this phase of earnings season. The adjusted weighted average surprise, which includes 98.5% of reports so far, is 14.5%, a good number. Bank earnings have been quite constructive so far. I am calculating adjusted forward EPS growth of about 8%, which is a good number - although it is normalizing coming off the disaster caused by Covid-19 shutdowns, as expected. It is too early to draw a lot of conclusions about this earnings season, although it feels like we are off to a good start.

Market Model and Outlook

Our market upside model, which is based only on average sell side target prices, now suggests a 12.5% one year upside potential to the all cap market. I am calculating the market's forward P/E multiple at 21.2x. About 88% of the Top 1,000 are showing positive upside to target prices, which is average.

While 3Q21 earnings have been encouraging so far, inflation seems to be the primary worry for investors right now. The last time non-core inflation was in this range was right before the 2008 bear market, which seems like a reason to worry. Like the current situation, the 2008 inflation was also partially caused by a huge spike in energy prices. The last time core inflation was in this range was in the early 1990s, and, in fact, core inflation was much lower than the current level back in 2008. The speculation and debate centers around whether or not the current inflation situation is "transitory" and caused by repercussions from the Covid-19 pandemic. So far, given the market's resiliency, the consensus seems to be that the current inflation situation is transitory.

It seems like over the next few weeks we should get a clearer picture of the economic and earnings backdrop. Investors will closely monitor earnings results and management comments about how inflation and supply chain disruptions are impacting business over the next month or so. The next Fed meeting is on November 2nd and investors will key in on anything the Fed says about inflation and the tapering of bond purchases. As long as earnings progress continues and the Fed does not surprise us then the market's recovery will most likely endure.

Weekly Report, Conference Call and Podcast

Our clients are invited to receive our CIO's weekly podcast and weekly report. In addition, all clients are invited to participate in our weekly conference call. We provide these services to our clients free of charge and they are not available to non-clients. In the weekly report and the audio programs, Ken Roberts and Bryn Harman discuss market developments and trends that we observe in our weekly research efforts. Please contact Bryn Harman at bharman@palousecap.com for more information.

All analysis in this report was provided by Bryn Harman, CFA, PCM's Chief Executive Officer and Chief Investment Officer. Mr. Harman can be reached directly at 509-220-4253 or bharman@palousecap.com.

If readers have any questions about anything mentioned in this report please feel free to contact us any time at 800-624-3833. Readers can also refer to our website, www.palousecap.com, for more information and can email PCM's Chief Investment Officer directly at bharman@palousecap.com with any questions. Readers should not assume that any investments in the securities mentioned in this program were or will be profitable or will continue to be held in the future. Pursuant to Rule 206(4)-1(a)(2)(A) we will provide a list of all trades made on behalf of clients in the past year upon request.

The data used to create our reports is provided by Bloomberg L.P., Standard & Poors, The U.S. Energy Information Administration, The U.S. Federal Reserve, The U.S. Department of the Treasury, The U.S. Department of Energy, Baker Hughes Company, The U.S. Securities and Exchange Commission, The U.S. Bureau of Economic Analysis, The U.S. Bureau of Labor Statistics, The U.S. Centers for Disease Control and The American Automobile Association unless otherwise indicated.

The PCM market model examines the universe of the 1,000 largest actively traded equities trading in the United States (referred to as the "Top 1,000"). The "Price to Earnings Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total estimated net income (from sell side estimates) for the respective market capitalization range or sector. The "Price to Book Value Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total last reported shareholder's equity for the respective market capitalization range or sector. "Upside to Target" is calculated using float adjusted market capitalization weightings and the one year upside potential to the average sell side target price for each security.

"Market cap" means market capitalization.

"LCV" refers to PCM's Large Cap Value Strategy.

"TR" means our Large Cap Total Return Strategy.

"SMID" means Small to Mid Capitalization and also refers to our Small/Mid Cap Value Strategy in certain contexts.

"ACT" means our All Cap Tilt Strategy.

"DI" means our Diversified Income Strategy.

"SPX" refers to the Standard & Poors® 500 Index ("S&P® 500"). The Standard and Poor's 500 Index is a free-float capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic equity market. The S&P 500 equal weighted index is the equal weighted version of the SPX. The S&P® High Dividend Yield Index measures the performance of 80 high dividend yield equities within the SPX. The S&P SmallCap 600® index is a capitalization weighted index that measures the performance of 600 small capitalization stocks.

The Russell 3000® Index is a float-adjusted, market capitalization weighted index comprised of equities of the 3000 largest domestic companies. The Russell 2500® index is a subset of the Russell 3000 index comprised of the 2500 smallest cap equities in the Russell 3000 and represents the SMID segment of the domestic equity market. The Russell® 2000 Index is a subset of the Russell 3000 index comprised of the 2000 smallest cap equities in the Russell 3000 index and represents the small cap segment of the domestic equity market.