GKV Capital Management

Quarterly Update

First Quarter 2021

GKV
CAPITAL

First Quarter Review

Gardening 101

Opening Thoughts

The U.S. economy is like a garden well planted. It is responding to the care, attention and stimulus of the past year. As we point out in the Quarterly's essay, we expect the economy, like our analogous garden, to blossom fully in 2021/2022 and to remain strong during the next 18 months. Contrarian thought exists based on the near record levels of common stock prices, but we believe these forecasts of a stock market decline are premature. In time they will be right. Many indicators of market excess have been extolled almost daily by the financial media, but we think the concerns for the market's near future misunderstands the resilience and strength of the economy as illustrated via our metaphorical garden.

The stock market has become more democratized than at any time in its history because of the internet, its trading platforms and the absence of transaction commissions. With this expansion of equal access to the financial community, new variables have been introduced to the analysis of stock prices. Also, we discuss the advent of new investment vehicles and the behavioral shifts in the current investors' psychology.

Earlier this year we commenced a weekly series on YouTube called Money Talks in which we review for you various trends, ideas and events in the financial markets. Between Money Talks and our Quarterly publication, we endeavor to keep you abreast of our financial thinking. We always encourage your opinions and a two way dialogue.

Enjoy your walk through this issue's garden.

1Q21 Data Points

DJIA YTD	**7.8%**
S&P 500 YTD	**5.8%**
NASDAQ YTD	**2.6%**
US Bond YTD	**-3.4%**
10-Year Treasury Yield	**1.74%**
S&P 500 LTM Dividend Yield	**1.45%**
S&P 500 EPS Next 12-MTH	**$179.32**
S&P 500 P/E	**22x**

First Quarter Review

The equity markets, particularly in the U.S., continued to record strong gains in the first quarter of 2021. Progress toward an end to the pandemic domestically propelled optimism that the economy could reopen fully by the summer. The tremendous stimulus passed in 2020 combined with another massive round this year combined with pent-up demand has Wall Street forecasting very strong economic growth this year and well into next.

The S&P 500 gained 6% for the first quarter of 2021. The Dow Jones Industrials, the worst performing major U.S. index of 2020, jumped 7.8% and the technology biased NASDAQ gained 2.8% after posting incredible gains in 2020. Small cap companies, as measured by the Russell 2000 index, soared in the first quarter with prospects of fully reopening. Small companies tend to be more volatile, outperforming in good times and underperforming in bad times. Small companies simply don't have the infrastructure to weather downturns as larger companies do. The Russell 2000 gained 12% for the first quarter versus 5.8% for the S&P 500.

Much like last year, while the broad indexes recorded solid gains for the first three months of 2021 not all industries benefitted equally. With a focus on a reopening economy, the worst performers of last year significantly outperformed last year's winners. Energy was the best performer gaining 29% followed by financial services which gained 15%. The work from home trade paused with information technology up only 1.7%, consumer discretionary, which includes Amazon, up 2.9% and the worst performer, consumer staples gaining 0.5% through March 31st.

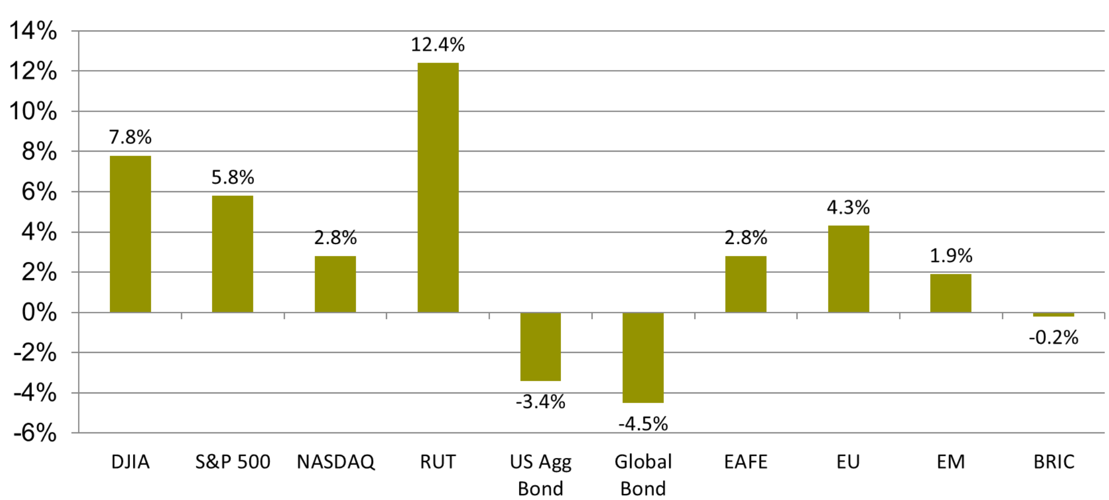
Estimates for earnings of the companies in the S&P 500 called for $172.47 per share for 2021 and $200.03 per share in 2022. If these estimates hold up, they represent 41% growth over 2020 pandemic impacted earnings and an additional 16% growth into 2022. Prior to the pandemic, earnings in 2019 totaled $155.84, so earnings this year are already expected to hit new all-time highs.

The U.S. equity markets in the first quarter generally outperformed global equity markets, although all major indexes recorded gains for the first quarter. The MSCI EAFE (Europe, Australia, Far East) closed the first quarter up 2.8%, Europe gained 4.3%, and emerging markets closed the year up 1.9% as slow vaccine rollouts and new waves of infection continue to keep economies from fully reopening. Global GDP growth is expected to have shrunk 3.5% in 2020 due to the pandemic but is expected to rebound sharply by 6% in 2021.

At the height of the pandemic, unemployment spiked to 14.7% in April last year and has subsequently declined to 6.0% by the end of March. For context, following the 2008 recession, the high point for unemployment was just over 10% in October of 2009. Consumer spending has remained positive due in part to the significant stimulus. This includes payments made to individuals, extra unemployment checks and payments to small businesses.

Interest rates increased dramatically with fears of inflation as stimulus continues to be pumped into economies worldwide. The 10-year treasury jumped to 1.74% on March 31st from 0.93% at the start of the year. Rising interest rates have had a negative impact on bond prices taking the U.S. aggregate bond index down 3.4% for the first quarter. We expect the rate of increase in interest rates to slow, but rising rates will continue to put pressure on bonds for the foreseeable future.

2021 Performance by Asset Class



Gardening 101

"A garden is a grand teacher. It teaches patience and careful watchfulness; it teaches industry and thrift; above all it teaches entire trust."

- Gertrude Jekyll (1843-1932)

It's spring. The economy has been given all the nutrients necessary to yield the best harvest in decades. The reopening is accelerating, GDP growth is strong and will get stronger during the next 15 months. Corporate earnings in 2021 and 2022 will reach record levels. Think of the present U.S. economy as a garden. It has been given an abundance of water, fertilizers, soil amendments, and pesticides to ensure spectacular growth for all varieties. Allegorically, money is abundant, interest rates are close to 40 year lows, government policies are stimulative, Covid vaccines are plentiful and effective, and production is accelerating to meet mushrooming demand. All the ingredients for economic success are present to sustain hyper growth in comparison to the past. Existential events can occur to ruin the best designed gardens and economies. Severe storms and droughts and new varieties of horticultural diseases can decimate our well-tended garden. Inflation, wars, political and social unrest can destroy economic projections.

Our economy is poised to benefit all areas and industries. The initial success of the high technology industries during the pandemic is now spreading to all industries including the basic manufacturing and service areas. They will prosper during the next 18 months if "black swan" events can be prevented. In our well prepared garden some species were more drought and environmentally resistant to adversity like the high technology industries. But because of our fiscal and monetary focus to resuscitate all areas of the economy quickly, we are now seeing the fruits of our labors to expand the benevolence of our work to all varieties in the garden.

In the context of portfolio management, the focus for successful investing in 2020 was on high technology companies. Now that we have given all areas of our garden the ingredients for success, in 2021 the focus on a successful investment portfolio must be extended to the blossoming of the economy's more traditional areas. We will see this year and next a rigorous colorful blossoming of all planted varieties and in all regions of our garden. The central, southern and northern regions of our country will experience increasing growth for 2021/2022 and not just coastal areas with high technology concentrations. A successful stock portfolio, in our opinion, this year will need to contain value and cyclical components as well as high growth. The valuations of high growth companies are presently very high. Although further growth will occur in these companies this year and next, their valuations already reflect much of this positive outlook. The strong emotional gratification experienced from this area of our garden has already been realized. On an investment performance basis, we earned the majority of our anticipated future rewards from high technology last year while all other areas of our garden were doing poorly. Now our emphasis on portfolio composition must be altered to a balance of growth and value. Since the transition of political power in Washington to a more balanced mix of Democrats and Republicans in conjunction with breakthroughs in vaccinations, we feel more confident of a wider disbursement of the government's largess to all economic areas. This has allowed a reallocation of portfolio assets to a much more diversified investment portfolio. All varieties and species in our garden should do well. The neglected plants last year may well become the favorites of this year – allegorically yielding the greatest price appreciation in the stocks of those companies most hurt by the pandemic.

The beauty and intrinsic satisfaction of all areas of our garden displaying the fruits of our abundant care should continue well into the end of the growing season. In economic terms, investor confidence for 2021 and into 2022 should remain high. As we explained in our weekly video Money Talks on YouTube, the bullish sentiment among money managers is very high and few expect any disruptive calamities. Public confidence about the future is also very high and almost universal. Contrarians would say this positivity is a matter of concern. Their thinking is all the good news is reflected and things can't get even

better. Often in the past when the herd thinks one way, the most financially rewarding direction is the opposite path. Ignoring timing, this conjecture about herd mentality is almost always axiomatically true. But timing is the key and missing ingredient in a contrarian's outlook. A stopped clock is right twice a day. In our opinion, the fruits of all the work to prepare our garden by the government will continue for a while longer until all areas and regions of the economy are blossoming in synchronization. The season of enjoying the creation of our garden will not end in a matter of weeks or months. We do not expect the stock market performance in 2021 to equal 2020. This would be a pleasant surprise. The reduction in expectations for financial gain this year is also the forecast of the herd cognoscente, so perhaps 2021 will yield increases beyond our expectations. Possibly, the amount of sun and rain for our garden will be perfect throughout the season and no existential events will ruin the fruits of our labors as expected by some. In our judgment, the U.S. economy and world economy will not sidestep all perceived negative events during the next 24 months but the most likely path is for the economy and our garden to show sustained excellence.

As we all know, plants grow. They spread out and at some point need to be trimmed and cut back. As stock prices rise, or the price of a specific stock rises, the market reaches levels which embody greater risk. It is likely that such a phenomenon will occur this year even in the context of a growing economy. At that time we will pursue a strategy of either thinning the portfolio's positions or introducing late cycle stocks into our garden. As mentioned before, the current bull market will end. This is indisputable. The question is when. It is the unknown that has plagued investors since they first met under the Buttonwood tree by Wall Street about 240 years ago. Occasionally, our broad market timing is very accurate, but the strategy of thinning our portfolio positions and modifying our general investment exposure is the best alternative versus depending on correct general market timing. It assumes great prescience to harvest your garden right at the peak of its brilliance because you anticipate tomorrow a catastrophic storm or a sun obliterating deluge of locusts.

We have discussed in our weekly YouTube presentations on Money Talks, cryptocurrencies such as Bitcoin, Ethereum and Dogecoin along with NFTs. Because all the ingredients for a prosperous economy and garden have been applied, it is not unexpected to find we have produced excess stimulus in some peripheral areas of our garden for experimentation. We become tired of the norm and want to experiment away from the usual plants. In other words, excessive monetary stimulus will create pockets of funds which the populace likes to use for a greater adrenaline rush. A successful garden has been created but now we want to gamble on the unconventional species: cryptocurrencies, NFTs, and meme stocks. In other words, we want to see if we can discover that rare tulip in the unused part of our garden which will fund our desire to buy a Lamborghini or a better house or eliminate our debts. Our gamble is to pursue the uncommon and in creating uniqueness we will create value. Hopefully enormous value. Like the tulip craze in the 15th century, most will lose money. The early practitioners may make excellent returns on investment. Some of our experimental flowers will disappear in time completely but a few may change our gardens for all times. Digital currencies are a fact of the future in our judgment. Blockchain technology will be a viable and increasingly pervasive force in our financial world. Fiat money will become digitized accelerating the already reduced use of paper money with the rise of credit and debit card transactions. Digital currency controlled by central banks, such as the Chinese government's present experiment, will at some point supplement paper currency. Bitcoin and some of the new cryptocurrencies may survive in a secondary role but the real enduring plants will be grafts from these original experiments of the early 21st century. A garden today is almost completely different from the conventional garden of 100 years ago. Technology today is completely different from 50 years ago. Almost all aspects of industrial production are dramatically different from 5 decades ago. There is no reason to assume currency and the processing of financial transactions will be immune. We are not advocating substantial investment in cryptocurrencies but an intellectually innovative idea has been unleashed into the financial world which we suspect will evolve into a common daily reality.

If you are still enjoying our garden analogy, let's continue it to review the financial past. In the 1960s and early 1970s Wall Street and its investment gurus were ecstatic over a handful of stocks labeled at that time the "Nifty Fifty." It was the common wisdom that all portfolios must contain a good representation of these companies if they were going to be successful. They were named the "Nifty Fifty" because they all traded at price/earnings ratios of about 50x or more. Some of the names were Xerox, IBM, Avon, Eastman Kodak, General Electric, Burroughs, S.S. Kresge, Polaroid, Sears Roebuck, and Coca Cola. If you owned equal shares of these stocks in 1972 and never changed your portfolio, you would have been a very unsuccessful investor. Yet at that time these were all "must" stocks to own. Walmart is the only exception but the reward of owning it for the past 50 years has been modest on a relative basis. Favored varieties of plants in the garden always change. Today Microsoft, Facebook, Netflix, Alphabet, Apple, Amazon are the favored entities. As mentioned earlier, as they blossom fully, the strategy will be to reduce these holdings but the timing is always subjective and problematic. Periodic economic afflictions always produce portfolio changes and the emergence of a new favored group.

A good garden depends on sunlight, water, and good soil. There has to be solid infrastructure and intelligent regulation but not so much as to hinder performance of growth. This brings our garden analogy to government and taxes. Biden's proposed tax increases will not cause an economic collapse. History has shown that tax changes have very little long term effect on stock prices. Only about 25% of all U.S. stocks are owned by U.S. taxable investors. The other 75% is owned by tax exempt organizations. In the short-term significant changes in the nation's tax structure as proposed by Biden may have some negative effect. However, we believe the tax changes Biden has advocated represent a preliminary litmus test to determine the extent and degree of sentiment for tax changes. As previously mentioned in our weekly video commentaries, the Democratic party control of Congress is very thin. The Democratic majority will not be able to pass any tax legislation without the blessing of the party's moderates. It is likely that Biden's proposed tax changes will undergo significant alteration. We expect the final changes will be acceptable to the moderate segments of both political parties which will mean smaller tax increases in all proposed areas. The Republican far right and Democrat's progressive wing will not get what they want. Juxtaposed to the tax bill, the size of the proposed infrastructure bill will also be adjusted in size. If the garden is sustained by ever rising debt to pay for water and fertilizer, the garden will collapse. Existential events to adversely affect our increasingly prosperous economy are punitive tax increases on very productive segments of our economy and inflationary debt accumulation. The cost of building a long-term prosperous garden has to be considered carefully by Congress. Estate tax exemptions will probably be reduced. 1031 exchanges will probably stay the same. The capital gains tax rate will rise but remain well below Biden's initial proposal. Corporate taxes will also rise less than his present proposal and income tax rates on the very wealthy will be increased. The elimination of the stepped-up basis for estate taxes will probably not succeed but is difficult to predict. If our expectations are correct, tax changes in 2022 will be of a short, moderate effect on security prices. Biden believes in consensus building and his tax changes represent the opening salvo in negotiations.

The state of growth in your garden is very important. Its market value is determined by whether or not it is prospering and the rate of new blossoms is accelerating or is it close to full bloom and soon showing deceleration in new growth. We do not think economic growth will peak until late this year or early next and continued growth will push stock prices modestly higher this year from present levels.

When everyone has planted their garden, in time the demand for gardening supplies has to fall. In the U.S., the average household has the highest share of its assets in stocks in more than 50 years. The number is up to 47% according to Citibank. Also institutional equity funds have cash reserves of only about 4% according to the Bank of America. A further decline would be a negative sign for equity prices since the fuel to stimulate further gains would be absent. In 1970, the proportion of investor assets in equities was at a peak, which again reoccurred in 1999. After both dates the S&P 500 index's annual return for the next decade was between negative and 5%. Money has been extremely abundant for investment as a result of unprecedented fiscal and monetary stimulus. More stimulus beyond what is presently proposed is unlikely. When the percentage of stock assets relative to total assets reaches a new peak, it may be time to dust off the old axiom buy low and sell high and consider selling the gardening supply store. When you are fully invested and everyone else is fully invested, and with no further government stimulus on the horizon and a peak to economic growth then there is little fuel to push the value of equity portfolios higher. Our gardening endeavor has been successful, a vacation is recommended and patience is needed for the reoccurrence of a once again favorable growth environment.

However, human nature is interesting and human certainty is usually wrong. You may miss that gardening supply business and the unbearable feeling of having sold it too soon. Also, we all know that historically the markets have always recovered from a collapse to reach new highs. The garden will bloom again and its supplies will be needed again. We are not blessed with the insight for certainty. Consequently a garden needs to be pruned, not turned under. In 1996 former Federal Reserve chairman Alan Greenspan said the stock market is experiencing "irrational exuberance." But it took almost 4 years and much higher stock prices before a peak was reached followed by a severe collapse. In the past four years, we have witnessed several psychological phenomena which would indicate that we are at a peak in security prices only to learn we are wrong. It is analogous to thinking a garden cannot bloom any more than it has, but it does. Several years ago Wall Street coined the acronym "TINA" which means "There is no alternative." This expression implied that the stock market is at a peak since investors thought this is the only game in town and therefore to a smart investor it must be overpriced. They were wrong. The next psychological negative indication was "FOMO" which is short for "Fear of Missing Out." Again this acronym implied investors are fearful of missing further rises in the stock market so the corollary is investors must be fully invested. And the negative indicator, can the herd panicking to be fully invested possibly be right. To the surprise of contrarians, they were and the stock market has continued to rise. Next came the implied folly of "YOLO, you only live once." Could anyone have coined a more clean-cut expression that the market was at a peak? This acronym simply postulates that rational analysis of equity prices can be thrown to the wind and disregard all risk because supposedly you are on this earth only once. Eat, drink and be merry and keep buying stocks regardless of price. How could this philosophy not signal a market top? So far this interpretation is also wrong. Wild stock trading off of thematic themes or on internet trading platforms would also seem to represent a frothy, momentum oriented, high risk stock market at a peak. So far this indication has also been early if not wrong. "All-In" is the final psychological investor approach. This acronym implies investor fatigue. I want to make my fortune now. Rational analysis is meaningless. Forget prudence. Put everything in and exit the game wealthy. Even if you know nothing about gardening or the necessary conditions for success, plant those seeds and dream of the most beautiful garden on earth.

So far none of these psychological indicators have correctly signaled the end of the bull market. In time they will be correct. As we mentioned earlier, available funds for equity investments is low and diminishing. But the timing for when they reach their nadir is critical. With Adam Smith's millions of invisible hands functioning in the stock market, no one knows when the supply of investable funds can no longer support the existing equity price levels. At some juncture pruning and reallocating portfolio assets will be the correct strategy. For the moment the "you only live once" and "all-in" philosophies are still in play. The plants in the garden are on steroids just like the economy in 2021 and investors' psychological attitudes.

The stock market today is probably more democratized than at any time in the history of our Republic because of commission free trading and the advent of internet trading platforms. Although we think our portfolio, our garden is unique, it is a composite of the same variables affecting us all. The drawing in of the public in unprecedented numbers has produced an equality among investors which has altered to some degree the analysis of the market place. It has expanded the dimensions of the garden in which we invest. The public is no longer a visitor to the garden, but a voice in its creation. The dramatic growth of public participation in stock investing has introduced new investment variables. It has fostered the belief that the people can financially benefit within the financial establishment. So to some extent the traditional analytical models for the stock market have been upended. New gardening methods have been introduced to broaden appeal. More risk and volatility have been added and traditional sentiment indicators have been diminished in efficacy along with the supremacy of analytical tools. Price movement in GameStop, AMC, Hertz and other stocks adapted by the new era influencers all defy rational analysis. Although we believe the broadening of the investment community is good, new participants with new ideas have been added to the garden and it remains to be seen if they will increase the probability of havoc or assist to further sustain the bull market to new heights. Behavioral economics has been altered in the past couple of years. In our allegorical garden new seeds are beginning to germinate. Once something is widely known and acknowledged it is usually discounted in the financial markets. But our thesis, for the moment, is that new phenomena have been introduced from unprecedented stimulus to pandemic dislocations, to new market adherents and techniques, and this time may be different regarding the possible heights for equity prices. The new army of influencers have taken a seat at the poker table and neurological theory hypothesizes that brain activity of different people doing the same task converge thus shaping the way both behave. This new dimension in market price theory could well move stock prices beyond the limits of conventional wisdom. Where ignorance is bliss, tis folly to be wise.

Enjoy the beauty of the garden in full blossom. It will last through the year. The combined success of the components comprising the garden reflect their current fair value, but in our opinion its aggregate value is not yet extended.

Southern California
299 W Hillcrest Dr.
Suite 119
Thousand Oaks, CA 91360

Northern California
1350 Treat Boulevard
Suite 260
Walnut Creek, CA 94597

Phone: 805-497-2616
www.gkvcapital.com
E-mail: greg@gkvcapital.com

Independent Investment Advisory

GKV Capital Management is an independent investment advisory firm registered with the Securities and Exchange Commission since 1975. We provide portfolio management services for our clients which include individuals, families, charitable trusts, corporations and retirement plans. We are an independent, fee-only advisor. We do not receive commissions and we do not sell any financial products. We have a fiduciary responsibility to put our clients' interest first.

Client accounts are separately managed and tailored to meet the specific needs, including risk tolerance, investment objectives, and tax consequences of each client. Client assets are held at an unaffiliated brokerage firm.

With extensive expertise in security analysis, we make direct investments on behalf of our clients buying individual securities. This eliminates costly mutual fund fees and increases the flexibility to manage volatility. We actively allocate capital to take advantage of investment opportunities altering exposure to individual companies, industry sectors, and asset classes in anticipation of the changing investment and economic environment.

We are transparent in all facets of our asset management practice and believe it is important for our clients to know what they own, why, what their performance is, and what they are paying in fees.

We build comprehensive portfolios for our clients with a goal of reducing volatility and producing prudent growth. We protect and build wealth at GKV Capital.

GKV Capital Management

Build Your Wealth to Fund Your Passions