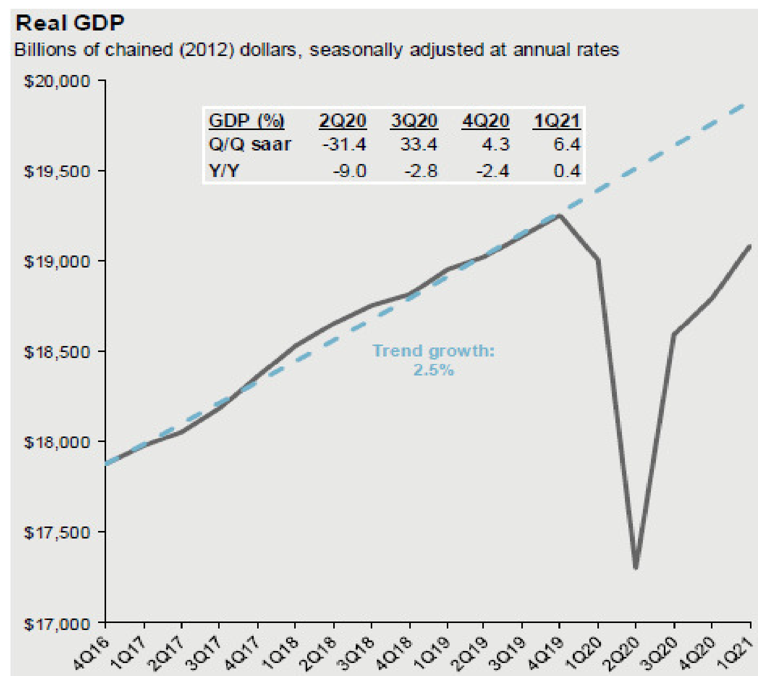
Alley Company Dividend Portfolio
2021 Q2 Letter

July 16, 2021

Apropos of the summer heat, the U.S. economy is currently running hot. Indeed, according to the Atlanta Fed's GDPNow model, the economy expanded at a rate of more than 7 percent in the second quarter. While pent-up demand from the pandemic continues to be unleashed, there is also broad strength within the major component parts of gross domestic product (GDP) – consumption, government spending, business investment, and housing.

As Exhibit 1 below depicts, the economy has already made an impressive V-shaped rebound from the COVID shock of 2020, but ample room still exists to fully recover to the preexisting trend-growth path of 2.5 percent per annum.

Exhibit 1: V-Shaped Economic Rebound and Trend Growth



Source: JPMorgan Guide to the Markets. U.S. Bureau of Economic Analysis

Clearly, the pace of growth in the U.S. economy will moderate at some point in time in the not-too-distant future. Pent-up demand will run its course and monetary and fiscal accommodation will be tapered.

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This reality shouldn't be too unnerving for investors, however, as the drivers of GDP look to be supportive of the new economic expansion cycle for the foreseeable future. As we have long opined, a backdrop of *sustainable* economic growth, even if moderate, is favorable for equity markets.

Consumption by U.S. consumers represents the largest component of GDP at approximately 68 percent. It has rarely been a good idea to bet against the U.S. consumer and today that looks to be particularly the case. The outlook for the job market is favorable with over 9 million openings and wage growth has improved in recent years. Household debt as a percentage of disposable income is at its lowest level in over 40 years and the personal savings rate has more than doubled, providing dry powder for future consumption.

Government spending currently accounts for approximately 18 percent of GDP. The Biden administration has proposed over $4 trillion in fiscal spending with the American Jobs Plan and American Families Plan, on top of the $1.9 trillion American Rescue Plan passed in March. While these bills are unlikely to be passed in their proposed form, some level of fiscal spending, including on infrastructure, can support economic growth into the future as funds are disbursed over a multi-year period.

Nonresidential fixed investments, which account for approximately 13 percent of GDP, have risen to new highs on technology-related investments. With technology permeating business more than ever before, it is critical for companies to keep up with investments to maintain competitiveness and drive productivity. Software investment, for example, rose 10.5 percent adjusted for inflation in the first quarter of 2021 driven by the ongoing adoption of cloud computing, collaboration tools, and e-commerce.

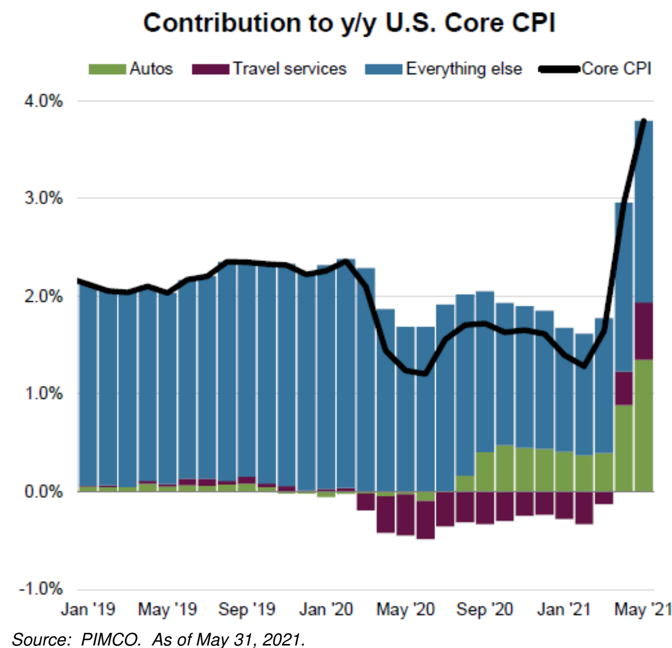
While housing currently represents only 5 percent of GDP, the sector is notorious for "punching above its weight." With the ripple effects from purchasing a new home – e.g., movers, furniture purchases, household projects, etc. – turnover can have an outsized impact on economic activity. Mortgage rates remain near all-time lows, which is supportive of affordability for a growing pool of buyers. Meanwhile, the median existing-home sales price topped $350,000 for the first time in the second quarter which provides valuable equity for homeowners. Importantly, lending standards continue to remain strict relative to the reckless underwriting practices of the 2008 housing crisis.

In 2021, the robust demand side of the economy has been met with re-opening supply bottlenecks. As a result, the Consumer Price Index (CPI) has increased to over 3.5 percent from below 2.0 percent. While modest inflation is desirable for a developed economy like the United States, high and sustained inflation – last seen in the 1970s – could have more problematic implications for consumer purchasing power, interest rates, and corporate profit margins. Thus, Fed officials are keenly watching the developing price pressures.

Fed Chairman Jerome Powell has recently suggested that the uptick in inflation is most likely "transitory" in nature and that 1970s-style price pressure is unlikely to develop. Exhibit 2 below takes a look under the hood at some of the recent drivers of inflation and reveals that sectors such

as autos and travel services – which are potentially being impacted by temporary factors – have had an outsized impact on the recent trends.

Exhibit 2: CPI Trends



Source: PIMCO. As of May 31, 2021.

Given the sharp economic rebound and supply disruptions, elevated inflation levels are likely in the near term. That said, the megatrends of globalization and technological innovation and adoption continue to be disinflationary forces that are unlikely to be displaced by the near-term effects of recovering from the pandemic. The bond market, for its part, is seemingly sending a clear signal of tepid inflationary pressures over the longer term as the yield on the 10-year Treasury bond recently ticked back under 1.3 percent.

Entering the summer months of 2021, the U.S. economy is essentially firing on all cylinders. Longer term, the economy is likely to moderate to more normal levels of growth and, with that, inflationary pressures should moderate as well. In the stock market, lower quality and highly cyclical companies have been big beneficiaries of the rapid recovery, but their day in the sun may not be lasting. Quality companies, on the other hand, have the ability to navigate through economic cycles, compound earnings growth over extended periods of time, **and share generous dividends with shareholders along the way** – these factors put them in a good position to regain market leadership in the environment ahead.

Quarterly Performance Update

During the second quarter of 2021, the Alley Company Dividend Portfolio outperformed the Russell 1000 Value Index by a modest amount. Through the first half of the year, we are pleased with the performance of the portfolio on the heels of very strong performance in the prior calendar year. As noted, lower quality and highly-cyclical companies have been beneficiaries of the recent market environment, but we don't expect this trend to be lasting.

From an individual holdings perspective, top contributors to and detractors from performance in the portfolio during the second quarter were:

Top Contributors	Top Detractors
Discover Financial (DFS)	Altria (MO)
BlackRock (BLK)	RPM International (RPM)
Microsoft (MSFT)	Abbott Laboratories (ABT)

Top and bottom performing sectors in the marketplace during the quarter are displayed in the table below.

Top Performing Sectors	Bottom Performing Sectors
Real Estate (+)	Utilities (-)
Technology (+)	Consumer Staples (+)
Energy (+)	Industrials (+)

(+) indicates that the portfolio is overweight this sector and (-) indicates that the portfolio is underweight this sector relative to the benchmark.

During the second quarter, Merck (MRK) completed their planned spin-off of Organon (OGN). We elected to not continue to hold shares of OGN in the portfolio and liquidated the position during the quarter.

Dividend announcements among Alley Company Dividend Portfolio holdings during the second quarter were:

Company	Dividend Change
Ameriprise Financial (AMP)	+9%
Apple (AAPL)	+7%
Chevron (CVX)	+4%
Medtronic (MDT)	+9%
Paychex (PAYX)	+6%
PepsiCo (PEP)	+5%
Procter & Gamble (PG)	+10%
Union Pacific (UNP)	+10%

Alley Company Dividend Portfolio

The investment philosophy of the Alley Company Dividend Portfolio focuses on striking the balance between attractive absolute dividend yield and strong dividend growth underpinned by solid company fundamentals of our portfolio holdings. We employ a bottom-up, research-driven process focused on fundamental analysis of our portfolio holdings.

Alley Company, LLC

Alley Company is a boutique investment management firm that is dedicated to operating a discernible and disciplined investment philosophy and generating superior risk-adjusted investment returns. Alley Company was founded in 1998 and in 2006 established the Alley Company Dividend Portfolio to capitalize on investment opportunities in quality companies with strong dividend-paying cultures.

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