QUARTERLY MARKET UPDATE

JULY 2021

MARKET LANDSCAPE

Name	YTD 2021 Return (%)
Barclays US Aggregate Bond	-1.6
Barclays US Credit	-1.3
S&P 500 TR USD	15.3
Barclays US Corporate High Yield	3.6
MSCI Emerging Markets	7.4
MSCI EAFE	8.8
Russell 2000 TR USD	17.5

Data Source: Morningstar Direct

Another Strong Quarter

The Standard and Poor's (S&P) 500 rose to another record high during the second quarter of 2021 as risk assets generally maintained their upward momentum. A combination of positive factors, led by significant progress in the reopening of society in a post-lockdown environment stimulated economic growth and support for global equities.

The pace of vaccinations in the US accelerated meaningfully in the second quarter, with daily vaccinations hitting a peak of more than three million per day by the middle of April. The increased pace of vaccinations combined with a decline in Covid-19 cases helped numerous states more fully reopen their economies or elicited their intentions to do so. That signaled to investors that a return to pre-pandemic normal was now likely just a matter of time.

Additionally, monetary support from the Federal Reserve (Fed) in the form of persistently low interest rates and bond purchasing activities continues to provide a favorable backdrop in which the economic recovery can maintain itself. Alongside these efforts, Congress has been providing significant fiscal support in form of government spending directly to businesses and individuals. The impact of these stimulative payments, totaling about $5 trillion, has been consequential.

This government financial support, along with a resumption of normalized economic activity, is supportive of robust economic fundamentals throughout 2021 and beyond. The Fed is projecting a 7.0% increase in real Gross Domestic Product (GDP) this year. For 2022, the Fed forecasts this growth in GDP to be 3.3%, which while reduced, is still higher than the 10-year average of 2.3% (2010-2019) and the Fed's long-run projection of 1.8%.

Employment metrics are sound, with the unemployment rate at 5.9%, job openings at all-time highs, and wage growth trending higher. Expectations are that approximately 7.5 million jobs will be created as the economy recovers from the dislocations formed during the shutdowns.

And finally, corporate earnings results and expectations are consistent with the prospect of increasing market prices. First-quarter corporate earnings were very strong, with the majority of US companies beating earnings estimates. In aggregate, year-over-year earnings growth estimates for the S&P 500 in 2021 are at present 34.8%, and 11.8% for 2022.

In sum, a material improvement in the pandemic outlook and continued government support for the economy combined to create a foundation for strong market gains in the first half of 2021. These conditions should remain intact for the next few quarters, which could fuel job creation, incomes, spending, profits, and markets as we progress into the latter half of this year and perhaps beyond.

Sector Returns

S&P 500 Sectors	YTD 2021 Return (%)
Information Technology	13.8
Consumer Discretionary	10.3
Communication Services	19.7
Health Care	11.9
S&P 500	15.3
Consumer Staples	5.0
Materials	14.5
Real Estate	23.3
Utilities	2.4
Industrials	16.4
Financials	25.7
Energy	45.6

Data Source: Morningstar Direct

Inflation Transitory?

While current conditions have been and should be complementary to economic growth and corporate earnings over the next number of quarters, they are also stimulative of

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price increases. And it is this specter of inflation that poses a risk to continued and unencumbered market gains.

Core Personal Consumption Expenditure (PCE) prices in the US, which exclude volatile food and energy costs, increased 3.4% year-over-year in May of 2021 (following a 3.1% gain in April, which matched market expectations). It is the highest rate since 1992 bringing it well above the Fed's 2% target.

Fed officials have been reiterating such price pressures are transitory because of the nature of the fiscal stimulus, supply constraints, and rising commodity prices. We largely agree with this outlook, though recognize that some of these issues will not be eliminated in the months ahead.

Inflationary factors are sometimes broadly classified as either demand (demand-pull) related, or supply (cost-push) related. Demand-pull inflation can mostly be attributed to an expanding economy or increased government spending; generally, things that spur consumer demand for goods and services. We are experiencing this phenomenon currently as we emerge from the pandemic. Pent-up demand, in the form of elevated savings and proclivity to spend, in conjunction with government stimulus, is high.

Additionally, cost-push inflation is present as supply-chain disruptions from the seizure of normal business activity have not yet been fully repaired. Commodity prices, raw materials, and other input prices are steep, adding to the demand side price pressures.

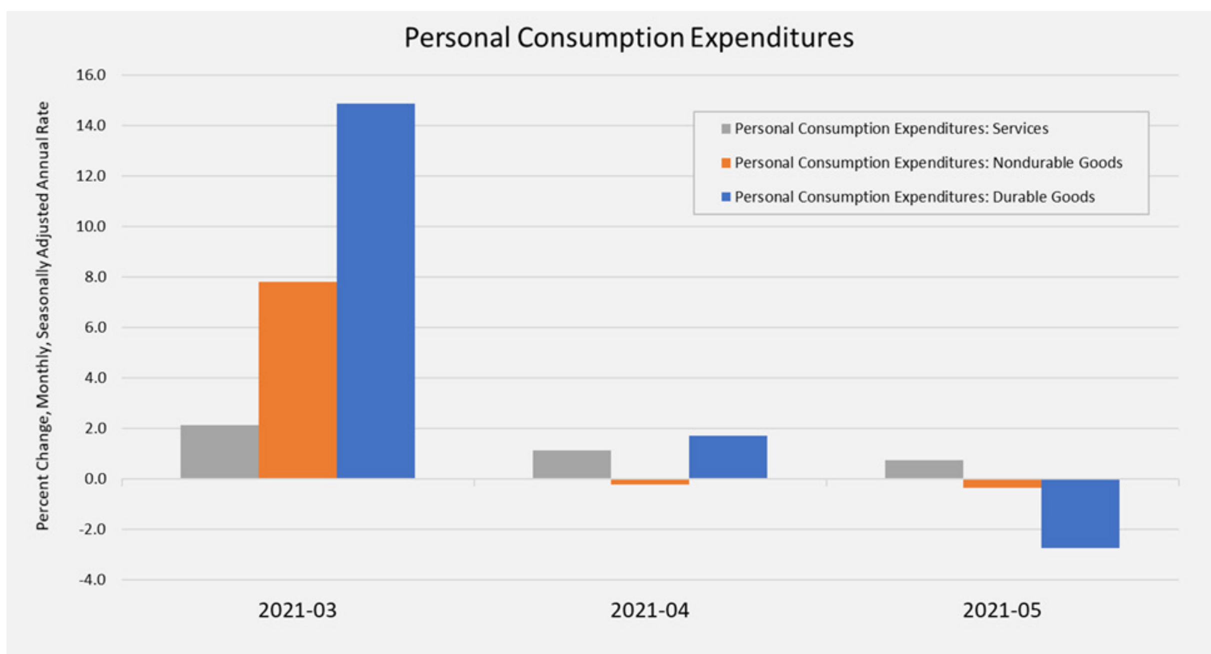
It is our view that the cost-push component of inflationary pressure will abate. The supply chain mechanisms of all goods and services across all industries are exceptionally complex. A wholesale, top-down disruption of these processes is extremely damaging, and it will take some time for the normal mechanisms to repair themselves to once again find equilibrium. But they will, and as they do, the rate of inflationary change will diminish.

Consumers Adjust

Concurrently, demand preferences of consumers will also adjust. The magnitude of pent-up demand will weaken over time, and spending preferences will correct to diminish overall price pressure. It is for these reasons we are in alignment with the Fed's language regarding the transitory nature of the current inflationary pressures.

The idea of inflation altering consumer spending behavior, and ultimately mitigating cost pressures, can be illustrated with recent Consumer Price Index (CPI) trends. CPI data can be segmented into different categories; take durable goods vs services, for example.

Chart 1 - Consumption Expenditures



Source: Bureau of Labor Statistics via Federal Reserve Bank of St. Louis

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Data for the month of May indicate that CPI increased year-over-year at a rate of 4.9%. Looking specifically at the category of durable goods (cars, appliances, electronics, etc.), it increased at a much higher rate of 10.3% for the same timeframe. By contrast, CPI for the services sector increased only 3.1%.

As a result of this divergence, Chart 1 demonstrates the migration of consumer expenditures to the relatively cheaper services sector. Considering current circumstances, people have altered their spending preferences (demand profile) and are voting to maintain spending levels on services and experiences while reducing purchases of items that have been impacted more severely by the high input costs.

The effect of this aggregate reduction in purchasing preferences is not immaterial. Chart 2 highlights the coincident reduction in lumber prices, for example, as high durable goods prices have caused consumers to hold off on home building and other large purchases. Admittedly, the 50% drop from the high in the price of lumber is not entirely due to lower demand, but it is certainly a significant contributor. This phenomenon, translated across a broad spectrum of goods, is deflationary.

Monetary Base

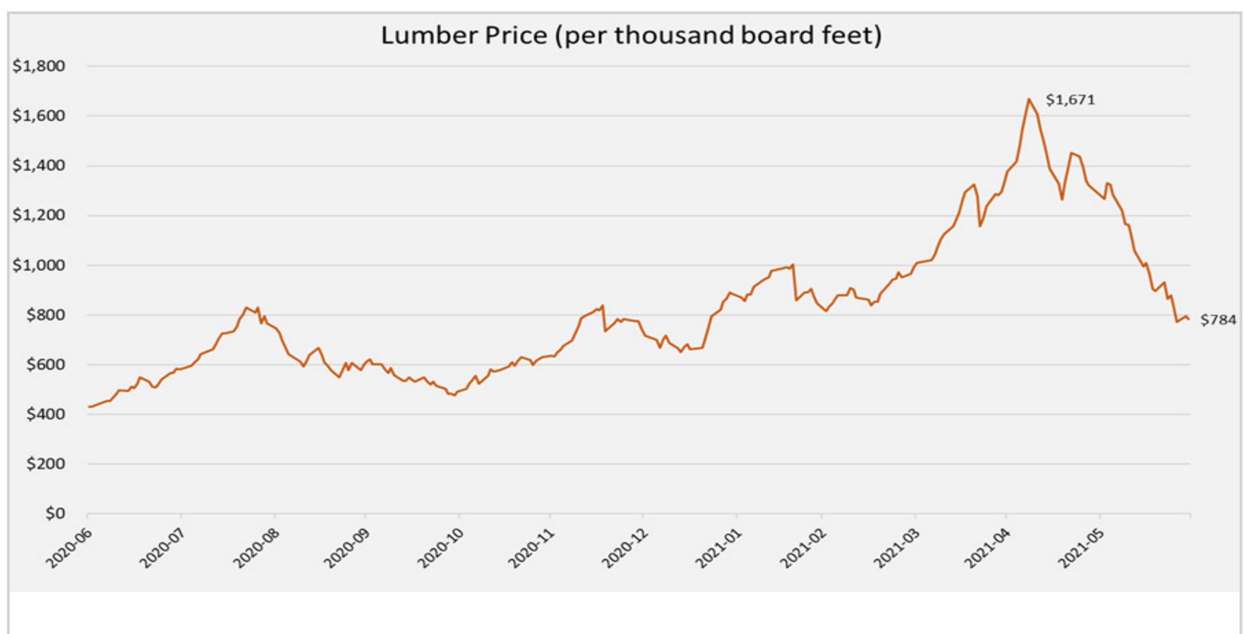
While we suspect that much of the current inflation attributable to constricted supply factors and elevated components of demand may be fleeting (supporting the transitory narrative), the impact of the inflated money supply will likely increase in both magnitude and importance as we move into next year and beyond.

We view inflation as primarily a monetary phenomenon, contingent largely on the size, velocity, and growth of the money supply in the economy. Its recent massive expansion and its effects should not prove as short-lived. The US money supply, as measured by M2 (M2 is a calculation of the money supply that includes all includes cash, checking deposits, savings deposits, money market securities, mutual funds, and other time deposits), is currently $20.4 Trillion, which is approximately 27% higher than when the pandemic hit in 2020.

Historically, annualized M2 growth is in the realm of 6%. The rapid increase in the amount of dollars in circulation, much of it distributed through direct payment, not through normal banking and reserve lending channels, will exert upward inflationary pressures when and until this difference is either absorbed or reversed.

This is not to indicate runaway inflation is imminent. It is simply to write that the economy could experience inflation rates higher than we have been accustomed to over the next few

Chart 2 - Lumber Prices



Source: Bureau of Labor Statistics via Ycharts

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years. Forecasts of 3.5% inflation for 2021 and 4.5% inflation in 2022 seem reasonable. While certainly higher than in the recent past, one should remember that long-term inflation rates exist in the 2.5% to 3.5% range, depending on the period measured.

Fed Dependent

Regardless of the varied elements of inflation, the actions of the Fed related to interest rates, and investor response to these measures are likely the biggest threats to economic and market stability going forward. In early June, selected inflation statistics supported the notion of inflation pressures diminishing, plausibly validating the Fed's belief that surging inflation is temporary, thereby dampening the prospect that the Fed might tighten its policy ahead of its communicated schedule.

The June Fed meeting revealed, however, that Fed officials had begun discussions about accelerating the reduction of quantitative easing; Fed forecasts showed interest rates could begin to rise late in 2022, sooner than previously expected. After some market volatility, investors remained confident that the Fed would not remove economic support too quickly. The S&P 500 hit another record high by the end of the quarter.

While the market holds this sanguine view, the Fed may indeed be contemplating softening its very loose policy prescriptions sooner than some may think. There are those that believe a tapering plan will be announced in August or September this year and begin in early 2022.

If the Fed decided to reduce its bond-buying from its current $120 billion of Treasury and agency mortgage-backed securities each month to $80 billion, for example, it would still represent an overall dovish stance. Similarly, if the Fed eventually bumps up the target range for the fed funds rate from 0.00-0.25% to 0.25-0.50% early in 2023, the policy rate is still going to be accommodative.

But it would represent a tightening of policy, nonetheless. And because everything is relative, moves such as these can cause nervousness in the markets. This is a potential risk. As we have written previously, the predominant contributor to robust equity returns over the past number of years has been the historically low interest rate environment.

Whether engineered by the Fed or simply a byproduct of positive and reinforcing economic synergies, equity prices are mathematically enhanced in the presence of reduced discount rates. When these conditions are altered, it is objectively fair to conclude that it could cause apprehension and bouts of market instability.

That moment has yet to arrive, though. The pace of gains has diminished recently, but the market still very much appreciates the conditions (economic growth, strong earnings, historically low inflation) it sees and anticipates, despite valuation. The S&P 500 sits at a forward price-to-earnings (P/E) ratio of 21.4, according to FactSet. This is higher than the 5-year average of 18.1 and above the 10-year average of 16.1.

Until the Fed alters its forward guidance in a way that dissatisfies market participants, though, we can expect to see the markets using periods of weakness to buy the dips, and all manner of equity sector and styles (small, large, value, growth, cyclicals, discretionary, etc.) should continue to present a desirable target for investors, even at historically fully valued levels.

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