Insights: July 2021

Market Overview and Performance

To a large extent, the first half of 2021 has delivered all that we had anticipated and more from an investment perspective. While defensive assets like fixed income and gold have not been additive to portfolios, risk assets, and US stocks in particular, have produced substantial gains to an extent that most only thought possible by year end at best. As we wrote before the US Presidential election late in 2020, regardless of who won the election, the acting administration would have to tackle two challenges to move the country and economy forward. First, COVID-19 vaccines would have to be developed and widely distributed among the population. Second, a massive amount of stimulus would have to be injected into the economy to re-start an environment where virtually all commerce had been brought to a dead halt. On the positive side, both of these things have transpired. Vaccines are now readily available and several rounds of legislated stimulus dollars have been dispersed. As a result, the trajectory of the virus was significantly curtailed and economic growth has been robust. However, as we look ahead to the second half of the year, concerns have arisen. Namely, the vaccine uptake rate has not been nearly as high as hoped and strong growth measures that were spurred by re-opening of the economy seem to be abating. As private equity manager Hamilton Lane commented this week, "COVID watching has moved front and center for the U.S. as we watch the 4th wave of case and hospitalization accelerations…While this new spike remains unlikely to derail the manufacturing economy, it is again disrupting travel and social gatherings, and could impact school and return to work plans. Over the weekend, Goldman Sachs even moved to adjust lower their second half of 2021 GDP forecasts." We remain confident that the elements for further sustained growth within the economy are in place and will continue throughout the second half of the year, however, "back to normal" remains elusive.
As always, thank you for reading our latest Insights.

	Quarter to Date June 30	***Year to Date June 30***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	2.33	15.25
Russell 2000 Index	1.94	**17.54**
MSCI EAFE Index	-1.13	**8.83**
MSCI Emerging Markets Index	0.17	**7.45**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.70	**-1.60**
Barclay's U.S. Aggregate Credit Index	**3.55**	**-2.49**
Barclay's U.S. Aggregate Corporate High Yield Index	1.34	**3.62**
Barclay's Municipal Bond Index	0.27	1.06
Macro Measures		
Gold	3.26	**-6.52**
Crude Oil	**23.01**	**49.98**
CBOE Volatility Index	**-20.21**	**-31.96**
USD Dollar Index	-0.85	2.79

Current Theme – First Half Risk Asset Performance Has Exceeded Expectations, However Concerns Over the Virus and Rising Inflation Remain at the Forefront

Within the US, the Rate of the Vaccine Roll-Out has Plateaued Causing Variant Worries While Elevated Inflation Measures Could be a Problem if Growth Slows

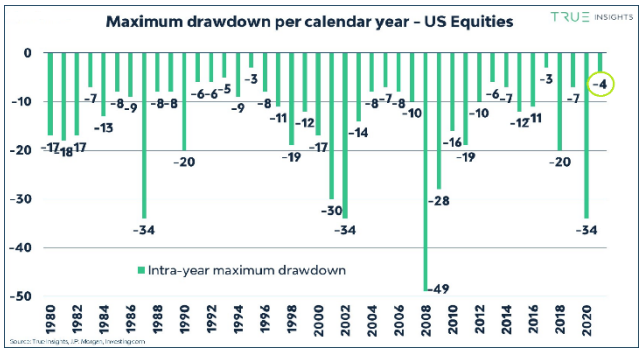
With returns in the high teens thus far in 2021, its not hard to see why investors are enthusiastic about US stocks. Clearly, the re-opening of much of the economy over the past six months has initiated a dramatic period of growth in which investors have a strong conviction about wanting to participate.

S&P500 7 Successful Tests of 50 Day Moving Avg. in 2021

Source: Refinitiv

As the chart above highlights, the S&P 500 has been on a steady march higher over the past twelve months, and each time the Index declines slightly back to its 50 Day Moving Average (7 times thus far in 2021), investors have stepped in to buy more stocks at this key technical measure of market strength.

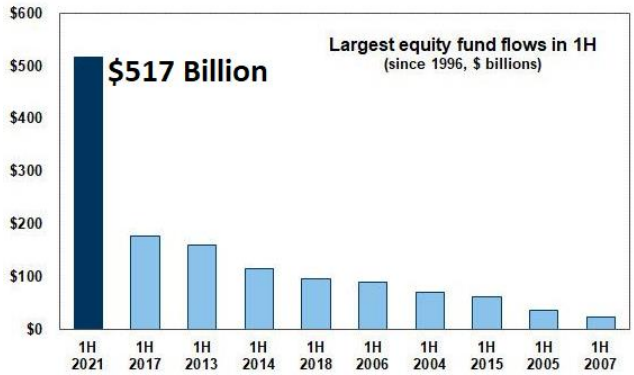
Largest Decline in 2021 is -4; Three -5% Pullbacks on Avg.



Source: True Insights; J. P. Morgan; Joroen Blokland

In fact, as the previous chart illustrates, the largest decline so far in 2021 has been just -4%. Keep in mind that according to LPL Research and others, since 1950, the S&P 500 has averaged *three* -5% pullbacks per year and one -10% drawdown. What's apparent is the fact that there are plenty of investor dollars on the sidelines ready and waiting to take advantage of any opportunity, even if its relatively small.

Global Equity Inflows in First Half 2021 Largest on Record



Source: Goldman Sachs Investment Research Division

Consider the chart above from Goldman Sachs. In the first half of 2021, over $500 billion dollars flowed into global equities, dwarfing any other start to a calendar year. To give a sense of the magnitude of this activity, Goldman Sachs points out that if this pace continued for the balance of 2021, the full year addition of capital would be larger the last 20 years of inflows *combined*.

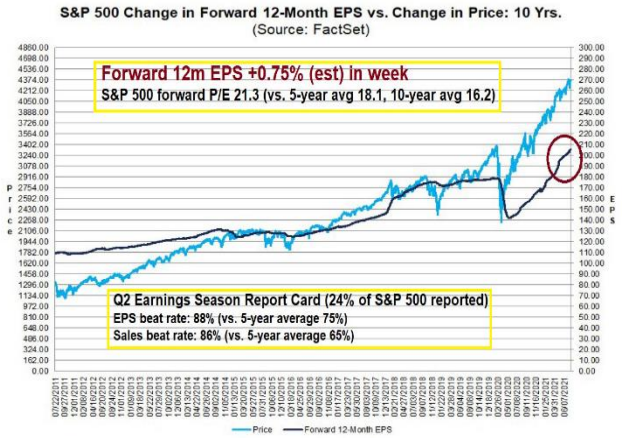
Market Breadth Has Deteriorated Across Most Segments

Source: Bloomberg; Liz Ann Sonders

Having a steady stream of buyers introduces a certain amount of comfort into markets, but it does not however, guarantee that all areas of the equity market will rise in a coordinated way. Differentiation is inevitable. In our April Insights letter, we wrote about

the incredible breadth in the market when 95% of S&P 500 stocks were trading above their 50 Day Moving Average – a level only achieved twice before in 2003 and 2009. However, as the previous chart demonstrates, breadth has declined steadily since that time with the percentage of names above the 50 day measure now at just 47%. Notably, the chart also shows that breadth of the Nasdaq (broad technology) and the Russell 2000 (small cap) actually peaked in February. The interpretation here is that one can no longer "just buy the market", stock selection matters.

Forward Earnings Continue to Increase; Now Up to $214



Source: Factset; Cam Hui

As we have long stated, prices follow earnings, so while the whole market is no longer rising, earnings most certainly are. As the chart above shows, earnings continue to climb with the 2022 estimate now over $214, bringing down the forward Price/Earnings ratio below 21 as reported results exceed expectations. We have also seen a change in leadership which is helping to drive the momentum higher in earnings growth.

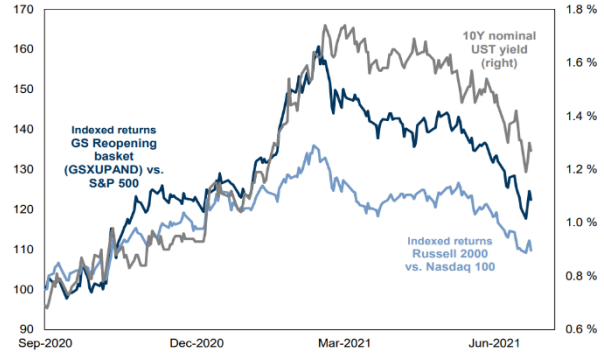
Seasonality Trends are Right on Track Thus Far in 2021

Source: Goldman Sachs Global Investment Research; The Market Ear

The previous chart suggests that over the last 35 years, the Nasdaq 100, or the very largest technology companies, historically assume leadership around July and then continue to hold that position for the remainder of the year. That pattern has held true this year as well as earnings and revenues for large technology names have proven to be incredibly robust.

Cyclical and Reflation Trade Theme Peaked in March

Exhibit 3: Cyclical stocks and Treasury yields have recently declined
as of July 22, 2021

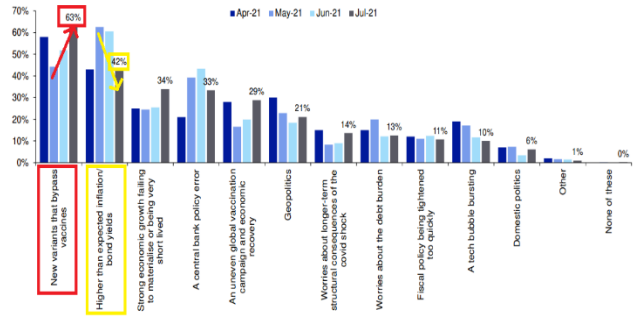


Source: Goldman Sachs Global Investment Research

Importantly, the other dynamic impacting the market is what is ceding leadership. In anticipation of the economy re-opening, reflation trades have rallied strongly since last Autumn. As the chart from Goldman Sachs illustrates, indicators of the re-opening boom such as the 10 Year Treasury Yield, Small Cap over Large Cap, and their own basket of "Reopening" stocks have all faded from the high seen in early March.

Investors More Worried About Variants than Inflation

Figure 1: Which of the following do you think pose the biggest risks to the current relative market stability? Please select up to three

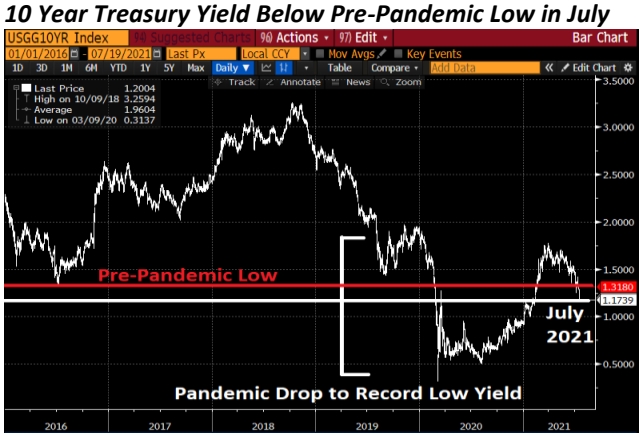


Source: Deutsche Bank

While growth of the US economy remains very strong on an absolute basis, there are some legitimate reasons for this to be occurring. As the Deutsche Bank chart above shows, about 65% of their large institutional clients believed that rising inflation due to

an overheating economy was the biggest threat to market stability in May while only about 40% considered COVID variants to be the biggest risk. Two months later, their July survey shows that those figures have reversed, a somewhat worrying trend.

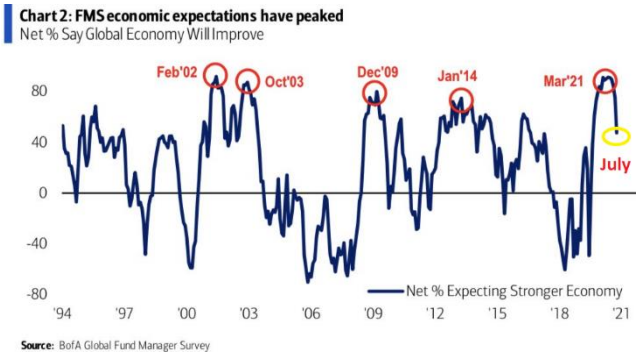
10 Year Treasury Yield Below Pre-Pandemic Low in July



Source: Bloomberg

The Bond market is telling us that investors believe the variant risk will indeed stifle growth and throw the recovery off-track. Consider the graph of the 10 Year Treasury yield above which encapsulates some sentiment of growth expectations. Its now trading *below* pre-pandemic levels hitting 1.13% on July 20th.

Manager Survey: Growth Expectations Have Peaked



Source: BofA Global Fund Manager Survey

Bank of America confirmed this view in their July Global Fund Manager Survey. As one can see above, expectations for improving economic growth have been on the decline since March with roughly only 40% of respondents seeing expansion. The bank produced a similar chart for inflation expectations which had clearly been the main lingering concern during the first half of 2021. As the following charts Guggenheim Investments illustrate, an examination

Inflation Spike Limited to a Few Sectors

Source: Guggenheim Investments

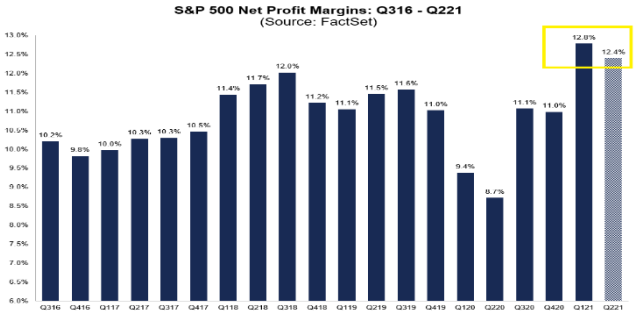
of the components of Core CPI reveals that only a few sectors with temporary supply and demand issues account for much of the move higher, things like cars, hotels and airlines. When those segments are removed from the measure, inflation does not appear to be widespread. The Bond market has embraced this view. The chart below from Nordea highlights the fact that even as headline inflation continues to move higher, investors are pricing in *lower* inflation for the outlying periods. In short, bond investors believe that inflation will be contained and not lead to Fed policy mistakes.

Bond Market Pricing in Lower Inflation Going Forward

Source: Nordea and MacroBond

We see further confirmation that inflation has not negatively impacted the ability of corporations to successfully execute their business via profit margins. As seen below, S&P 500 profit margins are roughly 12.5%, the highest level recorded since Factset began tracking the data in 2008.

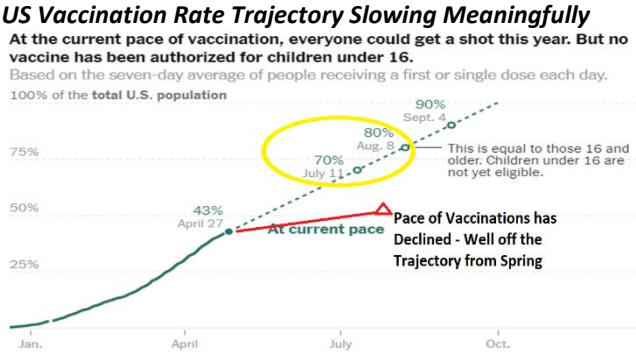
Rising Inflation Has Not Impacted Profit Margins



Source: Factset

Companies then, have largely been able to manage any temporary input cost increases and maintain profitability. Certainly, one of the most significant challenges to economic growth has been difficulties in labor supply, but thus far, wage inflation has not been a problem. If it was, we would see it reflected in the profit margin numbers above.

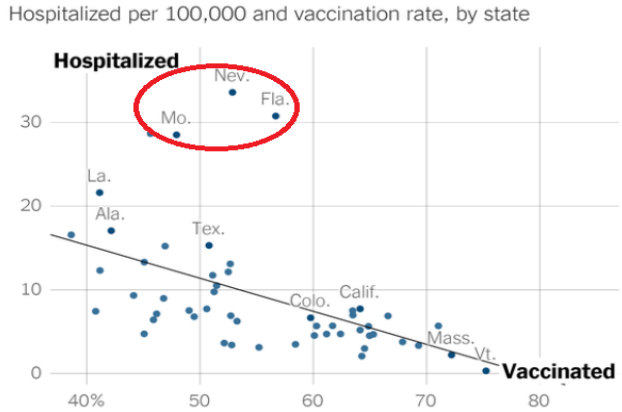
US Vaccination Rate Trajectory Slowing Meaningfully



Source: New York Times

The focus for many then turns to the pace of economic growth. As we discussed, the market appears to be worried about the most recent COVID trends. We used the chart above in our April Insights letter. At the time, the pace of vaccination in the US would have achieved roughly 75% of adults by this time (yellow circle). However, that has not happened. As one can see, the actual level is about 50% (red triangle) and at the current pace, it would take another eight months to reach 75% vaccinated. This is important because if the variants force a return to more restrictive measures, the economy will suffer. We are already seeing the effects in some areas. The chart below for example, shows that the states with lower vaccination rates are experiencing higher hospitalizations. This is particularly challenging if economic activity slows in states like Nevada and Florida that are tremendously dependent on attracting tourists to visit their state.

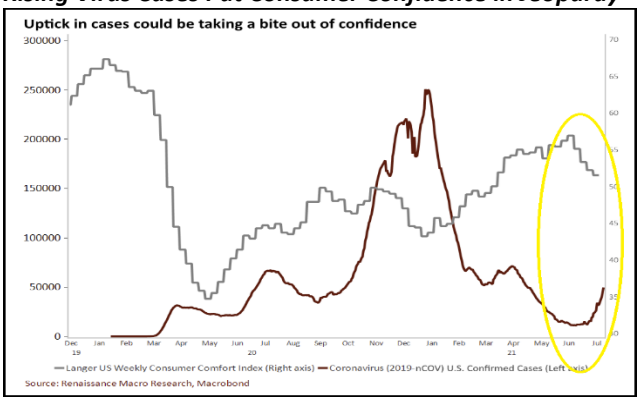
Lower Vaccination States Seeing Higher Hospitalizations



Source: The New York Times

More broadly, as we have written about many times in the past, consumer spending comprises about 70% of US GDP. Consumer confidence plays a huge role in consumer behavior, and as the chart below from Renaissance Macro highlights, when virus cases increase, confidence tends to retreat. Thankfully, with the distribution of vaccines coupled with the people who have already been infected, the health impact of the current variant should prove to not be as devastating. However, negative sentiment among both consumers and investors has the potential to turn into a self-fulling prophecy with negative consequences.

Rising Virus Cases Put Consumer Confidence in Jeopardy



Source: Renaissance Macro research; MacroBond

Going Forward

As we stated in our opening comments, the returns achieved via the equity markets have surpassed what we believed was achievable during the first six to seven months of the year. While we certainly were believers in the growth thrust that would occur due to large stimulus dollars, an accommodative Fed policy and the re-opening of the global economy, the amount of pent-up dollars that flowed into the market was larger than we would have anticipated. As we discussed, market rotation away from the reflation trade and into fundamentally strong entities with growing earnings and sales is very healthy and welcomed in our view. It is also a testament to not chase short-term trends. While Value and Small Cap companies dominated the earlier part of 2021, Growth and Large Cap have now outperformed year to date. This is also a good illustration of why risk management is critical to portfolio construction so that we are able to gain exposure to a broad range of various segments of the market while at the same time having the flexibility to take advantage of opportunities as they arise. This holds true for fixed income and commodities like precious metals. While those exposures will trail in a strong risk-on environment, they will be important components if the growth worries resulting from the virus variants comes to fruition. At this point, our view is that no serious harm will be done to the economy and second half growth will remain elevated. However, there clearly are signs that investors are wary of a potential slowdown so we remain vigilant.

As we wrote in our April Insights, we did take profits in selected equity positions in early May when the S&P 500 pushed above 4200. Locking in those profits has proved beneficial as we continue to find opportunities in quality companies which we view as trading at discounts to their long-term value, namely in the financial, industrial and consumer sectors. With that said, we never reduced our exposure to the large capitalized technology and communication names which were out of favor during the recovery trade enthusiasm, but have since proved their incredible earning power and sustainability of their business models and now have resumed the mantle of market leadership. We believe these names will continue to lead the market higher throughout the second half of the year. We have been able to identify several strong cash generative businesses across industry groups that have proven that their business can succeed in both challenged economic environments and recovery periods simultaneously. This most recent earnings reporting period has allowed another opportunity to increase investments to those companies.

Small and mid-cap stocks have delivered outsized returns since the election last November, but have now been eclipsed by the large cap segment. These companies are more levered to the US economy and benefit from the re-opening dynamics. In general, these companies do best when the rate of improvement is highest, not necessarily when the expansion as a whole takes hold. We therefore reduced some exposure to these market cap segments.

We continue to believe that compelling opportunities exist within non-US exposure. In fact, our dedicated Japan exposure in particular has been very additive over the past twelve months. Despite the lagging vaccine response in Europe and some emerging markets, a global economic recovery in the second half of the year when the rate of improvement in the US wanes somewhat makes these areas attractive.

Within fixed income, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value. Fixed income allocations have been very challenging for investors thus far this year with first half declines experienced for the first time in decades. While the prospect for returns remains muted in treasuries for example, we do believe that allocations to other areas can offer better results and diversification benefits.

Our measured allocation to gold has continued to serve as a non-correlated asset despite the recent declines. Broader commodity exposure has proven to be beneficial this year.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.