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First Half Review and Investment Outlook

July 2021

Equity share prices remained strong in the first half of 2021, as positive momentum that began in the fall of 2020 with the arrival of COVID-19 vaccines continued, and the S&P 500 reached new all-time highs. Improving economic growth, government policy support, and strong earnings overcame concerns about inflation and the potential for central bank policy mistakes. The table below provides total return figures for key asset classes for periods ending June 30th. U.S. stocks continued their outperformance versus foreign equities, a premium which has proved durable over the past decade. (It should be noted that the prior decade favored foreign stocks.) Unlike a year ago when bond returns were superior to those of both U.S. and foreign stocks, fixed income returns were well below those of equities and in many cases slightly negative.

Major Asset Class Indices[1]	Total Return 1st Half 2021	Total Return Last 12 Months
S&P 500 (U.S. Large Cap Stocks)	+15.2%	+40.8%
MSCI EAFE (Foreign Developed Large Cap Stocks)	+8.8%	+32.4%
Bloomberg Aggregate Bond Index (U.S. Investment Grade Bonds)	-1.6%	-0.3%
US Short-Term Treasury Bills (Money Market Fund)	+0.0%	+0.1%

In the 1st quarter, U.S. stocks were led by cyclical sectors, as these more economically sensitive industries saw their share prices increase following positive news on vaccinations and business reopenings, and the tailwind provided by the recently passed federal stimulus. In the 2nd quarter, market leadership returned to many of the technology growth stocks that led markets through much of the recovery in 2020. Despite the steady[2] and strong equity returns, volatility was not absent from the market, as individual stocks and sectors have displayed higher levels of volatility in both directions – up and down. One such example in the capital markets is the retail-driven rallies in several smaller cap stocks.

Bond yields have increased for almost all maturities thus far in 2021. A gradual steepening of the yield curve is generally viewed positively by equity investors, as it indicates an improving economy. The bellwether 10-year U.S. Treasury bond's yield has increased from less than 1% on January 1st to 1.4% at the end of June, a relatively large move over a short time period. Most of this increase occurred in the first quarter, however, and some strategists have pointed to the recent decline in yields – especially on longer-dated bonds – as a cause for concern. Although there may be technical reasons for the decline, some believe the bond market is now signaling the potential for a slowdown in the second half of the year due to (a) decelerating support from monetary and fiscal policy and (b) peak earnings and economic growth for this cycle.

The U.S. economy has continued to improve, helped by the fact that over half the U.S. population is estimated to be now fully vaccinated. Despite worker shortages and logistical hurdles, U.S. GDP growth is estimated to have been over 7% in the 1st half of 2021, the fastest seen in decades. In the 2nd half of 2021, U.S. GDP growth is expected to be over 5%, which would remain well above average, as households spend down record savings and business sector growth continues, despite near term supply constraints. Looking beyond the U.S., the International Monetary Fund (IMF) raised its forecast for global GDP growth to 6% in 2021, marking a sharp post-pandemic recovery with a rate of growth that, if achieved, would be the highest since 1980. This follows a global GDP decline of 3.5% in 2020, which was the worst 1-year contraction of economic output during peacetime since the Great Depression.

The massive fiscal stimulus prompted by the pandemic's economic repercussions (and totaling over $5 trillion) is winding down, with supplemental unemployment benefits ending in early September. Though the Federal Reserve believes that

[1] The S&P 500 Index is a broad measure of U.S. large capitalization stocks; the MSCI EAFE Index (Net) is a broad measure of mid-large capitalization stocks in developed international markets; the Bloomberg U.S. Aggregate Bond Index is a broad index of U.S. investment grade bonds; the 90-Day U.S. Treasury Bill represents short-term government money market funds. Returns are provided by sources deemed to be reliable but are subject to change or revision.

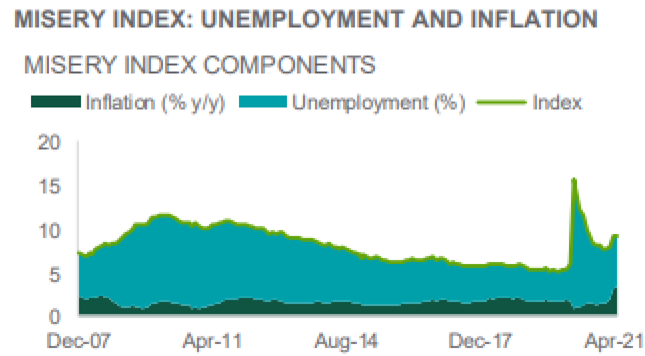
[2] In 2021, the S&P 500 has not experienced a 10% decline or correction. On average, historically these occur every 2 years or less. Following bear market recoveries, they have generally occurred within 3 years.

there is more work to be done to rebuild employment, the official U.S. unemployment rate is now less than 6%, which is the 20-year average. The labor scarcity issue is exceptionally complex with many other factors at play, including childcare, changes in workers' expectations, and lingering COVID-19 worries. Regardless of how these factors evolve over the long term, higher wages – especially for lower-skilled workers – could well be one of the pandemic's lasting impacts.

Pandemic-related shortages, logistical constraints, and wage pressures have contributed to higher recent inflation. Predicting inflationary trends is notoriously difficult, and the question of whether inflation will remain sticky is still to be determined. What is known is that thus far the annual inflation rate in the U.S. – as measured by core CPI – has reached 3%, including an increase of almost 1% in one month, the highest since 1982.

This Too Shall Pass

The misery index, created amid the stagflation of the 1970s, simply sums unemployment and inflation. It has recently been at a decade-high — and more recently driven by higher prices as elevated unemployment only slowly declines. Concerning? Not overly. Plentiful job openings should solve for the unemployment issue in upcoming months. Inflation is proving a bit stickier than many expected, as supply chains are slow to untangle and reset, but we are seeing some rollover in pricing (e.g., lumber prices halved over the past two months).



Source: Northern Trust Co.

Although there is no guarantee that higher inflation is here to stay, many investors are focused on that possibility. A major risk to the financial markets is that the U.S. Federal Reserve and other global central banks may be forced, as a result of accelerating inflation, to tighten monetary policy more quickly than they would prefer – a development which would likely dampen economic output and cause investors to reduce their appetite for equity risk. History, however, shows that equity investors will tolerate at least some acceleration in inflation if it is accompanied by stronger economic growth and higher earnings.

We are closely monitoring economic factors to evaluate whether recent interest rate and inflation pressures will be transitory or will persist well beyond the end of the pandemic. Historically, low interest rates and easy credit breed financial problems, which can be delayed by government policies but not necessarily fixed. These can cause economic distortions in areas such as housing prices and margin debt, the latter of which has increased more than 50% over the past 12 months and recently reached an all-time high. Extreme increases in margin debt have been precursors to significant market corrections.

Developments in the first half of the year have not changed our near-to-intermediate term investment outlook, which remains cautious in the face of continued strong equity performance and relatively high market valuations. The deceleration of monetary and fiscal stimulus, which were crucial to helping many individuals and businesses economically survive the pandemic, will be a headwind. We maintain our more conservative approach to fixed income by keeping bond maturities relatively short. Above all, we remain focused on our long-term investment goal of participating in market increases while limiting exposure to significant declines; we implement this strategy by regularly rebalancing diversified portfolios of high-quality stocks and bonds, which we believe should compensate investors for the inevitable uncertainty present in the economy and capital markets.

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