

ECONOMIC & MARKET INSIGHTS

Second Quarter 2021

EXECUTIVE SUMMARY

As the second quarter began, the economic recovery from the coronavirus pandemic was gathering steam, and returning to a normal life seemed possible. Investors were optimistic, turning to downtrodden sectors of the equity and commodity markets which were most responsive to the rebound in global demand and rising inflation. The second quarter was a good one for investors with all major asset classes advancing. The U.S. stock market reached a new high. International and emerging equity markets lagged the U.S. recovery but also produced healthy returns. While small-cap and value-oriented cyclical stocks outperformed earlier in the year, market leadership reversed during the quarter with large-capitalization companies and growth once again taking the lead. Stock prices were supported by healthy corporate earnings and the promise of a robust economic recovery buoyed by central bank stimulus. The rebound in corporate earnings since the depths of the pandemic has been exceptional. Earnings for S&P 500 companies increased almost 50% during the first quarter, and a record number of companies have issued positive guidance for the second quarter. After stumbling earlier in the year, bond markets gained lost ground when interest rates stabilized.

The second quarter ended with an uptick in volatility as new variants of the virus seemed to be gaining ground. This development could set back the reopening of economies worldwide and upend global growth expectations. The number of new coronavirus cases has recently trended upward in several regions and some governments are delaying reopening or again putting in place restrictions designed to limit the spread of the virus. This uncertainty calls into question stock valuations, commodity prices, and the level of long-term interest rates.

The Federal Reserve inadvertently added to investor anxiety towards the end of the quarter by announcing that potential rate hikes could be sooner than expected. The market reacted quickly to the Fed statement, pushing down long-term interest rates and flattening the yield curve. Other factors also suggest a deteriorating view of long-term growth and inflation potential. There are indications that even if the recovery continues, U.S. economic growth and corporate earnings are close to a peak. Despite high current inflation readings, TIPS breakeven rates reflect moderate expectations for long-term inflation. Flows into commodities that would benefit from re-inflation have turned negative. While the outlook remains positive, elevated valuations across investable assets, and unusually high uncertainty call for asset allocations close to target levels, broadly diversified across global markets and investment styles so that an overall investment program will be buffered under any scenario.

ECONOMIC INSIGHTS

Economic growth remains robust as the recovery gathers additional steam. Vaccinations in the U.S. have reached the important threshold of over half the population receiving at least one dose, allowing the country to near herd immunity. Rapidly falling cases have also allowed people to resume more activities from their normal lives. Massive stimulus and increased savings have all contributed to heightened consumer spending. These factors have raised prices for most goods and services, potentially paving the path for higher inflation in the future. Normalization of the economy continues and even the most beaten down sectors are showing encouraging signs of improvement. All these factors favor an extended recovery in GDP growth, and U.S. output levels are set to rise above pre-pandemic levels by year-end 2021 – a remarkable feat considering the state of the world just twelve months ago.

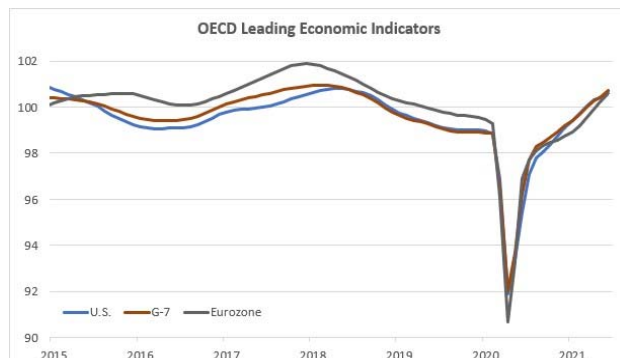
Following large declines in 2020 stemming from the pandemic, S&P 500 operating earnings have had a remarkable recovery – rising over 50% year over year. So much so that S&P 500 earnings are expected to hit a new all-time high later this year. The speed and the extent of the recovery reflects that large and influential sectors, such as technology, health care, and consumer staples, realized smaller impacts from the pandemic. In some cases, companies within these sectors even benefited from the crisis. A continued recovery in the more greatly impacted sectors should help power an extension in earnings over the coming months. While the near-term outlook appears constructive, it's yet to be seen if it can be sustained further into the future as it will likely have to overcome higher input costs, wages, and corporate taxes.

The next few months will provide more clarity on the next stage of the recovery. The future state of supply chains, the labor market, and economic growth will determine if higher inflation is transient or structural. These factors will also help establish the forward path of the U.S. Federal Reserve, which has started receiving heightened pressure to rein in at least some of the pandemic-related aid. The country continues to walk that fine line of robust growth without economic overheating. That said, numerous risks persist, such as runaway inflation and new strains of the coronavirus, that could derail the recovery and dramatically change the forward outlook.



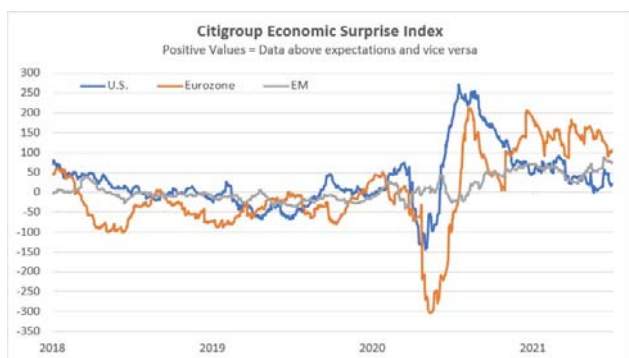
Federal Reserve Bank of New York

Following a remarkable recovery from pandemic lows, the Weekly Economic Index has started to level off. Nonetheless, this index, which measures several daily and weekly indicators that approximate GDP growth, is still well above any pre-pandemic readings.



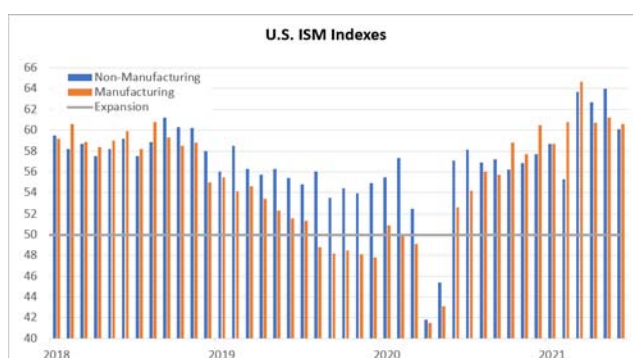
Organization for Economic Cooperation and Development

Leading economic indicators have continued to rise, going against some concerns that economic growth could be leveling off. Strength in these metrics has been widespread and present across many areas of the economy and various regions.



Citigroup

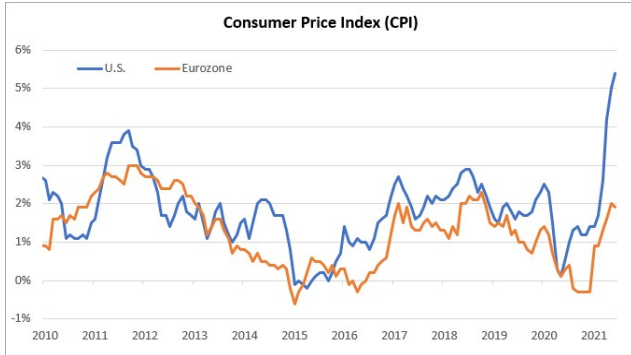
Expectations have come more in line with results recently, contributing to lower readings in Economic Surprise Index metrics relative to the prior year. The trend within emerging markets has seen the largest increase over the past several months.



Institute for Supply Management

Both manufacturing and service ISM Indexes are at historically-elevated levels despite having fallen somewhat from recent all-time highs. While the manufacturing sector recovered more quickly, the services sector has since caught up as people resume various elements of their daily lives.

The unprecedented level of fiscal and monetary policy injected into the system during the pandemic has so far proved to be a powerful jolt to jumpstart the recovery. The word “unprecedented” is not used lightly, as the federal debt level is projected to reach a new all-time-high relative to GDP by the end of this year. This ratio is even slated to be higher than the period following World War II. While the scale of government intervention appears to have been effective, it also presents an increasing risk if the government fails to demonstrate fiscal discipline in the future once the economy has greater strength to stand on its own footing. Failure to do so could unleash inflation, force higher taxes, and stifle growth.



U.S. Bureau of Labor Statistics

Inflation has risen considerably since the depths of the pandemic in early 2020. While price increases were initially contained to certain high demand areas of the economy, such as consumer goods and housing, other harder hit areas that cut supply are now also seeing higher prices – like travel and leisure.



Bloomberg

The federal budget and Federal Reserve balance sheet have ballooned following numerous financial and economic aid efforts deployed to combat the effects of the pandemic. While daunting, it is likely this level of spending will continue in the near term as aid efforts remain and additional spending plans (such as infrastructure) are introduced.



U.S. Federal Reserve and Bloomberg

The U.S. Dollar (USD) has recovered modestly relative to a basket of other global currencies, although it remains well below heightened levels reached during the pandemic when investors fled to global reserve currencies. The potential for higher yields could increase the relative attractiveness of the USD going forward.



Bloomberg

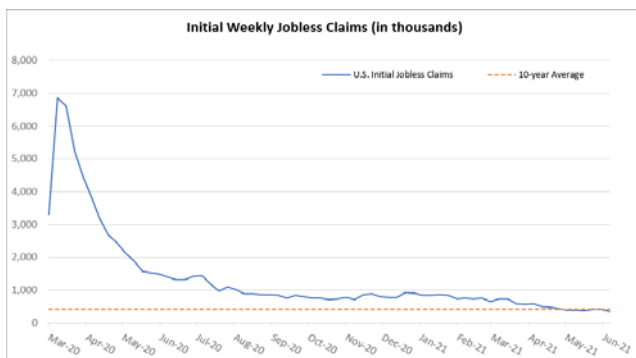
After declining meaningfully during 2020, S&P 500 earnings are slated to reach new highs later in 2021. Resiliency in larger constituent sectors (technology, health care, etc.) has helped with the speed of the resurgence.

Some productivity gains have also been realized from adaptations made to operations in the pandemic.

EMPLOYMENT AND THE CONSUMER

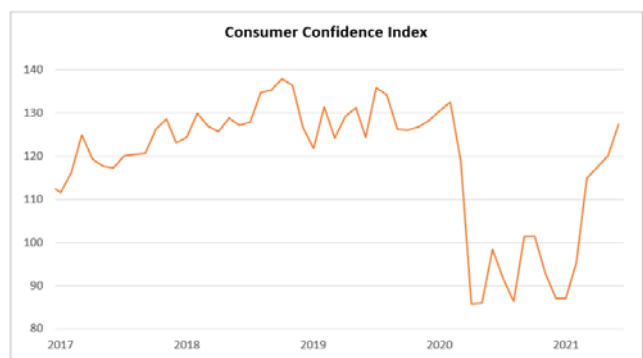
The recent economic growth has been led by an exceptionally strong labor market rebound. When the pandemic first took hold, the majority of people who lost their jobs were in low-wage sectors. Couple that with a high level of labor demand and a low level of supply, employers are almost required to increase wages to entice people to return to work. The risk to be aware of is if these higher wages could inevitably lead to medium- to long-term inflation, typically less "transitory" in nature than the Federal Reserve would like. To be as cautious and preventative as possible, the Fed will likely be monitoring how the increased wages and consumer prices may affect inflation. It should then act promptly to mitigate any further unwarranted long-term inflation.

Since the start of the pandemic around February 2020, nearly 66% of all jobs have been recovered. That is an enthusiastic figure not to be dismissed, however, around one-third, or 7.5 million, of the pre-pandemic jobs are left vacant. During June, about 850,000 nonfarm jobs were added to the economy which is the largest monthly gain in 10 months. On the flip-side, more Americans officially entered the job market, which consequently increased the national unemployment rate to 5.9%. Finding the right person for the job takes time, but demand for labor is exceedingly high. As the economy and businesses reopen, companies across all industries are struggling to find adequate labor to service pent-up consumer demand. This is evident from looking at a monthly survey conducted by the Labor Department, termed JOLTS (Job Openings and Labor Turnover Survey), that measures job vacancies. It produced the highest nonfarm job openings since the survey's creation in 2000, which tallied in at 9.3 million jobs that remain vacant through April 2021. This figure also accounts for the increase of people who entered the job market. Together the elevated unemployment rate and high level of job vacancies emphasize the real issue as being the supply of labor, which has been complicated by prolonged unemployment benefits, lingering fear of contracting COVID-19 in public, childcare responsibilities, and unplanned early retirements. As unemployment benefits expire throughout the rest of 2021, more people are anticipated to return to work and this dynamic situation should improve.



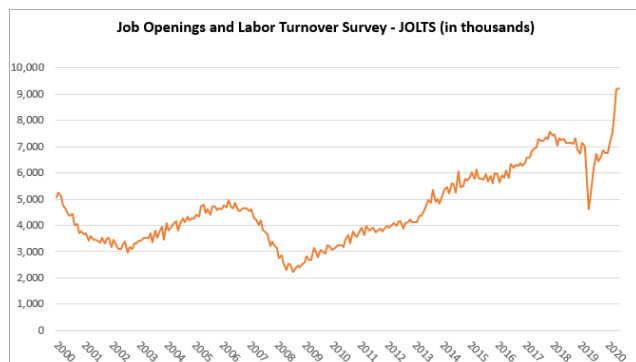
Labor Department

Weekly jobless claims have progressively trended lower and even trickled below the 10-year average in late May, although they are still slightly above pre-pandemic levels.



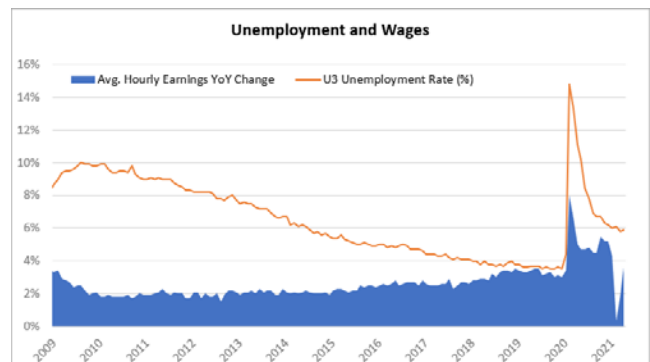
Conference Board

Consumer confidence levels spiked and reached the highest level since February 2020. This is a welcoming sign for future optimism.



U.S. Bureau of Labor Statistics

According to this survey, the quantity of job vacancies has never reached this level, which takes into account people who have recently entered the job market thereby increasing the labor force participation rate.



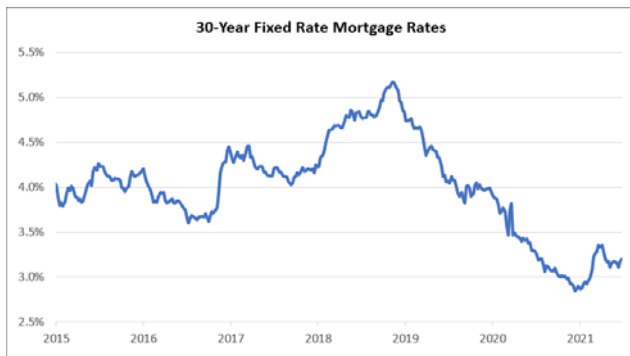
U.S. Bureau of Labor Statistics

The national unemployment rate continued its decline to levels last seen in 2014. To achieve full employment, the demand and supply of labor will need to coalesce as unemployment benefits expire.

RESIDENTIAL AND COMMERCIAL REAL ESTATE

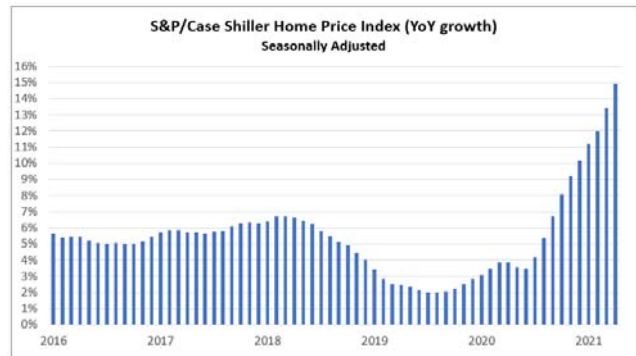
The U.S. residential housing market remained red hot as people began to realize their “new normal” lifestyles, which often call for more time at home and thus more space. This, in conjunction with still low borrowing rates, has contributed to some of the largest annual home price increases in decades. The median existing-home sales price in May topped \$350,000 for the first time according to the National Association of Realtors. This figure was nearly 24% higher than a year ago and the biggest year-over-year price increase ever recorded in data going back to 1999. While the strength in the residential property market has been astounding, there are some signs it is beginning to cool modestly. Higher prices have drawn in more listings while some buyers without an immediate need to move have paused their search in hopes of restarting after things calm down.

The commercial market is seeing more of a uniform recovery after a variety of sectors were disproportionately impacted by the pandemic. With vaccination rates hitting important thresholds in many developed nations, companies are starting to call back employees to the office for at least part of the week. This has some companies taking advantage of increased vacancies and lower prices to expand footprints in certain high traffic areas. The hotel industry, which was possibly the hardest hit, is starting to regain its footing as many now vaccinated vacationers are eager to resume traveling. Higher occupancy rates have led to many hotels asking furloughed workers to return to work. Even still, many establishments are struggling to find adequate staffing to service the recovery in demand. Other portions of the market, such as retail, are also learning to adapt and survive within the new paradigm. For example, Brookfield and Simon Property Group have partnered to convert unused space within shopping malls into ghost kitchens to address the rising demand for food delivery. All in all, the market is starting to more fully recover and/or adjust for what the future need for space may look like.



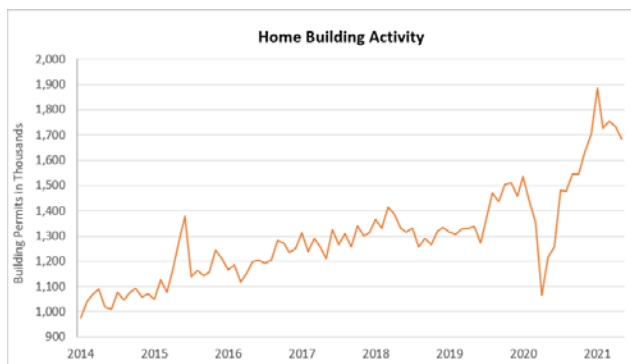
Mortgage Bankers Association

Mortgage rates continue to be at historically low levels sub-3.5%, despite rising from all-time lows below 3%. Low borrowing costs have contributed to higher prices, hurting home price affordability for many first-time buyers.



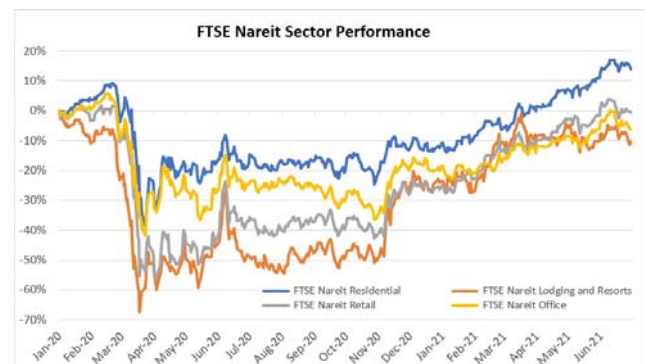
S&P/Case Shiller

Gains in home prices have reached their highest level in decades fueled by low borrowing rates and a desire for more space. However, it's foreseeable that price growth could slow going forward as supply and demand factors become more balanced.



U.S. Bureau of the Census, U.S. Department of Housing and Urban Development

Homebuilding activity remains elevated but has fallen off from peaks due to elevated input costs such as lumber. Notably, the price of lumber has plummeted from highs and is now back to 2020 levels.



Nareit

Almost all real estate sectors have demonstrated an impressive recovery from lows reached during the height of the pandemic. Residential REIT equities are reaching new highs while other sectors are nearing prior peaks.

MARKET INSIGHTS

EQUITY MARKETS

Equity indices trended higher during the second quarter and even marked the fifth consecutive quarter of a positive total return for both the S&P 500 and Nasdaq Composite Indices. Real estate, energy, and technology were the leaders as the economy flourished while the lone negative performer was utilities, falling by 0.4%. Energy has more than rebounded from last year's 33% decline but faces a headwind as OPEC debates whether to boost oil production going forward. In the U.S. and internationally, large-cap stocks led small-caps while growth beat value over the quarter which contradicted the first-quarter's themes. Year-to-date small-caps and value retain their leads, although much smaller than a quarter ago. Based on current forward P/E ratios, stock valuations still appear high but have been justified somewhat as earnings have caught up recently and are expected to climb throughout the rest of the year during the prosperous economic reopening, further compressing these ratios. Lower interest rates validate some of the elevated equity valuations, but higher inflation, corporate taxes, and wage pressures may likely dampen these valuations over the next few years.

Internationally, markets performed well albeit to a lesser extent than in the U.S.. Emerging market stocks' valuations are closer to their long-term historical averages as compared to developed. This potentially presents a more compelling forward valuation opportunity within emerging market equities, although not without additional risks. Paired with positive future growth expectations, this creates a favorable dynamic for maintaining non-U.S. equity exposure within a diversified portfolio.



Bloomberg

Trailing 12-month price-to-earnings ratios remain heightened as compared to their 10-year track record, although European and Emerging Markets have come down. Some risks including higher inflation and taxes threaten to moderate these levels further.

FIXED INCOME AND ALTERNATIVES MARKETS

Fixed income performance was positive for the second quarter across all major sectors, paring back losses from earlier in the year. Despite robust growth projections and rising inflation, notably in the U.S. and Europe, government bond yields generally declined. Investment grade corporate bonds and TIPS outperformed, supported by longer average maturities relative to other bond segments and, in the case of TIPS, elevated inflation expectations. U.S. Treasuries remained underwater after experiencing the largest drop in decades during the first quarter. Riskier bond sectors, including emerging market debt and high yield bonds, have outperformed so far this year.

The Federal Reserve’s June meeting unexpectedly triggered volatility as investors reacted to statements that rate hikes might come sooner than expected. After the sharp market reaction, the Fed reiterated a slow and steady approach to pulling back monetary support. By quarter-end, interest rate expectations were tempered, and falling long-term yields flattened the yield curve. Improving fundamentals contributed to modestly tighter credit spreads which fell to historical lows in many sectors. Despite record new issuance, corporate and municipal bonds were buoyed by resilient demand from investors with record inflows into mutual funds and ETFs. State and local municipalities, which continue to benefit from COVID-related fiscal support, are experiencing record tax revenues and several states, including New Jersey, had their credit outlook upgraded by a major credit rating agency. Municipal bond valuations also benefited from concerns that higher taxes would hamper high income earners.



Barclays Capital

Credit spreads continued to fall during the quarter, rewarding investors who have taken on credit risk. Spreads across the credit spectrum are at historic lows, far off the peaks seen at the height of the coronavirus crisis. High yield corporate default rates are below 2% and are expected to decline further.



Bloomberg

Yields in most major bond markets declined or were stable during the quarter. The U.S. yield curve modestly flattened despite higher growth and inflation expectations. Bond investors seem to be sanguine about the threat of long-term inflation and aggressive action by the Fed to normalize rates.



Bloomberg

The TIPS Implied Inflation Index declined during the quarter despite higher growth forecasts and rising inflation. Investors appear to believe current inflation levels are transitory. Indications the Fed would more aggressively pull back monetary stimulus and slow the economy also tempered breakeven rates.



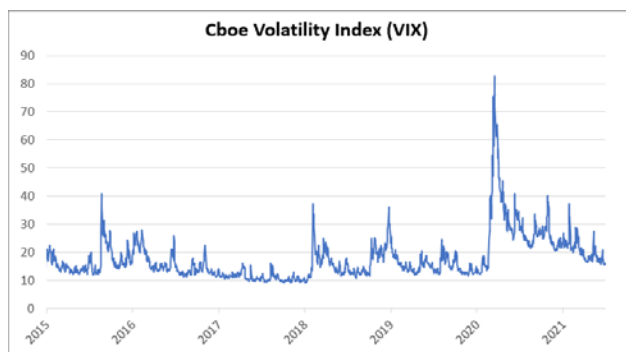
Bloomberg Barclays

The share of global bonds with negative yields modestly declined during the quarter. Germany is now the only major bond market with debt yields below zero. The shift towards positive rates as real yields and inflation normalize is considered healthy for bond markets.

Hedge funds had another solid quarter, led by equity hedge and event driven strategies. So far, 2021 has seen the best hedge fund results in over 20 years according to Hedge Fund Research (HFR). Equity-oriented strategies benefited from price momentum in energy and technology stocks and a favorable stock picking environment with wide dispersion across stocks. Event-driven strategies benefited from the healthy supply of distressed debt and the improving M&A environment. Tactical global macro traders took advantage of volatility in oil prices and interest rates while thematic strategies struggled with the changing economic landscape.

After coming to a near standstill during the pandemic, private equity deal activity continued to rebound. Recent private equity exits through IPOs has surged and is now on par with strategic acquisitions which historically has dominated exit activity. Investor demand for SPAC IPOs, as well as high yield debt, is a tailwind for the private equity and credit investments. Credit dispersion in private credit, while at historically low levels, has made the available universe more robust than in the public bond markets.

Commodities were the highest performing asset class in the second quarter, and for the first half of the year. Prices continued to surge, reflecting the pick-up in global demand and inflation as well as supply backlogs. Gains were led by the energy and agriculture sectors which faced unusual supply uncertainty. Prices for many natural resources, such as lumber, hit multi-decade highs but have since fallen back. After strong demand from investors in 2020, commodity funds experienced small outflows during the quarter, suggesting there may be less technical support for large price gains going forward.



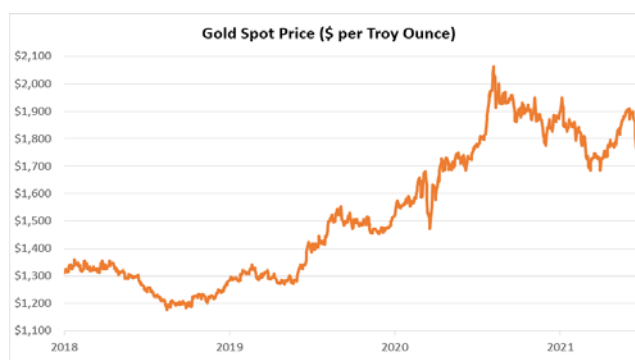
Cboe, Bloomberg

Expected stock market volatility, as measured by the VIX Index, was muted for much of the quarter, raising alarms that investors are too complacent about stock market risks. Concerns over new COVID variants and hawkish comments from the Federal Reserve sparked temporary spikes into the high 20's.

Bloomberg

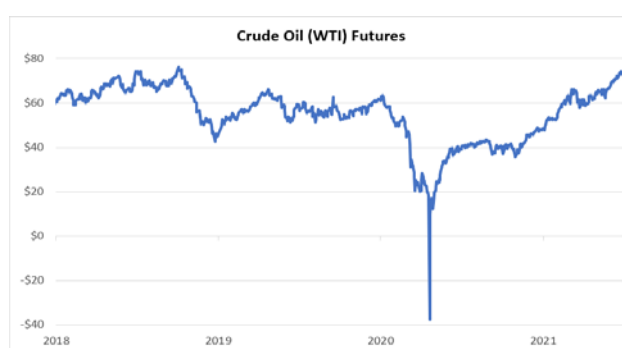


The price of Bitcoin, as well as other digital currencies, lost almost half its value after hitting an all-time high in mid-April. Government regulatory scrutiny, a setback in institutional usage, and short-term selling pressure as investors raised cash for tax payments were potential drivers of the price declines.



Bloomberg

After plummeting earlier in the year, the price of gold rose modestly during the quarter. Other precious metals, such as platinum and silver, continued to see large declines. As economic recovery gained a foothold, demand for "safe-haven" assets such as gold has been muted.



U.S. Energy Information Administration

WTI crude oil spiked 24% during the quarter, propelled by rebounds in transportation and travel, reaching its highest price since 2018. Other energy commodities like natural gas experienced similar gains. Disagreement between OPEC and other oil producers over supply targets set off recent price volatility.

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