

ECONOMIC & MARKET INSIGHTS

Third Quarter 2021

EXECUTIVE SUMMARY

Investor sentiment was erratic during the third quarter, resulting in subdued performance for most investable assets. Equity markets echoed the rebound in corporate earnings, reaching new highs during the first weeks of summer. At the same time, bond yields fell to levels not seen in months, suggesting bond markets anticipate slower economic growth. In September, rising inflation, the threat of tighter U.S. financial conditions, heavy handed regulation in China, and the continued spread of COVID-19 had rattled stock and bond investors. Stock markets suffered large drawdowns while higher interest rates weighed on bond prices.

Although broad U.S. equity and fixed income markets were flat for the quarter, international markets did not fare as well, partially due to a stronger U.S. dollar. The regulatory turmoil in China and high COVID-19 infection rates in some countries undermined emerging markets. Small-capitalization stocks, which are more geared to economic growth, also declined noticeably. While inflation was a headwind for the core bond markets, sectors that do well in inflationary environments, including high-yield, bank loans, and inflation-protected securities, outperformed. Upward momentum in commodities persisted, led by higher energy prices. Despite the muted quarter, most risk assets have strong results year-to-date, while fixed income remains down for the year.

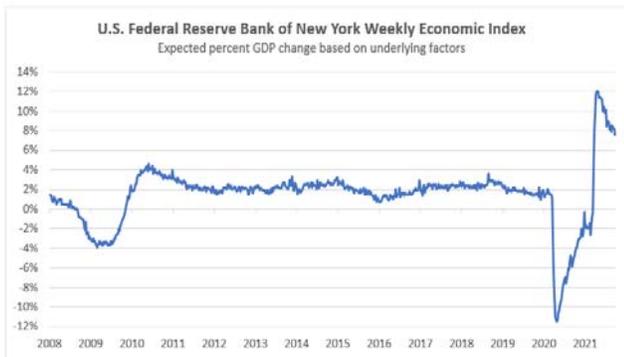
The economic recovery from the Coronavirus pandemic carried on during the quarter. U.S. GDP growth has been running at over 5% but is likely to moderate. Shortages of commodities, manufactured goods, and labor should put the brakes on output in the coming months. The U.S. Federal Reserve seems poised to tighten monetary policy and government stimulus spending, which had supported the economy during the pandemic. In addition, the boost from infrastructure and social services spending proposed by the Biden administration may be less than expected. While supply shortages and pent-up demand have caused U.S. inflation to rise to a level not seen in decades, the pullback of fiscal and monetary stimulus, as well as secular trends, should contain inflation. Long-term deflationary pressures encompass aging demographics, productivity gains driven by technological innovation, and elevated government debt (and the resulting increased taxes).

One consequence of the COVID-19 pandemic may be a wider range of outcomes for economies and financial markets globally. Most countries lag the U.S. recovery and may have more potential for growth to accelerate. U.S. stimulus during the COVID-19 crisis has been almost 25% of GDP, far larger than other countries. Some low-income countries, with slower vaccine rollouts and less policy support, may take years to recover. With high asset valuations and a world economy that has fallen out of sync, a diversified portfolio that incorporates defensive and growth assets is more important than ever.

ECONOMIC INSIGHTS

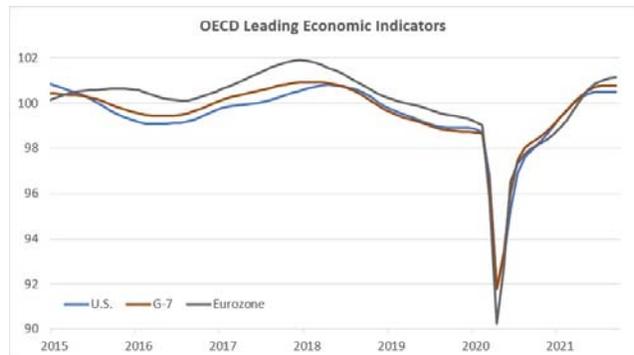
The recovery from the pandemic continues as we enter the final quarter of 2021. That said, the “honeymoon phase” may be coming to an end as new concerns and economic issues are arising. These include possible new variants, in addition to the repercussions of the unprecedented level of monetary and fiscal intervention. Specifically, excess money supply and unforeseen supply chain disruptions have contributed to higher levels of inflation which may be here to stay. Pent-up demand as the economy ramps back up has only exacerbated this issue, making it harder for supply to catch up. Additionally, global central banks are preparing to begin tapering support, adding to the list of potential headwinds moving forward.

While these concerns can appear daunting, progress in combating the pandemic could provide an additional boost to prolong the expansion. Increasing vaccination rates, paired with natural forms of immunity, has resulted in much of the U.S. population having some form of protection against the virus. Additionally, the duration of the pandemic has caused many businesses to adapt their models to be able to function in the current environment. This continues to translate to heightened levels of economic activity, as measured by a variety of metrics. High output levels also reflect that we are emerging from one of the deepest (but quickest) recessions recorded in history. GDP growth has recovered to pre-pandemic levels and is on track to maintain its growth trend heading into 2022.



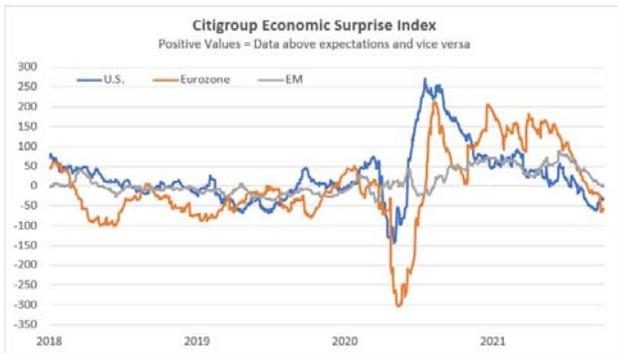
Federal Reserve Bank of New York

This economic index, which measures several daily and weekly indicators that approximate GDP growth, continues to be at unprecedented levels reflecting that the U.S. is still in recovery mode from the pandemic, although it has declined somewhat recently. The rapid snapback has translated to pre-pandemic levels of GDP growth.



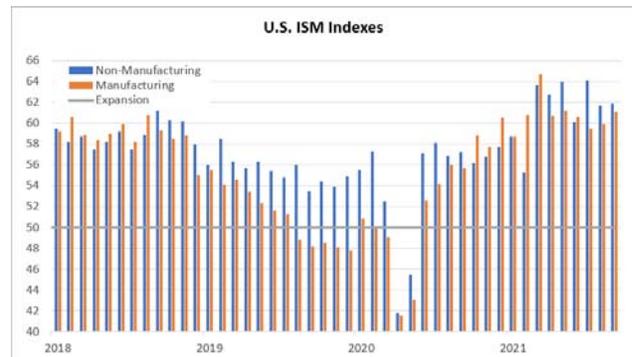
Organization for Economic Cooperation and Development

Leading economic indicators have maintained their trajectory upwards, suggesting that there is room for continued growth in the economy against emerging headwinds such as elevated inflation and the potential central bank tapering.



Citigroup

Following outsized readings during and immediately after the start of the pandemic, economic surprise readings have been much closer to expectations. In fact, recent indicators have underwhelmed expectations suggesting that growth is starting to level off.

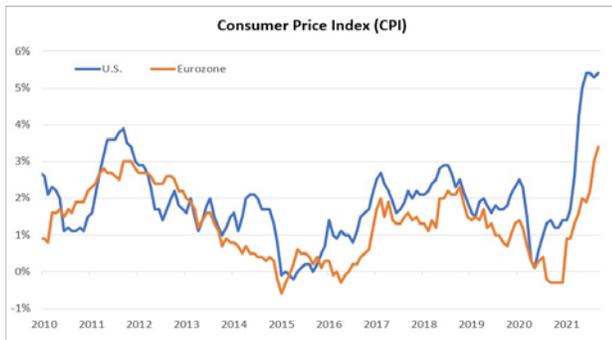


Institute for Supply Management

Both ISM Indexes have come down from historic highs reached earlier in 2021. That said, they both remain well in expansionary territory (above 50) and the services (non-manufacturing) index has caught up with the manufacturing index in recent months as more of the economy comes back online.

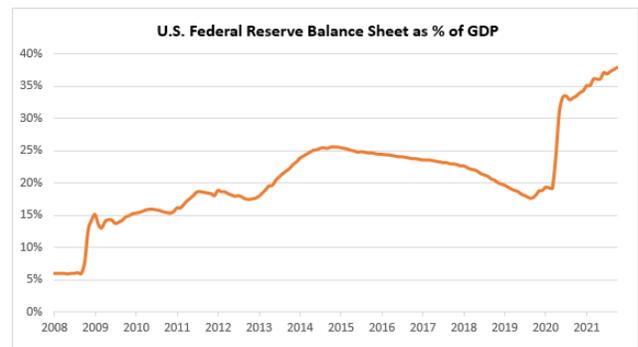
As we advance in the recovery, much of the focus has shifted from concerns about growth to the potential ramifications of the massive efforts put forth to combat the impact of the pandemic. Debt levels in the U.S. are approaching historic levels and it is uncertain if they will subside in the coming years. While the extensive stimulus efforts have propelled the recovery, they may have contributed to adverse effects in the near- and medium-term. Perhaps most prominent is the impact on inflation, which has risen considerably throughout the year. The Consumer Price Index (CPI) has been running at over 5% for much of this year, reflecting heightened levels of demand intersecting with supply shortages across major areas of the economy. Additionally, the stark recovery in the job market has resulted in limited slack in the labor force which has pushed wages higher. All of this translates to higher consumer prices and possibly lower profit margins.

S&P 500 Index operating earnings have made a remarkable recovery this year after a large decline in 2020. The resiliency in earnings partially reflects that larger sectors, such as technology and healthcare, were moderately or even positively impacted by the pandemic. Additionally, some productivity gains were unlocked as businesses were forced to adapt to a more virtual world. While operating earnings are expected to reach a new all-time-high this year, there are fresh headwinds looking forward, such as higher input costs, taxes, and interest rates, which could slow growth. This backdrop, paired with elevated valuations, could make the equity markets more susceptible to future volatility.



U.S. Bureau of Labor Statistics

CPI has risen to over a 5% growth rate in the U.S., with the Eurozone not far behind. While pandemic-related price declines may have amplified these numbers, demand and supply shocks have sent price increases throughout many areas of the economy. Although the Fed believes much of the increases are transitory, it is foreseeable that some of the recent inflation is more structural in nature.



Bloomberg

Federal monetary aid has continued to support the recovery but is likely to start tapering off in the coming months as the economy is better able to stand on its own footing. Projections anticipate that the deficit could fall in the coming years, although that assumes limited further spending and/or increased revenues from tax increases.



U.S. Federal Reserve and Bloomberg

The U.S. Dollar rose over the quarter from earlier lows this year. After an initial flight to quality during the pandemic in 2020, the Dollar had fallen to lower levels. Since then, a slowdown in China paired with higher inflation and rates should offer some support to the currency going forward.



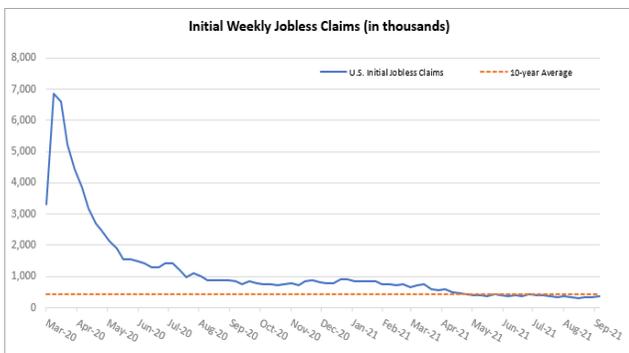
Bloomberg

S&P 500 earnings are slated to reach new all-time-highs by the close of the year. The recovery in earnings is remarkable considering the extent of the pandemic and the impact on business models. Resiliency in key sectors, government aid, and improvements to productivity all helped in the pace of the rebound.

EMPLOYMENT AND THE CONSUMER

The past quarter's economic growth has been shadowed by a similar improvement in the labor market, but not without added concerns. Amazingly, of the 22.4 million jobs shed during the pandemic, nearly 17 million, or 77%, have been recuperated. Still, it appears that the labor market recovery is nearing a plateau given the slow improvement in the national unemployment rate. Pre-pandemic, the country had boasted a 3.5% unemployment rate, which has more recently fallen to 4.8% through September as 194,000 non-farm jobs were added. The plateau effect may be largely attributable to an insufficient amount of labor supply throughout the economy as reflected by the Job Openings and Labor Turnover Survey (JOLTS). The survey's data has trended higher, reflective of record levels of job vacancies. As businesses reopen, fewer workers have returned for various reasons including augmented unemployment benefits which have since expired, restricted levels of immigration, higher childcare costs, and persistent pandemic-related fears. The exceptionally strong demand for labor has driven up average wages to sustained levels last seen before the Global Financial Crisis. Economists have justified concerns that wage growth can translate to higher long-term inflation, not necessarily transitory as assumed, which is being carefully monitored by the Federal Reserve. Strong labor demand, in addition to expired COVID-related unemployment benefits, should lead to gradual improvements in labor conditions and a declining unemployment rate over time.

As inflation picked up this year, some of the largest catalysts for the increase include increased consumer demand coupled with strained supply chains in many economic sectors. Notably, the global semiconductor chip shortage impacted an array of goods in various sectors, most prominently automobiles. Similarly, higher airfares, restaurant prices, and rents have contributed to elevated inflation. Linked to this, consumer confidence has retreated since its pandemic-era highs in the second quarter, but is still above the benchmark level of 100, indicative of further upside potential in the near term. However, the two back-to-back index monthly declines suggest consumers have grown more cautious and are likely to curtail spending amounts moving forward.



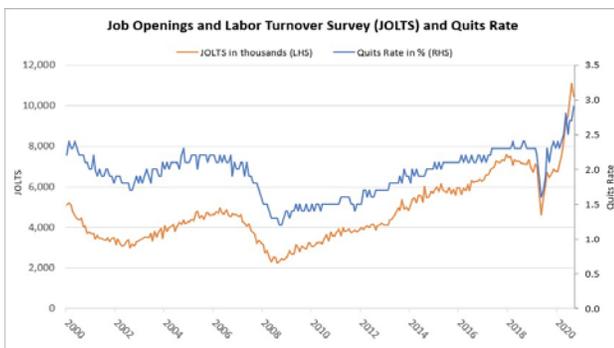
Labor Department

Initial weekly jobless claims have moderated as many employees returned to work in sectors across the economy.



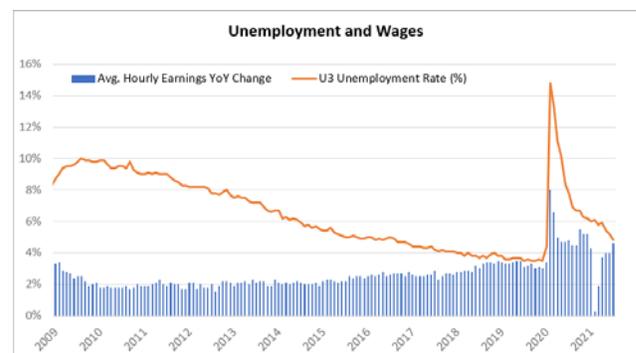
Conference Board

In the third quarter, consumer confidence fell from the pandemic peak likely due to higher inflation.



U.S. Bureau of Labor Statistics

A record number of job vacancies exist nationwide, ironically in line with the rate of workers who are proactively quitting their jobs. Reasons for this abound such as enhanced unemployment benefits and higher childcare costs.



U.S. Bureau of Labor Statistics

Higher average wages paired with strong labor demand should help the economy edge closer towards full employment.

RESIDENTIAL AND COMMERCIAL REAL ESTATE

Low rates and plentiful demand have kept inventories low and home prices elevated. In many cases, homes were receiving multiple offers and trading hands for levels well above the initial asking price. The sticker shock and aggravation have caused many buyers to pause their searches and contemplate sitting out of the market until things calm. Fewer potential buyers are possibly cooling the hot market, at least modestly. Despite the small pullback, home sales remain well above historic levels, and homes that do hit the market are on average selling much faster than they had prior to the pandemic. Prices continue to be high, but the pace of growth is slowing. Homebuilding is trying to catch up with heightened demand but has been somewhat restrained by various input and labor shortages.

After an initial slow start, the commercial real estate market is also in the middle of a strong recovery. While favorable supply and demand dynamics have lifted the entire commercial sector, evolving consumer behaviors have served as tailwinds to certain areas of the market while negatively impacting others. Commercial growth areas generally include multifamily and industrial in addition to specialty areas such as life sciences where there is a premium placed on customized workspaces. In some cases, vacancy rates in areas like multifamily and industrial are now below pre-pandemic levels with rents rising quickly. The rise of e-commerce has only accelerated throughout the pandemic with shifting lifestyles and elevated consumer needs resulting in an insatiable demand for industrial logistics facilities near densely populated areas. Other areas, such as office and retail, have had a tougher time but are finally catching up. While return to office was delayed for many companies due to the spread of the Delta variant, certain sectors, such as technology, have made headlines for expanding their office footprints. Many other companies have recently called workers back and in office levels have reached post-pandemic highs. The retail sector has also demonstrated new signs of life as people have started resuming aspects of their daily lives, translating to increased foot traffic and occupancies.



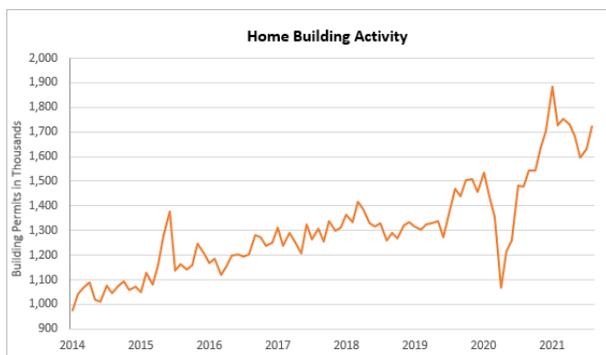
Mortgage Bankers Association

Mortgage rates have bounced off all-time-lows but remain at relatively low levels. Reduced borrowing costs have helped somewhat mitigate rising prices for home affordability. Home affordability would be further eroded if rates were to continue moving higher.



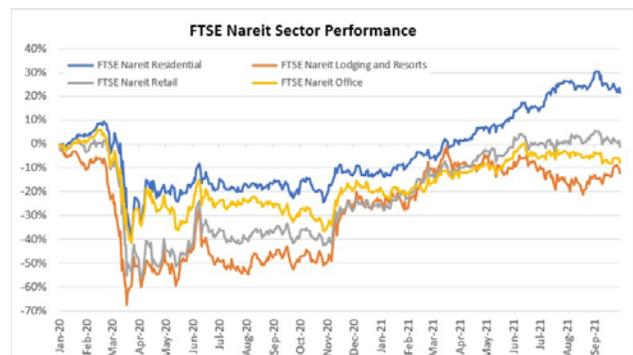
S&P/Case Shiller

Gains in home prices marched higher, rising nearly 15% year-over-year. The rapid increase in home values has turned-off some prospective buyers who have exited the market temporarily.



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

Homebuilding activity has stayed elevated but has struggled to keep up with demand, especially for starter homes. U.S. residential construction has continued to shift towards the suburbs and lower-cost markets.



Nareit

The broad REIT market demonstrated impressive gains in 2021. The residential portion of the market was resilient throughout the crisis and remains a standout performer, although other areas have made a strong comeback.

MARKET INSIGHTS

EQUITY MARKETS

Stocks were mixed last quarter depending on the index, region, or sector evaluated. S&P 500 sectors were mixed as well with financials rising the most, nearly 3% given the prospect of higher future interest rates, while industrials lagged more than 4%. Energy was slightly negative last quarter but retains its stellar 2021 rise, capitalizing on elevated oil prices given OPEC's planned restriction of oil output and an imbalance of supply and demand. Globally, large-cap stocks outperformed small-caps although to a much less drastic measure outside the U.S. However, it is important to note that small-cap stocks historically perform well in rising-rate environments. Year-to-date, domestic large-cap stocks and small-caps flip-flopped their leadership. Growth beat value globally given resurgent Delta variant fears and disappointing economic data relative to expectations. Current U.S. company valuations remain elevated although they have fallen modestly last quarter given reported strong earnings reports. Ensuring higher inflation and tax rates do not degrade the purchasing power of firms is paramount for the Federal Reserve to monitor.

In general, international equity indices were negative for the quarter. Developed non-U.S. markets grossly outperformed emerging markets in USD terms due to China's newly enforced regulation measures. Recent underperformance has contributed to more compelling valuations for non-U.S. stocks when compared to U.S. counterparts. Similarly, various structural growth opportunities, waning effects of the pandemic, and the potential for a lower dollar in the long-run justify maintaining a steady allocation to international equities in a diversified portfolio.



Bloomberg

Global trailing 12-month price-to-earnings ratios remain higher than they've been during their past 10-year track record, although developed non-U.S. valuations swiftly fell last quarter as strong earnings were reported.

FIXED INCOME AND ALTERNATIVES MARKETS

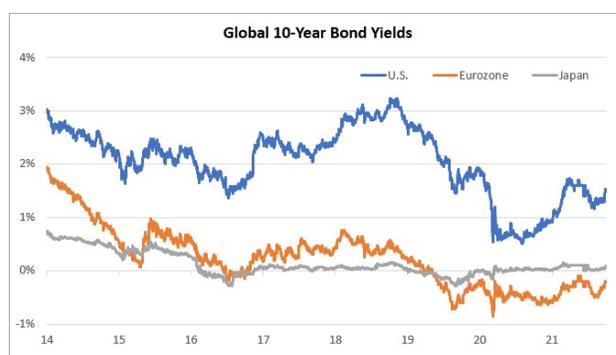
After a flat third quarter, U.S. fixed income markets remain in negative territory year-to-date. Government bond yields climbed following the September Fed meeting due to both higher real yields and greater inflation expectations. The supply and demand backdrops for municipals remained favorable and yields rose sharply in September, improving valuations versus U.S. Treasuries. Lower-quality taxable and municipal bonds both outperformed, while corporate credit and municipal bond spreads remain historically low. After support from COVID-19 stimulus programs and solid tax receipts, municipal fundamentals remain healthy. U.S. corporate credit has lower leverage and stronger balance sheets than before the COVID-19 crisis. Corporate high yield default rates are roughly 1%, at the bottom of the historical range.

Current expectations are that the Fed will soon scale back asset purchases and raise the Fed Funds Rate next year. Other central banks such as the ECB are also signaling tighter monetary policy but seem poised for slower implementation than the Fed. Forward looking returns for high-quality U.S. bonds are under 3% with yields well below the current pace of inflation. In this environment, higher-yielding sectors such as bank loans and direct lending, as well as tax-efficient municipal bonds, have seen strong inflows. With higher tax rates likely on the horizon, flows into municipal funds are the second highest on record. However, high-quality bonds have proven their worth during equity market drawdowns. Demand continues to be robust with investors pursuing a mix of safe-haven bonds and riskier higher-yielding securities.



Barclays Capital

Credit spreads saw a small uptick during the quarter, modestly improving valuations. Credit spreads remain at historic lows, far off the peaks seen at the height of the Coronavirus Crisis. High yield corporate default rates are roughly 1%, reflecting relatively strong corporate balance sheets.



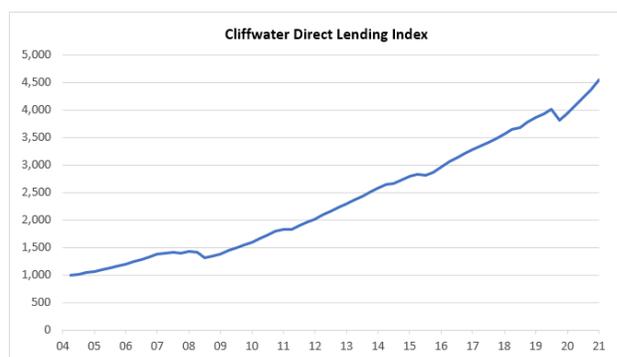
Bloomberg

Yields in most major bond markets were stable for the quarter, despite a rise in volatility in September. Higher yielding U.S. bonds are attractive to international investors faced with meagre and even negative rates in their home countries. Structural factors are keeping rates low in Europe and Japan.



Bloomberg

The 10-year TIPS Implied Inflation Index rose during the quarter, reflecting an uptick in inflation expectations. Medium-term inflation expectations have exceeded long-term expectations since the beginning of the year, perhaps reflecting that investors are less optimistic about long-term U.S. economic growth.



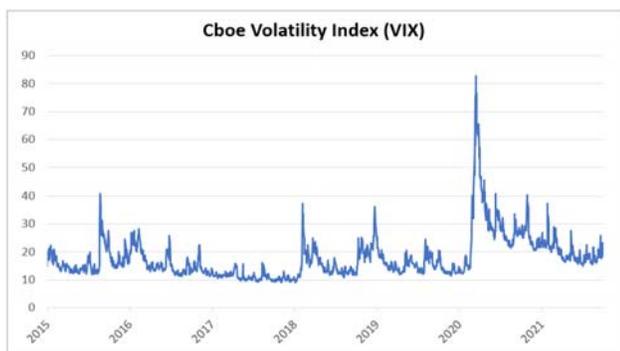
Bloomberg Barclays

The Cliffwater Direct Lending Index measures the performance of middle market corporate loans. Over time, investment income is the primary source of return. Principal losses during the COVID-19 crisis have been reversed and the Index is up more than 15% since the market bottom in March 2020.

Hedge funds had another solid quarter, posting broad-based gains during the September downturn in the equity and fixed income markets. Commodity and event-driven strategies did particularly well, proving their diversification benefit during periods of market volatility. The hedge fund space continued to show wide dispersion across individual funds, highlighting the importance of manager selection.

In private markets, fund raising is on track for a record year with a growing share from direct lending funds. Direct lending provides capital to middle market companies through private lenders. Middle market companies have experienced robust revenue and earnings gains during the recovery from the COVID-19 recession. Capital that has been committed but not invested has risen sharply over the past few years, dominated by private equity and real assets funds. Private equity exit activity continues to be robust, with higher levels of SPAC IPOs than in the past and fewer strategic buyouts.

Commodities were the highest performing asset class in the third quarter and year-to-date. Energy prices have risen sharply, particularly for natural gas, driven by the rebound in demand, new supply constraints, and below average inventories. Underinvestment resulting from the shift to clean energy sources and new regulatory restrictions has created a secular drag on energy supply. Market intervention by OPEC and weather-related problems have also constrained supply. Industrial metals had mixed results as the disruption caused by the Evergrande crisis and the slowdown in the Chinese construction industry weighed on construction-related commodities. Precious metals, which are sensitive to real interest rates, declined in response to expectations for tighter monetary policy.



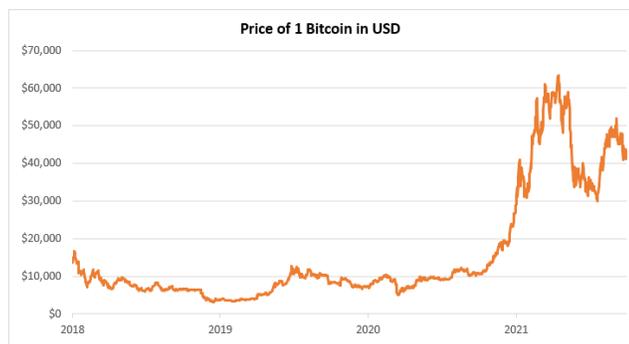
Cboe, Bloomberg

Expected stock market volatility, as measured by the VIX Index, rose modestly during the September market sell-off. Expected volatility remains at modest levels. The number of days with a price move of 1% or more in the stock market is well below average over the past year.



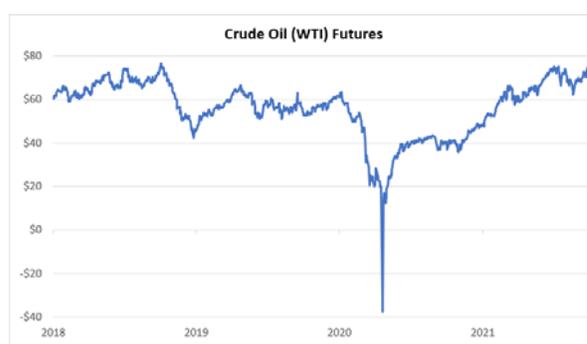
Bloomberg

Precious metals, which are sensitive to the level of real interest rates, declined in response to expectations for tighter monetary policy. Platinum and silver experienced the largest declines, but gold, a popular safe-haven in investor portfolios, also lost ground.



Bloomberg

The price of Bitcoin has been volatile over the past year. Although the cryptocurrency fell by 25% during the third quarter, the price has doubled since December 2020. Government regulatory scrutiny, a setback in institutional usage, and concerns over energy demand have impacted the digital currency sector.



U.S. Energy Information Administration

WTI crude oil continued to rise during the quarter, propelled by rebounds in transportation and travel as well as supply constraints. Efforts to control the oil supply by OPEC, weather-related problems, and limited inventory have dampened energy supply. Natural gas prices have skyrocketed and are at historic highs.

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The S&P 500 Index is a market capitalization-weighted Index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard and Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of eleven different sectors; the CBOE Volatility Index is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. It is created by the Chicago Board Options Exchange (CBOE); the Dow Jones U.S. Real Estate Index measures the performance of real estate investment trusts (REITs) and other companies that invest directly or indirectly in U.S. real estate through development, management, or ownership, including property agencies; The FTSE Nareit US Real Estate Index Series is a comprehensive family of REIT-focused indexes that span the commercial real estate industry, providing market participants with a range of tools to benchmark and analyze exposure to real estate across the US economy at both a broad industry-wide level and on a sector-by-sector basis. Leading economic indicators (LEI) are statistics that precede economic events. They predict the next phase of the business cycle. The OECD Composite leading indicators (CLIs), designed to anticipate turning points in economic activity relative to trend, continue to strengthen in most major economies. The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. A Treasury Bill (T-Bill) is a short-term U.S. government debt obligation backed by the Treasury Department with a maturity of one year or less. The ISM manufacturing index, also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy. The ISM Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. The Citi Economic Surprise Index measures the pace at which economic indicators are coming in ahead of or below consensus forecasts. When the index is negative, it means that the majority of reports are coming in below expectations, while a positive reading indicates that most data is coming in ahead of expectations. The Cliffwater Direct Lending Index (CDLI) seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements. The Data in this newsletter is obtained from sources which we, and our suppliers believe to be reliable, but we do not warrant or guarantee the timeliness or accuracy of this information. Consult your financial professional before making any investment decision. Past performance is no guarantee of future results. Diversification/asset allocation does not ensure a profit or guarantee against a loss. Economic and market forecasts presented herein reflect our judgment as of the date of this presentation and are subject to change without notice. These forecasts are subject to high levels of uncertainty that may affect actual performance. Accordingly, these forecasts should be viewed as merely representative of a broad range of possible outcomes. These forecasts are estimated, based on assumptions, and are subject to significant revision and may change materially as economic and market conditions change. These forecasts do not take into account the specific investment objectives, restrictions, tax and financial situation or other needs of any specific client.

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