THE NEXT GENERATION WEALTH PERSPECTIVE
Growing In Strength

Macro Summary

Markets	▪ Market strength continued through the second quarter with all major indices finishing near or at record highs. The S&P 500 posted a gain of 8.5% on strong first quarter earnings and a rebound in growth stocks. ▪ European & UK markets followed the U.S., up 7.1% and 5.6%, respectively. A slow vaccination rollout and resurgence in coronavirus cases weighed on Japanese equity markets, slightly down at 0.3%. Asia ex-Japan returned 3.7% and emerging markets were up 5.1%.
Economy	▪ Gross Domestic Product (GDP) growth in Q1 2021 was an impressive 6.4% on strength in capital expenditures, consumer spending, and housing. A decline in inventories held back growth but should provide a tailwind in Q2 and Q3. ▪ The April Employment report started out the quarter weaker than expected but picked up momentum in May and June. The labor force participation rate has been lower than expected, especially in the prime age labor force.
Federal Reserve	▪ During the June Federal Open Market Committee (FOMC) meeting, the Fed has once again pledged to keep the federal funds rate very accommodative until labor market conditions improve and inflation reaches a level moderately above 2% for some time. As a result, they will continue to purchase at least $80 billion of Treasury securities and $40 billion of agency mortgage-backed securities per month. ▪ All eyes will be on the next FOMC meeting July 27-28 and the Economic Policy Symposium at Jackson Hole from August 26-28 for communication on withdrawal of monetary stimulus.
Inflation	▪ Inflation remains elevated, as expressed by the Consumer Price Index (CPI) for both the headline index and the core index (excluding food and energy). The Federal Reserve believes it will remain elevated in coming months before moderating as the bottlenecks and supply/demand imbalances related to the pandemic are able to work themselves out.
Risks	▪ Equity markets are at all-time highs and the Federal Reserve and the Federal Government are on the front end of a reduction in unprecedented fiscal and monetary stimulus. ▪ The Delta variant of COVID-19 is experiencing a surge in Asia and regions of the U.S. It may be more contagious to those not vaccinated and could become more of an issue as we move into the colder months.

	Q2 RETURN	YTD RETURN
Standard & Poor 500 Index	8.55%	15.25%
Balanced Portfolio - 60 / 40	6.01%	8.51%
Dow Jones US REIT Index	11.68%	20.28%
MSCI EAFE Index	5.17%	8.83%
Barclays Aggregate Bond	1.83%	-1.60%
Barclays Municipal Bond	1.42%	1.06%

What's Happening

The economic recovery is in full stride. First quarter GDP growth advanced 6.4% and, according to CNBC/Moody's Analytics, median GDP forecast are 10.5% for Q2 and 8.0% in Q3, which is significantly above average. While only 48% of Americans have been fully vaccinated, the reopening of the economy is full speed ahead. The demand for workers is at an all-time high and businesses are enticing them with higher wages and/or signing bonuses. The federal government is still supporting the recovery through extended unemployment benefits lasting until the beginning of September. More recently, the Child Care Tax Credit will put even more cash in the hands of families with monthly checks distributed to qualified families with children under the age of 17.

The second half of 2021 should see robust job growth as government support slows and schools reopen, freeing individuals to participate in the workforce once again. As we begin to see this happen, there should be a transition from public sector driven growth to private sector driven growth. The sudden liftoff in the economy has caused some supply/demand imbalances pushing CPI to over 5%, which is high in recent years. The yield on the 10-year treasury reacted, moving as high as 1.74% in Q1 before reversing and ending Q2 at 1.46%. It is possible the markets are beginning to believe the Fed's forecasts for inflation being transitory or anticipating slower future economic growth as federal stimulus winds down and monetary stimulus begins to fade through a reduction in asset purchases and, eventually, higher short-term rates.

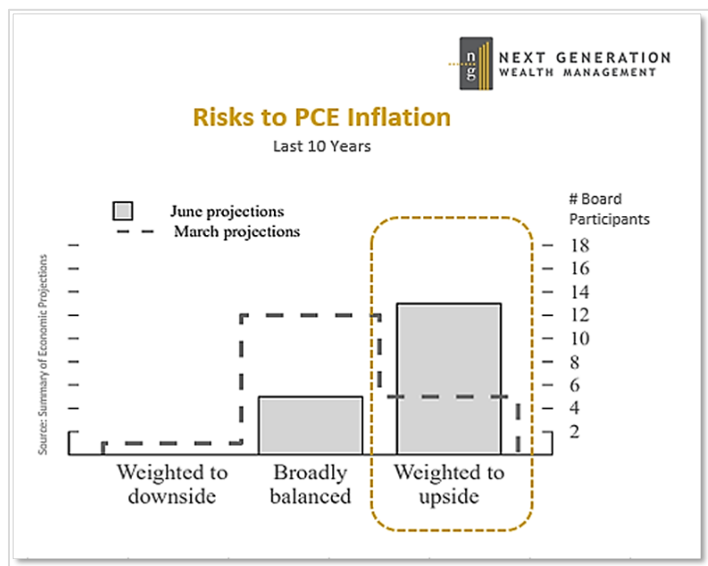
Fiscal & Monetary Stimulus

The government has done its part to inject stimulus when and where it can. After the $1.9 trillion COVID-19 Relief Bill signed in March, President Biden followed that up with a $1.2 trillion Bipartisan Infrastructure Framework bill. The details of how the money will be spent are yet to be determined but the bill addresses such issues as lack of high speed internet, providing clean drinking water, fixing rural roads and bridges, rural rail connectivity, upgrading airports, harbors and waterways, and more. Recently, Senate Democrats on the budget committee announced plans for a $3.5 trillion budget package that would allow President Biden to vastly expand upon the Bipartisan Infrastructure Framework bill to address social welfare, family aid and environmental programs.

Similar to last quarter, The Federal Reserve policy makers decided to keep the target range for the federal funds rate at 0 to 0.25% and expects it will be appropriate to maintain this target range until labor market

conditions have reached levels consistent with the committee's goal of maximum employment, and inflation has risen to 2% (and is on track to moderately exceed 2% for some time). In addition, they plan to continue to purchase at least $80 billion per month of Treasury securities and at least $40 billion per month of agency mortgage-backed securities. The belief is that these asset purchases foster a smooth functioning market and accommodative financial conditions, thereby supporting the flow of credit to households and business.

With the economy currently growing at a very healthy rate and inflation over 5% as measured by the CPI, market participants are beginning to wonder when will the Fed begin to reduce its stimulus and what impact it will have on the markets. As for the timing of the process, the discussion of reducing the asset purchases has begun within the Fed. Fed members reiterated their intention to provide notice well in advance of an announcement to reduce the pace of purchases. While it is acknowledged that current inflation is running hotter than expected, Fed members continue to believe that it will ease as transitory factors dissipate. However, some members on the committee have shifted their view on inflation risk from being broadly balanced to weighted to upside. Committee members have noted reported difficulties hiring workers to meet demand, likely reflecting factors such as early retirement, concerns about the virus, childcare responsibilities, and expanded unemployment insurance benefits. Collectively they agree that labor shortages should ease throughout the summer and into the fall as progress on vaccinations continues, social distancing unwinds further, more schools reopen, and expanded unemployment insurance benefits expire.



As for the Fed's next move, all eyes will be on the rate-setting committee's meeting July 27-28, the Economic Policy Symposium August 26-28, and another FOMC meeting in mid-September. One of those meetings will serve as a forum to lay the groundwork to begin tapering bond buying in late 2021 or early 2022.

Economic Environment

The economic recovery is accelerating. Real GDP in Q1 was 6.4% led by capital expenditures, consumer spending, and housing, highlighting the rebound in the private sector.

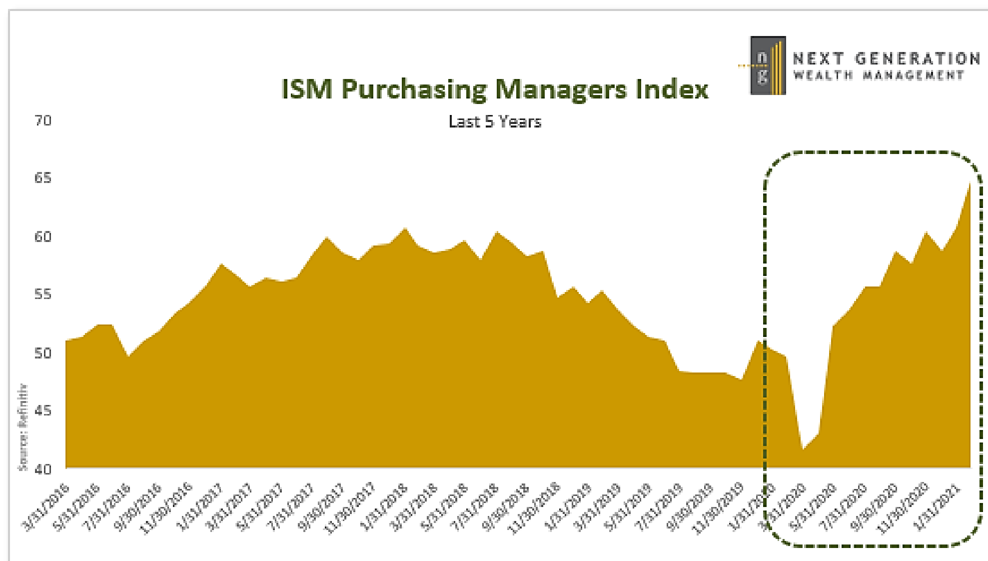
Capital expenditures saw a robust increase of 9.9% in Q1 led by investment in equipment and intellectual property. This is being driven by low corporate bond yields and tight credit spreads, recovery in profits, and the need to grow and improve the domestic supply chain.

A reduction in inventories detracted 2.6% from GDP, reflecting growth in demand which was unmatched by growth in production. Production has been hampered by bottlenecks relating to the pandemic, which can be caused by supply shortages, shipping issues, labor being slow to return, and other factors. The Federal Reserve

refers to these bottlenecks as transitory issues. Eventually, we should see these bottlenecks working themselves out, allowing the supply chain and production to operate smoothly and return to normal. As production catches up with demand, this should boost GDP as manufacturers and producers of goods can restock the shelves. Inventory rebuilding should be a tailwind for Q2 and Q3 GDP.

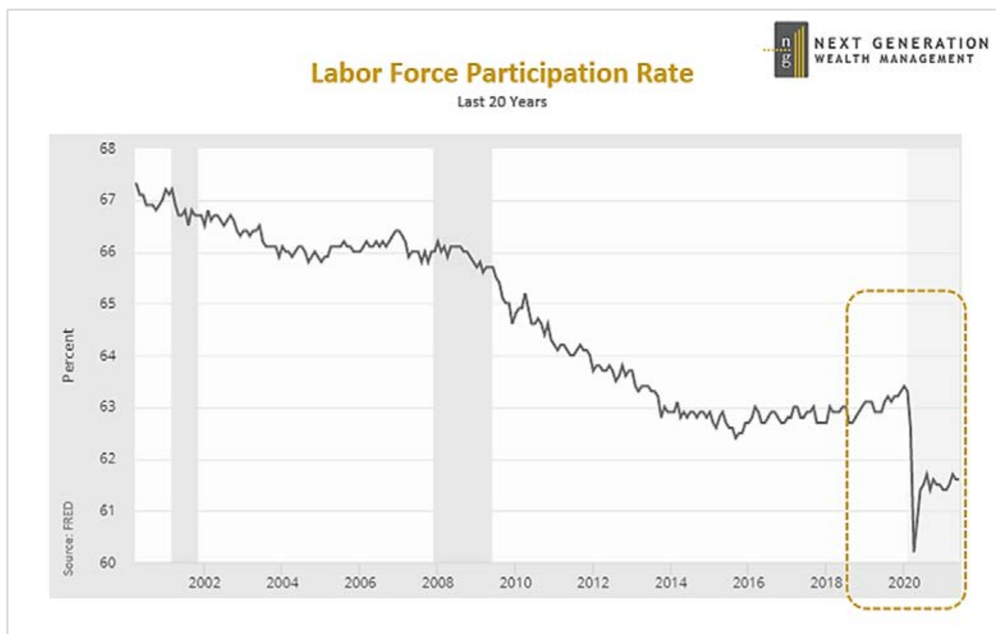
Forecasts for GDP growth in Q2 are over 10% as the economy fully reopens and consumer confidence continues to remain high. Consumer spending is robust as well and can be attributed to strong job growth, consumers saving more money, and a new wave of fiscal stimulus checks provided to families with children.

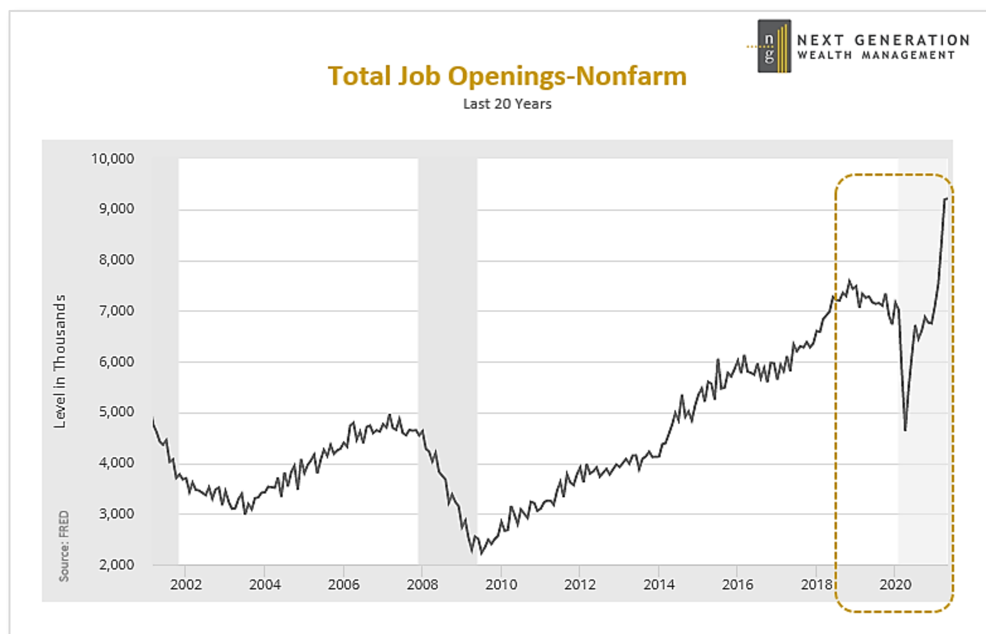
The June Institute of Supply Management Manufacturing Purchasing Manager's Index (PMI) confirmed the economic strength. For five consecutive months, the index remained above 60, which is historically high. The June Manufacturing PMI registered 60.6%, down 0.6% from May and down 4.1% from March, which was the peak for this cycle. The report was led by strength in new orders, production, and backlog. The prices index component of the report registered 92.1%, up 4.1% from May, confirming the inflation registered in the CPI. To put things into perspective, the price index is at its highest level since July 1979. Not surprising, weakness in the report was seen in the employment and inventories index (49.9% and 51.1% respectively). Optimism remained strong among those businesses which survived; however, companies and suppliers continue to struggle to meet increasing levels of demand. Record long raw material lead times, wide scale shortages of critical basic materials, rising commodities prices and difficulties in transporting products are continuing to affect all segments of the manufacturing economy. Worker absenteeism, short-term shutdowns due to parts shortages, and difficulties in filling open positions continue to limit manufacturing growth potential. All previously mentioned issues relate to bottlenecks the Federal Reserve believes are transitory.



The April Employment report began the quarter weaker than expected but picked up momentum in May and June. Overall, performance still lacked the numbers some economists were expecting. Fed Chair Jerome Powell has said "there is still a long way to go" in repairing a labor market that is 7.5 million jobs away from its pre-pandemic level. Labor force participation has been lower than expected, especially in the prime age labor

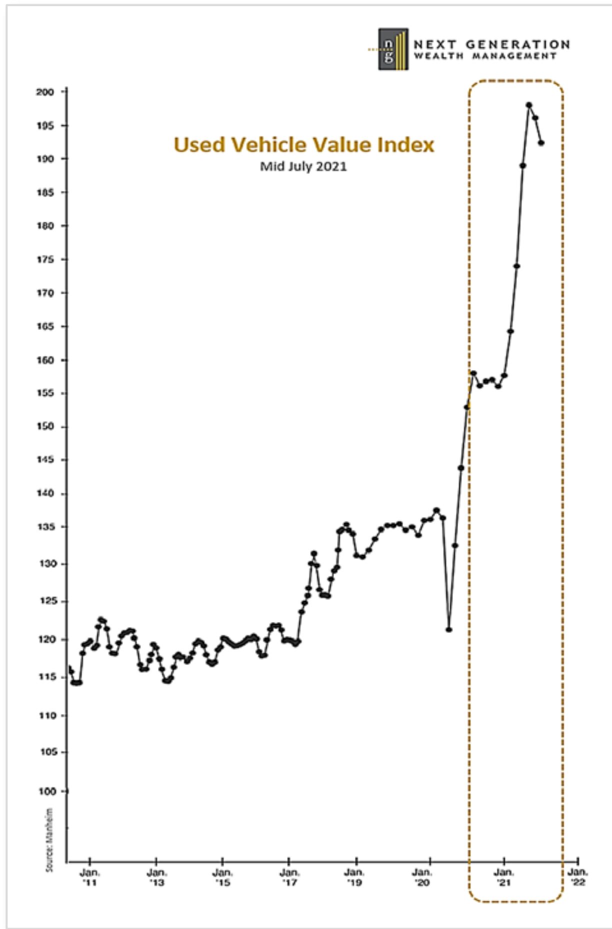
force. The pandemic has lingering effects holding some workers out of the workforce for reasons such as health conditions, childcare issues, and receiving extended federal unemployment benefits under the American Rescue Plan Act. Job openings are at a record high and businesses are in desperate need for workers. Wage gains have been accelerating as a result.

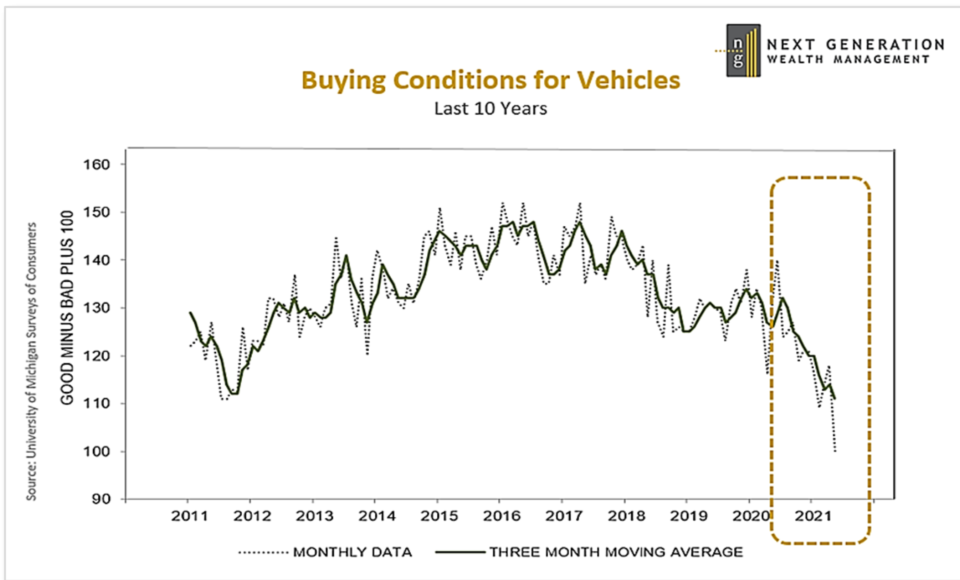




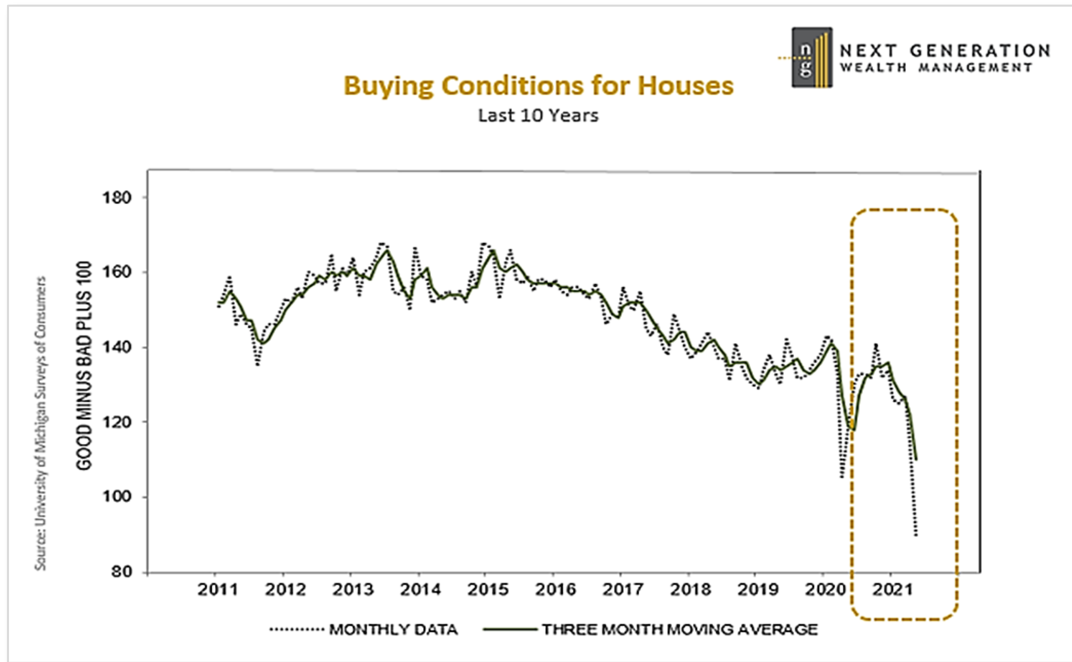
Inflation

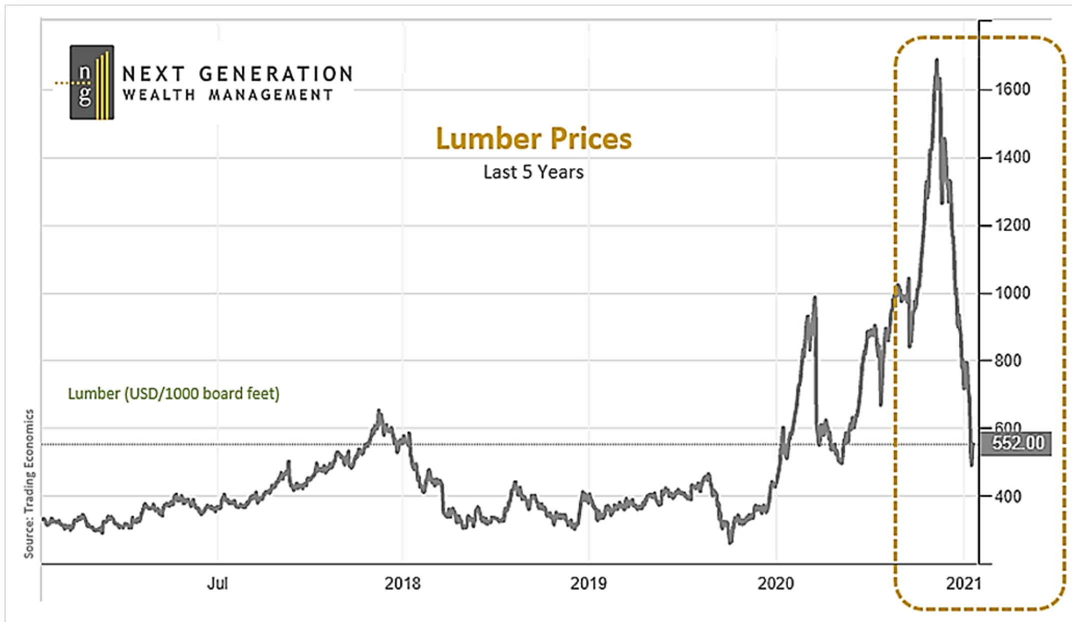
Inflation has been rising. The last three-monthly CPI reports were blowouts and could be signaling much higher than expected inflation. The June CPI report, released July 13, measured the CPI and Core CPI (excluding food and energy) each up 0.9% month to month. Over the last 12 months, the CPI is up 5.4% and Core CPI, 4.5%, which is much higher than the Federal Reserve's long-term target of 2%. Digging a little deeper into the numbers one can see that much of the recent rise in CPI (excluding food and energy) is due to used vehicle prices, which were up 10.5% in June, accounting for more than one-third of the increase. In fact, used vehicle prices had similarly high readings in the April and May CPI reports. Will this trend prove to be transitory and decline in the future, having an opposite effect on the CPI data, or will prices increase further? It's hard to tell, but we can see the beginning of demand destruction identified in the University of Michigan consumer survey reports. The survey of consumers for buying conditions of vehicles is at a low point not seen since 2008. We have also seen a drop in Mannheim's used vehicle price index in June and July. This particular index serves as a good leading indicator for the CPI used vehicle component by a few months.



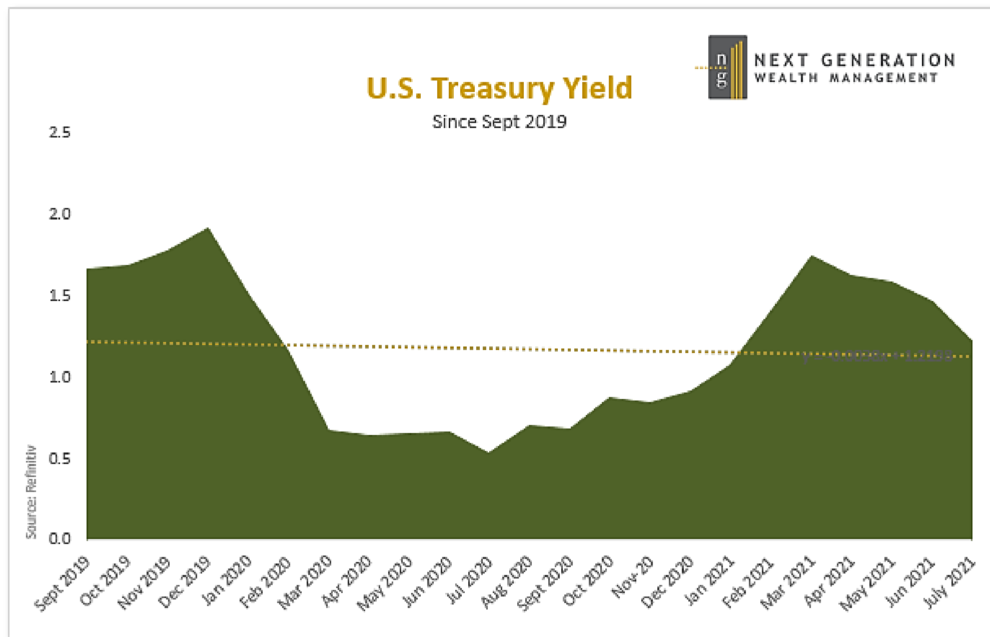


We have seen similar examples of demand destruction and production increases in the housing sector. The strong housing market last year caused a surge in lumber prices. But now, according to survey data, that surge in prices has caused housing to slow. Lumber mills are reopening post pandemic and are struggling to catch up with demand causing prices to reverse.



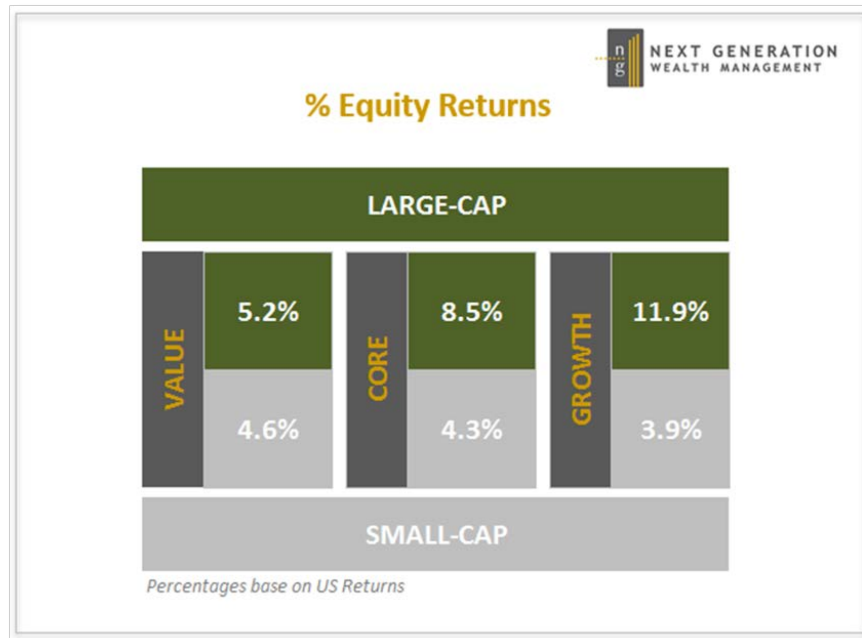


It has yet to be determined whether the inflation will be transitory like the Fed believes. One indicator to watch for changes in inflation expectation is the 10-Year Treasury Yield. Yields should rise as inflation expectations increase to allow investors to receive a real (inflation adjusted) return on their investment. As inflation became a worry for the market, the yield began to rise in the first quarter. However, during the second quarter, the yield declined from 1.74% to 1.30% (as of this writing). If the market were to expect these inflation numbers to persist, interest rates would indeed be higher.



The Financial Markets

The equity markets continued their strength in the second quarter of 2021. Fueled by a very accommodative central bank, massive fiscal stimulus, continued vaccination rollout, broad geographic reopening, and very strong corporate profits, the markets posted its fifth consecutive quarter of positive performance since the first quarter of 2020. The quarter ended with most indices at or near their all-time highs. In a reversal from previous quarters, large cap growth stocks outperformed their value counterparts by 6.7%. This may have reflected the decline in the 10 Year Treasury Yield. We continue to believe that value stocks will perform relatively well as the economy recovers from the pandemic, businesses reopen, and manufacturing and production are free to catch up with demand. Earnings growth of 62% is forecast for the second quarter, followed by 23% in Q3 and 17% in Q4, recovering from the pandemic-affected 2020. As earnings catch up with stock prices, valuations will look more reasonable in the future. While we may believe that valuations are stretched for segments of the equity markets relative to growth rates or historic norms, trying to call the peaks and valleys is impossible to do consistently. Diversification and periodic rebalancing allow us to buy low and sell high while adhering to a long-term investment strategy.



Small cap stocks lagged behind large caps, and the style performance among that group was muted. The Russell 2000 was up 4.3% in Q2 and small value slightly outperformed small growth. Small cap stocks should benefit disproportionately from a strong U.S. recovery relative to large cap stocks since they tend to be more domestically focused.

For the most part, international stocks were in positive territory with Japan being the only region posting a negative return. Japan experienced a persistent increase in cases of COVID-19, which led the government to delay lifting the state of emergency. Vaccine rollout has been slow, but recently increased as the country hosts the Summer Olympics.

The bond market reversed first quarter losses as the rate on the 10-year treasury yield fell from 1.74% to 1.47% at quarter-end. As yields fall, bond prices rise and the return for the quarter on intermediate government bonds was in the low single digits. Credit spreads tightened, allowing for higher risk fixed income strategies to perform even better than low risk government bonds. Bonds continue to play an important part of a well-diversified investment strategy. We continue to keep the average duration (a proxy for time to maturity) of the fixed income portfolio short to limit risk ahead of a monetary tightening cycle. This part of the portfolio can be used to take advantage of opportunities as they present themselves.

Risks – What We Are Watching

Inflation

With the elevated CPI reports during the second quarter, inflation has become the leading concern among investors. While the Fed has believed from the beginning that inflation this cycle will be transitory, the markets remained skeptical. As economic reports stabilized during the quarter and anecdotal evidence pointed toward moderating prices, bond yields reversed course. However, we are not out of the woods. Wage pressure and

housing costs are up as well and tend to be stickier forms of inflation. We will be keeping an eye on these areas for longer lasting effects.

Delta Variant

Japan and other parts of Asia are experiencing a third wave in cases of COVID-19 caused by the Delta variant, which may be more easily transmitted among the unvaccinated. Businesses closing and social distancing have returned to regions affected. In the U.S., cases are on the rise in most states, with the Delta variant the source. Vaccination efforts have increased as we head into the winter months when much of the U.S. spends time indoors and the virus is more likely to spread. Changes in the path of economic recovery will be monitored closely and necessary actions taken where appropriate.

Government Spending & Higher Taxes

The Federal Government had a very robust response to the pandemic in providing stimulus to avoid a more severe recession and possibly even a depression. However, the federal debt has ballooned to over 130% of GDP. In addition, lawmakers have recently proposed a $1.2 trillion Bipartisan Infrastructure Framework bill along with Democratic led $3.5 trillion fiscal budget. The Biden administration has suggested tax increases on corporations and the wealthy to pay for much of the spending. Increased spending and higher tax implications could have long term effects on the economy, financial markets, and the value of the U.S. dollar.

Concluding Thoughts

Halfway through, 2021 so far feels pretty good. Equity markets have performed well, and interest rates have been held in check. Approximately 50% of the U.S. population is fully vaccinated, with much higher vaccination rates for individuals over 50. The economy is recovering, with businesses reopening and employment on the rise. We can see a clear path to recovery, but we will have a hiccup or two along the way. Rest assured that we will keep an eye on developments as they occur and, if you ever have questions or concerns, feel free to contact us.

Enjoy the rest of your summer.

All the best,

Ed

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Senior Portfolio Manager

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