Investment Update

July, 2021

2021 Second Quarter Update

Review: The S&P 500 delivered another quarter of positive performance, returning 8.5%. Estimates for 2021 corporate earnings and US GDP growth continued to increase in the quarter, supporting US equities, which outperformed international equities. Despite higher than expected inflation reports in April and May, bond yields declined in the quarter, leading to positive returns for major bond indices.

Period	2Q21	1Q21	2020
S&P 500	*8.5%*	*6.2%*	*18.4%*
MSCI EAFE[1,2]	*5.4%*	*3.6%*	*8.3%*
MSCI Emerging Markets[2]	*5.1%*	*2.3%*	*18.7%*
Barclays U.S. Aggregate Bond	*1.8%*	*-3.4%*	*7.5%*
Barclays Municipal Bond	*1.4%*	*-0.4%*	*5.2%*

[1]Europe, Australia, Far East

[2]MSCI returns are in U.S. Dollars

Inflation: The Return of Public Enemy Number One?

From lumber to used cars, signs of higher inflation have appeared this year in a variety of product categories. Indeed, the year-over-year changes in the Consumer Price Index (CPI) for April and May—4.2% and 5.0%, respectively—were the highest readings since 2008. However, the key debate for investors is not whether there is higher than average inflation now—clearly, there is—but whether it persists and, if so, at what level. The view of the Federal Reserve is that most current inflationary forces are transitory and that inflation will stabilize near 2% in 2022. Others believe that the Federal Reserve is too complacent and that their inaction in the near term may lead to sustained levels of higher inflation.

There are strong reasons to believe in the view of the Federal Reserve. First, there is significant slack in the labor market. As the chart shows on the next page, current employment levels are still much lower than pre-pandemic levels, so it will potentially take several years to get back to full employment levels that could lead to wage inflation. Second, most of the $6 trillion in stimulus enacted by Congress since March 2020 was one-time in nature. Even the proposed bipartisan infrastructure bill deal would only result in roughly $115 billion of net new spending per year, and as proposed, it will be fully funded anyway. This "fiscal drag"—i.e., less deficit spending versus prior levels—represents a headwind to growth and inflation in 2022 and, to a lesser extent, 2023.

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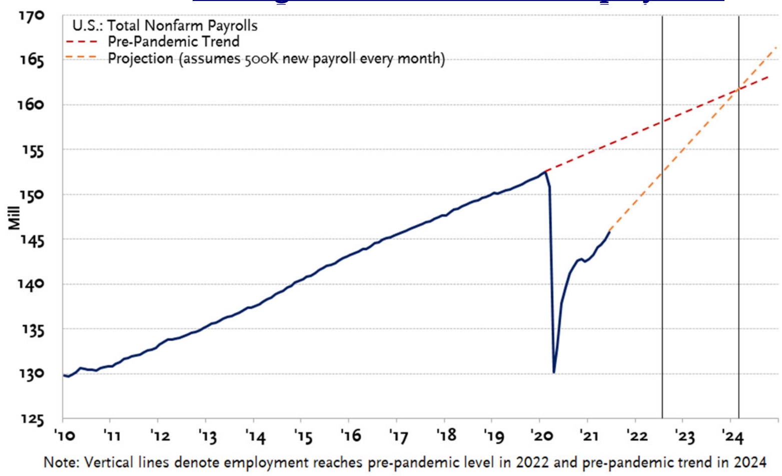
A Long Road to Maximum Employment



Source: Bureau of Labor Statistics, data through June 2021

Outlook: The economic recovery in the United States has generally been stronger than expected, and the consensus GDP growth estimate for 2021 is now 6.6%, up from 5.7% three months ago. Consumer spending is robust and expected to drive strong growth through year-end as pent-up demand leads consumers to spend some of their excess savings they accumulated over the past year. The stronger economic outlook has also flowed through to estimates for corporate earnings, with Standard & Poor's now assuming 53% year-over-year growth in S&P 500 earnings for 2021, up from 41% three months ago.

The outlook for international growth continues to be mixed and heavily influenced by management of the pandemic. For example, the estimate for 2021 GDP growth across the Eurozone has increased slightly in the past three months as vaccination rates have improved. The outlooks for emerging economies vary widely, as low vaccination rates have left many countries vulnerable to the delta variant of COVID-19. Additionally, some of the recent economic data from China would suggest that the strong post-COVID rebound is losing steam, which is a headwind for other emerging economies.

Potential risks to our near-term outlook include:

- Spread of delta (or other new) variant through unvaccinated populations
- Faster than expected deceleration in economic growth from current peak levels
- Signs that inflation may not be transitory, leading to faster than expected monetary tightening by the Federal Reserve

Strategy: The broad-based rally in cyclical sectors relative to the overall market has faded some in the past few months. For it to resume, earnings estimates for those sectors would need to go higher, which may be difficult now that we are entering a period of decelerating economic growth. Therefore, in the near-term, we prefer higher quality equities less dependent on the economic cycle. We also continue to favor the risk-reward in equities over fixed income given our outlook for robust economic growth.