Investment Perspective

The unexpected strength of the boom is straining various supply chains and labor pools and, as a result, stoking inflation

The post-pandemic economic recovery is surprisingly strong. Estimates for GDP and corporate earnings growth continue to be revised higher. The unexpected strength of the boom is straining various supply chains and labor pools and, as a result, stoking inflation. This upward pressure on prices is expected to be transitory. However, there are fears that higher inflation may be more permanent thereby motivating investors to buy equities and commodities instead of fixed income instruments. Are we at a major inflection point for inflation? This is not yet determined, but we do know the Federal Reserve is temporarily willing to tolerate inflation greater than 2%. As a result, it will be hard to distinguish between secular and transitory inflation as they will initially look similar. Regardless, growth-oriented equities are well positioned for moderately higher inflation because “good businesses” have pricing power and volume growth. Overall, the investment environment is favorable, especially for quality small and medium-sized growth stocks. Internationally, the first half gain was the best for global equities in 100 years. A summary of year-to-date index returns for the period ending June 30, 2021 is as follows:

Dow Jones Industrials	13.8%	Russell 2500	17.0%
MSCI EAFE	9.2%	S&P 500	15.3%
NASDAQ Composite	12.9%	Wilshire 5000	15.5%

GLOBAL ECONOMY

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Global economic growth (ex. U.S.) is likely to increase 6% this year and initial estimates project 4.8% in 2022. This represents the strongest growth in over 30 years. The combination of unprecedented expansionary monetary policy, fiscal stimulus, vaccine deployment and massive pent-up demand is driving the global economy. Fiscal and monetary stimulus in 2020 and 2021 is estimated at $31 trillion. The post-pandemic recovery is stronger than expected and the return to normalcy is fueling a strong cyclical rebound in GDP growth. Among major countries, China is rebounding the strongest at 8.3% GDP growth (China was the only major economy to grow last year) followed by the U.K. at 7.3%, the U.S. at 6.5%, the Euro area at 4.2% and Japan at 3.2%. The global outlook continues to improve as the coronavirus pandemic recedes and the world gradually returns to normalcy. However, there is concern regarding the rapidly spreading Delta variant in Asia, Europe and South America.

The U.S. economy is expected to grow 6.5% this year with above-average growth decelerating over the next 24 months. Near term, after a first quarter gain of 6.4%, GDP growth in the second, third and fourth quarters is projected at 9%, 7% and 6%, respectively. The most powerful contributors to growth include impressive consumer spending, a robust housing market, inventory rebuilding and resurging capital equipment expenditures. Fiscal stimulus and improving employment will continue to support consumer demand. Highly

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impacted industries such as leisure and hospitality are snapping back on sweeping vaccine deployment and increased mobility. Housing remains buoyant as families respond to work-from-home trends and the desire for a new lifestyle. Capital spending is growing in response to the resurgence in business activity. The Institute for Supply Management (ISM) manufacturing index settled down to a robust 60.2 in June from 61.2 the prior month. Initial jobless claims reached the lowest level since the pandemic began and the unemployment rate drifted down to 5.9%. The Conference Board consumer confidence index jumped to 127.3 in June – the highest reading in over 35 years – a clear sign of economic optimism. Bottom line, consumers are spending enthusiastically, and the job market is strong – these are key ingredients for a sustainable expansion. In May, there were 9.2 million job openings versus 9.3 million unemployed. Potential workers will gradually seek employment as the government's financial support for over 12 million people is reduced on September 6. Interestingly, 4.4 million new businesses were started in 2020-a modern record. The American Renaissance has begun!

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INFLATION & INTEREST RATES

Inflation has increased significantly over the past year. The Fed's preferred measure of inflation, the core personal consumption expenditure (PCE) price index, which excludes the impact of food and energy prices, is up 3.4% y/y. Headline inflation as measured by the consumer price index (CPI) is up 5.4% y/y -- the largest increase since August 2008. Core inflation (CPI excluding food and energy) rose 4.5% y/y -- the largest increase since November 1991. Used car prices surged 45% y/y and accounted for a large portion of the recent core increase, as did the jump in transportation services. For example, car rental prices exploded 110% y/y. People are on the move with the pandemic receding.

Current Fed policy is targeting 2% core PCE inflation over the long term with tolerance for transitory periods of inflation greater than 2% to foster fuller employment. The Fed's policy objectives allow the economy to run hotter than usual for a short period to offset more than a decade of inflation under 2%. In fact, the global fight against deflation over the last 10 years has been difficult – as evidenced by exceptionally low interest rates and massive central bank balance sheets. Accordingly, the current tolerance of above-trend inflation is appropriate in the context of these objectives. Consensus monetary forecasts suggest the Fed may begin tapering the $120 billion per month bond buying program in early 2022 with the first interest rate hike in 2023. Today, there is "talk of taper", effectively a jawboning tactic to communicate the Fed's growing confidence in achieving its policy objectives. The risk is that persistently high inflation might force the Fed to raise interest rates faster and higher than expected. This, in turn, could compress stock market valuations depending upon its degree and the rate of change.

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CORONAVIRUS UPDATE

The U.S. is making significant progress in deploying vaccines. To date, 160 million people have been fully vaccinated representing 50% of the total population. Vaccines are readily available for nearly everyone more than 12 years old and approval for children is expected shortly. Approximately 530 thousand vaccinations occur per day – down from over 3.3 million in early April. However, there are pockets of resistance slowing the goal of vaccinating most of the population and developing herd immunity. Rapid vaccine deployment has clearly helped restore some normalcy. An overall sign of progress is the simultaneous increasing mobility of people and the commensurate decline in virus related infections and deaths. However, the major concern is the Delta variant which is the most dominant strain of new infections. It is spreading rapidly across the country among those unvaccinated populations and especially in Arkansas, Missouri and Nevada. Globally, the coronavirus continues to pose a significant threat in countries with low vaccination rates. Unfortunately, inconsistent global vaccine deployment combined with efficacy issues regarding widely used Chinese vaccines are risks that will hamper a full return to normalcy. Interestingly, the pervasive trends of globalization have been checked by the pandemic, which may be a notable residual effect of this crisis. The pandemic appears almost over for those countries sufficiently vaccinated, especially in the minds of consumers and investors, despite warnings from public health officials. We have made substantial progress, but there are still risks.

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INVESTMENT OUTLOOK

The U.S. economy passed its pre-Covid peak last quarter, only nine months after the trough of the recession. Aggregate corporate profits reclaimed prior peak levels even faster as economically sensitive companies benefited from an acceleration in growth. The fundamentals supporting a robust investment outlook include strong economic growth, accelerating earnings momentum and rising investor confidence. Additionally, the combination of low interest rates, moderate inflation and ample liquidity in capital markets provides a solid foundation for stock market gains, initial public offerings (IPOs) and mergers & acquisitions (M&A). We now expect S&P 500 (SPX) operating earnings of $195 per share this year, up significantly from the depressed levels in 2020. Looking ahead, $215 is possible in 2022. The SPX is valued at 21.7x estimated 2021 earnings, supported by a 10-year Treasury yield of 1.20% (versus 1.75% early May). Stock market valuations are higher than usual due to the unique combination of exceptionally low interest rates, moderate inflation and above-average growth. It will be important to remain vigilant in identifying potential excesses in future years. There are many positives, but irrational exuberance could upset the stock market.

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Asset flows into equities continue at the fastest pace in two decades. In fact, BofA Global Research notes that the annualized rate of equity inflows in the first half of 2021 is cumulatively greater than all equity inflows over the last 20 years! These impressive equity flows coincide with substantially smaller asset flows into Treasuries. Several factors explain this. Household balance sheets are the healthiest in a generation and, as a result, a greater portion of household savings is available for deployment into higher earning assets like the stock market. Equities are fast becoming the preferred asset class of choice for investors. It has taken a long time to reach this juncture as the hangover from the Global Financial Crisis (GFC) required a period of balance sheet and sentiment repair. The tailwinds for equities may last longer than many investors perceive. With the yields on long-term Treasury bonds below inflation, real interest rates are negative, which is pushing investors into higher earning asset classes in the pursuit of better returns.

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From a technical perspective, the stock market is healthy. Breadth and momentum as evidenced by the NYSE advance/decline line suggests the stock market is poised to continue its advance. This year has been marked by a rotation among investment styles and sectors. For example, the energy and financial sectors have been two of the best year-to-date performers at 28% and 27%, respectively. In addition, small capitalization value indices outperformed large capitalization growth indices whereas those roles were reversed in 2020. We expect a series of mini rotations driving the market higher while periodically benefiting some sectors over others. There may be some temporary narrowing of market breadth as the year-to-date winners take a rest and leadership may shift to growth stocks. Positively, the VIX option volatility index declined from a reading of 30 in January to 16.5 in early July. A lower VIX reading in the context of a rising stock market is a positive confirmation. Also, the first half increase of 14.4% for the SPX ranked 15th best since 1928. After an above-average first half return over this period, the SPX rose 77% of the time in the second half with an average gain of 6.4%. Finally, the SPX held above its 200-day moving average (MA) without a 5% correction in the first half. This occurred 15 times since 1928 and provided an average full year return of 22.2%

We expect above-average returns for the stock market this year. It is important to note that momentum trends can be sustained for longer than expected. We expect M&A activity to remain robust with small and medium-sized companies likely to benefit given the unspent capital sitting in Special Purpose Acquisition Companies (SPACs). In addition, corporate balance sheets are generally in good shape, especially those of the large commercial banks who are ready to lend. Massive global liquidity, strong fundamentals, above-average growth rates and improving asset flows for equities support the current environment. The key risks include Brexit, coronavirus contagion, cyber-attacks, the Delta variant, disappointing earnings, excessive exuberance, military conflicts, social unrest, tapering too fast, tax rate increases, unexpected inflation and vaccine failure. In our opinion, quality small and medium-sized growth companies remain likely to achieve above-average annual returns over the next few years.