Investment Update

Second Quarter 2021

As with three months ago, the broad stock market indices are still showing significant year-over-year gains and the S&P 500 finished the quarter at an all-time high. Large US technology companies performed well in June as interest rates fell, but generally have been relative laggards since last September when vaccine optimism led investors to focus on companies better positioned to benefit from the economy reopening. The daily speculation continues about when the Federal Reserve will deem the economy strong enough for its policies to become less accommodative. In recent weeks the Fed pulled forward its forecast for a first interest rate hike from 2023 to 2022 and many on its board have expressed that starting to talk about tapering purchases of government and mortgage-backed bonds sooner than later (or even just starting to talk about talking about it) is appropriate. During the quarter the Fed unwound their corporate bond holdings accumulated last year, and corporate bond yield spreads to Treasuries tightened (which is to say their prices were unaffected by the selling) showing that at least capital markets appear strong enough for there to gradually be less and less policy intervention.

Equity Markets (Total Return)	2Q'21	1-Year
Dow Jones Industrials	5.1%	36.3%
S&P 500	8.5%	40.8%
S&P Mid-Cap	3.6%	53.2%
S&P Small-Cap	4.5%	67.4%
MSCI All-Country World	7.5%	39.9%
MSCI Foreign Developed Markets	5.4%	32.9%
MSCI Foreign Emerging Markets	5.1%	41.4%
US Bond Markets (Total Return)	**2Q'21**	**1-Year**
Barclays US Treasury	1.7%	-3.2%
Barclays US Municipal	1.4%	4.2%
Barclays US Corporate Investment Grade	3.5%	3.3%

The first quarter earnings numbers reported early in April and May were much better than expected with some 85% of S&P 500 companies beating analysts' consensus estimates (normally 60-65% of companies beat). The peculiarities of the sudden and short 2020 recession we are recovering from have made modeling company earnings difficult for investors, and many companies themselves suspended the practice of providing estimates of their upcoming earnings. The one-year anniversary of the March 23rd stock market bottom passed last quarter, but this quarter has marked one year since the nadir for many economic metrics making for extraordinary year-over-year increases.

Perhaps the most attention-grabbing numbers have been the inflation readings at levels not seen in many years. Looking back to before the shutdown last spring, the two-year increases do not look nearly as alarming and are well within the range seen over similar timeframes. The pronounced year-over-year price increases in the broad CPI number are mainly caused by just a few of the many component goods and service categories. Some are those that saw the most precipitous drops in demand a year ago such as travel, some are areas with well-documented supply chain issues, and some are just caused by temporary trends. Vehicles would fall into both the latter two categories, with used car prices being bid up for lack of new car supply due to manufacturers'

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inability to source components. There is also increased demand from commuters preferring to do so alone rather than in public transit, or people moving out of cities who might need a vehicle or a second vehicle as a result. Most of these dynamics point to the price increases being transitory, but the important question is whether we might be seeing the beginning of more broad-based inflation.

Expected inflation amongst consumers is an important consideration in whether it occurs in the first place or accelerates further. If you think the price of a product you have some interest in is going to be notably higher in six or twelve months, that might spur you to purchase it today even absent an immediate need. That expectation might also lead you to ask for higher wages. If consumers and workers collectively make more and more of these sorts of decisions, it in turn can contribute to that expectation becoming reality.

On the other hand, expected inflation amongst investors does not at all contribute to future inflation coming to fruition, just the possible overpricing of inflation hedges. We can think of many times in the past when there seemed to be consensus that textbook pressure on some economic or investment variable would head in one direction or another, only to see it not happen. Some of what the Fed did to support and stimulate the economy in the aftermath of the 2008-’09 financial crisis *should* have created inflation but there was not any of note in the years since. The similar sorts of accommodative tools it is employing today, as well as the possibility of further significant government spending for infrastructure, again has many convinced inflation should be coming.

Inflation above the Fed’s 2% target over time will eventually result in higher rates, certainly at the short end of the interest rate curve where traditional Fed policies have the most influence. We would also expect longer-term rates to move up in that scenario, but to a lesser extent than short rates. This would not be good for stocks all things being equal, but at current levels, equity investors seem mostly focused on the positive benefits to companies of operating in an environment of economic recovery that could contribute to inflation and higher rates in the first place. The yield of the 10-year Treasury has fallen steadily throughout the quarter and continues to fall in July, even though there is no asset class more affected by inflation than bonds. Bond investors may be signaling faith that the Fed will be quick to dampen any inflation that appears out of control, but also the possibility that we will soon return to the lackluster growth experienced for much of the last decade.