INVESTMENT COMMENTARY
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Executive Summary

Most asset categories have experienced gains so far this year as financial markets have been relatively calm. This is in sharp contrast to the surge in volatility experienced in 2020 as the spread of Covid-19 forced global economies to shut down and caused markets to plummet. The economic rebound thus far has been stronger than most anticipated, but US growth and policy support have likely peaked. Uncertainty remains high and the spread of the Delta variant poses a risk to the outlook. Yet, our base case assumes a continued global economic recovery transitioning to a more moderate pace being supported by still-accommodative monetary policy. This backdrop should continue to underpin corporate earnings and risk assets, but valuations are generally stretched.

In our view, proper diversification remains as important as ever. Our tactical positioning themes include:

- Continue to target an underweight position to core/investment grade bonds given historically low yields.
- Target an underweight position in US large cap stocks as valuations may reflect an overly optimistic outlook. Emphasize high quality companies with pricing power.
- Remain fully invested in international and emerging markets stocks that stand to benefit from more attractive valuations and their greater orientation toward cyclical sectors.
- Target an overweight position to real assets given the risk of higher inflation.
- Maintain a slight overweight position to certain flexible/alternative strategies that are potentially attractive for their diversifying returns.

Asset Category Performance (As of July 31, 2021)	YTD 2021	Full Year 2020	Last 5 Years*	Last 10 Years*
Fixed Income				
Municipal Bonds (Barclays 1-10 Year Municipal)	+1.0%	+4.2%	+2.6%	+3.0%
Taxable Bonds (Barclays Intermediate US Gov/Credit)	-0.1%	+6.4%	+2.7%	+2.7%
Bank Loans (S&P/LSTA US Leveraged Loan)	+3.3%	+3.1%	+4.7%	+4.4%
High Yield Corporate Bonds (Barclays US High Yield)	+4.0%	+7.1%	+7.0%	+6.6%
Equities				
Global Stocks (MSCI All Country World)	+13.1%	+16.3%	+13.8%	+10.2%
US Large Cap Stocks (S&P 500)	+18.0%	+18.4%	+17.4%	+15.4%
US Small Cap Stocks (Russell 2000)	+13.3%	+20.0%	+14.3%	+12.3%
Non-US Developed Markets Stocks (MSCI EAFE)	+9.7%	+7.8%	+9.4%	+6.1%
Emerging Markets Stocks (MSCI Emerging Markets)	+0.2%	+18.3%	+10.4%	+3.6%
Real Assets				
Commodities (Bloomberg Commodity)	+23.4%	-3.1%	+3.9%	-4.5%
Energy MLPs (Alerian MLP)	+38.5%	-28.7%	-2.4%	+0.6%
Global REITs (MSCI ACWI REIT)	+24.0%	-4.8%	+7.5%	+9.4%
Flexible/Alternative Strategies				
Directional Hedge (HFRI FOF Strategic)	+5.3%	+14.6%	+7.1%	+4.4%
Less-Directional Hedge (HFRI FOF Conservative)	+5.8%	+6.5%	+4.9%	+3.5%

*Note: Data provided by Zephyr Associates. *Indicates annualized return. Past performance is not indicative of future results.*

Market Review

Most broad asset categories have experienced solid gains thus far in 2021, with the exception of high-quality bonds that suffered amid a rise in interest rates earlier in the year. Aside from the retail investor "short squeeze" frenzy that occurred in January, financial market volatility has been relatively low. This somewhat benign environment is in sharp contrast to the surge in volatility experienced in 2020 as the spread of Covid-19 forced global economies to shut down and caused markets to plummet. Currently, inflationary concerns are top-of-mind as realized inflation rates have accelerated to multi-decade highs given the strong rebound in economic growth and pandemic-related supply constraints.

Global equities have generated strong returns on a year-to-date basis with many major indices trading near record highs. US stocks have continued their outperformance driven by earnings growth well ahead of consensus expectations. Beneath the surface, quite a bit of style rotation has occurred as capital moved between cyclical stocks and secular growth stocks. The "reopening" or "reflationary" trade, which has generally benefited smaller cap and value-oriented companies, reversed sharply over the last couple of months amid a cooling of economic data and a decline in interest rates.[1] Emerging markets stocks have struggled of late with particular weakness in China resulting from a regulatory crackdown on industry, notably against large technology firms and private education companies.

In fixed income markets, investment grade bonds have faced performance headwinds by way of rising interest rates since August 2020. As a result, shorter duration and lower-rated sectors, such as bank loans and high yield, have outperformed as credit conditions continued to improve. Yet, longer-term interest rates are well off their highest levels of the year. For example, the 10-year Treasury bond yield reached 1.75% in late March 2021, but currently stands at 1.30% despite elevated inflation readings. This move lower may reflect a shift in investor expectations for slower economic growth and moderating inflation—however, the monthly purchases of $80 billion in Treasury securities via the US Federal Reserve's (Fed) quantitative easing program likely distorts this signal. Meanwhile, short-term interest rates remain anchored near zero given current Fed policy.

Macro Backdrop

The Covid-19 recession was both one of the deepest and shortest in history. According to the National Bureau of Economic Research (NBER), the US economic contraction lasted just two months. In determining that a trough occurred in April 2020, NBER did not conclude that the economy had returned to operating at normal capacity. Rather, the committee decided that "any future downturn of the economy would be a new recession and not a continuation of the recession associated with the February 2020 peak. The basis for this decision was the length and strength of the recovery to date."[2]

Indeed, economic growth thus far has outperformed consensus expectations and past recoveries, driven by significant fiscal and monetary stimulus, accelerated vaccine distribution, and strong consumer demand. For instance, US household disposable income increased in 2020 as fiscal transfers outweighed losses in pay—very unusual for a recession year. In the US, most economic indicators have returned to pre-Covid levels, though employment, arguably the most important, has lagged. There are still 7 million fewer Americans at work now than they were in February 2020, before the pandemic began. While this is a productivity story to be celebrated, it also raises some concern about structural unemployment. Strategas Research Partners points out, "it seems safe to assume that some companies, faced with a severe shortage of workers, have moved to automate their businesses, making them less dependent on labor."[3]

As typical, we seek to frame the macroeconomic backdrop by considering a range of potential outcomes. What remains unique about the current environment is how dependent the outcomes are on the course of Covid-19. This is evident in the so far uneven global economic recovery. Countries that have contained the virus more successfully, whether through vaccinations, lockdowns, or both, have tended to see their economies hold up better. For example, China has largely contained the pandemic and was the first to return to its pre-Covid GDP level, though consumption is taking time to normalize amid slow vaccination rollouts and sporadic virus

outbreaks. In the euro area, a sluggish initial vaccination rollout and repeated lockdowns tipped the bloc back into recession earlier this year, but supportive policy could underpin a strong bounce-back.[4]

Acknowledging an unusually wide range of potential outcomes, our base case assumes a continued global economic recovery transitioning to a more moderate, but still above-trend, pace. While US growth and policy support may have peaked for the cycle, economic activity outside the US may continue to accelerate as Europe and Japan are perhaps a couple of quarters behind in the recovery. The path of US fiscal policy remains uncertain, yet, despite any new infrastructure spending, the expiration of pandemic support programs will result in a meaningful fiscal drag—a negative impact on growth. Some central banks have begun taking steps toward normalization, but overall monetary policy is likely to remain accommodative as interest rate hikes in most developed markets are not expected in the near-term. Therefore, absent a severe external shock, recession risk remains low. Even as US fiscal stimulus diminishes, consumer balance sheets are well-positioned to fuel higher consumption with household savings that exceed pre-pandemic levels by over $2 trillion.[5]

The spread of the highly transmissible Delta variant has caused renewed Covid-19 flare-ups around the world, posing a risk to the economic outlook. Fortunately, the advanced vaccine rollout appears to have weakened the link between cases and hospital admissions[6]—but as the rate of infection increases, the possibility of some form of economic shutdown, most likely on a regional basis, remains in play. And even if no shutdowns are enacted, just the threat can have an impact on behavior and consumption patterns. For example, based on the University of Michigan's survey, US consumer sentiment fell to a near-decade low in July as respondents cited concerns about the pandemic and inflation.[7]

Absent a severe resurgence in the pandemic, inflation is probably the key macro risk. Most economists expected a spike in inflation as the US economy reopened from the Covid-19 lockdown. Its magnitude, however, has caused some to question whether the recent increase is a temporary phenomenon or the beginning of a secular shift higher.[8] We tend to agree with PIMCO's assessment that "the world is witnessing a transitory spike, driven by year-over-year base effects, supply bottlenecks, and temporary shortages, that should moderate into 2022."[9] Therefore, our base case is that inflation will be marginally above the Fed's 2% target for the next couple of years. Yet, we recognize that there are risks to this view. It's possible that supply shortages and bottlenecks don't resolve as quickly as expected, or perhaps wage increases accelerate despite the apparent labor market slack. Our analysis will continue to evolve as new economic data arise. In particular, we'll be monitoring wage trends as supplemental unemployment insurance benefits expire. As always, maintaining a high degree of humility and flexibility is important. And we are reminded by Jason Trennert at Strategas Research Partners that "that higher inflation in and of itself is not as problematic as a central bank deciding to fight it."[10]

Monetary Policy

We've previously observed that, over the past decade or more, investor sentiment and the broader economy have been increasingly at the mercy of central banks. Low interest rates and accommodative policy became the norm as central bankers aimed to combat the deflationary pressures of the 2008 global recession. In light of the effects of Covid-19 on economic activity, the US Fed again unleashed a series of moves to stabilize markets by slashing the benchmark interest rate to zero, launching a new round of quantitative easing (QE), and expanding liquidity programs. Our view remains that central banks continue to have an asymmetric view of the world and will likely err on the side of accommodation in order to provide downside protection to the economy.

Since 1996, it has been understood among Fed policymakers that the (undeclared) target for inflation was around 2%. In January 2021, Chairman Ben Bernanke made this *implicit* inflation target *explicit* and official. In this framework, when inflation has approached or exceeded the traditional 2% target, even temporarily as it did in 2018, the FOMC has responded by raising the baseline federal funds rate to combat rising prices.[11]

In August 2020, Chairman Jay Powell announced a revision to the Fed's policy framework by re-framing its goal an *average* inflation target (AIT) of 2%. This change means that the central bank will tolerate inflation

above its target "for some time" to offset periods when inflation was below its target. Obviously, "for some time" is open-ended and subjective language.[12] The Fed has also shifted from focusing on trying to act in advance of inflation based on its forecasts, to waiting until inflation actually arrives. James Mackintosh at the Wall Street Journal writes, "with monetary policy's effect on the economy famously having long and variable lags behind, as Milton Friedman emphasized, this raises the probability that the Fed acts too late to rein in rising inflation."[13]

Last week at the Jackson Hole Economic Policy Symposium, Chair Powell noted that "central banks cannot take for granted that inflation due to transitory factors will fade." Yet, the Fed's QE tapering decision in 2021 and the (later) tightening decision have been split, with Powell also saying "the timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test."[14] At this point, it seems the Fed is focusing almost exclusively on the full employment part of its dual mandate.

Market Outlook

Uncertainty always exists, but, at the moment, it is very hard to read the incoming data given the unprecedented Covid-related disruption and rebound.[15] Still, our base case view is that a combination of continued economic recovery and still-accommodative monetary policy should remain broadly supportive of corporate earnings and risk assets, such as global equities and credit. And the likelihood of an imminent US or global economic recession appears low—absent a severe external shock. Without a recession, history suggests an equity bear market (commonly defined by a peak-to-trough decline in stock prices of at least 20%) is unlikely. However, stretched equity valuations and low bond yields portend below-average returns from traditional asset classes. We also expect market volatility to increase. Though difficult to predict what the catalysts might be, there's no shortage of geopolitical events currently in play. US politics alone offer plenty of potential flashpoints for volatility over the next few months as Congress focuses on a bipartisan infrastructure package, an additional $3.5 trillion spending budget and the taxes that are likely to accompany it, a potential government shutdown, and the debt ceiling.[16]

Overall, global equity valuations currently stand above their historical averages and are most elevated in the US. For example, the forward price/earnings (P/E) multiple for the S&P 500 is now roughly 21.1x compared to the 10-year average of 16.3x.[17] Perhaps some level of valuation premium relative to history is warranted given the low level of interest rates. However, continued strong earnings delivery will be particularly important for the US stock market. We continue to see better return prospects in international and emerging markets stocks where earnings have more room for positive surprises and valuations are more reasonable. We also believe the recovery in global economic growth will benefit value stocks and traditional cyclical sectors, such as energy, financials, and industrials. Relative valuations also distinctly favor value over growth stocks.

Certainly, on a comparison of earnings yields to bond yields, stocks look *relatively* undervalued. In fact, over half of the S&P 500 Index companies have a dividend yield greater than the 10-year Treasury rate.[18] Yet, this may say more about the overvaluation in bonds given historically lows yields and tight credit spreads. We also worry that financial markets may be underpricing the risk of higher inflation. Historically, nominal asset classes like broad equities and fixed income have had a negative response to inflation surprises, meaning that when inflation increases, asset values generally fall. Real assets, on the other hand, such as commodities, have exhibited a positive response to inflation, underscoring their potential effectiveness in mitigating the effects of inflation.[19]

Tactical Asset Allocation Views & Portfolio Positioning Themes

Within the context of a sound, long-term asset allocation framework, we believe that an active, flexible approach can enhance returns by shifting capital to attractive risk/reward opportunities. Portfolio activity in 2020 was much higher than normal as we sought to take advantage of market volatility. But our positioning themes have remained fairly consistent over the last several months. In our view, valuations are generally rich while macro uncertainty is high. Therefore, proper diversification remains as important as ever.

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Cash					
Cash & Short-Term Bonds				✓	
Fixed Income					
Investment Grade Municipal Bonds		✓			
Investment Grade Taxable Bonds		✓			
Bank Loans and High Yield Credit			✓		
Equities					
US Large Cap Stocks		✓			
US Small Cap Stocks			✓		
Non-US Developed Markets Stocks			✓		
Emerging Markets Stocks			✓		
Real Assets					
Commodities and Natural Resources				✓	
Public Real Estate	✓				
Flexible/Alternative Strategies					
Diversifying Hedge				✓	

Note: Based on research and opinion provided by Greycourt & Co. Tactical views reflect a three-year investment horizon. Suggested asset class weights are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investing horizon.

- **Continue to target an underweight position to core/investment grade fixed income.** High quality bonds play an important role in portfolio strategy, providing a source of stability and liquidity. Yet, historically low yields have diminished the income component and diversification potential of these "protective assets."

- **Target an underweight position in US large cap equities while emphasizing high-quality stocks.** Low interest rates and an ongoing economic recovery should continue to provide support to US equities. However, valuations are stretched and perhaps reflect an overly optimistic outlook. Therefore, we recommend an underweight position. We also continue to prefer a tilt towards higher quality companies (those with strong balance sheets, stable earnings, and high margins) that typically exhibit pricing power.

- **Remain fully invested in more reasonably priced international developed and emerging markets stocks.** In our view, non-US stocks stand to benefit from more attractive valuations and their greater orientation toward cyclical sectors. The headwind of a strong US dollar over the past several years should also reverse itself, given the large and expanding US federal budget and current account deficits. And despite recent underperformance, we believe emerging markets offer investors access to the most powerful structural growth themes of the expansion ahead: technological innovation and the rise of the EM Asia middle class.[20]

- **Target an overweight position to real assets given attractive valuations and the risk of "stickier" inflation.** While the recent uptick in inflation is likely transitory, upside inflation risk has increased to due supply/demand imbalances and stimulative policies. Commodities and commodity-producer equities can help hedge against surprise increases in inflation while providing potential capital appreciation in a higher growth environment.

- **Maintain a slight overweight position to diversifying alternative strategies.** We continue to believe that certain types of hedge fund strategies are valuable for their diversifying active returns. In our view, the investment case is particularly compelling given stretched US equity valuations and extremely low yields across most fixed income sectors, while taking into consideration the less-liquid nature of some alternative strategies.

- **Where appropriate, continue to develop private equity and private real estate investment programs.** Because of the associated illiquidity and inherent inefficiencies, private assets typically compensate investors with a premium return. We recommend maintaining the planned pace of commitments as new capital deployed during periods of economic disruption often generate significant upside.

Special Topic: Potential Tax Policy Changes

Uncertainty remains around the prospect for tax hikes related to President Biden's ambitions for infrastructure and other spending. While a bipartisan deal was announced on more-modest infrastructure spending that used means other than tax increases to raise revenue, a second spending package is also under consideration that would employ some of the tax proposals of the original American Families Plan announced back in April. Those include an increase in the top federal tax bracket to 39.6% for families earning more than $400,000 and an increase in the long-term capital gains tax rate for those with annual income above $1 million.

Specifics have and will continue to change amidst the sausage-making of legislation, including any proposed effective dates for tax changes. It's possible that both measures could be passed along party lines using the "reconciliation" process, which would not require bipartisan support. We expect this to play out over the next couple of months. In the meantime, we've shared below some observations from Strategas Research Partners. We will continue to monitor closely and reach out to make recommendations as appropriate.

- **Tax increases will likely be passed as part of the Democrats' budget reconciliation bill.** Democrats are likely to start out pushing for a $3.5 trillion spending package, but the lack of appetite for that level of tax increases, as well as rising inflation will make it difficult to get that much spending. Still, we expect tax increases to be enacted as part of the plan. The Strategas base case sees a 25% corporate tax rate, 25-28% capital gains/dividend tax rate, a 39.6% highest personal income tax rate, and modest changes to the estate tax rate and exemption amount. The elimination of cost basis step-up seems unlikely due to a lack of support in the Senate.

- **Most tax changes are implemented around the time of enactment.** Changes to individual income taxes are most likely to go into effect for calendar year 2022, as well as an increase in the corporate income tax rate. Changes to capital gains/dividend taxes are likely to go into effect around the time of enactment of the legislation or when the legislation is introduced—both of which are looking like fourth quarter events.

- **However, there is a possibility that some tax increases could be retroactive.** The 1968 and 1993 income tax increases were retroactive. Both passed mid-year and were set back to January 1st. Estate tax changes in 1993 and 2010 were also retroactive, but policymakers warned in advance of changes occurring that year. We found no historical record of capital gains tax increases being retroactive.

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