Quarterly Economic Update

June 09, 2021

MACROECONOMIC COMMENTARY

Fiscal/Monetary Policy

By Michael McNair

MMT Madness

Over the past year, Modern Monetary Theory, or MMT for short, has emerged at the forefront of economic debate in the U.S. MMT has become a hot-button issue within financial, economic, and even political circles. The simple mention of MMT evokes a visceral reaction from the mainstream.

Reading the critiques makes it clear that the critics haven't sufficiently studied MMT; thus, they fail to understand the nuance of the arguments.

MMT has only recently gained notoriety within the mainstream financial community. However, the Fiscal Policy Report first began writing about MMT in 2010. We believe that over a decade of study has provided us the requisite knowledge to discuss the true tenets of MMT and judge its merits as an economic theory.

What is MMT

MMT traces its origins back to Abba Lerner's 1943 paper on "Functional Finance." According to Lerner:

"The first financial responsibility of the government (since nobody else can undertake that responsibility) is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current prices would buy all the goods that it is possible to produce. If total spending is allowed to go above this there will be inflation, and if it is allowed to go below this there will be unemployment."

Most economists today, including Keynesians, will agree with the statement that fiscal policy can be used to rescue the economy during periods of insufficient demand. It is important to understand why.

At the individual level, if we save a portion of our income, we can spend more in the future. However, at the macro level, we cannot save by spending less. This is because total income in the economy is equal to the amount of spending in the economy (income = spending).

When aggregate demand contracts, the private sector cuts jobs, which decreases incomes and causes lower spending (i.e., lower aggregate demand), which in turn creates a feedback loop between lower incomes and lower spending. The paradox of thrift, popularized by John Maynard Keynes, says that in recessions, individuals take seemingly rational steps to protect themselves by saving more and spending less, but when done at the national level, these attempts are self-defeating because they cause a decrease in consumption which perpetuates the economic contraction. As a result, incomes go down as unemployment rises, and ironically the economy ends up saving less.

However, government deficit spending can replace private sector spending, allowing the private sector to accumulate savings without a drop in aggregate income.

MMT's Major Insight

Most financial and economic thinkers generally agree that it was appropriate for the government to deficit spend during an extreme economic shock like the pandemic. However, the traditional economic consensus differs from MMT about the constraints to government spending.

Lerner's key insight is that governments operating in a fiat currency system are not constrained by the need to issue debt or taxes to spend money. These governments can simply print money and spend it.

Some traditional economists take issue with this statement because in their models' governments are constrained by their ability to issue debt. It's unnecessary to go deep into the details to defend Lerner's conclusion because it's a conclusion that isn't radical for most people. The ability of governments to print money is what a fiat currency system means.

We have the two cornerstone assertions made by MMT:

1) Government spending will be effective in supporting the economy during periods of economic slack
2) In our current fiat currency system, monetarily sovereign governments can print money

Most people would agree with both statements. Certainly, more so than would admit that they agree with MMT.

However, the vitriol towards MMT occurs because most critics mistakenly believe that MMT claims that government debt is irrelevant and budget deficits are a free lunch that can always be increased to stimulate economic growth; however, this is a strawman argument, and it is imperative to understand that MMT purports nothing of the sort.

What MMT actually asserts from the axiom that governments can effectively borrow from themselves is that government deficit should be used to ensure that demand in the economy is in line with supply, and the success of fiscal policy should be judged on its success in attaining policymakers macroeconomic goals (creating full employment and price stability).

According to Lerner,

"The first financial responsibility of the government (since nobody else can undertake that responsibility) is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current prices would buy all

the goods that it is possible to produce. If total spending is allowed to go above this there will be inflation, and if it is allowed to go below this there will be unemployment. The government can increase total spending by spending more itself or by reducing taxes so that the taxpayers have more money left to spend. It can reduce total spending by spending less itself or by raising taxes so that taxpayers have less money left to spend. By these means total spending can be kept at the required level, where it will be enough to buy the goods that can be produced by all who want to work, and yet not enough to bring inflation by demanding (at current prices) more than can be produced."

The MMT argument is that you can only judge the appropriateness of government deficits in relation to the state of the economy.

Consuming and investing below the potential of the economy represents a deadweight loss. It represents goods and services that could have been produced – and thus consumed or invested - but were not. Any forgone production is not saved. As we have stated, the economy cannot save in aggregate. Therefore, in times when demand in the economy falls below the economy's full production potential, governments should run deficits to increase demand in line with the economy's capacity to produce.

However, in times when demand is exceeding the economy's capacity to produce, incremental demand will not create more output; rather, it will only create higher prices. In this scenario, the government should reduce spending and increase taxes to bring demand in line with the economy's production capacity and ensure price stability.

It's easy to see why people are skeptical of MMTers suggesting that printing money and running deficits are the solutions for low economic growth. You might ask, "If deficit spending is so good for the economy, then why don't we just always run large deficits?" The answer is that government deficits will only increase economic wealth when the economy is operating below full capacity, and there are ample idle resources, such as unemployed workers or unused factories, that can be brought on to meet the increased demand from government spending. When actual GDP is near potential GDP, then any increase in spending from the government will be inflationary as it will only increase prices and not output.

A common question on social media is how the government can hand out large stimulus checks to people. The assumption is that if they can send stimulus checks during the pandemic, then they can do it anytime. But this is a false conclusion. The reason that the government can send out stimulus checks and run trillion-dollar deficits during a pandemic is that household spending has collapsed, leaving large spare production capacity in the economy.

MMT is not saying that deficits are a free lunch and can be increased without constraint. MMT explicitly states that idle productive resources are the real constraint. Government deficits are only able to increase real GDP when demand is below the production capacity of the economy. The economy has already used real resources to increase production capacity, but a demand deficiency is "artificially" constraining GDP below the real wealth-producing capacity of the economy. Government deficits are just a means of removing that artificial constraint and allowing the economy to produce at its full potential.

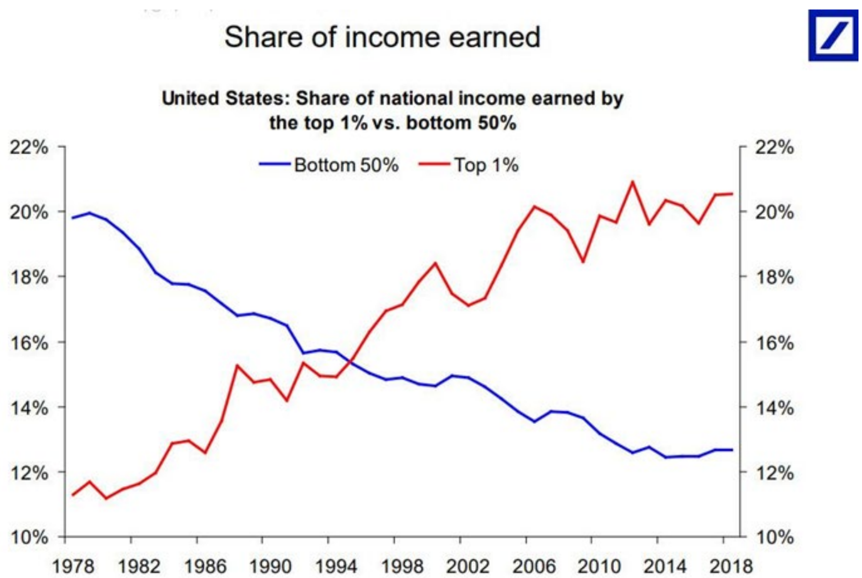
While the supply side acts as the “real” constraint to the economy, there are times when insufficient demand is the limiting factor and not capacity. It is just that the demand constraint can be overcome with increased government deficits, while the supply constraint cannot.

Demand constraints occur because of the savings preferences of the private sector. We’ve already explained that one source of demand deficiency can arise as a result of households and businesses getting scared and deciding to reduce spending and increase savings. But demand deficiencies can occur even outside recessions because the private sector has a preference for withholding some of their income in the form of savings. Since the spending of any economic agent is the income of another, the preference to save creates a problem for the economy. What must occur is for another entity to spend in excess of their income (i.e., deficit spend) to keep incomes from falling. A household can increase their savings by withholding income and lending money to a business (who is deficit spending) in the form of a corporate bond, for example. In this way, households can increase savings without total spending in the economy falling. However, the only way for the private sector in aggregate (households + businesses) to save is for the government to run a deficit.

By running a budget deficit, the government is allowing the private sector to accumulate savings, via increases in money or government debt. Therefore, to increase the pool of savings in the private sector, the supply of government debt or money must continually increase.

The important point is that the surplus of one sector exactly equals the deficit of the other sector. Therefore, the only way for the private sector to be in surplus is for the government to run a deficit and vice versa.

One important factor determining the private sector’s savings preferences is the distribution of income. High-income individuals spend a small percentage of their income, while low-income individuals spend a large portion. The dramatic shift in the distribution of income over the past 50 years has led to higher savings preferences among the private sector. As a result, higher government budget deficits have been necessary to sustain total spending in the economy.



Source: Saez and Zucman (2019), https://taxjusticenow.org , DB Global Research

The Concerns over Government Deficits

The common concerns over government deficits include the crowding-out effect, unsustainability of government debt accumulation, and inflation. We will address each concern and determine if they are a legitimate risk in the current environment.

<u>Crowding-Out Effect</u>

Crowding-out occurs when savings are constrained, and the government must compete with the private sector for the limited capital available to fund investment. The best example of this savings constrained environment is the U.S. during the 19th century. The U.S. was a new and rapidly growing nation with the need for significant investment in infrastructure. However, the amount of profitable and productive investment far exceeded the domestic supply of savings. Therefore, U.S. growth was dependent on the supply of excess savings from Britain to fund the needed investment. When British savings became constrained and the flow of capital to the U.S. was choked off, such as in 1837, the U.S. fell into a severe depression which resulted in widespread bank failures and defaults.

When investment is constrained by a lack of savings, government investment competes with the private sector for the finite amount of available savings. Thus, increases in government investment cause interest rates to rise in a phenomenon known as the crowding-out effect. Because most supply-siders believe that the private sector is superior to the government in investing in productive projects, they believe that the government should reduce their spending to allow for more spending by the private sector.

In contrast to a savings constrained world, a demand constrained world is one in which the economy can produce far more than is currently being produced; thus, it is a lack of demand, not supply, that is constricting economic growth.
In a demand constrained world, the private sector is wishing to reduce spending and increase savings.

The result of this excess savings is that interest rates decline, and capital is forced into speculating on financial assets rather than investing in projects that increase the productivity in the economy. This is certainly the world that we currently find ourselves. The lack of consumption and investment from the private sector makes it imperative that the government fill the void and increase deficit spending to support incomes. The U.S. has a need for investment to replace its failing infrastructure. This investment can raise the productivity of the economy and fill the void for the reduced investment from the private sector.

Since the U.S. has been in a demand constrained world, crowding out is not currently a risk.

Deficits will lead to Unsustainable Government Debt

The level of debt is only relevant in comparison to the level of wealth (often proxied by GDP) that is available to service the debt. In a demand constrained economy, operating below full capacity, government spending (or any spending for that matter) will have a significant multiplier effect, where every dollar spent will create well over a dollar of new income or GDP. While debt increases, the income to service that debt increases at a far greater rate. In this environment, it is wrong to say that government deficits increase the debt burden because the debt burden would be worse if we did not increase the deficit. While debt might be higher (at least in the short run), the ability to service the debt will be greater because of the multiplier effect.

This seems like voodoo economics to some, but it occurs only when a certain condition exists in the economy: We have much more capacity to produce than we are currently producing. In the case where the economy is capacity constrained, increasing the deficit will worsen the debt burden because debt would rise faster than real GDP.

Government Deficits Lead to Inflation

A final concern with government deficit spending is that it will cause inflation. The truth is that all spending (public or private) can cause inflation if it causes demand to rise faster than the real capacity of the economy to produce it. The essential factor that determines if increased government spending will cause inflation is the amount of slack in the economy. If the government increases spending and the economy is operating well below full capacity, then output will rise, but inflation will not.

Recently, inflation has increased, but it remains at a low level. The real issue has been the uneven nature of inflationary pressure. The pandemic caused a rapid shift in the consumption basket, which has created a situation where supply and demand are tight in certain areas and loose in others. The best example is the surge in demand for housing-related goods and services that pushed lumber prices to an all-time high. At the other end of the spectrum, demand for travel-related services collapsed. Production capacity was built based on the pre-pandemic demand preferences, and it takes time for resources to be redeployed to meet the changing demand. However, just as the consumption basket narrowed in response to the pandemic, it should broaden as the economy re-opens. While the consumption basket is likely to look different than it did pre-pandemic, it should look much more like 2019 than it did in 2020. As a result, supply and demand should normalize and inflation moderate.

However, if inflationary pressures accelerate, then fiscal policy should become restrictive. Abba Lerner explicitly says that “The first financial responsibility of the government (since nobody else can undertake that responsibility) is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current prices would buy all the goods that it is possible to produce. If total spending is allowed to go above this, there will be inflation,” and as a result, the government should decrease spending or raise taxes.

The reality is that the actions needed to restrict fiscal policy – cutting spending, raising taxes - are politically difficult. Therefore, it is likely that monetary policy will be relied on to curb inflationary pressures since it is more isolated from political influence.

Conclusion

MMT does not state that government debt is irrelevant or that budget deficits are free lunch that can always be used to increase economic growth.

What MMT does say is:

- The proper position of fiscal policy depends on the state of the economy. Since the economy has been in a demand deficient state for at least the past decade, MMTers have suggested that government can increase deficits and create growth without negative consequences. Opponents misunderstand this nuance and mistakenly make that extension that MMT deficits can always be increased without negative consequences.
- In our current fiat currency system, countries with monetary sovereignty can effectively borrow from themselves, which prevents these governments from ever being forced into defaulting on their debt. This ability to print money distinguishes the public sector from the private sector, where insolvency is a real risk. Importantly, a lack of default risk by monetarily sovereign governments does not mean that government debt is irrelevant or costless. It just means that default is not among the risks. But default is not the only means by which debt constrains a country’s future economic growth. However, as long as deficit spending has a multiplier above 1, the increase in debt is sustainable because the debt servicing capacity will grow by more than the growth in debt.

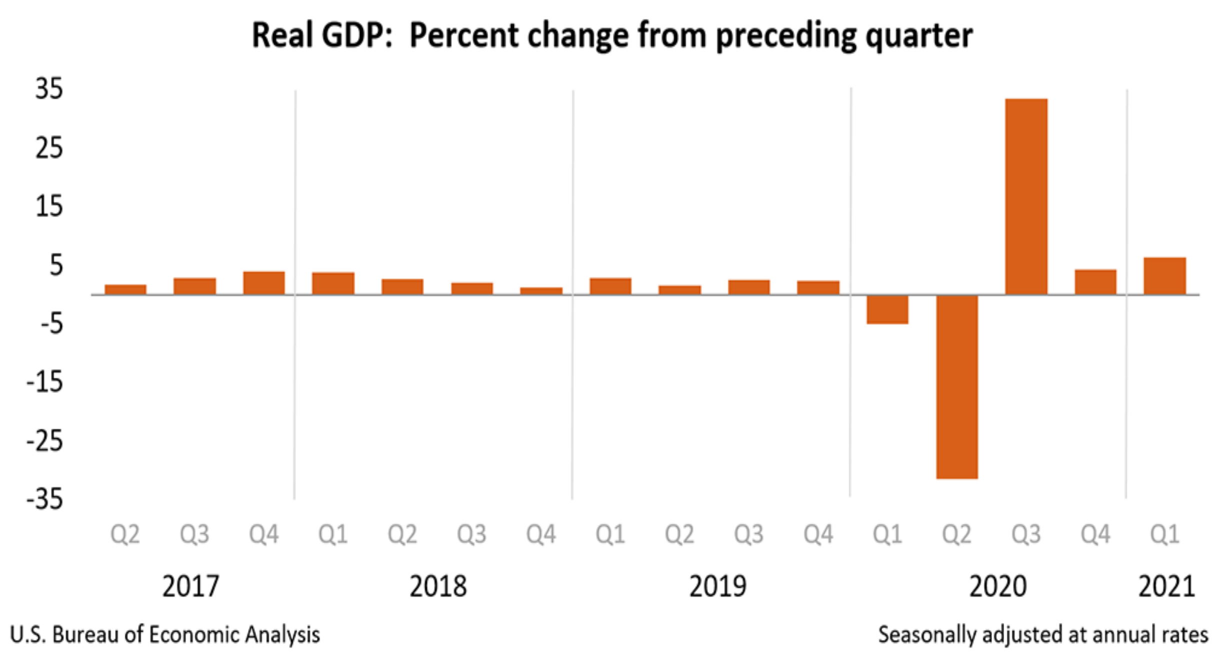
- The multiplier will be above 1 when the economy is demand constrained and operating with large output gaps – as is the current state of the economy.
- When the economy is suffering from deficient demand relative to the full production capacity of the economy, government deficits - via debt or money printing – can support incomes and generate higher real GDP without the negative consequences of price instability or a rising debt burden.
- When demand in the economy is higher than the ability of the economy to produce at stable prices, the government should reduce spending or raise taxes.
- Attempts by the private sector to save by withholding income will be self-defeating because lower spending leads to lower-income; thus, total savings in the economy will not increase. However, increased government deficit spending can offset the withheld spending by the private sector, prevent a contraction in income, and increase private sector savings.
- Government deficits should be judged on the basis that they facilitate the achievement of full employment and price stability and not based on achieving some arbitrary measure such as "a deficit maintaining a certain percentage of GDP". According to Abba Lerner, *"fiscal policy…shall be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound. This principle of judging only by effects has been applied in many other fields of human activity, where it is known as the method of science… The principle of judging fiscal measures by the way they work or function in the economy we may call Functional Finance. (1943)."*

Economic Outlook

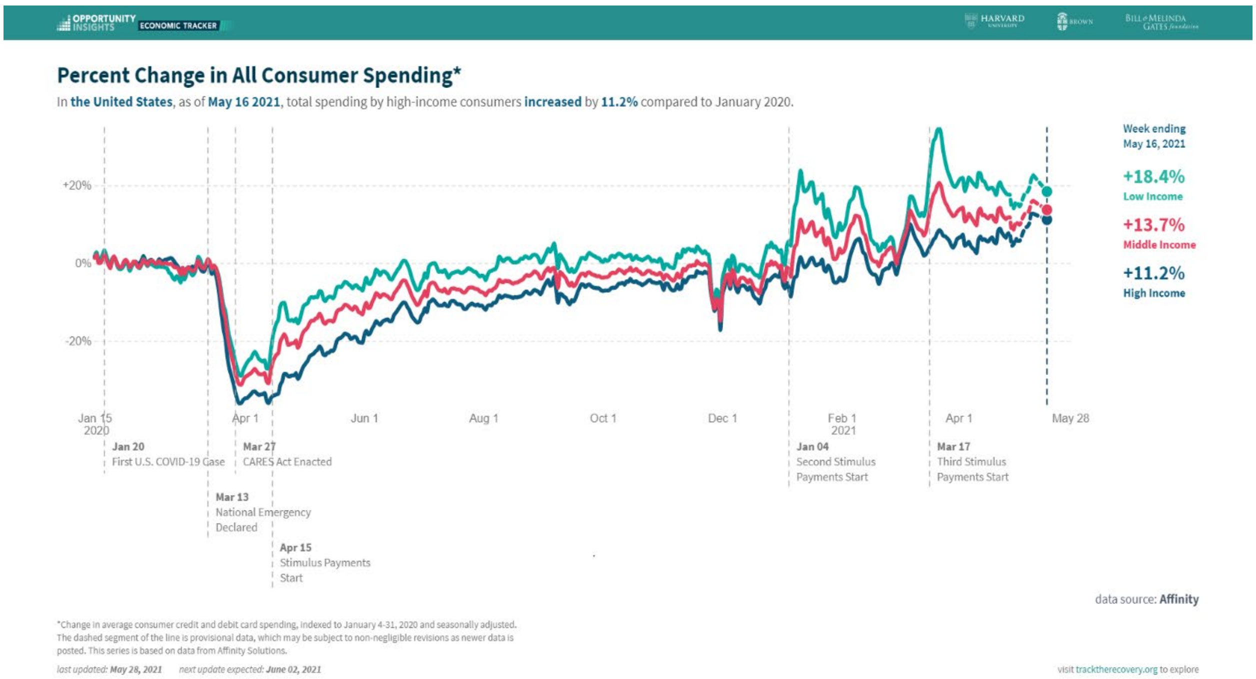
By Bobby Long

Despite the economic headwinds we have endured in our battle against the COVID pandemic and with many areas around the country just now fully lifting restrictions, economic conditions have been surprisingly healthy and remain very supportive to fuel continued strength. It was understood that after forcefully halting business activity and limiting individual mobility, the re-opening would bring a significant rebound once these restrictions were lifted. What may not have been as well understood was just how healthy the consumer was going into the pandemic and their ability to spend excess savings and stimulus payments on the consumption of goods. This combination of excess savings, low-interest rates supported by accommodative monetary policy, and broad fiscal stimulus and assistance has provided a huge boost to consumer spending and housing-related industries. This has come at the expense of services, but it has provided a sufficient bridge until these service-related industries open back up. Economic indicators have been volatile due to the unique circumstances, and large amounts of stimulus injected, so it will be important to monitor the underlying trends as this normalizes to gauge the true health of economic conditions.

After the deep negative plunge in GDP and sharp rebound last year, 4Q20 GDP came in at 4.3% and rose again by 6.4% in the first quarter. This was driven in large part by consumer spending on both durable and nondurable goods after additional stimulus payments were distributed. Increased consumer spending on services also picked up as vaccinations rolled out and businesses opened back up with a noticeable pick up in food services and accommodations. Estimates for second-quarter GDP growth have a wide dispersion, but consensus is around 9% and the Federal Reserve Bank of Atlanta's running estimate GDPNow is forecasting 10.3%.

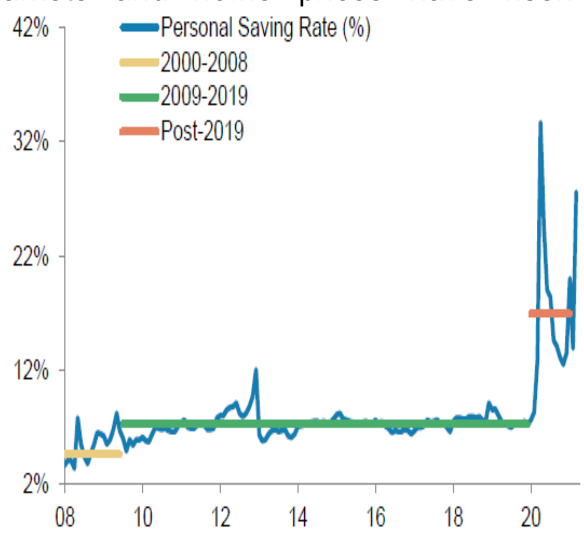


As we move through the year, GDP growth will lose support as stimulus payments and excess unemployment benefits are withdrawn. Consumer spending has indeed been strong. As the chart below shows, much of this can be directly tied to stimulus payments. The boost to spending can be seen across all income brackets, but the lower-income bracket has been more prone to spend these payments and may have less capacity to continue spending going forward.



Overall, consumers still have excess savings and the capacity to continue spending, especially in high and middle-income brackets that are more likely to have seen their overall net worth increase as financial markets and home prices have risen.

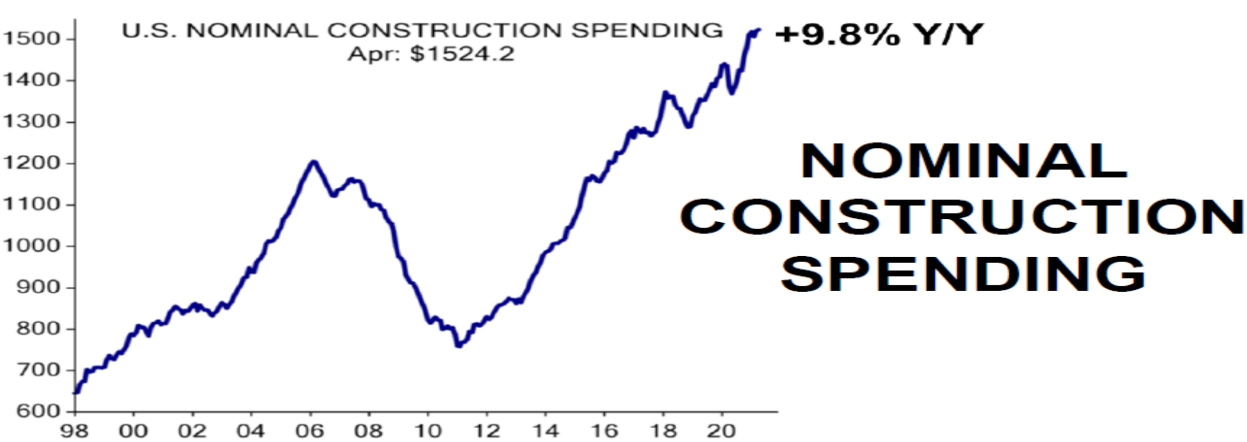
As the chart to the right shows, the personal savings rate had been higher going into the COVID-19 pandemic, averaging 7.3% since 2008. Pandemic restrictions combined with stimulus payments led to a significant increase in personal savings. While this is coming down, it is still elevated and represents excess spending capacity. While hard to truly measure, there is an estimated \$2.2 trillion of "excess cash" available to spend. Much of this is concentrated in the top 10% income group, but this still leaves roughly \$1 trillion in the hands of the bottom 90%, who have a higher marginal propensity to spend liquid assets.



Note: Charts are through March 2021.
Source: Bureau of Economic Analysis, Federal Reserve, Morgan Stanley Research

Consumers were relatively healthy going into the pandemic-induced recession and remain in decent financial shape now that we are seemingly on the other side. Mortgage debt has increased, but credit card and HELOC debt have declined. Debt to disposable income has been stable and debt-service costs manageable with the support of low-interest rates. As a broader re-opening of the economy continues and consumers resume normal activities, consumer spending can remain supportive. Spending has been largely directed towards the consumption of durable and nondurable goods over the past year. Overall spending on goods was 19% higher than the February 2020 level. Within goods, this was driven by the following subcategories: motor vehicles and parts up 50%, recreational goods and vehicles up 32%, and furnishings and durable household equipment up 26%. This spending is likely to taper off and be redirected towards the service industry. These industries took the biggest hit from pandemic related restrictions, and spending on services is still 2% below the February 2020 level. Within services, the following subcategories have lagged: recreation services down 19%, transportation services down 18%, and food services and accommodations down 6%. These industries will be the biggest beneficiaries as consumers get back out and likely be a source of continued GDP growth. While many areas of the country have been operating with little restrictions, many major metro areas have only recently begun to fully open back up, and workers are just now beginning to come back to offices.

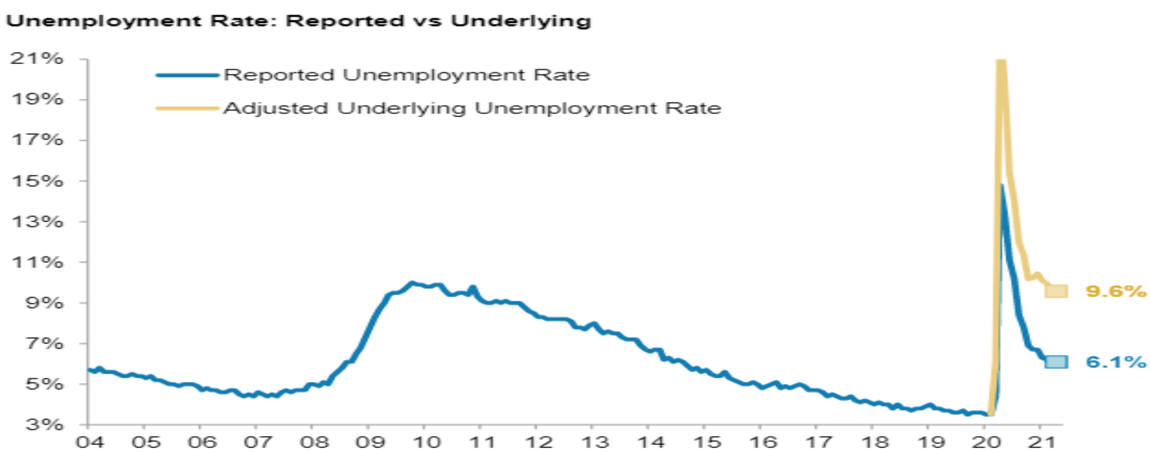
Housing activity has been a big source of strength for both spending and labor. Already strong before the pandemic, it has only increased as consumers have found themselves wanting additional space and with the excess savings to direct towards making it happen. Demand for single-family homes outside of urban areas has increased, and as workers have spent more time at home with families, they have increasingly been more willing to spend money to redefine spaces. Stimulus payments and low-interest rates have aided their ability to do this. New construction, existing home sales, and remodeling activity have all been very strong. The longer dated chart below shows the strong level of construction spending relative to prior housing booms and highlights the sharp increase on top of that over the past year. Low inventories, strong demand, and low-interest rates can continue to drive higher construction spending; however, if spending cooled a little, it could become a drag on economic growth.



Source: Evercore ISI

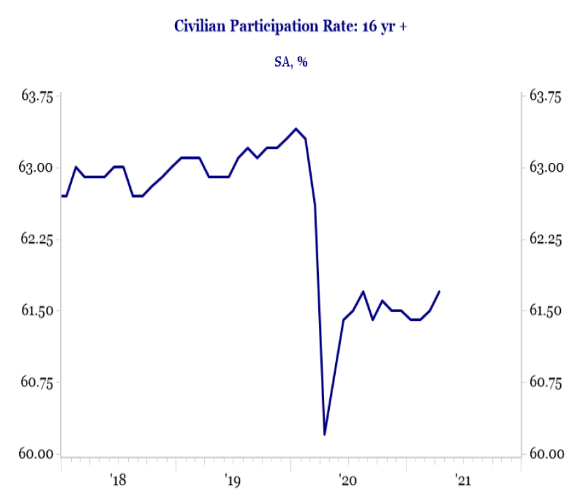
Business investment has also been a positive contributor to growth with strong investment in equipment and intellectual property products above pre-pandemic levels. The increased demand for goods has depleted inventories, and supply chain disruptions have not helped the situation. This has created abnormally low inventory levels and should support higher manufacturing activity as businesses work to bring these inventory levels back up. Technology-related investment is also likely to remain supportive as businesses have looked to boost productivity from workers with flexible working environments. Investment in non-residential structures will likely remain weak but could begin to slowly improve from current levels.

Labor markets have continued to improve, but at a slower pace with mixed results. As the chart below shows, the headline unemployment rate has fallen to 6.1%. However, there are a lot of unemployed workers who are not being picked up in that headline number.



Source: Bureau of Labor Statistics, Morgan Stanley Research

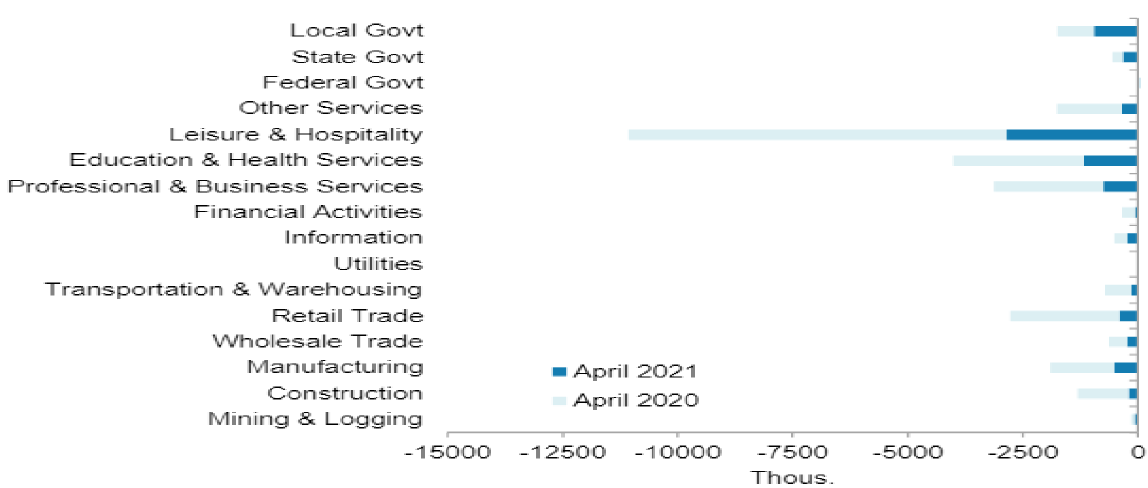
The labor force participation rate is still much lower at 61.7% versus pre-pandemic levels above 63%. Many workers are not actively seeking employment or have dropped out of the labor force. Some of these unemployed may be temporary and could be drawn back in as unemployment benefits are decreased and as wages rise. Others may have temporary dropped out until childcare and schools fully re-open. Retirements have been at elevated levels, and some of these may be retired due to unemployment, which could later return to the labor force.



Source: Bureau of Labor Statistics

Initial jobless claims have continued to trend lower, but continuing claims remain elevated, and the pace of decline has plateaued more recently. The pace of nonfarm payroll increases has also slowed recently, painting an uncertain picture around the strength of the job recovery. The overall level of nonfarm payrolls remains significantly below pre-pandemic levels. After an initial surge off the lows, it is taking the shape of a weaker square-root shaped recovery.

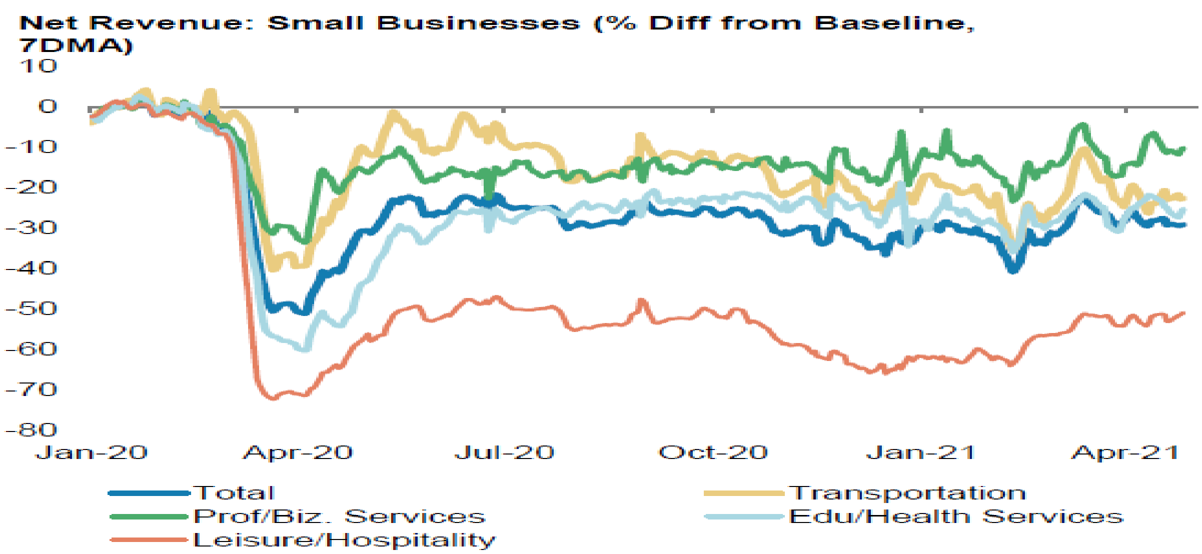
Job losses were disproportionally concentrated in service industries. The chart below shows how these initial job losses were distributed across industries in April 2020 and how they have since recovered. Leisure and Hospitality, Education and Health Services, and Professional and Business Services all experienced a larger degree of job losses. These industries have made substantial improvement but continue to represent a large portion of lost jobs that have not returned. On one hand this is somewhat discouraging, but on the other hand, these jobs could come back very quickly as the re-opening continues and consumers redirect spending towards services as mobility increases.



Source: Bureau of Labor Statistics, Morgan Stanley Research

There does seem to be some sort of dislocation in labor markets. The number of working age unemployed remains elevated, however businesses are struggling to find workers and are raising wages and incentives in their efforts to hire them. There may be regional differences, but help wanted signs seem to be everywhere, and some businesses are being forced to not open due to lack of staff. This may be in part due to excess unemployment benefits being offered that are competitive with lower-wage workers. Payroll trends show that lower-wage jobs have been slower to return to pre-pandemic levels. As benefits are discontinued and demand for services continue to increase, these workers could be brought back into the labor force quickly.

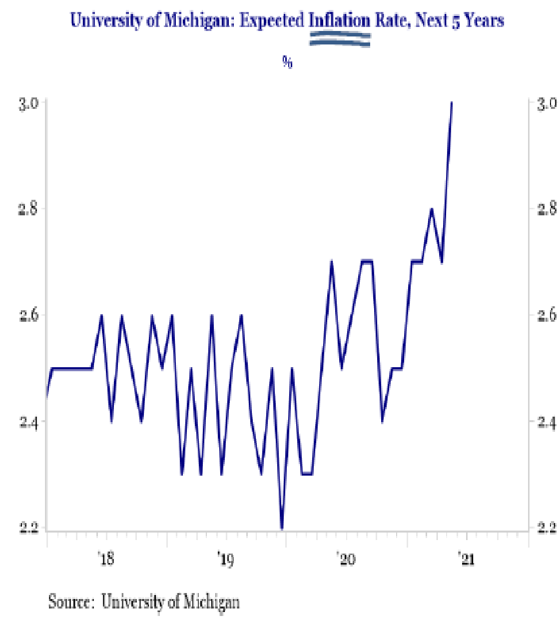
Small businesses have been dealt a tough hand through this pandemic. Many are concentrated in service industries and have been left to navigate restrictions that have made it almost impossible to operate. Some have temporarily closed, while others continued to operate at unprofitable levels. Many of those temporarily closed have begun to re-open. Others may never re-open. Government assistance has kept many of these businesses out of bankruptcy and gone a long way to help avoid a deeper recession. As these small businesses continue to re-open and resume normal operations, they will play a big role in the next leg of job growth and determine whether employment moves back toward pre-pandemic levels. As the chart below shows, total small business revenues are still down 26%, with leisure and hospitality down 51%. We need to see the revenues moving higher in order for these businesses to bring back additional workers.



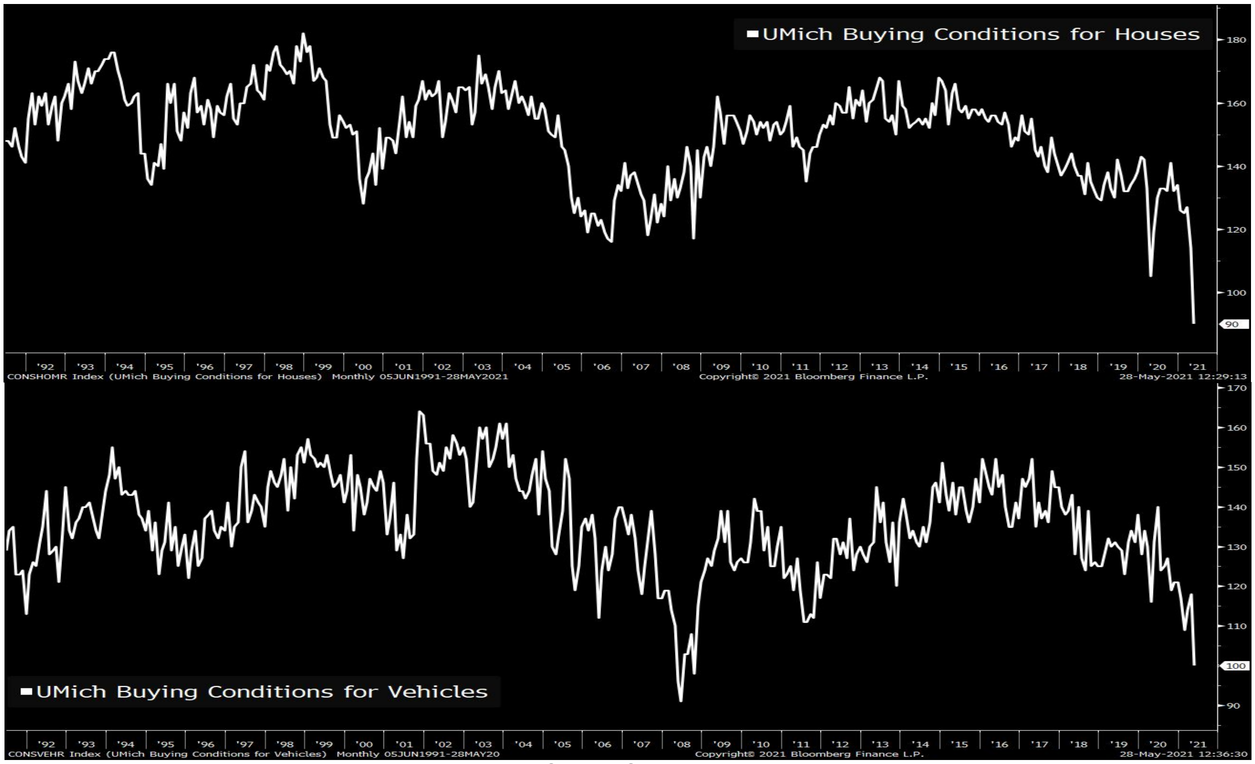
Source: Womply, Morgan Stanley Research

Despite a large number of workers who remain unemployed, wages are rising with the lower-wage bracket seeing the strongest pressures. There is a broad push to increase minimum wages and tighter labor conditions have paved the way for this to move higher. This may be artificially driven in part by excess unemployment and assistance payments keeping some workers out of the market, but the higher wages will likely stay. If small businesses do not see revenues recover quickly, these costs could be difficult to pass on and may pressure margins and weigh on rehiring decisions.

Businesses large and small are facing a broader increase in costs in addition to wages. Supply chain disruptions have led to shortages across a variety of durable and nondurable goods that have pushed prices higher. Some of these costs are being passed on, and some are being absorbed in margins. With consumer incomes and savings elevated, large amounts of monetary and fiscal stimulus in the system, and supply/demand imbalances, we are seeing real inflation across markets. After decades of a downward trend in inflation and aggressive monetary policy in an effort to avoid slipping into a deflationary environment, both inflation and inflation expectations have ticked up sharply.



The debate is whether this inflation is a temporary spike or represents a sustained shift higher. The strong demand driven by higher incomes and pent up spending should fade over time. Supply disruptions have resulted in shortages in the face of this stronger demand. As demand normalizes and businesses bring low inventory levels back up, these imbalances should stabilize. Price pressures may persist for a couple more quarters, but this argues that the uptick in inflation is likely more temporary. If wage pressures persist and workers are not drawn back into the labor force, businesses may be forced to compete for labor, which could kick off a more sustained cycle of inflationary pressures as wages, consumption, and prices move higher. A sustained uptick in inflation expectations would be a little more concerning but is just worth monitoring for now. If consumers begin buying in anticipation of higher prices, it can fuel a cycle of inflationary pressures. The University of Michigan consumer sentiment survey charts on the following page indicate consumers have more disciplined hands and may be a better gauge of expectations. As the prices of housing and autos have increased, consumers are showing they are willing to step back from these markets with expectations that prices are overextended and more likely to moderate. It would be concerning if they felt the need to chase these assets as prices increase.



Source: Strategas

Economic conditions appear supportive to generate above-average growth as the recovery continues to unfold. Demand for labor is strong, and employment can improve as more workers move back into the labor force. The risk is these workers could permanently fall out of the workforce, but as benefits expire and wages improve, we think they are more likely to be drawn back in. Monetary policy remains very accommodative, and the Federal Reserve still seems willing to let things run versus tightening prematurely. Wage growth could eventually pressure business margins but is okay for now with businesses having some room to pass these costs on to consumers. We may have marked a shift in long-term inflation trends. Inflation seems to be ticking up at a sharp pace; however, this could moderate as economic conditions stabilize. The Federal Reserve has been trying to bring inflation up to their 2% target for years and has said they are willing to let it drift higher in order to help employment. The risk is inflation continues to rapidly increase, and they are forced to tighten policy more aggressively before the economy and employment have fully recovered, choking off the economic expansion. Under current conditions, they still appear to have room to take a gradual approach to remove accommodation. On the fiscal side, infrastructure spending can provide some added stimulus as monetary tapers. Inflation, labor, and regulatory policy all carry risks that should be monitored, but for now, underlying conditions support a continued expansion.

RSA PORTFOLIO STRATEGY

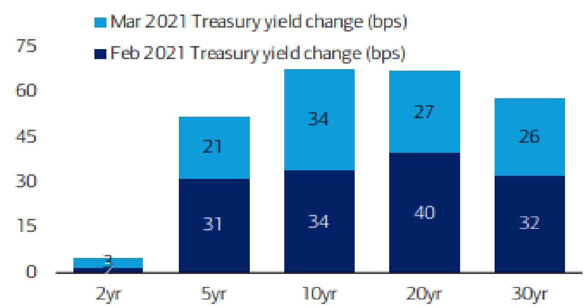
Interest Rates and Fixed Income Strategy

By Lance Lachney

At the time of our last quarterly meeting, the interest rate move that began in January continued its upward path at a rapid pace. The sharp increase in rates during March was similar to the preceding month, with 10yr treasury yields rising over 30 basis points. Financial markets began pricing in faster than expected economic growth, due to the passage of the $1.9 trillion American Rescue Plan and the accelerated deployments of vaccinations. The Federal Open Market Committee meeting provided a continued dovish stance with no expected rate hikes until 2024 and a willingness to let inflation run above 2% for an extended amount of time. The yield curve steepened quite a bit during this time as the spread differential between 2yr and 10yr treasuries hit 158bps by the end of the month. Corporate spreads were essentially flat during March with the investment grade sector underperforming its treasury counterparts. Mortgage-backed and high yield securities both outperformed due to their lower-duration profile, with junk bonds narrowly posting a positive return.

Figure 2: The rapid rise in interest rates continued in March

March Treasury yield changes: +18bps for 5yr, +31bps for 10yr, +24bps for 20yr and +22bps for 30yr.



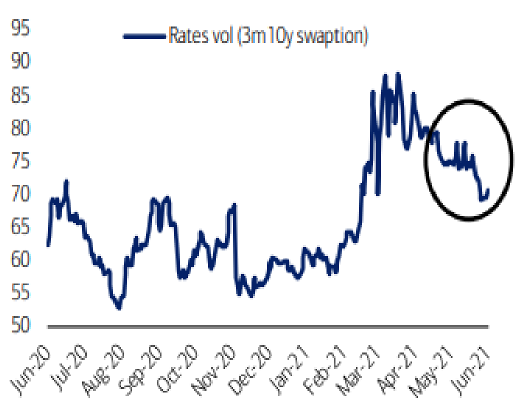
Source: Bloomberg

BofA GLOBAL RESEARCH

April provided a bit of stability to the fixed income market after three consecutive months of rising interest rates. The first quarter of 2021 resulted in negatives returns of approximately 4.5% for the treasury and investment grade sectors. The beginning of the month was highlighted by the 916,000 increase in the March employment report, leading to a brief move higher in the belly of the curve. Treasury yields managed to slowly grind lower during the month, even as retail sales spiked and inflation data came in stronger than expected. There were market signs of a sharp recovery in the economy and accompanying inflationary pressures as well. Treasury Inflation Protected Securities (TIPS) were the top performer within fixed income for the month, posting a 1.60% return. Treasury yields rallied for three straight weeks before moving slightly higher at the end of the month.

Figure 2: Interest rate vol (3M10Y swaption)

Interest rate vol declined in May



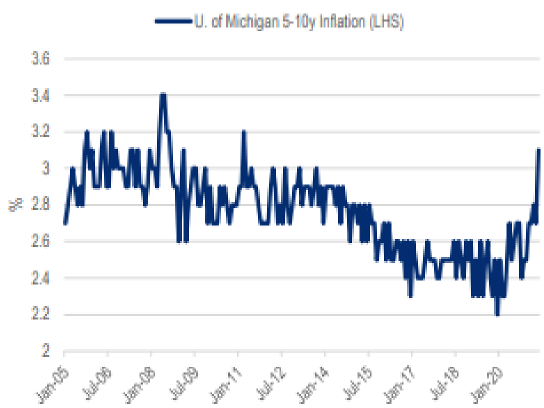
Source: Bloomberg

BofA GLOBAL RESEARCH

The month of May has been somewhat of a tug of war on the economic front. A very weak jobs report for April pushed the belly of the curve lower as the market priced in a slower path of interest rate hikes from the Fed. On the flip side, a 4.2% yoy increase in headline inflation moved intermediate yields in the opposite direction. Strong earnings, relatively low rates, and tight corporate spreads have eliminated a good portion of the volatility experienced during the first quarter. Total returns in fixed income have improved over the last two months due to marginally lower rates and corporate spread tightening.

The current state of fixed income markets is one of the most difficult trading environments that I have witnessed. For starters, inflation has returned. This can be seen in breakeven markets, commodity prices, consumer sentiment, and in actual inflation data. However, there are several questions to answer going forward. Prices are currently rising at the fastest rate in more than a decade. The current readings are somewhat distorted due to the collapse in pricing experienced a year ago at the onset of the pandemic. The recovery has produced increasing demand that is coinciding with limited supply, as witnessed in the auto industry and services sector. The demand for labor and wage income has picked up, but how will this be affected by the nearly 8 million workers, mostly from lower-paying industries, that have yet to return? Have we witnessed the peak in items such as lumber that has benefitted from a hot housing market fueled by low mortgage rates and disposable income? Is this all "transitory" as the Fed insists, or could the market be understating the tail risk after decades of declining inflation. While inflation expectations priced into the market have rebounded substantially over the past year, they are also expected to moderate over time.

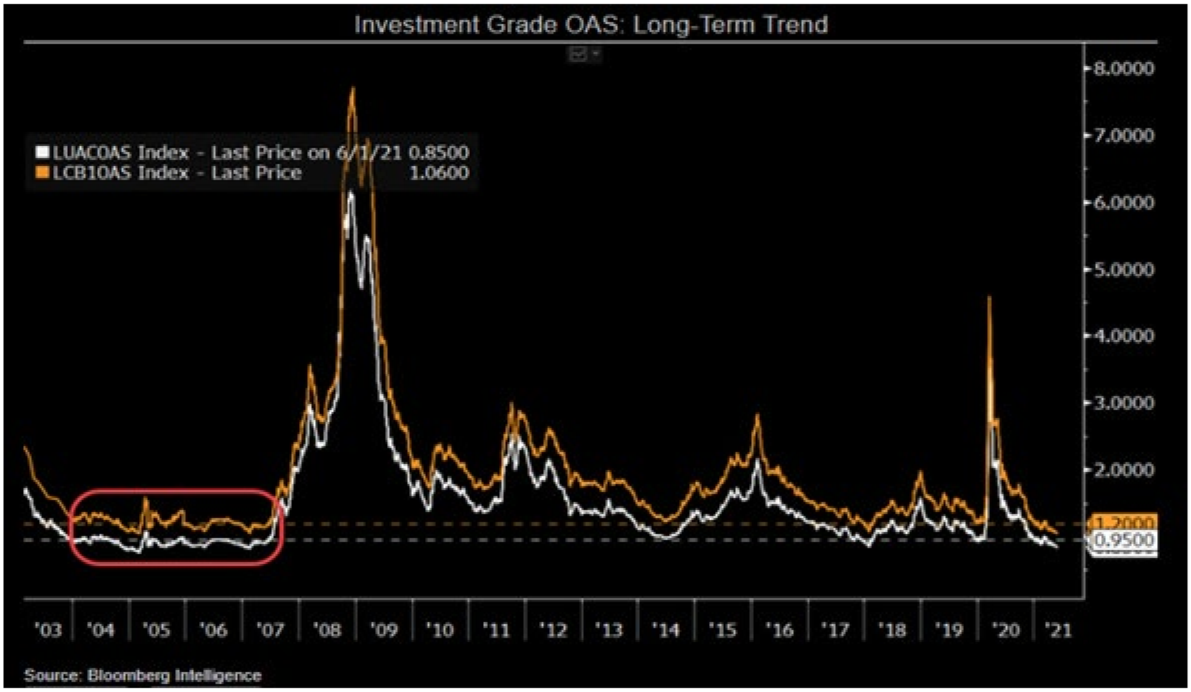
Figure 10. Survey based inflation expectations remain in their historical range but are rising quickly



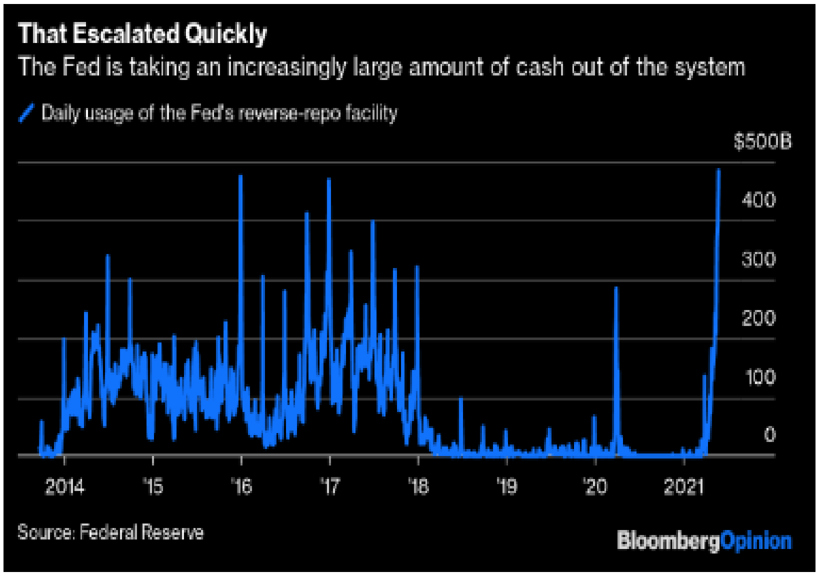
Source: Citi Research, University of Michigan

The next impediment to investing in fixed income is the valuation of credit in general. Currently, investment grade corporate spreads have approached levels that existed just prior to the financial crisis. At approximately 85bps, the current yield of the corporate index is a little over 2.1%. Essentially, high-grade investors are not even receiving 25bps of compensation for each unit of duration risk taken. Meanwhile, high yield participants are dealing with spread levels inside 300bps. The sector is continuing a lengthy streak of monthly gains. The Bloomberg U.S. High Yield Index has now returned 8.85% fiscal year-to-date, outperforming treasuries and investment grade debt by over 1200bps and 800bps, respectively. Last year, companies used primary debt markets to raise liquidity, but that quickly turned into refinancing and liability management exercises at much cheaper rates. Investment grade supply has fallen off after a robust 2020, but high yield issuance in May totaled $46.5bn to become one of the busiest months ever. The Federal Reserve has recently announced its intention to sell the portfolio of corporate debt and ETFs of the Secondary Market Corporate Credit

Facility. While the amount absorbed turned out to be minuscule, the symbolism of the facility created during the depths in March 2020 cannot be understated. It swiftly restored confidence, leading to a rally within all credit markets, and provided the runway for companies to access capital in the primary debt market. This action taken by monetary policymakers also reveals the final obstacle with fixed income investing in the current landscape.



Global monetary accommodation has blurred the lines of valuation relative to fundamentals. In theory, better economic news should lead to higher interest rates and



tighter corporate spreads. However, the continued involvement of monetary tinkering has pushed investors into riskier assets, resulting in spread levels that are tighter than they would be otherwise. While portfolio managers applauded the Fed for its elimination of a vicious default cycle last year, they are now grappling with insufficient investment options going forward. The risk is that if yields were to push higher, spread levels have little to no room to narrow. Because the duration of the corporate index has lengthened considerably over the last decade, credit investors are likely to be severely punished. Outside of the corporate credit market, there is credible debate as to when the Fed will begin to taper its $120bn monthly purchases of treasury and mortgage-backed securities. This discussion might start to take place at the June FOMC meeting, and a reduction in MBS may become a logical first step given the strength in the housing market. The Fed's balance sheet has grown to a shade under $8 trillion, producing a large amount of reserves in the process. This large increase in bank reserves and other money fund assets have driven a demand/supply imbalance in cash-equivalent securities. The lack of alternative places to safely place excess cash has led to a surge in the Fed's Reverse Repo Program (RRP). By providing this venue, the central bank is halting downward pressure on short-term rates by establishing a zero percent floor. The point is to reveal how complex it has become to navigate financial markets with continuous involvement of monetary policymakers.

Trading activity during this time has been fairly light. Treasury trades have consisted of relative value ideas in the belly of the curve during the sell-off in late March and a recent long-end swap in order to reduce duration at minimal cost. Most mortgage-backed transactions have been the reinvestment of prepayments, and the outright purchases have been executed to tighten up our underweight positioning. Within corporates, the fund has maintained its involvement in very short high-yield paper. These additions have been made in free cash-producing names with solid short-term liquidity. Once again, we are opting for short-term credit risk in lieu of interest rate risk out the curve where minimal spread compression can occur. It has been a very difficult environment as spread levels of corporate debt have tightened substantially. Companies are now regularly exercising make-whole calls as front-end spreads have collapsed leaving investors with reinvestment risk in a low-yielding, long duration environment. There's never been a better time to raise capital in Corporate America. Unfortunately, we reside on the other side of that trade.

Domestic Equity Strategy

By Hunter Bronson

U.S. equity markets continue to turn in stellar performances with 2/3rds of the fiscal year in the books. The S&P 500 has returned just over 26% and the S&P 400 just shy of 48% fiscal-year-to-date. Small cap, value, and risk-on factors have all continued to outperform. Indeed, with domestic vaccine rollout pulled forward ahead of expectations and re-opening accelerating, the broad outperformance of value factors has been quite impressive.

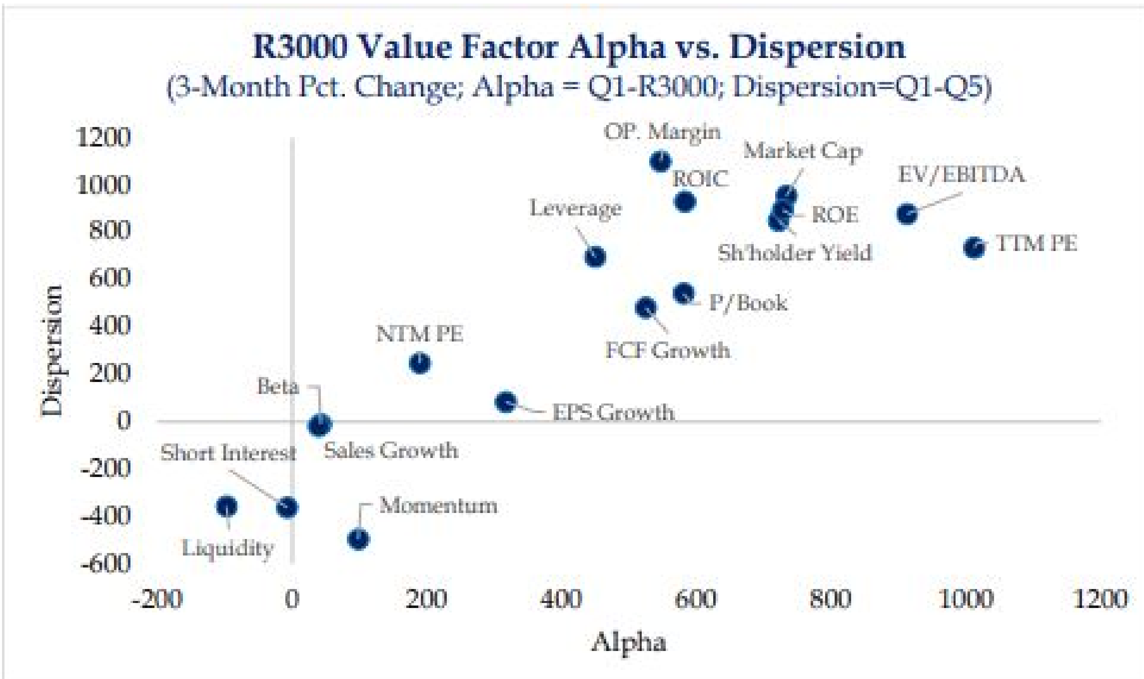


Figure 1: Value factors outperforming; Source: Strategas

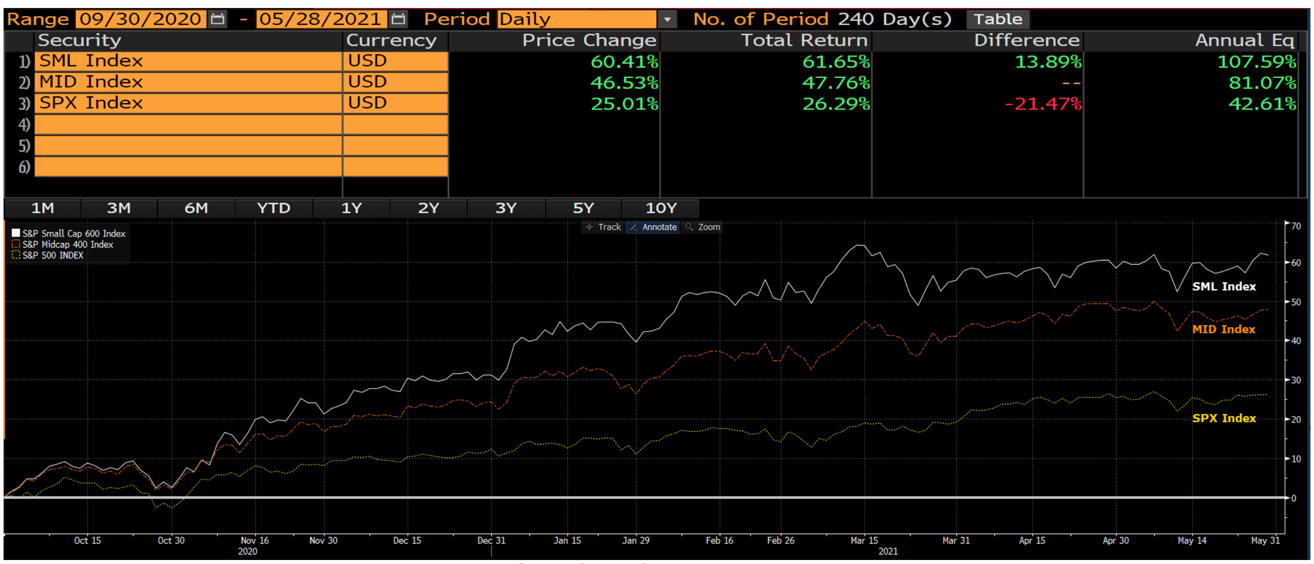
To this point in the cycle, Investors have been rewarded handsomely (7-8% outperformance) simply being over-exposed to very basic measures of value and operational leverage. This is very typical of early-cycle recovery periods. As the market and economy bottom, earnings begin to outperform overly depressed expectations and valuation multiples also rise across the board. Because of their higher level of exposure to short economic fluctuations, cyclical (value) companies' earnings expectations tend to get extrapolated too far in both directions. Thus, in recovery periods, their earnings expectations rise fastest, and these stocks tend to outperform.

Range 09/30/2020 - 06/01/2021 Period Daily No. of Period 244 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	B3000V Index	USD	47.43%	50.21%	27.16%	83.80%
2)	B3000G Index	USD	22.30%	23.06%	--	36.39%
3)						
4)						
5)						
6)						

Figure 2: FYTD Value Outperformance vs. Growth

We see more evidence of early cycle behavior in the recent consistent outperformance of smaller companies across the cap space.



Range 09/30/2020 - 05/28/2021 Period Daily No. of Period 240 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SML Index	USD	60.41%	61.65%	13.89%	107.59%
2)	MID Index	USD	46.53%	47.76%	--	81.07%
3)	SPX Index	USD	25.01%	26.29%	-21.47%	42.61%
4)						
5)						
6)						

Figure 3: FYTD Small Outperformance vs. Mid vs. Large

While the value/leverage tilt to the market has been strong, we are beginning to see signs that early cycle behavior could be cooling, if only for a brief period.

Transitioning to Mid Cycle?

To reiterate, the leadership and direction of recovery haven't been particularly surprising. The market is following a well-worn recovery path. However, like everything else in this cycle, the speed at which we are progressing through the recovery is remarkable. The recession, itself, arrived nearly instantly with the lockdowns, an almost historically unique situation. The trough arrived a mere two months later with unemployment spiking to 15%. From there, the sharp recovery was just as fast. In fact, 2020/21 saw the first ever recorded instance of a falling unemployment rate during a recession. Fourteen months on from the trough, and we are only a couple of percentage points away from **peak** levels of employment from pre-Covid!

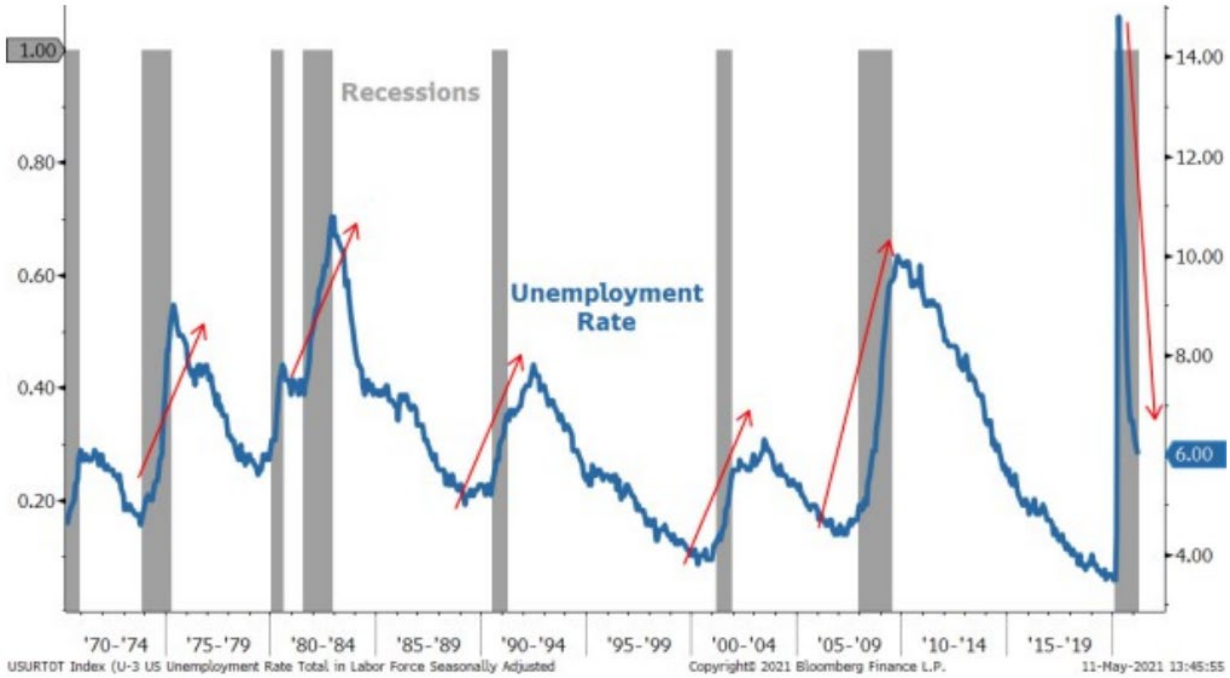


Figure 4: Unemployment falling during a recession is historically unprecedented; Source: Morgan Stanley Research

Normally, it would take the economy several years to work through this degree of dislocation. Thanks to hyper-aggressive fiscal and monetary policy, consumer balance sheets remained relatively healthy, and demand has snapped back just as rapidly as re-opening has allowed. See more evidence of this in the rapidly rising retail sales numbers below - even during a recession.

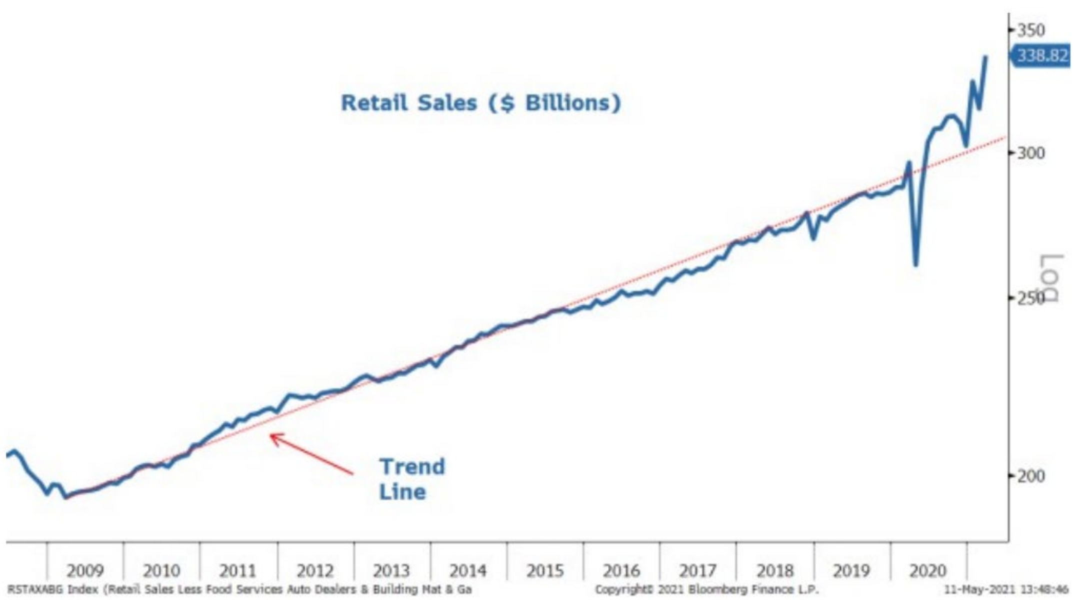


Figure 5: Rising retail sales during a recession is a highly unusual condition; Source: Morgan Stanley Research

Taken together, the rapidity and breadth of the recovery, the clear outperformance of cyclicals, and the aggressive upward revision of earnings estimates suggests that we may be setting ourselves up for a little disappointment. We would not be surprised to see a transition to a period in which earnings and earnings quality again take on an increasingly important role in determining forward returns and outperforming stocks – especially in more developed markets. We don't believe this would be disastrous for markets. On the contrary, we think it would probably be healthy for investors to consolidate gains and reset earnings expectations.

The Inflation Question

Unfortunately, the blunt tools of fiscal and monetary policy aren't quite as useful for managing the complete restart of global supply chains from a standstill. The problem is exacerbated by the disjointed pace of re-opening across the globe and even across regions within nations. The result of this snap-back in consumer demand coupled with supply constraints should be clear to anyone who has taken an Economics 101 course – inflation.

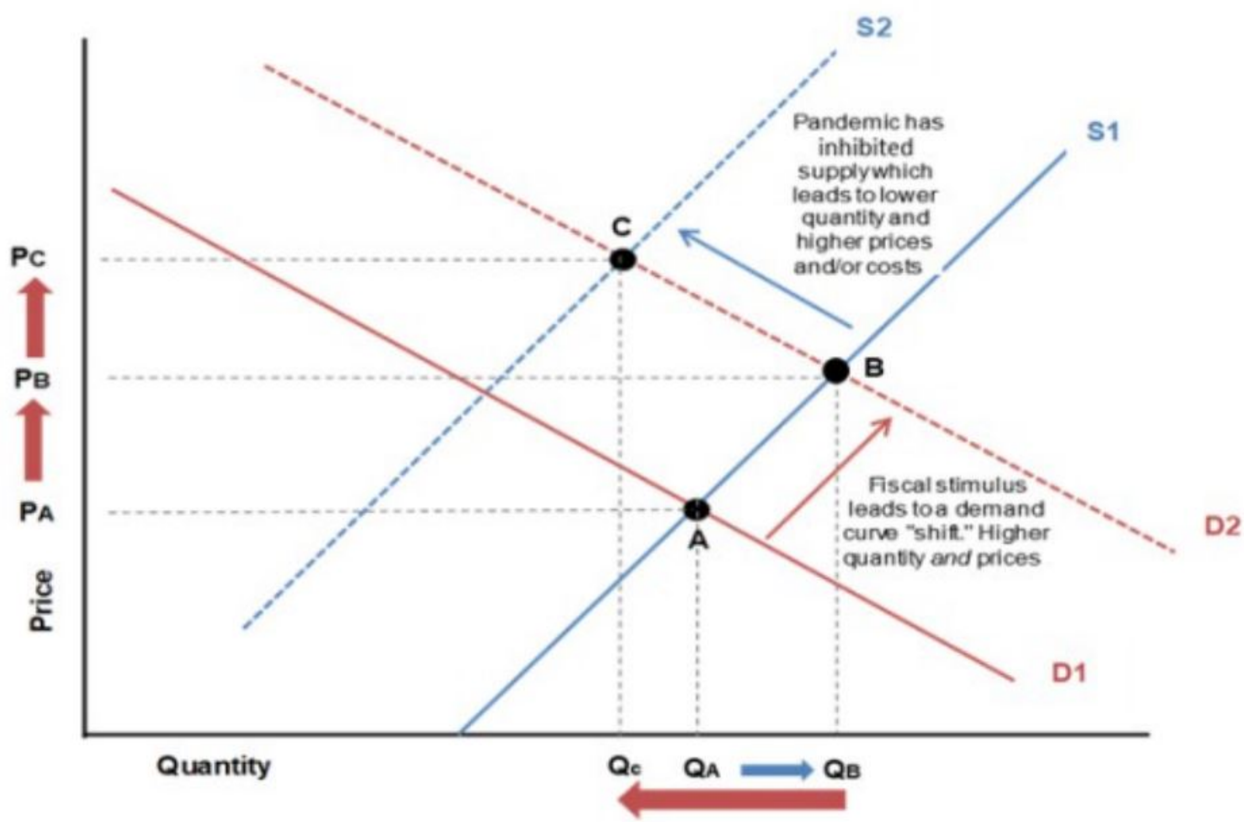


Figure 6: Theoretical supply/demand curve shifts given fiscal stimulus and Covid constraints

Intuitively, prices can move higher and more rapidly in the face of both supply constraints and demand surges than either in isolation. There is almost unanimous consensus that inflation is headed higher – the only debate is how high and for how long? Frankly, the anecdotes are hard to ignore – rapidly rising house prices and rental rates, increasing fuel costs, 3-day car rentals that cost more than cross-country flights, new cars being flipped for more than sticker after being driven 20k+ miles. There are countless stories in this genre, and people are paying attention.

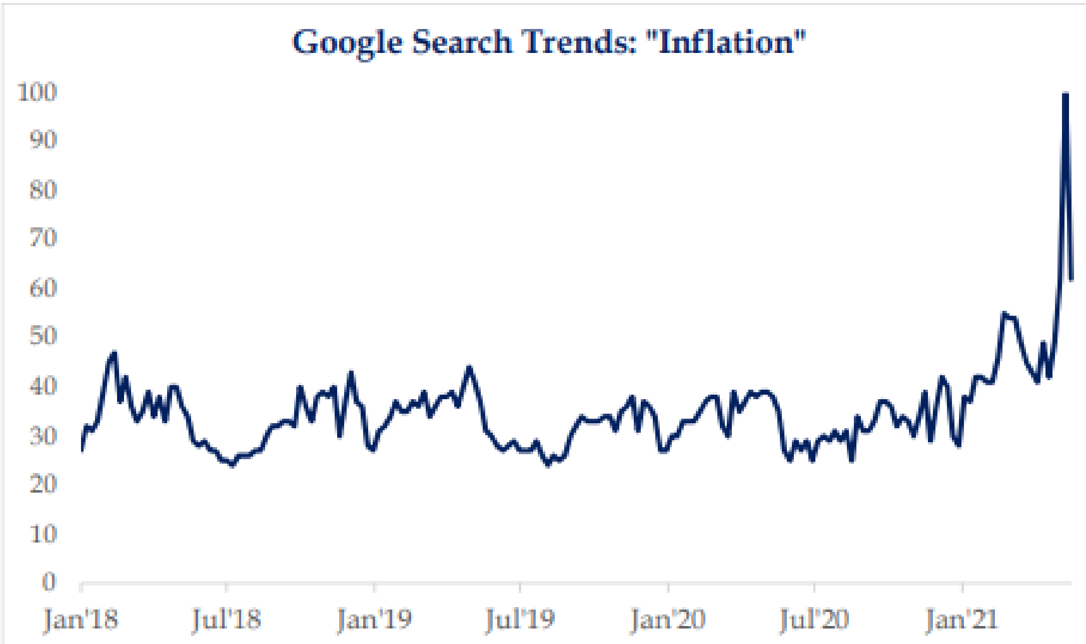


Figure 7: The "man on the street" is aware of inflationary pressures.

Ultimately, we believe that the inflation issue will resolve itself if supply constraints ease and capital expenditures can catch up to increased demand. If so, we believe that global markets should rebalance and stabilize around a more manageable price trend – this is our base case, and we believe it is consensus.

WWII – A Corollary?

To tie it all together, why should we care about inflation? Morgan Stanley recently released a piece comparing the post-COVID market to that of post-WWII. The similarities are striking.

1. The war and COVID created massive increases in savings unlike any other periods in history. Additionally, these savings coincided with economies that were largely shut down to any semblance of normal activity.

Figure 8: Domestic savings - WWII & today

2. As the economy opened up then and today, demand surged into materially constrained supply conditions. In the case of the 1940s, supply chains and labor pools were impaired for quite some time, and this led to sustained inflation.

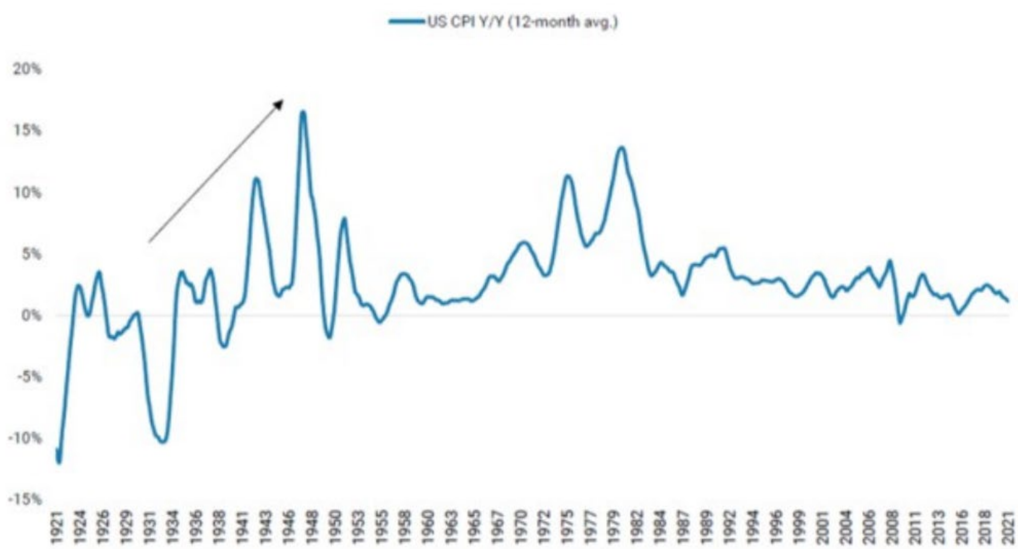


Figure 9: Surge in Demand with Supply Destruction was Inflationary in the 1940s; Source: Morgan Stanley

3. The Federal Reserve was engaged in financial repression leading up to and during WWII due to the Great Depression—very similar to today's condition post the Great Financial Crisis. It was the only other time in history in which rates were pegged at the zero bound for any substantial length of time. In the 40's the demand surge forced the Fed off of the zero bound. The combination of rising inflation and rates was brutal for equity risk premiums and earnings multiples.

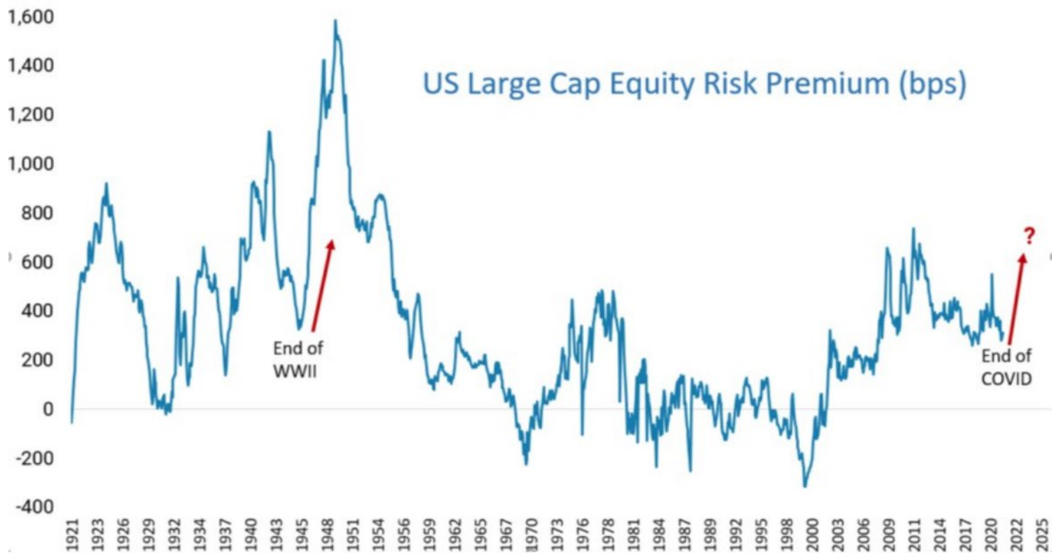


Figure 10: Equity Risk Premiums Blew Out in the 40s; Source: Morgan Stanley

Frankly, we think this is far from a perfect analogy, especially on points 2 and 3. The supply interruptions from COVID are likely to be much shorter lived than those of WWII. The destruction of physical capital from the two periods isn't comparable; thus, inflation should be more transitory. Furthermore, we think Chairman Powell will continue to everything he can to talk rates down. However, we do think the comparison at least rhymes and is likely to be directionally instructive. Even a brief bout with inflation could cause equity risk premiums to rise, earnings multiples to fall, and earnings/quality to take center stage.

To be very clear, falling multiples do not necessarily mean falling stock prices. If earnings grow more than the multiple contracts, the price is still higher. We would even consider this setup a fair base case with earnings expected to grow mid-double-digits through at least next year.

As a staff, we think we are situated well to handle such a setup. While we each have our own individual styles, collectively, our process tends to be earnings and quality-oriented. Additionally, as Kevin mentioned in our last brief, we have a modest level of put spread collar protection in case of a choppy market. We believe this protection is more valuable if we enter into a period of increased market choppiness.

In closing, and to borrow a phrase from Strategas's Jason Trennert, we still live in a TINA (There is No Alternative) world. Real rates remain historically low, credit spreads are tight, and the Fed and the Treasury remain on your side. We don't want to fight any of those forces, and we continue to prefer higher equity exposure.

International Equity Strategy

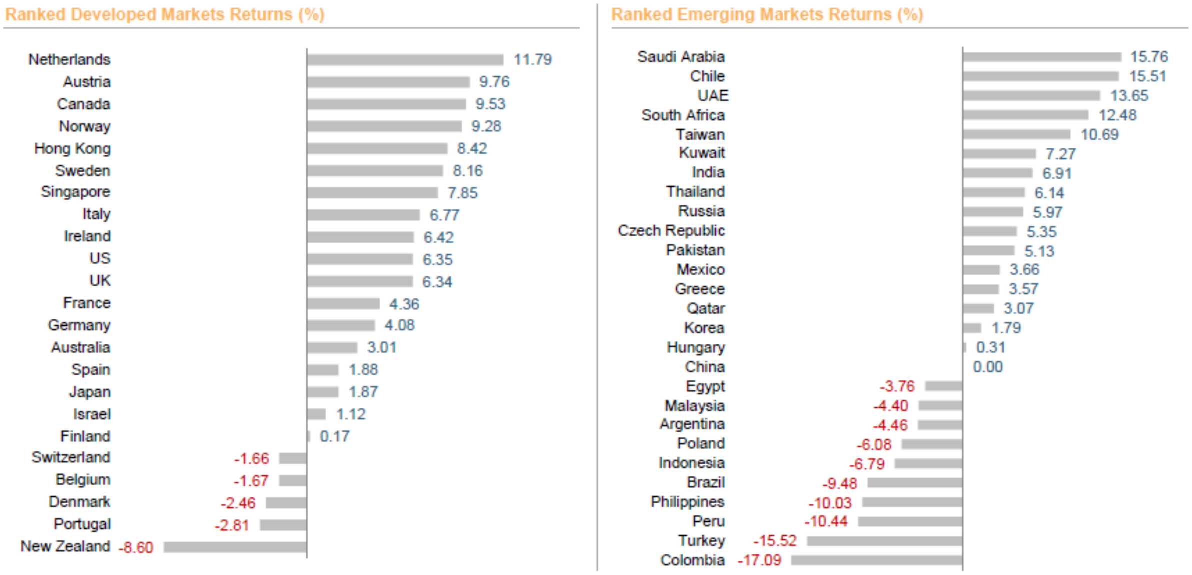
By Steve Lambdin

The global equity markets picked up right where they left off in 2020, forging ahead to new multi-year highs as increased optimism surrounding coronavirus vaccine rollouts, sharply improving global economic prospects, significant corporate earnings growth, and a sea of global fiscal and monetary stimulus measures all came together to form a global rebound not seen since the end of the second world war. This led the International Monetary Fund (IMF) to raise its forecast of global growth to its highest level in many years. Also, investor sentiment reached levels most of us have not witnessed in our investing lifetimes and led to significant outperformance of equities over fixed income, as the latter suffered from rising interest rates and higher inflation expectations. We continued to see cyclical parts of the equity market perform the best as well as value shares performing much better than growth shares. The European Central Bank (ECB) pledged to accelerate its bond buying program, and the news of further U.S. stimulus measures were well received by investors around the globe. At this point, the stage seems to be set for a broad global economic re-opening from the pandemic, with some regions further along than others. Investors will be monitoring the vaccine rollout efforts in Europe and Asia for any clues on how this might affect each region's outlook. We are now tasked with just how much economic optimism is already priced into the equity markets. This should make for interesting times in the months ahead.

	March 2021		1Q 2021		YTD 2020	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	4.4	4.4	6.2	6.2	18.4	18.4
MSCI ACWI	2.7	3.5	4.6	5.9	16.3	14.2
MSCI ACWI ex USA	1.3	3.2	3.5	6.5	10.7	6.0
MSCI World	3.3	4.2	4.9	6.1	15.9	13.5
MSCI Emerging Markets IMI	–1.2	–0.5	2.9	4.6	18.4	19.2
MSCI EAFE	2.3	5.3	3.5	7.6	7.8	0.8
MSCI Europe	3.1	6.1	4.1	7.6	5.4	–2.2
MSCI Pacific	1.0	4.0	2.5	7.7	11.9	6.2

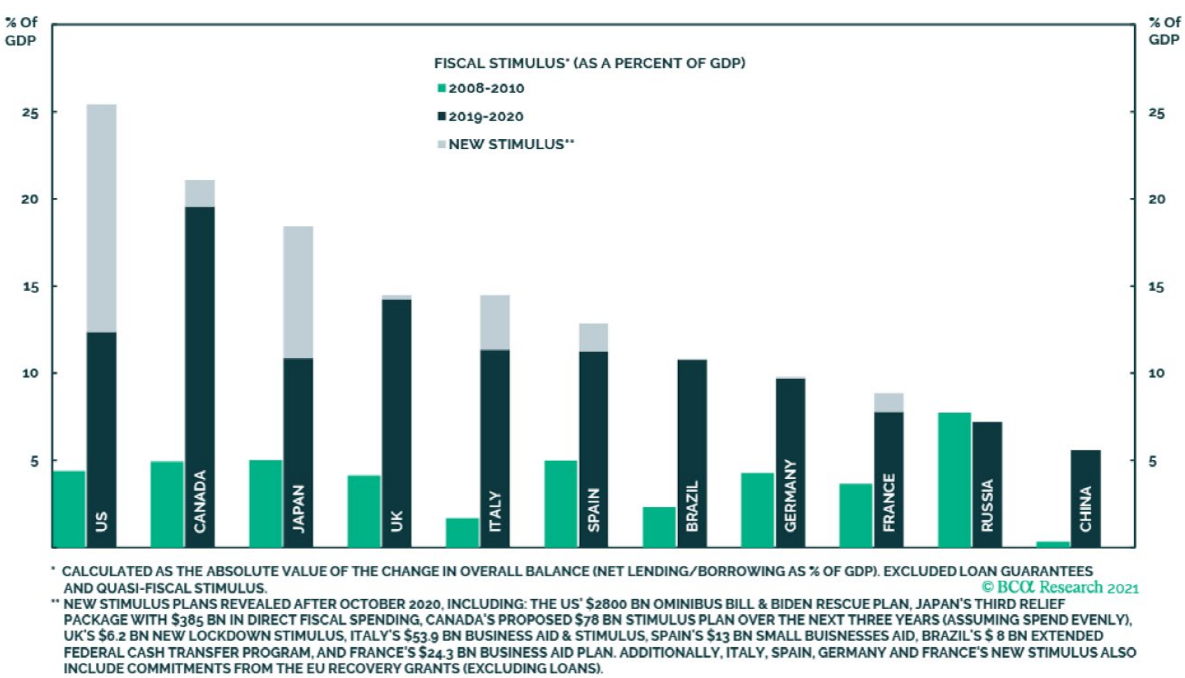
Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +3.48% and +2.29%, respectively, during the first quarter of 2021 vs. +6.17% for the S&P 500 Index. Investors were just a bit more cautious on equities outside of the U.S. as the vaccine rollout was well behind in Europe and Asia relative to the U.S. Also, the U.S. dollar surged in the quarter from the rise in global interest rates and inflation readings, which hurt returns by -4.1% for unhedged U.S. investors. The European region was stronger than the Asian region as the equity markets in the Netherlands, Germany, and France were much stronger than the Japanese equity market. Eight out of the eleven sectors of the MSCI EAFE Index generated gains, led by the cyclical sectors of Financials, Energy, and Consumer Discretionary. Also, commodities were a mixed bag in the period as crude oil led the way rising +22%.



Sources: Resource Consulting Group, MSCI

So far into the second quarter of 2021 thru the end of May, global equities have been strong again as the recovery trade has gained further momentum in most of the developed markets around the globe. Economic data points are accelerating with many at the highest levels we have seen in many years. About the only area of concern recently has been the performance of the emerging markets, as many of these countries are still suffering from heightened covid-19 caseloads. The MSCI EAFE Index and the MSCI Emerging Markets Index are up approximately +6.5% and +4.8% respectively, vs. +6.1% for the S&P 500 Index.



Source: International Monetary Fund; BCA; Todd Asset Management

Asia Update

Despite signs of a sluggish recovery, the Asian equity markets continued recent trends in the first quarter and moved higher. The state of emergency issued for parts of Japan in January from the coronavirus did dampen investor appetite just a bit here and kept a lid on any sizable gains in the market. Japan trails the rest of the developed markets in vaccination levels as only 1% of the population had received the vaccine as of the end of March. Countries in the Asian basin are certainly depending more on the herd effect to control the spread of the virus vs. the use of vaccines in most other parts of the world. However, as we progressed to the end of the quarter, vaccination efforts are picking up, and quarantine measures are being relaxed to re-open the economy. The Japanese equity market did rise +2% in the quarter, even as the Yen dropped -7% against the U.S. dollar as U.S. interest rates rose in the period. Hong Kong and Singapore equities rose +7% and +9%, respectively, mainly on the heels of better economic data points. Overall, the MSCI Pacific region rose +2.5% in the period, which was the weakest region in the MSCI EAFE Index.

As the Chinese economy was the first major economy to take the hit from the coronavirus pandemic last year, it is only natural to expect this economy to be the first to come out on the other side of this as well. This is exactly what happened, as first quarter 2021 GDP rose an astonishing +18.3% from a year earlier. This was a record-breaking quarterly reading and could perhaps be a blueprint for what to expect with the other economic regions around the world. This is a great start to the year and could put growth in this economy above the government's stated +6% growth for 2021. The recovery this year will be much more balanced vs. the growth seen last year. We will see a pickup in household consumption going forward. However, as the economy begins to track to pre-pandemic levels, government officials announced plans to withdraw some stimulus measures and focus on debt containment and the bubble in the real estate sector. This caught investors by surprise as the equity market sold off on the news, which led to virtually flat returns for the quarter. Industrial production garnered further strength recently as first-quarter production rose +24.5% from a year earlier. This was an impressive result, even though it was a tad below expectations. Auto production rose substantially, as did general purpose equipment and metal products. We expect the pace of growth to slow down from current levels but remain firmly in growth mode. Fixed asset growth rose +25.6% in the first quarter, which was supported by a heavy dose of stimulus measures. We expect this to slow down as these measures are withdrawn. Exports remained strong as April exports are up +32.3%, as global PMI's are at or near record levels. This economy is really benefitting from the recoveries going on in the U.S. and Eurozone economies. Retail sales remain strong, as April sales rose +17.7% from a year earlier as spending on jewelry and furniture items were brisk. We expect this to trend downward in the coming months as is the case with other key economic data points, but still staying on a good growth trajectory. The global recovery has lifted CPI out of a short-term deflation grip, as April rose +.9% from a year earlier, which was the second straight month of year-over-year price increases. We think this will increase even more in the months ahead as the recovery gains further traction. As mentioned earlier, most expect the People's Bank of China

(PBOC) to tilt toward a tapering stance in the months ahead to keep the banking sector liquidity tight. Looking out for the next few months, we see the recovery in this economy slowing a bit from current levels but remaining in growth mode in a post pandemic world.

Source: Evercore ISI

In similar fashion to the rest of the world, the Japanese economy struggled from the recent lockdowns in the economy as first-quarter GDP fell -1.3% from the previous quarter, or -5.1% from the previous year. This broke a string of two quarters in a row of growth. The economy here continued to be plagued by increasing infection rates from the pandemic as vaccination efforts were well behind most other parts of the world. Private consumption and investment, government expenditures, and net exports were all a drag on the economy, while an inventory build helped to support growth in the quarter. It will be important going forward to see this inventory build worked down. While exports were weak for most of the quarter, we did see some signs of life as March and April exports were up +16.1% and +38%, respectively. This economy should continue to benefit from trade as the global economy continues to re-open. This is important as inventory build was beginning to be a problem. Industrial production continued to rebound as March and April production rose +2.2 and +2.5%, respectively on a month over month basis. We would expect this trend to continue over the near term. Japan's leading economic index continued to move higher as March's reading of 102.5 was a post pandemic high. Similarly, the Bank of Japan's (BOJ) Tankan survey rose to a +5 in the first quarter from a -10 in the prior quarter. These are important data points moving in the right direction. Consistent with recent trends, consumer confidence reached 36.1 in March, the highest levels in over a year. As always, better readings here is always a key to a growing outlook. However, a better vaccination strategy would go a long way to restoring a more confident consumer. With the lifting of the state of emergency late in the first quarter, the labor market got a little bit of a shot in the arm, as the March jobless rate fell back to 2.6%, while the jobs-to-applicant ratio rose to 1.10. Perhaps these improving conditions can continue. Over the next few months, we believe economic readings may improve slightly on the margin, but significant movements may lag what we will see in other economies around the globe. Lockdowns have not been lifted as quickly as in other regions, and the Tokyo Olympic games will much likely have a smaller economic impact than originally planned. This could also keep a lid on any outsized gains in the equity markets relative to other regions.

Sources: Evercore ISI

Europe Update

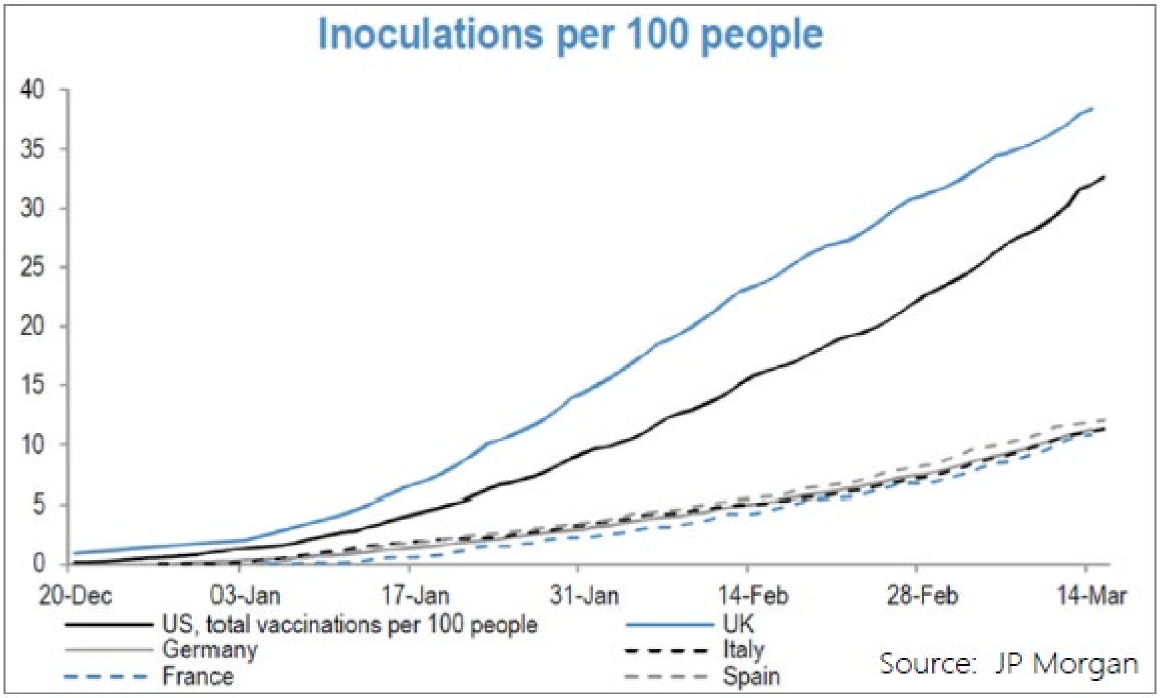
Investors spent most of the first quarter focusing on what a re-opening trade will look like post pandemic. However, muddling the focus was news on new lockdowns in parts of the Eurozone as vaccine rollouts have been well below expectations. As of mid-March, less than 10% of the populations in Germany, France, Italy, and Spain had received any vaccine, vs. 25% in the U.S. and even a higher percentage in the U.K. We expect this to get much better as we move through the next several months. The ECB did pledge to accelerate its massive bond-buying initiative in order to bring a bit of relief from rising interest rates. From an economic standpoint, we did see a general acceleration in several key datapoints in the quarter, especially the manufacturing PMI, as it hit an all-time high. The MSCI European Index (ex. U.K.) rose +3.5% in the quarter, as this remained near all-time highs. This would have been much better had currency movements not cost unhedged investors -4.8% as result of rising interest rates. The equity markets in the Netherlands, Sweden, and Italy led the way in the region with returns of +11.7%, +8.1%, and +6.8%, respectively in the quarter.

The European economy slipped back into double-dip recession territory as first-quarter GDP fell -.6% from the previous quarter or -1.8% from a year earlier. This was the second quarter in a row of negative growth and a firm indicator of what extended lockdowns have done to the economy. Many countries in the Eurozone suffered from rising infection rates right as vaccine rollout efforts were very slow to materialize. The resulting quarantine put a damper on economic growth for most of the quarter. Of the large European economies, the German economy suffered the most as private consumption took a nosedive as consumers were not able to spend. Eurozone industrial production slipped -1.6% in December after posting successive increases in October and November. Industrial production in the Eurozone did manage to pick up late in the quarter as March indicated slight growth from the previous month as manufacturing resumed in some regions, especially in northern Europe. We expect further momentum in this as we move through the summer. The economic confidence index continued recent trends as May rose to 114.5, which is the highest levels in over three years and very near the highest levels in the history of this data point. This is a good indication that we are on the cusp of a powerful economic re-opening in this region. We should see restaurants, lodging, air travel, and retail back in operation soon. After a rough start to the year in January, retail sales are coming back nicely as March sales were up +2.7% from the previous month. Rebounding demand is now being felt in prices, as core CPI rose +2.0% in May from prior year levels. This is the highest level in nearly three years as supply constraints coupled with heavy demand are forcing prices upward. However, many believe this will reverse somewhat in the months ahead as supply chains calm down a bit. Employment readings continued to improve as the April unemployment rate fell to 8.0%, down to its lowest level in almost a year. We should see this continue in the same direction as job openings and hiring become more prominent in the next few months.

Source: Morgan Stanley; Haver Analytics; Eagle Global Advisors

The U.K. benefitted particularly well on the vaccine rollout in the first quarter as it was well ahead of its European counterparts. This was welcome news for investors as the

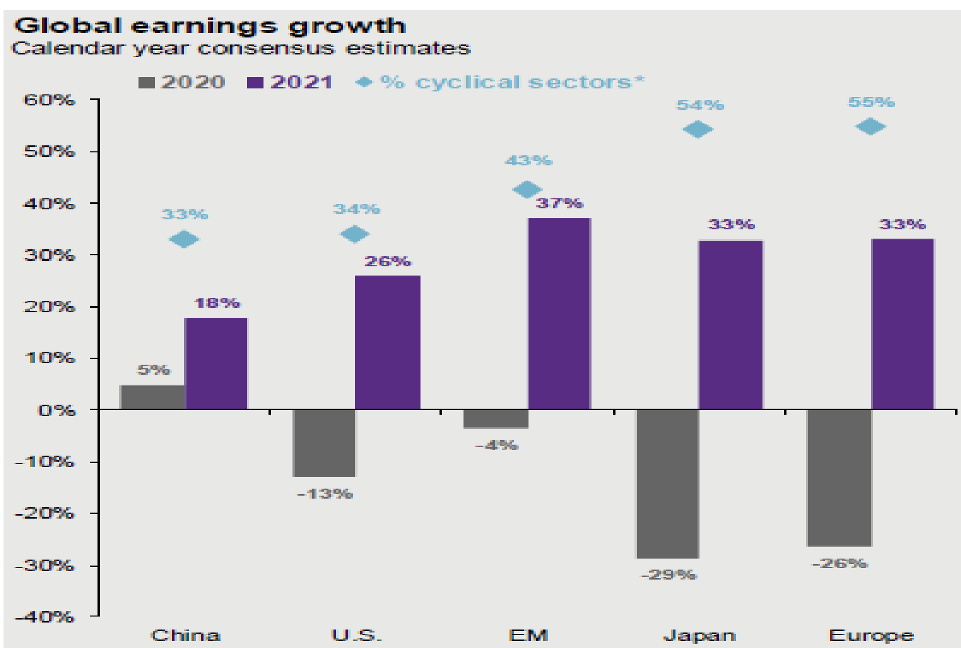
U.K. experienced one of the worst virus outcomes of the major economies around the globe. This helped push aside the effects of recent virus lockdowns and propelled equity markets higher. The MSCI U.K. Index rose +6.3% in the first quarter and wound up being one of the best performing major markets around the world for the second quarter in a row. Economically sensitive parts of the market performed well, especially the energy, basic materials, and financial stocks. Rising interest rates and commodity prices aided these sectors of the market. With the bulk of the economy still reeling from the lockdown, GDP fell -1.5% in the first quarter from the previous quarter and fell -6.1% from a year earlier. However, we believe we are on the cusp of a dramatic shift in economic growth starting the second quarter. Restrictions in activity are being lifted on a weekly basis, and early indications of consumption are very optimistic. Industrial production had a nice upward trend in the quarter, as March showed a +1.8% rise from the previous month. Manufacturing was very strong, benefitting from ramping up of depleted inventory levels in most businesses as well as the oil & gas sector from rising energy prices. Retail sales growth has been stellar lately as April sales rose 9% from a month earlier. Store re-openings are pushing sales up each week as consumers are eagerly awaiting these re-openings. We would expect these trends to continue for the foreseeable future. With the resumption of economic activity in the region, core CPI rose +.6% in April from the previous month, the highest monthly change since the pandemic. Retailers are taking advantage of low inventory levels to raise prices. While this is somewhat aggressive at this point, we do expect this to level off over the next several months and remain at manageable levels after this. At its early May meeting, the Monetary Policy Committee (MPC) voted to maintain its main benchmark interest rate at .10% and keep its bond purchase target at 895 billion pounds. Interest rate increases still seem quite a ways off. The MPC did lower the pace of its asset purchases within its already communicated targets. We see the MPC as even more optimistic on near-term economic growth than it was a few months back. This was welcomed news by most investors. First-quarter unemployment fell to 4.8%, which is consistent with businesses slowly re-opening and looking for workers. We would expect this trend to continue as this economy moves toward a full re-opening. Going forward, with the U.K. region well ahead of most other countries in vaccination levels, we expect significant economic growth over the near term. We are optimistic this could be good for equity markets here as the region should benefit from its heavy cyclical exposure.



Sources: Eagle Global Advisors; JP Morgan

Emerging Markets

Emerging market equities underperformed on a relative basis in the first quarter vs. the developed markets as coronavirus spread further in India as well as certain Latin American countries. This, coupled with the uneven distribution of available vaccines to these regions, cooled off investor enthusiasm for the group. Also, Chinese equities struggled a bit in mid-February as investors started to become concerned about valuation levels as well as tightening policies from the monetary authorities here. This did not surprise us too much, as China was the first to experience the pandemic shutdown and would probably be the first to change the direction of easy monetary policies. Commodity prices continued to move higher, as crude oil, copper, and aluminum were all strong in the period. The equity markets in the Middle East were generally strong in the quarter, while the countries in the Asian basin and South America were detractors from performance. The MSCI Emerging Markets Index still managed to rise +2.3% in the first quarter of 2021 but underperformed the developed markets as mentioned above. We still see further upside in this asset class going forward as the vaccine rollout pushes hard into the emerging markets over the next several months. This should spur some type of "re-opening" trade here as well, but maybe not quite to the degree as we have experienced in other markets. Investors still need to keep an eye on inflation and interest rates, as sudden unexpected changes can change the mood quickly in this asset class.



Sources: Factset; MSCI; S&P; Thomson Reuters; JP Morgan Asset Mgmt.

International Equity Activity/Strategy

Looking out into the summer of 2021, we still see a good environment for global equities to perform well in what is being labeled as the “re-opening trade”. Economic and monetary stimulus actions remain at unprecedented levels in almost every major economy around the world. As the coronavirus vaccine continues to be distributed around the globe, workers are flowing back to jobs, while consumers are flush with cash and ready to spend. This is creating demand bottlenecks with supply chain issues in many industries that have experienced little of this over the last couple of decades. This will be good news for corporate margins and earnings growth for the balance of 2021. Most economists believe rising interest rates will remain at a level not too high to curtail economic growth projections, and inflation will be only “transitory” in nature and remain manageable in most parts of the world. With these points in mind, we could easily see many equity markets push to new highs as investors remain comfortable with the continuation of the “risk-on” trade.

We did not add any fresh money to our international equity asset allocation recently since our addition in December. However, we are evaluating a couple of different actions at the present time, which could result in a short-term trade idea within this assts class. We continue to be very active with our put/call writing strategy on EEM, as premiums remain very attractive for this in the current equity market and interest rate climate. Emerging market equities remain an asset class that looks attractive to us going forward over the long term. Our current allocation to Emerging Market equities is approximately 3.75% of total assets and approximately 11.07% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios. *(Credit is given to the following entities for charts provided: Factset, MSCI, S&P, Thomson Reuters, JP Morgan Asset Management, Eagle Global Advisors, Evercore ISI, Haver Analytics, Morgan Stanley, BCA, Todd Asset Management, International Monetary Fund, RIMES, Capital Group, Resource Consulting Group)*