Quarterly Economic Update

September 15, 2021

MACROECONOMIC COMMENTARY

Fiscal/Monetary Policy

By Michael McNair

The slate of monetary and fiscal policy actions over the next few months is the busiest in recent memory. The list of fiscal and monetary policy actions occurring through the end of the year include passage of the budget, infrastructure, fiscal cliff, debt ceiling, Biden's $3.5 trillion spending package, tapering, and Fed reappointments.

The fiscal spending and tax package will undoubtedly get most of the attention in the media, considering the legislation introduces the largest tax increase in over 50 years and the largest spending package in more than 100 years.

Budget Reconciliation

Democrats do not have the 60 votes needed to pass traditional legislation through the Senate. Therefore, Democratic leadership has decided to use the budget reconciliation process to push their economic package through Congress. Budget reconciliation has become the go-to route for Presidents to pass their signature legislation. President Bush, Obama, and Trump used the budget reconciliation to pass the Bush Tax Cuts, the Affordable Care Act, and Tax Reform, respectively.

The reason for using the reconciliation process is that it requires only a simple majority to pass - 218 votes in the House and 51 votes in the Senate (with the Vice President serving as the tie-breaking vote).

However, there are specific rules to the reconciliation process that limit the scope of legislation relative to traditional legislation. The most important of these rules are:

1) The legislation can only be budget-related changes – policies that have no fiscal impact are not allowed.
2) Provisions cannot increase the deficit in any fiscal year after the window of the reconciliation bill (typically 10 years in the future) unless the costs outside of the budget window are offset by tax revenue increases.

The first step in the budget reconciliation process requires both chambers of Congress to pass a directive that includes which committees should report, the date to report, the amount of budgetary change, and the time over which the change should be measured.

This critical first step was set in motion at the beginning of the month when the House voted to approve a $3.5 trillion budget reconciliation, advance a bipartisan infrastructure bill, and move forward with sweeping voting rights legislation.

The Afghanistan crisis has added new complexity to the process. President Biden's approval ratings have taken a hit and have lowered the odds of passing his signature policy legislation. However, we should note that President Obama and President Trump had worse public support when they passed the Affordable Care Act and tax reform, respectively. In the end, the fear of losing Congress in the midterm election motivated legislators to make the compromises necessary to pass the legislation.

Nancy Pelosi has taken several steps to wrangle the necessary support. First, she has decided to tie together the infrastructure bill with a larger spending packing. Second, she tied the vote on budget reconciliation with the John Lewis Voting Act, which was co-sponsored by all nine moderate Democrats who have threatened to withhold support for budget reconciliation.

Size of the Fiscal Package

Congress agreed to set a maximum $3.5 trillion gross spending limit as well as a $1.75 trillion increase in the deficit for the budget reconciliation bill. The amount of spending in the bill can go up to $3.5 trillion, but all spending over $1.75 trillion must be paid for with tax revenue increases to offset the deficit.

The guidelines create a wide range of outcomes for gross spending and tax increases. Cornerstone Macro's policy team's base case assumption is that Democrats can achieve $1.8 trillion of tax revenue increases, which would offset the gross spending measures. Their base case assumes "$783 billion in revenues paid by businesses, $751 billion paid by wealthy individuals, and another $252 from drug pricing reforms ($1.8 trillion total). The $1.8 trillion includes $290 billion in relatively painless savings, such as more revenue from tax enforcement ($120 billion) and $170 billion for repeal of the Medicare rebate rule."

The $751 billion in tax increases from wealthy individuals assumes a top individual rate of 39.6% starting around $452K/$509K (single/joint), a 28% capital gains rate kicking in at the same level, the imposition of the 3.8% net investment income tax (NIIT) on the active business income of the pass-through businesses if that income is not already subject to employment taxes, a permanent extension of the active loss limitation (that Republicans created in the 2017 reforms), and taxing carried interest as ordinary income. It is also possible Democrats will seek to reverse the increase in the estate tax exemption (which doubled from $5.5/$11 million under the 2017 reforms) as consolation for failing to repeal stepped-up basis; however, the revenue from this change may not be worth the political fight. Democrats are also expected to claim at least $200 billion from increased tax enforcement (the result of giving the IRS an additional $80 billion in funds for a net gain of $120 billion).

Budget Impact Of Certain Tax and Health Care Offsets ($BN Over 10 Years)

Provision	Description (Base Case vs High)	Base Case	High
Corporate			
Corporate Rate	25% vs 28%, no phase-in for either	410	701
GILTI	19% rate curb QBAI & FTCs vs 26.25% rate, no QBAI, CbC	250	534
BEAT/SHIELD	Revenue neutral BEAT reforms vs Biden's SHIELD	0	390
FDII	Scale FDII for parity with GILTI vs. Full Repeal	40	124
Alternative Minimum Tax	Restore old corporate AMT vs Biden's 15% AMT on Book Income	40	148
Limit Interest Deductions	Disallow deductions for excessive borrowing in the US	19	19
Stock Buybacks	Impose excise tax or deem as dividends taxable to individual	n/a	75
CEO Pay Excise Tax	Levy excise tax on companies w/ high CEO pay ratios	n/a	150
Like Kind Exchanges	Eliminate LKE for large real estate transactions	n/a	20
International Tax for Oil/Gas	Include foreign oil & gas extraction income in GILTI	n/a	86
Repeal Fossil Fuel Preferences	Repeal various cost recovery related provisions	n/a	35
Superfund Taxes	Reinstate 3 taxes on crude/petroleum 2x previous rate	25	25
Carbon Polluter Import Fee	Tariff carbon intensive imports like steel, cement, oil	n/a	100
Carbon Tax	Establish $15 per ton carbon tax	n/a	600
Individual			
Top Individual Rate	39.6% Top Bracket at $452K/509K (Single/Joint)	132	132
Capital Gains & Dividends	28% for $400K+ vs. Repeal Step Up & 39.6% for $1+mn	150	322
NIIT	Make the 3.8% tax apply to active income for pass throughs	237	237
Active Loss Limitation	Make the loss limitation for pass throughs permanent	43	43
Carried Interest	Treat as ordinary income or deem comp. annually (Wyden)	14	63
Estate Tax	Reduce exemption to $5.5/11mn or $3.5/7mn with 45% rate	56	251
Tax Enforcement	IRS gets $80bn for enforcement vs. Biden's compliance plan	120	718
Derivatives	Wyden bill to mark to market derivatives	n/a	17
Pass Thru Deduction	Eliminate benefit above $400K, allow services to benefit	n/a	114
Health Care			
Drug Pricing	Cap Prices to Inflation (Grassley bill) vs HR3 Drug Price Negotiation	82	533
Delay Medicare Rebate Rule	Delay the rule codified in IIJA beyond 2025	170	170
TOTAL		$1,787	$5,605

Sources: OMB, JCT, CBO, TPC, Press Reports, Sen. Sanders, Cornerstone Macro.

Notes: Capital gains and dividends score for 28% rate reflects an amalgam of estimates but is uncertain. Other notable policies being discussec that are not shown include mark to market for billionaires, forced distributions for mega retirement accounts, a 20-cent tax per pound on plastics, a methane polluter fee, limits on conservation easements, and limits on deductibility executive compensation in excess of $1mn. The table also does not include potential revenues that JCT might estimate for changes in compliance from reporting requirements or the macroeconomic effects of fiscal policy included in a "dynamic" estimate.

The gross spending amount above our base case of $1 – 1.8 trillion of tax "offsets" will be determined by the degree to which Democrats agree to allow the budget deficit to expand.

The Manchin Problem

Budget reconciliation is a complicated legislative process, but the point is that it allows Democrats to write and approve a massive spending package without Republican support. The major caveat is that the Democrat's razor-thin, 50 votes + VP, majority requires support from all 50 Democratic Senators to pass the legislation. Unfortunately for Democrats, there are already signs of dissension within their ranks.

Earlier this month, Sen. Joe Manchin (D-WV) penned an op-ed in the Wall Street Journal unequivocally stating that he would not support the $3.5 trillion budget reconciliation bill. Sen. Manchin's emphatic public opposition to the legislation is noteworthy because the Democrats cannot afford a single defection. The financial markets did not miss the significance of Manchin's statements, and stocks levered to the passage of this bill sold off. Given the financial market response, it is worth giving our perspective of the Senator's actions.

It is important to understand that Sen. Manchin is in a much stronger position than House moderates, who threatened to withhold support only to capitulated once they were threatened by Democratic leadership. Manchin's support in West Virginia only grows the more he battles with progressives within the party. Nevertheless, we do not believe that Manchin is willing to individually derail the President's signature legislation.

There has been a clear pattern to the Senator's public interactions with this administration. Strategas Political Analyst, Dan Clifton explains, "At the start of the year, Manchin vowed that he would not vote for a $2 trillion COVID package in February, and then he voted for a $2 trillion COVID package in March. In June, Manchin wrote an op-ed saying that he would not support the Democrats' voting reforms. He then voted for a Democratic voting reform bill weeks later. We get the sense that Manchin needs these high-profile media days to give him cover to vote for the legislation being put forth by a more liberal Democratic Congress. Manchin remains close friends with the President and is a key member of the Senate leadership."

Sen. Manchin never drew a line in the sand, and we believe that he will eventually vote in favor of the legislation. We do not believe the question is whether a deal gets done and taxes are raised but by how much. The significance of the Senator's public opposition is the degree to which he can persuade other Democrats to limit the size, scope, and timing of the eventual bill.

We agree with Dan Clifton that Manchin's op-ed should be viewed as "an implicit warning that Democrats are about to put out one giant piece of legislation (let's say 10k pages of text), with bigger health care changes than Obamacare, the largest energy bill in our lifetimes, and cradle-to-grave social policies. This spending will be paid for with a wide range of tax increases, many of which have never been formally vetted by legislative committees. And Congress is going to try to pass this wide-ranging legislation in a matter of weeks."

Manchin is calling for a pause to figure out the path of the pandemic, determine whether higher inflation is transitory, and analyze the economic impact of a large budget package. Manchin's objections increase the risk that it will take longer than the six weeks that Democratic leadership has targeted to complete the reconciliation package.

The political wrangling needed to find the appropriate mix of spending and tax increases that can bridge the differences between a few Senate moderates and House progressives is only one of the reasons that the reconciliation bill could take months and not weeks to pass. The other major issue is the upcoming debt ceiling fight.

Cornerstone's Andy Laperriere explains that "Democrats are likely to include a debt limit increase (if history is a guide, they will suspend the limit until March 2023) on the continuing resolution that must pass before September 30 to prevent a government shutdown. However, it is not clear this approach has sufficient support to become law. So far, 46 Senate Republicans have vowed to have no part of a debt limit increase that helps to finance the Democratic agenda and have called on Democrats to pass it themselves using the budget reconciliation process.

Most likely, Democrats will follow through with their threat to include a debt ceiling increase on a bill funding the government (probably a three-month continuing resolution, or CR). In all likelihood, the bill will get voted down because it won't get 60 votes in the Senate. A failed vote to raise the debt ceiling is likely to get the attention of investors. After this is rejected, Democrats will probably pass a clean CR (with GOP support) to keep the government open. Finding a path forward on the debt ceiling will not be so easy and will tie up the Democratic leadership. Default is not likely, but the risk is not negligible. Most likely, Democrats will have to pass a debt ceiling increase without the help of many, if any, Republicans."

The debt ceiling has policy implications outside of its impact on delaying the budget reconciliation process. The most important implication of the debt ceiling fight is the unintended consequence that it will have in causing severe distortions in financial market liquidity through the end of the year.

Merging of Fiscal and Monetary Policy

Since 2000 there have been two periods when the Treasury was within weeks of running out of cash because the closure of the debt markets prevented the issuance of treasury securities (after 9/11 and Katrina). However, the biggest liquidity risk for the United States Treasury has come in the form of the political circus surrounding debt-ceiling showdowns.

Congress passes the budget, which creates the need for the Government to borrow; yet, it threatens to unnecessarily force the United States into default by not allowing the Treasury to issue the debt needed to pay for the agreed-upon spending.

In August 2015, the Treasury Borrowing Advisory Committee responded to these repeated temporary funding risks by setting new guidelines for the Treasury General Account (TGA) to provide a liquidity buffer for the Treasury. TBAC set a target for a cash balance, at that time around $350 billion, proportional to the size of the deficit and the perceived risks around hitting government spending and revenue targets. Under the guidelines, the funds can only be used as 1) a contingency for natural disasters, 2) when Treasury funding markets may be temporarily closed, and 3) ahead of reaching a debt ceiling limit to prevent the unnecessary furlough of government employees.

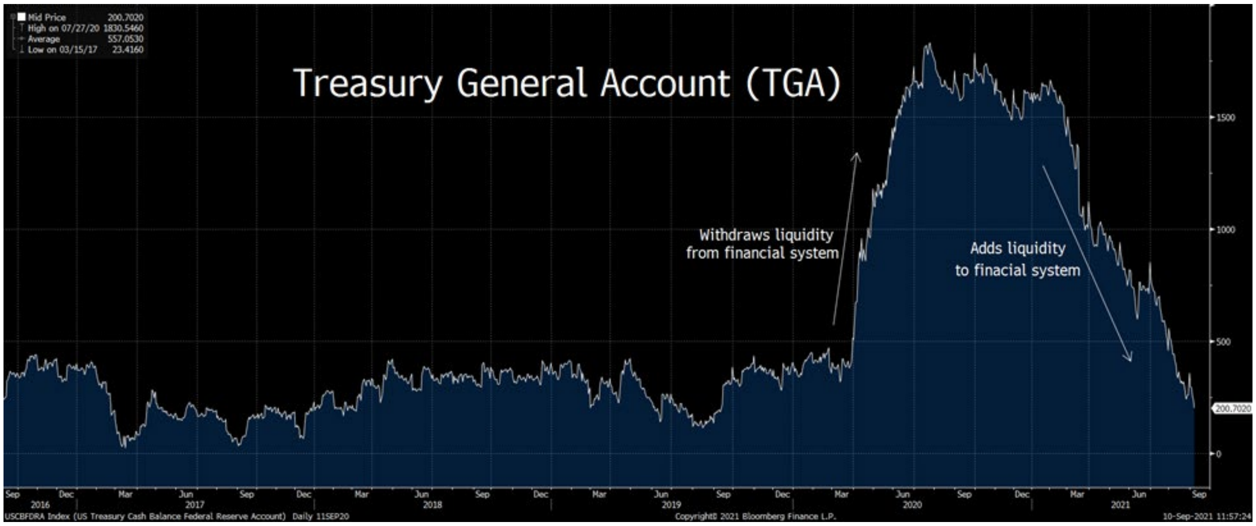
Since 2015, the swings in the balance have largely reflected debt ceiling dynamics. If Congress failed to ratify a debt ceiling raise, the Treasury would draw down its balance to keep the government open as long as possible. Once the debt ceiling was raised, the Treasury would rebuild its balance. The TGA balance should have stabilized after the House passed the Gephardt amendment in 2019, which automatically raised the debt ceiling to fund any future spending bill. However, the pandemic took over for the debt ceiling and caused the largest fluctuation in the TGA balance to date. The dramatic increase in the budget deficit meant that the size of the TGA balance also needed to increase to provide a sufficient liquidity buffer.

The TGA is important because it has an outsized effect on financial conditions. The TGA balance increases when the Treasury issues more debt than they deficit spend. Critically, the TGA cash sits at the New York Fed and not in the commercial banking system where it could be lent out. When the balances are building, it is the functional equivalent of stuffing cash under the mattress - it sucks money from the financial system - but adds liquidity to the system when the balance is drawn down.

The problem is that the Federal Reserve, not Treasury, is supposed to be the sole entity tasked with setting monetary policy. Further, Treasury's monetary policy actions (raising and draining TGA balance) have the sole purpose of providing policymakers enough time to agree on a deal to increase the debt ceiling and not based on setting appropriate monetary policy for the financial system.

To make matters worse, the Fed and the Treasury have failed to coordinate policy which has often led to the Treasury and Fed working in opposite directions (Fed trying to add liquidity while the Treasury is withdrawing liquidity), mitigating the monetary policy efforts of the Fed. However, in 2021 the Fed and Treasury have been pulling in the same direction - both adding significant liquidity to the system. But make no mistake, this action has been entirely coincidental - but impactful, nonetheless.

In 2020 concerns over debt market closure and the increased size and unpredictability of government revenues and spending caused the Treasury to issue $4.8 trillion of debt, but only did $3.5 trillion of deficit spending, leading to a $1.3 trillion increase in the TGA. The only reason the TGA buildup did not tighten financial market liquidity is that the Fed was running an even larger QE program at the time.



When the budget deficit stabilized earlier this year, Treasury decided to draw down its cash balance at the Fed from $1.65 trillion to $500 billion by the end of July.

However, the debt ceiling extension that has been in place since 2019 expired at the end of July. Since August, the Treasury has been forced to undergo "special measures" to keep the government open. These measures include drawing down the Treasury General Account (TGA) at the Fed, as well as some debt and pension deferrals and reclassifications (up to around $350 billion). Depending on whether the debt ceiling is set at the current level of debt, or around $400-450 billion lower than the current level (it is currently unclear whether the Treasury is allowed to count debt used to build up the TGA as part of the new debt limit), the Treasury will need to come up with either $500 billion or $900-950 billion of "special measures" by the end of October. Depending on the technical ruling on that issue, this means that Treasury Secretary Yellen will have to draw the TGA down by somewhere between $350-550 billion between August and the end of October, the point at which we assume Congress signs off a debt ceiling extension. This will be the **equivalent to running an additional $1.4-2 trillion of annualized quantitative easing (QE)** up until the point the debt ceiling is raised.

When the Treasury draws down the TGA, it effectively pays a check directly to a government employee, to a contractor, to a government agency, or a welfare recipient. That person, business, or agency then presents the check to a commercial bank. At that point, the Fed creates a deposit in the commercial bank to honor the check. As that deposit is a liability of the commercial bank, the Fed then gives the bank an equivalent amount of excess reserves in return.

The individual, contractor, or agency will then spend the funds, likely within a month. Consequently, the money created in the commercial banking system from this kind of activity tends to have a higher velocity or money, or Main St. effect, than QE, which tends to cause cash to circulate first and foremost among the buyers and sellers of financial assets. We expect a partial offset to this liquidity from ~$140 billion of PPP forgiveness over the period but then support from low single-digit core bank lending plus the ongoing current $1.4 trillion QE program.

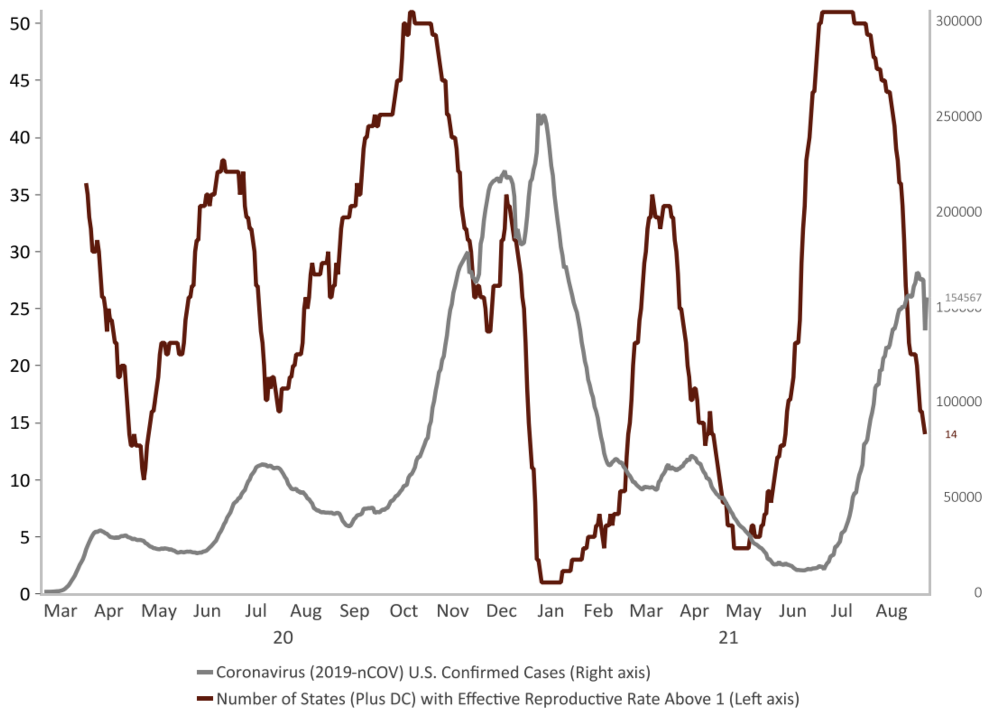
Once Congress signs off on a debt ceiling extension, likely in October, the process will run in reverse as the Treasury will raise its issuance – above the amount needed to fund the deficit - and rebuild its TGA cash balance. When the Treasury deposits those funds at the Fed, the Fed will cancel the commercial bank deposit as well as a bank excess reserve. The increase in the TGA account (Treasury withdrawing liquidity) is set to occur just as the Fed is expected to begin tapering its QE program. If the Fed follows through with their tapering, then the TGA uptake will completely offset the remaining QE purchases, leaving little or no sequential money supply growth for a couple of months. This sets up the potential for a deflationary air pocket in November/December.

Economic Outlook

By Josh Husted

The 3rd Quarter edition of the Economic Outlook will borrow its form from technology analyst Kevin Gamble's favored Equity Outlook format: a top 10 list. Its beauty lies in its simplicity, and it is well-suited to deliver signal through an incredibly noisy economic data environment. As Renaissance Macro Research's Jeff deGraaf stated in his most recent Weekly Survival Guide, *"Data continues to echo off the Covid shock from 18 months ago. Those distortions can be seen in many of the inconsistencies in today's market."*

1. <u>The Delta variant has impacted many areas of the US economy, but the net effects are manageable, and its influence should wane in the coming months.</u>

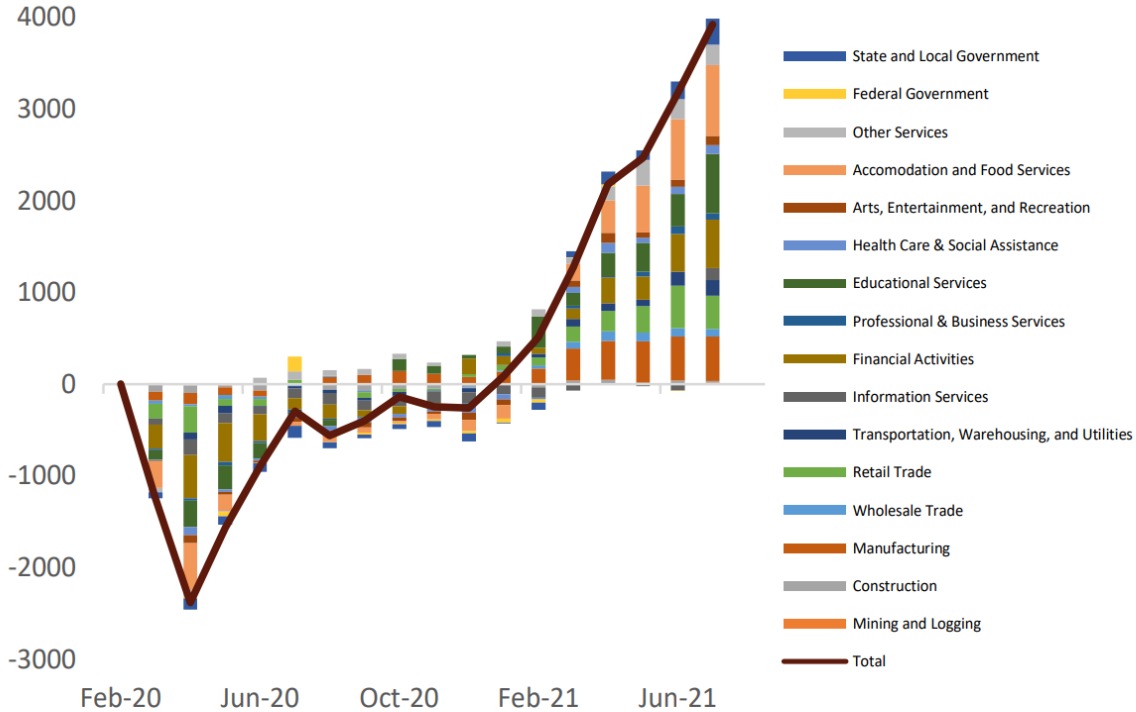


As the number of states with a reproductive rate above 1 continues to fall, case growth in the US will moderate. This means that in all but 14 US states, COVID-positive people are, on average, infecting less than 1 other person. Vaccination rates have reaccelerated and now stand at 54.1% fully vaccinated people as of 09/10/21. Finally, COVID hospitalizations are down in the "hotspot" states. Delta's impact in the economic data was seen in softer mobility trends, weak female labor participation, poor six-month business climate sentiment among small business leaders, higher sick call-ins to work, falling consumer confidence, and declines in the Empire and Philly Fed manufacturing indexes. However, consumption is steadily growing, with the softer acceleration due primarily to seasonality. Delta could be causing a shift as we've seen some slowing in gambling, restaurants, and hotels, but that has been made up for in general merchandise stores and electronics/appliances.

2. Current employment dynamics reveal a change in power from companies to employees and force us to ponder if they portend a more structural shift.

Job openings exploding

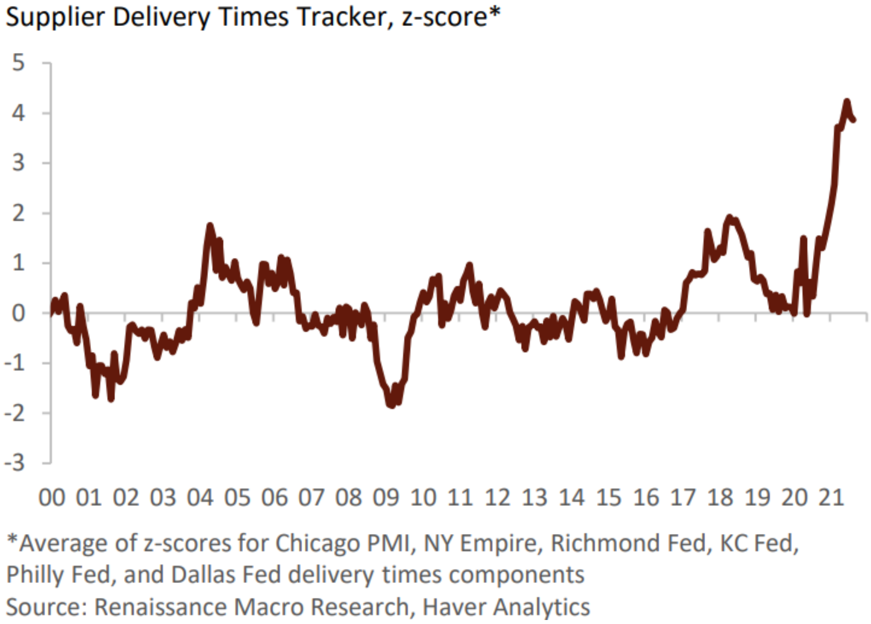
Job Openings, change since February 2020 (000s)



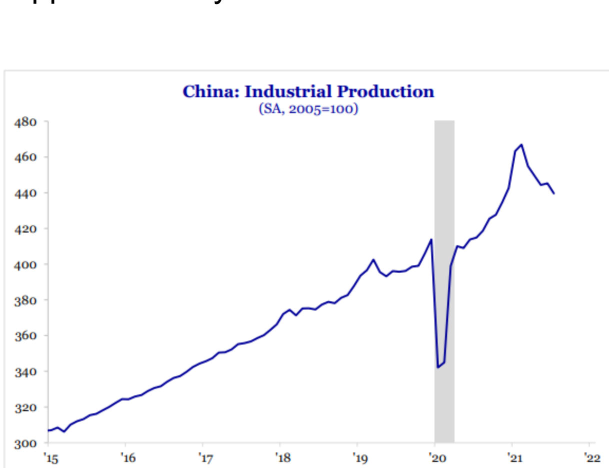
Source: Renaissance Macro Research, Haver Analytics

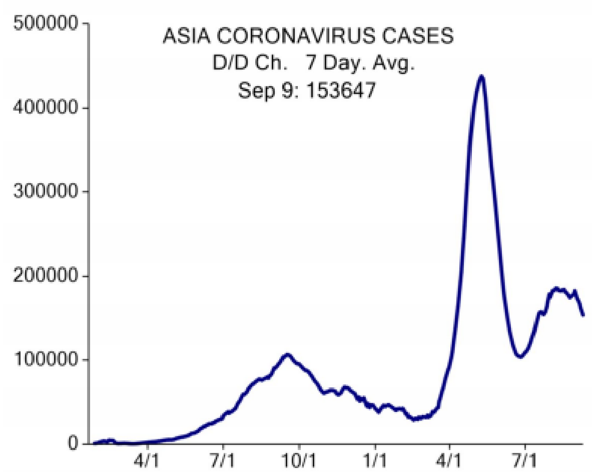
Job openings have surged by roughly four million since February 2020, rising across all industry groups. In July, job openings surged 7.4% to a record 10.9 million. The bulk are at the low end but are coming increasingly at the high end as well. There is always a lot of debate over whether these are phantom openings that lack the hiring intensity to get filled. But even if half of these openings are "real," it implies a significant uptick in labor demand. Regardless, hiring rates remain strong and firings, as proxied by a decline in jobless claims, continue to decline. The private sector quits rate rose to a three-month high of 3.1%, and the quits rate in the retail trade sector jumped to 4.4%, a record. This reinforces the strong growth in wages and is a good sign for jobs growth. U.S. nonfarm payrolls surprised to the downside in August, rising just 235,000 m/m. The household jobs survey was stronger, however, with U.S. unemployment falling to 5.2% and the labor force participation rate holding steady. There also continued to be upward pressure on wage growth, with average hourly earnings up +0.6% m/m and 4.3% y/y. Labor inflation has not been transitory so far.

3. **<u>The US's economic reliance on global supply chains is constraining production as they are increasingly stretched to their breaking point.</u>**

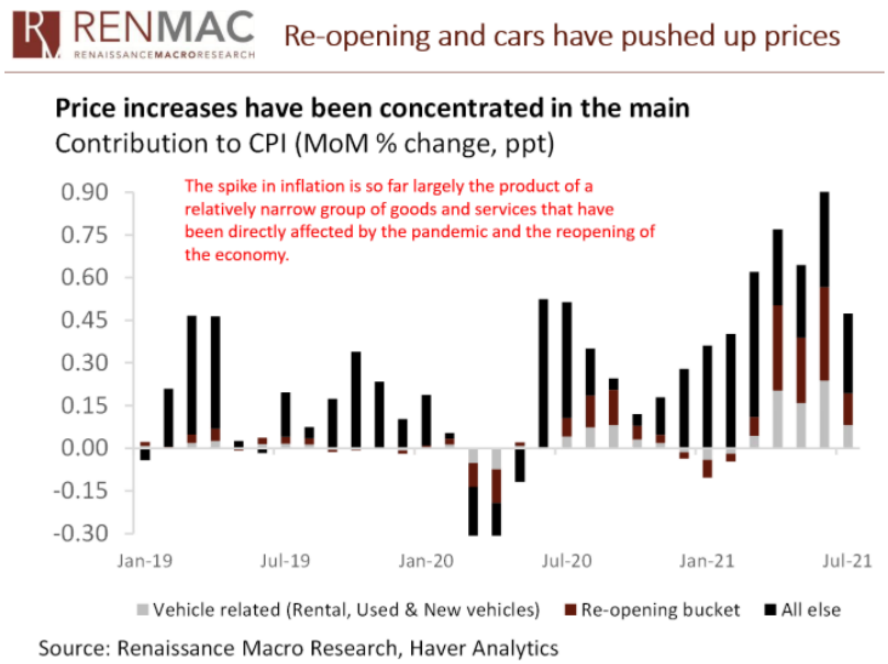


China's and emerging market countries' battle with COVID is having far-reaching effects on the global supply chain. Weaker healthcare systems, lower vaccination rates, and tougher lockdown policies have led to production delays that have bottlenecked critical supply components, most notably semiconductors. There is little the Fed can do to control a supply-constrained economy, which could put them in the awkward position of downgrading their growth forecasts while sticking to a 2021 QE taper timeline. While the current weight of delta variant spread and persistent supply chain disruptions are leading economists to cut estimates for Q3 GDP growth, there is positive news--estimates for 2022 growth should rise. Consumers cannot buy what cannot be sold, but this dynamic only pushes growth out further, it does not eliminate it. Furthermore, while China's industrial production slowed Y/Y in July, Asia COVID cases are falling, and supplier delivery times have ticked down from their peak





4. **<u>Consumer Price Inflation (CPI) is high, and there is no consensus as to if it is transitory or permanent.</u>**

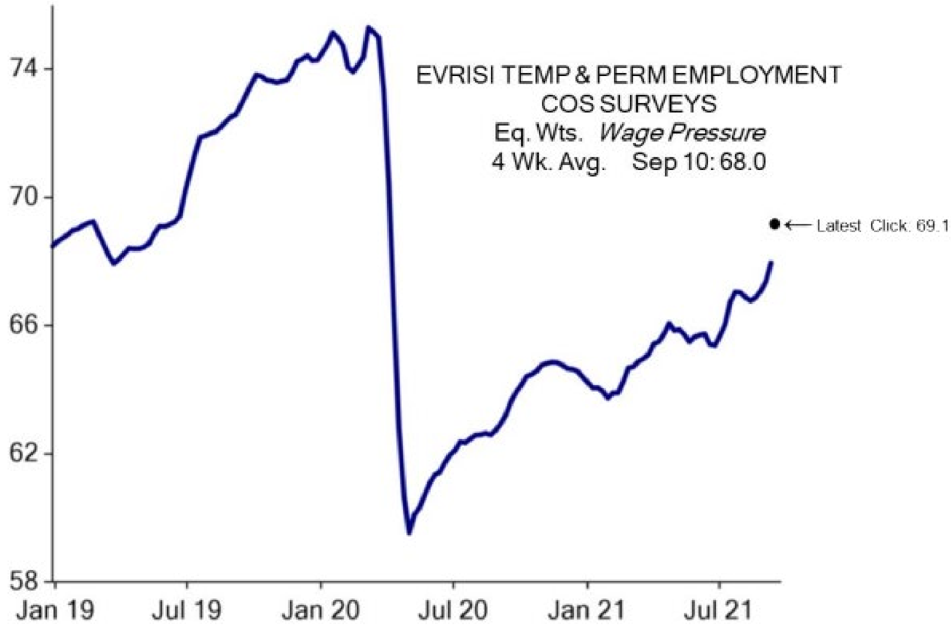


Recent data have been unable to resolve the transitory/non-transitory inflation issue. Used car prices, which contributed to ~half of the increase in June headline CPI inflation, should moderate when supply bottlenecks ease. Autos & parts sales fell -3.9% m/m in July. If “Mr. Market” is to be believed, inflation expectations are coming in. Much of the positioning around inflation appears to have lost its appeal with recent oversold conditions in energy, relative trend breaks in copper, and a dollar breakout. In addition, we are seeing the beginning signs of a contraction in inflation expectations as ten-year breakeven inflation rates have retreated from their peak in May.

On the other side of the debate, survey-based measures of inflation expectations remained elevated, with longer-term expectations at ~3%. Small businesses continue to report that pricing is a significant problem. If inflation was purely a function of strong demand, then the non-transitory “camp” would win. Labor demand is strong, wages are accelerating, earnings are advancing, rents are increasing, and Evercore ISI’s survey of retailers revealed pricing power increased again this past week to a record high.

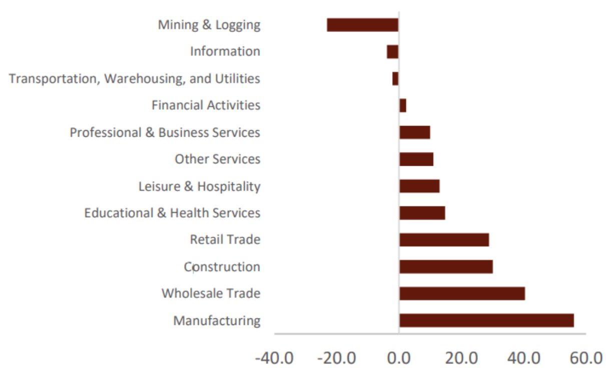
It is important to note that when discussing inflation, one must differentiate between the inflation of what consumers pay for goods and services (captured in CPI) and what companies must pay for inputs and wages. Wage inflation, which is readily observable in today’s job market, only begins to affect CPI when businesses can successfully pass their increased labor costs through to consumers. If they cannot, they must either increase productivity or suffer from decreased margins. Technology has been an incredibly powerful deflationary force over the last several decades and must be respected as a countervailing strength to labor’s recent wage gains.

5. **<u>Wage inflation is running red-hot and could spell trouble for employers the longer it persists.</u>**



Wage inflation has finally arrived in the US economy, answering one of economists' more lingering questions and placating the proletariats' demand for fairer pay. Average hourly earnings ticked up +0.6% m/m and 4.3% y/y, the highest pre-pandemic read since the BLS began compiling the data in '06. Massive increases in consumer net worth, fiscal and monetary stimulus, $2 trillion in consumer excess savings, and a robust safety net for the unemployed have all contributed to a rejection of unappealing low-wage jobs by the working class. Quits are an excellent confirmatory data point with which to pair changes in average hourly earnings, and they are rising. The more people that are willing to sing along with Johnny Paycheck's chart-topping single in 1977, the more employers will have to increase pay and/or benefits to attract and retain workers. As anecdotal evidence, consider Amazon's most recent announcement to cover 100% of college tuition for U.S. hourly employees!

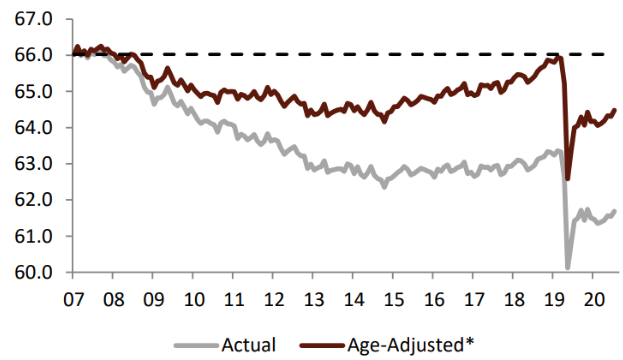
Manufacturing quits up sharply
Quits, % change since February 2020



Source: Renaissance Macro Research, Haver Analytics

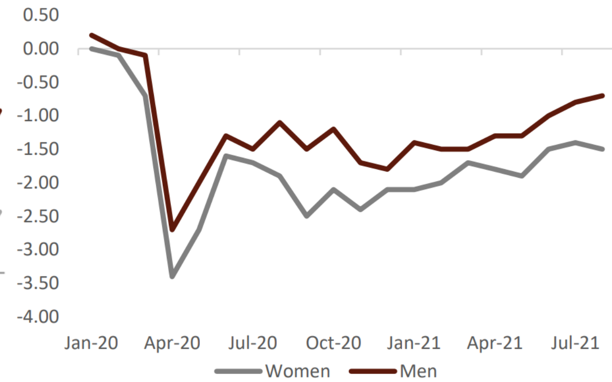
6. **<u>Weak labor force participation continues to constrain GDP growth potential, particularly among prime-age women and jobs that one can't work from home.</u>**

Still a ways to go on participation
Labor Force Participation Rate



*Holds demographics fixed to 2007
Source: Renaissance Macro Research, Haver Analytics

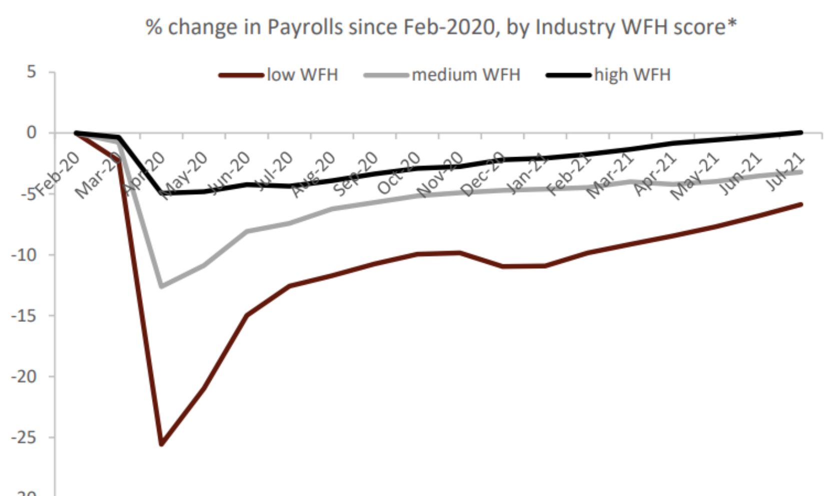
Prime age women are trailing
Prime Age Labor Force Participation Rate (change since Dec 2019)



Source: Renaissance Macro Research, Haver Analytics

The household measure of employment rose by 509,000, with the participation rate flat at 61.7%. Permanent unemployment sank by 443,000, the sharpest drop during the pandemic. The participation rate for prime-age men is rising more rapidly than the rate for prime-age women – a sign that school closures and child-care are lingering constraints on labor supply. Prime-age EPOP rose to 78%, a cycle high – a rate we did not see until 2016 in the last expansion. Employment has nearly recovered (0.05% above pre-pandemic levels) in sectors with high teleworkable feasibility, with sectors like information services, data hosting, and related services experiencing the maximum gain. Sectors with low teleworkable feasibility have recovered dramatically but are down 5.8% from pre-pandemic levels. Under this category, sectors like hospitals, truck transportation, etc., experienced the maximum recovery.

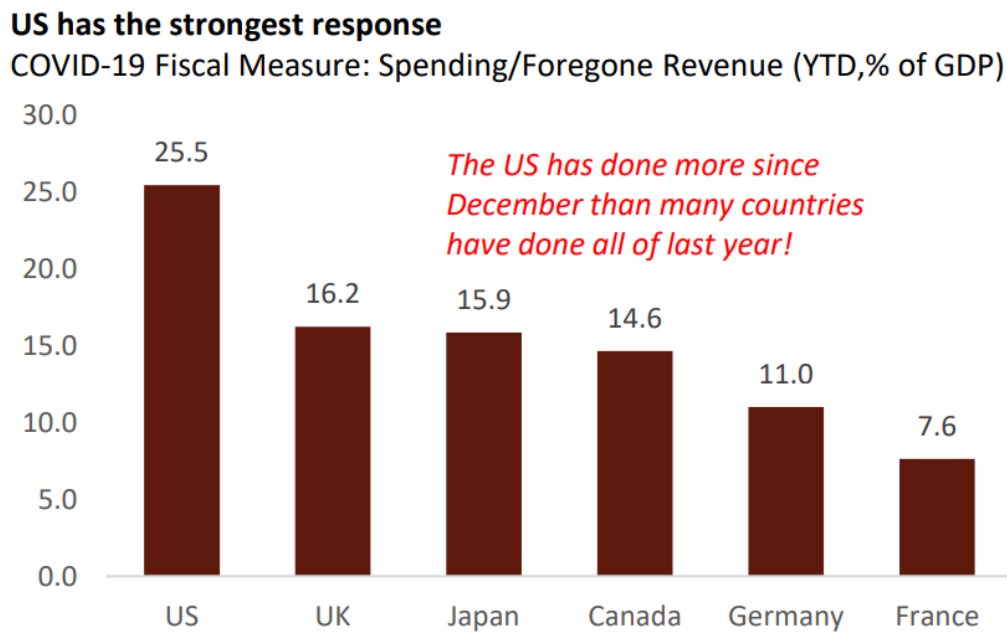
Jobs that can be easily done from home back to normal



* - generating employment wtd. mean at Industry level by merging St Louis Fed Occupational Proximity score with BLS Employment Stats by NAICS Code (at 3 digit level)

Source: Renaissance Macro Research, Haver Analytics

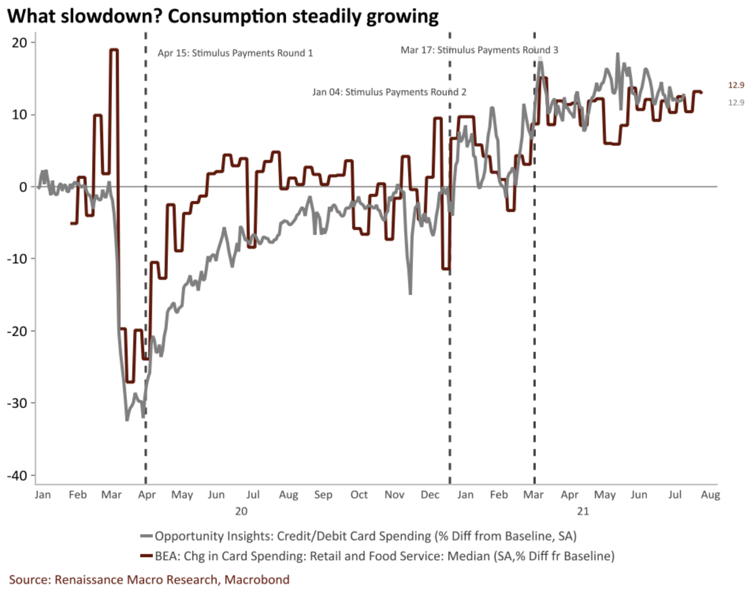
7. **<u>The US stock market and economy are the strongest worldwide, largely in part to our willingness and ability to blunt the COVID impact with massive fiscal stimulus.</u>**



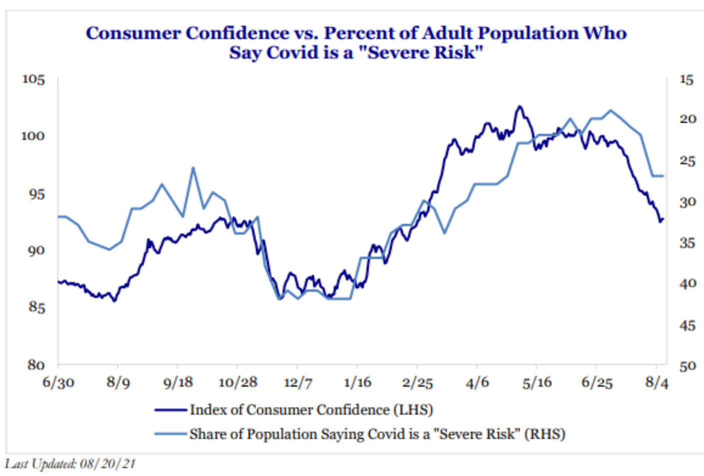
Source: Renaissance Macro Research, Haver Analytics

The US economy continues to outperform the rest of the world and has powered the US stock market's share of the MSCI World Index to cycle highs. Economists are lowering Japan's 2021 GDP forecast, due to the discussion of hard lockdowns. China's production has slowed dramatically due to COVID, while the country simultaneously grapples with President Xi's attempts to blunt income inequality through his "common prosperity" policies. Asia's composite PMI plunged to 47.4%, and Evercore ISI's survey of company sales in China hooked down to 52.3. As COVID cases wane, ex-US economies could see a short-term relative resurgence, providing tactical opportunities. Regardless, we expect the US economy to continue to outperform over the long term.

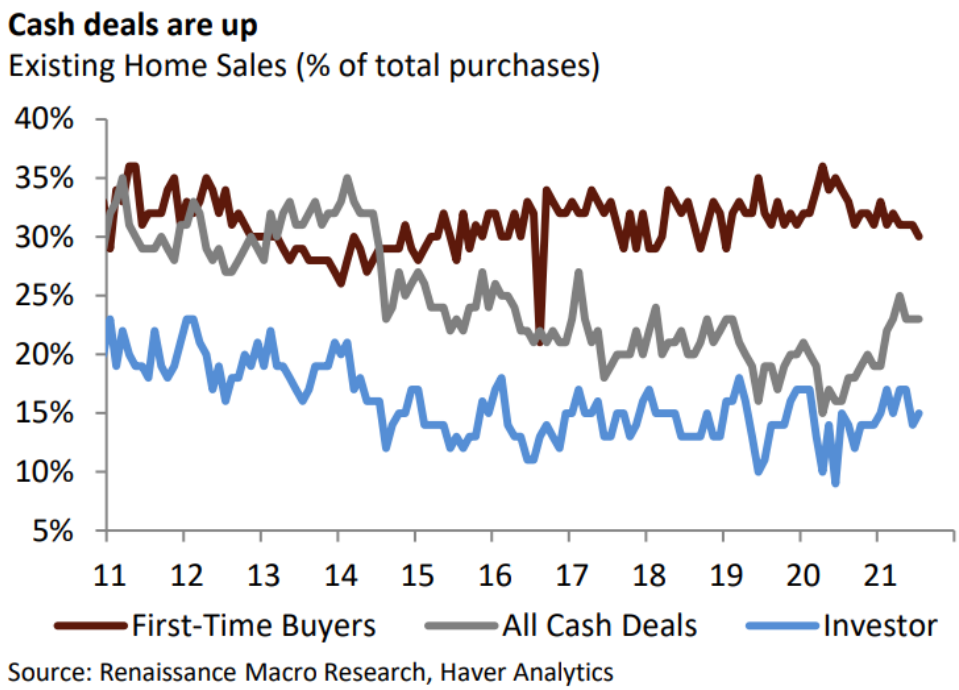
8. **<u>US mobility has softened alongside the spread of the delta variant, but consumption has remained seasonally strong.</u>**



The combination of a novel and misunderstood virus, rampant misinformation, distrust of the government, and inconsistent guidance from public health authorities has resulted in unpredictable economic responses to COVID. A wide range of reactionary behavior is evident, with some still wearing a full suite of PPE in public and others shunning social distancing and returning to pre-pandemic behavior. The resulting mixed demand response is pushing GDP growth out further and contributing to transitory inflation. TSA travel data have drifted down, and restaurant reservations on OpenTable have weakened slightly in the U.S. As previously discussed, net demand has not fallen, but it has shifted. This intuitively aligns with the bifurcated response to the spread of the delta variant. Those who react with extreme caution are shifting their consumption to durable goods while the remainder are exercising pent-up demand on travel and services. The important factor for the US economy is that the level of consumer spend continues to increase.

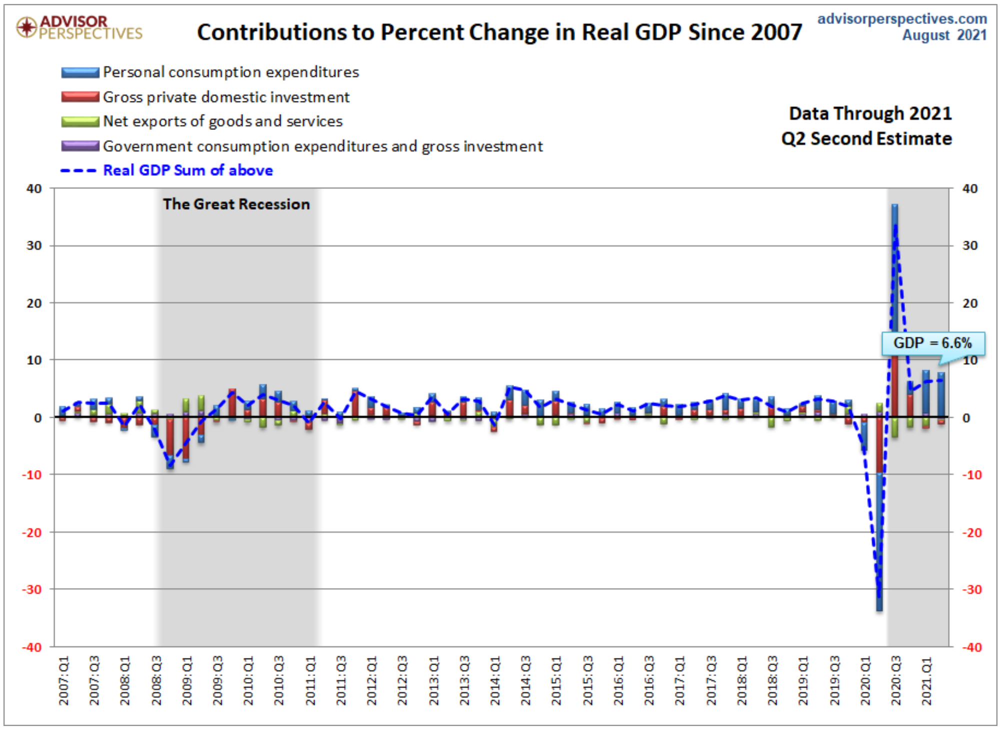


9. **<u>The housing market has slowed its rate of price appreciation and sales growth, but the underlying dynamics remain incredibly strong.</u>**



Home demand has stalled as pending new home sales fell -1.9% in July. The culprit is most likely deferred sales of new homes by homebuilders. Existing home sales were up 2% in July, led by an increase in all-cash deals. US Housing starts declined 7% M/M in July, likely a result of supply constraints. Regardless, housing fundamentals- mortgage rates, income growth, affordability, and sentiment- still look positive for an upturn in late 2021 and 2022.

10. **<u>Q2 GDP growth was 6.6%, reflecting an economy still running above trend in pursuit of a full recovery, but economists are talking down Q3 due to COVID and supply constraints.</u>**



Real gross domestic product (GDP) increased at an annual rate of 6.6 percent in the second quarter of 2021, according to the "second" estimate released by the Bureau of Economic Analysis. In the first quarter, real GDP increased 6.3 percent. The update reflects upward revisions to nonresidential fixed investment and exports that were partly offset by downward revisions to private inventory investment, residential fixed investment, and state and local government spending. Imports, which are a subtraction in the calculation of GDP, were revised down.

The "Strategas Leading Indicator of Manufacturing" (SLIM) survey indicated weaker new orders and extremely stretched supplier delivery times in its mid-August print. Automotive News is reporting that "Toyota, GM, Ford, and VW all said production would be crimped in the coming weeks due to a shortfall in semiconductors." U.S. industrial production rose +0.9% m/m in July, pulling the operating rate up to 76.1%. The Atlanta Fed's tracking estimate for 3Q U.S. real GDP is at 3.7% q/q A.R. Inventories are moving further behind final sales. Eventually, they will need to be rebuilt, and when they are, they'll provide a substantial lift to top-line GDP growth, a positive for manufacturing.

Capex intentions remain strong, yet concerns over stagflation are increasing. Economic bottlenecks are lasting longer than expected, and there have been new disruptions in 3Q from harsh weather and new auto plant shutdowns. Consumer confidence fell in August, but we expect inventory rebuilds to help normalize any consumption volatility.

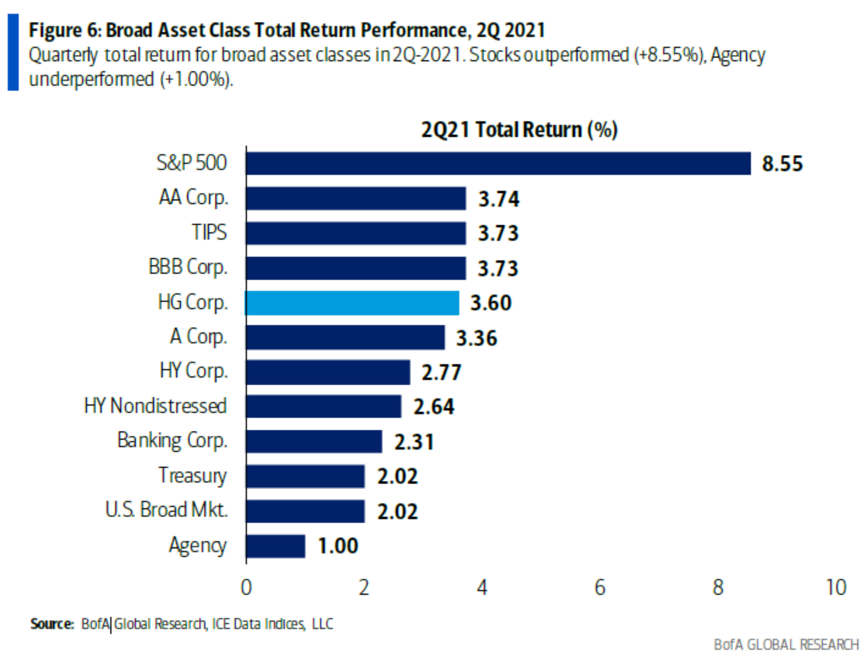
RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Julie Barranco

When we last met in early June, we spoke of the difficult trading environment that fixed income managers were experiencing as interest rates were heading lower and credit spreads remained at tight levels. Yields on the long end of the curve were declining, with the 10-year Treasury yield moving from 1.60% early in the month to roughly 1.47% at the end of the month. Most of this decline was attributed to weaker than expected employment data for April and May, even as inflation was running hot. With equity markets performing well during the month, credit spreads remained strong. High-grade outperformed high-yield for the month due to its longer duration profile which was a benefit as long end rates moved lower. The chart below shows a summary of returns for the quarter ended June 30:

2Q-2021 returns



Source: BofA Global Research

For the quarter, equities provided the best returns by far, with the S&P 500 returning over 8.5%. Within fixed income high-grade credit outperformed high-yield, again partially due to the longer duration profile. Treasuries and government-related securities returned the least.

Into July, economic data was a little more mixed relative to expectations as opposed to the strong data prints earlier in the year. Additionally, a global surge in Covid-19 cases driven by the Delta variant was cause for concern. A return to mask mandates and social distancing in some areas led to a further decline in interest rates, and risk assets traded mostly weaker during the month. Inflation data came in notably higher than consensus yet again, with the year-over-year CPI moving to 5.4%. Food, energy, hotel, and airline prices were the biggest movers. Retail sales were solid for the month as well. At the same time, consumer confidence readings dropped a bit, as did industrial production data for the month.

By month end, five-year Treasury yields declined 20 basis points to .69%, while ten-year Treasury yields declined closer to 25 basis points to 1.22% as investors seem to be questioning whether the robust growth in the first half of the year could continue through the rest of the year. Credit spreads widened a bit during the month, but the spread on the IG Index was still near the low end of its range at 92 basis points.

For the month of July, equities continued to be the best performing asset class, returning roughly 2.4%. Within fixed income, Treasuries produced the highest return at 1.34%, closely followed by high-grade credit at 1.21%. High-yield returned only .36% for the month as weaker credit spreads and the shorter duration profile did not benefit this sector.

August started off with rates remaining near their lows following the July 28th Fed meeting that really provided no new information. The FOMC statement hinted at getting closer to tapering of their monthly bond purchases but did not indicate a start date earlier than late 2021 or early 2022. While Chairman Powell did recognize the uncertainty around supply constraints driving recent price pressures, he stuck with his transitory inflation theme for the most part and also downplayed the economic risk of the Covid Delta variant.

The July employment data released early in the month surprised to the upside and led to a significant move higher in rates. A few days later, the monthly inflation data was released, with the CPI coming in strong but not overshooting the consensus as it did the month before. The monthly PPI came in higher than expected and led to concerns about inflation at the wholesale level, further feeding into consumer prices. A big downside miss for August Consumer Sentiment led to a downward move in Treasury yields mid-month.

The latter half of August included the minutes from the FOMC July meeting being released as well as the annual meeting in Jackson Hole. Overall the message from the minutes was as expected – most of the officials agreed that reducing the pace of their bond purchases this year was warranted as they were closer to reaching their inflation and unemployment goals. Chairman Powell’s speech at Jackson Hole basically reiterated these points, along with the statement that the Committee would be in no hurry to begin raising interest rates once the tapering was completed. Therefore, we believe it’s likely they could announce a formal plan at the next meeting in late September and begin tapering purchases before the end of the year.

For the month, equities were by far the best performing asset class, returning over 3%. Within fixed income, high-yield performed the best, returning .55%. Government securities were slightly negative for the month, while high-grade corporates returned -.20% as interest rates rose and credit spreads remained flat.

September is often a sluggish month for the markets. After a weak employment report showing only 235,000 jobs added versus the consensus of 733,000, and the unemployment rate declining slightly to 5.2%, rates sold off a bit, and the curve steepened. The corporate new issue market has been strong coming back from the holiday weekend, as is typically the case; roughly $60 billion was issued the first two days that week and credit spreads have held steady so far. The upcoming Fed meeting, as well as debt ceiling concerns, are factors that could affect the markets during the latter half of September.

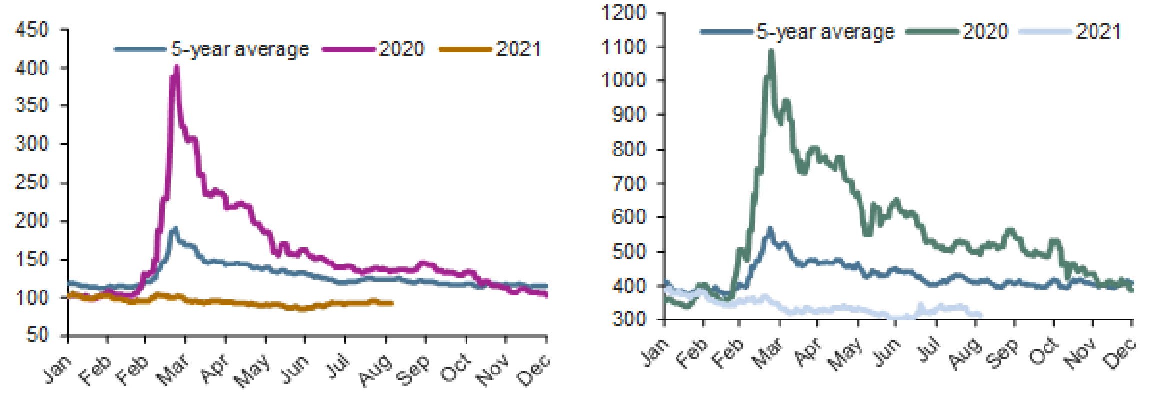
We are closing out the current quarter with essentially the same issues that we were concerned about last quarter. Inflation is still on investors' minds despite the transitory nature that the Fed insists is still the case. Issues remain within the supply chain in more than one industry, while labor demand is still high. These concerns, along with rise in Covid cases throughout the summer, have fed into growth expectations. Interest rates have declined and remained at fairly low levels for the last couple of months, and we have seen more than one economist lower their growth projections for the remainder of 2021 and 2022.

Credit markets have seen spreads remain narrow. While in general, spreads are a bit wider than earlier in the summer, overall, they remain near historically tight levels. This is the case within high grade credit as well as high yield credit. Issuance has been slower overall as many companies have gotten their financing needs taken care of. Concessions have been minimal as there has been plenty of demand for any new issues that have come to market. We have also continued to see companies exercising their make-whole call options on shorter end debt as yields have remained extremely low. We have had several issues called over the summer and have struggled with reinvestment options while seeing our portfolio duration lengthen.

The charts below depict credit spread movement for 2020 and year to date 2021, as well as the 5-year average:

US Corporate Bond Indices (OAS)

US High Grade Corporate Master Index	US High Yield Master II Index



Source: BofAML Indices (C0A0), CreditSights

Source: BofAML Indices (H0A0), CreditSights

	Sep 3	Change (bp)				Sep 3	Change (bp)		
	2021	Week	MTD	YTD		2021	Week	MTD	YTD
High Grade	92	0	0	-11	**High Yield**	314	-3	-7	-72
Financials	80	0	0	-9					
Industrials	95	-1	-1	-12					
Utilities	108	-1	-1	-11					

Source: CreditSights

With rates having moved lower since our last meeting, particularly on the longer end of the curve, our activity within the fixed income portfolio has been fairly light. Within the corporate sector, we have added some secondary positions, mainly in shorter maturities that still offered a decent spread. Issues purchased include Occidental Petroleum, Dish, Ford, Citigroup, and Bank of America, to name a few. All of these purchases were offered at attractive spreads within their sectors and allowed us to add yield without a large amount of credit risk. The new issue calendar was slower through July and August, as is often the case; however, we did participate in a handful of new issues throughout the summer. Corporate spreads have remained tight and fairly stable, as we previously discussed; while they have widened marginally in the last several weeks, we don't see any major cause for concern at this point; however, we are monitoring levels closely. We continue to be overweight the credit sector, with a shorter duration position than that of the Index. We will continue to look for attractive names/maturities to selectively add to the credit sector, particularly if we get any further weakness in spreads that provides an opportunity.

In the agency debt sector, we have seen spreads remain stable and fairly tight. After a brief move wider back in the spring, spreads have steadily narrowed and are close to their pre-pandemic levels. We had one maturity last month, and we chose to let those funds be reinvested into the mortgage portfolio as that sector offered a better spread than agency debt. Because spreads continue to be fairly small within this sector, we have found it prudent to invest cash within the credit and mortgage sector more so than the agency sector. We would expect any upcoming trades to be maintenance type trades to replace a call or maturity, or perhaps a swap to adjust interest rate risk. We currently do not anticipate adding any significant new money to this sector, given the tightness of spreads versus Treasuries.

Spreads have remained fairly stable within the mortgage sector as well. With rates continuing to decline since our last meeting and the Fed continuing to buy mortgage securities outright, the mortgage sector has performed well. Prepayments have slowed some in more recent months, but overall remain remain at healthy levels. If the Fed begins to taper their Treasury and mortgage purchases later this year as expected, we may see spreads widen a bit. Activity within this sector has included purchasing FNMA, and GNMA 2.5% 30-year pools, These purchases were made to reinvest prepayments and to raise weightings in these coupons as well as the sector as a whole. Additionally, the Fed has been a large purchaser of these coupons from time to time, which has aided performance. Despite adding money to the sector, we are still underweight versus the index, and therefore have room to add to the sector when opportunities arise. We will also continue to monitor interest rate movements and adjust duration as needed.

Lastly, within the Treasury portfolio, we added a 9-year maturity; at the time, we were a bit underweight that part of the curve versus the Index and wanted shore up the weightings. Additionally, we executed a swap selling a lower coupon 2027 issue and purchasing a higher coupon 2027 issue to adjust duration while keeping our sector weighting stable. We continue to be underweight the index, and our duration is a bit lower than the index, which we think is prudent at this time. We continue to watch yield levels closely and will adjust our Treasury positions and duration as needed.

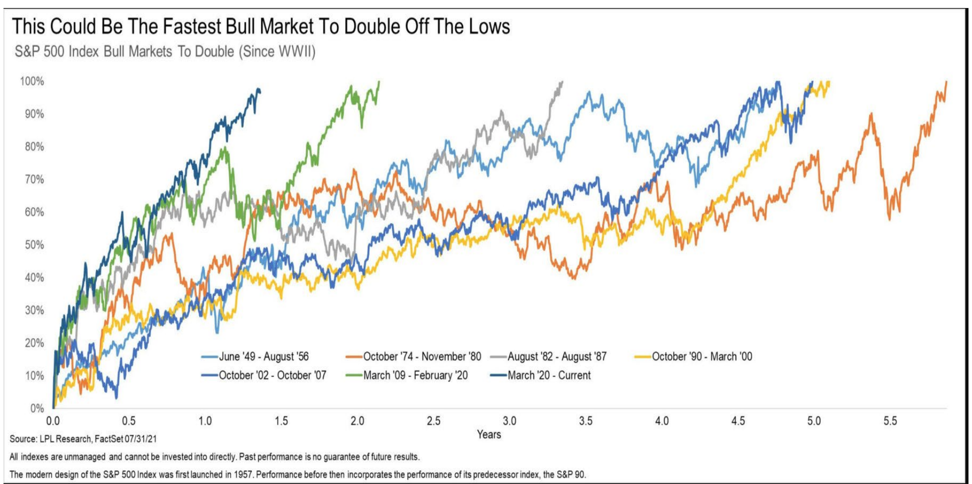
Domestic Equity Strategy

By Adam Rogers

Market Activity

U.S. markets continued their grind higher over the summer, and despite a handful of both positive and negative disruptions, volatility diminished, and apathy towards equities prevailed for much of the season. Earnings across the board have been stellar, and capital seems to be everywhere as record-high profits and cash balances abound in report after report, with 2Q being one of the best "beat and raise" earnings seasons ever. Meanwhile, valuations have soared. The recovery off the lows in 2020 has been faster than any since WWII, as the unprecedented transfer of wealth from government to corporates and households flooded the economy with capital, enabled by our endlessly dovish Federal Reserve.

Exhibit 1: Fastest double

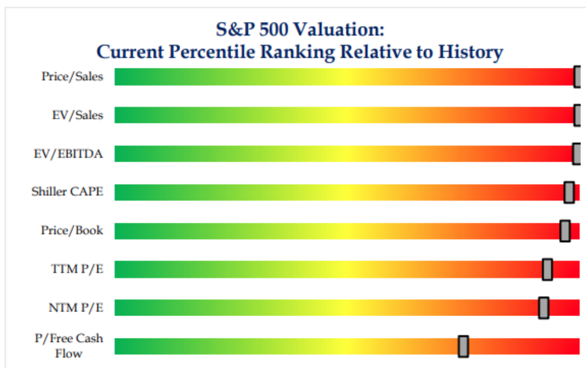


With global growth now showing hints of slowing and Fed tapering on the horizon, the easy conclusion is that this market has likely run its course for now. How long can this go on? Any time the market has made a big run, this is the most obvious question on people's minds. So we will address where we are in the cycle using four indicators that have been consistently helpful in the past: **extreme valuations relative to interest rates, euphoric investor sentiment, problematic inflation, and tight monetary policy**. If U.S. equities are cycling into a bear market, one or more of these will be flashing warning signs. We'll start with valuation and sentiment, then try to understand a murky inflation picture, finally ending with the most important factor, Fed activity. The reason it all comes down to the Fed is that, for better or worse, their massive balance sheet expansion has essentially cornered the bond market and crowded others into riskier assets. The TINA (There Is No Alternative) trade continues to dominate allocation decisions with the U.S. 10-year treasury trading at the equivalent of 75x earnings. Forecasting the Fed has become more crucial than ever.

Valuation

Beginning with valuations, we'll concede that the alarm bells should be ringing, judging equity market valuations at face value.

Exhibit 2: Stretched Valuations

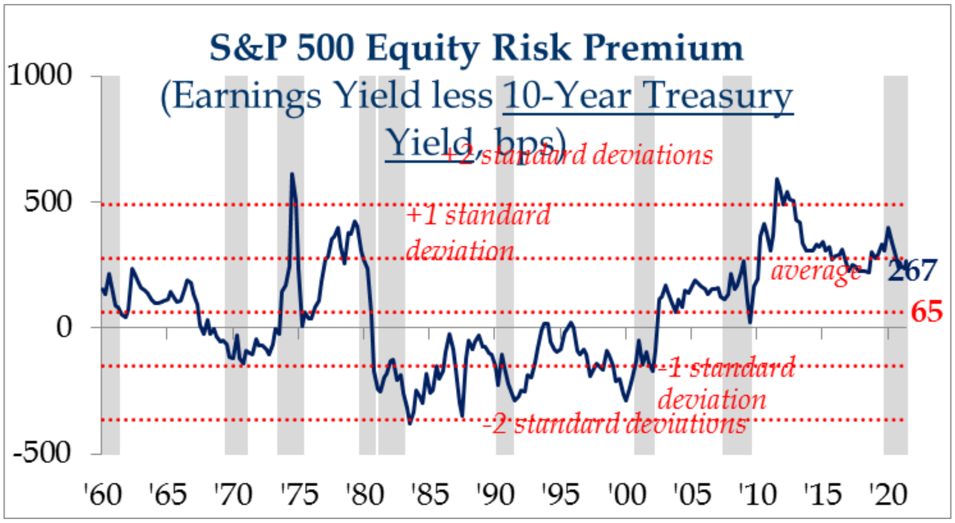


Source: Strategas

However, valuations outside this vacuum paint a different picture. Interest rates play a large part in determining whether equities are "overvalued" or not. Using a simple comparison of dividend yields and 10-year treasury yields as an example; at the top of 2000, the S&P Dividend Yield was around 18% of the US 10-year yield. In 2007 it was 37%. In those cases, the dividend yield on equities was much lower than the risk-free 10-year. Today, the ratio of S&P dividend yield/US 10 year is 106%, a stark contrast to those previous "overvalued" tops.

The equity risk premium is another contextualized measure, and despite face value levels being elevated, the S&P earnings yield minus the 10-year treasury yield is still roughly 1 standard deviation higher than its long-term average, suggesting equities are cheap relative to interest rates.

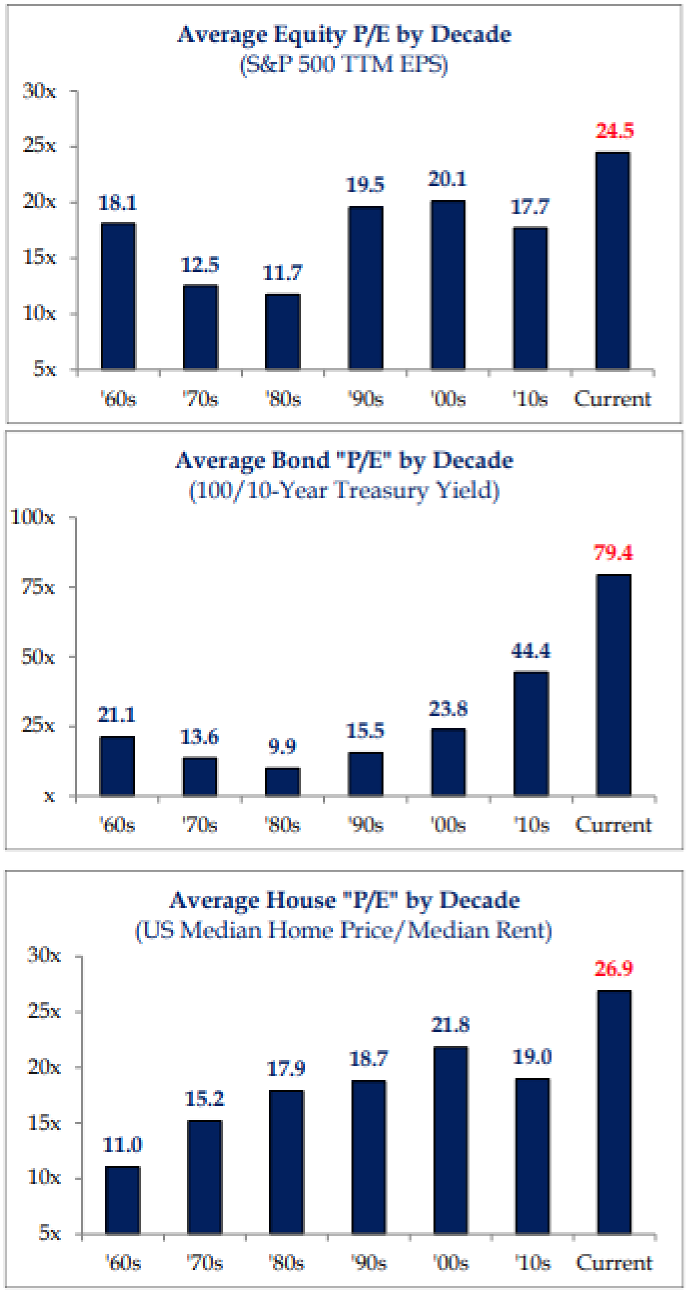
Exhibit 3: Equity Risk Premium



Source: Strategas

The chart below conveys the environment more clearly. While equities may be expensive relative to history, relative to bonds and housing, they are the cheaper alternative.

Exhibit 4: Relative Valuations



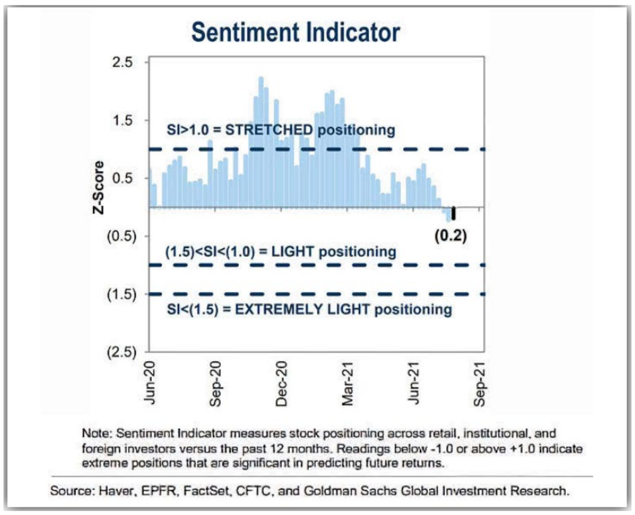
Source: Strategas

Our conclusion then remains the same as it has been for much of the recovery. Stocks are not cheap relative to history, but they are still attractive on a relative basis. The interest rate environment is crucial, which is why inflation and fed response are so vital to the near-term outlook.

Sentiment

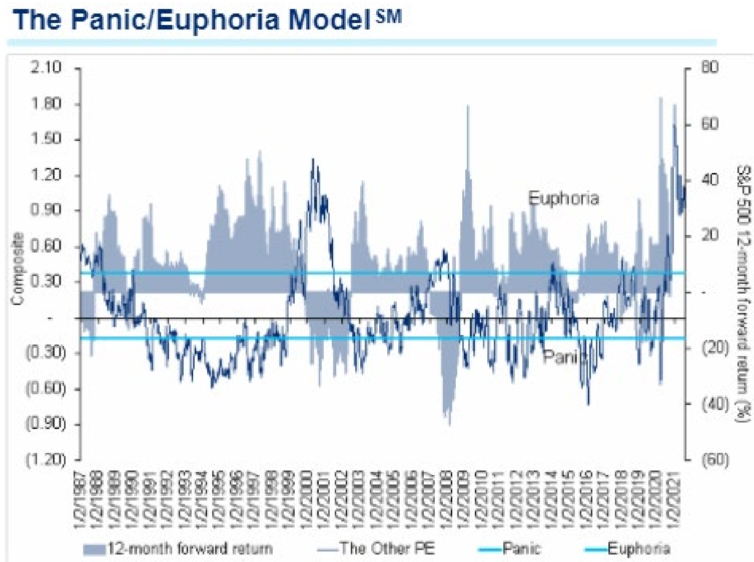
This is always a difficult topic to measure with any certainty as anecdotes and data collide. Sometimes everything lines up and tells the same story, but today that isn't the case. For example, the Goldman Sachs Sentiment Indicator, a shorter-term tool that measures equity positioning, shows a current reading of "light," implying equity investors are wary of having too much exposure.

Exhibit 5: GS Sentiment Indicator



On the other hand, Citi's Panic/Euphoria model, a metric combining short interest, margin debt, fund flows, gas prices, and derivative activity to gauge sentiment, has been firmly in "Euphoria" territory for months now.

Exhibit 6: Citi's Panic/Euphoria Model



Other sentiment clues: The AAII bear reading recently jumped to its highest level in months, and the VIX curve suggests hedging activity is picking up and sentiment is cooling. Wall street strategists are also growing nervous.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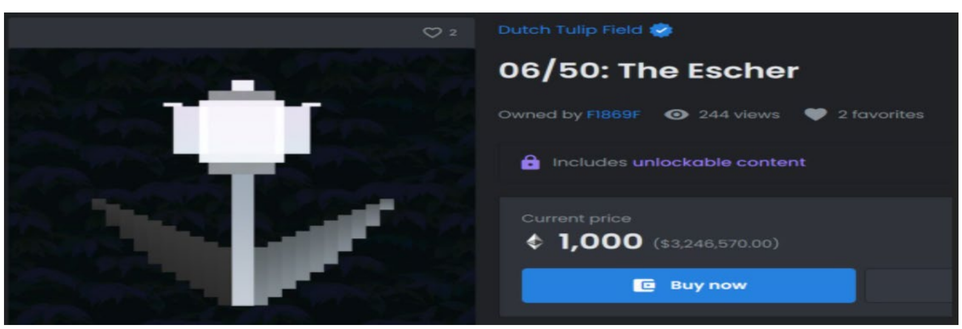
More Strategists Say a Storm Is Brewing in the U.S. Stock Market

- 'Global stock markets may be entering a period of turmoil'
- Calls for market volatility are growing louder on Wall Street

Ironically, these examples of nervousness are happening at the same time people are buying virtual pet rocks for $500k, or this tulip NFT which can be yours for the low, low price of $3.2 million.

Exhibit 7: NFT Mania



Anecdotes of hysteria abound in the NFT world, and while we don't dismiss the signal, there have been similar mini bubbles over the past year (SPACs and Hydrogen come to mind) that have since burst and left no trace of damage to the broader equity indexes.

Bitcoin in July had fallen over 50% from its high in April, wiping out some of the euphoria while equities trudged slowly higher over the same period. What we're looking for is unmistakable equity market euphoria, but as of right now, the picture isn't clear. Given the mixed signals and difficulty determining a concrete standing for sentiment, our conclusion is to chalk this indicator up as neutral for the time being.

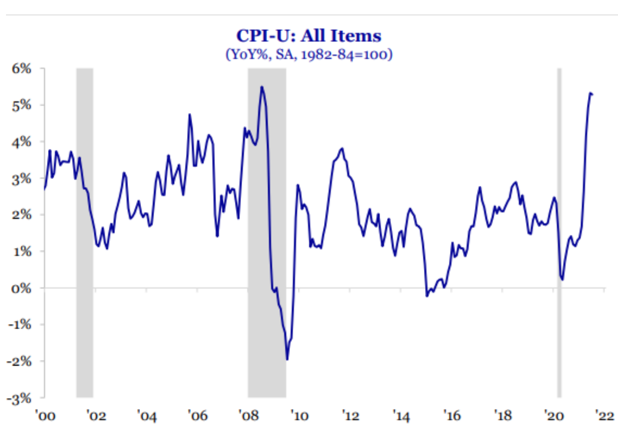
Inflation

Next, we move on to inflation measures, which have been elevated recently, driven by sudden shocks in a few key areas (sawmills, port congestion, semi-conductors, etc…). We think the Fed is likely correct that these components of inflation will prove to be transitory and that base effects make the headline numbers appear more worrisome than they are. However, wages and rents are also picking up speed, and these are usually sticky. With so many moving parts over the past year, the financial community is having a difficult time reaching a consensus on where we stand, as base effects, bottlenecks, a demand shock, and Covid variants are clouding the picture.

To be clear, what we're looking for are late-stage expansion signals where some combination of wages, oil prices, and inflation expectations steadily accelerate to worrisome levels. The pandemic and subsequent stimulative response have created short-term supply/demand imbalances, which makes this a more difficult exercise with many variables. For our purposes here, we will simplify and break it down to headlines, bond market beliefs, wages, and Fed forecasts.

The official numbers are unmistakably bad, but most of the extreme price increases have come from pockets most affected by Covid. The Fed's preferred measure of inflation, the PCE, is at the highest level since 1992, while headline CPI is at 5% for the first time since the 2008 oil spike.

Exhibit 8: Headline CPI



Interestingly, the markets haven't reacted negatively to the headlines. Most market participants are likely banking on the fact that what we're witnessing in the short term is a result of simultaneous demand and supply shocks. On the demand side, Covid created a boom in demand for consumer and household goods, as can be seen in the chart below.

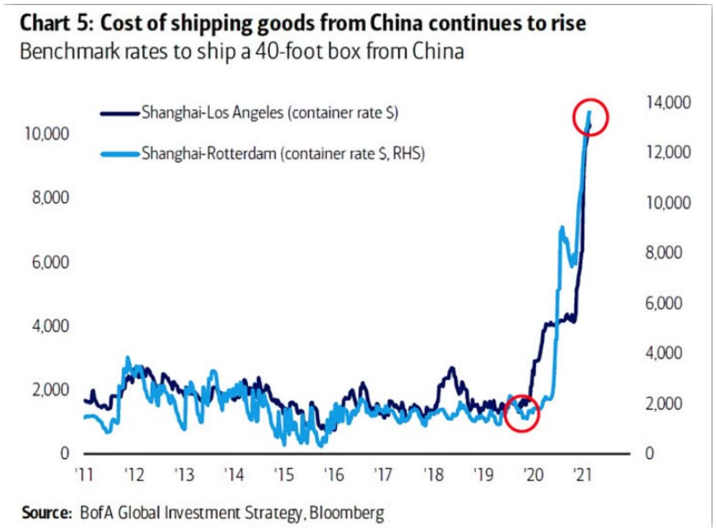
Exhibit 9: Spending Frenzy

Figure 20: The current strong sales level goes well beyond "pent-up" demand with the boom over the last 12 months dwarfing the shortfall last year due to closures and disruptions

Source : Census Bureau, Haver, Deutsche Bank Asset Allocation

Covid has also wreaked havoc on supply chains with port congestion, quarantined workers, and lockdown restrictions going on at the same time demand for products is skyrocketing. This imbalance has led to soaring container rates for goods coming out of China, a cost that brick and mortar and e-commerce retailers then try to pass on to consumers.

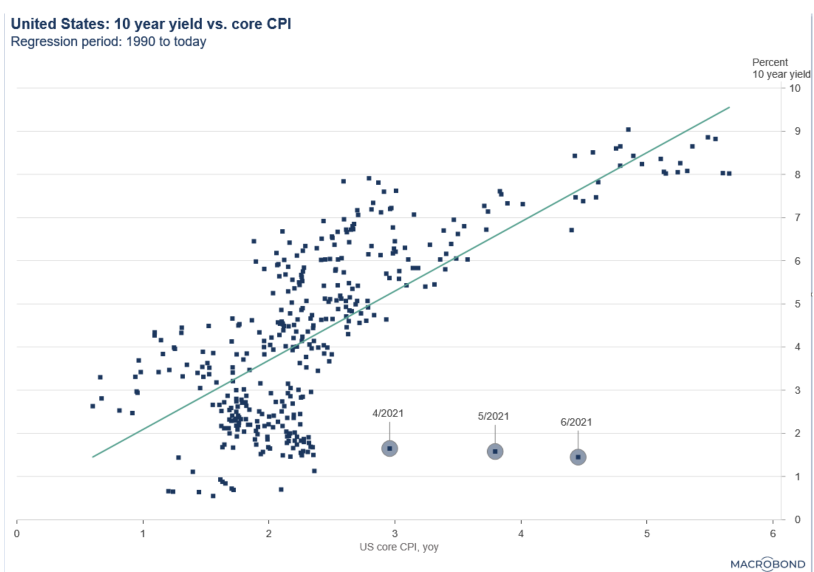
Exhibit 10: Supply Shock



We doubt this is the new normal in the same way that $50 for a sheet of plywood wasn't the new normal. Supply constraints will ease, demand will return to trend, and a good portion of the inflation pressures of the past few months will prove to be short-term anomalies.

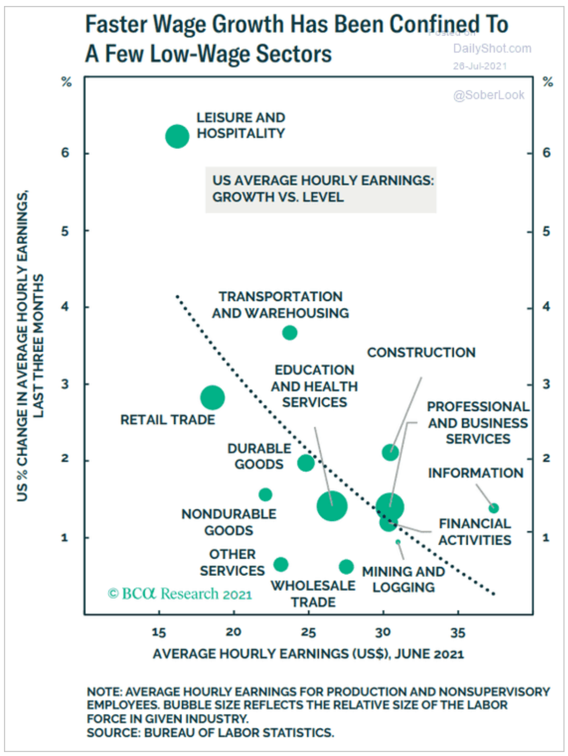
The bond market tells the same story. The chart below shows how the correlation between the 10-year and Core CPI has completely broken down (the July and August dots would be right there with June). Either interest rates are coiled and set to rocket meaningfully higher, or Core CPI is set to revert lower – we would bet on the latter.

Exhibit 11: Yields and CPI Dislocation



So, we've established that there are transitory components to inflation which both the Fed and market agree will be resolved. Wages, however, are also ticking higher, particularly towards the lower end. Currently, 50% of small businesses have unfilled positions, and companies are raising pay to attract workers, with job openings at multi-decade highs. Early in the pandemic, lower-wage workers fell out of the labor force, which distorted wage numbers. Now, as the lower end is coming back, they are demanding and receiving higher pay, particularly in the Leisure and Hospitality space. Much of the rest of the labor force is still seeing sub 4% growth in earnings, especially near the upper end.

Exhibit 12: Wage Growth

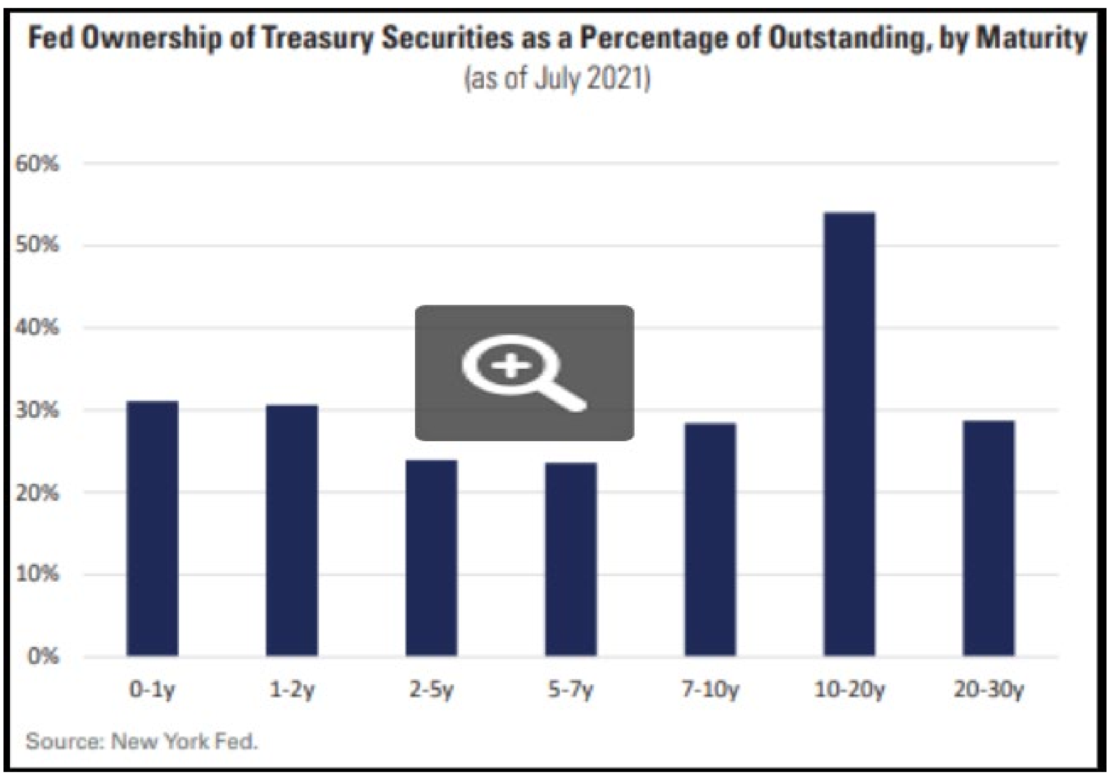


Fed Activity

How is the Fed interpreting this uneven data? From 1951 to 1970, William McChesney presided as Fed Chair and famously quipped that it was the central bank's job to "take away the punch bowl just as the party gets going." Last year at Jackson Hole, Fed Chair Powell unveiled a new approach, just as the economy was coming out of the pandemic lockdowns of 2020 and after a decade of below-trend growth and stubbornly below-target inflation. The idea being that the Fed should err on the side of extreme accommodation and looseness, attempting to push unemployment down to levels previously thought unreachable while letting inflation overshoot its 2% target to bring up the long-term average.

This year at Jackson Hole, the Fed Chair sounded pleased with their efforts and maintained his stance that transitory inflation components will ease. The Fed is forecasting PCE of 3% for this year and 2% for 2023. Taper plans have been put on hold for a few months, with the base case being a November-December start while rate hikes are off the table for the rest of this year. QE has been going on for a long time, and the Fed balance sheet has more than doubled to over $8T over the past couple of years. The Fed is now the majority owner of treasuries, holding over 50% of the 10-20y issues. They are relentlessly accommodative and will not be murdering this market in the near term. Tapering and rate hikes are on the horizon, though, so we will be carefully monitoring the market response next year should that unfold according to the Fed's plan.

Exhibit 13: Fed Dominance



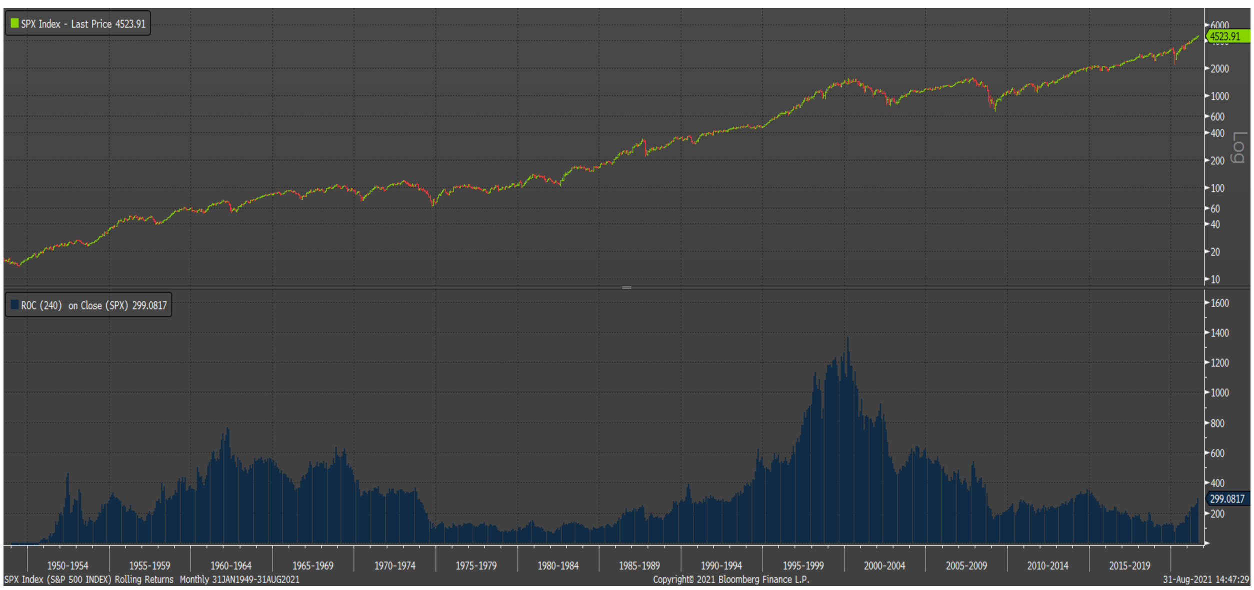
Summary and Reasons to be Optimistic

- Equities have doubled off the pandemic lows following unprecedented fiscal and monetary accommodation. Consumers are flush with cash, and jobs are plentiful.

- Valuations are rich across every asset class relative to history, though interest rates are also extremely low relative to history.
- Sentiment towards equities is mixed with enough of a wall of worry to keep full-fledged euphoria at bay.
- Inflation is bumpy and uneven, with transitory components likely to ease and wages rising in concert with Fed hopes.
- The Fed remains accommodative.

As of this writing, the S&P500 is up roughly 35% for our fiscal year. We've repeated many times here some version of the saying "time in the market beats timing the market," and this year was no exception. As a pension fund, time in the market is our greatest advantage and affords us the luxury of making asset allocation decisions with the long-term in mind. As strong as this market has recently been, the 20-year rolling return remains in average territory.

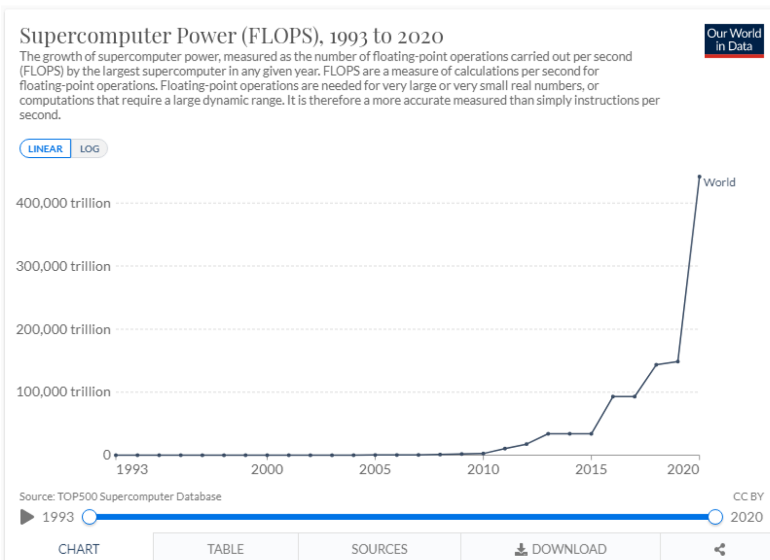
Exhibit 14: Rolling 20 Year Returns

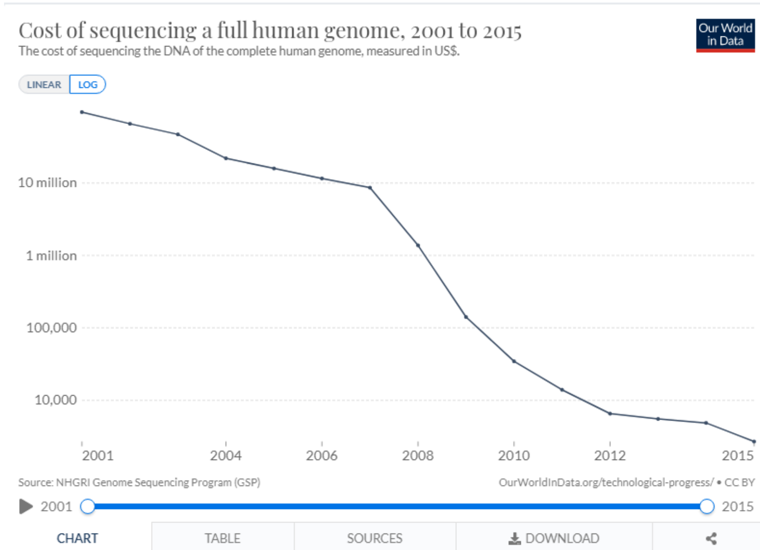


Final Thought: From Kitty Hawk to Mars

"The optimist always wins" is an old reliable adage, useful for life and investing. On December 17th, 1903, the optimistic Wright brothers, after four years of experiments, achieved humanity's first successful flight. Now, 118 years later, NASA's Mars Helicopter Ingenuity, carrying a postage stamp-sized swatch of fabric borrowed from the Kitty Hawk plane, is exploring the red planet from the air. Amazing. Technology and human progress are growing on an exponential curve as each new technology enables even newer technologies to be built afterward, compounding year after year. New companies and even industries arise as a result. Google, Facebook, and Amazon didn't exist when I was a child. Now they are three of the biggest companies in the world. What companies will dominate 20 or 30 years from now? History tells us it will likely be a completely different cohort operating in spaces we don't have a good handle on just yet (Artificial Intelligence, the Metaverse, Quantum Computing, Fusion Power, etc…). We can only imagine at this point, but it's fun to think about. Perhaps it's not a stretch to imagine that the world our children and grandchildren create will seem just as magical to us as ours would seem to the Wright brothers. The ride from here to there won't be perfect. We will certainly have pullbacks and consolidations, but we are confident that over the long-term, equities will remain the best way to capture our productivity and technology advancements.

Exhibit 15: Compounding Progress




Cost of sequencing a full human genome, 2001 to 2015
The cost of sequencing the DNA of the complete human genome, measured in US$.
Our World in Data
LINEAR
LOG
10 million
1 million
100,000
10,000
2001
2004
2006
2008
2010
2012
2015
Source: NHGRI Genome Sequencing Program (GSP)
OurWorldInData.org/technological-progress/ • CC BY
2001
2015
CHART
TABLE
SOURCES
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International Equity Strategy

By Steve Lambdin

Global equity markets delivered strong gains in the second-quarter as economic growth accelerated. Robust earnings growth and positive news on the COVID-19 vaccination front propelled many markets to fresh new highs. In addition, stimulus measures by the various central banks around the globe continued at an unprecedented pace, which helped keep interest rates supportive for growth. Most key economic data points and sentiment measures tracked higher in the period. Global growth estimates were revised higher, with the continued global re-opening leading to the best growth rates in nearly 50 years.

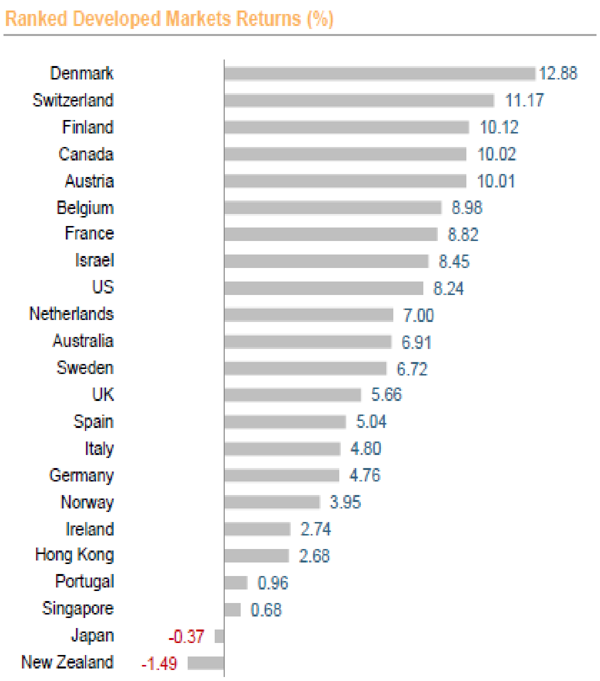
Thus far, the various COVID-19 variants we have seen have not derailed the global re-opening but rather pushed things out and to the right a bit. This led to a reverse in equity leadership in the quarter, with growth stocks outperforming value and bonds registering a positive return in the quarter. News flow out of the U.S. Federal Reserve (FED), the Bank of Japan (BOJ), and the European Central Bank (ECB) seemed to be well received and had no major surprises to shock investors. Also, trade discussions between the U.S. and China, as well as with the European Union (EU), were relatively quiet albeit progressive in the quarter. We expect to see further progress on vaccination efforts around the globe in the coming months, especially in emerging markets. If successful, this could push the global equity markets to even further highs.

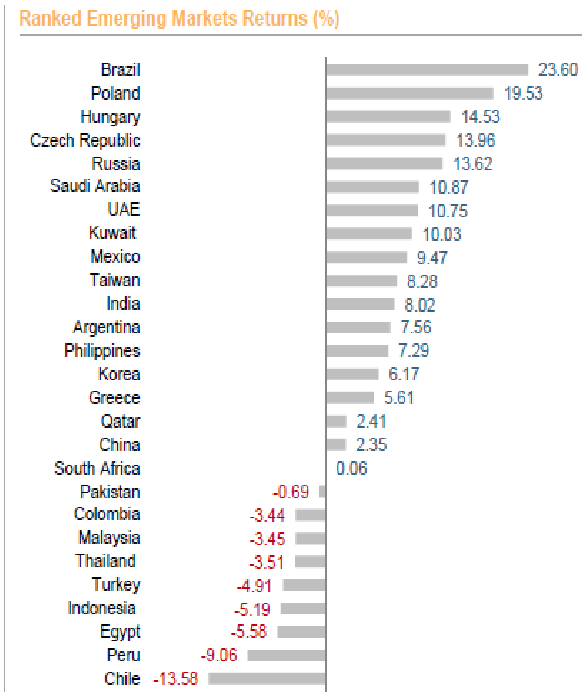
	June 2021		2Q 2021		YTD 2021	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	2.3	2.3	8.5	8.5	15.3	15.3
MSCI ACWI	1.3	2.1	7.4	7.1	12.3	13.4
MSCI ACWI ex USA	–0.6	1.3	5.5	4.7	9.2	11.5
MSCI World	1.5	2.3	7.7	7.6	13.0	14.2
MSCI Emerging Markets IMI	0.4	1.1	5.7	4.5	8.7	9.3
MSCI EAFE	–1.1	1.4	5.2	4.8	8.8	12.7
MSCI Europe	–1.4	1.6	7.4	6.5	11.8	14.5
MSCI Pacific	–0.7	1.0	1.3	1.9	3.9	9.8

Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +5.2% and +5.7%, respectively, during the second quarter of 2021, versus +8.5% for the S&P 500 Index. Investors remained more comfortable with U.S. stocks as economic growth looks higher in the U.S., along with a very accommodative FED as a tailwind. The U.S. dollar fell slightly in the quarter, which helped returns by +0.40% for unhedged U.S. investors. The European region was much stronger than the Asian region as the Japanese equity market was a severe laggard due to the region's COVID-

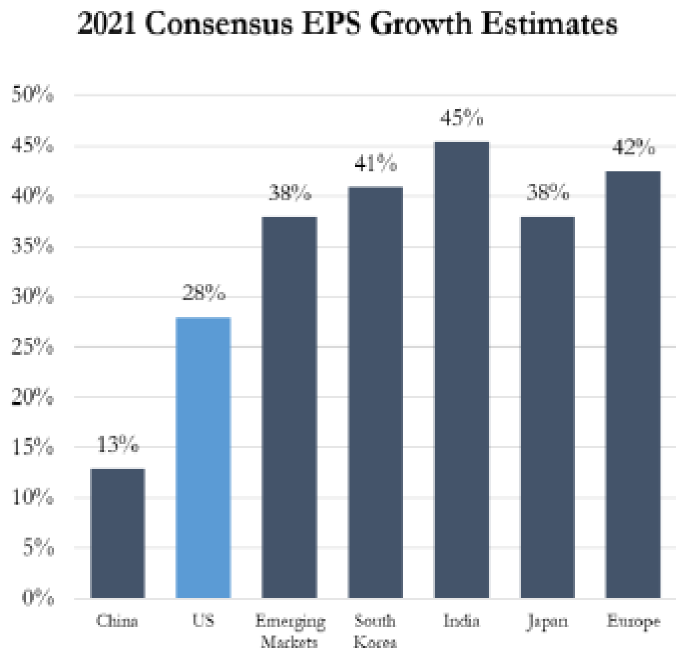
19 outbreaks resulting in more localized lockdowns. Ten out of the eleven sectors of the MSCI EAFE Index had a positive return, led by health care, technology, and consumer staples. Also, commodities were very strong in the period as the Bloomberg Commodity Index rose +13.3% in the period, led by crude oil's rise of +24%. Consumers are beginning to feel the pinch at the pumps.





Sources: Resource Consulting Group, MSCI

Quarter to date through the end of August, most global equity markets have pushed higher on the heels of very bullish quarterly earnings, healthy economic readings, and further progress on the vaccine rollout. However, emerging markets continue to struggle as the Chinese equity market has been weak from the increasing regulation of technology companies. Many of these companies have lost a significant amount of market capitalization recently. Investors will be watching developments on this front going forward. The MSCI EAFE Index is up approximately +2.5%, and the MSCI Emerging Markets Index is down -4.2%, while the S&P 500 Index leads the way, rising +5.4%.



Source: Bloomberg; Todd Asset Management

<u>Asia Update</u>

The Asian equity markets struggled relative to other major regions around the globe in the second quarter, with the Japanese equity market posting a -0.30% return. The COVID-19 vaccination rate remained very low for most of the quarter, which led government officials to delay the easing of restrictions until very late in the quarter. This led to further credibility issues with the current government officials.

Chinese equity markets were relatively weak as well as the government's crackdown on internet companies and the U.S. announcement of investment sanctions against Chinese defense companies spooked investors views toward the region.

But there were a few bright spots as the Australian equity market rose +7% as economic growth continued to surprise, resulting in the economy now being bigger than it was in 2019. Also, Hong Kong equities performed decent as stiff COVID-19 protocols were eased quite a bit in the quarter. Overall, the MSCI Pacific region rose +1.3% in the period, which was the weakest region in the MSCI EAFE Index.

The Chinese economy maintained a brisk pace of expansion after a record first quarter, with second-quarter GDP up +7.9%, in line with expectations. China continued to distance itself from the effects of COVID-19 and provide a window for what other countries can expect in a post-pandemic global economy. Estimates for growth in this economy probably need to be raised again. Growth seems very balanced with robust consumer spending and the export side of the economy having a strong outlook as the rest of the world comes out of the pandemic.

However, as good as economic growth has been, lately, we expect things to slowdown from the torrid pace of the first half. We could see more domestic spending from the other major economies around the globe pressure the large manufacturing base here. In a pre-emptive move, the People's Bank of China (PBOC) initiated a surprise cut in the required reserve ratio (RRR) to pump liquidity into the financial system to help support the economy. We believe this was probably more of a "one off" move in order to solidify the near-term outlook rather than the beginnings of a new easing cycle.

Industrial production continued to shine as June production rose +8.3% from a year earlier and an impressive +15.9% for the first half of 2021. Electrical machinery, medicine, and general-purpose equipment have been strong, while auto production has taken a recent downturn from the lack of semi-conductor supply. Fixed asset growth cooled in June but was still up +12.6% in the first half of 2021.

As mentioned earlier, exports remained strong, with June exports up +20.2% from the previous year and +28.1% for the first half of 2021. Even though this will slowdown in the months to come, we expect exports to remain strong for most of 2021 as the European and U.S. economies strengthen. While posting an +8.5% rise year over year in July, retail sales trended downward in the second quarter as the COVID-19 delta variant and flooding in central China hampered spending. Prices continued to move higher recently as July CPI rose +1.0%, which was the fifth straight month of higher prices. Prices probably won't move much over the near term as we have competing forces pushing and pulling prices now.

Going forward into the later part of 2021, we expect economic data points to continue to slowdown from current levels but remain firmly in growth territory. The real change is the willingness of the PBOC to provide support to accomplish this. This should give investors a degree of confidence in the economic outlook here over the next few months. This will have to be balanced with recent government action toward the large internet/technology companies, which could make for volatile equity markets over this timeframe.

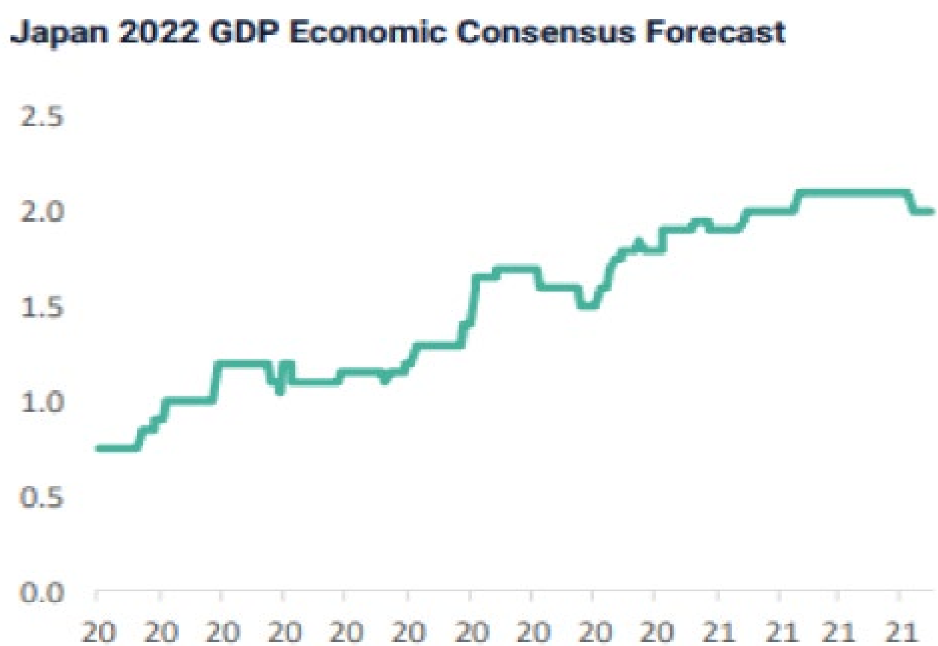
Source: Evercore ISI

The Japanese economy avoided a recession as second-quarter GDP rose +0.3% from the previous quarter or +1.3% from the previous year. Surprising consumer spending provided the strength in the economy, while inventory contribution and net exports were a drag on growth. While the news on spending was welcoming, this also led to further spreading of the COVID-19 virus. Couple this with the low vaccination rate in the nation, and you had a situation that turned into another public emergency. This pushed ratings of the Suga administration to a record low. It will be important to see how the vaccination levels improve through the third quarter and what effect this will have on the economy.

Exports continued their recent strength, as June and July were up +48.6% and +37%, respectively. This is a positive and clearly shows the rebound that is happening outside of Japan on a global scale, which can help cushion the blow from the latest lockdowns that threaten domestic demand. Automobile exports to the U.S. and technology equipment shipments to China and the rest of Asia have been robust.
Industrial production remained strong in the quarter as June rose +6.2% from the previous month, which was aided by the boost from the Olympic game. However, gains may be harder to come by going forward.

Japan's leading economic index continued to trend higher through the quarter as June's reading of 104.1 set another post-pandemic high. We believe this data point is a promising signal that Japan is on the cusp of participating in the global recovery story seen elsewhere around the globe. Also confirming this was consumer confidence reaching 37.5 in July, the highest levels since February 2020. These readings, coupled with an easing of COVID-19 restrictions and more vaccinations, should be a strong recipe for a more sustained positive outlook in the coming months.

Coming as little surprise when considering the restrictions that were in place for the bulk of the second quarter, the labor market took a setback, with the June jobless rate rising to 2.9% and the jobs-to-applicant ratio rose to 1.13. If other economic readings are an indication of what is to come over the next few months, we should see some improvement in labor statistics as well. As we move into late 2021, we see plenty of signs of improving sentiment and economic growth. By each passing week, this economy is pushing past the height of virus restrictions that have hampered growth. Therefore, we would expect a bit of catchup going forward. We just don't know how strong growth will be and whether it results in higher equity markets.



Sources: Bloomberg; Jefferies

Europe Update

There was a lot to like for investors for the second quarter across this region. The pace of vaccine roll-out accelerated throughout the period, and economic readings were generally very strong. In fact, several datapoints reached record high levels in the quarter. In addition, corporate earnings were very healthy as loosened social distancing flowed into better business activity. Travel picked up substantially through the quarter as Europeans seemed to have plenty of pent-up demand for leisure related activities. The region continued to be buoyed by the flow of various forms of fiscal and monetary stimulus. Investors digested these issues and pushed the MSCI European Index (ex. U.K.) up +7.8% in the quarter, near all-time highs. The U.S. dollar weakened against the Euro and helped returns for unhedged investors by +1.3% in the period. The equity markets in the northern Eurozone were the strongest in the quarter, with many posting double-digit returns.

The European economy emerged from recession territory as second-quarter GDP rose +2.2% from the previous quarter or +14.3% from a year earlier. The outlook gained traction throughout the quarter as pandemic restrictions were eased across many countries. Business activity flourished, and consumers seemed eager to spend. This led the Organization for Economic Cooperation and Development (OECD) to raise its growth forecast aggressively in the period. It seems like most parts of the economic puzzle in the Eurozone are firing on all cylinders.

The northern European economies showed the best growth as virus restrictions were lifted a bit quicker than their southern neighbors. The German economy was a little below average, showing growth of only +1.6% from the previous quarter and +9.4% from a year earlier. However, we expect Germany to pick-up in the third quarter as their key automotive and machinery industries are set to increase production. Eurozone industrial production fell in May and June as supply chain issues crimped the ability to produce goods. However, we expect this to reverse in the months ahead as kinks in the supply chain begin to work out.

The economic confidence index continued to move in the right direction as July rose to 119.0, an all-time. This certainly seems to indicate a powerful recovery story is developing in the region. Retail sales looked very strong as May and June sales were up +4.1% and +1.5%, respectively. There is no doubt that pent-up demand is a powerful force right now.

Prices moved higher recently as expected, with core CPI up +1.6% in August from prior year levels. However, core CPI excludes the significant rise in energy prices we have witnessed this year which is being watched by investors very closely. Consistent with most other economic readings, the July unemployment rate fell to 7.6%, the lowest level in over a year, which bolsters the growth outlook as we head into the later stages of 2021. With everything we have seen over the last few months, we expect the strong recovery to continue in the region as we move further into the re-opening phase.

Source: Eagle Global Advisors; Evercore ISI

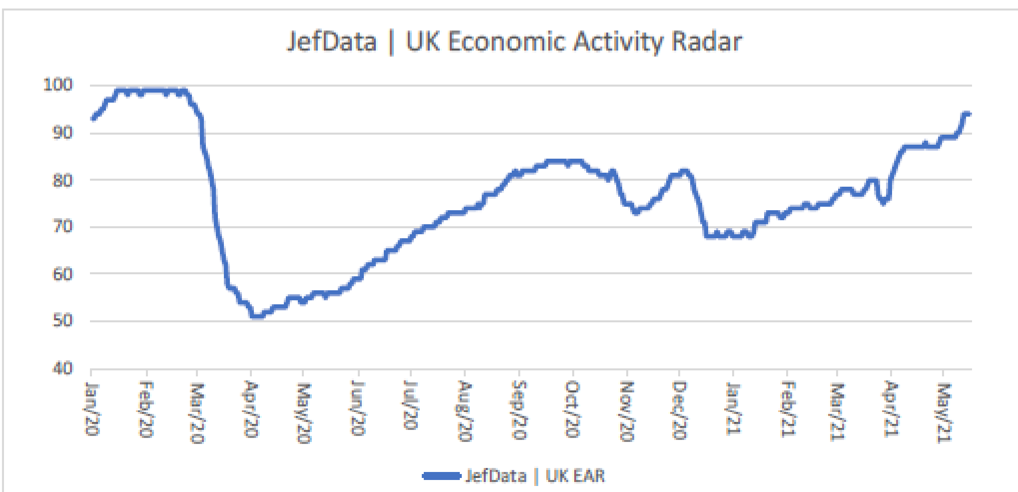
The U.K. equity market continued recent trends and posted its third quarter in a row of gains. Value and cyclical oriented shares performed the best, as small and midcap shares outperformed the large cap part of the market. Vaccination efforts continued to forge ahead, even as the government delayed the lifting of social distancing laws during the period. The MSCI U.K. Index rose +6.0% in the second quarter, a solid return considering the issues it faced here over the quarter. Healthcare and consumer staples stocks led the way as financial stocks trailed, with interest rates falling slightly in the quarter.

GDP rose +4.8% in the second quarter from the previous quarter and +22.2% from a year earlier. As a result, GDP growth expectations have been lifted for 2021 and 2022, even as growth will fall to a more normalized level over the next couple of quarters. Industrial production was a mixed bag from month to month as manufacturing remained strong while the oil and gas sector struggled. We expect this to reverse somewhat in the current quarter as inventory levels are beginning to rise. Retail sales growth cooled a bit with June sales basically flat with the previous month. This came as little surprise as May was so strong from the easing of social distancing guidelines in many areas within the U.K. We still expect this to improve further as we move through the third quarter and things begin to normalize. We still see plenty of pent-up demand from the consumer.

Core CPI rose steadily in the second quarter to +2.4% in June from the year earlier period. The consensus view is that the spike in inflation is still transitory in nature and will peak sometime in late 2021 or early 2022 before normalizing. The BOE also expects inflation to fade as we move forward, so this certainly worth watching going forward.

At its early August meeting, the Monetary Policy Committee (MPC) voted to maintain its main benchmark interest rate at 0.10% and keep its bond purchase target at 895 billion pounds. The MPC still believes inflation will ultimately fall back to its 2% targeted level over time and does not intend to tighten monetary policy until significant progress is made on eliminating spare capacity in the economy. With no real surprises were communicated, we still don't see interest rate increases on the table until late 2022 at the earliest. Second-quarter unemployment continued its recent trend and fell to 4.7%, the lowest level in a year. Most expect this rate to hold steady even as the government curtails its furlough program toward the end of the third quarter. This will be a test of just how strong the labor market is. Going forward, growth should flatten out a bit later this year as we anniversary the big downdrafts of 2020. We are optimistic that further equity market gains lie ahead as valuations remain decent and earnings begin to accelerate with a further re-opening of this economy.

Jefferies UK Economic Activity Radar

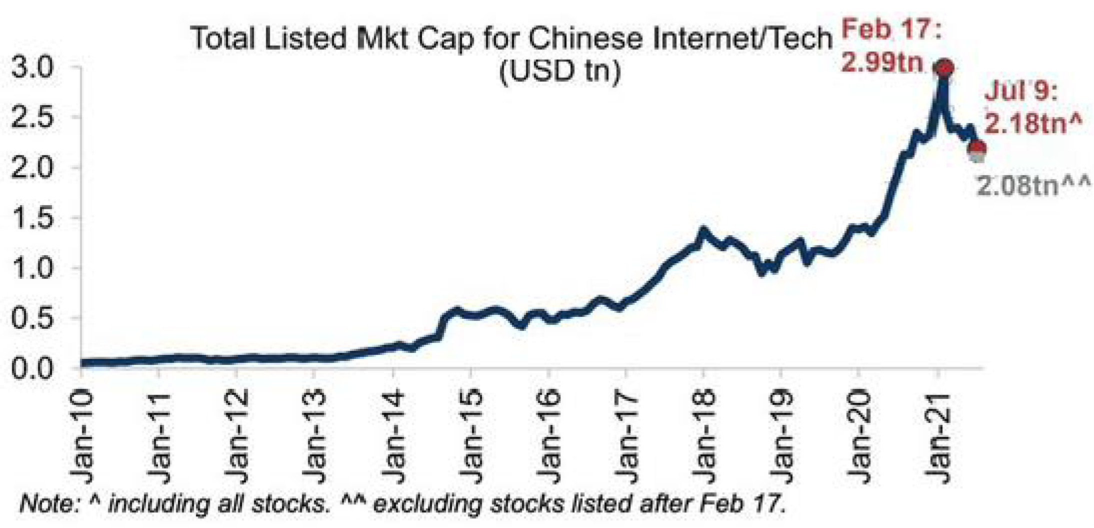


Sources: Jefferies

Emerging Markets

Emerging market equities rose in the second quarter on the heels of strong demand for materials used in the manufacturing process. This was the fifth consecutive quarterly gain in this index. Resource rich countries were some of the best performing markets as most commodity prices soared in the period. In addition, some level of progress was made on the vaccine distribution front, which brought some slight comfort to investors. However, gains would have been much higher had it not been for the weakness in the Chinese equity market. The government has started to withdraw some stimulus measures in the economy while stepping up measures to scrutinize many of the largest technology companies. These issues spooked investors and put a damper on additional gains in the emerging markets index.

Also, of note was rising inflation in several countries leading to interest rate hikes in Brazil, Russia, and Mexico. Investors will be keeping a close eye on inflation readings going forward. The MSCI Emerging Markets Index still managed to rise +5.05% in the second quarter of 2021, about in-line with the global developed markets outside of the U.S. Looking ahead, we still see a good case for emerging markets long term. Faster growing economies from an expanding middle class is a nice recipe for higher markets. This coupled with decent valuations
and earnings growth could push these markets much higher over time. In the near term, the re-opening trade is a positive catalyst that must be balanced against what is happening in China, as well as the noted inflation trends. This could make the ride a little bumpy.



Sources: Bloomberg; Factset; MSCI; Todd Asset Management

International Equity Activity/Strategy

As we look out into the end of our current fiscal year and the beginnings of a new one, we still see the potential for further gains in the global equity markets. The spread of the COVID-19 Delta variant should slow down going forward as global vaccination rates increase. This should lead to further economic strength in most parts of the world as global trade picks up steam. We believe this will push the global economy to some of the best growth we have witnessed in decades. Global merger activity and the IPO market both remain robust, with little evidence of a slowdown. Global interest rates should remain contained enough to not be an obstacle for most investors. The chatter among the central banks over the next few months on when to taper stimulus actions should be expected as a natural progression of the "re-opening" trade. However, this will be monitored very close for anything unexpected.

While supply chains in many industries remain a mess, we do expect this to get better on the margin going forward as workers continue to report back to their jobs. On the other side of the ledger, we must keep an eye on inflation readings going forward. Many believe this could be stickier than what central banks have been pointing toward and worry it could take the momentum out of equity markets. In addition, investors will be watching developments in China with respect to many of the large internet/technology companies that have been subjected to a heightened level of scrutiny. Even with these issues in mind, we could still see further equity market gains in the coming months.

We did add approximately $300 million to a fund designed to capture any further gains in the European "re-opening" trade going forward, as we believe this region remains behind the U.S. Also, we continue to be very active with our put/call writing strategy on the Emerging Markets as we position ourselves to add to this asset class if we see any significant weakness over the near term. Premiums remain very attractive for this in the very low interest rate climate. Emerging market equities remain an asset class that looks attractive to us over the long-term. Our current allocation to Emerging Market equities is approximately 3.51% of total assets and approximately 11.75% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios. *(Credit is given to the following entities for charts provided: Factset, Bloomberg, MSCI, Todd Asset Management, Jefferies, Eagle Global Advisors, Evercore ISI, RIMES, Capital Group, Resource Consulting Group)*