



# Q2 2021

## INVESTMENT REVIEW

# Market Review and Outlook

*If you thought the first quarter was good, the second quarter was even better!*

Markets continued their strong march upward during the second quarter with the S&P 500 Index up 8.5%, bringing year-to-date gains to 15.2%. Other major equity markets participated, with foreign and emerging market equities up 5.4% and 5.1%, respectively, in the second quarter. Bond markets, after a tough first quarter, also rallied, with high quality municipal bonds up 1.4% and high yield municipals up 3.9% for the quarter. See the table below for further details for the asset classes over different timeframes.

The recent strong returns have been driven by a solid economic backdrop and phenomenal corporate revenue and earnings growth. According to FactSet, companies within the S&P 500 are expected to grow Q2 revenues and earnings on a year over year basis 19% and 62%, respectively. This comes on top of similar growth numbers of 11% and 53% for revenues and earnings in Q1. Additionally, the macroeconomic situation remains strong, with job growth averaging 540,000 per month this year, unemployment at 5.9%, and manufacturing and services indices not far from record highs. Most importantly, fear over the COVID pandemic seems to have lifted, with 47%\* of the U.S. fully vaccinated (57% of 18 and older). Even with various new strains prevalent, health professionals believe the vaccines will still provide strong protection against the worst of

COVID's symptoms. Foreign countries are also making great strides in vaccinating their citizens, with only South America and pockets of Southeast Asia seeming to be struggling at the moment. This has led to optimism and stronger economic growth throughout the world.

Although there is a lot of good news, there are issues that need watching. Market metrics are priced above historical levels: have the markets come too far too fast? Has the accommodative stance of Central Bankers started an inflation fire that will need to be extinguished quickly, which could put the brakes on economic growth? And in the U.S., has all the government spending (and planned spending) put our deficit in such a position that it becomes a burden on our economy?

With regard to equity markets in general, S&P 500 returns over the last five years have compounded annually at an extraordinary 17.6%. The rapid rise in stock prices have given some investors pause, but earnings growth suggests the market may just be reflecting a very strong corporate performance. Evercore ISI, an independent research firm, recently upped their S&P 500 earnings forecasts to \$222 (from \$182) for 2021 and \$242 for 2022. At 4,300, S&P 500 trades at 19.4x and 17.8x 2021 and 2022 earnings estimates, respectively, which are hardly in bubble

*Continued next page ...*

Index	2Q21	YTD	1-Year	3-Year	5-Year	10-year
S&P 500	8.5	15.2	40.8	18.6	17.6	14.8
Russell 2000 (Small Cap)	4.3	17.5	62.0	13.5	16.4	12.3
MSCI EAFE (Int'l)	5.4	9.2	33.0	8.9	10.9	6.5
MSIC Emerging Markets	5.1	7.4	41.3	11.6	13.4	4.6
Barclays Municipal Index	1.4	1.1	4.2	5.1	3.2	4.3
Barclays Muni High Yield	3.9	6.1	14.3	7.6	6.2	7.0

Note: Returns are in %; returns greater than 1 year are annualized. Source: Bloomberg

\*NY Times COVID Tracker, with data from CDC, Texas Department of State Health Services, Colorado Department of Public Health & Environment, U.S. Census Bureau

# Market Review and Outlook

territory and are really quite reflective of the high growth companies that make up a good deal of the index. Therefore, we really don't see a near term risk of a market meltdown even given these great recent returns.

The risks discussed above do give us pause and force us to continue to be rigorous in our asset allocation process. Although we do not believe that any one of the above issues as well as broader external risks will lead to a rapid and destructive selloff, it makes the discipline of diversification ever more important. There are areas of the market that are very expensive (see our discussion on bubbles later on in the Investment Review), but there are other areas that are relatively attractive, such as cyclicals and value stocks; so we are rebalancing some money to managers that focus on those segments. Managers that have the ability to invest in structured credit or hedge some market risk have also been valuable to portfolios so we have left hedge fund allocations at full weights.

Inflation has jumped, but components that have driven the majority of this rise (used cars, car rentals, lumber) are mainly due to supply chain disruptions caused when supplier shut capacity during COVID. In fact, inflation readings later this year might actually be higher than expectations, but these pricing pressures should begin to subside by the end of the year as suppliers catch up with the pent-up demand. We believe prices might be

slightly elevated from pre-pandemic levels but 1970s style inflation is not in the picture. Therefore, bond portfolios should still provide a consistent but low level of safe returns and remain a source of "dry powder" should there be any buying opportunities.

Last quarter we noted the \$5.6 trillion in Federal stimulus deployed through COVID relief. These bills provided needed help to a deeply contracting economy, but also inflated the level of federal debt held by the public as a percent of GDP to 100% (a record). As recently as 2007, before the Global Financial Crisis, this ratio was 35%. The U.S. government ran a fiscal deficit of \$3.1 trillion in 2020 with the Congressional Budget Office (CBO) projecting the same for 2021, and this excludes any additional spending on infrastructure, with estimates running from anywhere from \$1 - \$4 trillion for these bills. Government spending at these levels is not sustainable, but in our view, the fixes (unknown as of yet) and impact are long-term phenomena and will gradually bleed into (negatively) economic growth in market returns over decades. We do not mean to sound glib on this topic but this structural issue will take years to solve. Some possible resolutions, like increased taxes might have some short term ramifications as markets digest new rates and the impact on corporate profits. But investors seem to adjust quickly to new circumstances and new normals, which then set the bar for future returns.

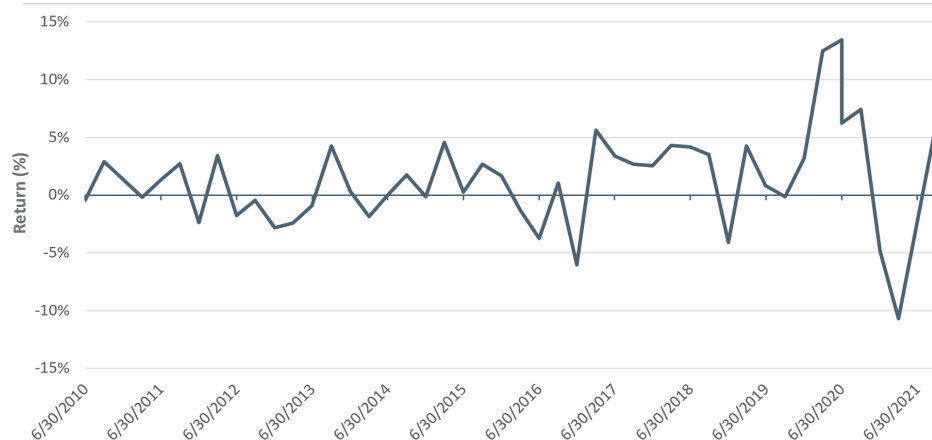
To sum up, there are good reasons for the good returns. We still believe there is a great deal of money and demand to support markets and provide investors with incentives to stay invested. We have noted risks, which will cause bumps along the way, but our expectation is for client portfolios to benefit from a continued rally the second half of 2021.

# U.S. Equities

## Highlights

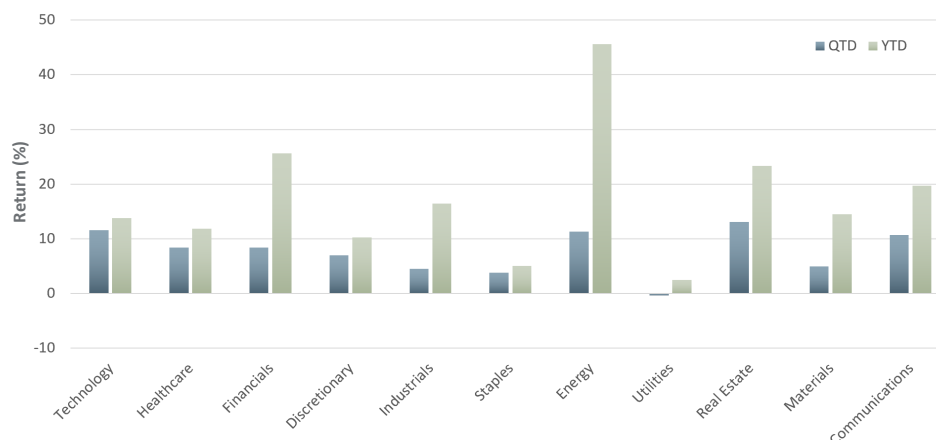
- U.S. Equity indices posted their fifth consecutive strong quarter of growth as states began to reopen for the spring. All the broad indices were up, with the S&P 500 returning 8.6% and passing the 4,250 mark, now a remarkable 2,000 points higher than its pandemic low.
- Inflation worries dominated headlines throughout the quarter as CPI numbers spiked by 5% in May on the back of stimulus check driven demand and bottlenecked supply pressures. While there is continuing debate over whether this inflation will be transitory or not, the release of the Personal Consumption Expenditures Price Index two weeks later abated fears, coming in at a more moderate 3.5%. However, the potential impact of inflation cannot be understated as high inflation rates could force the Fed's hand, resulting in reduced stimulus or higher interest rates, potentially hampering market growth.
- The Federal Reserve sparked its own headlines later in the quarter when Chairman Powell announced the possibility of an increase in rates ahead of the previous 2023 prediction, raising worries that the Fed may enact more hawkish monetary policy sooner than anticipated. Despite the quarter's strong returns, some pockets of weakness have been shown following worrisome inflation data, unemployment numbers and Fed announcements. As markets trend closer to overbought territory, negatively perceived policy shifts and poor economic data can quickly swing market sentiment.
- Growth stocks outpaced value stocks for the first time in two quarters, with the S&P 500 Growth Index returning a sizeable 11.9% while the S&P 500 Value Index returned just 5.0%. While value stocks do still look more attractive than the more highly valued growth stocks from a valuation perspective, lower bond yields and decreased inflation worries led investors to search for returns in familiar places, turning those hungry for yield back to the reliable tech stocks that had provided stable returns throughout the pandemic.
- Real Estate, Information Technology and Energy were the top performing sectors this quarter, returning a respective 13.1%, 11.6% and 11.3%. The theme of reopening continues to play out across markets, with Real Estate seeing massively increased demand in both the residential and commercial segments and Energy prices continuing to soar as increasing consumer demand and shrinking supply is causing a tremendous spike in prices.

## Growth vs. Value Relative Performance



Source: Bloomberg

## Sector Returns QTD vs. YTD



Source: Bloomberg



# International Equities

## Highlights

*Developed markets did well in the second quarter, returning 5.6% as countries finally ramped up distribution of much needed COVID-19 vaccinations amid the spread of more contagious variants.*

- The U.K. market gained 5.6%, with its cyclically oriented economy and highly vaccinated populace poised for a vibrant recovery in the wake of Brexit. Though they are well positioned for economic growth and have one of the most vaccinated populations in the world at over 50% fully vaccinated, the country is currently being roiled by the highly contagious Delta variant of COVID-19. This variant, assumed to be twice as infectious as the original strain of the virus, now makes up over 97% of cases in the country, leading to Hong Kong's decision to halt all flights from the UK toward the end of the quarter.
- France posted one of the strongest returns in the second quarter, with the CAC 40 up 10.0% as the

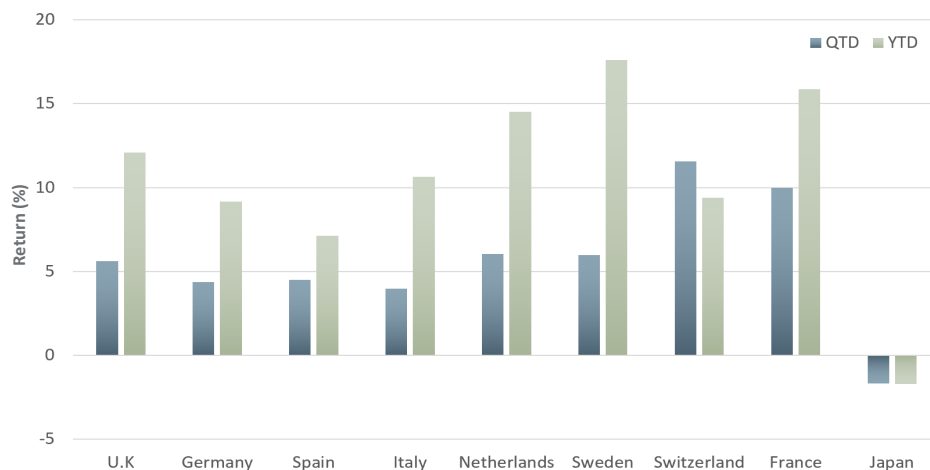
country slowly reopened from their third major lockdown imposed in March. While yet another lockdown was difficult for the French people, Macron was able to slow the spread of the virus and utilize the time to ramp up vaccinations, going from only 4% of citizens being fully vaccinated to 30%. In an attempt to stop the transmission of COVID-19 on airlines, France also became the first country to institute a 'health pass' or health passport, a new form of digital documentation required in order to utilize certain transportation.

- Japan was the weakest performing country across developed markets, returning only 1.7%, suffering from a perfect storm of low vaccination rates, the world's oldest population, and the emergence of both the Alpha and Delta variants within their borders. Given Japan's highly urbanized society, it is extremely challenging for them to fully contain the

virus as it becomes more contagious, especially as they attempt to keep cases low in preparation for the summer Olympics.

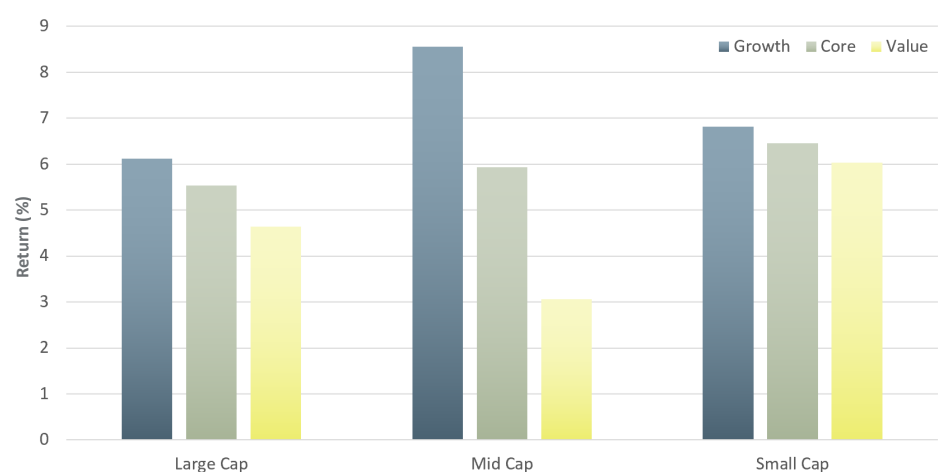
- Stocks delivered a mixed bag of returns in developed markets across style biases, with value stocks continuing to benefit from the reopening while lower bond yields benefitted larger cap growth stocks. Large-cap growth stocks barely beat out small-cap value, returning 6.1% vs 6.0%. Developed markets, in particular European countries, are in a favorable spot for the upcoming reopening; their economies are reliant on cyclical companies that benefit from continuing economic expansion and have low exposure to the already expensive Technology companies.

## Country Returns QTD vs. YTD



Source: Bloomberg

## Growth vs. Value QTD



Source: Bloomberg



# Emerging Market Equities

## Highlights

*Delta Variant Roils Emerging Markets: Emerging Markets continued to lag other equity markets in the second quarter, returning 5.1% as nations struggle to distribute vaccinations to desperate populations facing the threat of increasingly contagious COVID-19 strains.*

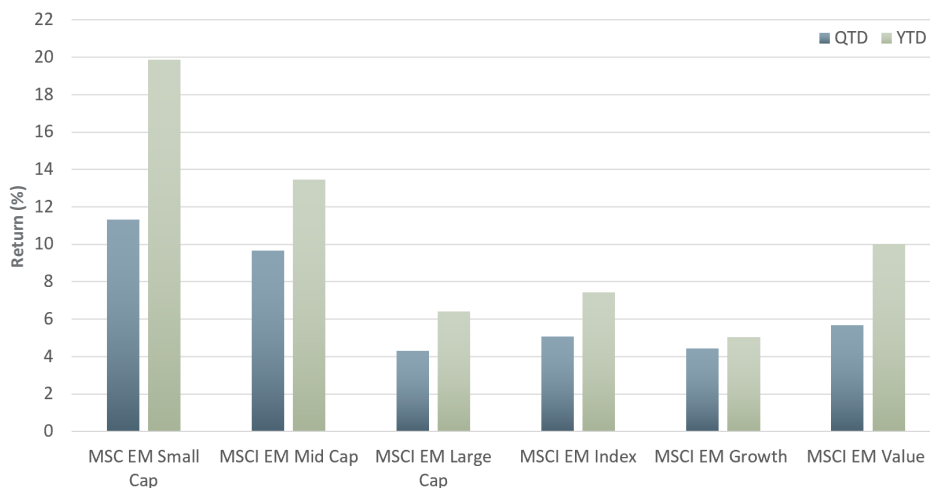
- China returned 6.9% as they continued to rapidly vaccinate their country throughout the quarter, ramping up to a whopping 20 million daily vaccinations in June, over half of the world's daily total. China continues to slow down their economic stimulus and saw their "credit impulse," a measure of new financing generally used to measure business cycles, begin to cool off. Despite these two assumed headwinds, Chinese demand does not seem to be slowing as the economy continues to forge onward, with their increasingly tech focused economy becoming less reliant on financing to drive production.

- India returned 5.8% in the second quarter, facing a major challenge as the world's second largest population suffered a massive outbreak of the highly contagious Delta variant of COVID-19 in May, battering their already overtaxed healthcare system. Despite being the world's largest producer of COVID vaccines, India has struggled to vaccinate its own population due to a host of internal supply chain issues; India currently only has 4% of the population fully vaccinated, leaving it in a precarious spot as COVID continues to evolve newer, more contagious strains.
- Brazil and Argentina were the strongest performers, returning 23.4% and 24.9% respectively, continuing their rollercoaster-like market performance as their leadership continues to struggle haphazardly to contain the pandemic. Plagued by a slow vaccine rollout, Brazil recorded the highest single day new

COVID cases in early June as the Delta variant began its assault on a country already beleaguered by the second largest death total in the world.

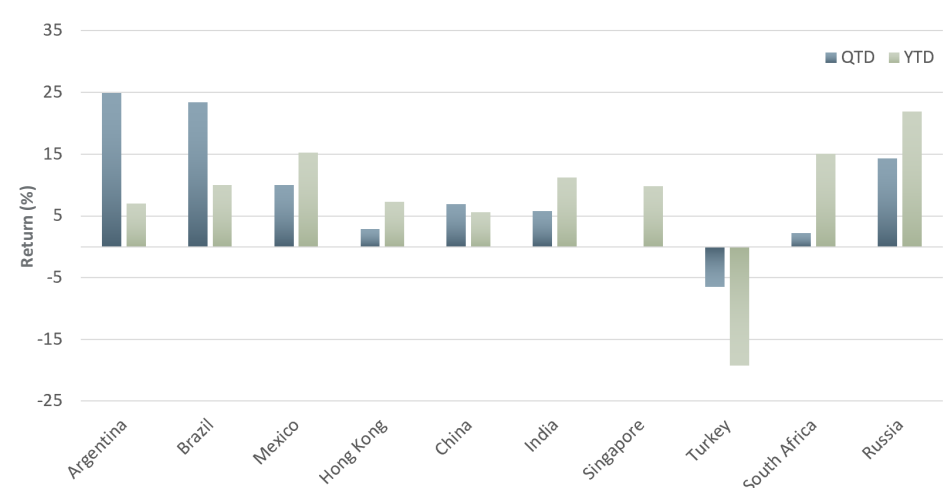
- Despite the looming threat of the Delta variant, emerging market stocks are not without their own macroeconomic tailwinds; the U.S. dollar, while trading flat now, is anticipated to weaken as economies recover, while cyclical stocks are expected to benefit from future yield curve steepening. These factors directly impact emerging markets, with emerging market value beating out emerging market growth for the quarter, returning 5.7% vs 4.4%. Small caps performed even better and continued their trend of leading economic recoveries, with the MSCI Emerging Markets Small Cap index returning 11.3% vs just 4.3% for large caps.

## Emerging Market Index Returns QTD vs. YTD



Source: Bloomberg

## Emerging Market Country Returns QTD vs. YTD



Source: Bloomberg



## Highlights

*“Yield reversal is the name of the game”:* After a sharp rise in bond yields in the first quarter amid a rise in inflation expectations and economic growth along with significant fiscal and monetary stimulus, bond yields followed a downward trend in the second quarter. Technicals more than fundamentals helped drive the second quarter curve flattening.

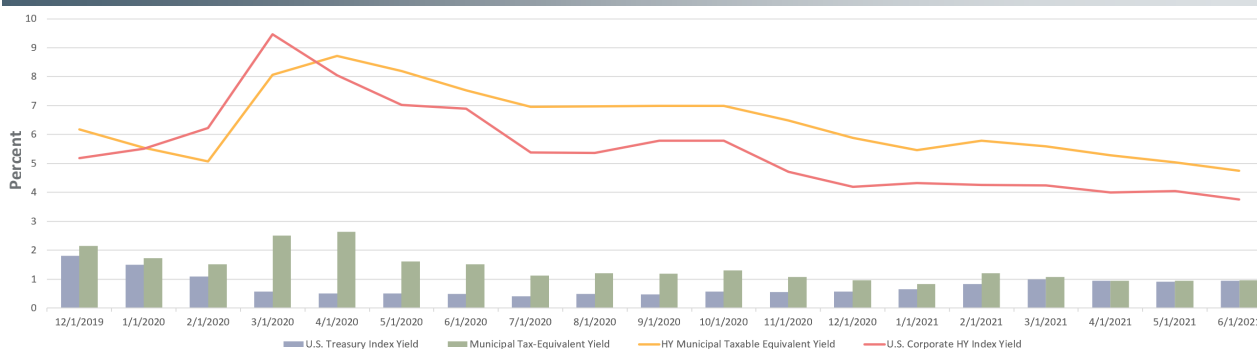
- The 10-year Treasury yields started the second quarter at 1.74% following a sharp rise in the first quarter. However, the 10-year Treasury yield finished the second quarter at 1.45% having spent most of the quarter range bound between 1.55-1.65%. Short-biased trades, betting on yields rising, were closed out during the second quarter giving support to lower yields along with economic data prints that came in below expectations and added to weaker sentiment on economic growth.
- The municipal bond market remains strong with state and local municipalities in robust financial positions. Despite 16 consecutive weeks of inflows, investor demand for municipal bonds remains high as we enter a seasonally favorable supply/demand period. Municipal bond returns benefitted from the decline in Treasury yields, finishing the quarter in positive territory. However, high demand for municipal bonds has pushed prices to elevated levels with the 10-year municipal-to-Treasury ratio at 68% (ratios below 100% imply municipals are expensive relative to Treasuries) well below its long-term average of 93%. Selection remains paramount within the richness of the municipal bond universe.
- High-yield municipal bonds continued their strong first quarter start with an outperforming second quarter return of 3.9%. High-yield municipals continue to benefit from economic optimism,

improved risk sentiment, and lower high-quality bond yields. High-yield municipals remain strong fundamentally but with an index yield of 3.1% far below a long-term average of 6.2%, high-yield municipals are starting to look a bit expensive. We remain favorable on high-yield municipals especially relative to other fixed income assets but deep credit analysis is key to performance.

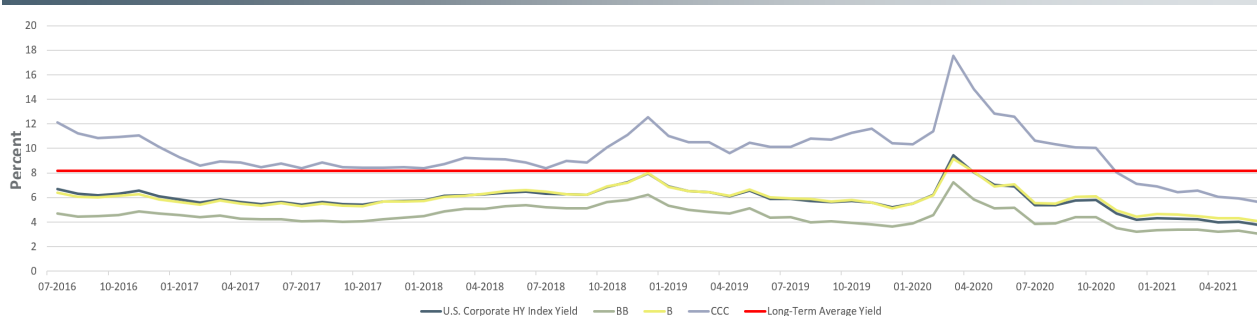
- High-yield corporate bonds returned 2.7% in the second quarter. High-yield corporates continue to be the definition of risk-taking with an index yield of

4.0% versus its long-term average of 8.2%. The headline isn't as striking as the fact that CCC yields (lowest rated high-yield bond) are at 5.6%. This implies that an investor will earn 5.6% annualized while the company has a material probability of default! Compared to high-yield municipals that have a taxable-equivalent yield of 4.8%, an investor can get similar yield to the weakest issuers in the high-yield universe; the low yields do not justify the extra risk for incremental return compared to other fixed income assets.

## High Yield Municipals Look Best on a Tax-Equivalent Basis



## High Yield Corporate Yields are Not Worth the Risk



Source for both charts this page: Bloomberg



# U.S. Economy

## Highlights

### *"Is the U.S. Economy Peaking or Just Normalizing?"*

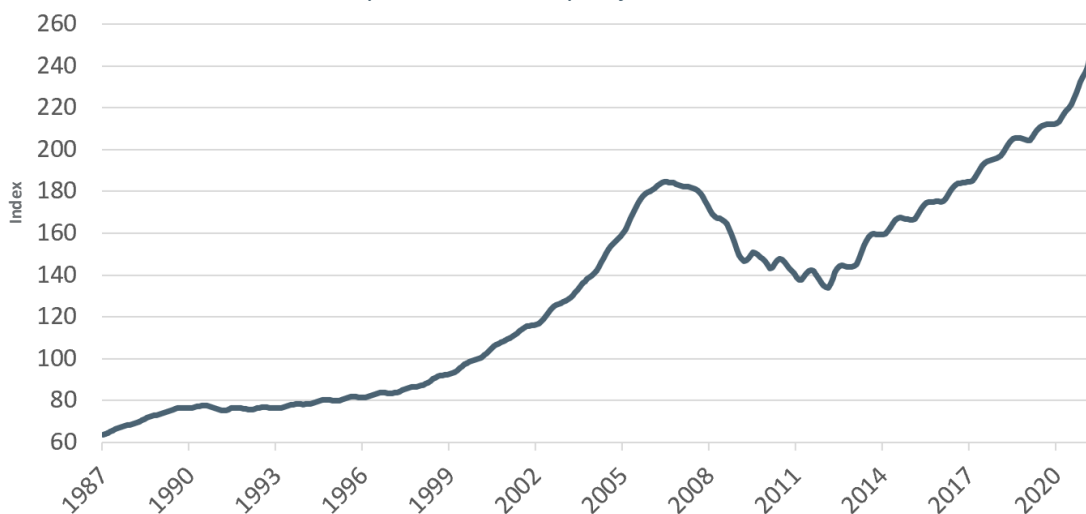
- Despite some negative headlines, the labor market continues to improve (see Special Topic later in the Investment Review). Although payroll reports missed rosy expectations, the recent JOLTS (job opening) report shows 9.3 million openings while the Conference Board's jobs plentiful survey is at its highest level since 2000. The labor market has improved but health concerns and structural changes since the pandemic has kept the economy from full employment. Just like the economy will take time to recover, the labor market will as well. Assuming that COVID in the U.S. remains on its current trajectory, we expect employment to continue to improve as we move into the fall.

- The housing market has started to slow leading to headline concerns of another bubble that could derail the economy; we believe slowing data should be expected given the recent unsustainable pace. As supply remains well below demand, pricing has naturally increased. We think that home buyers have strong balance sheets and are not over-levering into a falling price market like 2008, lessening the chance of a bubble forming. Moreover, low mortgage rates and a strong economy are additional tailwinds that can sustain an upward pressure on house prices.
- Any inflation measure tells the same story: inflation is running high. Supply chains remain a key cog in supporting higher inflation, as delays in deliveries and high order backlogs reduce supply while consumer

demand remains high. However, recent ISM data suggests that delays and backlogs are starting to trend down, an early indicator that inflation may have peaked. While it is too early to call it a positive trend, it is an improvement. As delivery times decline and backlogs turn into inventories, this should help alleviate some pricing pressures. We know inflation will be high in the near-term but supply chain fixes should help to alleviate the concern of 1970's style inflation.

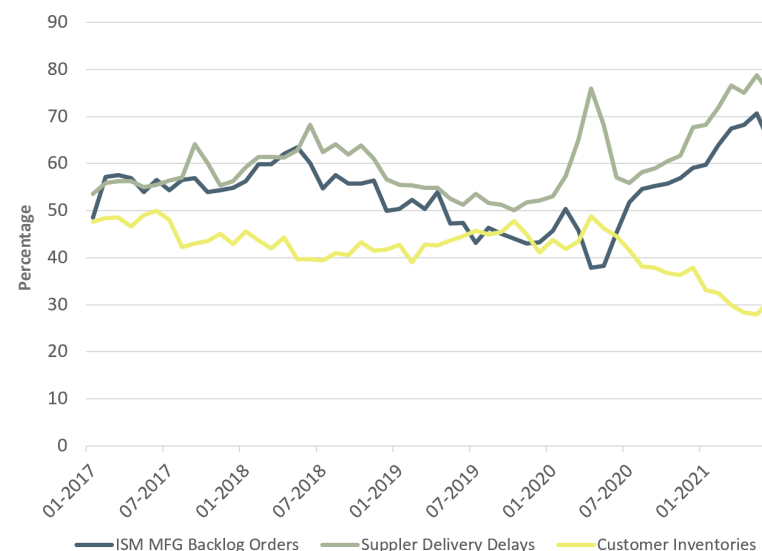
## S&P/Case-Shiller U.S. Home Price Index

Index Jan 2000=100, Monthly, Not Seasonally Adjusted



Source: Economic Research Division, Federal Reserve Bank of St. Louis

## Supply Chain Improving?



Source: Bloomberg



# International Economy

## Highlights

*"Slow and steady pace to an economic recovery."*

- As European restrictions were gradually lifted and virus cases declined, the European economy has enjoyed a moderate improvement in economic activity. While concerns regarding the Delta variant have weighed on sentiment, the vaccine rollout has allowed for the European economy to begin its normalization process. Despite this, economies remain fragile with the U.K., Spain, France, and the Eurozone as a whole, seeing contractions in first quarter GDP. However, as service and manufacturing PMIs (Purchasing Manager indices) have improved and maintained expansionary levels (above 50), it is likely that second quarter GDP will begin to reflect these improvements and show that Europe's economic recovery is beginning in earnest.
- European and Asian manufacturing have remained strong throughout the pandemic. Two exporters that can be seen as indicators of global trade, Germany and South Korea, have shown trending export growth

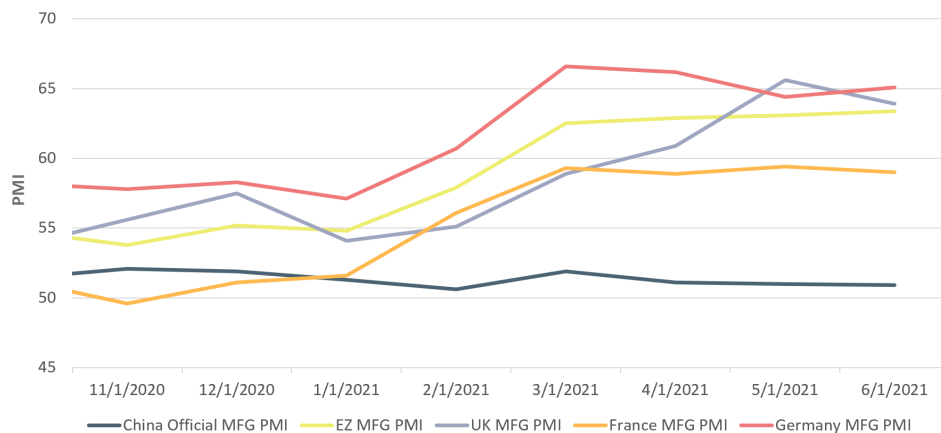
recently; while the base effects make the chart look better than reality, the trend is what is important. Improved demand for goods has resulted in improvements in trade, a good indication that the global economy has started its recovery.

- China was the first economy to begin its recovery and is expected to be a leader of global growth in 2021, alongside the U.S. However, economic data has been a little mixed for China as its PMIs, retail sales, and industrial production began the year on solid footing, but have now started to slow (although it should be noted that the slower pace is from extremely elevated levels). A couple of factors are contributing to this slowing. First, input cost inflation has risen significantly with China's most recent producer price inflation print at 9% year-over-year - this is negatively impacting domestic and foreign consumption of Chinese goods. Second, China's largest trading partners, emerging Asian nations, remain stuck in a low growth environment amid a slow vaccination

program against the pandemic. Until these headwinds are reduced, data will likely be underwhelming although we expect the overall growth backdrop to remain firm.

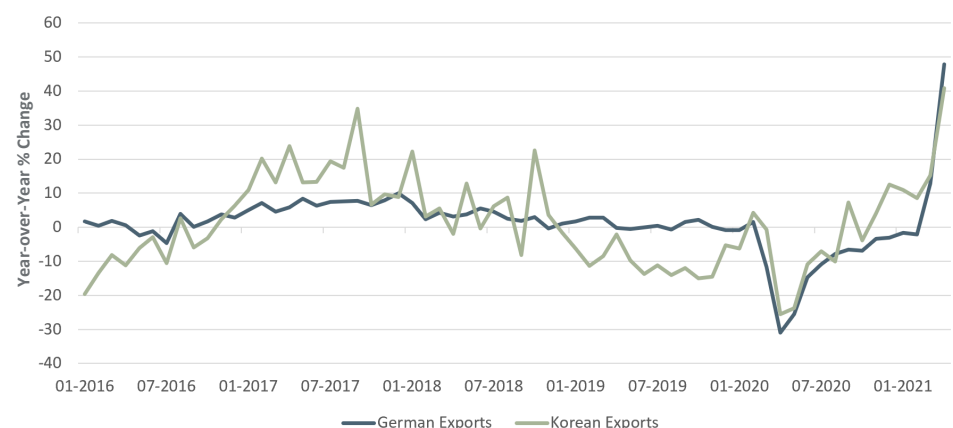
- Emerging market economies remain at a standstill. First quarter GDP data showed improvements but countries are still stuck in a recession. Notable standouts include India and Singapore that showed expansionary growth in the first quarter. Emerging markets will have a different path to recovery as, unlike developed markets, emerging market governments did not deploy significant fiscal stimulus. As we have seen, large fiscal stimulus induces a sharp economic response. Given emerging markets are more export oriented, this will drive growth until domestic consumption improves. Higher commodity prices and higher real rates make emerging markets attractive but slow or contractionary growth in the domestic economy may offset some of those tailwinds.

## Europe Grows as China Stalls



Source: Bloomberg

## Global Trade Comeback



Source: Bloomberg



## Highlights

*Commodities had a strong quarter across the board as economic reopening benefitted nearly all market segments.*

- Real estate continued to run hot in the second quarter with the S&P Global REIT Index up 10.4% as the huge reopening driven demand for both residential and commercial real estate strengthened further. U.S. REITs saw even greater returns, with the US REIT indices up 11.7%. Home prices saw their largest annual increase in May with the average home price passing \$350,000 for the first time as a major property shortage and low lending rates continue to drive up prices nationwide.
- Though lumber prices finally showed signs of slowing this quarter, sharply declining by 45.3% in the month of June alone, prices still remain elevated, up 64.3%

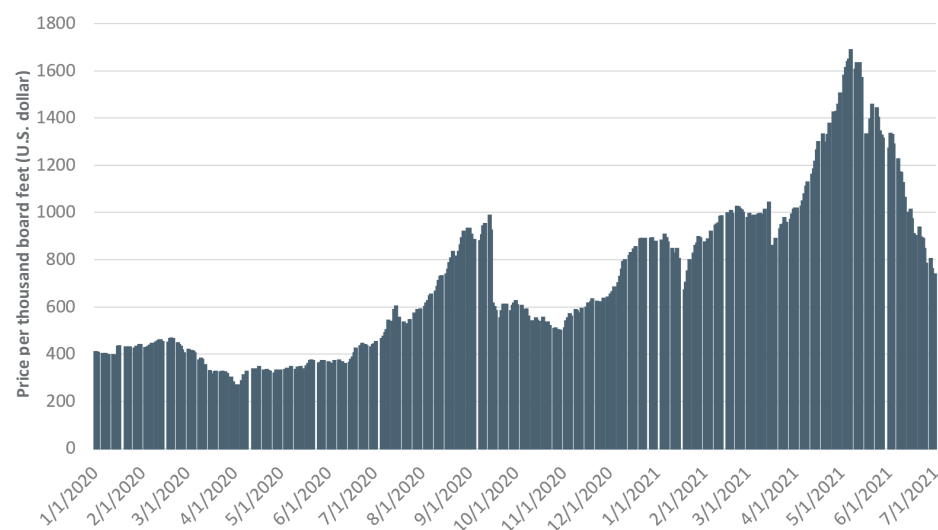
over the last 12 months. Demand for lumber quickly spiked during the pandemic as home improvement projects became increasingly popular while the housing shortage continued to spiral out of control; people desperate for homes resorted to building their homes given the scarce supply of houses, further driving up the already high demand for lumber.

- Energy prices continued to climb in the second quarter with natural gas up 32.6%, MLPs up 21.2% and gasoline up 17.1%. Energy markets are facing a very different story from a few months ago as massively increased demand is burning through the excess supply that had been created during the pandemic. OPEC has stated that they believe crude stockpiles may fall below their five-year average in

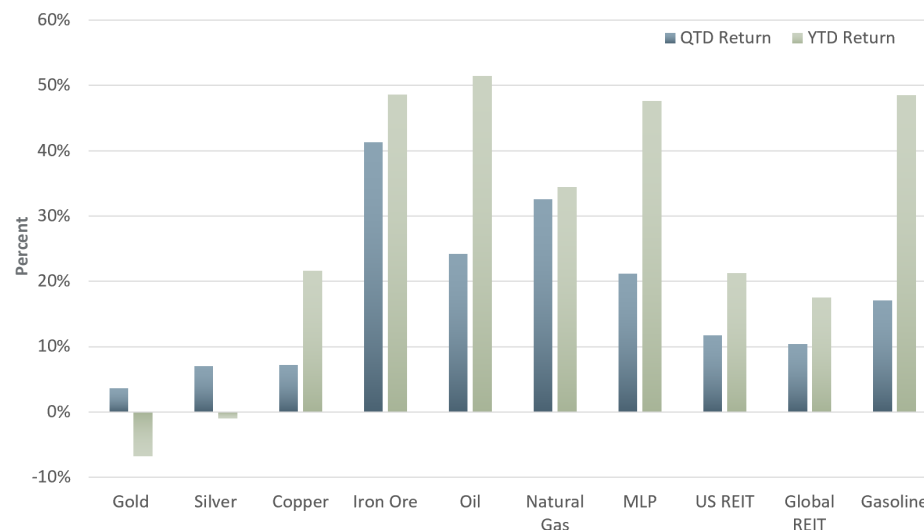
the second half of the year, leading to them relaxing production limits imposed when there was more oil than there was room to store it.

- Precious metals had an interesting quarter with iron ore prices rising by 41.3% as China, the largest consumer of iron ore and greatest producer of steel, ramped up its steel production to record levels to take advantage of skyrocketing prices. Classic inflation hedges gold and silver returned a respective 3.6% and 7.2% as high initial inflation numbers turned investors toward more defensive investments. The potential for a weaker dollar as well as an increased probability of inflation lay an interesting backdrop for precious metals, which may see more purchasing than they normally would during economic expansion.

## Daily Lumber Price



## Commodity Returns QTD vs. YTD



# Special Topic: Bubbles

## The Term “Bubble” is Often Overused, Although Parts of the Market Are Richly Valued

The S&P 500 has risen 92% off its March 23, 2021 COVID pandemic lows in just over 15 months. This comes on top of a strong 2019 that has produced a 5 year compound annual return of 17.7%, one of the best 5 year numbers in the history of the S&P 500. With high profile names like Apple, Paypal and Tesla up much more than this, many say these types of gains cannot continue and that we are in a bubble that is destined to pop.

Historically, bubbles have come in all different flavors but generally they all have participants that ignore any rationale valuation metrics, which lead to large losses upon the bursting of the bubble. A famous example is the Dutch Tulip bubble, or Tulipmania, that took place in Holland in the 1630s. Tulips became a fashionable status symbol for the wealthy and were highly prized. Speculators were drawn in and pricing became extreme (it is noted that the price of a single tulip at one point exceeded the annual income of a skilled worker, although this is open to debate). Once investors woke-up to the fact they owned an irrationally priced asset,

the price collapsed as sellers tried to unload their tulips to no avail.

More recent bubbles, such as the Nifty 50 (1972), the dot.com craze (or tech bubble) of 1995 – 1999, and the financial crisis (2008/2009) had various themes. The Nifty 50 had high quality companies that were priced to the stratosphere, while the dot.com craze had overpriced good companies but plenty of speculative ones that were priced way outside historical norms. The financial crisis burst due to hidden bombs; no one thought house prices could sink like they did leading to trillions of dollars of mortgage losses for banks, which brought down the rest of the market with it.

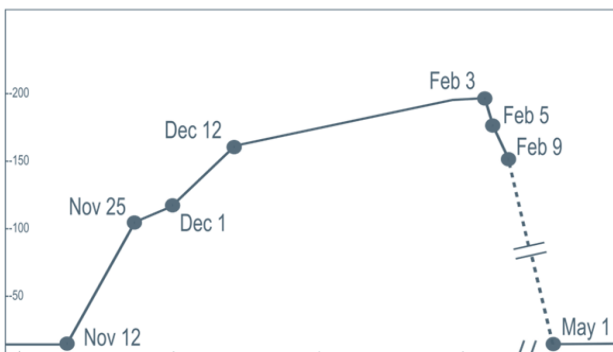
A lot of money was lost during the bursting of the above bubbles, but the opportunity to make a lot of money afterwards also occurred. Take for example the stories of Apple, Cisco, Intel and Microsoft during the dot.com bubble. Two stocks, Cisco and Intel lost over 80% of their value in under 3 years from their peaks (mid 2000) and to this day are still almost 60% below

those highs. Meanwhile, Microsoft and Apple, although losing 62% and 78%, respectively from their peaks, are now 200% and 9,800% above those original peaks 20 years ago. Cisco and Intel are both thriving and solid companies in 2021, but were priced so far above their expectations in 2000 that they have never been close to regaining their (over) value from years ago. On the other hand, Microsoft and Apple's growth exceed expectations enormously, giving them good reason to blow away their old valuation high water marks.

Today, we have seen certain stocks act like the tech stocks of 2000. Tesla, Zoom Video and Peloton for example, have had enormous returns since 2019, but have also seen very large peak to trough declines (all three stocks have currently rebounded from their lows, but Cisco and Intel had similar bear market rallies that eventually fizzled out). Additionally, their valuations are priced to reflect sizzling growth and low interest (discount) rates over the next few decades. These stocks will need to continue to grow at exceptionally

*Continued next page ...*

### Tulip Price Index, 1636-1637



Source: The values of this index were compiled by Earl A. Thompson in Thompson, Earl (2007), "The Tulipmania: Fact or Artifact?", Public Choice 130, 99-114 (12007). More at: <https://www.history.com/news/tulip-mania-financial-crash-holland>.

### Peak to Trough dot.com Valuation

	Peak Valuation (market cap, \$ billion)	Peak Date	2002 Trough Valuation (market cap, \$ billion)	Trough Date	Years Peak to Trough	Peak to trough draw-down, %	June 30, 2021 Valuation (market cap, \$ billion)	Previous Peak to Current, %	Previous Trough to Current, %
CSCO	552	3/27/2000	63	10/8/2002	2.53	-88.6%	223	-59.6%	254%
INTC	503	8/31/2000	88	10/8/2002	2.10	-82.5%	227	-54.9%	158%
MSFT	613	12/27/1999	232	7/25/2002	2.58	-62.2%	1,863	203.9%	703%
AAPL	23	3/22/2000	5	10/9/2002	2.55	-78.3%	2,286	9839.1%	45620%



# Special Topic: Bubbles

*Continued*

high rates to justify these valuations or their stocks prices risk being slashed.

We cannot predict if and when stratospherically priced stocks may burst, but we also don't believe the overall market has to follow suit. The economic backdrop remains very supportive, with easy monetary policy remaining in place, more fiscal stimulus (in the form of infrastructure) being proposed and consumers sitting on \$4 trillion of excess savings. This all provides a strong underpinning to the general market.

Additionally, corporate revenue and earnings are expected to grow at above trend levels through 2022. FactSet's bottom-up S&P 500 estimates are for \$190 of earnings in 2021 (35% year over year growth) and another 12% in 2022 (to \$212 earnings). According to DataTrek, a data and market newsletter, this reflects decreases in Q2 and Q3 earnings (from Q1), which will

have to be revised upwards. As if aware of this sentiment, Evercore ISI recently upped their S&P 500 earnings forecasts to \$222 (from \$182) for 2021 and \$242 for 2022. At 4,300, S&P 500 trades at 19.4x and 17.8x 2021 and 2022 earnings estimates, respectively, which are hardly bubble territory and are quite reflective of the high growth companies that make up a good deal of the index.

Although we do not believe the market is in a bubble, we are well aware of how far and how fast we have come from the pandemic lows. Markets are forward looking and may have priced in most of the expected earnings growth for the next 18 months. We are not expecting anomalous large drawdowns, but would also not be surprised if returns are lackluster over the same timeframe. Profit taking can be a healthy exercise and we do not see the selling of some of these high flyers bleeding into broader market sectors. There are still

pockets of the market that have room to run (cyclicals, value, foreign stocks), and by maintaining a diversified portfolio allocated to some of these areas, investors can still earn relatively attractive returns even if the headline index returns are weak.

## Tesla, Zoom Video, and Peloton Returns

Stock	Recent Return History	Recent Return Timeframe	Most Recent Drawdown	Drawdown Timeframe (days)	Current Price/Sales	Current Price/Earnings (ttm)
Tesla	2000%	5/19 – 1/21	-36%	113	18x	425x
Zoom Video	394%	6/19 – 10/20	-52%	203	34x	122x
Peloton	568%	9/19 – 1/21	-50%	112	10x	200x
S&P 500*	45%	6/19 – 6/21	-10%	21	3x	25x

\*S&P 500 trailing twelve month (ttm) earnings is based upon actual Q320, Q420, Q1 21 and estimated Q2 2022  
Source: FactSet



# Special Topic: Labor Market

## Thoughts on the Unemployment Rate and the Labor Market

Anecdotal evidence across the country points to a labor shortage, with sign on bonuses and raised pay rates becoming common. Businesses are turning away customers and opening for reduced hours due to staffing constraints while the May Job Openings and Labor Turnover Survey (JOLTS) has surged to a record high of 9.2 million vacancies. This may seem strange given that the number of people employed remains 7.6 million short of pre-COVID levels. The following provides some color to this data and the labor market in general, which supports our view that labor markets are indeed strong, but not as strong as headlines suggest.

- The overall **unemployment rate** portrays a strong recover, with the rate having surged from 3.5% pre-COVID to 14.8% in the spring of 2020 (this was the highest unemployment rate since data collection started in 1948) before recovering to the current 5.9%. The current unemployment rate equates to 9.3 million people seeking work, coincidentally equal to the number of vacancies in the JOLTS survey. We agree that the recovery is strong and that it will likely continue to improve over the coming months. However, the headline number masks the uneven nature of the job recovery and is flattered by changes in the participation rate.
- The **Participation Rate** among the civilian labor force plummeted during COVID (see chart on next page). The Participation Rate measures those who are either employed or actively looking for employment as a percentage of the overall civilian working-age population (261 million). Having spent the past decade hovering around 63%, it fell to 60.2% during the initial COVID shock and has been stuck around 61.5% since last summer; the fall in the participation rate equates to around 4 million people who have exited the labor force and are not actively seeking employment. If these people returned to the labor force, the unemployment rate would be 8.3% instead of 5.9%.

*Continued next page ...*

## JOLTS



Source: Federal Reserve Bank of St. Louis

## Unemployment Levels by Industry

Industry	Unemployed (in thousands)			Unemployment Rates (%)		
	May 2020	May 2021	Change	May 2020	May 2021	Change
Leisure and hospitality	4,434	1,294	-3,140	35.9	10.1	-25.8
Wholesale and retail trade	2,895	1,301	-1,594	15.1	6.6	-8.5
Education and health services	2,458	840	-1,618	10.1	3.4	-6.7
Manufacturing	1,782	705	-1,077	11.6	4.8	-6.8
Government workers	1,603	474	-1,129	7.4	2.2	-5.2
Professional and business services	1,578	952	-626	9.0	5.4	-3.6
Construction	1,187	642	-545	12.7	6.7	-6.0
Other services	1,165	341	-824	18.4	5.3	-13.1
Transportation and utilities	1,018	566	-452	14.2	7.2	-7.0
Self-employed workers	915	579	-336	9.4	5.3	-4.1
Financial activities	559	292	-267	5.7	3.0	-2.7
Information	259	157	-102	10.9	5.8	-5.1
Agriculture	105	138	33	6.5	8.4	1.9
Mining, quarrying, and oil and gas extraction	64	64	0	8.4	9.6	1.2
<b>Totals</b>	<b>20,514</b>	<b>8,829</b>	<b>-11,685</b>	<b>13.0</b>	<b>5.5</b>	<b>-7.5</b>

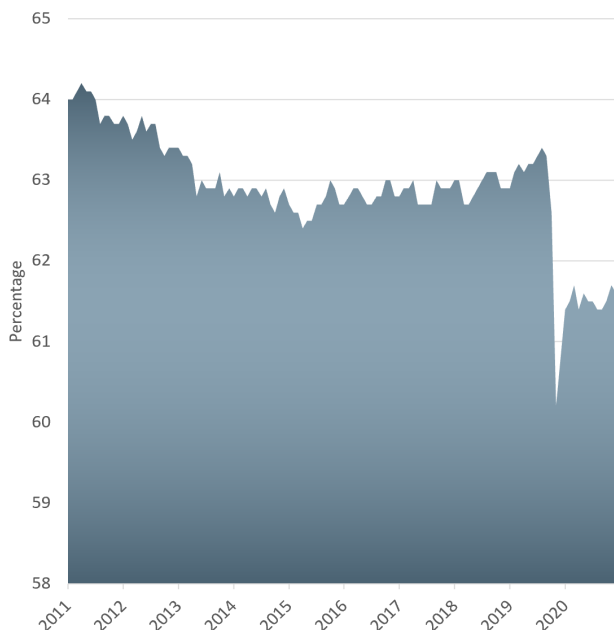
Source: U.S. Bureau of Labor Statistics



# Special Topic: Labor Market

*Continued*

## Labor Force Participation Rate



Source: Federal Reserve Bank of St. Louis

- Overall data conceals an **uneven recovery**, with the Leisure & Hospitality and the Retail industries struggling to rebound. The Leisure & Hospitality Industry employs around 16.5 million workers and, while the sector's unemployment rate has fallen sharply from last May's 36%, it remains in double digits. Conversely, the Professional and Education & Health Industries have both recovered to the 3-5% levels. It remains to be seen whether all the lost jobs will return to the hardest hit sectors or whether some COVID-induced changes, such as increased automation and self-service, will remain.
- **Unemployment benefits** can certainly cause workers at the lower end of the pay scale to prefer staying at home, especially when coupled with increased childcare needs and a desire to avoid contracting COVID. The numerous stimulus checks, child credits, and unemployment top-up payments have provided some with a disincentive to work. The impact of unemployment assistance varies throughout the country, with high social benefit states such as Massachusetts providing up to \$1,234 a week for a family (equivalent to \$61,168 per year) with Federal child tax credits and stimulus checks available on top of this. The Republican-Chaired Committee on Ways and Means released analysis showing that a family of four with two unemployed parents could have received over \$109,000 in benefits in the April 2000 to September 2021 period; while this is likely not many families experience, it does demonstrate the potential disincentive to find employment. As states seek to incentivize the unemployed to return to work, we are seeing the additional COVID-

related unemployment payments ending early and states offering cash bonuses to incentivize the unemployed back to work instead.

- **Baby boomers** are also muddying the employment picture. Boomers have benefited from soaring net worth and swelling retirement accounts, allowing some to bring forward their retirement plans. This is another trend to watch and only time will tell how permanent it will be. We can see that the participation rate of over 55-year-olds has fallen from 40.2% in 2019 to its current 38.4%, a greater relative decline than for the overall workforce participation rate. The Bureau of Labor Statistics had forecast a general downward trend in the participation rate for this age group over the next decade – it may be that COVID has sped up that trend.
- In addition to lots of short-term noise, we have long-term **demographic trends**. Growth in the labor force is a key long-term driver of GDP growth. For the 30 years between 1980 and 2009, the civilian workforce grew around 1.1% a year. In the most recent decade, this growth rate fell to just 0.4%. JP Morgan research suggests that the growth rate in the 2020-2029 decade could slump to 0.2%. Whether COVID-induced changes cause a further permanent decline to these long-term structural trends remains to be seen; a workforce that is barley growing will be a formidable headwind to real GDP growth.



# Tactical Asset Allocation

## Market Street Growth Strategy *Second Quarter 2021*

ASSET CLASS	NEGATIVE	NEUTRAL	POSITIVE	
<b>CASH</b>				
<b>INVESTMENT GRADE BONDS</b>				
Municipal Bonds				
<b>HIGH YIELD DEBT</b>				
High Yield Municipal Bonds				
High Yield Corporate Bonds				
Emerging Market Debt				
<b>HEDGED ASSETS</b>				
Long/Short Equity				
Distressed Credit				
<b>EQUITIES</b>				
U.S. Equities - Large Cap				
U.S. Equities - Small Cap				
Developed Market Equities				
Emerging Market Equities				
Private Equity				
<b>REAL ASSETS</b>				
MLPs				
Global Real Estate/REITs				
Natural Resources/Energy				

Notwithstanding some portfolios moving towards higher fixed income allocations as part of the recent strategic asset allocation review, portfolios are generally underweight high quality investment grade Fixed Income and slightly overweight cash. While investment grade bonds are a bedrock for portfolios during volatile markets, municipal bonds remain relatively expensive; we will wait for a better entry point before rebalancing back into the asset class.

We have maintained an underweight exposure to municipal high yield debt. While there are certainly risks to some segments of the high yield muni market, the tax-exempt yields remain a key attraction; the prospect of higher tax rates under a Biden administration will only enhance the appeal of tax-exempt bonds. As the discount to net asset value on closed-end funds narrowed we have reduced exposure; we tactically buy and sell closed end funds depending on the discount level. Portfolios also have a tactical allocation to dollar-denominated emerging market sovereign debt.

Hedge fund allocations are in flux as we move to the new strategic asset allocations. We will aim for portfolios to be fully allocated as we believe that hedged strategies make sense given their diversifying and less correlated attributes. We continue to refocus hedge fund exposures towards unique alpha-generating opportunities that can provide attractive risk-adjusted returns.

Having added to U.S. equities over the past year, we still believe that the rally has further room to run. As the U.S. economy reopens, the consumer is in a great position to spend. Coupled with unprecedented monetary and fiscal stimulus, the U.S. economy and corporate earnings are well positioned to power ahead. While portfolios are neutrally allocated to international equities, within the asset class we prefer emerging markets over developed markets. Market Street's private equity program provides attractive exposures that cannot be obtained in the public markets.

We believe MLPs continue to offer the potential of very appealing total returns, although a strong first half rally has reduced their attractiveness. Despite the excitement around green energy, the transportation of hydrocarbons from wellhead to end consumer will be critical for years to come. We remain more neutral to negative both global REITs and natural resources, preferring to put money to work in plain vanilla U.S. equities.



## INVESTMENT TEAM:

**Michael R. Eisner, CFA**  
Senior Vice President  
Chief Investment Officer

**Robert J. White, CFA, CFP®**  
Director of Investments

**Ross Miller, CFA**  
Portfolio Manager

**Jim Talalas**  
Investment Analyst

## MARKET STREET TRUST COMPANY:

**Main Office:**  
2 International Drive, Suite 301  
Portsmouth, NH 03801  
800.962.6876 phone

[www.marketstreettrust.com](http://www.marketstreettrust.com)

*This presentation has been prepared by Market Street Trust Company. The views expressed herein represent opinions of Market Street and are presented for informational purposes only. They are not intended to be a recommendation or investment advice and do not take into account the individual financial circumstances or objectives of the investor who receives it.*

*Certain statements included in this presentation constitute forward looking statements. Forward looking statements are not facts but reflect current thinking regarding future events or results. These forward statements are subject to risks that may result in actual results being materially different from current expectations.*

*Past performance (before and after taxes) does not guarantee future performance. There is no assurance that Market Street Trust Company funds will achieve their investment objectives, or that they will or are likely to achieve results comparable to those shown herein, or will make any profit, or will be able to avoid incurring losses. Exposure to foreign currencies may cause*

*additional fluctuation in the value of any investment. Each investor must assess the suitability of an investment, one's tolerance for risk and the impact on one's diversification strategy. This presentation does not constitute an invitation to buy or an offer to sell securities, or any other products or services.*

*This is intended as general information only. Investors in these funds may be required to meet certain criteria under the securities laws in order to qualify. Any discussion of U.S. tax matters is not intended and cannot be used or relied upon for the purpose of avoiding U.S. tax-related penalties.*

*Please visit our website for additional information on the funds and any investment fund updates. As always, please feel free to contact us if you would like to learn more about our investment program.*

