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IN THIS ISSUE



QUARTERLY MARKET INSIGHT
2ND QUARTER 2021

## SEMICONDUCTOR SHORTAGE

In recent quarters, an acute shortage of semiconductors has affected the global automaking, smartphone and consumer electronics industries. Semiconductors, often referred to as microchips, or chips, are silicon-based integrated circuits that can store data and act as the brains of a device. Amid the shortage, U.S. consumers may find their new Ford F-150 pickup on backorder or Microsoft's next generation Xbox X gaming console sold out. Volkswagen AG, Ford Motor Company and Toyota Motor Corporation were all forced to stop production at various points in 2021 due to the semiconductor shortage.

Pandemic-related developments have unquestionably contributed to the current situation. Demand for personal computers, home networking gear, webcams and monitors surged in 2020 as white-collar professional service workers in advanced economies found themselves suddenly forced to work from home. Demand for cloud-based data center capacity also skyrocketed as many of those same workers embraced video conferencing during the day and video streaming at night. The global auto industry nearly shutdown production in the early part of the pandemic, but then sharply ramped up once vaccines were announced. According to an April 2019 white paper from consulting firm Deloitte, electronics systems powered by semiconductor-based chips comprised 40% of the cost of a new car in 2017 and is projected to reach 45% by 2030. This compares to 20% as recently as 2007.

There are also several important contributors to the semiconductor shortage unrelated to the pandemic. A crippling February cold snap in Texas caused power outages that shut down semiconductor plants in the Austin area. A fire in the Japanese plant of a major global automotive chip-maker disrupted production for several weeks. Critically, large U.S. chipmakers have increasingly adopted a business model focused on chip design and the outsourcing of most manufacturing to foreign suppliers. Paul Wick, lead portfolio manager of Columbia Seligman Technology and Information fund, has noted "Semiconductor companies have been moving away from independent production to a more efficient outsourcing production model since the 1990s resulting in less slack…(and) a very slim chip inventory – a pivot that occurred after some huge inventory write-downs when the tech bubble burst in 2000."

According to The Economist, roughly 80% of the world's semiconductor manufacturing capacity is in East Asia centralized around two suppliers: Taiwan Semiconductor Manufacturing Company (TSMC) in Taiwan and Samsung Electronics in South Korea. Taiwan stands out as a particularly vulnerable choke point in the global semiconductor supply chain because it is under constant threat of invasion by China, and TSMC currently dominates the outsourcing of high-end chips used in many advanced applications. Adding capacity is not simple given the advanced technology and highly specialized equipment needed to build a new foundry or expand a current one. The Boston Consulting Group and Semiconductor Industry Association recently estimated a cost of more than $1 trillion over 10 years for the U.S. to reach "complete manufacturing self-sufficiency" in semiconductors.

In the short-term, certain industries will likely face continued headwinds related to the semiconductor shortage. Bloomberg estimates semiconductor shortages will erase $61 billion of sales for automakers in 2021. Product cycles for smartphones, internet routers and gaming consoles could face significant delays into 2022 and beyond. On the other side of the ledger, surging demand and a much broader set of end markets has led to improved earnings visibility for semiconductor manufacturers and could change how investors assign a valuation to the stocks of these companies.

The most important long-term consequence of the shortage will most likely be capacity expansion. TSMC recently announced $30 billion in new spending on capacity additions and additional spending of $100 billion over the next three years for further expansion. Samsung has pledged $116 billion over a decade timeframe in an effort to catch up with TSMC's dominance in logic chips. In early June, the Senate passed the U.S. Innovation and Competition Act, a $250 billion bipartisan bill designed to counter China's technological development. The legislation contains $52 billion to fund domestic semiconductor research, design and manufacturing initiatives. Over a longer term timeframe, the proliferation of 5G mobile networks, wider adoption of data-intensive video streaming and gaming and more people working from home will very likely increase overall demand for powerful and efficient chips. While semiconductor production bottlenecks and shortages are likely to dissipate over the next six to twelve months, many investors expect the evolution in chip demand to drive a multi-year industry super cycle.

# ECONOMY

## A CONSUMER BOOM

Consumer activity has been a driving force behind what could be the fastest economic growth in decades in the second and third quarters. With stimulus checks sent to a large portion of Americans in the first quarter and pent-up consumer demand from a long year of lockdowns, the U.S. economy is poised to outpace its strong first quarter annualized growth rate of 6.4%. According to the median estimate in a recent Bloomberg survey of economists, second quarter real gross domestic product (GDP) is likely to expand at an annualized pace of 10.0%. Consumer spending, the largest component of GDP, rose 11.4% in the first quarter and is estimated to post another double-digit growth rate of 10.0% in the second quarter.

Federal Reserve policymakers also have an optimistic outlook for the U.S. economy, as they raised their projection for GDP growth in 2021 from 6.5% in March to 7.0% at their June Federal Open Market Committee (FOMC) meeting. Fed officials also increased their projections for inflation in 2021 and the timeline for raising the federal funds rate at the June FOMC meeting. The median FOMC participant now expects two 0.25% rate hikes by the end of 2023. At the March FOMC meeting, the median participant did not expect the first rate hike until 2024. Various Fed officials and market commentators have suggested that the reason behind the FOMC pulling forward its rate hike path guidance lies in signs of stronger-than-expected economic growth and inflationary pressures in recent months. While FOMC Chairman Jerome Powell recently acknowledged that "…inflation could turn out to be higher and more persistent than we expect," policymakers expect most price pressures to simmer down later in the year as supply catches up with demand. This view notwithstanding, in June the FOMC increased its expectation for inflation in 2021 to 3.4% compared to its previous forecast of 2.4%.

| ECONOMIC INDICATORS | LATEST | 3MO PRIOR | CHANGE* |
|---|---|---|---|
| REAL GDP (QoQ ANNUALIZED) | 6.4% | 4.3% | ▲ |
| TRADE BALANCE | -71.2 | -70.6 | ▼ |
| UNEMPLOYMENT RATE | 5.9% | 6.0% | ▲ |
| NON-FARM PAYROLLS | 850K | 785K | ▲ |
| ISM MANUFACTURING | 60.6 | 64.7 | ▼ |
| ISM NON-MANUFACTURING | 60.1 | 63.7 | ▼ |
| RETAIL SALES (LESS AUTOS) | -0.8% | -3.2% | ▲ |
| INDUSTRIAL PRODUCTION | 0.9% | -2.9% | ▲ |
| HOUSING STARTS | 1572M | 1447M | ▲ |
| CONSUMER PRICE INDEX (YoY) | 5.0% | 1.7% | ▼ |
| CONSUMER CONFIDENCE | 127.3 | 114.9 | ▲ |
| EXISTING HOME SALES | 5.8M | 6.24M | ▼ |
| CONSUMER CREDIT | 35.28B | 20.27B | ▲ |
| CRUDE OIL PRICE | $ 73.47 | $ 59.16 | ▼ |

Source: Bloomberg. Past performance does not guarantee future results. *The change arrow is indicative of a positive or negative change in the economic nature of the data series. For example, a downward-pointing change arrow assigned to the crude oil price field will correspond with an increase in the actual price of crude oil over the last three months. This is because a short-term increase in the price of crude oil has historically been detrimental to aggregate U.S. consumer spending.

The Conference Board Consumer Confidence Index reached a mark of 127.3 in June, which was well above the median estimate of 119.0 from a Bloomberg survey of economists. This marks the fifth consecutive monthly increase and was the highest reading since February 2020. According to the Commerce Department, the unchanged reading in consumer spending, which accounts for more than two-thirds of U.S. economic activity, followed an upwardly revised 0.9% jump in April. Household spending was supported by rising vaccination rates and household savings from rounds of government aided stimulus when the pandemic restricted businesses and activities.

## EMPLOYMENT AND MANUFACTURING

According to the U.S. Labor Department, 850,000 domestic jobs were added in June, the largest monthly increase since last August. Initial jobless claims fell by 51,000 to a pandemic-era low of 364,000 for the week ending June 26. The unemployment rate rose from 5.8% to 5.9% as more Americans joined the labor force. The ISM Manufacturing Index, a measure of U.S.-based manufacturing, slipped slightly to 60.6% in June, but remains well above the 50% threshold for expansionary activity. The survey indicated that rising costs for materials and labor shortages drove the decline.

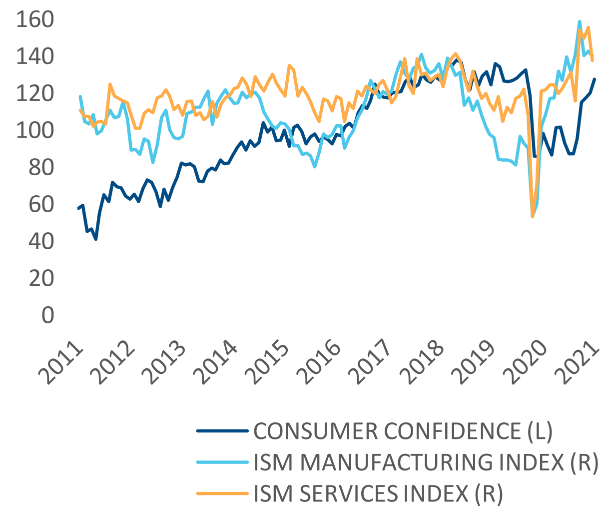
The Institute for Supply Management (ISM) reported that economic activity in the U.S. manufacturing sector continued to expand in June but at a softer pace than it did in May, as the ISM Manufacturing Index declined to 60.6 from 61.2 in May. This reading came in slightly lower than the consensus expectation of 61.0 and represents the thirteenth consecutive month of manufacturing sector expansion. None of the eighteen manufacturing industries tracked in the Index reported a contraction in activity during June. Although manufacturing only accounts for roughly 12% of U.S. GDP, it is a closely watched area of the economy due to its inherent cyclicality.

## HOUSING

Sales of new U.S. single-family homes fell in May to a one-year low while the average price of newly built houses soared amid a surge in raw material prices. The second straight monthly decline in sales was the latest indication that the tailwind from the COVID-19 pandemic could be subsiding. New home sales dropped 5.9% to a seasonally adjusted annual rate of 769,000 units last month, the lowest level since May 2020. Sales of previously owned U.S. homes also fell in May, marking the fourth straight monthly decline as higher prices and lean inventories weighed on buying. The Case-Schiller Home price index increased by 14.6% year over year in April, its highest reading in more than 30 years of data. With demand high and mortgage rates low, the National Association of Realtors reported Wednesday that pending home sales rose 8% from April to May.

CHART 1

CONSUMER CONFIDENCE RECOVERS




Source: Bloomberg. Past performance does not guarantee future results.

# EQUITY

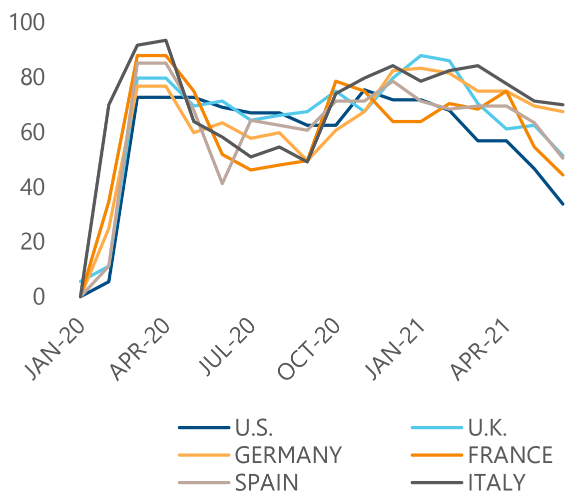
## FIRST HALF STRENGTH

U.S. stock indexes marched higher in June for a fifth consecutive month and posted double-digit returns in the first half of the year as economies reopened and vaccination campaigns progressed in most developed countries. After a slow start, vaccination efforts in the European Union are catching up to the U.S. and U.K. in terms of percent of population vaccinated. Many measures of economic activity in advanced industrial nations have picked up amid eased COVID-19 restrictions. According to the Oxford COVID-19 Government Response Stringency Index, which tracks nine indicators including business closures, school closures, and travel bans, restrictions in the U.S. and U.K. have reached the lowest levels since last March. The S&P 500's 8.55% return in the quarter extended the index's gains this year to 15.25%, the second strongest performance in the first half of a year since 1998. The strongest first half performance since 1998 was 2019's 18.54% return. The technology-heavy Nasdaq climbed 9.49% in the quarter, while the Dow Jones Industrial Average and small cap Russell 2000 posted more modest advances of 4.61% and 4.05%, respectively.

The strong quarterly performance of domestic stocks was also supported by declines in both bond yields and inflation expectations after rapid ascents in the first quarter. Accelerating inflation in recent months and a strengthening economy fueled some investors' expectations that the Federal Reserve will likely begin raising interest rates earlier than 2024, which was a target date that Fed officials had signaled as recently as March. As discussed in the Fixed Income section, in their mid-June meeting Fed policymakers moved closer to investors' expectations by pulling forward their anticipated interest rate hike timeline to 2023. Subsequent comments by Fed officials attempted to dampen worries about tightening monetary policy too quickly.

The stock market's rotation into value and cyclical stocks that began last fall faded in the quarter. A more hawkish Fed, lower bond yields, and easing inflation concerns were credited with growth stocks outperforming their value counterparts. The S&P 500 Growth index outperformed the S&P 500 Value index by 6.94% in the quarter after trailing the Value index by 8.65% and 3.83% in the first quarter and fourth quarter, respectively. The growth-oriented technology and communications sectors were among the S&P 500's top-performing sectors, with quarterly gains of 11.56% and 10.72%, respectively.

CHART 2
EASING COVID-19 RESTRICTIONS




Source: University of Oxford. Past performance does not guarantee future results.

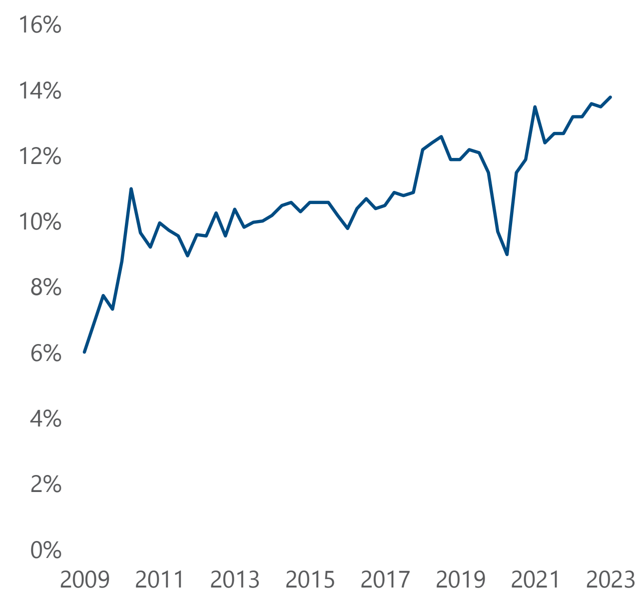
Despite value trailing growth in the quarter, the energy sector remained near the top of the sector leaderboard with an 11.30% quarterly return. The energy sector's 45.64% performance through the first half of 2021 is 20% ahead of the financials sector, which was the second-best performing group over this period. It is the energy sector's best performance in the first half of a year since the S&P 500 Energy index's inception in 1989. The International Energy Agency (IEA) projects global oil demand will rebound by 5.4 million barrels per day (bpd) this year after contracting 8.6 million bpd last year. The IEA expects further demand recovery of 3.1 million bpd next year, leading to demand surpassing pre-COVID levels by the end of 2022. Improving oil demand led the price of West Texas Intermediate (WTI) crude oil to surge by more than 20% for a second consecutive quarter and surpass $70 per barrel for the first time since October 2018.

As inflation accelerated, corporate operating margin projections were revised lower. According to data compiled by Bloomberg, analysts have lowered their near-term margin estimates for 142 companies in the S&P 500. Health care and technology sector margins are expected to be hit the hardest by rising inflation. Supply chain disruptions and the rapid economic rebound created pricing pressures for a wide array of input resources including aluminum and semiconductors. This amplified a gap between strong demand and weak supply that can be seen in high profile areas of the economy including existing homes and used cars. Some companies are attempting to offset higher input costs by raising prices for consumers. Historically, increasingly higher levels of inflation have made it difficult for firms to fully pass their rising costs on to consumers. The widening gap between producer and consumer price inflation in recent months highlights the margin pressure faced by many companies.

Higher wages and taxes are additional factors that could pressure corporate profit margins. Recovering economic activity, labor shortages, and extended COVID-19 unemployment benefits may lead to stronger wage growth in some industries. Spikes in average hourly wages can be particularly troublesome for consumer industries such as food, retail, and apparel. However, S&P 500 margin expansion over the last decade suggests companies in aggregate were able to absorb steady increases in wages. Proposed legislation including a higher global minimum corporate tax rate and an infrastructure bill partially funded by higher corporate taxes would also affect margins, but with varied sector implications. Despite these challenges for corporate profitability, analysts still project S&P 500 margins to expand in the second half of this year and next year as earnings growth outpaces rising costs.

CHART 3

S&P 500 PROFIT MARGINS BOUNCE BACK




Source: Bloomberg. Past performance does not guarantee future results.

FIXED INCOME

## A LESS DOVISH FED

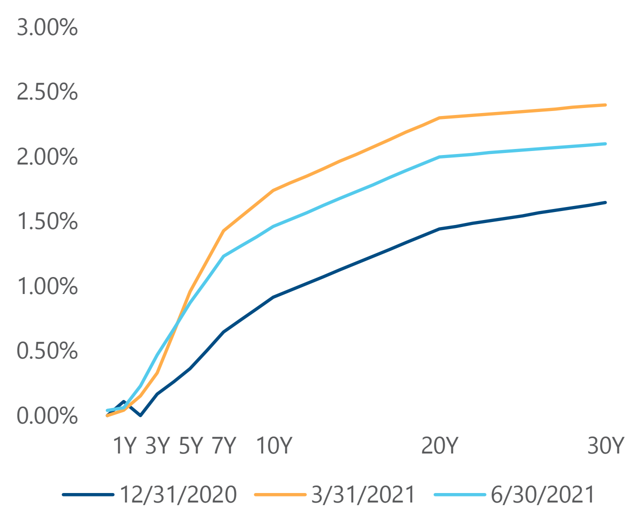
The April through June period brought a partial reversal in several of the major first quarter developments across fixed income markets. Market-based measures of inflation expectations cooled off. Yields across much of the maturity spectrum moved lower, which led to a flattening of the yield curve. Over the course of May and June, messaging from Federal Reserve officials began to shift away from the very dovish stance undertaken from March 2020 through March 2021. A number of FOMC members explicitly noted higher-than-expected realized inflation and a faster recovery in economic growth than originally projected. Finally, Fed policymakers signaled at their June FOMC meeting their intention to begin discussing the first steps toward policy normalization.

During the quarter, the Bloomberg Barclays U.S. Treasury Index posted a return of 1.75%, composed of 1.34% of price return and 0.41% of coupon income. This reversed approximately 40% of the index's 4.25% first quarter decline. The Bloomberg Barclays Corporate Bond Index, which measures the investment grade, fixed rate corporate bond market generated a total return of 3.55% in the quarter broken into 2.70% of price return and 0.83% of coupon income. Its second quarter gains enabled the index to claw back about 75% of its first quarter losses. Similar to the previous three quarters, the environment for corporate credit remained largely supportive. The credit spread on the Bloomberg Barclays U.S. Corporate High Yield Bond Index tightened by approximately 0.20% following 0.70% of tightening in the first quarter.

In the second quarter, yields on the 2-year U.S. Treasury note climbed from 0.16% to 0.24%, while yields on the 10-year maturity declined from 1.74% to 1.47%. As seen in Chart 4, this reversed a significant amount of the bear-steepening that occurred in the U.S. Treasury yield curve in the first quarter. A majority of this reversal occurred after the mid-June FOMC meeting, at which the central bank raised its 2022 inflation forecast and signaled the potential for interest rate increases before the end of 2023. In June, the "dot plot" of Fed governors' fed fund policy rate projections indicated a median expectation of two 0.25% rate hikes in 2023 compared to zero in March. Upward pressure on yields at the front end of the yield curve combined with downward pressure on yields at the longer end was partially driven by the hawkish tilt in Fed policy at the June FOMC meeting taking investors by surprise. Some market commentators have suggested that the bond market is beginning to price in a potential Fed policy mistake by pulling forward interest rate hikes in

CHART 4

U.S. TREASURY YIELD CURVE MOVEMENTS




Source: Bloomberg. Past performance does not guarantee future results.

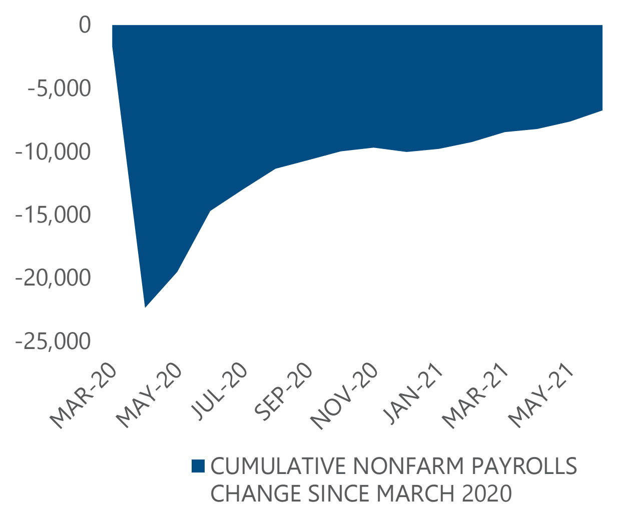
order to fend off inflationary pressures. Others have argued that the sharp shift lower in yields has mostly been driven by technical factors including a significant Treasury market positioning imbalance in favor of short duration exposure and healthy foreign demand.

Shortly after the June FOMC meeting, Fed leadership strived to dull investor concern about the more hawkish tone. Chairman Jerome Powell told a House panel the following week that the central bank would not raise rates preemptively, but would wait for signs of realized inflationary pressures before taking action. Although Powell noted that recent price increases have been larger and somewhat more persistent than expected, he maintained that they are mostly tied to supply chain disruptions related to the economic reopening (see Spotlight section). He also noted that the labor market recovery has been relatively weak compared to strong economic growth, citing as potential causes lingering concerns about COVID-19, child care needs and disincentives to work associated with enhanced unemployment benefits.

Although Federal Reserve officials will undoubtedly monitor inflation trends closely in coming months, they seem to have placed a higher priority on the "maximum sustainable employment" objective of their dual mandate. In its most recent Summary of Economic Projections, the FOMC estimated the longer run, normal rate of unemployment consistent with its employment mandate to be 4.1% compared to the current unemployment rate of 5.9%. As Chart 5 depicts, U.S. nonfarm payrolls remain nearly 7 million below their pre-pandemic peak in February 2020. Employers added 850,000 workers to payrolls in June compared to the consensus estimate of 720,000. At a monthly rate of 850,000 payroll gains, it would take eight months to fully regain all of the nearly 24 million combined jobs lost last March and April. At rates of 700,000, 500,000 and 300,000 average monthly payroll gains, it would take roughly 10 months, 14 months and 23 months, respectively, to recover all of the jobs lost last spring. Assuming Federal Reserve officials continue to view bouts of inflation as transitory, the pace of payrolls gains could be a more important determinant of the timeline for interest rate hikes than trends in price levels.

Over a 6- to 12-month period, we believe clients' fixed income portfolios will benefit from duration exposure moderately below benchmark. This will be especially relevant if Fed policymakers raise the federal funds rate at a faster pace than is currently priced in markets. Tight credit spreads notwithstanding, we think the favorable economic backdrop warrants an overweight allocation to corporate credit including U.S. high yield and preferred stocks, if suitable for client portfolios.

CHART 5
DOMESTIC PAYROLLS RECOVERY




Source: Bloomberg. Past performance does not guarantee future results.

## PEAK GROWTH?

In last quarter's Outlook section, we summarized the potential economic and market effects of the coronavirus vaccination trajectory, large-scale fiscal stimulus and the Biden administration's plans for higher corporate tax rates. As the second quarter progressed and the economic reopening accelerated, the dominant market storylines changed. The uncertainty surrounding the nature of domestic inflation and the U.S. Federal Reserve's preferred path for monetary policy normalization have now taken center stage.

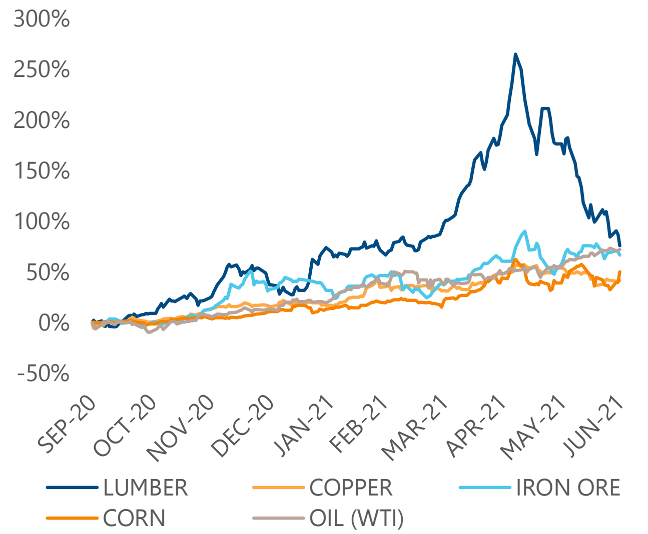
Against a backdrop of surging prices for many commodities and travel-related goods and services, a vigorous debate has emerged about whether recent inflationary pressures are most likely to be fleeting or persistent. In certain areas of the economy including semiconductors (see Spotlight section), existing homes and used cars, acute supply shortages have driven prices sharply higher. Investors in the transitory inflation camp observe that the so-called "base effects" of suppressed price levels from a year ago amid widespread lockdown measures will soon drop out of year-over-year inflation data. As seen in Chart 6, some commodities that experienced the sharpest price increases over the last nine months have recently begun to cool off. Those who argue inflationary pressures will be more long-lasting point to the trillions of dollars of fiscal stimulus still coursing through the financial system, increasingly higher minimum wages and the potential for persistent supply chain constraints.

In addition to the inflation debate, market participants are engaged in a tug-of-war about the timeline for the Federal Reserve's withdrawal of emergency-era policy support. In a mid-June FOMC statement, policymakers provided updated projections on the path of the federal funds rate that indicated two 0.25% rate hikes by the end of 2023. This surprised a good number of investors in large part because the March version of these projections indicated no interest rate hikes by the end of 2023. Fed officials said the reason they took a small initial step in the direction of paring back accommodative policy was because the pace of the economic and labor market recovery exceeded their expectations of only a few months ago.

Among the most prominent features of the second quarter were the decline in longer dated U.S. Treasury yields and the transfer of equity market leadership from industries set to benefit the most from economic reopening to large cap growth stocks (see Equity section). Additionally, as discussed in the Fixed Income section, the U.S. Treasury yield curve flattened significantly from mid-May through the end of June. All three of these developments imply that investors have become less enthusiastic about the prospects for long-term economic growth. We think it is too early to tell if the rate of U.S. economic growth has peaked and that a swift return to meager pre-pandemic growth is all but inevitable. We do not dismiss this possibility out of hand, but we see plenty of evidence suggesting the current domestic

CHART 6

SELECTED COMMODITY PRICES



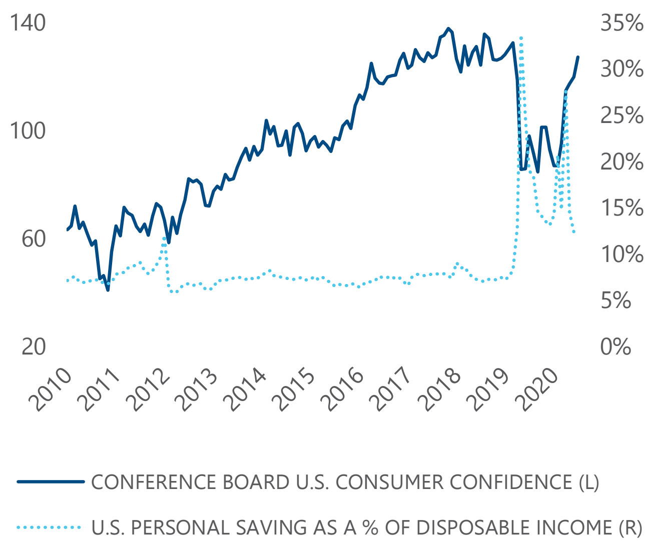

Source: Bloomberg. Past performance does not guarantee future results.

economic expansion can sustain annual real GDP growth rates above the 2.1% average from 2000 through 2019 for longer than it has recently become fashionable to believe.

Despite recent concerns about reaching peak growth, we believe the current economic, market and policy environments remain favorable to risk assets including global equities and corporate credit. Although the rate of change in policy support has decelerated, the combination of Federal Reserve policy and fiscal policy is arguably more stimulative than at any time since the 1960s. As discussed in the Economy section and seen in Chart 7, American consumers are expressing increasing levels of confidence and consumer balance sheets are as healthy as they have been in a generation. The labor market recovery plods along despite periodic soft patches. Meanwhile, U.S. corporations have vastly improved their balance sheets over the last 12 months and are poised to generate strong profit growth in 2021 and 2022. Finally, another phase of the economic reopening could emerge in September as schools reopen, summer vacation season ends and pandemic-era supplementary unemployment benefits are set to expire.

For the above reasons, we believe investors should remain overweight global equities relative to U.S. government bonds and cash over the next 6-12 months. Within equity allocations, we favor increasing exposure to the most GDP-sensitive areas of the market including domestic mid cap, domestic small cap and emerging markets. These areas are more closely tied to the business cycle and should experience a disproportionately stronger boost to revenues and earnings than other areas of the market. In fixed income allocations, we believe investors will benefit from shifting exposure from core, investment grade areas of the bond market toward satellite fixed income classes including domestic high yield bonds and preferred stocks. This should allow portfolios to benefit from a much healthier corporate balance sheet picture than existed a year ago. Within alternatives allocations, we view a modest position in gold as an effective hedge against further declines in real (inflation-adjusted) interest rates and a potential beneficiary of short-term surges in demand for safe-haven assets.

CHART 7
U.S. CONSUMER CONFIDENCE AND FINANCIAL HEALTH




Source: Bloomberg. Past performance does not guarantee future results.

| ECONOMIC FACTORS | CURRENT OUTLOOK |
|---|---|
| U.S. GDP Growth | The median projection for 2021 U.S. GDP growth in a Bloomberg survey of economists rose to 6.6% in July from 6.2% in April with a range of 2.4% to 7.7%. |
| Federal Funds Rate | Market participants are pricing in the first 0.25% Fed rate hike by December 2022 and three hikes by December 2023 as implied from the U.S. OIS Curve. |
| Inflation | Expectations for average annual inflation over the next five years derived from U.S. TIPS breakevens declined to 2.50% after peaking at 2.77% in mid-May. |
| Employment | According to the NFIB's June survey, a record net 28% of U.S. small business owners reported plans to fill open positions over the next three months. |
| Consumer Confidence | The Conference Board's June survey of 3,000 U.S. households reached its highest level since February 2020 driven by consumers' assessment of labor conditions. |
| Oil | A failure between OPEC and its allies to reach a production agreement in early July could enable oil prices to continue grinding higher in the second half of 2021. |
| Housing | Limited supply, elevated home prices and raw material inflation are likely to at least partially offset robust housing market demand in coming quarters. |
| International Economies | The median projections for 2021 GDP growth in the euro zone, China and Japan, based on recent Bloomberg surveys of economists, are 4.5%, 5.6% and 2.6%, respectively. |

| | MINIMUM | | NEUTRAL | | MAXIMUM |
|---|---|---|---|---|---|
| FIXED INCOME | | ● | | | |
| Core Bonds | | | ● | | |
| TIPS | | | | ● | |
| Non-Investment Grade | | | | ● | |
| International | ● | | | | |

CURRENT OUTLOOK

We believe an underweight to fixed income in multi-asset class client portfolios remains appropriate. The total return prospects of high-quality bonds is likely to be capped over the next 6-12 months amid an environment of strong economic growth and the potential for periods of elevated inflation. Within core segments of fixed income allocations, we think a moderate duration underweight relative to benchmark is sensible given our base case of gradually higher government bond yields over the second half of 2021. Although they are not a perfect hedge for inflation, we believe an allocation to Treasury Inflation-Protected Securities (TIPS) should continue to help dampen the volatility of fixed income allocations compared to nominal U.S. Treasuries. Outside of core fixed income, we believe high yield bonds and preferred stocks will continue to benefit on a relative basis from of a benign credit environment and above-trend economic growth.

| | MINIMUM | | NEUTRAL | | MAXIMUM |
|---|---|---|---|---|---|
| EQUITIES | | | | | |
| Large Cap | | | | ● | |
| Mid Cap | | | | ● | |
| Small Cap | | | | ● | |
| Developed International | | | | | |
| Emerging Markets | | ● | | | |

CURRENT OUTLOOK

Despite elevated valuations and concerns about the impact of inflation, we believe an overweight to equities relative to high-quality bonds and cash remains justified. Although the rate of change in policy support is decelerating, U.S. consumers are expressing increasing levels of confidence and their balance sheets are at their healthiest levels in a generation. Any improvements in the pace of the labor market recovery should further boost consumer sentiment. U.S. corporations have vastly improved their balance sheets over the last 12 months and are poised to generate strong profit growth in 2021 and 2022.  Finally, another phase of the economic reopening could emerge in September as schools reopen, summer vacation season ends and pandemic-era supplementary unemployment benefits are set to expire. Within equity allocations, we favor increasing exposure to the most GDP-sensitive areas of the market including domestic mid cap, domestic small cap and emerging markets. These areas are more closely tied to the business cycle and should experience a disproportionately stronger boost to revenues and earnings than other areas of the market.

| | MINIMUM | | NEUTRAL | | MAXIMUM |
|---|---|---|---|---|---|
| ALTERNATIVES* | | | | ● | |

| | CAP PRES | IWSG | BAL | GWSI | GROWTH |
|---|---|---|---|---|---|
| Global Real Estate | | | | | |
| Global Infrastructure | | | | | |
| Gold | | ● | ● | ● | |
| Hedged Equity | ● | ● | ● | ● | ● |
| Arbitrage | ● | ● | ● | | |

CURRENT OUTLOOK

We believe an allocation to alternative asset classes and strategies remains appropriate despite expectations for above-trend economic growth in 2021. This is driven by our view that alternatives can be an effective portfolio diversification tool in an environment characterized by bouts of policy uncertainty and a low risk-free rate. Within an alternatives allocation, we believe an allocation to gold should help most client portfolios better navigate the next 6-12 months. This is largely based on our observation of gold's tendency to behave as a safe-haven asset in periods of market stress and the potential for it to benefit from U.S. dollar weakness and negative real (inflation-adjusted) interest rates.  Our diversified alternatives portfolios, as seen in the table to the left, are designed to decrease the overall risk profile of our five investment objective-based portfolios (CAP PRES, IWSG, BAL, GWSI, and GROWTH).

The above minimum/neutral/maximum recommendations represent MainStreet Advisors' current positions relative to our Strategic Asset Allocation ranges. Views expressed have a 6-12 month horizon and are those of the MSA Investment Committee.
*Cap Pres: Capital Preservation, IWSG: Income with some growth, Bal: Balanced, GWSI: Growth with some income

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