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Financial Outlook

Second Quarter 2021

Summary

At a Glance

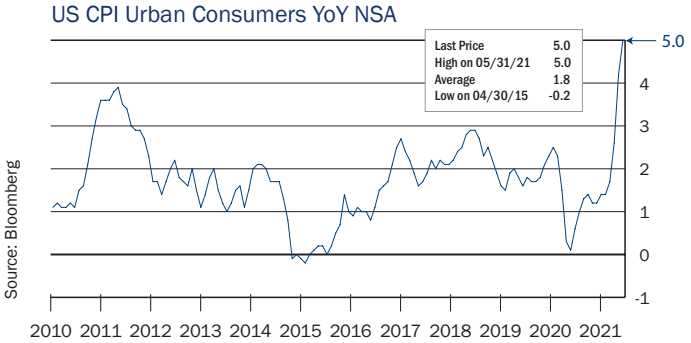
- Asset markets expect the low rate environment to stay in place for a very long time
- Persistent inflation pressures could lead to more hawkish monetary policy than the market expects
- US Equities look fairly valued as long as bond yields stay in this year's range
- Longer-term, higher bond yields could threaten the equity market
- Corporate bonds are priced at the rich end of the historic range, leaving little room for bad news

Point of View

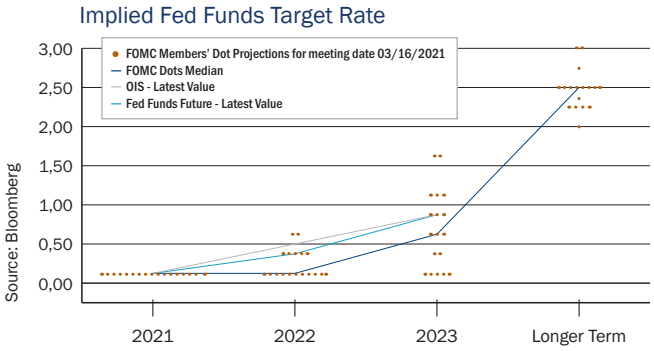
Jan Erik Warneryd, Chief Investment Officer

In what now seems like a predictable pattern, global Equity markets rose again in Q2 2021. History shows, however, that we need to be humble about our ability to predict markets, especially from one quarter to the next. When surveys of investors point to expectations of further gains far into the future, there is reason to stop to ask "what assumptions does this outlook rest on?". If the assumption is that, say, interest rates will stay low "forever", what would change if that turned out not to be the case? How much of today's demand for assets is directly linked to ultra-accommodative monetary policy? When fiscal stimulus has been added to already-low rates, has that further increased asset values? Will these stimulative policies be withdrawn at some point? If so, what will happen? There are many questions but few answers at this point, although we may have received a minor yet important hint from Federal Reserve Chair Powell that inflation concerns may finally have shown up on the FED's radar screen.

Let us take a quick look at inflation again: below is a chart showing year-on-year inflation rates going back to 2010. As can be seen, we are right now experiencing the highest rates in long time, in fact, apart from a very brief oil-driven spike in July 2008, just before the Global Financial Crisis, these are the highest inflation levels since 1990. Now, it appears the market isn't very concerned about the actual level of inflation, but rather is focused on whether the FED will consider it transitory and not act to reign it in or whether it will prove sticky enough to force monetary tightening.



The June 2021 "dot-plot", where individual Federal Reserve Open Market Committee members indicate their forecast of FED funds for the next few years, showed a very slight increase in the possibility of rate hikes in late 2022 and a median expectation of 2 hikes (50 basis points) in 2023 (see below).



Perhaps counterintuitively, the bond market's response to the potential for slightly earlier tightening than expected was a flattening of the Treasury yield curve accompanied by lower rates from about the 10-year maturity and beyond. This could be interpreted as the market, on the one hand, believing that the FED has finally reached a point where they will take inflation into consideration when setting policy. On the other hand, the fact that the yield on 10-year Treasury Notes now is below 1.5% would also seem to indicate that the market believes the economy is vulnerable to rate hikes and that the tightening campaign will be limited to just a few rate hikes before the economy feels the impact and starts to slow down materially. This implies a significant shift in the market's implied ability to cope with even slightly higher rates and could be a significant headwind to further Equity market gains. However, it is also possible, and perhaps more likely, that the bullish reaction in the bond market was more a result of position squaring by investors anticipating a steeper yield curve. The FEDs newfound concern for inflation, as mild as it seems, was enough to force some market participants to buy back short positions in long bonds and sell shorter maturities. In a market where the FED is still buying $80 billion in the Treasury market every month, it doesn't take much to force prices higher and yields lower.

It seems reasonable to assume that until the FED starts to taper their purchases in the bond market we are unlikely to see any significant change in yields. Our base-case is that the yield on 10-year US Treasuries will stay in a 1.3-1.8% yield range at least until the FED has committed to a date for the tapering to begin. The next step after tapering, which could be a drawn-out process lasting the better part of a year or even longer, will likely be a hike in the FED Funds rate, which the market now expects will happen towards the end of 2022 or early 2023. It is important to note that the market only sees a total of three hikes of 25 basis points each until the beginning of 2025, which would represent a very mild tightening cycle indeed. The market consensus appears to favor the economy to settle back into the low growth/low inflation mode that had been in place since the GFC once the pandemic-induced bounce-back is over, and this is well reflected in current market expectations. A stronger, longer lasting period of growth and sticky inflation does not appear to be reflected in market pricing, especially in bonds. Even given the many longer-term uncertainties, the real yield on 10-year Treasury Inflation Protected Securities (TIPS) is only negative 90 basis points, meaning that buyers are essentially guaranteed to lose almost 1% per year in real terms if they hold the bonds to maturity. Real yields this low appear inconsistent with the massive monetary and fiscal stimulus we have experienced since the beginning of the pandemic and therefore there is significant risk that Treasury yields will increase in coming years.

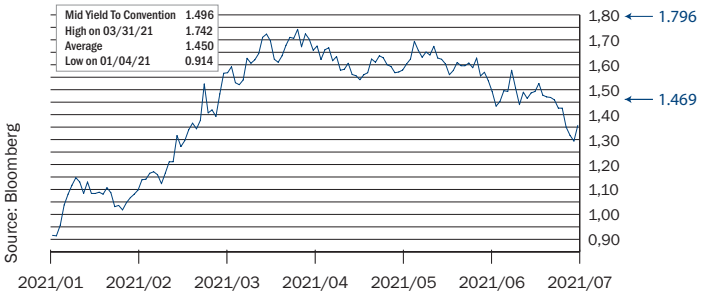
Bond Markets

Radha Lai, Portfolio Manager

Mark McDonnell, Senior Portfolio Manager

The first half of 2021 was almost a tale of two bond markets neatly divided by the end of the first quarter. As seen in the ten-year Treasury chart below, the bond market sold off during the first quarter, rising in yield from less than 1% to a peak on March 31st just shy of 1.75%. While the Fed signaled it was on hold well into 2023, the bond market saw the combination of strong growth, solid gains in the fight against COVID, and the prospect of significant fiscal stimulus as a potent mix that could spell inflation. While the two-year note remained well anchored by the Fed talk, longer Treasuries sold off. Bond market participants set up what is called a "Steepener Trade" where they were long Treasuries maturing in a few years and sold short longer maturities. It would appear that, the Fed had their back and growth was all but guaranteed and significant inflationary pressures were developing. In fact, the rise in yields tended to coincide with the rise in growth expectations and the concurrent rise in inflation expectations. But just like the ten-year note peaking in yield on March 31st the spread between the two-year and the ten-year note peaked on that day as well.

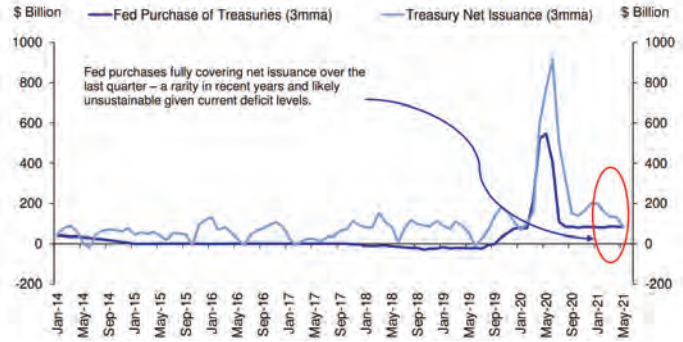
Ten Year Yield



Source: Bloomberg

That all changed markedly during the second quarter. While the market consensus for 6.6% GDP growth for 2021 remained, some financial data came in modestly weaker than expected and fiscal stimulus bills were increasingly receiving resistance. In a market positioned for ever increasing growth, any miss becomes significant. The implications for the Treasury market were two-fold: potentially slower growth and less Treasury issuance. As a result, yields peaked and started a slow grind lower further exacerbated by the Federal Reserve's continued buying of $80 Billion a month in Treasuries and $40 billion a month in Residential Mortgage Backed securities. As Deutsche Bank points out, this resulted in the Fed buying up virtually all of the net new supply of Treasuries.

Net Treasury Issuance and Fed QE

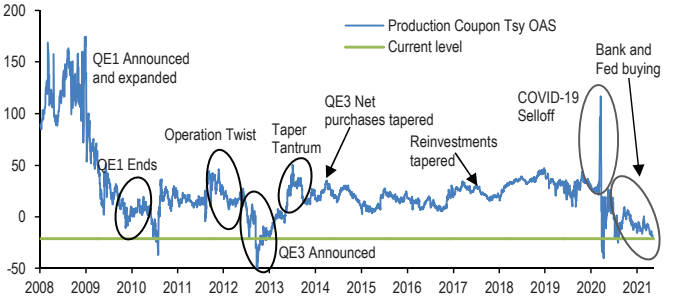


Source: FRB, SIFMA, Bloomberg Finance LP, Deutsche Bank

All this finally came to a head at the June FOMC meeting where the Federal Reserve signaled that they may begin tightening sooner than the market expected - in the fourth quarter of 2022 rather than in 2023. This, coupled with the previously discussed positioning caused the market to violently unwind the "Steepener Trade", driving long-term Treasury rates aggressively lower. Unfortunately, in our opinion, the market is misinterpreting lower rates, which were primarily driven by a combination of technical factors, as an indication that the economy is going to slow down. While there may be some truth to that statement, especially in light of the reduction in Supplemental Unemployment Benefits scheduled to end in September, we believe that the tight labor markets will readily absorb these workers. Currently almost half the states have already ceased providing additional unemployment benefits and the 26 states that still provide it represent roughly 70% of the insured.

We mentioned the Fed's continued buying of residential mortgages. As seen in the following chart from JP Morgan, that action has distorted the mortgage market as well. When one factors in the homeowner's option to prepay his or her mortgage into the yield on the security, we see that there is very little value in much of the mortgage market. In the previous quarter we bought those "current coupon" mortgages as they had some value, especially with the Fed as a solid buyer. This quarter we sold many of our lower coupon holdings and reinvested some of those proceeds into higher coupon MBS.

Mortgage Option Adjusted Spread



Source: JP Morgan

STRATEGY

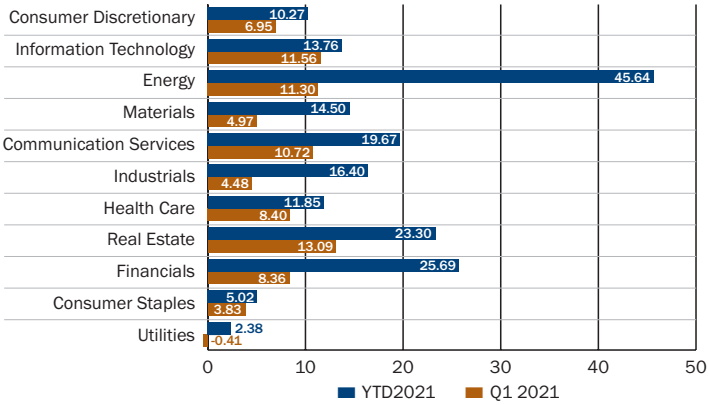
We continue to position the portfolios to be modestly shorter than the index in duration and modestly underweight in both corporate debt and residential MBS sectors. As value driven investors we see both of these sectors as overpriced and look to add only if the market were to enter a period of de-risking. The "carry", or additional yield one receives over Treasuries to own those sectors, is at or near all time lows. We have successfully waited for opportunities to present themselves in the past and are confident we will see an opportunity in the future.

U.S. Equities

Jan Erik Warneryd, Chief Investment Officer

US Equities continued their climb higher in the second quarter of 2021, supported by a combination of strong earnings, ample liquidity and low interest rates. The S&P 500 Index returned 8.55% for the quarter and 15.25% year-to-date. All sectors except for Utilities had positive returns during the quarter and all are up year to date (see below). The Energy sector continued its strong performance as it is bouncing back from many years of underperformance, followed by Financials and Real Estate on a year-to-date basis.

S&P 500 Index
Total Return (%) by Sector / Quarter End June 2021



Source: S&P Dow Jones Indices

An important reason for the equity market's continued surge higher is that interest rates have stayed low and even declined in the long end of the bond market in recent months. The following chart shows the gap between the earnings yield (inverted P/E) on a CAPE basis (real 10-year average earnings) on the S&P 500 Index versus the real yield on 10-Year Treasury Inflation-Protected Securities (TIPS) since 1998. Currently, the yield gap in favor of US Equities is 3.70% versus an average of 3.23%. This indicates that, given where real yields are, Equities are slightly cheaper than the average since 1998.

The valuation metrix used in this chart is based on the CAPE ratio which currently stands at about 37. This is the highest level since December 1999, when it reached above 44. Then, as now, there was significant dispersion between sectors in the market. Value, as a factor, had underperformed in the late 1990s but made a strong comeback even as the overall market declined in subsequent years. The backdrop is similar now, with Price/Earnings ratios ranging from 11.7 for Telecom Services and 11.8 for Banks, to 36.4 for the Consumer Discretionary sector. The overall S&P500 P/E ratio is at 22.5 (all numbers are based on I/B/E/S consensus estimates as reported by Morgan Stanley on 07/01/21).

One key difference between 1999 and now is the amount of stimulus and hence, how loose current financial conditions are. In 1999, the US government ran a budget surplus and yet real yields on TIPS were around 4%. Now, in 2021, the budget deficit is about 15% of GDP and the real yield on 10-year TIPS is at negative 90 basis points. It is difficult to reconcile the size of the Government's financing need with the ultra-low level of yield without giving the fact that the FED is buying $80 billion in Treasuries every month significant credit. For this reason, it is very difficult to read price signals from the Bond market other than to say that a likely rebalancing ultimately will include bond yields rising from current levels.

In 1999, the bull market in Equities ultimately ended at least partly because of the FED's tightening campaign that lasted from June 1999 to June 2000 and raised the funds rate from 4.75% to 6.5%. According to both the FED and market pricing, we are about 18 months or so away from the first monetary tightening and when it happens, it is expected to be much slower and shallower than the 1999-2000 cycle. If this turns out to be correct, we should not expect the equity market to worry about tighter conditions for quite a while yet.

STRATEGY

As outlined above, Equities look fairly valued if Bond yields stay at current levels or rise modestly. We believe 10-year Treasury yields are likely to stay in a roughly 1.30-1.80% range until the FED starts to taper Treasury and Mortgage Bond purchases. For this reason, we believe US Equities will continue to perform well even though there are parallels with the 1999/2000 Nasdaq bubble era. A key distinction is that in the current era, the FED is still adding monetary stimulus whereas in 1999, they started a hiking cycle. Since no withdrawal of monetary stimulus is likely in the near term, Equities should stay well supported even at these lofty levels. In our S&P 500 Sector Selection equity strategy, we continue to have a value tilt, favoring Telecom and Financials while being underweight richly valued sectors such as Consumer Discretionary. We are also continuing our strategy of having no allocation to the Energy and Real Estate sectors.

Regarding Energy, we believe that although performance has been strong this year, there are longer-term headwinds that will eventually slow down or even reverse the sector's performance in the medium to long term. These include the commitment to end the use of fossil fuels in coming decades by many governments, corporations and investors. This will lead to less investment capital available for new exploration which will have two conflicting impacts; on the one hand, investors will value fossil fuel-related assets lower, but on the other hand, the scarcity of supply will keep prices higher than they otherwise would be. On the whole, as investors who prefer to invest in sectors that are likely to grow in tandem or faster than the economy overall, we have decided to focus on more sustainable parts of the equity market.

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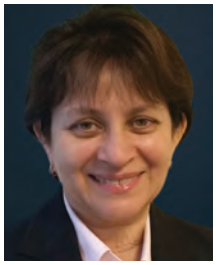

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