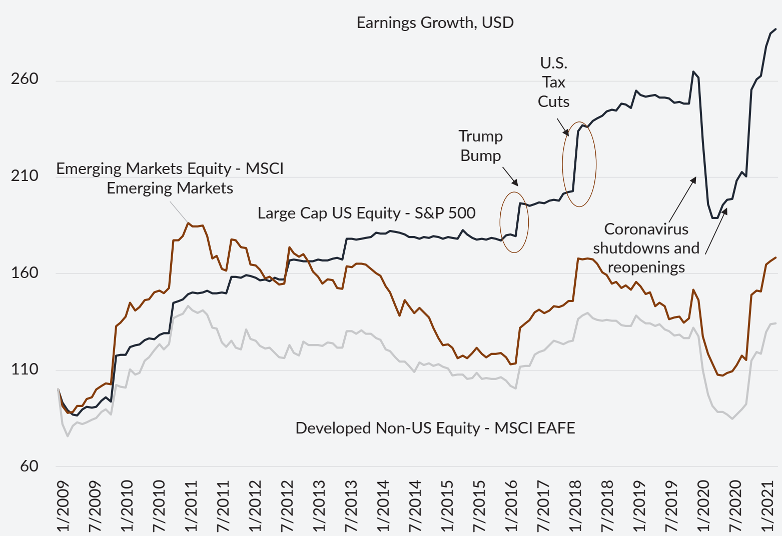
Stembrook Market Review — Second Quarter 2021

Economic activity and corporate earnings continued to boom in the second quarter, as economies ramped up reopening efforts and pent up demand helped boost spending. Consumption accounted for over 68% of U.S. GDP in the first quarter. Economists look at high frequency economic data to guide them in making their forecasts. These figures include, consumer debt and credit transactions, which were up 23% from 2-years prior (pre-pandemic levels). For the same period, travel and navigation app usage was also positive. Hotel occupancy is still down –10% from 2 years ago and TSA traveler traffic is still down –21%.[1] The consumer is coming back, but the leisure and hospitality industries still need time to catch up.

In the long run, equity returns are driven by earnings; in other words, how much a company earns after the bills are paid. For goods producing companies, earnings fell at the start of the pandemic (see Global Earnings Growth chart below). Certain service providers, like Amazon, saw little disruption to earnings as demand for their services *increased* from the pandemic. Earnings must continue to increase for stocks to justify higher prices as a result of the rally over the past 15 months.

Gloabal Earnings Growth



Global earnings have rebounded at a rapid pace since the lows of May 2020 as economies have reopened.

Inflation has been on the minds of investors over the past few months. Global central banks took very aggressive measures to stabilize economies during the pandemic, these actions tend to be inflationary. At the end of June, the year-over-year change in inflation was 5.4% in the U.S., the largest 12-month increase since August 2008. Most of this increase can be attributed to energy prices.[2] Inflation erodes purchasing power, making your dollars worth less than before. This is one item that we will be keeping a very close eye on in coming months.

Our proprietary models forecast long-term, pre-tax returns ranging from 0% to 1% for fixed income-like asset classes and 7% to 9% for equity-like asset classes (see table below). We maintain target weight allocations to equities and fixed income. Our more detailed observations and current portfolio positioning are outlined in the following comments.

Expected Market Returns and Risks
7-10 Year Horizon

As of 30-Jun-21
Expected Risk and Return – 7-10 Year Horizon

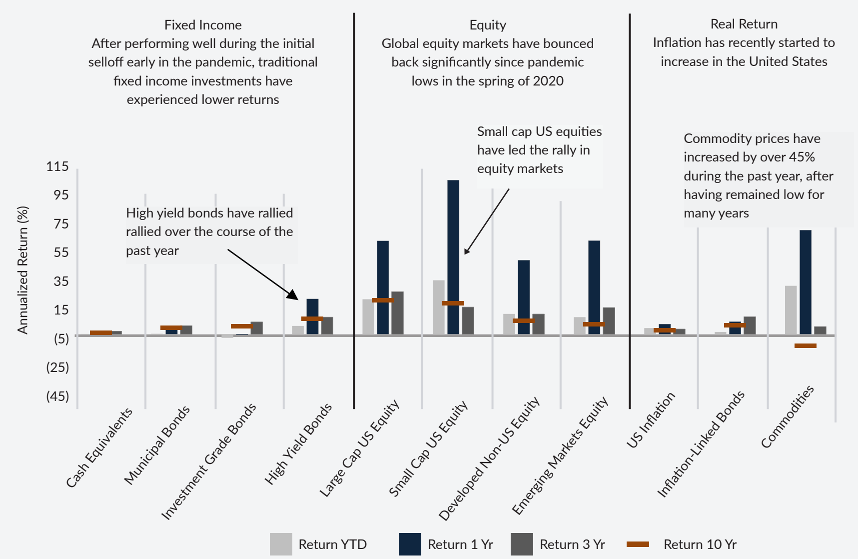
		Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
	Inflation	2.3%	2.3%	3.1%
Fixed Income	Municipal Bonds	0.5%	0.5%	4.4%
Fixed Income	Inflation-Linked Bonds	1.3%	0.7%	5.6%
Fixed Income	Investment Grade bonds	1.3%	0.7%	6.7%
Fixed Income	High Yield Bonds	0.5%	-0.1%	13.2%
Equity	Broad Market US Equity	7.3%	5.7%	16.9%
Equity	Developed Non-US Equity	7.5%	5.7%	21.4%
Equity	Emerging Markets Equity	9.3%	6.0%	29.6%

A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Economic Backdrop

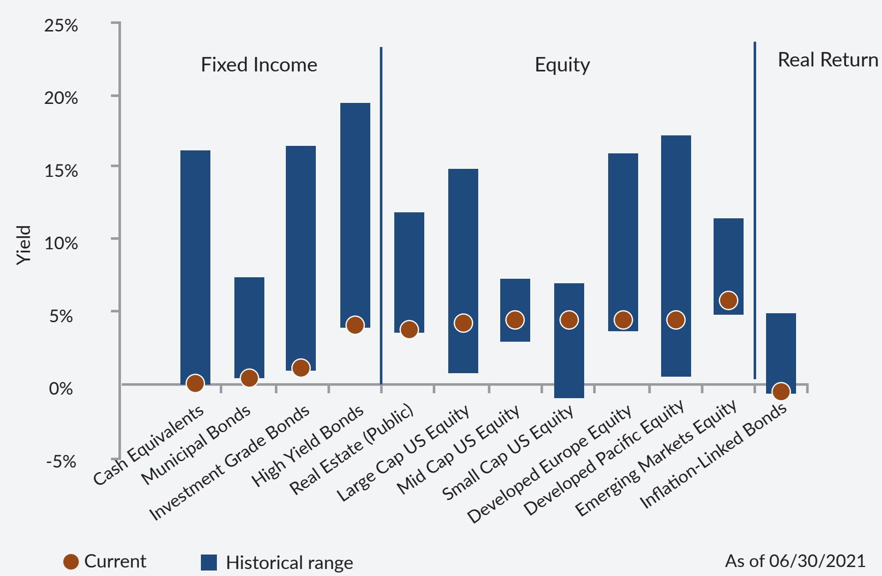
- **Global GDP is expected to continue to pick up steam in the second quarter as economies rebound from the pandemic, global GDP is forecasted to increase by 10.2% in the quarter. In the U.S., GDP is expected to increase to 9.2%.[3]**
- The U.S. is not the only country that is experiencing above trend inflation. Global prices are expected to increase by 3.1% in the second quarter.[4]
- Despite a stronger global economy, there are still areas of weakness in developed economies. The Eurozone economy is expected to contract by -2% and the Japanese economy is expected to contract nearly -4%.[1]
- Emerging markets' economies continued to build upon first quarter growth, with GDP expected to increase by 9.9% in the second quarter. The breadth of strong GDP growth has increased, with all major emerging economies expanding at a rate of over 7%.[3]
- The U.S. housing market has taken the past year in stride. In March, New Privately Owned Housing Starts reached their highest level since June of 2006[5]
- Global business confidence remains at an elevated level, as managers look to a rebounding economy, post pandemic. Both services and manufacturing purchasing managers' indices remain well above 50. Developed markets readings are higher than those for emerging markets for both service and manufacturing. A level above 50 indicates expansion, while a level below 50 indicates contraction.[6]

Historical Market Returns



Historical market returns as of June 30th, 2021. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

Yields Across Assets Classes



Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Bond yields are generally low versus historical range.

Equities

- **Global stocks had a very strong quarter, up 6.4%.[7] After having trailed in the first quarter, growth oriented technology stocks in the Nasdaq Index were up 9.4% in the second quarter.[8]**
- Rising energy prices helped to lift energy stocks in the second quarter. The index ended the quarter up 8.4%.[9]

Commodities

- **After many years of low to negative returns, commodity prices rallied in the second quarter, up 13.3%.[10]**

Fixed Income

- **Increased inflation expectations sparked a rally in inflation linked bonds. The asset class was up nearly 4% in the quarter.[11]**
- Investment grade bonds in the U.S. bounced back in the second quarter, up 1.5%.[12]

Global Asset Class Returns

Asset Class Name	Last 10 Years	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Large Cap US Equity	S&P 500 11.4%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%	EM Eq 37.3%	CPI 2.0%	S&P 500 31.5%	EM Eq 18.5%
Small Cap US Equity	Small Cap 9.8%	Real Estate 9.2%	Real Estate 17%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%	Intl Eq 25.0%	Inv Grd Bnd 0.0%	Real Estate 28.7%	S&P 500 18.4%
Real Estate (Public)	Real Estate 7.8%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%	S&P 500 21.8%	Infl-Indx Bnd -1.8%	Intl Eq 22.8%	Infl-Indx Bnd 13.1%
High Yield Bonds	HY Bnd 5.6%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%	Small Cap 13.2%	HY Bnd -2.1%	Small Cap 22.7%	Small Cap 11.2%
Developed Non-US Equity	Intl Eq 4.9%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%	Real Estate 8.7%	Real Estate -4.0%	EM Eq 18.6%	Intl Eq 8.4%
Emerging Markets Equity	EM Eq 3.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%	HY Bnd 7.5%	S&P 500 -4.4%	HY Bnd 14.3%	Inv Grd Bnd 7.5%
Inflation-Linked Bonds	Infl-Indx Bnd 3.4%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%	Inv Grd Bnd 3.5%	Small Cap -8.5%	Infl-Indx Bnd 10.6%	HY Bnd 7.1%
Investment Grade Bonds	Inv Grd Bnd 3.2%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%	Commod -13.0%	Inv Grd Bnd 8.7%	CPI 1.3%
Inflation	CPI 1.5%	Commod -13.3%	CPI 2.0%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 2.8%	CPI 2.1%	Intl Eq -13.3%	Commod 5.4%	Commod -3.5%
Commodities	Commod -5.9%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%	CPI 2.1%	Real Estate -5.1%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Current Positioning

We have **sold our high yield bond position** in tax-deferred portfolios as spreads have fallen below normal levels and prices increased by over 18% during our holding period. We have sold the position in taxable portfolios in a tax-efficient manner.

We maintain our **overweight to developed non-U.S. and emerging market** equities, where valuations and long-term return potential remain attractive.

We also maintain our **underweight to large cap U.S. equities.**

We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market over time, with less volatility. These investments outperformed in the first half of the year.

We maintain a **slight overweight to inflation-linked bonds** for taxable and tax-deferred investors.

In the coming months we will be keeping a close eye on the potential changes to tax policies for both individuals and corporations, as well as inflation. We will keep you informed as to our strategies for navigating these potential changes.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA

Thomas Kosinski

Endnotes and Sources:

Text:

(1) JP Morgan Asset Management: Consumer/debit credit transaction and TSA traveler traffic are measured on 7-day moving averages. App Annie data is compared to 2019 average and includes over 600 travel and navigation apps globally, including Google Maps, Uber, Airbnb and booking.com. As of 6/30/21.

(2) BLS: Percent changes in CPI for All Urban Consumers (CPI-U). As of June 6/30/21.

(3) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 6/30/21.

(4) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 6/30/21.

(5) Bloomberg: US New Privately Owned Housing Units Started by Structure Total SAAR. As of 3/31/21.

(6) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 6/30/21.

(7) Bloomberg: MSCI ACWI Total Return. 3/31/21-6/30/21.

(8) Bloomberg: NASDAQ 100 Stock Index Total Return. 3/31/21-6/30/21.

(9) Bloomberg: MSCI ACWI/Energy Total Return. 3/31/21-6/30/21.

(10) Bloomberg: Bloomberg Commodity Index Total Return. 3/31/21-6/30/21.

(11) Bloomberg: S&P 10 Year TIPS Index Total Return. 3/31/21-6/30/21.

(12) Bloomberg: Bloomberg Barclays U.S. Aggregate Bond Index Total Return. 3/31/21-6/30/21.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 6/30/21.

Source: Stembrook Research.

(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predict- ed range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 6/30/21.

Sources: Cash Equivalents Yields since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, Municipal Bond Yields since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, Investment Grade Bond Yields since March 1976. Barclays Capital, High Yield since December 1984. BofA Merrill Lynch, Barclays Capital, Real Estate (Public) Earnings Yield since March 1976. NAREIT all Equity, Large Cap U.S. Equity Earnings Yield since March 1976. Standard & Poor's, BARRA, Mid Cap U.S. Equity Earnings Yield since June 1991. Standard & Poor's, BARRA, Small Cap U.S. Equity Earnings Yield since December 1993. Standard & Poor's, BARRA, Developed Europe Equity Earnings Yield since March 1976. MSCI Europe, Standard & Poor's Europe 350, Developed Pacific Equity Earnings Yield since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, Emerging Market Equity Earnings Yield since December 1998, Inflation-Linked Bond Real Yield to Maturity since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

Global Earnings Growth: As of 6/30/21.

Source: The BEst (Bloomberg Estimates) Earnings Per Share (EPS Adjusted) estimate returns Earnings Per Share from Continuing Operations, which may exclude the effects of one-time and extraordinary gains/losses.

Historical Market Returns: As 6/30/21.

Source: Bloomberg, Stembrook Research.

Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Con- sumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns: As of 12/31/20.

Source: Thomson Reuters, Bloomberg, Stembrook Research.

Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Ag- gregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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