Stembrook Market Review — Third Quarter 2021

Inflation and the looming debt ceiling combined with stalled budget negotiations in the U.S. have dominated headlines over the past three months. Real estate developer, Evergrande's missed debt payments rattled Emerging Markets. This and other events pushed Chinese equity prices down –16% during the quarter.[1] These events, all of which we are keeping a close eye on, have sparked volatility in what has been and remains, a relatively calm year for stocks.

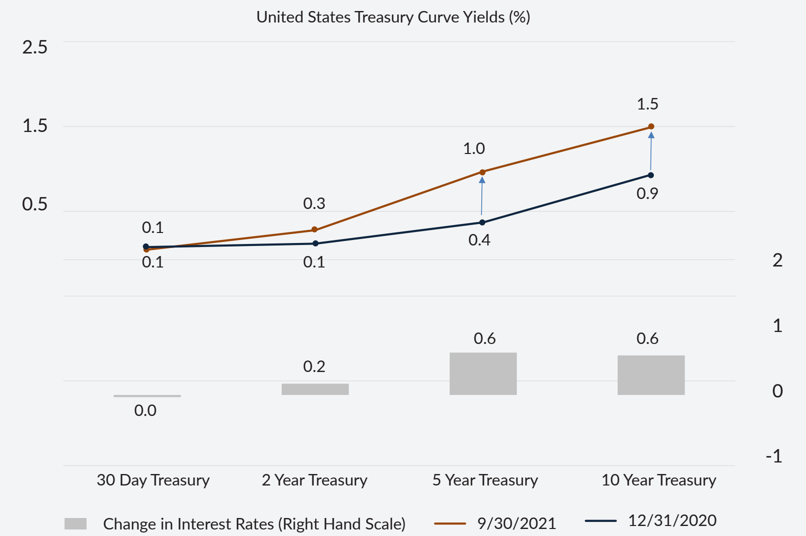
Inflation remains elevated. After years of ultra-accommodative policies from central banks and as economies have roared back from Covid-19–related shutdowns, supply chains and labor supply have struggled to keep up. This has led to higher prices. The energy sector, which had struggled for years due to low oil prices, has seen a dramatic rebound this year, up nearly 66% year-to-date.[2]

With rising inflation, we have seen rising interest rates that have tempered returns in fixed income markets. Over the course of the year, investment grade bonds are down by -0.9%.[3] This rise in interest rates has been a boon for the financial sector, with global financial stocks up over 50% since the start of the year.[4]

In the coming months, we will be keeping a close eye on budget negotiations and potential changes to tax policy. We will keep you informed on how we plan to navigate any upcoming changes and work with you and your tax advisor to take action, if required.

Our proprietary models forecast long-term, pre-tax returns ranging from 0% to 1% for fixed income-like asset classes and 8% to 10% 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.

Rising Interest Rates



Intermediate term interest rates have risen by over 0.5% since the beginning of the year.

Expected Market Returns and Risks
7-10 Year Horizon

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

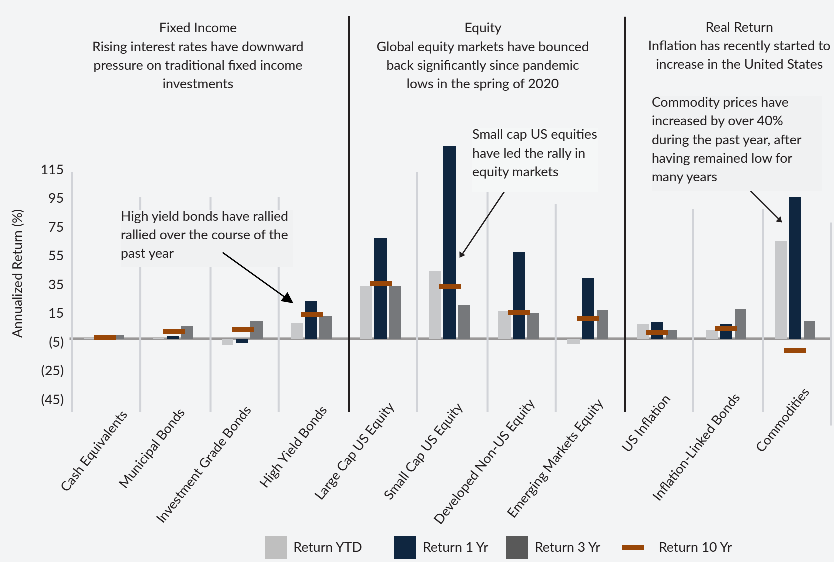
		Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
	Inflation	2.3%	2.3%	3.1%
Fixed Income	Municipal Bonds	0.6%	0.6%	4.4%
Fixed Income	Inflation-Linked Bonds	1.3%	0.7%	5.6%
Fixed Income	Investment Grade bonds	1.3%	0.7%	6.7%
Fixed Income	High Yield Bonds	0.8%	0.1%	13.2%
Equity	Broad Market US Equity	8.1%	6.3%	16.9%
Equity	Developed Non-US Equity	8.0%	6.2%	21.4%
Equity	Emerging Markets Equity	9.8%	6.4%	29.6%

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

Economic Backdrop

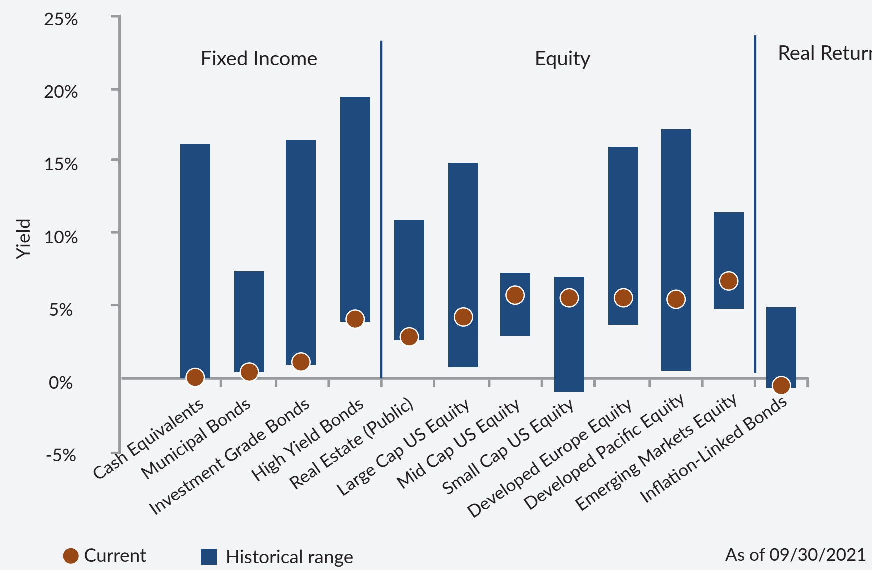
- **After a very strong second quarter, GDP growth is expected to decelerate in the third quarter. Despite this slowdown, the global economy is expected to grow at a 4.3% annualized pace, with all G-20 countries showing growth. Economists expect the pace of growth to pick up again in the final quarter of the year.[5]**
- Inflation remains elevated, expected to increase at a 4.3% pace globally and a 5.4% pace in the U.S .[6]
- Similar to developed countries, emerging markets economies are expected to decelerate in the third quarter, but still continue to grow at a moderate pace of 5.3%, with the majority of economies expanding.[5]
- After picking up at a robust pace in the first half of the year, high frequency economic data such as TSA Traveler Traffic, purchase mortgage applications and hotel occupancy moderated as the Delta Variant slowed economic activity in the U.S.
- Global business confidence remains at an elevated level, as managers look to a re-bounding economy, post pandemic. Both services and manufacturing purchasing managers' indices remain well above 50. Developed markets readings remain higher than those for emerging markets for both service and manufacturing. A level above 50 indicates expansion, while a level below 50 indicates contraction.[7]

Historical Market Returns



Historical market returns as of September 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 took a breather in the third quarter, falling by 1.6% after what has been a very strong year, in which they are up nearly 28%.[8]**
- Emerging markets equities were hit the hardest in the quarter, down 6.8% over the period.[9]

Commodities

- **Driven by higher energy costs, commodity prices continued to increase in the third quarter, up 6.6%.[10]**
- Oil prices have increased by nearly 57% since the start of the year.[11]

Fixed Income

- **The rally in inflation-linked bonds continued in the third quarter as inflation concerns remained elevated. TIPS were up 1.5% over the past 3 months.[12]**
- Shorter duration notes have outperformed longer duration treasury bonds in the U.S., as interest rates increased.

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

Earlier this year, we **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 remaining positions 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.

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 we approach the end of the year, please keep tax planning and gifting strategies in mind. If you would like to discuss your specific tax situation or plans for year-end gifting, please let us know and we can schedule a time to speak.

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) Bloomberg: MSCI China Total Return: 6/30/21-9/30/21.
(2) Bloomberg: MSCI ACWI/Energy Total Return. 12/31/20-9/30/21.
(3) Bloomberg: Bloomberg Barclays U.S. Aggregate Bond Index Total Return. 12/31/20-9/30/21.
(4) Bloomberg: MSCI ACWI/Financials Total Return. 12/31/20-9/30/21.
(5) 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 9/30/21.
(6) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 9/30/21.
(7) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 9/30/21.
(8) Bloomberg: MSCI ACWI Total Return. 6/30/21-9/30/21, 12/31/20-9/30/21.
(9) Bloomberg: MSCI Emerging Markets Total Return. 6/30/21-9/30/21.
(10) Bloomberg: Bloomberg Commodity Index Total Return. 6/30/21-9/30/21.
(11) Bloomberg: Generic Crude Oil Futures. 12/31/20-9/30/21.
(12) Bloomberg: S&P 10 Year TIPS Index Total Return. 6/30/21-9/30/21.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 9/30/21.
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 predicted 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 9/30/21.
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.

Rising Interest Rates: As of 9/30/21.
Source: The Federal Reserve

Historical Market Returns: As 9/30/21.
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, Consumer 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. Aggregate 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.

Disclosures