



Market Recap

Equities around the globe continued to surge in the second quarter. The U.S. and developed international markets led the way, with the S&P 500 Index gaining 8.5% and developed international stocks rising 5.7%. Emerging-market stocks trailed in terms of progress on the COVID-19 front and in turn rose by a more modest 4.9%.

Within the U.S. stock market, the rotation from growth to value stocks took a pause, with the Russell 1000 Growth Index gaining 11.9% versus a 5.1% rise for the Value index. Smaller-cap value stocks slightly outperformed their growth counterparts and have been the top-performing segment of the U.S. market this year.

In fixed-income markets, the 10-year Treasury rose as yields dipped below 1.50% in June, ending the quarter at 1.45%, down from 1.75% at the end of March, despite higher inflation readings during the quarter. This contributed to a solid 2.0% return for the core bond index. In fact, inflation fears were felt more strongly last quarter, and core bonds remain down 1.6% for the year as a result of the first quarter selloff.

The Big Picture Bottom Line

Our assessment of the macroeconomic backdrop and outlook has not meaningfully changed since last quarter-end. We continue to expect a strong global economic recovery over the next 12 months at least, driven by expanding COVID-19 vaccinations and immunity, and still-accommodative global monetary and fiscal policy (although increasingly less so). While most asset class valuations are expensive, these macro conditions remain broadly supportive of corporate earnings and risk assets, such as global equities, corporate bonds, asset-backed securities, and floating-rate loans.

Inflation risks *have* increased in the past three months. But in our view, the weight of the evidence (our base-case) still suggests much of the recent price surge is transitory and that *sustained high* inflation is not an *imminent* risk. This is primarily because there remains meaningful slack in the economy and labor market. We expect the competitive forces of supply and demand to restrain price increases over the coming months as economic activity continues to normalize. We are already seeing this trend in many commodity markets.

However, as Jay Powell says, there is significant uncertainty as the economy recovers from the unprecedented pandemic-induced dislocations. There are inflationary and deflationary risks on either side of our base case. We are not adamant in our macro or market views. Our analysis and views will continue to evolve as new economic data arise and the markets respond.



Our Financial Markets Outlook & Portfolio Positioning Allows for a Range of Scenarios

As COVID-19 vaccinations and immunity spread across the globe, we continue to expect a strong global economic recovery contributing to healthy corporate earnings growth. This should bode well for riskier but higher-returning asset classes over the near term (next 12 months) at least. Credit markets should benefit as well. While the Federal Reserve is now signaling it is moving closer to beginning to taper its quantitative easing asset purchases, monetary policy and interest rates should remain accommodative for a while.

Base Case

First, regarding our base-case economic/market view, looking out over the shorter to medium term, we anticipate:

- continued positive returns for equity and credit markets on the back of strong early- to mid-cycle economic and corporate earnings growth along with still-accommodative government policy.
- outperformance from non-U.S. equity markets that are more economically sensitive and have lower valuations than the S&P 500, and that have lagged the United States in rolling out widespread vaccinations but are now catching up.
- a continued market rotation generally toward cyclical/value stocks from defensive/growth stocks; and
- poor core bond returns, as Treasury yields are likely to be pressured somewhat higher from current low levels due to stronger global growth and reflation.

We believe our portfolios are well-positioned for continued strong performance in our base-case scenario of an ongoing global economic recovery as the world emerges from the pandemic. But we also own asset classes that should do fine in the event of unexpectedly strong inflation which include meaningful allocations to flexible bond strategies that we expect to do better than core bonds in this environment. And, as always, in our more conservative balanced portfolios we maintain important positions in assets like core bonds that provide ballast and strength in the event of a deflationary surprise or shorter-term exogenous shock.

On the major question of whether recent signals are harbingers of a sustained period of meaningfully higher inflation, we believe it is too early to tell. Or whether, as the Fed believes most of the recent sharp price increases will prove transitory, as current supply shortages catch up to demand and increasing productive capacity comes online as the pandemic recedes.

As multi-asset portfolio managers and risk managers, we remain open to a *higher*-inflation scenario outside of our base case. If the Fed continues its current stated policy path (as we expect) and the global recovery continues, we do expect U.S. inflation over the next five-plus years to exceed the 1.7% average core PCE inflation of the past 20 years. But that is far from saying we expect to see a high-inflation regime (say, on the order of 4% to 5% or higher *sustained* annual CPI inflation). In any case, we hope to get more clarity on this question over the next few quarters as additional wage, price, and inflation expectations data come in.



Diversification Nevertheless Remains Important

While our base case is positive, the range of outcomes is always wide, and these are far from ordinary times. As a result, we don't make aggressive bets on a single outcome even if our analysis suggests it is more likely. We acknowledge there are scenarios that could drive inflation to be higher and occur sooner than we expect. There could also be shocks like more-dangerous COVID-19 variants or political unrest that lead to a market correction or worse.

While a sustained period of high inflation would be bad initially for most equities, over time many areas would likely do well. Even as currently positioned, most of the "reflationary" assets we own have historically also performed well (or relatively well) in inflationary environments, including Emerging-market equities, cyclical/value stocks (such as financials, energy, materials, and industrials), and trend-following managed futures strategies. And in the event of a macro shock and deflationary pressure, we maintain meaningful positions in core bonds, which would help offset declines elsewhere. Put simply, we are diversified, as always.

Given the uncertainties, we believe long-term investors should balance the upside returns in a reflationary scenario with downside risks from an inflation surprise in either direction. We incorporate inflation and deflation risks around our base-case outlook into our thinking. We have exposure to defensive assets (to varying degrees depending on the client's risk level), but in general our portfolios are tactically tilted toward reflationary return-generating assets.

Potential Tax Changes

Confusion remains around the prospect for tax hikes related to President Biden's ambitions for infrastructure and other spending. While a bipartisan deal was announced on more-modest infrastructure spending that used means other than tax increases to raise revenue, a second spending package is also under consideration that would employ some of the tax proposals of the original American Families Plan announced back in April. Those include an increase in the top federal tax bracket to 39.6% for families earning more than \$400,000, an increase in the capital gains tax rate for those with annual income above \$1 million, and the elimination of the 1031 like-kind exchange rules for real estate.

Specifics have and will continue to change including around the effective date of any tax changes. And it's no certainty that anything will pass. Still, the possibility exists that one or both measures could be passed along party lines using the "reconciliation" process, which would not require bipartisan support. What that would look like in final form won't be known for some time. What we can do is advise maintaining awareness of any potential impacts and working with your advisory team to plan accordingly, such as around the timing of asset sales and business income where possible. We will be watching this closely and are prepared to make recommendations if appropriate.

Closing Thoughts

Again, our current base case is that inflation does not get out of control. But we update our tactical views as new information becomes available. And structurally, our portfolios are well-diversified across a range of macro scenarios around our base case.

As COVID-19 vaccinations and immunity spread across the globe, we continue to expect a strong global economic recovery. This should bode well for riskier but higher-returning asset classes over the near term (next 12 months) at least. While the Fed is now signaling it is moving closer to beginning to taper its QE asset purchases, monetary policy and interest rates should remain accommodative for a while.

The path of fiscal policy in the United States is less certain, given the political dynamics and polarization. The expiration of the pandemic support programs will turn from a fiscal boost to a fiscal drag later this year and in 2022. But this should also lead to increased labor supply, mitigating wage inflation pressures.



2021Q2 Investment Letter

Period End

06/30/2021

With the likelihood of a U.S. recession very low—absent a severe external shock—we see low risk of a bear market. Of course, 10%-plus stock market corrections can always occur. As we move further into the U.S. earnings cycle, the odds of a typical mid-cycle market correction increase. However, despite elevated S&P 500 valuations and a likely deceleration in S&P 500 earnings growth, we believe global equities have additional return potential in this cycle. More specifically, we continue to see superior shorter- to medium-term return prospects in international and EM equity markets, where earnings have more room for positive surprises and valuations are more reasonable. As always, though, equity investors should be prepared for a bumpy ride.

We thank you for your continued trust. We welcome questions you may have about potential tax changes, or any aspect of your portfolio and financial picture.

Rainey & Randall Investment Team