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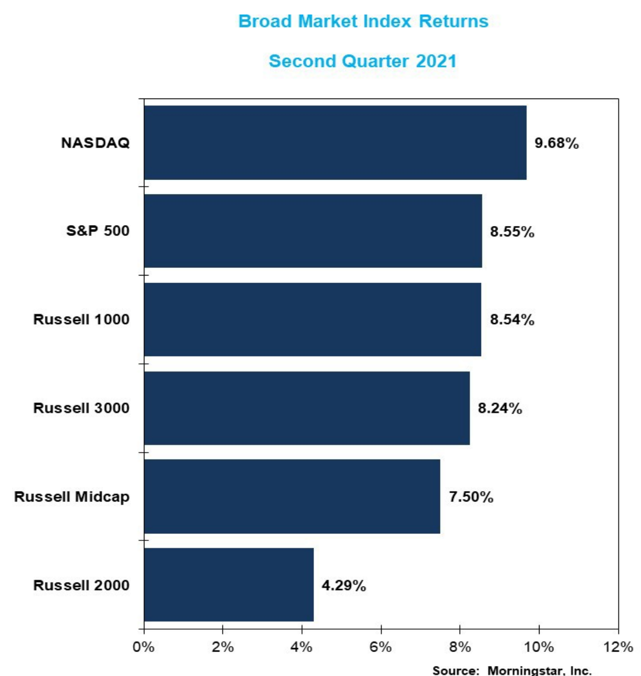
We hope this finds you and your loved ones doing well and enjoying the summer. Reopening is underway and continuously evolving in establishing our new normal.

The overall economy is recovering from the significant and acute recession caused by the pandemic. The combination of unprecedented fiscal and monetary stimulus, increasing business reopening, and decreasing virus cases have created the ingredients for the growth in the economy. Along with all of this good news is the risk of a correction and inflation is spiking. Throw in the impact of the new variants and we continue to live in "interesting" times.

The Economy

The US economy grew robustly in the quarter as unprecedented fiscal stimulus and aggressive monetary policy have combined to create conditions ripe for growth. In addition, the economy continues to open up with virus cases remaining on the decline. Within this context, the Bureau of Economic Analysis released the third estimate of the first quarter 2021 real GDP, a seasonally adjusted annualized increase of 6.4%, the same as the prior estimate, and higher than the 4.3% increase in the prior quarter. The employment situation also improved, but in spotty fashion as high unemployment payments continue to be a disincentive for many to return to work. The May report showed that employers added 559,000 jobs in the month, and that the unemployment rate fell to 5.8%. The Federal Open Market Committee (FOMC) maintained its supportive monetary policy response to the pandemic, leaving the funds rate target range of 0% to 0.25% unchanged. However, the central bank's "dot plot," a forecast of future rate changes, turned somewhat more hawkish, as additional Fed governors indicated that the current rise in inflation will necessitate increases in short-term interest rates earlier than previously anticipated. The FOMC now expects the first interest rate hike to occur sometime in 2023.



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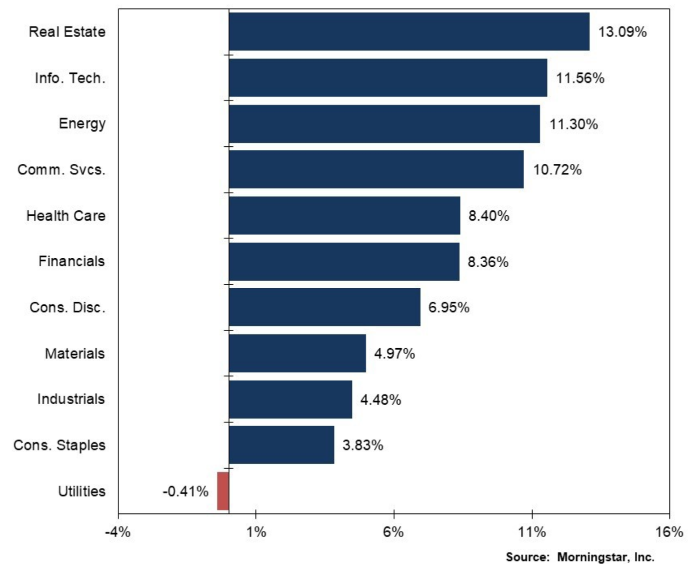
Highlights

GDP

In the latest data available, the Bureau of Economic Analysis released the third estimate of the first quarter 2021 real GDP, a seasonally adjusted annualized increase of 6.4%, the same as the prior estimate, but higher than the 4.3% increase in the fourth quarter of 2020, as the economy rebounded from pandemic lows. Strength was especially strong in consumer segments, as consumers have benefited from two rounds of fiscal stimulus. Other areas positively contributing were fixed investment and federal non-defense spending.

Corporate profits rose by 2.4% (not annualized) during the quarter after having declined 1.4% in the prior period. Inflation has accelerated, although the FOMC has stated that it believes the rise is "transitory."



HOUSING

The housing segment continued to slow modestly in the latest quarter, primarily as a result higher home prices and increased mortgage rates. Existing-home sales for May (the latest monthly data available) declined to an annualized rate of 5.8 million units, about 1% lower than the results from April, but up about 45% from year-ago levels. The inventory of existing homes was approximately 2.5 months of supply, lower than levels of the prior year. Existing-home prices in February increased 23.6% from May 2021. In the new-home segment, the NAHB Housing Market Index, a measure of home building activity, ended the quarter at 81, off from a reading of 83 in the prior month, and lower than its cycle high of 90 in November 2020. Analysts believe the housing market remains in solid condition, and prospects remain positive for the remainder of 2021 and into 2022.

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EMPLOYMENT

The May employment report (the latest data available) demonstrated that the jobs situation is improving as virus cases have declined and the economy continues to open. Employers added 559,000 jobs during the month, lower than the consensus expectations of a gain of 663,000. The leisure/hospitality and education/healthcare industries experienced the strongest gains, while construction and retail posted modest losses. Economists indicate that employment will continue to trend higher until the economy reaches full employment sometime in 2022. The unemployment rate in May declined to 5.8%, and the labor force participation rate edged lower to 61.6%.

FED POLICY

The FOMC made no change to the federal funds rate target range of 0% to 0.25%, but it is paying increasing attention to the acceleration in inflation. The committee left its outlook generally unchanged in the communication following its most recent meeting, but the recent acceleration in inflation resulted in a “dot plot” (the forecast of the fed funds rate) that was more hawkish than previously. The dot plot now shows that more governors than before believe that the first interest rate hike will be necessary in 2023. The FOMC termed the rise in inflation as “transitory,” but the equity and fixed income markets were nevertheless spooked. Analysts believe the Fed will announce that it will begin tapering its asset purchases beginning in September, with reductions occurring at monthly intervals.

Interest Rates

Fixed income securities’ prices on balance were higher (and yields lower) in the quarter as the economic rebound continued but not at the pace of prior quarters. While inflation spiked as a result of the FOMC’s continued aggressive monetary policy and trillions in fiscal stimulus passed by Congress, interest rates moved only slightly higher on the negative news. Because there was not a more precipitous rise in rates, it is possible that the market agrees with the FOMC that the current inflation scare could be transitory. As mentioned above, the FOMC made no change to its policy stance, but indicated that it sees rates rising somewhat earlier in 2023 than had previously been expected. As such, the FOMC is expected to maintain the target federal funds rate range at between 0% to 0.25% for the foreseeable future.

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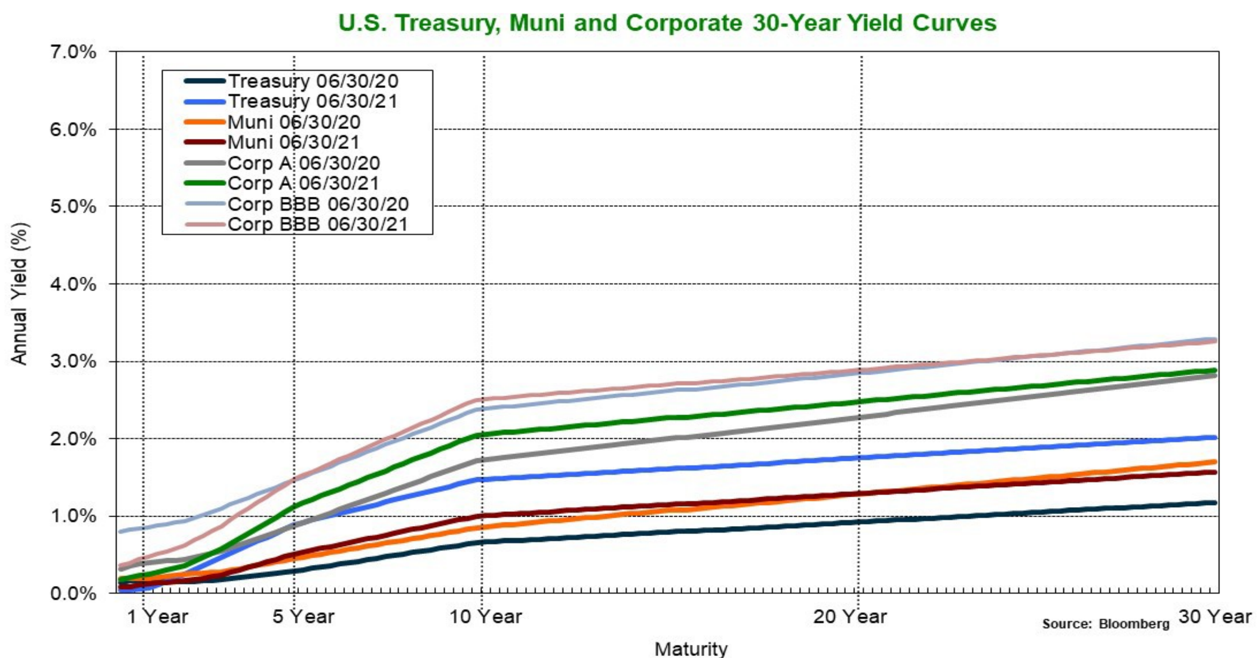

The shape of the Treasury yield curve flattened modestly during the second quarter, with yields on the shortest-term maturities rising somewhat, while yields in the intermediate- and long-term segments of the curve edged lower. Analysts believe the flattening reflects expectations that short-term rates will need to be increased sooner than expected, but the economy's trajectory slowed, causing longer-term rates to decline. Yields rose more than 0.10% on short-term maturities, while falling more than 0.20% on intermediate- and long-term securities. By the end of the quarter, the yield on the benchmark 10-year US Treasury note was lower, ending at 1.47%, compared to 1.74% on March 31.

Total returns on fixed income securities were mainly higher, with positive returns in almost every segment of the market. The Bloomberg Barclays Treasury 5-7 Yr. Index rose by +1.4% for the quarter. The Bloomberg Barclays US Credit Corporate 5-10 Yr. Index jumped +2.9% during the three months. High yield securities, which often follow the performance of equities, gained ground, posting a return of +2.7%. Municipals posted moderately higher results in the quarter, as the Bloomberg Barclays Municipal Bond Index edged higher by +1.4% during the quarter. Prices of non-US fixed income securities were higher in the quarter, as the Bloomberg Barclays Global Aggregate ex-US Index gained +0.9%. Emerging markets bonds posted solid gains, with the JPM EMBI Global Index higher by +3.9%.

Equity Markets

Stocks continued to rally following the pandemic-related selloff of the first quarter of 2020. Broad-based indices posted their fifth consecutive quarter of robust gains, with many indices having soared more than 80% from their pandemic lows. Analysts point to three primary drivers of the ongoing

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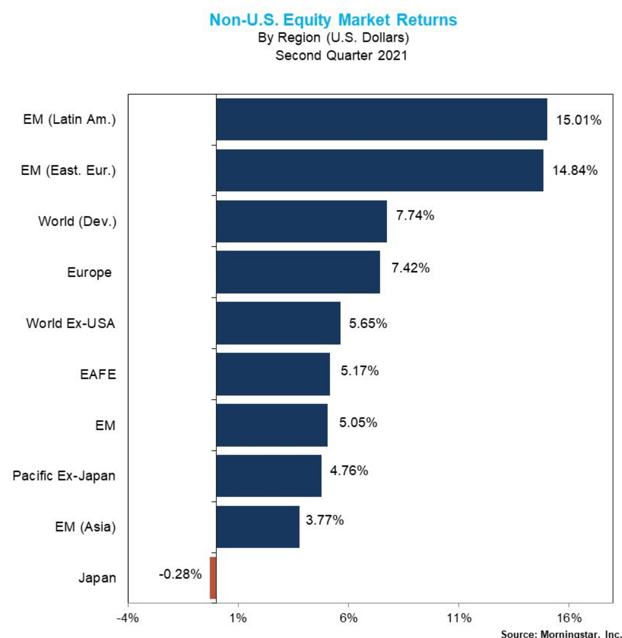
rally: First is the ongoing re-opening of the economy as virus cases have declined precipitously; second, the FOMC continues to maintain an aggressive monetary policy stance, even in the face of a spike in inflation; and third, an historic level of fiscal stimulus is now coursing through the system. Returns on broad equity market indices moved steadily higher throughout the quarter. When the quarter ended, the S&P 500 Index had advanced +8.6% and has gained +41% over the past 12 months.

Performance of 10 of the 11 primary economic sectors was positive during the quarter, with the more cyclical sectors posting higher returns as the economy accelerated. Real Estate, Information Technology and Energy were the strongest performers on a relative basis, generating returns of +13.1%, +11.6%, and +11.3%, respectively. The Utilities, Consumer Staples, and Industrials sectors were the poorest relative performers, posting returns of -0.4%, +3.8%, and +4.5%, respectively.

The Russell 1000 Index of large capitalization stocks generated a +8.5% total return. Within the large cap segment, growth stocks outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, underperformed large caps, and finished the quarter with a total return of +4.3%. Small cap value outperformed small cap growth. The NASDAQ Composite, dominated by information technology stocks, finished the quarter with a gain of +9.7%. The Dow Jones Industrial Average of 30 large industrial companies advanced by +5.1%.



Real Estate Investment Trusts (REITs) were higher during the quarter, with the DJ US Select REIT Index up +11.8%. Commodities also posted solid gains, with the Bloomberg Commodity Index adding +13.3% for the quarter.

International stocks also generated material gains during the quarter, and generally performed in line with US equities. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, rose by +5.5%. The MSCI EAFE Index of developed markets stocks advanced by +5.2%. Regional performance was generally positive for the quarter. The Latin America region was the strongest performer on a relative basis, with a return of +15.0%. Japan was the poorest relative performer, declining - 0.3%. Emerging markets performance was positive, as the MSCI Emerging Markets Index was higher by +5.1%.

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Looking Forward

The global economy is forging ahead as it continues to recover from the very severe, but also very brief, recession triggered by the pandemic. The confluence of factors such as accelerating business re-openings resulting from a decline in virus cases, aggressive monetary policy implemented by world central banks, and historic levels of fiscal stimulus in the US have created favorable conditions for the economy. A byproduct of these conditions is that asset prices have risen to, in certain cases, extreme valuations. Another implication of the combination of simultaneous massive stimulus and an aggressive FOMC monetary stance is that inflation has spiked. Despite the FOMC's declaration that the rise in prices is "transitory," inflation remains elevated. Fed governors are concerned enough that more of them now believe they will need to raise interest rates earlier than had previously been anticipated. The Fed is worried that a wage-price spiral may develop, where rising wages would increase disposable income, which in turn would cause increased demand for goods and an attendant rise in prices. While the rising wage component of the equation has not yet materialized due to the disincentives to work provided by the high unemployment benefits, it could eventually become an issue. Among the concerns cited by economists are that new variants of the virus that are causing issues in Europe and other parts of the world could make their way to the US; equity prices are at valuations that risk a correction; and rising gasoline prices could eat into consumers' disposable income and erode confidence. In addition, trade wars and other geopolitical risks – including US-China and US-Russia relations – always pose a potential threat to growth.

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