Financial Fitness for Life℠

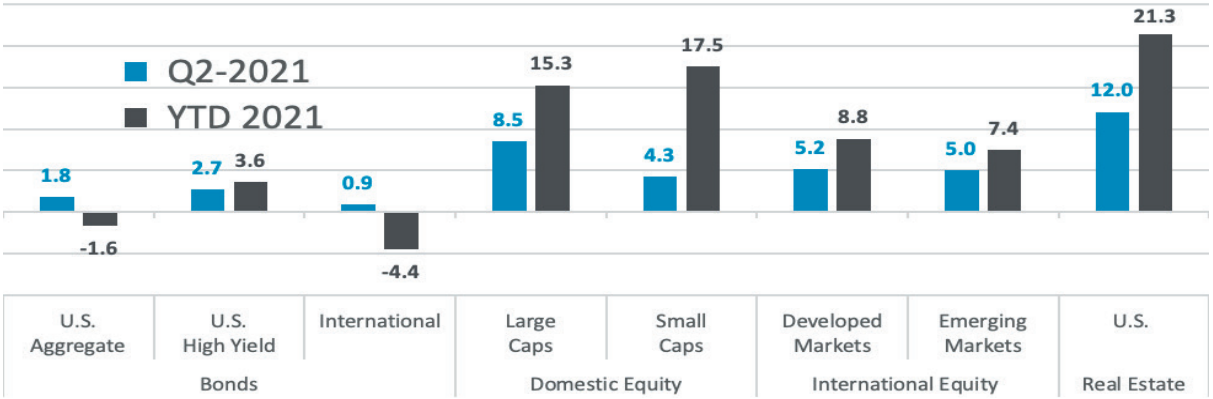
# Quarterly Client Update

## And the beat goes on…

Essentially treading water for the first half of the quarter, markets found their footing and finished positive across every major asset class. Continued vaccination success, massive amounts of fiscal and monetary stimulus, solid economic activity, and earnings acceleration all contributed to the investor optimism that witnessed the S&P 500 deliver positive quarterly results for the fifth consecutive quarter, which is the longest consecutive streak since the nine-quarter stretch that ended in 2017. Though many of the quarter's headlines centered around fear-invoking risks like inflation and sooner than expected modifications to the Fed's accommodative policy, the markets appeared unphased as concerns of growth moderation sent yields lower and equities higher. While still lagging other major US equity markets year-to-date with a return of 12.54%, as markets shifted toward higher quality, the more interest-rate sensitive and growth-oriented NASDAQ led the charge with a second-quarter return of 9.49%, as compared to returns on the S&P 500 of 8.55% and 15.25% for the quarter and year, respectively. While only delivering returns of 4.29% in the second quarter, US small-cap stocks, as measured by the Russell 2000 index, garnered solid returns for the year of 17.54%, only to be outdone year-to-date by the S&P MidCap 400 return of 17.59%.

With uneven COVID containment across emerging market countries, along with varying degrees of inoculation success, surging commodity prices, and falling US yields, the MSCI Emerging Market Index delivered a positive return of +5% in the second quarter; bringing the year's return across developing countries to 7.4%. Conversely, foreign developed countries (primarily Europe and Japan) continue to lag the US in vaccine rollout progress, though France and Germany are approaching 50% of their populations receiving at least one inoculation. Rising concerns over the Delta variant continue to threaten the near-term recovery. Fortunately, recent vaccination success and easing of some travel restrictions drove the cyclical heavy MSCI EAFE Index (Energy, Financials, Industrials, and Materials make up more than 40% of the index) +5.2% for the period, bringing the total for the year to +8.8%.

Despite high levels of inflation reported over the quarter, long-term inflation expectations are actually down on average. When coupled with an overly accommodative and reassuring Fed, along with the looming fiscal cliff and Delta variant posing risks to the expansion, the market witnessed the yield on the 10-Year Treasury contract about 30 basis points (0.30%) to end the second quarter at 1.45%; still up more than 0.50% for the year. While the inverse relationship between bond prices and yields pushed the return on the Bloomberg Barclays U.S. Aggregate Bond Index up 1.8% for the quarter, the index remains down -1.6% for the year.




Source: Bloomberg

## Economy

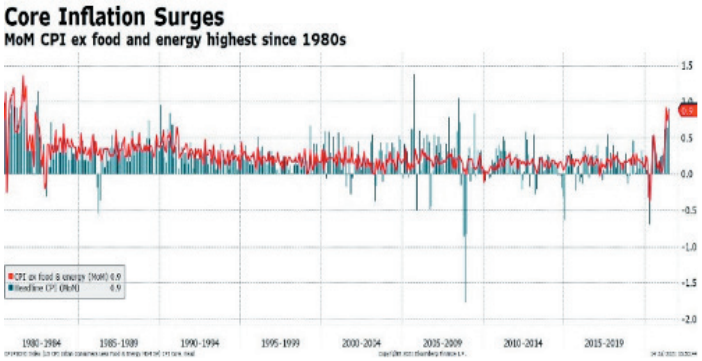
Though first quarter GDP accelerated at a 6.4% rate, the US still sat below its pre-pandemic growth levels. Massive amounts of Congressional and monetary stimulus continued to drive economic activity back into positive territory in the second quarter. The Conference Board forecasts that US Real GDP in the second quarter will rise to a 9.0% annualized rate and 6.6% year-over-year for 2021. While Bloomberg forecasts have moderated in recent weeks, they're still anticipating second-quarter growth of 10% (from 11% in March), and 7.2% for 2021 (from 7.7% in March). Growth of 7.2% for the year would be the fastest annual rate since the economy surged out of the 1981-1982 recession. With the effects of the March Congressional stimulus package fading, several key economic indicators have demonstrated some recent softening. While consumer spending was robust in the first quarter (up +11.4%, according to Bloomberg), we've witnessed a normalization in retail spending in both April and May. Furthermore, as the economy has continued to reopen, consumers have started to shift their spending preferences away from goods and more toward experiences and services, like dining out and traveling. In general, consumers appear poised to drive significant pent-up demand, as evidenced by their elevated savings of 14.9% (more than double the post-Great Financial Crisis average), unprecedented consumer net worth, and an M2 Money Supply of more than four trillion dollars above average levels – up 18% year-over-year, and 30% higher since February 2020. Given that the consumer comprises roughly 70% of our economy's output, spending should serve as a significant driver for economic growth for the remainder of the year. That spending should be supported further in the intermediate term from both the monthly child tax credit payments that are going out this month, coupled with the eventual spend-down of excess savings.

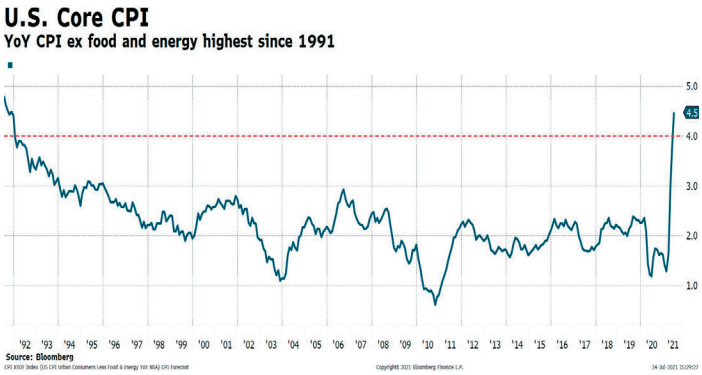
## The Fed, Inflation, and Labor Market

Over the course of 2021, equity markets have become increasingly more dependent on overly accommodative central bank policy, where Fed policy appears priced to perfection and risks of a policy mistake appears more likely than not, hence the flattening yield curve. Though continually pressured, the Federal Reserve has remained resolute in their current policies and messaging, maintaining their accommodative stimulus through open-ended Quantitative Easing (QE4) and keeping rates historically low. This "anything it takes" mentality has seen the Fed's balance sheet balloon to more than $8 trillion, with no real signs of slowing. The Fed is currently purchasing $120 billion ($80 billion US Treasury securities and $40 billion in mortgage-backed securities) per month and has indicated the intent to maintain this pace through 2021 and possibly into 2022, before beginning to taper their purchases. As we've communicated in the past, taper does not mean that the Fed will halt buying bonds; it means that they will slow the pace of their purchases. Tapering could reduce purchases from $120 billion per month to approximately $100 billion per month in a transparent and well-communicated manner. Perhaps the two most monumental changes coming out of the surprisingly hawkish June Federal Open Market Committee was the mention of "talking about talking about tapering" and revising their projection for rate increases from 2024 to 2023. The Fed continues to communicate that their decisions will hinge on actual data and not forecasted data. In the third quarter of last year, the Fed changed its policy framework to achieve 2% inflation and adopted a soft, or flexible, inflation averaging approach. This soft approach would hypothetically allow inflation to run above 2% for an undisclosed period, as long as the average falls back 2% over the long run. With so much emphasis on inflation, what's often overlooked is the Fed's dual mandate to both average their 2% inflation target and their commitment to achieving "substantial further progress" toward the goal of maximum employment.

Inflation measures the rate of increase in prices of goods over a given period, and high inflation levels can damage productivity and economic growth. Last year, prices fell in March and April and remained low in May, creating a low base for future year-over-year readings – resulting in price level changes that might be slightly exaggerated. But in looking at the economic data, it's hard to deny inflation currently exists. The Consumer Price Index (CPI), a prominent measure of inflation, witnessed Headline CPI come in at 5% and 5.4% in May and June, respectively, which are the highest readings since 2008. After stripping out the more volatile food and energy components, the Core CPI registered its highest reading since 1991, 3.8% and 4.5% for the same respective months. While the increases in the

basket of goods measured in the CPI in April, May, and June did include some noise resulting from the base effect, most of the price increases have been a result of significant supply chain disruptions, coupled with a significant surge in demand. During the pandemic, inventory levels were significantly depleted, and once the economy began to reopen, demand surged, causing a bottleneck in the supply chains. Many consumers have felt this if they've tried buying a car, buying a house, or even building a deck. This type of supply chain disruption is relatively normal during recovery periods and can be seen as mostly transitory. Therein lies much of the debate around inflation – will it be transitory (temporary) or structural (sticky)? When looking at the most recent two CPI reports, more than half of the total increase in Core CPI can be attributed to used cars, rental cars, hotels, and airfare. These small categories only represent a combined total of Core CPI of about 6%. Their large price jumps are due to reopening and supply chain disruptions, both temporary, or transitory. Conversely, the larger components like rent and healthcare represent roughly 49% of Core CPI and have experienced only modest price gains; though the two consecutive readings of 0.3% for rents is worth noting and will be important to monitor going forward. One of the major issues causing disruptions across nearly every economic sector is semiconductor, or chip, shortages. Our everyday lives have become dependent on chips; they're found in nearly everything from automobiles, dishwashers, phones, computers, to microwaves, etc. Through May, the average order-to-delivery interval reached all-time highs of 18 weeks. In other words, if a single chip was ordered in May, it took 18 weeks for that single chip to be delivered – hence the severe disruption in production and significant spike in new and used car prices.

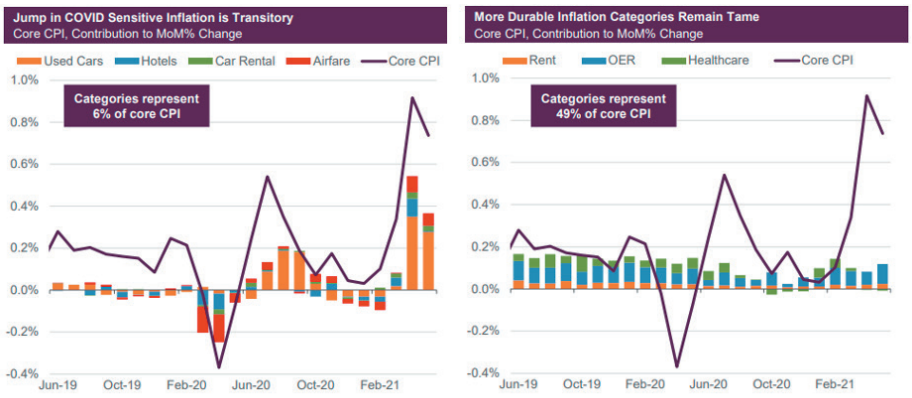



Over the coming months, perhaps the most telling variable to monitor for clarity around inflation's transitory or structural nature will be wage growth. It's difficult for inflation to be sticky or structural without upward wage pressure. June's 3.6% year-over-year wage growth is worth noting, though not overly concerning. Should the labor market start to exhibit the same pricing power as we've witnessed in commodities, we could witness a wage/price spiral, causing yields to normalize quicker than anticipated and indicating inflation might last longer than expected. When wages increase, businesses must increase the cost they charge for their goods and services to compensate for the higher wages, adding to inflationary pressures. If prices remain elevated, workers will eventually demand another wage increase to offset the increase in their cost of living – making inflation more structural. To correct the labor shortages and hire workers to meet surging demands, employers are getting creative to hire and retain workers, including higher wages. Several retailers, like Walmart, have raised their internal minimum wages to $15 per hour or more. Once these changes are made, an employer can't reduce employees' salaries, making these changes more permanent. Additionally, during first-quarter corporate earnings announcements, nearly every announcement mentioned inflation and the rising input costs applying pressure to their margins, and furthermore, their intentions to pass those increased costs along to consumers. Much like wage increases, if a company can successfully pass along cost increases, and consumers are willing to pay those higher prices, then once supply chain disruptions normalize and their cost of goods fall in line, many companies are not willing to slash consumer prices – again making inflation more structural and stickier than transitory and temporary.

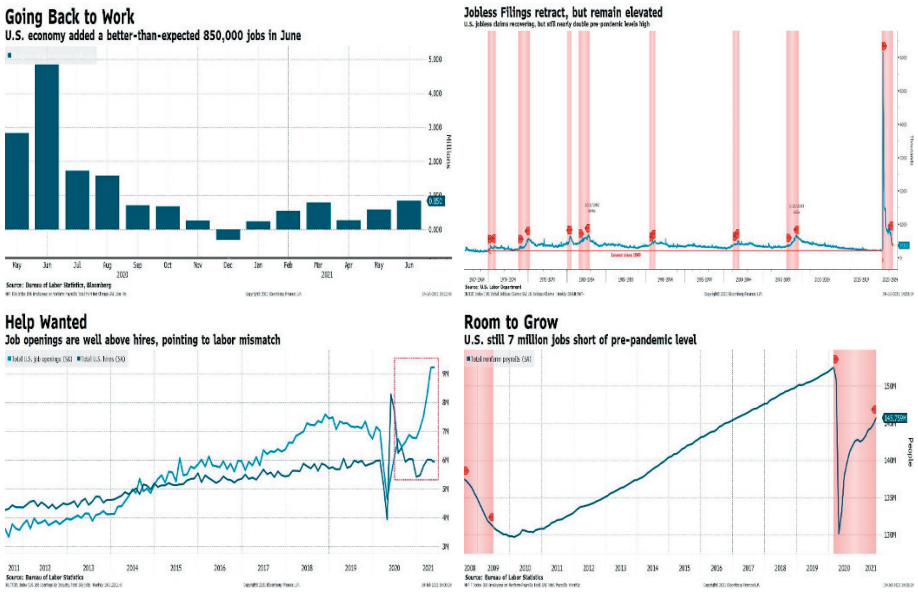
We partially agree with the Fed and Treasury Secretary, Janet Yellen that the current supply chain disruptions will start to work out, and price gains will start to normalize. We believe that inflation will be transitory in the sense that

it should start to moderate sometime in the third or fourth quarter of this year from its current levels. However, we also think that we could be headed for a regime change in future inflation. In other words, the post-Great Financial Crisis inflation averaged less than 2%, and we wouldn't be surprised to see the next several years running closer to the 3% range. Outside of that view, when looking at the June CPI numbers of 5.4% and 4.5% on Headline and Core, respectively, it's understandable investors are fearful. However, we are still dealing with some base effects, which are causing overstated numbers. This same base effect will also impact year-over-year CPI data as we approach the second and third quarters of next year, except then we'll experience a reverse base effect. This time next year, the base will be these elevated inflation results currently being reported, which could produce negative year-over-year CPI readings. Given the cliff experienced during the heart of the pandemic, followed by sharp V- shaped reversals, we anticipate several variables to suffer from base effects for at least another year or so, continuing to insert noise into the data. When looking at the metrics closer, about 50% of the components tracked in the CPI basket that contributed to growth came from transitory components like buying used cars (up 45% YoY) and dining away from home. Therefore, as production comes back online, many supply chain disruptions should dissipate and lead to a moderation in inflation.




Source: Guggenheim Investments, Haver Analytics. Data as of 05/31/2021. OER stands for owners' equivalent rent of primary residence.

While targeting an average inflation level of 2% is a critical Fed component, the goal of achieving maximum employment still needs to see "substantial further progress." The April 2020 unemployment rate peaked at post-Great Depression highs of 14.7%. While the headline unemployment rate has recovered, with June's unemployment rate coming in at 5.9% after adding 850,000 jobs, the bottom line is that while momentum in the labor market is developing, it is still fractured. First-time unemployment filings finally broke through 400,000 per week, and while 373,000 weekly claims are a significant improvement, new unemployment filings are still nearly double the pre-pandemic levels of about 200,000. Returning the labor market to pre-pandemic maximum employment levels is one of the Federal Reserve's primary objectives, a requirement before raising rates. By their admission, a long road ahead remains. The US jobs market is still running at an approximate 7.6 million pre-COVID deficit. Unlike other recovery periods, this deficit does not remain outsized due to the lack of job openings. In fact, to the contrary, the JOLTS, or Job Openings and Labor Turnover Survey, for April indicated that job openings were running at all-time highs of nearly 9.3 million, setting the stage for accelerated job growth in the second and third quarters. Many market participants blame the pandemic-related unemployment benefits that have been extended multiple times for the disconnect in the labor market. Truth be told, they probably have served as a disincentive; however, it's important to remember that many schools around the country were virtual all year, requiring individuals to seek childcare if they reentered the labor force. Additional factors are healthcare

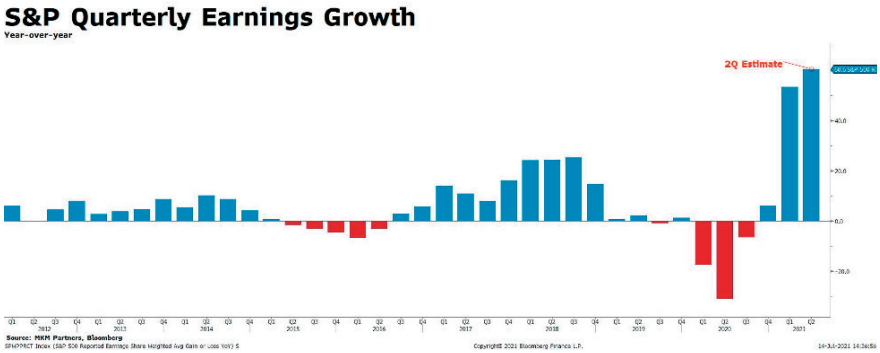


concerns (which have diminished with increased vaccination) and a lack of skilled labor. Several states will end the extended unemployment benefits in June and July, with the rest set to expire September 7. Schools are set to reopen nearly everywhere in August and September, diminishing the need for childcare, and we anticipate the labor market will start to mend and accelerate growth in the August through November timeframe.

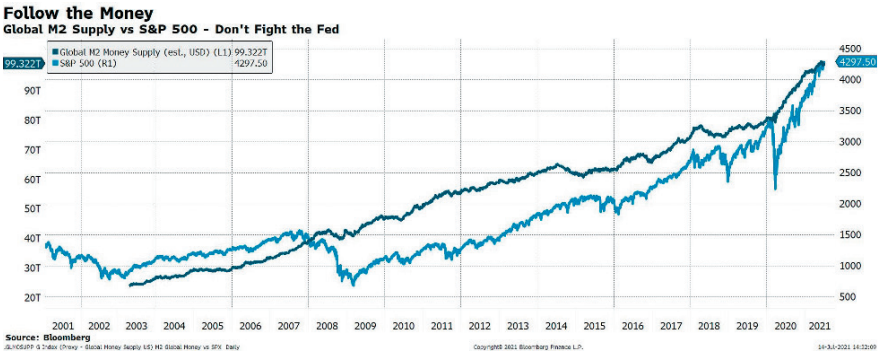
## Implications looking forward

With the unprecedented amount of monetary and fiscal stimulus poured into the economy since March of 2020, we are fundamentally bullish long-term on equity markets, particularly over the next twelve months. We have been clear that we believe this recession is a bookend recession: caused by a virus, and as such, should end with a vaccine. To date, vaccination efforts have been largely successful. COVID and the Delta variant still pose an enormous risk to our recovery. Our collective economic recovery is dependent upon vaccination success here and abroad. Developed countries with established vaccination protocols in place, like the UK, Germany, and France, should continue to fare well. Still, a complete global economic recovery depends upon successful vaccination campaigns in other developed and emerging markets as well. With this framework in mind, we would not be surprised to witness the US dollar start to weaken as Europe and other countries continue to come back online.

Earnings are expected to be strong all four quarters this year and the first quarter did not disappoint. As of April 1, 2021, FactSet estimated a first-quarter earnings growth rate for the S&P 500 of 23.7%, and the actual growth came in at 52.5%. This is the highest mark since the first quarter of 2010, and it set a record for positive earnings surprises of approximately 90%. Second-quarter earnings will kick off the week of July 12, led by major Wall Street banks, and we anticipate several dividend increases and share buybacks. Current expectations by FactSet for earnings growth now sits at 64% year-over-year, while the second-quarter earnings growth will fall victim to the same base effect that saw earnings contract more than 20% in the second quarter of 2020, earnings should remain robust. A common theme from the first quarter's results we expect to carry over to the second quarter is centered around rising input costs (inflation), the impacts on margins, and expected consumer price increases. Going forward, we will continue to emphasize profit margins, and given the price increases of many input costs, focus on management's messaging around current and projected profits and perception of a potential tax increase that may impact the ability to generate consistent margins.




We subscribe to the investing world adage, 'Don't fight the Fed.' It is important to remind investors of the strong correlation between the change in money supply and the path of equity markets, as illustrated in the "Follow the Money" chart. To jumpstart the economy, the Fed grew the M2 money supply by more than 30% from February 2020 through May of 2021; thus far, the market has held up its strong correlation. While solid earnings growth and the Fed are two components driving our preference for equities in 2021, perhaps the most telling signal is the positive vaccine developments and the optimism surrounding vaccine rollouts. Fed-imposed low-interest rates and massive amounts of federal stimulus all provide a positive



backdrop supporting risk assets like equities. We would expect to see cyclical or value-oriented sectors continue to benefit from reopening over the short term. We are, and will always be, long-term investors. We feel that long-term, companies positioned to capitalize on the strong secular growth trends such as cloud computing, artificial intelligence, machine learning, and e-commerce are all leading the race toward digitization. Those longer-term secular growth trends should persist. The key is identifying those companies that can deliver consistent, stable, and predictable earnings. In the short term, we still believe there are benefits to "renting" value and continuing to own growth as we navigate the current economic recovery as well as the post-pandemic economy.

With short-term interest rates expected to remain low, we anticipate the yield curve to steepen as the year advances, with longer-dated bond yields continuing to inch higher, putting further downward pressure on the price of traditional government securities, and further promoting the well-known acronym "TINA" There Is No Alternative, meaning no alternative to equities. Given that the current yield on the S&P 500 is nearly identical to the 10-year US Treasury bond yield at 1.35%, many investors find themselves weighting equities higher to boost their income and return potential. Turning to equities to make up for lost income, or even incorporating more esoteric credit vehicles like bank loans, structured credit (MBS, CMBS, CLOs, etc...), or high-yield bonds to boost yield often increases the underlying level of risk, leading to unintended consequences. Our focus remains on quality with a commitment to each portfolio's respective risk target. This quality focus served as a drag during the early months of 2020, where low quality and speculative investments like meme stocks (i.e., AMC and GameStop), SPACs, and Ark Funds were all the buzz. As the year has progressed and the future uncertainty surrounding growth, inflation, and Fed policy has increased, investors' focus on quality has renewed.

The longer-term backdrop for equities appears supportive, but in the short term, we remain cautious. We see several risks that could dampen our outlook. First and foremost is the containment of the COVID-19 virus and the threat variants pose to a sustained global recovery. Aside from the virus, we see inflation and Fed missteps as potentially the largest risk facing markets. Should inflation continue surprising to the upside, market volatility may ensue, and the Fed's rhetoric will continue to come under pressure. Additionally, with expectations of further yield curve steepening, we think it is important to shorten portfolio duration, which reduces interest rate risk and helps offset expected losses should yields continue to rise. Ultimately, we believe the backdrop supports further equity market gains over the second half of 2021. However, we see the path forward to more moderate returns (as compared to the first half of 2021) to be marred with increased levels of volatility.

With so many headlines and so much change occurring, we will avoid any complacency in our approach. We continue to monitor the ever-changing landscape and stay nimble, maintaining a disciplined and diversified approach in our portfolios, with a continued emphasis on quality. We constantly look for opportunities to ensure the portfolios we manage match the objectives and risk tolerance of the clients we have the privilege to serve. As always, we appreciate your business and ongoing trust. We invite you to reach out to your advisor with any questions or concerns and encourage you to schedule your next review.

**Chris Osmond, CFA, CAIA®, CFP®**
Chief Investment Officer
Investment Advisory Committee
cosmond@pciawealth.com

**Eric Krause, CFA**
Portfolio Manager
Investment Advisory Committee
ekrause@pciawealth.com

(913) 491-6226 | **FITrusts.com**



Financial fitness for Life℠