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Outlook for July 2021

Second Quarter Recap

High vaccination rates, broad economic reopenings, and the subsequent release of pent-up demand led to economic growth in the quarter that will be close to 10% when ultimately reported at the end of July. Historic fiscal and monetary stimulus combined to offset any negative impact of supply chain and labor shortages. Businesses, who became even more confident of ongoing economic expansion, increased spending on capital projects, particularly the spend on productivity enhancing technology investments. Consumer spending was boosted by strong jobs gains, increased wages in many industries and very high savings rates coming into the quarter.

Overseas economies have largely experienced a slower, more delayed recovery as relatively low vaccination rates allowed the second and third Covid19 waves to spread more widely and lethally. Renewed shutdowns and delayed reopenings caused double dip recessions in Europe, Japan, and Latin America with growth turning positive in these regions only near the end of the quarter. China was an exception as their recovery preceded that of the other developed market economies with the country now clearly in expansion moving into the second half of the year.

Financial markets produced strong returns around most of the globe. Continued loose monetary policy and another round of fiscal stimulus together helped drive equity prices higher in the U.S. Beneath the surface, the relative performance between the growth and value styles, or cyclical vs. non-cyclical equities, tended to favor the higher earnings growth sectors as interest rates stopped rising and actually declined from end of March highs. However, cyclical sectors such as Energy and Real Estate joined Information Technology and Communications Services among the top market performers as corporate profits increased markedly. Greater breadth of the equity market advance has led to a more sturdy and healthy market environment. While not rising at the same magnitude as seen in the U.S., international equity markets nevertheless produced impressive price performance on the back of economic growth in the U.S. and China as well as anticipation of a return to growth in their domestic economies.

The shift down and flattening of the treasury yield curve produced positive performance in the investment grade fixed income market. The directional move was somewhat surprising given the strong economic growth environment and the higher inflation indicators. This decline in rates likely reflects the market belief that the Fed will not prematurely tighten to slow the economy. However, investors should not rule out the possibility that lower rates can be a sign of a more dramatic slowdown in economic growth over the coming quarters. In addition to lower interest rates, below investment grade and emerging markets bonds were further supported by the prospect of improving economic conditions around most of the world.

Inflationary Concerns

The threat of excessive monetary and fiscal stimulus ultimately unleashing an inflationary cycle has climbed to the top of the list of market risks now that the severity of the pandemic appears to be largely under control. A pickup in the April and May inflation indicators was expected as 2021 prices are compared to those at the depths of last year's recession. But the magnitude of price increases exceeded expectations as powerful reopening demand was met by the remnants of pandemic induced supply constraints in both product manufacturing and labor.

Within commodities, prices of most products increased notably at the beginning of the quarter stoking broader inflationary fears. Higher prices evoked two economic reactions. The first was an increase in supply as commodity producers boosted output. The second was a decrease in demand as higher prices caused consumers to defer or reduce purchase of the more expensive product. An example was the dramatic move in lumber prices and its impact on the hot housing market. Lumber appreciated 85% from the beginning of the year to the mid-May peak. Heavy demand for new homes and lingering labor shortages from the pandemic were the major factors in the price rise which dramatically increased the cost of homes and home improvements. These price increases dampened demand at the same time production of lumber ramped up to take advantage of the higher prices. Prices subsequently declined 55% over the back half of the quarter and moved into the third quarter lower than they were at the beginning of the year.

Not all commodity supply/demand issues have been resolved so quickly, namely energy supply which continues to be managed carefully by the OPEC+Russia cartel. Greater regulatory restrictions on drilling and transportation for oil and gas likely restrained the reaction of U.S. shale producers who have yet to meaningfully increase production at prices which are up 50-60% from the beginning of the year.

Labor shortages are another inflation pain point as potential employers are increasingly citing their biggest limitation being the inability to attract qualified job applicants. Mitigating factors such as the end of enhanced unemployment benefits, fewer childcare issues as children return to the classroom, and dissipating virus concerns could relieve some of the pressure. There may, however, be more permanent labor supply issues due to limited immigration, earlier baby boomer retirements, and labor skills mismatches. Any sustained wage pressure caused by these shortages could manifest itself in higher inflation and/or lower profit margins unless employee productivity increases as well.

Central Bank Reaction

The market, and most importantly the Federal Reserve, so far views the recent increase in the inflation rate as transitory, or a temporary phenomenon that should not necessarily lead to a more immediate tightening of monetary policy. Messaging coming from the Fed governors has been somewhat mixed and is leading to concern over another taper tantrum as the bond market reacts negatively to the first signs of monetary tightening. The most important voices continue to be Chair Powell, Vice Chair Clarida, and NY Fed President Williams who all remain resolute in their vow to let inflation run at a level above the 2% target for an extended period.

The Fed and other global central banks appear to be heeding lessons learned over the last 20 years that inherent disinflationary forces in the global economy should change the approach to monetary policymaking (which had previously dominated since the last inflationary cycle in the 1970s). Central banks appear to be taking a more reactive than proactive approach to burgeoning inflation rates as they are more confident in their ability to eradicate systemic inflation as opposed to their effectiveness in a more nefarious deflationary environment. This monetary policy approach has allowed more inflation in asset prices as opposed to the prices of most goods and services.

Our Perspective

World Economy

- Economic growth rates in the U.S. likely peaked at the end of the second quarter as comparisons to 2020 get tougher entering the second half of the year and the effect of fiscal stimulus checks wanes. This deceleration will nonetheless still remain at above average growth as high savings rates should continue to drive consumer spending and production at businesses continue to attempt to keep up with this strong demand.
- Continental Europe and Japan will continue their recoveries as vaccination rates rise to the levels already seen in the U.S. and U.K. Latin America and India are further behind in their efforts to control the pandemic given the recent outbreak of the delta variant of Covid19. It is encouraging that vaccines are being delivered to these countries at a higher rate, but logistical issues around distribution remain.
- Chinese economic growth will be comfortably positive, but pandemic induced changes to global supply chain management principles could begin to impact industrial production as more companies move away from manufacturing in the country.

Equity Markets

- Earnings will continue to be the primary driver of U.S. equity returns. The second quarter earnings season should be strong, but like the overall economy, comparisons become more difficult looking towards the third and fourth quarters. Most of the return expected for all of 2021 may have already been achieved in the first half of the year.
- Having underperformed year to date, developed international and emerging market equities may catch up slightly to the U.S. over the coming months as they experience a delayed emergence from economic restrictions and lockdowns.

Monetary Policies/ Currencies

- Global central banks will not raise policy rates for the remainder of the year, but markets will watch for indications of the timing and magnitude of the reduction in asset purchases which could begin at the Fed by the end of the year.
- The People's Bank of China may be an exception to these generally easy policies as they are beginning to tighten certain policy rates to battle excessive speculation in the real estate market.

Bond Markets

- Strong economic growth and lingering inflationary pressures should push interest rates somewhat higher across the yield curve although central bank bond purchases at the current rate should prevent any sharp upward spike.
- Spreads on U.S. high yield bonds have narrowed to the extent that investors are likely not being adequately compensated for the below investment grade risk. Emerging market debt, where many of the issuing countries are just beginning to emerge from pandemic induced recessions, may be a better high yielding option.

Commodities

- Oil prices should begin to follow the lead of the other commodities with greater supply forthcoming to take advantage of higher prices. Opec+Russia production discipline has been impressive, but U.S. shale producers remain the wild card. Continued strong demand as consumers switch the bulk of their purchases to services from goods should keep prices in somewhat of a trading range around current levels.
- With the current inflation indicators continuing to be viewed as transitory and cryptocurrencies gaining greater acceptance as an inflation hedge, gold prices will have difficulty moving meaningfully higher through the summer months.

What This Means for Investors

Slowing, but still strong economic growth with central banks largely remaining accommodative continues to be a favorable environment for risk assets. As inflation rates decline with increased supply of both goods and labor, bond yields will increase only gradually allowing earnings growth to be the primary driver of equity prices. Having experienced delays in broad vaccine distribution and subsequent reopenings, international markets may close the performance gap with the U.S. over the coming months.

For more market insights, contact a Cerity Partners advisor or visit the thought leadership section of ceritypartners.com.

Index Performance Data

	2Q 2021	YTD	1-Year	3-Year Annualized
Equity Index Returns				
Dow Jones	5.08%	13.79%	36.34%	15.02%
S&P 500	8.55%	15.25%	40.79%	18.67%
Russell 2500	5.44%	16.97%	57.79%	15.24%
MSCI ACWI	7.39%	12.30%	39.26%	14.57%
MSCI EAFE	5.17%	8.83%	32.35%	8.27%
MSCI Emerging Markets	5.05%	7.45%	40.90%	11.27%
Other Index Returns				
MSCI U.S. REIT	12.00%	21.80%	38.05%	10.14%
Bloomberg Commodity Index	13.30%	21.15%	45.61%	3.90%

	2Q 2021	YTD	1-Year	3-Year Annualized
Fixed Income Returns				
Barclays Aggregate Bond Index	1.83%	-1.60%	-0.33%	5.34%
Barclays 1-10 Year Municipal Bond	0.62%	0.36%	2.43%	3.91%
Merrill Lynch High Yield Master II	2.77%	3.70%	15.62%	7.15%
Citi World Government Bond Index	0.74%	-2.36%	-1.40%	4.31%
JPM Emerging Markets Bond Index Global	3.93%	-1.00%	6.81%	6.48%
Barclays TIPS	3.25%	1.73%	6.51%	6.53%
Citi U.S. 3-Month T-Bill	0.01%	0.03%	0.08%	1.31%

Source: FactSet, Morningstar Direct
**Citi World Government Bond Index is the hedged index

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Second Quarter Market Summary

							Annualized			
		3Q20	**4Q20**	**1Q21**	**2Q21**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
U.S. Equity Benchmarks	**Price**									
Dow Jones Industrial	34,503	8.22	10.73	8.29	5.08	13.79	36.34	15.02	16.66	13.50
NASDAQ Index Composite	14,504	11.24	15.63	2.95	9.68	12.92	45.23	25.72	25.80	19.32
S&P 500	4,298	8.93	12.15	6.17	8.55	15.25	40.79	18.67	17.65	14.84
Russell 1000 (Large Cap)	2,421	9.47	13.69	5.91	8.54	14.95	43.07	19.16	17.99	14.90
Russell 1000 Growth	2,732	13.22	11.39	0.94	11.93	12.99	42.50	25.14	23.66	17.87
Russell 1000 Value	1,564	5.59	16.25	11.26	5.21	17.05	43.68	12.42	11.87	11.61
Russell Mid Cap	3,169	7.46	19.91	8.14	7.50	16.25	49.80	16.45	15.62	13.24
Russell Mid Cap Growth	1,825	9.37	19.02	(0.57)	11.07	10.44	43.77	22.39	20.52	15.13
Russell Mid Cap Value	2,653	6.40	20.43	13.05	5.66	19.45	53.06	11.86	11.79	11.75
Russell 2000 (Small Cap)	2,311	4.93	31.37	12.70	4.29	17.54	62.03	13.52	16.47	12.34
Russell 2000 Growth	1,583	7.16	29.61	4.88	3.92	8.98	51.36	15.94	18.76	13.52
Russell 2000 Value	2,481	2.56	33.36	21.17	4.56	26.69	73.28	10.27	13.62	10.85
S&P GICS Sectors	**Weight**									
Consumer Discretionary	12.4%	15.06	8.04	3.11	6.95	10.27	37.08	19.36	19.69	17.89
Consumer Staples	5.8%	10.38	6.35	1.15	3.83	5.02	23.29	14.14	8.04	11.49
Energy Sector	2.8%	(19.72)	27.77	30.85	11.30	45.64	49.38	(6.09)	(0.80)	(0.02)
Financials	11.0%	4.45	23.22	15.99	8.36	25.69	61.77	13.97	17.05	13.71
Health Care	13.1%	5.87	8.03	3.18	8.40	11.85	27.92	17.03	14.06	15.67
Industrials	8.4%	12.48	15.68	11.41	4.48	16.40	51.45	15.02	14.40	12.80
Information Technology	27.6%	11.95	11.81	1.97	11.56	13.76	42.40	30.31	31.21	21.99
Materials	2.6%	13.31	14.47	9.08	4.97	14.50	48.51	14.87	14.59	10.09
Communication Services	11.2%	8.94	13.82	8.08	10.72	19.67	48.38	23.27	10.89	11.30
Utilities	2.5%	6.14	6.54	2.80	(0.41)	2.38	15.77	10.49	7.41	10.56
Real Estate	2.6%	1.92	4.94	9.02	13.09	23.30	31.88	14.71	9.56	11.06

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								Annualized		
		3Q20	**4Q20**	**1Q21**	**2Q21**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Global Equity Benchmarks	**Price**									
MSCI ACWI	3,017	8.13	14.68	4.57	7.39	12.30	39.26	14.57	14.61	9.90
MSCI AC World x-USA	352	6.25	17.01	3.49	5.48	9.16	35.72	9.38	11.08	5.45
MSCI EAFE	2,305	4.80	16.05	3.48	5.17	8.83	32.35	8.27	10.28	5.89
MSCI EAFE Growth	2,214	8.43	13.09	(0.57)	7.42	6.81	30.97	12.45	12.47	7.76
MSCI EAFE Value	2,881	1.19	19.20	7.44	3.01	10.68	33.50	3.78	7.81	3.86
MSCI Emerging Markets	1,375	9.56	19.70	2.29	5.05	7.45	40.90	11.27	13.03	4.28
MSCI BRIC	410	10.41	15.26	(0.10)	5.40	5.30	34.00	11.37	14.92	4.18
MSCI Japan	3,868	6.94	15.26	1.57	(0.28)	1.28	24.84	7.24	10.19	7.15
Interest Rates	**Yield**									
3m Treasury Bill	0.05	0.03	0.02	0.01	0.01	0.02	0.07	1.19	1.11	0.59
U.S. LIBOR 3m	0.15	0.06	0.06	0.05	0.04	0.09	0.21	1.44	1.41	0.88
U.S. Treasury 3m	0.45	0.04	0.05	0.06	0.09	0.15	0.23	1.30	1.44	1.07
U.S. Treasury 10yr	1.45	0.16	0.21	0.32	0.39	0.71	1.09	1.75	1.98	2.07
U.S. Treasury 30yr	2.06	0.34	0.40	0.51	0.56	1.07	1.82	2.27	2.50	2.81
Fixed Income	**Price**									
Citi 3-month T-bill	660	0.03	0.02	0.02	0.01	0.03	0.08	1.31	1.14	0.60
BC U.S. Gov't & Related 5-7	106	1.33	0.80	(2.65)	1.44	(1.24)	0.87	5.92	3.47	3.65
BC Municipal Bond 1-10 Year	115	1.07	0.98	(0.26)	0.62	0.36	2.43	3.91	2.48	2.97
BC TIPS	114	3.03	1.62	(1.47)	3.25	1.73	6.51	6.53	4.17	3.40
BC Aggregate	106	0.62	0.67	(3.37)	1.83	(1.60)	(0.33)	5.34	3.03	3.39
ML High Yield Master II	105	4.71	6.48	0.90	2.77	3.70	15.62	7.15	7.30	6.50
Citi World Gov't Bond Index	956	0.72	0.26	(3.08)	0.74	(2.36)	(1.40)	4.31	2.58	3.84
JPMorgan EMBI Global	924	2.28	5.49	(4.74)	3.93	(1.00)	6.81	6.48	4.44	5.34

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								Annualized		
		3Q20	4Q20	1Q21	2Q21	YTD	1-Year	3-Year	5-Year	10-Year
Real Estate	**Price**									
MSCI U.S. REIT	1,363	1.63	11.52	8.76	12.00	21.80	38.05	10.14	6.32	9.38
FTSE EPRA/NAREIT Europe	1,916	6.15	16.96	(4.32)	10.95	6.16	31.80	5.45	7.43	6.10
Commodities										
Bloomberg Commodity Index	95	9.07	10.19	6.92	13.30	21.15	45.61	3.90	2.40	(4.44)
Energy	29	4.34	2.21	17.32	23.23	44.58	54.19	(10.49)	(3.80)	(12.22)
Agriculturals	58	11.90	21.36	6.81	12.77	20.44	63.57	10.56	0.38	(3.13)
Livestock	22	13.83	2.45	10.44	(1.46)	8.83	26.91	(6.72)	(4.88)	(4.02)
Softs	39	7.67	14.26	(1.49)	18.68	16.91	43.83	3.40	(4.65)	(8.29)
Industrial Metals	156	11.18	14.25	7.49	9.41	17.60	49.37	7.56	10.99	(1.62)
Precious Metals	220	7.80	2.41	(9.26)	3.93	(5.70)	4.11	11.65	4.80	(0.46)
Currencies	**Price**									
ICE Dollar Index	92	(3.60)	(4.21)	3.66	(0.85)	2.78	(5.09)	(0.78)	(0.75)	2.21
Euro / U.S. Dollar	1	4.41	4.34	(3.94)	0.90	(3.08)	5.59	0.52	1.31	(1.99)
Pound / U.S. Dollar	1	4.63	5.74	0.93	0.13	1.06	11.80	1.52	0.66	(1.49)
U.S. Dollar / Yen	111	(2.18)	(2.17)	7.03	0.44	7.50	2.88	0.07	1.59	3.23

Source: Factset, Morningstar Direct, iShares website