ACCESS FINANCIAL SERVICES, INC.

July 12, 2021

Quarterly Review and Outlook

Second Quarter, 2021

Table 1: Benchmark Returns as of June 30, 2021

INDEX	3 Mo.	6 Mo.	12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	8.55	15.25	40.79
Dow Jones Select Dividend Index	3.33	23.69	50.71
Russell 2000 Index (small-cap stocks)	4.29	17.54	62.03
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	5.17	8.83	32.35
S&P Europe 350 Index Net TR Index (US$)	7.39	11.90	35.02
MSCI Japan Net Total Return Index (US$)	(0.28)	1.28	24.84
MSCI Emerging Markets Net TR Index (US$)	5.05	7.45	40.90
COMMODITIES & CURRENCIES			
US Dollar	(0.85)	2.78	(5.09)
Euro	1.09	(2.93)	5.55
Gold	3.15	(6.98)	(4.00)
Oil (West Texas Intermediate)	24.36	52.33	81.42
MVIS CryptoCompare Bitcoin	(42.14)	20.27	272.06
BONDS			
BBgBarc US Aggregate Bond (inv. grade)	1.83	(1.60)	(0.33)
BBgBarc US Treasury 20+ Year	6.80	(8.06)	(10.72)
BBgBarc US Treas. Inflation Protected Secs.	3.25	1.73	6.51
BbgBarc Municipal Bond	1.42	1.06	4.17
BBgBarc US Corporate TR (corporate bonds)	3.32	(1.28)	2.99
BBgBarc US Corp. High Yield Bond	2.74	3.62	15.37
S&P International Sov Ex-US Bond US$	0.56	(5.93)	3.04

BBgBarc: Bloomberg Barclays; Source: Bloomberg and Morningstar

Global stocks and other risk assets continued their march higher during the second quarter.

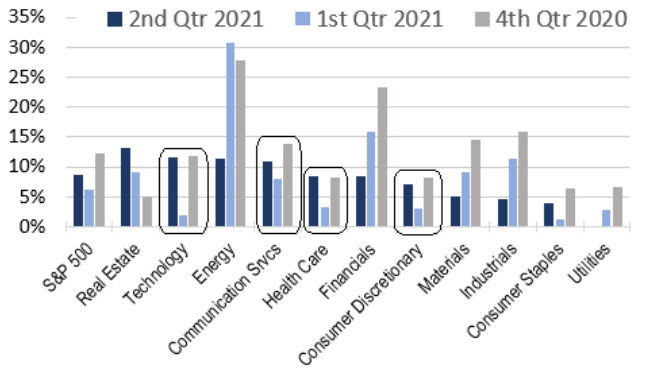
The pandemic is barely behind us and new variants of the virus are a growing threat, but the financial markets have already progressed through both the recovery and expansion stages of the business cycle thanks to economic reopening, fiscal and monetary stimulus, and pent-up demand.

As shown in Chart 1, the variation in sector returns within the US stock market narrowed in the second quarter to a range of -0.41% (utilities) to +13.09% (real estate) for a difference of 13.50% versus 29.69% in the first quarter and 22.82% in the fourth quarter, 2020 and "growthier" sectors (technology, communication services, health care and consumer discretionary) bounced back after weaker relative returns during the first quarter.

Safe haven US Treasuries also rallied as longer term interest rates declined following their sharp move to the upside during the first quarter on fears that the Fed would have to act sooner than projected to tame the high rates of inflation showing up in many areas of the economy (Chart 2).

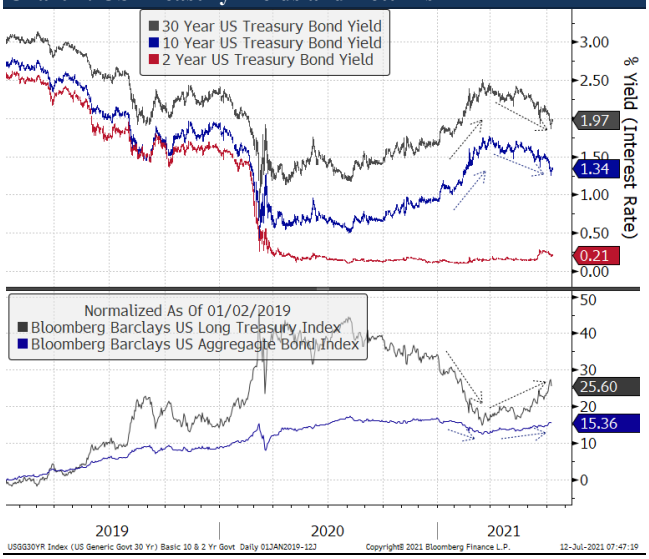
Three factors continue to drive our macroeconomic outlook and cyclical investment strategy. The first factor is the progress being made on the path to a post-pandemic state, and the return to pre-Covid economic conditions. The second is the likely contribution to growth from fiscal policy over the coming year. The third is the outlook for monetary policy and whether conditions will remain stimulative for both economic activity and financial markets.

Chart 1: US Stock Market Returns by Sector



Source: Access Financial Services using Bloomberg Data

Chart 2: US Treasury Yields and Returns



Source: Access Financial Services using Bloomberg Software & Data

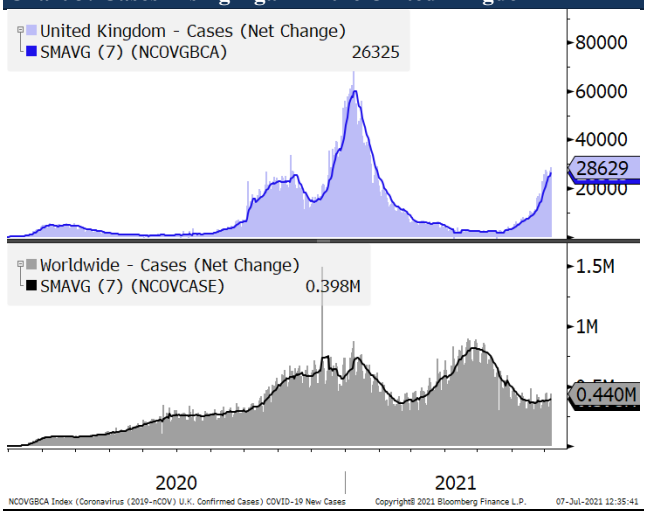
Nearly 18 months after the pandemic began, the global economy is on the mend. In its latest round of forecasts released on May 31, the Organization for Economic Co-operation and Development (OECD) projects that the global economy will expand by 5.8% this year, up from its March projection of 5.6%. The Organization also lifted its growth forecast for 2022 from 4% to 4.4%.

After a rough start, the vaccination campaign is progressing well in most advanced economies. The US and the UK were the first major developed economies to roll out the vaccines, followed by Canada and the EU. While Japan has lagged behind, the pace of vaccinations has picked up lately. 20% of the Japanese population has now received at least one dose.

Developing economies are still struggling to secure enough vaccines. Fortunately, this problem should ease over the next six months. The Global Health Innovation Center at Duke University estimates that pharmaceutical companies are on track to produce more than 10 billion vaccine doses this year. While perhaps not enough to inoculate everyone who wants to be vaccinated, it should suffice in providing protection to the most vulnerable members of society.

Novel strains of the virus are of real concern. First identified in India, the so-called "Delta variant" is spreading around the world. The number of new cases in the UK, where the Delta variant accounts for over 90% of all new infections, is rising again (Chart 3).

Chart 3: Cases Rising Again in the United Kingdom

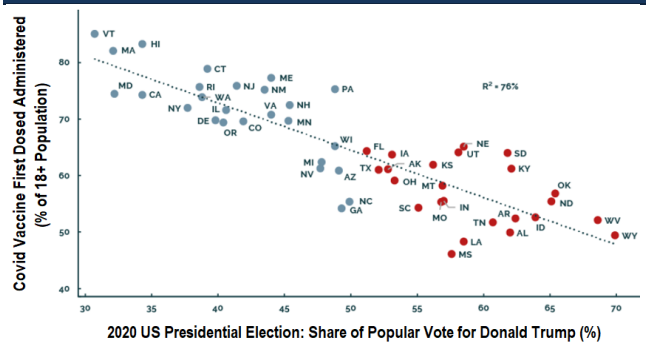


SMAVG (7): seven day moving average
Source: Access Financial Services using Bloomberg Software & Data

It is likely that the Delta variant will produce another increase in cases in the US this summer. Despite ample availability, one-third of Americans over the age of 18 have yet to receive a single dose of a vaccine. As is the case with most everything in the US, the question of whether to be inoculated has become politicized. In many Republican-leaning states, more than half the population remains unvaccinated (Chart 4). Admittedly, part of this relationship may also be capturing an urban/rural divide, with residents in less-dense rural areas (which typically support Republican presidential candidates) perhaps feeling a lower sense of urgency to become vaccinated against the disease.

Vaccine hesitancy will likely diminish as the evidence of their effectiveness continues to grow. According to analysis by the Associated Press using CDC data, fully vaccinated people accounted for less than 1% of the 18,000 Covid deaths in the US in May. A study out of the UK showed that two doses of the Pfizer-BioNTech vaccine was 96% effective against hospitalization from the Delta variant, while the Oxford-AstraZeneca vaccine was 92% effective.

Chart 4: US Vaccination Rate and Political Affiliation



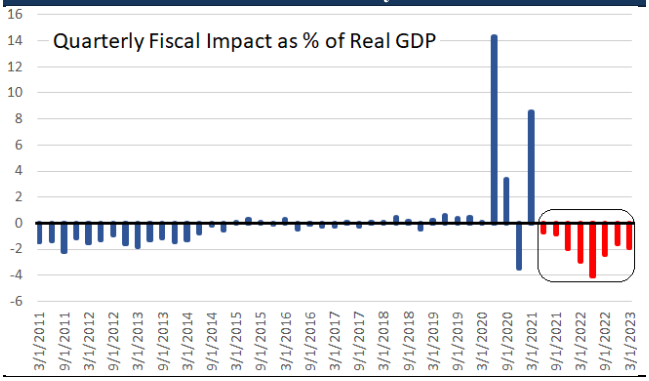
Source: BCA Research using data from US Centers for Disease Control and Prevention and Cook Political Report as of June 30, 2021

While another wave of the pandemic will curb growth this summer, the economic impact will be smaller than in the past. At this point, the initial panic of the pandemic has faded. Politically, it will be more difficult to justify lockdowns in countries such as the US where almost everyone who wants a vaccine has already been able to get one.

The macroeconomic backdrop remains positive for the US in the third quarter but economic growth will likely peak and government stimulus is also peaking.

After cranking the fire hose to full blast during the pandemic, policymakers are looking to scale back support. US fiscal policy is set to detract from growth in the coming quarters reflecting the one-off nature of some of the fiscal response to the pandemic (Chart 5). This is true outside the US as well.

Chart 5: Contribution of Fiscal Policy to Real GDP Growth



Note: Red bars are estimates
Source: Access Financial Services using data from The Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution

The positive spin on this is that much of the fiscal response has been aimed at supporting income that has been lost due

to a drastic reduction in services spending, which will continue to recover over the coming months as the effect of the pandemic continues to recede.

Tighter policy does not necessarily mean tight policy. The International Monetary Fund sees advanced economies running an average cyclically-adjusted primary budget deficit of 2.6% of GDP between 2022 and 2026 compared to an average deficit of 1.1% of GDP between 2014 and 2019.

In the US, Congress is debating an infrastructure bill, a key element of President Biden's "Build Back Better" agenda. If the bill fails to move out of the Senate, we expect Congress to use the reconciliation process to pass most of Biden's legislative program. This should result in an additional 1.3% of GDP in federal spending per year over the next eight years which will be only partly offset by higher taxes.

Biden's ambitious legislative proposals, the $2.3 trillion American Jobs Plan and the $1.8 trillion American Families Plan, will face battles in Congress this summer and fall. If he loses these contests, he will still be able to pass a major bill in the fourth quarter. But the implication is that financial markets face higher uncertainty over the coming three months due to the potential for mistakes and doubts in the period before the end-game in November or December.

This uncertainty should result in higher financial market volatility even though the private economy is strong. The markets are unlikely to simply look through congressional missteps. A failure of the Biden administration to pass any further fiscal spending in 2021 – albeit a low probability – would scrap the argument that 2020 marked a sea change in US fiscal policy. It would support the idea that fiscal policy is reactive rather than proactive and that the US political system remains gridlocked even when Congress is controlled by a single party. Investors would have to downgrade their expectations for long term US government spending and GDP growth and price in a deflationary tail risk similar of the 2010 to 2014 period.

Far more likely, Biden will score one or possibly two legislative victories reinforcing the reflationary fiscal backdrop for this year.

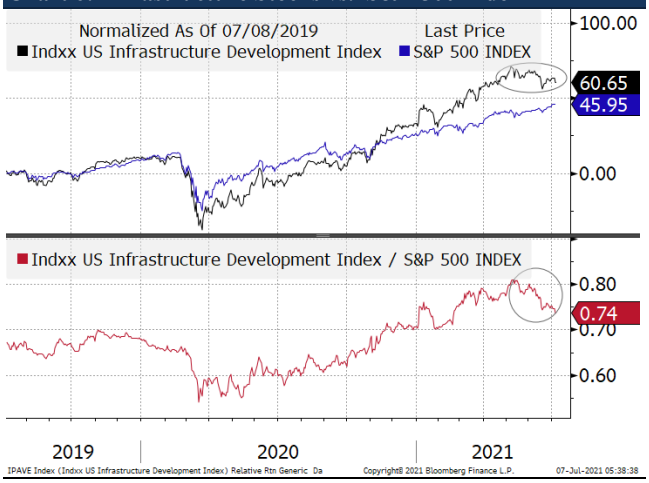
The first bill to pass could be a bipartisan infrastructure deal worth about $1.2 trillion. Last quarter I laid out our argument for a bipartisan option and on June 24 a deal in principle was reached. Infrastructure is popular, Republicans are in desperate need of a public relations victory, and they themselves supported ambitious infrastructure plans under President Trump.

Regarding the composition of the bill, even Republicans support funding for traditional infrastructure (roads, bridges, and highways), transportation, housing, and broadband Internet. These measures seem all but guaranteed to pass.

The American Families Plan – the so-called "human infrastructure" package, i.e. welfare package – is less popular. If traditional infrastructure passes via bipartisan cooperation, Democrats will have a better chance of incorporating aspects of the Families Plan into the reconciliation bill. The public supports higher individual income taxes at the highest brackets although somewhat surprisingly not higher capital gains taxes.

The stock market appears to have become pessimistic about Biden's chances of passing infrastructure judging by the underperformance of infrastructure related stocks since May 11 (Chart 6). This leaves room for a rally in this group as the bill works its way through Congress in the third and fourth quarters.

Chart 6: Infrastructure Stocks vs. S&P 500 Index



Source: Access Financial Services using Bloomberg Software & Data

The takeaway is that the Biden agenda will largely succeed this year with fiscal policy remaining supportive.

After the Senate passes Biden's reconciliation bill, the markets will need to look forward to slowing (albeit still high) growth, a large fiscal drag, higher taxes, eventual Fed rate hikes, and reasonable odds of a return to congressional gridlock in 2022.

Markets interpreted the June Federal Open Market Committee (FOMC) meeting in a hawkish light. Both the two-year and five-year yield (shorter term interest rates) jumped 0.10% following the meeting. The US dollar, which is sensitive to changes in short-term rate expectations, strengthened by nearly 2%. In contrast, long-term bond yields declined following the meeting, with the 10-year and 30-year bond yield falling by 0.06% and 0.19%, respectively.

We think the market overreacted to the changes in the Fed's projections which now show seven of eighteen FOMC participants anticipate an interest rate hike in 2022 and the majority (13 members) expect at least one rate hike

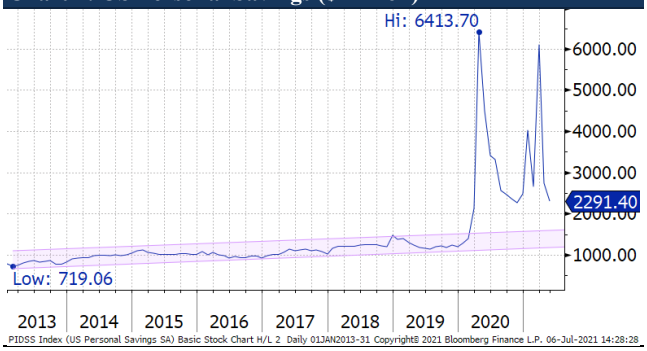
before the end of 2023 raising the median forecast for the Fed funds rate to 0.6% (two 0.25% interest rate hikes) by the end of that year. As Chair Powell himself noted during the press conference, the Fed's projections are "not a great forecaster of future rate moves," before adding that "Lift-off is well into the future."

Rather than obsessing over the projections, investors should focus on the questions that will actually drive Fed policy, namely how long it takes the US economy to return to full employment and what happens to inflation in the interim and beyond.

There is a lot of uncertainty over these questions – both on the demand side (spending) and the supply side (labor market).

On the demand side, the pandemic led to unmatched changes in household spending and saving behavior. Goods spending surged while services spending collapsed. Overall spending declined, and together with increased transfer payments, savings swelled. As of May, US households were sitting on $2.3 trillion in savings (Chart 7).

Chart 7: US Personal Savings ($ Billion)



Source: Access Financial Services using Bloomberg Software & Data

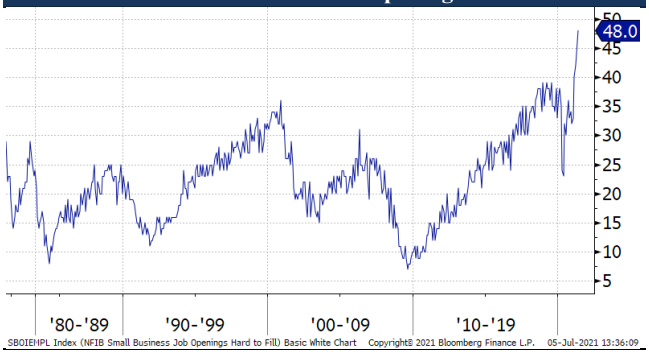
$2.3 trillion is equal to almost 17% of annual consumption. Even if a third of this cash reserve were to make its way into the economy, it could lift aggregate demand significantly.

Turning to the supply side, there were over 4% fewer people employed in the US in May than in January 2020. Taken at face value, this would suggest the presence of a substantial amount of labor market slack. However, the National Federation of Independent Business (NFIB) small business survey tells a different story. It showed that 48% of firms reported difficulty in filling vacant positions in May, the highest percentage of respondents in the 46-year history of the survey (Chart 8).

Along the same lines, the nationwide job openings rate reached a record high of 6% in April, up from 4.5% in January 2020. The job quits rate, a good proxy for worker confidence, is also at a record high.

Assuming that a large fraction of sidelined workers return to the labor market in the fall due to the end of enhanced unemployment benefits and schools reopening, the question is how fast will firms hire them?

Chart 8: NFIB Small Business Job Openings Hard to Fill



Source: Access Financial Services using Bloomberg Software & Data

There is a lot of turnover in the labor market. Gross job flows are much larger than net flows. Between 2015 and 2019, 66.1 million people were hired on average per year compared with 59.6 million who quit or were discharged.

This churn is especially strong in the retail and hospitality sectors, the two segments that account for the bulk of today's shortfall in jobs. In April of this year, retailers hired nearly 800,000 workers. An additional 1.42 million workers found jobs in the leisure and hospitality sectors. This is equivalent to 5.3% and 10.1% of total employment in those sectors, respectively, and this is only one month's worth of hiring.

During past V-shaped recoveries, employment growth has often surpassed 5% on a year-over-year basis. Such a growth rate would produce a net 670,000 new jobs per month, enough to restore full employment by mid-2022. This is the optimistic assessment.

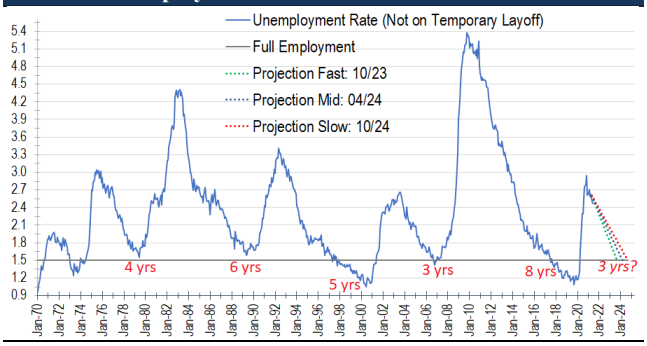
The less optimistic read is that after a recession the economy normally takes years to reabsorb the unemployed (Chart 9):

> 1974-75 recession: 4 years
> Early-1980s recession: 6 years
> Early-1990s recession: 5 years
> Dot-com bust: 3 years
> Global financial crisis: 8 years

After the pandemic recession, reabsorbing the unemployed (that are not just on 'temporary layoff') could also take a few years.

From a historical perspective, there is a notable consistency in employment recoveries. While the last five recessions were different in their severities, durations, and peak unemployment rates, the unemployment rate declined at a consistent pace of 0.4% to 0.5% per year during the recoveries that followed.

Chart 9: Unemployment Rate Since 1970



Source: Access Financial Services using Bloomberg Data

After the mild recessions of the early-1990s and the dot-com bust, the pace of recovery in the unemployment rate was at the lower end of 0.4% per year. Whereas after the global financial crisis (GFC) and its surge in permanent unemployment, the pace of recovery was at the upper end of 0.5% per year. Still, the difference in the pace of the decline in unemployment per year was marginal (Table 2A, far right column).

Table 2A

	Unemployment							
	Date				Unemployment Rate (%)			Pace of
Recession	Peak	Full	Months	Years	Peak	Full	Differ-ence	Decline/ Year (%)
74-75 Recession	1975-Sep	1979-Jun	45	3.75	3.14	1.51	1.63	0.43
80s Recession	1983-Mar	1989-May	74	6.17	4.43	1.58	2.85	0.46
90s Recession	1992-May	1997-Jul	62	5.17	3.42	1.46	1.96	0.38
DotCom Recession	2003-Aug	2006-Oct	38	3.17	2.65	1.43	1.22	0.39
GFC Recession	2009-Oct	2017-Jul	93	7.75	5.38	1.45	3.93	0.51

Source: BCA Research and Bloomberg

Another near-constant through the past fifty years is the definition of full employment. It is achieved when the permanent unemployment rate reaches around 1.5% (solid gray line on Chart 9).

Combining the latest permanent unemployment rate of 2.5 percent, the unemployment rate at full employment, and the consistent recovery paces implies the US economy will reach full employment between September 2023 and September 2024 (Table 2B and projections on Chart 9).

Table 2B

	Unemployment							
	Date				Unemployment Rate (%)			Pace of
Recession	Peak	Full	Months	Years	Peak	Full	Differ-ence	Decline/ Year (%)
74-75 Recession	1975-Sep	1979-Jun	45	3.75	3.14	1.51	1.63	0.43
80s Recession	1983-Mar	1989-May	74	6.17	4.43	1.58	2.85	0.46
90s Recession	1992-May	1997-Jul	62	5.17	3.42	1.46	1.96	0.38
DotCom Recession	2003-Aug	2006-Oct	38	3.17	2.65	1.43	1.22	0.39
GFC Recession	2009-Oct	2017-Jul	93	7.75	5.38	1.45	3.93	0.51
Pandemic	2020-Nov	**2023-Sep**	34	2.84	2.95	1.50	1.45	**0.51**
Pandemic	2020-Nov	**2024-Mar**	40	3.34	2.95	1.50	1.45	**0.43**
Pandemic	2020-Nov	**2024-Sep**	46	3.81	2.95	1.50	1.45	**0.38**

Source: BCA Research, Bloomberg & Access Financial Services

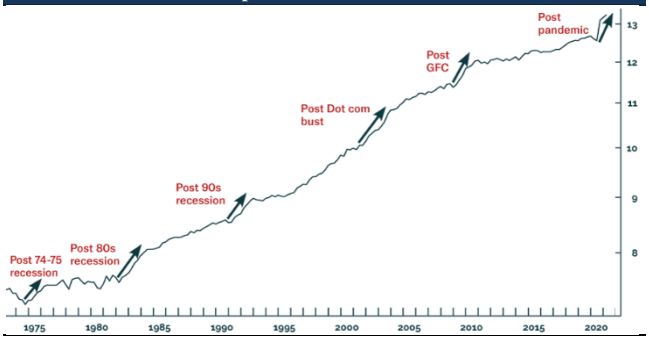
The Federal Reserve has stated that it will not raise the Fed funds rate until the economy has reached full employment. Based on the consistent pace of the past five employment recoveries, it means September 2023 at the earliest, but more likely closer to early- to mid-2024. Yet US interest rate futures are pricing the first Fed funds rate hike between December 2022 and March 2023.
Further, the post-pandemic jobs market recovery could conceivably be at the lower end of its 0.4% to 0.5% per year pace for a couple of reasons.

First, reducing the unemployment rate does not only mean creating jobs for the currently unemployed. It also means creating jobs for those that have left the labor force but plan on rejoining. When these so called inactive people rejoin the labor force they add to the number that are counted as unemployed.

During the pandemic, the number of inactive people surged by an unparalleled 8 million. Even now, the excess inactive stands at 5 million. As these millions gradually return to the labor market, it will weigh on the pace of the recovery in the unemployment rate.

Second, after every recession there has been an acceleration in productivity (Chart 10). This is because the period immediately after a recession is when the economy experiences the most intensive clearing out of dead wood, restructuring of capital and labor, and absorption of new technologies and ways of working.

Chart 10: US Real Output Per Worker



Source: BCA Research

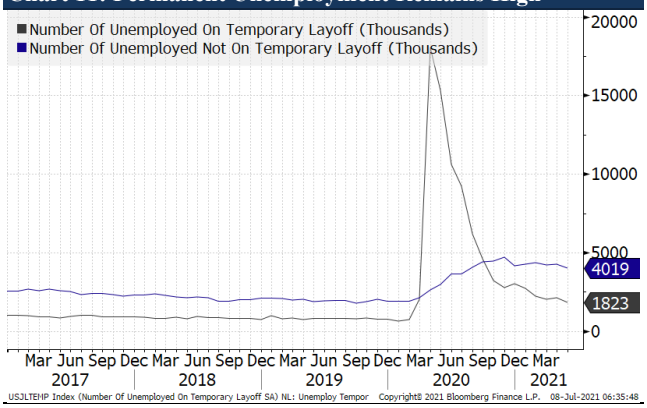
If anything, the post-pandemic productivity boom could be larger than normal because the pandemic has forced all of us to adopt new technologies and ways of working and living. The unfortunate consequence of this post-pandemic productivity expansion is that the pace of absorption of the excess unemployed and inactive could be slower than in the past.

At the last FOMC press conference, Jay Powell supported this line of thought:

Most of the act of sort of going back to one's old job – that's kind of already happened. So, this is a question of people finding a new job. And that's just a process that takes longer. There may be something of a speed limit on it. You've got to find a job where your skills match, you know, what the employer wants. It's got to be in the right area. There's just a lot that goes into the function of finding a job.

The act of going back to one's old job for those on temporary layoff is relatively straightforward. For job creation, this is the low hanging fruit, much of which has already been picked. Now comes the harder part – finding jobs for those not on temporary layoff whose numbers have barely declined from the peak (Chart 11).

Chart 11: Permanent Unemployment Remains High



Source: Access Financial Services using Bloomberg Software & Data

Moreover, even achieving full employment by June 2024 assumes clear blue skies through the next few years.

Turning to inflation, in August of 2020, the Fed formally adopted a "flexible average inflation targeting" framework. Using this framework, it seeks to offset periods of below target inflation with periods of above target inflation. The goal is to better anchor long term inflation expectations, while giving households and companies more clarity over where the price level will be many years out.

In discussing this new framework, the Fed has made it clear it needs to see three things before it considers raising short term interest rates:

> The labor market must be at "maximum employment"
> 12-month personal consumption expenditure (PCE – the Fed's preferred inflation measure) inflation must be above 2%
> The FOMC must expect inflation to remain above 2% for "some time"

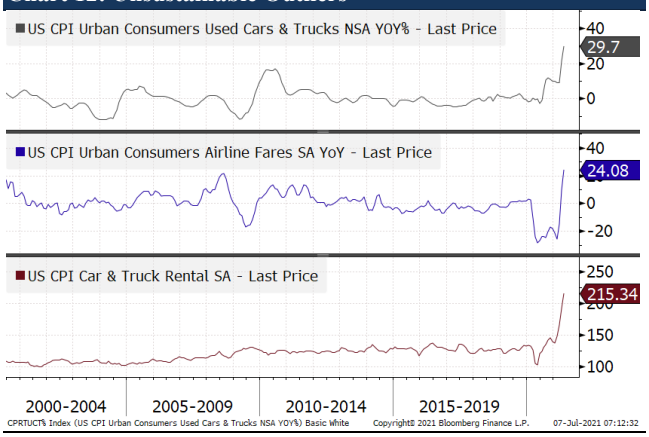
If the US economy achieves full employment by the middle of next year under the optimistic scenario, the first criterion will be satisfied. However, without full employment it will be difficult for the Fed to justify raising short term interest rates and for inflation to remain at or above the Fed's 2% target.

As an aside, unless the rent of shelter inflation component of consumer price inflation (CPI) gets closer to 3% and remains there, it will be difficult for core inflation to remain at over 2% because rent of shelter inflation makes up 32.5% of consumer price inflation. It is now running at 2.2%.

PCE inflation registered 3.4% in June, so at least for now, the second criterion is satisfied. The big question concerns the third one.

More than half of the increase in CPI in April and May can be explained by higher vehicle prices and a rebound in pandemic-affected service prices (airfares, hotels, event admissions, etc. – Chart 12). Outside those sectors, the level of the CPI still remains below its pre-pandemic trend, while the level of the PCE deflator is barely above it.

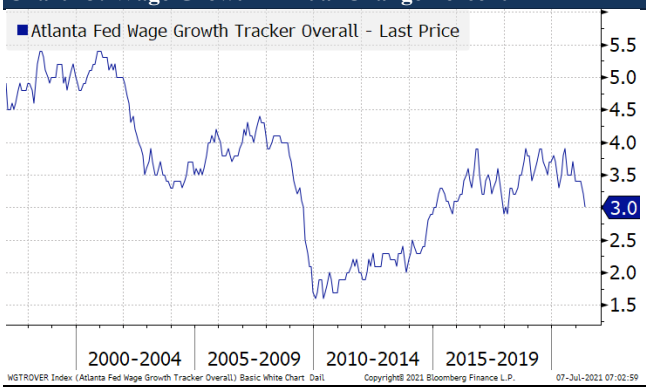
Chart 12: Unsustainable Outliers



Source: Access Financial Services using Bloomberg Software & Data

And aside from a few low-wage sectors such as retail and hospitality, overall wage growth also remains contained according to the Atlanta Fed Wage Growth Tracker (Chart 13).

Chart 13: Wage Growth Annual Change Percent

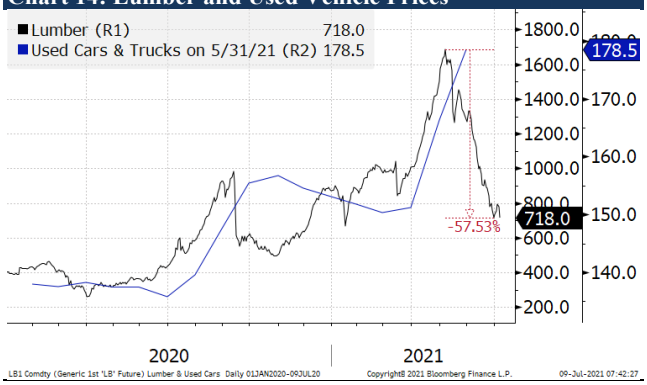


Source: Access Financial Services using Bloomberg Software & Data

We share the Fed's view that much of the upside surprises in the recent inflation prints are the result of transitory reopening factors and the low base effects caused by measuring year-over-year inflation using a starting point of the pandemic lows. Increases in used car prices will slow once rental car companies rebuild their fleets to match increasing demand and new car production can resume at its intended pace, lumber prices will continue to ease as sawmills ramp up operations to capture outsized profits, and the pace of increases in airfares will slow once staffing bottlenecks can be resolved and more flights are added to meet growing demand.

Since mid-May, the 60% collapse in the lumber price shows what happens when supply bottlenecks ease. Other prices that are being supported by temporary supply constraints – such as used car prices – are likely to suffer the same fate (Chart 14).

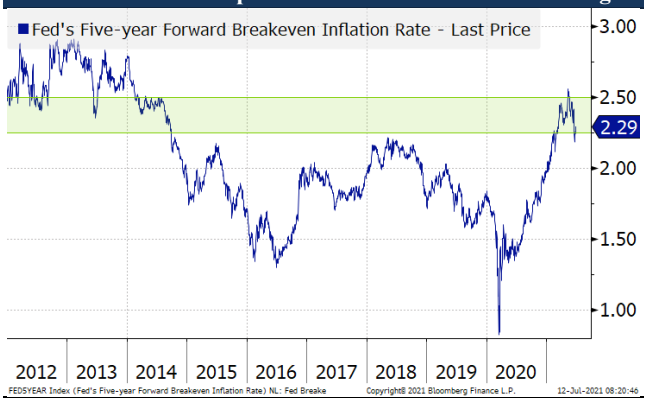
Chart 14: Lumber and Used Vehicle Prices



Source: Access Financial Services using Bloomberg Software & Data

Market expectations of inflation have recently dipped back to the low end of the Fed's comfort zone (Chart 15). Inflation expectations five to ten years out in the University of Michigan's Survey of Consumers also dropped from 3% in May to 2.8% in June.

Chart 15: Inflation Expectations at Low End of Fed's Target



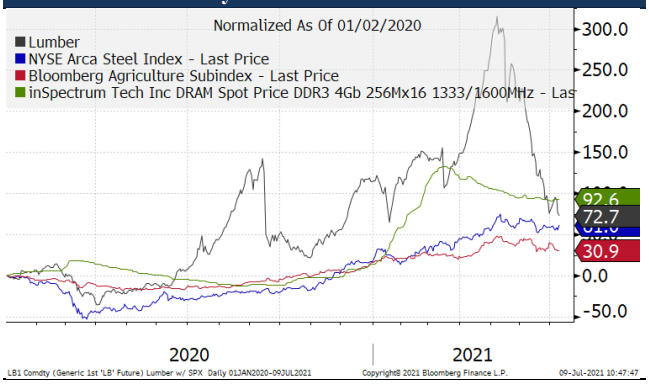
Source: Access Financial Services using Bloomberg Software & Data

Overall producer price inflation should also decline. Chart 16 shows that lumber, steel, agriculture, and memory chip prices appear to have peaked. The price of copper and other industrial metals are also down, albeit by a more modest amount.

Oil is the only major commodity that has not corrected, but even here the one year inflation rate (52 week rate of change in price) has collapsed (Chart 17). This is significant as the oil inflation rate feeds straight into the headline CPI inflation rate.

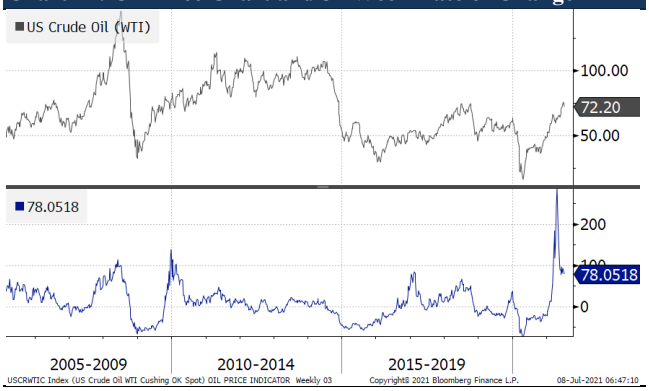
As commodity inflation subsides, so should broader inflation. And as inflation subsides, so will inflation expectations because inflation expectations follow realized inflation.

Chart 16: Commodity Prices



Source: Access Financial Services using Bloomberg Software & Data

Chart 17: Oil Price Chart and 52 Week Rate of Change



Source: Access Financial Services using Bloomberg Software & Data

Taken together, all this suggests that the recent surge in inflation is indeed likely to be transitory and inflation expectations are too high.

Using expectations for the so called terminal rate (longer-term) Fed funds rate as a proxy for the neutral rate of short term interest rates, the Fed's estimate of the terminal Fed funds rate has fallen from 4.3% in 2012 to 2.5% at present. Surveys of primary dealers and other market participants suggest that investors think the terminal rate is even lower than what the Fed believes it to be (Chart 18).

Chart 18: Fed's Terminal Rate Projection Vs. Market Pricing

OIS: Overnight Index Swaps showing where market believe one-month rates will stand in five years
Source: Access Financial Services using Bloomberg Software & Data

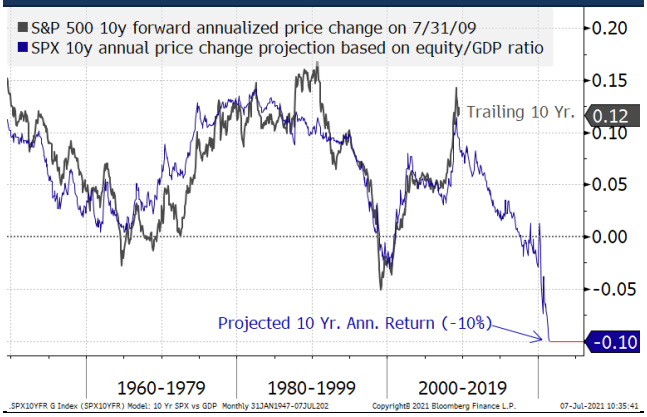
It is an open question as to whether the neutral rate really is as low as widely believed. But if it is, raising rates prematurely would be a mistake. Given the zero lower bound constraint on nominal policy interest rates, the Fed would be hard pressed to ease monetary policy by enough to respond to any future deflationary shock. In contrast, if inflation proves to be more persistent, lifting interest rates to cool the economy would be relatively straightforward.

All this suggests that the Fed is likely to maintain its "go slow" approach as neither persistent inflation nor an accelerated path to full employment can be taken for granted.

A good general rule is to remain bullish on stocks as long as growth is likely to remain strong for the foreseeable future. Historically, bear markets rarely occur outside of recessions. With both fiscal and monetary policy still supportive, and households sitting on plenty of dry powder, the odds that the global economy will experience a major downturn in the next twelve months are low.

That said, the risk-reward profile for equities has deteriorated since the start of the year. Global stocks have risen 12% year-to-date, implying that investors have priced in an increasingly optimistic economic outlook. Stock market valuation measures are very high and point to poor long term future returns. For example, a model based on the US stock market capitalization to GDP ratio indicates the projected ten year annualized return for the S&P 500 Index is likely to be around -10% (Chart 19). Another model based the price-to-sales ratio of the S&P 500 implies a projected ten year annualized return of around -4% (Chart 20).

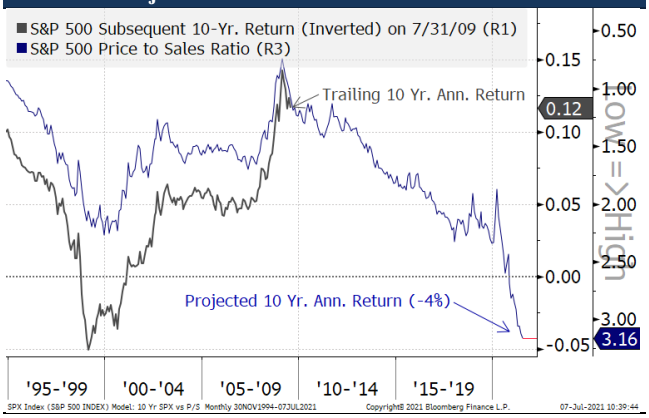
Chart 19: Projected 10 Yr. Returns - Market Cap/GDP Model



Source: Access Financial Services using Bloomberg Software & Data

From a valuation perspective, the US stock market is trading more than two standard deviations above the long-term average (Chart 21, top panel). This is a valuation extreme only seen in the dot-com era. It is also extended on a technical basis (Chart 21, bottom panel). About 40% of S&P 500 industry groups are trading in the top 10% of their historical valuations. In a way, markets have borrowed returns from the future.

Chart 20: Projected 10 Yr. Returns – Price to Sales Model



Source: Access Financial Services using Bloomberg Software & Data

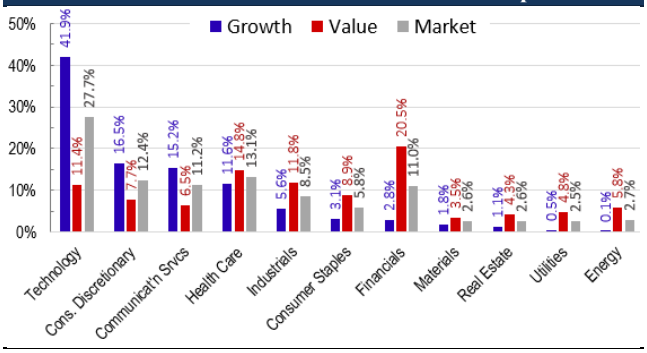
With valuations close to an all-time high, equity markets do not have much safety margin and are vulnerable to a correction. While high valuation is not necessarily an impediment to continued market gains, they do act as a speed limit implying returns of US stocks are to be modest going forward.

Chart 21: S&P 500 Valuation and Technical Measures

Source: BCA Research

It is common to separate stocks into two categories: growth and value. S&P Dow Jones Indices categorizes value stocks as those stocks having low price/book value ratios, low price/earnings ratios, and low price/sales ratios. Growth stocks have high levels of sales growth, earnings growth, and stock price momentum. The market weighting of the stocks in each category is shown in Chart 22.

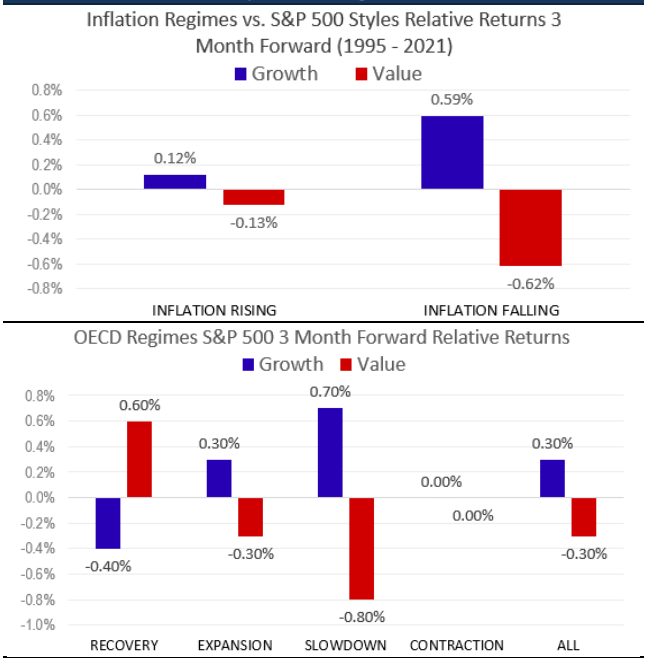
Chart 22: S&P 500 Growth Vs. Value Sector Composition



Source: Access Financial Services using BlackRock Data

Value stocks tend to be more sensitive to changes in economic growth. As the top panel of Chart 23 shows, growth stocks have a history of generating stronger returns than value stocks in an environment of slowing inflation. Further, peak economic and earnings growth, and the business cycle moving into a slowdown stage have tended to benefit growth sectors (Chart 23, bottom panel).

Chart 23: Growth Has Outperformed When Inflation Slows And When the Economy is Slowing



Source: Access Financial Services using BCA Research Data

Much of the explanation can be found in the sector composition of the two styles. Value's top allocation is financials, for which stabilizing rates and a flattening yield curve are detrimental. Growth's top allocation is information technology, which does well in an environment of lower growth and stable interest rates.

Slower growth is usually associated with lower overall stock market returns. Stocks are also likely to face headwinds as spending shifts back from goods to services as goods producers are overrepresented in stock market indices compared to the broader economy.

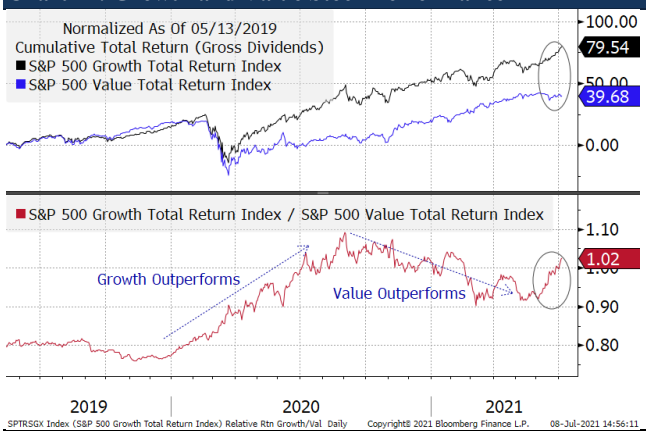
We think the business cycle is at the crest of the expansion stage and is shifting into a moderate slowdown. While growth will remain strong, it has likely peaked and is starting to decelerate. This can be seen in the ISM Manufacturing and Services indices slipping from their March and May highs and Bloomberg consensus estimates of GDP growth slowing from 6.4% in 2021 to 4% in 2022.

The fact that global growth is peaking at high levels will soften the pressure on stocks. Likewise, the need to rebuild inventories and satisfy pent up demand for some manufactured goods that have been in short supply will keep goods production from falling too drastically.

The reflation trade that crushed bonds during the first quarter, drove stock indices to repeated records and re-energized long dormant value stocks this year is showing signs of stalling. While earnings growth is expected to remain strong, a change in its pace often manifests itself in a change of market leadership from value to growth.

Between November 5, 2020 and May 10, 2021 when economic growth was accelerating and longer term interest rates were rising, value stocks outperformed growth stocks by 16%. Recently, however, the case for growth stocks has strengthened. With interest rates stabilizing and inflation decelerating, there are early signs that growth stocks are staging a comeback, outperforming value by 12% since May 10 (Chart 24).

Chart 24: Growth and Value Stock Performance

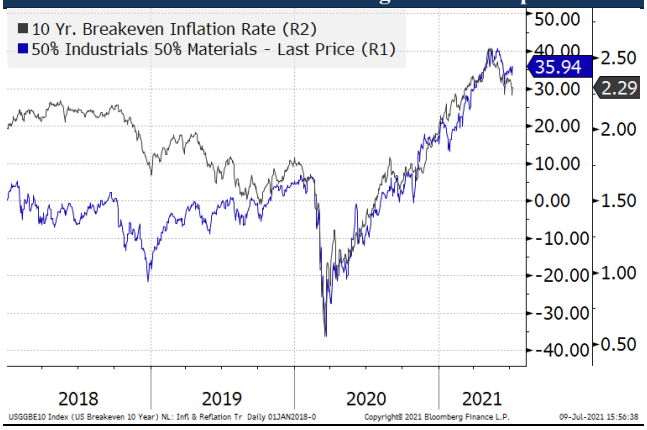


Source: Access Financial Services using Bloomberg Software & Data

The relationship between value stocks and inflation expectations can also be seen in Chart 25 showing the performance of industrial stocks and materials stocks (both

sectors are heavily weighted with value stocks) compared to inflation expectations.

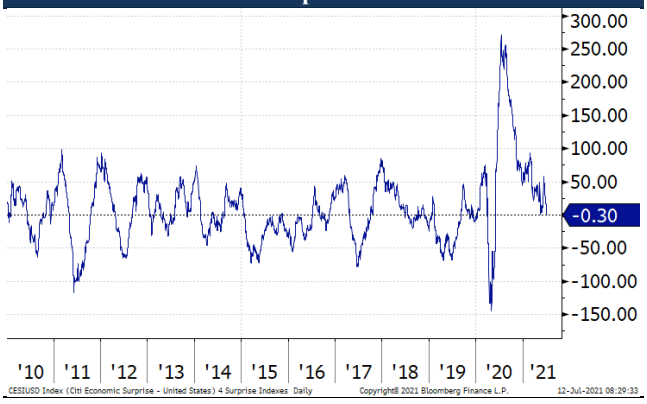
Chart 25: Value Stocks Are Tracking Inflation Expectations



Source: Access Financial Services using Bloomberg Software & Data

Most recently, data on July 6 showed that US service providers expanded in June by less than forecast. And Citigroup's economic surprise gauge which measures the magnitude to which reports either beat or miss forecasts has dipped to its lowest level since February (Chart 26).

Chart 26: Citi Economic Surprise Index



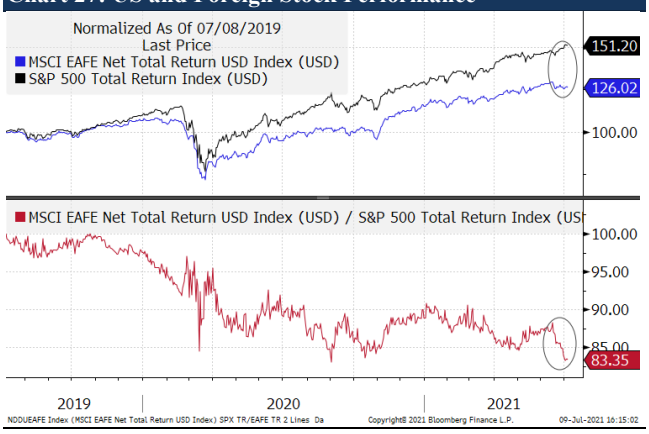
Source: Access Financial Services using Bloomberg Software & Data

Taken together, the cross-asset picture suggests that investors increasingly see the best days of the so called reflation trade in the rearview mirror.

If the period ahead is defined by strong productivity, slack in the labor market, low inflation and new variants of the virus spreading across the globe, investment strategy should shift more toward growth stocks and treasury bonds which both benefit from lower long term interest rates, inflation and economic growth. In addition, a productivity boom will be facilitated by technology and new economy sectors which make up the bulk of the growth stock category.

This extends to overweighting the growth-heavy US versus the value-heavy euro area and developed foreign markets versus emerging markets which have also turned south in relative performance terms recently (Chart 27).

Chart 27: US and Foreign Stock Performance



Source: Access Financial Services using Bloomberg Software & Data

These themes have been playing out since mid-May in relative performance terms as the interest rate on 10-year Treasuries fell below 1.3% recently to the lowest in more than four months further signaling that investors are souring on the growth outlook (Chart 28).

Chart 28: 10 Year Treasury Bond Yield

Source: Access Financial Services using Bloomberg Software & Data

Our clients' portfolios have been overweight value stocks, underweight foreign stocks and underweight treasuries for some time. We are now in the process of shifting to a more neutral value/growth profile and integrating treasuries into the portfolios.

Though our base case calls for benign conditions to persist well into 2022, that scenario is not assured. The uncertain macro backdrop coincides with ambitious valuations in stock and bond markets. Financial assets have little margin for error at levels that imply investors are pricing in a lot of good news. It will require a negative catalyst to trigger their vulnerability, however, and they are poised to continue along their merry way if the potential threats do not materialize.

Brant Kairies
952-885-2732