JULY 2021

Economic & Market Commentary

Prepared by the Private Ocean Investment Committee

Executive Summary

- Economic conditions recovered substantially in the first half of 2021 as COVID-19 restrictions eased and monetary and fiscal policy remained accommodative.
- Inflation spiked in May to 5%, the largest year-over-year increase since the Global Financial Crisis. Most of this was attributed to key sectors of the economy such as used and new car sales and home prices. The Federal Reserve and market expectations suggest this rise in inflation is transitory and therefore not a long-term concern.
- Global equity markets continued to climb to all-time highs, even amidst shrugging off short bouts of volatility caused by the retail investor frenzy back in January.
- Real estate markets have enjoyed a broader based recovery with hotels, resorts, office, and retail rebounding in the first half of the year. Domestic and international real estate continue to be a strong source of returns as well as a solid hedge against short-term inflationary pressures.
- Going forward there are several key themes that we continue to monitor including regulatory tightening around the China stock market, recovery from the ongoing COVID-19 pandemic, inflation fears, and additional fiscal policy coming out of Congress focused on infrastructure spending.

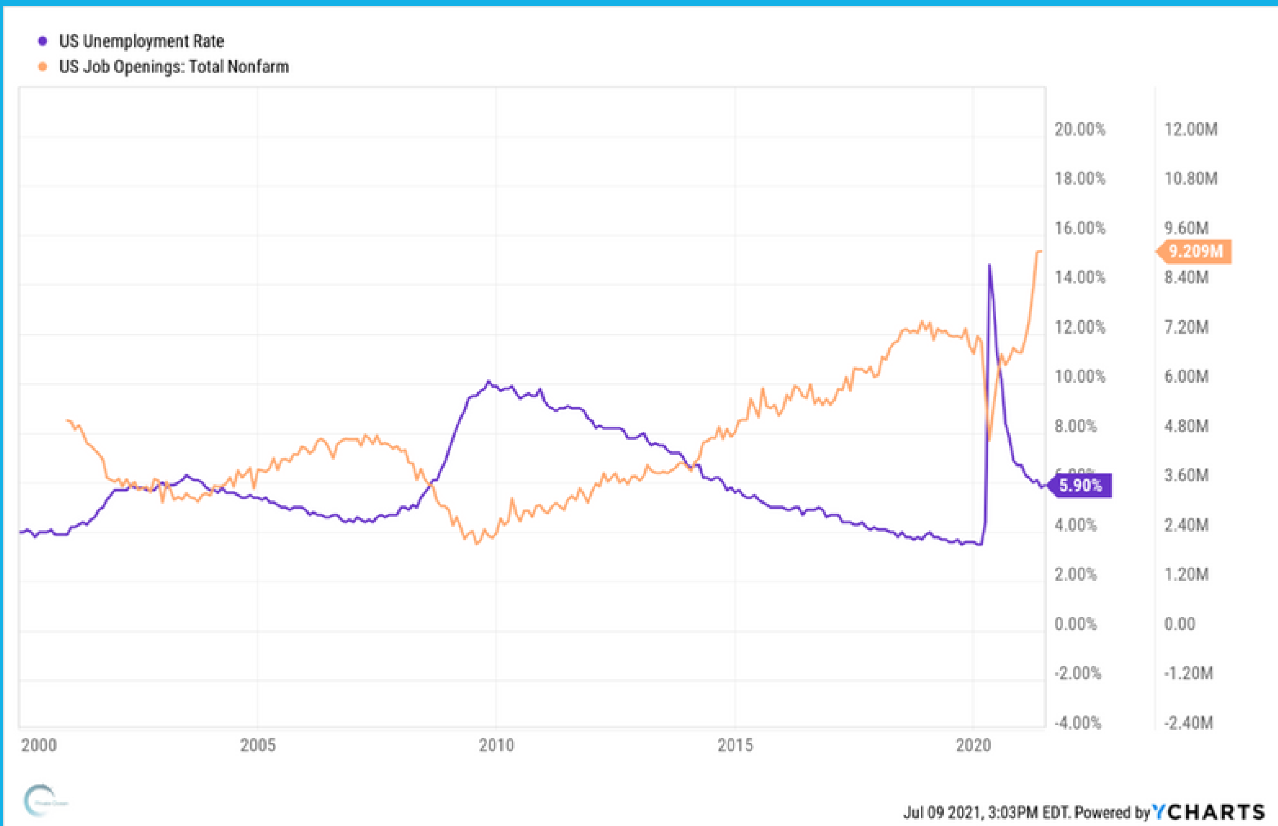
Economic Environment

Major Themes

As we pass midyear of 2021, we reflect on a few key themes that appeared across the economy and markets. Heading into the year, there were still several headwinds that the economy faced including the ongoing COVID-19 Pandemic and its associated lockdowns. US equity markets also saw large bouts of volatility due to the frenzy around so called “meme” stocks, renewed attention on cryptocurrencies, and continued uncertainty around the reopening of the economy. Inflation has also been a hot-button topic, because if inflation rises it will put pressure on the Federal Reserve (the Fed) to taper bond purchases and potentially raise short-term interest rates sooner than expected. This in turn would lower returns in fixed income markets and may slow economic growth. We continue to see strong support from both the Federal Reserve and Congress, with the potential for additional fiscal spending in the form of an infrastructure bill. This could continue to benefit the US economy and further aid in the recovery process. Finally, issues with China continue, including hostilities towards countries like Taiwan as well as regulatory issues with Chinese stocks, some of which have been delisted on the Hong Kong and China stock exchanges, and others that have been blocked from US investment entirely due to an Executive Order.

Employment Market

Since the beginning of the year, unemployment has been on a steady decline as vaccination rates have increased and large portions of the economy have begun to reopen. At the end of 2020, the unemployment rate was 6.7%. In recent months this has dropped to 5.9%. The June jobs figures also showed that more workers are returning to the labor force -- as those previously not looking for work resumed the job hunt. Job openings have also sharply increased, which means slack in the labor market is easing and there are greater opportunities for workers to rejoin the labor force.

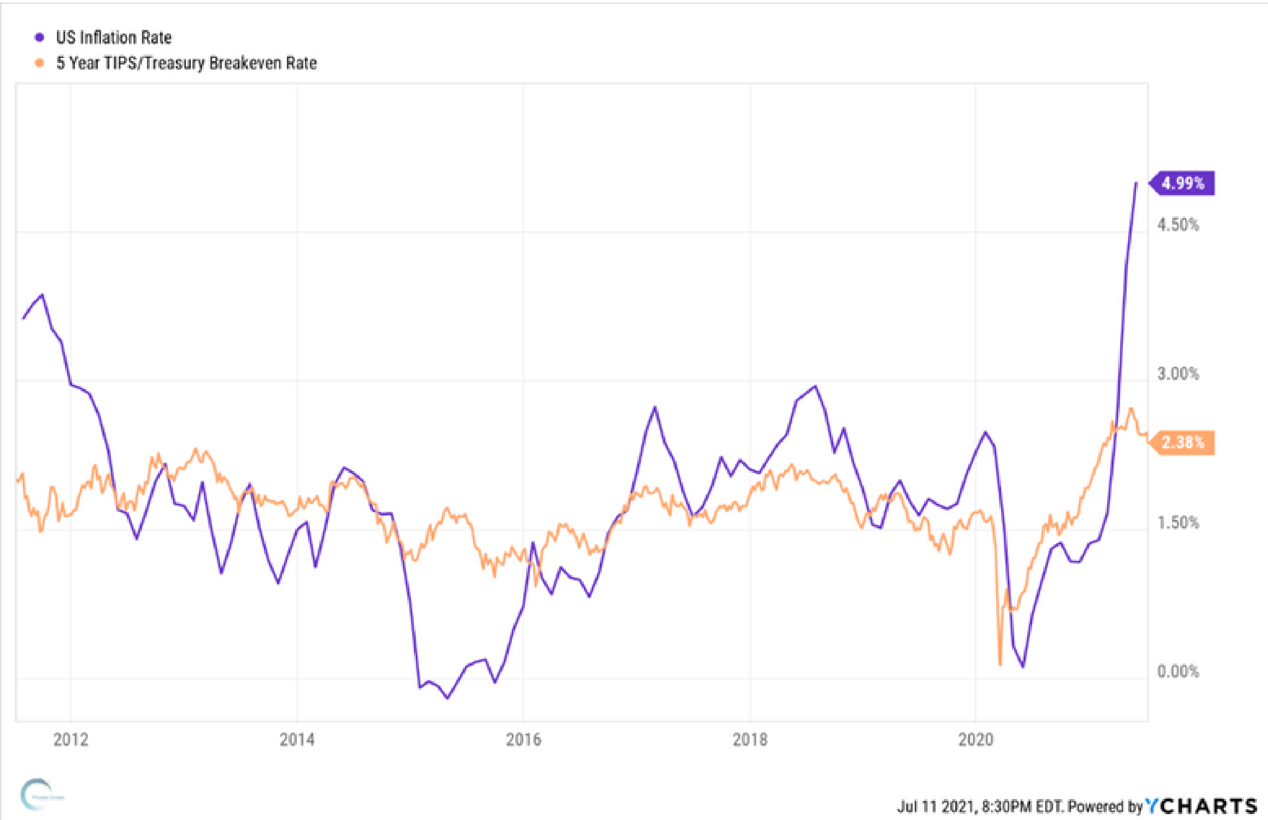


Inflation & Interest Rates

In early 2020, during the initial stock market sell off and economic closures, we saw inflation drop substantially. In fact, low inflation persisted stubbornly for many years prior and even as we began to recover coming out of the market bottom in March 2020. Since the recovery began, there have been concerns about inflation spiking due to supply chain disruptions and a surge in consumer demand. The ongoing narrative coming out of both the Federal Reserve and more recently from the White House has been that this initial spike of inflation is temporary as the economy reopens and that surge in demand needs to be met. Sectors seeing notable inflation include new and used car sales, existing and new home sales, and the energy sector led by a rebound in oil and gas prices.

Short term inflation is not a great investment concern, though we continue to monitor inflation for persistence. Even if inflation were to run slightly higher than the Fed's average target of 2% for an extended period, the Fed has already indicated that they would not immediately act in response as inflation has run well below this average target for some time. Should inflation continue rising precipitously, it may force the hand of the Federal Reserve to begin tapering bond purchases and pulling back on some of their quantitative easing measures. This would lift interest rates to higher levels sooner than expected. Regardless, moderate inflation may be beneficial for assets held in your portfolio such as global real estate, inflation protected bonds, along with global equities.

The market, as measured by the breakeven inflation rate, is anticipating inflation being much lower than the recent 5% Core one-year CPI figure released in May. Market expectations, as measured by the difference between Treasury Inflation Protected Securities (TIPS) and treasury bonds, see inflation around 2.4%.



Interest rates also dropped rapidly in the beginning of the year and have remained near-zero. While interest rates have been somewhat volatile recently, most of this volatility is associated with expected inflation rates. The yield on the 10-year Treasury bond has since moderated to roughly 1.4%, up from 1.1% as noted in our previous commentary. Fixed income market conditions have recovered substantially since last year as spreads have tightened and liquidity has returned to many parts of the bond market.

We maintain that US dollar denominated high yield corporate bonds and emerging market debt offer attractive yields to investors in an environment where yield is hard to come by.

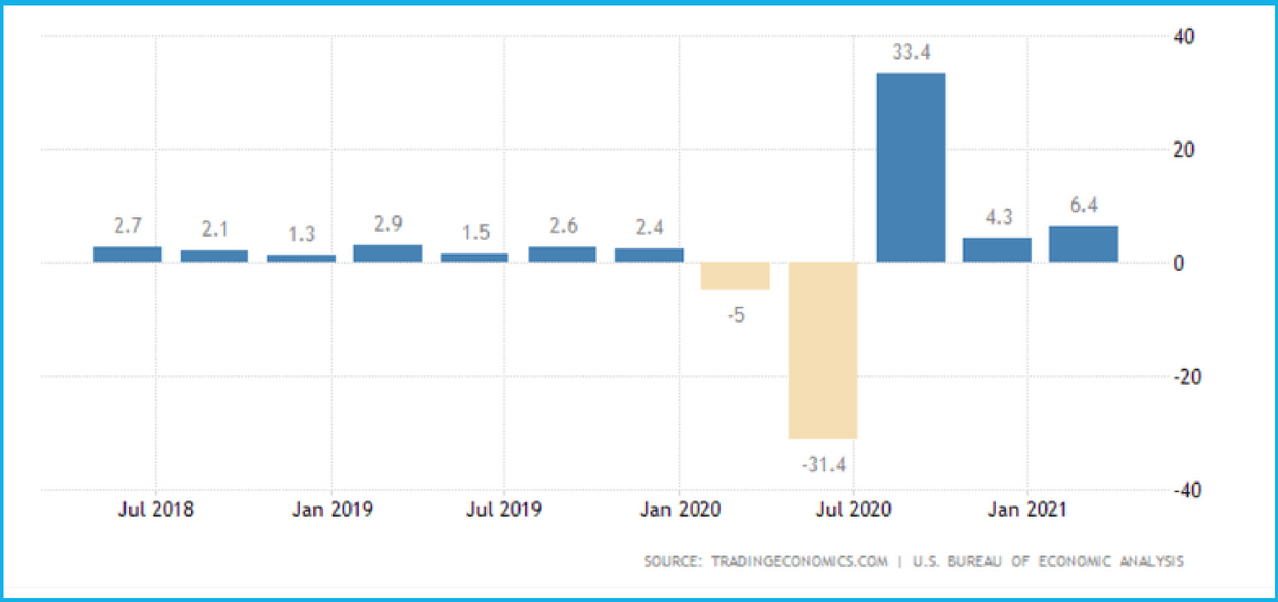
Consumer Confidence

Consumer confidence continues to be an important economic indicator and gives us an idea of how consumers are thinking about the current state of the market and the economy. Consumption is the largest component of GDP, and therefore, consumer confidence offers insight into how the economy may fare going forward. One of the leading surveyors of consumer confidence is The Conference Board. The Board’s most recent Consumer Confidence Index reading suggests a substantial recovery is underway after having suffered a large shock at the onset of the COVID-19 Pandemic.

Economic growth

US Economic growth has rebounded sharply as has global economic growth, albeit to a lesser extent. While the US economy has been reopening through the first half, some developed nations and several emerging market countries continue to struggle with the virus and are experiencing a slower reopening process. Regardless, it is our belief that these economies will also reopen more fully as vaccination rates rise.

US GDP growth dropped by -5% and -31.4% in the first and second quarters of last year, respectively. More recently we have seen a healthy rebound in Q3 2020 of +33.4% followed by +4.3% in Q4 2020, and +6.4% in Q1 2021. We anticipate these trends continuing as we head into the second half of the year and beyond. Another key theme that we continue to monitor is the potential for additional fiscal spending in the form of an infrastructure bill, which could add meaningfully to GDP growth over the next several years. This positive recovery in GDP growth could offer a welcome tailwind for equity markets and Private Ocean portfolios going forward.



Domestic Markets

In the first half of the year, US equity markets experienced some modest volatility. Most of this occurred in late January as retail trading reached a feverish pace. This was attributed to certain securities that saw large amounts of short interest from some hedge funds and other institutional players, while a swarm of retail traders and other hedge funds took opposing positions in those same securities. This "retail versus institutional" equity showdown ultimately led to some substantial losses for many parties involved. This activity has since subsided. Other parts of the US equity market have enjoyed a healthy recovery, with value and small cap stocks benefiting from the reopening of the economy. US large cap stocks as measured by the Russell 1000 Index offered a total return of 15% for the first half of 2021. US small cap companies have rebounded strongly from the market bottom of last year and have continued their outperformance. Small cap stocks as measured by the Russell 2000 Index offered a total return of 17.5% for the first half of the year.

Developed International Markets

We continue to see disparities across developed markets as COVID-19 related restrictions vary by country. As those countries with fewer cases and higher vaccination rates have been able to reopen, their economies have begun to recover more swiftly than those countries who still face broader lockdowns. As such, the global recovery has been less synchronous than initially anticipated. Regardless, portfolios continue to benefit from being broadly diversified to both capture the positive returns of the strongest performing markets (such as parts of Europe) while dampening losses of poorer performing markets. International developed equities, as measured by the MSCI All World Ex USA index offered a total return of 9.9% for the first half of 2021.

Emerging Markets

Emerging market countries continue to be disproportionately impacted by the virus and its fallout. Less effective vaccination campaigns and lack of vaccination supplies in some emerging market countries have led to slower economic recoveries. Additionally, with less fiscal support as well as less room for monetary stimulus, the impacts to these countries have been somewhat exacerbated as compared to their developed market counterparts.

Recently, issues have risen in some segments of China's stock market, due to sharp regulatory tightening by the Chinese government. The Biden Administration has also expounded on the Executive Order 13959 put in place under the Trump Administration, which bans investment in key Chinese security and technology companies. These risks have been a major deterrent for many investors and has caused some retraction in the China stock market. At its peak, in February the China technology stock market had a market capitalization of nearly $3 trillion. Since then, it has lost over $1 trillion of market value. Despite these headwinds, emerging market equities have recovered and continue to a ride a strong wave of positive momentum. This paired with their relatively attractive valuations as compared to developed markets leaves us optimistic for emerging market equities. To add to this, value-oriented companies have outperformed the broader emerging market index. Emerging market stocks, as measured by the MSCI Emerging Market index, returned 8.8% in the first half of the year.

Fixed Income

Inflationary fears and uncertainty as to when the Federal Reserve will raise rates are continued headwinds for fixed income markets. Fixed income returns year-to-date have been a mixed bag. On one hand, there has been an increased demand for shorter duration bonds and higher yielding credit such as high yield corporate bonds, investment grade corporate bonds and high yielding municipal bonds. This has been accompanied by a shift away from longer duration bonds such as Treasury bonds, which tend to suffer more when interest rates rise. Exposure to inflation protected bonds has been beneficial to investors given the temporary rise in inflation. Private Ocean portfolios are aligned with these shifts, being shorter on duration than the aggregate bond index, while also taking on additional credit exposures via high yield municipal and high yield corporate bonds, which have attractive yields given the current environment. The broad based, domestic fixed income market, as measured by the Bloomberg Barclays US Aggregate Bond Index, was down -1.7% for the first half of the year. Short term corporate bonds have been relatively flat, returning just 0.1% over the same period, according to the Bloomberg Barclays US Corporate 1-5 Year Bond Index.

High Yield

High yield corporate bonds as well as high yield municipal bonds have benefited from the accommodative environment offered by the Federal Reserve. With much needed liquidity being infused into the market, these bond markets have been able to thrive. This has certainly shown in their year-to-date returns. High yield corporate bonds, as measured by the Bloomberg Barclays High Yield Corporate Index are up 3.6% so far this year while also yielding 4.7% over the trailing 12 months, offering meaningful income to portfolios. High yield municipal bonds also offered strong performance and are up 4.8% according to the Bloomberg Barclays Municipal Yield Index while also yielding 3.4% over the trailing 12 months.

Emerging Market Debt

As the first half of the year comes to an end, emerging market debt did experience modest losses of -1.4% (as indicated by the Bloomberg Barclays Emerging Market Bond Index). Part of the negative performance has to do with emerging markets recovering at a slower pace than their developed counterparts. Another reason for the underperformance is that sovereign debt tends to be longer in duration and maturity. This means that when interest rates rise there can be negative performance as the longer end of the yield curve tends to be impacted more meaningfully by interest rate moves. Regardless, emerging market debt continues to offer beneficial diversification attractive yields to fixed income portfolios.

US Tips

Treasury Inflation Protected Securities (TIPS) as well as the municipal real return fund have performed well this year due to the rise in inflation and market expectations that inflation may run slightly higher going forward. According to the Bloomberg Barclays US TIPS Index, TIPS have returned 1.4% in the first half of 2021. As for the Municipal Real Return Bond Fund, it has produced a return of 3.1% over the first half of the year. Both funds add meaningful diversification as well as inflation protection to portfolios.

Real Estate

Heading into 2021, many REIT (Real Estate Investment Trust) sectors including hotels, resorts, retail, and office space faced headwinds caused by the ongoing COVID-19 pandemic. Specialty REITs such as data centers and cell towers as well as sectors like industrials and warehousing were able to buoy some REIT performance. More recently, we have seen a broader based recovery across REITs as economies begin to reopen. With travel activity recovering, sectors like hotels and resorts have started to benefit. As consumer demand skyrockets, retail has bounced back. While remote work has been largely beneficial for many companies and enabled them to continue operating even during lockdowns, a return to the office and even a hybrid approach of remote-office work has helped office REITs recover as well. Domestic REIT markets are the strongest performing asset class year-to-date with a return of 22.9%. The international REIT market has also recovered sharply and is up 12.7% for the first half of the year.

Alternatives

Liquid alternative markets have been strong in recent months. Early in the first quarter of 2021, the Private Ocean Investment Committee decided to reduce exposure to liquid alternatives overall. Following this decision, Private Ocean portfolios now have exposure to just one fund, which is the BlackRock Systematic Multi-Strategy fund. This fund has continued to grow and has offered meaningful returns since we first invested in it. It has also added diversification and downside protection during some of the recent volatility, particularly during the market turmoil we saw back in January. The BlackRock Systematic Multi-Strategy fund has returned 4.1% for the year, which puts its performance right between stocks and bonds as we would expect from a liquid alternatives fund.

Conclusion

Consistent with our last commentary, we remain optimistic about 2021 which has shaped up to be a solid year so far. With ongoing support from the Federal Reserve as well as continued talks on additional fiscal spending, the market environment remains accommodative, especially for global equities and real estate. The driving themes of higher inflation, regulatory scrutiny in the China stock market, as well as the strong economic backdrop and recovery inform our investment viewpoint for 2021. While significant uncertainty remains on these themes, Private Ocean portfolios are diversified with the intention to successfully manage overall portfolio risk associated with these issues.

As always, should you have questions we encourage you to reach out to your advisor. We thank you for your continued faith in us and the markets and look forward to continuing to serve you and your families as we head into the latter half of the year.

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Sources

- *YCharts*
- *Morningstar Direct*
- *FRED St Louis Federal Reserve*
- *The Conference Board*
- *Bureau of Labor Statistics*
- *The Federal Reserve*
- *Statista*