

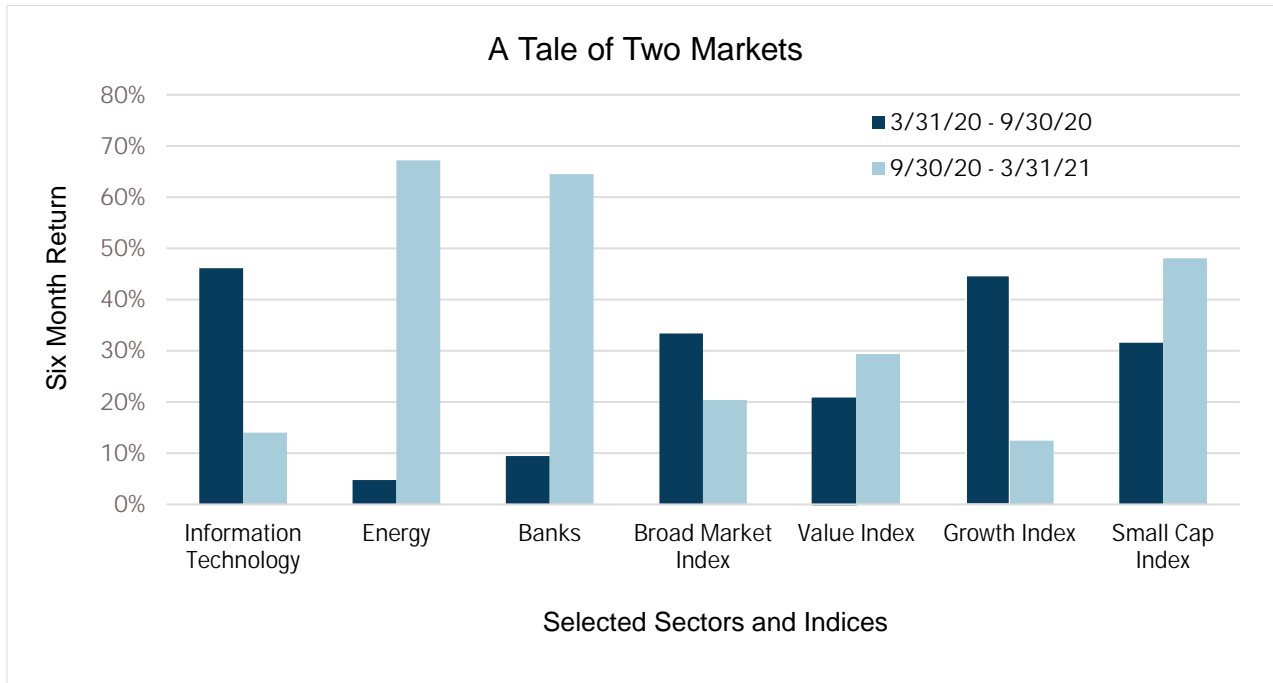
Financial Markets

Stocks continued to march higher during the first quarter of 2021, as the S&P 500 Index gained 6.2%. The market's performance was notable for the continuation of trends that emerged in the latter portion of 2020, namely investors incorporating expectations for an economic resurgence. The Russell 1000® Value Index, primarily comprised of companies in more cyclical sectors, outpaced the technology and communication services-heavy Russell 1000® Growth Index by over ten percentage points during the quarter.

Meanwhile, small capitalization stocks, as measured by the Russell 2000® Index, again led all primary domestic indices during the period with a return of 12.7%. Prices of core economic commodities like oil and copper also increased by double digits.

Bond investors also priced in the economic rebound as yields on longer maturity securities moved significantly higher. In particular, the yield on the 10-year US Treasury bond rose by 0.83% to end the quarter at 1.74%. Bond prices, which move inversely with interest rates, declined during the quarter. As a result, the Bloomberg Barclays US Aggregate Bond Index registered its first quarterly loss in three years, and its largest since 1981.

change in the market's character. So-called "old economy" stocks in the banking, industrial, and energy sectors began to lead the way, while previous market leaders slowed their ascent; many faster growing companies saw their speculative valuations contract. Additionally, stocks of economically sensitive smaller capitalization companies outpaced the stocks of larger firms.

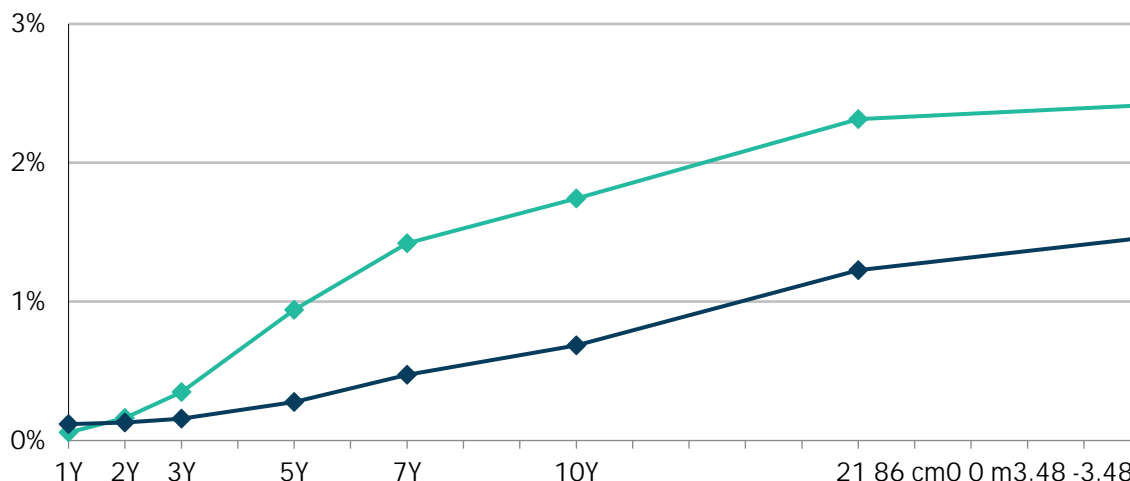


Sector Return Source: Bloomberg.
 Index Return Sources: Russell 1000® (Broad Market Index), Russell 1000® Value (Value Index), Russell 1000® Growth (Growth Index), and Russell 2000® (Small Cap Index).

Further developments in 2021 have buttressed investors' burgeoning economic confidence and supported a continuation of the broad market rise. Though COVID-19 infection rates remain stubbornly high and virus variants are a concern, accelerating vaccine distribution efforts have provided some promise that a return to more normal activities is drawing near. Yet the passing of the Biden Administration's American Rescue Plan Act may figure even more prominently in investors' minds. The \$1.9 trillion stimulus package will provide additional fuel for the economic recovery, and economists now anticipate an economic boom. Partially by way of 2020's contraction, year-over-year GDP growth in the high single digits is expected for 2021. This would mark the largest annual increase in GDP since 1984.

While we believe 2021's high expected growth rate will moderate, several tenets of the stimulus could help sustain a longer-term expansion. Extending supplemental unemployment insurance benefits, providing transfer payments to lower paid workers, and expanding the child and earned income tax credits, are all measures targeted to the lower rungs of the economic ladder that were disproportionately impacted by the pandemic. Though these efforts are designed to address rising wealth inequality, they may also encourage more sustainable economic growth if they are renewed or expanded upon in future legislation. Relative to higher earners with ample savings, the recipients of the above measures are far more likely to spend newfound benefits. This is likely to have a compounding effect and generate additional economic activity well into the future.

Bond investors are also anticipating an economic recovery. At roughly the same time the stock market rally changed in character, the interest rate environment also changed course. The steepening yield curve, with long-term interest rates rising faster than short-term rates, portends economic expansion. Notably, short-term rates have not budged. Indeed, the Federal Reserve has explicitly committed to keeping short rates low for an extended period, assuring markets of ample continued stimulus. At the longer end, the rising rates reflect both economic optimism and expectations for higher inflation.



Inflation Expectations

With economic activity expected to pick up sharply in the second half of the year, and more deficit spending by the government, we have received many client inquiries relating to inflation. To be sure, it's reasonable to expect that inflation will be higher than the recent past. As last year's activity restrictions reduced demand, they in turn pushed down prices of many goods, services, and commodities. Simply by way of the arithmetic of year-over-year comparisons, it's a virtual certainty we'll see higher price readings in the coming months. The uptick in inflation forecasts is also normal alongside stronger economic activity. Add in that pent-up demand is meeting limited supply (from manufacturers and service providers pausing and/or shuttering operations), and we may see prices adjust higher until capacity comes back online. These are all relatively short-term phenomena.

Treasury Inflation-Protected Securities, or TIPS, provide a measure of the market's consensus inflation views. At the end of March, TIPS implied a 2.7% Consumer Price Index (CPI) rate over the next five years. This is well above expectations of 1.5% only six months ago, and much higher than the 0.6% reading we saw amid the worst of the economic uncertainty a year ago. It is worth noting that current yields in the TIPS market also imply expectations for inflation to diminish in the back half of the coming decade—to a rate of 2.2%.

A rising expectation for inflation is notable given how rarely actual inflation has edged above the Federal Reserve's stated price stability target of 2% over the last decade. It also reflects evolving Fed policy which now states that 2% is a "symmetrical" goal. In essence, this means that because inflation readings have stayed

persistently below the target for some time, they could come in above that level without causing concern or immediate action by the Fed – especially if unemployment remains elevated. Thus, we don't think higher near-term projected inflation, especially at the levels implied, is problematic for markets nor cause for alarm.

Moreover, we do not view a longer-term inflation spiral as likely given several mitigating forces. First, as additional supply returns to meet the continuing demand, it will serve to eliminate most "scarcity" pricing in pockets of the economy. Further, as we have previously noted, the Fed used many of its tools to keep the economy afloat during the pandemic. In fact, it likely has few levers left to pull, beyond "more of the same." Conversely, the Fed has plenty of tools at its disposal to slow an overheating economy and tamp down concerning inflationary trends. But Federal Reserve intervention may not be required. The same secular forces that have kept inflation in check for several decades remain evident, including productivity-enhancing technology and global sources of low-cost labor and manufacturing. The potential path for more concerning levels of inflation would likely be through self-fulfilling behavior. In such a scenario, workers and employers alike begin to expect higher inflation throughout the economy and demand higher wages/prices in advance of expected