The economy continued to run hot throughout the second quarter as several economic indicators hit all-time highs. Discussions on the economy evolved from the shape and pace of the recovery toward the impact of supply chain disruptions, a disconnect between the unemployment rate and number of job openings, and the prospect for heightened inflation. The economy remains at a point where year-over-year comparisons are against recessionary levels of a year ago. In addition, as the COVID related restrictions have eased, we have experienced a natural demand shock that has boosted economic readings. We would expect the level of readings to gradually decline as we move into the fall, at which point more straightforward comparisons will be easier to gauge.

**INDUSTRIAL ACTIVITY**

Industrial activity remains a strong point. The ISM Manufacturing PMI index eclipsed a reading of 60 for the first time since 2003. A reading over 50 indicates an expansion in activity. The Services PMI reached a record high reading of 64 in May, before decelerating to a still robust reading of 60.1 in June.

*Source: Institute of Supply Management, June 2021 reportonbusiness*
What has been a challenge for manufacturing activity has been supply chain constraints and the ability to hire enough workers to meet demand. As it relates to the supply chain, both the availability of raw materials as well as logistical challenges are hampering production. For example, in the automotive industry a lack of supply of semiconductors used in new car production has resulted in outsized demand for used vehicles as new car production levels lagged demand.

Order backlogs are at elevated levels, indicating that industrial activity is likely to remain robust for some time. Backlogs have continued to climb as inventory levels have now dropped near all-time lows.

**Consumer**

The consumer remains strong, with the latest round of stimulus payments issued in March helping to spur growth into the second quarter. Consumers are now sitting on nearly $3 trillion of added savings above the level they had pre-COVID. There is also a shift occurring in consumer spending patterns, as retail spending has stabilized and started to decline, while spending on services is rapidly rising. This is not unexpected as pandemic related restrictions have eased and consumers return to increasing their spending on services such as restaurants, hotels, airfare and entertainment. This shift was evidenced in May, when retail spending was down 1.3%, while spending on services rose 1.8%.

An offsetting factor to the strength in the consumer’s balance sheet is the rising cost of housing. Housing prices have now shot up 15% over the past year, and the ratio of home prices to income has now grown near the level it hit prior to the great financial crisis. An offsetting factor to this ratio is the fact that mortgage rates remain near record low levels, resulting in more manageable debt service costs.
A growing topic of interest is inflation. Inflation began to accelerate in April, growing 0.8% on a month-over-month basis, followed by 0.6% growth in monthly prices in May. The one-year inflation rate now stands at 5.0% through May. Inflation statistics have been impacted by transitory impacts such as lower price levels a year ago given the pandemic driven recession. In addition, the surge of demand coming out of the pandemic has led to excess price increases on items where supply and demand are out of balance. Of note is used cars, where prices are up nearly 30% over the past year.

Even without these transitory impacts, there are signs that secular forces of greater price inflation may be forming. Some items such as apparel, which had been in a deflationary trend for the past several years, are experiencing price increases and are no longer serving as an offset to other goods with rising prices. In addition, naysayers to the inflation argument note that for inflation to remain outsized, one would need to see wage growth. We are starting to see signs of that emerge. According to the Bureau of Labor Statistics, wages, in aggregate, grew 0.7% in April and 0.5% in May. Higher compensation is particularly evident in the services sector.
An argument for higher inflation does not necessarily mean 1970’s hyperinflation. For much of the past 25 years inflation has been range bound with prices rising anywhere between 1% and 4%. Given current trends, being at the higher end of this range is not unrealistic. Until we have greater clarity around how supply and demand patterns associated with these transitory impacts flow through the system, it’s too early to decipher whether we are at risk of hyperinflation. At this point we see that risk as less probable.

**MONETARY POLICY**

The Federal Reserve has begun to acknowledge that inflation has returned, although ambiguity remains around how much of the recent uptick in prices is due to transitory effects. At its June meeting, the Federal Reserve Open Market Committee (FOMC) began the process of beginning to talk about slowing, or tapering, their asset purchases. Currently, the Fed is purchasing $80 billion of additional Treasury bonds each month, along with $40 billion of mortgage backed securities. Following the meeting, several Fed governors spoke, offering varying views on the urgency to begin slowing the pace of asset purchases. This will likely be a more significant debate in upcoming FOMC meetings.
As we look ahead, there remains reason to be optimistic about the endurance of the recovery. Record low inventories are likely to drive manufacturing activity until inventory levels catch up with past trends. In addition, the strong economy has resulted in record high levels of corporate profitability, which will likely encourage companies to increase their operational and capital spending. Consumer savings are also at a point where consumers can afford to increase their discretionary spending, with recent spending patterns indicating a desire among consumers to spend. Lastly, in Washington discussions are ongoing around further stimulus with a potential infrastructure package that could add greater demand to the economy.

The next phase of the economic cycle will be influenced by the response of policy makers. As stimulus is removed from the economy, its likely to have an impact. Given the strength of current economic conditions, we believe the economy can withstand the gradual reduction of stimulus, albeit at a moderate pace.

Another trend that is likely to occur is a continued shift in consumption away from goods and toward services. What remains to be seen is how the pandemic will have affected consumers’ preferences and spending patterns over the long-term. It will take time for this to become apparent.

We look to the fall as a point of interest to better assess what normalized economic conditions may look like. At this point, schools will have returned to normal schedules, more workers will be back onsite, and the post pandemic summer travel and entertainment surge will have subsided.
Interest rates were once again the dominant story driving the bond market. While long-term rates steadily rose throughout the first quarter of 2021, the yield curve flattened in the second. The result was higher intermediate-term rates, while long-term rates were notably lower. Changes in yields were the primary factor influencing bond market returns for the quarter. Overall, the Bloomberg Barclays U.S. Aggregate index gained 1.8%, although year-to-date results remain negative.

The prominent influence on the yield curve was the June Federal Reserve Open Market Committee (FOMC) meeting. The FOMC indicated an expectation for the Fed Funds rate to increase in 2023, along with the prospect of a reduction in the pace of quantitative easing. Following the Fed’s announcement, yields on 2-to-5 year Treasury bonds rose, while yields on 10 through 30 year Treasuries fell. This created a flattening in the curve, as the yield differential between 10-year and 2-year Treasuries came down.
As rhetoric around the prospect for higher inflation has increased, it was surprising to see such a considerable drop in long-term yields. We believe several factors contributed to this outcome. First, there has been an influx of foreign buyers into the Treasury market as yields are attractive relative to many other sovereign bonds that currently carry a negative interest rate. Second, as the federal government has been spending in response to the most recent fiscal stimulus package, banks have had a surge of deposits on their balance sheet. They have largely been investing the influx of deposits in Treasury and mortgage-backed-securities as they look to earn some yield in an environment where loan demand remains tepid. Lastly, some investors interpreted the latest FOMC statement as an indicator that the Fed may be more aggressive than previously thought in seeking to contain inflation, and therefore, they see less risk of higher rates over the long-term. Collectively, these factors have contributed to a notable rally in bond prices and retrenchment in yields.

Given the drop in long-term rates, longer dated bonds performed best, while shorter term maturities had fairly muted returns. High yield bonds remain the top performing sector of the bond market as their yield advantage has helped to more than offset any impact from changing rates.

Sectors outside of Treasuries are measured by their spread, or the yield differential between comparable maturity Treasury bonds. Spreads across the fixed income asset class are at or near their all-time lows. Low spread levels provide less cushion for error in the event that defaults rise, although current corporate fundamentals appear quite strong. As such, we view the present environment as having a lower probability of defaults and therefore remain comfortable with spread sectors such as investment grade and high yield corporate bonds. The return potential of these sectors, however, is less attractive relative to historical averages.
Compounding the challenge of low spreads is the fact that borrowers have been issuing longer denominated debt. The chart below highlights the duration, or sensitivity to interest rates, of the broader bond market. There has been a steady rise in overall duration over the past decade. Given that longer term bonds are more sensitive to changes in interest rates, a higher duration for the bond market as a whole leads to greater interest rate risk. Based on these conditions, the bond market appears riskier to us given the lack of spread and above average interest rate risk in an environment where expectations are that interest rates have a greater probability of rising over the next several years.

Source: Touchstone Investments, Bloomberg Barclays

INVESTMENT GRADE BOND SPREADS

HIGH YIELD BOND SPREADS

Source: Bloomberg. YTD as of 6/30/2021
An added challenge going forward is the potential impact on market dynamics should the Fed begin to reduce its pace of asset purchases (i.e. tapering). Since last spring, the Fed has been purchasing an incremental $80 billion of Treasuries each month along $40 billion of mortgage backed securities. This activity is on top of its directive to reinvest principal and interest payments of the bonds held in their portfolio. The effect of these actions has not only been suppressing the yield on Treasuries, but pushing investors toward riskier segments of the bond market where they can better access liquidity and attain higher yields.

We have limited history to go off to assess the impact of tapering. The one historical episode of tapering was announced in 2013 and took effect in early 2014. This event is fondly referred to as the Taper Tantrum. Interest rates had risen six months before tapering began as investors began to anticipate the announcement. The 10-year Treasury had increased a little over a half of a percent during this time. Following the announcement, long dated bond yields fell while intermediate yields remained range bound. Having learned from this experience, the Fed seems focused on communicating their intentions around tapering well in advance of such action. The one caveat could be a lack of consensus among the FOMC, as there appears to be a growing divide among Fed Governors around how quickly tapering should begin.

Municipal bonds remain attractive, as tax proposals out of Washington have led some investors to increase their exposure to tax exempt income sources. Market supply has been unable to keep up with demand, resulting in lower yields and higher prices. A common comparison between taxable and tax-exempt bonds is the ratio of AAA rated municipal bonds to Treasuries. That ratio finished the quarter near all-time lows among some maturities. In fact, in some instances investors would be better off owning a Treasury bond and paying the taxes than owning the tax exempt municipal bond.

Given the nature of the municipal market, opportunities to find attractively priced bonds exists for patient investors and those willing to put the work in. So, while the municipal bond market appears rich in aggregate, pockets of opportunity remain to realize an adequate relative return.

As we look ahead, we believe moderate return opportunities exist within the bond market. However, now is not the time to chase risk at any cost, as volatility in interest rates and the prospect of higher inflation lead us to conclude that the risks are to the downside, versus the upside. In this environment, we believe it’s most prudent to focus on absolute return rather than taking on risk to stretch for a slightly better yield. Over time, we see conservatism as paying off as dislocations will inevitably occur, and having higher quality, liquid bonds should position investors to take advantage of any opportunities that arise.
**EQUITIES**

Equities continued an upward climb as the combination of favorable economic conditions, ample liquidity and better than expected corporate earnings helped fuel interest in stocks. The S&P 500 rose 8.6% and has appreciated 15.2% year-to-date. This marked the second best first half (after 2019) for the S&P 500 since 1998.

While markets continue to gain, the underlying support for higher prices was growth in earnings. First quarter earnings came in better than forecast leading to strong expectations for the remainder of the year. Strong earnings led to a slight decline in the market-wide price/earnings (P/E) multiple, despite prices rallying nearly 9%.

Market sentiment shifted away from the first quarter’s cyclical recovery theme and reverberated back to many of the trends that persisted during the back half of 2020. Growth stocks did better than value. Larger cap stocks outpaced small U.S. stocks outperformed international. The path, however, was anything but steady. For the first half of the quarter, value stocks continued to outpace growth. As vaccinations continued to trend higher and COVID-19 related restrictions eased, investors continued to flock to those stocks that would benefit from an economic recovery. The trade started to ease heading into the final month of the quarter. Following the June FOMC, the shift turned more abruptly, as growth and large cap stocks returned to favor in a meaningful way. As the quarter progressed, the performance of growth stocks tended to be more highly correlated with long-term Treasury yields (falling yields have been beneficial for growth stocks).

<table>
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<tr>
<th>Index</th>
<th>Q2 2021</th>
<th>YTD</th>
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<tbody>
<tr>
<td>S&amp;P 500</td>
<td>8.6%</td>
<td>15.2%</td>
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<tr>
<td>NASDAQ</td>
<td>9.7%</td>
<td>12.9%</td>
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<tr>
<td>Dow Jones Industrial Average</td>
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<td>Russell 2000</td>
<td>4.3%</td>
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<td>Russell 1000 Growth</td>
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<tr>
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<tr>
<td>MSCI EAFE</td>
<td>5.2%</td>
<td>8.8%</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>5.1%</td>
<td>7.5%</td>
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From a sector standpoint real estate was the best performer, as concerns around the prospect of inflation drove increased interest in the sector. Technology rebounded having trailed the broader market in the first quarter. The energy sector continued to climb, resulting in 2020’s largest laggard being up 46% year-to-date. On the other side, it was the more defensive and economically cyclical sectors that lagged. Utilities were the one sector that failed to generate a positive return. Consumer staples, industrials and materials also lagged the broader market.

Small Cap stocks, which were off to a strong start to the year, stalled out. Alternatively, international stocks lagged the returns of their domestic partners. While economic conditions are improving across the globe, higher levels of stimulus in the U.S. have led to more a consistent and sizable rebound for both the economy and equity market returns.

Looking ahead, it’s important to recognize that market averages don’t adequately depict the range of valuations in the market today. Dispersion among price/earnings multiples within the S&P 500 is particularly high. Moreover, there is an outsized number of stocks valued at price/earnings (P/E) multiples that are greater than the market average.
Another element of the market ecosystem worth calling out is the above average level of concentration. Returns of the largest stocks in the S&P 500 have outpaced returns of the rest of the index. As a result, the largest 10 stocks in the S&P 500 make up 30% of the weight of the index. This is down from 33% at the end of 2020 but remains outsized relative to history.

The combination of wide dispersion in valuations and higher concentration in the market leads us to conclude there is an increased opportunity to generate returns from stock selection. Put differently, we see the market being more of a stock pickers market going forward. Understanding the appropriate valuation to pay for a business, in addition to deciphering its earnings trajectory as the economy resets in a post-COVID environment, is likely to be element of value add going forward. In this type of an environment, we would expect active investment strategies to do better than passive.

While stocks have already generated a year’s worth of returns in the first half, we believe a stock picker’s market leaves additional return to be had. Volatility is likely to ebb and flow, especially as interest rates adjust to changes in rhetoric from the Federal Reserve. Strong economic conditions, favorable sentiment toward stocks, and a wide array of opportunities in the market leave us comfortable with current equity market conditions.

Source: Touchstone Investments
REAL ASSETS

Real assets generally produced positive returns. Once again pipelines and commodities stood out as the top performers. Surging demand for select commodities, increased supply chain challenges, and declining levels of crude inventory served as key factors driving these results.

The price of crude oil continued to climb throughout much of the quarter, resulting in 24.5% appreciation in price. Demand for gasoline has returned, as weekly gasoline sales volumes are up 25% from levels at the end of March. In fact, the week of July 2nd was highest week for gasoline demand on record.

On the supply side, during the height of the pandemic, the stock of crude oil rose to the point where there was limited storage capacity. Since the fall of 2020, crude oil inventories have been in decline and are now back to normalized levels. A slowdown in production and lack of drilling activity is leading some to worry that inventories will continue to be drawn down.

### GASOLINE DEMAND

**Weekly U.S. Product Supplied of Finished Motor Gasoline**

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<td>Sales (Barrels per Day)</td>
<td>8,000</td>
<td>7,000</td>
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<td>4,000</td>
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<td>2,000</td>
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</table>

Source: U.S. Energy Information Administration

### CRUDE OIL INVENTORIES

**U.S. crude oil stocks**

- **Weekly**: The weekly data shows a general upward trend in crude oil inventories with fluctuations, indicating a gradual increase in supply.
- **5yr Range**: The range is used to compare current inventories with historical data, showing that inventories are within the expected range for this period.

Source: U.S. Energy Information Administration
Outside of oil, there was a divergence in returns across other commodities. Industrial commodities used in construction, such as lumber, copper and iron ore have been particularly volatile with some hitting record highs. Lumber prices continued to skyrocket, accelerating nearly 80% in the first six weeks of the quarter, before selling off during the second half. All in, lumber prices ended the quarter up less than 6%. Copper was less volatile, but rose 9%, having been up as much as 20% by mid-May. Lastly, iron ore stood out as it was able to withstand a selloff and finished the second quarter up over 20%.

Agricultural commodities like corn have also seen strong price gains. By quarter end, the price of corn had softened as much needed rainfall throughout the drought-ridden Midwest was viewed as a positive for yields, leading some to conclude supply could be higher than previously thought.

The dollar weakened during the quarter, but its performance was largely a tail of two episodes. The dollar peaked at the end of the first quarter, experiencing a steady decline throughout April and May. The currency rebounded during the last couple of weeks of June following the FOMC meeting, to finish the quarter down just under 1%. Year-to-date, the dollar has strengthened versus a basket of other global currencies.

Gold ended the quarter up as the Philadelphia Gold/Silver index gained 5.0%. The price of gold sold off late in the quarter following the FOMC meeting. Gold has been trading in an inverse manner to the real yields (inflation adjusted) on Treasury bonds. When real yields have risen, gold has sold off. As they’ve fallen, gold has been the beneficiary.

Public real estate was a strong performer as the global MSCI World Real Estate index lifted 10.1%. Capitalization rates (cap rates), a common valuation measure within real estate, have fallen to roughly 4.5% and are now at the lowest level over the past 20 years. On its own, this measure would indicate fairly rich valuations to the asset class. Within real estate, the industrial and apartment sectors trade at cap rates below 4%, while the less attractive office, retail and hotel sectors are all north of 5%. Similar to the broader equity markets, there is an increasingly wider range of valuations across asset classes.
LOOKING AHEAD

The economy is off to a roaring start with conditions appearing poised to continue, albeit at a more moderate pace. Over time the economy will have to grapple with offsetting factors of less stimulus and tighter central bank policies. It will be a challenge for policy makers to thread the needle and moderate policy at just the right place. Therefore, one should expect some variability in economic readings and conditions over the next several years as we move toward more normalized policies.

At the halfway point in 2021, the market has already shown a strong outcome. Year-to-date returns are already ahead of our expectations for the full year. As such we expect more muted results for the remainder of the year, with pockets of volatility along the way as markets adjust to varying economic datapoints and central bank policies. It seems increasingly more likely that the Fed may begin to slow its pace of asset purchases in the next few quarters. As the market anticipates this slowdown in monetary stimulus, it will likely have an impact on stock and bond market expectations and positioning.

We are gradually in the process of moving away from a stimulus fueled recovery and the recent demand surge that has resulted from an easing of pandemic restrictions. As this rising tide moves out, not all boats will lift, and we believe we will enter a phase of the market where selection decisions around the right stocks and bonds will be of greater importance than broader market trends.

Inflation will remain a key topic throughout the remainder of 2021. Inflation readings are likely to remain noisy as the impact of transitory items is likely to skew readings higher in the short-term. As we move into the fall and winter, we would expect more accurate depictions of the inflationary climate.

Our guidance as we move forward is to focus on the long-term and recognize there will be noise along the way. At this time, we don’t believe it’s prudent to accept greater risk in order to chase small amounts of incremental return or yield. As these unusual economic and market conditions evolve, we will continue to evaluate opportunities for outsized returns for our clients. We believe patience will be prudent and, in the meantime, have strong convictions in how our clients’ portfolios are balanced relative to the risks and opportunities in the current climate.

On behalf of the entire team at Telemus, we want to express our gratitude to our clients. To those of you who might not yet be clients of Telemus, please feel free to contact us.

Telemus Investment Committee
Important Disclosures and Notices

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The Institute of Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) Report on Business is based on data compiled from monthly replies to questions asked of purchasing and supply executives in over 400 industrial companies. For each of the indicators measured (New Orders, Backlog of Orders, New Export Orders, Imports, Production, Supplier Deliveries, Inventories, Customers Inventories, Employment, and Prices), this report shows the percentage reporting each response, the net difference between the number of responses in the positive economic direction and the negative economic direction and the diffusion index. The Consumer Price Index (CPI) measures the performance of US inflation (not seasonally adjusted) which is the rate of change of consumer goods prices. The data is from Bureau of Labor Statistics. The value of the current month CPI is estimated by the average value of the previous two months CPI. The Bloomberg Barclays Capital U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass throughs), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS). The Bloomberg Barclays US Intermediate Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers that have between 1 and up to, but not including, 10 years to maturity. The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices’ EM country definition, are excluded. The Bloomberg Barclays US Mortgage Backed Securities (MBS) Index tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. The FTSE World Government Bond Index is a broad index providing exposure to the global sovereign fixed income market; the index measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. It comprises sovereign debt from over 20 countries, denominated in a variety of currencies.

The Bloomberg Barclay’s Municipal Bond Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds. The S&P 500 index includes 500 leading companies in the US and is widely regarded as the best single gauge of large-cap US equities. The Dow Jones Industrial Average (DJIA) is a widely-watched benchmark index in the U.S. for blue-chip stocks; it is a price-weighted index that tracks 30 large, publicly-owned companies trading on the New York Stock Exchange and the NASDAQ. The Nasdaq Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depository receipts (ADRs), and real estate investment trusts (REITs), among others. The Russell 2000 index measures the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index. The Russell 1000 Growth Index is a composite that includes large and mid-cap companies located in the United States that exhibit a growth probability. The Russell 1000 Value Index measures the performance of the large cap value segment of the US equity universe. The Russell 1000 Growth & Value Indices are subsets of the Russell 1000 Index. The MSCI EAFE Index is an equity index which captures large- and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 876 constituents, the index covers approximately 85% of the free float adjusted market capitalization in each country. The MSCI Emerging Markets Index captures over 1,300 large- and mid-cap securities across 27 Emerging Markets (EM) countries and five world regions. The Bloomberg Commodity Index (BCOM) is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification. The ICE U.S. Dollar Index (USDX) futures contract is a leading benchmark for the international value of the US dollar and the world’s most widely-recognized traded currency index. The Alenian MLP Index is the leading gauge of energy infrastructure Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX). The Philadelphia Stock Exchange Gold/Silver Index (XAU) is a capitalization-weighted index composed of companies involved in the gold or silver mining industry. The MSCI World Real Estate Index is a free float-adjusted market capitalization index that consists of large and mid-cap equity across 23 Developed Markets (DM) countries. All securities in the index are classified in the Real Estate Sector according to the Global Industry Classification Standard (GICS®).

Any reference to an index is included for illustrative purposes only, as an index is not a security in which an investment can be made. Indices are unmanaged vehicles that serve as market indicators and do not account for the deduction of management fees and/or transaction costs generally associated with investable products. It should not be assumed that portfolio holdings will correspond directly to the comparative index benchmark shown above. The holdings and performance of Telemus client accounts may vary widely from those of the presented indices. Advisory services are only offered to clients or prospective clients where Telemus and its representatives are properly licensed or exempt from licensure. No advice may be rendered by Telemus unless a client service agreement is in place. All composite data and corresponding calculations are available upon request.