2021 MIDYEAR OUTLOOK

Open for Business

Commerce Trust Company™
Wealth | Investments | Planning®

ECONOMY REOPENS FOR BUSINESS

What a rebound! An effective vaccine rollout (over 100 million Americans vaccinated), combined with trillions of dollars of federal spending and the Federal Reserve's (Fed) quantitative easing, has led to a strong reopening of the U.S. economy. Real GDP increased by an estimated 6.4% in the first quarter of 2021, indicating the U.S. economy has nearly fully recovered from the deepest recession since the Great Depression. (Figure 1) Fiscal and monetary policy remains in hyperdrive, and forward guidance from the Fed suggests continued easing until the unemployment rate approaches its pre-pandemic levels. Unemployment peaked a year ago at 14.7% and has quickly fallen to 6.1% as of April. Cumulative job losses are still roughly 8.2 million, suggesting unemployment is closer to 9% of the workforce in place prior to the COVID outbreak.

However, with the reopening, many of the hardest hit industries (i.e., travel, leisure, hospitality) are coming back with a bang, as restaurants are resuming full indoor dining. CDC-revised guidance, which has prompted the lifting of some mask mandates, has allowed people to grow increasingly comfortable simply being around each other again.

MARKET SUMMARY

- The economy is rapidly reopening due to vaccinations and stimulus
- Pace of rising 10-year Treasury yield slows
- First-quarter GDP grew by 6.4%, second quarter could even be better
- Surging demand and constrained supply have collided to produce a bout of inflation
- We remain committed to risk-oriented assets in client portfolios

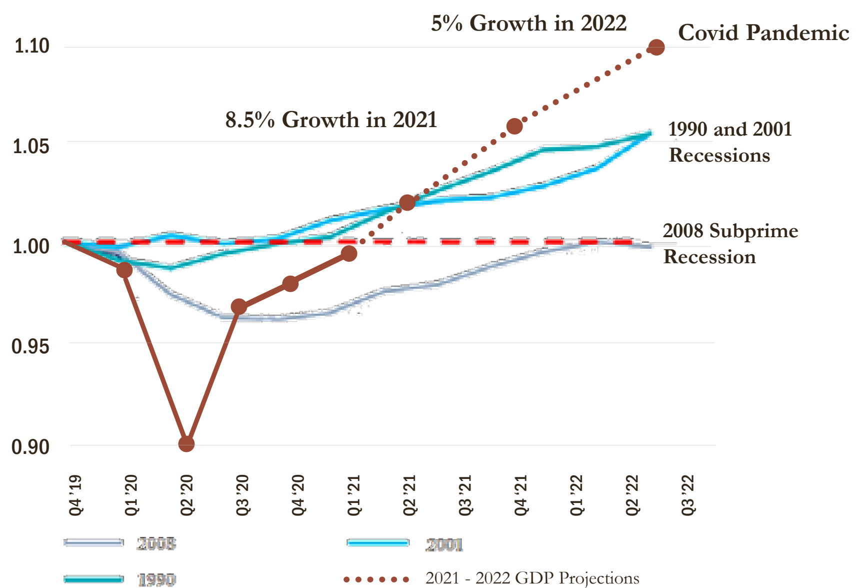
ECONOMIC OUTLOOK

The United States is largely back in business, and business has been good. Rejuvenated consumers have excess cash to spend (much of it courtesy of federal stimulus checks), and surging retail sales are a reflection of their optimism. Surveys of businesses echo their customers' confidence, and the stellar earnings reports and outlooks issued by publicly traded companies for the first quarter suggest all of this enthusiasm has been warranted.

While the demand side of the economy is booming, the supply side is still staggering from the effects of the pandemic. Disruptions up and down global supply chains have led to shortages from basic commodities to finished products. Prices in bellwether commodities like oil, copper, and corn are up over 30% since the beginning of the year, while lumber stands out for nearly doubling amid a building boom spurred (at least in part) by record-low mortgage rates. Quite a bit farther down the chain, the automotive sector has been hampered by a shortage in microchips, which has severely curtailed new car production and led to soaring prices for used vehicles. Put it all together, and the Consumer Price Index (CPI) in April posted a 4.2% year-over-year jump, the largest such move in over a decade.

Supply challenges are also surfacing in the U.S. labor market, as April's employment report tallied far fewer

U.S. GDP PLUNGED, BUT WILL RECOVER MORE QUICKLY THAN ANTICIPATED (MUCH FASTER THAN THE LAST THREE RECESSIONS) (FIGURE 1)

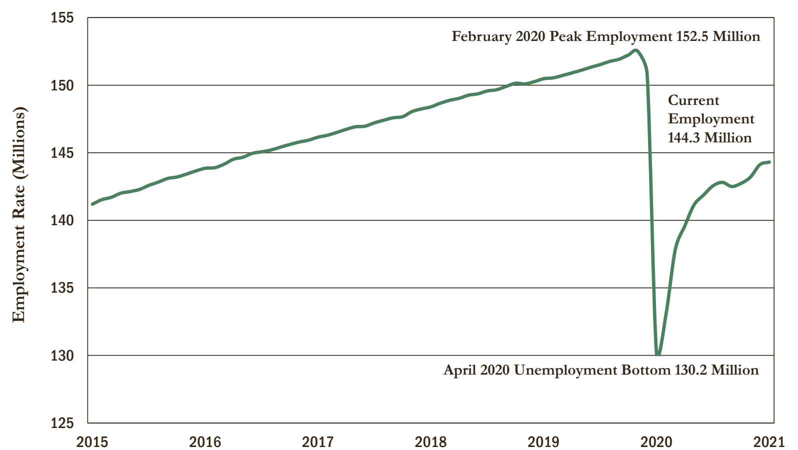


Source: Citi Research, Commerce Trust Company

job gains (266,000) than economists and the markets expected (upwards of 1 million). Furthermore, at the same time that the Bureau of Labor Statistics reported that the United States had 8.2 million fewer workers than at its pre-pandemic peak, it also reported that there are a record 8.1 million job openings that are unfilled. (Figure 2) A "skills gap" certainly helps explain some of that conundrum, but employers of less skilled workers appear to be having the most difficulty drawing people back into the labor force. Many point to "generous" supplemental unemployment benefits as a disincentive to work, with some states going so far as to eliminate those benefits ahead of the federal phaseout in September. The supply/demand imbalance in the labor market has yet to meaningfully find its way into hard wage statistics, but employer surveys and ample anecdotal evidence (desperate "help wanted" signs in retail/restaurant storefronts, minimum wage hike announcements from some of the country's largest employers) suggest labor cost pressures are building.

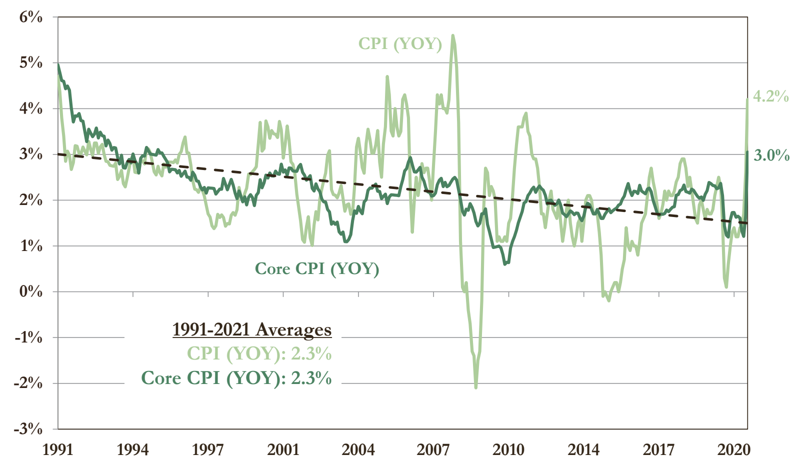
Both the Biden Administration and the Fed believe this current bout of inflation to be a "transitory" increase, not unlike all the other

TOTAL NON-FARM EMPLOYMENT (LARGE GAP TO FILL) (FIGURE 2)



Source: Bloomberg

INFLATION – MODEST BUT TURNING UP QUICKLY (FIGURE 3)



Source: Bloomberg

inflation spikes we've seen over the last three decades. (Figure 3) We tend to agree, as in the near-term we expect to see supply chain issues ultimately resolve themselves as the pace of reopening accelerates around the world. Longer-term, we believe the deflationary impulses of innovation, globalization, and demographics that have tamped down inflation for over a generation remain firmly in place. Therefore, with the recent COVID-induced recession now behind us, we believe the economy will continue to move smartly ahead, even with the prospect of some inflation numbers that might give us pause. Rates remain quite low on a relative basis, and earnings are accelerating rapidly.

KEY TAKEAWAYS: ECONOMIC

- **Rejuvenated consumers have excess cash to spend (much of it courtesy of federal stimulus checks), and surging retail sales are a reflection of their optimism.**
- **Disruptions up and down global supply chains have led to shortages from basic commodities to finished products.**
- **The recent spike in inflation is considered "transitory" by the Fed.**

EQUITY OUTLOOK

With the S&P 500 up over 10% this year and over 80% from the lows in 2020, the question we hear often is, "is it time to sell or at least reduce equities below my long-term target?" We recommended overweighting equities last fall and that recommendation remains in place. At the beginning of the year we felt equities offered attractive risk-adjusted returns versus fixed income and money market options. Money market returns remain at zero and fixed income returns have posted negative returns in the 1% to 2% range. Over the last several years money has been flowing out of equities into fixed income, but that changed in the last couple of quarters, providing a strong demand for stocks. Consumer confidence rose sharply over the last two months, supporting the appetite to take on more risk in a portfolio. Eventually this will become a negative, but this appetite for more risky assets will persist this year.

Another question we receive is that with valuation levels for stocks looking so extended, how can prices go much higher? One way we can gauge valuation is to look at the Price/Earnings ratio which began the year at historic levels following the pandemic lows for earnings. We knew that as the vaccine was distributed, allowing the economy to reopen, earnings would rebound. Analysts were expecting a nice increase in first-quarter earnings when reported in April and May. Not only did they increase, but earnings were 21% ahead of elevated expectations. Companies have

KEY TAKEAWAYS: EQUITY

- **Earnings growth is expected to continue in 2021 and 2022.**
- **An infrastructure bill, if passed by Congress, could be favorable for stocks.**
- **More economically sensitive sectors heavily represented in Value stocks will benefit from a stronger economy.**

done a commendable job of navigating around varying COVID restrictions, supply bottlenecks, labor shortages and sharply rising commodity prices. Earnings growth is expected to continue in 2021 and 2022, which should drive down valuation levels to more reasonable levels as they come through.

There are a couple of important topics that we are monitoring: inflation and its impact on interest rates, as well as the potential for higher taxes. Equity prices have climbed even in the face of a rising 10-year yield now hovering around 1.65%, up from 0.9% at the beginning of the year. If the Fed remains committed to not increasing short-term rates in 2021, we think stocks will continue to move higher even as the 10-year Treasury moves above 2%.

However, sustained inflation could alter the Fed's policy stance and monetary measures, which could be a risk to equity prices. The Biden administration is pushing for an infrastructure bill, which would be a positive for equity prices. However, such a bill would likely be paid for by higher taxes for corporations and higher earning individuals. We believe equity markets are aware of this and have priced in some increase in tax rates. We view an increase in corporate taxes to 24-25% from 21% as manageable for companies that are growing earnings at such a strong level.

Yes, the stock market will have periodic 4% to 7% corrections over the remainder of the year, but the longer-term trend over the next six months remains higher. As far as portfolio positioning, we removed our overweight to Growth over Value recognizing the more economically sensitive sectors, heavily represented in Value, will benefit from the strong economy. We like Large- and Mid-Cap stocks over Small-Cap issues, which look very expensive on a valuation basis. We have not changed our underweight position regarding International equities versus Domestic. For another year, Large-Cap International stocks (EAFE index) trail Domestic stocks (S&P 500 index) by 4%. While Europe's Value tilt should prove beneficial, Japan's weak equity market continues to drag down International returns. We are overweight Emerging markets, which has been a mixed bag. China's equity market is down, and Brazil and India are battling COVID cases, slowing down their economic growth.

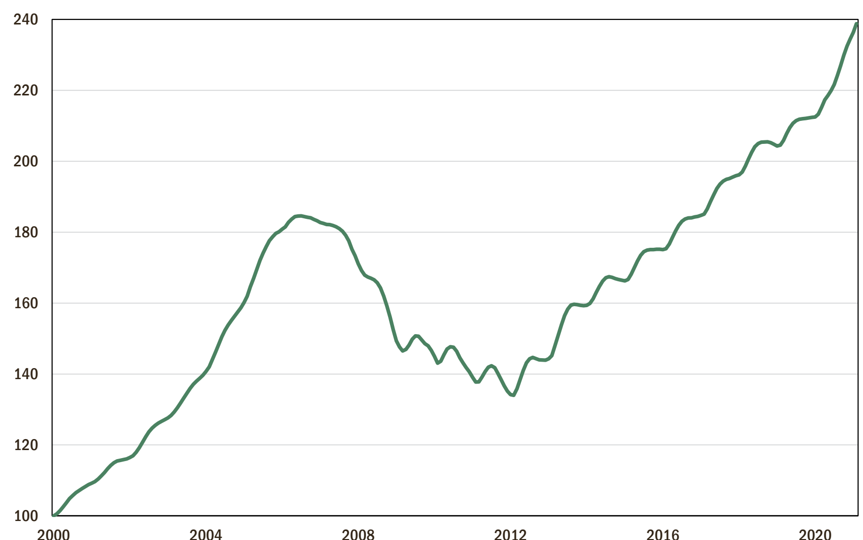
ALTERNATIVE INVESTMENTS OUTLOOK

Energy and other commodity prices have rebounded strongly since the bottom of the pandemic. Structural changes are underpinning the price advances. The economic stimulus has helped the lower income households who tend to consume more commodities than higher income households. We also have supply deficits in many areas, including energy, industrial metals, lumber, etc. Demand is recovering at a faster rate than supply is expanding. In the commodities futures markets you have spot (current) prices trading at higher prices than forward (future) prices. Commodities have historically been volatile investment sectors and have been disappointing to investors as they have added risk without additional return to portfolios.

As we discussed in our Annual Outlook, real estate was going through a transformation prior to COVID. Traditional retail malls were already in decline and with tenant bankruptcies and store closures, we expect repurposing of real estate to continue. Office space needs are being assessed as working from home has been popular with employees and technology has enabled worker productivity. Residential real estate demand and prices have been rising, aided by low interest rates, and limited new supply. The Case Shiller Nominal Home Price Index is at a new high. (Figure 4) Other areas such as storage, cell towers, and health care have also been strong. Periods of high growth and inflation have historically provided a good backdrop for investing in the real estate sector.

CASE SHILLER NOMINAL HOME PRICE INDEX

(FIGURE 4)



Source: Bloomberg, Baird

2021 MIDYEAR OUTLOOK

KEY TAKEAWAYS: FIXED INCOME

- **Investors searching for more yield led to growing demand in the riskier asset classes.**
- **The 10-year Treasury yield is not expected to reach much higher than 2.0% in 2021.**
- **The prospect of higher tax rates has already intensified investor appetite for tax-free income offered by muni bonds.**

FIXED INCOME OUTLOOK

Rising interest rates and rate volatility created headwinds for the bond market in the first half of 2021. Fiscal and monetary stimulus helped jump start the economic recovery at such a quick pace that inflation expectations also grew rapidly. Positive COVID news, massive liquidity injections and unprecedented fiscal support helped economic data improve and business optimism rebound. These factors led to higher Treasury yields, especially for 5- to 30-year Treasuries. Further improvement in the economy will help provide fuel for rising inflation concerns in the short run.

After a mid-year spike, inflation in the United States is expected to moderate by the end of 2021. The deflationary pressures that have affected markets for decades – increasing automation and aging demographics – haven't gone away. These factors will constrain how pervasive inflation could become and help minimize the chances of the Fed raising the overnight federal funds rate in 2021.

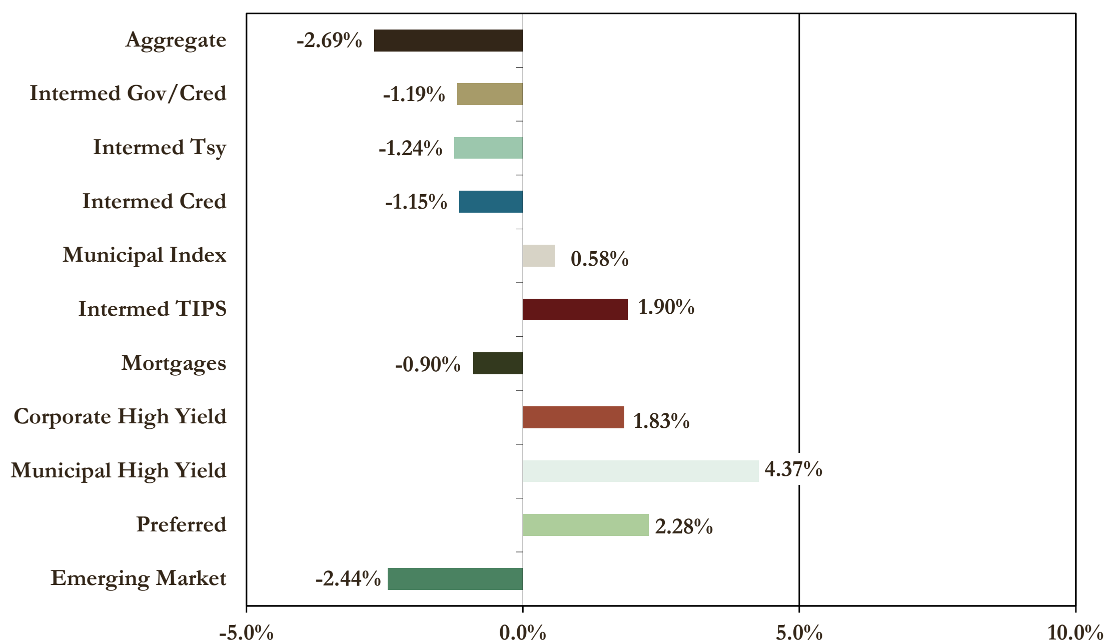
Elevated inflation expectations led to a rise in interest rates and have created something of a bear market in bonds so far this year. Performance for fixed income sectors are running flat to negative year-to-date (YTD). The Barclays Aggregate Bond Index has generated a -2.69% YTD return (as of 5/20/2021) with Treasuries being the laggard of the fixed income market. High Yield has been one of the few sectors that generated a positive return YTD. Investors' searching for more yield led to growing demand in the riskier asset classes.

The excessive amount of liquidity provided by the Fed has stretched valuations, leaving fixed income sectors expensive as we approach the second half of 2021. Finding value in taxable bonds and tax-exempt municipal bonds is currently difficult. In the taxable market, Corporate bond and High Yield credit spreads have reached low levels not seen since 2018. The risk premiums on investment grade Corporate credit of 94 basis points (bps) and 328 bps for High Yield are well below their respective 20-year averages of 161 bps and 564 bps. This leaves little room for upside improvement in the performance for Corporate bonds and High Yield from spread tightening. Focus should be on select issuers that

have not finished rebounding from the COVID-19 impact, primarily found in travel and leisure sectors. As the economy continues to improve and pandemic-related credit pressures continue to subside, High Yield may still generate some positive returns. For April, Moody's reported that the 12-month global speculative grade default rate continues to roll over, reaching 5.6%, which is over a full percentage point below the year-end peak of 6.8%.

Despite the threat of higher inflation, municipal bond yields have remained stubbornly low. So far in 2021, municipal bonds have outperformed U.S. Treasuries by over 4.0%. The Barclays Municipal Bond Index has generated a YTD return of 0.58% (as of 5/20/21). Fund flows into municipal bond mutual funds are at nearly $46 billion and continue to outpace 2019, which was a record year. Supply is typically low in the first half of the year with this year being no exception. Though year-over-year supply has increased, aided by more taxable municipal issuance, demand for municipals is simply overwhelming. The prospect of higher tax rates has already intensified investor appetite for tax-free income. Muni-Treasury ratios are historically low in the 10-year and 30-year spots while the 5-year ratio has

FIXED INCOME YTD RETURNS (AS OF 5/20/2021) (FIGURE 5)



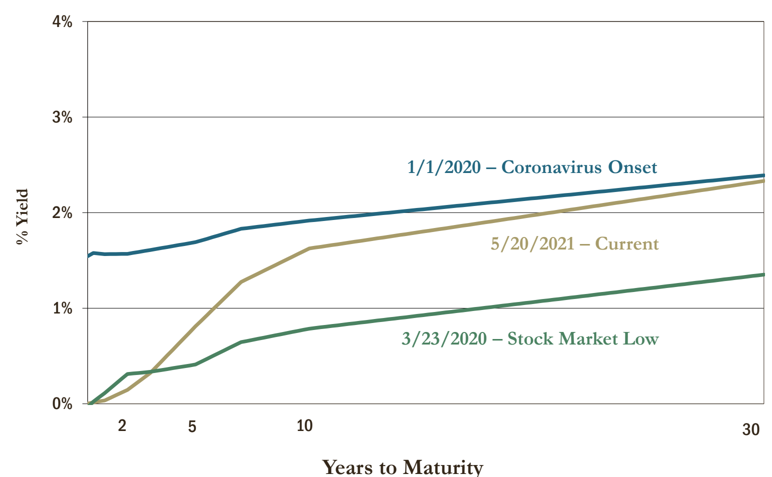
Source: Bloomberg

2021 MIDYEAR OUTLOOK

moved a bit higher. There is no other way to put it, the municipal market is expensive. Even with spillover effects from higher U.S. Treasury yields, any decent move higher in muni yields will likely be short-lived without a significant increase in supply in the back half of the year.

Low interest rates abroad will help constrain how high and how fast U.S. Treasury yields can climb, as yield-starved foreign investors represent a steady source of demand. Many countries are lagging the United States in terms of opening up their businesses and are at an earlier recovery stage. As foreign economies rebound, they too will likely have to contend with rising inflation and see their yields climb, leaving U.S. interest rates more exposed to the impact of its own rising inflation expectations. Currently at 1.64%, the 10-year Treasury yield is not expected to reach much higher than 2.00% in 2021. After a volatile first half, we should see greater stability in Treasury yields due to the bond market gaining a better understanding of the fiscal stimulus impact on the economy. Looking out beyond the post-pandemic horizon, we could see a renewed bout of interest rate volatility as other countries rebound from the pandemic.

TREASURY YIELD CURVE GREAT RECESSION – VS – 05/20/2021 (FIGURE 6)



Source: Bloomberg

Further weakness in bond returns is possible for the remainder of the year, but it's likely to be less severe than experienced YTD. The economic outlook remains promising and global demand for yield will help limit deterioration in bond prices. To hedge some of the potential risk related to inflation and rising rates, maintaining target duration for fixed income portfolios below neutral is suggested for the time being. Despite the challenging environment confronting the bond market, it helps to remember that bonds provide ballast in diversified portfolios, dampening the swings of a volatile stock market.

CONCLUSION

Is it fair to say we have clawed our way back to a pre-COVID operating economy? Some of the economic data says we are within striking distance, despite the specter of long-term inflation and the underemployment of a massive part of the paycheck workforce. For now, it is clear that U.S. stimulus and monetary policies have been a life preserver, but we've certainly borrowed against future prosperity at a steep cost. An infrastructure bill is possibly coming, but divisive politics make it hard to count on these measures. The economy is likely to keep expanding from the first quarter to the second quarter. However, we do expect some consolidation from time to time in an overstretched equity market. It's probably not until later in the year when the stock market has to worry about a combination of higher interest rates, potential changes in tax policy starting in 2022 and a deceleration in the rate of U.S. growth. For now, it is a relief to see the economy and the markets reach this point given where we were exactly this time one year ago.

KEY STATS

8.5%
2021 U.S. GDP GROWTH FORECAST

11.36%
S&P 500 YTD*

6.1%
2021 UNEMPLOYMENT YTD**

1.63%
10-YEAR U.S. TREASURY YIELD*

-2.69%
BLOOMBERG BARCLAYS AGGREGATE BOND INDEX YTD RETURN*

0.58%
BLOOMBERG BARCLAYS MUNICIPAL BOND INDEX YTD RETURN*

* AS OF 5/20/2021
** AS OF APRIL 2021

INVESTMENT POLICY TEAM - JUNE 7, 2021

Disclosures: Past performance is no guarantee of future results, and the opinions and other information in the Midyear Outlook are as of June 7, 2021. The Midyear Outlook is a special report designed to provide investment information on economic markets for Commerce Trust Company's clients. It is intended to provide general information only and reflects the opinions of the Commerce Trust Company Investment Policy Committee.

This material is not a recommendation of any particular security, is not based on any particular financial situation or need, and is not intended to replace the advice of a qualified attorney, tax advisor, or investment professional. Diversification does not guarantee a profit or protect against all risk. Commerce Trust does not provide tax advice or legal advice to clients. Consult a tax specialist regarding tax implications related to any product and specific financial situations. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, it's accuracy, completeness or reliability cannot be guaranteed.

2021 MIDYEAR OUTLOOK
COMMERCE TRUST COMPANY AUTHORS

WM. MICHAEL CODY, CFA®
SENIOR VICE PRESIDENT, DIRECTOR OF FIXED INCOME TRADING

SCOTT M. COLBERT, CFA®
EXECUTIVE VICE PRESIDENT, CHIEF ECONOMIST AND DIRECTOR OF FIXED INCOME MANAGEMENT

MADISON MCCARTY
SENIOR VICE PRESIDENT, SENIOR PORTFOLIO MANAGER

CYNTHIA RAPPONOTTI, CFA®, CAIA®
SENIOR VICE PRESIDENT, SENIOR PORTFOLIO MANAGER

BRENT SCHOWE, CFA®
SENIOR VICE PRESIDENT, DIRECTOR OF INVESTMENT RESEARCH

JOSEPH C. WILLIAMS III, CFA®
EXECUTIVE VICE PRESIDENT, DIRECTOR OF INVESTMENT STRATEGY

1-855-295-7821 | commercetrustcompany.com

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

Commerce Trust Company is a division of Commerce Bank.

CTC0621-PC1378