TRANSCRIPT

Quarterly Market Update – Q3 2021

Presenters: Jake Weinstein & Cait Dourney

Jake Weinstein: Hello, I'm Jake Weinstein and I'm joined by Cait Dourney, we are analysts on Fidelity's Asset Allocation Research Team. Welcome to the quarterly market update.

Today, Cait and I are going to go through the events of the second quarter of 2021 and provide an outlook for the remainder of 2021 for the economy and the capital markets. Many of these slides that we're going to provide to you can be found with other material at Fidelity.com/qmu.

So, let's get started, to say the least. It's been a very interesting market, very interesting times. Everyone always says the word unprecedented. We've had potentially the first time we ever had an economy completely shut down and then seeing what happens when it reopens major stimulus from fiscal and monetary authorities and markets that are now, at least as of the beginning of July, trading at all-time highs. Bond yields are doing going have been going up in the first quarter, took a little bit of a pause.

And so what Cait and I are here to do is just provide a little bit of perspective of what's been going on and provide guidance for how you should think about investing and give you investment ideas and how you should think about your portfolio, not only now, but for the intermediate and longer term horizons. And so, this slide here shows pretty much what we're going to go through, as summarizes the events that took place over the past quarter. Starting up in the top left, the macro environment. We had a continued global economic

expansion. It broadened, but as we are going to go through, it happened a little bit different speeds with different regions across the countries. And a lot of that had to do with the virus, different variants of the virus, but also the distribution of the vaccine.

And so, for asset markets, they behaved well and responded nicely to a continued economic expansion by equities reaching their all-time highs. But bond yields also fell, which was good for bond prices. Now, as far as the outlook for the rest of the year, we think that the virus still matters. The progression of these virus variants do matter. But ultimately, we think that we are moving really into the mid cycle phase for the U.S. with the reopening becoming reality. But what that means is that activity and inflation rates may be reaching a peak. And Cait will go into more detail about that later. But we're also going to talk about the rest of the world, because it's easy to forget about the rest of the world, especially China, a very important country to follow. And there's been a bit of restrained policies and less economic momentum happening over in China, which means that the US is going to be the primary driver of the global cycle.

And as we've been reopening, this is a bit impacting a lot of people. We've had supply-side disruptions, shortages of goods, shortages of types of things that have been not very commonplace over the past several decades. We're not used to. And the good news is we think that some of these shortages and disturbances from supply side will likely ebb, but we think that they may last a little bit longer and into the second half of this year as the economy continues to heal from this very unique and unprecedented time. And because of that, monetary policymakers are still becoming being very accommodative. But we think that in the second half of this year, we may have reached peak stimulus

and liquidity growth. So, what that means for asset markets and we've been talking about this for the last year, is that politics, policy decisions are probably going to have a significantly more higher, increasingly large influence on asset returns. And because of all that stimulus, we've had very high asset valuations, which suggests that perhaps some of these positive expectations have been built into asset prices. And so what this all means is that with less liquidity growth, potential for more inflation, higher valuations, we think that there are higher odds of market volatility in the second half of this year, which is fine because it's completely normal for the markets to experience volatility.

When you get to the mid cycle environment, you can and normally get types of drawdowns or market corrections. But overall, the cyclical outlook does remain constructive. And that's extremely important because we think that it still makes sense to have a tolerance and allocation to riskier assets such as equities. But because of this volatility, we think that portfolio diversification remains as important as ever. Give a recap now of performance for the largest asset classes in the second quarter. Impressively, every asset class on this page, whether it's stocks, bonds, commodities, gold, high quality, low quality bonds, different types of sectors of equities all performed.

Positively, the best performer in the top left was commodities, as though supply shortages I mentioned caused there to be a higher prices for things such as copper, things such as lumber, things that takes to build homes, to build other types of things and other input prices. So that was a very good quarter for commodities. For the several quarters in a row, real estate stocks had a good quarter as well, perhaps due to lower the lower interest rate environment and equities outperform bonds. Now, within equities, it was a little bit of a rotation as large cap stocks started doing a little bit better than the

small cap, which is a little bit different than what had been happening over the previous 12 months. And growth stocks did better than value, not shown on this page, but also another bit of a different rotation compared to the previous 12 months. So, a lot of this talk about this reflation trade took a bit of a pause in the second quarter. But the good news is that is still the second quarter was still good for risky assets. Equities still did better than bonds. And in this bottom chart, I'm showing you as a long term 20-year average of the difference between equity markets and bond market returns since the nineteen forty six. And you can see that holding equities over bonds over long periods of time is advantageous.

And you can see the last data point is giving you about over the last 20 years, stocks have done four percent better per year, better than bonds. And just to recap the market summary, before I hand it over to Cait to dive deeper into the economy, it really is all about interest rates and a lot about the real cost of borrowing or real interest rates. And we'd like to show this chart and it breaks down the components of interest rates, whether it's nominal interest rates broken down between the real cost of borrowing from real yields and green and inflation expectations in blue.

And you can see a table in the top left show that in the first quarter, inflation expectations went higher, the real cost of borrowing went higher, and the 10-year Treasury yield, as a result went up by over 80 basis points. And it's normal for markets to take a bit of a pause quarter over quarter. And surprisingly to many, bond yields did fall. And I think a lot of the reason for this is because of the massively positive liquidity environment provided by accommodative central banks through quantitative easing policies across the globe. But what's interesting is if you see in that very top right in the second quarter of 2021,

inflation expectations were generally pretty tame. And this happened during a quarter when the inflation prints, whether it was CPI or PC, were actually pretty high and hit multi decade highs. And so, the market just doesn't really think that these inflation pressures are probably going to last too long. But that is what we're thinking is the key things to think about in terms of asset performance is the direction of interest rates, the direction of bond yields, and whether inflation continues to accelerate as it did over the course of the first half of the year. So, with that, I'm going to hand it over to Cait to go through the details of the business cycle.

Cait Dourney: Thanks Jake. As you know, we use a business cycle approach to allocation, which it means we think that the business cycle is a good starting point for thinking about how you should invest. So typically, you want to invest in economies that are earlier on in the business cycle and then hold less economically sensitive assets later on in the business cycle. And so, every business cycle rhymes, typically things like profits and inventories and credit, we think are the fundamentals of the business cycle. But this cycle has also been driven heavily by the virus and now the vaccine programs that are being rolled out. And so here on this graph are showing you graphically where our models think that all the world's major economies are in the business cycle. You can see on the far-right hand side is China, which entered and exited the virus cycle much earlier than most of the global economy. And China's activity is now close to a peak and even starting to decelerate in parts of the economy.

Next, we have the US where we've seen a very strong reopening over the last quarter, and we're getting closer to a peak reopening into a mid-cycle expansion phase rather than that rapid early cycle recovery a little bit earlier on in the U.S. are places like Europe, the UK, Australia, Canada, who are lagging

our vaccination rate by a little bit, but starting to pick up and really starting to reopen their economies and seeing growth pick up as a result.

You know, elsewhere in the world, we see economies that are still yet to see their strongest reopening phase. This is places like Latin America. So, Brazil or Mexico, India, these are places that are still struggling with the virus, starting to see more vaccinations. But we think probably the biggest. Is still ahead of these economies, so overall, what we're seeing is all of these economies are an expansion. None are in recession anymore. They've all started to recover out of the Great Recession of 2020. But you're seeing a lot of divergences across these economies as a result of different virus variants, different rates of vaccination, different amounts of stimulus.

And so, to us, this this makes for lots of interesting opportunities across this very diverse landscape. So, let's dig a little bit deeper into China specifically. So, China overall in 2020 was a positive impulse on the global economy. They did quite a bit of industrial sector stimulus, which resulted in their industrial activity rising very rapidly throughout, especially the second half of last year. You can see that on the left-hand chart in green. This is our proprietary measure of industrial output for China, which we build from component level data.

You can see that rapid rebound through the back half of last year and into early 2021. However, as we turn into the second half of 2021, we do think that China is starting to slow, and activity is starting to peak and decelerate.
You can see that in the Green Line, having turned over in the last few months, still in expansion. So still above that 50 percent line. But it is starting to decelerate off of peak levels. And we think that the reason for this can be

explained in large part by monetary policy in China, having moved from easy into more neutral territory. You see this with credit growth in the blue line having decelerated from its peak in 2020 down back towards pre pandemic levels. More recently, as we've talked about in the past, we think that Chinese credit growth is a leading indicator of Chinese economic activity and of global economic activity. And so, it stands to reason that as credit growth has started to decelerate, we should expect some deceleration in China. And it may be a more neutral impact or a slight drag on global demand versus the positive force that it was in 2020. Now, while growth on the growth side, China is decelerating, actually, and inflation side things are picking up quite a bit. So, on the right-hand side, we're showing you Chinese producer prices. So, we can these can be thought of as sort of import prices. And you can see that producer prices have accelerated to nearly almost too high single digits year on year.

And why this is important is because it actually impacts our inflation here in the U.S. So, we're showing it the producer price is against us, import prices in in green. And you can see that the two series are quite correlated. And so, when we think about the outlook for Chinese inflation, we expect that producer prices, higher producer prices in China will feed into higher US import prices. And actually, China may or may not be a deflationary force. Instead, it may be more of a neutral to inflationary force and be putting upward pressure on our inflation in the US. Now moving to another part of the global economy over to Europe. Things in Europe look quite promising. In terms of the re-openings, though, as I showed a few slides ago, Europe is earlier on in the cycle. We think that they're about they're starting to experience a pretty rapid reopening process. We can see that in some of the higher frequency data that we track, some on the left-hand side, I'm showing you mobility data, which is a very high

frequency indicator. And the blue line is showing the US and in the Green Line, I'm showing you some of the major European countries and see that U.S. mobility has been higher than European mobility for, you know, much of the much of the 2020 and 2021 period. But in the last several months, as Europe's vaccination rates have ramped up very quickly, their mobility has been able to pick up and has almost converged to that of the US.

We like to look at mobility activity because it's a good early indication of actual economic activity. And so, we would expect things like retail sales, service activity, other measures of economic output to start to pick up very quickly, reflecting that improvement we've seen in mobility, kind of accordingly. On the right-hand side, Europeans are feeling much more confident about the about the outlook. So, in the blue line here, we're showing you confidence of service industry companies. So, this would be, you know, restaurants, hotels, other services. And in the last several months, this service sector competence has risen very rapidly above pre-Covid levels, and in addition, we see confidence in other areas of the economy, like the consumer, where consumer confidence has risen to the highest level since early 2018. And these survey measures are important because they tend to lead future activity. So, when consumers and businesses feel more confident, they tend to spend and invest in helps fuel the overall economic recovery. So, while we're conscious of different virus variants and risks to the outlook, we are positive on Europe's rebound over the next several quarters. And I'll hand it over to Jake, who's going to talk in more detail about the US outlook.

WEINSTEIN: So, as I mentioned, the U.S. is going to be the key driver of the global business cycle. Cait showed you how there's different pace of activity between, say, China and Europe in the U.S., but it's the sheer size of the U.S.

economy and the massive amount of stimulus that has put consumers in a very good spot. And I just want to go through why what we think about the U.S. economy and what it means for earnings. So, we think about as economists, a lot of economists are historians. And a lot of times we ask questions of what's the most common period that you think that this Covid post-Soviet period is, and we've had this this description. We think that it most resembles the post-World War Two era. And this table on the left showed last quarter, if you saw it was going to go through it again. It's pretty impressive how similar the covid-19 period is to the end of the World War Two period in the late 1940s and into the early 50s. And the key thing that was the most similar that we're seeing is high levels of nominal growth rates. And what I mean by nominal growth rates is higher levels of real growth and higher levels of inflation. And together you get that real growth plus inflation equals high nominal growth. And so, it goes going through the table real quick from top to bottom.

In both periods, we had a short, sharp recession and extremely fast v shape recovery, very strong fiscal support, public debt to GDP ratios surging, both surging over 100 percent, extremely high fiscal support through supporting the employees, but also supporting consumers as well, high monetary support with the Federal Reserve intervening in bond markets both in the in the post-World War period and in obviously this most recent period yet to repair the financial system following the great financial crisis, as well as the Great Depression and the last one, this pent up demand savings surge.

And this is something the Cait has done a lot of work on. And we've been thinking about there's just been a significant amount of just savings, a very healthy consumer balance sheet and a mix in type of spending that consumers are doing pre-Covid compared to post or during Covid compared to post-

Covid. But what we want to get really get into is this chart on the right-hand side. And a lot of what Cait and I have been talking about and you've heard of saying a lot is talking about inflation and inflation matters a lot to not only asset prices and the economic growth and earnings, but also to policy as well. And so, the question comes down to is how are consumers going to react to higher prices? And this survey pulled from the University of Michigan survey, which is impressively has data back to 1951.

At the very end of this end of World War to analog, we're showing shows through time when people have been asked, is this a good time to buy household goods with this blue line shows as a percentage of those who said it's actually a bad time to buy because prices are high. And in that early 1950s period, it was a bad time to buy things as prices were high and as the dust settled and things got a little bit better, the prices, you know, gotten better. And it was it was more impressive time to buy things.

Then you went to the oppressive period of the 1970s were the same oppressive, I mean, oppressive for inflation. Inflation went higher and all of a sudden it was a bad time to buy things again because prices were high. Then you had globalization and that dissipated as well. And you entered this multi decade period where prices were pretty low for household goods. And you can see at the very end now that is starting to tick back up and how people respond to higher prices, whether that means they're going to buy more because they expect prices to be higher next year or if they take a break from things because they think things are going to go down in price over the next couple of years, that it will be the key.

And so how consumers respond will be critical, we think, to the economic recovery and the earnings outlook. And this next page shows the earnings outlook. And it's been a very impressive year for earnings. Earnings over the last three quarters have been revised higher. You can see on the right-hand side of the chart here, earnings in 2021 are expected to grow by a clip of 36 percent, very high level of earnings. The typical year you get on average is about high single digit earnings for earnings growth for the S&P 500. And you're looking at 2020 to thirteen percent expectations for earnings growth is still pretty high now, it has come down a little bit as we've kind of pulled forward some of the earnings expectations from 2022 into 2021 as the economy has bounced back quicker than the market had anticipated, but still think that 13 percent level is pretty good. So, the question will be, is can the market get there and can we get to 13 percent for next year? Because it's already the second half of 2021 and the market tends to look six months or out further. So, it's really the 2022 earnings, and can companies beat those pretty high expectations next year. And so, this left-hand side of the diagram goes through what it would take to get there.

And in terms of revenue and strong sales growth, high nominal GDP will be good for revenue. It has been very good. The consumer has been good as employment markets are getting better, the consumer is doing great. So help by fiscal stimulus and profit margins thus far have been very good, too, because a lot of companies have been able to price on these higher input costs to the end consumer, whether it's higher wage growth or these supply shortages that have pushed actually the higher input costs, causing input costs to go higher. And also profit margins have been supported by lower interest expense, as well as the Federal Reserve has kept interest rates low. So, profit margins have been great. But if you see some of these supply shortages

dissipate or continue, I should say, in the end, the companies aren't allowed to actually pass through higher costs. And if wage growth goes higher, that could crimp profit margins and have earnings growth not be as high as these expectations for 2022. So, it's the company's ability to actually maintain those high profit margins, which will be key, and that will be something that we're paying very close attention to over the course of the rest of the year. So, with that, I'm going to hand it to Cait to talk a little bit about the labor markets,

DOURNEY: Thanks Jake. So, Jake mentioned one of the challenges for companies is the risk of wage pressure. And so we wanted to dig a little bit more into this because we've gotten questions on this topic and we're seeing something pretty unique in the labor markets right now, which is that we see what we're showing in the left hand side is that we have very high rates of job openings. So, for example, in the last several months, job opening rates have risen to the highest in several decades. But at the same time, we still have a decently high unemployment rate, around six percent. So, you can see on this chart we've plotted, you know, each observation between 2001 and 2019. You see that typically as the rate of job openings increases, the unemployment rate tends to fall and vice versa.

But in the black diamond here, we've pointed out April of 2021, whereas I mentioned we have a decently high unemployment rate of about six percent, but a quite high rate of job openings. And so, we've been doing a lot of work on this internally. And it does look like there are several factors that are holding back workers from returning, returning to work, or returning to the labor force. Some of these factors are more near. So, for example, there are many workers who are not back at work because childcare is closed or schools are, we're not fully in person. And that's making the parents have to stay at

home for the children. Another reason is that there are very generous unemployment benefits that may be discouraging some workers from returning to work. So, these are more near-term factors that should dissipate by the fall around September. But there are other factors that may be stickier and may actually hold back labor supply. We're showing one of these on the right-hand side here. So, one of these factors is that the labor supply did decline pretty significantly during the pandemic. So, on the far left for showing you the civilian labor force, 16 plus, which declined by about a percent and a half relative to recovered levels. And this is around three and a half million people or so. And this is a pretty big decline. It's actually about twice the decline that we saw during the global financial crisis about a decade ago. And what what's important is that who left the labor force was very also very different than the global financial crisis.

This time, many of the labor force levers were people 55 and over. So that's shown on the right-hand side, the far right-hand bar where about, you know, three and a half million people or so left 55 in class, left the labor force. And yes, we did see prime age men in. Major women also leave during this time, and some of those folks may be the ones who are needing childcare and so having to stay at home, but these 55 plus workers are likely folks that are permanent leaders for the labor force. So they are, in many cases, early retirees. They're probably not going to come back to work after the pandemic at a large scale. And so, this decline in the availability of labor means that there may be upward pressure on wages that can stick around past the expiration of unemployment benefits or past the reopening of childcare and schools. There are other factors at play here that are we're thinking about, but that are harder to quantify, like shifting preferences.

So, some folks are deciding they would prefer to spend more time with family and friends rather than, you know, returning to a traditional office setting. There are also skills mismatches. So, the types of skills that are required for jobs that companies are trying to hire for may be different than the skills that the unemployed workers have. So, all of these factors are combining to put some pressure on availability of labor, which in turn puts upward pressure on wages that we think might stick around for the next several years.

So, digging a little bit into the wage side, a little bit more here on this chart, we're showing you how quickly wages and salaries recovered during the Covid recession. So, the blue line is wages and salaries in 2020 and 2021 indexed to the start of the current recession. So that zero line is the start of the recession. What we're comparing against in green is the global financial crisis, recession. And where you can see is that although the blue line declined by more than it did in the 08 recession, it recovered much more quickly. So, it so actually wages and salaries for the economy as a whole recovered back to pre-pandemic levels within about eight months of the start of the recession.

So, in the back half of 2020, in comparison, after the financial crisis, it took several years in order for wages to recover back to prerecession levels. And what's important about these this data is that it does not include any unemployment benefits. It does not include any stimulus checks. It's exclusively wages and salaries earned from an employer. And so, part of this is explained by lower income workers who bore the brunt of layoffs early in the recession. And then as they gained their regained their jobs, helped to push this up. But we're really seeing it across the board. We included a few more data points to illustrate this point in the table, the first one being in our internal

analyst survey where we survey company analysts across equity and fixed income.

Almost three quarters of our analysts expect companies to have to wage rate, raise wages in order to either retain or attract new workers. The second point is that we saw wage growth recover to pre pandemic levels for lower education groups. So, folks that have only a high school education or even less than that. And then the third point coming from one of the Fed surveys shows that the reservation wage rose about 20 percent for workers in the lower income groups earning less than sixty thousand dollars a year. And a reservation wages a wage that you would expect or want to have in order to come back to work. And so, you can see that across the board, but especially at these lower income categories, wage pressure really is really just picking up and recovering much faster than we've seen in past cycles. And so, Jake is going to talk about what this means for broader inflation and for the policy response.

WEINSTEIN: Great. Thanks, Cait. So, with higher wage growth and an improving labor market, as Cait mentioned, the idea generally over cycles is that when the labor market improves and wage growth accelerates, that typically means that inflation is going higher. But to get inflation to go higher, it takes more than just wage growth and improving labor market conditions. And it also takes inflation expectations to get higher. And inflation expectations have been really low over the last three to four decades. They've just been on a downward trajectory really ever since the early 1980s. And so, there's different ways to think about inflation expectations. And here's a couple of ways to think about it. The left-hand chart is an analyst that we ask our analysts at Fidelity, those who cover companies in both the fixed income and the equity divisions at Fidelity. And we asked them over the next three months, do you

think that prices charged, and input prices are going to be higher or lower? And you can see the major acceleration just from last year that almost 80 percent of them think that prices are going to be higher, both on. In terms of what companies can charge, but also what their input prices are, and that really matters, again, what I mentioned in terms of the profit margins before, whether people are going to be able to pass through prices along to the consumer. But for the most part, they're pretty similar to where they were maybe in 2017 and 2018. And so, the way to think about market inflation expectations is in the right-hand side. And this is the CPI swaps. I won't get too technical here, but the way to think about these lines here is that in the end of 2020, the Green Line inflation expectations were really subdued and the market didn't really think inflation was going to be high over the next one to two to five or even over the next 10 to 30 years.

But after the first quarter and second quarter and you got those high inflation prints, the level of long-term inflation expectations went higher, but also in more so in the short term than the long term. And so with this downward slope in line as of the end of June 2021 means is that the market thinks that you're going to get higher inflation over the next couple of quarters, but ultimately it's going to dissipate, go down and be relatively in line of long term historical averages over the next 10 to 30 years, which suggests that the market thinks that inflation will be transitory. Now, over the very long term, it's a very hard to predict where inflation is actually going. And this is a slide that's been in the back of our QMU deck for the last two to three years. And what it basically shows is that what are the long-term secular drivers that could be cause inflation to go higher or lower? And when we think about it, there's a lot of things that have been brewing in the economy that suggest that inflation

actually can be higher over the very long term, that the market may not quite be appreciating.

Now, the left-hand side just shows the actual global debt as a share of GDP has gone higher and higher and higher. We don't know about this. It's been happening and hasn't really had a major impact on interest rates or on inflation. But that is continuing to rise as interest rates remain low and policymakers basically are suppressing interest rates in what we call, quote unquote call financial repression. Now, with a secular impact on inflation can be on the right-hand side as a few other things I just mentioned policy. But the Fed is basically targeting higher inflation and fiscal policies are becoming more stimulative in nature and expecting more fiscal deficits going forward, those providing higher risk to inflation over the long term. Some people point out an aging demographics will be disinflationary, looking at Japan as an example where Japan has had poor demographics and in basically deflation for the last 20 years. But the U.S. demographics aren't as bad as Japan's. Our labor force growth is still growing. We do have an aging demographic, but we still have a growing labor force compared to an actual shrinking population in Japan. So, the demand and supply of factors are actually a little bit uncertain there in terms of the demographic impact on inflation, globalization is another reason why prices have gone lower.

I showed you the first chart in the early that talked about consumers expectations for durable goods being very low. And it's been low because we've been able to outsource capital and labor from the rest of the world, primarily China and Southeast Asia. But we think that global peak globalization may be on the horizon. We can't really get much more of a disinflationary push from globalization, and that could have an upward impact on inflation. But the

one thing that we think could happen is that you got technological process. We call this the Amazon effect, the building of robots. And as Cait was talking about, those labor will structure those structural issues and labor markets. If you continue to have structural issues and companies can't find good workers, maybe they'll build robots. Maybe they'll try to build more productive types of capital, more capital expenditures, and that could ultimately have a longer-term downward impact to inflation. So, nobody really knows. But we just like to look at the factors that we think could cause inflation to potentially go higher over the long term. But the Federal Reserve doesn't really care about those long-term factors. They might look at them, they may talk about them, but what they are focused on is the more near-term impact of inflation and employment. And they have a they have a dual mandate that focuses on both. And they tend to focus more on inflation historically, but more so on employment due to his new policy changes that it made at Jackson Hole last year in 2020.

So, we'll start with inflation and there's different inflation measures here. Core PCE is the main measure that it looks at. And these blue bars, the way to interpret these, if they're over zero or they're going to the right, that means they're running above the Federal Reserve's target. And the Core PCE is one percentage point above the Fed's target when you look at Core PCE on a year over year basis. And so, we want to look at more broader measures of this rather than just that, because the Fed looks at more broader measures of both inflation, unemployment, and these metrics. Here, whether it's the market-based Core PC, PCE or sticky CPI or the Cleveland median CPI, these things are different measures the Fed are looking at. And if you look at the change from just last quarter, many more of these metrics are getting into the territory where they're running above the Fed's implied Fed target. And so, we're

going to continue to monitor these. But the Fed is watching these. And that's why the last meeting at the end of the second quarter, the Federal Reserve started sounding a little bit more hawkish and concerned about inflation because it's these metrics that are running hot. However, we don't think they're actually going to shift to an all-out, more dovish policy because, as I said, they're way more focused on the employment side of the mandate, still paying attention to inflation, but employment has to get lower than where it is before you see them say raise interest rates.

And so, again, they're being more comprehensive in terms of how they're looking about employment, not just the headline U3 number, which is the number that we all know, which is a little bit below six percent at the end of the quarter, but also at the black Hispanic unemployment rates. But the comprehensive unemployment rates which continue, which also include discouraged workers and those that left the labor force. And so, as Cait mentioned, the unemployment, unemployment, structural issues, and that the people who actually left the labor force, that additional light blue bar on top of these unemployment rates shows that due to the loss of participation, unemployment's actually much worse than expected. And the Fed does pay attention to participation rates.

So, if they're looking at this more inclusively, it could be some time before we get the Fed to reverse policy and get truly dovish. So, the Fed has indeed paying attention to inflation. But I think it's the employment side of this and we should take them for their word that they're going to keep interest rates low until we get employment rates down to at least below these pre pandemic levels of I'm showing in the diamonds. So that's on the monetary side, the fiscal side is a little bit more baked in, the expectation there is that you're

going to continue to have fiscal deficit spending. The left-hand side shows that for the second year in a row, we're going to have another post-World War Two record of deficit of negative 15 percent of GDP for 2020 and for 2021.
We do expect there to be a little bit more spending package at the end of this year, but ultimately for twenty, twenty two, since the economy is getting better and the spending package that are likely is likely to be passed is going to be more over a 10 year horizon as opposed to that emergency stimulus that just completely just put a trillions of dollars into the economy instantaneously. So next year expect things to dissipate a bit, but still negative nine percent is an impressive deficit spending. Now, a lot of people have asked questions about this. And what does it mean? Because in order to get more spending, whether it's on infrastructure or other plans through the Biden plan, there are some pay for such as tax hikes.

And so, the way to think about this is what's going to be the impact on nominal growth. And what we show here is fiscal multipliers, which means that for every dollar worth of spending, what's that going to be? The impact on GDP and infrastructure spending, as you put it, into the economy, and it causes some real growth, creates perhaps jobs. You're buying things. It has a multiplying effect that historically has led to a higher GDP rate. The more you spend, however, you look at corporate tax hikes or high-income individual tax hikes, you're basically taking money from maybe from corporate savings or from high income earners savings that wasn't necessarily going into the economy.

So therefore, that has less of a drag from a multiplier standpoint. So, at the end of this year, you're likely to get a reconciliation package passed. More deficit spending is going to be, again, as I said, spending over the next 10 years with

tax hikes also going into effect probably next year. But ultimately, what this means is that it will lead to higher growth rates due to more favorable multipliers. But also, will, as I mentioned before, looking again to the left-hand side, you won't nearly have as much of that fiscal push as you did over the past couple of years. And so what this all means, you put it all together in terms of fiscal and monetary policy, as I mentioned before, and continue to talk about quarter over quarter is that policy has much, much more of a higher influence on asset prices as it did, as it used to say, perhaps over the last several decades. And what this diagram shows is the environment of interest rates and inflation and how that matters. And the way to interpret this is that there's four different ways to think about the direction of interest rates. It's a direction of real rates, nominal rates, and inflation expectations. And you can kind of put these into these different buckets. And I won't go into all this into greater detail.

But I will say is that over the past 12 months, what we have been experiencing from an interest rate environment is more of a reflationary type of environment and inflation. What tends to do well on a relative basis is small cap equities, value equities and non-U.S. equities with bonds underperforming. And that's been actually true historically. That's been the case and the playbook has worked out pretty well over the past 12 months on average. However, as we've been transitioning into this mid cycle environment, we're getting more of this weak growth flavor. And when I say weak growth, I don't mean there's been weak growth recently. I mean, those nominal growth rates are high.

What I mean by that is weak growth is the interest rate environment where real rates actually fall, and inflation expectations don't go up that high. And that's what we experienced in the second quarter. And as consistent with history,

what performs well on a relative basis in this weak growth environment has been the large cap growth stocks, large cap stocks, growth stocks and bonds performing a little bit better. So, where we go from here is going to be critical to the inflation outlook, inflation expectations and the policy response. And I think this is a good way and schematic to think about what the drivers of relative performance are going to be going forward. So now I'm going to hand it over to Cait to talk a bit more about the asset markets.

DOURNEY: Thanks, Jake. So, starting out with one of the most key drivers of forward-looking equity returns earnings. So here on this chart, we're showing you trailing 12-month earnings growth for the U.S., for developed market equities and for emerging market equities. And so, what you can see is that, you know, all three regions had negative earnings growth year on year throughout pretty much all of twenty, twenty. But since then, in the first and second quarter of 2021, earnings growth is positive again. Which is supportive of the forward-looking equity market outlook, looking ahead here, we've included the forward earnings per share estimates for the next 12 months. You can see that estimates are estimates show continued improvement in earnings per share growth anywhere from 21 percent year on year in the US, up to 25 percent year on year in emerging markets. So, this is this is a pretty robust rate of earnings growth that the market is expecting over the next 12 months. And, you know, Jake highlighted some factors that could either help these regions achieve this earnings growth or could be a drag on margins, things like increased cost or a wage pressure. So, tying this into valuations on the next slide here, we're showing you the PE ratios price to earnings ratios trailing 12 months for the same three regions.

And then if you look on the far right-hand side of the chart, you'll notice that these valuations are above historical averages for all three of these categories, with the US the most expensive relative to earnings. You know, there are there are factors that we like to consider when looking at these valuations. For example, the sector differences across the different regions. So, the US has bigger exposure to sectors that tend to command higher valuations, things like infotech or communication services, whereas developed markets tend to have bigger weights in sectors that are typically traded to discount things like financials. So that does explain some of the difference between the valuations. But overall, valuations are above historical averages looking out into next year. We've put markers on here for the forward price to earnings ratios. And if those strong earnings ratios, earnings expectations that we saw on the prior side, those come to fruition, then valuations would be more in line with historical averages based on today's prices. And when we think about valuations based on our research, they do matter for long term returns. Typically, high valuations are a challenge for forward, say, 20-year equity returns. But over a shorter time horizon, like a one year forward, they tend to be less predictive. So high valuations don't necessarily historically mean that the next 12-month equity returns are more challenge, something to consider when looking at these valuation charts, you know, digging a little bit more into the equity space.

We do we do look at sector performance through the business cycle, Jake, and some other members of the team recently put out, I thought, leadership paper going into the details of sector performance through the business cycle. So, we wanted to highlight this because we got some questions about which sectors do you well, as you transition into the mid cycle phase from the early cycle phase. So, in this grid here, I'm showing you all of the all the different

sectors of the equity market and we're showing you which sectors do very well. So, in early cycle, economically sensitive sectors like real estate, consumer discretionary industrials do well along with financials, materials, tech. But in as you transition into the mid cycle phase, there are some pretty significant changes in leadership. So some of the sectors that do very well in early cycle, like real estate, kind of hover neutral or perform in line with the benchmark in mid cycle, whereas other categories like communication services and infotech historically have done well in the mid cycle phase. Sectors that have historically done less well or underperform. The benchmark in the mid cycle phase include consumer discretionary materials and utilities. So, as we've as we've talked about before, every cycle is a little bit different. But in general, this is the historical performance of the sectors as you move into this cycle phase, using data going back, you know, many decades, you know, taking another cut of the data, looking at factors.

This is another question that we that we often get from folks. So, there are some similar to sectors. There are some meaningful leadership changes in factors when you move from the early cycle phase into the mid cycle phase. So here specifically, we're highlighting the quality factor. These are companies that have strong return on equity, earnings, stability, healthy capital structure. And these companies actually tend to underperform the broader market in the early cycle phase. You can see that on the lighter blue bar, typically they underperform by one hundred and fifty basis points annualized.

This is typically because in the early. The most economically sensitive things like value tend to do very well in early cycle, all parts of the economy are rebounding. But as you move into mid cycle where we are now, quality tends to do quite well. So, returns are positive on an absolute basis, and the quality

factor tends to outperform the broader market by about 250 basis points. So, I'm thinking in factory space, equality is a factor that we would highlight as having performed particularly strongly historically during the mid-cycle phase. And I'm going to turn it over to Jake to wrap it up.

WEINSTEIN: All right. So, we've given you a lot of information, a lot of hopefully some helpful perspectives. I'm just going to just recap what we talked about. The business cycle, as Cait alluded to and we talked about, is the U.S. is in a mid-cycle expansion phase. Global economies continuing to improve at different paces, easy financial conditions, low cost of real borrowing rates, providing access to capital for many companies. But there are risks ahead. The markets have done really well, and they've reached all-time highs. And when they reached all-time highs, sometimes they have a little bit of corrections and there's above average valuations, especially in some U.S. assets and some other types of assets. So, you should not be surprised if you see any volatility on the horizon, whether because we hit peak growth.

So, inflation, uncertainty, or some tapering of monetary support, as we alluded to. But overall, for your asset allocation, we still believe that and overweight to risk assets remains appropriate. But staying diversified during this time where you could have volatility is extremely important. And some members who we work with think that have it continue to have inflation resistant assets does make sense overall. And so, I just want to leave that with you guys is that we're still constructive in the economy, constructive on asset markets, expect some volatility. And if you have any questions about this, please reach out to your advisor and your advisor can help set up time to make sure that your asset allocation is in the appropriate place as asset prices do move along with these with volatile markets. So, with that, thank you very much. And thank you for joining us today.