Second Quarter 2021 Economic and Market Outlook

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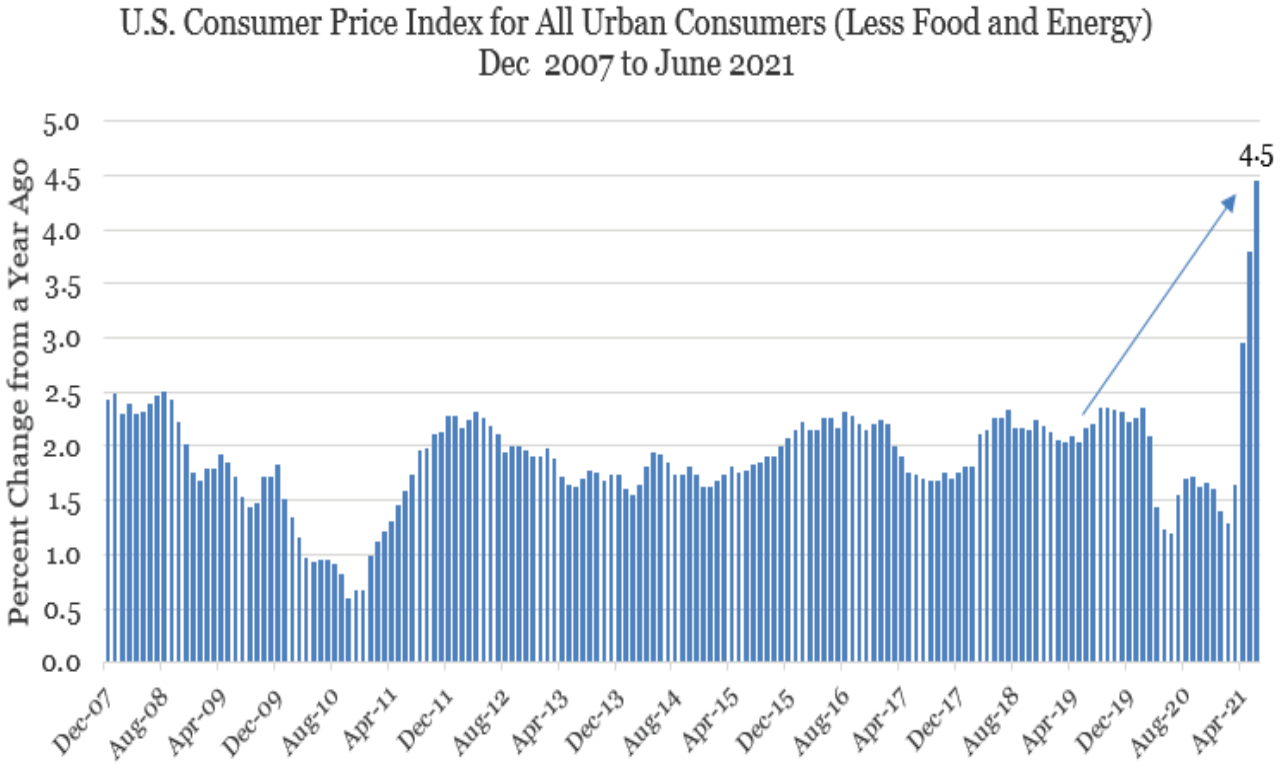
We expect that global growth will continue to improve in the second half of the year and into next year. In fact, the Organization for Economic Co-Operation and Development (OECD) revised their growth outlook for the economy to be higher and expects that global GDP will now expand by 5.8% this year and 4.4% in 2022. Consumer spending, as usual, will have the largest impact on the strength and durability of this recovery.

Typically following a recession, consumer spending takes some time to ramp up to the level it was prior to the downturn. This was not the case with the 2020 recession that resulted from the COVID-19 Pandemic. Unlike traditional slowdowns, personal savings rates actually increased last year as many people were able to maintain their incomes by working from home while at the same time reduced their discretionary spending. For those who lost their jobs, government sponsored assistance programs provided income in the interim which resulted in increased spending and additional savings.

Is U.S. Inflation Here to Stay?

Coming out of the Pandemic, some of these savings will be spent on travel, leisure and other activities that were previously unavailable due to travel restrictions and stay at home requirements. While this pent-up demand is good for global growth, there is evidence that certain prices are rising as a result. The Federal Reserve recently acknowledged that inflation in the U.S. was higher than it had originally anticipated, while at the same time welcomed the demand spike that caused it. The question is whether inflation, which increased by approximately 4.5% year over year, will prove temporary or will persist at this higher level.

Exhibit 1: Inflation Rises as U.S. Economy Recovers from the Pandemic



Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average [CPILFESL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPILFESL, July 16, 2021.

Our view is that the recent increase in inflation will be temporary. While the "headline number" is high, certain components of the Consumer Price Index were most sensitive to the reopening trade. In particular, airfares, hotels and vehicle prices had the largest increase. Outside of these particular sectors, the increase in CPI was modest.

This suggests that while the risk is not insignificant, the Federal Reserve is unlikely to dramatically increase interest rates to stave off inflation in the near-term and will only have to raise rates when inflation pressures are more sustainable. *Thus, our view is that the U.S. economy is not yet operating at full capacity, and therefore inflation is not an issue at the moment.*

Investment Opportunities

Now that we are through the worst of the Pandemic and the world is starting to return to normal, we see opportunities developing across a number of areas in the market. We feel that these opportunities will most likely be different than those which were strongest over the most recent period.

To put this in some context, the past decade was dominated by U.S. stocks, and the market was driven higher by the performance of consumer technology names such as Apple, Facebook, Google and Amazon. The most recent period followed what was referred to as a "Lost Decade" from 2000-2009 during which the U.S. suffered two recessions, including the great financial crisis.

As **Exhibit 2** illustrates, the S&P 500 Index returned a below average +2.7% annualized return for the 10-years ended June 2011, which is not much more than a risk-free bond would produce. However, over the last decade, the return to the U.S. stock market was +15.0% annualized, which is twice our long-term market assumption for U.S. stocks and double the realized return of +8.6% for the market over the full 20- year period.

Exhibit 2: U.S. Market Dominance Follows a "Lost Decade"

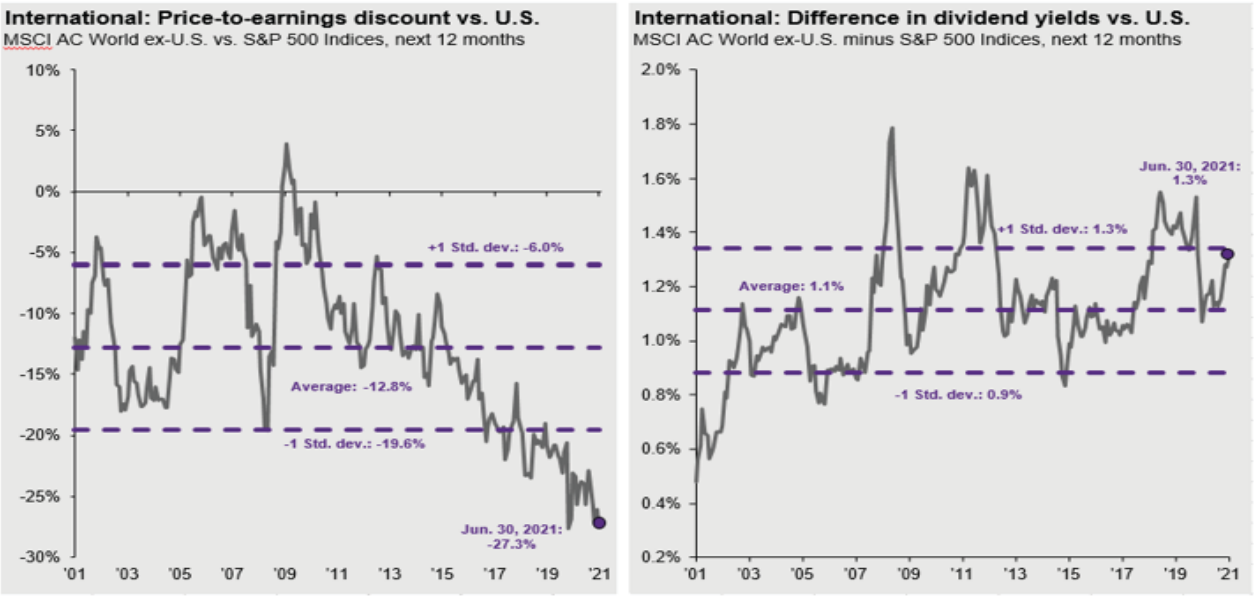
Source: Morningstar Direct. Past Performance is not a Guarantee of Future Performance.

The above average returns for the U.S. stock market over the past decade have driven valuations for the S&P 500 Index to near record levels. As of June 30, 2021, the U.S. market was trading at a 21.5x forward price earnings (PE) multiple, which is nearly one-and-a-half times higher than the 25-year average forward PE multiple of 16.7x.

Higher valuations for the U.S. market can be justified to some degree given the record profit margins of the largest index constituents, the low interest rate environment and the muted inflationary environment over the past several years. *However, these factors are beginning to change.* While we remain constructive on the U.S. market given the accommodative fiscal and monetary policies in place, the conditions that would support non-U.S. markets are beginning to develop.

Economic growth in Europe and Japan should pick up as vaccinations there ramp up. There is evidence that both manufacturing and service activity is improving in Europe and Japan and should accelerate later this year. This is good news for the global economy and should support stock markets outside the U.S. *The rotation from growth to value that began over a year ago should favor global non-U.S. markets.* In addition, there is significant valuation support for a recovery in these markets.

Exhibit 3: Non-U.S. Equity Markets Trading at Attractive Valuations vs. U.S. Markets



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30, 2021.

Non-U.S. markets, represented by the MSCI AC World ex-US Index tend to trade at a valuation discount to the S&P 500 Index. **Exhibit 3** shows that the average valuation discount for non-U.S. markets has averaged -12.8% since 2001. Over the past decade, where the U.S. market has been most dominant, the valuation discount has dropped to -27.3% as of June 30, 201, nearly double the average discount and they trade at a 1.3% yield advantage compared to the U.S. market.

Valuations alone do not drive shifts in market leadership. The relative attractiveness of international and emerging markets is improving. In addition, the investment opportunities abroad look interesting particularly given some of the headwinds facing the U.S. market which include rising interest rates, higher inflation, tighter regulation and potentially higher corporate and capital gains taxes.

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