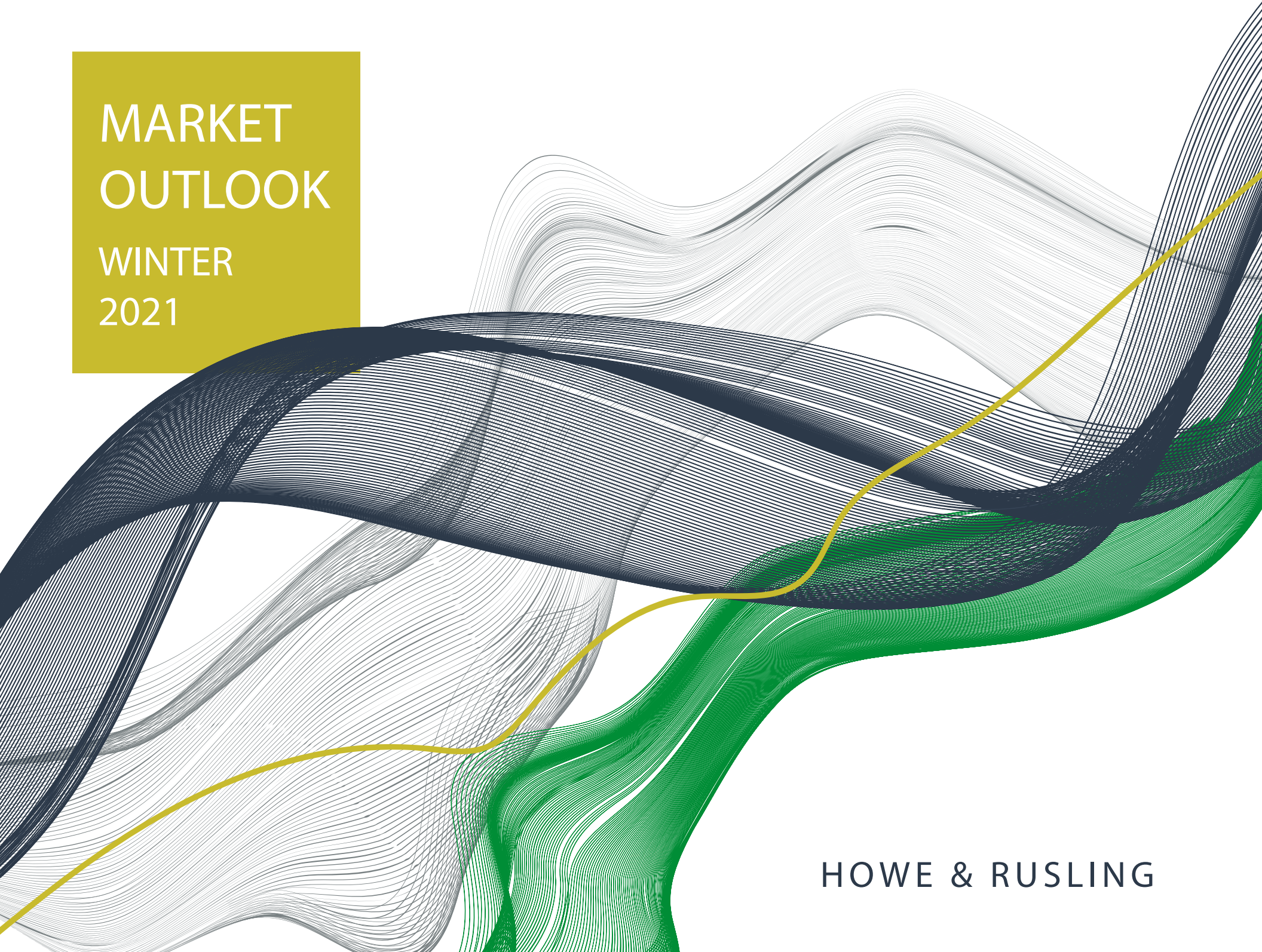
MARKET OUTLOOK

WINTER 2021



HOWE & RUSLING

ON OUR MINDS

On our minds is the power of the human spirit to endure and adapt. Be it pandemic, or political, the human spirit absorbs, processes, understands, and helps us form perspective. Perspective will be our theme.

This past year was not for the faint of heart. Lives were changed, and sadly, lives were lost. We will forever remember 2020, as will the history books. While there are brighter days ahead, let us not forgot the lost. On December 15, the National Cathedral embarked on a bell ringing for the 300,000 lives lost as of that date. The bells were tolled 300 times, one gong per 1000 people lost, for which the bell ringing lasted 30 minutes. For perspective, if in fact they rung the bell for every one of the 300,000, the bells would ring non-stop for 21 days. Imagine if you lived next door… the meaning would be clear (the deaths sadly were at 350,000 at year-end). When numbers are tossed around in large scale, like $1.0 trillion, $4.0 trillion, or 350,000—perspective gets lost.

It is hard to move forward without perspective, and it is especially critical in our Macro Outlook. While the past is critically important in framing the future, perspective is the motivator of actions. Our perspective combines insight, intelligence, and intuition to react, or provide guidance, for the present and the future. What will 2021 and beyond look like? How will markets move, governments react, people adapt? Just as 2020 was not for the faint of heart, the future surely is not. We are emerging from a global pandemic, and perspective for the future will shape results. We learned during 2020 that nothing was to be taken for granted, and early January 2021 in Washington added to this premise.

Our perspective for the economy relies on past theory, present conditions and trends, and a vision for the future. Regarding past theory, those who thought the markets during the pandemic would follow text-book traditional economic models were sadly mistaken. Investors who thought the end was near (for which you cannot fault anyone), and chose to withdraw from the markets, were also mistaken. Advisors who embraced rapidly changing conditions and were able to perceive a changed, but viable future, helped their clients immensely.

Given the present environment, and vaccines now in use, having perspective for the future is much easier for many, as hope has entered the picture. When people have hope, they have optimism. Optimism is wonderful, but in the context of investment management, fundamentals coupled with market trends, enhanced by calculated perception, outweigh optimism. The ability to perceive the future through the dawn's early light, and for clients to embrace this vision, is a hallmark of trust—trust for which we are very grateful.

THE PAST GUIDES THE FUTURE

FIXED INCOME

Framing the future, in the context of the next 3-6 months, we believe several indicators are coming to the forefront signaling clues. First and foremost, we believe the fixed income markets are prognosticators of the economy and subsequently equity market movements. While not rocket science, we believe it to be a fundamental indicator. The 10-2 Treasury spread gives markets advance warning of trouble ahead. The greater the number (spread), the better for the economy. The lower the spread, the signal flag is waved; when the spread turns negative, a recession is likely on the horizon 6-24 months later (as has been the case since 1955). Circled below are the times the spread has dropped below zero over the past 20 years, and the subsequent recession was not too far off. The spread barely dipped below zero in August 2019, and most purists ignored it, but the recession happened. Yes, a pandemic accelerated things, but what is to say the recession was not in the mix? The market was anxious in late 2019 and early 2020 from a very long bull run, so the indicator presumably would have been accurate. Given the typical lag time, the good news is the spread is continuing to favor a recovering economy.

10-YEAR TREASURY MINUS 2-YEAR TREASURY YIELD SPREAD (%)

in charts denotes times of recession

While the 10-2 spread is important, general interest rates are important factors in our longer-term view. The market consensus has been a 'lower for longer' approach by the Federal Reserve. With low rates, many investors fear negative rates, perhaps based on what the business channels might be broadcasting that week. Real short-term rates (rates adjusted by inflation) are effectively negative already (more on inflation and the impact addressed in the next section). However, nominal rates (unadjusted for inflation) are still positive, and the Federal Reserve will likely keep this as policy.

As you might recall, a few years ago the White House had called on the Fed to "go negative." While the press had endless programming hours debating negative rates, the Fed has many reasons for keeping interest rates positive. Negative rates in other developed countries were established by their central banks as their domestic banks were not lending out funds (which allow for capital expansion). By instituting negative rates, the central banks had hoped the banks in their system would increase loans and hence spark expansion. This just never really materialized, and the Fed has obviously taken note.

Furthermore, and a much bigger reason for positive nominal rates, is the United States (as opposed to most other developed countries) has a vast amount of investable dollars tied up in money market funds (as money market funds typically offer higher yields than savings rates and are considered safe). To give you insight, during 2020, money market funds took in $800 billion according to Morningstar Direct, whereas taxable bond funds only took in $396 billion. This points to just how conversative many investors were in 2020, but this savings stems from the Great Financial Crisis (more on savings in the next section). Specifically addressing money market funds, because of legislation passed after the Great Financial Crisis to protect investors, rules were established that placed access restrictions on many common money market funds if "they broke the buck." (This subject is long and complicated, but the goal of a money market fund is to keep the net asset value at $1 (a buck), or preserve capital investment. When investment income does not cover operating costs, the buck breaks.) Negative rates would create negative income, and many money market funds would fall into issue with regulations, which the Federal Reserve fully recognizes.

Finally, as perhaps counter to some of the above regarding negative rates, the 10-year Treasury broke 1% (can you believe it?!) in the first few trading days of 2021. The 10-Year had been hovering in the 0.90% range for months. This suppression has been principally led by the Fed; it is suppressing overall rates via the non-existent federal funds rate (see FOMC projection chart to follow). At the end of the day, the market will be the market, and there will be movement over the course of time from real economic factors (outside of the Fed). While the term "Don't Fight the Fed" has proven to be gospel, the 10-Year rate likely will not keep rising unbridled. It is somewhat sad the 10-Year is only around 1%, as anyone investing for that duration has agreed to accept only 1% per year in terms of income; but it is all about safety. Granted, there is inflationary degradation (as mentioned above regarding nominal versus real rates), but as in those negative interest rate countries, these investors are willing to lose some capital to protect the mass.

INFLATION & UNEMPLOYMENT

The above discussion on interest rates, and the how the Federal Reserve monitors both inflation and unemployment as triggers for rate movement, illustrates their respective importance to the economy.

For the past several months, the business channel topic du jour has been inflation. At first, inflation concern was related to potential large COVID-related government stimulus packages and the subsequent extra money in the hands of consumers who could drive up demand and push prices higher. As of late, with a thin Democratic majority created by the Georgia Senate run-off, added inflationary pressure could come from any increased general government spending. Additionally, concerns exist over some tighter supply chains, still a fallout from pandemic shutdowns.

FEDERAL OPEN MARKET COMMITTEE (FOMC) SUMMARY OF ECONOMIC PROJECTIONS

DECEMBER 2020 RELEASE

	2020	2021	2022	2023
PCE Inflation	**1.20**	**1.80**	**1.90**	**2.00**
2020 (September) projections	1.20	1.70	1.80	2.00
Core PCE Inflation (less Energy/Food)	**1.40**	**1.80**	**1.90**	**2.00**
2020 (September) projections	1.50	1.70	1.80	2.00
Unemployment	**6.70**	**5.00**	**4.20**	**3.70**
2020 (September) projections	7.60	5.50	4.60	4.00
Federal Funds Rate	**0.10**	**0.10**	**0.10**	**0.10**
2020 (September) projections	0.10	0.10	0.10	0.10
Gross Domestic Product	**-2.40**	**4.20**	**3.20**	**2.40**
2020 (September) projections	-3.70	4.00	3.00	2.50

PCE = Personal Consumption Expenditures

While we believe inflation needs to be carefully monitored, in the nearer term, we are not tremendously concerned.

Our reasons for less nearer-term inflation concerns include:

1 PANDEMIC ENDURANCE

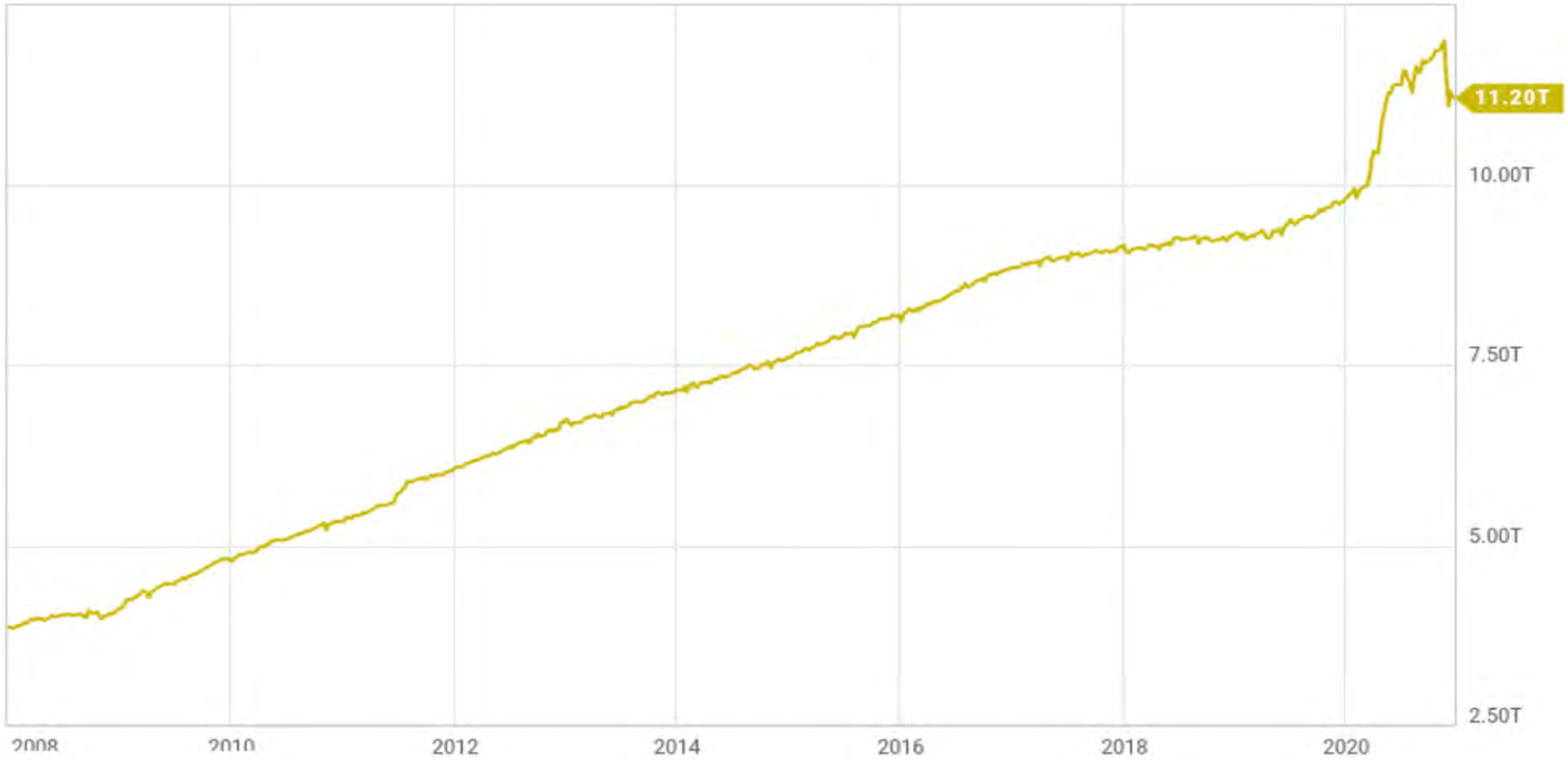
While 2020 ended with a fair amount of enthusiasm regarding the prospects of a "return to normal" in 2021, the virus is still an ongoing daily concern. With a new administration coming on board in a few weeks, no one knows for sure what it will do in terms of virus protocol. Allies like Germany and England are extending national lockdowns, and while President-elect Biden has called for a 100-day mask requirement, it is yet to be seen if any further actions are in his agenda. 2020 taught us to never assume things will work out as we hope, and if the virus is still raging, any exogenous actions cannot be discounted, especially if the end-game would be a promise of a very large stimulus package to offset any hardship.

Furthermore, regardless of governmental actions, January is anticipated to be a difficult month with infections from holiday travel and gatherings, coupled with a slower than anticipated and desired vaccine rollout. The challenge to the economy is with every person infected, there is a multiplier effect, caused by quarantine requirements of the infected individual and associated close contacts. Therefore, at least for the first quarter, any robust economic activity which could spur inflation should be minimal because of the virus.

2 SAVINGS

Another inflation concern for many business channel pundits is they believe the average American is unable to control their spending, and hence pandemic related fiscal policy distributions could result in unbridled spending resulting in price escalation from demand. This is feasible, but $600 is not $2000, and a little-known fact is the saving rate for Americans increased after the Great Financial Crisis of 2007-09, and savings were up 157% from the GFC to the start of the pandemic. From the pandemic onset through November 2020, another 19% was saved. With badgering in Washington, savings dropped 7% in December; however, they still are at very high levels. This level of financial discipline gets overlooked. Furthermore, lest we forget, two significant market collapsing events transpired in roughly the course of a decade, which have a true psychological effect on consumers; namely, many of the famed millennials have witnessed these two events in the scope of their short working careers, as well as those closer to the retirement bucket (and the huge amount of money market funds discussed above). Thankfully, markets have rebounded, but the fear-related scars are deep, so do not discount people's propensity to save which will in turn dampen inflation.

U.S. SAVINGS DEPOSITS ($)



3 UNEMPLOYMENT

It is hard to have concerning inflation when not everyone is working. One of the principal drivers of inflation is wage pressure, which is why the Fed watches employment numbers so closely. The lower unemployment is, the more people are working and earning, and hence competing for goods and services. As seen in the FOMC Pojections chart and below, unemployment should settle out at 6.7% for 2020.

Historically, the Fed would raise rates when unemployment dropped below 4% over concerns of higher inflation spurred by wage pressure and more money being in the hands of spenders. However, during 2019, when unemployment was under 4%, inflation pressure was benign. This change from modeling caused the Fed to announce in later 2020 that it would not default immediately to raising interest rates on lower unemployment numbers and would instead monitor inflation, including letting it run a bit hotter. For this reason, the Fed is "experimenting," which many are carefully watching (but with unemployment still high, this is not a current issue).

Further, there is dispute about the true level of unemployment, with some believing there is at least 3% more unemployed who have left the employment market. We believe it is a mix of both, which is still high. Also, while temporary job loss numbers have fallen (those laid-off and returning to their prior jobs), permanent job loss is now the second highest in history, and personal income has been down three of the past four months. Without jobs, and without rising income, it is harder to create pressure on inflation, at least in the near term.

4 DEFICITS

Finally, with changes in the political landscape, fears of runaway deficits prompt inflation concerns. The "blue wave" phenomenon presented concerns of excess government spending, but that same blue wave was associated with concerns of higher taxes. By definition, a deficit is nothing more than what a government spends versus what it takes in (taxes). This is a never-ending conversation, as regardless of the party in power, deficits are a present reality, especially considering pandemic related issues for many struggling businesses and individuals. Consensus is we are a long way from inflationary side-effects caused by deficit pressure; however, the printing of money to solve a deficit is surely inflationary in nature. With the Georgia run-off Senate election providing a thin blue wave, every senator is now a king, as each vote is critical. This can go in many directions, including more level heads, or much higher spending via pork belly projects to buy a vote. Time will tell, but a safe bet would be that business in Washington will likely not change much. That said, politicians are hopefully understanding the pressure on them to keep deficits in check. Call it maybe a signal for times to come, but even though California and Michigan elected predominately Democratic candidates, who would typically be associated with governmental spending policies, both states also had tax increases voted down, which usually does not happen hand in hand. Perhaps this was the electorate saying, "Do it with what you have," which could be a good sign. At least temporarily, John Maynard Keynes was looking down and presumably smiling, as his economic theory supported increased government spending and lower taxes. We are not so sure the lower taxes will be in place for long.

In the end, we have concerns of some slight inflation, but at least in the nearer term, which this Outlook addresses, we believe there are enough counterbalances at play.

GROSS DOMESTIC PRODUCT AND BANK DELIQUENCIES

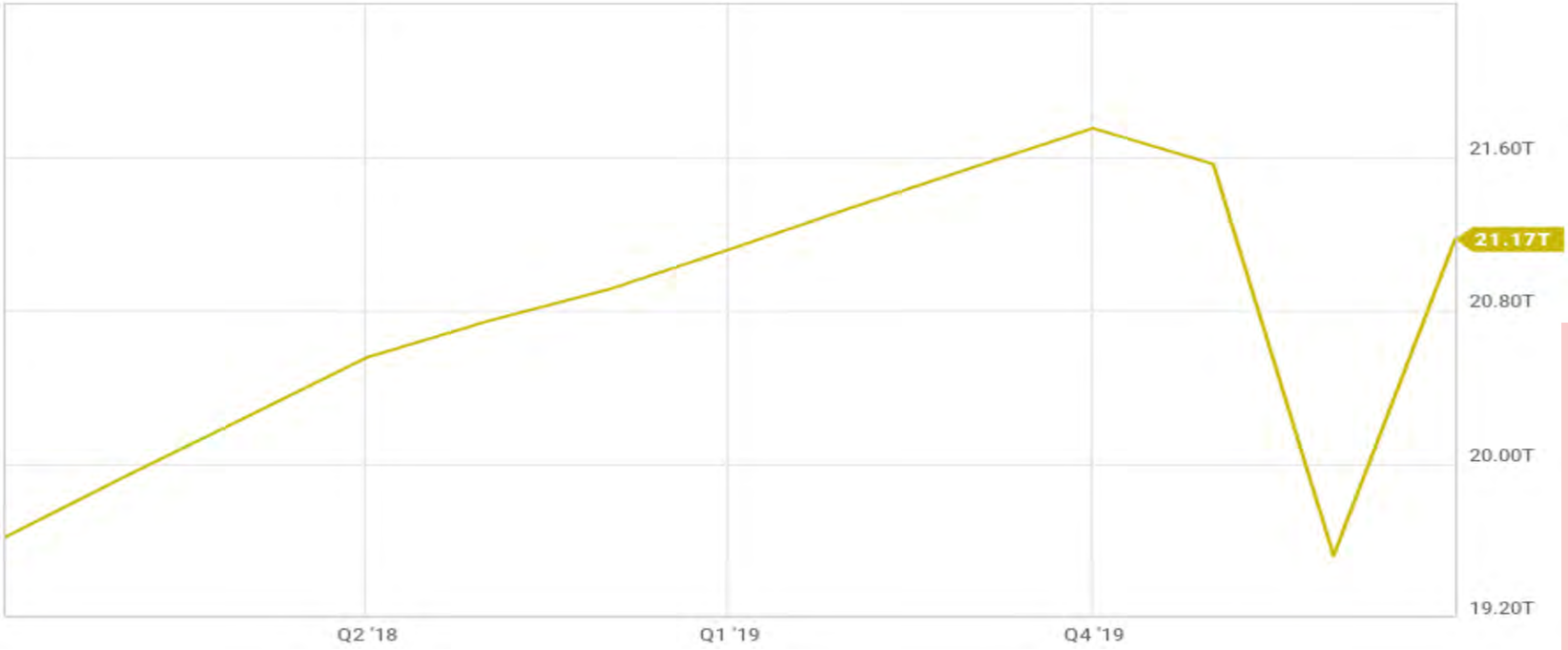
The inflation conversation needs to continue as we address GDP. Gross Domestic Product can surely be a driver of inflation when the economy is hopping. GDP is the market value of all goods and services and hence provides good insight into how the economy is faring. As was seen in the FOMC Projections chart, the Fed is projecting a -2.4% annualized retreat of GDP for 2020, principally related to COVID-19 shutdowns.

While the Fed projects a rebounding 2021, from a volume perspective, GDP as of Q3 2020 was at the same level as Q1 2019 (see below). The economy did recover from the horrendous second quarter of 2020, but only recovered by three-quarters, and still has a lot of ground to cover to catch up to pre-pandemic levels. Therefore, until GDP closes this gap and starts exceeding prior levels, we still have a long way to go regarding a full recovery. Likewise, inflation, in the nearer term, should not be a major market concern.

This could change in the second half of 2021 with widespread vaccine distribution, but as mentioned, vaccine rollout has been lackluster, and the virus is still very active. Furthermore, if a double dose needs to be administered after three weeks or so (with the Pfizer and Moderna vaccines), the full rollout could take much longer given we are effectively doubling the number of people needing a shot in the arm. Therefore, a 2021 quick jump of the economy will likely be slower, which will presumably hold back general expansion and GDP.

U.S. GDP

(09/30/2017 - 09/30/2020)



In the discussion of GDP, the effect of non-government debt has a big impact on the economy. Debt is good when used to create expansion, but it can be bad when times are tough, as loans cannot be repaid.

As can be seen from the chart of US non-performing total loans for all banks (non-payment for at least 90 days), tracing back four recessions to 1988, bad loans tend to rise just before and during a recessionary period, and then as the economy recovers, loans start to get paid in the normal course of business. However, this recession was non-traditional, as there was no precursor rise in non-performing loans. While there has been an uptick in bad loan activity since the start of the recession (Feb. 2020), we are close to record lows, which means the health of banks (and those with outstanding loans like consumers and businesses) is still stable. This is encouraging for the economy and would speak to the dramatic way we entered this uncharacteristic recession, but we will continue to monitor this carefully in the wake of closed businesses and higher unemployment.

U.S. NONPERFORMING TOTAL LOANS FOR ALL BANKS

09/30/1988 - 09/30/2020)

MARKET INFLUENCES

As we consistently say, the market is a forward-looking indicator. While the S&P 500 ended 2020 on an all-time high, the jagged blue line reminds us there were many bumps along the way to stardom. However, as we point out via the gray circles, the market does toss clues of its future direction. Market traders, which we are not, buy and sell on many factors, typically outside of fundamental facts. Perspective has nothing to do with their actions; they see a chart and pull the trigger. If they see a dip, or rise, of some technical factor (such as a moving average which is used above), they will buy or sell with that trend. They do this for both the broad market (such as an index) and for individual stocks. While we all like to believe a "good" stock will weather a storm based on its fundamentals, market trends will carry an entire market, regardless of how strong a company might be on paper. Market participants need to know this fact, as once the train leaves the station, it is very hard to pull it back.

We observe trends to help us with our weighting in the market, pulling back exposure when the signals point south and trying to get a jump start when the signals are pointing north. We make these decisions using our full breadth of knowledge coupled with our collective perspective. Right now, these signals are favorably positioned for continued near-term growth, but things can always turn quickly.

S&P 500 INDEX

2015 - 2020

SECTORS

As we create our perspective of future activity, we all need to recognize the portion of the market each sector compromises. The market share of each sector is important as we can identify where the money is invested in the market, which in turn has the power to move the market. In the infographic of sector share, it is obvious the huge role that technology, financial services, consumer cyclical and health care play in our overall economy, representing nearly 60% of invested assets based on size of firms. As these sectors move, so does the market. Conversely, while energy is a critical component of everyday life, the sector itself only represents a scant 3% of market capitalization share, with the same being true for real estate and utilities. The understanding of how the market moves based on its critical components affects our perspective for investing.

Sector weightings do move, and with an economy desperately in need of all-around good news, there will be shifts in the share of each sector. However, while the technology and consumer cyclical sectors (Amazon is a consumer cyclical name) got us through a pandemic, they presumably will still maintain large shares of the sector breakout based on the habit changes in our economy, only accelerated by the pandemic.

SECTORS BY MARKET CAP

Industrials, especially with any infrastructure spending (which has bi-partisan support), will likely move up from its 10% share. Health care, regardless of politics, will maintain, and presumably grow, its 12% weighting based on demographics of those needing care, as well as advances in the bioscience field. Financials, at 16%, will continue to grow, as a rebounding economy needs loans, and an eventual rise in rates always boosts bank stocks. Real estate will continue to be under pressure for a while with remote work. Energy stands to gain with the vaccine and pent-up travel demand, as well as ever-changing supply manipulation such as the Saudis reducing output by 1.0 million barrels a day for several months to come. The good news is energy stocks will rise for a while, albeit at the expense of the consumer. While not discussed in our inflation section, the rise in energy costs will lead to some real inflationary pressure, but the Fed understands the volatility of oil, and the games that get played, and hence discounts interim price changes (the same is true for food prices). Nonetheless, a larger share of consumer dollars will have to be spent on gasoline and heating oil, but with remote work and state travel restrictions from the virus, demand might not be as high as in the past.

OUR VISION

Throughout our Outlook, we have alluded to many factors that are both bullish and bearish given the unique present macro environment. This could likely be the case every time an Outlook is formed, but perhaps a pandemic in the mix justifies the comment. As we have been saying quarter after quarter for nearly a year, this pandemic has rocked traditional thought processes—and perspective—and therefore has forced managers like ourselves to use every ounce of cumulative knowledge and insight to guide our clients. While everyone was concerned about complacency at the start of 2018 (after a glorious 2017 market), that same complacency rolled through 2019 when markets were on fire. And then the fire hit… in February 2020.

With a pandemic still raging, government leadership shifting, and markets hitting all-time highs, our vision is more than 20-20 (sorry, we could not resist). In fact, our vision is laser sharp as we can see the challenges ahead, but we also see a road paved with opportunity. As discussed, sector selection is critically important, and this pertains to both the equity and fixed income markets. We are focused on both the fundamentals of the companies we buy and the market trends that tend to move those stocks or bonds. We will be carefully watching the actions of the next administration in the White House and looking for signals, including infrastructure projects or changes in regulations that could compromise or benefit certain sectors (we do not see much regulation loosening, but there could be enhancements to green initiatives). Aside from everyday market information, we will also be carefully monitoring policy that could include possible changes to retirement plans such as a higher age for starting RMDs, increased charitable limits from qualified accounts, and increased catch-up opportunities.

Our eyes are open wide, we believe brighter days are ahead, and our goal is to act in your best interest. Happy New Year!

end.

MACRO TEAM

TODD ARTWELL
FIXED INCOME
SENIOR STRATEGY
MANAGER

STEFAN ASTHEIMER
VICE PRESIDENT
STRATEGY

GREG FARRELL
VICE PRESIDENT
SENIOR PORTFOLIO MANAGER

ELIZABETH PERRY
PORTFOLIO OPERATIONS
MANAGER

SARAH SWAN
VICE PRESIDENT
CLIENT EXPERIENCE

MARK THOMPSON
EQUITY ANALYST

JOHN TRENTACOSTE
DIRECTOR OF FIXED INCOME

Registration with the SEC should not be construed as an endorsement or an indicator of investment skill, acumen or experience. Investments in securities are not insured, protected or guaranteed and may result in loss of income and/or principal. Diversification does not eliminate the risk of market loss. A long-term investment approach cannot guarantee a profit. While H&R believes the outside data sources cited to be credible, it has not independently verified the correctness of any of their inputs or calculations and, therefore, does not warranty the accuracy of any third-party sources or information. This communication may include opinions and forward-looking statements. All chart data has been sourced from YCharts, Bloomberg Professional Services, and Federal Reserve Bank of St. Louis. All statements other than statements of historical fact are opinions and/or forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the beliefs and expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such beliefs and expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements. All expressions of opinion are subject to change. You are cautioned not to place undue reliance on these forward-looking statements. Any dated information is published as of its date only. Dated and forward-looking statements speak only as of the date on which they are made. We undertake no obligation to update publicly or revise any dated or forward-looking statements. Historical performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss of income and/or principal to the investor. Investment process, strategies, philosophies, portfolio composition and allocations, security selection criteria and other parameters are current as of the date indicated and are subject to change without prior notice. This communication is distributed for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services. Nothing in this communication is intended to be or should be construed as individualized investment advice. Unless stated otherwise, any mention of specific securities or investments is for illustrative and informational purposes only. Adviser's clients may or may not hold the securities discussed in their portfolios. Adviser makes no representations that any of the securities discussed have been or will be profitable.

DISCLOSURES