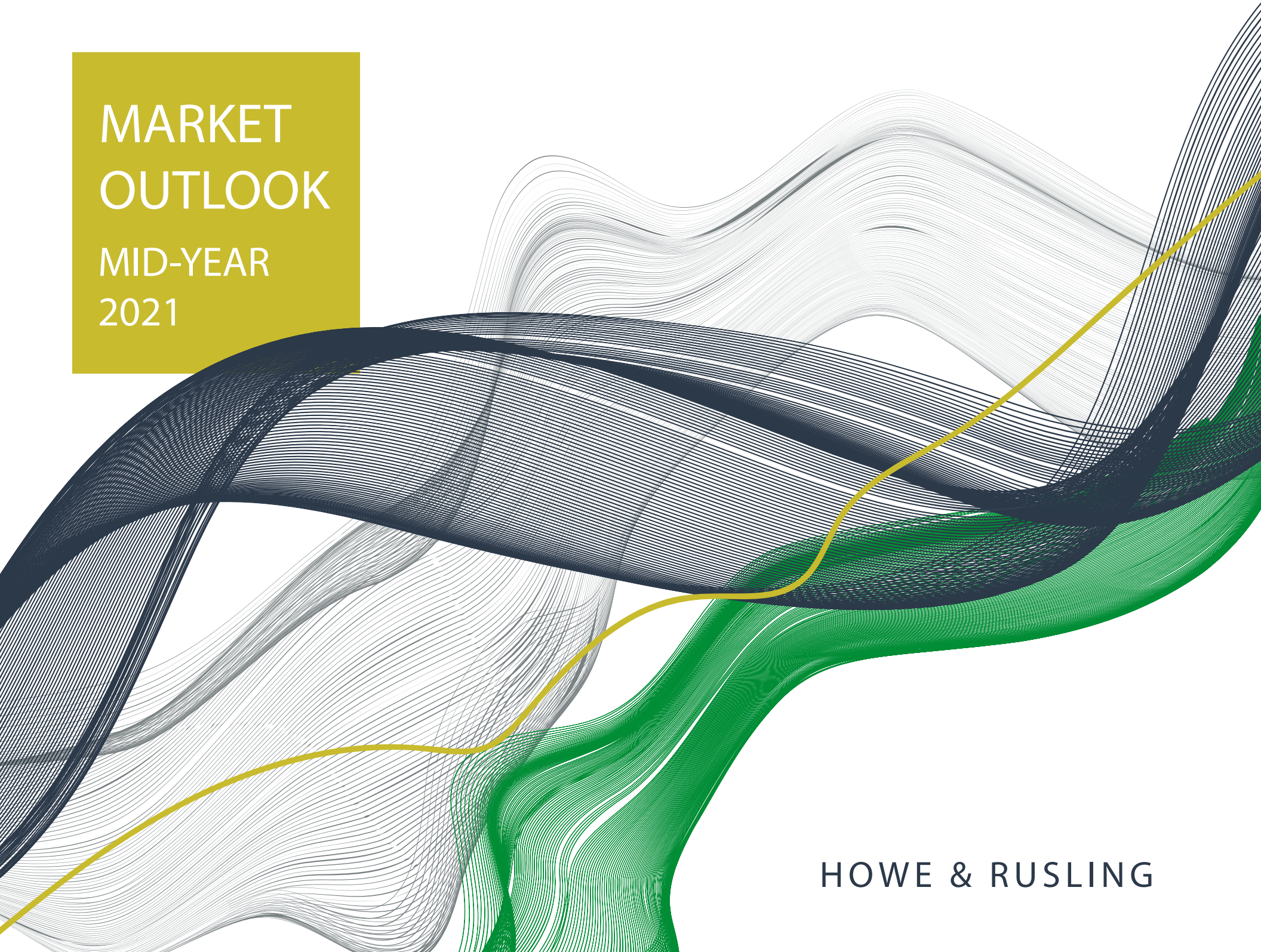
MARKET OUTLOOK

MID-YEAR 2021



HOWE & RUSLING

ON OUR MINDS

Last quarter we made thematic references to "**Back to the Future**," thinking perhaps the world was peeking around the corner at a return to some type of normalcy. As we start the second half of 2021, if our time traveler last quarter was dropped from the future into the Eastern US today, odds are this traveler might not have a clue a pandemic just ravished the world.

The paradox here is that the pandemic does still loom in many countries outside of the US, and sadly some domestic hotspots, indicating we are far from calling this a victory. During the writing of this Outlook, Japan declared no spectators at the upcoming Olympics due to high infection rates, principally from the new Delta variant. This Delta variant is today's concern, but tomorrow is still unknown. Fortunately, the vaccines have suppressed the variants so far, and have limited serious, deadly outcomes, but we are still learning day to day. Perhaps if the FDA formally approves some of the existing vaccines, versus the present emergency use authorization, there will be a higher level of acceptance which is likely needed to eradicate spread. However, region by region, the world is returning to business as usual. The question going forward will be, "What is usual?"

Business as usual today means returning to freedom of movement, freedom from restrictions, and freedom to recover from shutdown-related restrictions. However, while the desire is to return to what was familiar and standard in the past, the markets might not want to reclaim the same set of parameters. Given our short memories, 2018/2019 were fragile periods for the markets with excessive concerns of overvaluation, trade wars, and large businesses woefully under-investing in capital projects as they weighed trade policy. In that environment, what was an investor to do? The easy answer was to invest in high growth businesses with low capital intensity, like social media or search engine firms, while limiting capital investment in companies that provide grease to the wheels of the economy. Our memories are short, and the phrase "business as usual" needs an asterisk.

Do not get us wrong; history is our friend, and most people use history as a measurement for the future. However, very common to our investment industry are the coined words of "Past performance is no guarantee of future results." This very concise phrase perhaps sets our world apart from others, for while history is important, we are very conscious to not lay our foundation on the past. We obviously learn from the past, but in our view the future is merely a gentle smattering of the past, coupled with a generous amount of educated hypothesis.

The world has changed, and while we are still recovering, the recovery likely will not take us back to a familiar place. This is fine, for without change, there is no growth. As a society, and as an investing world, we take each day as it comes and add the collective sum to create a vision for the future. Just like life, investing takes courage, and we encourage you to consider our synthesis of these changing times as we all move forward.

Thank you, as always, for your belief in our ability to advise, and on behalf of all of us at Howe & Rusling, and especially our Macroeconomic Team, please enjoy our Mid-Year Market Outlook.

Greg Farrell, VP, Senior Portfolio Manager & Macroeconomic Team Chair

THE PAST GUIDES THE FUTURE

FIXED INCOME (& THE BROADER ECONOMY)

Rates matter. The stock market takes its lead from the bond market (rightful or not), and usually in the form of rates as an indicator, followed by yield and credit spreads (we will explain later). During the second quarter of '21, rates, as measured by the 10-year Treasury, have slowly dropped from the year high of 1.74% on March 31 to 1.45% at the close of the second quarter. While we try to keep this dialogue to quarter-end results, the 10-year has continued to move down since the start of the third quarter, principally from pandemic related concerns which will likely slow growth prospects for a while.

10-YEAR TREASURY RATE
(12/31/2020-6/30/2021)

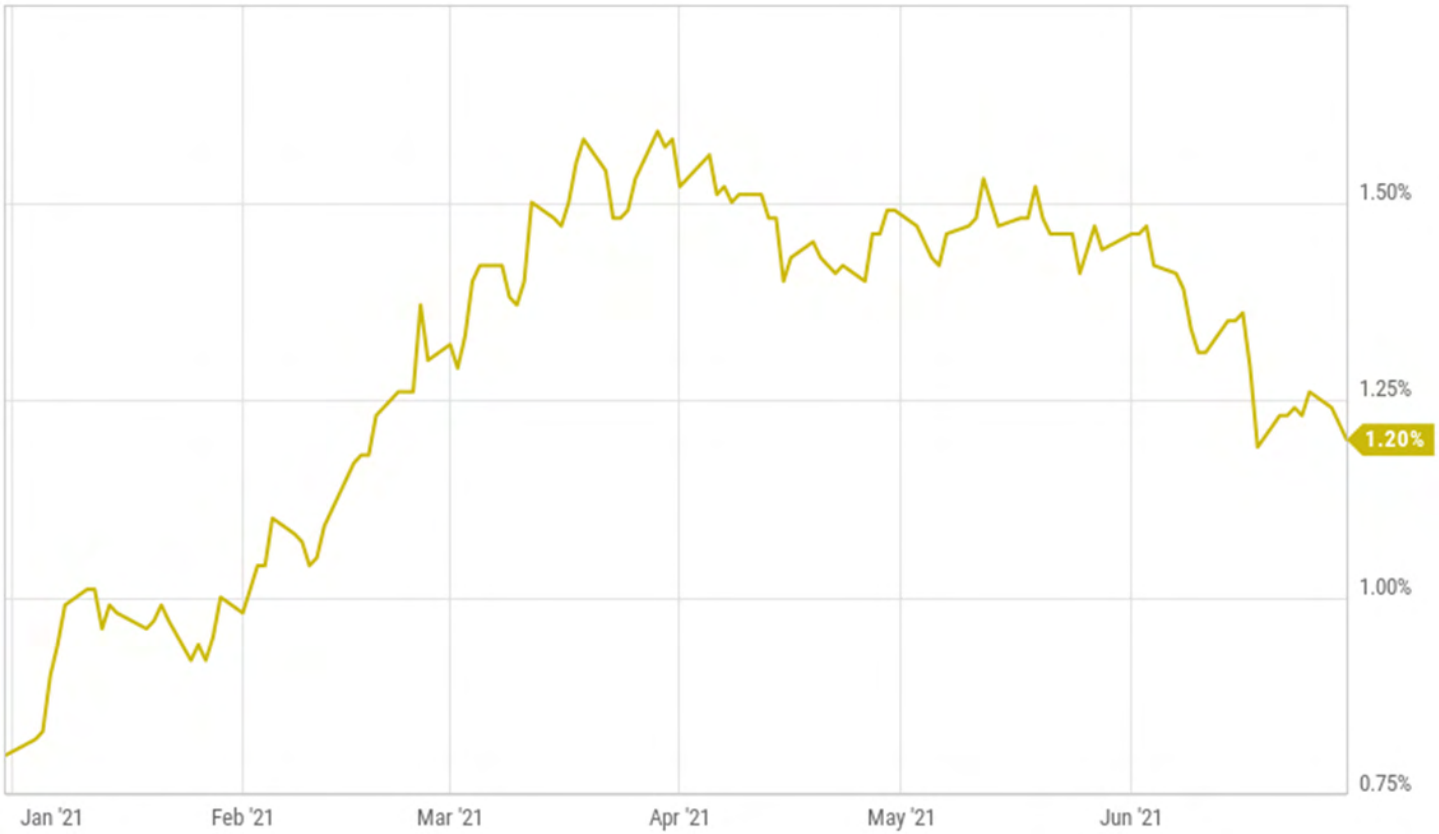
While everyone was dancing happily with the stock market cruising, the drop down of rates during the second quarter was signaling a slowing of the rapid second phase of the rebound which started in November 2020 with the announcement vaccines were ready for FDA approval. Rates matter (for the long term), and it takes skill to understand their impact on the overall economy and the subsequent reactions.

To provide some context, early in the pandemic, the Federal Reserve obliterated rates down to zero to stimulate the economy. Since then, and to present, they have repetitively maintained their dovish stance of no rate increases until 2023 or later. As the rebound continued to accelerate during the first half of 2021, the markets (principally the bond market participants) feared runaway inflation from short supply coupled with a faster than anticipated recovery. These fears significantly moved rates early in the year as the bond market took it upon itself to signal to the Fed that rates matter, and if the Fed was not going to raise rates (to control inflation), the market would. However, as weeks continued to pass, the market started to embrace the Fed's suggested transient theory of inflation as raw commodities (such as lumber and cooper) started to retreat from their parabolic climbs. This points to the fact no one can predict short-term rates. As we progressed deeper into the second quarter, various members of the FOMC (Federal Open Market Committee) started to signal a mixed message, with some members favoring a rate increase before their original 2023 date. Hence, the markets have rested a bit, feeling the Fed might not be as out of touch as feared.

YIELD AND CREDIT SPREADS

To add to the pause theory, yield spreads have narrowed a bit, which again is a sign of rest. The spread (difference) between the 10-Year Treasury rate and the 2-Year Treasury rate has tightened in the past quarter, signaling investors might be coming to terms with slightly less vertical growth in the economy and easing inflation concerns. The 10-2-Year Treasury Yield Spread chart (following page) basically shows the premium (or not) associated with holding a longer-term bond (the 10-Year) over a shorter bond. When there are high expectations for growth, coupled with inflation worries, the spread widens (as the 10-Year yield moves higher and faster than the 2-Year). Conversely, as growth expectations wane a bit, and inflation fears subside, the spread narrows. It should be noted the 2-year Treasury moves more with expectations of Fed policy, so movement in the 2-Year usually correlates to announcements or press conferences made by the Fed (the most recent reflected on the chart of June 16's FOMC Press Conference which pushed 2-Year rates up while the 10-Year rate bobbed but remained relatively even). As of the second quarter-end, the premium had shrunk to 1.20%, as investors await Fed actions and likewise come to grips with transient inflation and continued virus outbreaks globally.

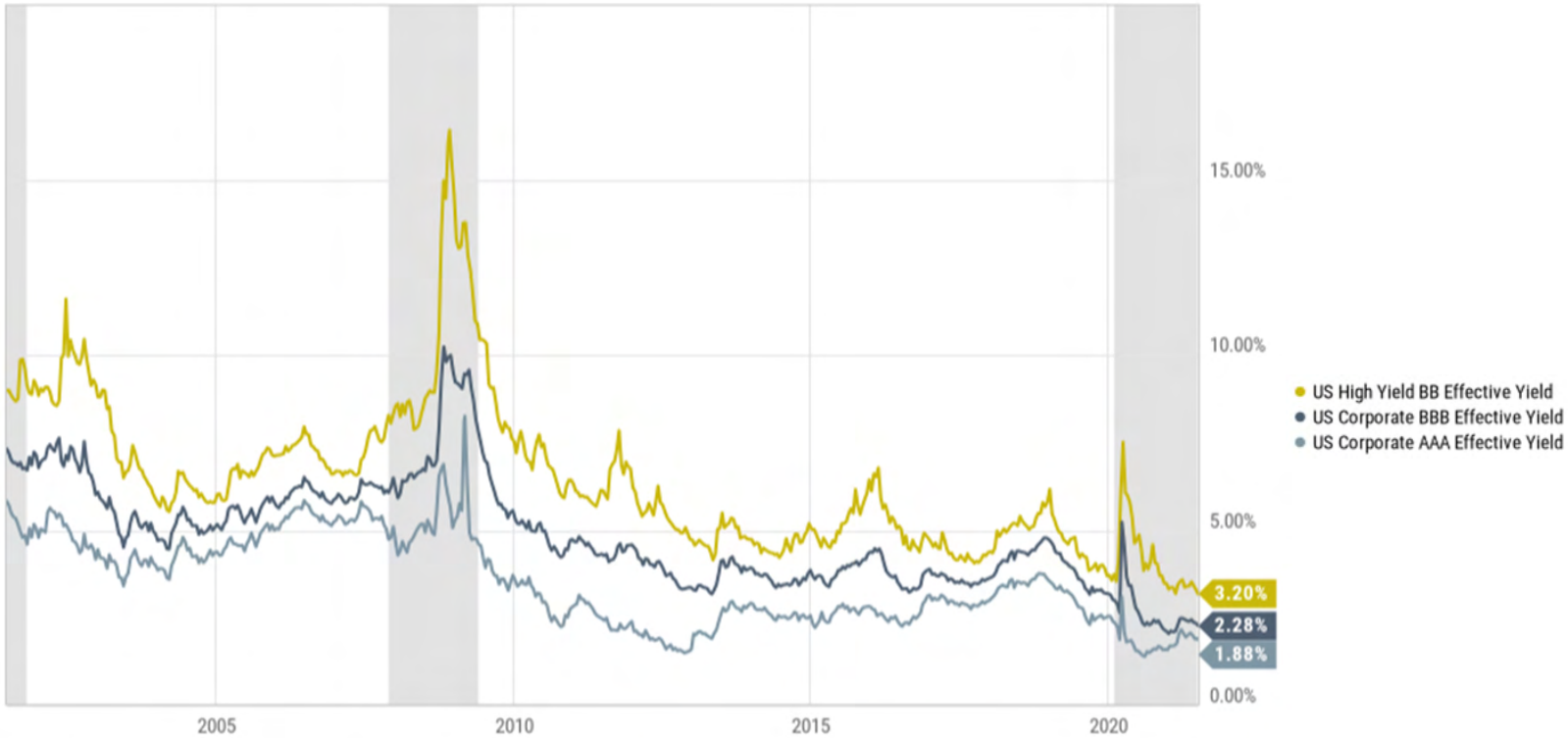
10-2-YEAR TREASURY YIELD SPREAD
(12/31/2020-6/30/2021)



The other fixed income activity at work these days is credit quality—which overall is pretty good at present. Bonds are rated by various agencies, but using Standard and Poor's rating system, AAA is the highest quality bond and represents the top of the category know as "investment grade." Investment grade bonds are high quality, lower risk, and usually are found in portfolios needing some yield but are much more concerned with stability and value preservation. Investment grade includes all the A rated bonds (AAA, AA, A) and BBB rated. After investment grade, we get into the high yield category. High yield formerly was referred to as "junk bonds," but the market felt that was an unfair label. High yield includes BB and all the Cs.

Indicative of a favorable economic climate, despite a transient pause, the credit spreads between high quality and high yield are extremely narrow. This is supportive of "rates matter." The lower the differential, the less reason there is to take on the risk of lower grade credit. If spreads are narrow, and continue to contract, the bond markets will continue to signal an all-clear environment.

CREDIT RISK DIFFERENTIAL
(6/29/2001-6/30/2021)



in charts denotes times of recession

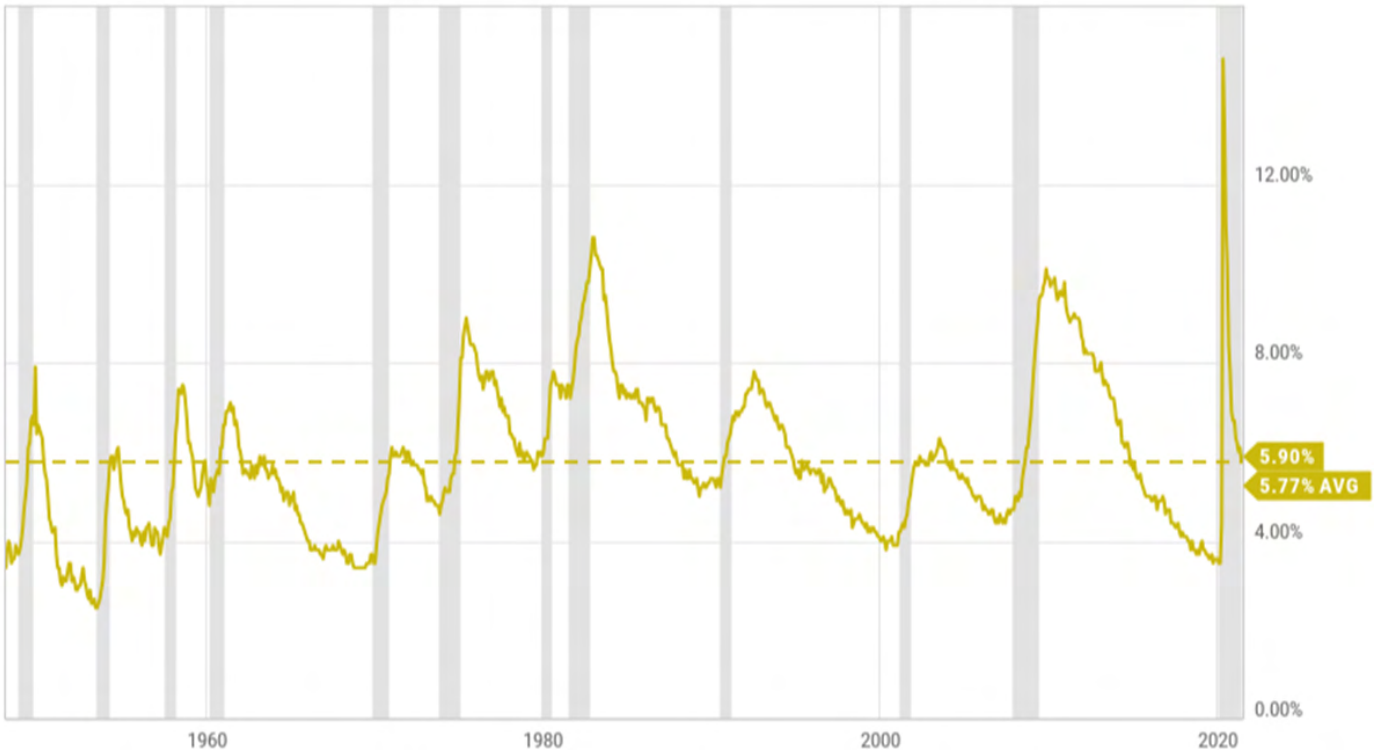
INFLATION & UNEMPLOYMENT

While we would like to be creative and discuss some other topics, these two areas have been hot topics, and hence we need to continue to shed light.

Unemployment has been an interesting phenomenon, as the huge number of unemployed initially had nothing to do with a traditional economic cycle, such as a downtrend which can lead to a recession. Not to rehash old news, but mandated and prolonged shutdowns forced companies to lay off millions. As the economy started to re-open its doors, business just did not happen as planned for several reasons. We will outline some categories of unemployed workers and the prospects moving forward.

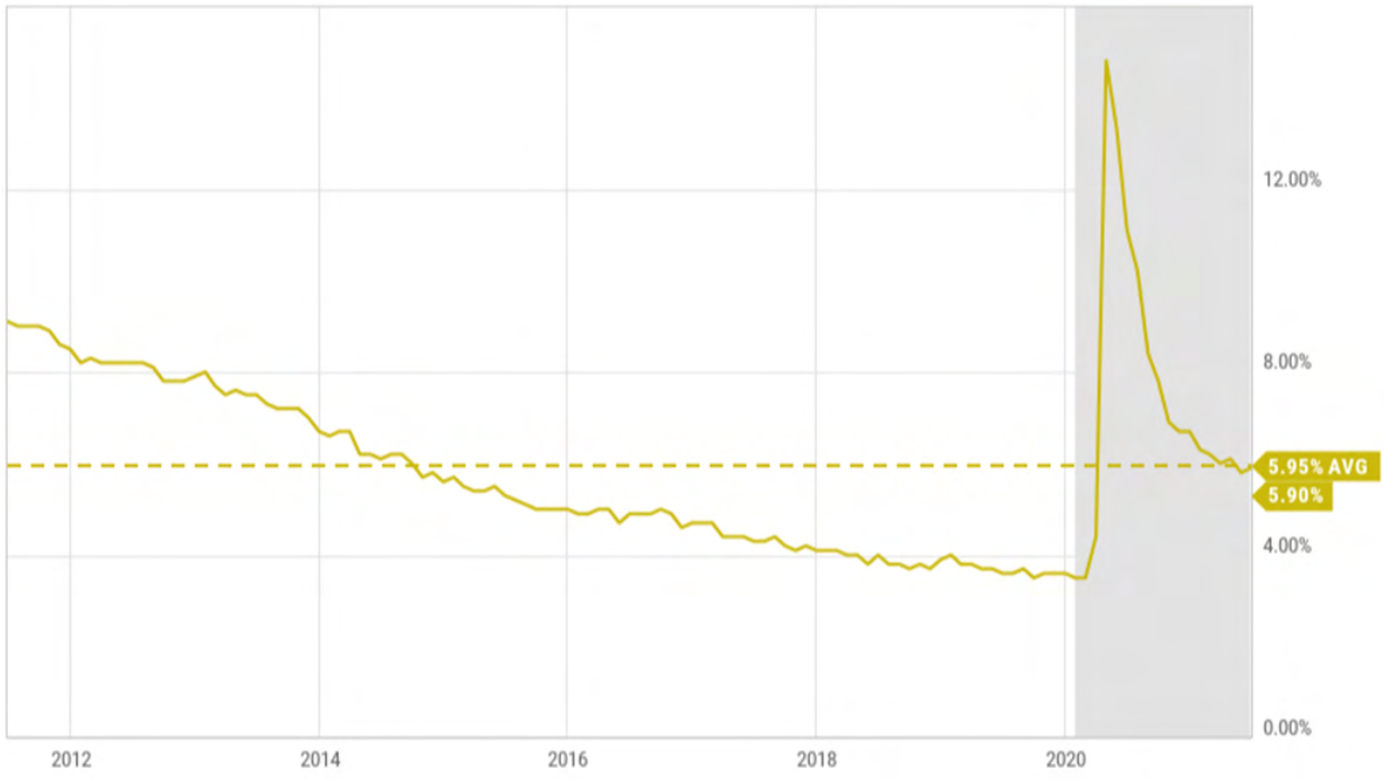
The key here is while unemployment grabs a lot of headlines, let's let the facts do the talking. As of the end of the second quarter, the number of unemployed was 9.5 million. That is a big number, but when you look at the actual rate of unemployment at 5.9%, amazingly, is it not too far off from the historical average of 5.77%.

HISTORICAL US UNEMPLOYMENT RATE
(1948-PRESENT)



Interestingly, the 10-year average, from June 2011 – June 2021, is 5.95% against today's 5.9%. So, while there is a lot of chatter around unemployment, and who is abusing the system or suffering, the economy has come a long way in its rebound. Granted, the present level is still 2% above the pre-COVID February 2020 figures, but averages are good.

TRAILING 10 YEAR US UNEMPLOYMENT RATE



Dotted line represents average

Coinciding with the number of unemployed at 9.5 million, per the Labor Department's JOLT report (Job Opening and Labor Turnover), there are 9.2 million job openings. One must scratch their head a bit… what is the disconnect?

First, in the early stages of the pandemic, and even up to the start of 2021 before the vaccine rollout, many individuals just did not want to engage with others, mask or not. Furthermore, for a lot of these individuals, remote work was not an option as they worked in service or manufacturing jobs requiring in-person attendance. This first category of workers who wanted to work but had virus concerns has slowly returned to work, mainly because of the vaccines.

Another category of unemployed workers was those challenged by childcare. As of result of schools being closed, many households had to figure out alternative care because beyond ABCs, schools serve as childcare for part of the day (which allows family members to work). The challenge was daycare centers were not an option for many unemployed workers. First, for some, the raw cost made it financially unattractive. Secondly, and principally, even before the pandemic, daycare centers were close to capacity, as most operations had waiting lists for years. Furthermore, the senior age population was a high-risk infection category, limiting another avenue for care. Fortunately, it appears schools will reopen this fall, camps are in full swing now, and seniors have a very high vaccination rate, all allowing for labor market participation now and surely by September.

Our next category of unemployed is the individuals who decided an unemployment benefit was enough; it might have been less than what they made before, or in some cases more with tack-on programs, but with the array of benefits, they decided this was the move for them. Many states (about half) have decided to curtail the federal unemployment benefit, and individuals are returning to work in those states. We believe this is an indicator that a high percentage will likely follow suit at the end of September when the federal program expires for all states.

The interesting story developing is whether there is an undercurrent in the unemployment picture which bears further watching. Will everyone go back to work? Have some people decided to retire earlier? While there have been business closures, which is affecting a few of the presently unemployed, an April report issued by the Federal Reserve indicated the closure projections were overestimated by double the reality. This is mainly from the Payroll Protection Program and other state and local grant and loan programs. Hence, we know the jobs are there, but will they be filled? We believe a good portion will be, and the economy will be onto the recovery versus rebound phase.

INFLATION

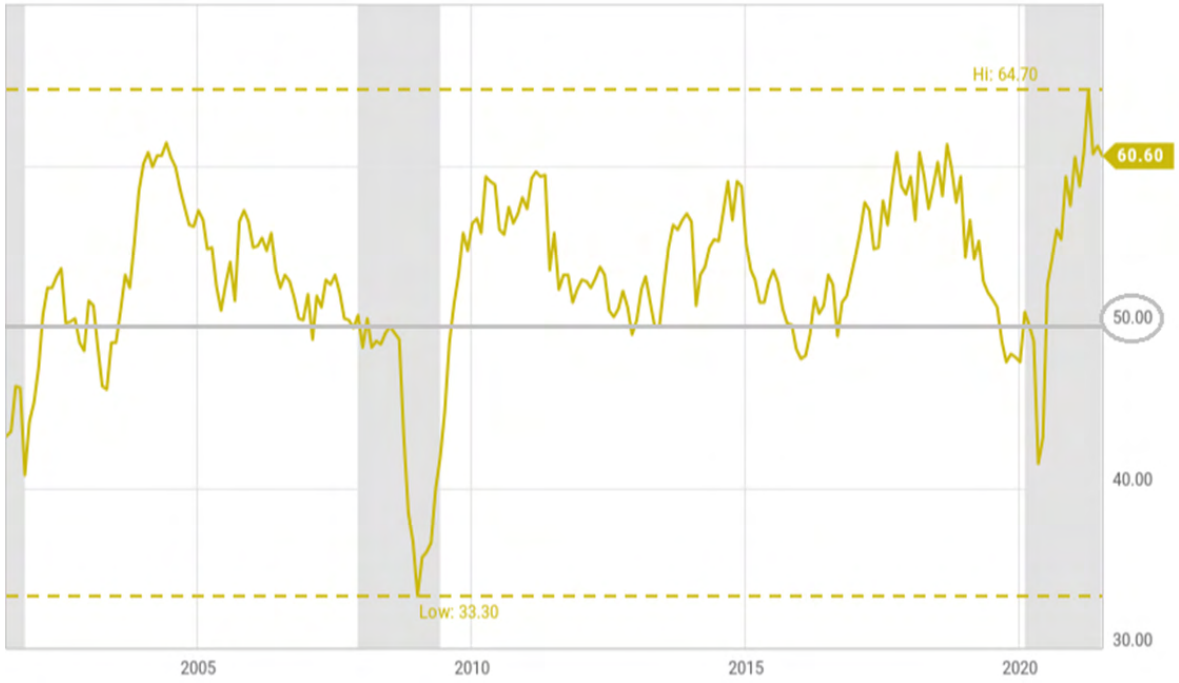
... perhaps the most discussed topic of all in 2021, even surpassing cryptocurrency!

The Federal Reserve has been critiqued endlessly since labeling inflation as "transitory." The general public seems disinterested in the notion of transitory as people seem to live in the here and now where "my gasoline and project lumber costs are very high." Fortunately, lumber has come down, as trees never got COVID, and it was just a matter of time with sawmills coming back online. Also, for the US, a fair amount of lumber comes from Canada, and there were issues with borders.

Further, while mentioning borders, ships have been a key variable in the inflation discussion as supply shortages are keeping prices up. The Port of LA is the busiest port in the US and the principal port for goods from Asia. The Port of LA has had huge backloads throughout the pandemic, as workers were needed, and we already mentioned several reasons for labor shortages. On the 5th of February, there were 41 ships at the port, 24 at anchor (just sitting there), and 17 at berth (started the unloading process) and the average anchor and berth combined stay was 8 days. These numbers move around a lot, as ships move in and out, but as of the end of June, the average stay was 3 days and there were only 7 at anchor and 14 at berth. As an aside, while walking in a local box home improvement store in June, the aisles were jam-packed with pallets, meaning supply is making its way to shelves (or floors!). This partially supports the transitory theory.

That said, the cost of goods overall is up, which by definition is inflation. Sure, it is easy to be up from when no one was doing anything a year ago. However, in part to do with the discussion on employment previously, supply is still short in many areas as productivity is lagging from a lack of workers. The Purchasing Managers Index (which surveys managers from all segments of the economy each month) gives a pulse of the economy. As can be seen from the most recent survey at the end of Q2 below, managers' positive attitude has taken a slight pause since the start of Q2, with the index dropping from a 20-year high of 64.70 recorded at the end of Q1. Granted, anything over 50 signals an expanding economy and confidence by purchasing managers, but the drop coincides with the movement in the 10-year Treasury, flattening out as the economy starts its shift from a rebound to recovery.

PURCHASING MANAGERS INDEX
(6/30/2001-6/30/2021)



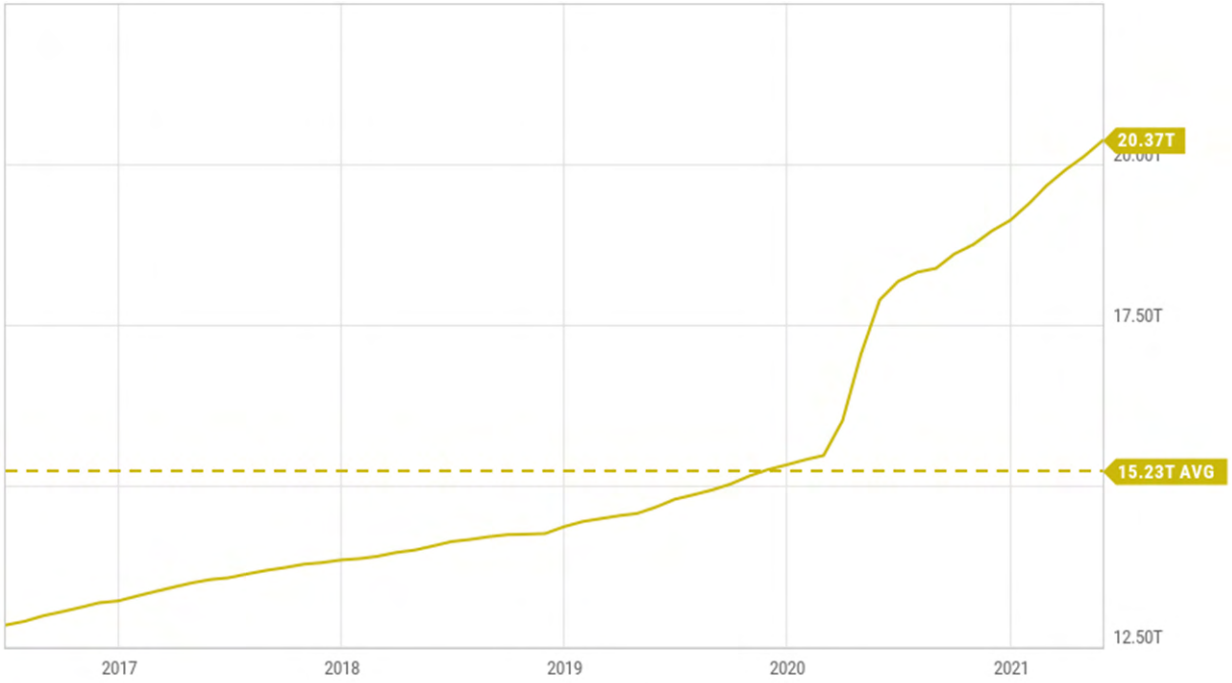
Reading above 50 signals expanding economy / below 50, contracting economy

The bigger play for inflation might not be goods or even wages pushing up prices, but money itself. Many argue that the money supply has increased 30% and regardless of wage pressure, or short supply of goods, eventually too much money will pressure prices and inflation will be here to stay. I heard it explained once like this: if you have $10 and 10 apples, each is $1. Increase the money supply by 30% and now you have $13 chasing 10 apples = $1.30 each. Throw in some restricted supply (like present) and the cost is higher as we imagine only 7 apples for the same $13 ($1.85 each). When supply catches up again, the apples still have $13 chasing them, or $1.30 versus $1.00 in an uninflated economy. This is good theory on paper, but if there is so much money, where is it?

To look for the money, the best way is to look at the Treasury Department's measure of money supply, known as M2 Money Stock. The US M2 Money Stock refers to the measure of money supply that includes financial assets held mainly by households such as savings deposits, time deposits, and balances in retail money market mutual funds, in addition to more readily available liquid financial assets as defined by the M1 measure of money, such as currency, traveler's checks, demand deposits, and other checkable deposits.

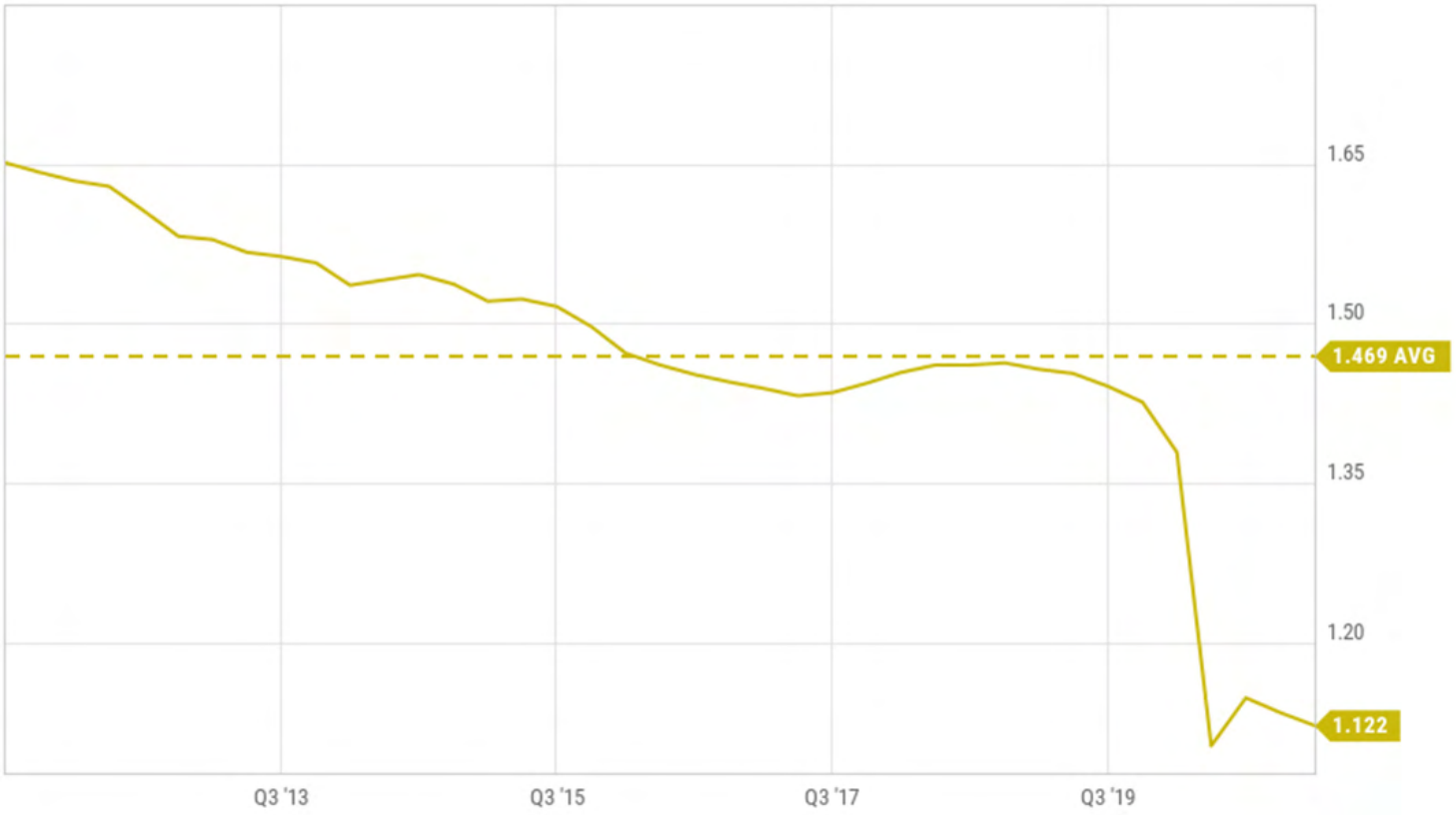
As seen, M2 has risen significantly since the pandemic, up about 30%... which is where the money is! This has come from several factors, presumably stimulus checks, but more significantly, a general lack of spending. This is good and bad; while funds have not entered the economy in the form of spending, they are close at hand which could prompt higher inflation from too much money chasing too few goods.

US M2 MONEY SUPPLY
(6/30/2016-5/31/2021)



The second thought on money supply, and its pressure on inflation, comes in the form of velocity. Velocity (of the M2 money supply) has been low relative to the past 10 years. While it is measured on a quarterly basis, and the second quarter numbers are not out, the trend is visible. Even if there is an uptick in Q2, it will be low compared to the past 10 years' average. Hence, hard core inflation has some work to do to gain speed.

VELOCITY OF M2 MONEY STOCK IN THE US
(9/30/2011-3/31/2021)



We are by no means saying inflation is not real, as we feel it just like you do in everyday prices. The price of transportation for goods (fuel) is a concern as eventually this could/will translate to higher product costs for suppliers and could find its way to the consumer. Also, higher rents could be an issue, based on supply and demand, and rents hardly ever go down once they go up. Therefore, there are a lot of moving parts that we need to monitor.

However, a lot has changed in our world since the horrendous bouts of inflation in the late 70s and early 80s. First off, our economy is now global, whereas during the 70s and 80s the lion's share of your goods came from your local stores and were produced domestically. Unions were powerful negotiators for their members and wages were constantly rising. Furthermore, leading up to this period during the late 60s and 70s, there was a doubling down of labor in the form of both sexes in the labor force, further exaggerated by the power of the baby boomers which were 30% of the population—most with money in their pockets. Dual incomes for some households led to higher demand on limited supply. In essence, the combination of all the above was a recipe for inflation (as well as a Fed which did not react fast enough).

Today, we have globalization of goods, thanks in part to the internet (also non-existent during the 70s and 80s). This globalization has created competition, which typically keeps prices in check. Furthermore, the upcoming workforce aged 20-40 are 25% of the present population, in line (or less) with history and therefore should not cause a dramatic change in spending. Finally, unions (for now) have less impact, principally a factor of many goods not being manufactured domestically. All said, inflation is always a concern, but with a good investment allocation, favoring sectors and tilts that can offset a rise, the effect can be managed.

MINDSET, RECOVERY & EARNINGS

MINDSET

This is not an economic or financial term commonly referenced; however, the mindset of individuals contributing, or not contributing, to the economy influences results (productivity).

The pandemic has triggered various emotions, attitudes, and activities across the population: attitude towards a vaccine, freedom of work environment, attitudes towards each other. However, for the decade leading up the pandemic, the way individuals formulated their attitudes had a lot to do with the delivery of news. Over the past decade, individuals have increasingly been "cutting the cord," which one would surmise would limit the delivery of news. However, the cord-cutting has allowed individuals to follow media of their choosing, which ranges from both extremes on the spectrum to the middle of the road. By following what we want to hear, it solidifies our vision, responses, attitude, and actions. A year-long isolation period only exaggerated this.

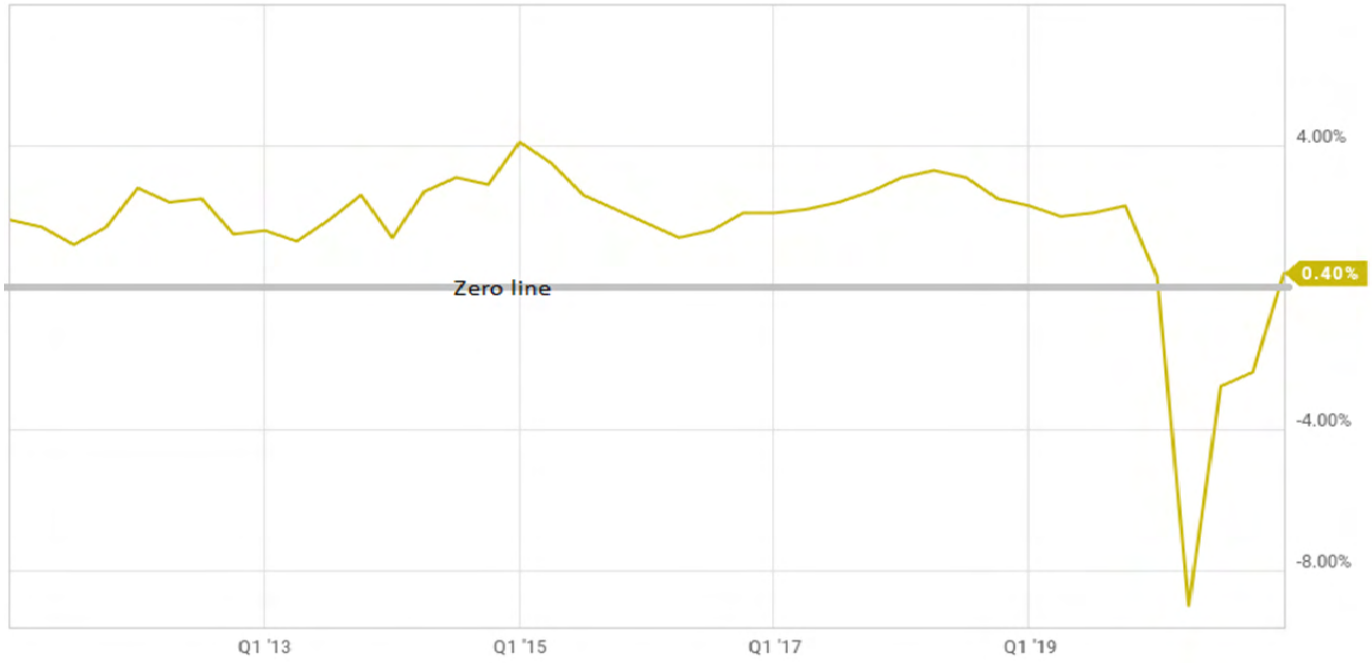
Our discussion on employment has a lot to do with mindset and corresponding activity. If someone feels unsafe, they likely will avoid, if possible, activities that make them feel this way. If that means changing a career, this will change the balance of the economy (as we knew it). If someone feels they should be entitled to continue to work remote, they might fight for that right, or their employer will change policies, or the individual might seek employment elsewhere. In the end, the balance of the economy, or business as usual, has changed.

The reason we mention this is in our Outlook is that mindset shapes an individual's activities, and in an economy that requires activity, the resultant action, or lack thereof, affects the wider economy—it essentially translates to output, as measured by Gross Domestic Product. We recognize the economy is changing based on many components, but productivity, while still strong, has changed and needs to be monitored as mindset evolves.

RECOVERY

As we watch productivity, one thing is certain: the economy has rebounded and is now poised to recover. Rebounds are the first phase of a recovery, which are usually fostered by government monetary and fiscal policy (sound familiar?). Rebounds last until the economy turns positive, again measured by GDP (which just barely happened at the end of Q1 on a year-over-year basis). Despite the pause we have been mentioning, current economic momentum points to the start of the recovery phase. We believe factors such as still less than capacity output, the slowly recovering global market, and higher vaccination rates will continue to lift the economy through recovery in the months ahead.

US REAL GDP YEAR-OVER-YEAR
(3/31/2011-3/31/2021)



EARNINGS

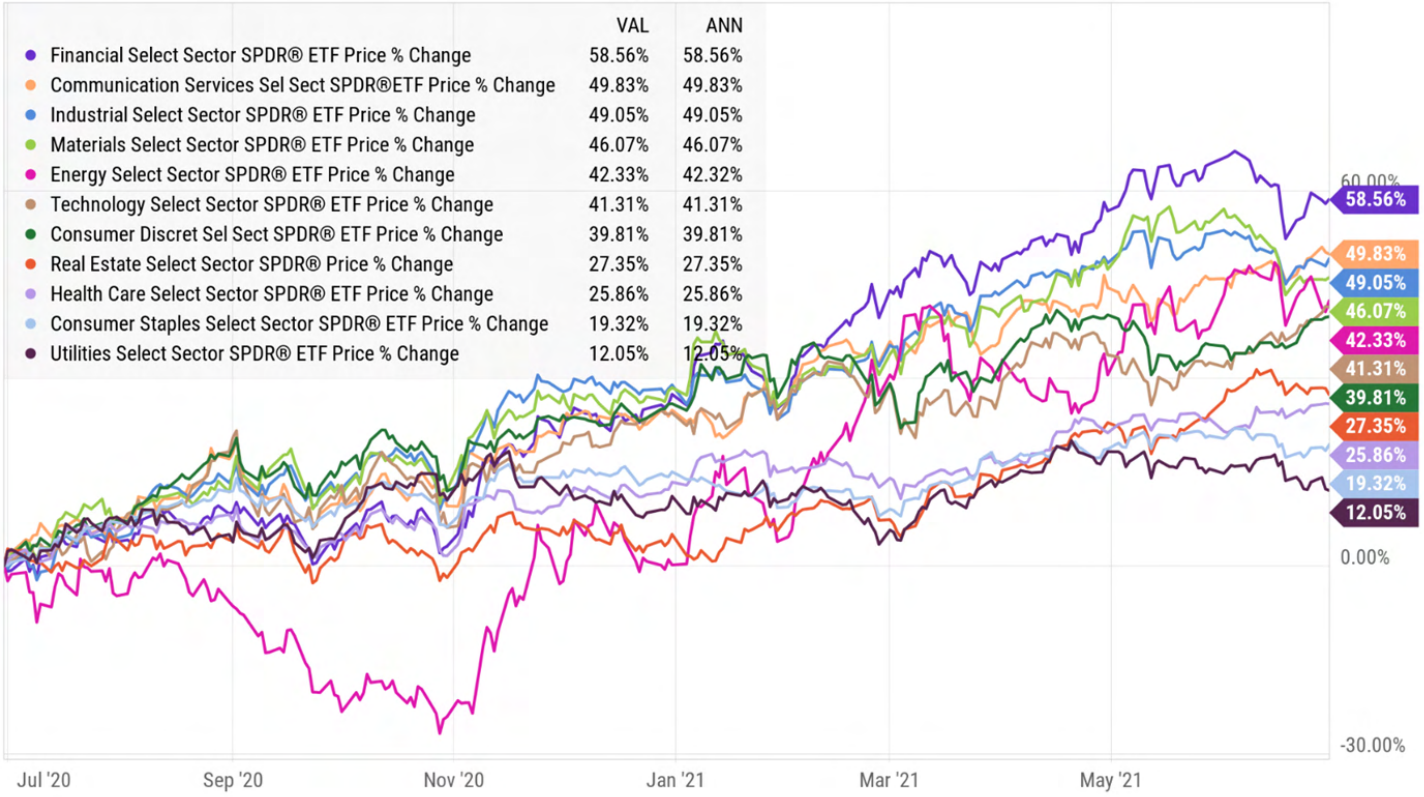
This is written in advance of the majority of second-quarter earnings announcements of publicly traded companies. Given earnings, and most economic indicators, are measured quarter-over-quarter and year-over-year, it has been a safe bet to say everything will be higher coming off a year when activity was nil. While we would like to take credit for ingenious insight, we are pretty sure the average kindergartener could make the same prediction (Robert Fulghum, "All I Really Need to Know I learned in Kindergarten"). However, to back up our safe bet, according to FactSet, Q2 estimated earnings for the combined S&P 500 companies are projected at 64% over last year.

We have mentioned in various writings the market moves on two things: interest rates and earnings. We saw interest rates make their impact in the first quarter, with choppiness in the equity and bond markets, when the 10-year Treasury made a big move to the upside (it has come down again as indicated throughout this Outlook). However, at the end of the day, earnings are the only true measure of a company. During the early stages of the pandemic, given the mass uncertainty, most companies withdrew their "forward guidance" (which is their estimate of the coming quarter). The market gave a pass to companies, for several quarters, to refrain from providing this forward guidance, as for the most part it was only going to be a guess versus a calculated estimate using statistical modeling. Now that we have somewhat of a vision for the future, companies are starting to release guidance, coupled with decent returns, as the economy rebounds and recovers.

The energy sector will be the largest contributor to the earnings increase of the 2nd quarter, principally as it was decimated in 2020 from virtually no travel. Airport TSA checkpoint traffic is up tremendously, and while still short of the same period 2019, it is only off by about 20%. In our inflation discussion, energy costs (prices) are up, which typically translate to higher earnings for the energy companies. Given all types of commerce are moving on the roads, rail, and air again, plus pent-up demand from individuals who just want to get out, it is no surprise energy is leading the way. It is the classic supply and demand scenario with limited supply and higher demand. As an aside, and related to our discussion on inflation, given the volatility of energy, and its supply which can be tightened or loosened by controlling countries or natural disasters, it is often excluded from inflation figures. However, many reporting entities incorporate the sector into their stories of rising inflation, strictly for dramatic effect.

While energy, from an earnings perspective, will be the winner, actual market movement is slightly different, as we show in our very colorful Sector Return graph. Our graph takes all 11 sectors and charts the market return of each sector per its corresponding ETF index.

SECTOR MARKET RETURNS YEAR-OVER-YEAR
(6/30/2020-6/30/2021)



We wanted to include the prior graph for several reasons. First, and most obvious, most sectors have had a very good run since last summer, posting very strong year-over-year market returns. Granted, one would have to invest on 6/30 last year and sold on 6/30 this year to get these returns, so like any investment, until the day it is sold, the return is an interesting point of discussion. However, it is good news for the overall economy as we transition to recovery.

We also wanted to highlight that market returns are different from earnings returns, and the two do not always move in sequence. Market returns involve a lot more than just actual results, as future earnings, market conditions, the overall economy, and sentiment all play into price. Given the huge swing in numbers, it will take some time for earnings changes to stabilize. However, for the next few quarters, we anticipate positive earnings which should boost market returns as a continued result of reopening (domestically and globally) coupled with easier monetary policy.

OUR VISION

The vision for the future is starting to become a bit clearer, but we still face hurdles with the continued unknowns surrounding the virus worldwide and at home. Additionally, it is yet to be seen the durability of the respected vaccines. While the vaccines have contributed to some "business as usual," time will tell, and as mentioned, business as usual might not be usual.

Our Market Outlook, which we inaugurated a year ago, has not known anything other than a pandemic environment. Our entire thesis over the past year has been geared toward one theme: the effects of the pandemic. It is somewhat reminiscent of the experience of the now "30-somethings" who, for the past 10 years or so since their entrance into the workplace post Great Recession, have not known anything other than low interest rates, low inflation, and a market with no major downturn or recession. It had been business as usual until the pandemic and resultant recession.

Trying to take history and mold it around the future is significantly more difficult this time around. We must be patient, we must think things through, and we must create the domino list. The domino list is a fail-safe of economics, as one action will trigger another, and so on. When we are forced to stay home, this means we will not travel, which means the transportation industry suffers, which dominos to energy. No cars on the road dominos to no customers for the local car wash; no customers dominos no car wax, which dominos to no employees needed, followed eventually by reduced dollars in the economy, and so on. As we emerge and recover, the same domino list needs to be created as things have changed, and now we need to think through each potential domino.

Central to our vision, and as a critical part of our Outlook process, our Macroeconomic Committee meets monthly to review the markets and economic indicators as a function of our fiduciary responsibility to our clients. Within these meetings we determine the appropriate allocation weighting between equities and fixed income for our clients who have portfolios containing both asset classes. Relative to the standard equity and fixed income split in a portfolio, our allocation will either be overweight equites (which means underweight fixed income), neutral (which means we position portfolios to agreed upon allocation target), or we underweight equites (and consequently overweight fixed income). At our meeting for this Market Outlook, we voted to maintain our overweight to equities by 5%, maintaining the same overweight positioning we voted to target at our November 2020 meeting. Our decision to maintain the overweight to equities rests on our belief in a continued recovery and a bond market presently enduring a low-rate environment because of accommodative monetary policy.

It has been a challenging 16 months or so, and we are not done yet. The world, and people, have changed. While we need to embrace the future, you can rest assured knowing our work and daily commitment to you, our clients, remains permanent and business as usual, contrary to the changing world around us.

end.

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