TFC FINANCIAL
The Financial Counselors

COMMENTARY | Q2 2021
July 2021

OUR VIEW

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Second Quarter Review

Equities continued to rise in the second quarter amidst optimism about economic growth and Covid-19 containment. Global equities, as represented by the MSCI All Country World Index, rose by 7.4% for the quarter and have returned 12.3% year-to-date through June 30. The S&P 500 gained more than 8%, for a year-to-date return of more than 15%. U.S. small company stocks gained 4% during the quarter, a slowdown from the torrid pace to start the year; small company stocks remain ahead of large company stocks for the year with gains of more than 17%. Developed international stocks, as measured by the MSCI EAFE Index, rose by more than 5%; the MSCI Emerging Markets Index also gained about 5% during the quarter.

Real estate was the top performing S&P 500 sector, gaining 13% during the quarter. The technology sector rebounded after a tepid first quarter, with returns of more than 11%. The energy sector also gained more than 11% for the quarter, bringing year-to-date returns to 45%. Utilities and consumer staples trailed in relative terms for the quarter and year-to-date periods. Commodity prices surged in response to economic reopening demand and supply chain disruptions, with oil, aluminum and copper among the big gainers. Although value stocks have outperformed growth stocks year-to-date, growth stocks surged into the end of the quarter and the value rally stalled.

The bond market rebounded after a difficult first quarter. The June Federal Reserve meeting gave notice to investors that the Fed may accelerate the timeline for tightening monetary policy. Investor consensus is that the Fed will begin reducing their purchases of Treasury and mortgage securities by the end of 2021, potentially bringing forward the first rate hike to late 2022. 10-year Treasury yields declined from 1.74% at the start of the quarter to 1.47% at the end of the quarter, contributing to a gain of 1.8% for the Bloomberg Barclays Aggregate Bond Index. The Bloomberg Barclays Aggregate Bond Index has declined 1.6% year-to-date. Municipal bonds continued to recover from last year's challenges.

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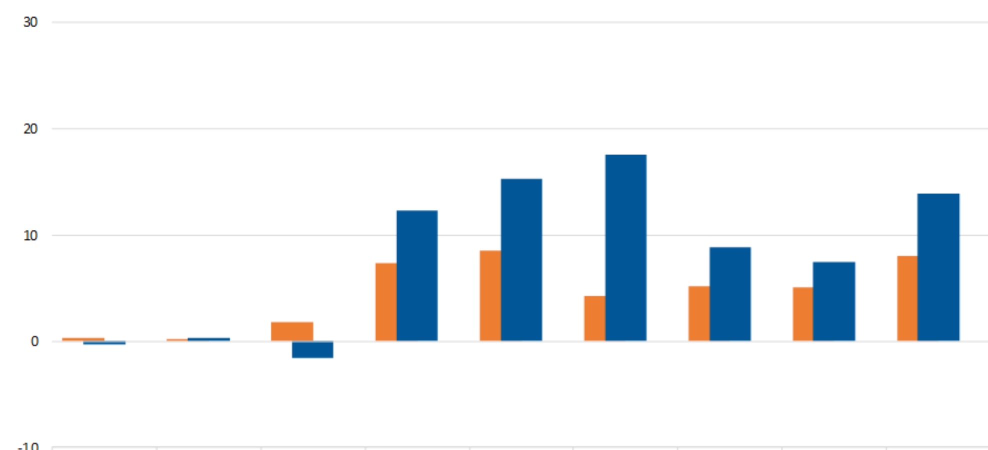
Quarter To Date Returns 6/30/2021



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	U.S. Small	Intl. Large Core	EM	Global Real Estate
QTD	0.3	0.3	1.8	7.4	8.5	4.3	5.2	5.0	8.1
YTD	-0.3	0.3	-1.6	12.3	15.3	17.5	8.8	7.4	13.9
Full Cycle*	2.6	1.8	2.8	19.3	21.6	27.6	12.3	20.1	3.0

* Full Cycle is the annualized return from February 12th 2020 peak to present.

Year-to-date, most TFC client portfolios have delivered positive absolute returns and have outperformed relative to client benchmarks. TFC's innovation and growth-oriented holdings contributed positively to absolute and relative performance in the second quarter. TFC's best performing holdings in the first quarter, U.S. small company value, lost momentum in relative terms despite delivering positive absolute returns. TFC's bond holdings gained ground in absolute and relative terms during the quarter.

Market Outlook

The U.S. economy appears to be approaching peaks in growth, inflation and policy stimulus. The economic boost from reopening is likely to slow in coming months; the surge of inflation caused by temporary factors such as rising used car prices, airfares, and supply chain disruptions are also likely to fade. Stimulus from fiscal and monetary policy is also likely to have peaked, with fiscal contraction in 2022 a possibility. With the U.S. economy reaching peaks in growth, inflation, and policy stimulus, there is significant "fog" of uncertainty about the future path for the economy and markets during the second half of the year. We expect to have a lot more visibility into the outlook after Labor Day; in particular, there should be more clarity about the state of the employment market after Labor Day, with schools reopening and enhanced unemployment insurance benefits expired. Given what we know now, we expect economic growth to fall from peak levels, but remain well above pre-pandemic levels into next year. We also expect inflation to stay above long-term trends, but to fall to levels that would not cause excessive damage to economic growth or stability. Inflation and debt sustainability remain long-term concerns, but we expect the day of reckoning on both issues to be a few years away.

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We are concerned, however, about the apparent conflict between the bullish economic signals provided by a rising stock market and bearish signals provided by falling bond market yields. There are a variety of plausible explanations for the seeming disconnect between the stock and bond markets, but we will monitor trends in both markets as we think about portfolio positioning and risk management.

Government policy is a common topic in client meetings and internal discussions. The Fed's intention to eventually reduce monetary stimulus is appropriate, as economic progress appears to support a gradual reduction in policy support. The Fed's change in tone should not be a major impediment for equities over the coming 6-12 months, barring a major rise in market expectations for interest rates and inflation. Sustained wage inflation could reshape the markets expectations for interest rates. TFC shares the consensus view that expiration of enhanced unemployment benefits and school reopening in September will ease tight labor market conditions. However, we are watching this "foggy" outlook closely for changes that would challenge our current expectations. Concerns about government spending may also be an overreaction. Much of the fiscal response to date in the U.S. and Europe has been aimed at supporting income that has been lost due to a drastic reduction in services spending. Proposals to increase government spending and raise taxes are the subject of heated debate and remain as potential catalysts for change in the economic and market outlook.

Covid-19 remains a threat. The Delta variant appears to be more transmissible and may increase the risk of hospitalization, but the most common COVID-19 vaccines in the U.S. offer high protection. Unfortunately, the pace of vaccinations has slowed significantly in the U.S. from mid-April levels, resulting in a slower rise in the share of the population that has received at least one dose. Covid-19 case counts are rising in parts of the country that have lower rates of vaccination.

Portfolio Positioning

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Global growth may be peaking but should remain above trend into next year. A strong growth, still-easy policy environment is a good backdrop for equities. Absent a major resurgence in the pandemic, a policy "error," or a sharper-than-expected deceleration in Chinese growth, the global economic expansion is likely to continue. Although equity returns will likely slow over the coming 6 to 12 months given how significantly stocks have rebounded from last year's low, stocks should continue to outperform bonds. TFC is positioned slightly above long-term strategic targets for stocks, expecting a continued recovery for the global economy and for corporate profits. Diversification within the equity portfolio continues to be important because the rotational shifts we have seen in recent years are happening so quickly. Diversification must be emphasized not just across sectors, but also across market cap, geographies, asset classes, and within asset classes. Just as important as diversifying is thoughtful rebalancing to trim back on areas that have outperformed and add to areas that underperform.

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We look forward to seeing you in person before the end of this year.

As always, we welcome your comments and questions.

Sincerely,

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