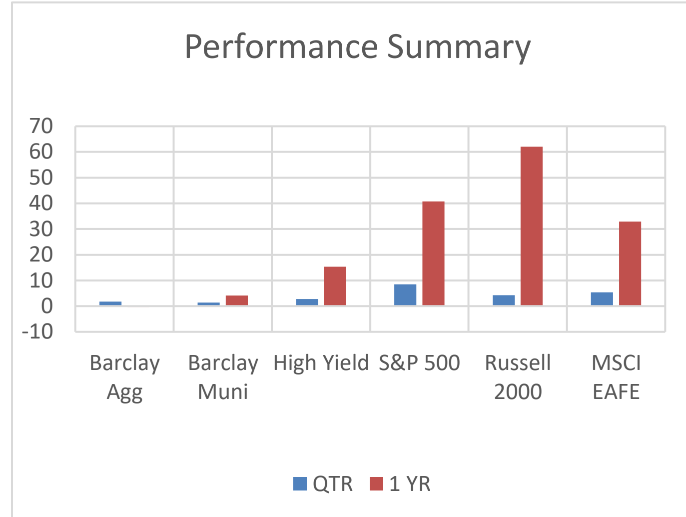


What a quarter it was for global stock markets-- just about everything was up! Overall, the Russell 2000 is up 17.5% for the year, the S&P 500 is up 15.3%, and the MSCI EAFE is up 9.2%. The first half of the year has been an ideal environment for financial assets. Under the surface there were some significant shifts in market performance during the quarter as the narrative shifted from an accelerating economy based on reopening to peak growth and peak inflation. This shift led to lower interest rates and a rotation into higher quality (but expensive) growth stocks, for the quarter U.S. growth stocks were up 11.9% compared to value stocks up 5.2%. Core bonds finished the quarter up 1.8%, while lower quality high-yield bonds did even better, up 2.7%.

- The message from recent market performance has been consistent: inflation pressures ease, bond yields fall back, earning momentum slows, all leading to growth stocks outperforming value. Rather than the end of the 'reflation' trade, we think it is more of a pause and reflation trades will reassert themselves, discussed in more detail below.
- The yield curve flattened in the second quarter as long-term inflation expectations declined based on Federal Reserves comments. We expect the Federal Reserve will allow economic growth to run "hotter" than normal and yields will increase in the back half of the year.

Below we touch on several topics relevant to investors: whether the economic cycle is at a mid or late stage; the impact of low bond yields on investors income and total return; and how quality stocks perform during inflationary periods.

Mid or Late Cycle?

Investors are debating whether the current economic cycle is in its mid or late stages of its economic recovery. This matters because the type of investment strategy that works in different stages of the economic cycle can vary greatly. In the early to mid-stages of economic recovery stocks that are more economically sensitive and value-oriented (financials, industrials, materials etc.) tend to outperform the broad market, and in the later stages of an economic recovery stocks that are growth-oriented and defensive tend to outperform (technology, staples, etc.). The chart to the right, from Ned Davis Research, sums up the relationship fairly well.

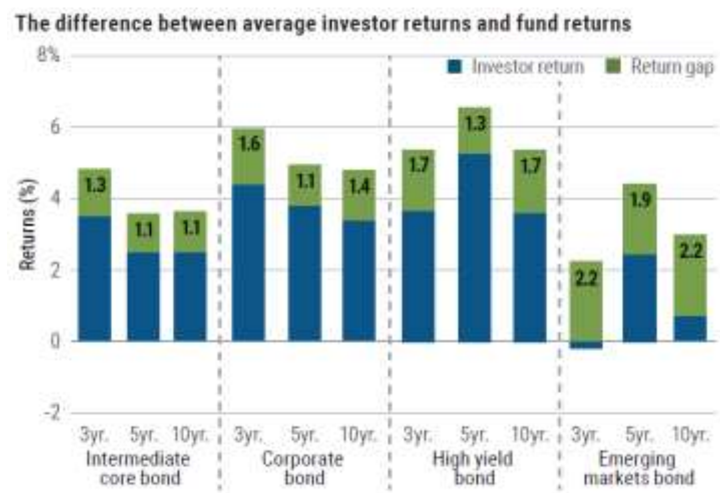
Investors reacted to the June Federal Reserve meeting as if the Fed was ready to put the brakes on the economic recovery and over tighten monetary policy. This reaction led to a flattening of the yield curve (lower long-term yields), a significant outperformance of growth stocks over value, and a sell-off in early economic cycle winners. This kind of market reaction can be described as late-cycle behavior, where investors start to believe the Fed is making a policy mistake, by turning too conservative, relative to where the economy is in the cycle. In our opinion, investors are overreacting to the Fed's message and will eventually realize we are still in the mid-range of the economic cycle, not the later stages. Below we highlight some of the reasons why we believe the economy/market cycles are near their midpoint and global stocks still have longer to run:

- S&P 500 earnings continue to be strong, with estimates for: up 35% in 2021 and over 10% in 2022
- The combination of monetary and fiscal stimulus will remain a net positive in 2021 and 2022
- Economic growth is peaking, but will remain strong and well above trend for a while
- Real yields remain very low (Fed funds – CPI) and at early cycle, not late cycle levels
- There is pent up demand and slack in the economy (room for unemployment to come down further)
- Consumer balance sheets, savings, and net worth are healthy and near all-time highs
- Capital spending is strong and accelerating; long-term we expect productivity to increase
- Global synchronization in the economic recovery

We think investors will become more comfortable with this view and the rotation back into mid-cycle investments will resume. At the margin, investors should position their portfolios towards cyclical, value, and foreign stocks, positioning themselves for higher interest rates and focusing on real return investments (alternatives, commodities, etc.). Clearly there are risks to this view (COVID variants, policy mistakes, geopolitical, etc.) and a correction in the market can happen anytime. In short, investors should resist the temptation to get too bearish.

Dude, Where's My Income (Return)?

Bonds have long played a key role in portfolios, providing income and total return, diversification from stocks, and capital preservation. However, low yields, inflation risks, rising rates, and high valuations in credit have investors reevaluating the role of bonds in their portfolios. We believe bonds can still provide some of these benefits, however, the current environment may require investors to adjust their expectations. First, investors will need to be realistic about future returns. The first chart to the right shows that the long-term return on core bonds is tightly correlated to starting yields at 94%. This simply means that when starting yields are low, long-term returns will be low and vice versa. Needless to say, with current yields on the Barclays Aggregate Bond Index around 1.5%, future returns are going to be low. In addition, when interest rates are this low, bonds are likely to provide less 'risk protection' during recessions and stock market selloffs.



To offset lower expected returns, investors will need to be disciplined in their bond investment decisions. The second chart to the right, from Morningstar, illustrates the impact lack of discipline can have on bond returns. It highlights, the total return achieved by funds in several bond categories compared to the return that investors in the funds actually earned. The difference is referred to as the 'Return gap' and reflects the poor timing decisions made by individual fundholders, which reduces their returns. Avoiding emotional and poorly timed investment decisions will be crucial to success in the low return years ahead.

Quality Stocks and Inflation

With inflation spiking this quarter, investors are rightly concerned about how their portfolios will perform in an inflationary world. To help answer this question, the research team at GMO did a study of how high-quality stocks performed during prior bouts of inflation. GMO identified eight periods in which U.S. CPI (consumer price index) remained above 5% for one year or longer and tracked the returns of the highest-quality stocks, the cheaper high-quality stocks, and the S&P 500 during these periods. The annualized returns are shown in the table and the average real returns (after inflation) are summarized in the chart, both below.

The results are clear, in prior periods of high inflation, quality stocks have outperformed the market by a wide margin. High quality outperformed in six of the eight periods, and 'cheaper' high-quality outperformed in seven of eight inflationary periods. The real returns provided by quality stocks were significantly higher, especially for cheaper quality stocks. Our take is sticking with a disciplined approach of holding quality-at-a-reasonable-price (QARP) stocks is a winning strategy for long-term success, and consistent with our approach at AWM.

Date	*Quality Return*	*Quality Value Return*	*S&P 500 Return*
6/1933-4/1935	14.4%	14.7%	4.9%
12/1940-5/1943	12.8%	18.5%	13.4%
3/1946-8/1948	5.3%	7.7%	1.9%
3/1950-12/1951	28.1%	35.6%	27.3%
6/1968-12/1970	3.3%	5.2%	-0.5%
2/1973-7/1982	2.5%	7.1%	4.8%
3/1988-1/1991	14.6%	14.3%	11.8%
2/2007-7/2008	-2.0%	-5.5%	-5.0%

Source: GMO

AVERAGE REAL RETURNS DURING INFLATIONARY PERIODS

Source: GMO

Closing Thoughts

These are unusual times for investors. Normal functioning in the financial markets is being distorted by excessive monetary and fiscal policy. This is suppressing interest rates, boosting the economy, and pushing investors to take more risk than normal. Creating a challenging environment for investors as some asset classes are clearly getting overvalued, and not knowing how long this ideal environment for financial assets will last. The best advice is to focus on your own investment goals and not worry about the general markets and what other investors are doing. The best way to get clarity on your investment goals is to do an in-depth financial plan. A good financial plan should look at your specific financial needs and help uncover what type of investment returns you need to achieve your goals and identify an acceptable amount of risk to take to achieve them. If you do not know the details of where you are today, where you want to go, it will be hard to build an investment plan that has a good chance of getting you there! If you need help building an investment strategy that can achieve your investment goals give us a call to discuss.

On the next page we review our outlook for the major financial asset classes.

Asset Class		* ↔ Neutral weight ↓ Underweight ↑ Overweight
Equities	***View****	***Comments***
U.S. Large Cap	↓	U.S. GDP is expected to be up 7% 2021 and over 5% in 2022. Even though growth is peaking it should remain substantially above trend for a while. We favor cyclical and value stocks and view the recent pull back as an opportunity to allocate to these areas. We are slightly under weight due to valuation and are allocating the difference to foreign stocks and alternatives that we believe can improve absolute and risk-adjusted returns the next few years.
U.S. Small/Mid Cap	↔	We are neutral to overweight on small/mid-cap stocks. We expect a strong economy to benefit small-cap stocks more than large-cap. They are likely to outperform large-cap stocks if interest rates and inflation continue to rise.
International Developed	↑	Valuations are attractive relative to U.S. stocks, and they are a little behind the U.S. in the economic cycle. This suggests there is more room for economic growth to increase. We like broad exposure to the foreign markets and would overweight dividend paying and value stocks in this environment. Strong global growth and a weak dollar should be a tailwind.
Emerging Markets	↑	Valuations are very attractive for the long-term. Emerging markets tend to be volatile and are always susceptible to further selloffs, but in a global economic recovery with low rates, a declining US dollar, and ample liquidity they should outperform.

Fixed Income		
Investment Grade	↓	With the 10- year treasury yield near 1.5% and real yields highly negative, we remain under-weight core bonds. We recommend keeping some exposure for disciplined risk management and diversification purposes. We are adding the difference to alternative asset classes.
High-Yield Bonds	↓	High yield bonds may continue to outperform as the economy recovers. However, investors should recognize valuations are high, and risk may be more like stocks if the economy slows. With credit spreads at all-time lows, we are cautious.
Municipal Bonds	↔	We are neutral on municipal bonds relative to Treasury bonds; however, they remain attractive for high tax-bracket investors.
TIPS	↔	TIPs are a hedge for higher inflation, we would hold positions in tax-deferred accounts as a long-term hedge against inflation and would favor them over traditional treasury bonds.
Floating-Rate Loans	↑	Similar to HY bonds, FRLs are likely to outperform core bonds in a strong economy. However, in a weak economic environment there is downside risk, we like small positions as a hedge against higher rates.
Emerging Markets	↔	This asset class can be volatile but also provides opportunity. Interest rates in many EM markets are higher than in the U.S.; we get some exposure thru our core bond managers and don't anticipate buying any direct positions.

Alternatives		
Absolute-Return/Alternatives	↑	We like this asset class and have raised our rating to overweight earlier this year, given the strong rally in stocks and bonds. We like alternative funds as a way to hedge volatility, provide real returns and improve the risk vs reward in portfolios.
REITs	↔	We are neutral on REITs. There are diversification benefits from owning REITs, however we recognize REITs may be structurally impaired in the future as a result of shifts in work habits and technology caused by the pandemic.
Commodities/Gold	↑	We view commodities as an effective way for long-term investors to diversify their portfolios and hedge against higher inflation. Commodities have bounced nicely off the bottom and should continue to perform well as the economic recovery continues. Gold and silver have underperformed YTD, however we still like small positions in portfolios as a hedge.

U.S. Stocks
Market Performance, Second Quarter 2021

Index	Q2 2021	1 YR
S&P 500	8.55%	40.79%
Russell 1000	8.54%	43.07%
Russell 1000 Value	5.21%	43.68%
Russell 1000 Growth	11.93%	42.50%
Russell Midcap	7.50%	49.80%
Russell 2000	4.29%	62.03%

Source: Morningstar

- Stocks rallied around the world. Investors rotated into growth stocks as concerns grew that the Fed may tighten policy earlier than expected. Growth outperformed value by close to 8% for the quarter.
- We believe we are at the mid-point of this economic cycle and expect investors to rotate back into cyclical and value stocks.
- Small-cap stocks lagged during the quarter; however, we expect relative performance to improve going forward.

International Stocks
Market Performance, Second Quarter 2021

Index	Q2 2021	1 YR
MSCI EAFE	5.38%	32.92%
MCSI EME	5.12%	41.36%
MSCI BRIC	5.48%	34.30%

Source: Morningstar

- Foreign developed markets had another solid quarter, but lagged US stocks. Longer-term valuations look more attractive than US stocks, and investors should maintain an overweight.
- Emerging market stocks also had solid returns but lagged their US counterparts. Valuations are relatively attractive, and investors should stay structurally overweight in the face of volatility.

Fixed Income

Market Performance, Second Quarter 2021

Index	Q2 2021	1 YR
Vanguard Total Bond Index	1.97%	(0.52%)
Barclays Muni Bond	1.42%	4.17%
Barclays US Corp High-Yield	2.75%	15.37%
JPM GBI- EM Global Diversified	3.54%	6.57
iShares TIPS Bond	3.21%	6.12%
BofA Merrill Lynch 3-month Treasury Note	0.01%	0.11%

Source: Morningstar

- Core bonds had a strong quarter as interest rates dropped during the quarter. Yields are very low and future returns are limited, however, core bonds still play a role in providing diversification and risk management.
- High-yield bonds had a strong quarter as yield spreads tightened towards all-time lows. We view high-yield as very overvalued and there is substantial downside risk when the next recession arrives. In our opinion, the risk vs. reward seems out of whack.

Alternative Assets

Market Performance, Second Quarter 2021

Strategies	Q2 2021	1 YR
PIMCO All Asset	6.09%	29.55%
AQR Diversified Arbitrage	1.32%	30.48%
JPMorgan Hedged Equity	4.02%	19.66%
Vanguard REIT	11.66%	34.33%
BNY Mellon Global Real Return	2.56%	15.78%

Source: Morningstar

- Alternatives were strong performers in the quarter and outperformed bonds by a wide margin. We are selectively bullish on alternatives and believe they can add substantial value to portfolios in the current environment. We view bonds as a source of funds.
- We like alternative assets as a strategic way to reduce risk and increase absolute returns in portfolios. We expect alternatives to significantly outperform bonds over the full market cycle. We view real return, commodity, precious metal and alternative strategies in general as an effective way to hedge against higher inflation.

Appendix:

Benchmark Definitions

U.S. Equity		Description
S&P 500	Index	The index includes 500 leading US companies and captures approximately 80% coverage of available market capitalization.
Russell 1000	Index	The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe and includes approximately 1000 of the largest securities. The Russell 1000 represents approximately 92% of the U.S. market.
Russell 1000 Value	Index	The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.
Russell 1000 Growth	Index	The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.
Russell Midcap	Index	The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.
Russell 2000	Index	The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.
International Equity		**Description**
MSCI EAFE	Index	The EAFE (Europe, Australasia, Far East) index consists of 21 developed market country indexes, excluding the US & Canada. It is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets.
MCSI EME	Index	The index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets and includes 23 emerging market countries in the index.
MSCI BRIC	Index	The index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the following four emerging market country indexes: Brazil, Russia, India and China.

Fixed Income		Description
Vanguard Total Bond Index	Index Fund	This index measures a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States—including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year.
Barclays Aggregate Bond	Index	The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-through bonds), ABS, and CMBS sectors.
Barclays Muni Bond	Index	The U.S. Municipal Indices cover the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.
Barclays US Corp High-Yield	Index	The index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market and excludes Emerging Markets debt.
JPM GBI- EM Global Divers	Index	The index tracks returns for actively traded external debt instruments in emerging markets. Included in the index are US-dollar denominated Brady bonds, Eurobonds, and traded loans issued by sovereign entities.
iShares TIPS Bond	ETF	The iShares TIPS Bond ETF seeks to track the investment results of an index composed of inflation-protected U.S. Treasury bonds.
BofA Merrill Lynch 3-month Treasury Note	Index	The 3-month US Treasury Note Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month, that issue is sold and rolled into a newly selected issue.
Alternative Assets		**Description**
PIMCO All Asset All Authority	Mutual Fund	The investment seeks maximum real return, consistent with preservation of real capital and prudent investment management. The primary benchmark for the fund is the S&P 500, with a secondary objective of Consumer Price Index +650 basis points.
AQR Diversified Arbitrage	Mutual Fund	The investment seeks long-term absolute (positive) returns. It invests in a diversified portfolio of instruments, including equities, convertible securities, debt securities, loans, warrants, options, other types of derivative instruments.
JPMorgan Hedged Equity	Mutual Fund	The investment seeks to capture the majority of the returns associated with equity market investments, while exposing investors to less risk than other equity investments. The fund invests in a broadly diversified portfolio of common stocks, while also selling index call options and purchasing index put options.

Alternative Assets		Description
Vanguard REIT	ETF	The investment seeks to provide a high level of income and moderate long-term capital appreciation by tracking the performance of a benchmark index that measures the performance of publicly traded equity REITs.
BNY Mellon Global Real Return	Mutual Fund	The fund allocates its investments among global equities, bonds and cash, and, generally to a lesser extent, other asset classes, including real estate, commodities, currencies and alternative or non-traditional asset classes and strategies, primarily those accessed through derivative instruments.