2021 MID-YEAR INVESTMENT UPDATE

U.S. Recovery from the Global Pandemic

FNBO Investment Management believes there are three primary reasons why the stock market is up 92.1% since the low on March 23, 2020.[1]

1 STRONG ECONOMIC REBOUND

In the 1st quarter of 2021, the U.S. economy grew 6.4%, reflecting robust consumer spending on goods, the reopening of businesses, and continued government spending related to COVID-19.[2] For 2021, economists expect U.S. GDP growth of 6.6%.[3]

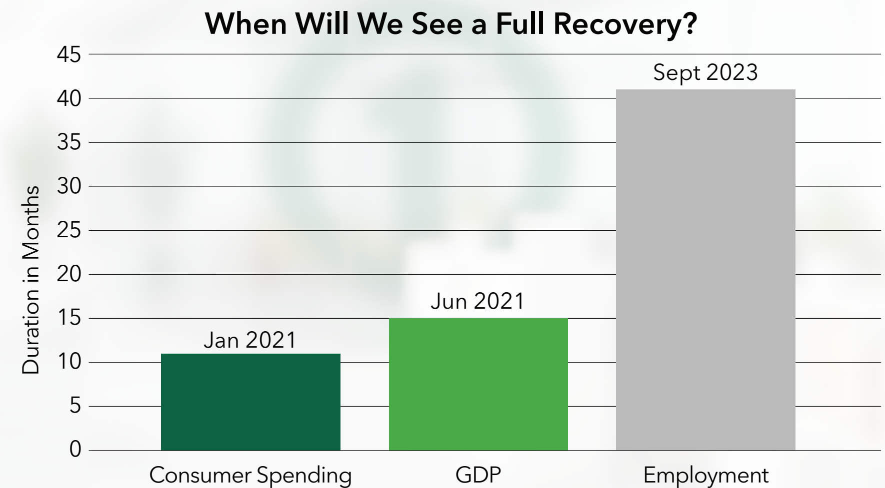
2 LIQUIDITY

Federal Government spending continues with the Congressional Budget Office (CBO) projecting a budget deficit of $3.0 trillion in 2021 on top of record spending last year.[4] In addition, the Federal Reserve is buying $120 billion in securities each month and maintaining the Fed Funds rate close to 0%.[5]

3 CORPORATE EARNINGS

Over the last year, corporate earnings have surpassed expectations by a significant amount as analysts have underestimated the economic recovery and profitability of companies.

The economic recovery has been uneven across industries, income, and demographic groups. As illustrated in the "When will we see a full recovery?" chart, consumption expenditures exceeded the prior high in January of this year. As consumer spending accounts for a significant portion of the U.S. economy, gross domestic product (GDP) benefited and surpassed prior levels in June. One area of the U.S. economy that is lagging is the labor market with the full recovery of employment not expected until late 2023.



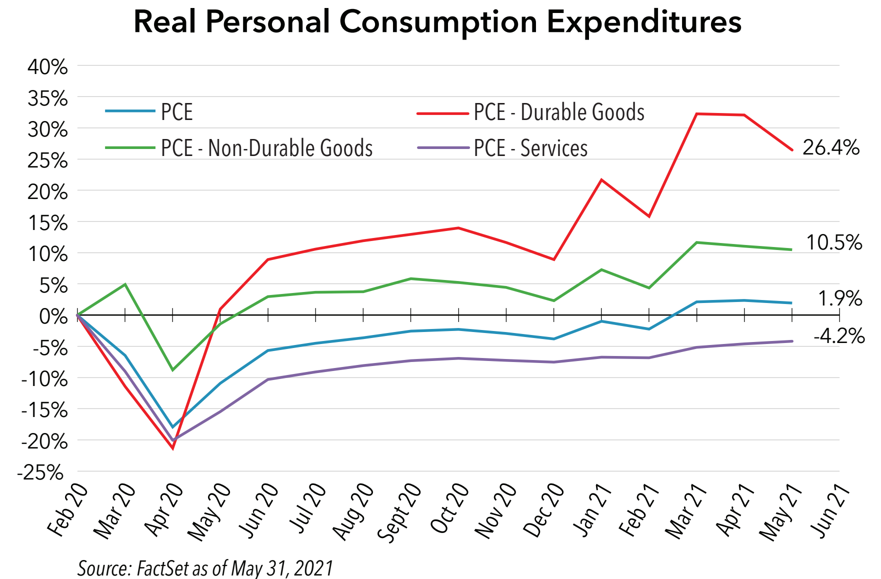
We evaluate the outlook for the economy, liquidity and corporate earnings to determine our view on the stock market.

① STRONG ECONOMIC REBOUND

Consumer spending on goods is growing at a faster pace than the overall economy, as individuals are purchasing big-ticket items, such as cars, electronics, and appliances. The "Real Personal Consumption Expenditures" graph shows durable goods spending rose 26.4% since February 2020. Non-durable goods spending, which includes food, healthcare and clothing, has also been resilient.

Real services spending fell over the last year as individuals were unable to purchase some services due to pandemic restrictions. We expect spending to recover in the second half of the year due to the pent-up demand for travel, leisure activities, and dining. The potential services recovery offers upside for additional consumer spending.

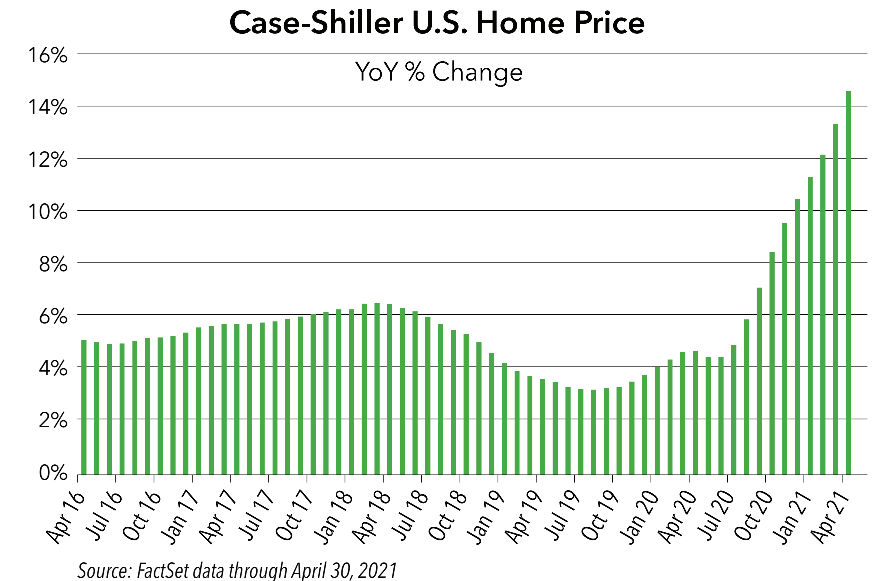
In our opinion, the outlook for consumption is strong as individuals have high levels of cash. The savings rate as a percentage of disposable income is currently 12.4%, above the 15- year average of 7.5% in the U.S.[6] We expect that the growth in services may be partially offset by a modest decline in durable goods.



Source: FactSet as of May 31, 2021

The U.S. housing market has been strong as work-from-home has encouraged relocation from urban apartments to suburban homes. Price increases have been spiking over the last year, as buyer demand outstripped supply. The inventory of homes for supply rose slightly in May but remains 21% lower than the prior year, according to the National Association of Realtors.[7] Historic low mortgage rates coupled with the Federal Reserve buying agency mortgage-backed-securities (MBS) has contributed to the housing boom.

As shown in the "Case-Shiller U.S. Home Price" graph, home prices reported an annual gain of 14.6% in April with many cities appreciating by over 20%. There has been growing discussion of a price bubble in the housing market, but the fundamentals of the market indicate continued strength. We expect housing prices to moderate but remain supportive of economic growth.



Source: FactSet data through April 30, 2021

STRONG ECONOMIC REBOUND

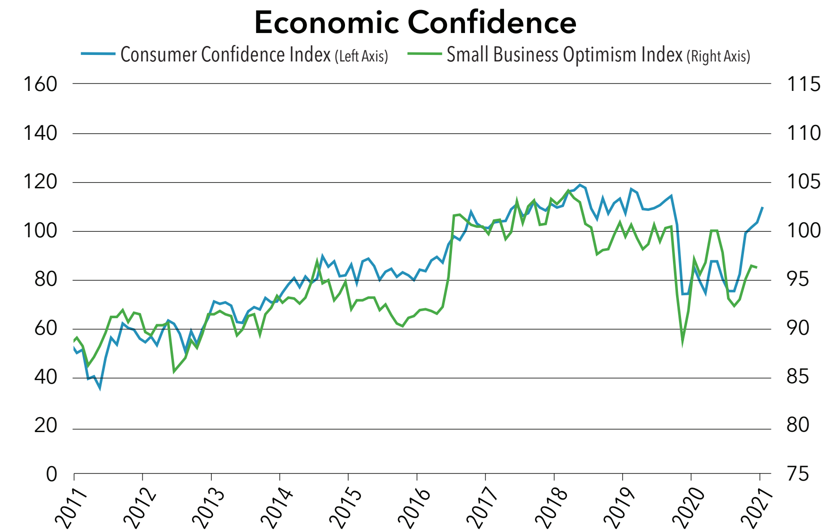
Economic indicators we monitor include the Consumer Confidence and Small Business Optimism Index. As depicted in the "Economic Confidence" chart, consumer confidence has rebounded sharply and is fairly close to pre-pandemic levels. One factor likely causing this surge is the rise in household net worth. A recent Federal Reserve report showed household net worth up $5 trillion as individuals benefited from the price gains in real estate and the stock market.[8] Typically, changes in household net worth are closely correlated with growth in consumption.

Small business optimism has also ticked higher in 2021, with company owners reporting an improved sales environment. Businesses are passing on higher operating costs and wages, resulting in high profitability on average. Companies have increased capital spending, which is critical to the improvement of worker productivity.

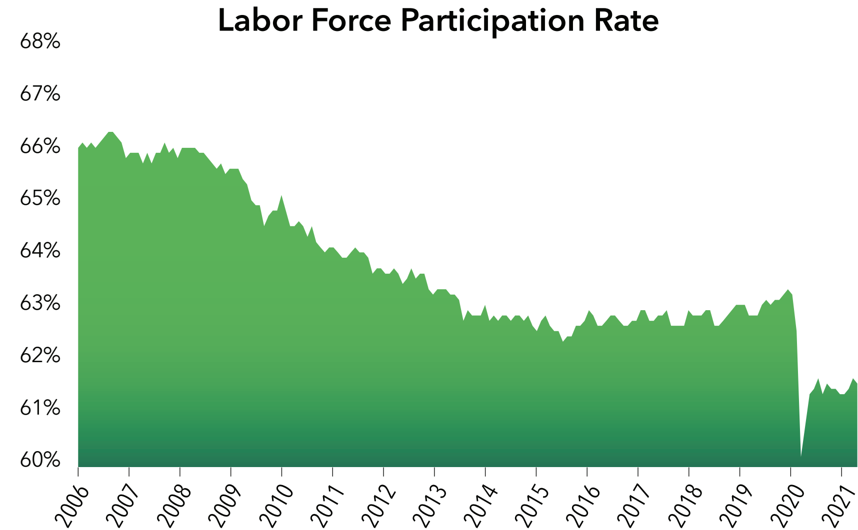
Employment Risk

The labor shortage remains an issue facing businesses. Total nonfarm payrolls were 144.9 million workers in May 2021, down 7.6 million workers from February 2020.[9] The labor force participation rate, which is the share of those age 16+ who are either working or looking for work, was 61.6% in June. Some of the most common reasons for not working include business closures, as well as childcare access, elderly care, and lack of transportation. Additionally, some workers that are near retirement age have made the decision to retire rather than come back to the office.

We see multiple catalysts for an improving job market and increased labor force participation. The first being supplemental benefit programs are ending in states between June and September. Second, most students in the U.S. are expected to resume in-person schooling this fall, enabling parents to return to the workforce. Lastly, job openings have increased to record levels and are now close to the total amount of unemployed workers.



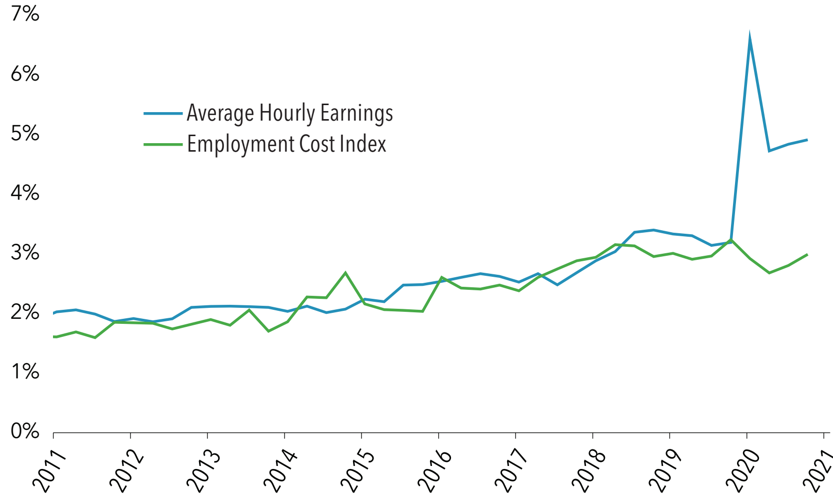
Source: FactSet through May 31, 2021



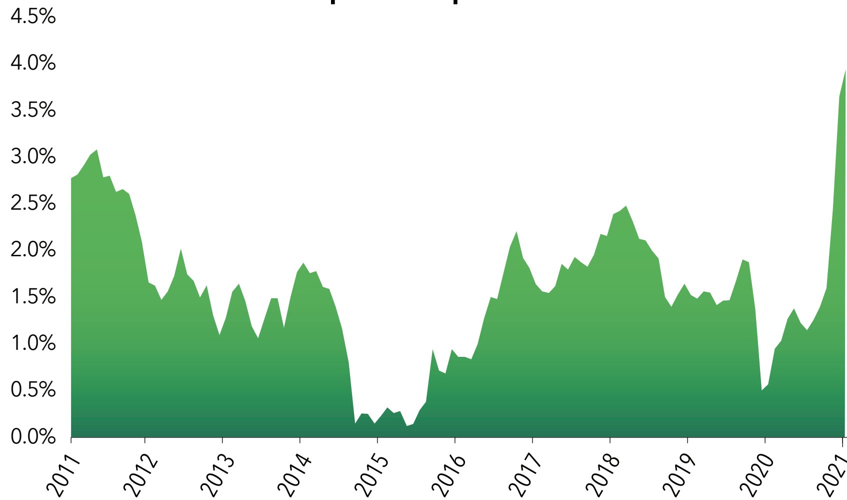
Source: FactSet as of June 30th

Although we expect improvement in the labor market, high unemployment remains a primary risk to a sustainable U.S. expansion.

STRONG ECONOMIC REBOUND



Source: Federal Reserve Bank of St. Louis through April 1, 2021



Source: U.S. Bureau of Economic Analysis through May 1, 2021

Businesses have responded to the difficulty to attract and retain workers by increasing wages. As illustrated in the "Growth in Compensation" graph, average hourly earnings were up 4.9% over the last year. This series has been affected by the shift in composition of the workforce as job losses at the beginning of the pandemic were concentrated in lower paying industries.

A second compensation indicator, the employment cost index (ECI), has gradually increased over the last 10 years and rose the most in 14 years in the first quarter.[10] Evercore ISI expects an acceleration in wages in the second quarter as employers try to find qualified workers. With wages representing the largest cost for most businesses, especially in service industries, an increase in labor costs could put upward pressure on prices and lead to higher interest rates.

Inflation Risk

Prices have accelerated in recent months, as indicated in the "Personal Consumption Expenditures Change Price Index" chart. The current economic debate is whether higher inflation is transitory, as the Federal Reserve believes, or is more problematic. Fed policymakers have noted that current price pressures reflect temporary strong demand as the economy reopens and expects easing in some of the supply chain bottlenecks.

For business owners and consumers, however, the average American family is enduring higher prices. Food, energy, and shelter combined represent around 50% of pre-tax income.[11]

COVID-19 Risk

With fairly high levels of vaccinations and the corresponding reduction in COVID-19 hospitalizations and deaths, the U.S. has effectively reopened its economy. The outlook for the rest of the world is more mixed with some countries reporting a spike in cases due to the contagiousness of the Delta variant. A potential global economic slowdown from the continued spread of COVID-19 could negatively impact U.S. growth.

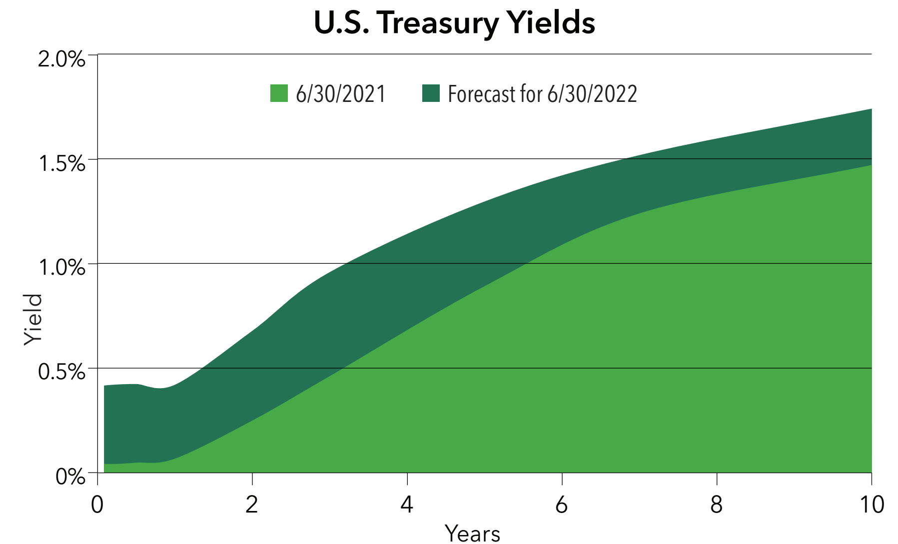
We see the potential of greater than expected inflation and higher interest rates as a primary risk. The possibility that vaccines could prove ineffective vs. COVID-19 variants remains a main risk to a sustainable U.S. expansion.

LIQUIDITY

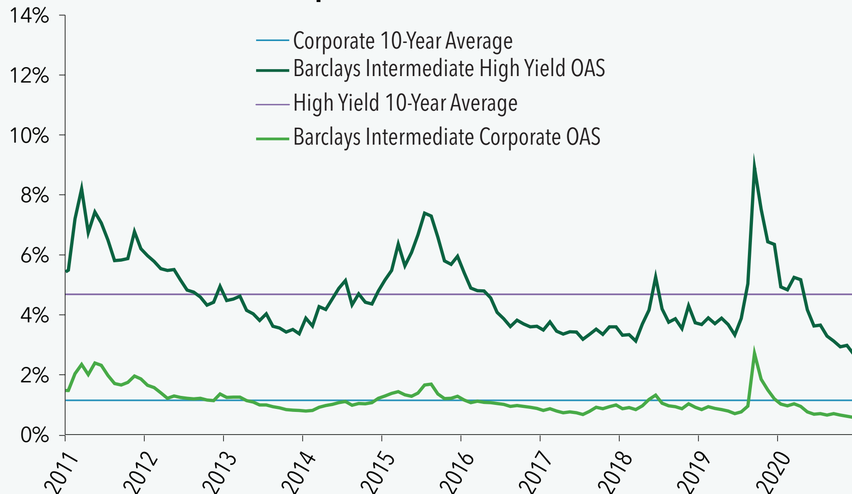
We view liquidity as a function of Federal Reserve support and government spending. The Federal Government is likely to maintain a substantial budget deficit, supporting economic growth. Excluding additional spending from an infrastructure deal, the CBO estimates a $1.15 trillion deficit for 2022.[12]

The Federal Reserve is contemplating the amount of monetary support. In the June FOMC meeting, the Fed adjusted their first interest rate hike to be in late 2023. They plan to wind down the pandemic-era corporate bond buying program and later this year may provide guidance on tapering the monthly purchases of Treasuries and agency MBS.[13]

After a spike in interest rates early in 2021, yields have stayed fairly steady. As illustrated in the "U.S. Treasury Yields" chart, yields are close to 0% for shorter maturity bonds and less than 1.5% for longer maturity bonds. As of June 30th, the fixed income market appears to be aligned with the Fed's view on inflation, as yields are only expected to modestly rise over the next year.



Source: Bloomberg as of 06/30/2021



Source: Bloomberg data as of 6/30/2021

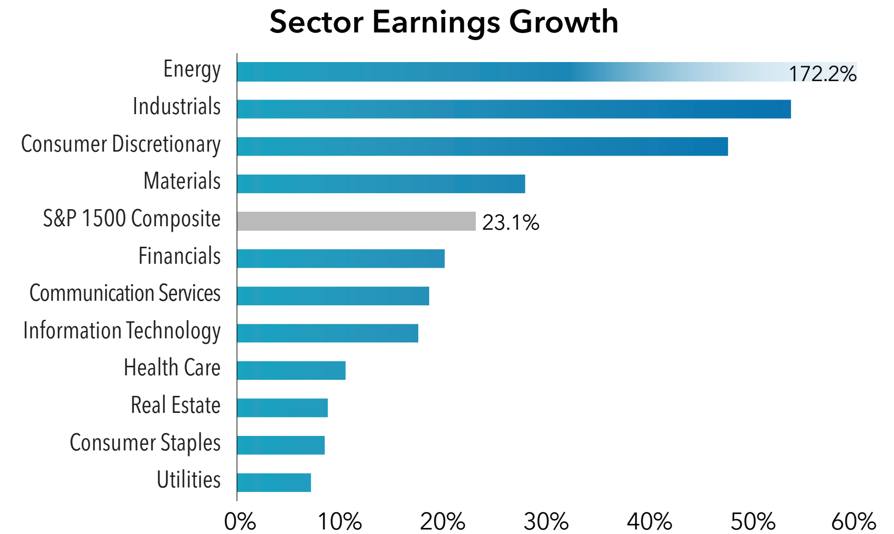
Economic growth and increased pricing power in certain industries have led to a sharp rebound in earnings, reducing credit spreads. The "Corporate Bond Index" graph shows corporate spreads are at their lowest level over the last 10 years for both investment grade securities and high yield bonds. The spread, or yield advantage, over government bonds compensates investors for the additional default risk, which is currently low.

The story is similar in municipal bonds with scarce issuance by municipalities and cash inflows into the market. Relative to history, municipal bonds are not attractively valued and vulnerable to higher Treasury yields or a shift to higher spreads relative to Treasuries.

CORPORATE EARNINGS

Over the long-term, we believe equity prices are closely correlated with the profit outlook of companies. In reviewing past market cycles, the peak in the stock market has coincided with an earnings top. Since mid-2020, company profits have exceeded expectations as analysts have underestimated the strength and pace of the economic recovery. We expect further positive results this quarter as companies report earnings.

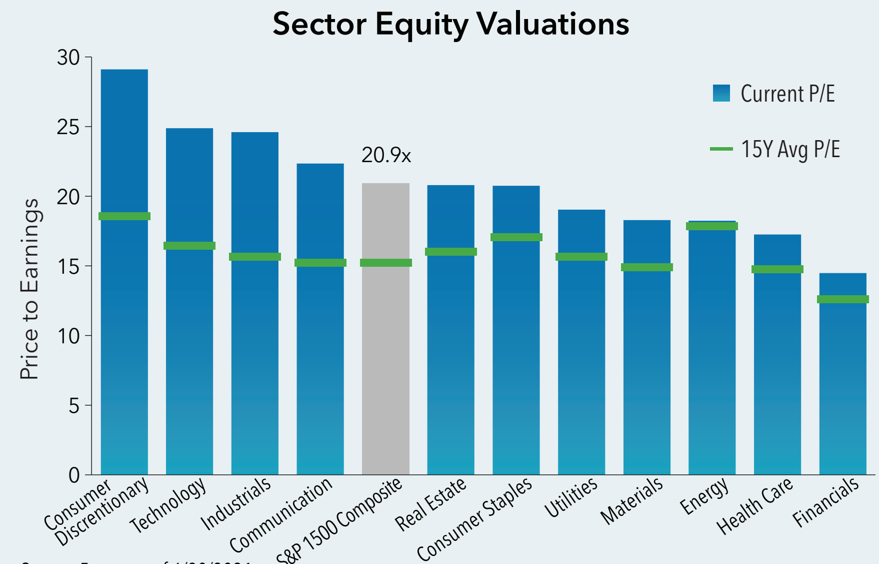
In the "Sector Earnings Growth" table, all economic sectors are participating in the recovery. As of June 30th, profit growth of 23.1% is expected over the next 12 months.[14] In evaluating the sector composition, the cyclical areas of the market (energy, industrials, consumer discretionary) are expecting earnings growth of over 40%. The defensive areas, such as real estate, consumer staples and utilities are anticipating more subdued growth. Growth in company profits are supporting the stock market appreciation.



Source: Factset as of 6/30/2021; Energy earning growth 172.2%

Some of the positive earnings outlook is priced into the market with U.S. equities trading at high valuations. The "Sector Equity Valuations" chart illustrates the U.S. market price-to-earnings (P/E) ratio of 20.9x, well above the 15.2x historical average. Excluding energy, the sectors expecting the most profit growth are trading at the highest premiums.

We use market valuations as a sentiment indicator. Our current assessment is that investors are optimistic about the economy and corporate earnings environment. When combined with low interest rates, we believe that in the short-term profit growth can justify the high valuations.



Source: Factset as of 6/30/2021

OUR OUTLOOK & STRATEGY ADJUSTMENTS

In the second half of 2021, we expect a similar macro-environment and tactically favor equities over fixed income. Our expectation is economic growth may moderate somewhat later this year from the 6% level but remain in the 3 – 4% range. In our opinion, the economic expansion will lead to a continuation of strong corporate profitability with positive earnings results. We expect liquidity to remain high with the federal government and Federal Reserve supporting the economy. With likely higher economic risk in 2022 and premium stock market valuations, however, equity gains may be limited.

Within equities, we continue to favor U.S. equities over international equities based on the strength of the U.S. economy and excess liquidity. Our investment thesis of an attractive post-recession opportunity in U.S. small- and mid-cap (SMID) stocks remains intact. During the second quarter, we added exposure to our global real estate fund.

Market leadership has broadened from high returns in large cap growth companies. As depicted in the "Equity Return Comparison" table, small cap and value stocks are outperforming in 2021. We believe that a diversified equity portfolio will continue to add value relative to concentrated growth holdings.

In fixed income, real interest rates (yield minus inflation) are negative with inflation exceeding the yields across maturities less than 10 years. Over time, we expect interest rates to ebb higher with the 10-year Treasury ending the year below 2%. We limit interest rate risk in bond portfolios by emphasizing short and intermediate maturity securities and have recently added an allocation to floating rate investments. Floating rate bonds have a variable interest rate, which can be a benefit in a rising interest rate environment. On a relative basis, we believe bonds are not attractive as compared to other asset classes due to our expectation of low returns over the next few years.

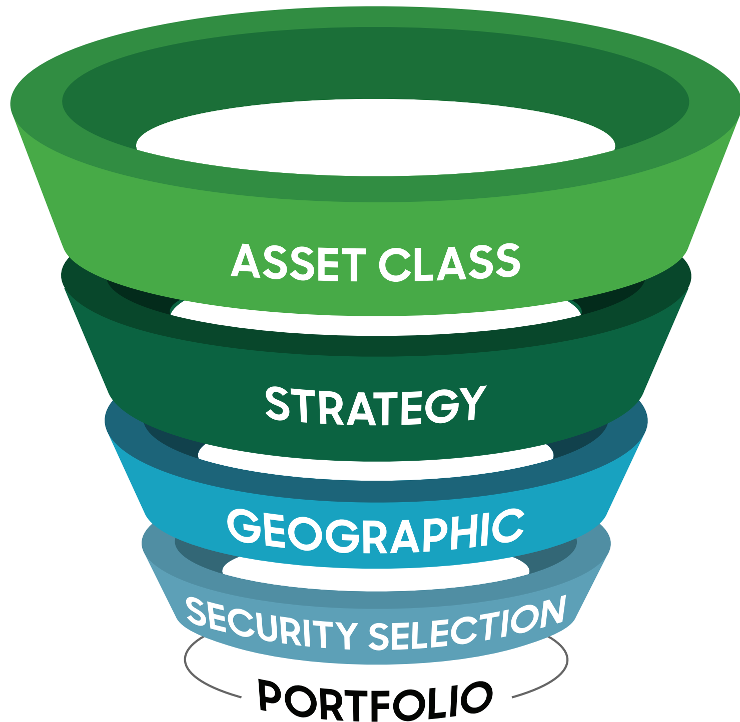
Equity Return Comparison

Market Cap	2020	2021 YTD
Large Cap	21.7	14.5
Small Cap	16.4	16.3

Style	2020	2021 YTD
Growth	44.7	14.6
Value	-1.3	17.0

Source: Morningstar; Returns as of 6/30/2021

In our opinion, alternative investments (Alts) offer the potential to diversify investment portfolios, while striving to meet client return goals. Currently, our primary holding is through a hedged equity mutual fund that provides exposure to U.S. equities while offering some downside protection through the use of options. Earlier this year, we added an allocation to a commodities fund, which may help protect client portfolios against inflation.



Market adjustments in all asset classes are occurring more rapidly, shrinking the window to capitalize on investment opportunities. As a result, investing for the long-term in a diversified portfolio is even more critical for investment success. We believe investors should diversify at the asset class, strategy, geographic, and security selection level. Finding the right asset mix for your portfolio is a personal decision based on goals and risk tolerance.

With the dynamic and ever-changing market in a post-COVID-19 world, we believe it's an excellent time to review your financial goals and confirm the asset allocation plan with your advisor team.

We hope you found this year's Mid-Year Investment Update thought-provoking and beneficial.

Kurt Spieler, CFA®
Chief Investment Officer

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For 2021 Outlook asset class definitions, key terms, and model definitions, please visit www.fnbo.com/outlookdefinitions.

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Sources:

1 Yahoo Finance; S&P 500 Price Return from 3/23/2020 – 6/30/2021
2 U.S. Bureau of Economic Analysis; Real Gross Domestic Product (GDP) rate released June 24, 2021
3 Bloomberg Economic Forecasts as of 06/30/2021
4 Congressional Budget Office estimates as of July 1, 2021
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7 National Association of Realtors; May Existing Home Sales Report released June 22, 2021
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9 First Trust, June 21, 2021 Outlook "www.ftportfolios.com"
10 Wall Street Journal; "U.S. Job Openings Held at Record Level Headed Into Summer" released July 7, 2021
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