LOOK AHEAD

Q3 2021

DISCLAIMER

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The Consumer is in Control

Hourly Wage Growth Pre-Pandemic vs. Current

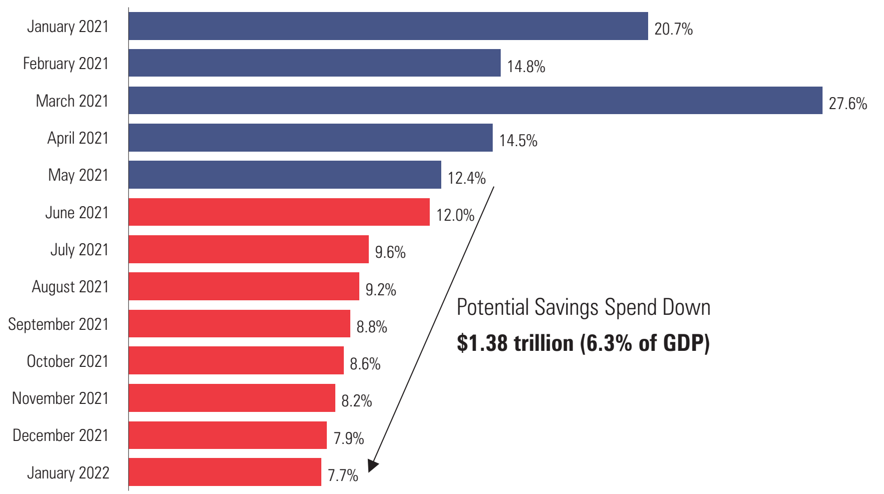
	Average Hourly Wage		
Sector/Industry	**Pre-Pandemic February 2020**	**Current May 2021**	**Wage Growth %**
Durable Goods Manufacturing	$10.42	$11.48	+10.17%
Finance	$14.24	$14.97	+5.13%
Retail	$7.80	$8.10	+3.85%
Textile Mills	$8.14	$8.44	+3.69%
Nonmetallic Mineral Manufacturing	$9.85	$10.19	+3.45%
Leisure & Hospitality	$6.53	$6.74	+3.22%
Printing	$9.32	$9.60	+3.00%
Wood Products	$8.44	$8.69	+2.96%
Motor Vehicles & Parts	$10.73	$11.02	+2.70%
Professional & Business Services	$13.30	$13.61	+2.33%
Overall	**$9.50**	**$9.74**	**+2.53%**

Taken alone, $2.3 trillion in stockpiled savings is 10.4% of GDP.

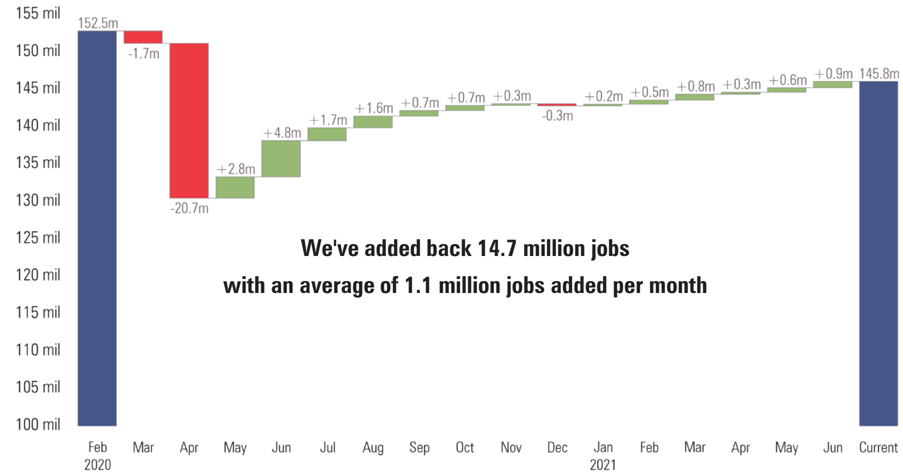
Assuming consumers continue to spend down their savings as the economy reopens, it is not far-fetched to see the personal savings rate return to pre-COVID levels by January 2022.

Potential Spend Down of Personal Savings

Savings rate as a % of disposable income



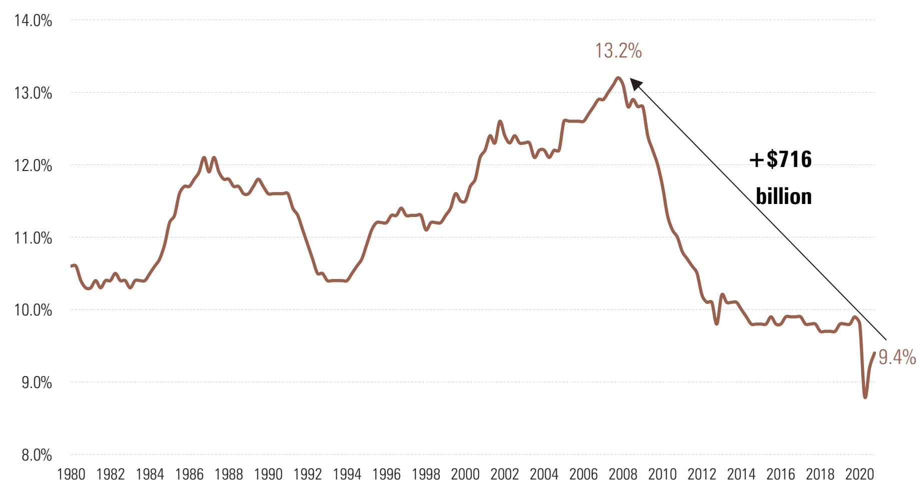
Jobs Gained & Lost since the Pandemic Began



Even at the tail-end of the pandemic, consumer debt to disposable income is still at multi-decade lows.

If consumers returned to prior peak levels of debt service, it could total $716 billion or 3.2% of GDP.

Interest Payments as a % of Disposable Personal Income



Data Sources: Bureau of Labor Statistics, Federal Reserve Bank of St. Louis

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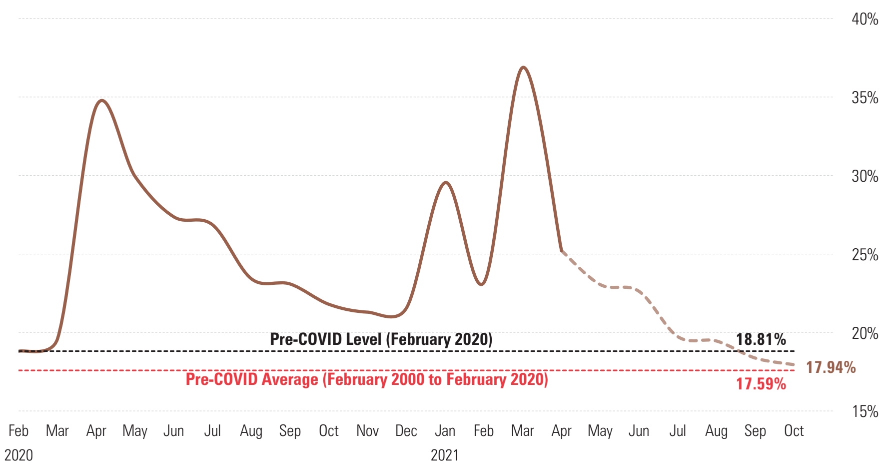
A Bumpy Ride Back to Normal

Government transfer payments as a share of disposable income remain elevated but are declining. If the next few months follow a similar trajectory as Q2-Q3 2020, we could see this ratio decline back to pre-COVID levels by October.

Government Transfer Payments % of Disposable Personal Income

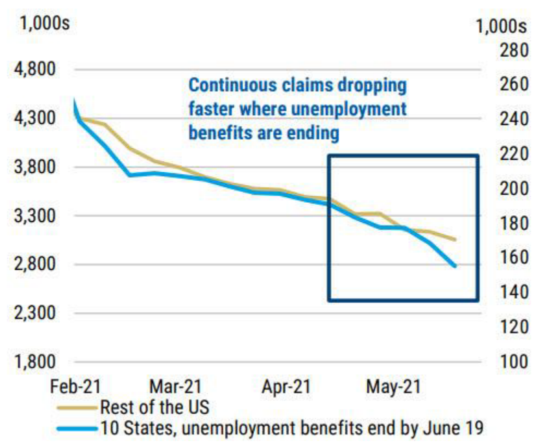


Right now, with extra benefits the "get off the couch" wage is $19.35/hour. By removing the $300 per week in additional federal unemployment benefits, the "get off the couch" wage drops to $11.85/hour.

Implied Minimum Wage *Including* Extra Federal Unemployment Benefits

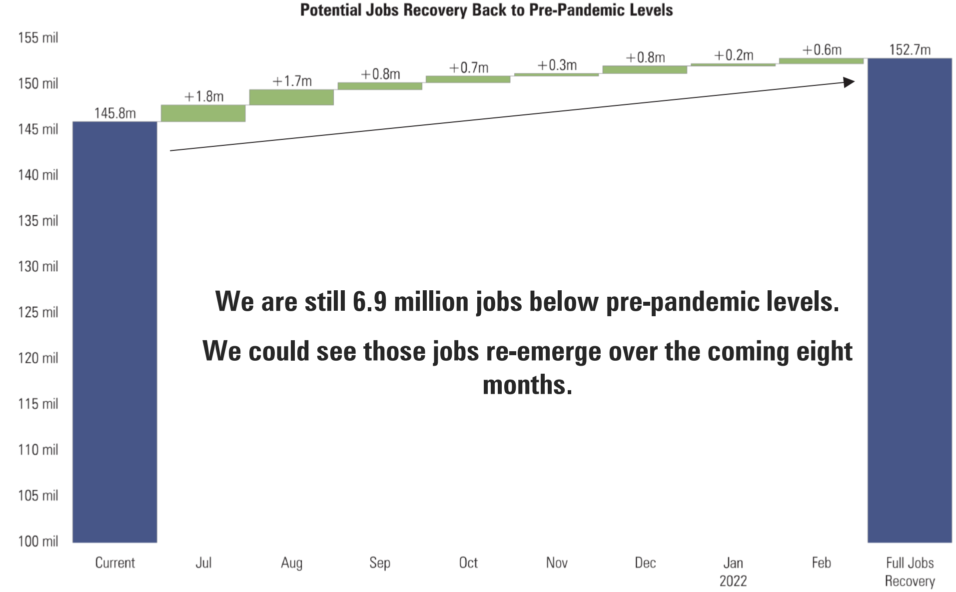
Implied Minimum Wage *Excluding* Extra Federal Unemployment Benefits

Continuing jobless claims in 10 states where Federal unemployment benefits expire relative to the rest of the US



With 26 states cutting off extended unemployment benefits early, a return to work will likely accelerate and perhaps lessen wage inflation in the coming months.

Potential Jobs Recovery Back to Pre-Pandemic Levels



Data Sources: Federal Reserve Bank of St. Louis, FileUnemployment.org, Morgan Stanley

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Earnings Expectations – The Base Effect Continues

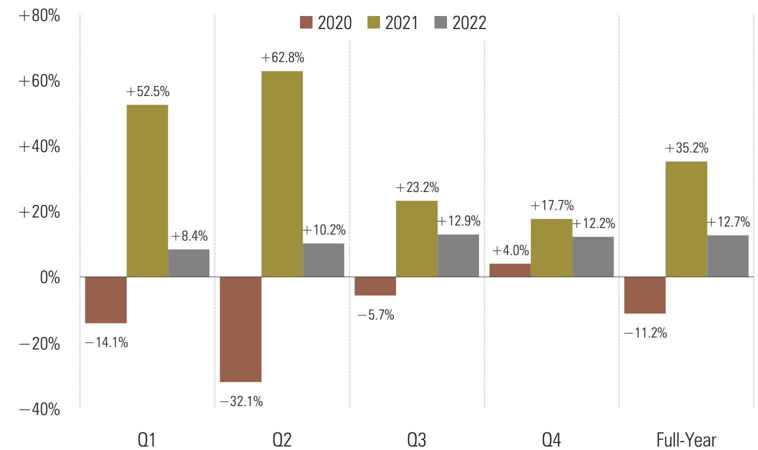
Valuations on U.S. equites remain elevated. Current valuations run the risk of much higher volatility as events unfold in the coming quarter.

S&P 500 Forward Price-to-Earnings (Next Twelve Months Estimates)

On a forward basis, the S&P 500 is currently trading **20.2%** above the 5-year average and **35.1%** above the 10-year average P/E ratio.

The base effect in corporate earnings likely won't be felt until Q2 when we compare to Q2 2020 when we were at the depths of our full economic freeze.

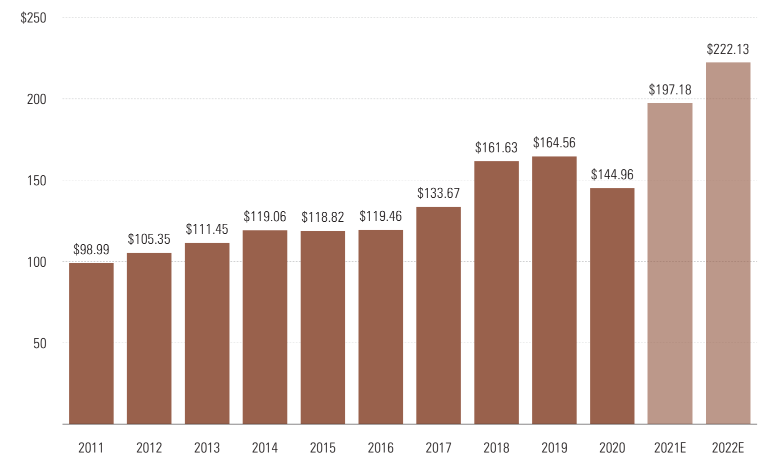
S&P 500 Earnings Growth: 2020 – 2022



Investors should look at raw dollars and see if they are buying real dollar growth or simply base effect percentage growth.

Raw dollars for the S&P 500 are expected to return to growth compared to 2019 and 2020. In fact, full-year 2021 will be more than just a play on percentages but real earnings growth in absolute dollars.

S&P 500 Calendar Year Earnings per Share



Data Sources: Bloomberg, FactSet

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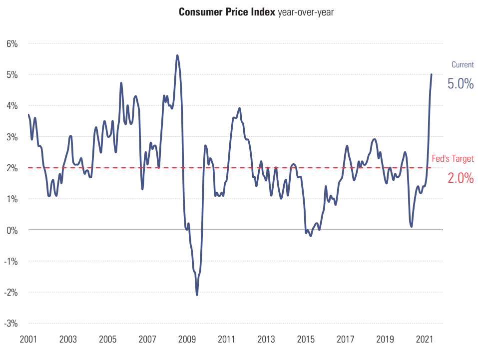
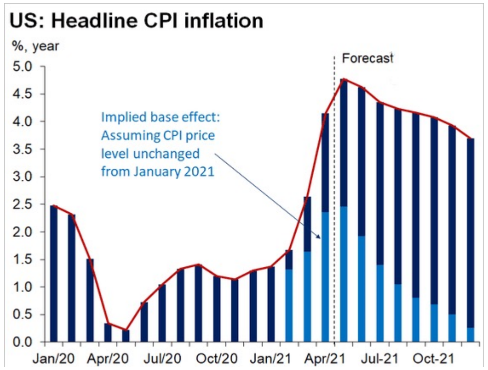
Higher Inflation – Lots of Noise, Not Enough Signal

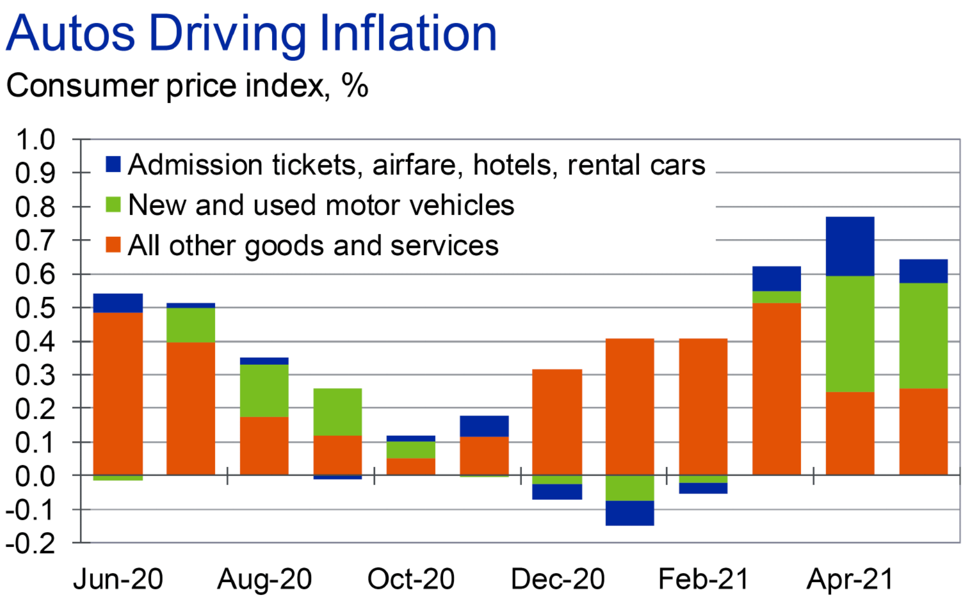
(Transitory Inflation)

Headline CPI for May was reported at a whopping 5%. But when breaking the components of the Consumer Price Index down further we can see the culprits driving inflation right now are areas that were hit the hardest by the pandemic. This is the "Base Effect" at work.



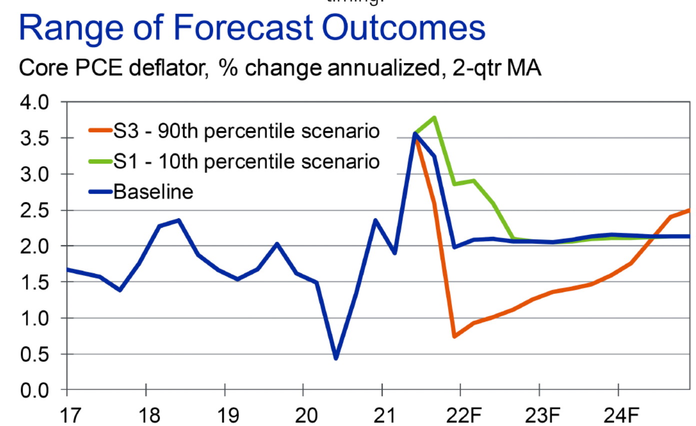


Admission tickets, airfare, hotels and rental cars accounted for about 25% of April's CPI increase and 10%-15% of the rise in May.



What's Ahead?

Per analysis by Moody's Analytics, baseline core PCE inflation is expected to settle around the Fed's 2% target by late 2022. Moody's expects CPI inflation to peak slightly higher but follow a similar timing.



Right now much of the inflation we are seeing is cost-push inflation, which is generally transitory, mostly driven by supply shocks (generally in oil but, post-pandemic it could be anything) which should normalize over the next year.

So, what's the proof that we are in a transitory cost-push inflation environment? Look at the 10-year treasury yield which has dropped as investors are grabbing yield while they can before a potential softening of inflation is seen.

Data Sources: Federal Reserve Bank of St. Louis, Moody's

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Fixed Income – The Year of Living Dangerously

It is still tough to find total return in Fixed Income, as shown by the steep year-to-date declines for longer-dated Treasury ETFs.

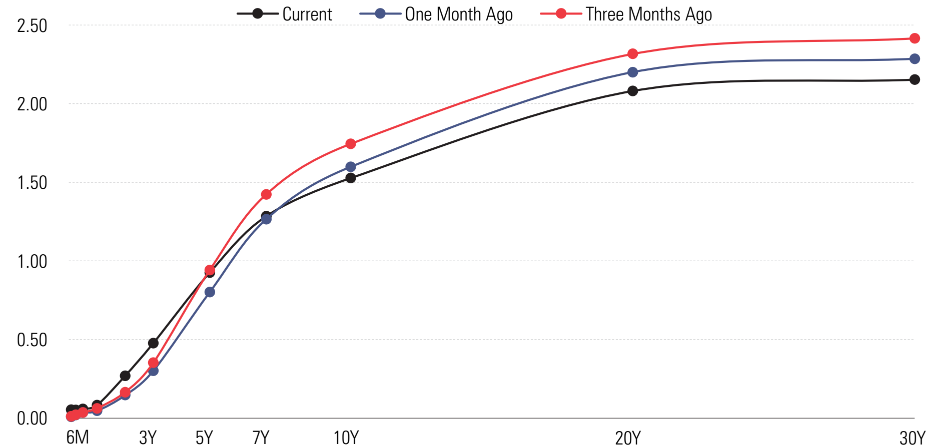
Hardest Hit Areas of Fixed Income Year-to-Date

Ticker	Name	Price	Yield (%)	YTD TR (%)
EDV	Extended Duration Treasury Bonds	135.35	2.07	−11.13
TLT	20+ Year Treasury Bonds	144.35	1.66	−8.48
TLH	10-20 Year Treasury Bonds	146.95	1.51	−7.71
BLV	Long-Term Bonds	103.03	2.80	−5.74
VCLT	Long-Term Corporate Bonds	106.94	3.08	−3.72
IEF	7-10 Year Treasury Bonds	115.49	0.82	−3.72
EMB	Emerging Markets Bonds	112.46	3.82	−2.98
BIV	Intermediate-Term Bonds	89.96	1.88	−2.77
LQD	Investment Grade Corporate Bonds	134.36	2.29	−2.73
BND	Total Bond Market	85.89	1.85	−2.55
AGG	Core U.S. Aggregate Bonds	115.33	1.74	−2.42

- Yield chasing will increase exposure to companies who may be at higher risk of default or downgrades by credit rating agencies.
- The least risky part of the yield curve currently looks to be in the 2-to-5-year range. This should press down on income returns and mitigate the risk reduction advantages fixed income can provide.

It's clear the Fed wants to do their part to lift wages on the lower end of the income spectrum. However, they will need to balance the increase in long-term interest rates within the real economy against an ongoing economic expansion.

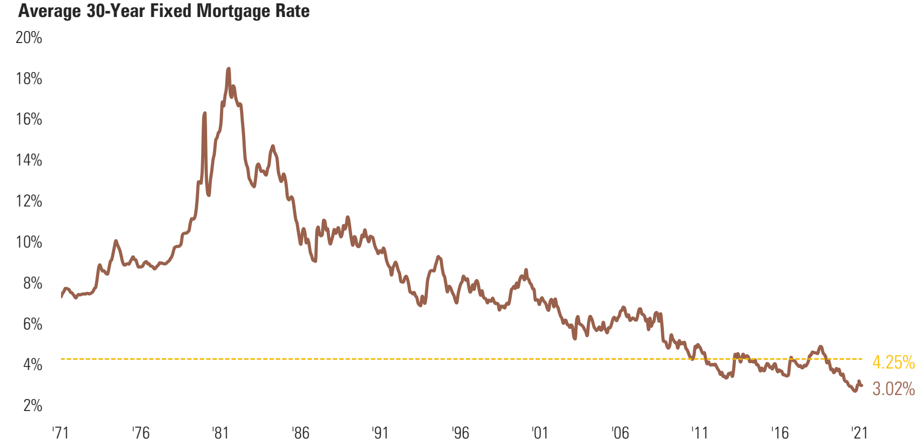
U.S. Treasury Yield Curve



We expect the Fed to manage the long-end of the yield curve through the purchase of additional longer-dated treasuries, pushing down interest rates.

This could occur when mortgage rates spike above 4.25%.

Average 30-Year Fixed Mortgage Rate



Data Sources: Bloomberg, Federal Reserve Bank of St. Louis

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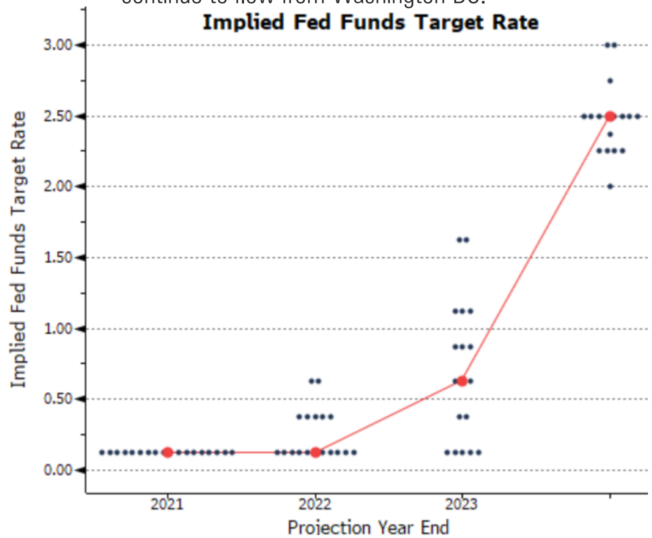
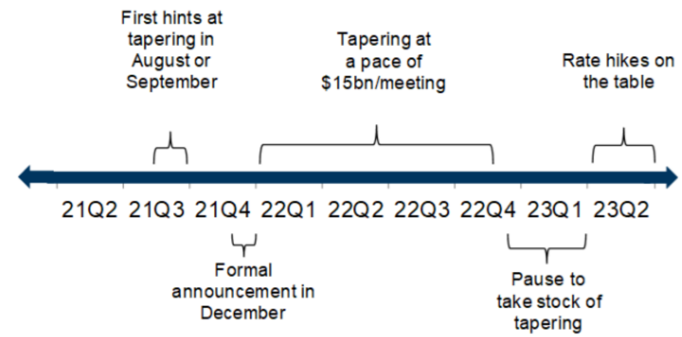
Federal Reserve & Fiscal Policy

While monetary policy adjustments add some headwinds going forward, fiscal support will continue to flow from Washington DC.



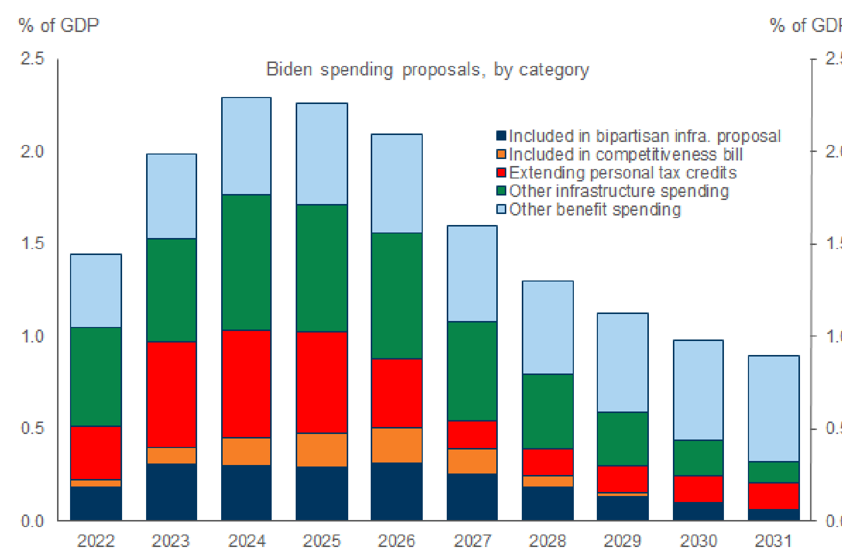
Possible Timeline for Tapering



Consensus expectations are for the first hint about tapering to come in August or September, followed by details such as the pace in November, and then a formal announcement at the December FOMC meeting that would begin the taper process in January.

Taper talk of 2013 saw higher yields, lower equity prices

Congress is likely to approve at least 1% in GDP of spending, probably less than 2%



Data Sources: Bloomberg, Goldman Sachs

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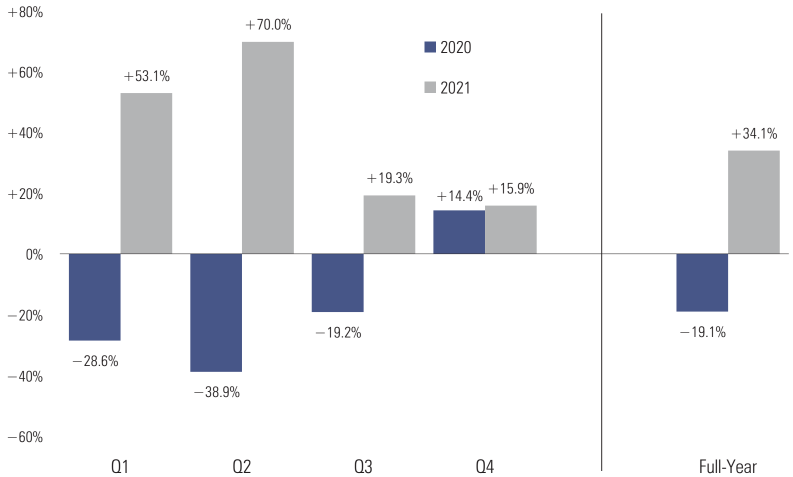
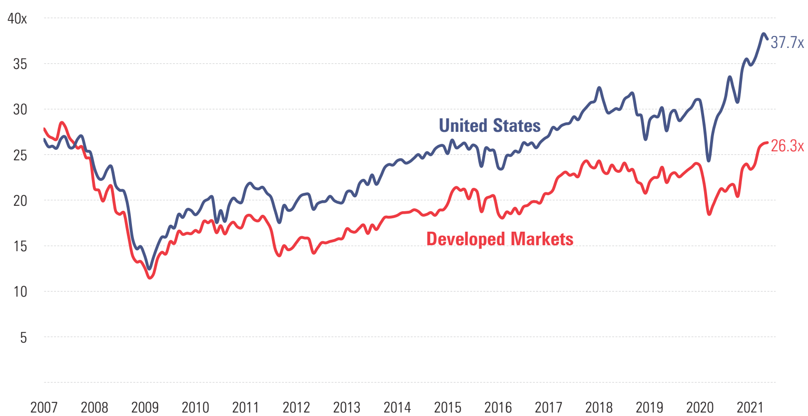
Developed Markets

While a return to earnings growth is still anticipated in 2021, the pace of the recovery in Developed Markets is expected to lag Emerging economies while valuations remain elevated on a relative basis.

MSCI EAFE Earnings Growth: 2020 vs. 2021



Historical CAPE Ratio Developed Markets & United States

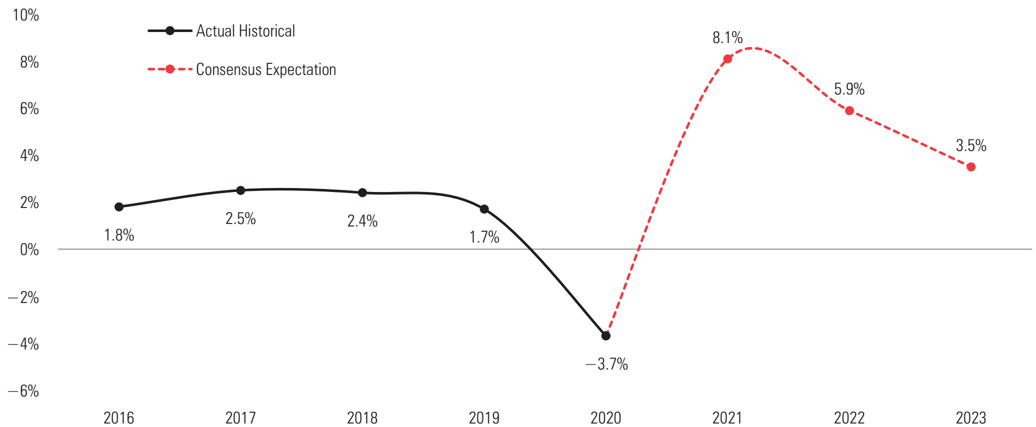


Developed Markets are currently trading at a 30% discount to the U.S., with 2021 EPS expected to grow 1.1% below the U.S. growth rate.

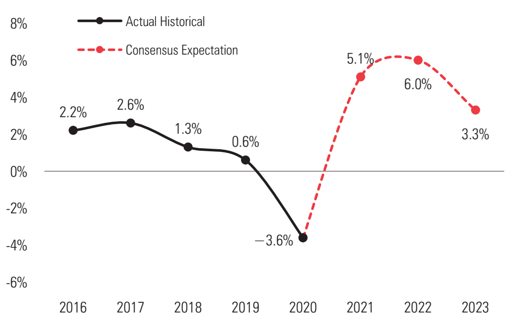
With an average of 11% of GDP and 17% of employment tied to tourism, an economic recovery in the Developed Markets is highly dependent on the timing of reopening.

Economic activity could remain subdued heading into Q3, with the pace of reopening and the loosening of mobility restrictions across Western Europe as key factors.

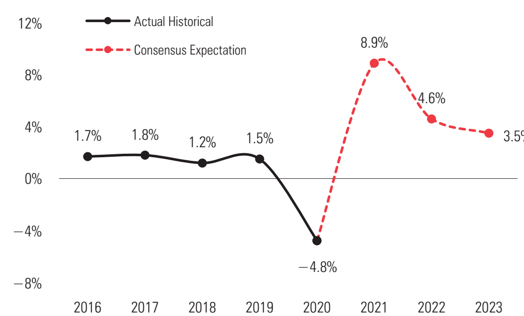
EAFE GDP Growth



Germany GDP Growth



United Kingdom GDP Growth



Data Sources: Bloomberg, Barclays

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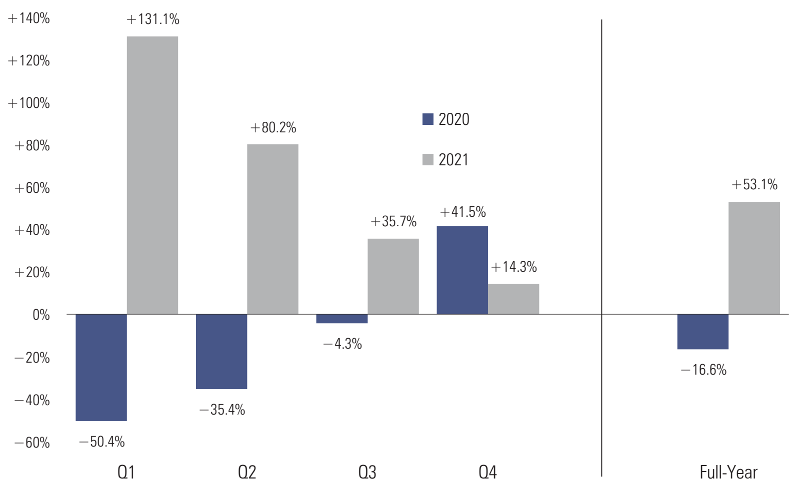
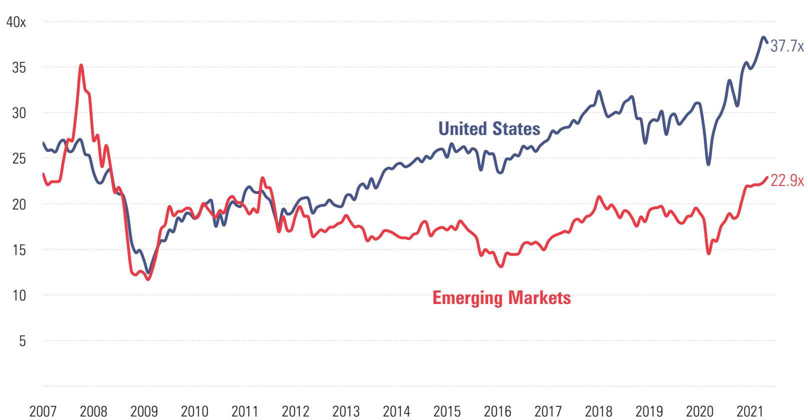
Emerging Markets

From an earnings growth and valuation perspective, Emerging Markets remain the favorite within the broad spectrum of equity investing.

MSCI Emerging Markets Earnings Growth: 2020 vs. 2021



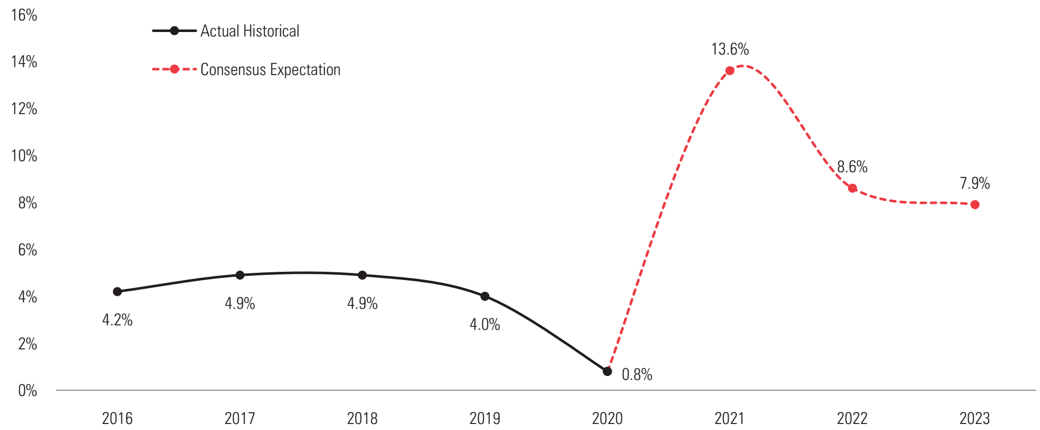
Historical CAPE Ratio Emerging Markets & United States



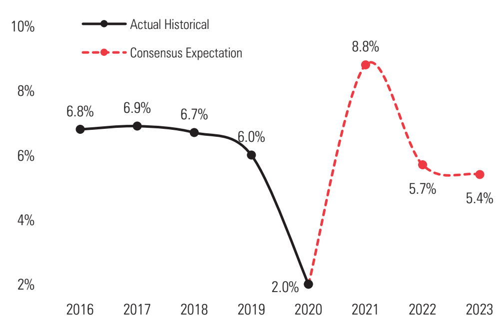
With Emerging Market valuations trading at a 39% discount to the U.S. and 2021 EPS expected to grow at 17.9% above the U.S. EPS growth rate, Emerging Markets present a clear opportunity.

We anticipate a sharp recovery in annual growth rates, driven by further easing of COVID lockdowns combined with the support provided by fiscal and monetary policy.

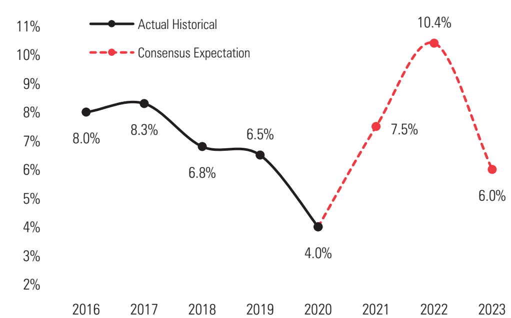
Emerging Markets GDP Growth



China GDP Growth



India GDP Growth



Data Sources: Bloomberg, Barclays

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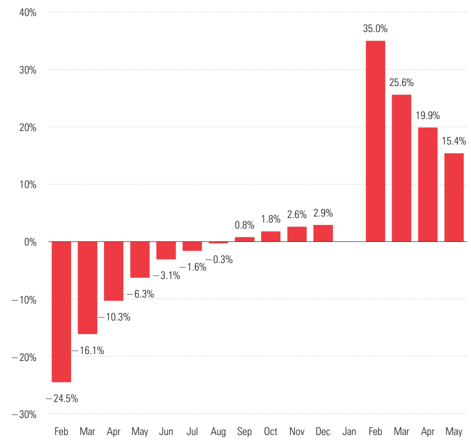
China – A Bumpy Ride Back to Normal

China has achieved a post-pandemic recovery in most areas, including manufacturing and fixed asset investment (capital spending).

China ISM Manufacturing Index

China Fixed Asset Investment Growth (YoY%)

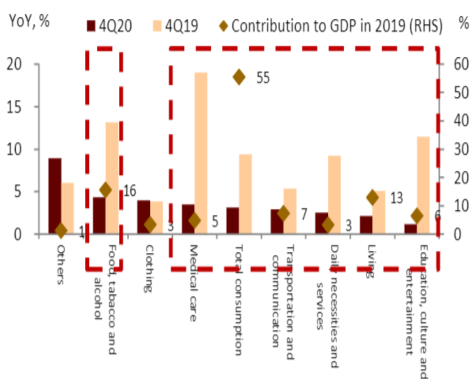


"Return to Normal" sentiment has led market participants to take profits this year, leading to muted returns for Chinese equities

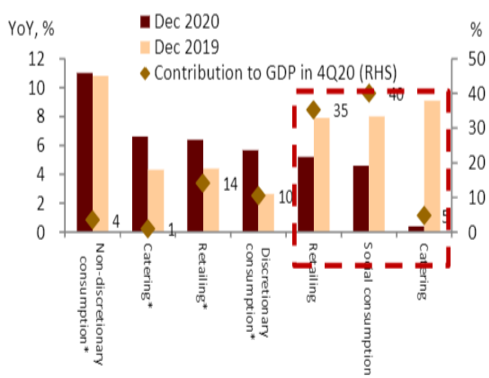
CSI 300 Index Year-to-Date

A couple of major laggards in the recovery have been the services sector and small/medium-sized business.

Consumption expenditures on most items have not returned-to pre-pandemic levels

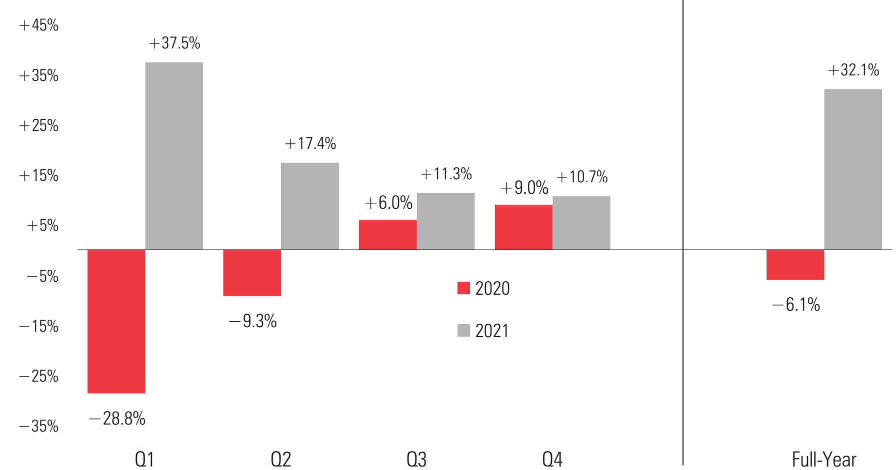


Year-over-year growth rates of overall goods consumption for small/medium sized enterprises have not returned to pre-pandemic levels



Yet earnings growth expectations for China remain amongst the best globally

MSCI China A Earnings Growth: 2020 vs. 2021



The People's Bank of China has indicated they will be cautious about adding additional stimulus into the economy but remain supportive.

Data Sources: Bloomberg, CICC

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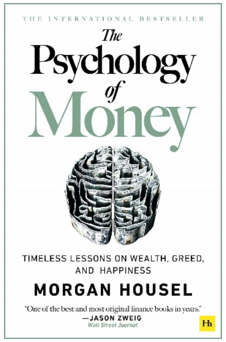
Appendix – Always Prepare for Pain



As the economy is muddling through a reopening, fits and starts to supply and demand should be the only expectation.

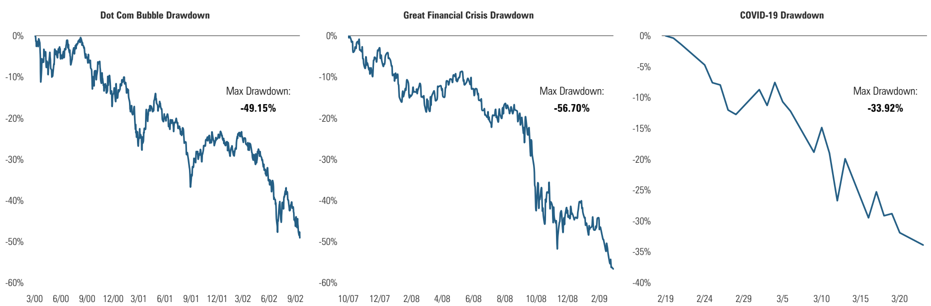
Unfortunately, it is in our nature to consider things that are volatile as risky and painful. In the real-world volatility is risk, risk is pain, and avoiding pain is essential to sustain life.

However, volatility is the necessary ingredient to investing. Our friend Morgan Housel, author of *Psychology of Money*, helps us think about volatility and pain in this short video: Click on this link to watch.

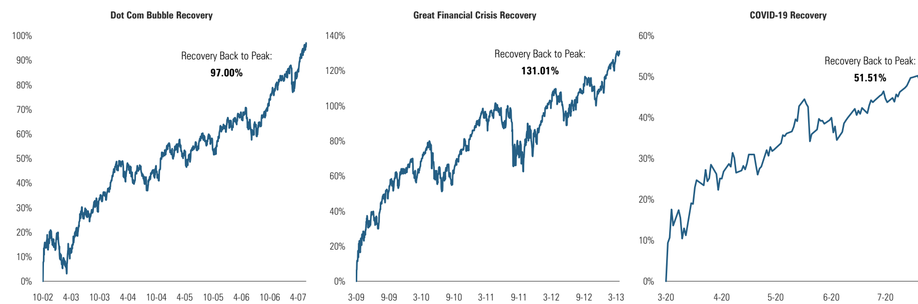
Normal drawdowns in equity investing look something like this:

Type of Decline	Average Frequency	Average Length
–5% or more	About 3 times a year	47 days
–10% or more	About once a year	115 days
–15% or more	About once every 2 years	216 days
–20% or more	About once every 3 ½ years	338 days

In fact, when you think about the largest drawdowns on the S&P 500 on major life events, it looks incredibly painful



Here's the good news: It generally gets better. Let's go back to the drawdown charts for those painful events. Now, look at the recoveries before experiencing the next drawdown.



Investing is a world of volatility. You can see from the table below the market has spent approximately 6 times as many days "10% or more below" its previous all-time high than it has at a "new all-time-high".

	Percent of Trading days, 1950-Dec. 2020
New all-time high	6.4%
0%-10% below previous all-time high	50.5%
10%-30% below previous all-time high	34.9%
30% or more below previous all-time high	8.2%

While painful, market and economic gyrations are necessary to create the environment for returns.

As Morgan points out in the video here, there is a "cost to investing…a price for admission to investing." Pain might be that price.

Link to *Morgan Housel on Risk*: https://youtu.be/dwvyM7kkD6g

Data Sources: Morgan Housel, Bloomberg

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Our View & Recommendations

Our View

- Much of the recovery in corporate earnings are priced into U.S. equities
- The Federal Reserve continues to institutionalize lower rates as a way to lift lower income Americans' wages, including racial minorities.
- Emerging Markets present the most attractive valuations
- President Biden will focus on infrastructure and reorganizing tax policy
- Possible start to a secular bull market in base metals

Recommendations

- The U.S. economy should experience a recovery in the Service sector as vaccine rates increase and Covid abates
- Corporate earnings growth rates will put a floor under equity prices as the U.S. weens itself off COVID-related support
- Fiscal support should provide a leg up as the Federal Reserve's discussion on tapering bond purchases continues. Expect a taper in late Q3 or early Q4
- The U.S. Consumer will continue to spend down precautionary savings as the jobs picture rapidly improves
- Maintain policy weightings to U.S. equities with a balancing of U.S. Large Cap Growth and Quality/Value
- Continue to actively manage fixed income, as yield chasers increase, defaults across the credit markets will have greater impact
- Overweight Emerging Markets as a best global price to growth opportunity
- Specific overweight to China domestic equities
- Consider some exposure to industrial commodities as a weak dollar and recovering global economies will push prices and profits higher

Strategy Update

- Review our latest installment with award-winning financial author Morgan Housel on volatility and investing

Mean Reversion Dashboard

Style Forward P/E as a % of 20-Year Average

Style

Size	Value	Blend	Growth
Large	122.3%	136.7%	167.4%
Mid	118.6%	134.5%	186.9%
Small	119.2%	134.0%	153.7%

Regions & Countries Forward P/E as a % of 20-Year Average

Regions

World	Developed Markets	Emerging Markets
127.7%	111.1%	95.9%

Countries

United States	Germany	United Kingdom	China	Brazil	India	Russia
145.6%	101.1%	87.0%	109.9%	63.2%	148.5%	47.3%

Sector Forward P/E as a % of 20-Year Average

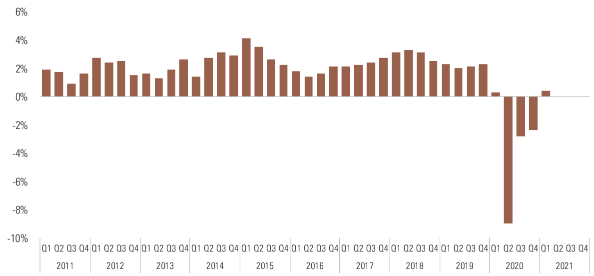
Sectors

Energy	Materials	Industrials	Consumer Discretionary	Consumer Staples	Health Care	Financials	Technology	Telecom	Utilities	Real Estate
84.0%	90.3%	117.5%	152.0%	103.1%	85.8%	71.5%	133.2%	108.8%	90.1%	254.2%

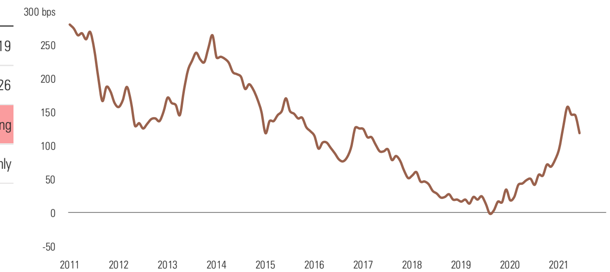
Data Sources: Bloomberg

Economic Dashboard

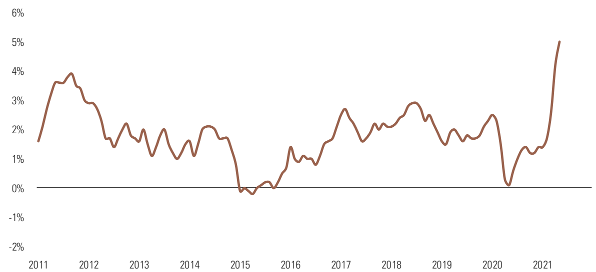
U.S. GDP Growth (YoY %)	
Latest Level	0.40
Change from Prior Quarter	2.80
Latest Direction	Expanding
Frequency	Quarterly



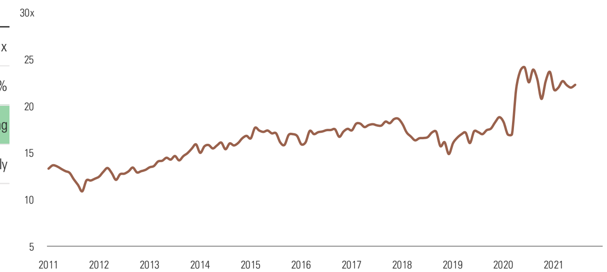
U.S. Treasury Spread (10 Yr vs. 2 Yr)	
Latest Level (basis points)	119
Change from Prior Month	-26
Latest Direction	Flattening
Frequency	Monthly



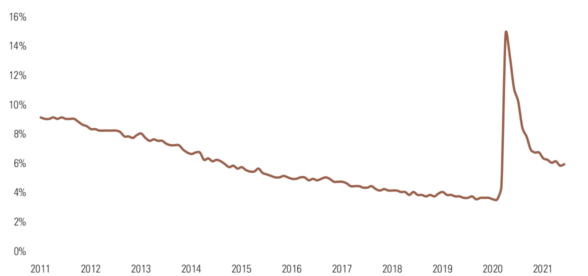
U.S. Inflation (YoY %)	
Latest Level	5.00
Change from Prior Month	0.80
Latest Direction	Rising
Frequency	Monthly



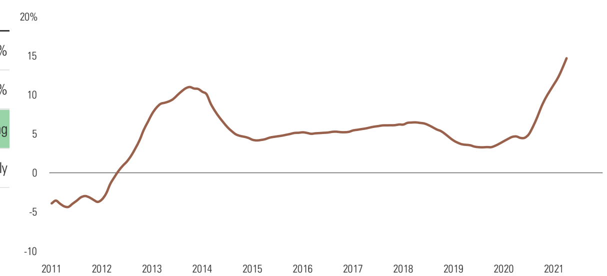
S&P 500 Forward P/E Ratio	
Latest Level	22.3x
Change from Prior Month	1.35%
Latest Direction	Increasing
Frequency	Monthly



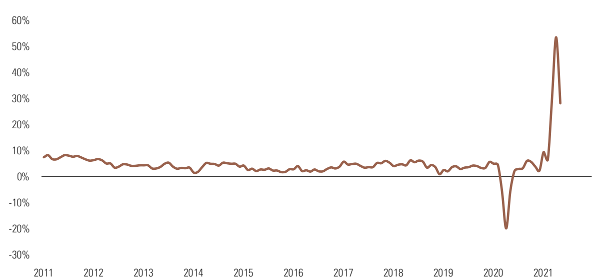
U.S. Unemployment (YoY %)	
Latest Level	5.90
Change from Prior Month	0.10
Latest Direction	Rising
Frequency	Monthly



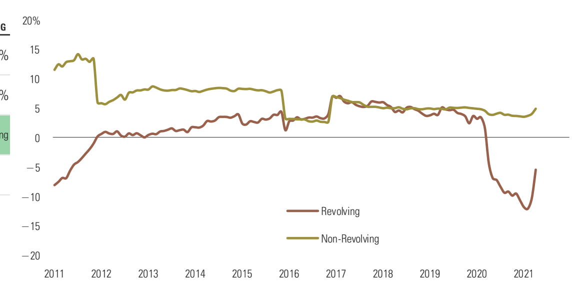
Case-Shiller Home Prices (YoY %)	
Latest Level	14.58%
Change from Prior Month	1.58%
Latest Direction	Increasing
Frequency	Monthly



Retail Sales (YoY %)	
Latest Level	28.10
Change from Prior Month	-25.30
Latest Direction	Decreasing
Frequency	Monthly



Consumer Credit (YoY %)	REVOLVING	NON-REVOLVING
Latest Levels	−5.5%	+4.9%
Change from Prior Month	−0.2%	+0.6%
Latest Direction	Decreasing	Increasing
Frequency	Monthly	



Data Sources: Bloomberg

Phillips & Company
Wealth Strategies | Vested

THANK YOU

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www.phillipsandco.com

Data Sources

Slide 2	**The Consumer is in Control** https://www.bls.gov/news.release/empsit.nr0.htm https://fred.stlouisfed.org/series/PSAVERT https://fred.stlouisfed.org/graph/?g=Dho7
Slide 3	**A Bumpy Ride Back to Normal** https://fred.stlouisfed.org/graph/?g=FaKh https://fileunemployment.org/dataview/ https://www.morganstanley.com/what-we-do/research
Slide 4	**Earnings Expectations – The Base Effect Continues** https://www.bloomberg.com/quote/SPX:IND https://insight.factset.com/
Slide 5	**Higher Inflation – Lots of Noise, Not Enough Signal** https://fred.stlouisfed.org/graph/?g=EFWY https://www.economy.com/
Slide 6	**Fixed Income – The Year of Living Dangerously** Bloomberg https://fred.stlouisfed.org/graph/?g=FaLJ
Slide 7	**Federal Reserve & Fiscal Policy** Bloomberg https://research.gs.com/
Slide 8	**Developed Markets** Bloomberg https://indices.barclays/IM/21/en/indices/static/shiller.app
Slide 9	**Emerging Markets** Bloomberg https://indices.barclays/IM/21/en/indices/static/shiller.app
Slide 10	**China – A Bumpy Ride Back to Normal** Bloomberg https://research.cicc.com/
Slide 11	**Appendix – Always Prepare for Pain** https://www.collaborativefund.com/blog/ Bloomberg
Slide 13	**Mean Reversion Dashboard** Bloomberg
Slide 14	**Economic Dashboard** Bloomberg