Bellwether
CONSULTING

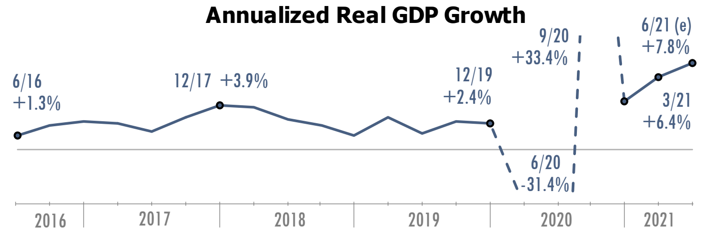
Your Quarterly Update on the Financial Markets
June 30, 2021

MARKET Recap

The US Economy: “Inflation and Participation”

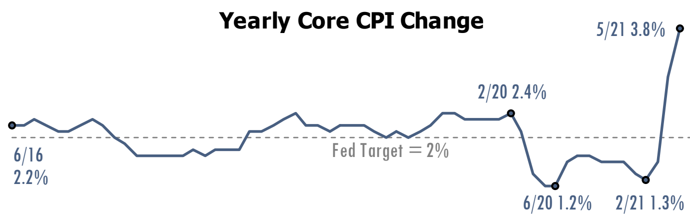
Economic growth continued to accelerate in Q1 and (as projected) Q2 as well. For the first quarter, most components of GDP expanded, particularly personal consumption, fixed investment, and government spending. Continued unemployment benefit support and PPP2 drove both personal consumption and government spending higher. For the second quarter, consumption and spending look to have moderated somewhat as assistance programs begin to run out, but economic activity still appears frothy.

Annualized Real GDP Growth

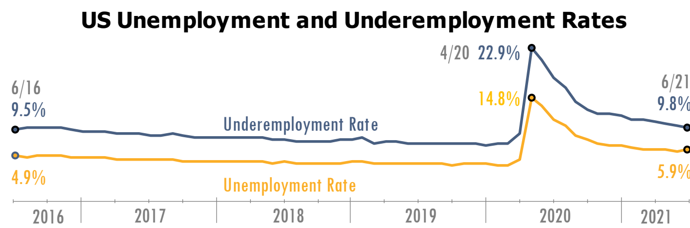


Headline inflation as measured by the Consumer Price Index spiked to 5.0%, a level not sustained since the 1980s. Recovery in beleaguered energy prices contributed to the surge; the more stable and influential “core” CPI, which excludes food and energy, rose 3.8% YoY. The Federal Reserve stuck firmly to the view that current inflationary pressures are transitory, and inflation will soon moderate on its own without Fed intervention. That’s likely true, in our view, as continued supply chain bottlenecks and other start-up jitters are sorted out through natural market forces. However, one factor that may not be transitory is upward pressure on labor costs, particularly for the service sector.

Yearly Core CPI Change



US Unemployment and Underemployment Rates



The June jobs report came in strong, with 850,000 new jobs added and a stable unemployment rate. However, the “workforce participation rate” remained at a depressed level of 61.6%. This statistic measures the percentage of the employable population that is either currently employed or unemployed but looking for work. Participation increased steadily from the end of World War II, driven by the Baby Boom and mainstreaming of women workers, reaching a peak in 2000. Arguably, rising participation helped drive the US economic success in the prior century.

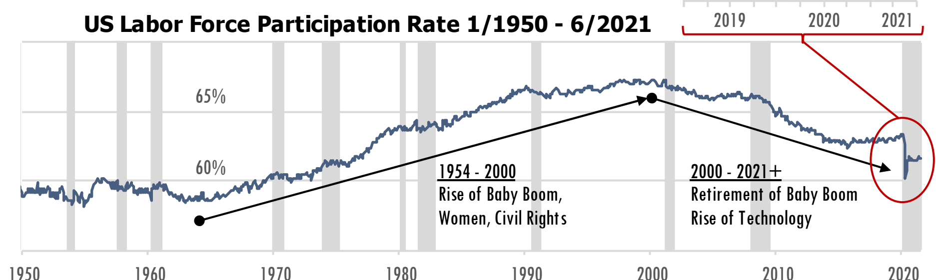
Unfortunately, there is no historical precedent for evaluating a participation shock. Upward pressure on wages will only be transitory if people are able and willing to return to the workforce. In recent decades, we have seen participation gradually decline as demographic trends have changed. Once again, COVID is proving to be a trend accelerator.

Some are quick to blame the Federal unemployment insurance supplement, scheduled to end in September, which makes unemployment an attractive alternative to lower-paying jobs. Fair enough, but there are other forces at play. From 2010 to 2020, the proportion of the US population between 45 and 64 years old increased from 22.0% to 26.4%. Displaced workers in this age group have been exposed to a year of simulated retirement and may not be so keen to return to full-time employment, particularly in fields which do not lend themselves to home-based work. Immigration and tax policies are also major factors which are difficult to rapidly change.

All eyes are looking toward the participation numbers for the September time frame. If the participation rate improves, that would likely support the Fed’s narrative on the course of inflation and maintain calm in the markets. If not, investors in Fed-driven risky asset classes should buckle up!

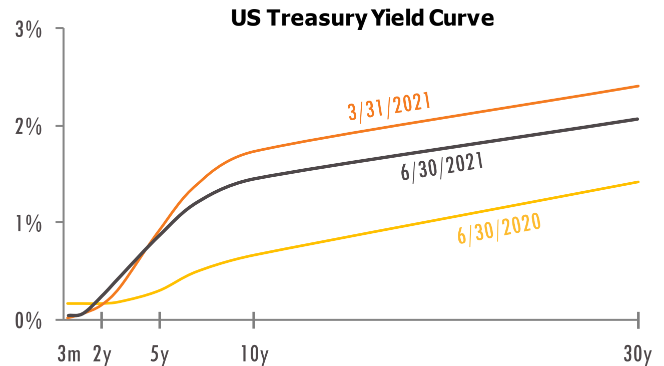
1/19
63.1%
6/21
61.6%
4/20
60.2%
2019
2020
2021

US Labor Force Participation Rate 1/1950 - 6/2021



The US Bond Market

The second quarter brought some retracement to long-term yields. Following marked steepening in the belly of the curve last quarter, yields on maturities in the 3-to-10-year region of the curve flattened. This was spurred by softening concern over inflation, which is now being viewed as transitory. Although inflation concerns abated, to an extent, the market has started pricing in a more definitive stance from the Fed on tapering repurchases. In the short end of the curve, the rise in the 2-year key rate from 0.16% to 0.25% should not go unnoticed. This rate had stayed locked in place for several quarters. Although 9 basis points is not a large number, the market (and Fed) is gaining visibility on what will be the first rate-hike since 2018.

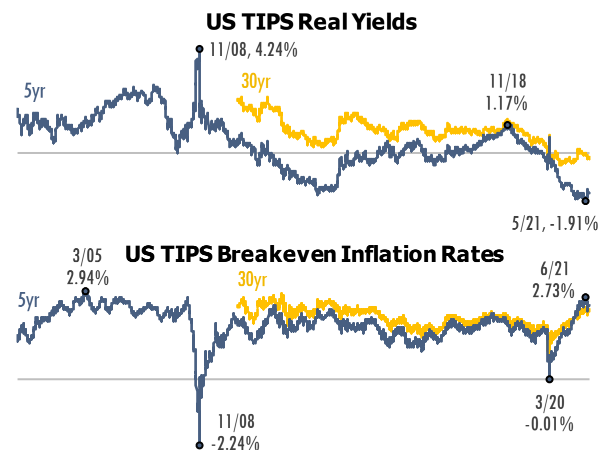


US Bond Index Returns	
Blmbrg Barclays	2Q21
Aggregate	1.83%
Short Gov't	0.00%
Interm. Gov't	0.62%
Long Gov't	6.43%
TIPS	3.25%
Municipal	1.42%
Interm. Credit	1.56%
Long Credit	6.45%
High Yield	2.74%
(CS) Lev. Loan	1.44%
MBS	0.33%

Credit spreads broke below their post-2008 lows during the quarter. High yield spreads ended the month of June at 304 basis points, tighter by 32 bps. Higher-quality corporate paper is trading at, or near, 20-year historical lows, based on option-adjusted spreads. Single-A credit quality spreads ended the quarter at 67 basis points, right on top of the previous trough enjoyed throughout much of 2004. Though defaults will remain elevated in the near term, the expectation is for these to be more isolated incidents within a handful of more COVID-stressed industries. S&P forecasts that the trailing 12-month default rate will decline to 4.0% by March 2022 (from 6.3% as of March 2021). This exceeds a historical range of roughly 2-3% in benign environments because below-investment-grade debt has yet to rebound in credit quality. Just under 40% of outstanding junk bonds remain rated B- or lower.

Mortgage-backed securities (MBS) lagged the other US Bond indices shown, only outperforming short-term government debt. This is true for the second quarter and it is also the case for the trailing 6 quarters. A high volume in prepayments as rates reached historical lows combined with tighter credit standards on mortgage originations due to economic contraction. However, MBS fared well despite these headwinds. Residential delinquency rates have stayed low and are likely to remain so; about 70% of mortgages issued in 2020 went to borrowers with credit scores of at least 760, up from 61% in 2019. Lending standards have been loosening as mortgage rates eased in the second quarter, which may lead to a new wave of prepayments and eventual (possibly later this year) Fed tapering of MBS purchases (currently $40 billion per month) may mean even more stumbles ahead for MBS in the short term. And, as rates rise, negative convexity in MBS could lead to additional pain.

At the end of 2018, the 5-year US TIPS key rate had climbed back over a 1% real yield. As it did so, it caught up to the 30-year TIPS real yield, which had been introduced after the Global Financial Crisis and had yet to trade at negative levels. That came to an end in 2021.



While US TIPS are designed to directly hedge inflation (as measured by CPI), locking in a negative real yield guarantees the (limited) erosion of purchasing power. This is much more of a concern currently on the shorter end of the real yield curve. The 5-year key rate has sunk to a new historical low. The implied breakeven inflation rate (where US TIPS would produce the same return over time as a maturity-matched US Treasury note) failed to break new ground as inflation expectations crept up through June, and has receded about one-quarter of a percent since.

The US Stock Market

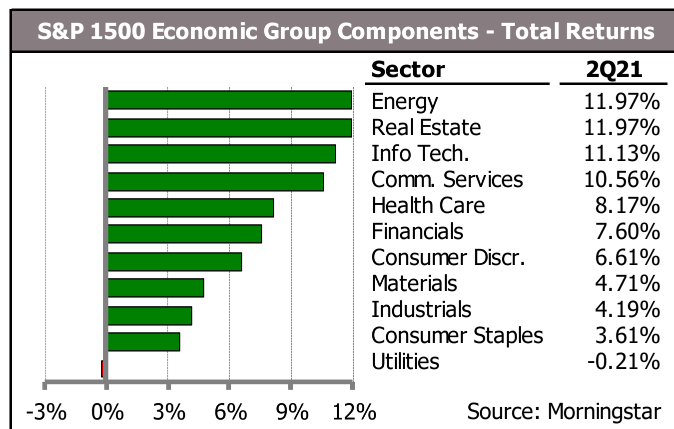
The US stock market had its fifth straight quarter of strong performance. This was fueled by optimism for continuing economic recovery, new government spending, and limited inflationary fears. All major benchmarks were up solidly, with the S&P 500 ending another quarter with a record close – its 34th for the year.

The quarter also saw a shift back to well-worn trends. Growth outstripped value by about 2x everywhere except in small caps. Small-cap indices generally underperformed their large- and mid-cap peers. In the factor benchmarks, the MSCI

US Stock Indices - Total Returns			
Large-cap Stocks	**2Q21**	**Mid-cap Stocks**	**2Q21**
S&P 500	8.55%	S&P Midcap 400	3.64%
Russell 1000	8.54%	Russell Midcap	7.50%
Growth	11.93%	Growth	11.07%
Value	5.21%	Value	5.66%
Broad Markets		**Small-cap Stocks**	
S&P 1500	8.14%	S&P Smallcap 600	4.51%
Russell 3000	8.24%	Russell 2000	4.29%
Growth	11.38%	Growth	3.92%
Value	5.16%	Value	4.56%

Barra momentum and low volatility indices outperformed their value, low leverage, and earnings yield counterparts. Growth stocks rallied as the Fed seemed to take a less tolerant stand on inflation after its June meeting. A flip-flop between growth and value can be symptomatic of vacillating expectations regarding inflation. If and when inflation becomes accepted reality, we may see a re-emergence of value. In midcaps, the S&P Midcap 400 Index posted performance about half that of the Russell Midcap Index, arguably driven by its capitalization and composition. The Russell Midcap includes more than twice the number of holdings and has an average market cap almost 3x higher than its S&P counterpart.

Energy was a top sector for a third consecutive quarter. Crude topped $75 per barrel for the first time since 2018 on growing demand. OPEC+ met in the final week of the quarter to discuss increasing production, although no agreement was reached, fueling fears that prices could sky-rocket. Natural gas also rose as supply disruptions, the rebounding economy and weather drove US prices to a 29-month high.



Sector	2Q21
Energy	11.97%
Real Estate	11.97%
Info Tech.	11.13%
Comm. Services	10.56%
Health Care	8.17%
Financials	7.60%
Consumer Discr.	6.61%
Materials	4.71%
Industrials	4.19%
Consumer Staples	3.61%
Utilities	-0.21%

The real estate sector also posted chart-topping returns. Traditionally, investors turn to REITs when bond yields decline or as an inflation hedge. This makes real estate a popular investment in times of inflation uncertainty. Some analysts point to real estate as a proxy for capitalizing on global logistics issues through companies that specialize in data storage, wireless infrastructure, and warehouses.

In a rebound from last quarter, tech completed the trio of top-performing sectors as inflation fears abated. Interestingly, the FAANG stocks (i.e., Facebook, Apple, Amazon, Netflix, and Google-parent Alphabet), which together dominated the market in 2020, appear to be dissociating. While Alphabet and Facebook continued to beat the broader markets and their sector peers, Apple and Amazon performed relatively in line with the broader market (despite Apple reporting record sales for the iPhone 12, iMac, and iPad). Netflix underperformed both the market and its peers with a paltry Q2 return of 1.3%. The difference seems to be that Alphabet and Facebook made the pivot from pandemic plays to reopening plays. Both firms reported a surge in advertising on their platforms as businesses turned attention to promoting themselves post-COVID. Netflix has faced increased competition from newer platforms. Services like Peacock, Disney Plus and HBO Max are limiting access to their programming, forcing Netflix to rely increasingly on original content.

Earnings growth in Q2 for S&P 500 companies is forecasted to come in at 63.6% YOY, which would be the highest year-over-year growth rate for a quarter since Q3 2009 [FactSet]. A double-digit earnings growth rate is also expected for the calendar year 2021. The above-average growth rates are the result of both higher forecasted earnings and the comparison to weak 2020 results.

While market volatility subsided in Q2, meme stocks continued as a force for market disruption. Originally, the phenomenon centered around small-cap stocks where there was a low entry price and high passion by retail investors. However, as attention has increased (including from the SEC), both the roster of stocks involved and the understanding of the forces fueling the frenzies have broadened. In addition to Reddit and other retail investors, momentum-based hedge funds have exerted influence on many of the names, typically through algorithmic trading.

Beyond providing interesting headlines and business school case studies, the meme stock phenomenon has presented a particular challenge to track records for many small-cap managers. Only the most momentum-focused managers consider allocating market-weight positions to meme stocks as these stocks lack well-constructed investment theses. As trading activity drives up prices and, by

Selected "Meme" Stock Performance

	Trailing Returns			Mkt Cap	In
Company	**3 m**	**6 m**	**1 Y**	**($ B)**	**R2000?**
GameStop Corp (GME)	13%	1037%	4834%	15.09	
Ocugen Inc (OCGN)	18%	339%	3543%	1.45	Y
Koss Corp (KOSS)	3%	575%	1604%	0.18	
AMC (AMC)	455%	2574%	1221%	26.07	Y
Express, Inc. (EXPR)	61%	613%	321%	0.41	
Nano Dimension (NNDM)	-4%	-9%	275%	1.98	
Tilray Inc (TLRY)	-18%	119%	253%	7.69	
Bed Bath & Beyond (BBBY)	14%	87%	214%	3.27	Y
Fubo TV Inc (FUBO)	45%	15%	207%	4.22	Y
Macy's Inc (M)	17%	69%	176%	5.81	Y
BlackBerry Ltd (BB)	45%	84%	150%	6.79	

Performance for periods ending 6/30/2021 Source: Morningstar

extension, market caps in these stocks, their outsized returns have a noticeable impact on the performance of the Russell 2000 index that becomes impossible to match without holding a meaningful position in the meme stock.

Unfortunately for many small-cap managers, "what goes up must come down" may not apply. With GameStop becoming part of the Russell 1000 at quarter-end, any reversal in its performance will impact that index, not the Russell 2000. Despite its larger market cap, AMC will remain in the Russell 2000; as of May 7th, the cutoff date for data used in reconstituting the index, AMC was valued at a mere $4.3 billion. A quick analysis of identified meme stocks in the Russell 2000 shows that a reversal equivalent to their price change over the past year would have an impact of about -100 basis points, with the majority of the effect coming from AMC. In the Russell 2000 Value Index, where AMC has a larger weight, the impact would be -173 bps.

International Markets

Sentiment further strengthened in the second quarter, pushing global equities higher. Yields remained within a tight range, despite rising inflation expectations globally. Vaccination campaigns in developed markets finally reached a healthy pace. Although many EM countries continue to struggle, their equity markets have been supported by a weaker US dollar and commodity strength. While higher US rates may eventually make cyclical EM exposure less attractive, US real rates are currently at multi-decade lows; yield-hungry capital could flow to EM markets for some time.

Europe

Many countries achieved material reopening and vaccination progress in Q2. The improvement in outlook propelled equities to record highs. Companies within the Stoxx 600 Index beat earnings expectations by more than 13%, the largest margin in over a decade. Driving this solid beat were banks, consumer goods, and retailers.

Foreign Stock & Bond Indices - Total Returns

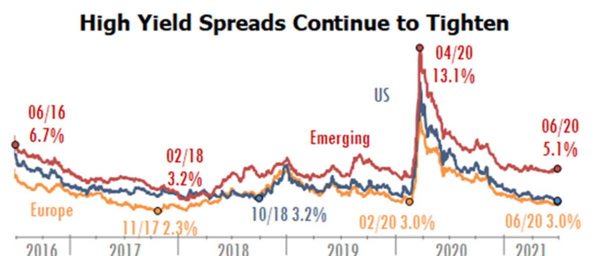
MSCI Broad Indices	**2Q21**	**Barcap Global Indices***	**2Q21**
MSCI ACWI ex-US	5.48%	Global Aggregate	1.31%
EAFE (Developed)	5.17%	Pan-Euro	0.82%
Emerging Markets	5.05%	Asian-Pacific	0.79%
		Eurodollar	0.58%
MSCI Regions		Euro-Yen	0.85%
Europe	7.42%	Other Currencies	0.85%
Japan	-0.28%	** Unhedged*	
Pacific ex-Japan	4.76%		
Latin America	15.01%		

As is typical in the early stages of a recovery, demand for consumer cyclicals and discretionary goods is strong. Unemployment is still fairly elevated (at 7.3% in May), and these sectors may continue to see growth in tandem with higher employment and wages. Away from consumers, industrials have outperformed on strong global demand. The Euro-area Manufacturing PMI for June touched an all-time high of 63.4, led by export powerhouse Germany.

An uptick in demand from reopening pushed up inflation, albeit more modestly than in the US. The European Central Bank's key inflation metric signaled a 2.0% YoY increase in prices in May, compared to 1.3% in March. Inflation expectations continued to rise, but bond markets remained relatively calm. The French 10-year nominal yield re-entered positive territory after nearly a year, while the German 10-year rate moved up 9 bps to -0.21%. For investors to get a positive real yield, sovereign rates would need to rise dramatically – not likely, based on the ECB's recent statements.

Unlike the US, where the Fed has started "thinking about thinking about" tapering asset purchases (possibly in Q4), the ECB remains ultra-dovish. President Lagarde pledged to continue the bond-buying program, and at a "significantly higher" pace than in the first months of the year! This divergence allows the ECB to watch how investors respond to the US central bank's attempt at tapering – and design its policies to avoid market tantrums.

Surprisingly dovish statements were timely for weaker economies. Dependent on the ECB to finance their debt, 10-year Italian yields peaked at 1.2% in May, up almost 50 bps from March. However, ECB reassurance helped assuage fears and the 10-year ended Q2 at 0.8%.

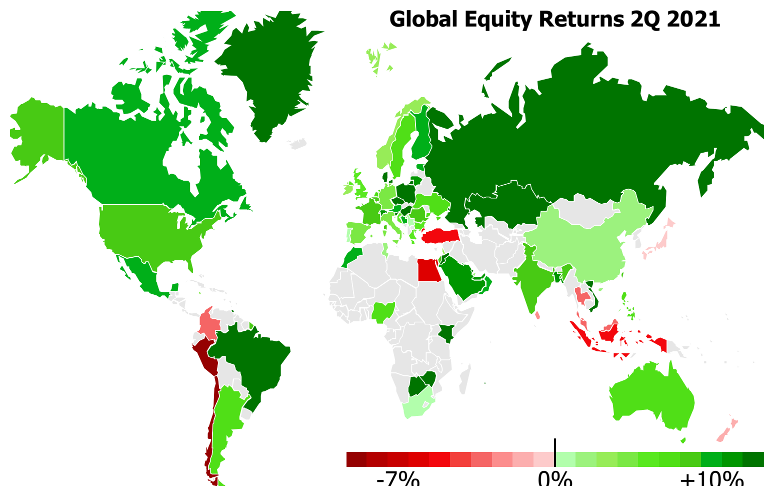


Credit remains loose for corporations. Spreads tightened to pre-pandemic levels, allowing companies to raise capital at attractive rates. Emerging high yield, however, offers a moderate premium compared to historical lows.

Americas

After Canada's GDP rose 1.4% in Q1, output in Q2 faltered as drawbacks led to a decline for the first time since the start of the pandemic. According to Statistics Canada, GDP contracted by 0.3% in April and, likely, another 0.3% in May as tighter restrictions were imposed on the public to combat a resurgence of COVID-19.

Data suggests that Canada's economy is positioned to rebound in the second half of the year as industrial demand in large urban areas is growing at a strong rate. This is prominent in Vancouver, Montreal, and Toronto as vacancy of spaces for leasing and purchasing decreased by 35%, 28%, and 25% in Q2, respectively. Another positive indicator is the resurgence of the US market, which should positively impact Canada's exports. However, as inflationary pressures rise in the US, it is expected that the Bank of Canada may raise rates by the end of the year.



Brazil's economy bounced back to pre-pandemic levels, lifted by the largest stimulus package in the emerging markets (8.3% of economic output). Brazilians defied calls to lock down, impelling normal activity. Agriculture grew by 5.7%, its fastest pace in four years. Industry expanded by 0.7%, the services sector grew 0.4%, and fixed business investment rose 4.6% in the quarter. Government debt now stands at 87% of GDP, a level considered unsustainable for developing countries.

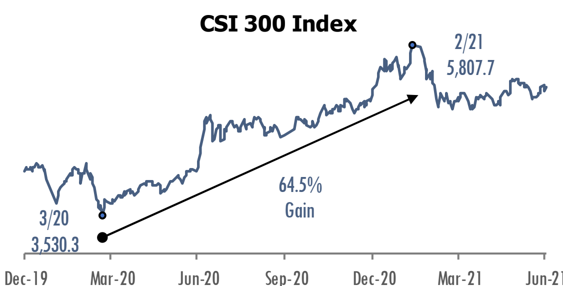
Mexico has finally started to shake off the pandemic, growing 25% in May as the manufacturing sector rose 36% in the same month. Other areas contributed to growth as well, including the services sector which rose nearly 20%. April's data was also revised upward to 22% versus April 2020. The Mexican economy continues to benefit from robust export activity and the broad reopening of the US, Mexico's top trade partner. After last year's dismal economic performance, the finance ministry expects 2021 GDP growth to recoup much of the ground lost in 2020.

Asia

The economy of China grew 18.3% in the first quarter from a year earlier, a record rate that was much higher than the 6.5% YoY growth recorded in Q4. The number is misleading compared with last year's low pandemic base of -6.8% recorded in 1Q20. When compared with Q4 2020, the economy expanded just 0.6% in the first quarter, a historically sluggish pace. As the second quarter's data starts trickling in, it is visible that momentum is slowing down.

There are a number of challenges, including signs of inflation, factory output slowing, and lagging consumer recovery. Inflation has become more concerning, as producer prices were up YoY in March by 4.4% and in April by 6.8%, the fastest rate of increase in more than two years. Chinese exporters' profits have been falling as raw materials (copper, aluminum, and steel) prices surge and global shipping costs remain elevated. While order volume has reached pre-coronavirus levels, profits have dropped by more than 30% in Q1.

Factory output, a key growth pillar in China's pandemic recovery for more than a year, remained stable during the second quarter. Even though the industrial output growth rates have slowed, they still matched median forecasts made by economists. In June export demand weakened while supply bottlenecks held back production. Global chip shortages, international logistics jams, and rising delivery costs have weighed on manufacturers' operations. The sub-index of new export orders fell deeper into contractionary territory, signaling weakening external demand for Chinese goods.



Consumers emerged from the pandemic with retail sales jumping 34.2% in March from a year earlier. After more than a year of expansion led by manufacturing and exports, it looked like the economy might tilt toward consumption-driven growth. However, Q2 disappointed as retail sales growth declined to 17.7% in April and 12.4% in May. April's lackluster consumption data came even as China's labor market showed signs of improvement. China's CSI 300 Stock Index gained 3.5% in Q2, a slow growth when compared with 2Q20's increase of 13%. Year to date, stocks have been almost flat.

Japan's economy continued to lose steam this quarter as extended emergency measures put in place to halt a rise in coronavirus infections stifled growth. Preliminary GDP data showed a likely 4.5% shrinkage in the first quarter and full-year growth expectations have been revised downward.

Prime Minister Suga faced calls from lawmakers to provide an extra budget to support the economy. However, he expressed little desire for action due to enormous public debt and the fact that the government had already initiated three

pandemic-related packages worth a combined $3 trillion. Additional stimulus is expected before the end of the third quarter. Projections for the size of the economic package range between $45 billion and $90 billion.

Concerns remain around potential negative economic impacts from holding the Tokyo Olympics games that were postponed from 2020. A "quasi-emergency" status is in place in 10 prefectures, including Tokyo. Estimates of the economic benefits from the Tokyo Olympics are already expected to be around 5% smaller due to the barring of overseas spectators. Prime Minister Suga has also not ruled out the possibility of switching to a no-spectator scenario if another COVID-19 state of emergency is declared. This scenario would have an additional 5% negative impact on the economic benefit. Economic gains are expected to be around $4.8 billion based on current conditions.

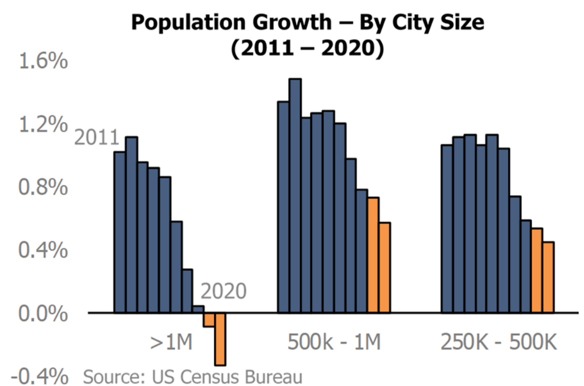
Focus On: Trend-Catalyzing COVID-19

In their exhaustive series The Story of Civilization, Will and Ariel Durant chronicle the rise and fall of the major civilizations through recorded history. Discerning readers are likely to notice that history surely has a habit of repeating itself, though in variations on a theme. The authors make a point of this on more than one occasion, borrowing from the ancient book of Ecclesiastes, "...there is nothing new under the sun."

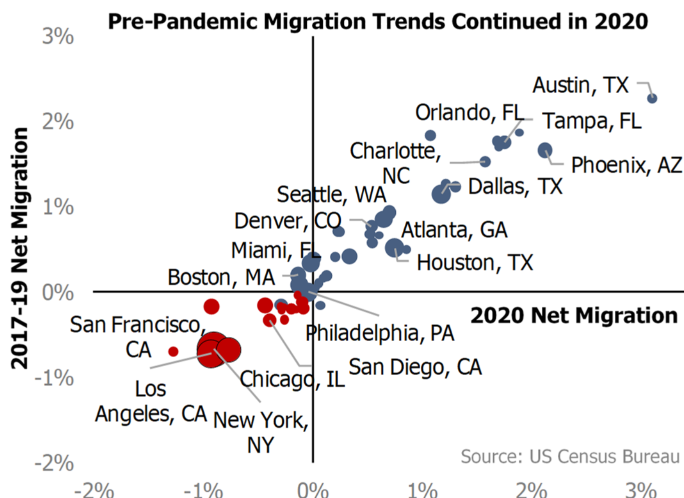
The trends that move financial markets tend to be cyclical. Fortunes have been made studying these historical cycles and fortunes have been lost under the false belief that this time things would be different. However, breakouts do occur when spurred by fundamental change. Social distancing, for one, has accelerated many seismic trends that predated the pandemic. Some of these trends may decelerate. Yet, many are likely to persist or build off momentum induced by the pandemic. Where these breakout trends push or pull markets jointly, rather than counteract, may determine the most opportune places to position your portfolio and help identify novel risks.

Divisive Demographics

The US population grew by an estimated 0.35% in 2020, a 100-year low. While some point to COVID-19 impacts to explain this anemic figure, the fact is we have been dealing with stagnating population growth for the better part of two decades. The pace of population increases noticeably slowed after 2000, more so following the Great Financial Crisis, and recently due to immigration restrictions. With fewer births, more deaths, and unpredictable immigration flows, domestic migration has been key for regional growth. The ability to attract young workers is more important than ever for a city's fiscal health and local economy.



America's largest cities, however, have been struggling with this. Even prior to the pandemic, fewer and fewer Americans felt the need to migrate to New York, Chicago, and other large metropolises in recent years. The flight from density witnessed in 2020, although stark, was a continuation of a multi-year trend. Big cities, especially those with a population of over a million, are losing residents to smaller, more affordable urban centers.



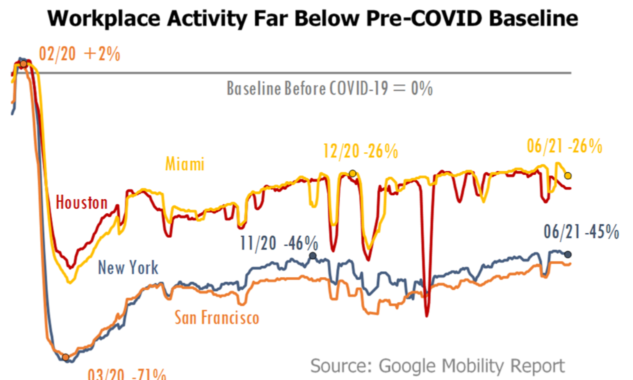
The largest metros, ostensibly described as "gateway" cities, have been outpaced by the up-and-comers since at least 2015. Major beneficiaries of domestic migration have been the "Sun Belt" cities of the South like Austin, Orlando, Tampa, and Phoenix. Underscoring the importance of domestic migrants is the comparison of 3-year net migration trends versus 2020 net migration, shown alongside. During the pandemic, we saw migration trends accelerate approximately 20% above the pace set between 2017 and 2019. While it remains too early to predict the demise of Chicago or LA, the accelerated trends and the potential impacts of more distributed economic activity are palpable.

Before the pandemic, a fast-growing job market, lower taxes, and affordable housing were some common traits that enticed people to move. And, although the initial wave of

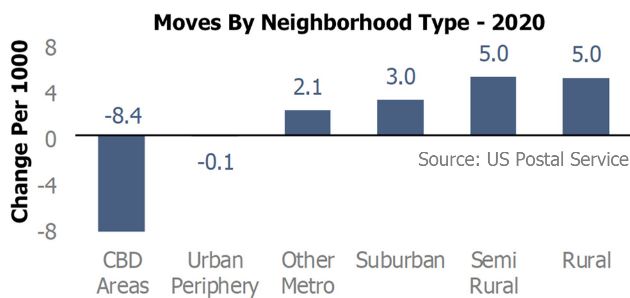
COVID-19 related moves was health-related and (potentially) short-term, the acceptance of remote work as standard practice has opened up further long-term opportunities for dispersion away from gateways.

Changing How We Work

A person's job has always been an important anchor for where they live. But after a year and a half of working from home, many office workers are re-evaluating how much time they actually want to spend in an office. March and April saw nearly 7.5 million workers quitting (a record pace), confident of better opportunities. In this environment, employers have taken a wait-and-watch approach, cautious of pushing too hard. Across most regions, estimates show return-to-office activity plateauing at levels reached last fall, despite the vaccination progress and removal of pandemic restrictions.



Technology companies offer a glimpse into how bargaining power has shifted. Faced with an acute shortage of skilled labor, many have guaranteed remote or hybrid work as a sweetener for most employees. The high-paying tech jobs this could affect are disproportionately concentrated in the expensive, coastal gateway cities – if WFH gains acceptance, it will create a population of footloose workers who can exit to the suburbs and other metros. The first market to feel this impact is real estate – more specifically, office and residential sectors.



Office rental demand stabilizing at 15-20% below pre-pandemic levels in gateway markets could create a glut of expensive inventory. Property owners have benefited from the long-duration nature of office leases, but empty space is piling up. In New York, nearly 18% of all office space is unoccupied, while LA and Chicago reported higher vacancy rates of 24% and 22% respectively. And it could get worse. Real estate services company, CBRE, estimates that almost a third of office space in Manhattan will be up for renewal within three years and companies are already indicating they will need much less space.

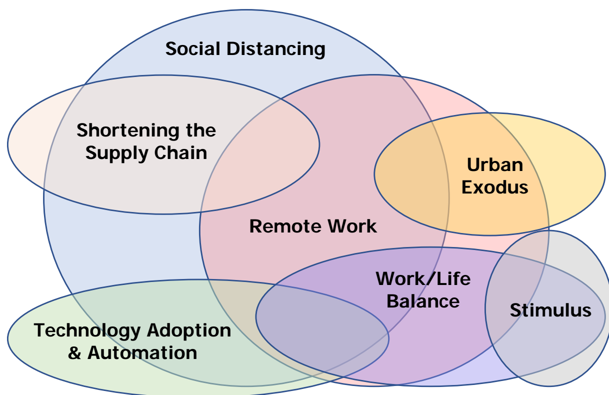
Even if not fully remote, a hybrid office schedule allows workers added flexibility around their location. Within gateway metros, this means a shift away from the dense, central business districts (CBDs) close to offices. According to USPS zipcode changes in 2020, CBD areas, on average, lost 8.4 residents per 1,000 population, while most other neighborhood types gained ground. Looking at this data, it is not surprising that suburban, single-family homes prices are at record highs around gateway cities as well. Even if city dwellers aren't heading to the heartland just yet, they are making their way to the suburbs in droves.

The Roaring 2020s

The decade started with an eerie, almost suffocating, economic quiet.

Economies around the world are at various states and stages of reopening as the cumulative death toll of the virus peaks over 4 million. The resumption of what we remember as our pre-COVID everyday life is surreal in its normality. The great masses had holed up in relative isolation for the better part of a year, or more. Now they yearn to reconnect. Alcohol consumption had moved from bar to living room, from late night to late afternoon, and from frequently a bit much to just a bit frequent. Many of the trends or themes in force during the pandemic are likely to revert to pre-pandemic norms, though not all at once. Air travel and hotel stays have picked up, but more for leisure than business.

The decline in business travel is a bit sticky. It was already on an established downward trend going into 2020. The pandemic essentially brought business travel to a full stop. Employees and employers saw that some essential business trips were less essential than previously thought. The sluggish pace of adopting video teleconference technology to replace expensive and time-consuming travel warped to plaid speed. Any stigma to handling certain types of meetings remotely vanished. In-person meetings will be on the uptick as employees call back their staff to HQ, but it is difficult to see business travel returning to anywhere near pre-pandemic levels unless the aging hipster crowd gloms onto it as an anachronistic and poetically ironic experience to indulge in whenever the opportunity strikes.



COVID-19's legacy is being written now in overarching themes. Where these themes defy prevailing long-term trends or butt up against natural dampeners, they will be more likely to revert. However, some are building on established trends. The added momentum will speed changes in the way we work, live, save, and spend. It is too early to measure the impact of many of these unfolding trends and too early to predict how office work schedules and routines will look once stable. Yet, thinking through the logical chain of effects that are more and less likely to unfold lends insight into where financial markets are headed this decade. This should give pause to those expecting a reversion to pre-pandemic norms and those riding the momentum of the past 12 months.

The Rise of Thematic Investing

Geographic risks in a US equities portfolio receive little attention. Yet, migration towards more affordable, less congested areas poses an obvious headwind for some companies that rely on local revenue. Having a view on regional allocation within the US would make sense under this environment, but not a view that would be easily expressed in an off-the-shelf investment fund. Asset managers have not focused on geographic exposures within the US as a way to outperform or to manage risk, except in real estate. Outside of municipal bond strategies, investors cannot access this type of choice.

However, asset managers are giving more thematic choices to investors. Sometimes characterized as narrow or gimmicky, thematic funds have gained traction in recent years. Ten years ago, such funds represented just 0.6% of global equity assets under management. As of Q2 2021, the market share hit 2.1%, with nearly all of this growth occurring over the last three years. A total of 167 new thematic funds were incepted in 2019 and 237 more in 2020, increasing the number of thematic strategies by 50%. Many of the older thematic funds focus on a single equity sector. More recent additions tend to focus on themes that stretch across sectors and are expected to transcend traditional economic cyclicality.

Morningstar has developed a new taxonomy to classify these funds that they described as "mushrooming" in popularity before the pandemic, and have seen accelerated adoption since. The rise in popularity of funds with environmental, social, and governance (ESG) criteria constitutes a significant part of this trend, but not the majority, and broad ESG mandates are excluded. Many structural, demographic, and technological themes are seen expressed as well.

Morningstar's categorizes thematic funds as Technology, Physical World, Social, or Broad Thematic. The first three include many sub-categories with dozens of underlying themes. Like ESG, thematic funds are popular in Europe, where 51% of global thematic AUM resides. While 89% of thematic AUM is actively managed, the predominant choice (63%) in the US is passive management. Pictet is the biggest thematic manager, but nearly isolated to the European market. In the US, Ark Management has gained a dominant position through their popular ETFs that have resonated with younger investors.

Getting Used to Change

Rapid advancement in technology has been, arguably, the greatest thematic driver of change for these past 50 years of the Information Age. While this is unlikely to change any time soon, the pandemic has accelerated many of the themes that have been advancing slowly during the last decade thanks to the benefits of technology and the benefits it brings.

The 2020s could be a very interesting time defined by a cultural re-evaluation of how the way we live our lives might better align with what we truly value. Or, it could be a missed opportunity to apply the introspection we have all gained in relative isolation to make the start of 2030 a much better place than we began in 2020. Most of this will occur outside of investment portfolios. Yet financial markets are just the world we live in writ in terms of dollars and cents.

Investors have attempted to express their market outlook or risk appetite by tilting towards either value or growth stocks. Economic expansion had historically rewarded growth investors, while economic stress favored value-adherents – not so in 2020. The forces of growth and value are complex and can vary across sectors and industries. Some pockets of the economy, perhaps a geographic region like the Sun Belt, may experience growth drivers while other pockets of the economy are favoring value. Some of the themes that accelerated due to the pandemic are likely to transcend market cycles.

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