

**Quarter-In-Review** – It was a strong quarter for the markets as the vaccine rollout gathered steam around the world. Vaccination rates in the U.S. surpassed 50% in late May and it seems like business as usual in much of the country. Other regions lag the U.S., but over the last two-to-three months we have seen a material increase in inoculations. As you would expect the markets embraced this trend with gusto. The S&P 500 index added +8.5% in the second quarter, bringing the YTD return to +15.2%. Of the eleven industry sectors, only Utilities lost money during the quarter (-0.4%), and all sectors are in the black for the year. It is basically the same story overseas, although returns in Europe, Japan, and the emerging world have been somewhat more muted than those in the U.S.

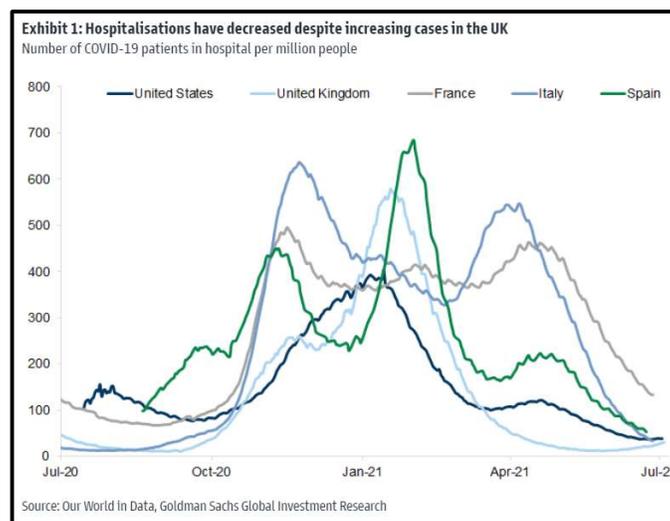
Fixed income markets also performed well. Despite the increase in inflation all bond sectors made money as yields fell. For example, the yield on the 10-year Treasury fell from 1.75% to 1.44% during the quarter, and as a result, intermediate-term Treasury bonds gained +2.5%. High-yield bonds were up +2.4% for the quarter while investment grade corporate bonds added +3.9%. It is worth noting that most bond categories have been lackluster so far this year. Intermediate-term Treasury bonds are still down -3.4% YTD while investment grade bonds have lost -1.8%. Only the riskiest high-yield segment is positive for the year (+2.7%). The contrast between the macro backdrop and the bond market performance during the second quarter is something of a paradox. Global growth was strong, commodities prices were soaring (crude oil closed well above \$70/barrel), and inflation is at multi-year highs, but yields declined. We are going to take this letter and explore this paradox in more detail as it holds a few clues about what the markets could have in store over the coming months.

**Vaccination Success Story** – After a rough start, the vaccination campaign is progressing well in most advanced countries. The U.S. and the U.K. were the first major developed economies to roll out the vaccines, followed by Canada and the

Market Benchmarks			
Market Indices	2 <sup>ND</sup> Qtr	Ytd	3-Yr An
S&P 500 Index	+8.5%	+15.2%	+18.5%
Russell 2000	+4.0%	+17.4%	+13.4%
Global Equities	+7.0%	+12.8%	+14.6%
Int'l Index (EAFE)	+5.4%	+9.6%	+8.5%
Emerging Mkts	+5.1%	+8.8%	+11.4%
Other Indicators			
Fed Funds Rate	0%-0.25%	0%-0.25%	0%-0.25%
2-Year Treasury	0.26%	0.16%	0.12%
10-Year Treasury	1.44%	1.75%	0.92%
S&P 500 P/E Ratio*	21.5	21.9	22.3
Crude Oil	\$73.47	\$59.16	\$48.45
Core Inflation	3.4%	1.4%	1.4%
*Forward 12-month operating earnings per S&P			

E.U. And while the developing world is lagging behind the developed, the good news is that the pharmaceutical companies are on track to produce more than 10 billion vaccine doses this year.

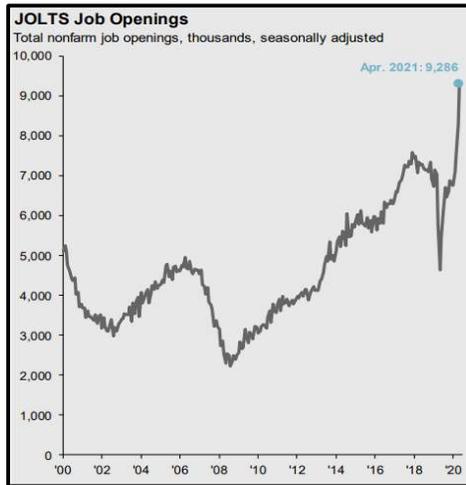
Despite the trend in vaccinations, the trend in Covid cases is something of a mixed bag. Case counts have dropped meaningfully in the developed world (the U.K. is a current exception), but parts of the emerging world have seen noticeably higher numbers due to the spread of the Delta variant. However, vaccines appear to be breaking the link between COVID cases and hospitalization rates (chart below). A recent study out of the U.K. showed that two doses of the Pfizer vaccine was 96% effective against hospitalization from the Delta variant. Recently cases have been increasing at a rate of roughly 25,000 per day in the U.K, however, fatalities are running at 'just' 25 per day, which is 1.8% of the peak fatality rate. Recent studies indicate that Delta variant cases result in 5-10 times



smaller fatality rates compared with the outbreak of B.1.1.7, likely a result of high vaccination rates and natural immunity. This is clearly a welcome development to alleviate human suffering, and from an economic perspective, it means that activity is getting back to normal in much of the developed world.

**Boom Times!!** – Falling Covid infections combined with the easing of restrictions (together with the ongoing fiscal and

monetary stimulus) have led to some impressive growth numbers. The U.S. economy grew +6.3% in the first quarter and is projected to grow by +8% or more in the second quarter. These are numbers the U.S. hasn't seen in decades. Real time indicators of economic activity such as credit card transactions, OpenTable restaurant bookings, or TSA volumes are all back to or above 2019 levels. Consumers are flush with cash and looking to spend. Anyone who has tried to vacation this summer in some of the domestic hotspots such as Hawaii or the national parks have undoubtedly had to battle the crowds.



The labor market, as you would expect, is also healing. Payroll growth picked up to +850K in June – a 10-month high - while the unemployment rate is pushing towards 5%. But there is something of a disconnect when it comes to the labor market. There are still roughly 4% fewer people employed in the U.S. now compared to January 2020. But how do we square this with the fact that more and more employers are having a hard time finding employees? Bars and restaurants can't fill positions, and the number of job openings is at the highest level ever (see chart above). Certainly, generous unemployment benefits are keeping some people out of the job market. Furthermore, school closures have kept many people at home due to childcare difficulties. Reduced immigration is also playing a part. The good news is that all three factors are probably fleeting and more people should enter the labor force this fall.

The housing market is also doing exceptionally well. Prices are up almost +15% year-over-year on a nationwide basis, and more in certain markets. This is the fastest level of appreciation since 2005/2006. Home inventory levels remain extremely low for this time of year and homes are not sitting on the market for very long. Interestingly, we are still not seeing the signs of froth we saw back during the housing bubble of the early 2000s. Credit underwriting standards are still relatively conservative and we aren't hearing many stories of the second cousin who has bought five spec condos in Florida to flip, at least not yet. More disturbing is the fact that home prices relative to rents have surpassed their 2005/2006 highs, but this doesn't mean the market is due to crash. The more likely scenario is that prices should

level off in the months and quarters to come, which is welcome news for those looking to buy.

The economic backdrop overseas is mixed, and much of the world is playing catch-up with the U.S. For example, European growth was anemic in Q1 but rebounded strongly in Q2. It is the same story in large parts of the emerging world where infection rates have yet to come under control and the Delta variant is a much bigger risk due to lower vaccination rates. But the general theme is one of recovery translating into robust

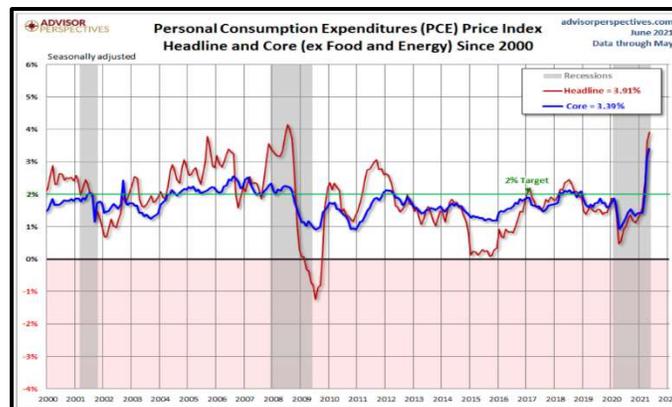
growth. This growth combined with the fallout from COVID is putting severe strain on supply chains and stoking inflation concerns.

**The Inflation Debate** – There is little doubt now that inflation is on the rise. As you can see below, the May inflation data came in at the highest level we have seen since 2008, with the headline number up +3.9% year-over-year and the core (excluding food and energy) up +3.4%. How worried should we be about this?

To answer this question, we have to delve into the permanent versus transitory debate once again. Much of the inflation spike in May was driven by a few narrow areas, namely hotels, airfares, and used car prices. For example, used car prices were up +7.3% in May and have soared roughly +30% over the last year. Used cars alone account for roughly half of the inflation increase in May (see the chart at the top of the next page). This is unprecedented and due largely to COVID's impact on rental car demand and the on-going chip shortage. Soaring lumber prices have also played a role given that prices almost tripled between May 2020 and May 2021.

This gets to the heart of the permanent versus transitory inflation debate. Are car prices going to increase another 30% in the year to come? Will lumber prices double again because producers fail to react to pricing signals? Are employees going to start demanding higher wages because car prices are soaring? Reasonable people can disagree, but we would contend that the answer to the

three questions is probably no. At some point car production will pick up to meet demand. Lumber producers will harvest more trees to capitalize on higher prices. And critically, higher prices are unlikely to feed through into a wage-price spiral similar to what we saw in the 1970s. We are actually seeing hints that the market is already adjusting. Used car



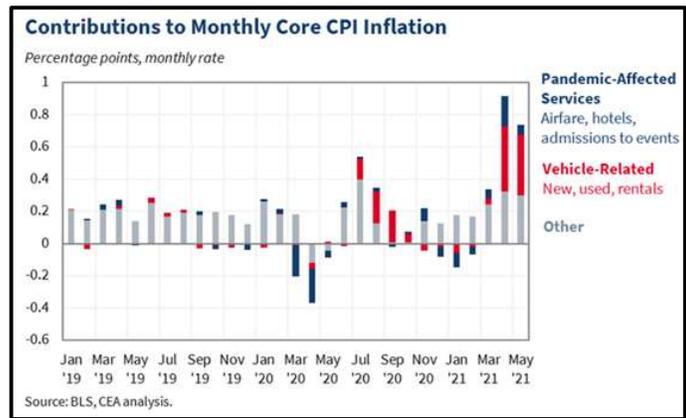
price appreciation flatlined in June and lumber prices were basically cut in half during the same month. As we discuss below, the bond market's reaction to the inflation data indicates to us that the transitory argument may be winning the day.

**We Have Reached Peak Stimulus (for now)** - The June

Fed meeting was one of the more eventful ones in a long time. While there were no changes in policy, the Fed did hint that they might do two things: 1) Begin to reduce their asset purchases at some point around year-end, and 2) possibly raise interest rates in late 2022.

This took the markets by surprise. The assumption has been that the Fed was many quarters away from tightening policy. As a matter of fact, with 'zero interest rate policy' (ZIRP) becoming a permanent feature for both the Bank of Japan (BoJ) and the European Central Bank (ECB), a natural question was whether the Federal Reserve will ever be able to raise rates above zero again. The majority of Federal Open Market Committee members say they can and believe 2.5% is the resting spot for the fed funds rate. Not surprisingly, 7 out of 18 FOMC members want to pump up rates as early as 2022, especially given the current economic boom and elevated inflation levels. Monetary policy is going to become a little less generous in the months to come.

It is the same story on the fiscal side. There is no doubt that the U.S. government has been spending like a drunken sailor ever since COVID hit (roughly \$4 trillion since April of last year). That's a level of spending usually reserved for wartime. But this won't last forever and we should distinguish between the absolute level of spending and the rate of change. Government deficits are large even at the best of times, and during COVID they ballooned out of proportion for very good reasons. However, over the next few months this emergency spending will run off and the rate of change will flip negative. As you can see from the chart to the right, the tailwind from fiscal spending will soon turn into a headwind as the size of the deficit contracts. Some think President Biden's proposed infrastructure plan will continue the COVID spending trend. But assuming his plan is enacted (which is far from a given), the plan is too small to make a big difference. Just half of the proposed \$1.2 trillion in spending is actual new investment, and



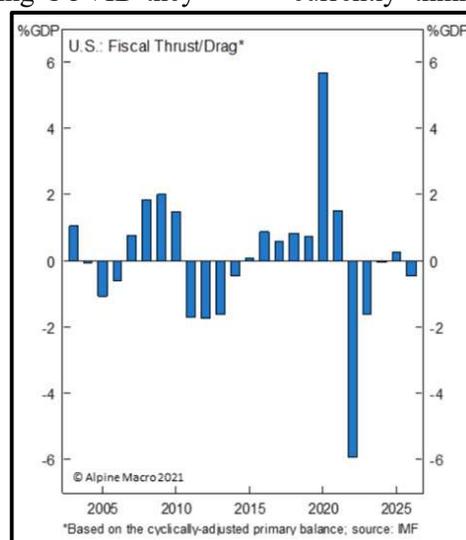
this will be spread over 8 years. In other words, each year there will be \$75 billion in new investment, which is about 0.3% of current GDP. This will do little to change the overall trend.

**What Does it All Mean?** – Just as trees don't grow to the sky, the U.S. economy can't grow at over 8% quarter after quarter anymore. The growth rate is

likely to slow in the months to come. The chart at the top of the next page is a good representation of this. Goldman thinks growth peaks in the third quarter while the consensus of Wall Street economists think we have seen the peak. But regardless, growth is likely to slow to roughly +4% by early next year and less than +2% by late next year. No one is predicting a recession by any stretch, just that the surge induced by the reaction to the COVID crisis is nearing an end.

The bond market is sending the same signal. If you look at the table at the top of page one, something quickly jumps out at you. The inflation number spiked in the second quarter and short-term rates increased, but long-term rates fell. That doesn't seem right. Higher inflation should equal higher long-term rates, right? What is the bond market telling us? First, a flatter yield curve (the difference between 10-year and 2-year rates) is predicting slower economic growth three-to-six months out as we have discussed above. Second, the bond market doesn't appear to think that inflation is a long-term problem – it is voting in favor of transitory versus permanent.

Slower growth would be a welcome change in some respects. For those worried about inflation this should lessen or remove significant price pressures in the system. Furthermore, the Fed is likely to realize that an unfolding slowdown means they can be more patient than they currently think. However, the risk over the coming months is that policymakers make a mistake. Policymakers are not as good as markets in sniffing out secular changes with enormous long-term consequences. For example, it took a long time in the 2000s for the BoJ to discover that it could not end its ZIRP, with the central bank finding that out the hard way: Every time it tried to bump up rates, the yield curve flattened, stocks tumbled, and the economy fell back into a recession. Similarly, back in 2011, the ECB discovered the new equilibrium rate by mistakenly pushing up rates from zero at a time of a brewing



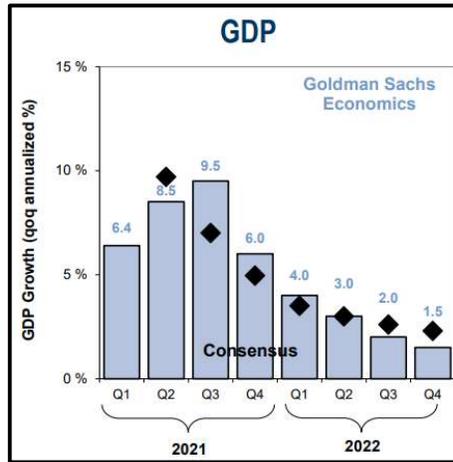
sovereign debt crisis. Could we experience something similar in 2022?

The bond market may also be signaling that the Fed will make a mistake if they tighten policy too soon. By bringing forward the date for the first rate hike the Fed has indicated the intention of a 'pre-emptive' rate hike. We think the odds of such a mistake are low at the moment, but we are watching closely. The old market adage coined by Marty Zweig of 'three hikes and a stumble' could prove to be prophetic this cycle.

### What Will it Take to Trigger an Inflation Problem?

– The question we get most often is what will it take to trigger inflation similar to that of the 1970s? As we explain below, we think we could get there in the years to come, but we simply think it is too soon to buy into the dominant narrative of an imminent inflation spike. The most cited reasons for why inflation is around the corner are monetary and fiscal profligacy, Modern Monetary Theory (MMT), and rising commodity prices. However, except for MMT, all these reasons are the same arguments that were used to predict inflation after the 2008 financial crisis. Obviously, these turned out to be false prophets as inflation proved to be quiescent over the last decade. We think we are in a similar situation now baring a major regime change. Growth is likely to slow and inflation risks should moderate.

What is the regime change that would make us switch on the inflation outlook? MMT is the wildcard. We cannot rule out a renewed fiscal push in the months to come. The infrastructure package is too small to make a difference, but a multi-trillion dollar social spending plan could do the trick, especially if the Fed accommodates it by implicitly buying the bonds used to finance the spending. We are not arguing that such spending is desirable or undesirable, only that to get a durable rise in inflation we need to see a durable rise in fiscal activism. What are the odds we see something before Congress starts focusing on the mid-term elections early next year? We think the odds are less than 50/50, but as we said earlier, reasonable people can disagree. Looking out longer, however, we think the odds do favor meaningfully higher inflation. The lesson that fiscal authorities are likely to take from the COVID crisis is that every downturn can be cured



through more spending. If there is a recession in the next two-to-three years the only upper limit on how high deficits can go is inflation. We suspect we will explore those limits in the years to come.

Looking Ahead – The pandemic that struck the global economy early last year caused a fearsome economic slump, but the rollout of vaccines has led to its mirror image – an economic boom. Consumers are flush with cash, firms struggle to find employees, and markets are celebrating. But as always risks remain. Only one in four people around

the world has had a first dose of vaccine and only one in eight is fully protected. The recovery is going to be uneven for some time to come, especially as the Delta variant spreads far and wide. Additionally, shortages of everything from computer chips to houses is leading to rising prices and the threat of both inflation and what monetary authorities might do to try and fix the problem. Rising used car prices puts pressure on many people, but the Fed can't fix the issue by increasing rates.

This means that the outlook today is strangely murkier than it was last fall. Back then it was reasonably clear that a combination of massive monetary and fiscal stimulus combined with effective vaccines would lead to a durable rebound in both economic growth and the markets. Today optimism is running high that growth will boom, but the risks are higher today. Will the Fed tighten rates too soon? Will fiscal support wane, or conversely, will the bond market revolt at soaring deficits and rising inflation? These are questions on which reasonable people can disagree. In a strange way we think a growth slowdown in the months to come will prove to be a good thing as it will alleviate the inflation concerns and signal to the Fed to sit tight. Risk assets such as equities and corporate bonds should perform reasonably well in this environment, but returns will moderate from the heady levels of the last year as fundamentals catch-up with expensive valuations. We continue to think stocks will beat bonds over the next year, and will explore the topic in more detail next quarter.

**David L. Gemmer**

**Charles Blankley, CFA**

The material presented (including all charts, graphs and statistics) is based on current public information that we consider reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. The material is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation or take into account the particular investment objective, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this material is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. The price and value of investments referred to in this material and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Fluctuations in exchange rates could have adverse effects on the value or prices of, or income derive from, certain investments. No part of this material may be (i) copied, photocopied or duplicated in any form by any means or (ii) redistributed without the prior written consent of Gemmer Asset Management LLC (GAM). Any mutual fund performance presented in this material are used to illustrate opportunities within a diversified portfolio and do not represent the only mutual funds used in actual client portfolios. If you would like a complete list of mutual funds used in an actual client portfolio, please contact our office. Any allocation models or statistics in this material are subject to change. GAM may change the funds utilized and/or the percentage weightings due to various circumstances. Please contact GAM, your advisor or financial representative for current information on allocation, account minimums and fees. Any major market indexes that are presented are unmanaged indexes or index-based mutual funds commonly used to measure the performance of the US and global stock/bond markets. These indexes have not necessarily been selected to represent an appropriate benchmark for the investment or model portfolio performance, but rather is disclosed to allow for comparison to that of well known, widely recognized indexes. The volatility of all indexes may be materially different from that of client portfolios. This material is presented for informational purposes. If you would like a complete listing of previous and current recommendations, please contact our office.