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INVESTMENT STRATEGY QUARTERLY

BIDEN'S AGENDA: DEFINING FALL POLICY SPRINT

Letter from the Chief Investment Officer

The View From The Mountaintop

As we sit atop our prosperous peak, admiring the views of the fastest economic growth since 1984, the best start to a bull market, and the record-breaking quarter of earnings growth, it's wise to remember that not too long ago we began our uphill journey from the depths of the COVID-19 ravine. Often, the best views come after the hardest climbs. So now it's time to catch our breath and peer over the horizon at what's to come as we begin our descent from this peak. However, just as the summit of one mountain can become the base of another, the investment landscape goes on indefinitely, which makes adhering to a disciplined investment strategy of the utmost importance.

Akin to a stout rope extended to a slipping climber, a record amount of fiscal stimulus restrained the unprecedented tumble in economic growth. Now, as seasoned hikers, we've headed back to stadiums, theaters, schools, and restaurants, moving the economy onward and upward–despite the new variants lurking along the trail. But the days of soaring fiscal aid are ending. Even as Congress debates over as much as $4.5 trillion of 'physical' and 'human' stimulus, a compromise will likely yield half that amount, with the distribution spread over a ten-year period. With excess disposable income already descending ~$1 trillion from its $2 trillion peak, an unavoidable fiscal cliff looms next year. Fortunately, four factors should cushion the economy from a hard fall: 1) gradually filling the record 10+ million job openings; 2) increasing wages; 3) rebuilding depleted inventories; and 4) boosting business capital expenditures. Indeed, the economy should keep climbing at an above-trend economic pace through at least 2022 (2022 GDP Forecast: ~3.3%).

The eruption in economic growth over the last year has packed sizable returns in commodities' backpacks, particularly for oil. Bolstered by OPEC's supply discipline and the industry's reluctance to invest more in new drilling, oil prices are currently at three-year highs. Our forecast calls for tempered moves from this point on–prices peaking slightly higher in the first quarter of 2022 before subsiding to the mid $70s by this time next year. One of the medium-term caps on oil demand is the fact that the higher prices go, the more incentives it creates for fuel efficiency and electric vehicles. Moreover, as miles driven in the US approach a record, rising gasoline prices could pose a risk to our economic outlook–and, even more so, in countries that are highly reliant on imports, such as Japan and Germany. In fact, soaring gas prices were one of the root causes of US recessions in 1981, 1990, 2001, and 2008.

The economy trekking upward at a sustainable pace eases pressure on the Federal Reserve (Fed) to maintain an ultra-accommodative monetary policy. As a result, the Fed's first step this quarter will be dialing back the emergency-induced bond purchasing program. But until the Fed's balance sheet plateaus mid next year, we're in the camp that believes there are many miles to go before it tightens policy and raises interest rates (not until 2023). The expected decrease in Fed bond purchases has many analysts concluding interest rates will spike, but we don't follow that path. The reason: our government will issue significantly less debt next year. As a result of healthy economic growth, the 10-year Treasury yield will scale gradually higher to 1.75% over the next 12 months. However, the upward climb will be limited due to solid demand from foreign buyers, pension funds, and retirees acting as a rappelling force. While low yields can be discouraging, investors should view bonds as a safety harness for their portfolio. Bonds may not seem necessary during the less challenging legs of a journey, but they will be appreciated when the trip gets tough. With rates likely to move slightly higher, we favor short-to-intermediate bonds over longer-dated maturities. Historically tight credit spreads limit the upside potential for investment-grade and high-yield bonds, but both sectors should earn more than Treasurys. We also expect supply dynamics to remain supportive for municipal bonds.

The equity bull market keeps ascending to higher altitudes. With a secure macroeconomic backdrop, above-trend earnings growth, rising dividends, and low interest rates, this rally should have endurance. Impressive earnings have been the bedrock, and CEOs are signaling that supply chain shortages, pricing pressures, and labor misalignments will resolve soon. Therefore, our S&P 500 2022 earnings estimate of $225 translates into a 4,950 price target by the end of next year. While our bias is to the upside, the proposed corporate tax hike could result in a 3-5% reduction to our earnings forecast. However, given the history of previous tax increases and the resiliency of corporate America, it should not cause a crevasselike decline at this early stage of the bull market. As any hiker knows, the higher the altitude, the thinner the air becomes. While the S&P 500 avoided a 5%+ pullback for over ten months, it did succumb on the last day of the quarter. However, temporary periods of fatigue are normal and, given the supportive long-term fundamentals, equities should regain their footing and offer up some attractive buying opportunities.

US equities remain our preferred territory, as the strong economic recovery and magnitude of earnings growth make it the leader of the pack. Given the recovery's durability, we favor select cyclicals. Clipped to our carabiner are the Consumer Discretionary, Financials, Communication Services, Industrials, and Energy sectors. From a market-capitalization perspective, we're eyeing opportunities for small-cap stocks as the Delta variant falls off, as they are more highly leveraged to recovery prospects. For similar reasons, we remain constructive on the emerging markets when assessing international exposure, particularly select regions in Asia. A ramp up in the pace of vaccinations in the region could create near-term opportunities given the relative attractiveness of valuations. However, as the recent regulatory-induced equity declines in China have shown, active management is paramount to grapple with the complexities of these less-liquid markets.

Skilled mountain climbers undergo months of preparation: visualizing their goals, conditioning their bodies, packing for inclement weather, and evaluating the best route (and alternatives) to reach the summit. Wise investors practice similar preparation when preparing for their financial future: identifying objectives, assessing risk tolerance, protecting against events that could be detrimental to the plan, and determining asset allocation parameters that act as a compass for the stated goals.

Our outlook serves as a panoramic view of the economy and various asset classes as we enter the final quarter of 2021. We understand that there can be an avalanche of financial headlines at times, but with confidence in your plan and a trusted advisor as your spotter on the belay rope, we hope you have the guidance and tools needed to move mountains when it comes to accomplishing your investment objectives and that you reach your investment summits safely.

Lawrence V. Adam, III, CFA, CIMA®, CFP®
Chief Investment Officer, Private Client Group

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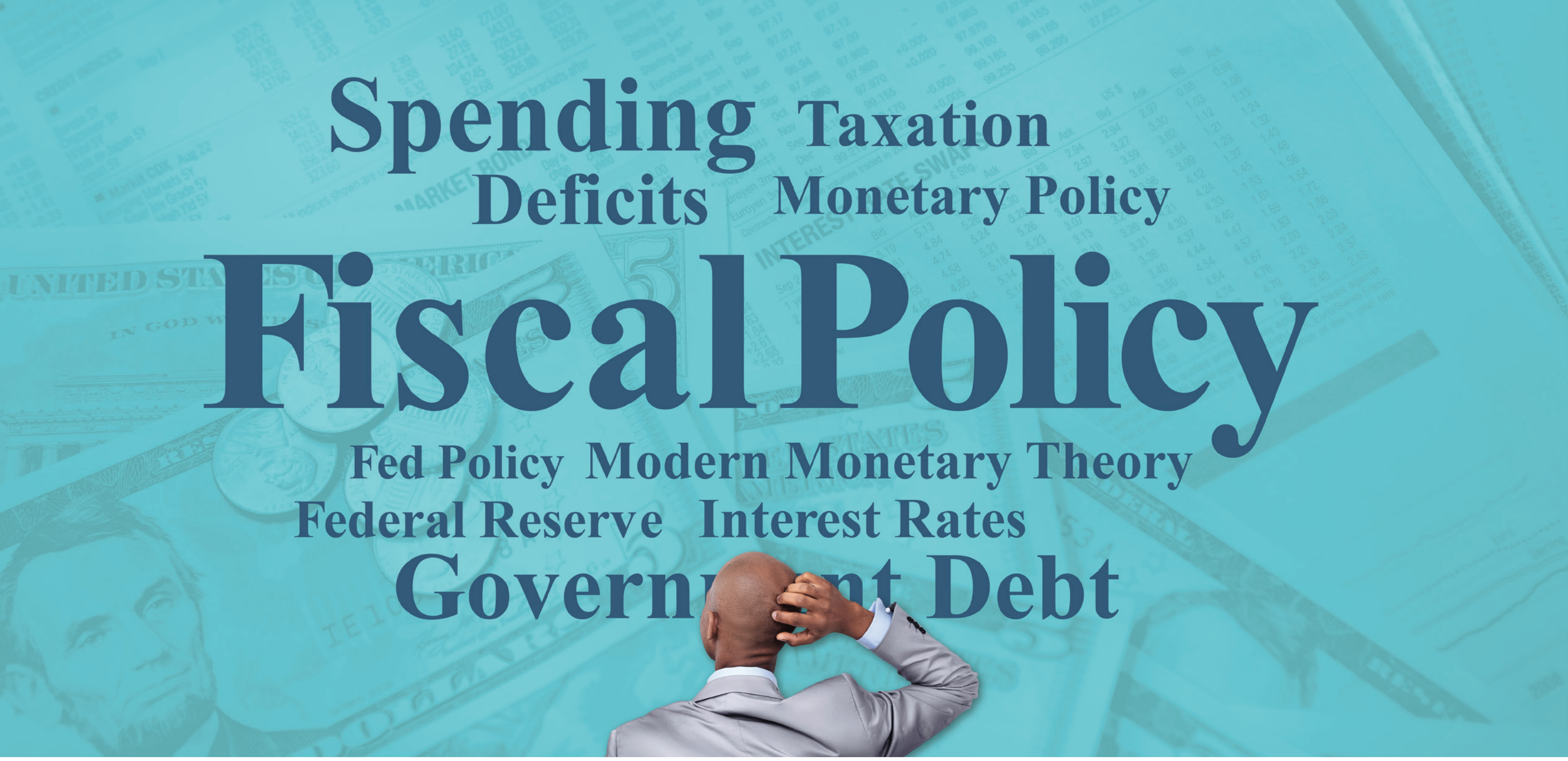


Economic Outlook: Fiscal Policy Beyond the Pandemic

Scott J. Brown, PhD, *Chief Economist,* Raymond James

To counter the economic effects of the COVID-19 pandemic, lawmakers approved $5.2 trillion in fiscal stimulus in 2020 and 2021–over 25% of annual gross domestic product (GDP) and more than most other countries. At the end of August, the national debt stood at $28.4 trillion. Should investors be worried? What do we mean by 'fiscal stimulus' and have attitudes toward federal deficits and debt changed?

WHAT IS FISCAL POLICY?

Fiscal policy refers to the use of tax and spending policy to influence economic behavior. Cutting taxes or increasing government spending is expansionary (or 'stimulative'), meaning that it adds to growth. Raising taxes and cutting spending is contractionary, meaning it subtracts from growth.

Fiscal policy stands in contrast to monetary policy, which is the setting of short-term interest rates (or also, in recent years, large-scale buying of Treasury and mortgage-backed securities) to influence economic activity. Monetary policy is quick to implement, as the Federal Reserve (Fed) can lower short-term interest rates whenever it decides to do so; however, it has a long and variable lag and it could take a year or more before the full impact is felt. In contrast, the effects of fiscal policy are more immediate, though it often takes time to implement. The conventional view among economists is that neither policy can be used to fine tune the economy. Monetary policy is the primary tool to guide the economy, and has been likened to steering a supertanker, while fiscal policy is reserved for fighting recessions. However, we're seeing some debate about whether the conventional view will continue.

> The government is not like a household. Our children and grandchildren do not have to pay off the national debt.

In a recession, the loss of jobs and income leads to reduced spending, which leads to further job losses, and further reductions in spending, and so on. Fiscal stimulus is intended to halt this snowballing and can be thought of as a bridge supporting aggregate demand while the private sector recovers. That bridge should be long enough to get to the other side. Stimulus was massive following the 2008 financial crisis–the federal budget deficit rose to 10% of GDP. In hindsight, while it prevented a much more substantial downturn, it wasn't large enough to propel the economy to a full recovery right away. From the start, the Biden administration did not want to make the same mistake.

In every recession, lawmakers announce some sort of tax rebate. Economists caution that sending one-time checks to individuals isn't effective as these checks are more likely to be used to pay down debt or add to savings, and are less likely to be spent. However, as we saw during the pandemic, income support can provide a critical lifeline for people who have lost jobs and income, and can prevent more substantial economic weakening.

Increased government spending is also used to fight recessions. Such stimulus should be targeted, timely, and temporary. Large-scale spending is difficult to plan quickly and, as we saw in the aftermath of the 2008 crisis, there may not be shovel-ready projects. Getting the money out rapidly is important. You don't want to add stimulus after the economy has already recovered. Ideally, added spending should be pulled back as private-sector demand recovers.

The 2008 financial crisis and the pandemic both led to significant economic downturns, but they were different than typical recessions and very different from each other. Following the financial crisis, it would take a long time to repair the damage to household and business balance sheets. We tend to focus on federal fiscal policy, but state policy played a key role in dampening the recovery. Most states have balanced budget requirements and state budgets turning red in the aftermath of the financial crisis led to spending cuts. About a third of the $831 billion American Recovery and Reinvestment Act of 2009 was aid to states, which limited job cuts initially, though state and local government employment still fell sharply and did not fully recover until 2019.

State tax revenues appeared to be at risk in the early stages of the pandemic, but federal support helped the national economy to recover, and most states saw a quick rebound in revenues. The pandemic recession was the sharpest and briefest on record, but brought massive job losses. The recovery has been swift, but partial. A full recovery is not going to happen until the pandemic is fully behind us, and it won't be over until it's over everywhere.

DEFICITS AND DEBT: SHOULD WE BE WORRIED?

The government is not like a household. Our children and grandchildren do not have to pay off the national debt. Does that mean

Fiscal and Monetary Policy

Fiscal Policy

The use of tax and spending policy to influence economic behavior

- Implemented by the government to fight recessions
- Can take time to implement, but effects are felt quickly

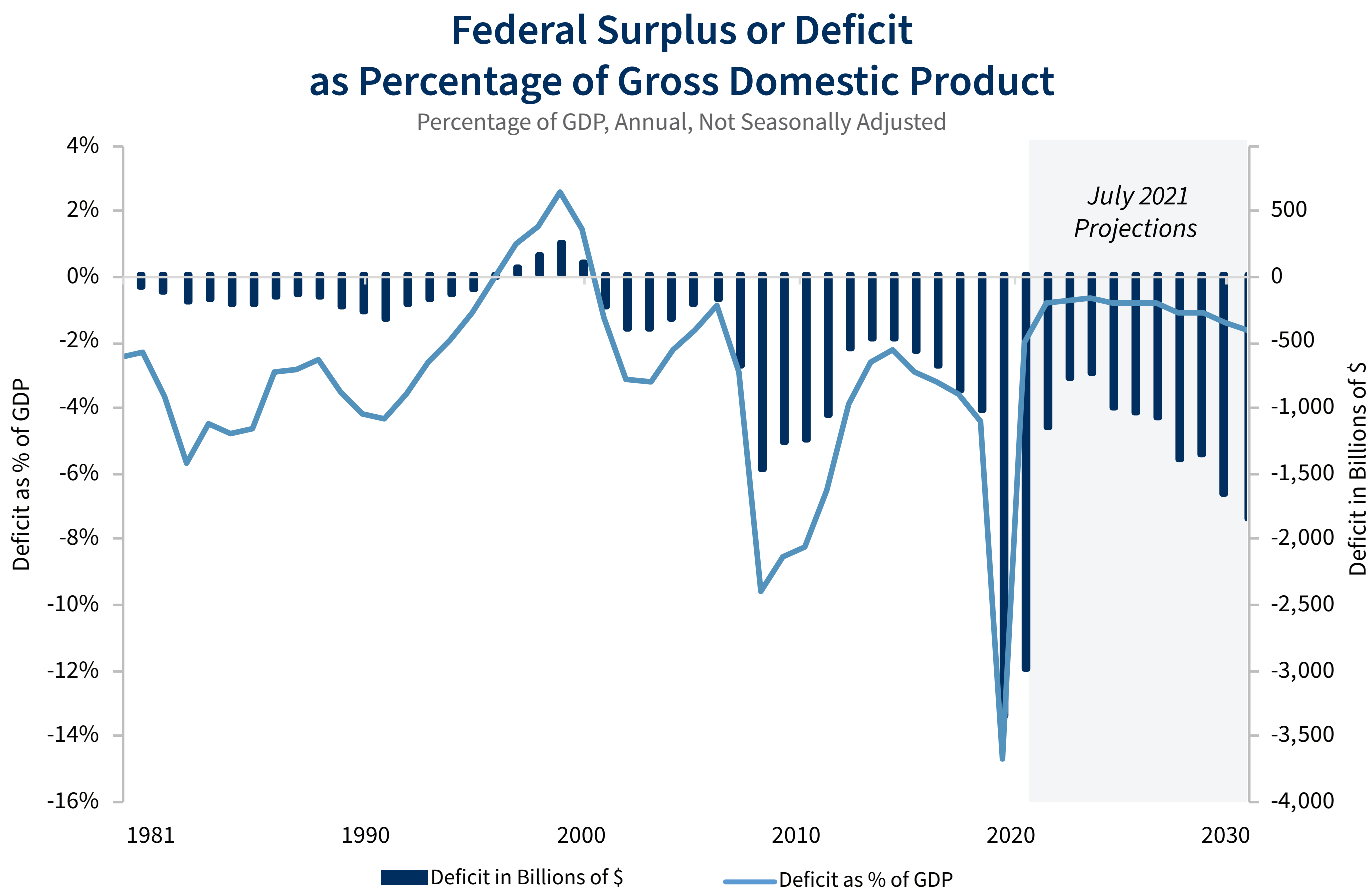
GOVERNMENT

Monetary Policy

The setting of short-term interest rates or buying of assets to influence economic activity

- Implemented by the Federal Reserve to guide the economy
- Is quick to implement, but may take time for the impact to be felt

CENTRAL BANK



Source: Congressional Budget Office, as of 7/31/2021 (based on current legislation – does not include infrastructure plan)

we shouldn't be concerned about the debt? The key issue is whether we can meet interest payments on the debt and whether we can roll over existing debt as it matures. So far, the US government can easily borrow and making payments on the debt shouldn't be a problem if interest rates rise moderately. Of course, there may come a point when government borrowing begins to crowd out private borrowing, reducing business investment and constraining consumer spending, but there's no sign that we're anywhere close to that.

What about inflation? Federal debt and deficits do not cause inflation. We ran deficits of around 5% of GDP in the 1980s and inflation trended lower. Japan has a debt-to-GDP ratio of 265% and has been battling deflation for years. That said, fiscal stimulus, especially direct payments to individuals, has boosted demand, while the pandemic has disrupted supply chains. Supply chain issues usually resolve themselves over time, but pandemic-related pressures have been more severe and have lasted longer than initially expected. The danger is that long-lasting supply chain disruptions could boost long-term inflation expectations, which could become self-fulfilling. While that is unlikely to be the case, we won't know for sure until much later.

MODERN MONETARY THEORY – A NEW ERA?

Over the last few decades, Democrats, when in power, adopted pay-go rules. Tax cuts or increased spending had to be matched by additional revenue sources or spending cuts in other areas. Exceptions were made for recessions and war, but otherwise spending and tax changes had to be deficit neutral. For example, this is how the Affordable Care Act (Obamacare), which passed in 2010, was paid for.

When the Democrats gained control of the House in 2019, they did not reinstate pay-go rules. Many on the far left have embraced Modern Monetary Theory (MMT), which essentially says that deficits don't matter and the government can spend whatever it wants (up to a point). Proponents of MMT argue that the pandemic experience of large deficits and low interest rates proves the theory, while opponents say it has been set against a naïve 'straw man' interpretation of conventional macroeconomics.

Critics of MMT point out that it isn't particularly 'modern' (such ideas have been around for a while), it isn't 'monetary' (we're talking government taxation and spending, which is fiscal policy), and it isn't much of a theory. It starts with its conclusion, unlike conventional economics which is built up from basic principles.

> "Fiscal stimulus is intended to halt this snowballing and can be thought of as a bridge that must be long enough to get to the other side."

Conventional wisdom on deficits has evolved, but not due to MMT. In the late 1980s, a decade of government borrowing had begun to put upward pressure on long-term interest rates. Fed Chair Alan Greenspan had an agreement with Congressional leaders to lower interest rates if they moved to reduce the budget deficit. The first President Bush and President Clinton each signed legislation to reduce the deficit.

In recent years, the conventional view has come to see more leeway in government debt. The key is that real interest rates (the rate at which the government borrows adjusted for inflation) should not exceed the growth rate of GDP on an ongoing basis.

WHERE DO WE GO FROM HERE?

In July, the Congressional Budget Office (CBO) projected that the federal budget deficit would fall from 14.9% of GDP in fiscal year 2020 to 13.4% in fiscal year 2021 (ending in September), and then drop to 4.7% of GDP in fiscal year 2022 and 3.1% of GDP in fiscal year 2023. The CBO's projections are based on current law and do not include the infrastructure bill, which would add a few tenths of a percent of GDP to the deficit in each of the next few years. The important point is the deficit will be coming down significantly, much as it did after the response to the 2008 financial crisis.

The federal budget deficit was on an unsustainable trajectory before the pandemic, around $1 trillion and rising as a percentage of GDP. We don't have to balance the budget, but we should eventually try to get our fiscal house in order. That means having a deficit that grows no more than GDP, which would stabilize and begin to reduce the debt-to-GDP ratio. Achieving this could involve increased tax enforcement and debate about spending reductions, including entitlement reform. Increasing taxes will be difficult, but lawmakers could work to reduce 'tax expenditures', the $1 trillion-plus in tax breaks that are embedded in the tax code. The important point is that there's no need to rush.

KEY TAKEAWAYS:

- Both fiscal and monetary policy are used to support the economy. Fiscal policy refers to the use of tax and spending policy to influence economic behavior. Monetary policy is the setting of short-term interest rates (and also, in recent years, large-scale buying of Treasury and mortgage-backed securities) to influence economic activity.
- In a recession, the loss of jobs and income leads to reduced spending, which leads to further job losses, and further reductions in spending, and so on. Fiscal stimulus is intended to halt this snowballing and can be thought of as a bridge supporting aggregate demand while the private sector recovers.
- Should we be worried about the debt? The key issue is whether we can meet interest payments on the debt and whether we can roll over existing debt as it matures.

Emerging Markets: An Uneven Recovery, but Strong Long-Term Potential

Tracey Manzi, CFA, *Senior Investment Strategist,* Investment Strategy

The global economy has recovered strongly from the pandemic, however, growth has been uneven. Advanced economies have been in the driver's seat throughout the recovery, as access to vaccines and acceptance rates have accelerated the reopening process in their respective economies. Emerging markets have faced considerable challenges as the lingering virus and slower than anticipated vaccine rollouts have created headwinds for their recoveries.

These diverging paths have led to a narrowing in the growth premium between developed and emerging markets and caused the performance of emerging market equities to fall further behind their developed peers. While the recent setback is disappointing, we still believe that emerging markets offer strong long-term potential and diversification benefits in a balanced portfolio. Below, we outline the factors that are shaping our view and some issues to watch in the current macro environment.

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FACTORS SHAPING OUR OUTLOOK

GROWTH SETBACK IS TEMPORARY

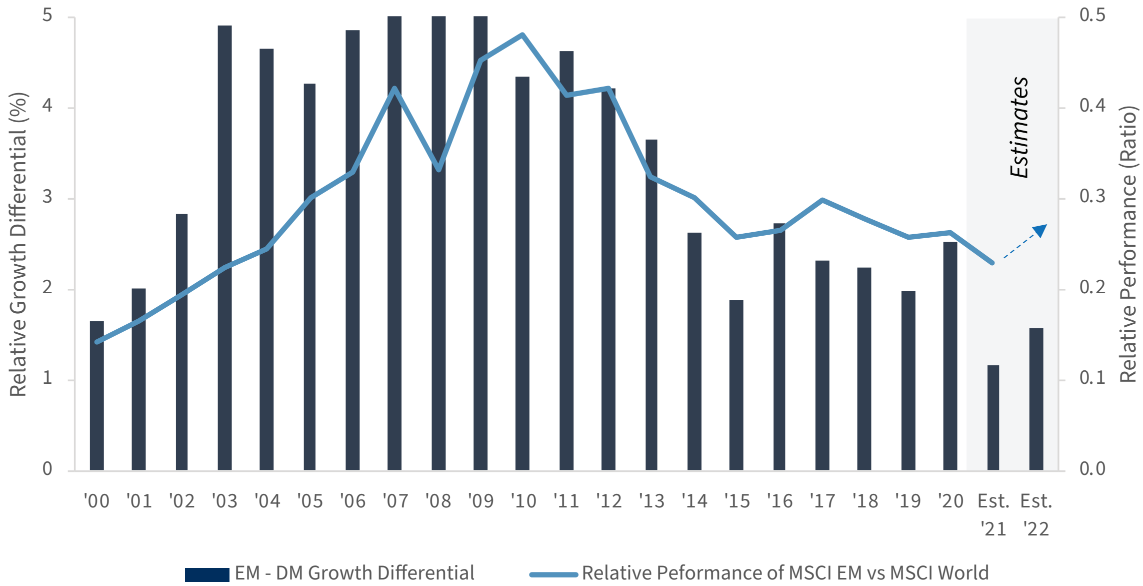
Emerging markets have been a dominate force in the global economy over the last twenty years. In 2001, emerging markets accounted for over 40% of global growth. Today, they represent nearly 58% of the global economy. The International Monetary Fund expects their share to rise to over 60% by 2025 as the urbanization of their economies and growth of the middle class continues. While pandemic-related challenges are temporarily restraining growth relative to developed markets, we do not expect this trend to continue. With vaccination rates improving and tentative signs that COVID cases are stabilizing, the near-term weakness in emerging market growth may not be as soft as the market fears. This should tilt the growth differential back in favor of emerging markets, with another meaningful boost when the impact of the sizeable fiscal and monetary stimulus in developed markets starts to fade.

ATTRACTIVE VALUATIONS

The recent weakness in emerging market equities has widened the valuation gap with developed markets even further from already discounted levels. The underperformance of the asset class has caused the MSCI Emerging Markets Index to trade at a 30-35% discount relative to the MSCI World Index and a 40% discount to the

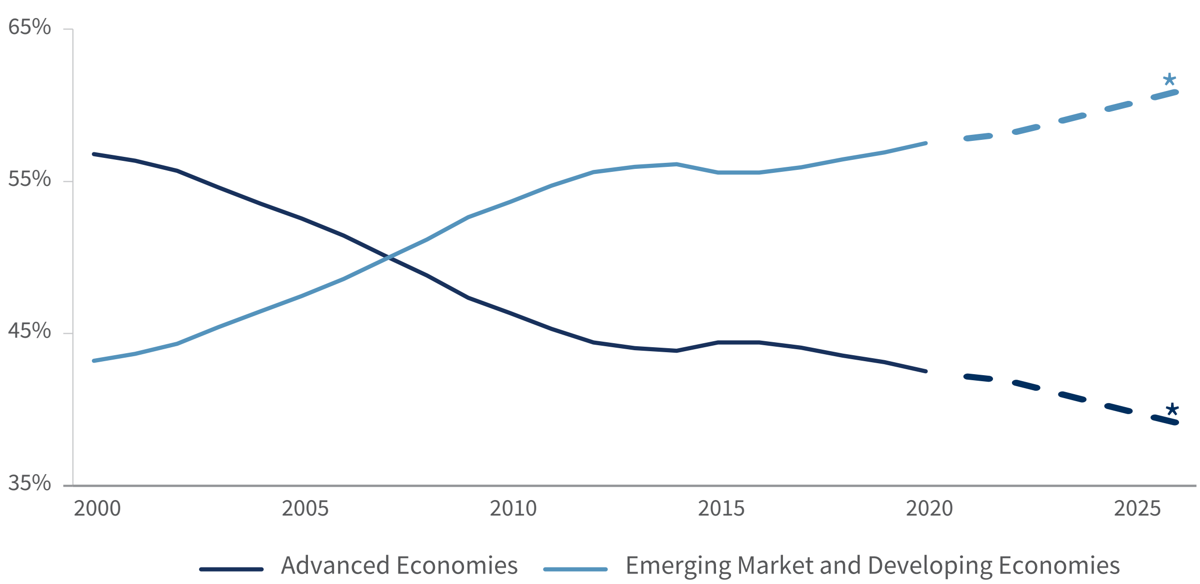
Growth Differential and Relative Performance Are Highly Correlated

Emerging markets tend to grow faster than advanced economies, with the relative performance of equity markets closely tied to the directional trends. While emerging markets have lagged, we expect rising vaccination rates and a strong global recovery to turn the growth differential back in their favor.



Share of Global Growth

The International Monetary Fund (IMF) expects emerging markets to capture an increasingly larger share of global growth on a purchasing-power parity basis in the coming years, making their economic importance hard to ignore.



Source: IMF, as of 9/15/2021
* Dotted lines represent forecasted numbers

S&P 500 Index. This is significantly below historical averages. While much of the discount is attributable to the valuation premium associated with US stocks, emerging market equities are nearing their cheapest levels in over twenty years. These attractive valuation levels will surely appeal to valuation-conscious investors.

EXPANDING MIDDLE CLASS

The rapid ascent of the middle class has been one of the key drivers behind the explosive growth in emerging markets over the last two decades. While the pandemic may have stalled consumption growth across the globe, we do not believe that the slowdown will turn into a permanent impairment in emerging markets. With the size of the global middle class expected to rise considerably over the next decade, and the bulk of the gains coming from the Asia Pacific region, we believe the slowdown will be short-lived. Once the pandemic-related challenges start to level off, the rising middle class should support increasing consumption and underpin growth trends for years to come.

TECHNOLOGY LEADERS

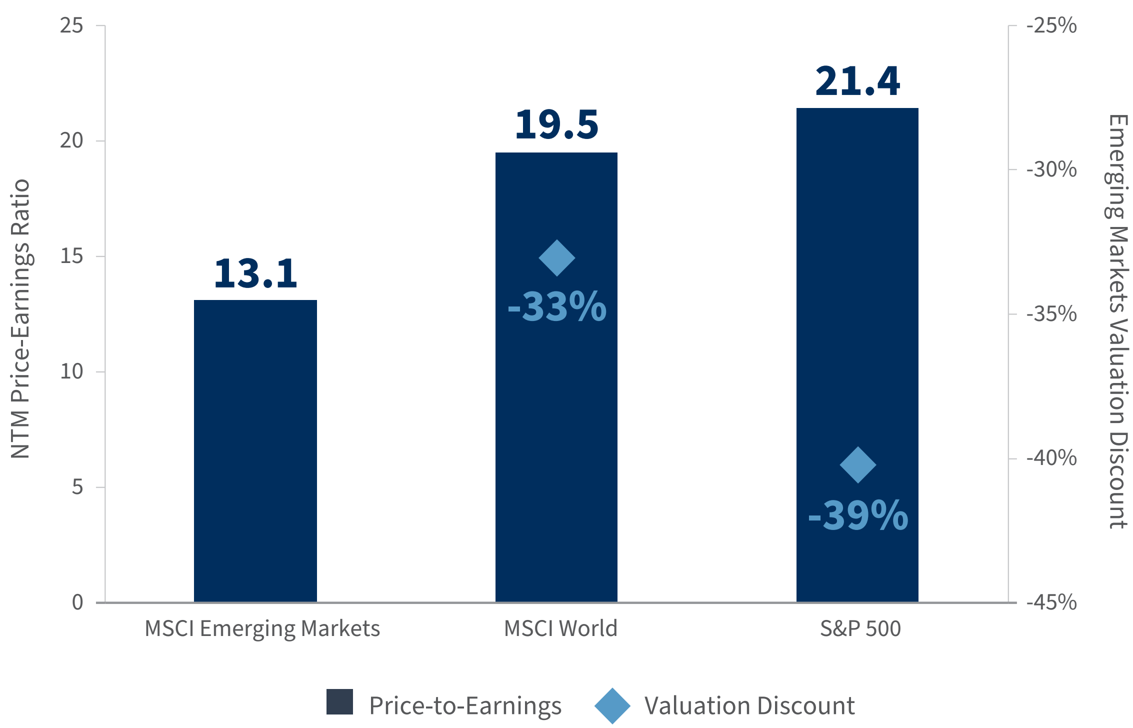
Over the last decade, emerging markets have transformed from cyclically-oriented, commodity-based markets to high-powered technology leaders. While cyclical factors continue to play a role, the Technology sector has emerged as one of the most important drivers within emerging market growth. While China was at the forefront of this revolution, a growing list of tech-related companies within the emerging market universe are trying to capitalize on the growing markets for e-commerce, mobile banking, artificial intelligence, health care, electric-vehicle batteries, and more. We expect these trends to continue as more companies look to meet the needs of their tech-savvy consumers.

WHAT TO KEEP AN EYE ON

CHINA

While China emerged quickly from the pandemic, lingering virus outbreaks and ongoing supply chain issues have taken a toll on its domestic economy. The slowdown is coming at a time when

Emerging Markets are Attractively Priced



Source: FactSet, as of 9/7/2021

Beijing's broadening regulatory crackdowns have also undermined investor confidence in the market, leading to underperformance of Chinese equities over the last six months. It has also weighed on the performance of emerging market equities given China's heavy weight in the index. While it is impossible to know how long China's regulatory reforms will continue to weigh on Chinese stock prices, the weakness does not seem to be spilling over into the wider emerging market universe. One of our favored indicators for flagging risk aversion in emerging markets is the JP Morgan Emerging Market Bond Index spread, which has been remarkably stable through China's recent rout.

FED TAPERING

Emerging markets are extremely vulnerable to changes in Federal Reserve (Fed) policy. History has shown that Fed tightening, or even the expectation of future rate increases, can often trigger instability and capital flight away from emerging markets. With the Fed inching toward tapering its asset purchases, emerging markets have been bracing for what could come next. The last time the Fed signaled tapering was on the horizon in 2013, 10-year Treasury yields climbed nearly 1.25% over a four-month period, which caused a 10% decline in emerging market equities. We do not expect a repeat of the 2013 episode, as the Fed has been carefully preparing the markets so there will not be any surprises that would lead to an unwanted tightening in financial conditions.

US DOLLAR

There is a strong inverse relationship between the performance of emerging market equities and the US dollar. This means that when the dollar is appreciating relative to foreign currencies, emerging market equities tend to underperform the S&P 500 Index, and vice versa. Emerging markets have remained weak as the Fed's Broad Trade Weighted Index has been in a structural uptrend since late 2011. While our longer-term view suggests the dollar is overvalued and should weaken relative to its foreign trading partners, pandemic-related uncertainties and the dollar's role as a safe-haven currency have kept its value elevated on a relative basis.

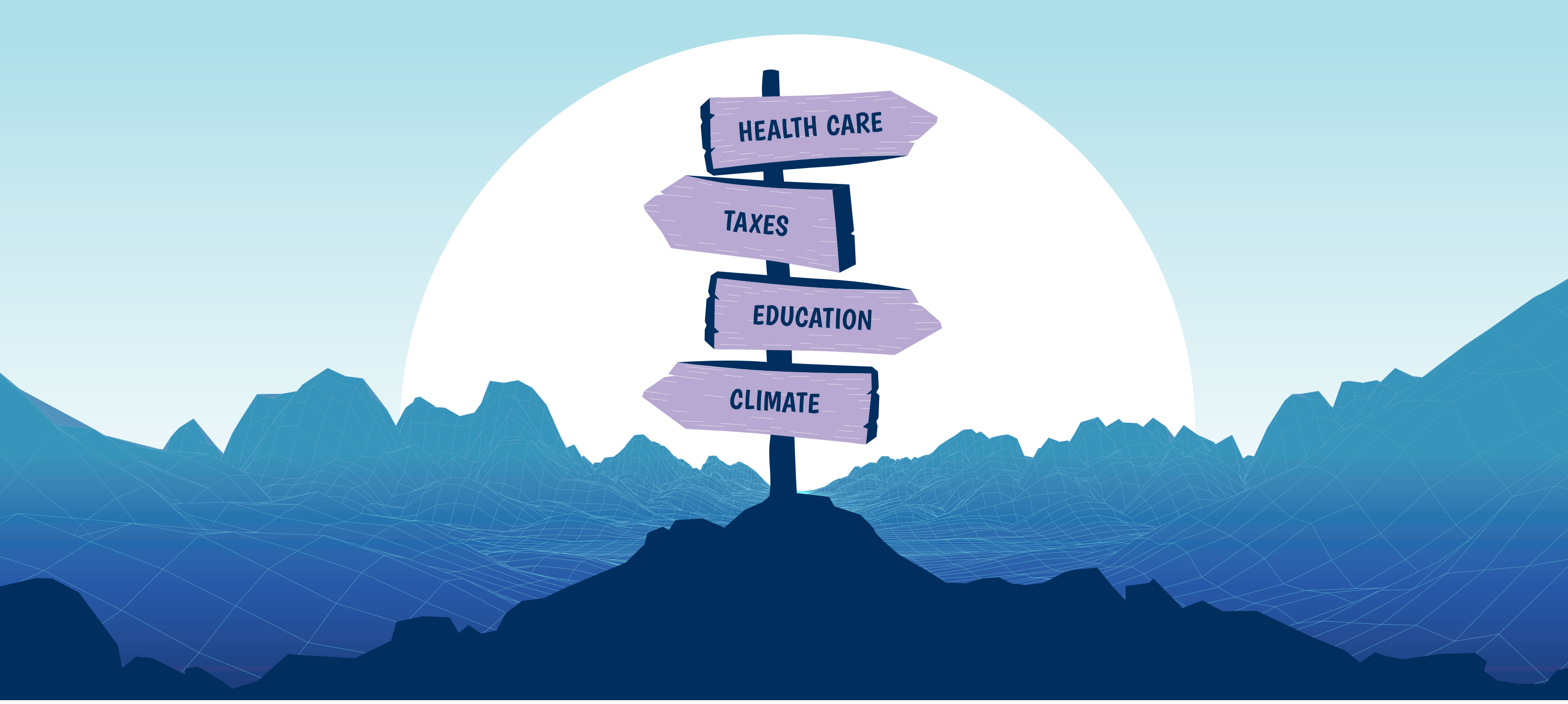
> “While the pandemic may have stalled consumption growth across the globe, we do not believe that the slowdown will turn into a permanent impairment in emerging markets.”

IN CONCLUSION

We continue to believe that emerging markets will remain a powerful driver of global growth and the recent narrowing in its growth premium should be short-lived. The longer-term benefits of investing in economies with superior growth prospects and supportive demographic and consumer trends should lift valuations relative to its developed market peers. While the coming months may bring some additional turbulence, emerging market equities remain cheap. As always, it pays to be selective when investing in emerging markets as the asset class is not a homogeneous group.

KEY TAKEAWAYS:

- Global growth continues to shift away from advanced nations toward emerging markets.
- Emerging market equities are nearing their cheapest levels in over 20 years.
- The rising middle class should support increasing consumption and underpin growth trends for years to come.



Biden's Agenda: Defining Fall Policy Sprint–Infrastructure, Fiscal Cliffs, and America's Global Role

Ed Mills, *Managing Director, Washington Policy Analyst,* Equity Research

Passing the bipartisan infrastructure deal, negotiating a budget reconciliation package, funding the government for the next fiscal year, raising the US statutory borrowing limit ('debt ceiling'), and settling key defense and foreign policy decisions top a long list of priorities in DC. Add in a variety of must-pass deadlines creating a series of fiscal cliffs, and we could see a fairly volatile several months in DC.

The market impact will depend upon the overall success or failure of these efforts, with a debt limit being a top near-term concern. Longer term, the market will be closely watching the tax and spending decisions of the reconciliation bill. Overall, we expect 2021 to end with the finalization and passage of Biden's 'Build Back Better' infrastructure and domestic agenda before DC transitions to a midterm election year that will determine control of the House and Senate for the remainder of Biden's term.

LEADING THE CHARGE: FINALIZING AND PASSING BIDEN'S 'BUILD BACK BETTER' ECONOMIC PACKAGE

President Biden's 'Build Back Better' plan, aimed at funding infrastructure and domestic priorities, faces a series of critical tests in the coming weeks. The process is likely to be complicated by political negotiations and various fiscal cliff deadlines. However, we believe the most likely final outcome remains passage of an overall economic package between $2 trillion and $3 trillion, with tax increases and other revenue changes to offset a significant portion of the new funding.

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The portion with the greatest clarity and highest probability of passage is the bipartisan infrastructure package that has already cleared the US Senate and includes approximately $550 billion in new infrastructure spending. The bipartisan portion broadly targets new funding for roads and bridges, rail, transit, ports, airports, water systems, power and grid, electric vehicles, and broadband.

Next on the agenda is the negotiation of a reconciliation bill, with a maximum total of $3.5 trillion – a number that is extremely likely to be negotiated downward. According to the framework developed

Passing the bipartisan infrastructure deal, negotiating a budget reconciliation package, funding the government for the next fiscal year, raising the US statutory borrowing limit ('debt ceiling'), and settling key defense and foreign policy decisions top a long list of priorities in DC.

by Congressional Democrats in August, this bill is seeking to address priorities on climate, housing, technology, education, and health care. The reconciliation bill is expected to extend the current Child Tax Credit, which is set to expire in December. The spending in this package is anticipated to be offset by tax changes and policy changes that increase revenue. As this is being done through 'budget reconciliation,' passage requires a simple majority in the House and Senate (no filibuster/60-vote threshold applies). Leaders are aiming to finish this bill in the October-November timeframe, but as we have seen in past policy debates, this could easily slip until December. Disagreement among Democrats could also prevent final passage, so depending on what is included or excluded among the spending and tax priorities, we could see policy-driven market volatility.

Changes to individual, corporate, international, and investment taxes are being discussed as ways to pay for the reconciliation bill. There has been a pledge by Congressional Democrats to limit tax increases to households above $400,000. President Biden has proposed a corporate tax rate increase from 21% to 28%, while House Democrats have proposed a 26.5% top rate, coupled with a tax cut to 18% for small businesses with taxable income below $400,000. Tax relief around the restrictions on State and Local Taxes (SALT) have also been promised, but details are limited. Dividends, capital gains, and other non-wage income taxes are also likely to be increased in a final bill. House Democrats have proposed raising the top income tax rate from 37% to 39.6% and increasing from 20% to 25% (28.8% with the 3.8% Affordable Care Act surtax) the long-term capital gains and qualified dividends for households with annual income above $400,000. Households with annual income above $5 million would be subject to a 3% surtax. Limits to Roth IRA conversions are also proposed. Increased IRS enforcement on unpaid tax liabilities is also a key revenue raiser expected in the final bill. These tax details provide an outline of the trajectory of a potential final bill. However, as negotiations remain fluid, these tax provisions could change significantly before a final deal is struck.

One final thing to watch that will have a dramatic impact on the final bill: The Senate's 'Byrd Rule' named after former Senator Robert Byrd (D-WV). Generally speaking, the Byrd Rule requires items in a budget reconciliation to be tied to spending and revenue. This could cause some policy priorities to be ruled out of order by the Senate parliamentarian. Candidates for Byrd Rule exclusions include a clean energy standard and immigration citizenship changes. The biggest question remains what level of spending and revenue can attract the support of both the moderate and progressive wings of the Democratic Party to get a final bill across the finish line. The fate of the bipartisan infrastructure bill has been tied to these dynamics for both sides to retain leverage and has contributed to the friction seen within the Democratic Party on the path forward.

BREWING BEHIND THE SCENES: FISCAL CLIFF THREATENS MARKET VOLATILITY

As lawmakers work to settle the expansive economic agenda outlined above, key fiscal deadlines around government funding and the debt limit add complicating factors to this fall's political dynamics. The initial strategy for Democrats has been to tie a debt limit increase to a short-term government funding bill at the end of September. This initial strategy elevated government shutdown/ debt limit concerns in the market. Although the initial budget resolution unlocking the reconciliation process for a follow-on supplemental bill did not include an immediate pathway for Democrats to raise the debt limit with a simple majority vote, the option is not off the table. Ultimately, the reconciliation instructions can be amended, or a separate budget resolution can be passed purely to address the debt limit, although this is a procedurally drawn-out process. From a big picture perspective, although concerns over fiscal showdowns have been elevated, we see a pathway to the resolution of the debt ceiling debate without threatening a breaching of the fiscal cliff.

PREPARING FOR WHAT'S NEXT: US/CHINA TENSIONS ON ESCALATORY TRAJECTORY

Earlier this year, we highlighted that the Biden administration views US domestic and foreign policy as interconnected and aims to enact economic policy to ensure the US remains globally competitive with China. This philosophy has arguably led to a 'no bark, all bite' dynamic as capital markets, national security, and human rights pressures drive the downward trend in US/China relations. Looking ahead, we see greater chances of increasing confrontation tied to the year-end target for commitments made under the 2019 "Phase One" trade deal, hawkish legislation being developed in Congress, China enacting foreign capital market barriers for domestic firms, and 2022 focusing attention on China's human rights issues ahead of the February Winter Olympics. The Biden administration's actions may turn more hawkish on China in the aftermath of the Afghanistan withdrawal and ahead of the 2022 midterms, which may be reflected in comprehensive China policy legislation Congress aims to finalize this fall.

A top geopolitical risk for the market is China's approach on Taiwan reunification efforts and the impact on global supply chains. There are major market concerns over a potential invasion or other military moves on Taiwan by China, which may rise as a concern for investors as tensions continue. Rhetoric may add to this concern by both the US and China over Taiwan's fate, especially in and around the renewal of General Secretary Xi Jinping's leadership position in 2022. Taiwan will continue to be seen as one of the top geopolitical risks, and current US military posturing toward building up US forces in the pacific region is a dynamic to watch for increased conflict potential. In the near term, these dynamics accelerate US planning and policies investing in the diversification of semiconductor and other sensitive supply chains to areas deemed less vulnerable to potential economic disruption.

IN ALL, A CONSEQUENTIAL FALL

As discussed, the scope of the political agenda through the end of the year sets up a key timeframe for the market as a catalyst for the finalization of Biden's domestic economic agenda. We expect decisions made by lawmakers in the coming weeks and months to carry significant impact into 2022 and beyond as key policy changes are implemented and digested by markets. The finalization of these policy priorities also opens the door to new focus areas by the administration and Congress in 2022, which at this stage we see focusing on reining in the market power of dominant technology platforms and increasing broader antitrust/market concentration scrutiny. Expect the rest of this year to define the political conversation into the 2022 midterm elections that will determine the impact of policy decisions from DC through 2024.

KEY TAKEAWAYS:

- We believe the most likely final outcome remains passage of an overall economic package between $2 trillion and $3 trillion, with tax increases and other revenue changes to offset a significant portion of the new funding.
- Although concerns over fiscal showdowns have been elevated, we see a pathway to the resolution of the debt ceiling debate without threatening a breaching of the fiscal cliff.
- The Biden administration's actions may turn more hawkish on China in the aftermath of the Afghanistan withdrawal and ahead of the 2022 midterms, which may be reflected in comprehensive China policy legislation Congress aims to finalize this fall.
- Expect the rest of this year to define the political conversation into the 2022 midterm elections that will determine the impact of policy decisions from DC through 2024.

Q&A: COVID-19 Update

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The COVID-19 Delta variant resulted in a new wave of cases in the US. Below, we discuss the impact of the Delta variant on the economy and supply chains; how the US compares to other nations in vaccination and pandemic responses; the effectiveness of vaccines against Delta; and possible future impacts of potential new variants.

Q: How has the Delta variant affected the economy and supply chains?

A: What we've seen is that the spread of the Delta variant is just adding to the supply chain issues burdening the world since summer 2020. Demand levels remain strong and are improving in the US and Europe due to substantial fiscal support and recovering economies, but labor shortages in the US and component shortages out of Asia are exacerbated by Delta. Most Asian countries have had a 'zero COVID' policy, which helped these economies experience less disruption from the pandemic last year. However, the Delta variant appears much more difficult to contain with traditional lockdowns, so the virus spread is much more severe across Asia than it has been at any other point in the pandemic. This has caused manufacturing shutdowns across India, Thailand, Malaysia, and Vietnam, and port shutdowns in Vietnam and China, which are impacting supply into the US. It is unclear when this will resolve itself, but it is clear that Delta has only exacerbated an already reasonably historic global supply chain issue, which is helping create inflationary pressures in the US, holding back economic growth, and impacting individual companies severely. Although the economic and profit recoveries continue, they are likely to be modestly held back by continued supply chain woes created by the Delta variant.

Q: How is the US handling the pandemic/vaccination progress compared to other developed nations?

A: As discussed above, most nations in Asia have had a 'zero COVID' policy which limited the impact of the early variants of the pandemic, while a select few refused vaccines and declared there was no virus present in their nations despite a lack of mitigation measures. Some nations took a less stringent

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approach to nationwide policy than Asian countries and others, like the US, have implemented varying policies at different times, levels of government, and parts of the nation. The politicization of the virus, mitigation measures, and vaccinations has resulted in the US having an excess supply of vaccines, but a vaccination rate 45th in the world. As of this writing, ~56% of Americans are fully vaccinated.

Over time, the responses have changed as new tools like vaccines have become available. Some nations, like Canada and Saudi Arabia, have issued vaccine mandates. There is also an increasing focus in some areas on 'vaccine passports' that allow individuals to participate in some activities like traveling, eating out, and going to concerts that those who are unvaccinated are not able to do. The response to vaccine passports is similar to the overall nationwide response. Some areas like New York City are using them while the vast majority of the nation is not. Going forward, we anticipate vaccine passports will not be adopted nationwide nor will there be universal vaccine mandates.

Q: What impact will potential future variants have on the vaccination process and lockdown measures?

A: First generation COVID vaccines do a good job preventing COVID including the Delta variant (one study in The New England Journal of Medicine indicated a drop from 94% efficacy against Alpha to 88% against Delta for symptomatic infection) and a very good job at preventing severe disease/hospitalization (still above 90% for all variants). Effectiveness against severe disease appears to persist, whereas prevention of infection (including asymptomatic infection) per se begins to wane within months and is exacerbated by new variants like Delta. It remains to be seen if third booster doses (now being implemented) will improve durable prevention against the Delta variant. Even if they do, it is entirely possible that further mutations of the Spike protein (beyond those in Delta) could lead to a slightly worse set of outcomes relative to the above (e.g., faster decline in immunity, more breakthrough severe cases) or even render current vaccines mostly ineffective. For example, there are conflicting data about the Lambda variant but some experiments suggest it may be even more evasive of current vaccines. Whether it's Lambda or something else, it is relatively likely current vaccines will continue to lose efficacy against variants that emerge under selective pressure of widespread vaccination.

That said, two dynamics will, in our view, preclude widespread shutdowns like we saw in 2020: 1) even if new variants evade prior immunity to some extent, the experience with Delta suggests there will be some benefit of cross-immunity between variants, which at a minimum will limit severe outcomes, and will be continually increasing with more vaccinations (and more infections unfortunately), and 2) the vaccines (particularly mRNA vaccines) can be easily adapted to new variants. So seasonal vaccines targeted to prevailing variants could always be a reasonable measure in lieu of full shutdowns.

Economic Snapshot

US economic growth was blistering in the first half of the year (stronger than the GDP figures would suggest, held back by a reduction in inventories and a wider trade deficit). The Delta surge has stalled the recovery in consumer services, but that's likely to be temporary. Growth in consumer spending and business investment was expected to moderate (though remain at a strong pace) even before the Delta surge, partly reflecting a reduction in fiscal stimulus. Inflation pressures remain persistent, but are still expected to be transitory. The Fed is on track to gradually reduce monetary accommodation.

DR. SCOTT BROWN
Chief Economist

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	GROWTH	GDP growth moderated, following outstanding strength in the first half of the year, partly reflecting an impact from the Delta variant. Growth should remain relatively strong in 2022.
FAVORABLE	EMPLOYMENT	Nonfarm payrolls have continued to rebound, but still have a long way to go. While demand for labor is strong, labor force participation has been slow to rebound, reflecting fear of the virus, childcare issues, and early retirements.
FAVORABLE	CONSUMER SPENDING	Wage growth is supportive of consumer spending. Lower vehicle sales reflect supply constraints (semiconductor shortage), but retail sales are still trending about 12% higher than the pre-pandemic trend.
FAVORABLE	BUSINESS INVESTMENT	Capital goods orders and shipments exhibited an exceptionally strong trend in the first half of the year, fueled by robust growth in corporate profits. The pace is likely to moderate in the near term.
FAVORABLE	MANUFACTURING	Growth in new orders has remained strong, fueled by the pandemic shift toward goods. Supply chain difficulties and labor issues have continued, restraining output growth in a number of industries.
FAVORABLE	HOUSING AND RESIDENTIAL CONSTRUCTION	Housing demand remains strong and mortgage rates are low. However, shortages of labor and materials have restrained supply and higher home prices have reduced affordability.
FAVORABLE	THE DOLLAR	With the Fed now on a path of reduced monetary stimulus, the dollar is expected to appreciate against the other major currencies.
FAVORABLE	REST OF THE WORLD	A mixed bag. The spread of the virus and the distribution of vaccines has varied widely; however, vaccine mandates in many countries will help their economies recover more rapidly.
NEUTRAL	INFLATION	Production bottlenecks and materials shortages have been more intense and have lasted longer than expected. Problems are likely to continue into 2022. Inflation in services has risen, but more moderately.
NEUTRAL	MONETARY POLICY	The Fed is expected to begin tapering the monthly pace of asset purchases later this year, in a process likely to end around the middle of next year. The Fed isn't debating interest rate hikes, but those may come in early 2023.
NEUTRAL	LONG-TERM INTEREST RATES	Bond yields normally rise in an economic recovery. Fed asset purchases have helped keep long-term interest rates from rising much, but we may see an increase ahead of Fed tapering.
NEUTRAL	FISCAL POLICY	A reduction in fiscal stimulus (compared to the massive levels of 2020 and 2021) will subtract from GDP growth over the next few quarters, but should be more than offset by increased private-sector demand.

Sector Snapshot

This report is intended to highlight the dynamics underlying the 11 S&P 500 sectors, with a goal of providing a timely assessment to be used in developing your personal portfolio strategy. Our time horizon for the sector weightings is not meant to be short-term oriented. Our goal is to look for trends that can be sustainable for several quarters; yet given the dynamic nature of financial markets, our opinion could change as market conditions dictate.

Most investors should seek diversity to balance risk versus reward. For this reason, even the least-favored sectors may be appropriate for portfolios seeking a more balanced equity allocation. Those investors seeking a more aggressive investment style may choose to overweight the preferred sectors and entirely avoid the least favored sectors. Investors should consult their financial advisors to formulate a strategy customized to their preferences, needs, and goals.

J. MICHAEL GIBBS
Managing Director of Equity Portfolio & Technical Strategy

These recommendations will be displayed as such:

Overweight: favored areas to look for ideas, as we expect relative outperformance

Equal Weight: expect in-line relative performance

Underweight: unattractive expectations relative to the other sectors; exposure might be needed for diversification

For a complete discussion of the sectors, please ask your financial advisor for a copy of *Portfolio Strategy: Sector Analysis.*

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	CONSUMER DISCRETIONARY	12.3%	Supply chain bottlenecks remain an issue, putting upward pressure on cost inflation and, in conjunction with reduced activity during the Delta variant rise, acting as a drag to forward earnings estimates and relative performance. However, we remain positive on the consumer outlook as demand remains strong, supported by elevated savings rates, strong credit, abundant job openings, and low interest rates.
OVERWEIGHT	FINANCIALS	11.0%	The Delta variant has weighed on the economic recovery in recent months, along with interest rates and the yield curve. However, balance sheets remain strong for the sector, supporting continued released reserves, dividend increases, and share buybacks. We remain positive on the fundamental outlook (and see valuation as attractive) for Financials given our expectation that interest rates will grind higher and loan growth will improve as the economic recovery ensues, accompanied by a tapering in Fed asset purchases (which is likely in the coming months).
OVERWEIGHT	COMMUNICATION SERVICES	11.4%	We maintain our Overweight stance, as fundamental and technical trends both remain strong, accompanied by a relatively attractive valuation in our view. We continue to favor the sector's combination of leverage to the economic recovery, as well as secular growth drivers from increased connectivity in today's environment along with the 5G rollout.
OVERWEIGHT	INDUSTRIALS	8.0%	We acknowledge the continued supply chain struggles, but demand remains strong (with a large backlog of orders). Additionally, inventories will need to be replenished from very low levels over time, leading to elevated new orders, which should support performance trends over the intermediate term. The sector could also get a boost from infrastructure stimulus.
OVERWEIGHT	ENERGY	2.5%	Earnings estimate revision trends remain the best out of all sectors, supported by WTI crude oil that has climbed back to ~$70/barrel. The higher oil price environment, accompanied by efficiency gains from the low price environment over the past several years, is resulting in large free cash flow for the sector. Instead of using the cash to over-produce, companies are using it in shareholder-friendly ways such as large variable dividends and buybacks. We also view valuation as attractive with oil prices at current levels.
EQUAL WEIGHT	INFORMATION TECHNOLOGY	27.9%	The sector's fundamental momentum remains strong, and relative performance has drastically improved as interest rates have moderated in recent months. We recommend a healthy allocation to the sector, but maintain an Equal Weight stance as we believe valuation could be a headwind to relative performance (given our expectation for a grind higher in interest rates).
EQUAL WEIGHT	HEALTH CARE	13.5%	Health Care has seen relative strength trends improve in recent months and valuation remains inexpensive. However, we are not convinced the sector is set for sustained outperformance due to relatively less leverage to the economic recovery, along with headwinds from potential drug price legislation and changes to the tax code (with a focus on multinationals).
EQUAL WEIGHT	MATERIALS	2.5%	The Delta variant's impact on global manufacturing, along with a slowdown in emerging markets is weighing on the sector's fundamental outlook and recent relative strength trends. While valuation has become relatively attractive, the potential for a rising US dollar remains a headwind.
EQUAL WEIGHT	REAL ESTATE	2.7%	Real Estate remains our favored interest-sensitive sector as it offers leverage to the recovery, along with relative protection from higher inflation. That said, rising interest rates could act as a headwind for the group, along with relatively slow FFO (earnings) growth.
UNDERWEIGHT	CONSUMER STAPLES	5.8%	The Consumer Staples sector offers generally consistent, but slow, earnings growth, which in the economic recovery remains unattractive relative to other sectors. Additionally, we see margin concerns as many operators struggle with rising input costs resulting from global supply chain bottlenecks.
UNDERWEIGHT	UTILITIES	2.5%	The Utility sector continues to exhibit the worst fundamental trends of all sectors in our view, and its slow growth decreases the value proposition versus other areas. Our positive view on the economic backdrop, along with the potential for rising interest rates, contributes to our Underweight stance.

DISCLOSURE

All expressions of opinion reflect the judgment the author, the Investment Strategy Committee, or the Chief Investment Office and are subject to change. Past performance may not be indicative of future results. There is no assurance any of the trends mentioned will continue or forecasts will occur. The performance mentioned does not include fees and charges which would reduce an investor's return. Dividends are not guaranteed and will fluctuate. Investing involves risk including the possible loss of capital. Asset allocation and diversification do not guarantee a profit nor protect against loss. Investing in certain sectors may involve additional risks and may not be appropriate for all investors.

International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic volatility. Investing in emerging and frontier markets can be riskier than investing in well-established foreign markets.

Investing in small- and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor.

There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.

US government bonds and Treasury bills are guaranteed by the US government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. US government bonds are issued and guaranteed as to the timely payment of principal and interest by the federal government. Treasury bills are certificates reflecting short-term obligations of the US government.

While interest on municipal bonds is generally exempt from federal income tax, they may be subject to the federal alternative minimum tax, or state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax. Municipal bonds may be subject to capital gains taxes if sold or redeemed at a profit.

If bonds are sold prior to maturity, the proceeds may be more or less than original cost. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revisions, suspension, reduction or withdrawal at any time by the assigning rating agency.

Commodities and currencies are generally considered speculative because of the significant potential for investment loss. They are volatile investments and should only form a small part of a diversified portfolio. Markets for precious metals and other commodities are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Investing in REITs can be subject to declines in the value of real estate. Economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.

High-yield bonds are not suitable for all investors. The risk of default may increase due to changes in the issuer's credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of your portfolio.

Beta compares volatility of a security with an index. Alpha is a measure of performance on a risk-adjusted basis.

The process of rebalancing may result in tax consequences.

Alternative investments involve specific risks that may be greater than those associated with traditional investments and may be offered only to clients who meet specific suitability requirements, including minimum net worth tests. Investors should consider the special risks with alternative investments including limited liquidity, tax considerations, incentive fee structures, potentially speculative investment strategies, and different regulatory and reporting requirements. Investors should only invest in hedge funds, managed futures, distressed credit or other similar strategies if they do not require a liquid investment and can bear the risk of substantial losses. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

The companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence.

The indexes mentioned are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities. The Bloomberg Barclays U.S. Aggregate Bond Index contains approximately 8,200 fixed income issues and represents 43% of the total U.S. bond market.

The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. The JP Morgan Emerging Market Bond Index tracks U.S. dollar denominated Brady bonds, loans and Eurobonds.

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