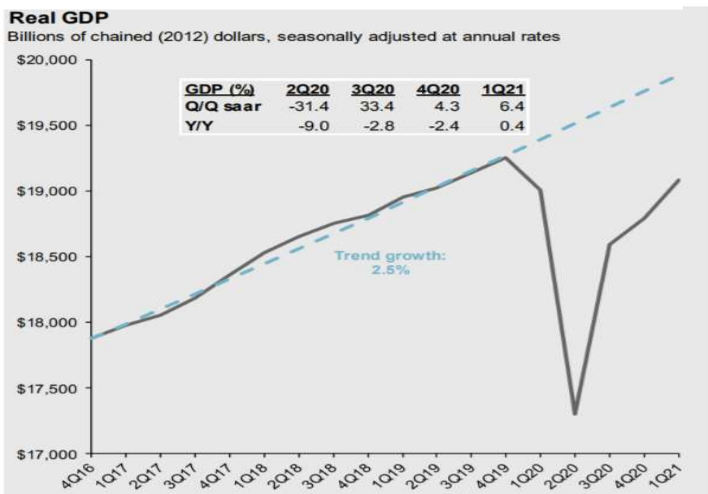
ALTERNATIVELY SPEAKING…

QUARTERLY COMMENTARY – 2Q 2021

Introduction:

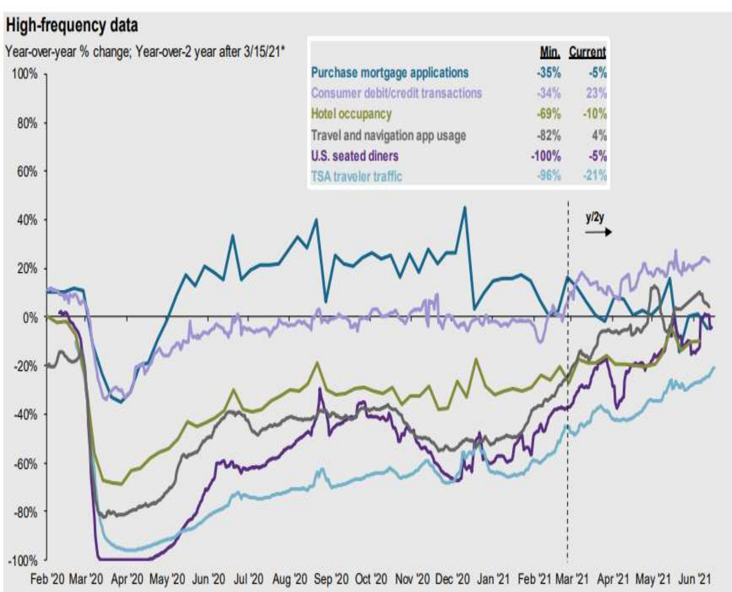
Figure 1: Trend GDP and growth:



Source: JPM Asset Management

The US economy continued its successful march towards recovery during the second quarter. Social distancing restrictions were significantly eased, and 67.1% of those 18+ have now received one vaccine dose. 58.2% of US adults are fully vaccinated, and normal activities like dining-out and travel are finally returning to pre-pandemic levels. As we close out the first half of 2021, we note that Q1 real GDP grew by an annualized 6.4% and we are on pace to deliver a 7.8% second quarter growth rate according to Atlanta Fed's GDPNow forecast. Demand across various activities continues to pick up and normalize based on a variety of real time high frequency data metrics.

Figure 2: High Frequency Demand Data:



Source: JPM Asset Management

Employment:

On the employment front, job growth was strong as the economy added an average of 541k jobs per month in the past three months through May 2021. June's employment number highlighted an 850k increase that was largely concentrated in services sectors, and expectations point towards an even stronger 1 million+ increase in employment in July. With that said, we still stand short of approximately 7.5 million jobs versus that of the pre-COVID high. Total non-farm job openings have elevated past pre-COVID levels. In short, labor data suggests a favorable employment outlook.

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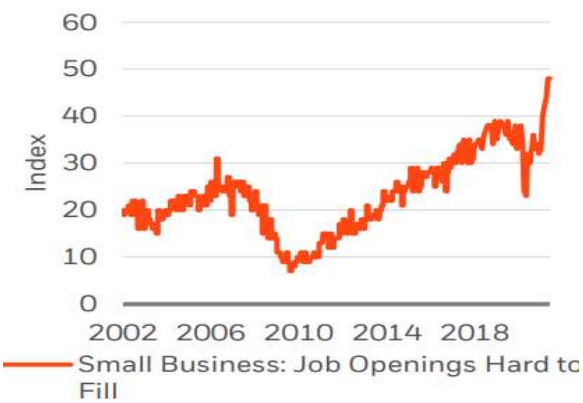
Inflation:

With the rapid reopening of the economy, inflation trended higher. April and May 2021 CPI (year over year inflation) prints showed +4.2% and +5.0% price increases and are currently on pace to annualizing at +6.5% YTD through May. While many of the pressures in the data are one-time transitory price increases, there are plenty of reasons to believe that inflation may persist at levels higher than previously seen.

Figure 4: Jobs Hard to Fill Index:



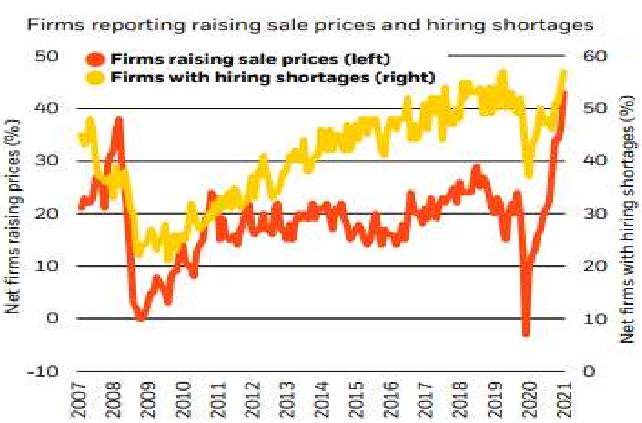
Source: Department of Labor

- We covered this in our early inflation piece in Q1. Constrained supply has been outstripped by demand. Since February 2020, the excess savings is likely around $2.5 trillion or about 15% of annual consumer spending. This is a tailwind for consumer demand.

- Despite unfavorable market reaction to labor prints in recent months, the labor market has been so strong that there aren't enough participants to fill the job vacancies. Jobs hard to fill index shows that new openings now exceed pre-Covid levels by nearly 20%. These frictions should be alleviated to some degree as benefits roll off. However, there are structural skills mismatches that add to wage inflation pressures which are not transitory. Charts like Figures 4 and 5 highlight the mounting inflationary pressures evident within the labor markets.

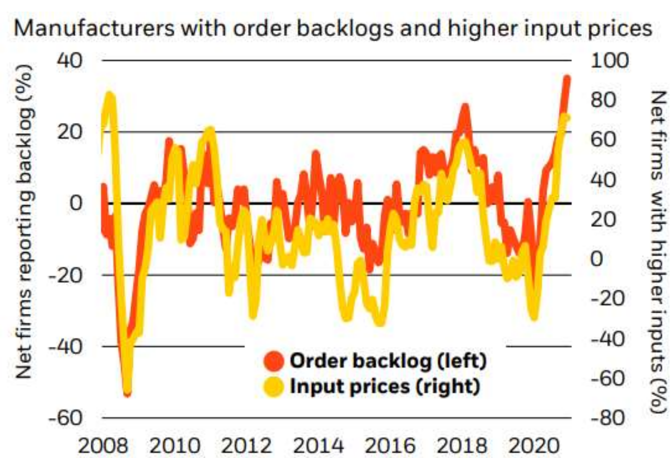
- Manufacturer order back logs and input prices are now at the highest levels since the GFC. Figures 5 and 6 highlight the ongoing supply side constraints/increases.

Figure 5: Survey data on rising sales prices and hiring shortages:



Source: Bloomberg, National Federation of Independent Businesses (NFIB) survey data, as of June 8, 2021.

Figure 6: ISM Manufacturing survey data showing Increases in order backlogs and input prices:



Source: U.S. ISM Manufacturing Survey, as of May 27, 2021.

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To be clear, we are not in the runaway inflation camp. However, we maintain a view that current inflation expectations and real yields are too low for the growth outlook that is in play today.

General Market Update:

Most major indices posted positive returns during the second quarter. The equity markets represented by the S&P 500 (US equities) and MSCI ACWI (Global equities) indices posted second quarter returns of +8.5%, and +7.5%, respectively. Bond markets, represented by the Bloomberg Barclays US Aggregate Bond Index, posted a quarterly return of +1.83%. Despite strong economic and inflationary data points, underneath the hood, the reflation narrative took a pause. While the first quarter was characterized by a "risk-on" outlook, the second quarter saw a flight to safety as investors became concerned about the growth outlook with the emergence and spread of new COVID variants. Yields broadly fell across the treasury curve, and cyclical and value sectors underperformed technology and growth sectors. Admittedly, the move in markets is a bit puzzling given not only how early we are in this economic recovery, but also provided how accommodative monetary and fiscal support has been.

Fixed Income and Credit:

Fixed income markets as measured by the Bloomberg Barclays Aggregate Bond Index returned +183bps during the second quarter yet are still down -1.60% YTD. Riskier sectors like US corporate high yield as measured by the Bloomberg Barclays US Corporate High Yield Bond Index returned +2.74% during the quarter. Spreads were already low coming into the quarter and have grinded even tighter during the quarter to about 300bps. Yields fell across the curve, with longer dated treasuries seeing a strong bid despite accelerating inflationary pressures. As a result, we saw a flattening of the yield curve. Chair Powell also communicated that the Fed would not raise rates "pre-emptively" over inflationary fears. Even with the bearish signal fixed income markets have priced during the quarter, we maintain our view that government bonds no longer serve as the efficient diversifier of balanced portfolios. This view is further cemented by the inflationary risk that exists today. Base effects will continue to fall off as we move forward, and it could be that bond markets have largely been held in check because investors want more data points to confirm that inflation is broader and more persistent after all the base effects are removed. However, the risk of not getting ahead of this potential heightened inflation regime is too high in our opinion. We believe the GDP and yield data in the chart below helps support our view on rates moving higher from here.

- Figure 3 below charts historical and forecasted real GDP in orange, and the 5-year real bond yields in yellow (this nominal minus the forecasted inflation rate). The green mountain chart takes the spread of the two. The dotted blue box highlights that if forecasted real GDP is realized (2021 **AND** 2022). This would be the largest divergence if output forecasts are realized and if current real yields didn't move. We take the view that this is not sustainable and there is more convergence ahead.

- Economic growth has been rapid given the accommodative policy and easing of restrictions. We are now only 0.9% away from reaching pre-covid level output levels in GDP if consensus forecasted estimates are met.

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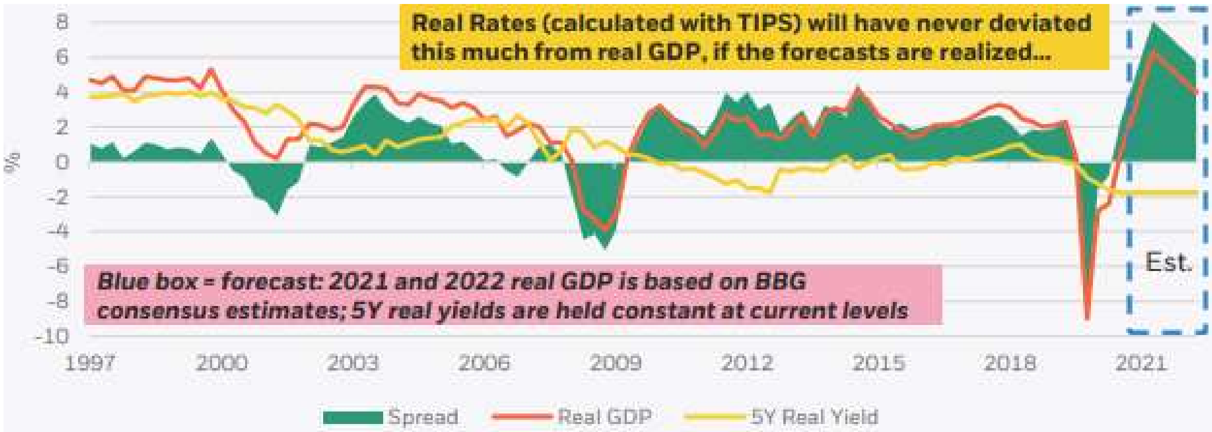
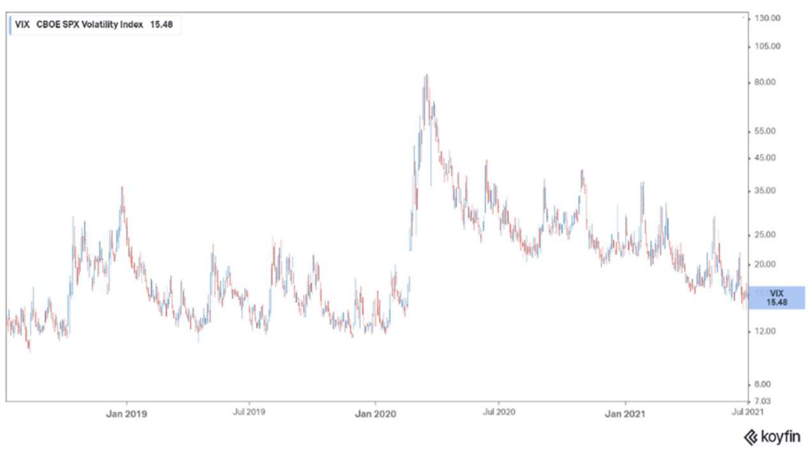
Figure 3: Historical Chart of Real GDP vs. Real Yields:



Source: BlackRock and Bloomberg as of 4/30/2021

Equity:

Figure 7: VIX Index:



Source: Koyfin

Volatility across equity markets trended lower during the quarter. The VIX Index, a measurement of expected overall equity market volatility finished the quarter at 15.48. Current volatility levels are still elevated relative to history, but we expect that easy fiscal and monetary conditions will further push this to newer lows. Factor and style activity on the other hand told a different story. We saw considerable dispersion and strong trend reversals at the sub-index levels during the second quarter. While last quarter saw growth indices underperform cyclicals and more value-oriented sectors, the second quarter brought on a reversal in some this YTD outperformance with the Russell 1000 Growth Index outperforming the Russell 1000 Value Index by nearly ~+700bps. Growth and technology sectors, which largely consists of long duration assets, saw a nice tailwind from the rapid fall in yields during the second quarter. Yield moves and economic misses in data caused such a strong market reversal that Russell 1000 Value Index underperformance against the Russell 1000 Growth Index in June alone was roughly -800bps, the largest monthly spread in nearly 20 years.

We maintain our view that the post-Covid era provides a ripe environment for stock pickers. The unprecedented level of policy and economic uncertainty has caused tremendous price distortions across sectors and factors- ultimately setting up a backdrop where corporate earnings have little margin for error. Furthermore, you have businesses revamping operations during a period of rising input costs that can potentially eat away at existing profitability estimates. As a result, dispersion should remain elevated

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which potentially allows those managers that apply a value aware and fundamentally driven investment process to thrive.

Alternatives:

Alternative portfolio performance during the second quarter helped cement our bull case for alternative strategies and assets. Equity and bonds remain expensive in our view, and therefore, we seek absolute return potential from alternative strategies. While equity and fixed income markets each posted positive quarters, our alternative managers across strategy and asset classes were able to deliver compelling returns to complement the beta component of our portfolios.

Equity substitutes:

- Long-short equity managers continue to deliver strong and differentiated sources of return for our portfolios. While the first quarter proved to be a very fruitful quarter for more value focused managers, these strategies took a took a bit of a back seat this quarter. Helping offset these results, our more tech focused and growth style long short equity strategies were able to contribute strong outperformance. The contrast in first half 2021 performance between growth and value highlights the importance of applying a multimanager approach when investing in long short equity strategies.

- Why were these managers able to shine during the quarter? These managers often buy high quality, large cap companies that are rapidly growing sales and earnings which are set up to grow at an accelerated pace given their adoption of business models that play into industries benefitting from long term secular tailwinds. On the short side, they are selling stocks of businesses that are operating in sunset industries facing headwinds. As mentioned before, the overall market found economic data and news to be underwhelming and rotated towards quality and safety in high growth themes and names- almost a re-up of COVID 2020 winners. It's important to note that these types of stocks also carry higher premiums/multiples and carry much more interest rate sensitivity.

Fixed Income Substitutes:

- We maintain our preference for fixed income alternatives. We continue to allocate our portfolios across a variety of low duration and low volatility strategies that help diversify returns away from broad fixed income indices which rely largely on duration and credit risk factors. Instead, we prefer to allocate capital to opportunities that we believe have far better return and risk characteristics. Why is this so important in today's environment? Bonds can hedge growth, but not inflationary risks. The chart below illustrates how traditional bonds performed in high inflation

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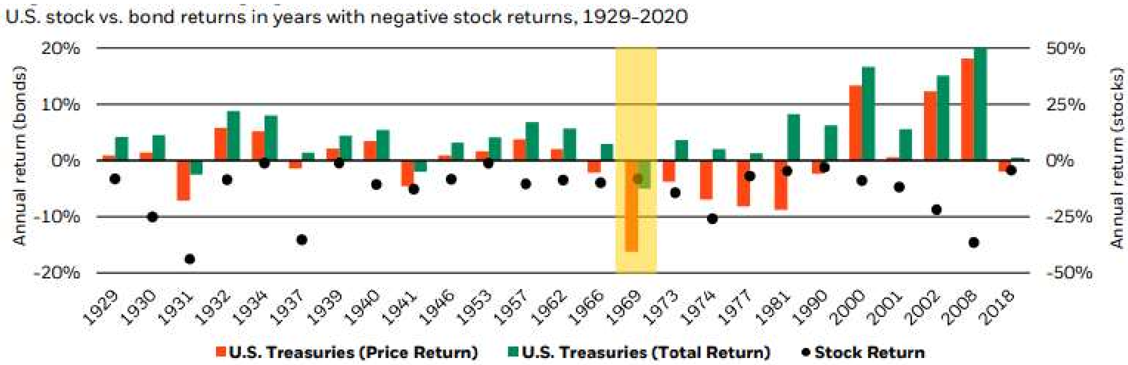
environments vs. stocks. In such a scenario, we believe that the 60/40 model construction is far less effective.



Source: BlackRock and Bloomberg as of 4/30/2021

- An example of such a fixed income substitute is event driven exposures. These managers employ investment strategies that are designed to capture price movements generated by broader corporate events (M&A, special situations, credit, M&A credit, relative value credit, restructuring/reorg credit). Such strategies have been able to deliver strong risk adjusted returns given a backdrop of elevated deal volume and tightening spreads in corporate and structured credit markets over the past two quarters. Unlike traditional fixed income, duration (interest rate sensitivity) has little to do with the strategy's ability to generate returns. Rather, more idiosyncratic risks like the probability of deal completion and regulatory risks impact a manager's ability to deliver positive returns.

- Real estate and private credit exposures continued to perform well in this economic backdrop. Both asset classes have made their way into the portfolio for their high-income potential and are likely to outperform traditional bonds in an environment of higher inflation. Given the absolute low levels of yields earned in generic corporate credit markets, higher nominal yields in these two alternative asset classes allow for higher real income potential. Furthermore, real estate portfolios are able to reset rents at lease expirations to better track inflation, while private credit loan coupons are attached to a floating rate and provide meaningful spread premiums that help lenders fight higher inflation levels.

Conclusion and Outlook:

We have been very pleased with our overall investment positioning and in particular, the robust performance and diversification that our alternative allocations have provided. The journey back to pre-COVID economic levels walks an uncertain path, however, the monetary and fiscal backdrop continues to be **incredibly** accommodative. Top of mind, of course, is the inflation debate. Understanding the inflationary path is critical given the bind that the Fed is in today- either tighten monetary policy at the risk of slowing down what has been a successful recovery or act too late and run the risk of overheating the economy.

Many believe we will quickly return to the pre-COVID environment of secular stagnation, and therefore, it's business as usual in holding the same mix of stocks and bonds. This is obviously no easy

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pivot for policy makers or investors given that we potentially find ourselves at a crucial policy and economic inflection point. Our view is that the traditional asset allocation models carry too much risk in today's market environment- and that there is an alternative approach to navigating these uncertain times.

We see a world that fully re-opens with wider vaccine adoption and falling mortality rates from the virus. The pent-up demand will likely continue to face constrained supply chains, and we expect that inflationary pressures are here to persist longer than yields current imply. The economic restart globally has not fully taken place. There are plenty of economies/demand that have yet to come online given their localized issues with vaccine distribution. We believe this recovery has plenty of room to broaden out. While coronavirus wreaked havoc last year, it is our view that the virus's direct impacts will be far more muted given continued vaccine rollouts and therapeutics. Savings and household debt levels are at very favorable levels, while consumers flushed with cash. Even though there are many risks to be concerned about, we believe are that we are well positioned for this regime shift. Current positioning expresses a pro-risk tilt across our portfolios in what we believe to be in a prudent and disciplined manner- such positioning heavily incorporates alternative strategies and assets. At the same time, this also means avoiding hugely distorted areas of the market. We think it is a prudent time to more heavily own assets that should hold up better for a pro-growth and pro-inflationary regime- real estate, ex-US and value stocks, and private credit.

As always, thank you for your trust and confidence.

Best,

Johann Lee, CFA

Director of Research

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