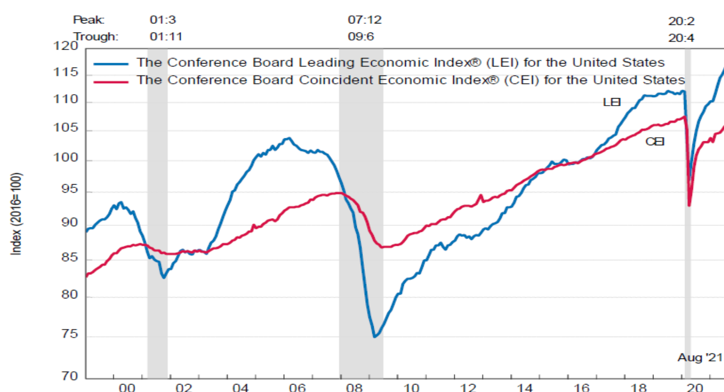
VANDERBILT Ave.
ASSET MANAGEMENT

3rd Quarter 2021

Vanderbilt's outlook has been that economic growth and inflation would be higher than the consensus forecast, and that growth will moderate as we approach year end. There are risks to our economic forecast. One of the primary risks remains **Covid Delta Plus**. Covid continues to present challenges to the global economy. The Delta Plus variant is more contagious and dangerous than previous variants and represents a headwind to growth-despite not having the complete lockdown like last year. Covid Delta Plus has negatively impacted an otherwise strong labor market. Both demand for and the supply of workers should increase if Covid Delta Plus goes back into retreat. As we go to press, the United States is averaging more than 2,000 daily deaths and has surpassed 700,000 fatalities in total. Over the last fourteen-day period, new cases and hospitalizations have dropped by 27% and 18% respectively. One of the keys to bringing the Covid Delta Plus related infections under control is a global vaccination program that inoculates a large percentage of the world populace. In the U.S. 56% are now fully vaccinated.

Economic growth has been strong this year (6.7% real GDP for second quarter) but we see it moderating for 2022. We do not forecast a recession. U.S. consumer spending is the primary reason we are optimistic on growth. The consumer is two-thirds of the $22 trillion U.S. economy. Consumption grew at an 11.4% annualized rate in the first quarter and was up 12.0% for the second quarter. The consumer sector is as large as China's economy (the world's second largest economy after the U.S.) and is three times larger than Japan's economy (the world's third largest). Consumer balance sheets have strengthened during the past eighteen months. Personal savings have swelled to $1.7 trillion dollars, the equivalent of eight percent of GDP. The economic lockdown caused consumers to suspend activities such as travel and leisure, entertainment and commuting. Nearly $65 billion dollars was retained in housing and student loan expenses and another $20 billion dollars saved in lower interest costs. In addition, household revolving credit lines are only 20% utilized. The labor market has been an important backbone to consumer spending. The labor market has gained back almost three-quarters of the 22 million jobs lost last year. Consumer spending has also been aided by the 6.1% year-over-year gain in personal income. Fiscal aid (such as enhanced unemployment benefits) has further supported the consumer as has a continued low interest rate environment from Federal Reserve monetary policy. The consumer balance sheet has been significantly strengthened from debt paydowns and a buildup of consumer savings. The U.S. Leading Economic Indicators rose sharply in August and continue to rise on a steep trajectory. The Leading indicators increased by 0.9% in August following a 0.8% increase in July and a 0.6% increase in June. The trend in the Leading Iindicators is consistent with robust economic growth for the remainder of the year.

***The Conference Board Leading Economic Index®* (LEI) for the U.S. Increased in August**



Vanderbilt has an **inflation** outlook higher than the consensus for the second half of 2021, but we think inflation will level off by the second half of 2022. Since the early 1980's, inflation has steadily declined thru three economic expansions and periods of low unemployment. Low inflation drivers have included technological innovations and demographics. Demographics have impacted inflation as life expectations rise people will save more thereby applying downward pressure on interest rates and inflation. While supply chain bottlenecks have occurred recently, expectations are that they will resume their normal flow as workers return and transport systems ramp up. Current inflation gauges are seeing upward pressure on prices due to pandemic induced "base effects". Current CPI readings are up 5.1% year-over-year. The University of Michigan Consumer Survey in August found that consumers expected higher inflation down the road. Finding labor has become increasingly difficult with average hourly earnings increasing by 4.6%. Present inflation is attributable to wage price pressure and unprecedented pressure on the supply side of the equation. Confidence in restraining inflation depends in part on the Fed's willingness to act if prices rise too quickly. However, this is the most dovish Fed in decades and policy may be slow to react. We think by the fourth quarter of 2021 supply chains will start to stabilize in order to maintain efficiency of production. Investment in technology has surprisingly risen rapidly, driven partly by the remote work at home movement. The resulting efficiencies in productivity and e-commerce will eventually help to moderate pricing pressures. If Vanderbilt's forecast is wrong, inflation could experience a longer upside surprise. Health care (one-sixth of the U.S. economy) has recently seen some inflationary pressures. Medicare payments and health care insurance costs have recently risen. The U.S.-China trade conflict could cause further problems in the supply chain. Finally, shelter (owners' equivalent rent), which makes up about a third of the CPI, may rise in line with house and rent prices.

Corporate Bonds
3rd Quarter 2021

At its recently concluded FOMC meeting the Federal Reserve indicated a pivot in their aggressive **monetary policy** accommodation. Federal Reserve Chairman Jerome Powell all but confirmed what most Wall Street analysts had been forecasting. That the Federal Reserve would begin tapering the monthly asset purchases of $120 billion later this year and conclude the program by mid-2022. This would be the precursor to considering interest rate hikes. Chairman Powell stated, "the decision to wind down asset purchases and the decision to raise interest rates are separate". The Fed noted uncertainties remain including the Covid Delta Plus variant and a potential growth slowdown in China. In order to consider lifting rates, the Fed we believe wants to see a labor market that is fully healed. With regard to their dual mandates: (1) the Fed's inflation outlook is 4.2% for the fourth-quarter 2021 and moving lower to 2.2% for 2022 (the core PCE rate, their preferred inflation gauge, is currently at 3.6% year-over-year through August) and (2) with regard to full employment, millions of jobs remain missing compared with before the pandemic. The Fed is likely to move very cautiously when adjusting interest rates higher (both with regard to timing and the pace of increases) due to these missing jobs. Major uncertainties persist looking out to mid next year when the Fed begins to formulate policy with regard to raising the Fed Funds rate from its current level. It does appear at this time that whenever the Fed has completed their lift of interest rates, that rates will still be at relatively low levels vis-à-vis historic norms.

During the third quarter, while traders waited for the Fed's lead with regards to the timing of its taper of monthly treasury and mortgage bond purchase program, interest rates remained low, and range bound. With the yield on the 2-year treasury note hitting a low of 0.16% during mid-quarter, the 5-year treasury yield dropping below 0.70% and the 10-year, at times, below 1.20%, investment grade corporate bonds provided additional income and return to investors above comparable duration treasuries. With strong fundamentals, and a general recovery in the economic landscape, corporate bond spreads over treasuries remained tight, as indicated in the chart below, and ended the third quarter at +58 basis points above the

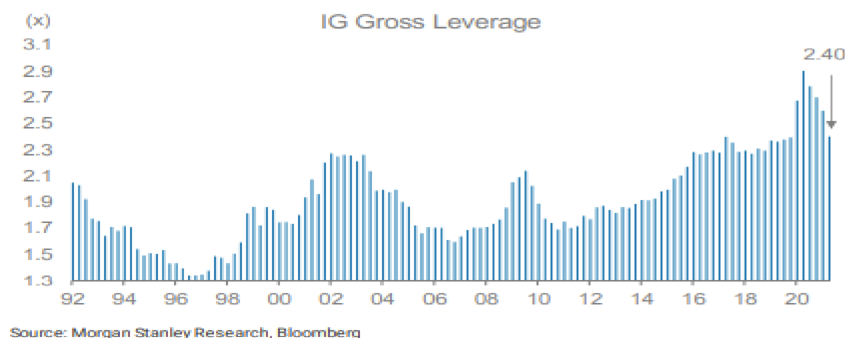
Intermediate Corporate Index, with a total return for the quarter of 0.19% and an excess return over treasuries of 0.34%.

Corporate earnings announced in July were strong, continuing along the same positive trajectory we observed in the previous quarter, resulting in stable spreads for corporate bonds. Eighty six percent of companies that reported had positive earnings surprises.

Earnings Surprise

	2Q-21 Earnings			
Sector	Total	Positive Surprise	Negative Surprise	% Positive
Information Technology	78	73	4	94%
Health Care	61	56	5	92%
Consumer Discretionary	57	51	6	90%
Financials	61	55	5	90%
Consumer Staples	30	26	3	87%
Industrials	69	59	8	86%
Communication Services	24	19	5	79%
Real Estate	29	23	5	79%
Energy	23	18	4	78%
Utilities	28	21	7	75%
Materials	28	19	7	68%
Total	488	420	59	86%

Other notable improvements in corporate fundamentals included a sharp decline in gross leverage to 2.4x, with 75% of investment grade companies improving quarter over quarter, taking us back to pre-Covid levels (see bar chart below). We see this trend continuing into the next earnings reporting season.



Strength in the corporate sector was not only a result of an increase in income and earnings, but also a reduction in debt. Year over year, the median investment grade company cut its debt by 2.3%, beneficially increasing the gap between income and debt.

Your portfolio remained overweight to corporates, with an average quality rating that superseded that of the index. Among the corporate sub-sectors that we believe stand to outperform going forward are banks, technology, and healthcare. Banks such as A-rated Bank of America have ridden out the flat yield curve with a positive earnings surprise in July. Now it is poised for even higher earnings as the spread widens between the interest rates banks pay for short-term deposits and receive for long-term loans. A-rated Honeywell International is a worldwide company that combines technology and manufacturing to serve a wide array of industries ranging from aerospace, commercial building safety, and technology for oil refining and energy efficiency. In its quest to be the software leader within the life sciences industry, Honeywell recently acquired a provider of manufacturing execution system software for the pharmaceutical manufacturing and biotech industries. Honeywell delivered strong earnings in July and should continue to perform well in the next quarter. We also like A-rated Abbott Laboratories, which is a diversified health care company that offers medical testing, devices, pharmaceuticals, and nutritional products. Abbott's earnings reported in July were strong, handily beating analysts' estimates. It manufactures a rapid Covid-19 test that, in response to the opening of the economy, should be in high demand going forward. With corporate spreads over treasuries at historical tight levels, and a relatively flat credit curve, we prefer to keep your portfolio invested in higher rated securities that offer more yield than treasuries without incurring substantial risk.