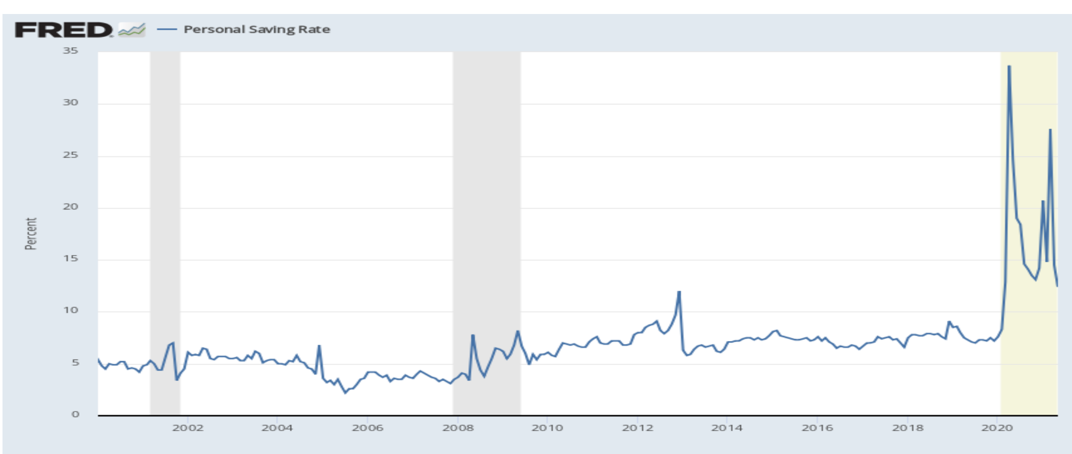
VANDERBILT Ave.
ASSET MANAGEMENT

2nd Quarter 2021

In this quarterly we will provide updates on monetary policy, the outlook and status of the economic recovery and the inflation forecast.

We think coming changes in Federal Reserve **monetary policy** are on point and will be positive for the economy. It appears that the Fed is getting in front of any potential longer run inflationary pressures. At their recent meeting the Fed said (1) they anticipate two increases by 2023; (2) they would begin a discussion of when to gradually commence the reduction of their $120 billion monthly purchases of U.S. Treasury and Agency Mortgage-Backed securities and (3) they think current inflationary pressures are transitory and forecast a 2.1%-2.2% inflation level for 2022-2023 (per the core PCE which is the Fed's preferred gauge of inflation and is currently running at 3.4%). As they have stated in the past, the Fed said both the increase in the Fed Funds rate and the reduction in the amount of securities purchased would be implemented on a gradual basis. Chairman Powell said policy would remain highly accommodative and they have yet to reach their maximum employment goal. Their transitory inflation outlook is centered on pent up demand from the success of the vaccine program losing some growth momentum, supply side constraints working themselves out and the base effects from comparing prices against prices at the low of the recession last year beginning to diminish. The Fed continues to maintain that should they be wrong on inflation they will be able to control any persistent and/or accelerating price increases. This Federal Reserve policy should lead to an orderly and gradual change from the highly accommodative policy adopted when the pandemic hit and result in a continued low interest rate environment by historic norms.

We are at an inflection point regarding the U.S. **economy**. This is an unprecedented economic recovery-a first of a kind event. We foresee strong growth in the next six months and eventually moderating. After first-quarter growth of 6.4%, second quarter is expected to come in at 7%-8%. For the full year, 2021 is expected to grow at approximately 6%-7%. Coming out of the pandemic induced recession, both consumer and business sector balance sheets are strong in contrast to the 2008-2009 Great Recession. The consumer (approximately two-thirds of GDP) savings rate has increased significantly (as outlined in the graph) and is helping fuel pent up demand.



Household savings are at an unprecedented level of $2.3 trillion versus $734 billion coming out of the 2008-2009 financial crisis. Savings have been aided by the fiscal stimulus payments and suppressed spending due to the economic lockdowns. Consumer liquidity will continue to power the economic recovery but with pent up demand gradually slowing. Consumer delinquent debt is at the lowest level since 1999. Companies are reporting exceptionally strong earnings. Corporations posted first-quarter profits 23% above expectations. Second-quarter earnings are also expected to be strong further enhancing cash flows. Another distinguishing feature between now and 2008-2009 is the financial condition of the banking sector. The banking sector is positioned to provide funding for growth as lending demand picks up.

The **inflation** outlook is critical for monetary policy and the pattern of the economic recovery. We think recent inflationary pressures will be transitory as demand momentum slows, supply constraints adjust to the pent-up demand and base effects comparisons run their course. Regarding the goods sector, raw materials like aluminum, copper, oil, iron ore and lumber have all been in short supply in recent times and their prices have hit record highs. Copper, a metal most tied to global growth due to its usage in electronics and housing, soared above $10 per metric ton. Gasoline prices doubled over the past year while lumber prices more than tripled.

In terms of where we are now, all inflation gauges are seeing upward pressure on prices due to the pandemic induced base effects. With the economy reopening, finding labor has become increasingly difficult amid lingering concerns about safety, childcare and extended government subsidies. These labor shortages have caused wage increase pressures. In addition, supply chain bottlenecks have put upward pressure on prices. For example, with new car production slowed by semiconductor chip shortages, both new and used car prices have risen. Sawmills are running at full capacity but have not kept pace with the housing boom. We view these and other supply chain constraints as transitory as supply will catch up with pent up demand. Commodity prices across the board have recently started to retreat.

Since the early 1980's, inflation has steadily declined through three economic expansions and periods of low unemployment. The hyperinflation of the 1970's and early 1980's was rooted in loose monetary policies. While a concerted effort to reduce the growth in the money supply has been credited with restraining inflation, there were other factors as well:

Technological Innovations. Technological innovation provides constant downward pressure on prices, reducing the need for certain goods and services. For example, demand for cameras has decreased significantly as result of competition from smartphones.

Global Supply Chains. Global supply chains have grown rapidly complex the past 20 years. Competition has brought down the cost of moving raw materials from one country and having them assembled in another country. This lowers production costs to a certain degree, and they are passed on to consumers. While supply chain bottlenecks have occurred recently, expectations are that they will resume their normal flow as workers return and transportation systems ramp up.

Demographics. An increase in life expectancy has pressured inflation lower. As life expectancies rise, people will typically save more throughout their working lives to help fund a longer retirement. This high savings rate in effect applies downward pressure on interest rates and inflation.

Working Capital. While savings rates create capital to invest, less regulation has allowed for the creation of oligopolies within industries across the U.S. economy. When a company has more market strength, its growth rate is faster while avoiding having to invest more than if it was competing more fiercely with a rival. This has a capping effect on the amount of capital needed to fuel growth and this also provides downward pressure on interest rates and inflation.

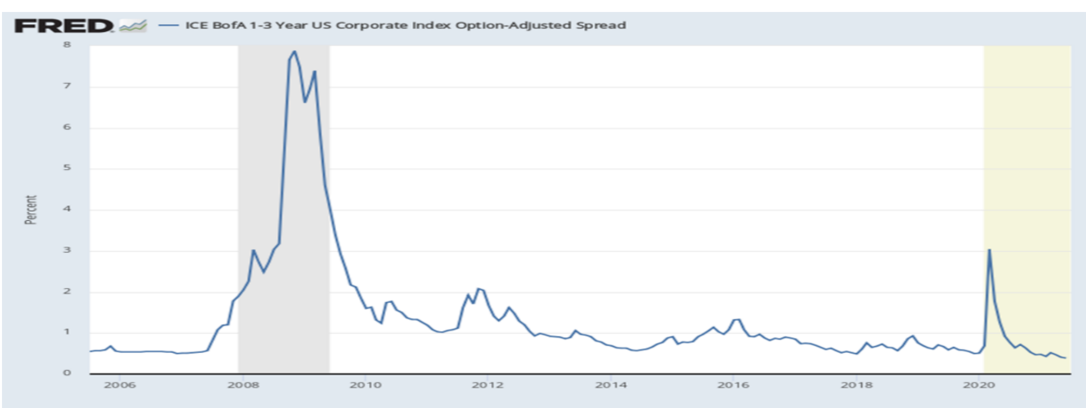
Income Inequality. Income inequality has been a growing issue in the U.S. for several decades. With national incomes skewed towards the wealthy and less going to lower income groups, upward pressure is placed on savings and less towards spending.

Savings. With workers receiving lower rates on their savings, they are forced to save more for a retirement that could be extended by improving life expectancies. The prospect of saving more while continuing to pressure interest rates lower creates a paradox for retirees and contributes towards lower interest rates and inflation.

In terms of where we are going, inflation is heading higher in the near term but should moderate starting in the fourth quarter of 2021. Confidence in restraining inflation depends in part on the Fed's willingness to act if prices rise too quickly. We think supply chains will start to stabilize going forward in order to maintain efficiency of production. Ironically, investment in technology is rising rapidly in the wake of the pandemic. Examples include a greater shift to ecommerce, video conferencing, artificial intelligence and the adoption of robotics. This has the potential for businesses being run more efficiently, boosting productivity and stabilizing the inflation rate.

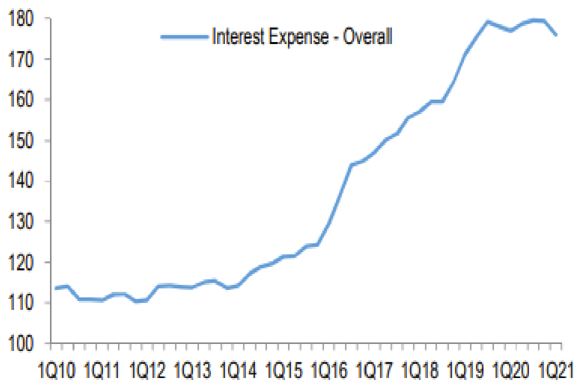
Corporate Review
2^{nd} Quarter 2021

After a strong corporate earnings season dominated the month of April, spreads on corporate bonds tightened to reflect solid fundamentals. Coupled with rates that were range-bound during the first part of the second quarter, prices on corporate bonds increased across the board. However, after the Fed convened in mid-June, releasing comments regarding potential rate increases in 2023 once the economy is fully recovered, the shape of the treasury curve rapidly morphed, finishing the second quarter with the short end increasing in yield (from 0.16% on the 2-year to 0.25%), and the yield on the long end dropping (from 1.74% on the 10-year to 1.48%). So while fixed income securities celebrated the greater part of the second quarter, increasing in price due to tightening spreads and low interest rates, the flattening yield curve that surfaced after mid-June resulted in some price underperformance to securities that are benchmarked to the shorter part of the curve as compared to those that are longer dated in maturity. Spreads, however, remained at historical tight levels as depicted in the chart below:

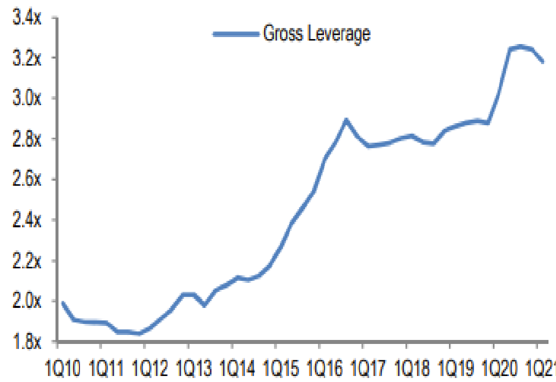


Your portfolio has remained overweighted to the corporate sector whose positive performance can be attributed to the recovery in the market which took form as a result of the fiscal stimulus package, the Fed's 120-billion-dollar monthly bond buy-back program, and the rapid vaccine rollout. The stimulus package encouraged spending after months of lockdown, and has also resulted in high levels of savings, the benefits of which should roll into the second half of the year. The Fed's bond buy-back program has created accommodative financial conditions, which have supported the flow of credit to both households and businesses. The impressive vaccine rollout has allowed the economy to achieve a solid opening with benefits reaching across industry sectors.

The credit fundamental improvements have included decreases in interest expense, gross leverage, and year over year long term containment of debt.



Source: J.P. Morgan



Source: J.P. Morgan, Bloomberg Finance L.P.

These reductions to leverage, interest expense and debt have been layered on top of improvements to Interest Coverage and EBITDA (a measure of cashflow). The combination has resulted in a positive outlook across the investment grade sector, leading to spread compression. As the economy continues to gain strength, and the Fed holds off curtailing bond buybacks or increasing rates until full employment is reached, we expect second quarter earnings to mirror the strength of those in the first quarter. We remain overweight to the corporate sector, but with spreads tight, we choose to overweight higher quality A-rated securities as investors are not being sufficiently compensated to take on additional risk.

The backdrop of the last three months was a period defined by strong economic data, particularly rising prices across industry sectors, a booming housing market, strong consumer demand, wage increases, and labor and supply shortages. The stock market delivered a textbook response to the strength in the economy, gradually continuing an upward trajectory. Bonds, however, have behaved in a more unusual fashion. Bond bulls may have been anticipating a slowdown in the housing sector. We disagree with this viewpoint for the following reasons: mortgage rates are low; credit availability is improving day by day and millennials are entering a stage where family formation is starting to take hold.