October 2021

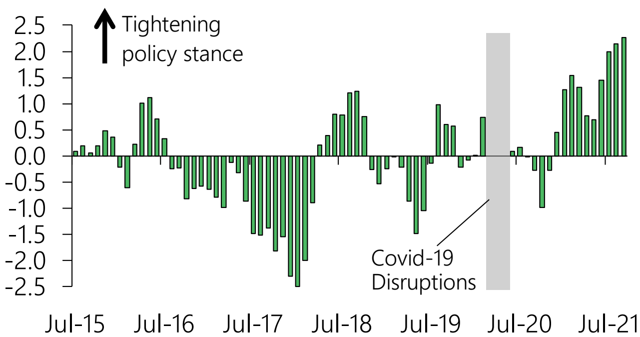
GLOBAL INVESTMENT OUTLOOK AND STRATEGY

- **China Disruptions Continue, But Investment Opportunities Emerging**
- **U.S. Fiscal Policy & Debt Ceiling Standoff May Endure Until Year End**
- **Covid-19 Uptick Pushed Out Timetable to Clear Supply Chain Logjams**
- **Fed to Incrementally Reduce Net Asset Purchases as Inflation Persists**
- **Equity Emphasis on Quality and Growth in Uncertain Backdrop**

China's Governance Regime Shift Causing Economic and Financial Market Disruptions

1 Unprecendented Regulatory Tightening

Privately-Owned Enterprise Regulation Proxy
Z-Score



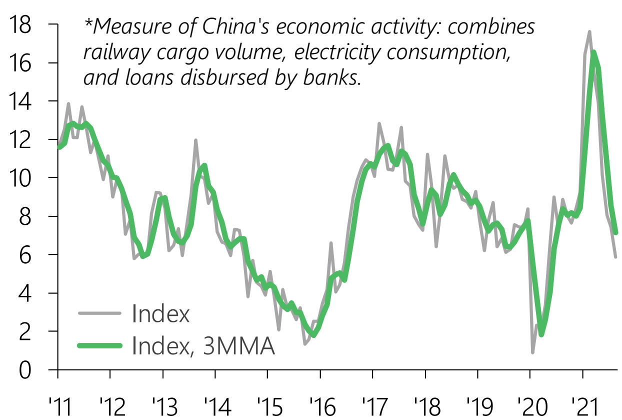
Note: reflects the text-mining results of news among POE-heavy sectors. Data points during Mar-Jun 2020 have been removed due to COVID disruptions.

2 And a New Governance Framework

Social & Economic Stability	• Rebalance share of economy in favor of labor • Enhance social safety net and improve labor welfare
National Security	• Double down on self-sufficiency initiatives, e.g., tech • Strengthen cybersecurity capacities, reduce data security risks
Financial Risks	• Promote RMB internationalization via opening-up of onshore markets • Curb regulatory arbitrage and financial stability risk
Environmental Stability	• Decarbonization: Reach peak emissions by 2030 and carbon neutrality by 2060

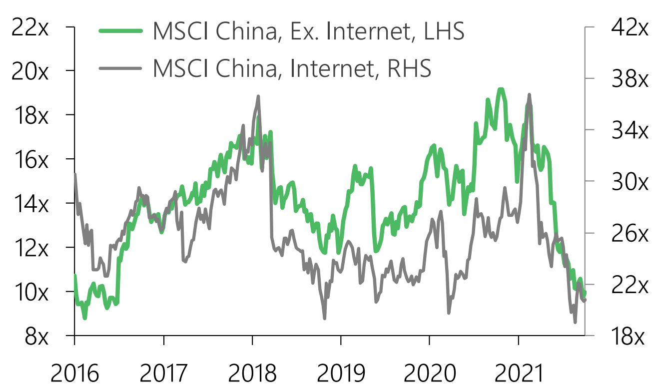
3 Along with Tighter Credit is Hitting Growth

Li Keqiang Index*



4 And Roiling Stocks; Notably Internet/Media

Price-to-Earnings Ratio of Chinese Equity Indices
Bottom-Up, Next Fiscal Year Earnings



Sources: Goldman Sachs, Morgan Stanley, Bloomberg, FactSet, 9/30/21

Is China Still Investable?

China's unprecedented regulatory tightening over the past year has raised fears that President Xi Jinping now seeks to reign in, if not reverse, the nation's multi-decade progression toward Western-style capitalism. After prioritizing economic growth in previous years, China has realized its goal of becoming a "moderately prosperous society" and is now entering a new governance regime focused on multiple fresh policy objectives and a regulatory reset. Growing inequality has become too big to ignore ideologically, triggering policymakers to pursue a policy of "common prosperity," which aims to balance growth and broad social objectives, including reduced inequality.

Amid escalating tensions with the U.S., Chinese officials also have raised national security to a higher level, and there is a bid in Beijing to lessen external vulnerabilities. Recent internet restrictions are mostly a catch-up of regulation to address legitimate concerns over possible abuses of market power. In all, the goal of higher government intervention is to ensure sustainable long-term growth and global competitiveness. We do not view the increase in regulatory tightening as a deliberate crackdown on private enterprises. While the new governance framework should, over time, lead to more sustainable growth, it will come at the cost of softer near-term macro conditions.

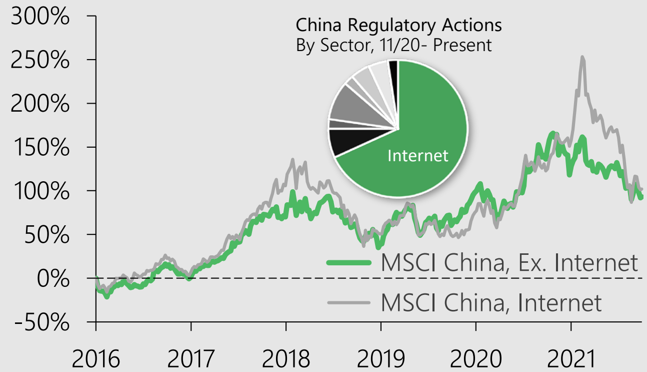
Due to the recent Covid-19 outbreak and a heightened regulatory environment, we are further reducing our 2021 real GDP growth projection to +8.0 percent. For 2022, we believe growth could normalize at between +5.0 and +6.0 percent. The government's "zero-tolerance" policy has kept the coronavirus under control but, along with policy tightening, has contributed to a sharp slowdown in economic activity The policy will likely remain in place through the Beijing-held Winter Olympics in February 2022, implying growth could remain choppy.

Recent regulatory tightening, broad in scope and applied heavy-handedly, could also be a near-term economic drag via lower employment in the most impacted areas and reduced private investment amid policy uncertainty. Moreover, the recent power generation crunch adds to downside risks. While we believe the Evergrande crisis is largely contained, further cooling of the property sector is likely. As growth has slowed more than expected and could slide further, policymakers will likely react with added stimulus measures. Fiscal spending detracted from GDP growth in the first half of 2021 but is now becoming supportive. Finally, we project more reserve requirement ratio cuts and credit growth to trough in the fourth quarter of 2021.

The regulatory reset, along with the contagion fears linked to Evergrande's woes drove offshore Chinese stocks sharply lower in the third quarter. The offshore technology sector, which constitutes 40 percent of MSCI China market capitalization, is where the loss is most concentrated. The regulatory shockwave started with fresh Internet sector regulation just days after 100th Anniversary of the Chinese Communist Party on July 1. The second wave was triggered by forced non-profit and banned foreign capital for after-school tutoring. Regulatory concerns spread to more sectors in August. Macroeconomic concerns and the Evergrande saga weighed on the investor sentiment in September.

Sharp Correction in Chinese Stocks

Performance of Chinese Equity Indices



Source: FactSet, 9/30/21

We view internet restrictions as mostly a catch-up of regulation to address legitimate concerns over possible abuses of market power. While we await more details, we expect regulatory framework to be reasonable to ensure sustainable long-term growth and global competitiveness, especially for top Chinese tech giants. After all, if China's ultimate goal is to remain an economic superpower, it requires a vibrant and innovative tech sector. In the absence of population growth, the sector's inherent productivity potential is critical in driving economic growth. Following consensus earnings cuts and valuation multiple contraction, we believe the regulatory risk is now largely priced in Internet stocks.

We are sticking with our position in tech giants while we cut our holdings in education and online streaming. Some post-pandemic opportunities still exist in our view, especially within the services sector. Capital market development, renewable energy, and reopening themes remain intact, and mass consumption should benefit from "common prosperity" policies. Growth will continue in China, but we are at a point in time when winners and losers are being sorted out.

We do believe China is investable, but a higher risk premium is required as until the ultimate policy regime is fully in place.

China's Key Policy Priorities and the Potential Impact

	Policy Goals	Positive	Negative

Labor	"Effective measures should be taken to implement the people-centered development thinking, and solve the problems of employment, income distribution, education, social security, medical care, housing, pension, child care, food safety, etc."	• Income redistribution could be positive for mass-market consumer products and services:
		  • Apparel & footwear
		  • Food & personal products
		  • Hotel, restaurants & leisure
		  • Auto & auto components
		  • Household durables
		  • Online retail
		  • Insurance
		  • Tech hardware: consumer electronic products
		• Encouraging birth rate should be positive for:
		  • Baby products & services
		  • Health care
		• Promoting full employment will benefit adult professional/technical skill training
			• Increasing labor salary and protection will increase cost for
			  • Private sectors that were less stringent with labor protection (e.g. food delivery, internet)
			  • Labor intensive sectors
			• Lowering living cost could be negative for
			  • Property developers & agents, especially in high-end market & school districts
			  • Education: private tutoring
			  • Health care: e.g. drug prices, equipment & services
			  • High-end baby products
			  • Insurance: to provide low cost health insurance
			• Income redistribution and more taxes will be negative for:
			  • Property
			  • Luxury products
			  • Liquors

Ideology	"Continuously enhance the dominance and voice in the ideological field."	• Tightening control on ideology could help domestic consumption and domestic consumer brands ("Guo Chao")	• Tightening control on ideology will negatively impact:
			  • Education
			  • Interactive entertainment (e.g. short videos)
			  • Media & interactive media (e.g. games)
			  • Movie & entertainment (e.g. movies, music, literature)

Capital	"Strengthen anti-monopoly and prevent disorderly expansion of capital."	• Lowering financing cost will help highly leveraged sectors:
		  • Utilities
		  • Property
		• Anti-trust may help SMEs, especially in internet sectors
		• Promoting domestic capital markets will help brokers and asset managers
			• Lowering financing cost will negatively impact:
			  • Banks
			  • FinTech lenders and payment
			• Anti-trust will be negative for:
			  • Big Tech

Information	"Strengthen the protection of critical information infrastructure and data resources. Enhance the data security early warning and tracing capabilities. "	• Increased state control on Big Data will help banks to reduce operating costs and credit costs	• Increased privacy protection and data security control will be negative for internet and platform companies with massive user data and client traffic

Resources	"China adheres to the path of ecological priorities, green and low-carbon development. China will strive to achieve carbon peak by 2030 and carbon neutrality by 2060."
	
	"Food security is an important foundation of national security."
		• De-carbonization will benefit:
		  • Clean energy sectors: solar, wind, water, UHV transmission, etc
		  • New materials related sectors: lithium, copper
		  • Environmental protection
		  • EV, EV battery & auto components
		  • Materials firms benefiting from supply reduction
		• Food security and self-sufficiency will benefit: agriculture related sectors
			• De-carbonization will be negative for:
			  • Traditional energy sectors: coal, oil & gas
			  • Manufacturing sectors with high energy consumption: steel, construction materials, chemical & materials, etc

Technology	"Enhance high-level technological self-reliance."
	
	"Promote the transformation of made-in-China to created-in-China, China speed to China quality, and Chinese products to Chinese brands"
		• Promoting advanced manufacturing will support:
		  • High-end tech hardware
		  • Electronic equipment
		  • Semiconductors
		  • Aerospace & defense
		  • 5G infrastructure and adoption
		  • Robotics
		• Focusing on self-sufficiency in technology will benefit:
		  • Software, AI, cloud, quantum computing
		  • Health care and health care equipment
			• Promoting advanced manufacturing will be negative for labor intensive, low-end manufacturing sectors

Source: BofA Global Research, 9/10/21

Numerous Crosscurrents, but Expect Above-Trend U.S. GDP Growth Into 2022

The fourth wave of Covid-19 infections, product shortages, rising prices, and the end of federal aid contributed to a decline in confidence and economic activity in the third quarter. As a result, we cut our third-quarter real GDP growth forecast to +4.0 percent from +6.0 percent but kept the fourth quarter at +5.0 percent. Boosted by federal transfer payments (i.e., stimulus checks), consumer spending on goods has bounced back from its Covid-induced recession low in April 2020 and is now well above its pre-pandemic trendline. Although we expect demand for goods (ex. autos) to normalize into 2022, inventory restocking and elevated backlogs should sustain solid levels of manufacturing activity. As Covid-19 fears ebb, pent-up demand for services (and autos, as supply constraints/prices ease) should also help drive above-trend, albeit moderating, GDP growth next year. Improving employment growth, record-high household net worth, and excess personal savings of $2.6 trillion provide consumers the wherewithal to spend. Yet, while shoppers are generally accepting higher prices, evidence of demand destruction is mounting. Consumer surveys of buying conditions for houses and vehicles are now at 39- and 47-year lows, respectively (Exhibit 1). Increasing energy prices are also a headwind for spending, with rising gasoline prices alone reducing disposable income by roughly $120 billion in the last year.

Drag From Tax Hikes May Partly Offset Boost From Increased Fiscal Spending

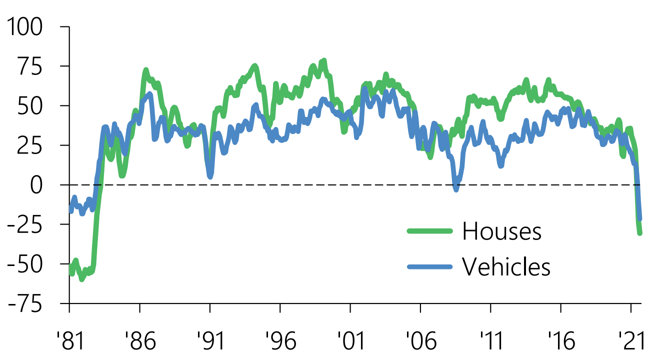
As illustrated in Exhibit 2, the U.S. economy faces significant fiscal drags in out-years without higher federal spending. A proposed fiscal 2022 reconciliation bill that entails $3.5 trillion in added spending over ten years, offset by tax hikes, is mired in intra-Party politics. We suspect a figure closer to $2 trillion or less is needed to satisfy moderates. Meanwhile, the Senate's $1 trillion bipartisan infrastructure bill may languish in the House until Congress can compromise on a reconciliation package. While the bill's specifics are yet to be determined, higher corporate tax rates are one of the more important aspects for financial markets. An increase in the base corporate tax rate from 21 percent to about 25-26 percent is expected, but tax rates on foreign earnings remain highly uncertain. Many multinationals (including big tech firms) benefit from exceptionally low taxes on income booked in low tax nations, and most of the proposals so far are particularly punitive on this element of the current U.S. tax code. Furthermore, a global agreement to set a minimum 15 percent corporate tax rate just cleared a major hurdle when Ireland agreed to join a coalition of 140 countries aiming to tax international companies, limit avoidance, and divide tax revenue more equitably. Corporate taxes appear headed higher, but the associated drag from a possible hit to confidence and capital spending is harder to isolate.

Timetable to Clear Global Supply Chain Logjams Pushed Out to at Least 2022

The input shortages that have cascaded across global supply chains started to show some signs of easing in late spring, per the ISM Report on Business. Yet, since then, the more contagious

Exhibit 1: Consumer Survey: Buying Conditions

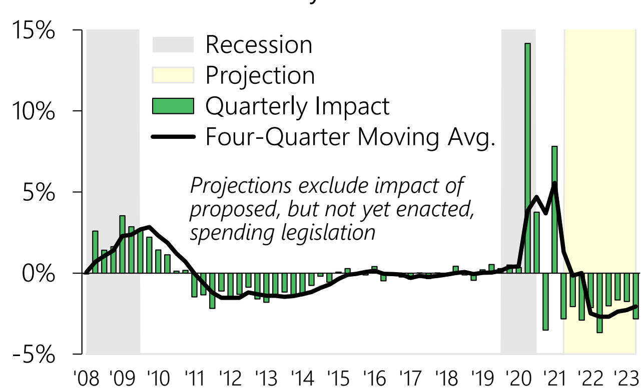
Good Time to Buy Minus Bad Time to Buy
3-Month Moving Average



Source: University of Michigan, 9/30/21

Exhibit 2: U.S. Fiscal Impact Measure

Contribution of Fiscal Policy to Real GDP Growth



Source: Hutchins Center at Brookings, 8/27/21

Delta variant of Covid-19 has spread worldwide, intensifying supply shortages and inflationary pressures. Case in point, export-heavy countries in Southeast Asia enacted measures to control large outbreaks, resulting in production shortfalls and shipping delays. In August, a two-week partial closure of China's third-busiest shipping port to quarantine workers also contributed to a backup in containerships and a spike in freight costs. In addition, record-high Asian imports are now choking West Coast ports, with snarls across the logistics ecosystem. However, absent significant setbacks, which is a big "if" given lingering Covid-19 risks and the newfound energy crunch, supply-demand conditions should normalize into 2022, easing (if not reversing) goods inflation. We had expected goods inflation to roll off by year-end, keeping the impacts of rising services inflation and lagged effect of surging home values well in check. Yet, we now forecast core PCE inflation may remain in the mid-three percent range through the first quarter of 2022, subject to the track of the pandemic (Exhibit 3). Many of the input imbalances and cost hikes will likely prove transitory, but persistent labor shortages may contribute to "stickier" inflation.

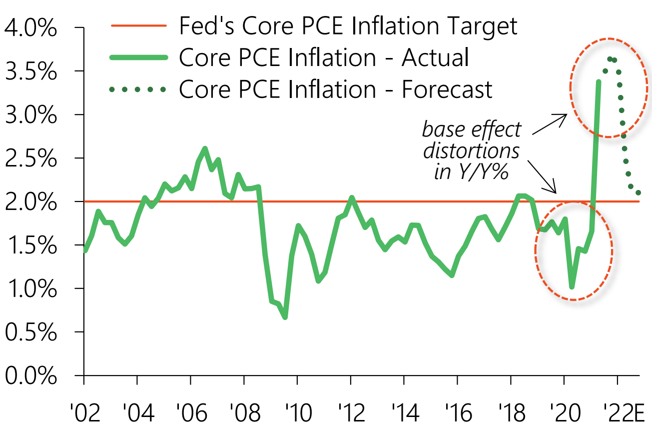
Apparent Labor Shortages Adding to Supply Chain Woes and Inflation Worries

Unless offset by higher productivity, tightening U.S. labor conditions could trigger a wage-price spiral, imperiling the transitory inflation thesis and forcing the Federal Reserve to hike interest rates. The number of U.S. job openings now exceeds the number of people unemployed by 1.3 times, and a record 50 percent of small firms say they cannot fill positions. A historically high job quit rate of 2.7 percent is also consistent with a tight labor market. In contrast, September's unemployment rate of 4.8 percent, so-called "underemployment" rate of 8.5 percent, and labor participation rate of 61.6 percent imply sufficient labor market slack. About 7.8 million people are seeking employment at this time, while a net 4.5 million have dropped out of the labor force since the pandemic's onset in early 2020. A rising percentage of people retiring, Covid-related health/family considerations, shifting work-life priorities, a skills mismatch, less unauthorized immigration, and, until recently, the availability of enhanced unemployment insurance benefits have all likely contributed to near-term labor shortages. Recurrent Covid fears and a resistance to vaccine mandates may also temper seasonal hiring ahead of the holidays. As a result, wage pressures will continue to mount as employers scramble to find workers try to entice people to reenter the labor force. Thus far, much faster wage growth has been limited to a few low-wage sectors, and subdued benefits costs are tempering the impact of higher wages (Exhibit 4).

Euro Area Holds its Own Against Pandemic but Soaring Energy Prices a New Risk

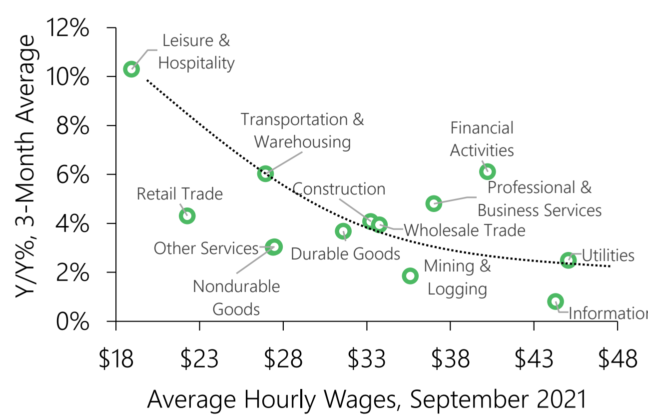
The 19-country Euro Area economy weathered the late summer wave of coronavirus infections relatively well, as world-leading vaccination rates precluded the need for wholesale lockdowns. Consequently, we believe real GDP remains on track to expand about +4.5 percent in 2021 and return to its pre-pandemic trendline by mid-2022. Still, the rapid spread of the Delta variant of the coronavirus worldwide is intensifying global supply chain woes, eroding confidence, and impeding economic activity near term. The Euro Area Composite PMI, a key gauge of business conditions, moderated to 56.2 in September (>50 expansionary) from a 21-year high of 60.2

Exhibit 3: U.S. PCE Price Index (Y/Y Percent)



Source: U.S. Bureau of Economic Analysis, Bloomberg, 10/1/21

Exhibit 4: U.S. Wage Growth by Industry



Source: Department of Labor, 10/8/21

in July. Supply shortages have contributed to a sharp rise in manufacturing backlogs, implying producers may be in catch-up mode well into 2022. Moreover, while export growth is slowing from high levels, the outlook for domestic spending looks favorable over at least the next twelve months. The European Central Bank will also stay highly accommodative but marginally slow the pace of net asset purchases. Nonetheless, our forecast for above-trend real GDP growth again in 2022 hinges on a continued recovery in the services sector, which may be sensitive to pandemic fluctuations. Soaring energy costs also threaten to sap confidence and hit spending. Moreover, a declining credit impulse foreshadows slower growth in late 2022 and in 2023.

Japan Still on Track for Reopening While Political Concerns Have Subsided

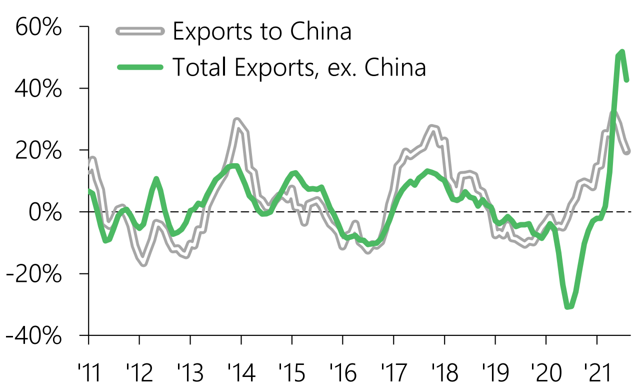
Japan is still on course to grow +2.5 percent this calendar year despite a near-term soft patch. The Delta-variant-driven resurgence in Covid cases contributed to, like elsewhere, a softening in economic indicators in the third quarter. However, a delayed but well-managed vaccination effort sets the stage for a broader reopening of the economy in the fourth quarter and moving into 2022 as restrictions begin to ease in October. Meanwhile, the resignation of Prime Minister Suga, who had become increasingly unpopular due to his handling of the pandemic, alleviates concerns the Liberal Democratic Party (LDP) may lose its long-running majority in upcoming fall elections. The recent appointment of Fumio Kishida, with the backing of the Party's veteran lawmakers, buoys the prospect of the business friendly LDP staying in control. Export demand growth, having moderated to still healthy levels, is a continued support for the manufacturing sector and corporate confidence (Exhibit 5). Slowing demand from key trade partner, China, is a risk, but is tempered by strength in other markets and a nascent recovery in domestic demand. The Bank of Japan is still on hold as inflation remains absent, auguring for a weak yen as monetary policy appears set to tighten elsewhere.

Covid-19 and China Slowdown Delaying Recovery in Other Emerging Markets

Emerging market economies currently face rising Covid-19 infections, higher inflation, mixed commodity prices, and slower economic growth in China. The pace of economic recovery has varied, as China, South Korea, and Taiwan enacted strict measures to control the coronavirus outbreak and were able to reopen their economies sooner as a result. Yet, many other emerging nations were reluctant to take similar harsh steps, resulting in increased outbreaks and delayed economic recoveries. The share of population fully vaccinated against the coronavirus across the emerging world is low, with India at 16 percent, Mexico 34 percent, and Brazil 41 percent. We do not expect key emerging markets to catch up to developed nations on vaccinations until the late fourth quarter, at the soonest. In terms of inflation, while food and energy have pushed prices higher, we believe it is transitory. Nonetheless, the central banks of Brazil, Chile, Mexico, Turkey, Russia, and South Korea have increased interest rates in response. Commodity prices may have hit their cycle peak, as copper prices have sunk about 15 percent, creating a headwind for some exporting countries in terms of fiscal and current account deficits. Of particular note, China's weakening growth is a risk for the broader emerging economies recovery (Exhibit 6).

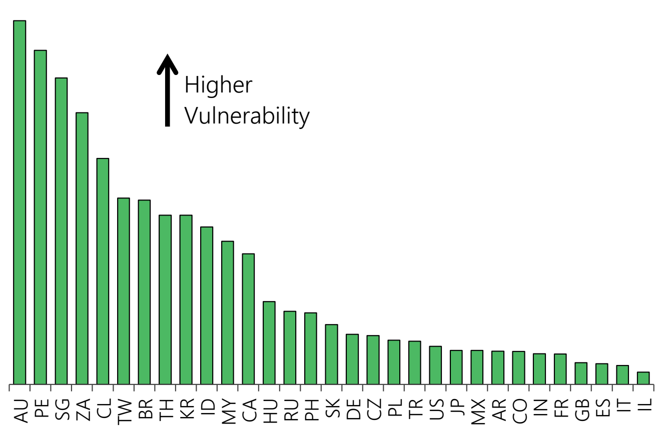
Exhibit 5: Japan Foreign Exports, Y/Y Percent

Three-Month Moving Average



Source: Japan Customs, 9/30/21

Exhibit 6: Vulnerability to China Slowdown

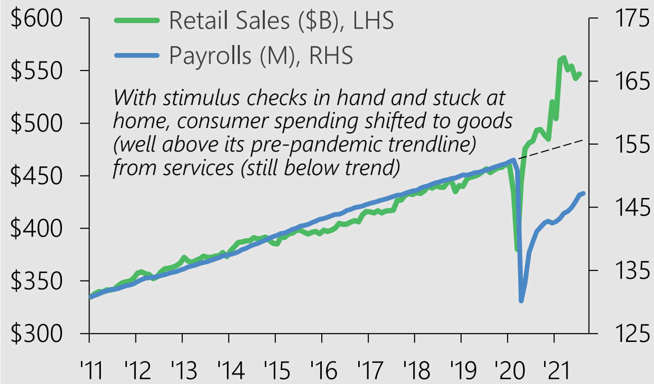


Source: Citi Research, 10/1/21

Global Macro: Other Notable Data Points

Above-Trend Goods Demand Should Normalize

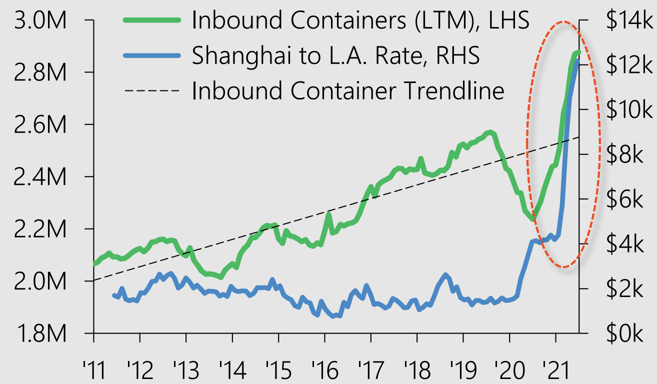
U.S. Retail Sales versus Nonfarm Payrolls
Monthly, Seasonally-Adjusted



Source: U.S. Census, Department of Labor, 9/30/21

And Take Some Pressure Off Supply Chains

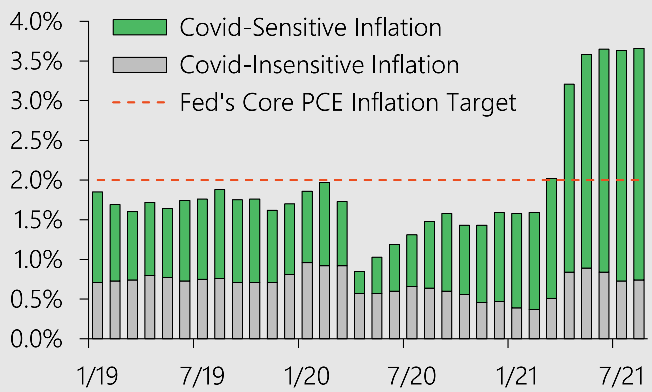
Port of L.A. Container Imports vs Container Rates
40-Foot Equivalent Units



Source: Port of Los Angeles, Drewry World Container Index, 9/30/21

Covid-Sensitive Items Driving PCE Price Spike

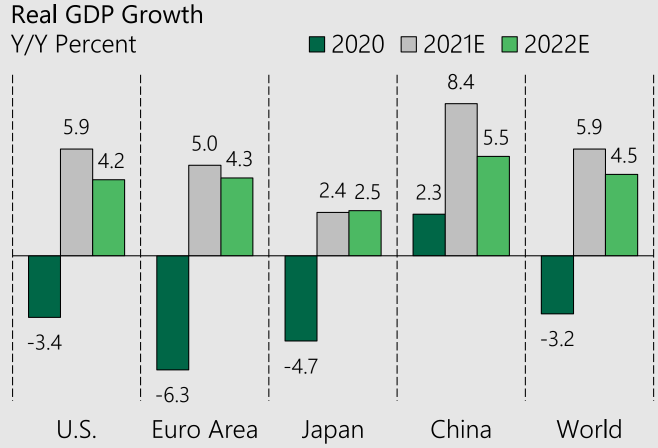
U.S. Core PCE Price Index
Contribution to Y/Y Percent Change



Source: Federal Reserve Bank of San Francisco, 9/30/21

Another Year of Solid Growth Expected in '22

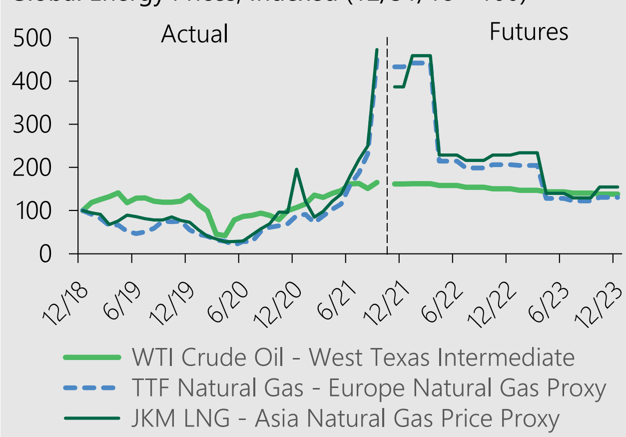
Real GDP Growth
Y/Y Percent



Source: Bloomberg (Consensus), 9/30/21

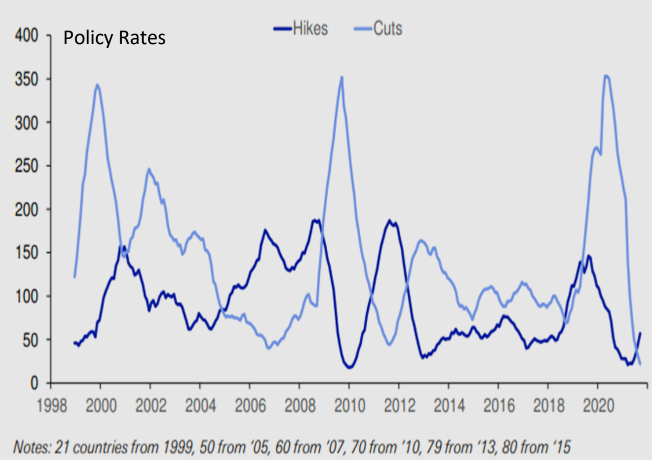
But Soaring Global Energy Prices a Sizable Risk

Global Energy Prices, Indexed (12/31/18 =100)



Source: Factset,10/7/21

As Is End of Global Monetary Easing Cycle



Source: Deutsche Bank, 9/28/21

The Fed Signals It Will Formally Announce Asset Taper at November Meeting

Barring any substantial macro developments, we expect the Federal Reserve (Fed) to formally announce at the November FOMC meeting its intent to taper asset purchases. However, we do not expect the Fed to purchase fewer bonds until at least January 2022. The Fed is currently buying $120 billion per month of mortgages and U.S. Treasuries. The current consensus view is asset purchases will shrink in added increments of $15 billion per month ($10 billion in U.S. Treasuries and $5 billion in mortgages), with the taper ending in mid-2022. Although financial markets widely anticipated the taper announcement would come by year end, many investors were surprised by the Fed's recent signaling on the quicker pace of the wind-down. As a result, the yield on 30-year U.S. Treasury bonds rose to over +2.0 percent, with 10-year U.S. Treasury bonds going over +1.5 percent. It will take much of 2022 before the Fed ends its asset purchase program completely. Therefore, we do not expect any rate hikes until late 2022 or early 2023. Fed fund futures currently imply a 70 percent probability of one or more 25 basis point rate increases by the end of 2022. Finally, two regional Fed presidents resigned following an inquiry into personal trading activities – both these presidents were more hawkish. Depending on their replacements, the trajectory of the asset taper and subsequent path of interest rates could potentially change.

Supply Chain Issues Will Keep Inflation Elevated in the Medium Term

The core PCE Price Index, the Federal Reserve's preferred measure of inflation, reached +3.6 percent in June. That is the highest inflation reading since the early 1990s. Financial market participants have widely expected elevated inflation given low year-over-year comparisons and pandemic-related disruptions, but many also expected it would be transitory. However, supply chain bottlenecks have persisted due in large part to the resurgence of Covid-19 worldwide. As a result, optimism for a swift resolution of supply chain constraints is fading heading into the holiday season. Even Chair Powell, the eternal optimist on transitory inflation, conceded that "as reopening continues, bottlenecks, hiring difficulties and other constraints could again prove to be greater and more enduring than anticipated, posing upside risks to inflation." The U.S. economy initially experienced demand-pull inflation in mid-2020, but supply chain woes have transformed it into cost-push inflation. Development of the latter may maintain pressure on inflation through the first half of 2022. Companies have realized they have pricing power and are increasing prices commensurate with the rise in input costs and sometimes more. Still, this phenomenon may fade later in 2022 as increased taxes and a decline in consumer savings will likely dampen demand. As labor, shipping, and other Covid-related constraints ease, pricing pressures within goods should lessen accordingly. Even so, dramatic increases in home prices will result in higher shelter inflation in coming quarters (shelter about 33 percent of CPI, 17 percent of PCE), limiting the benefit from goods disinflation (or even deflation).

Taxable Fixed Income Strategy

We maintain durations at or below the benchmark, as we believe the ongoing worldwide rollout of Covid-19 vaccines and their efficacy against known variants will improve global economic activity, pushing interest rates higher over time. If anything, we expect supply constraints to hold back global growth more than lingering pandemic fears, as we expect global demand to outpace even the rapidly increasing global supply of goods. We continue to emphasize holdings in cyclical industries where appropriate, as we expect industries such as airlines and leisure to disproportionally benefit as the global economy emerges from the pandemic. Although the debt ceiling debate provides a near-term distraction, we do not anticipate the U.S. government will default and may trade opportunistically on any dislocation. We expect longer maturity interest rates to be volatile in the coming months, as expectations for a Fed response to elevated levels of inflation change and we plan to take advantage of shifting investor sentiment tactically. Also, we have modestly increased portfolio liquidity to take advantage of potential opportunities provided by tax-gain selling in the fourth quarter. The income advantage should continue to drive performance, with yields well above benchmarks across most strategies we manage.

Municipal Yield Curve Steepens

The tax-exempt yield curve steepened during the third quarter, reversing most of the flattening from the second quarter. Short-term yields were little changed, while intermediate and long-term rates increased approximately fifteen basis points (Exhibit 7). Municipal yield ratios refer to AAA general obligation yields as a percentage of comparable maturity U.S. Treasuries. Intermediate and long-term tax-exempts cheapened on this basis during the quarter, although they remain rich on a longer-term basis (Exhibit 8). In terms of performance, shorter bonds generally outperformed longer bonds, and lower quality bonds outperformed higher-quality bonds (Exhibit 9).

Municipal Issuance Slows and Demand Remains Strong

Total municipal issuance was approximately $114 billion during the third quarter versus nearly $121 billion in the second quarter and almost $145 billion in the comparable period last year (Exhibit 10). Issuance often decelerates over the summer on a seasonal basis. Many municipalities also likely reduced bond issuance because they received stimulus funds from the American Rescue Plan. Looking forward, it seems likely that total 2021 issuance will fall in between 2019 and 2020 levels. In terms of demand, fund flows have remained exceptionally strong thus far this year.

Tax-Exempt Fixed Income Strategy

The outlook for tax-exempt rates and, ultimately, performance continues to be heavily impacted by macro factors, including inflation, monetary policy, and fiscal policy. Municipals are likely to track Treasuries with one key exception. Municipal demand will likely increase further if Congress raises tax rates to fund increased government spending. This nuance suggests that tax-exempt yield increases may continue to lag Treasuries. We plan to maintain duration near current levels and, as always, view diversification as a vital component of managing portfolio risk.

Exhibit 7: Municipal Bond Yields and Spreads

				Change (bps)	
Yields	12/20	6/21	9/21	3Q21	YTD '21
2-Yr MMD AAA GO	0.14	0.16	0.17	0.01	0.03
5-Yr MMD AAA GO	0.22	0.49	0.50	0.01	0.28
10-Yr MMD AAA GO	0.71	0.99	1.14	0.15	0.43
30-Yr MMD AAA GO	1.39	1.50	1.67	0.17	0.28
2-10 MMD Spread	0.57	0.83	0.97	0.14	0.40
10-30 MMD Spread	0.68	0.51	0.53	0.02	-0.15
2-30 MMD Spread	1.25	1.34	1.50	0.16	0.25

Source: Thomson Reuters, The Bond Buyer, 9/30/21

Exhibit 9: Bloomberg Municipal Bond Indices

	3Q21	YTD		3Q21	YTD
Muni Bond	-0.27	0.79	GO Bond	-0.25	0.30
3-Year	0.09	0.50	Revenue Bond	-0.29	1.07
5-Year	0.13	0.30	Electric	-0.07	0.40
7-Year	-0.03	0.15	Hospital	-0.24	1.90
10-Year	-0.15	0.41	Housing	-0.47	0.21
Long	-0.74	1.57	IDR/PCR	-0.27	0.94
			Transportation	-0.36	1.56
AAA	-0.41	-0.35	Education	-0.34	0.78
AA	-0.28	0.23	Water & Sewer	-0.31	0.03
A	-0.28	1.55	Special Tax	-0.32	0.78
BAA	0.11	4.02	Tobacco	-0.58	1.09

Source: Bloomberg, 9/30/21

Exhibit 8: Municipal to U.S. Treasury Ratios

Ratios	12/31/20	3/31/21	6/30/21	9/30/21
2-Yr MMD/UST Ratio	114.8%	86.4%	64.0%	61.4%
5-Yr MMD/UST Ratio	60.8%	54.3%	55.0%	51.8%
10-Yr MMD/UST Ratio	77.5%	64.3%	67.4%	76.6%
30-Yr MMD/UST Ratio	84.4%	72.5%	71.9%	81.6%

Source: Bloomberg, Thomson Reuters, 9/30/21

Exhibit 10: Historical Municipal Bond Issuance

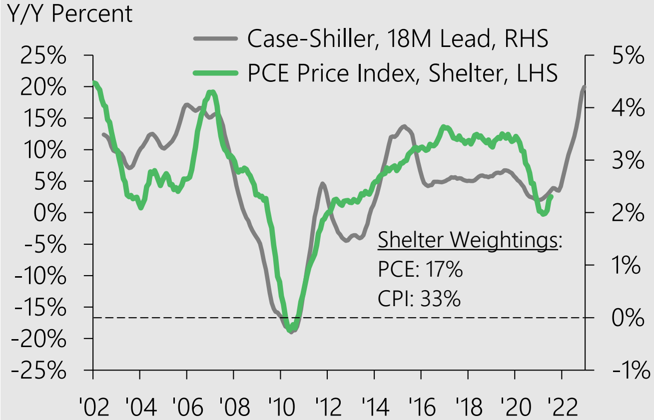
	2017	2018	2019	2020	2021
1Q	$92,326	$65,485	$79,508	$95,283	$111,375
2Q	$108,723	$100,050	$94,112	$115,067	$120,689
3Q	$92,210	$87,002	$107,114	$144,650	$114,421
4Q	$155,355	$86,396	$145,612	$129,545	
Total	$448,614	$338,933	$426,347	$484,545	$346,484

Source: The Bond Buyer, 9/30/21

Fixed Income: Other Notable Data Points

Bigger Impact on CPI from Shelter Inflation

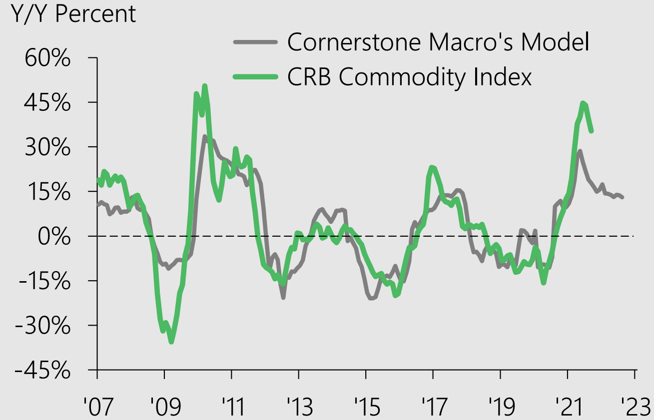
U.S. Shelter Inflation vs Case-Shiller Home Price Index
Y/Y Percent



Source: U.S. Dept. of Labor, S&P Case-Shiller, 9/30/21

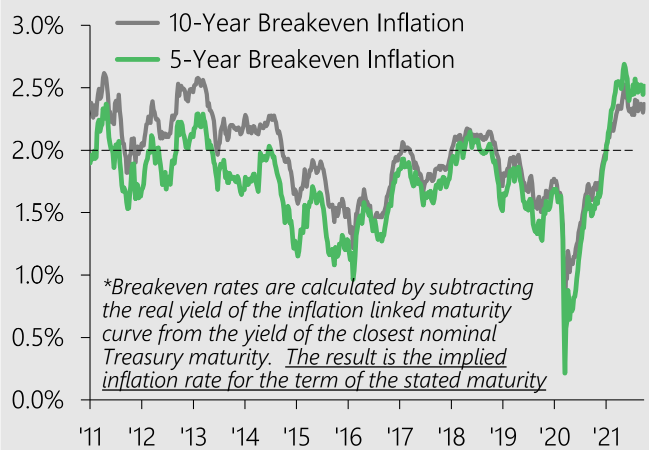
Commodity Inflation Projected to Moderate

Commodity Research Bureau Index
Y/Y Percent



Source: Cornerstone Macro Research, 10/1/21

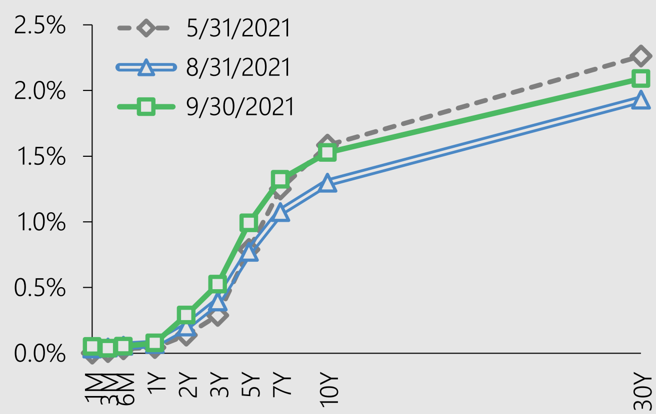
Inflation Expectations Remain Elevated



Source: Federal Reserve Bank of St. Louis, 9/30/21

Curve Re-Steepening After Summer Flattening

U.S. Treasury Yield Curve



Source: FactSet, 9/30/21

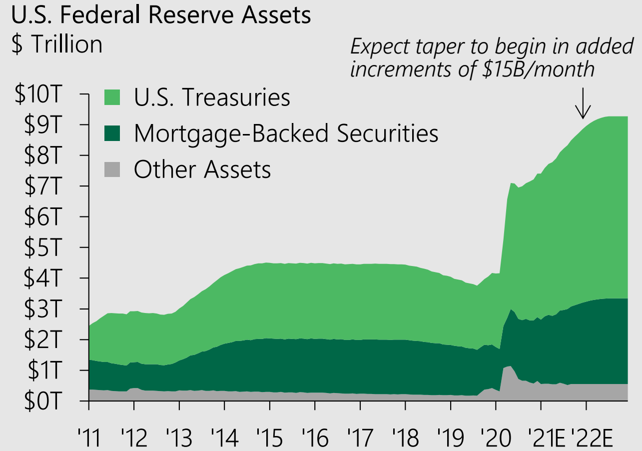
Excess Reserves Signal Too Much Liquidity

U.S. Excess Reserves of Depository Institutions
$ Trillion

Source: U.S. Federal Reserve, 9/30/21

Fed to Taper as Inflationary Pressures Persist

U.S. Federal Reserve Assets
$ Trillion



Source: U.S. Federal Reserve, 9/30/21

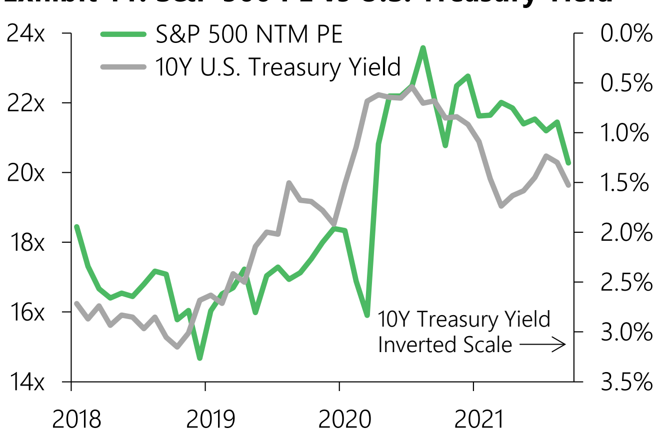
Mid-Cycle Investment Environment Bodes Well for Quality Growth Stocks

With financial markets awash in liquidity, equity investors shrugged off gathering macro risks during the first two months of the third quarter, with the S&P 500 Index gaining +5.5 percent from June 30 to August 31. However, in September, the number of risks such as the Covid-19 resurgence, rising costs, persistent supply chain issues, slowing economic growth, the federal budget/debt ceiling standoff, China property woes, prospective Fed tapering, negative earnings pre-announcements, spiking energy prices, and rising bond yields became too many to ignore. Consequently, the S&P 500 pulled back -4.7 percent for its worst monthly performance since March 2020. Bottom-up earnings for the S&P 500 are projected to grow +28 percent year over year in the third quarter and +22 percent in the fourth quarter, bringing full-year 2021 growth to +45 percent. Corporate earnings growth will continue to slow into 2022 as year-over-year comparisons become more challenging. Consensus bottom-up estimates currently suggest +9 percent earnings growth for the S&P 500 in 2022 but do not yet include the potential drag from higher corporate taxes or the distinct possibility of sustained supply/labor shortages and lower margins. Going forward, falling excess liquidity growth and rising bond yields will also likely put downward pressure on stock valuations (Exhibit 11). The combination of slowing earnings growth and contracting market multiples imply a mid-cycle investment environment in which strong growth becomes scarcer and quality growth stocks are relative outperformers.

The "Chinese Government Put" and Global Financial Markets

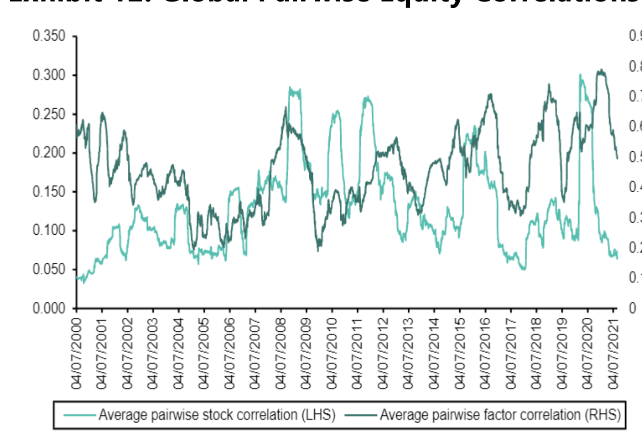
Developed markets generally outperformed emerging markets in the third quarter and year to date. Within emerging markets, Latin America and Asia Pacific (ex-Japan) both had negative returns in the quarter. The underperformance of Asia Pacific, weighed down by China, was the primary reason for the underperformance of emerging markets versus developed markets in the quarter. Much like the Federal Reserve has done, Chinese policymakers have conditioned global investors to expect it will intervene at times of economic stress. Without this perpetual stimulus, China's economy seems unable to generate the level of growth Chinese leaders seek for reasons of social stability. With China's 2022 annual real GDP growth at risk of breaking below +5.0 percent, we expect officials will aim to ease policy again, especially with the Beijing Winter Olympics around the corner in February 2022. Nonetheless, there is an increased risk policymakers may implement stimulus measures only incrementally, raising global economic growth uncertainty and putting downward pressure on equity valuation multiples. The end of the global monetary easing cycle also adds to uncertainty and valuation pressures, suggesting investor gravitation toward quality growth stocks may be a worldwide phenomenon. Global pairwise stock correlations have plummeted over the last year, indicating stock picking is the key driver of relative outperformance (Exhibit 12).

Exhibit 11: S&P 500 PE vs U.S. Treasury Yield



Source: FactSet, 9/30/21

Exhibit 12: Global Pairwise Equity Correlations



Source: Bernstein, 9/14/21

Global Equity Strategy

We continue to believe that market volatility will remain elevated against a backdrop of highly unpredictable and interrelated variables, including the path of Covid-19, multiple fiscal policy issues (including corporate tax increases), monetary policy, and growth challenges in China. Sector leadership will remain highly dependent on these variables, and we remain watchful for opportunities to make larger "bets" as more clarity emerges over the next several months. In the meantime, portfolios remain highly diversified with an emphasis on quality, growth, and valuation. Quality, as we define it, refers to companies with strong management teams, resilient business models, and financial strength that allows for reinvestment in organic growth opportunities and a discipline in returning excess capital back to shareholders. Dividend-paying growth stocks are especially attractive as investors seek stocks that can provide growth and income, particularly in a lower return, more volatile backdrop.

Higher interest rates were a contributing factor to a correction in equity markets at the end of the third quarter. As was the case earlier in 2021, growth stocks lagged due to their "long duration" status as higher interest rates become embedded in key valuation metrics (i.e., DCF calculations). Yet, unlike earlier in the year the macro backdrop has changed. The economic rebound is now further along, and we believe that investors will gravitate to stocks with strong visible growth as comparisons become more challenging for many value/cyclical-oriented companies. Furthermore, supply chain issues appear to be less impactful for key sectors within growth indices, including health care and technology, which collectively constitute more than 60 percent of the Russell 1000 Growth Index. Although we expect third quarter earnings to be challenged for many companies in these sectors, we remain watchful for opportunities once share prices more than reflect near-term challenges.

We continue to favor the technology sector as both secular (i.e., cloud spending, e-commerce) and cyclical (i.e., enterprise spending) growth drivers remain firmly in place. Healthcare stocks offer a compelling combination of visible growth and valuations. However, we are avoiding pharmaceutical companies as drug price reductions remain a goal of the Biden Administration. Financial stocks continue to have appeal due to a combination of valuations, benign credit trends, strong capital returns, and the possibility of higher earnings revisions as interest rates edge higher. We have reduced exposure to select industrial and consumer stocks due to a combination of high valuations and potential earnings reductions from persistent supply chain challenges.

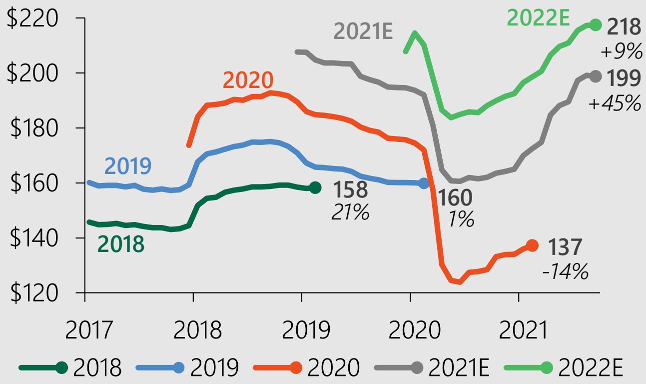
We prefer investments in China, South Korea, Singapore, and India in international portfolios. We believe China still offers significant medium- and long-term investment opportunities and, thus, remain overweight. With that said, the tightening regulation and social pivot may lead to a higher equity risk premium and lower corporate profitability, the impact of which will vary widely across sectors. A balanced approach is still prudent. We are sticking with our position in technology giants as we believe the value is emerging with regulation risk largely priced in. Some post-pandemic opportunities still exist in our view, especially within the services sector. Capital market development and reopening themes also remain intact, and consumption should benefit from "common prosperity" policies. Carbon neutrality will also be a multi-year secular trend in which we seek to increase exposure. We cut our holdings in education and online streaming due to concerns about shifting regulation and have no direct exposure to property developers.

We believe many emerging markets are past peak Covid-induced lockdowns, with economic reopenings facilitated by the acceleration in the pace of vaccinations. We also do not expect emerging market central banks to hike interest rates enough to curb their respective nation's economic recovery drastically. In South Korea, we prefer investments in technology, financials, e-commerce, and electric vehicle battery manufacturers. Singapore investments are primarily in the financial, technology, gaming, and e-commerce sectors, and India holdings are primarily in consumer, financials, energy, information services, and industrials. We also remain positive on materials such as iron ore and copper due to strong global (ex-China) steel production and a large prospective U.S. infrastructure package.

Global Equities: Other Notable Data Points

Bottom-Up EPS Estimates Have Steadily Risen

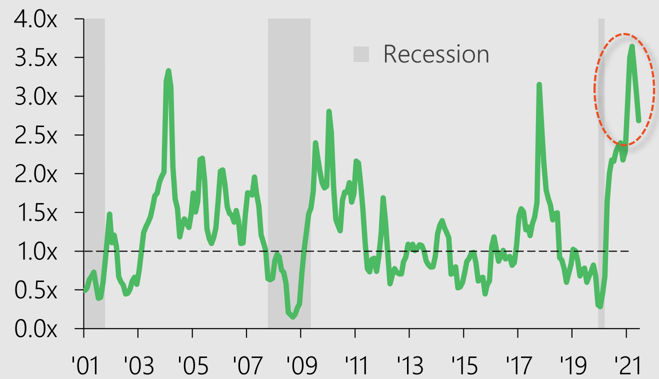
S&P 500 Consensus EPS Estimates
Bottom-Up, Calendar Year



Source: FactSet, 9/30/21

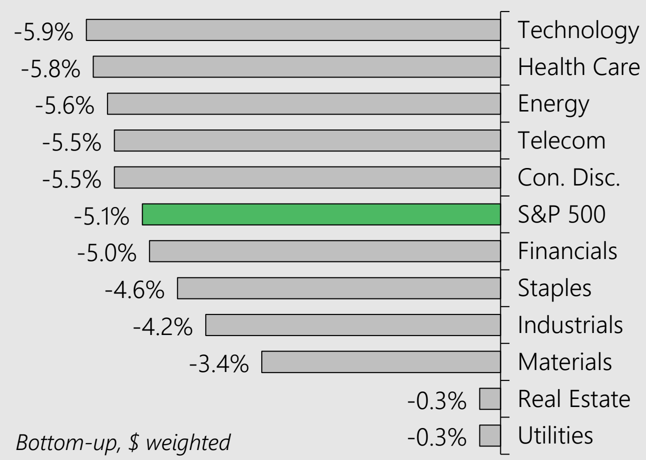
But Earnings Revisions Ratio Has Peaked

S&P 500 Earnings Revision Ratio
Number of Up Revisions ÷ Number of Down Revisions



Source: FactSet, 9/30/21

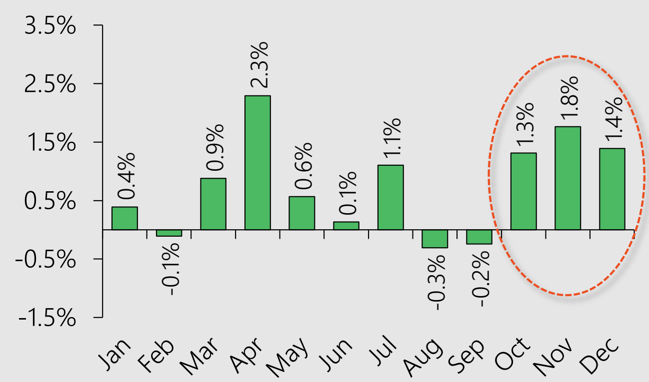
Proposed Tax Hikes Will Dampen 2022 EPS



Source: Wolfe Research, 10/5/21

Seasonality Working in Favor of 4Q Returns

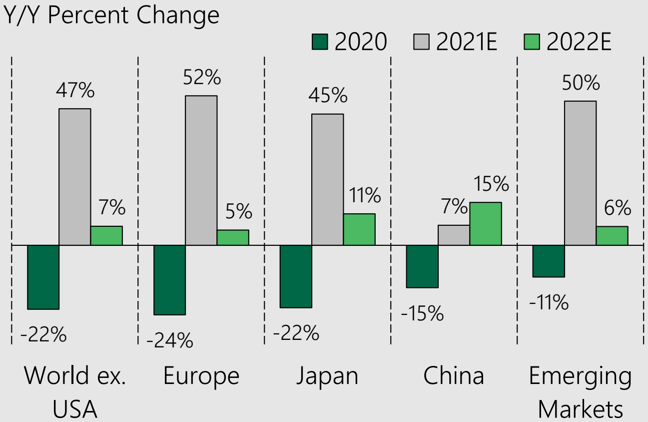
Seasonality of S&P 500 Index Price Returns
Average M/M Percent Returns for Last 30 Years



Source: FactSet, 9/30/21

Subdued Global EPS Growth Estimates for '22

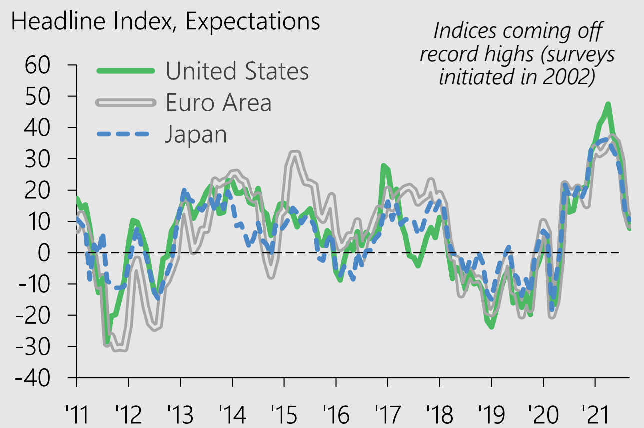
Bottom-Up EPS Estimates for MSCI Indices
Y/Y Percent Change



Source: FactSet, 9/30/21

Investor Confidence Coming off Record Highs

Sentix Investor Confidence
Headline Index, Expectations



Source: Sentix, 9/30/21

NOTICE: This analysis contains the collective opinions of our analysts and portfolio managers and is provided for informational purposes only. While the information is accurate at the time of writing, such information is subject to change at any time without notice, and therefore, so may the investment decisions of Sit Investment Associates.

sitinvest.com | sitfunds.com
612-332-3223