QUARTERLY MARKET REVIEW

SECOND QUARTER 2021

First Business Bank.

EXECUTIVE SUMMARY

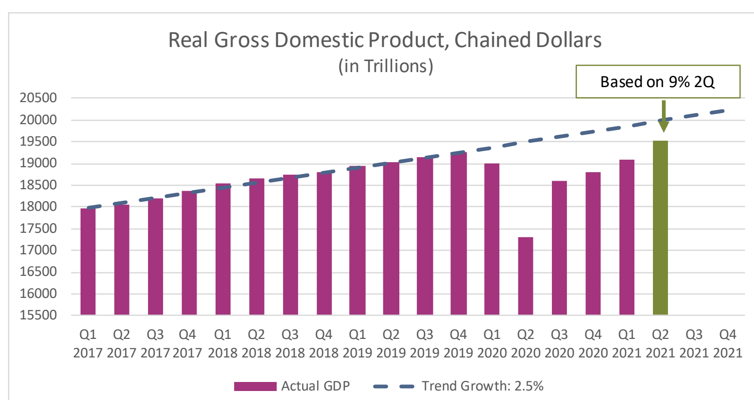
We are still in the early stages of a powerful economic recovery driven by consumers with trillions of dollars burning holes in their pockets, businesses eager to hire workers, and still-enormous fiscal and monetary policy support. Nonfarm payrolls are expanding. Industrial production is growing, and ISM Manufacturing PMI remains well in expansion territory above 60. The data points to an economy that is recovering faster than typically seen following recessions. Partly due to the surge in demand, inflationary pressures are the highest in over a decade. This strength continues despite scarcity of labor, supply chain disruptions, and materials shortages. The consensus estimates of 2nd quarter GDP growth are currently between 9% and 10%. And, although the recent recession was significant, it was short, and businesses and workers will emerge from the downturn with less permanent and lasting damage than occurred after the Great Recession.

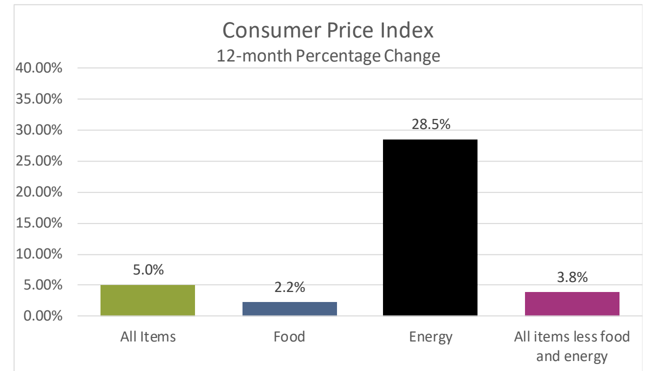
Equity markets have remained attractive in the first half of this year with large cap markets posting a return of 8.5% for the quarter and 15.3% year to date. Technology and communications services stocks finished the quarter strong, helping the S&P 500 and Nasdaq to surge to record-high levels. Bond markets have seen some volatility so far in the year as investors adjust for higher growth and inflation rates. The 10-year U.S. Treasury rate dropped 28 basis points to 1.47% after rising 82 basis points in Q1. Shorter rates have stayed in a fairly tight trading range between .10% and .16% in 2021 until trading as high as .278% in late June. Fed Chairman Powell and other Fed governors reiterated a commitment to low short-term rates through 2022 and to market stabilization.

ECONOMIC RECOVERY CONTINUES AT A STRONG PACE

Strong economic recovery continued with GDP growth of 6.4% annualized in the first quarter. The increase in real GDP in the first quarter reflected increases in personal consumption expenditures (PCE), nonresidential fixed investment, federal government spending, residential fixed investment, and state and local government spending. Personal consumption grew by 11.3%, fueled by strong demand for durable goods (+48.6%), non-durable goods (+14%), and services (+4.6). The increase in federal government spending largely reflected payments of administration fees relating to the Paycheck Protection Program and the purchase of COVID-19 vaccines.

Analysts see the economy expanding in the neighborhood of 9% in Q2 as the recovery continues, although rising price pressures are already weighing on some sectors, namely the housing market. Growth of 9% annualized in Q2 (shown in the chart in green) would elevate our real GDP above the prior peak in December of 2019 but remains below the trend growth rate of 2.5%. Strong continued growth through the end of the year could see us back on that track.





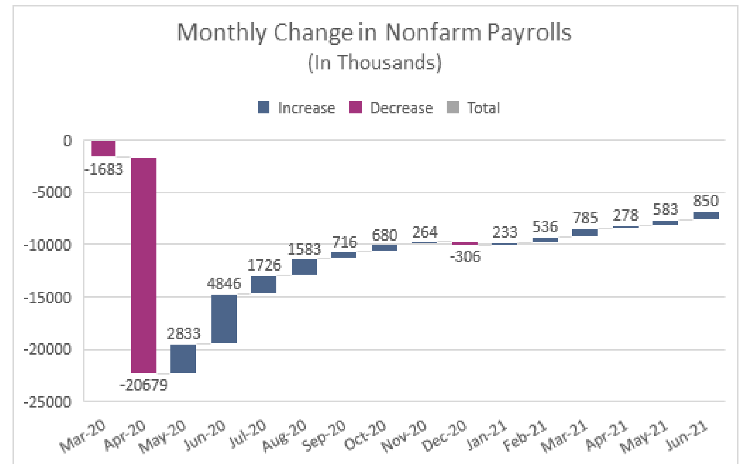
Inflation is on investors' minds as the post-pandemic economic rebound is driving the biggest surge in inflation in nearly 13 years, with consumer prices rising in May by 5% from a year ago. The core price index (ex-food and energy) rose by 3.8% in May from the year before — the largest increase for that reading since June 1992. Consumers are paying higher prices for many of their purchases, particularly big-ticket items such as vehicles. Prices for used cars and trucks leapt 7.3% from the previous month, accounting for one-third of the rise in the overall index.

The hotter-than-expected inflation data in April and May has helped feed speculation that the Fed could begin talking about stepping back from its accommodative stance. Though the inflation readings are well above anything seen since the financial crisis, the Federal Reserve has been largely dismissive of the numbers. Central bank officials believe the current rise is due to temporary factors that will abate as the year goes on and look higher because of comparisons to the year-ago period when much of the economic activity remained subdued due to pandemic restrictions. In recent testimony, Chairman Powell acknowledged that some inflation pressures are stronger and may be more persistent than anticipated. He characterized the current situation as caused by "extremely strong demand for labor, goods and services" compounded by a "supply side caught a little bit flat-footed." He cited airline tickets, hotel prices, and lumber as examples of prices influenced by surging demand that should resolve in the coming months. We have seen this to some extent already in the lumber market where futures contracts have fallen by almost 50% from highs hit in early May. When looking at year-over-year changes in any data, including inflation, keep in mind that the levels from one year ago were negatively impacted by the pandemic-related shutdowns, which significantly depressed both productions and prices.

The Federal Open Market Committee (FOMC) met June 15 and 16 and the official statement was only slightly changed from the meeting in April. The target rate is unchanged at zero to .25% and monthly purchases of $120 billion in securities will continue. The slight change was that, although the pandemic was still noted as a risk, it was no longer cited as an item that was causing "tremendous hardship." Many FOMC members appear to be more confident that the U.S. economy is on track to meet the stated goals, signaling a shift to a more hawkish stance. The Federal

Reserve Board projections in June reflect higher real GDP growth in 2021 and higher PCE inflation for the year (3.4% versus 2.4% in March). The projected federal funds rate for 2023 rose from .1 in March to .6 following the June meeting. As was the case following the Great Recession, we would expect the Federal Reserve to begin this process by paring its $120-billion-a-month bond buying.

The ISM Manufacturing index edged just lower to 60.6 in June. This seasonally adjusted composite index measures the change in production levels across the U.S. economy from month to month. Equal weight is given to new orders, production, employment, supplier deliveries, and inventories. The index has dropped in recent months from the 38-year high of 64.7 reached in March. The details of the recent readings provided clear evidence that shortages in materials and labor were constraining the rate of expansion. Based on the recent drop in global commodities prices, it is possible that shortages of some raw materials have started to ease.



QUICK NOTES

- Durable goods rose 2.3% month over month in May, driven by a 7.6% m/m increase in transport orders, including a rebound in motor vehicles and commercial aircraft.
- IHS Markit U.S. Manufacturing Purchasing Managers Index (PMI) hit 62.6 in June, pointing to a record pace of growth in factory activity.
- IHS Markit U.S. Services PMI dropped in June to a still-strong 64.8 after setting an all-time high of 70.4 in May.
- Consumer confidence, based on the University of Michigan's Index of Consumer Expectations, rose to 85.5 in June. This after a drop in May to 82.9, down from a post-pandemic high of 88.3 in April. Consumer confidence remains well below pre-pandemic levels exceeding 100.
- Retail sales, measured as month-over-month change, fell 1.3% in May after an increase of .9% in April and a huge 11.3% surge in March. Compared against the same month a year ago, May retail sales were up 28.1%.

As of late June, 46% of U.S. adults are fully vaccinated against Covid-19 and 54% have had at least one dose. Although missing the target of 70% by July 4, this vaccination rate is contributing to the resumption of such activities as travel and dining out. High frequency data indicates that U.S. seated diners are back to pre-pandemic levels while hotel occupancy remains down 10% and air traffic is still down 24%. Significant improvement has been made in both categories in the last three months.

The Biden administration proposed a $2+ trillion infrastructure plan at the end of the first quarter. The initial proposal met with fierce opposition over both how to pay for the plan and the scope and size of the spending. A bi-partisan agreement evidently has been reached on a much smaller plan featuring $579 billion in new spending including:

- $312 billion for roads, bridges, passenger and freight rail, and public transit
- $266 billion in non-transportation infrastructure including broadband, power, and water

The original proposal sought significantly higher dollar amounts for other categories on which agreement could not be reached, including expanded childcare, job training, affordable housing, and climate change. Democrats favor pairing this smaller infrastructure bill with a larger tax and spending bill that would address social policy areas of the party agenda while Republicans favor decoupling of the two bills. It is not yet entirely clear how the additional spending will be offset by revenue increases. Spending will be paid for through increased IRS enforcement and the redirection of unused state and local coronavirus relief funds. The framework also proposes private-public partnerships and bonds, among a bevy of other potential funding mechanisms.

EMPLOYMENT UPDATE

After falling short in April and May, job growth surged in June as businesses endeavor to keep up with a rapidly recovering economy. Hiring in June accelerated as nonfarm payrolls increased by 850,000. The unemployment rate rose to 5.9% in June from 5.8% the prior month as some previously discouraged workers rejoined the available workforce. Since March, the economy added 1,702,000 jobs and net growth in payrolls since last May totals 15.6 million. Still, about 9.5 million people were unemployed and potentially available to work in June, while employment was still down by about 6.8 million jobs compared with pre-pandemic levels.

Job gains in the second quarter were led by leisure and hospitality, which added 977,000 jobs. Average weekly wages in leisure and hospitality were up 10.4% in May from February 2020. This is great news in an industry that suffered the steepest job losses last year. Despite strong gains, employment levels in this sector remain 2.2 million lower than prior to the pandemic. Other industries with net gains were education and health services, state and local government, retail, and information.

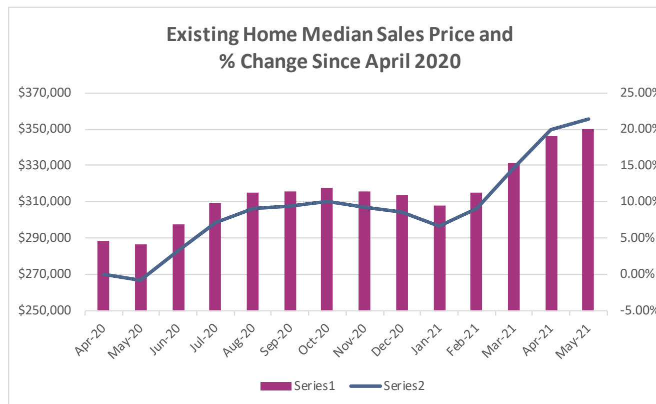
Meanwhile businesses are still struggling to attract and retain workers. Job openings, as measured by the Bureau of Labor Statistics, reached a high of 9.3 million through April, a high-water mark for the series that dates back to 2000. The rate at which workers quit their jobs, a sign of confidence in the labor market, also rose to a record high in April, and the rate at which workers were laid off fell to a record low. Fears of catching the virus have presumably continued to keep some away from work, while many are still having to stay home to look after children and other dependents. The recent moves by 26 states to opt out of the enhanced federal unemployment benefits could have convinced some lower-wage claimants to return to work. That said, while the extra payments are only just starting to expire, the recent jobless claims data suggest that the announcements haven't yet had much impact.

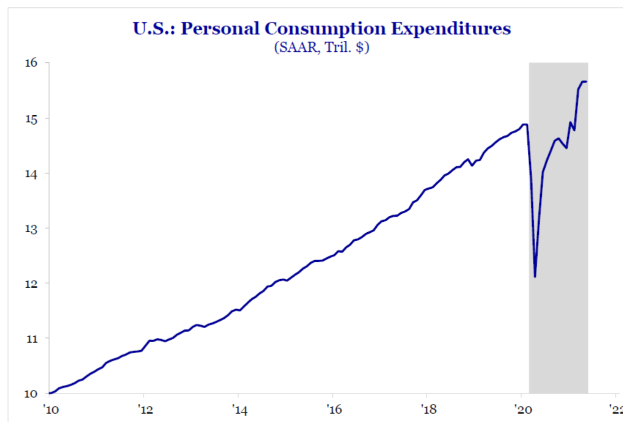
Average hourly earnings increased +1.6% in the quarter and are up 3.6% year over year. The U.S. workweek decreased in June but remained elevated, as companies appear to be trying to compensate for worker shortages by increased hours. Productivity numbers have jumped higher as greatly increased production is achieved with significantly fewer employees.

HOUSING MARKET

The net worth of U.S. households has climbed to new heights in 2021. Thanks to a $3.2 trillion increase in equity holdings and $1 trillion escalation of real estate values, household net worth has surged to more than $136.9 trillion. From a historical perspective, household net worth has nearly doubled from its level of a decade ago as the nation was still escaping the throes of the Great Recession. The increase in housing values is due to the super-hot housing market that has driven the steepest year-on-year appreciation in records that go back to 1999. Prices are being driven up by low mortgage rates, a shortage of homes for sale, and a surge in demand. However, over the past few months the housing market has cooled as more people are priced out of the market.

Consumers splurged on goods in the last year while sequestered at home. Direct payments from government stimulus helped to boost spending. Now that restrictions are lifted and vaccinations allow us to venture out, we have seen a decline in goods purchases and a boost in spending on services, which constitutes the dominant share of total consumer spending. All that spending has eaten into savings. The personal saving rate fell to 12.4% in May from 14.5% the previous month. The rate remains considerably higher than February 2020, when it stood at 8.3%, meaning people still have plenty of money to spend. Strong consumer spending is a positive sign for the balance of the year since personal consumption represents 68% of the U.S. economy.





Source: Strategas Asset Management

ELSEWHERE IN THE WORLD

April data confirmed that world trade flows have experienced uninterrupted growth for the last 12 months and remain well above pre-pandemic levels. Purchasing managers' outlooks generally are improving in recent months. Recovery from the pandemic has varied by region and appears closely linked to vaccination rates. In Britain, the process is rolling along smoothly with 47% fully vaccinated and economic data indicating expansion. The UK is leading the recovery, as its PMI has risen to 64.2 from sub-50 last quarter. The Eurozone is also surging. The European Union countries have seen a bumpier rollout of vaccines with around 25% of residents fully protected. Despite elevated Covid-19 cases and numerous strict lockdowns, consumer confidence in the EU is nearing pre-recession highs. The non-German economies in Europe recorded a 63.1 PMI in May — a sharp gain from 48.1 in the prior quarter. Nations that are less reliant on consumer services and have heavier exposure to industrial activity, such as Germany and the U.S., have reported more consistent and solid PMI readings. Japan's recovery remains challenged, but it has finally moved into expansion territory with a PMI reading of 53. As of mid-June, less than 9% of the population in Japan was vaccinated. With the 2021 Olympic Games only weeks away, the country's health situation remains precarious. China has pulled back a bit, due to a slowing in exports as the dollar has declined since the start of the year. Still, manufacturing trends in China remain positive.

MARKET COMMENTARY

The S&P 500 posted a strong return of +8.5% for the quarter, bringing the year-to-date return to +15.3%. Year-to-date sector performance definitely has favored value sectors that underperformed in 2020 (pink bars), although growth was the leader and made up some lost ground in Q2. Communications services and technology posted strong returns in the quarter but continue to lag energy and financials on a year-to-date basis. Again, there have been no negative sector returns for the quarter or year to date. The weakest-performing sector so far in the year is utilities with a return of +2.4%.

As of late June, Facebook joined Apple, Microsoft, Amazon, and Alphabet (Google) in the exclusive $1 trillion market-cap club.

Clearly we see the impact of vaccines on the economic recovery in sector returns post the vaccine accouncement on November 6, 2020. Significant price rebounds have occurred since that date in sectors highly leveraged to "reopening," including energy, airlines, retail REITs, hotels, resorts, and cruise lines.

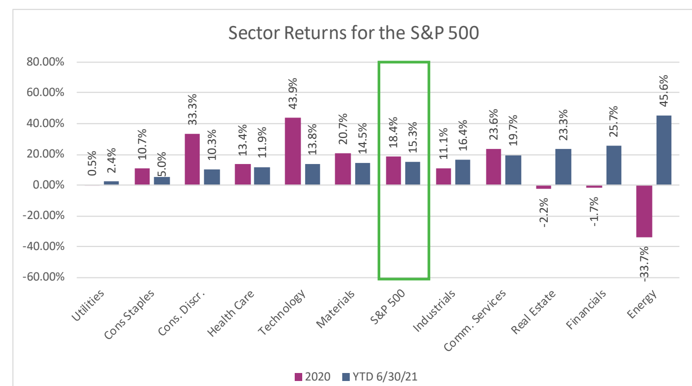
Earnings growth is strong in 2021, much stronger, in fact, than analyst estimates: 87.5% of companies exceeded the analyst earnings estimates in the first quarter. That was a record high going back to the mid-1990s and well above the long-term historical average of 65%. In fact, 55% of companies beat even the highest analyst estimate. This is driving EPS estimate revisions higher although as 2021 earnings revisions reflect stronger growth expectations for this year, 2022 estimates have been revised lower. Consensus today is that earnings will increase by 36% in 2021 and a more modest 11.8% in 2022.

Corporate cash balances are near record high levels after companies rushed to issue debt and shore up balance sheets in the early days of the pandemic. Quarterly reports show that companies held $1.94 trillion in cash and short-term investment on their balance sheets at the end of the first quarter of 2021. Although down from year-end, it is up 30% from the $1.49 trillion at the end of the first quarter of 2020.

Small cap stocks posted a gain of 4.3% for the quarter, maintaining the top spot for the year to date at 17.5%. Small cap stocks have almost, but not quite, recovered to the high of +19.6% set in March.

Value has outperformed growth for the year to date but growth was the dominant style in Q2, rising 11.9% versus 5.0% for value.

Global equities have underperformed for U.S. investors as a stronger dollar and currency translation has had a negative impact on returns. Developed markets, as measured by the Europe, Australia, and Far East (EAFE) index, rose by 5.17% for the quarter and 8.83% year to date. Emerging markets have slightly lagged with a quarterly return of 5.05% and 7.45% for the year to date. Earnings in emerging markets and Europe have been particularly stong, rising 47% and 43% year to date. Despite strong results, the MSCI AC World ex-U.S. index trades at almost a 25% discount to U.S. markets.



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Northeast Wisconsin:
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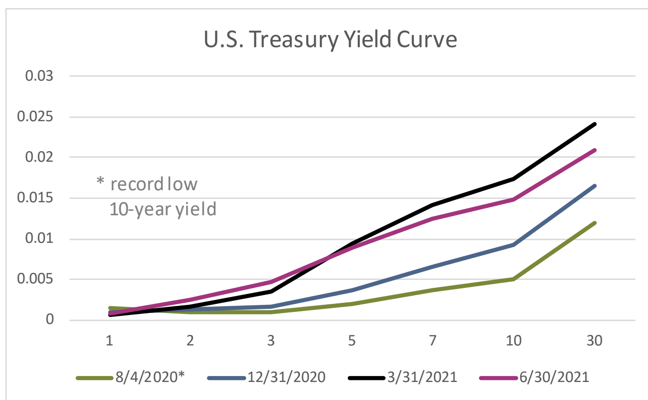
U.S. Equity Returns

YTD 2021	Value	Blend	Growth
Large	17.0%	15.3%	13.0%
Mid	19.5%	16.2%	10.4%
Small	26.7%	17.5%	9.0%

10-year Annualized	Value	Blend	Growth
Large	11.6%	14.8%	17.9%
Mid	11.7%	13.2%	15.1%
Small	10.8%	12.3%	13.5%

Bond rates have seen a fair bit of volatility so far in 2021. We experienced significant yield curve steepening in the first quarter as markets factored in stronger growth and higher inflation. Long duration bonds underperformed the short end of the curve by 4% (-0.5% versus -5%). As this second quarter began, markets were projecting that the 10-year Treasury note rate would rise above 2%. The second quarter has brought about a flattening in the yield curve and longer duration bonds outperformed with a return of 5.3% versus -0.6% on the short end. Two factors appear to be at play. First, following the FOMC meeting, investors have moved forward their expectations for monetary policy tightening. This is reflected in the large rise in real yields on the short end of the yield curve. Second, investors now discount less inflation over the long run. Inflation compensation as measured by inflation swap rates, for example, has declined, particularly on the long end of the curve. This is consistent with the view that earlier Fed tightening will reign in inflation pressures somewhat faster.



PORTFOLIO AND OUTLOOK

Portfolios have continued to benefit from an overweight in equity securities as appreciation from attractive equity returns has carried our exposure back to the higher end of the range. Through May, our trailing one-year performance is ahead of the peer group benchmark across the board for all risk categories.

Equity valuations have improved in recent months, due primarily to rising earnings estimates and despite upward movement in prices. The S&P 500 trades currently at a forward price/earnings ratio of 21.1X relative to a 20-year average of 15.7X. The dividend yield of 1.4% remains attractive relative to bond yields, especially after considering the preferential treatment of qualified dividends for taxable investors. We continue to view equities as the more attractive asset class as compared to fixed income. Accordingly, we will continue to allow our portfolios' equity levels to remain at the higher end of the allowable range.

As our investment team looks to the second half of the year, we are focusing on a few major themes. First, inflationary pressures are spooking some investors and remain a topic that our clients are eager to discuss. The bond market and the Federal Reserve are currently viewing inflation as transitory and believe it will, at least to a large extent, work itself out over time. According to a recent survey of 500 institutional investors, the prevailing expectation for inflation is that the average rate will be 3% over the next five years. While not alarmingly high, this level of inflation will have a negative impact on the "real returns" in bond portfolios and be a modest headwind for equity markets. Moderately higher levels of inflation may also argue in favor of some alternative asset classes that we may choose to own for tactical reasons.

As discussion and negotiations continue regarding both the infrastructure plan and the larger plan to promote agenda items, including climate, health, and social programs, we are mindful that proposals for offsetting revenue increases are likely to impact tax rates, both corporate and personal. We have a close eye on proposed legislation so that we can make advantageous portfolio changes within this tax year and prior to passage of higher tax rates on capital gains.

Covid-19 posed many challenges to our team as in-person meetings were impossible while market volatility and future uncertainty made communication even more crucial. We rose to the challenge to connect more frequently with timely written communications and with video and voice calls in place of in-person meetings. Like all of you, we are pleased to be back to business as usual and look forward to seeing many faces that we have missed in these past 15 months.

Index Returns	2Q 2021	2021 YTD
S&P 500 Index	8.55%	15.25%
Russell 2000	4.29%	17.54%
MSCI EAFE Index	5.17%	8.83%
MSCI Emerging Markets Index	5.05%	7.45%
Bloomberg Barclays U.S. Aggregate Bond	1.83%	-1.60%
Bloomberg Barclays U.S. Treasury 1-3 Year	-0.04%	-0.09%
Bloomberg Barclays U.S. Treasury 5-7 Year	1.42%	-2.20%
Bloomberg Barclays Municipal Index	1.42%	1.06%
Bloomberg Barclays U.S. Corporate High Yield	2.74%	3.62%
S&P GSCI Gold Index	3.15%	-6.96%
Bloomberg Commodity Index	13.30%	21.15%

Source: Morningstar Direct

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