WestStar

Wealth Watch

Second Quarter 2021 & Outlook

In ancient Babylon and Greece it was imagined that a goddess would spin a wheel to randomly impose blessings or misfortunes on the world. This "Rota Fortunae," or "Wheel of Fortune," has been adapted to contemporary contexts throughout the ages, with the modern iteration being the gameshow.

Wheel of Fortune

The last three years could be viewed in this context. Indeed, while we are all too aware of the tragedy that was 2020, the tremendous results so far in 2021 recall to mind the Wealth Watch newsletter published in July 2019 wherein we noted the S&P 500 had had its best first half since 1997. Two years later we applaud the US stock market having had its second-best first half this century. Similarly, while in 2019 we lauded first quarter GDP growth of 3.2%, Q1 2021 GDP grew at 6.4% with some estimates suggesting a 9% growth rate in Q2!

While misfortune befell 2020 and blessings abounded in both 2019 and the first half of 2021, what might lie in store as the wheel of fortune spins in the second half?

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Your wealth, well managed.

What You Need To Know:

- Nearly all major categories posted positive returns in the second quarter
- Year-to-date the US has led the world with stocks outperforming bonds overall
- WestStar's proactive tactical positioning has added value over the past year
- While inflation has accelerated, current conditions continue to suggest a normalization underway
- Stocks may still have potential to continue their rally
- Volatility may accelerate in the second half, which suggests a tactical neutralization of Value and Small-Cap stocks is in order

Asset Class
Index Performance*
Year-to-Date
As of June 30, 2021

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Commodities
21.15%

US Small Cap Stocks
17.54%

Real Estate
6.11%

US Large Cap Stocks
15.25%

International Developed Market Stocks
8.83%

International Emerging Market Stocks
7.45%

Alternative Investments
4.44%

High Yield Bonds
3.62%

Money Market (Cash)
0.07%

US Investment-Grade Bonds
-1.60%

International Bonds
-4.42%

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Market Performance: *America's Got Talent*

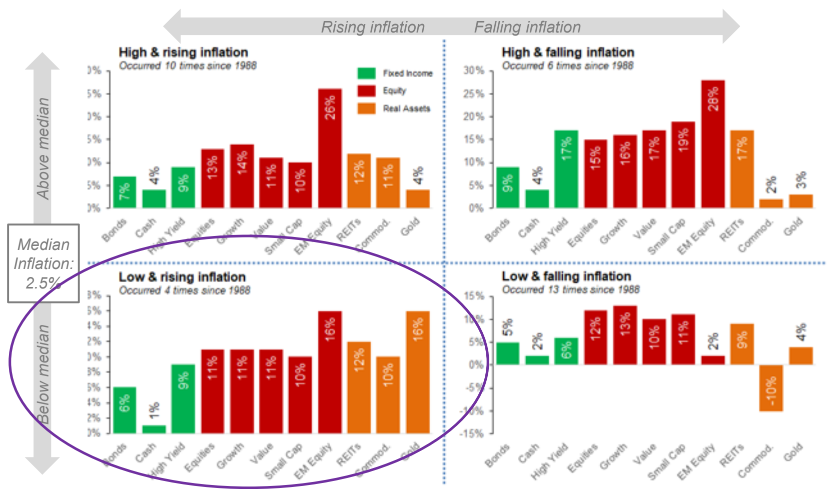
All major asset classes posted positive returns in the second quarter. Most notably, and in a striking reversal from being a years-long laggard, commodities continued their rebound amid economic reflation and were up +13.3% in Q2 and +21% year-to-date through June. The US outperformed the rest of the world across nearly all asset classes—even within fixed income which generally posted negative results. US Large Cap stocks outpaced Small Cap and both Developed Market and Emerging Market stocks while High Yield bonds led within Fixed Income and remained the only positive bond category year-to-date. The US has also led the world economically in 2021, with real GDP expected to be in the 6.5% - 7% range this year!

Tactical Strategy: *Press Your Luck*

Our tactical positioning over the past year has proven exemplary, with our emphasis on the best-performing categories (small cap stocks, value stocks, high yield bonds, real assets) and de-emphasis on the laggards (large cap stocks, investment-grade bonds, international bonds) contributing to the performance of our client portfolios. We always maintain a proactive approach to our tactical positioning, enacting strategy modifications as market conditions warrant. Given the research and analysis as described in the remainder of this edition of the Wealth Watch, several tactical shifts are justified in anticipation of second-half circumstances.

Inflation: *The Price Is Right*

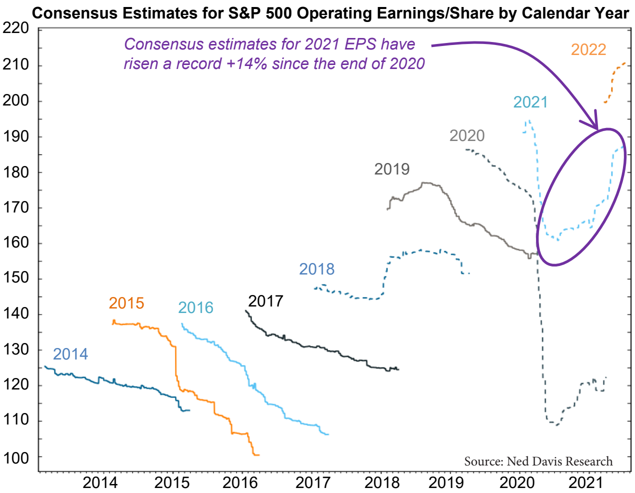
The Consumer Price Index in June spiked 5.4% year-over-year, the fastest pace since August 2008. While a full third of the increase in June was due to a record 10.5% jump in used car and truck prices, inflation overall was broad-based, with many areas including food, energy, airline fares, apparel, shelter and lodging experiencing multi-year surges. One must remember, however, that year-over-year statistics are in comparison to the depressed levels of the COVID shutdown. One of our consultants, Ned Davis Research, estimates that this "base effect" accounts for approximately 1.2 percentage points of the aforementioned year-over-year inflation rate. Furthermore, imbalances in supply (bottlenecks in production and supply chains, labor shortages) and demand (consumers with high savings resuming economic activities en masse) are factors of the global reopening theme. As the base effect and supply/demand imbalances normalize over time, so, too, will inflation, which may have peaked in the second quarter. Historically, similar environments have produced asset class returns accordant with the lower left corner of the chart below:



*Large Cap: S&P 500 Index; Small Cap: Russell 2000 Index; Int'l Devel: MSCI EAFE Index; Int'l Emerg: MSCI Emerging Markets Index; Core Bond: BbgBarclays Aggregate Index; Int'l Bond: BbgBarclays Global Aggregate ex-USD Index; High Yield: BbgBarclays US Corporate High Yield Index; Cash: BofA Merrill Lynch 3-Month US Treasury Index; Real Estate: FTSE EPRA/NAREIT Developed Index; Commodity: Bloomberg Commodity Index; Alternatives: Wilshire Liquid Alternatives Index

Stock Valuations: *Jeopardy(?)*

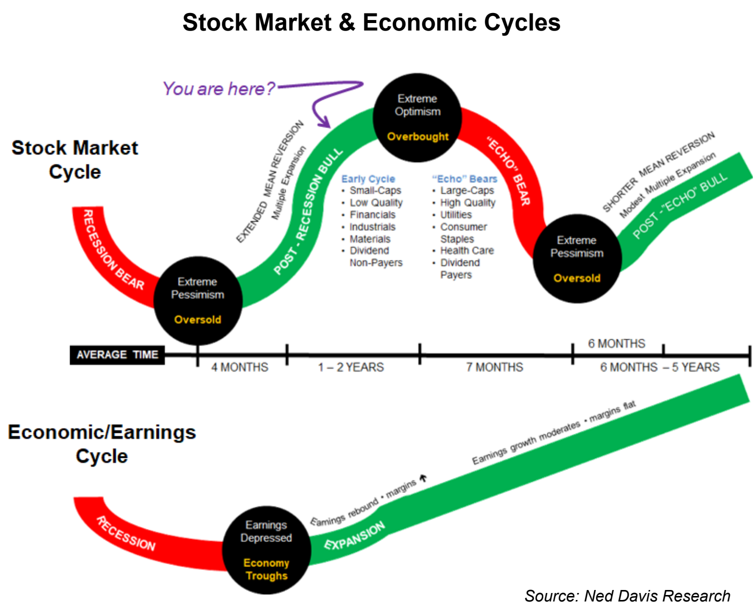
One area of concern among investors has been that by some measures, such as the price/earnings ("P/E") ratio being high, stocks appear expensive at current levels. This is understandable considering that forward P/E on the S&P 500 was 21.5 on June 30th vs. the 25-year average of 16.7. Interesting, however, is the fact that the P/E ratio has actually declined (indicating stocks have grown cheaper) most recently due to stronger-than-expected corporate earnings.



Historically analyst earnings projections for S&P 500 companies are revised downward by an average of 8% over any given year since 1984. Ironically, upon official reporting day, these companies tend to beat these downwardly-revised estimates, with an average of 71% exceeding consensus since 1994. In other words, analysts typically begin by being overly optimistic, then overdo it in their attempt to correct their excessive estimates as shown on the chart at left. We find, however, that 2021 has not followed this historical pattern. This year consensus EPS estimates have actually risen by a record 14% since year-end. Furthermore, in the first quarter 87% of companies beat consensus—also a record—with three of the highest all-time beat rates occurring in the last four quarters. While it remains to be seen whether revision momentum has peaked, stocks are likely not in jeopardy at this time. Strong earnings overall may indicate that stocks are not as extended as one might think and should provide corporations the resources to resume repurchase programs—another source of demand for the market.

Second Half Outlook: *Name That Tune*

Examination of historical economic and stock market cycles reveals several trends as reflected on the chart at right. Over the past 60 years every recession has been accompanied by two cyclical bear markets on average—let's name them "recessionary bears" and "echo bears." An economic recession typically triggers a recessionary bear market, as was the case in 2020. Then, as we noted in both the April and July 2020 editions of the Wealth Watch, the stock market tends to bottom several months before the recession ends and what follows is a strong bull market which tends to last a median of 15.6 months. Market volatility often resumes in the second year of expansion and at times corrections become shallow cyclical "echo bear markets" which last a median 6.8 months. While at present positive factors still outweigh negative ones overall, we recognize the potential for increased volatility in the second half and have made a tactical shift toward large cap stocks.



Remain Focused on Long-Term Strategy: *Who Wants to Be a Millionaire*

As we formulate investment strategies we incorporate forward-looking risk and return projections for all major asset classes and categories. It is with this rigorously researched 10+ year outlook that we devise our long-term strategic asset allocation strategies; a process which has been proven to be the most effective way to meet one's investment goals. That being said, an old Wall Street adage comes to mind: "The market can remain irrational longer than you can remain solvent." In other words, the way the markets *should be* acting is not always they way they *are* acting. It is in recognition of this aspect that we employ our tactical positioning to emphasize areas of opportunity and deemphasize areas of risk within our long-term framework. Accordingly, while we continue to favor stocks over bonds at this time, we feel that the expected benefits of our emphasis on Value and Small-Cap stocks have been attained and are now shifting back toward a "neutral" state on both. As the "wheel of fortune" spins on the second half of 2021, we remain committed to our long term strategy and our proactive near-term assessments therein.

The team you can trust.

As true fiduciaries, our focus isn't on selling products to our clients. Instead, we focus on providing personalized service and real financial solutions.

Our team of wealth management professionals has the valuable depth of expertise you need to navigate life's events.

From retirement planning and investment management to trust services and estate settlement, we can help you devise the most effective plan to meet your financial goals.

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