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## A Message from the TOPS® Portfolio Management Team

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### *2<sup>nd</sup> Quarter 2021 Market Commentary*

“It Was Another Very Strong Quarter For The Economy And Financial Markets”

First Half 2021 stock market returns were well above average, marking the fifth consecutive positive quarter for most indexes, both here and abroad. In the U.S., the massive fiscal and monetary stimulus, combined with the efficacy of the COVID vaccines and relatively rapid vaccination process, resulted in a rapidly re-opening economy. These positive factors, in turn, have led to an extremely strong earnings recovery and a flood of liquidity into the stock market. However, concerns about rising inflation and a possible Federal Reserve shift away from super-easy policies caused bond yields to rise in the first half.

As a result, the TOPS portfolios earned a wide range of returns for the first half (+3.8% to +14.1%). The more aggressive TOPS portfolios (higher equity allocations) were aided by the continued resurgence of diversified market leadership for the first half overall, although large cap growth returned to its leadership position in Q2.

We continue to note all TOPS portfolio returns for the trailing three-year, five-year and ten-year timeframes remain well into positive territory, with many recording double-digit returns over differing timeframes.

After discussing Q2 and year-to-date 2021 financial market results, we will address three questions that are important to TOPS portfolio returns and strategies:

Can the V-Shaped recoveries of the U.S. economy, earnings per share and stock markets continue?

- Will rising inflation rates force the Federal Reserve to change its easy money policies?
- With inflation rising, why aren't bond yields higher?
- Second Quarter and Year-To-Date Market Review

As noted above, stock market returns have been positive for five consecutive quarters and trailing twelve-month (TTM) returns are remarkable. The TTM return for the large cap S&P 500 is +40.8%. That is a tremendous return, except in comparison to the gains from S&P SmallCap +67.4% and MidCap +53.2%. New all-time highs were reached by all three indexes during Q2 and the S&P 500 closed the quarter with its 34th new closing high of 2021. MidCap and SmallCap were less than 3% below their highs, so the half ended on a strong note.

For Q2, the top indexes were S&P Growth +11.9%, S&P GSSI NA Natural Resources +11.1% and MSCI World Real Estate +10.1%. Of course, we were gratified to see our largest allocation –the S&P 500 – recorded a strong +8.5% return. The other equity indexes represented by ETFs in the TOPS portfolios also reported solid mid-double-digit gains: FTSE Developed ex-US (developed international) +5.7%, S&P Value +5.0%, FTSE Emerging Markets +5.7%, S&P SmallCap +4.5% and S&P MidCap +3.6%.

Rising inflation rates and worries about how the Federal Reserve might respond were shrugged off by investors in Q2, so bond yields declined modestly. The 10-year US Treasury yield dipped from 1.73% to 1.45% during Q2. The Barclays US Aggregate Bond returned +1.8% and the Barclays US TIPS index was even stronger at +3.2%. Most bond market sectors posted positive returns for Q2 and Investment Grade and High Yield bonds were among the stronger sectors.

Year-to-date equity returns were led by diversifier indexes: S&P GSSI NA Natural Resources +32.7%, S&P SmallCap +23.6%, S&P MidCap +17.6% and MSCI World Real Estate +16.8%. These results are well above normal full-year returns and the S&P 500's +15.3% return was the second highest recorded since 1998. S&P 500 Value +16.3% outperformed S&P 500 Growth +14.3%. International stocks lagged, but FTSE Developed ex-US (developed) +10.0% and FTSE Emerging Markets +9.0% were still well above average.

Despite the Q2 improvement, the 10-year US Treasury Bond yield rose from 0.93% at yearend to 1.45% for the first half of 2021. Barclay's US TIPS recorded a positive return of 1.7% versus the broader Barclay's US Aggregate at -1.6%. US High Yield achieved positive returns while developed international and emerging market bonds were negative.

### *Will V-Shaped Recoveries Continue?*

The short answer to this question is "not forever". The current +41% 12-month S&P 500 gain, as well as the forecasted +10% Q2 GDP and +64% Q2 earnings (EPS) gains are simply not sustainable in a slow-growth world. This doesn't mean any of the "V's" will collapse, but it does indicate investor expectations should moderate as the year goes along.

Several long-term macro factors behind slower longer term economic growth remain in place: Demographics trends (an aging population and slowing birth rates) will continue to result in older (often nonworking) persons growing as a share of the population. High amounts of debt have been proven to weigh on economic growth, and government, corporate and consumer debt have all ballooned in recent years. Government budget deficits are another factor, as they must eventually be pared back through tax increases or spending cuts.

In the shorter term, the massive stimulus in place has helped create significant wealth and large growth in cash reserves for both companies and consumers. As these funds are spent for business investment and consumption, the US economy should continue to expand, but at a slower pace. EPS comparisons will be harder to beat, so year-over-year EPS growth is likely to slow in 2H 2021 and beyond. On paper, these factors should be expected to cause a diminution of stock market gains at some point.

### *Will rising inflation cause the Fed to change policies?*

The May Consumer Price Index (CPI) rose to +5.0%, the highest reading in 13 years. The largest contributors were energy (versus very depressed oil prices a year ago); used cars and trucks (shortages); food away from home (restaurants raising menu prices); and car and truck rental (shortages). Many commodities are supply-constrained, so strong demand caused price increases for many building materials, metals and agricultural products.

The Federal Reserve has been warning us for months that inflation was likely to exceed their 2% target this Spring, but they have consistently stated that the higher prices will be "transitory" and would not cause them to go beyond "thinking about thinking about" a shift from their \$120 billion monthly bond purchases (Quantitative Easing or QE) or exiting their Zero Interest Rate Policy (ZIRP).

However, the Fed's favorite inflation indicator, the price index for Personal Consumption Expenditures (PCE) also surprised everyone in May with a 3.9% rise. The Core indexes (which exclude energy and food) were also well above the Fed's 2% target, with Core CPI +3.8% and Core PCE +3.4%. As a result, the "Dot Plot", which is a chart showing the FOMC members' economic expectations, had some interesting shifts in June. They show the Fed members now think Core PCE could remain elevated and that ZIRP (zero interest rate policy) may end in 2023 rather than 2024.

If the PCE remains stubbornly high in coming months, we would expect the Fed to consider shifting toward somewhat tighter policies. The first step would likely be a well-telegraphed reduction of monthly bond purchases. Many pundits question why the Fed continues the aggressive bond purchase program, amidst such high economic success, especially the purchase of mortgage bonds in a red-hot real estate market.

### *With inflation rising, why aren't bond yields higher?*

According to fund flows in Q2, it appears investors bought longer-dated US Treasuries to hedge the risk of the Fed shifting toward anti-inflation policies which would slow the economy. Although that would push interest rates higher in the shorter term, the return to slow growth could lead to lower interest rates over time. Many investors may also agree with the Fed that the current burst of inflation will prove to be transitory.

Another possibility is that until the Fed decides to reduce its \$120 billion of monthly bond purchases, investors believe it will continue to overwhelm the supply created by budget deficits. This is important because corporate and mortgage-backed bonds are priced at premiums (wider yield spreads) over Treasuries, so if Treasury yields are low, the broader fixed income markets will also have lower yields than might otherwise be the case.

We continue to expect bond yields to normalize over time. Real (inflation adjusted) yields are currently in negative territory, whereas historically yields have exceeded inflation rates. Therefore, the TOPS fixed income strategy is to reduce “interest rate risk” by owning shorter maturity ETFs and to offset that by accepting a little more “credit risk” by owning ETFs that hold US corporate and international bonds. We also hedge against inflation by diversifying away from nominal US Treasuries into TIPS (Treasury Inflation-Protected Securities) and utilizing floating rate securities.

### *TOPS Portfolio Strategies*

The combination of fiscal and monetary stimulus, along with the desire of businesses and consumers to return to normal spending patterns suggests the US economy will grow throughout 2021, albeit at a somewhat slower pace than the red-hot numbers so far. The TOPS portfolio team will continue to monitor and assess the importance of potential Federal Reserve policy shifts and President Biden’s infrastructure and tax initiatives, as well as the constant flow of economic and financial market data as we strategically implement our philosophy of maintaining broadly diversified portfolios.

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