Webster Bank

Return to Normalcy

In the 1920 presidential race, candidate Warren G. Harding campaigned on the slogan "Return To *Normalcy*." The world had just endured both World War I and the Spanish Flu, with a combined death toll well over 50 million people. Harding, with the help of his controversial word choice, earned a landslide victory. The Roaring Twenties followed, and the rest is history.

Capital Markets Review

Equity Markets

Fast forward 101 years, and the global economy is "returning to normalcy" following the Pandemic of 2020. The S&P 500 notched its best first half of the year since 1998, rising 15.3% through June 30th after an 8.5% second quarter performance. U.S. small cap stocks (Russell 2000 index) did even better, rising 4.3% in Q2 to bring the year-to-date return up to 17.5%. U.S. growth stocks (Russell 1000 Growth index) narrowed the gap against value stocks (Russell 1000 Value index) in the second quarter, rising 11.9% versus 5.2%. International equities continue to lag, returning approximately 5.0% for both developed and emerging markets.

Bond Markets

U.S. bonds, as measured by the Barclays Aggregate bond index, were up 1.8% for the quarter but are down 1.6% for the first half of 2021, while high yield bonds added 2.7% to finish the first half up 3.6%. Alternative investments, as measured by the HFRX Global Hedge Fund index, returned 2.4% for the quarter.

Fed actions support equities

The Federal Reserve continues to hold short-term interest rates near zero despite increasing fears of inflation. Government bond purchases continue at the rate of $120 billion per month, with tapering of those purchases likely to begin at the end of 2021. In the short run, the Fed's actions give support to equity markets and high yield bonds, as investors seek more attractive returns than can be found in government bonds.

Asset Class Returns

Asset Class	Benchmark	Q2 April-June 2021	YTD	2020
U.S. Large Cap	S&P 500	8.5	15.3	18.4
U.S. Large Cap Value	Russell 1000 Value	5.2	17.0	2.8
U.S. Large Cap Growth	Russell 1000 Growth	11.9	13.0	38.5
U.S. Small Cap	Russell 2000	4.3	17.5	20.0
International Developed	MSCI EAFE	5.2	8.8	7.8
Emerging Markets	MSCI EM	5.0	7.4	18.3
U.S. Investment Grade	Barclays U.S. Aggregate Bond	1.8	-1.6	7.5
U.S. Inflation-Indexed	Barclays U.S. TIPS	3.2	1.7	11.0
U.S. High Yield	BBgBarc U.S. Corp High Yield	2.7	3.6	7.1
EM U.S. $ Debt	JPM EMBI Global	4.1	-0.7	5.3
Absolute Return	HFRX Global Hedge Fund	2.4	3.7	6.8

Source: Morningstar

"The global economy is returning to normalcy following the pandemic of 2020."

U.S. Sector Review

Real Estate and Information Technology led the way amongst the S&P 500 sectors for the second quarter of 2021, while Utilities and Consumer Staples were the worst performers for both Q2 and year to date. Energy, Financials and Real Estate are the top performers so far this year after a disappointing 2020. Our additions to Real Estate and Financials earlier this year helped us to participate in the broad economic recovery currently underway.

Sector Returns: Q2 and 2021

Source: Morningstar

Equities	Index	Q2 April-June 2021	YTD	2020
Communication Services	S&P 500 Sec/Communication Services	10.7	19.7	23.6
Consumer Disc.	S&P 500 Sec/Consumer Disc.	6.9	10.3	33.3
Consumer Staples	S&P 500 Sec/Consumer Staples	3.8	5.0	10.7
Energy	S&P 500 Sec/Energy	11.3	45.6	-33.7
Financials	S&P 500 Sec/Financials	8.4	25.7	-1.7
Health Care	S&P 500 Sec/Health Care	8.4	11.9	13.4
Industrials Information	S&P 500 Sec/Industrials	4.5	16.4	11.1
Technology	S&P 500 Sec/Information Technology	11.6	13.8	43.9
Materials	S&P 500 Sec/Materials	5.0	14.5	20.7
Real Estate	S&P 500 Sec/Real Estate	13.1	23.3	-2.2
Utilities	S&P 500 Sec/Utilities	-0.4	2.4	0.5

Theme Review

As we do each quarter, we turn our attention now to the 2021 themes identified at the beginning of the year. At the midway point, our themes remain intact.

THEME 1: INNOVATION ACROSS SECTORS – EMBRACING TECHNOLOGY

Our “innovation” theme is more than a short-term call. Technological innovation is a theme that will permeate equity selections for the next decade and longer. In 2020, companies with the ability to pivot to the remote working environment, adapt their supply chain processes, and innovate using industry-specific technology thrived. Success came from dynamic and often unconventional process adaptions incorporating new and emerging technologies. Process innovation and the adoption of industry-specific technologies is, in our opinion, the single biggest challenge facing companies across all sectors of the economy going forward.

Even as the impact of COVID-19 continues to fade, certain behaviors adopted during the pandemic are likely to persist. The importance of the home as the center of our world will continue to bring increased home automation, digital transactions, online shopping with rapid delivery and many other related innovations. As millennials demand more automated and technologically savvy solutions, continuous innovation will be a requirement for survival in an increasingly competitive market.

THEME 2: CYCLICAL RECOVERY – CYCLICAL AND VALUE ARE NOT SYNONYMS

In our previous editions of Market Insights, we have discussed the resurgence of value stocks as the U.S. economy began to reopen. In establishing this theme, we differentiated between the terms “value” and cyclical”, arguing that there are many cyclical companies that are considered “growth” stocks.

For the first half of 2021, Energy, Financials, and Industrials have led the market’s climb higher, returning over 45%, 25% and 16%, respectively. The growth-oriented sectors that led the way in 2020 (Technology and Consumer Discretionary) have lagged, returning 11.6% and 6.9% in the first half.

We did not aggressively adjust portfolios to broadly increase our value-oriented holdings, even though value stocks trounced growth stocks in the first quarter, 11.3% to just 0.9%. In the second quarter we saw a huge reversal, with growth catching up, 11.9% versus 5.2%. As of mid-July the value/growth gap has narrowed further, as cyclical participation broadens to include both value and growth companies.

THEME 3: FIXED INCOME AND ALTERNATIVE STRATEGIES: DUAL OPTIONS FOR DOWNSIDE PROTECTION

The environment for bonds continues to be challenged. While interest rates continue to hover at historically low levels, the fact that inflation is beginning to appear in the economic data indicates to us the next move in rates will be up rather than down. Rising interest rates negatively impact bond prices. As a result of this, we continue to underweight bonds in client portfolios, focusing on shorter maturities and lower credit quality. Our strategy continues to work well in 2021, with clients' bond portfolios outperforming the Bloomberg Barclays Aggregate Bond Index, which has generated a negative return so far this year.

To offset our lower bond allocation, we continue to overweight our allocation to alternative investment strategies. The strategies we are utilizing tend to show lower levels of volatility as compared to stocks while generating attractive returns for clients.

Portfolio Positioning

Bullish on equities

We have been moderately bullish on equities all year and remain so as we move into the second half of 2021. At the risk of sounding like a "broken record" we believe the fundamental reasons supporting our optimism (i.e., continued economic reopening driven by massive demand, an extremely accommodative Federal Reserve, and strong corporate earnings) are still in place. Despite some (well founded) concerns about inflation and the Fed's ability to continue making the right moves, we are still confident that equities have room to run. In broad terms, we certainly continue to favor equities over fixed income.

At the same time, we are cognizant that the S&P advanced over 8% in the 2nd quarter (the 5th consecutive quarter it has advanced) and we recognize the need to watch for emerging risks moving forward.

Slight bias to growth vs. value

Taking a more nuanced look at our equity positioning, we have maintained a slight bias to "growth" sectors over the "traditional value" sectors for several years. After a 1st quarter where value outperformed growth by a tremendous margin, growth recovered nicely vs. value in the 2nd quarter 11.9% versus 5.2%. In the longer term, we still favor innovative companies that can grow their revenues and earnings, which leads us to maintain our slight "bias" to growth sectors (such as Technology, Communication Services and Health Care). An added benefit to "growth" sectors is that they often have stronger balance sheets and more cash on hand. This allows them to withstand periods of market volatility a bit better. That said, it is possible that the two styles continue to "trade off" leadership positions for the remainder of the year. We strive for a semblance of balance between growth and more cyclical sectors, such as financials and real estate, both of which we have added to in 2021.

U.S. vs. International

Invest at home and abroad

We believe in global diversification and feel it is important to invest both at home and abroad. At this time, we continue to prefer U.S.-based stocks over their international counterparts (as we have for several years). However, we have closed some of that gap by recently adding to international stocks/funds in many client accounts. The deployment of vaccines, and economic rebound has been faster in the U.S. than in the rest of the world (with the exception of China). In addition, the U.S. came into the pandemic in better economic standing than Europe. However, we fully expect (and hope) the rest of the world "catches up" to us on the vaccination front. Once they do, their economies (and stock markets) should follow suit. Combine that with increased levels of global trade, and you have a decent environment for non-U.S. equities.

Fixed Income

Bearish on fixed income

We came into 2021 bearish on fixed income and remain so now. We expect continued gradual interest rate increases to weigh on returns of government bonds. With government bond yields still deeply negative in terms of their inflation-adjusted ("real") returns, there is not much compensation being offered for a great deal of interest rate risk. We still see fixed income as an important diversifier, and a way to offset equity volatility. However, we are currently underweight relative to our long-term targets, favoring shorter portfolio duration and slightly lower credit quality in an actively managed portfolio, given the likely trend of rising rates.

Liquid Alternatives

Leveraging liquid alternatives for diversification

As was the case when we wrote at the end of the 1st quarter, we continue to overweight liquid alternatives and prefer them to traditional bonds now. We use liquid alternatives for their ability to provide diversified return streams that have low correlations to traditional equity and bonds. In some ways, these liquid alternatives now provide greater portfolio diversification than bonds. There are various types of liquid alternatives in our client portfolios, and they serve different purposes. Some are used for their low correlation to stock markets and as risk mitigation for the overall portfolio. Others give us access to different or non-traditional areas of the fixed income market. Collectively, these funds continue to play a beneficial role within client portfolios.

Outlook for 2nd Half 2021 and Beyond

Positives outweigh negatives

Looking forward, the challenges of navigating the global economic reopening are numerous. Inflation is currently exceeding the Fed's preferred 2% target rate, and GDP growth in the U.S. and China is red hot, while other countries continue to flounder. The Fed is faced with the difficult task of tapering bond purchases without causing a spike in rates. The "Wall of Worry" is alive and well.

Our view, in summary, is that the positives associated with the reopening far outweigh the negatives and we maintain our bullish view on both the global economy and selected equity markets.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.

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