Grant Street Asset Management, Inc.

INVESTMENT ADVISORS

# GRANT STREET ASSET MANAGEMENT, INC.
# QUARTERLY LETTER
# 3RD QUARTER 2021
# October 15, 2021

The third quarter of 2021 saw further progress of economic and social reopening that started during the first half of the year. Jobless claims have continued to tick down as employment recovers and retail spending remains robust. All of this transpired in the face of the stubborn delta variant of COVID-19, but the most recent virus data indicates the delta wave has peaked and is subsiding. As we look to the final quarter of the year and beyond, the data we track supports a positive outlook over the next 12 months for the markets and the economy, but we are closely monitoring some specific risks that may introduce near-term market volatility, although not derail the economic recovery.

Taking a closer look at the state of the U.S. consumer, we see a very encouraging picture related to personal finances as household income and savings continued to rise during the quarter. According to the Bureau of Economic Analysis, Personal Income increased 1.1% in July and the Personal Saving Rate was 10.1%. While these figures are encouraging and underscore a healthy consumer, it should be noted that increased government social benefits in the form of advance Child Tax Credit payments went into effect in July and likely contributed to some of these increases. Nonetheless, consumers continue to be optimistic as evidenced by positive retail sales growth in August and a spending shift from goods to services like travel and entertainment. As the global reopening continues, we expect a larger portion of retail sales to be spent on services.

Turning to equity markets in the third quarter, after a very strong first half of 2021, equity markets around the world paused, and in some cases declined. There are a number of specific issues that we believe contributed to recent volatility: the delta variant outbreak, the Federal Reserve discussing a plan to taper bond purchases along with increasing rates sooner than originally planned, uncertainty around inflation, and the proposed U.S. legislation that greenlights massive spending and potential tax increases. However, as reflected in the table below, all but one major equity market (emerging markets) are still strongly positive for the year.

| Equity Index | 1Q 2021 | 2Q 2021 | 3Q 2021 | Year-to-Date |
|---|---|---|---|---|
| S&P 500 (Large Companies) | 6.2% | 8.6% | 0.6% | 15.9% |
| Nasdaq 100 (Technology-heavy) | 1.8% | 11.4% | 1.1% | 14.6% |
| S&P 400 (Mid-sized Companies) | 13.5% | 3.6% | -1.8% | 15.5% |
| Russell 2000 (Small-sized Companies) | 12.7% | 4.3% | -4.4% | 12.4% |
| MSCI EAFE (Europe, Australia & Far East) | 3.5% | 5.2% | -0.5% | 8.4% |
| MSCI Emerging Markets | 2.3% | 5.1% | -8.1% | -1.3% |
| MSCI ACWI (All Country World Index) | 5.2% | 7.2% | -1.1% | 11.5% |

Relative to equities, fixed income markets experienced muted returns during the third quarter. Within the fixed income landscape, we have seen a continuation of low interest rates, historically tight credit spreads, low default rates and strong demand for yield globally, all of which translate into a challenging environment for bonds. The U.S. 10-year Treasury is on pace for a negative return in 2021, its first sharply negative return since 2013. This bond environment forces investors to look beyond traditional fixed income to construct a truly defensive segment of a portfolio that can keep pace with higher inflation.

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| Fixed Income Index | 1Q 2021 | 2Q 2021 | 3Q 2021 | Year-to-Date |
|---|---|---|---|---|
| B. Barclays U.S. Aggregate Bond | -3.4% | 1.8% | 0.1% | -1.6% |
| U.S. 10-year Treasury | -7.0% | 3.0% | 0.0% | -4.2% |
| B. Barclays 1-3 yr. U.S. Treasury | -0.1% | 0.0% | 0.1% | 0.0% |
| U.S. 3-month T-Bills | 0.0% | 0.0% | 0.0% | 0.0% |
| B. Barclays U.S. Corp. High Yield | 0.8% | 2.7% | 0.9% | 4.5% |
| B. Barclays Municipal Bond | -0.4% | 1.4% | -0.3% | 0.8% |

Inflation continues to make headlines and is a risk factor we have been focused on for much of 2021. Inflation, as measured by the Federal Reserve's preferred metric (PCE), increased to a 30-year high (4.3% year-over-year) in August. The inflation has been widespread, from commodities and goods and services to wages. There is some belief that we may have reached the peak of this inflation cycle during the quarter, but even as year-over-year rates retreat, there is consensus that we may remain above the 2.0% - 2.5% long-term Fed target through 2022.

Inflation typically manifests as an increase in prices and can result from the mismatch between supply and demand. When global economies were shuttered in 2020, supply chains were not just disrupted, they were literally shut down. The supply shortage that has followed (microchips for vehicles as an example), coupled with massive fiscal and monetary support across the globe (i.e., stimulus and rock bottom interest rates) has resulted in more dollars chasing fewer goods.

Inflation, or inflation expectations, influence bond yields as investors require higher yields to maintain purchasing power in a higher inflation environment. As inflation has climbed, we would expect to see bond yields rise. However, aside from a sharp increase in the first quarter, we have not seen a material increase in bond yields in 2021. This may suggest that bond investors expect current levels of inflation to be relatively short-term or transitory in nature.

The Federal Reserve will likely begin to taper its bond purchases in the fourth quarter. When it will raise short-term rates will depend on inflation and unemployment measures as we enter 2022. We expect the 10-year U.S. Treasury rate to climb steadily through the end of 2021 and beginning of 2022 to approximately 1.7% - 2.0%. This compares to 1.5% as of the writing of this letter and 4.5% historic average. Inflation in various commodities and materials is likely to moderate as the supply chain normalizes, but wages may remain above average for some time. Some economists refer to wage inflation as "healthy inflation" because it improves the buying power of the consumer. There is no doubt that government support and COVID-driven fears and illness have impacted the labor markets and wages this year. As Federal support rolls off and vaccines increase, we will be watching for changes in the data. Overall, high inflation makes bonds less attractive in the current yield environment, and the risk to equity markets is reduced earnings growth from compressed profit margins. Inflation continues to be a risk factor that demands our time and attention as we construct client portfolios.

Another force of uncertainty that will likely influence markets in the fourth quarter are the ongoing negotiations in Congress. Currently, Congress must raise the debt ceiling to avoid a pending U.S. default before mid-October, or pass a newly offered stop-gap spending bill to extend the deadline to early December. They will also have to agree on a separate funding bill by December 3 to avoid a government shutdown. Intertwined with those urgent issues are a proposed $1-$3 trillion infrastructure bill and $3.5 trillion social safety net spending bill that would result in significant tax increases on the wealthy. Negotiations continue, but if passed as proposed, taxes would increase on those earnings over $400,000, the capital gains tax rate would increase, the estate tax exclusion would drop dramatically, and corporate tax rates would increase, among other impacts. Progress on these proposed bills seems to be changing by the hour. We are closely monitoring how any legislation passed this year may impact clients and are working on potential strategies to reduce any increased tax burden. We expect to have more definitive guidance in the fourth quarter.

On portfolio construction, we favor a diverse equity portfolio to drive growth. Given the strength of the consumer, healthy corporate balance sheets, and accommodative global central banks, we believe global equities are likely to continue their march higher over the next twelve months, and portfolios are positioned to benefit. The equity market volatility we are currently experiencing is well over-due in our opinion and likely represents a healthy and temporary pullback from highs reached earlier this year.

Traditional fixed income will act as portfolio ballast, but it will provide little in terms of long-term growth or protection from higher inflation. As a result, on the defensive side of client portfolios we continue to blend traditional and alternative fixed income investments that exhibit the downside protection we expect from high quality bonds while earning a return sufficient to protect purchasing power. This approach is crucial in maintaining balance across the portfolios over the long-term.