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MARKET REVIEW
NOVEMBER 2021

SMB Trust Services

FED TAPERING AND RATE HIKE EXPECTATIONS

In March of 2020, in an effort to combat an economic downturn and stabilize credit markets, the Federal Reserve turned to bond purchases for the second time in a little over a decade. Nine months later, in December 2020, Fed policymakers said they remained committed to buying bonds at a rate of $120 billion per month to support the economy until "substantial progress" was made toward full employment and their new 2.0% average inflation goal was reached.

Since December 2020, the U.S. labor market has added back 5.8 million jobs and the unemployment rate has fallen around 2% to 4.6%. This year's labor market recovery led Federal Open Market Committee (FOMC) Chairman Jerome Powell to announce on November 3 that the central bank will take its first step toward dialing back its pandemic stimulus by tapering its $120 billion per month bond purchases. The Fed will reduce its purchases in November and December by $15 billion per month - $10 billion in Treasuries and $5 billion in mortgage-backed securities. The size of the reduction in purchases beyond December will be driven by the economic outlook to provide flexibility to accelerate or slow down the pace. If the $15 billion per month taper pace is maintained, the Fed's purchases will be phased out by next June.

TAPER TANTRUM AVOIDED

Over the course of 2021, Fed policymakers evolved from "not talking about talking about" reducing emergency-era bond purchases to signaling in late July the likely launch of tapering toward the end of the year. Ominous predictions of a "taper tantrum 2.0" were fairly prevalent this year, harkening back to the sharp back-up in U.S. Treasury yields in the summer of 2013. In late May of that year, then-FOMC Chairman Ben Bernanke indicated in congressional testimony that the central bank "…could in the next few meetings…take a step down in our pace of purchases…" Bernanke noted this was conditional on a continuation in a trend of generally positive economic news that had begun in the spring of 2013. Despite the seemingly pedestrian nature of these comments, they caused an intense bond market reaction. At the time, the Fed's post-crisis bond purchases, or so-called quantitative easing program, had been in place in various forms for nearly five years. Bernanke's comments clearly took many bond market participants by surprise, as yields on the U.S. 10-year Treasury bond climbed from 1.93% on May 21, 2013 to 2.99% on September 5, 2013.

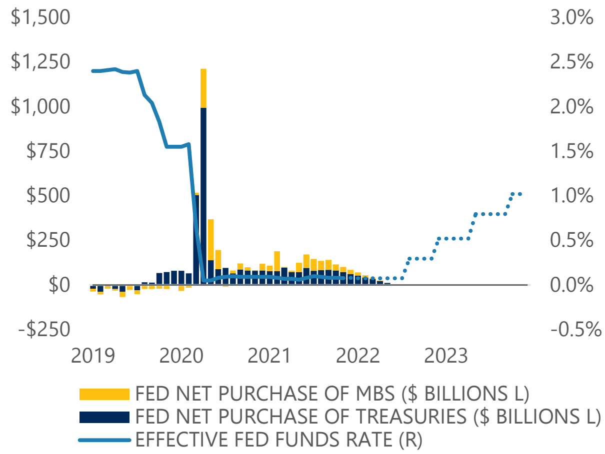
With the benefit of hindsight, most market observers agree that in 2013 poor communication from Fed policymakers about plans for reductions in asset purchases (and the implications of those plans for future interest rate hikes) were the fuel that ignited the original "taper tantrum." Many investors might wonder what is different this time around. First, communication has been better. Second, according to New York Fed surveys, bond market participants widely anticipated reductions in Fed asset purchases as early as February. On the communications front, in 2021 Fed policymakers have repeatedly emphasized that asset purchase tapering is not directly linked to the path of future interest rate increases. In 2013, bond markets were caught off guard mainly because it was assumed Bernanke's comments meant an initial Fed rate hike would occur sooner than anticipated. Ironically, policymakers did not implement an initial quarter-point rate increase until more than two years later in December 2015. This time around, Fed officials, led by Chairman Jerome Powell, have explicitly linked the liftoff of rate hikes to "substantial further progress" toward the FOMC's employment and inflation criteria. Bond markets have thus far largely believed the Fed's messaging and have mostly behaved in an orderly fashion compared to 2013.

INTEREST RATE AND INFLATION OUTLOOK

Chairman Powell reasserted at the November FOMC meeting that the beginning of tapering does not provide any signal regarding the timing of interest rate increases, noting that the domestic labor market still has ground to cover before rate hikes occur. The Fed's outcome-dependent language, without a specific employment threshold for raising rates, gives it flexibility to wait and see how inflation and employment progress. This approach provides policymakers with an option to more quickly tighten policy if elevated inflation persists. The Fed is in a delicate position since tightening monetary policy too

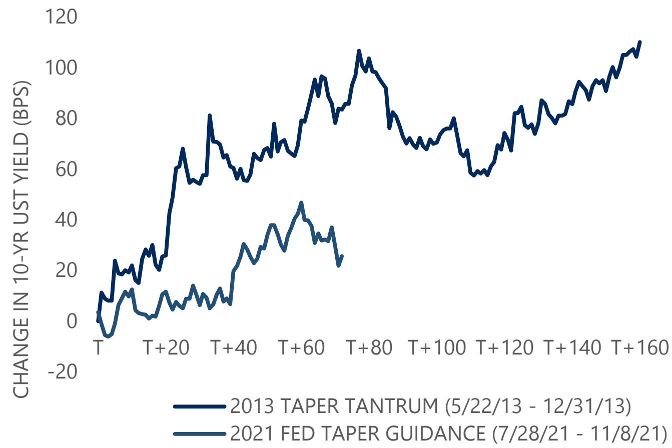
FED STIMULUS WINDING DOWN

BOND PURCHASES AND FED FUNDS RATE, 2022-2023 FORECAST



Source: Federal Reserve Bank of St. Louis & Bloomberg.

2013 TAPER TANTRUM VERSUS 2021 VERSION



Source: Bloomberg.

quickly could derail the economic recovery. Meanwhile, tightening too slowly could further stoke inflation, which would likely require more aggressive tightening later on. Fed officials' quarterly projections in September signaled one quarter-percentage point interest rate hike in 2022 and three hikes in 2023. Pricing in the federal funds futures market indicates investors expect elevated inflation will lead to a slightly more hawkish Fed next year with two 0.25% interest rate increases in the second half of 2022 and another two hikes in 2023.

Recent developments in inflation data seem to have caused some doubt to seep into the "transitory" inflation view. Chairman Powell reiterated that Fed officials expect elevated inflation will likely be temporary, but slight changes in the Fed's November post-meeting statement conveyed increased uncertainty in the inflation outlook. The Consumer Price Index (CPI) year-over-year (YoY) growth rate has been largely unchanged around 5.4% between June and September as housing rent and energy replaced reopening-sensitive items as the main inflationary drivers. The year-over-year growth rate in core CPI, which excludes food and energy, has moderated to 4.0% in September from 4.5% in June. The prices of reopening-sensitive items, such as used vehicles and air fares, have cooled off somewhat since the summer due to improving supply and the COVID-19 Delta variant temporarily weighing on demand. Meanwhile, the rise in rent prices accelerated and, along with wage growth, is becoming a pivotal factor for the "transitory" inflation debate. Rent represents a large portion of household expenditures and is the largest CPI component with a 31.2% weight in the index. As such, rent heavily influences the overall inflation outlook. Historical evidence shows that home price growth is useful for forecasting rent growth since it leads rent prices by close to two years. Based on this historical relationship, economists at the Federal Reserve Bank of Dallas project the recent surge in home prices will lead to higher rent growth in 2022 and 2023. Despite the outlook for rising rents, a Bloomberg survey of 48 economists shows the median projection calls for annual consumer inflation to peak this quarter and steadily weaken to 2.3% by the end of next year.

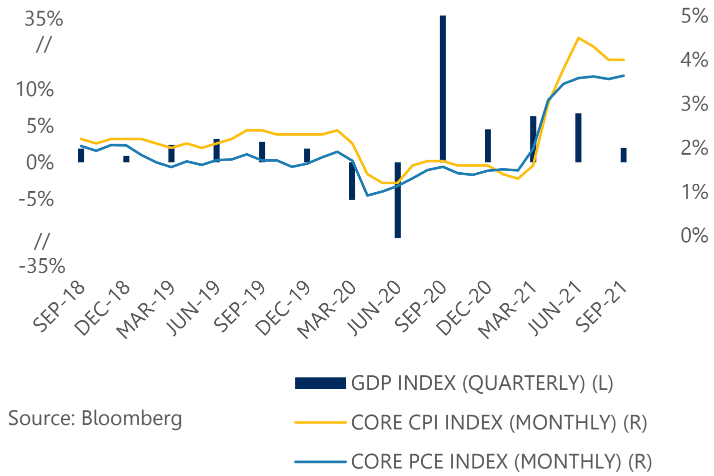
Another area of uncertainty is the composition of the FOMC policy-setting committee. President Biden has sweeping power to reshape the FOMC next year by nominating four of the twelve FOMC voting members by February. One seat is vacant due to President Trump's nominees Stephen Moore and Judy Shelton failing to secure enough Senate support to be confirmed. Vice Chairman Richard Clarida's term ends in January. Vice Chairman of Supervision Randal Quarles announced he is stepping down early from his dual role as Fed governor in December after his vice chairmanship ended in October. Biden also has the opportunity to pick a new Fed Chair instead of renominating Powell. Economists and investors believe Fed Governor Lael Brainard is the only other candidate in the running for Powell's Chair position. President Biden is expected to make his Chair decision by the end of the month. The forthcoming nominations increase policy uncertainty mainly because many central bank observers expect the Biden administration to favor nominees who are more concerned with the job market recovery than tightening policy to control inflation. Senator Sherrod Brown, Chair of the Senate Banking Committee, said recent conversations with Biden indicated "there will be a much greater emphasis on workers" when looking for nominations.

Over the course of 2021, Chairman Powell and his FOMC colleagues broke the market expectations link between asset purchase tapering and interest rate hikes. The more difficult part for policymakers will be in coming months and quarters amid elevated inflation and bond market expectations for an initial 0.25% policy rate hike in mid-2022. As the curtain closes on 2021, investors will no doubt keep a close watch on the FOMC leadership makeup and any signals from Fed officials that changes in labor market and inflation data have caused a shift in policy direction.

ECONOMY

GDP AND CONSUMER PRICES

SEPTEMBER 2018 THROUGH SEPTEMBER 2021



Source: Bloomberg

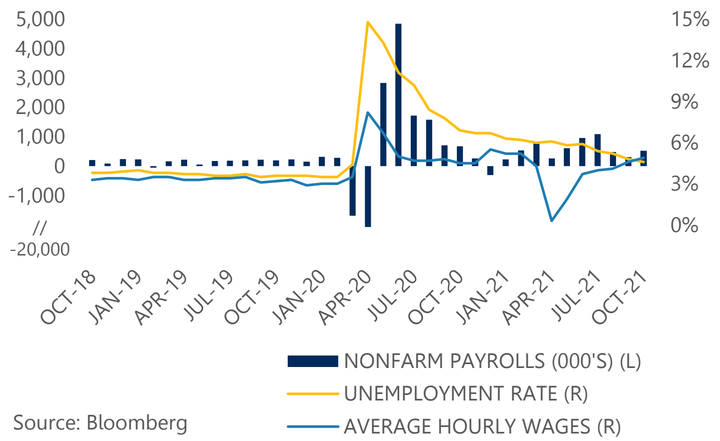
Third quarter U.S. economic growth disappointed with an annualized growth rate of 2.0%, the slowest since the 2020 recession ended. Consumer spending was weaker in the quarter amid a rise in COVID-19 cases due to the Delta variant and persistent supply chain issues.

The Core Consumer Price Index (CPI), which excludes food and energy, rose 4.0% year over year for a second consecutive month. Used car prices, which have been a large contributor to rising costs over the last several months, fell 0.7% for the month.

The Federal Reserve's preferred inflation gauge, Core PCE, was up 3.6% from a year ago. With both inflation gauges remaining elevated, it could provoke the Fed to become more hawkish as inflation appears to be more persistent than first thought.

LABOR MARKET

OCTOBER 2018 THROUGH OCTOBER 2021



Source: Bloomberg

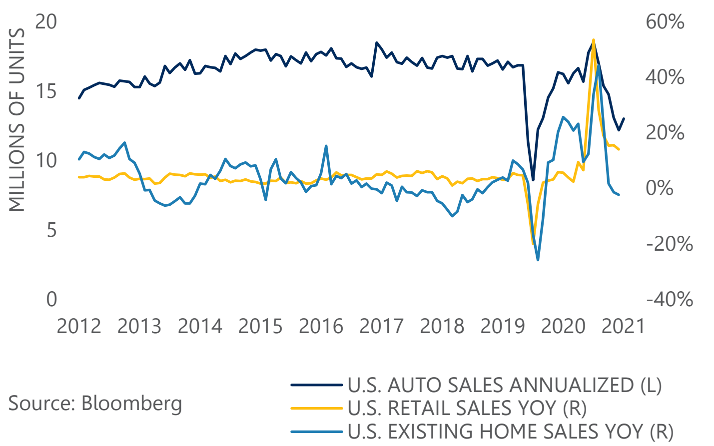
The U.S. labor market added 531,000 jobs during October, the largest monthly increase since July. September job gains were revised higher to 312,000 from 190,000 jobs. Despite the strong employment recovery, the labor force is still approximately 4 million jobs short of 2020's February peak.

Job gains in leisure and hospitality led the widespread gains during the month, which also included notable gains in professional and business services, manufacturing, and transportation and warehousing.

The unemployment rate ticked down to 4.6% from 4.8% in September while the participation rate was unchanged at 61.6%.

HOUSING, AUTO AND RETAIL SALES

OCTOBER 2012 THROUGH OCTOBER 2021



Source: Bloomberg

U.S. vehicle sales rose in October to 12.99 million units annualized after falling for five consecutive months since peaking in April. Supply chain issues, primarily stemming from the semiconductor shortage, have contributed to lower sales over the last six months.

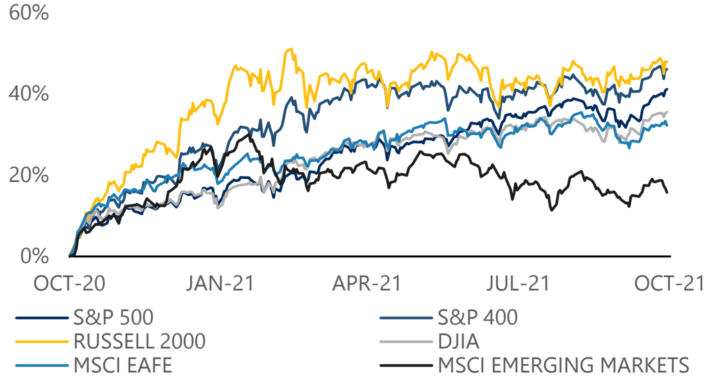
U.S. retail sales unexpectedly rose 0.7% in September compared to economists' median forecast for a decline. Sales were up 13.9% from a year prior, down from 15.4% growth in August.

Existing home sales declined 2.3% year over year in September due to higher prices and tougher comparisons as the real estate market heated up late last summer.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, OCTOBER 2020 THROUGH OCTOBER 2021



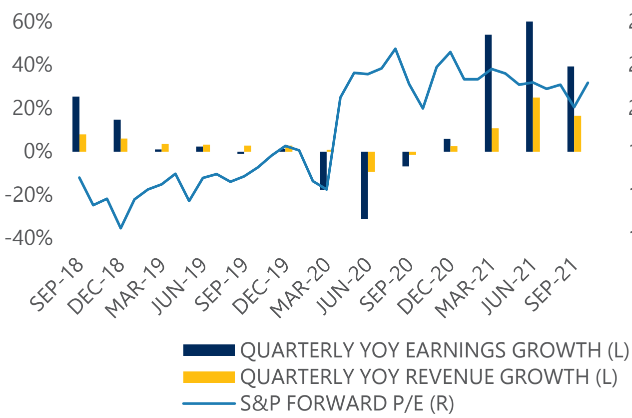
Source: Bloomberg. Past performance is no guarantee of future results.

U.S. equities rebounded sharply in October after a moderate sell-off in September. The S&P 500's 7.01% return was the index's best monthly performance since last November. A strong start to the third quarter earnings reporting season somewhat eased investors' concerns about supply chain disruptions and rising prices.

Foreign stocks trailed the U.S. as declines in Japan and Brazil weighed on developed and emerging market indexes, respectively. Investors appeared to take a defensive approach in Japan ahead of the country's general election at the end of October. Brazil stocks extended their losses this year amid concerns the country's president will try to breach the fiscal spending limit to increase social aid ahead of next year's election.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, SEPTEMBER 2018 THROUGH OCTOBER 2021



Source: Bloomberg

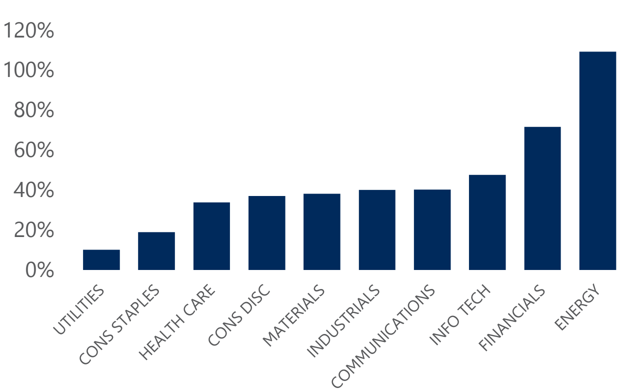
Third quarter earnings reports continued the trend in recent quarters of broadly beating analysts' pandemic recovery estimates. S&P 500 earnings are on pace for 37.46% growth compared to analysts' initial projection for 28.35% growth.

Around 83% of the 279 S&P 500 companies to report so far have exceeded earnings estimates, which is above the five-year average beat rate of 76% and long-term average of 64%. Materials and industrials are the only sectors trailing estimates.

Analysts project one more quarter of elevated earnings growth of 19.7% in the fourth quarter, followed by a sharp deceleration to single-digit growth in the first quarter of next year due to tougher year-over-year comparisons.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

OCTOBER 2020 THROUGH OCTOBER 2021



Source: Bloomberg

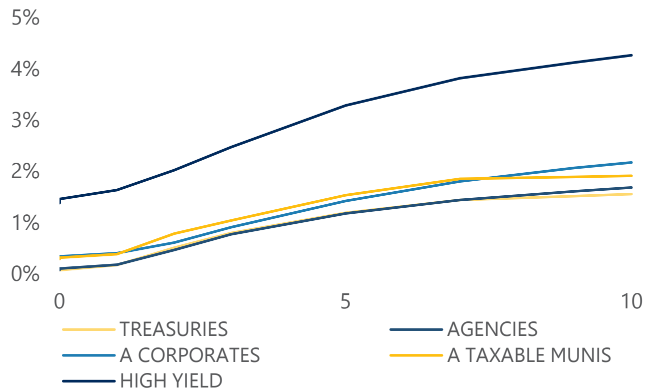
All S&P sectors had positive returns in the month, led by double-digit gains in the consumer discretionary and energy sectors. The discretionary sector was led by a 43.65% monthly gain in Tesla (TSLA), which accounts for around 18% of the sector's weight. TSLA's performance was attributed to greater optimism for the electric vehicle (EV) market as the infrastructure bill being discussed in congress includes several items that may help accelerate EV adoption.

The energy sector's strong month extended its performance this year to 58.07%. Shares of oil companies continue to benefit from the rally in crude oil prices which reached a seven-year high above $80 per barrel.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF OCTOBER 2021



Source: Bloomberg

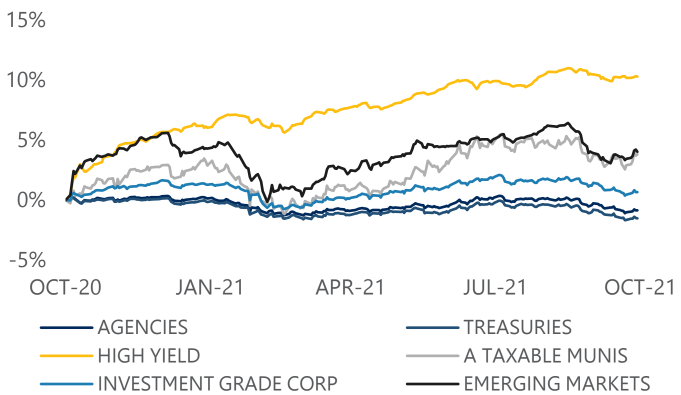
Yields across the U.S. Treasury maturity spectrum shifted higher in October for the third consecutive month. Yields on the two-year, five-year, and ten-year maturities increased by 0.22%, 0.21% and 0.07% respectively during the month.

Shorter dated U.S. Treasury yields out to three-year maturities have finally moved off historically low levels in anticipation of reductions in Fed asset purchases and an increasing number of Federal Open Market Committee (FOMC) members projecting at least one rate hike by the end of 2022. Two-year Treasury yields closed October at a 19-month high of 0.50%.

Single A-rated Taxable Municipal yields are noticeably higher than single A corporate bond yields from two- to seven-year maturities despite similar credit rating profiles.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

OCTOBER 2020 THROUGH OCTOBER 2021



Source: Bloomberg. Past performance is no guarantee of future results.

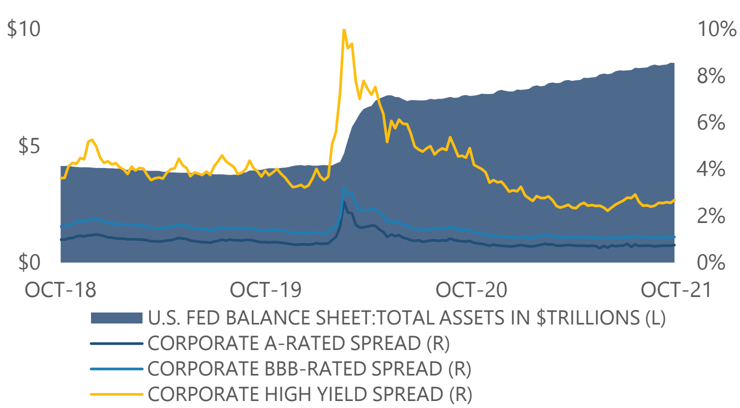
Above-trend economic growth and an accommodative policy backdrop have enabled lower quality bond segments to outperform their higher quality peers over the last year.

The two highest quality sectors in the accompanying chart, U.S. Treasuries and U.S. Agencies, posted negative 12-month returns. Meanwhile, the two lowest quality sectors, High Yield and Emerging Markets bonds, reported healthy 12-month returns of 10.3% and 4.0%, respectively.

Domestic high yield corporate bonds significantly outperformend emerging market bonds despite each having similar credit quality. Relative dollar strength in 2021 and the United States' head start on its vaccination campaign have contributed to the considerable performance difference.

FED BALANCE SHEET EXPANSION AND CREDIT SPREADS

OCTOBER 2018 THROUGH OCTOBER 2021



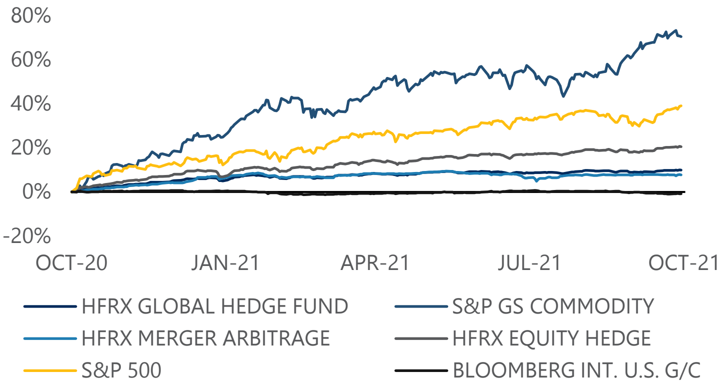
Source: Bloomberg

The Federal Reserve's balance sheet has expanded by roughly 105% during the pandemic to $8.6 trillion in October from $4.2 trillion in February 2020. The Fed communicated in its November 2-3 meeting that it will begin to reduce its bond purchases by $15 billion per month, but will remain flexible with the pace of tapering subject to economic conditions.

In mid-August, U.S. corporate high yield credit spreads touched their widest levels since early February amid a surge in COVID-19 cases driven by the Delta variant. High yield spreads have stabilized lower over the ensuing twelve weeks as case counts have peaked and the economic outlook has improved.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS
OCTOBER 2020 THROUGH OCTOBER 2021



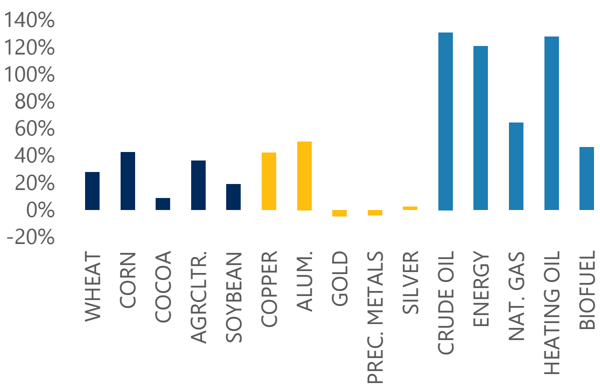
Source: Bloomberg. Past performance is no guarantee of future results.

Led by crude oil, copper and wheat, the broad commodities complex resumed its sharp ascent in October, climbing 5.5% during the month after taking a breather for most of June through September. Stretched supply chains and elevated demand have combined to drive many commodity prices higher in 2021.

Hedged equity and trend-following Commodity Trading Advisor (CTA) managed futures strategies were among the best performing areas of the hedge fund universe in October. Equity market neutral and merger-arbitrage strategies were among the weakest performing hedge fund groups during the month.

Interest rate-sensitive Relative Value Arbitrage strategies led inflows for all hedge fund styles in the third quarter.

COMMODITIES, 12-MONTH SPOT RETURNS
OCTOBER 2020 THROUGH OCTOBER 2021



Source: Bloomberg. Past performance is no guarantee of future results.

Intervention by the Chinese authorities and various European governments in natural gas markets to curtail recent price spikes helped push the front-month U.S. Natural Gas price contract down about 9.4% in October to close at $5.43 MMBtu.

Wheat prices climbed 7.4% in October amid strong demand from Middle Eastern and Asian countries, poor spring harvests and a Russian export duty.

Gold prices gained 1.5% in October, but have trailed most other assets viewed as inflation hedges in 2021. Despite historically low inflation-adjusted yields, expectations for higher nominal interest rates and recent gains in the dollar against major peer currencies have been headwinds for gold.

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NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			