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Bailard's Quarterly Review of Economic and Market Developments* Q2 2021

Chat with the CIO: The Strangest Recession in History Creates a Messy Inflation Puzzle

This quarter features a point-counterpoint with Frank Marcoux, CFA, SVP & Portfolio Manager - Sustainable, Responsible and Impact Investing and Chief Investment Officer, Eric P. Leve, CFA.

Inside this Edition:

Eric P. Leve, CFA: Frank, thanks for engaging me on this topic, one that has claimed a top spot on many investors' minds and seems perfect for us. You and I probably represent opposing sides among Bailard's research team: I perceive today's inflation to be shorter-term while you have the greatest anxieties about its possible persistence.

Frank Marcoux, CFA: Yes. This one is a head-scratcher. The National Bureau of Economic Research (NBER) still considers the U.S. to be in a recession despite the economy's sharp bounce back. Over the three quarters ended March 31, 2021, real economic growth has amounted to 10.3%, the highest level for a three-quarter period in more than 70 years. With this, the U.S. economy is likely to be larger than pre-pandemic levels very soon, and that leads to my concern over rising prices. We're already seeing it; at 5.0%, May's year-over-year Consumer Price Index (CPI, a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods) was the highest since a brief period in 2008. Before that, we hadn't seen 5% inflation since 1991. And we know there's a mountain of cash to spend that could add further fuel to price pressures. Usually, personal income falls in a recession; for example, in the Global Financial Crisis of 2008/2009, personal income fell by 7.7%. In contrast,

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*Please see important disclosures on page 19.

since February of 2020, income has risen 8.8%, largely due to stimulus from state and federal authorities to individuals (and businesses).

Eric: I want to go back to your comments about inflation rates being "highest since." In both of those cases inflation came down quickly after those peaks. In fact—only with the exception of the supply shock driven inflation of the 1970s—the challenge for central bankers in the U.S., Europe, and Japan in the past 30 years has been to avoid deflation. Even this time, many of the elements driving prices higher can reverse quickly. The items I'm thinking of are the ones getting the headlines: household furnishings were up 0.9% in May as individuals welcomed friends back into their homes, used car prices rose 7.3% on the month as semiconductor supplies limited new car production, plus car and truck rentals were up a shocking 12.1% for the month as people hit the road for vacation but found that rental car companies had sold off much of their fleets during the downturn.

In a nutshell, I see today's economy like one coming out of war and readjusting factory output to peacetime needs, which naturally leads to some supply dislocations. Of greatest concern to me is the 6.4% increase for domestic services. Here we're talking about labor and that backdrop is more disconcerting.

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Frank: Yes. Wages are notoriously sticky on the downside. They can build into lasting inflation as those higher wages become higher input costs that get passed onto the consumer who then needs higher pay to afford the goods, creating what (in the early 1970s) was called the "wage-price spiral." We're already seeing early evidence that the state and federal unemployment benefits have acted as a disincentive to return to the workforce. Fortunately, as state benefit provisions sunset, we're also seeing unemployment rates come down quickly. With essentially all additional benefits ending by September, we are likely to see the all-time record number of unfilled job openings come down. If this doesn't release the current upward pressure on wages, I'm concerned that wage inflation could become more entrenched.

From a broader perspective, I'm also concerned that the amount of monetary growth and debt issuance over the past 16 months could pave the way for higher prices. The 10-year U.S. Treasury yield began the year at 0.92% and, by June 30th, it was 1.47%. M2 (a measure of money in circulation in addition to deposits held in checking, savings accounts, and money market funds) has grown by more than one-third, from $15.4 trillion on December 31, 2019 to a recent high of $20.4 trillion on May 31st. And the outsized debt issuance isn't just a domestic problem, it has global implications.

Specifically, the U.S. dollar strength of late has fueled inflation in some emerging countries and has resulted in interest rate hikes in Mexico, Russia, Turkey, and Brazil (among others) to help moderate it. Can those countries afford the prospects of higher inflation fueled by the U.S.'s post-pandemic consumption? This consumption isn't simply consumer-led; business investment is also surging in tech, software, industrial goods, and input materials. Non-residential fixed investment rose at an annualized rate of 11.7% in the first quarter, led by growth in software and tech-equipment spending. This measure also logged similar double-digit increases in the third and fourth quarters of last year.

This stands in contrast to the experience after the financial crisis of 2008/2009 when companies were more cautious on spending, choosing instead to hire employees to drive growth. This time around, with a very challenging hiring environment leading to higher wages, companies are instead spending aggressively on software and other productivity-enhancing tools and technology. This spending, along with higher labor prices, could result in longer-lasting inflation in goods and services.

Eric: At the risk of being a dupe here, I see societal benefits to slightly higher inflation. I think about this from two perspectives. First, often the expectation of the ability to charge more for goods in the future is the incentive entrepreneurs need to make productivity-enhancing investments that you just mentioned. A more productive economy means more wealth overall.

The other element is how that wealth gets distributed. If wages rise faster than the inflation rate of goods, then you are generating real wage growth. The path of the past 20 years seems unbalanced and unsustainable. If we use the annualized growth in earnings for the S&P 500 Index as the "return to capital" measure and growth in real average hourly earnings as the "return to labor" metric, we see that capital grew by 7.6% annually while wages rose at a 0.8% pace, well-below the annual inflation rate for the period of 2.0%. I admit, inflation and especially wage inflation, is a genie one doesn't want to let out of the bottle. Many times in history, when it has risen, it has done so uncontrollably. And today's central bankers do seem to have a pretty blasé attitude toward incipient inflation risks, making a policy under-reaction a real threat.

Frank: I'm pretty tired of people calling the current inflation transient. How long is transient and when does even "transient" inflation begin to impair the economy? I find it difficult to believe that the supply chain issues currently plaguing the system will be gone by Labor Day or Christmas. The current supply bottlenecks are a major cause for our current "transitory inflation." If we can't eliminate them, we are likely to see "transitory" stretch well into 2022.

Your point about inflation being somewhat of a desirable outcome is a good one. Ultimately, the U.S. may well be better off if we tolerated higher inflation to attempt to inflate our way out of the debt load. However, while the U.S. economy can likely bear higher inflation, my concern about the potential knock-on effects for emerging markets remains. Once the Federal Reserve (the Fed) stops buying the vast majority of Treasury issuance, we'll see interest rate levels driven primarily by market forces; it could be well above today's 1.47% rate.

While the Fed has what is called a dual mandate—stable prices and full employment—I think the former responsibility is most critical. The Fed needs to telegraph its actions well, but for me that means preparing for increases in short-term interest rates earlier than most people forecast (currently, 2023).

Eric: What do you think the risks and benefits of such a move would be?

Frank: This is a rare time. Inflation bugs have been pessimistic Cassandras a lot over the past 40 years, but I think most would agree, today's environment has real potential to lead to 1970s-style inflation. The amount of debt we have is too large to "grow our way out of." As Western oil companies step back from major new oil projects, the relative power of OPEC (Organization of the Petroleum Exporting Countries) rises, even as we transition our demand away from fossil fuels. This power, plus China's control over many commodities both represent real inflationary risks. None of us ever want our central bank to slow down an economic recovery, but the current risks seem to demand it. What I would hate to see is investors overreacting to a Fed rate hike, driving short yields higher and pushing the economy back toward recession.

Eric: I know when you think about these outcomes, they are outliers. But you're right to point them out. At Bailard we've always thought in terms of future economic scenarios and today is a time when that spread of outcomes seems wider than any time in the past couple of decades. Thanks for the lively discussion, Frank.

The Case for Net Lease Investments in a Low Yield World

Jamil Harkness, Research and Performance Associate, Real Estate

In a nearly yield-less bond environment, the need for fixed income-oriented alternatives has dramatically increased for investors starving for long-term and predictable income streams. As a result, net-leased real estate has, of late, garnered significant attention from a wide array of institutional and individual investors. Net leases—also known as "NNN" or "triple-net" leases because the tenants are typically responsible for all expenses including real estate taxes and operating and other costs so that the rent received from the tenant is truly "net" to the landlord—offer the potential for investors to get higher yields from corporate tenants than those same corporations are paying on their debt obligations that trade publicly. This is one of the reasons that net-leased properties have experienced a surge of interest from investors and enjoyed significant yield compression over the past few years.

What is a Net Lease investment?

Many perceive commercial real estate (CRE) investments as high-maintenance and risky, particularly when compared to traditional fixed income vehicles. What exactly is a net-lease investment, and how does it differ from other real estate investments? In broad strokes, as referenced above, net-leases are structured to shift many of the costs and burdens of CRE ownership away from the landlord and onto the tenant. This shift nullifies many concerns surrounding rising expenses and maintenance costs, while offering long-term income generation. Additionally, most net leases have built-in rental rate escalations. These contractual rent "bumps" usually cause the rent to increase annually by a fixed amount (e.g., 2% to 3% per year) or varying increases indexed to inflation. These escalations enable the landlord/owner to count on an increasing income stream over the life of the lease.

Net-lease structures are common in three of the four main property types (retail, office, and industrial but excluding multifamily) as well as others including data centers, healthcare, and biotech facilities with varying lease terms and with a myriad of tenants across the credit spectrum. So, for discerning investors, there is plenty to choose from in terms of risk, duration, and yield.

Comparing NNN to government & corporate bonds

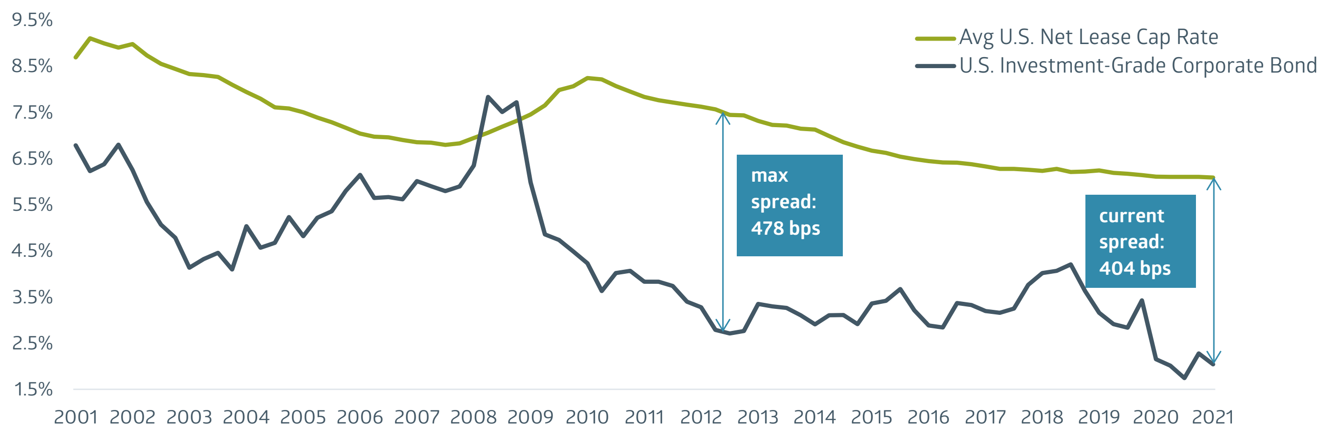
The most significant driver of the voracious appetite for cash-generating alternatives to traditional "risk-free" fixed income (e.g., government debt) is the dramatic compression of bond yields over all time periods since 2000. In just the past three years, bond yields for the 30-year, 10-year, and 5-year have all "come-in" since year-end 2018, at 92, 120, and 162 basis points, respectively (a basis point, or "bp," is 0.01%). The most commonly-used benchmark for real estate investors is the 10-year U.S. Treasury. At year-end 2001, the 10-year Treasury Note yield stood at 5.07%, 358 bps higher than it was on June 30, 2021.

Following a similar but even more dramatic trajectory, investment-grade corporate bonds have experienced greater yield compression than government debt. High-quality corporate debt is trading at historically low yields; as of June 30, 2021, the average corporate yield was 2.04% (a compression of 433 bps and 216 bps, respectively since year-end 2001 and year-end 2018). Yield-hungry investors often favor corporate bonds over government bonds to increase income from their bond portfolio. Because of the compression in investment-grade corporate yields, the traditional "arbitrage" is less compelling than it has been historically.

But what about inflation?

It's impossible to pick up a newspaper or catch TV and radio business news without hearing concerns about inflation. In spite of Federal Reserve Chairman Powell's assurances to the contrary, many market observers, economists, and investors believe that massive government spending coupled with the Fed's easy money policies are bound to trigger a run of inflation, which will erode consumer buying power

Comparing U.S. Corporate Bonds to Net-Lease Investment Cap Rates



Sources: Bailard, Inc., Real Capital Analytics, Bloomberg.

and make traditional fixed-income vehicles less attractive for investors. Over the last 20 years, annual inflation has averaged 2.1%; however, in the 12 months ending May 31, 2021, inflation was 5.0%, its highest level in 13 years. Any sustained rise in inflation will eat away at bond yields at a time when bond coupons are already skimpy. This will also heighten investor's interest in investments that have the potential to provide a "hedge" against inflation. Real estate, generally, has been viewed favorably from this perspective. Net-lease investments with contractual rent escalators as described earlier are not a perfect inflation hedge (especially if inflation starts to run away), but they are certainly much better than non-indexed traditional fixed income vehicles.

Considering risk and reward

With less incentive to invest in investment-grade corporate bonds, net leases (with an investment-grade tenant) can be a suitable alternative due to key structural similarities regarding low issuer/tenant default risk, yield generation, and perceived long-term cash flow into the future. In addition, capitalization rates[1] in the real estate market are the mirror image of bond yields in the public markets. Hence, both metrics can be understood to be a measure of the balance between risk and reward. With that said, the same structure and benefits afforded to investment-grade corporate bonds—like predictability (regarding yields) and an attractive passive payment structure focused on stable cash flow—applies to net lease investments too.

When comparing net lease cap rates against investment-grade corporate bond yields, the spread is substantially in favor of net lease investments. Like corporate bonds, net lease cap rates have compressed over the past 20 years but at a more modest rate. According to Real Capital Analytics (RCA), the average net lease cap rate was 6.1% as of Q2 2021, down 3 bps from the prior quarter. Over the last 20 years, the average yield spread between net lease cap rate and the investment-grade corporate bond yield was 294 bps. However, in the last year (ending June 30, 2021), the average spread increased to 408 bps, indicating even greater yield potential than investment-grade bonds (albeit with the slightly higher risk of leased real estate).

In the current low-yield environment, a net lease investment could be an ideal alternative investment for some investors due to higher yields *vis-a-vis* both corporate bonds and government bonds, as well as their inflation-hedging characteristics, achieved through rent escalation and pass-through of expense increases to the tenant. Those benefits do not come without the risk of illiquidity and re-leasing challenges in the case of a tenant default or if/when the tenant moves out at the end of its term. However, these risks are somewhat mitigated by the reality that the owner of the property (i.e., the landlord) still owns the real estate, which if they have done their due diligence properly, has significant intrinsic value. Simply put, when done carefully and prudently, net lease investments can be a relatively high-yielding and superior fixed income alternative.

1 A property's capitalization rate, or cap rate, is a measure of its Net Operating Income relative to its market value.

Growth vs. Value: Past, Present & Future

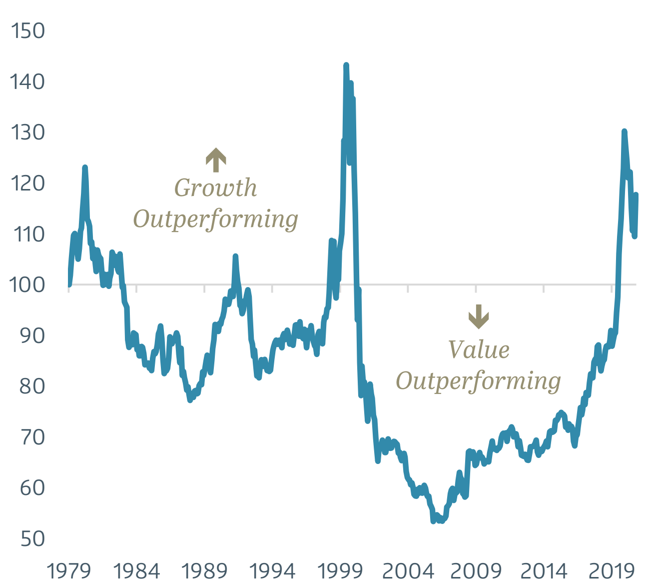
Joanne Howard, CFA, SVP, Investment Counselor and Portfolio Manager

The Value vs. Growth rotation and the reflation trade have dominated investor dialogue and decision-making this year.[1] This article reviews the past where growth has outperformed, the present where value has performed better since the introduction of the COVID-19 vaccine, and the future where we provide reasons to expect growth to produce superior returns. Exhibit 1 provides rear-view perspective on the 40-year history of the relative performance of growth and value. As displayed, there are times when value outperformed growth—including the first five months of 2021—but growth has outperformed both absolutely and relatively over most cycles in that 40-year period.

Exhibit 2 provides visual evidence of how the outlook for high inflation in the U.S. has appeared after a twelve-year absence. On June 16th, comments from the Federal Reserve suggested it was viewing inflation as perhaps more than transitory, signaling interest rate hikes may begin in late 2023 rather than 2024. As a result, some Fed members placed their tightening dots in 2022. The Fed has a vested interest in keeping interest rates as low as possible for as long as possible, thereby minimizing interest payments due on U.S. Treasury debt.

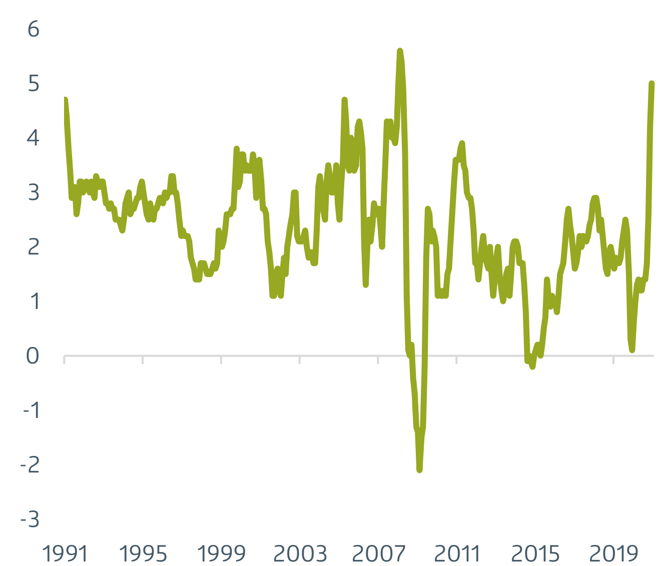
The U.S. stock market seemed to have been anticipating this more-hawkish stance from the Fed, as growth stocks outperformed value stocks for most of the month of June. This was in sharp contrast to the first five months of 2021, when the Russell 1000 Value Index (+18.4%) outpaced the Russell 1000 Growth Index (+6.3%) by 12% in anticipation of reopenings around the country. Moreover, since the Pfizer vaccine was

Exhibit 1. 40-Year History of the Relative Performance of Russell Growth and Value



Total Return (index) Relative to Russell 1000 Value, as of 6/30/2021
Source: Bailard, Inc., Intrinsic Research

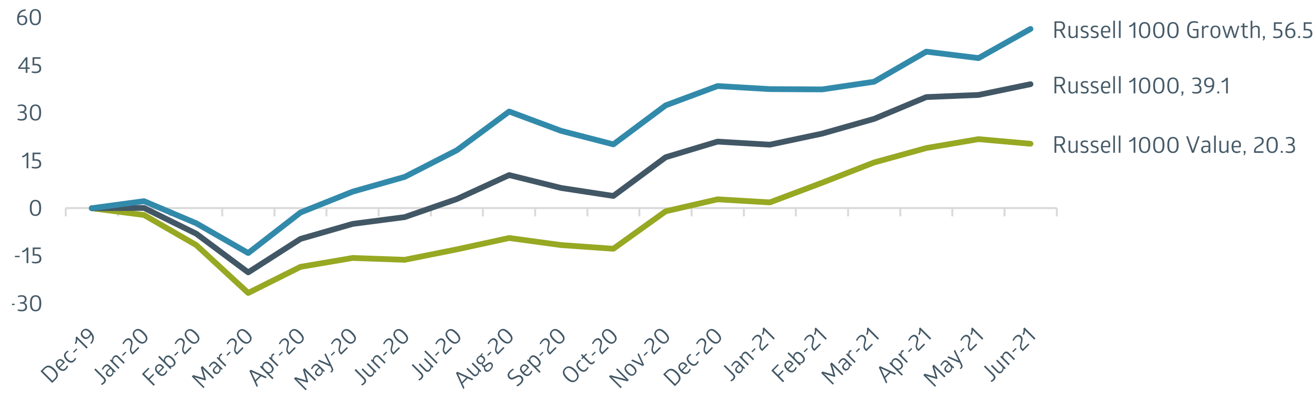
Exhibit 2. Inflation Surprise After Twelve Years



CPI – All Items (1982-84=100) Year % Change, as of 6/30/2021
Source: Bailard, Inc., Intrinsic Research

1 The reflation trade describes the focus on investments that traditionally benefit from an expanding economy during a time of rising consumer prices.

Exhibit 3: Recent Total Return Performance of Russell 1000 Growth, 1000 Value & 1000 Indices



Russell 1000 Growth, Russell 1000, and Russell 1000 Value, as of 6/30/2021. Source: Bailard, Inc., Intrinsic Research

Exhibit 4: Comparing Total Returns Since the Onset of the COVID-19 Pandemic

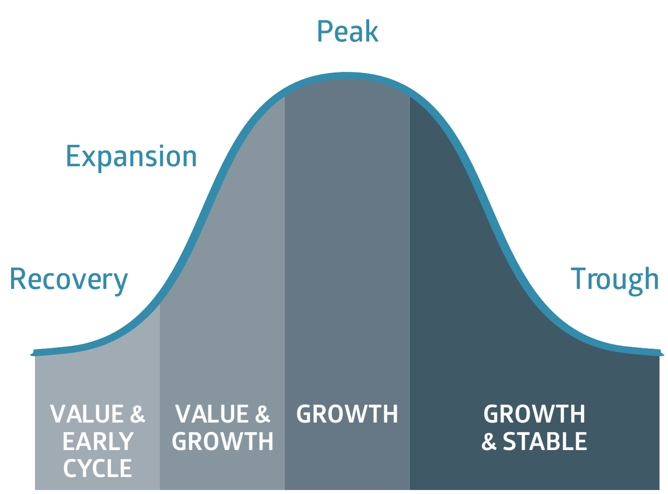
	Onset of COVID - Pfizer Vaccine Effective	Vaccine Approval - Year End 2020	Full Year 2020	First 5 Months of 2021	June 2021	18 months since onset of COVID
	12/31/2019	11/6/2020	12/31/2019	12/31/2020	5/31/2021	12/31/2019
	11/6/2020	12/31/2020	12/31/2020	5/31/2021	6/30/2021	6/30/2021
Russell 1000 Growth	31.4	5.4	38.5	6.3	6.3	56.5
Russell 1000 Value	(8.0)	11.7	2.8	18.4	(1.1)	20.3
Difference	39.4	(6.3)	35.7	(12.1)	7.4	36.2
S&P 500 Market Wtd	10.3	7.3	18.4	12.6	2.3	36.4
FAANG Equal Wtd	55.1	1.6	57.9	8.2	6.2	78.0

Source: Bailard, Inc., Bloomberg as of 6/30/2021

known to be over 90% effective in November 2020, the Russell 1000 Value Index has outperformed its Growth Index by 20%. Exhibit 3 shows the zigzag performance of these indices since January 2020. And, the table in Exhibit 4 provides more detailed performance for various time periods since the start of the COVID-19 pandemic.

As Exhibit 5 shows, now is the time in the economic cycle when a quality growth investment philosophy is the most challenged. Early in a recovery from an economic downturn or unexpected adverse event, such as the COVID-19 pandemic, the most economically-sensitive sectors and highly-leveraged stocks have tended to outperform. This includes industrials, raw materials, consumer discretionary, and financial sectors. As economic growth decelerates, growth stocks (which generally are found in the technology, health care, and media sectors) are expected to outpace the average. Finally, as the economy slows further, the more defensive sectors such as consumer staples, utilities, and

Exhibit 5. Growth & Value Relative Performance Around the Economic Cycle



telecom tend to do better and growth stocks usually continue to perform well based on favorable relative earnings.

During most of 2020—from the beginning of the pandemic until the announcement of the 90% effectiveness of the Pfizer vaccine in November 2020—the equity markets rewarded companies whose sales far exceeded expectations due to the work-from-home protocol. Examples of these beneficiaries included Zoom, DocuSign, DoorDash, Peloton, as well as the FAANG stocks (Facebook, Amazon, Apple, Netflix, Google). In many cases, these stocks had negative earnings as they were reinvesting cash flow into future growth through research and development, new products and/or capital expenditures. With the Pfizer vaccine approval in hand, the market assumed that the reopening recovery was a certainty even though it was months away, favoring all the industries that had been operating way below normal, i.e., hotels, restaurants, cruise lines, airlines, retail stores, and ridesharing. As cyclical and value stocks have outperformed, the valuation premium for growth has narrowed and is approaching pre-COVID levels. This is particularly noticeable in the relative price/earnings to growth ratio (known as the PEG ratio) shown in Exhibit 6.

While S&P 500 earnings per share may increase 30% to $190 per share, it is generally assumed that 2021 earnings are borrowing from earnings growth in 2022, which is estimated at $210 per share before any changes in tax policy. We are now confronting shortages of both labor (as many workers find unemployment benefits exceed after tax earnings less child-care expenses) and parts, especially semiconductor chips. While the earnings outlook is favorable, margins may be near peak levels and, pending forthcoming legislation, it is likely that corporate and individual tax rates may be rising in 2022.

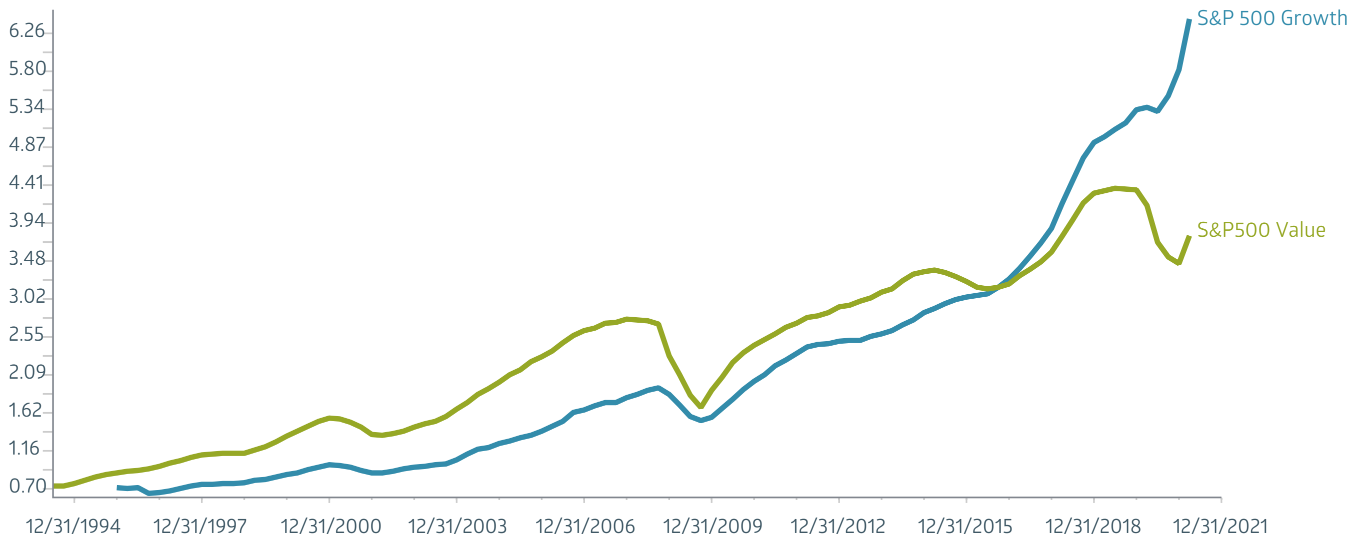
Stock prices have performed well, in aggregate, and valuations are high by almost every measure, except relative to bond yields. There are also indications of excess speculation reminiscent of the dot-com era of 1999 to 2001. These warning signs include high valuations for companies with negative earnings, record-high issuance of SPACs (Special Purpose Acquisition Companies) in both numbers and dollars, performance of meme[2] stocks, creation of the NFT (non-fungible tokens) market for digital images, and the focus on cryptocurrencies. As interest rates rise valuation levels will be under more pressure, especially long-duration technology stocks. Technology stocks

Exhibit 6. Relative P/E to Growth for S&P 500 Growth Universe

Price / EPS forward 12M / GRE (PEG) Relative to S&P 500, as of 6/30/2021. Source: Bailard, Inc., Intrinsic Research.

2 Meme stocks are those whose price movements are influenced more by social media chatter than by investment fundamentals.

Exhibit 7. S&P 500 Relative Earnings for Growth & Value



S&P 500 Growth vs. S&P 500 Value, as of 6/30/2021. Source: Bailard, Inc., Intrinsic Research.

are also more exposed to minimum tax and/or foreign tax proposals as well as threats of increased regulation and/or break up of some of their divisions. Health care stocks are exposed to Congress imposing drug price controls; this risk increased with the approval of Biogen's Alzheimer's drug, which has a list price of $56,000 per year.

As the market deals with the mixed messages of higher inflation and decelerating economic growth, we believe the seesaw pattern between growth and value will persist for the rest of the year. Some days value and cyclical stocks will outperform, as the market rewards stocks most impacted by infrastructure stimulus, onshoring of supply chain essentials, and economic expansion. Other days—when the market is "risk-off" with lower inflation prospects—growth and stable stocks will perform better. Growth will also respond to news on innovations in alternative energy, gene editing, artificial intelligence, virtual reality, security/cloud technology, 5G, precision cancer therapies, and comparable breakthroughs. Exhibit 7 is provided to compare earnings growth over the last 20 years for growth and value stocks in the S&P 500 Index.

During the balance of 2021, we expect the Fed to gradually introduce hints of tapering of monetary stimulus. At the same time, fiscal policy, which included $6 billion to offset the economic loss from COVID-19 in 2020-21, will also have less impact on the economy in 2022. As fiscal and monetary policies moderate and GDP growth slows back to trend, the market should pay more of a premium for the relative earnings. This is when the market should have more confidence in the relative earnings, which would be expected to reward both growth and GARP (growth at a reasonable price) stocks.

When in search of quality companies in the growth stage of their life cycle, volatile times such as these call for both patience and perspective. To that end, this piece provides a strong history of relative and absolute growth and value stock prices, valuations, and economic relationships.

Deconstructing Small Cap & How ESG Scoring Can Mitigate Risk

Osman Akgun, PhD, CFA, Vice President, Domestic Equities

Small cap stands for small market capitalization, where a company's market capitalization is the product of its share price multiplied by the number of outstanding shares. On the size spectrum, small cap is the moniker afforded to companies with a market capitalization of roughly $300 million to $2 billion. These are generally young companies with strong growth potential, but small caps also are typically less stable than their larger, more established peers. While this usually leads to more dramatic short-term price fluctuations and volatility, over longer evaluation periods, there is a greater likelihood that small cap stocks will outperform large caps.

Unfortunately, small cap stocks have a bad reputation

The increased volatility inherent in younger companies—primarily driven by the frequency with which new ventures go bankrupt—means that small cap investors must be willing to accept an increased measure of risk in exchange for higher potential gains.

Yet the risks may be exaggerated. News headlines focus on the negative, from claims of unchecked fraud to an unacceptable standard of corporate operations. The truth is, these are important considerations when investing in a company of any size. And, the relative performance of the Russell 2000 Index as compared to the Russell 1000 Index from 1979 to 6/30/2021 shows that individual small-cap stocks higher growth potential pays off in the long run, as small caps have outperformed large caps over time.[1]

Mitigating risk with an ESG overlay

By and large, Wall Street analysts are skeptics. Such was the reception when socially responsible investing (SRI) introduced the concept of limiting an investable universe to values-based themes over 50 years ago. In the decades since—and as SRI has built a long-term track record—investor interest has grown by leaps and bounds with Wall Street trailing begrudgingly behind. As the lens has broadened from values-based investing alone to include the evaluation of corporate data that shines a light on potential risk control and return benefits, the tide has shifted. Today we see a coalescing of investor interest hand in hand with financial institutions recognizing that returns need not be sacrificed in the pursuit of socially responsible investing.

A fundamental concept of sustainable investing is that firms with better environmental, social, and governance issues (ESG) practices tend to fare better over the long run; think of the investment risks posed by poor corporate governance or climate change. To quote Morningstar, "Funds with higher ESG ratings also bested their benchmarks by larger average margins than funds with lower ESG ratings. In other words, there was a better average payoff to investing in funds that courted less ESG risk."[2]

Applying ESG to small cap

As one might imagine, ESG factor data has been easier to gather for mid- and large-cap companies than their small brethren. With that, SRI and ESG factor scoring's early days began with the largest companies (for the largest impact) and has been filtering down the market cap size spectrum since. This historical large cap stock focus has served investors well in the past, but if we return to a period of small cap outperformance, it is time to pointedly shift attention to ESG scoring in the small cap universe.

And, as described earlier, utilizing an ESG framework can help mitigate the risk inherent in smaller companies and has yielded higher investment returns over time.

1 Source: Bloomberg. Russell began tracking the performance of small-cap stocks in 1979. Past performance is not a guarantee of future results.
2 https://www.morningstar.com/articles/1016714/did-esg-pay-off-for-fund-investors-last-year-yes-and-no

Understanding ESG score bias

Biased scoring on environmental, social, and governance issues may present a distorted picture for ESG investors, making some stocks appear more attractive or less risky than they actually are. Importantly, there are three main varieties of bias for investors to consider related to ESG scoring: industry bias, country bias, and size bias. For example, there is a well-known bias within the large cap space: larger-sized companies generally have higher ESG scores. That is, bigger companies have greater resources to address and report on ESG concerns and factors.

Yet, this bias is not as strong in the small cap space because the relative size difference of companies in the $300 million to $2 billion range is not as great. Bailard's research concludes that, unlike with large cap companies, ESG scoring bias within the small cap universe is insignificant.[3] This is good news for ESG investors.

For a deeper dive

This summer, *The Journal of Impact & ESG Investing* published an important piece from Bailard's research team that examines one of the three main ESG scoring biases. While we encourage you to visit Bailard's website for the full investigation, in summary, our research supports the view that investors should feel more confident in ESG scores within the small cap investing space without having to worry about size bias.

3 Akgun, Osman; Mudge, Thomas; Townsend, Blaine. May 2021. "How Company Size Bias in ESG Scores Impacts the Small Cap Investor," The Journal of Impact and ESG Investing, 1 (4) 31-44.

Closing Brief - Bailard's View on the Economy: A Well-Fed Market

Jon Manchester, CFA, CFP®, Senior Vice President, Chief Strategist - Wealth Management, and Portfolio Manager - Sustainable, Responsible and Impact Investing

Amidst record-breaking temperatures in the Pacific Northwest, the term "heat dome" has been used to describe how a high-pressure system traps warm air, like a lid on a pot. Seattle, with only three days over 100 degrees ever, hit triple digits three consecutive days in June. Portland established a new all-time high at 116 degrees, causing streets and sidewalks to buckle, and power cables supporting streetcars to melt. CBS News deemed the heat wave a once-in-a-millennium event for the region, while acknowledging this may happen more often due to our changing climate.[1]

Equities likewise continued on the boil over the first half of 2021, with the unrelenting sunny conditions pushing stock prices ever higher and parching the bear crowd. The benchmark Standard & Poor's 500 Index closed at a new all-time high on 35 of the 124 trading days, including five straight to end June. With a total return above 15%, the S&P 500 Index posted its second-best return over the first half of the year this century, trailing only 2019. Smaller capitalization U.S. stocks fared even better, riding the recovery wave to a nearly 24% return in the S&P Small Cap 600 Index.

The heat dome hovering over equity markets can be attributed in part to the enormous fiscal support doled out, but perhaps most importantly to the Federal Reserve's unyielding commitment to keep interest rates low. After an eye-opening first quarter in which the 10-year U.S. Treasury Note yield nearly doubled to 1.74%, it somewhat puzzlingly reversed course and finished the second quarter at 1.47%. This despite a rising chorus of inflationary data points and a normalizing U.S. economy. Gross Domestic Product (GDP) grew at a 6.4% annualized rate in the first quarter, inflation-adjusted, and second quarter growth could be in the 8% to 9% range once the numbers roll in.

Bond market investors appear to be largely nonplussed by it all, perhaps coolly ignoring the inflation noise and looking past the artificially high economic growth data in the near-term. However, it hasn't escaped attention that a major player in the bond market is our own central bank. The Fed's monthly purchases of $80 billion worth of U.S. Treasuries and $40 billion of mortgage-backed securities are designed to keep borrowing rates low, and this quantitative easing program has proven successful on that front. Raymond James calculated that the Fed has purchased nearly 60% of U.S. Treasury debt offerings since the pandemic started, and its importance is growing as issuance slows.[2] It also remains that the 10-year U.S. Treasury yield appears relatively attractive when you survey the global landscape: how do United Kingdom 10-year bonds at 0.7% sound, with a side of currency risk?

Stock market meteorologists expect the heat dome conditions to persist for some time yet, with the Fed potentially communicating its intent to taper bond purchases later this year. Fed Chairman Jerome Powell said of their June 2021 meeting: "You can view this meeting as the talking-about-talking-about tapering meeting." The quote clearly burnishes Powell's already stellar Fed-speak resume, but also underlines his heightened sensitivity to the markets' reliance on easy money.

Expect less. Pay More.

According to Federal Reserve Bank of St. Louis data, M2 money supply jumped from $15.4 trillion in January 2020 to roughly $20.4 trillion as of May 2021.[3] This rapid expansion sent coffers overflowing, and subsequently those excess funds have poured into a dizzying array of asset classes. The nascent NFT (non-fungible token) market—where digital items are

1 *"Pacific Northwest bakes under once-in-a-millennium heat dome," cbsnews.com, 6/29/21*
2 *"Institutional Equity Strategy Update," Raymond James, 6/18/21*
3 *"M2 Money Stock," fred.stlouisfed.org, May 2021*

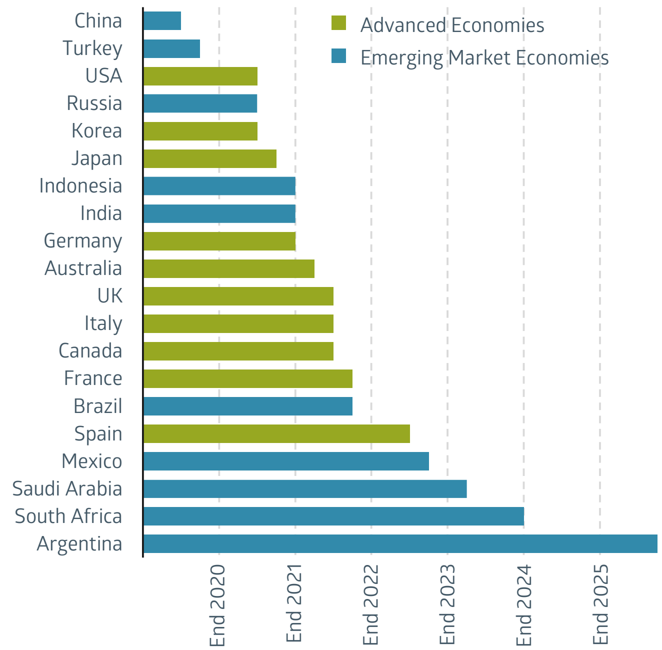
assigned ownership via blockchain—saw an investor spend $2.9 million earlier this year on Twitter CEO Jack Dorsey's first tweet: "just setting up my twttr." Fittingly, the transaction was done in cryptocurrency.

Money seems to be seeping into every possible area, seeking its level, perhaps nowhere more apparent than in the housing market. The S&P CoreLogic Case-Shiller 20-City Home Price Index shot up 14.9% year-over-year in April, registering its largest gain since 2005. Not surprisingly, the University of Michigan's "Good Time To Buy A House" survey hit an over-30-year low in May. Inventory shortages and supply chain challenges have only turned up the heat on prices, underpinned by historically low mortgage rates and enabled by Fed policy. With homes routinely selling above the asking price, the FOMO (Fear Of Missing Out) gauge is stuck on high.

Despite the rabid and, in some cases, disconcerting enthusiasm for risky assets, there are notable positives for equities beyond helicopter money. Halfway through the year, analysts have sharply revised their corporate profits estimates higher for the S&P 500. Wall Street envisioned 2021 earnings of $164/share for the Index at the outset of the year, but now expect $187. Notably, the S&P 500 Energy sector has seen its 2021 earnings estimate more than double, with West Texas Intermediate (WTI) crude oil up to $73/barrel from $48 at the end of last year. As a result, the forward S&P 500 price/earnings multiple based on 2021 profits is essentially unchanged. At a shade under 23x, it's a full valuation, but the forward-looking market is already considering 2022 and starting to gobble up the projected earnings upside. Other segments of the equity markets commanded less of a growth premium than the tech-heavy, U.S. large-cap benchmarks: mid/small-cap stocks, value, international.

In addition to robust earnings growth, equities have a strong buyer in the form of corporations themselves. Goldman Sachs tabulated $567 billion of share buyback announcements from U.S. companies through early June, a record-high for that point in a year.[4] Market behemoths Apple and Alphabet accounted for a combined $140 billion of that total. Goldman estimates $726 billion of repurchases for S&P 500 companies this year and believes corporations will represent the largest source of net U.S. equity demand for the

OECD expectations for when the G20 countries will recover to pre-pandemic GDP per capita



Source: OECD (2021), OECD Economic Outlook No 109 (Edition 2021/1)

remainder of 2021. When it comes to timing, corporations have not always been the most discerning of investors but they do serve as a key source of demand for equities, and this spike in intended buybacks is indicative of the confidence shown by management teams in future margins and cashflows.

The Jabs and the Jab Nots

In this new Coronaverse, the global economy remains beholden to public health outcomes. In May, the Organization for Economic Cooperation and Development (OECD) issued its semi-annual *Economic Outlook* and noted a stark disparity in how long it may take for countries to recover to their pre-pandemic GDP per capita levels. Among the G20 (Group of Twenty), some nations such as China, the U.S., and Japan have either already fully recovered or are expected to this year. In contrast, for G20 members including Argentina, South Africa, and Saudi Arabia, it may be 2024 or later. One key difference is the vaccination rate. In the case of South Africa, they had just one vaccination dose administered per 100 people in the total population as of late May.[5] As the report said,

4 *"Households and corporations will drive $500 billion of incremental equity demand through year-end," Goldman Sachs US Weekly Kickstart, 6/18/21*
5 *"No Ordinary Recovery," www.oecd.org/economic-outlook, May 2021*

Assuming the recovery remains on track, attention will likely swing to restoring some semblance of fiscal fitness.

from an economic perspective, it is a case of "more jabs, more jobs."

The U.S. jobs recovery has been uneven, perhaps distorted by the extended unemployment benefits and regional differences in vaccination rates. June's employment report indicated an encouraging 850,000 jump in nonfarm payrolls, bolstered by a 343,000 increase in leisure and hospitality jobs. However, as a *Bloomberg* story pointed out, U.S. payrolls remain nearly 6.8 million below their pre-pandemic level, lessening the pressure on the Fed to react and withdraw some monetary support.[6] The nonpartisan Congressional Budget Office (CBO) projects that employment will grow quickly over the second half of 2021, surpassing its pre-pandemic level by mid-2022.[7] This potentially gives the Fed some cover to bide their time, at least with respect to raising the Fed Funds target interest rate.

Assuming the recovery remains on track, attention will likely swing to restoring some semblance of fiscal fitness. The CBO estimates the federal deficit will hit $3.0 trillion in fiscal year 2021, roughly triple the 2019 shortfall. This would take federal debt held by the public to around $23 trillion, or 103% of GDP, by the end of the year. Not surprisingly, D.C. budget hawks are circling and a host of investment-related tax proposals have been floated to boost revenues. Thus far, political gridlock has impeded progress, although 130 countries recently endorsed a global minimum tax rate of 15% for corporations. One notable holdout is Ireland (and its 12.5% corporate tax rate) but all major economies, including China, are on board. Nevertheless, this tax pact has miles to go as it will need approval from Congress and the European Union amongst other hurdles.

For now, the heat dome conditions remain largely favorable for corporate profits. Tax rates may move higher, but S&P 500 companies paid a roughly 18% tax rate in 2020, a steep discount to the more than 31% average rate since 1993.[8] In fact, this year's first quarter S&P 500 operating margin of approximately 13% is a record high. It seems likely that rising labor, input, and eventually borrowing costs will dent margins going forward, but many companies enjoy strong pricing power and continue to achieve cost efficiencies via the ongoing digital transformation. Equities, of course, have a lot of this good news already baked into current prices. Any significant deviation from the consensus view—whether that's greater-than-anticipated inflation, a hawkish turn from the Fed, or some other veer off script—will pressure elevated stock multiples. In other words, enjoy the warm front while it lasts. We will be watching for a barometer change.

6 "U.S. Jobs Jump by Most in 10 Months as Economy Gains Steam," www.bloomberg.com, 7/2/2021
7 "An Update to the Budget and Economic Outlook: 2021 to 2031," Congressional Budget Office, July 2021
8 "S&P 500 Earnings And Estimate Report," www.spglobal.com, 6/30/2021

Q2 2021 World Events

WITH THE

S&P 500 Index

AS THE BACKDROP

Source: Bloomberg, Bailard. Past performance is no indication of future results. All investments involve the risk of loss.

Market Performance
As of June 30, 2021

U.S. Interest Rates	9/30/2020	12/31/2020	3/31/2021	6/30/2021
Cash Equivalents				
90-Day Treasury Bills	0.10%	0.07%	0.02%	0.04%
Federal Funds Target	0.25%	0.25%	0.25%	0.25%
Bank Prime Rate	3.25%	3.25%	3.25%	3.25%
Money Market Funds	0.01%	0.01%	0.01%	0.01%
Bonds				
10-Year U.S. Treasury	0.69%	0.92%	1.74%	1.47%
10-Year AA Municipal	1.13%	0.81%	1.30%	1.20%

Source: Bloomberg, L.P.

U.S. Bond Market Total Returns (US$) through 6/30/2021	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Bonds				
Bloomberg Barclays U.S. Treasury Index	1.75%	-2.58%	-2.58%	-3.22%
Bloomberg Barclays U.S. Corporate Index	3.55%	-1.27%	-1.27%	3.30%
Bloomberg Barclays U.S. Aggregate Index	1.83%	-1.60%	-1.60%	-0.33%
Bloomberg Barclays U.S. 1-15 Municipal Blend Index	0.90%	0.57%	0.57%	3.08%

Source: Bloomberg, L.P.

Global Stock Market Total Returns (US$) through 6/30/2021	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Stocks				
S&P 500 Index	8.55%	15.24%	15.24%	40.77%
Morningstar U.S. Small Value Index	5.65%	28.58%	28.58%	77.79%
Morningstar U.S. Small Growth Index	4.79%	4.34%	4.34%	43.51%
Morningstar U.S. Large Growth Index	15.42%	14.58%	14.58%	42.02%
Morningstar U.S. Large Value Index	4.15%	15.11%	15.11%	36.95%
International Stocks				
MSCI EAFE (Europe, Australasia, Far East) Index, net dividends	5.17%	8.83%	8.83%	32.35%
MSCI Emerging Markets, net dividends	5.05%	7.45%	7.45%	40.90%

Sources: Bloomberg, L.P. and Morningstar Direct

Alternatives (US$) through 6/30/2021	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
NFI-ODCE Index*	2.11%	4.26%	4.26%	6.13%
Gold Spot	3.65%	-6.76%	-6.76%	-0.61%
WTI (West Texas Intermediate) Crude Oil	24.19%	51.42%	51.42%	87.09%

Sources: Bloomberg, the National Council of Real Estate Investment Fiduciaries
**Q2 data not yet released. The second quarter return assumed to be same as the first quarter 2021 return.*

Past performance is no indication of future results. All investments have the risk of loss.

The Bailard Foundation Annual Update

for the year ending June 30, 2021

Serving the community in which we live has long been ingrained in the values of Bailard and the mindset of its employees. The desire and effort of helping our communities was foundational for the company, but there had never before been a formal channel to organize or amplify Bailard's service. To solidify the company's commitment to our communities and increase the impact of what Bailard, its employees, and clients support, the Bailard Foundation was created in May of 2019 in tandem with the Firm's 50th Anniversary. The Bailard Foundation supports initiatives that the Firm, its employees, and its clients value, as we seek to collectively improve the communities in which we live, work, and engage. The four focus donation areas of the Bailard Foundation are Affordable Housing, Homelessness & Poverty, Financial Literacy, and International Impact projects. Since inception, the Foundation has donated $126,508 to various grantees and remains appreciative of the incredible support received by clients, employees, and friends of the Firm.

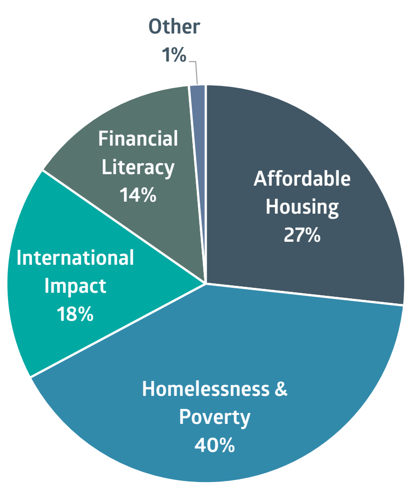
Giving Highlights

Pandemic Relief: The pandemic drove a number of the Bailard Foundation's charitable strategies over the past year. Given exceptional economic need, the Foundation focused on accelerating grant giving within its core values of Homelessness &Poverty and Affordable Housing. The jeopardizing of basic human needs such as shelter and food steered the Foundation's giving to a number of food banks including SF-Marin Food Bank, Second Harvest Silicon Valley, Alameda County Community Food Bank, and the Food Bank of Contra Costa & Solano Counties. The Foundation also gave to a several San Francisco Bay Area grantees addressing homelessness, including First Place for Youth, Glide Foundation, and Larkin Street Youth.

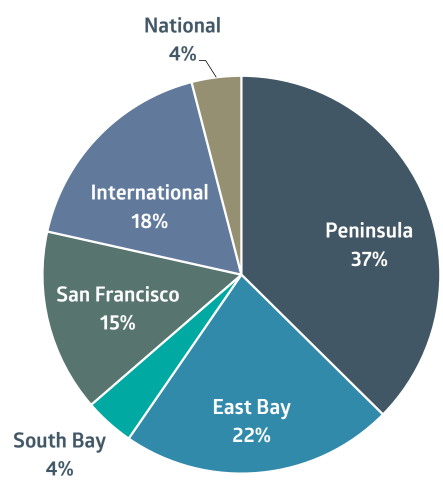
Black Lives Matter Movement: In regards to the Black Lives Matter movement, the Foundation implemented a number of initiatives beginning in the summer of 2020, starting with a $500 match on any employee gift to an

Bailard Foundation Giving Since Inception, as of 6/30/2021

By Foundation Focus Area



By Location



Source: Bailard.

organization that seeks to address and end systematic racism and oppression of Black, Indigenous and People of Color (BIPOC). Additionally, the Foundation gave new contributions in support of Larkin Street Youth Services, Hope SF, and the San Francisco Bay Area chapters of 100 Black Men and 100 Black Women. Through both campaigns, nine organizations received close to $19,000 in grants.

New Grantees: The Bailard Foundation's new grantees over the past year spanned all four focus areas of Financial Literacy, Affordable Housing, Homelessness & Poverty, and International Impact. A notable new grantee within the Homelessness & Poverty focus area includes First Place for Youth, which helps Bay Area foster youth transition to responsible adulthood. In regards to International Impact, the Foundation granted $5,000 to Raising the Village, which partners with rural communities in Uganda on economic self-sufficiency initiatives, helping lift villages out of poverty. On the Financial Literacy front, the Foundation made a new $5,000 grant to Able Works, which supplies youths and young families with financial education and life skills to help overcome economic hardship.

Grantee Spotlights

First Place for Youth

Mission: First Place for Youth helps foster youth build the skills they need to make a successful transition to self-sufficiency and responsible adulthood.

FIRST PLACE FOR YOUTH
MORE IS POSSIBLE

Services: Each year, more than 25,000 young people "age out" of the foster care system and face the prospect of independent living. First Place for Youth steps in to support young people coming of age in the foster care system whose families can't be there for them. Beginning with safe places to live, program participants are then matched with mentors, housing and employment specialists and youth advocates who help them to persist and succeed in school, build life and job skills, and work toward careers in high-growth fields.

Samburu Project

Mission: To provide access to clean water and continue to support well communities with initiatives that promote health, education, women's empowerment and general well-being.

Bailard's Involvement: In 2020, The Samburu Project drilled seven new wells that now provide clean water to communities in Samburu, Kenya. One of these wells was co-funded by the Bailard Foundation, and will support the 670 people of the Pasinae Self Help Group of Lechur Village.

The Bailard Foundation supports initiatives that the firm, its employees, and its clients value, as we seek to collectively improve the communities in which we live, work, and engage. The Bailard Foundation has a board of directors that is led by chairwoman Terri Bailard, widow of firm co-founder Tom Bailard, and features both select friends of Bailard, Inc. and employees.

DISCLOSURES

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ABOUT *THE 9:05*

Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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