Allocation Insights

Q3 | 2021

Third Quarter Macro Overview

When we published our 2021 outlook earlier this year, we talked about a strong recovery here in the U.S. and abroad, driven by the support and reopening of the economies after the pandemic shutdowns. And that has been the case this year. The U.S. posted economic growth of 6.3% (annualized) in the first quarter and 6.5% in the second quarter. Companies in the S&P 500 reported second quarter earnings growth of over 89% year over year.

As the global economic recovery unfolds, however, we are learning that while the unprecedented shutdown of the economy was swift, fully reopening has been and will continue to be challenging. Through economic data and company earnings we are seeing cost pressures, labor shortages, manufacturing component shortages, increased backlogs, and low inventories constraining many businesses. We expect that through the balance of the year and into 2022, many of these pressures will subside as the unemployment rate declines further. In addition, supply bottleneck pressures should ease as the rest of the global economy continues to open and vaccine administration increases, especially in emerging market countries.

As a result, we remain positive in the medium-to-longer term and believe we are still in the first half of a new economic cycle that is supported by a modestly delevered consumer, pent-up demand, and expansionary fiscal and monetary stimulus. In this quarter, we reaffirm our dynamic leanings as we continue to favor cyclical assets and those more closely correlated to economic growth. Despite this optimism, allocating assets in this next phase of the cycle is likely to be more nuanced. Historically, market returns, while still positive, have typically moderated following the initial rebound from a bear market and recession. The next stage of the market cycle is usually driven by the quality and growth of earnings rather than multiple expansion. So, we are focusing further on quality in our portfolios.

Our portfolio recommendations continue to be anchored in our long-term outlook, with a focus on diversification both across and within asset classes. Our dynamic leanings are against our long-term strategic asset allocation (SAA) and result from our short-to-medium-term views. In our base case, we expect economic growth in the U.S. to remain above trend in 2021 and 2022. We also anticipate that growth outside the U.S. will pick up as other regions get closer to herd immunity, setting the stage for a period of synchronized growth.

In the U.S., we believe that value as a style, which is comprised of more cyclical sectors, and small cap companies relative to large cap should continue to perform well.

Within equity, we also make several other decisions, one of which is how to dynamically allocate between U.S. and non-U.S. equity. We remain overweight non-U.S. equity, both developed and emerging markets, versus U.S. equity.

Within fixed income, we remain overweight to U.S. high yield relative to U.S. investment grade, with the guidance to implement this leaning only using active managers. Within investment grade, we are neutral between corporate, government, and securitized bonds. We are overweight Treasury inflation-protected securities (TIPS) as a hedge against higher inflation.

With that said, this remains an unprecedented environment, and we will revisit our dynamic leanings regularly and consider changes as new information becomes available.

STIFEL

Investment Themes

The following table summarizes our thinking across various asset classes and regions.

▲ Overweight ▼ Underweight ■ Neutral

	Asset Class	Previous	Current	Comments
Equity	U.S. Equity	▼	▼	Our base case assumes above-trend economic growth in 2021 and into 2022 supported by fiscal and monetary stimulus, a gradual return to "normal," and herd immunity. Equity markets outside the U.S., which generally underperformed in 2020, are more dependent on trade and levered to cyclical sectors, which should bode well for their future performance. A weakening/stable dollar is expected to be a tailwind for non-U.S. markets. Valuations of non-U.S. stocks are attractive relative to U.S.
Equity	U.S. Large Cap	▼	▼	The macroeconomic data is still supportive, especially for smaller companies, and we believe that small caps remain well positioned to benefit from the ongoing global economic recovery, an accelerating CapEx cycle, and the latest infrastructure package.
Equity	*Large Value vs. Large Growth*	▲	▲	The underlying sector composition of the large value investment style is more cyclical (financials, energy, materials, industrials, etc.) and hence more closely correlated to economic growth and the ongoing reopening of the global economy. We believe that large value stocks should continue to perform well as global economic growth is expected to remain above trend in 2022 (supportive of earnings) and U.S. Treasury yields have room to move higher.
Equity	U.S. Small Cap	▲	▲	The macroeconomic data is still supportive, especially for smaller companies, and we believe that small caps remain well positioned to benefit from the ongoing global economic recovery, an accelerating CapEx cycle, and the latest infrastructure package.
Equity	*Small Value vs. Small Growth*	■	■	We recommend a diversified approach, investing in both small cap value and growth.
Equity	Non-U.S. Equity	▲	▲	Our base case assumes above-trend economic growth in 2021 and into 2022 supported by fiscal and monetary stimulus, a gradual return to "normal," and herd immunity. Equity markets outside the U.S., which generally underperformed in 2020, are more dependent on trade and levered to cyclical sectors, which should bode well for their future performance. A weakening/stable dollar is expected to be a tailwind for non-U.S. markets. Valuations of non-U.S. stocks are attractive relative to U.S.
Equity	Non-U.S. Developed Markets	■	■	We are neutral within non-U.S. equity between developed and emerging markets as we find the risks to be balanced between both.
Equity	*Europe vs. Japan*	■	■	The European economy is more exposed to global trade, with public companies generating 50% of revenue outside of Europe. Japan's ongoing structural and corporate reform is a tailwind for company earnings. However, both Europe and Japan face some challenges that keep us at neutral within developed markets, for now.
Equity	Emerging Markets	■	■	A weaker dollar, stable oil prices, and a stronger global economy should benefit most emerging market countries. However, weaker healthcare systems and uncertainty around vaccine supply keep us neutral for now, despite attractive relative valuations to non-U.S. developed markets.

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Investment Themes (continued)

The following table summarizes our thinking across various asset classes and regions.

▲ Overweight ▼ Underweight ■ Neutral

	Asset Class	Previous	Current	Comments
Fixed Income	U.S. Investment Grade	▼	▼	Within fixed income, we are tilting to an overweight of U.S. high yield relative to U.S. investment grade with the use of active management. Default rates in high yield have come down, and while the impacts of COVID-19 will persist, we believe there is opportunity in certain cyclical sectors and the potential for yield enhancement in a low-yield environment.
	Corporates *Government/Agency* *MBS*	■	■	We recommend a diversified approach to the full spectrum of investment-grade fixed income.
	Inflation Protected	▲	▲	The Fed has revised its policy framework to allow for inflation to be above 2% for extended periods of time. We maintain an overweight as a hedge against higher inflation.
	Duration	■	■	The Fed is expected to stay accommodative for the foreseeable future, and while interest rates will likely move higher as the economy recovers and the Fed begins tapering, we don't anticipate rates rising dramatically. We believe we are in a lower-for-longer environment and remain neutral duration.
	U.S. High Yield	▲	▲	Within fixed income, we are tilting to an overweight of U.S. high yield relative to U.S. investment grade with the use of active management. Default rates in high yield have come down, and while the impacts of COVID-19 will persist, we believe there is opportunity in certain cyclical sectors and the potential for yield enhancement in a low-yield environment.
Alternatives	Private Assets	■	■	For investors interested in alternative investments and able to handle illiquidity, exposure to some combination of private equity, private debt, and/or private real estate can be considered as part of a diversified portfolio.
	Hedge Funds	■	■	For investors interested in alternative investments and able to handle less liquidity who have conviction about manager skill, exposure to hedge funds can be a helpful part of a diversified portfolio. This is especially true in volatile, low-return environments.

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within.

Diversification and asset allocation do not ensure a profit or protect against loss. Investing involves risk, including the possible loss of principal. Any data on past performance contained herein is no indication as to future performance. The value of any investment may fluctuate as a result of market changes. The information in this document is not intended to predict actual results, and no assurances are given with respect thereto. The products mentioned in this document may not be suitable for all types of investors.

Led by Stifel Chief Investment Officer Michael O'Keeffe, the Stifel CIO Office is comprised of several investment professionals. The team works collaboratively with other Stifel professionals to develop macroeconomic analysis, market analysis, strategic and tactical asset allocation guidance, applied behavioral finance, and specific investment solutions for advisors and clients.

Asset Class Risk

Bonds – Bonds are subject to market, interest rate, and credit risk. Prices on bonds and other interest rate-sensitive securities will decline as interest rates rise. Municipal bonds may be subject to state and alternative minimum taxes, and capital gains taxes may apply. High yield bonds have greater credit risk than higher quality bonds. Yields and market values will fluctuate, and if sold prior to maturity, bonds may be worth more or less than the original investment.

Equities – Portfolios that emphasize stocks may involve price fluctuations as stock market conditions change. Small and mid capitalization stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies.

International/Global/Emerging Markets – There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries.

Alternative Investments – Alternative investments involve a high degree of risk, often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing tax information, are not subject to the same regulatory requirements as more traditional investments, and often charge high fees, which may erode performance. An investment is appropriate only for investors who have the capacity to absorb a loss of some or all of their investment. Alternative investments may include, but are not limited to: Real Estate Investment Trusts (REITs), Commodities, Futures, and Hedge Funds. Real Estate – When investing in real estate companies, property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance. Commodities and Futures – The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains. Hedge Funds – Investors should be aware that hedge funds often engage in leverage, short-selling, arbitrage, hedging, derivatives, and other speculative investment practices that may increase investment loss. Hedge funds can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and often charge high fees that can erode performance. Additionally, they may involve complex tax structures and delays in distributing tax information. While hedge funds may appear similar to mutual funds, they are not necessarily subject to the same regulatory requirements as mutual funds.

Index Descriptions

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The average market capitalization is approximately $4 billion, and the median market capitalization is approximately $700 million.

The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The Standard & Poor's/TSX Composite Index is the benchmark Canadian index, representing roughly 70% of the total market capitalization on the Toronto Stock Exchange with about 250 companies included in it.

The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately $11 billion, and the median market capitalization is approximately $3.5 billion.

The Russell 1000 Growth Index measures the performance of those Russell 1000 index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 1000 Value Index measures the performance of those Russell 1000 index companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately $490 million, and the median market capitalization is approximately $395 million.

The Russell 2000 Growth Index measures the performance of those Russell 2000 index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 2000 Value Index measures the performance of those Russell 2000 index companies with lower price-to-book ratios and lower forecasted growth values.

The Russell Microcap Index is a capitalization-weighted index of 2,000 small cap and micro cap stocks, including the smallest 1,000 companies in the Russell 2000 plus 1,000 smaller U.S. based listed stocks. Over-the-counter stocks and pink sheet securities are excluded.

The MSCI World ex USA All Cap Index captures large, mid, small, and micro cap representation across 22 of 23 Developed Markets (DM) countries (excluding the United States). With 8,138 constituents, the index covers approximately 99% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

The MSCI Europe Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of the developed markets in Europe.

The MSCI Pacific Index captures large and mid cap representation across five Developed Markets (DM) countries in the Pacific region. With 470 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 322 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

The MSCI EM (Emerging Markets) Europe, Middle East and Africa Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of Europe, the Middle East, and Africa.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related, and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and nonagency). Provided the necessary inclusion rules are met, U.S. Aggregate-eligible securities also contribute to the multicurrency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt.

The Bloomberg Barclays U.S. Government/Credit Bond Index is a broad-based flagship benchmark that measures the non-securitized component of the U.S. Aggregate Index. It includes investment-grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related, and corporate securities.

The Bloomberg Barclays U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. The U.S. Treasury Index is a component of the U.S. Aggregate, U.S. Universal, Global Aggregate, and Global Treasury Indices.

The Bloomberg Barclays U.S. Treasury U.S. TIPS index includes all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value.

The Bloomberg Barclays U.S. Municipal Index covers the U.S. dollar-denominated, long-term, tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

The Bloomberg Barclays U.S. Credit Index measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate and government-related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals, and local authorities.

The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Bloomberg Barclays Global Aggregate Bond Index is a flagship measure of global investment-grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate, and securitized fixed-rate bonds from both developed and emerging markets issuers.

The Bloomberg Barclays Emerging Markets Hard Currency Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes U.S. dollar-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

The Wilshire U.S. REIT Index is a float-adjusted market capitalization-weighted index that measures U.S. publicly traded real estate investment trusts (REITs), excluding mortgage REITs, net-lease REITS, real estate finance companies, home builders, large landowners and sub-dividers, hybrid REITS, and companies that have more than 25% of their assets in direct mortgage investments.

The Wilshire ex U.S. Real Estate Investment Trust Index℠ (Wilshire ex U.S. REIT) measures global publicly traded real estate investment trusts, less all U.S. securities. The Wilshire ex U.S. REIT is a subset of the Wilshire ex U.S. Real Estate Securities Index℠ (Wilshire ex U.S. RESI).

The Wilshire Global REIT Index is a float-adjusted, market capitalization-weighted index that measures global publicly traded real estate investment trusts (REITs), excluding mortgage REITs, net-lease REITS, real estate finance companies, home builders, large landowners and sub-dividers, hybrid REITS, and companies that have more than 25% of their assets in direct mortgage investments.

Bloomberg Commodity Index (BCOM) is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually weighted two-thirds by trading volume and one-third by world production, and weight-caps are applied at the commodity, sector, and group level for diversification. Roll period typically occurs from the sixth to the tenth business day based on the roll schedule.

The S&P GSCI Crude Oil Index is a sub-index of the S&P GSCI Commodity Index. The production-weighted index reflects the returns that are potentially available through an unleveraged investment in the West Texas Intermediate (WTI) crude oil futures contract.

The Wilshire Liquid Alternative Index℠ measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe. The Wilshire Liquid Alternative Index (WLIQA) is designed to provide a broad measure of the liquid alternative market by combining the performance of the Wilshire Liquid Alternative Equity Hedge Index℠ (WLIQAEH), Wilshire Liquid Alternative Global Macro Index℠ (WLIQAGM), Wilshire Liquid Alternative Relative Value Index℠ (WLIQARV), Wilshire Liquid Alternative Multi-Strategy Index℠ (WLIQAMS), and Wilshire Liquid Alternative Event Driven Index℠ (WLIQAED).

Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.