F.L.PUTNAM
INVESTMENT MANAGEMENT COMPANY

June 30, 2021

Quarterly Market Update

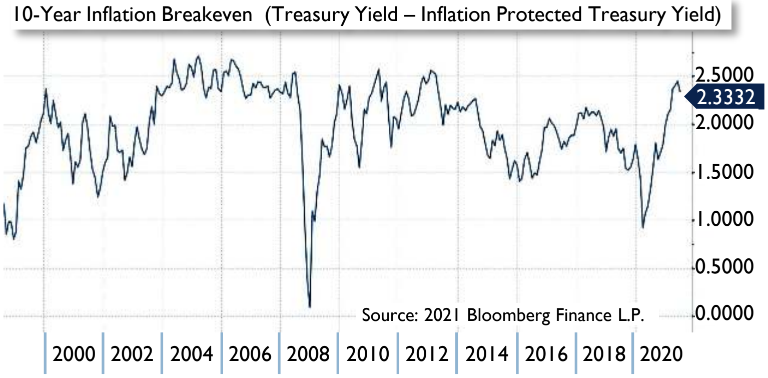
Macroeconomic Outlook

The second quarter of 2021 was dominated by a resurgence of economic activity in the United States as the economy reopened more fully as the pandemic eased. Pent-up demand and continued fiscal and monetary stimulus led to extraordinary growth relative to economic production that was depressed by the onset of the pandemic a year ago. Along with economic growth, inflation accelerated during the quarter to a greater extent than expected and the durability of increased inflation became a critical investment consideration.

We identified inflation as a key theme for the year when we published our *2021 Market Outlook* in January, which highlighted the relative appeal of real assets in an environment of low interest rates and highly uncertain future inflation trends. Economic data published since that time has reinforced this position as detailed in our last quarterly update and a subsequent webinar on the topic. Intriguingly, while inflation data consistently exceeded economists' expectations during the quarter, inflation expectations as measured by the difference in interest rates on fixed-rate Treasury bonds and inflation-adjusted Treasury bonds barely budged after jumping from roughly 1% to 2.5% over the prior 12 months, as shown in the chart below.

While the latest reading of the Consumer Price Index (CPI) of 5% certainly raised eyebrows, we believe it is important that this has not translated into increased inflation expectations in financial markets. Ultimately, prices relative to where they were a year ago make headlines, but it is expectations for prices in the future that can alter purchasing decisions and create a self-reinforcing inflation cycle. Investors are clearly buying into the Federal Reserve's (Fed) "transitory" inflation outlook for now. There is a long history of declining inflation in the US thanks to the growth of the less commodity-sensitive service economy and increased productivity due to technological innovation, but it remains unclear whether this can fully offset the magnitude of ongoing monetary and fiscal stimulus.

10-Year Inflation Breakeven (Treasury Yield – Inflation Protected Treasury Yield)



While inflation has run hot, progress in reducing unemployment has been uneven and we expect it will take time to achieve the Fed's other goal of broad-based and inclusive full employment. In addition, the Fed's shift to a framework based on average historical inflation rather than projected future inflation increases the chance of falling behind the curve and allowing inflation expectations to rise further. Despite last month's market gyrations as the Fed shifted expectations to a slightly earlier and more rapid normalization of interest rates in a few years, we believe inflation risk remains at the highest level in decades – especially in the context of today's rock bottom interest rates.

Inflation is not the only metric on the rise in 2021. Valuations across asset classes have been boosted by stimulus that will eventually wane, which has become our primary concern. Large growth-oriented US equities and US Treasuries are our greatest concern, but elevated valuations and low volatility across most traditional investments indicate a worrisome level of complacency despite heightened expectations. The more speculative corners of the market such as "meme stocks" sport valuations that are even more alarming. While the economic outlook remains benign and opportunities still exist, risks are gradually increasing as financial markets ascend in response to massive fiscal and monetary stimulus. We have made a number of adjustments to address these challenges from an asset allocation perspective and within each asset class, which are detailed in the pages that follow. ■

Asset Allocation

Investors shrugged off a wall of worry during the second quarter of 2021 and pushed equity prices significantly higher. Bonds and alternative investments also produced positive gains during the latest three months. Concerns of Covid variants, rising inflation, potentially higher taxes, and mounting geopolitical concerns did not deter investors from adding to risk asset positions. Large company growth stocks regained their leadership during the period after lagging value stocks over the last couple of quarters. Mid and small companies also produced solid results, although their gains slowed from the torrid returns of the first quarter. International investments benefited from investors' "risk on" focus but could not keep up with US equity returns. Bond investors were rewarded for taking on credit risk as corporate bonds produced solid gains. Real assets and real estate also produced positive returns for the period. Treasury securities were basically flat for the period as safety did not get rewarded.

The S&P 500 Index returned 8.5% for the three months, resulting in a gain of over 15% for calendar 2021. This was driven largely by growth stocks, which returned 11.9% for the three-month period

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capturing most of its 13.1% year to date return. Value stocks, which performed mightily over the previous six months, rose by 4.3% during the last three months and currently stand at a total return of 16.9% for 2021. As the economy continues to reopen, and supply and demand chains get back to more normal operations, we expect to see growth and value stocks share leadership going forward. Several factors, including a federal government spending package and interest rates, will have an impact on the relative performance of these two styles. We remain balanced in our allocation to value and growth as we move toward the back half of the year.

Small and mid-sized company returns were favorable but came back to earth during the quarter as they produced returns of 4.5% and 3.6%, respectively. These were solid returns but lagged both large company US and international stocks during the period. Given these stocks returned between 13%-18% during the first quarter, these were solid results. Year-to-date results are still remarkably strong as small companies have risen over 23.5% while mid-sized companies returned 17.5%. We remain overweight in our exposure toward mid-sized companies and neutral toward small firms. These firms continue to see strong rebounds in earnings as the economy reopens and have flexibility to be more nimble than their larger counterparts as resources get reallocated due to government spending and supply/demand changes.

International stocks also performed well during the quarter and produced solid results. Developed countries returned 5.9% for the quarter, followed by emerging markets at 5.1% and small company international stocks at 5.0%. Valuations for international companies remain compelling but the surprising strength in the US dollar has muted returns. The uneven reopening of global economies will likely drive stock prices relative to US firms. This area remains an attractive opportunity, but relative returns have not surfaced at this time.

Credit exposure produced the best results within fixed income. Intermediate and longer corporate bonds returned 1.0% and 2.7%, respectively, during the second quarter, although the asset class remains in negative territory year to date. Treasury inflation-protected securities (TIPS) also had nice results with 3.2% for the quarter. Portfolios that had exposure to preferred stocks also benefited from their return of 3.1% for the three months and 1.7% year to date. Floating rate notes were also up by 1.3%. Alternative asset classes of real estate and real assets supported portfolios with returns of 4.7% and 2.3% for the period. Gold rebounded from a poor first quarter with a return of 3.7% for the second quarter but is still down 7.0% for the year. We remain defensively positioned in fixed income with shorter-than-average maturities and little Treasury exposure. We have moved portfolios into a position to buffer them against rising rates and away from extremely low yields for Treasuries. While the economy continues to improve, we believe credit exposure appears more attractive than Treasuries. ■

US Equities

The cyclical stock rally that dominated the picture at the beginning of the year took a breather in the second quarter. While Value outperformed Growth by more than 10% through the end of March, this quarter the tables were once again turned somewhat, with Growth outperforming Value by more than 5%. The S&P 500 posted a return of 8.5%, while the Nasdaq gained 10.0%. Peeking under the hood, we see that the outperformance in Growth was not so much driven by high-growth "FANG" stocks (Facebook, Amazon, Netflix, Google) moving in a block as we have seen in the past but was in fact a result of Google itself, which was up a very strong 23% for the quarter, coupled with its hefty 4% weighting in the index. When you compare Google's performance to that of another growth darling, Amazon (it returned just 10.3%), or Apple (9.5%), we see that the outperformance in Growth was more localized to online advertising. The two other areas of the market driving index returns were Real Estate (14.1%) and Energy (13.9%). The Technology sector itself performed well (9.4%) but was not the main driver of index performance. With Energy and Real Estate strongly in the cyclical camp and leading the index, we see another hint that this quarter's reversal toward Growth leadership lacks gravitas. In addition, advertising revenue is linked strongly to the ongoing Covid reopening narrative. We don't see this quarter's performance as evidence of a false start to the pro-cyclical outlook, but rather, more evidence that a self-reinforcing economic expansion is taking hold as Covid restrictions continue to loosen.

With interest rates declining over the quarter, one would think that interest rate-sensitive equities such as Real Estate, Utilities, and Consumer Staples would have performed better, but only Real Estate posted strong gains. Utilities and Staples (0.1% and 2.4%, respectively) appear to be haunted by the specter of inflation, which is the hot potato *du jour.* The biggest hot potato of all has been lumber prices. With the red-hot housing market, lumber has become one of the most talked about commodities. While futures peaked in early May around $1,680 per thousand board-feet, as shown in the chart below, prices have dropped rapidly as additional milling capacity has been brought online. However, even with a more than -50% retrenchment from the May highs, prices are still up almost 100% over pre-Covid levels. Although the consensus outlook for inflation is that it is most likely to be transitory from Covid-induced macroeconomic shocks to the supply chain (and perhaps the trillions in corona-cash generated by the Fed-Treasury), recent higher prices are also more likely to

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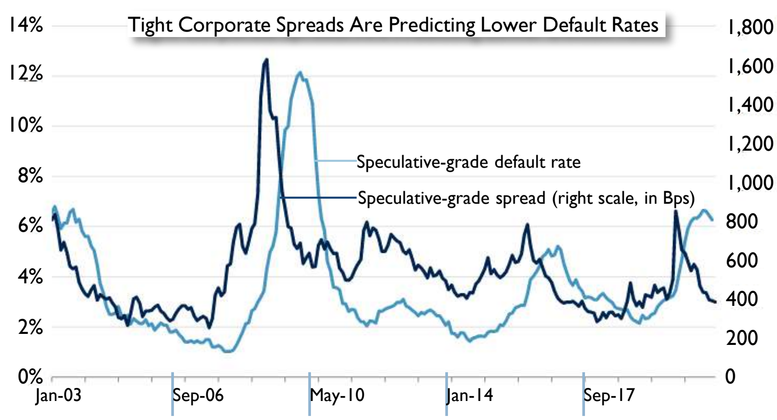
After an eight-month upward trajectory, Treasury yields paused their ascent in the second quarter. The 10-year Treasury yield briefly touched 1.74% at the end of March, the highest level since pre-Covid, but has subsequently stabilized and moved lower. The narratives responsible for pushing rates higher, a booming economic recovery and above-trend inflation, are still intact but momentum is fading somewhat. For the second half of 2021, expectations for US Real GDP growth and inflation are at 6% and 2.75%[1], respectively, primarily due to one of the sharpest recessions and recoveries on record. While some are shouting from the rooftops about higher inflation, the loudest voice in the room, Fed Chairman Jerome Powell, is sticking with the view that inflation is transitory. Currently, the market is inclined to agree. Market-based inflation expectations, as noted in the macro section on page 1, imply higher inflation in the near-term, but a return to its lower trend over time. After spending much of May and June in a 1.45% to 1.7% range, the 10-year Treasury yield has recently moved below that lower bound. Disappointing economic growth or a perceived Fed policy mistake could move interest rates even lower, but we believe broader market trends are still intact. Specifically, that means a dovish Fed, strong economic growth, and gradually increasing long-term rates while short-term rates remain pinned near zero. The first interest rates hikes are forecasted for 2023, but we will be increasingly vigilant for signs of persistent inflation and for any indication that the Fed has compressed that rate-hiking timeline.

The acronym TINA ("*there is no alternative*") has often been used to describe the relative attractiveness of the equity market in an environment of low interest rates. Within the confines of the fixed income universe, TINA aptly characterizes the appeal of corporate bonds and mortgage-backed securities compared to low-yielding Treasuries. With low interest rates, there simply is no alternative than to buy asset classes that offer incremental yield. Thus, investors have piled into investment grade and high-yield corporate bonds, driving yield spreads close to all-time lows. Rich valuations aside, it is hard to argue with the fundamental picture for corporate credit. Revenues are increasing, companies are flush with cash, and many companies have refinanced debt at lower rates while also terming out maturities. High-yield spreads are often viewed as a proxy for economic health as they reflect the extra amount of yield that investors require to lend to risky companies. Currently, that spread is 2.7% higher than a like-maturity Treasury, the lowest level since 2007. High-yield spreads are also a predictive measure for default rates as shown in the chart below left, and a 2.7% spread would suggest around a 2% future default rate for speculative grade companies. It is worth noting that this would be one of the lowest default rates in the last twenty years, a sign of how optimistic investors are about credit conditions and the economy.



In the tax-exempt sector, municipal bonds have remained impervious to any outside influences. Inflation concerns and the Fed's communication have taken a back seat to expectations for future tax increases from the Biden administration. Higher taxes increase the value of the municipal bond tax exemption and have led to strong flows into the asset class. Initially, city, state, and local finances were hit hard by Covid, but recent tax revenues have exceeded expectations, helped by a strong stock market and soaring property values. Also, issuers have many tools at their disposal to shore up finances such as raising taxes and cutting spending. Issuers can also raise money through primary bond markets, where demand remains extremely strong. Lingering credit quality concerns remain, but even the much-maligned State of Illinois received its first credit upgrade since 1998 from rating agency Moody's. You can add municipal bonds to the list of over-valued asset classes as municipal-to-Treasury ratios are the richest they have been since 2007. Despite this, the sector still compares favorably to Treasuries on a tax-adjusted basis from the perspective of investors in high income tax brackets.

As we move into the second half of 2021, allocations to corporate credit, municipal bonds, and mortgage-backed securities are favored over low-yielding Treasuries and agencies. Valuations look stretched but it is hard to dispute the positive trajectory of the US economy. Given the uncertain nature of inflation and its potential to overshoot, an allocation to TIPS is still recommended for client portfolios. ■

[1] Bloomberg survey of 75 economic forecasters

FLP NEWS

Ryan McQuilkin, CFA, CFP®
rmcquilkin@flputnam.com
781-943-3419

- F.L.Putnam is pleased to announce Ryan McQuilkin, CFA, CFP®, has been hired as a Portfolio Manager for the firm and brings an expertise in fixed income. Ryan has over 15 years of industry experience, most recently as a Managing Director and the Head of Fixed Income for Boston Private Wealth, LLC, where he oversaw the management of more than $2 billion in fixed income assets.

- Our next FLP Webinar Series: August 3rd, 4:00-5:00PM, EDT
  Sustainable Investing 101: Doing Well While Doing Good
  with Andrew Wetzel, CFA
  RSVP Gene Barton: gbarton@flputnam.com | 800.344.3435

- FLP will be opening new offices in Pembroke, MA and Lynnfield, MA in the fall of 2021. Also, coming soon, we will be unveiling our newly refreshed website – so keep an eye on flputnam.com in the coming months!

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stick. Thus, disinflation (that is, a gradual abating of inflationary pressures) is the most likely scenario we see as supply chains begin to normalize, rather than an actual deflationary reversal of recent price increases.

Inflation is not constrained to the housing market, either. The ongoing shortage in global semiconductor supply has also driven price increases across the board in this critical market. Geopolitical risk is rising rapidly and is coincident with tight semiconductor supply, making this a significant and potent global concern.

Our outlook for equities remains unchanged at this point, given the ongoing evidence supporting our thesis seen throughout the quarter and year-to-date. We are continuing our balanced approach within equities, accented by opportunistic but prudent additions to shares of cyclical companies and inflation beneficiaries where possible and reductions of increasingly expensive shares of rapidly growing companies. At this point, we are now moving into the slow summer vacation months where historically, trading volume tapers off and volatility increases as a result. While we will be watching closely for any indications that would necessitate a revision to our outlook, it is generally prudent to look on the appearance of any such signals during the slow summer months with a skeptical eye and to discount their apparent strength appropriately.

GLOBAL MARKET RETURNS		Last 3 Months	Last 12 Months[1]	20-Year Annual Return[2]
US Equities	S&P 500 *(Large US Companies)*	8.55%	40.79%	8.60%
	S&P 400 *(Mid-size US Companies)*	3.64%	53.22%	10.19%
	S&P 600 *(Small US Companies)*	4.50%	67.33%	10.82%
	Russell 3000 *(All US Companies)*	8.24%	44.15%	8.92%
	Dow Jones US Real Estate Index	11.68%	32.26%	9.69%
International Equities	MSCI World Index ex-US *(Developed Markets)*	5.86%	34.22%	6.43%
	MSCI Emerging Markets *(Emerging Markets)*	5.12%	41.36%	10.48%
	MSCI World ex US Small Cap *(Developed Markets Small Companies)*	4.96%	42.80%	9.50%
Fixed Income	Bloomberg Barclays Intermediate US Govt/Credit TR	0.98%	0.19%	4.01%
	Bloomberg Barclays US Corporate High Yield Total Return	2.74%	15.37%	7.79%
	Bloomberg Barclays Intermediate Corporate Total Return	1.70%	2.57%	5.03%
	Bloomberg Barclays US Intermediate Treasury TR	0.62%	-1.18%	3.47%
	Bloomberg Barclays US Treasury Inflation Notes TR	3.25%	6.51%	5.12%
	Bloomberg Barclays US MBS Index Total Return Value Unhedged	0.33%	-0.42%	4.17%
	Bloomberg Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged)	1.09%	5.90%	5.24%
	J.P. Morgan Emerging Bond Market Index Global Core	4.49%	7.45%	8.24%
	Barclays Capital 5-Year Municipal Bond	0.48%	2.24%	3.72%
Inflation	US CPI Urban Consumers Less Food and Energy NSA[4]	1.92%	3.80%	2.00%
Treasury Bill	US 3-Month Treasury Bill Index	0.00%	0.09%	1.41%

[1] Includes dividends for equity indices
[2] Annualized
[3] Inception Date 1/31/2001
[4] CPI data for time period is date ended 5/31/21

Source: Bloomberg Capital Markets