Market Insights

GLENMEDE

JASON D. PRIDE, CFA
Chief Investment Officer, Private Wealth

MICHAEL T. REYNOLDS, CFA
Investment Strategy Officer

ILONA V. VOVK, CFP®
Investment Strategy Officer

V.I.P. – Vaccinations, Inflation Fears and Public Policy

An Update on Key Economic and Market Drivers in 2021

"Any intelligent fool can make things bigger and more complex... It takes a touch of genius - and a lot of courage to move in the opposite direction."
– *Albert Einstein*

A touch of genius may be a stretch, particularly in the shadow of a quote from Einstein, but these writings are meant to simplify the complex world of investing for our clients. We typically focus on the most important factors driving economies and financial markets or both. At the start of the year, we noted that investors would likely spend 2021 focused on the transition to the new administration, the vaccine-induced recovery from the recession created by the COVID-19 pandemic and the "next normal" environment to which the economy would emerge.

[V]ACCINES

- COVID-19 case counts remain relatively contained
- Vaccine distribution is growing
- GDP and earnings are returning to normal

[I]NFLATION

- Inflation is rising, but not yet concerning
- Fed remains unlikely to respond soon

[P]UBLIC POLICY

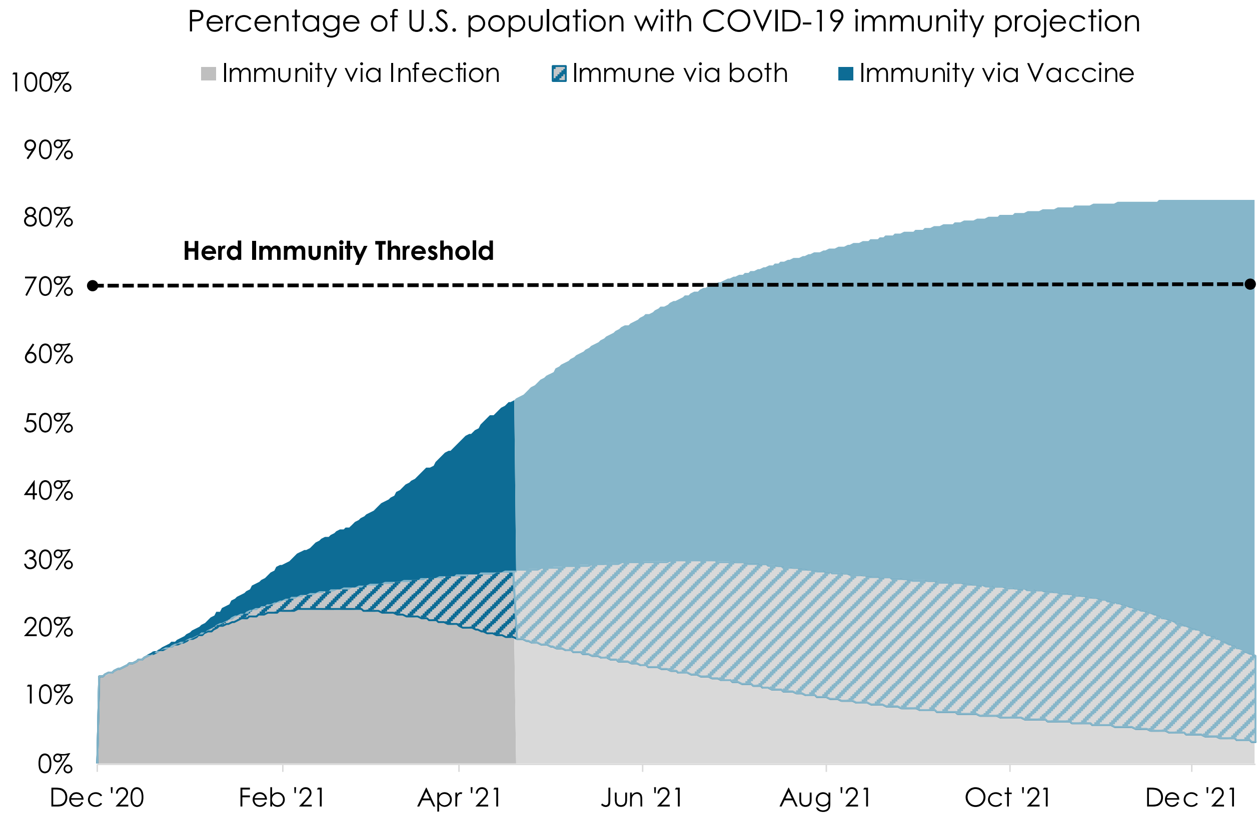
- Fiscal policy is stimulative on the whole in 2021
- Corporate tax increases likely

These themes are still timely, but the investment conversation has been refined to focus on vaccines, inflation and public policy. Accelerating vaccine distribution and the transition to more normal economic behavior underpin much of the market's moves since the middle of last year. This economic improvement and the fiscal and monetary stimulus that have helped the market along have led to a rise in inflation and in inflation expectations that is now creating its own discussion and concerns about magnitude. Lastly, public policy has been substantial in filling the hole in the economy left by the pandemic, but at a very high cost. While the much-needed stimulus substantially supported the economy, the next policy discussions will center on tax increases meant to bring the government budget back toward balance.

Vaccinations — To herd immunity ...

As of mid-April, over 30% of the U.S. population had been vaccinated on top of the approximate 25% of the population immune to COVID-19 due to previous infection. This brings the total percentage of the population immune to COVID to nearly 60% (Exhibit 1). We are not surprised to see the projection of this share reaching the 70% herd immunity threshold[1] by early summer, given the pace of vaccinations.

EXHIBIT 1: Vaccine-driven herd immunity appears possible by summer



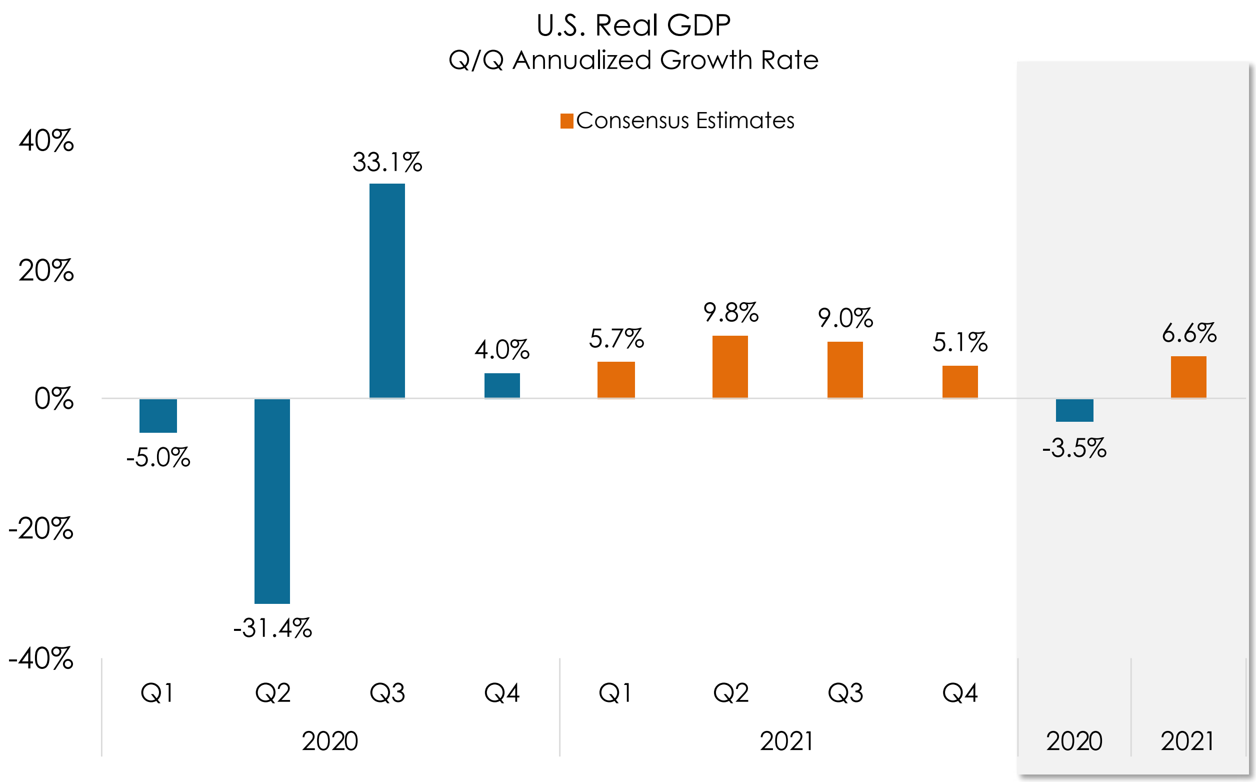
Sources: Glenmede, Bloomberg, Centers for Disease Control and Prevention (CDC), Johns Hopkins University *Data through 4/25/2021*

Data shown are Glenmede's estimates for the percentage of U.S. population with COVID-19 immunity, either via infection (gray) or vaccination (blue) or both (diagonal lines). Dark shaded colors represent reported data and light-shaded colors represent Glenmede's projections. Projections assume that immunity obtained via infection lasts for one year, first doses have a 70% efficacy rate, second doses have a 95% efficacy rate, and those not willing to take the vaccine starts at 25% of the population but falls to 10% over time. Actual results may differ materially from projections.

Of course, herd immunity and its threshold are rather nebulous data points given the lack of statistics on the percentage of immune individuals transmitting the disease and the evolution of different variants. However, the concept and its directional impact on the pandemic are not so squishy. At higher levels of population immunity, the virus and its variants will be less likely to cause as many serious illnesses and deaths, and the transmission of the disease from one person to another will slow. We may already be seeing this dynamic at work in the reported case count numbers, which have declined materially from their winter highs.

[1] The World Health Organization defines herd immunity as the indirect protection from an infectious disease that happens when a population is immune either through vaccination or immunity developed through previous infection. Often, a percentage of the population must be capable of getting a disease in order for it to spread, called a threshold proportion. If the proportion of the population that is immune to the disease is greater than this threshold, the spread of the disease will decline. This is known as the herd immunity threshold.

EXHIBIT 2: Consensus expectations show much stronger growth in 2021



Source: Glenmede *Estimates as of 4/15/2021*

Consensus estimates are an average of U.S. GDP forecasts from various economists. Blue bars represent actual results; orange bars represent estimates. These figures are projections which, though arrived at in good faith, are not guaranteed. Actual results may differ materially from projections.

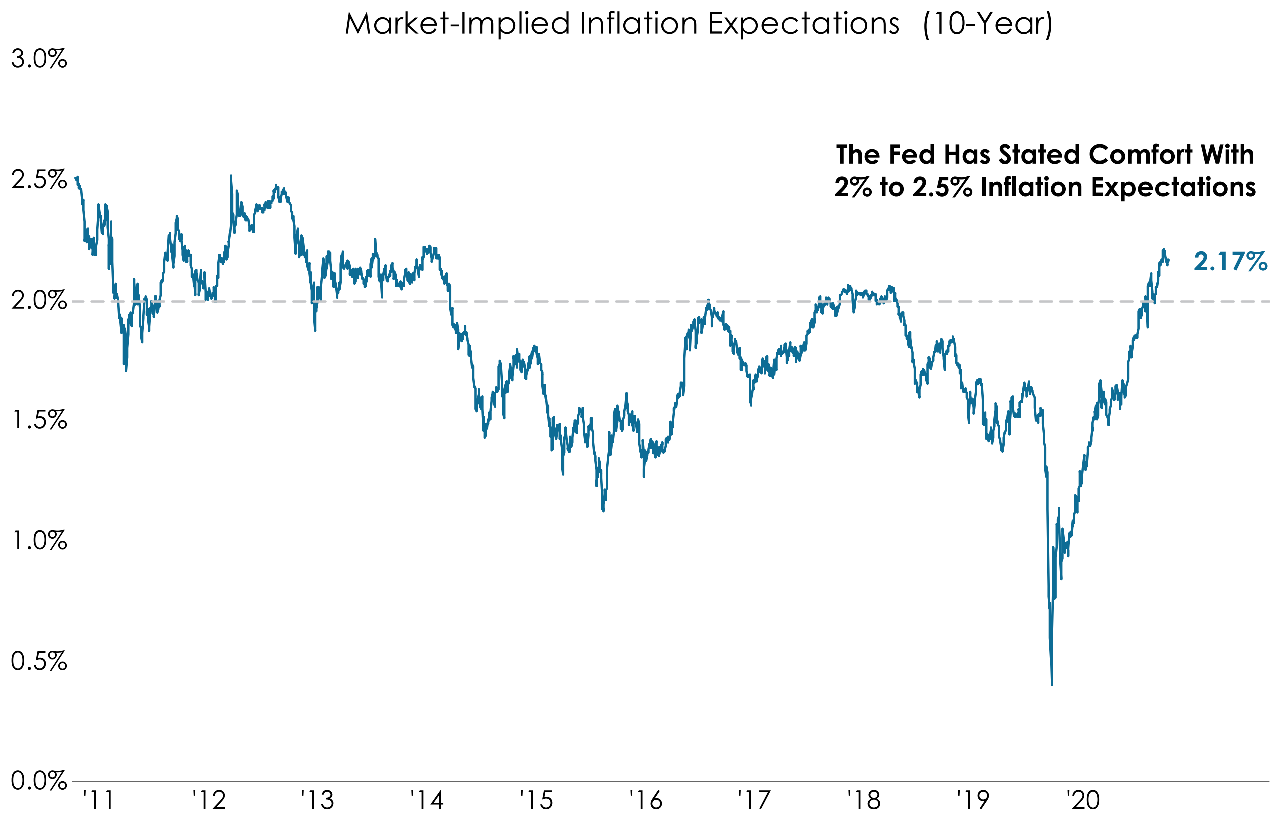
This accelerated distribution of the vaccines and the decline in COVID-19 cases have aided a broader and sustained reopening of an economy now bordering on recovery. In sharp contrast to last year's 3.5% decline in GDP, the economic consensus is now for a rise of over 6.5% in 2021, partly a reflection of the ongoing reopening as well as the boost to the economy provide by significant fiscal stimulus (Exhibit 2).

Are inflation fears warranted or overstated?

The narrative of the markets has turned to inflation in 2021. Market-implied inflation expectations have surged from their mid-2020 lows of below 1.0% to over 2.0% (Exhibit 3). Further, the U.S. headline Consumer Price Index (CPI) and Producer Price Index (PPI)[2] rose 2.6% and 4.1%, respectively, on an annual basis in March. The rise in inflation and in inflation expectations has triggered concern about further surges in inflation that may be more detrimental to the economy and market valuations.

[2] The CPI is a price index that measures the average prices of a basket of consumer goods and services, such as transportation, food and medical care. The PPI is a price index that measures the average prices received by domestic producers for their output, inclusive of intermediate goods. Both indexes are produced by the U.S. Bureau of Labor Statistics.

EXHIBIT 3: Inflation rising, but unlikely to reach concerning levels

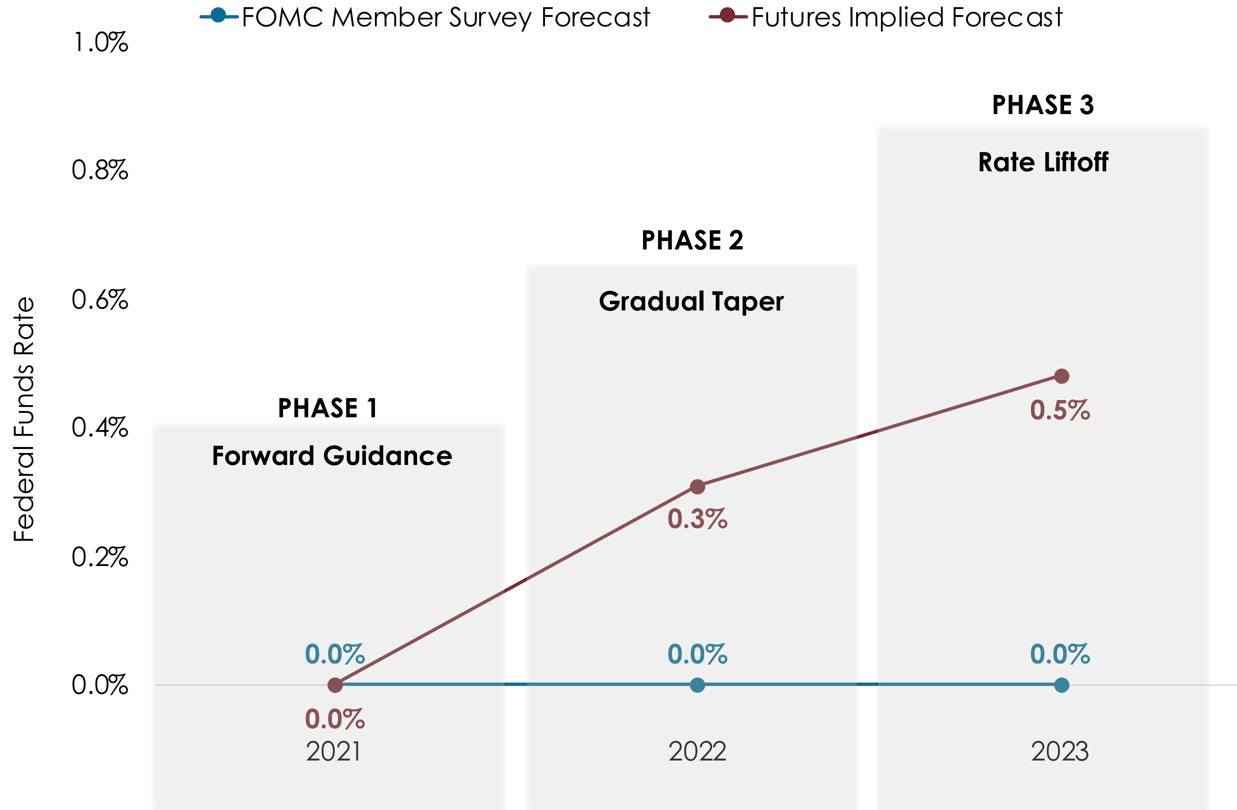


Source: Glenmede *Data through 4/15/2021*

Market-Implied Inflation Expectations (10-Year) are based on an equally weighted average of inflation expectations implied by 10-year inflation swaps and inflation implied by the relative yields on 10-year Treasury bonds and 10-year Treasury Inflation-Protected Securities (TIPS). All inflation expectations are adjusted to be congruent with the Fed's preferred inflation target, Personal Consumption Expenditures (PCE) inflation. Past performance may not be indicative of future results. Actual results may differ materially from market-implied expectations.

However, investors and prognosticators may need to hold back their urge to extrapolate these trends so far into the future. A good portion of the rise in inflation and inflation expectations is due to the embedded year-over-year comparables from the typically more volatile energy component. Thus, some of the higher reported inflation may be more transitory in nature due to the base effect from declining prices in March/April of last year.

EXHIBIT 4: Supportive monetary policy continues; Fed to transition slowly



Source: Glenmede, Bloomberg *Data through 4/1/2021*

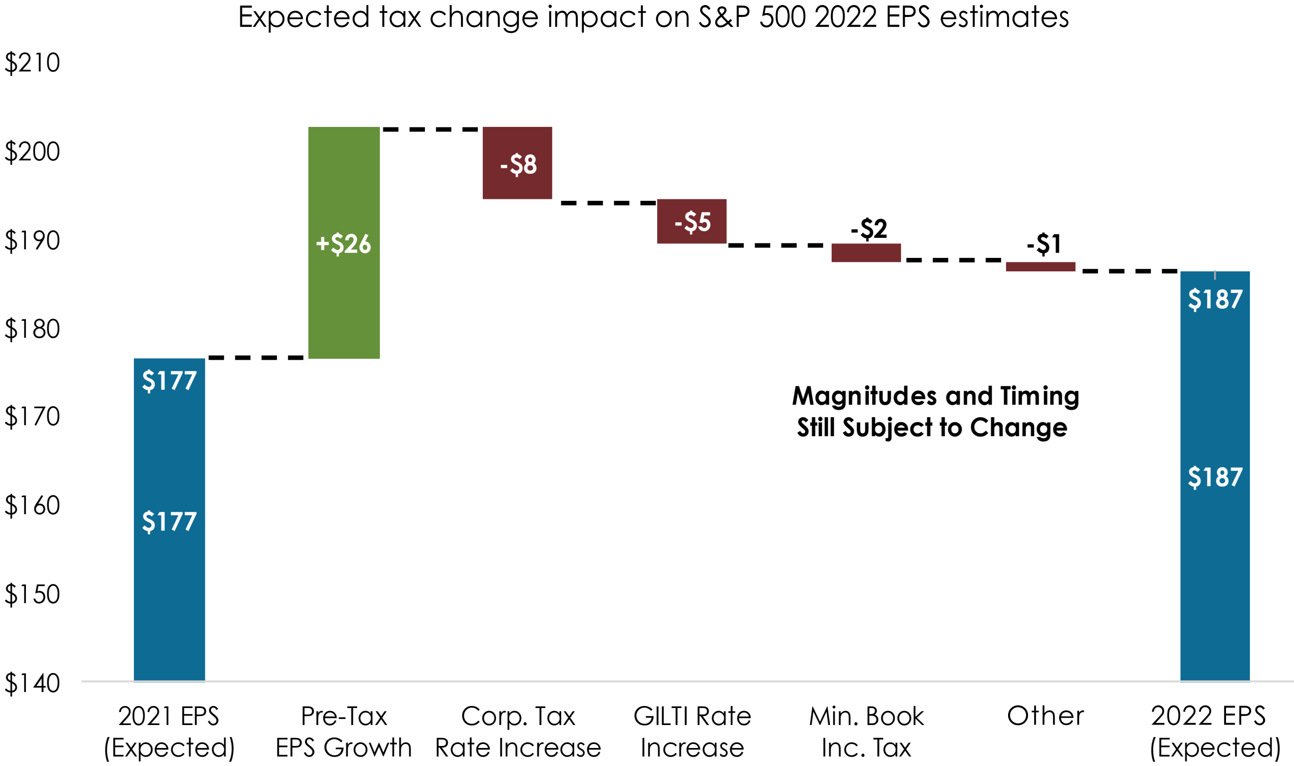
"Member Survey Forecast" represents the median voters' projections for the federal funds rate for year-end 2021, 2022 and 2023 via the Federal Open Market Committee's Summary of Economic Projections, as reported in March 2021. "Futures Implied Forecast" represents the level of the federal funds rate priced in via Federal Funds Futures contracts for year-end 2021, 2022 and 2023. Actual results may differ materially from projections.

Federal Reserve Chairman Jerome Powell has made it clear that the Fed intends to tolerate above-average inflation (over 2%) for a period of time before considering raising interest rates. While market expectations seem to point to an initial but slow rate liftoff by early 2022, our expectation remains that the federal funds rate is likely to remain anchored at 0% through 2022, and that most of 2022 will be allocated toward gradually tapering Fed bond purchases as a more measured removal of the significant monetary stimulus provided during the pandemic (Exhibit 4).

Public policy: Infrastructure or impending tax regime change?

The U.S. legislative agenda, with a series of large spending bills passed and some still on the table, remains a focal point in 2021. President Biden recently unveiled the American Jobs Plan, focused on $2 trillion of infrastructure spending. Key components of the plan meet traditional definitions of infrastructure, such as roads, bridges, ports, airports and transit systems, but the plan goes a few steps further by including provisions for broadband internet access, green energy generation and affordable housing, among others. However, unlike the past few rounds of fiscal stimulus, the upcoming bills will likely spread the spending out over multiple years and include funding sources such as tax increases that will, in part, offset the stimulative effects of the spending. As a result, the plan's stimulative effects would likely be felt mostly beyond 2021 to the tune of ~1.2% of U.S. GDP for the next eight years, but may be almost entirely offset by the impact of the corporate tax hike components of the bill.

EXHIBIT 5: As proposed, the Biden tax plan could shave ~9% off 2022 earnings

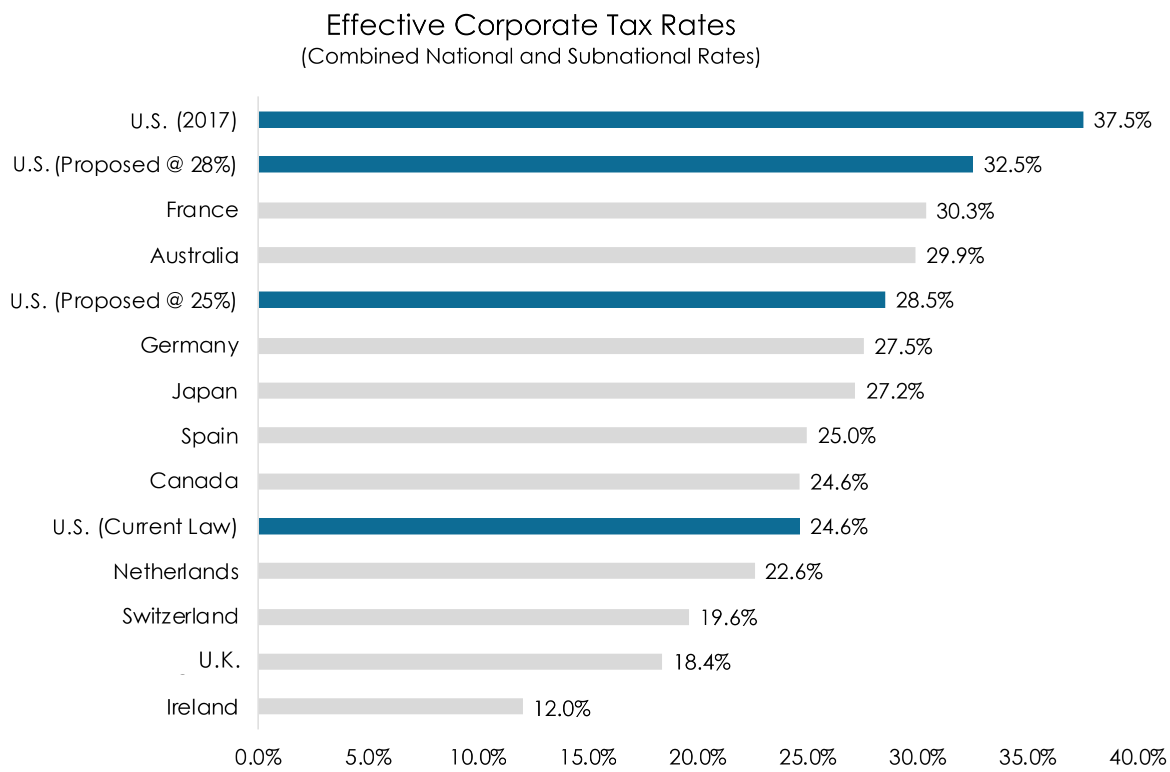


Sources: Glenmede, FactSet, Cornerstone Macro *Data through April 2021*

2021 EPS (Expected) refers to 2021 EPS estimates for the S&P 500. Pre-Tax EPS Growth refers to expected EPS growth based on 2022 consensus estimates for the S&P 500. Corp. Tax Rate Increase refers to the impact of increasing the statutory rate from 21% to 28%. GILTI Rate Increase refers to an increase from 11% to 21% of the global intangible low-taxed income rate. Min. Book Inc. Tax refers to a proposed 15% minimum tax rate on the book income of corporations. Other refers to the total impact from additional tax changes likely to be included in the final tax bill. 2022 EPS (Expected) refers to 2022 EPS estimates for the S&P 500. Corporate tax changes are based on estimates provided

The latest proposal calls for raising the corporate tax rate to 28%, along with an assortment of adjustments such as increasing the global intangible low-taxed income (GILTI) rate and instituting a minimum 15% tax on the book income for companies with over $2 billion in annual revenue. The proposed tax hikes would take a ~9% bite out of expected 2022 earnings for the S&P 500 (Exhibit 5). It is important to note, however, that due to the ongoing recovery from the pandemic and the impact of fiscal spending lifting the economy and top-line revenues for companies, earnings are still expected to grow in 2022 through this headwind.

EXHIBIT 6: Proposed changes may increase U.S. tax rates among peers



Sources: Glenmede, Tax Foundation *Data as of 4/9/2021*

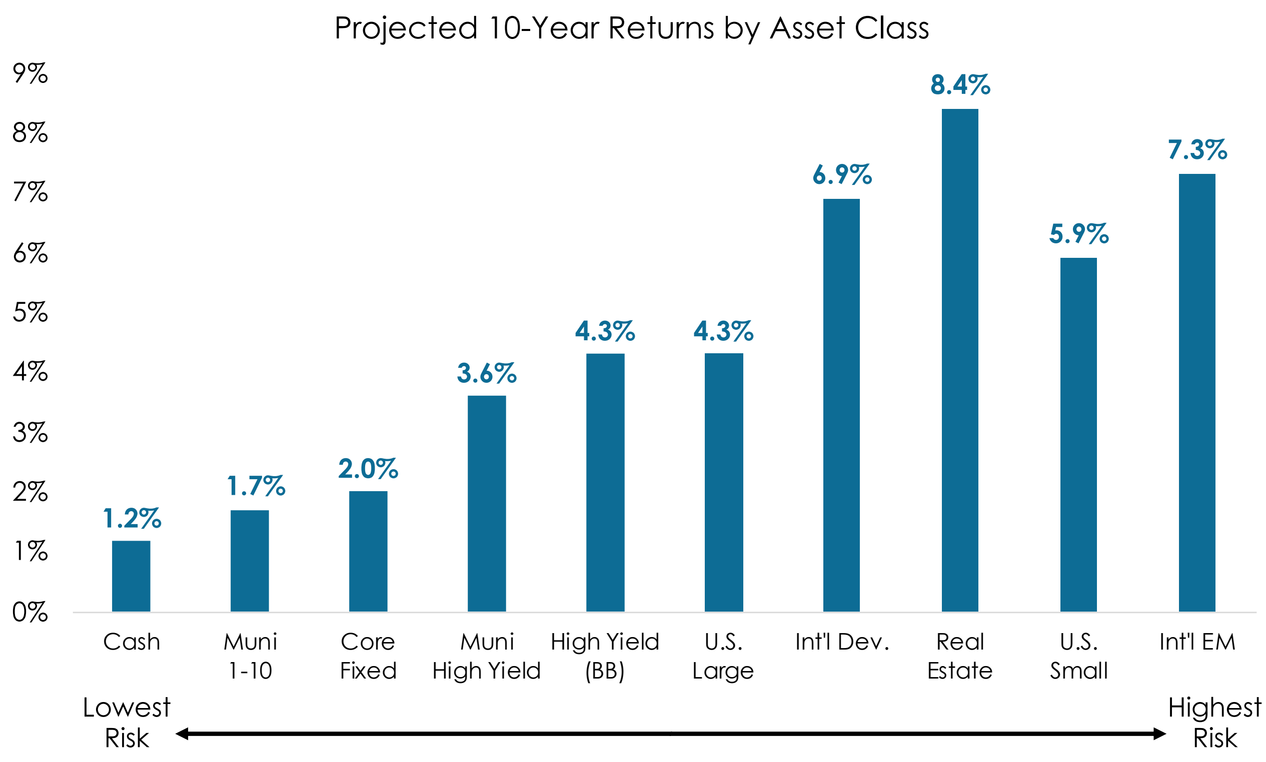
The dataset captures standard average effective corporate income tax rates for domestic companies in each country in 2019. Effective tax rates include the impact of statutory corporate tax rates as well as other provisions, exemptions and subsidies. U.S. (Current Law) represents the average effective corporate income tax rate in 2019. U.S. (2017) represents the average effective corporate income tax in 2017. U.S. (Proposed @ 25% or 28%) assumes an increase in the federal statutory corporate tax rate to either 25% or 28%, GILTI taxes, minimum book income tax and other provisions laid out in the Biden tax plan.

These proposed tax changes may be well intentioned to fund spending agendas and bring corporate taxes back to perceived fair rates. However, an unintended consequence could be a decline in the competitiveness of U.S. companies. Depending on the magnitude of the corporate tax rate increases, the effective corporate tax rate in the U.S., taking into account the various tax components, could end up being close to the highest if not the highest effective tax rate relative to its global peers (Exhibit 6).

Investment strategy: Maintain neutral risk exposure and be selective

The rise in financial markets has reduced our expected forward returns for most asset classes, but the incremental additional return attained by holding higher-risk investments remains relatively reasonable (Exhibit 7). However, this is a generalization given the disparity in valuations and expected returns. U.S. Large-Cap remains dearly priced by investors, leading to lower long-term expected returns by our estimation. U.S. Small-Cap appears more reasonably priced, but far less reasonably priced than when we made our overweight recommendation last year. International stocks, both developed and emerging, appear more attractive relative to their domestic alternatives, and Real Estate appears positioned to offer the best value on both a nominal and risk-adjusted basis. Meanwhile, our expected returns on fixed income have risen materially with the increase in rates but remain lower than would trigger us to recommend an increased allocation. As such, we continue to recommend a neutral allocation to risk within portfolios, an underweight to U.S. Large-Cap equity and overweights to U.S. Small-Cap and Real Estate.

EXHIBIT 7: Riskier assets offer reasonable compensation for additional risk



Sources: Glenmede, FactSet *Data as of 4/15/2021*

Data shown are Glenmede's proprietary estimates for 10-year expected returns for a number of asset classes. Proxy indexes for each asset class are as follows: Cash (Bloomberg Barclays Treasury Bellwethers 3M), Muni 1-10 (Bloomberg Barclays Municipal Bond 1-10 Index), Core Fixed Income (Barclays U.S. Aggregate Index), Muni High Yield (Bloomberg Barclays Muni High Yield 2% Issuer Cap), Corp High Yield (Bloomberg Barclays U.S. Aggregate Credit Corporate High Yield BB Index), U.S. Large (MSCI USA Index), Int'l Dev (MSCI EAFE Index), Real Estate (FactSet's Global Real Estate Investment Trusts industry grouping), U.S. Small (Russell 2000 Index), Int'l EM (MSCI EM Index). Risk is measured by standard deviation of historical annual returns. These figures are projections which, though arrived at in good faith, are not guaranteed. One cannot invest directly in an index.

What could cause us to reassess

We created this focused list of economic and market drivers not just to underpin our expectations but also to inform our awareness of associated risks. The table below outlines the summary of our observations and expectations on the left and the potential developments we are watching on the right. The ongoing vaccine rollout appears on track and the proliferation of virus variants seems manageable, but both deserve ongoing monitoring. Inflation is expected to rise but is unlikely to experience a sustainable surge above 3%; however, such a surge, if it were to happen, could prompt the Fed to take earlier action on the monetary policy front than expected. Tax policy changes appear to be en route but need to be sized and timed appropriately so as not to stifle the recovery and U.S. competitiveness. Lastly, financial markets continue to evolve quickly, and changes in valuations and bond yields could prompt us to respond with allocation changes as noted.

Observations	What We're Watching
Vaccines	**Vaccines**
• COVID-19 case counts relatively contained • Vaccine distribution is growing • GDP and earnings are returning to normal	• Material failures with vaccine distribution • Proliferation of virus variants that are more contagious and/or vaccine resistant
Inflation	**Inflation**
• Inflation is rising, but not yet concerning • Fed remains unlikely to respond soon	• Accelerating inflation that prompts the Fed to early action
Public Policy	**Public Policy**
• Fiscal policy is stimulative on the whole in 2021 • Corporate tax increases likely	• Timing and sizing of tax policy changes relative to fiscal spending
Investment Strategy	**Investment Strategy**
• Equity markets appear overvalued • Favor U.S. Small-Cap • Overweight Real Estate • Maintain neutral risk positioning	• Small-Cap stocks reaching extreme valuations • Larger-than-expected recovery for most impacted sectors/industries • Material rise in yields on longer-term bonds

These statements reflect Glenmede's opinions or projections, which may change after the date of publication. Actual future developments may differ materially from the opinions and projections noted above.

Such simplification may not be quite the equivalent of Einstein's genius, but by establishing this list of the most important economic and market drivers and identifying key items that may cause us to reassess, we prepare ourselves for both an environment that includes our base case as well as one that does not.

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