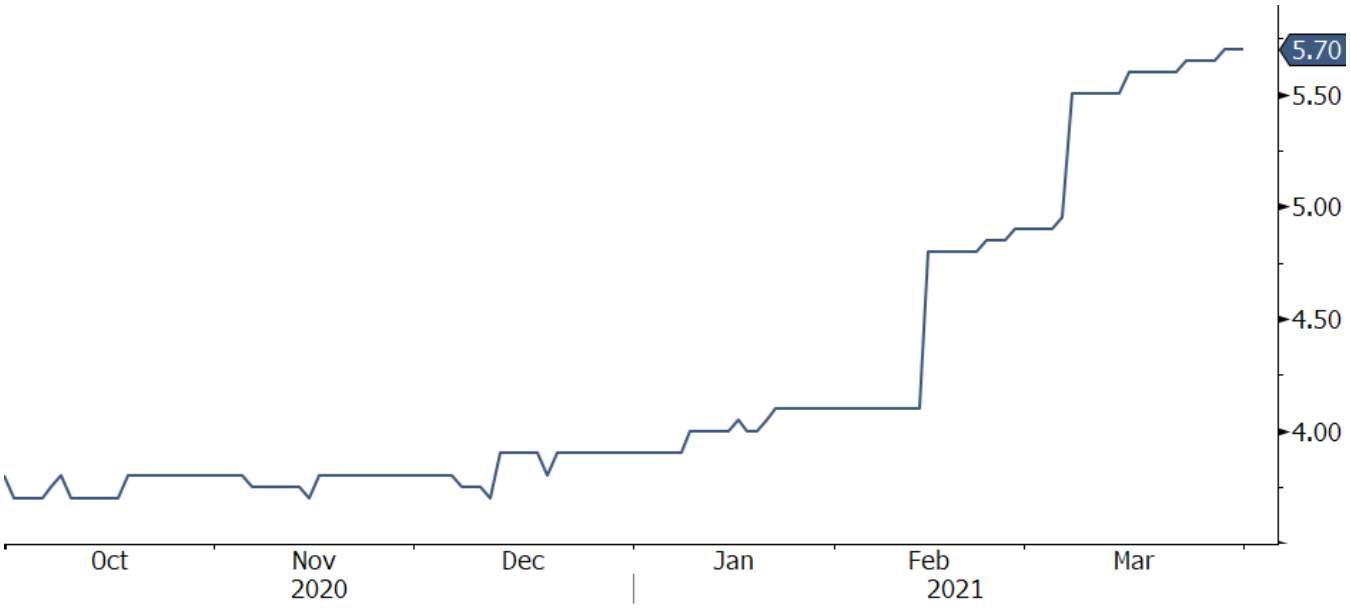
QUARTERLY REPORTS | 04.14.2021

2021 First Quarter Review

The first quarter was strong for stocks as the MSCI All Country World Index rose 4.6%. Economic optimism surged as an acceleration in the vaccine rollout coupled with passage of the American Rescue Plan ($1.9 trillion economic stimulus bill) bolstered economic growth forecasts for 2021.

Two key themes that were important this quarter include the outlook for inflation, and the recent performance shift from growth to value. We start with the inflation topic. The chart below tracks expectations for 2021 GDP growth from surveyed economists since last December. In October, they had modest expectations for growth. After the passage of the American Rescue Plan was assured, there was an almost 30% increase in annual GDP expectations to 5.7%. This is the highest annual GDP forecast we have seen in over two decades of these surveys.

U.S. 2021 GDP Consensus Forecast



Source: Bloomberg. Dates are as of 9/30/2020 – 3/31/2021.

Prospects for stronger growth spurred interest rates higher, and the U.S. 10-Year Treasury yield nearly doubled, ending the quarter at 1.7%. When prevailing interest rates go up, existing bonds become less valuable. The Barclays Aggregate Bond Index declined 3.1% through March, driven by a decline in the price of these bonds. At the same time, the increase in interest rates and the strength of the economic recovery raised questions about future inflation. Although one can never discount the possibility of inflation moving materially higher and becoming an issue, we currently agree with the Federal Reserve that any spurt of inflation will be relatively short-lived — or delayed beyond next year — for the reasons set out below.

While bond yields moved higher, they still remain well below levels seen as recently as 2019 when the 10-Year Treasury yield was in

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the 2-3% range. The Federal Reserve sets the discount rate (the short-term interest rate banks charge each other to make loans overnight), but market forces help determine longer-term yields, which factor in expectations for future inflation. These longer-term yields are still not at a high level, as compared with recent years.

U.S. 10-Year Treasury Yield



Source: Bloomberg. Dates are as of 3/31/2016 – 3/31/2021.

Unemployment is declining but there remains significant slack in the labor markets. As shown in the chart below, the current unemployment rate of 6% is still well above pre-pandemic levels and has a lot of room to come down. This is important to consider because typically, inflation does not pick up materially until labor markets are much tighter.

U.S. Unemployment Rate

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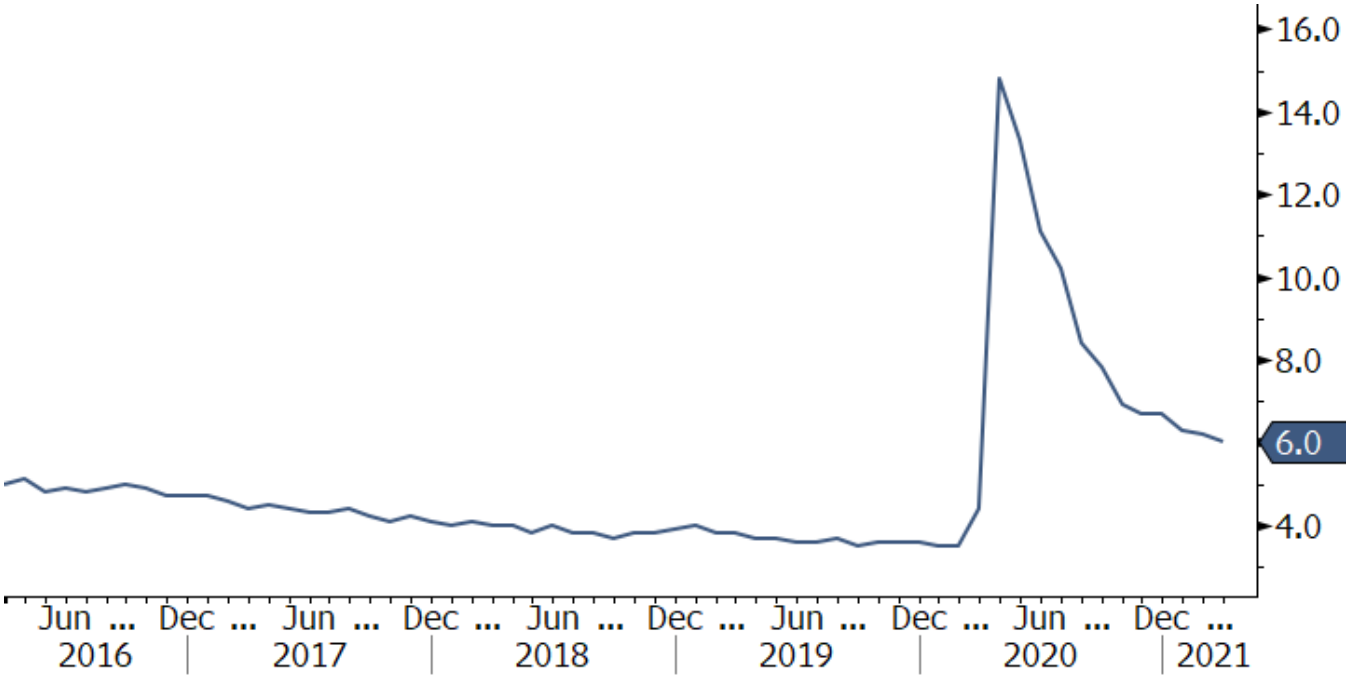

Source: Bloomberg. Dates are as of 3/31/2016 – 3/31/2021.

Unemployment only measures those actively seeking employment, so it is important to also track labor participation rates that capture additional labor slack. The chart below highlights labor force participation rates for individuals aged 25-54 (the core of the labor market) which removes any impact from demographic shifts. These rates are still below both the pre-pandemic levels as well as the pre-Global Financial Crisis level.

U.S. Labor Participation Rate for Persons Aged 25-54

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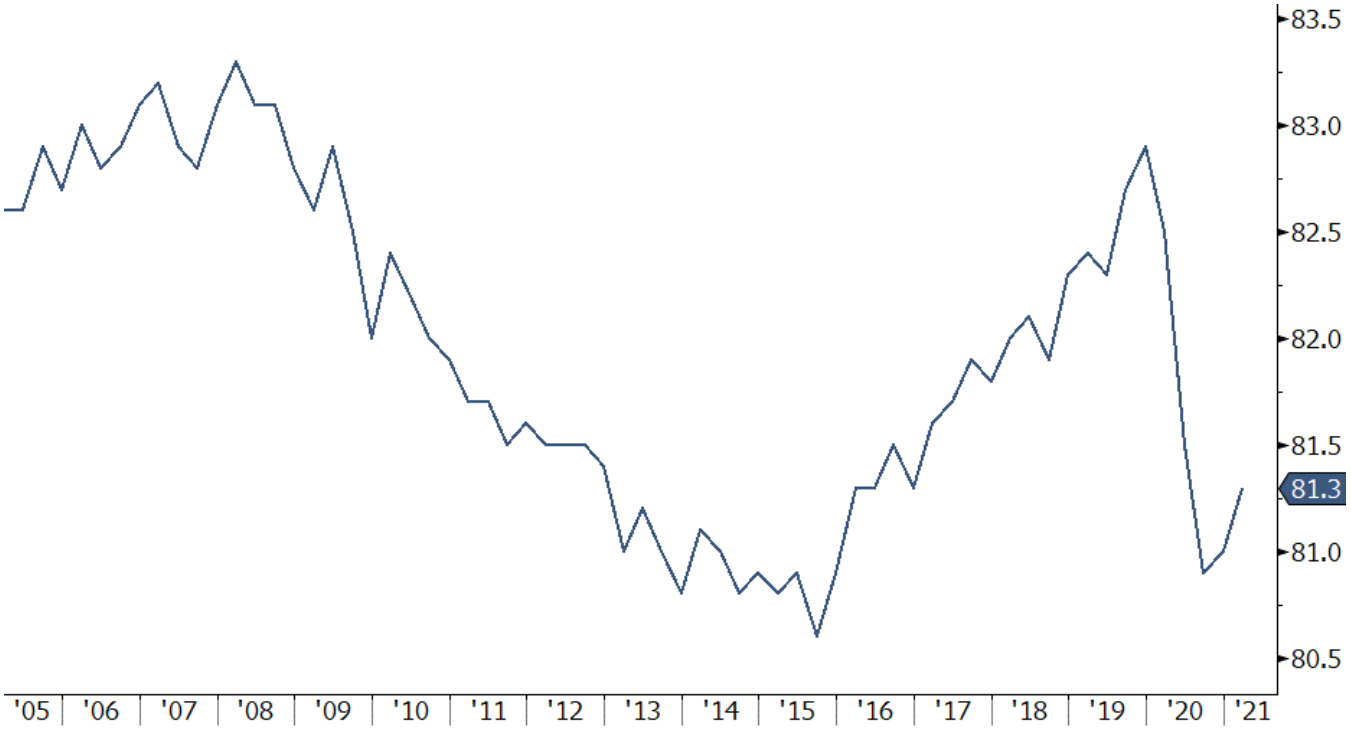
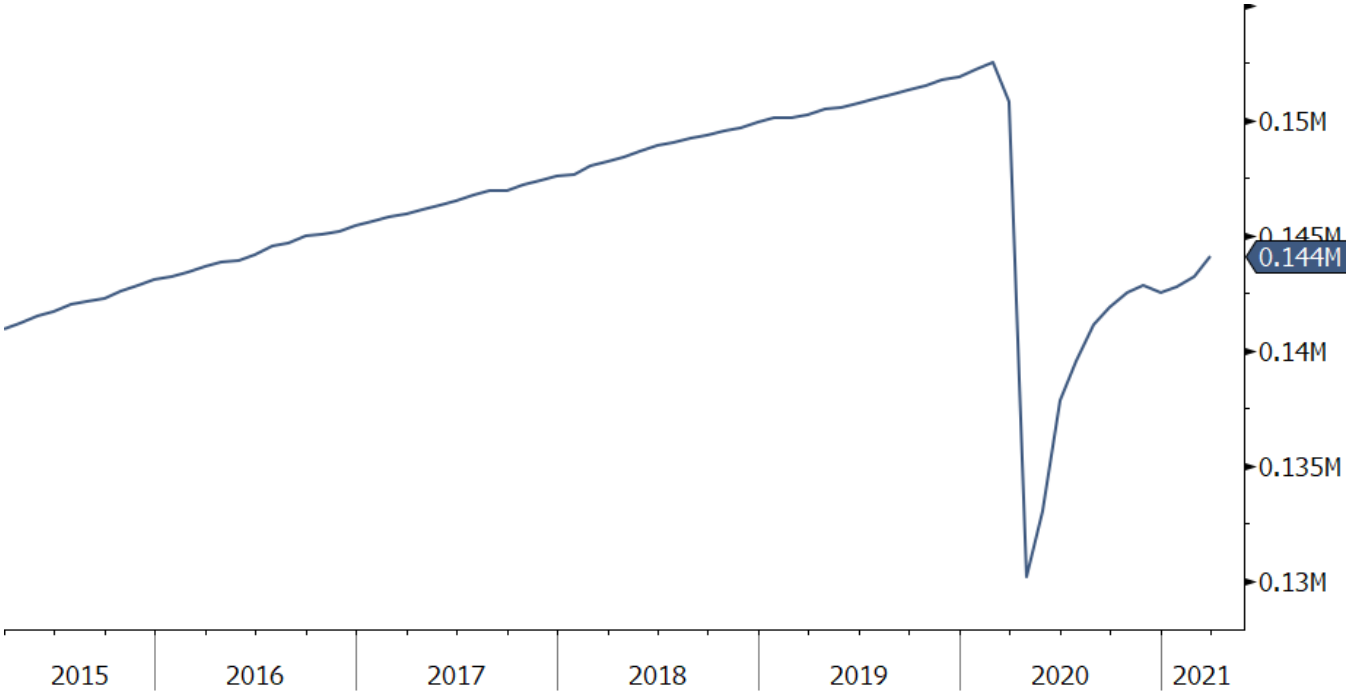


Source: Bloomberg. Dates are as of 3/31/2005 – 3/31/2021.

Another key data point to consider is U.S. non-farm payrolls, which combines the impact of a higher unemployment rate and a lower participation rate. As shown below, it is evident that the total of people employed is still well below pre-pandemic levels

U.S. Non-Farm Payrolls



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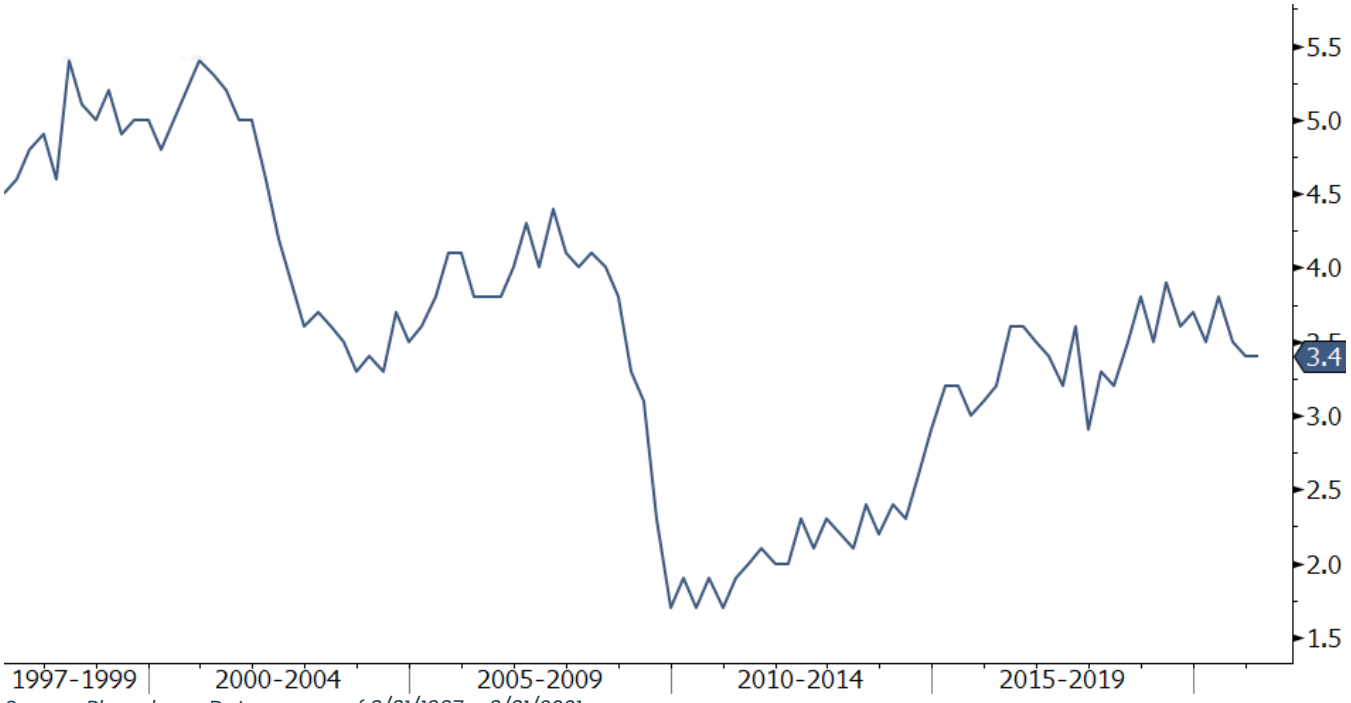
Source: Bloomberg. Dates are as of 3/31/2015 – 3/31/2021.

Wage growth is a necessary component for sustained inflation, and we think that labor markets would need to tighten significantly before they would set the table for rapid wage growth. Currently, median wage growth remains well below levels seen during the 1990s boom and even below the level before the 2008 global financial crisis.

U.S. Median Wage Growth



Source: Bloomberg. Dates are as of 3/31/1997 – 3/31/2021.

A significant wildcard for investors is the future path for U.S. household savings. Currently, household savings are at a multi-decade high, as shown in the chart below.

U.S. Household Savings as % of Income

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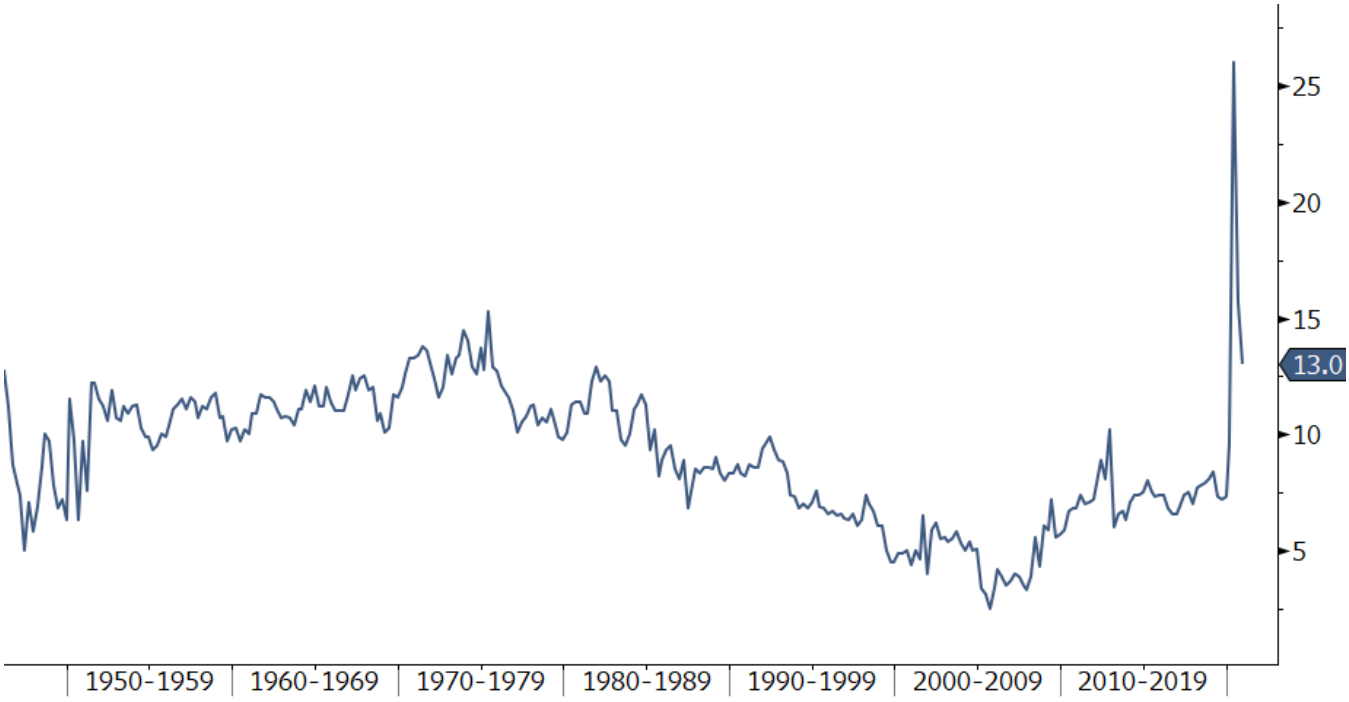

Source: Bloomberg. Dates are as of 12/31/1945 – 12/31/2020.

Are these savings considered "excess" or "hoarding" by individual households? If so, will Americans spend down their "excess" savings? How quickly and to what level? We do not know the answer to these questions — but we do believe there is the potential for significant additional demand for goods and especially services. It was clear that the consumption of many services was curtailed last year, and a key variable will be how quickly this segment of the economy returns to normal. This is important because services are about 2/3 of total economic spending. If this potential demand picks up, we could see an increase in inflation. As the chart below shows, personal service consumption remains 4.5% below the level seen at the end of 2019.

U.S. Personal Services Consumption

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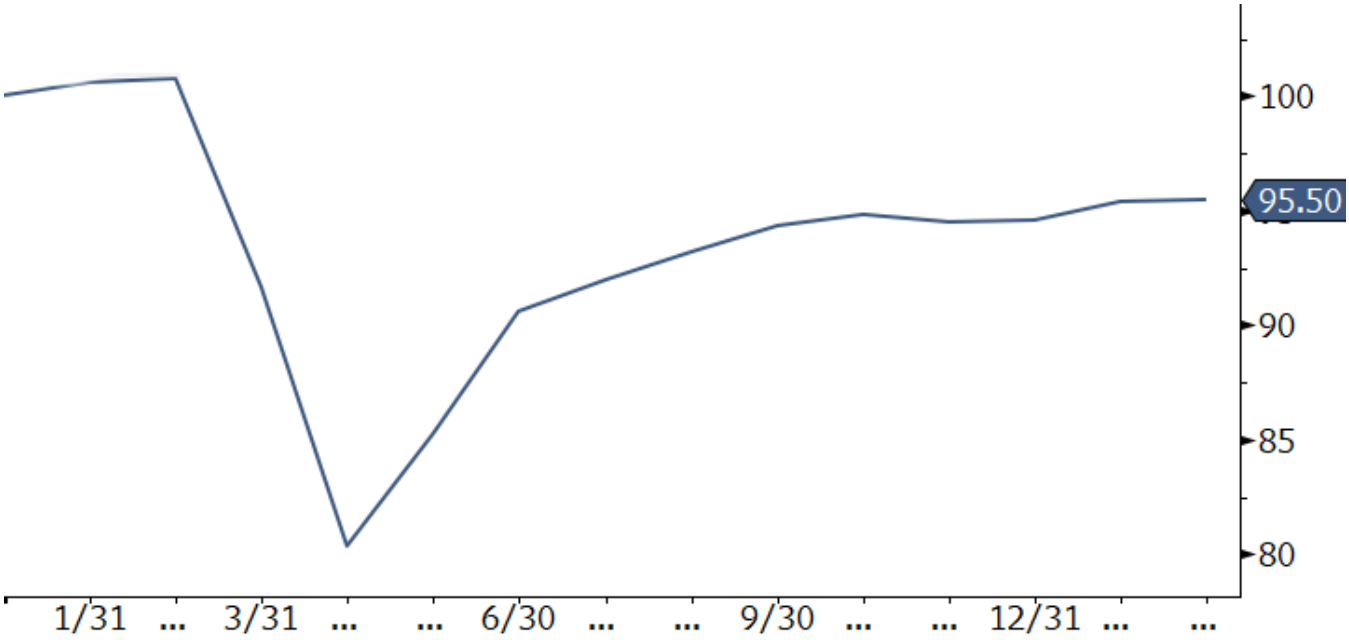

Source: Bloomberg. Dates are as of 12/31/2019 – 3/31/2021.

As a result of all of these data sources, we believe that there may be a pickup in inflation in the near term as the economy returns back to a steady state, but that renewed inflation is not likely to be a long-term trend.

Another key factor we have been watching closely is the tradeoff between growth stocks and value stocks. In our Q4 2020 update we highlighted:

In shifting economic environments such as this one, more cyclical companies – that we do not have as much exposure to – may be in favor with investors and thus may perform well over the near term. Value stocks in industries such as materials, energy, and financials could do well in 2021, as investors focus on a cyclical recovery and economic normalization. For this reason, after a year where our secular growers significantly outperformed, it is possible that our overall equity portfolios may lag in 2021. We intend to continue our approach of investing in high-quality and profitable growth companies, while continuing to research growth franchises that exist in these value-oriented sectors of the economy.

A rotation of this nature to more cyclical stocks did take place in the first quarter of this year. There was significant separation between returns of the Russell 1000 Growth Index and returns of the Russell 1000 Value Index, essentially beginning once passage of the American Rescue Plan stimulus was assured.

Year-to-Date Performance (S&P 500, Russell 1000 Growth, Russell 1000 Value)

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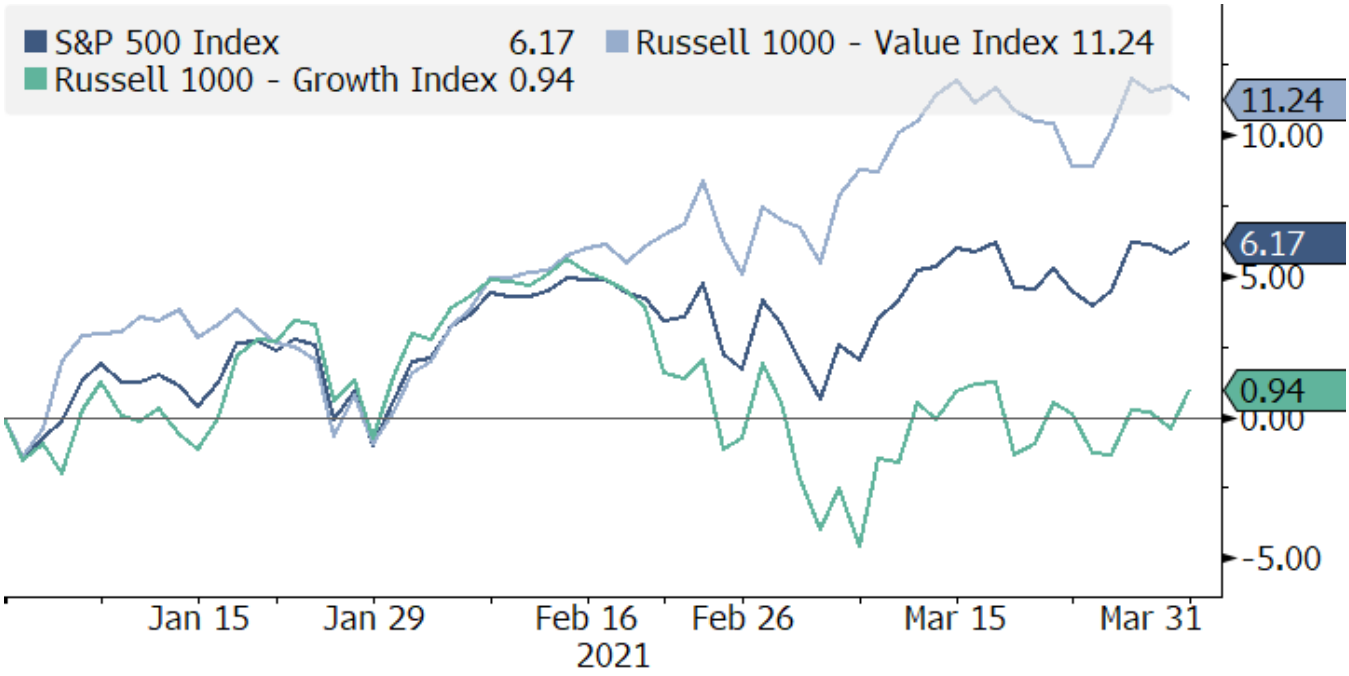
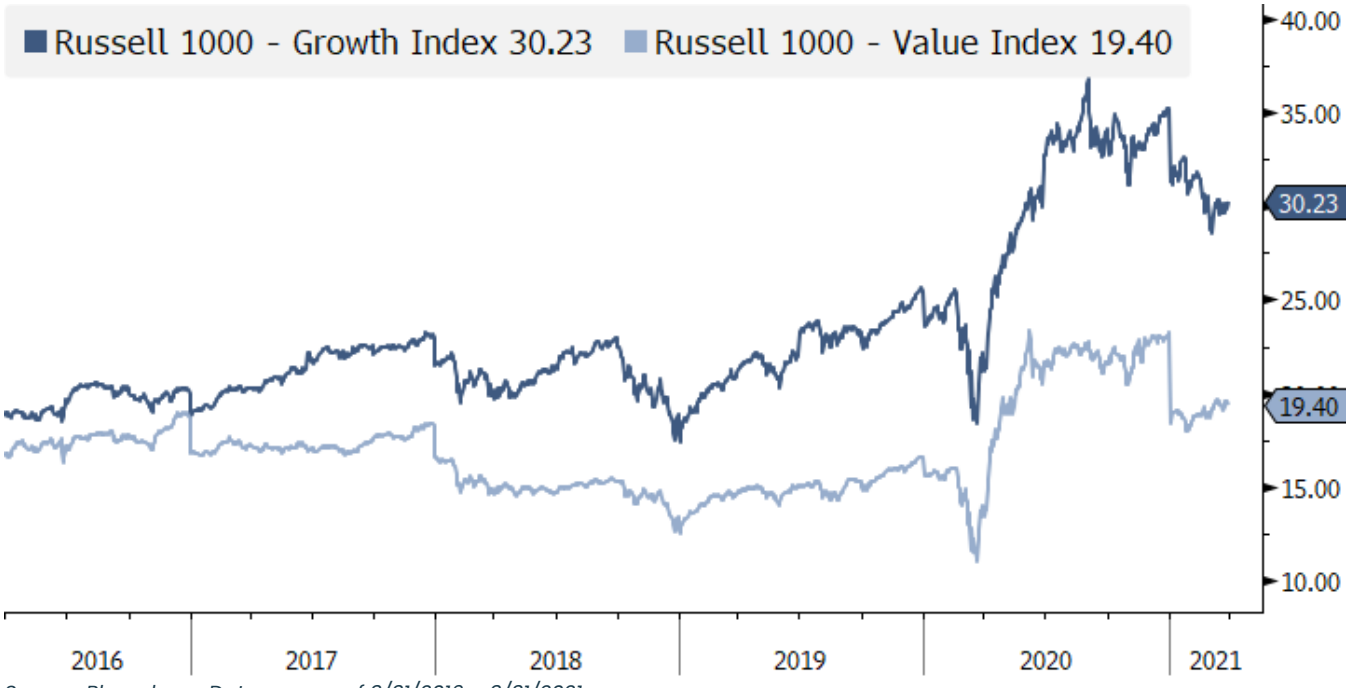


Source: Bloomberg. YTD as of 3/31/2021.

We view this as a partial unwinding of the price to earnings multiple premium that the Russell 1000 Growth Index received in 2020. In that year, the growth index outperformed the value index by over 35% driven by an expansion in the growth index's price to earnings multiple.

Price to Earnings Multiple (Russell 1000 Growth and Russell 1000 Value)



Source: Bloomberg. Dates are as of 3/31/2016 – 3/31/2021.

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Investors often point to the divide between "growth" or "value" as a fixed law of investing. Growth companies are expected to grow earnings at above-average rates. Historically, investors are willing to pay a higher multiple for companies that are increasing earnings at a faster than average pace and therefore, growth stocks tend to be more expensive and trade at a higher price to earnings multiple. Investors also tend to pay a premium for the predictability of earnings, so not all expensive stocks are growth stocks. Currently, these types of "growth" companies are clustered in the technology and healthcare sectors. In the past many technology firms used to be more cyclical, but more recently the expansion of technology into every activity and device, plus the shift to software as a service (SaaS) has made these firms more predictable. Healthcare is typically not a cyclical sector. The chart below shows the current breakdown of the Growth Index by sector, along with the change since five years ago.

Sector Composition of Russell 1000 Growth

Top Sector (%)	Current	5 Years Ago	Change (%)
Information Technology	44.16%	20.86%	*23.30%*
Consumer Discretionary	16.48%	15.65%	*0.83%*
Health Care	13.65%	16.63%	*-2.98%*
Communication Services	11.87%	15.21%	*-3.34%*
Industrials	4.72%	11.03%	*-6.31%*
Consumer Staples	4.47%	10.73%	*-6.26%*
Financials	1.90%	2.75%	*-0.85%*
Real Estate	1.71%	2.92%	*-1.21%*
Materials	0.80%	3.51%	*-2.71%*
Energy	0.09%	0.51%	*-0.42%*
Utilities	0.02%	0.05%	*-0.03%*

Source: Bloomberg as of 3/31/2021 and 3/31/2016.

As you can see in the chart above, the sector weights in the Russell 1000 Growth Index have significantly shifted over the last five years, and the share of technology has grown from 20% to 44%. In addition, the success and dominance of some of the large technology firms means that the Growth Index is also quite concentrated, with the top ten holdings representing over 44% of the entire index. Five years ago in 2016, the top holdings were more diversified and only represented about 24% of the entire Index. It is also interesting to note that Walt Disney was one of the top holdings in 2016 in the Russell 1000 Growth Index, and Walt Disney is now a top 10 holding in the Russell 1000 Value Index.

Top 10 Holdings in the Russell 1000 Growth Index (2016 versus 2021)

2016 Top Holdings (%)		2021 Top Holdings (%)	
APPLE INC	5.97	APPLE INC	10.43
MICROSOFT CORP	2.41	MICROSOFT CORP	9.52
FACEBOOK INC-CLASS A	2.35	AMAZON.COM INC	7.07
AMAZON.COM INC	2.15	FACEBOOK INC-CLASS A	3.81
ALPHABET INC-CL A	2.09	TESLA INC	2.76
ALPHABET INC-CL C	2.08	ALPHABET INC-CL A	2.59
VERIZON COMMUNICATIONS INC	1.95	ALPHABET INC-CL C	2.52
COCA-COLA CO/THE	1.73	VISA INC-CLASS A SHARES	1.93
HOME DEPOT INC	1.65	NVIDIA CORP	1.70
WALT DISNEY CO/THE	1.60	MASTERCARD INC - A	1.69
Total	23.98	**Total**	44.02

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Source: Bloomberg as of 3/31/2016 (left) and 3/31/2021 (right).

Conversely, value companies are categorized as companies with below-average price to earnings (P/E) and price to book (P/B) multiples as compared with the overall market. Stocks that trade at lower multiples may have lower earnings growth, but a lower multiple could also stem from opaque financial statements, higher leverage, cyclicality or even weak investor sentiment. Most investors value consistency of earnings and fear high levels of debt on a company's balance sheet. Thus banks, energy companies and other cyclical firms dominate the Value Index regardless of the earnings growth in these sectors. Cyclicality and leverage are more prominent concerns when the general state of the economy is uncertain, and these worries recede when economic growth prospects look strong.

Thus, value stocks tend to do well when the economy recovers because 1) company earnings are recovering and 2) investors are willing to pay more for those earnings as they accelerate. In turn, these types of companies typically perform worse and decline more during an economic downturn.

Sector Composition for the Russell 1000 Value Index

Top Sector (%)	Current	5 Years Ago	Change
Financials	20.57	23.28	-2.71%
Industrials	13.86	10.20	+3.66%
Health Care	12.57	12.21	+0.36%
Information Technology	9.51	10.90	-1.39%
Communication Services	9.17	4.07	+5.10%
Consumer Discretionary	7.81	4.20	+3.62%
Consumer Staples	7.08	7.28	-0.20%
Energy	5.09	12.78	-7.70%
Utilities	5.02	7.04	-2.02%
Materials	4.77	2.84	+1.93%
Real Estate	4.33	4.82	-0.50%

Source: Bloomberg as of 3/31/2021 and 3/31/2016.

Looking back at 2016 sector weights in the Russell 1000 Value Index, we can track the decline in the market capitalization of the energy sector, which fell 7.7% as an overall share of the index. More specifically, in 2016 Exxon and General Electric were the two largest names in the Value Index, but fell out of the top 10 as their share price declined. As we mentioned about Walt Disney, large companies that struggle will move out of the Growth Index and into the Value Index. This can be an opportunity if the headwinds are temporary, but can be a drag on the Value Index long-term performance if the issues are more structural. Pfizer, Johnson & Johnson, and Intel were also once growth stocks.

Top 10 Holdings in the Russell 1000 Value Index (2016 versus 2021)

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2016 Top Holdings (%)		2021 Top Holdings (%)	
EXXON MOBIL CORP	3.55	BERKSHIRE HATHAWAY INC-CL B	2.52
GENERAL ELECTRIC CO	3.04	JPMORGAN CHASE & CO	2.42
JOHNSON & JOHNSON	2.65	JOHNSON & JOHNSON	1.97
BERKSHIRE HATHAWAY INC-CL B	2.51	WALT DISNEY CO/THE	1.75
WELLS FARGO & CO	2.29	BANK OF AMERICA CORP	1.57
PROCTER & GAMBLE CO/THE	2.27	INTEL CORP	1.38
JPMORGAN CHASE & CO	2.23	COMCAST CORP-CLASS A	1.29
AT&T INC	2.07	VERIZON COMMUNICATIONS INC	1.26
MICROSOFT CORP	1.96	EXXON MOBIL CORP	1.24
PFIZER INC	1.85	CISCO SYSTEMS INC	1.15
Total	24.42	**Total**	16.55

Source: Bloomberg as of 3/31/2016 (left) and 3/31/2021 (right).

The value segment is less concentrated than the Growth Index with the top 10 holdings only accounting for 16.7% of the total Value index. As a whole, it is also dominated by financials and industrials and captures the entire market exposure to utilities, energy, and materials. This index includes more levered and cyclical stocks (which trade at a low price to book or price to earnings multiple). These securities tend to do poorly when the economy slows because earnings can quickly disappear and bankruptcy risk can rapidly rise. Conversely, these securities can do well at the onset of an economic recovery because the fear of bankruptcy recedes. Investors purchase these risky stocks at the beginning of a market recovery, but these are not securities one would hold over the long term. In other words, it is not a "value" rally but a "risk" rally, and these risky stocks are clustered in traditional "value" sectors. Our current view is that we do not want to chase a risk rally, but we will continue to monitor the market to see if a change is warranted.

As we mentioned in our last update:

At Choate Investment Advisors, we look to work with investment managers that are seeking out and investing in companies that have the potential to continue to gain market share by disrupting the status quo, and/or benefiting from secular tailwinds. We remain convinced that over time these companies will grow more rapidly than many others, and investors will ultimately benefit from such growth.

As investors, paying a premium for superior long-term growth makes sense. Global growth forecasts for the mid to long term continue to be anemic as demographics headwinds impact the U.S., China, and Europe. For example, the Congressional Budget Office is forecasting real GDP growth of 3.7% in 2021, 2.4% in 2022 but a long-term average growth rate of only 1.6% for the years 2026-2031. Therefore, finding companies that are taking share and growing faster than the baseline remains important. However, paying a premium for the heightened predictability of future earnings makes less sense.

In summary, the recent stimulus bill passage and rapid vaccine rollout are improving the U.S. economic growth outlook, while Europe and the less developed world continue to struggle. With faster economic growth and a quickening employment recovery, investors are hopeful that the traumatic Covid pandemic may actually be receding, and the return of normalcy and optimism is possible and tangible. We share this enthusiasm, while watching the horizon for sunshine or cloudy weather ahead.

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