

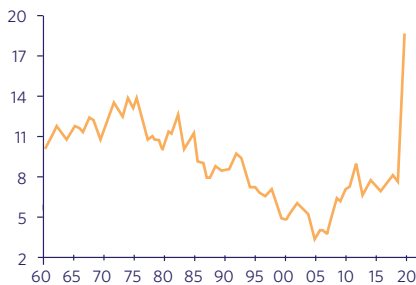
Re-Opening

The successful vaccine rollout has enabled a gradual re-opening across the United States and other parts of the developed world. A combination of money growth, wealth effect, robust earnings and monetary and fiscal stimulus is a powerful cocktail for economic growth and strong markets. The politicians' and central banks' unprecedented aggressive policies were intended to bridge economies to self-sustaining growth. We appear to be at that point.

What does this mean for investment markets? It has been observed that year two of an economic expansion tends to be better economically than year one, while year one tends to be better for the stock market than year two. The stock market looks ahead and prices in the recovery prior to it being clear if or when a recovery may occur. The market rallied hard out of the Covid lockdown last spring in anticipation of the good economic news we are seeing today. But once the recovery is clearly underway, and investors have priced in the good news, markets can be volatile as they adjust to the new reality.

CHART 1

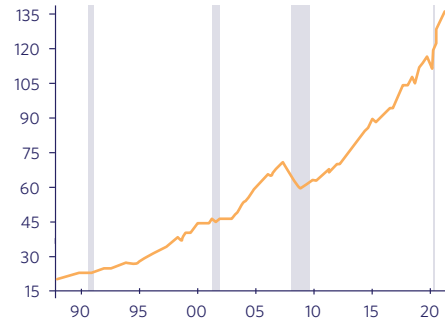
*U.S. Personal Saving Rate
12 Mo. Avg. (percentage)*



Source: Evercore ISI

CHART 2

U.S. Consumer Net Worth (\$Trillions)



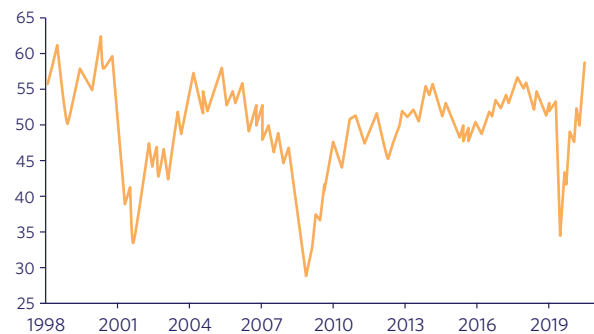
Source: Evercore ISI

The U.S. consumer has accumulated substantial savings and increased net worth over the past year. The CARES Act fiscal relief packages have created a historically high U.S. savings rate (Chart 1). U.S. consumer net worth at \$133.9 trillion is approximately twice its pre-Global Financial Crisis ("GFC") peak in 2007 (Chart 2). There is substantial financial capacity available to spend.

Companies are reporting stronger levels of activity than prior to the pandemic (Chart 3). Broader corporate surveys

CHART 3

*Evercore ISI Company Surveys
(0=weak, 100=strong)*

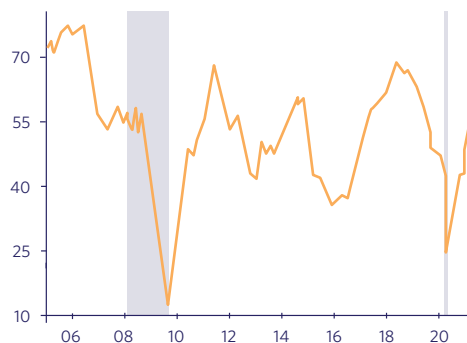


Source: Evercore ISI



are very strong, and retailer surveys are even stronger, which is not surprising based on retail sales figures (Charts 4 and 5).

CHART 6
Capital Goods Survey
4 week average (0=weak, 100=strong)

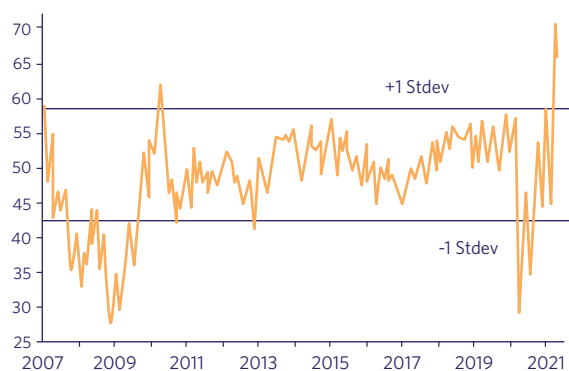


Source: Evercore ISI

Manufacturing strength isn't unique to the United States, as the global Purchasing Managers Index ("PMI") is at a 10-year high (Chart 7).

Economic activity during the pandemic was heavily tilted towards products instead of services, which suffered due to lockdowns and closures. Personal consumption of services is only halfway back to pre-pandemic levels (Chart 8). Easing of restrictions and confidence in the vaccines allows restaurants, airlines, hotels, and local businesses to re-emerge. This will be a major driver of growth in the upcoming year, as services typically represent 70% of the overall U.S. economy.

CHART 4
Evercore ISI Retailers Sales Surveys
4 week average (0=weak, 100=strong)



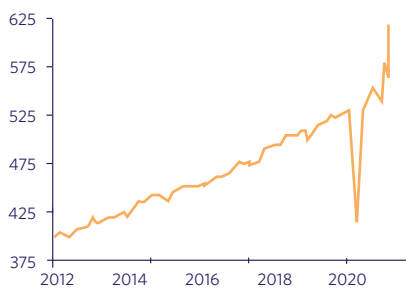
Source: Evercore ISI

CHART 7
Global Manufacturing PMI (Markit)



Source: Evercore ISI

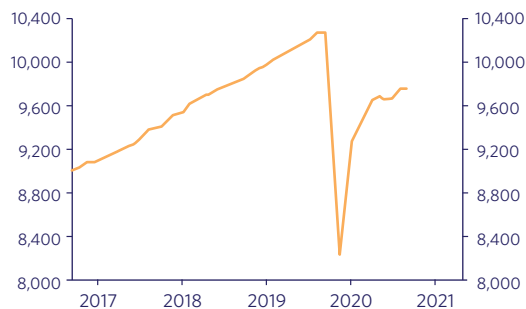
CHART 5
U.S. Nominal Retail Sales (\$Billions)



Source: Evercore ISI

Capital goods manufacturers are reporting a very strong environment (Chart 6). Along with transportation companies, they can't keep up with demand. Inventory rebuilding is underway, and manufacturing strength and capacity constraints are resulting in increased fixed investment.

CHART 8
Personal Consumption Expenditures: Services
(\$Billions)



Source: Strategas Research Group



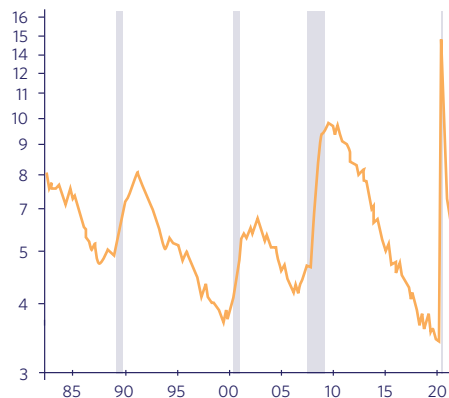
As a result of the service sector's re-opening and corporate investment, there has been a major reduction in unemployment (Chart 9). However, over 8 million Americans employed pre-pandemic remain out of the workforce. A significant employment issue seems to be finding willing workers as ongoing virus fears, online education parenting, and hefty stimulus checks are barriers for some to re-enter the labor force.

Regardless of any non-monetary factors impacting hiring, the Federal Reserve has made it clear that full employment is its primary focus. The Fed has consistently and clearly communicated its intention to maintain a very pro-growth posture for the foreseeable future. The current overnight Fed Funds rate results in a "real" or after-inflation expectations rate of -2.25%, which is historically very low and stimulative (Chart 10).

In addition to holding short-term rates near 0%, the Fed continues to purchase \$120 billion in U.S. Treasury and Agency mortgage-backed bonds per month. The Fed has almost doubled the size of its balance sheet to \$7.8 trillion since Covid hit the global economy in March 2020. The intention of buying these bonds is to reduce supply, suppress yields and therefore support economic growth. Although U.S. Treasury rates have increased somewhat from their Covid-lows, U.S. mortgage and corporate bond spreads remain at the low end of their historical range (Chart 11).

CHART 9

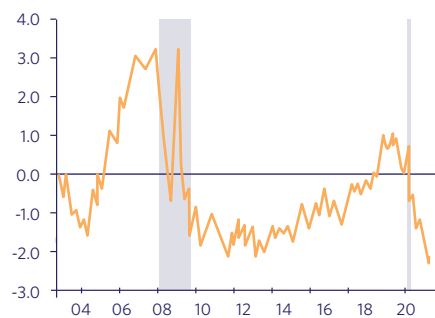
U.S. Unemployment Rate (percentage)



Source: Evercore ISI

CHART 10

Fed Funds minus Inflation Expectations (percentage)



Source: Evercore ISI

CHART 11

*U.S. 30-Year Fixed Mortgage Rate
Apr 15: 3.07%*



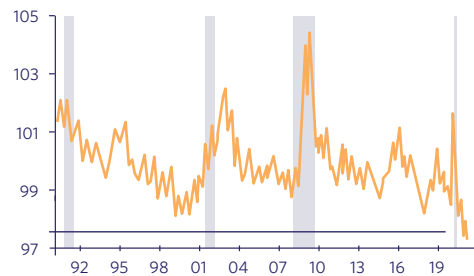
*Junk Bond Yields (Merrill Lynch)
Apr 15: 4.02%*



Source: Evercore ISI

CHART 12

Goldman Sachs Financial Conditions Index
Apr 27: 97.3



Source: Evercore ISI

Lyell Wealth Management has frequently observed how important liquidity is to economic growth and strong markets. It should be noted that, in addition to the Fed and U.S. politicians, most of the developed world's central banks and policy makers are proactively pouring liquidity into their economies. These actions have resulted in the most accommodative financial conditions for developed economies in modern history (Chart 12).

In parallel with the re-opening, U.S. household formation continues to strengthen. "Millennials" are in a demographic sweet spot as they marry and form independent households. The U.S. has experienced a steady surge over the past decade in household formation which is now hitting "Boomer" 1970s levels (Chart 13).

CHART 13

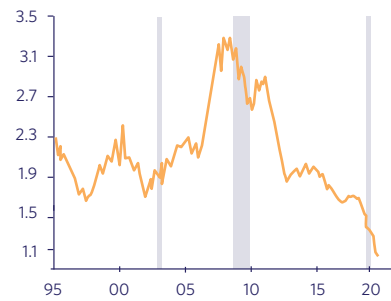
U.S. Household Formation
20 Qtr: Avg. 2020:3Q: 1.55 (Millions)



Source: Evercore ISI

CHART 14

U.S. Existing Houses for Sale (Millions)



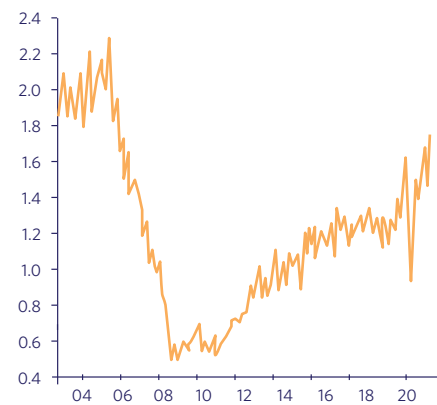
Source: Evercore ISI

U.S. house prices rose 13% during the pandemic, an enormous, and, considering the circumstances, shocking statistic. The desire for more personal space and safety led to a surge in demand, while the number of existing houses for sale is at multi-decade lows (Chart 14). It is estimated that the U.S. has a shortage of up to 4 million single-family homes. The current level of housing starts, while increasing, is still only meeting the

pace of household formation without addressing the previous shortfall (Chart 15). Due to low mortgage rates and income levels, the U.S. affordability index shows surprising consumer financial capacity to buy homes (Chart 16).

CHART 15

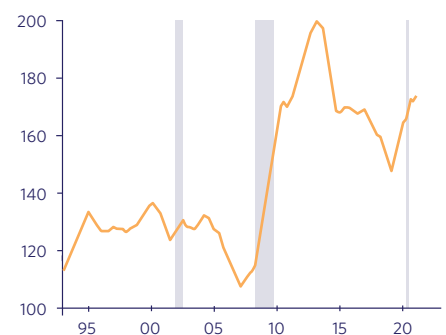
U.S. Housing Starts (Millions)



Source: Evercore ISI

CHART 16

U.S. Housing Affordability Index
12 Mo. Avg.



Source: Evercore ISI

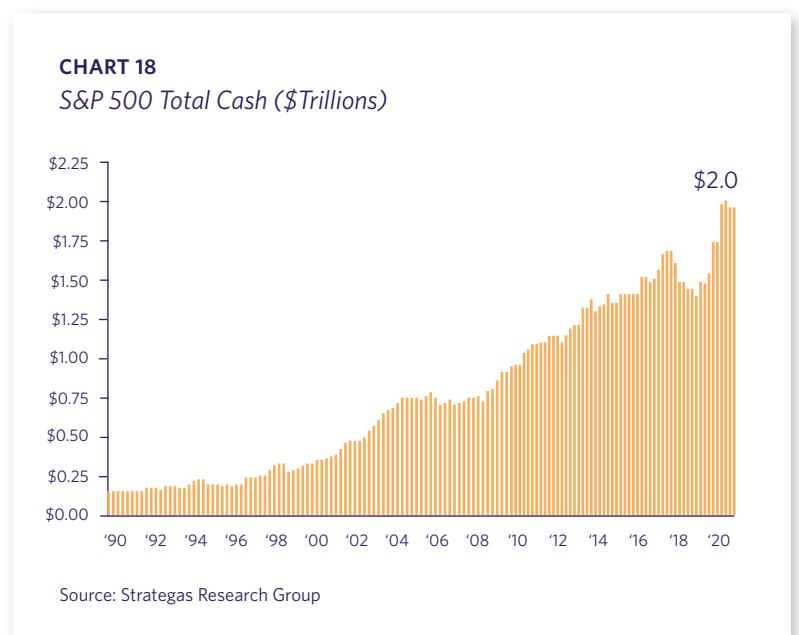
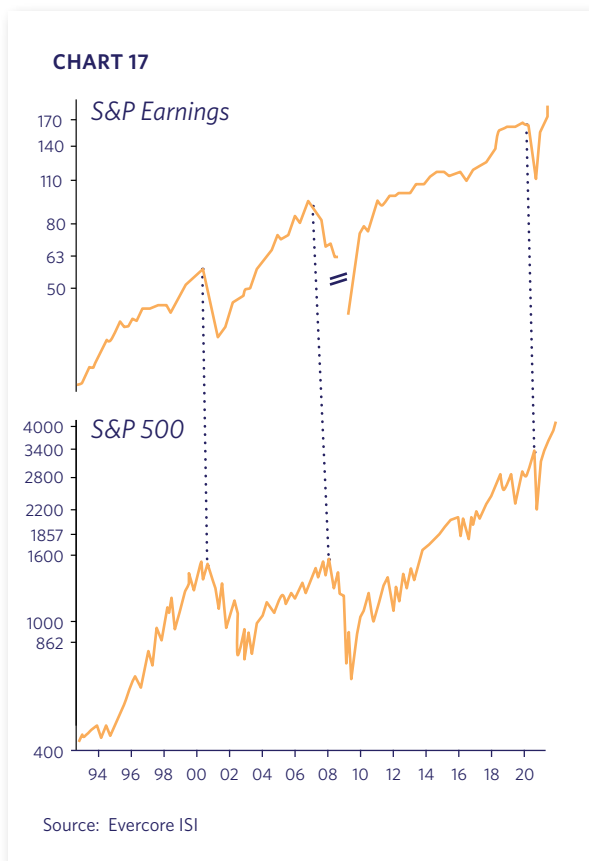


Housing construction's contribution to the overall economy cannot be overstated as it ripples through related consumer purchases and employment. This sector is a prime example of an area where self-sustaining growth has excellent prospects over the next several years.

The U.S. economy is growing at approximately a 10% pace versus the depressed 2020 comparable level. Although this rapid momentum will diminish later this year, we may still see 4% real growth in 2022. Corporate earnings expectations are rapidly being revised higher. Thus far in the Q2 earnings season, 90% of reporting S&P 500 companies have beaten earnings estimates; this is the best quarterly "beat rate" since tracking started in 1993. Evercore ISI is forecasting Q4 2022 S&P 500 earnings to increase to a \$250 run-rate from today's record \$200 pace. Stock markets typically peak after earnings peak, which suggests this bull market has years to go (Chart 17).

The large earnings growth is a result of several factors. The most valuable and largest companies, such as Alphabet, Amazon, Apple, Facebook and Microsoft, enjoy highly profitable businesses with massive cash flows. These five companies collectively increased revenues by \$250 billion over the past four quarters and will continue to thrive post-pandemic. Virtually every company is accelerating digitalization across their operations to increase efficiency and, ultimately, profitability. This uniform adoption of technology seems likely to benefit earnings in every industry for years to come. The S&P earnings' record levels can be understood in that the tech-centric "Covid winners" will continue to prosper in the years ahead, while the economically sensitive companies depressed during the pandemic will deliver staggeringly better financial results.

S&P 500 companies hold approximately \$2 trillion in cash on their balance sheets which is just below the all-time high. This large cash hoard provides the capacity to buy back stock, pay down debt or invest in future growth (Chart 18).



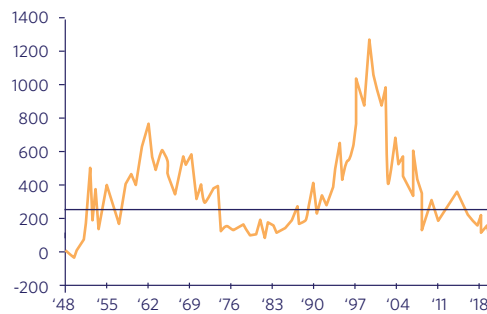


In addition to stock market peaks typically occurring after earnings peak, the number of stocks trending up usually declines prior to index tops. For example, when the market peaked in March 2000, only 35% of the S&P 500 stocks were trading above their 200-day moving average. Nine of the eleven industry sectors had “broken down” in terms of trend and momentum. Conversely, the number of S&P 500 stocks currently trading over their 200-day moving average exceeds 90% and all eleven sectors have positive trend and momentum. Minor corrections certainly can occur from this kind of strong market breadth, but a market top from these conditions would be unprecedented.

The past two quarters have seen a strong rotation to economically cyclical and “value” stocks from “growth” stocks. The financial, energy, industrial and materials sectors have been re-rated from their depressed pre-vaccine prices. It is Lyell Wealth Management’s view that some of these companies, such as housing-related ones, can continue to enjoy prolonged success. However, we also think many competitively well-positioned “Covid winners” will continue to succeed as well. We don’t see this as an either/or market as earnings growth and liquidity support both.

While the U.S. stock market has appreciated impressively in recent years, it is interesting to take a long-term return perspective. Looking back over the post-WWII era, the present 20-year rolling returns for the S&P 500 are slightly over 200% which is the low end of the historic range (Chart 19).

CHART 19
S&P 500: 20 Year Rolling % Change



Source: Bespoke Research Group

While the data gives Lyell Wealth Management a constructive view towards the economy and markets, there are some areas of concern. If the importance of liquidity is one lesson learned over the years, another is market positioning. Regardless of the merit, when too many investors support a theme, narrative or investment, a shake-out or retracement tends to occur. With this in mind, the recent flow into stocks is a concern. The amount of equity ETF flows by rolling 12-month sums has exceeded the January 2018 high, which unsurprisingly shortly preceded a market correction (Chart 20).

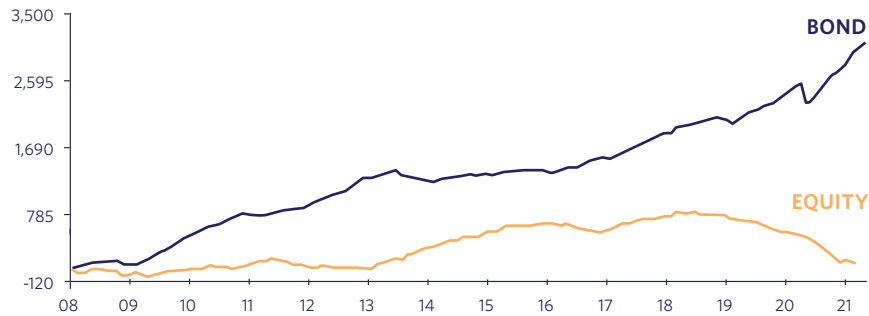
CHART 20
Equity ETF Flows
Rolling 12-Month Sum, (\$Millions)



Source: Strategas Research Group

CHART 21

Cumulative Net Flows into Equity vs. Bond Mutual Funds & ETFs
\$BN, 1/1/08 through 3/31/21



Source: Strategas Research Group

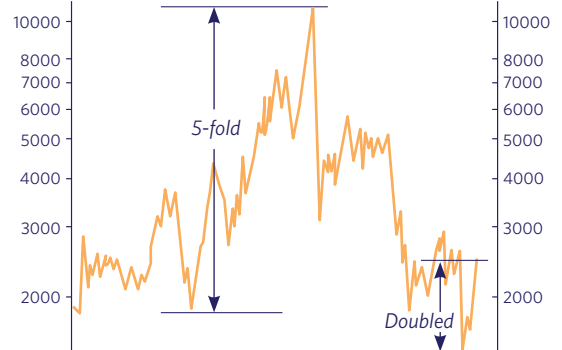
It is important to note, however, that the ETF and mutual fund cumulative flows from 2009 through Q1 2021 is overwhelmingly slanted towards bonds versus equities. Over this 12+ year period, fixed income and money market funds took in over \$3.1 trillion versus only \$200 billion in stock funds and ETFs (Chart 21). It's possible that the past year's heavier allocation into equities could only be the beginning of a "great rotation" from bonds and cash to stocks.

The large amount of fiscal and monetary activity is unprecedented. There are concerns that inflation may exceed the Fed's comfort level at some point, leading to a surge in interest rates. Prices are spiking in many commodities, ranging from lumber to industrial metals to corn. In our view, the Fed will excuse virtually all inflation data in the near-term as transitory, as their primary focus is on maximizing employment. There is justification for this approach, as we have seen several episodes over the last 20+ years in which massive commodity price increases have not led to similarly large moves in the Fed's preferred inflation measure (Chart 22). Fed tightening this year seems very unlikely, although it is probable that U.S. Treasury yields will be allowed to normalize to pre-covid levels over the next several quarters. We expect this normalization process will generate periodic stock market volatility, but not derail the rally.

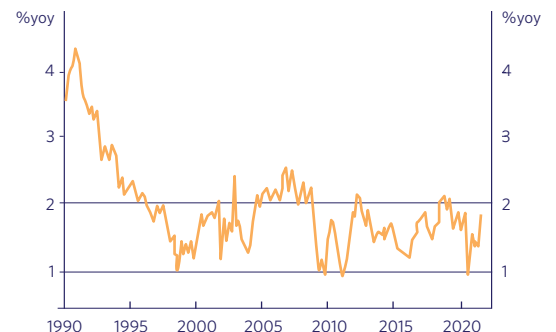
The U.S. is running extraordinarily high fiscal deficits, which would seem to be a problem eventually. For now, we take comfort that the USD remains the world's reserve currency and the U.S., despite its many challenges, is viewed positively versus many other potential capital destinations. The consensus forecast is for the USD to decline, but we place

CHART 22

S&P Goldman Sachs Commodity Index



U.S. Core PCE Deflator

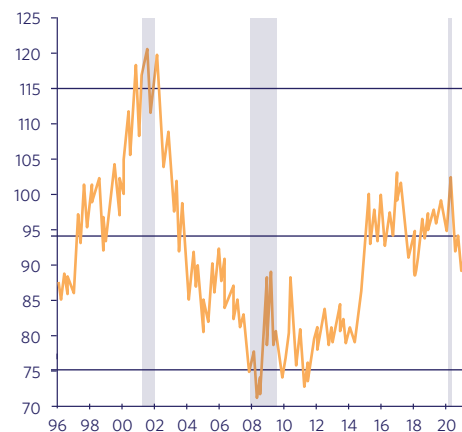


Source: Alpine Micro

little weight on these predictions. Forecasting currencies is notoriously challenging, and the economy is generally resilient to all but the most extreme currency moves. For perspective, the USD's current trading level is near the midpoint of the past 25 years, and there doesn't appear to be a near-term reason for alarm (Chart 23).

CHART 23

U.S. Dollar Trade-Weighted Index (DXY)



Source: Evercore ISI



Another area of concern is the frothy, speculative parts of the market best exhibited by crypto currencies, Special Purpose Acquisition Companies (“SPACs”) and the “swarm trading” exemplified by the GameStop episode. Excessive speculation inevitably follows loose monetary and/or fiscal policies, of which we have both. “Good” bubbles result in overinvestment in sectors that ultimately accelerate future economic growth. Over the past 150 years, the U.S. had good bubbles in industries such as electric utilities, railroads, automotive manufacturers, and communications infrastructure. We are likely seeing some good bubbles today with Alternative Fuels and Storage, Electric Vehicles and Infrastructure, Space, and Crypto/Digital Currencies/Blockchain. Many of the individual investments will ultimately prove worthless, but the surviving companies and technologies will become important drivers of the global economy in the decades ahead. In recent years we have had rolling bubbles expand and contract with minor ripples through the overall economy and markets. The current bubbles appear likely to cause similarly small waves when they eventually pop. We continue to monitor these emerging industries as some will eventually be investable for our clients.

Lastly, the tax and regulatory environment is shifting with the changes in the Presidential administration and Senate. The regulatory environment is moving back more to what the U.S. experienced during the Obama years. President Biden’s proposed tax changes seem likely to be negotiated down as some Congressional Democrats are expressing reservations on certain aspects. It is worth noting that only 25% of U.S. stocks are owned by accounts subject to taxes, with the remainder in tax-exempt and tax-deferred vehicles. However, the market is not priced for the passage of his entire proposal. If that were somehow achieved, it would involve an adjustment in stock prices.

Our belief is that the economy and markets will continue to expand for quite some time. There are reasons for concern in the form of inflationary pressures, tax uncertainty and most likely higher interest rates. But substantial liquidity, a healing job market and excess savings built up over the last year should provide a cushion against the inevitable speedbumps we experience over the next few years. That said, the “easy” returns in the market are likely behind us. Policymakers, corporations and investors will now find themselves facing the usual array of pros and cons that every economic cycle experiences. Managing through those headwinds will inevitably lead to volatility and uncertainty. As always, we encourage our clients to set aside ample liquidity to tide them through the difficult times and allow them to sleep better at night, while also maintaining an investment allocation that will provide growth over time.



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