commonfund

Fiscal Year-End and Mid-Year 2021
Market and Investment Review

July 7, 2021

The new fiscal year beginning July 1st will mark Commonfund's fifty-year anniversary – and what a memorable year it has been. As we write this letter, we are hopeful that the new year will bring positive developments and that progress towards getting "back to normal" will continue both in the U.S. and around the world. Rather than rehashing all the challenges of the past year, this letter will look forward as we anticipate where the markets will go coming out of what was decidedly an unusual year.

Things are Looking (Mostly) Up

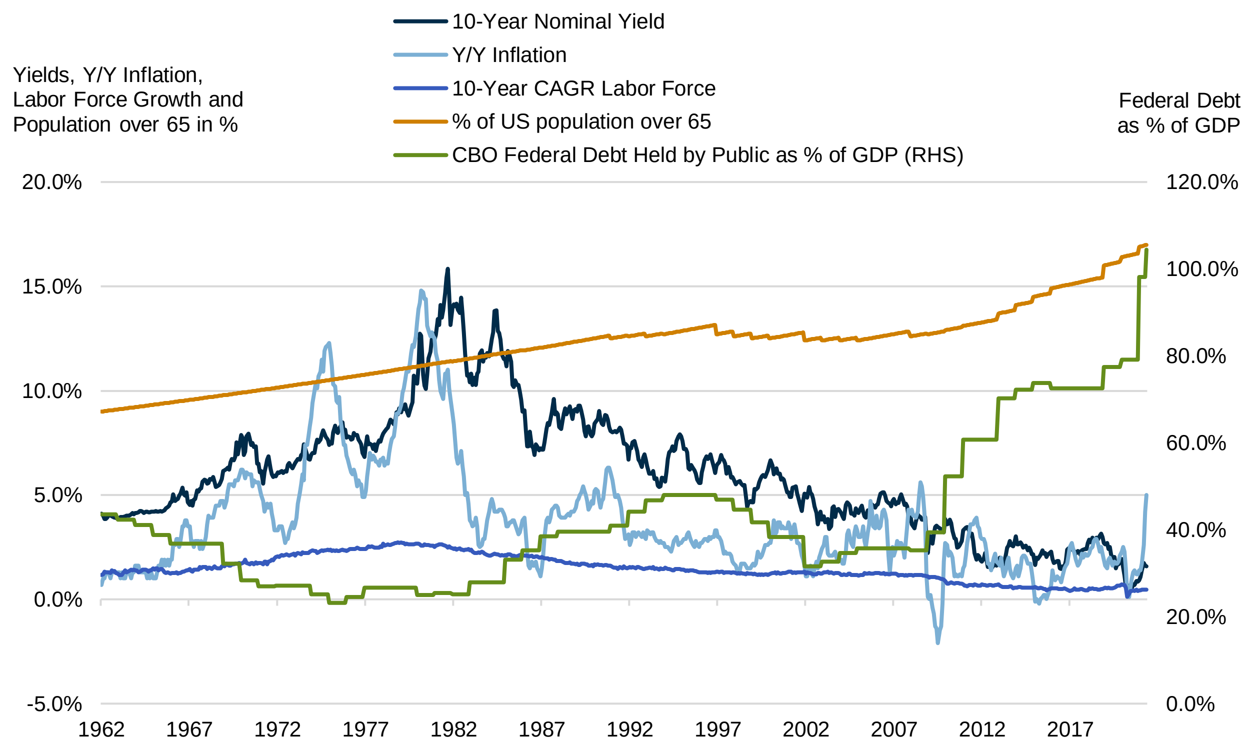
As we close out the fiscal year ending June 30, the markets overall appear healthy. Equity indices, domestic and global, are near all-time highs, corporate and high-yield spreads are approaching historic lows, and after a bout of indigestion in the first quarter of 2021, the risk-free interest rate markets have held steady. Corporate earnings are accelerating and will likely exceed the lofty levels of the first quarter at mid-year. While fiscal policy remains expansionary, as repairing America's infrastructure remains a goal of both parties, ideological disagreements remain in terms of content, size, and funding. Domestic economic data for the first six months of 2021 has maintained a positive trend, confirmed by first quarter U.S. GDP at 6.4 percent but, looking to the future, the economic "lift" may get heavier as the task of recovery transitions to generating consistent future growth while avoiding the negative short-term consequences of higher debt, deficits, and inflation.

In general, investors seem to be comfortable with the consistently positive economic data, even if some readings are below expectations. The employment picture continues to improve but remains 6.7 million jobs below pre-pandemic levels. With the unemployment rate at 5.9 percent and an average of 543,000 newly employed per month, there is still a long way to go to reach full employment—generally considered to be around 4.5 percent. Job seekers and businesses are eager to fill the employment gaps created over the last year. The participation rate, which is the share of the population that is either working or actively looking for work, continues to improve at 61.5 percent, but is well below the historical average of 63 percent, and the underemployment rate remains close to 10 percent. Encouragingly, the sectors hardest hit by economic shutdowns are showing a resurgence in hiring, particularly in the service-oriented leisure and hospitality sector.

Inflation Concerns

Inflation, and the impact it may have on fixed income allocations, has been a cause of concern for investors. The recent spike in CPI to 5 percent caught the attention of the financial markets as well as the Fed, igniting a debate over its transitory nature. Just like many other economic data points, the recent inflation measures represent a resurgence from the mid-pandemic lows and a positive sign of economic recovery. We believe that this spike is short term and should not be misconstrued as a secular trend, or having a major impact on the actions of the Federal Reserve. It was expected that the second quarter would show seasonally high inflation even with minimally high increases over last year. The components of recent consumer and producer inflation reports highlight a combination of supply issues and economic reopening. Going forward, accelerated labor costs (wage inflation) could present an economic hardship for businesses trying to recover particularly those that require low-skilled labor and have price inelasticity.

AN AGING POPULATION, LOWER LABOR PARTICIPATION AND HIGHER DEBTS HAVE KEPT YIELDS AND INFLATION LOW

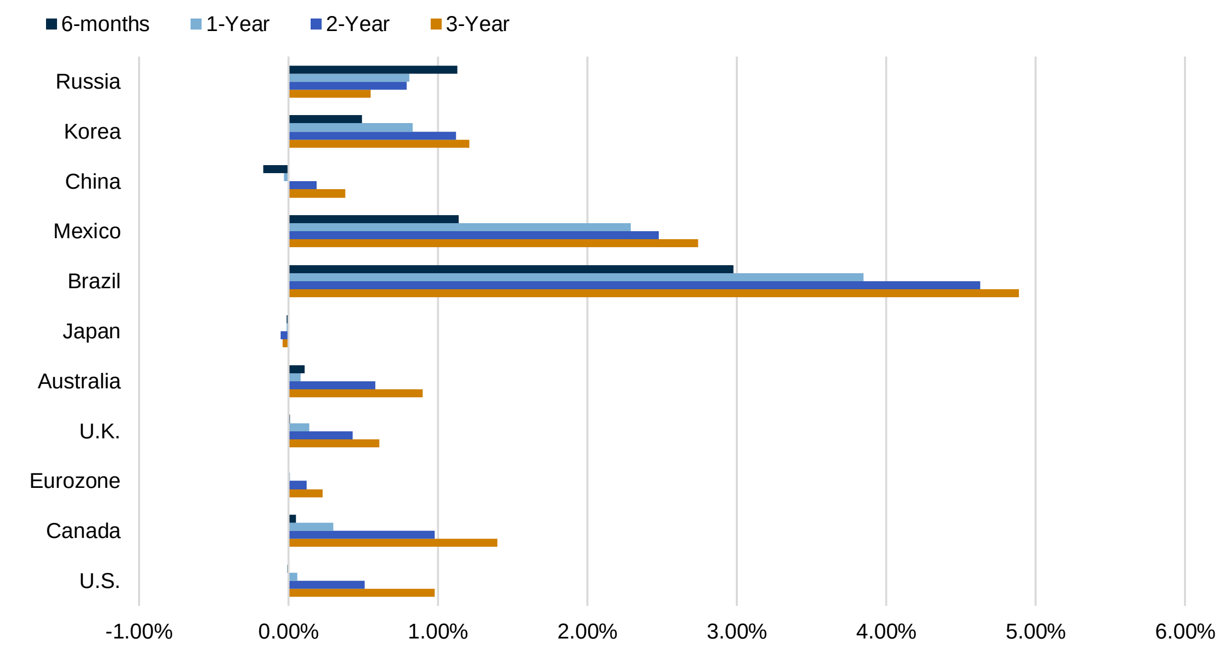


Sources: Bloomberg, Census Bureau and CBO

The inflation debate has not gone unnoticed by the Federal Open Market Committee (FOMC). They recognize that the risks to the reflation trade apply in both directions. On the one hand, there is the potential higher inflation that might follow from the easy money policies of central banks. On the other hand, there is the more hawkish view that reduces the amount of quantitative easing and leads to a possible stifling of our economic recovery. Ultimately, recent communications showed most FOMC members expect inflation to rise this year then slow down as supply shortages are resolved.

Nonetheless, the pace of the recovery has pushed the central bank to begin early discussions about adjusting the current accommodative policies. The most recent "Dot Plot" from the Fed shows that FOMC officials have projected potential interest rate hikes beginning sooner than previously expected—potentially in early 2023. But we do not believe that the Fed will start tapering asset purchases, or that there will be a material shift in the FOMC's strategy. As such, the Fed remains in line with its international counterparts in Europe and Japan—keep the money flowing.

MARKET IMPLIED POLICY RATE CHANGE FROM CURRENT

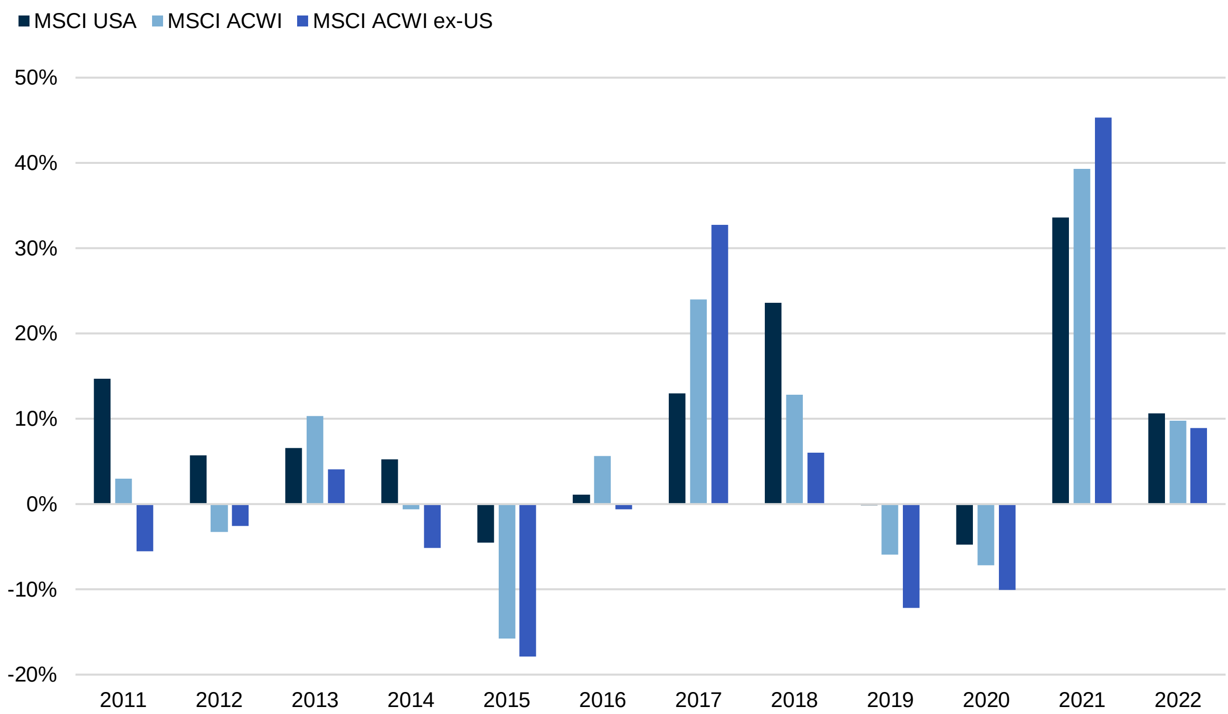


Source: Bloomberg

Corporate Earnings are Robust

Even with inflation accelerating more quickly, growth and corporate earnings are accelerating as well, which is a positive for both equities and credit. In the first quarter, more than 85 percent of reporting companies surprised to the upside, and more than 75 percent reported growth. The overall average earnings growth rate was 50.2 percent. Earnings reports for the second quarter are projected to exceed these levels before calming in the 2nd half of the year. The robust growth in corporate earnings has led to the highest upward revisions in earnings expectations since the 2017 corporate tax cuts. The benefits are two-fold: not only are corporations healthier and able to boost capital expenditures, but equity valuations, even at these higher index levels, are being supported by good, old-fashioned cash flows and not inflated expectations.

GLOBAL EARNINGS GROWTH



Source: Bloomberg

Risks on the Horizon

Uncertainty is a constant companion in the financial markets, as the potential for changing tax policy and increased regulation loom in President Biden's economic plans. Though Democrats have control of the executive and legislative branches of government, the formulation and implementation of new policies is not a quick process—not much of a surprise to any of us. Nonetheless, we are encouraged that, collectively, the government understands the need to invest in American infrastructure. However, historic deficits and continued large debt issuance make the funding of any new infrastructure projects a more difficult process. This will remain an area of interest and concern for investors for the months to come.

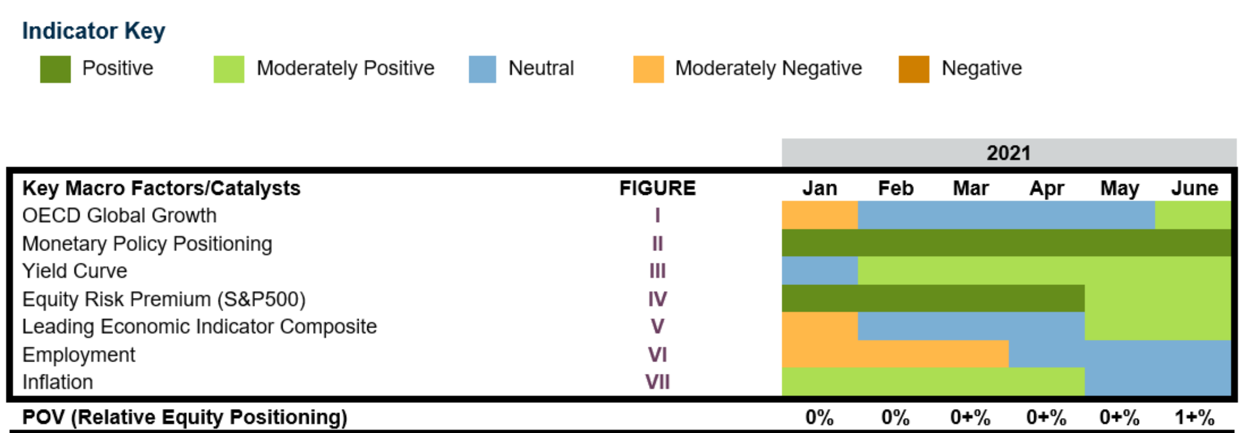
The question we are often asked in client meetings is "what risks are you most concerned about?" The short (and cute) answer is "all of them." Pre-COVID, a global pandemic was not a risk that was embedded in financial market expectations. Going forward, we expect this risk to be an addition to the concerns that keep us up at night. Consequently, we remain vigilant in our investment and portfolio construction processes—trying to see all potential scenarios. Risk management is a constant pillar of our investment management process—in good times and bad.

Now that we are a year removed from a significant market dislocation, and many portfolios have grown past their pre-COVID-19 levels, the concept of risk management is no less important as the markets enter the next phase. We expect strong GDP growth to continue through the 2nd and 3rd quarters of 2021 after which we believe the economy will enter a more moderately paced recovery. The U.S. economy is rebounding at a pace that is swift enough to support risk-based investing but not so quick as to force the accommodative hands of the global central banks.

The Commonfund Asset Allocation Dashboard and Portfolio Positioning

Our current tactical asset allocation points to a slight overweight to equities versus fixed income which reflects our cautiously optimistic view of the economy and the markets. First, we review over 40 global macro-economic factors in constructing our *Tactical Asset Allocation Dashboard*. From this large number of data points, we distill down our analysis to seven factors which we believe are most critical. Currently, within our Dashboard, three of the seven catalysts we track covering growth, and fiscal and monetary policy have become more favorable. However, two other catalysts, inflation and the equity risk premium, were downgraded in the last three months. On the positive side, leading indicators for the U.S. and globally continue to improve as a variety of mobility, manufacturing, and consumption indicators have rebounded with some reaching multi-decade highs. Additionally, the U.S. unemployment rate declined below the 18-month moving average and average 50-year rate as job openings are at their highest level in decades. On the negative side, despite robust upgrades to earnings estimates, implied earnings yields have fallen as stock prices continue to rise, even though real yields have become more negative recently. Consequently, the equity risk premium is at the lowest levels since the Great Financial Crisis at 5.2 percent, although it remains above the 30-year average of 3.8 percent. Inflation was downgraded due to the significant spike above the 30-year average. As mentioned previously, while we expect levels to remain elevated for the next few months, a small, sustained rise in inflation is the goal of the Fed and so long as the recent spike is transitory a slightly higher run rate could be a positive for the economy in the long run, so we are watching this measure closely.

SUMMARY OF FUNDAMENTAL, MACRO AND SENTIMENTAL INDICATORS



Source: Commonfund Research

In our equity allocations we focus on combining strategies and managers that are complementary and bring unique sources of risk and return, after controlling for factor exposures. While the long-anticipated rotation from growth stocks to value stocks leading the market finally took hold in the past 12 months, we continue to take a balanced approach to style exposures and allow our active managers to pursue their strategies based on proven processes. We also continue to combine quantitative, fundamental, and passive strategies to generate alpha, diversify portfolios, and control costs. The market environment has generally favored fundamental stock pickers over quants recently. In our 2021 Economic and Capital Market Outlook, we spoke about our belief that equity market participation would broaden out beyond technology stocks – leading us to favor the S&P 500 Equal-Weighted index over the traditional cap-weighted index – which we still favor today.

Private capital strategies have performed exceedingly well over the past year. Private equity and venture capital were beneficiaries of some of the trends that emerged in the pandemic and have produced very attractive returns as a result. Looking forward, we see many of these trends continuing. Whether it is Work-from-Home related products and services, the energy transition movement or private companies in many industries in need of capital for growth, we see compelling opportunities in the private markets and support full allocations in line with portfolio policy targets for illiquid exposure. And, let's not forget SPACS – they have become a new exit strategy for several of our private equity investments.

Fixed income and credit play an important role in well-diversified, long-term portfolios. While we advocate a slight underweight versus equities, we favor a neutral position relative to policy benchmarks for investment-grade debt and duration. We continue to see attractive opportunities in private credit, specifically in senior secured loans, and investing with managers that have long track records of lending to middle market companies.

A Time of Unusual Challenges

The past year plus have been extraordinarily challenging for the nonprofit sector. The constant change and uncertainty triggered by a global pandemic tested our institutions, our missions, our constituents, our teams, and ourselves. We have been honored, humbled, and determined to support our partner institutions through these challenges. As unprecedented as the pandemic has been, equally unprecedented has been the humanitarian, scientific, economic, and financial responses. The remarkable development and roll-out of vaccinations in the United States and globally, which has coincided with and contributed to an economic resurgence and strong recovery in financial markets, has provided some light at the end of a long tunnel for many nonprofits. There is greater visibility into operating revenues than existed just six months ago, fundraising events are regaining momentum, and the sharp recovery in endowment values has buoyed financial support and/or increased grantmaking. It has been quite a journey and it bears repeating, we feel honored to have shared this journey with our clients, and we look forward to partnering with you and supporting your financial goals for years to come.

Developments at Commonfund and Looking Ahead

It is hard to believe that it’s been 15 months since we cancelled Forum and began the new normal of working from home. Thanks to technology, the dedication of our staff, the support of our partners, and the trust of our clients, we are proud to say that Commonfund didn’t miss a beat. OK, there was the occasional technology glitch and we forgot that “we were on mute” more than we might care to admit—but we made it through the tunnel—together.

We have been working at full capacity and remain focused on our critical role in your success. While we have been encouraged by our ability to maintain productivity in a remote environment, we are excited to be back together in the office again soon. As of today, we are working towards a full reopening of our office locations post Labor Day. To be sure, we have proven that our work arrangements can be more flexible going forward, and we are planning for that to be the case, but it will be nice to be together in person.

There is no denying that human beings are social creatures and, as convenient as it is to meet in digital rooms, you cannot replace personal interaction. We all feel the need to connect in a three-dimensional world instead of the 2D world of computer screens. In that same vein, our team is hard at work planning for Forum 2022, which will be held at the JW Marriott Grand Lakes in Orlando Florida, March 16-18. We are excited to have the opportunity to bring many of you together, safely, for great content and speakers and to see many friends and colleagues. We hope you will join us. For those that cannot join us in Florida, we will be offering the ability to participate remotely via streaming.

Finally, we want to thank you for your partnership and your trust in Commonfund. We are committed to earning it every day.

Mark Anson and the Commonfund Investment Team

Important Notes

Generally

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