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Capital Perspectives

Monthly investment analysis and insights from Wilmington Trust Investment Advisors

ON THE RECORD

Staying Positive, Despite the Specter of Inflation

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Chief Investment Officer

The domestic COVID vaccine ramp is resulting in a quick drop in case counts. With this improvement in the public health situation at home and, to a lesser extent, abroad, restrictions on activities and travel are receding rapidly. We must answer the critical questions of how strong will the economic bounce be, how long will it last, and will inflation materially shorten this new economic cycle. Our analysis of the economy and markets points to a synchronized global upswing that we think may last well into 2022 if not longer and that while elevated, global equities will continue to rise. Accordingly, we have shifted portfolio assets further out of investment-grade fixed income and toward equities, specifically international developed stocks, to best position for a continuation of the recovery.

Acceleration, inflation, or stagflation?

The economy is healing and we believe will continue to do so, though there will be setbacks along the way. For example, as pandemic assistance in the form of stimulus checks and extra unemployment benefits roll off, consumer spending is likely to slow, particularly on goods purchases. We caught a glimpse of that in the retail sales figure for April, which disappointed and registered no change month over month. However, consumers are sitting on a collective $2.2 trillion of extra savings and have a whole lot of cabin fever. We expect spending on services—including travel, recreation, and restaurants—to accelerate into the summer, giving a second wind to the economic recovery. Capital expenditures by businesses, particularly on technology, should also aid the economic recovery.

More important than the question of the economy's resilience, is the considerable debate regarding the possibility of an inflationary overshoot. With so much stimulus

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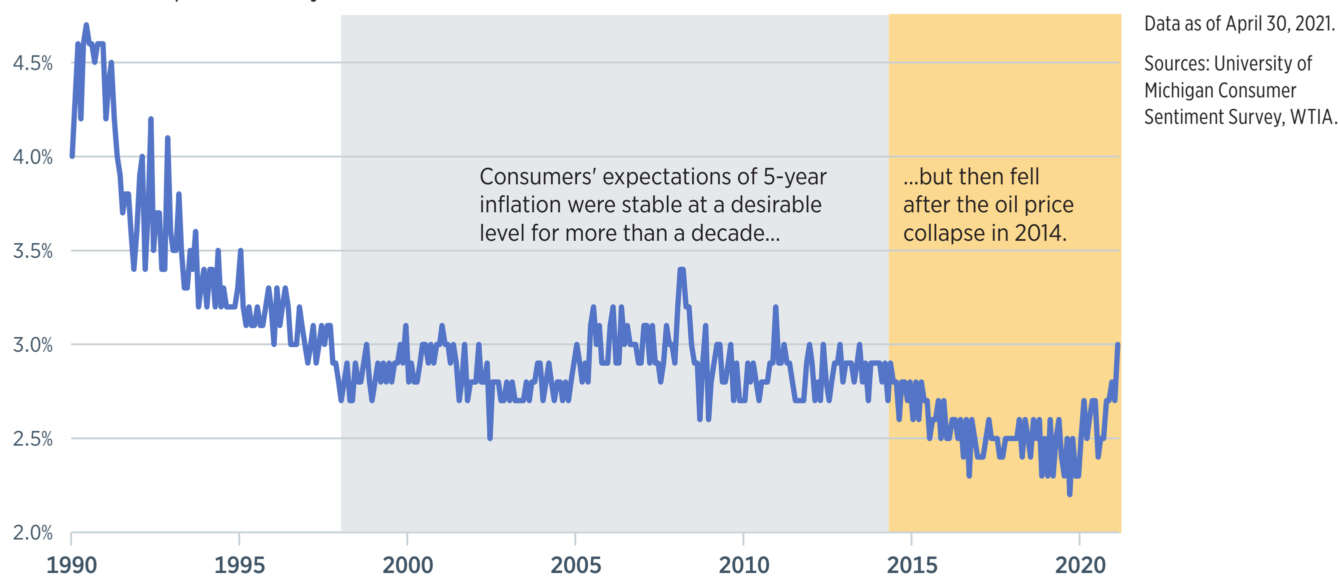
Figure 1

Inflation expectations moving higher

Consumers' expected five-year inflation



Data as of April 30, 2021.

Sources: University of Michigan Consumer Sentiment Survey, WTIA.

The Fed has promised to let inflation run above target but defining inflation that is too high or no longer transitory is challenging.

and liquidity sloshing about alongside pent-up demand, supply chain issues, and labor shortages, inflation risk appears greater than it has in decades. While the Federal Reserve has promised to let inflation run above target (in fact, the recent change in policy makes this more clearly its goal), the particulars of how to define inflation that has become "too high" or is no longer "transitory" is challenging. This has many worrying that the Fed will have no choice but to renege on every assurance it has made to maintain policy easing and bring an end to the shortest cycle in history.

We fall on the side that expects inflation to be transitory, with base effects, pent-up demand, and supply chain bottlenecks all fading in time to give way to inflation at or incrementally above the Fed's 2% target.[1] However, the inflationary risks are firmly skewed to the upside as services spending is expected to rebound strongly and represents a larger component of the U.S. economy. Inflation expectations have also moved decidedly higher since last year (Figure 1). We retain an overweight to commodities and equities, the latter of which can be an effective inflation hedge if demand allows companies to pass through price increases of inputs to customers.

Watering down the punch bowl

If, in fact, price pressures recede later this year, we would expect the Fed to maintain a zero-interest rate policy until at least the second half of 2022 or early 2023. An earlier shift in the Fed's policy for asset purchases (quantitative easing, or QE), however, is likely in our view. In other words, the punch bowl is staying on the table, but it is getting watered down a bit. We anticipate more open communication this summer regarding a plan to taper asset purchases from the current pace of $80 billion per month of U.S. Treasuries and $40 billion of agency mortgage-backed securities, with reduced purchases beginning in 2022. This is reasonable, as the

[1] The first of the Fed's two-pronged policy priorities is for stable prices, as measured by 2% year-over-year change in the Personal Consumption Expenditure Index. The other policy priority is maximum employment.

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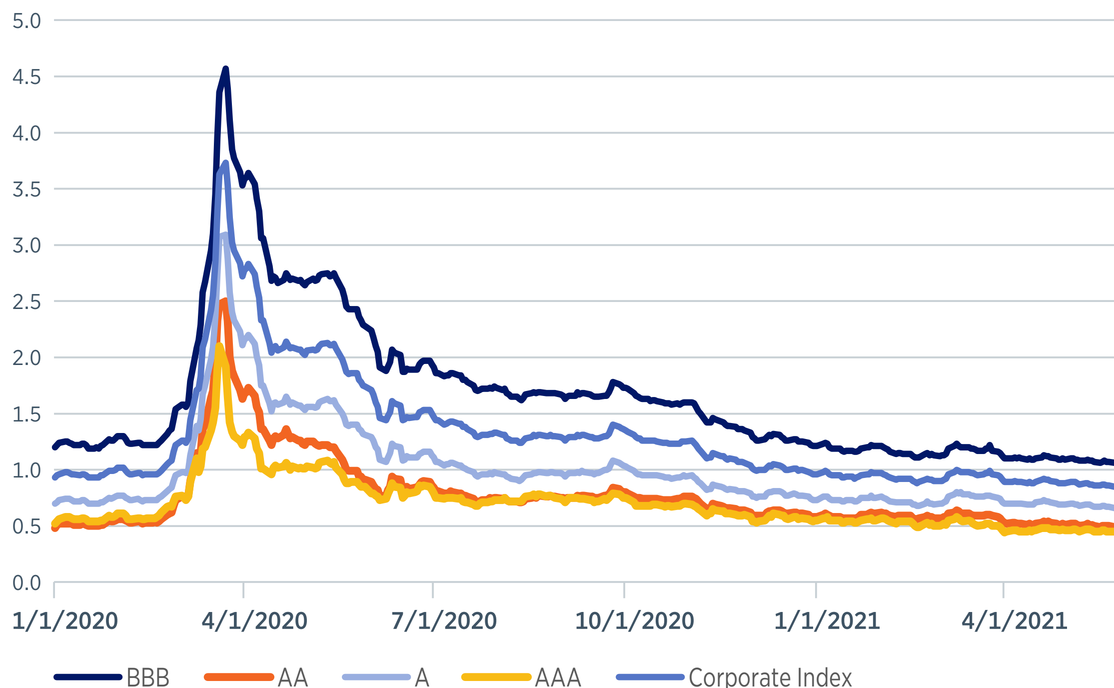
Figure 2

Investment-grade fixed income has become expensive

Investment-grade corporate spreads by rating



Data as of May 27, 2021.

Source: Bloomberg.

Figure 2 shows the average option-adjusted spread (OAS) for components of the Bloomberg Barclays U.S. Corporate Index segmented by credit rating. OAS measures the difference between the yield of a bond and that of a comparable treasury security, adjusted for embedded options.

Additional spending is certainly a priority, but this time spending and revenue offsets will have a much more moderate impact on economic growth.

resumption of quantitative easing began during the period of severe market instability in March 2020 and it is hard to make a case for asset purchases at that scale being necessary in the current environment. Furthermore, we believe that a healthy expanding economy should be accompanied by positive real yields and currently they are negative and moving lower as inflation rises. Tapering of QE would provide room for nominal rates to move higher thereby increasing real yields as well.

A second important policy channel to monitor is the trade-off between extra spending and higher taxes being debated in Washington. Pandemic-related fiscal assistance over the past year was larger than expected and was essentially “on the house.” Additional spending is certainly a priority, as evidenced by the Biden administration’s $6 trillion budget proposal, but this time the means of spending and revenue offsets will have a much more moderate impact on economic growth. It is still too early to opine on final details and market reaction to more spending and higher taxes, but overall, we feel the net effects this year and next should be minor from here. We address many of the most pressing questions from our clients regarding possible increases in this month’s In Focus.

Positioning portfolios

We have held an overweight to equities since November 2020 and an underweight to investment-grade fixed income since December. This month we have taken an additional step in that direction, reducing investment-grade fixed income, and adding the proceeds to a combination of international developed equities and cash.

Continued

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Current tactical asset allocation

	Tactical tilts	— NEUTRAL +	Positioning
Equities	U.S. Large Cap	○ ○ ○ ○ ● ○ ○	Overweight
	U.S. Small Cap	○ ○ ○ ○ ● ○ ○	
	International Developed	○ ○ ○ ○ ○ ● ○	
	Emerging Markets	○ ○ ○ ○ ○ ● ○	
Tax-Exempt Fixed Income	Investment Grade	○ ● ○ ○ ○ ○ ○	Underweight
	High Yield	○ ○ ○ ○ ● ○ ○	
Real Assets	Inflation-linked Bonds	○ ○ ● ○ ○ ○ ○	Overweight
	Global REITs	○ ○ ○ ● ○ ○ ○	
	Other/Commodities	○ ○ ○ ○ ● ○ ○	
Alternatives	Equity long/short hedge	○ ○ ● ○ ○ ○ ○	Underweight
Cash		○ ○ ○ ● ○ ○ ○	Neutral

The magnitude of equity returns going forward will likely be lower and volatility may be higher, but we still see equities outpacing bonds and cash.

Investment-grade fixed income remains challenged under our economic and market outlook. We expect interest rates to resume their climb higher, with the 10-year Treasury yield moving from 1.6% to a range of 1.9%–2.25% over the next 12 months. Credit spreads for investment-grade bonds versus Treasuries are back to pre-pandemic levels, meaning the asset class is quite expensive and investors are unlikely to pick up sustainable additional return from a tightening of spreads (Figure 2). Under this scenario, 12-month total returns on fixed income would be meager at best.[2] The recent dip in the 10-year Treasury yield below 1.6% offers an opportunity to further reduce our fixed income allocation and deploy those assets into a combination of cash and international developed equities, where we anticipate better risk-adjusted returns.

The equity market has had an incredible run over the last 14 months, and the "fast" or "easy" money for the cycle very well may be behind us. The magnitude of equity returns going forward will likely be lower and volatility may be higher, but we still see equities outpacing bonds and cash, hence our overweight across equity asset classes versus our strategic benchmark.

There are two areas of the equity market where we see greater opportunity: international developed equities and value-oriented domestic equities.

- It is within international equities that we deployed the bulk of the proceeds from trimming our fixed income allocation. The economic cycle in the international developed region (in Europe, Japan, and the UK) is behind that of the U.S. due to reduced fiscal impulse and challenges containing the virus. We anticipate an acceleration of activity in the region as we move into the second half of 2021. At this time, the U.S. may begin to decelerate as it grapples with tax policy and reduced policy support, so the growth differential between the two regions should begin to close. We expect equity investors to anticipate these dynamics

[2] For investors with multi-year investment horizons, which is the vast majority of our client base, fixed income can still provide attractive total return and risk mitigation, so retaining a healthy exposure to fixed income is appropriate in most cases.

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While cash yields nothing, it also carries no duration risk, and we find the optionality embedded in a neutral cash allocation appealing.

and reward international over domestic equities. We further believe international developed equities are likely to outperform as the global economy recovers given their higher sensitivity to global growth dynamics. Momentum in the region is improving, and valuations remain attractive relative to the U.S. Last, we see continued weakness in the US dollar which should further buttress non-U.S. equity values.

- Value-oriented domestic equities also look appealing, given upside risks to growth and inflation. Above-trend growth, upside surprises to economic data, higher inflation, and rising rates all create a backdrop that has historically rewarded value equities over growth. This month we trimmed our high-growth equities and added to our modest value overweight.

We have also added a bit to cash, shoring up that allocation to neutral versus our benchmark. While cash yields nothing, it also carries no duration risk, and we find the optionality embedded in a neutral cash allocation appealing.

As the economy moves forward in this recovery, patience will be warranted. Every data point is sure to be scrutinized by the market for signs that the economy is faltering or that inflation will short-circuit the cycle. We too will be scrutinizing the data, and for now the post-pandemic rebound continues to dominate the picture.

Until next month,

Tony

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IN FOCUS

Government Tax and Spend Q&A Roundtable

Luke Tilley
Chief Economist

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Evan Kurinsky
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At a glance:

- **The revised $1.7 trillion American Jobs Plan includes, among other things, spending for heavy infrastructure, workforce development, environmental spending, and tax credits funded by corporate tax increases**
- **Partial funding for the American Family Plan would come from personal tax increases targeting wealthier individuals and IRS efforts to clamp down on tax avoidance and loopholes, raising a targeted $1.5 trillion over 10 years**
- **If Democrats revert to budget reconciliation it could force significant reductions on the proposal, including funding for the Highway Trust Fund**

The landscape is rapidly shifting from one in which investors grapple with COVID-19-related uncertainty to one focused on policy uncertainty. Of particular focus for investors are the prospects for fiscal policy—specifically the Biden administration's two latest spending and tax proposals unveiled and revised in recent months. While uncertainty remains high around the machinations of the Washington legislative process and final policy details, the following provides our team's perspective regarding potential policy impacts on markets and the economy in response to the most-asked questions by our clients.

Q: What are the key components of the White House's proposed plans?

A: To level set, the Biden administration originally proposed a two-part plan totaling $4.4 trillion in spending and tax credits almost entirely funded by tax increases (according to the proposal, with revenue being generated over a 10–15-year window). Though proposed as two parts, passage could potentially occur in a variety of ways, including separately, all as one, or combining elements of both into one or more bills. In late May, the plans were formally included in Biden's first-ever budget proposal, with a $6 trillion total for fiscal year 2022 and deficits exceeding $1.3 trillion for the next 10 years.

- **Part 1:** The American Jobs Plan (AJP), originally included $2.6 trillion for a variety of infrastructure- and climate-related initiatives spread over eight years, and as proposed would be funded entirely from corporate tax increases over 15 years (the revenue-generating component is referred to as the Made in America Tax Plan). As of this writing, it has since been reduced by the White House to $1.7 trillion. Details of the revised plan are still somewhat sparse, but it includes spending for heavy infrastructure, housing care and workforce development, R&D, environmental spending and tax credits, and construction for affordable housing and schools.
- **Part 2:** The American Family Plan (AFP) includes $1.8 trillion of spending and tax credits for childcare-, education- and social welfare-related initiatives, IRS enforcement, and health care premium subsidies. This plan would be partially funded from personal tax increases targeting wealthier individuals and efforts by the IRS to clamp down on tax avoidance and loopholes, raising a targeted $1.5 trillion over 10 years.

As proposed, the effective corporate tax rate (what companies pay after deductions and other adjustments or "loopholes" permitted by current law) would return nearly to the level of the pre-Tax Cuts and Jobs Act of 2017 (TCJA), despite the proposed headline corporate tax rate returning just halfway to the pre-Trump level of 35% (Figure 2). This is largely due to proposed changes in the handling of foreign income and the reinstatement of the corporate alternative minimum tax.

Continued

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Figure 1

Key tax/revenue-generating components of American Jobs Plan

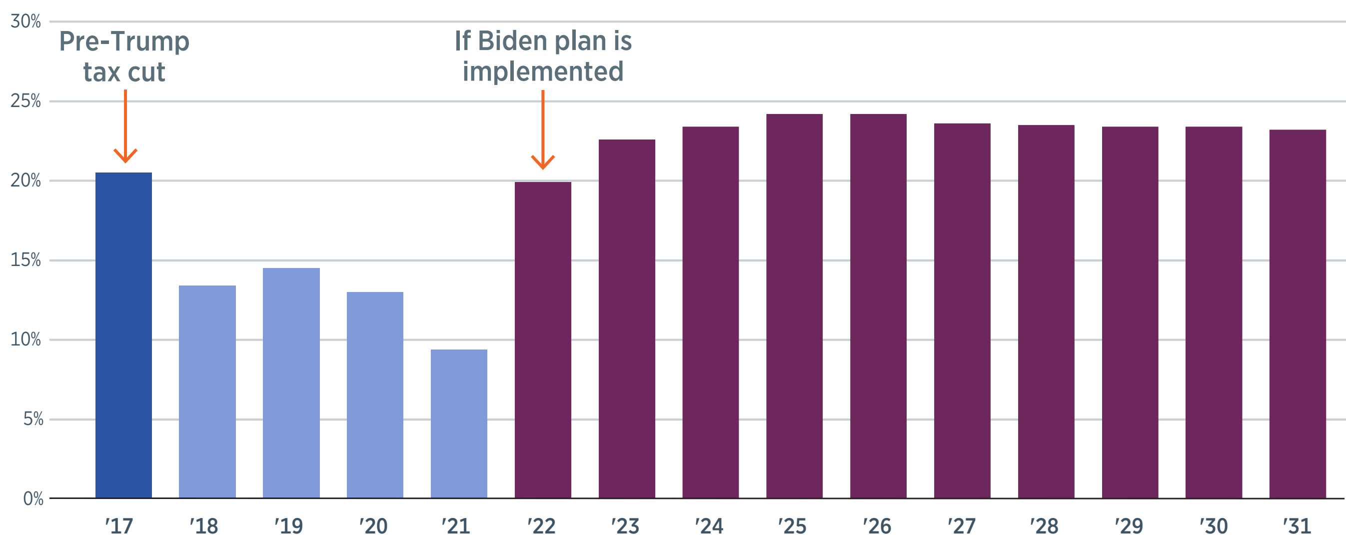
(This portion is referred to specifically as the Made in America Tax Plan)

Provision	$bn/15 years	Proposal
Corporate tax rate	**$858**	• Raise to 28% from 21%
Global intangible low-taxed income (GILTI) GILTI is the income earned by foreign affiliates of U.S. companies from intangible assets such as patents, trademarks, and copyrights	**$534**	• Raise to 21% from 10.5% and eliminate exemption for subsidiaries generating income from foreign tangible assets • Reduce the incentive to shift profits outside the U.S. using intellectual property
Foreign derived intangible income (FDII)		• Eliminate deduction for income received for exporting products linked to intangible assets held in U.S. • Target companies that make capital investments, which lower their tax bills
Minimum tax on book income (corporate alternative minimum tax)	**$148**	• Raise to 15% for companies that report more than $2 billion of annual net income
Base Erosion Anti-Abuse Tax (BEAT) with stopping harmful erosions and ending low-tax developments (SHIELD) rule	**$390**	• Eliminate tax avoidance by companies that acquire or merge with foreign firms
Fossil fuel industry tax preferences	**$147**	• Eliminate subsidies, loopholes, special foreign tax credits
Increase enforcement		• Funds for IRS to increase audit capacity
Penalize companies for offshoring		• Tax credit to support onshoring jobs • Eliminate ability to write off expenses if offshoring jobs
Global minimum corporate tax		• Multilateral coordination across countries regarding a minimum corporate tax

Source: White House fiscal year 2022 budget.

Figure 2

Effective corporate tax rate over time



Source: Strategas Research Partners, LLC.

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Figure 3

Key tax/revenue-generating components of American Family Plan

Provision	$bn/15 years	Proposal
Personal income tax rate	**$132**	• Raise top marginal rate on individuals to 39.6% from 37%
Capital gains/dividend taxes/ step-up in basis at death	**$323**	• Capital gains treated as ordinary income for households making $1 million or more • Eliminate step-up in basis for gains of over $1 million during estate transfers at death ($2.5 million per couple when combined with existing real estate exemptions)
Loss limitation rule	**$43**	• Make permanent a rule enacted in the 2017 TCJA to cut limited private companies from using losses to offset other income
Medicare and Self Employment Contributions Act taxes	**$237**	• Eliminate loopholes to expand payment of the 3.8% Medicare tax on investment income by those earning above $400,000
Increased IRS enforcement	**$711**	• $80 billion of funding for IRS to improve tax enforcement through increased audits, new reporting requirements for financial institutions
Like-kind exchanges (Section 1031)	**$20**	• End the special real estate tax break that allows real estate investors to defer taxation when they exchange property for gains greater than $500,000

Source: White House fiscal year 2022 budget.

At this time, we expect the corporate tax rate to rise as an offset to infrastructure spending, but it may ultimately fall closer to the 25% rate suggested by moderate Democrats.

Q: What does Wilmington Trust expect will ultimately be approved?

A: The situation is extremely fluid, and it is too early to opine on the many specific elements of each proposal, but we anticipate a slimmed-down set of spending items to be offset by an increase in personal and corporate tax rates. The corporate tax rate is likely to land somewhere in the mid-20% range effective in 2022, while the capital gains rate will likely be higher than it is today.

While it is still early stages, Democratic support for the plans as proposed is much more mixed than was support for the January 2021 American Rescue Plan. Democrats are operating under one of the slimmest majorities ever, and moderate Democrats have expressed some skepticism over the magnitude of spending and tax increases.

Infrastructure spending has bipartisan support and the best chance of moving forward on a bipartisan basis. However, there is considerable disagreement over how broadly infrastructure should be defined and the means by which it should be paid.

Republicans have expressed support for a narrower definition of infrastructure (highways, water and sewer, broadband, ports, public transit) with a price tag between $400 billion and $1 trillion, and a group of Senate Republicans proposed a plan totaling $568 billion (subsequently revised up to $928 billion), referred to as the Republican Roadmap. While there are areas of common ground between both parties, Republicans are broadly opposed to any increase in taxes.

At this time, we expect the corporate tax rate to rise as an offset to infrastructure spending, but it may ultimately fall closer to the 25% rate suggested by moderate

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Hear more infrastructure insights

from CIO Tony Roth and Professor Rick Geddes of Cornell University's Program in Infrastructure Policy, in a recent Capital Considerations podcast episode, Building Back Bridges & Roads? America's Newest Deal

Democrats. While a bipartisan deal with no tax hikes is possible, it is less likely. If Republicans will not entertain any increase in the corporate tax rate, Democrats could be forced to revert to budget reconciliation as a means of passage along party lines. In this case, the rules of the budget reconciliation could force significant reductions on the proposal, including staples of infrastructure spending such as funding for the Highway Trust Fund.

Q: How do we expect the Biden spending and tax plans will impact economic growth?

A: We won't have a specific forecast for the economic impact until we see the terms of the legislation, but we expect the combination of infrastructure spending and tax hikes would add marginally to U.S. economic growth in 2022.

Infrastructure famously takes years to build out, so the contribution next year would be positive but mild. Tax hikes would cut into growth (and likely more into equity markets) by reducing some capital expenditures (capex) by firms and spendable income for high-earning families, but extended tax credits for lower-income households would be another force pushing growth higher. Our baseline expectation for growth in 2021 is 7.6%, driven by consumers' spending of savings as well as strong capex, with risk to the upside if consumers spend more than we're currently assuming. While our 2021 forecast is higher than the Bloomberg consensus estimate of 6.5%, it comes at the expense of growth in 2022 where we would expect more of a slowdown under current law. We expect growth in the 2%–3% range in calendar year 2022, noticeably lower than consensus of 4%. This comes in part from an estimated -1.8% drag from fiscal policy under current law, according to the Hutchins Center Fiscal Impact Measure published by the Brookings Institution.

Q: What historically has been the impact of tax increases on equities? What do we expect this time around?

A: Historically, tax increases on corporations or capital gains have been infrequent, so we have few data points to analyze, but would expect higher taxes to be a headwind for equities. A corporate tax increase to approximately 25% with adjustments to taxation of international profits could result in a 3%–5% reduction of S&P 500 EPS for 2022.

In terms of the corporate tax rate, there has not been a major increase in the U.S. since the late 1960s when a 10% surcharge was implemented to help fund the Vietnam War. The corporate rate has been steadily falling ever since. Analysts estimate the proposed changes would reduce 2022 S&P 500 earnings per share (EPS) by $9 per share (a 5% decline), and under a moderate scenario (statutory rate to 25%, 18% GILTI, spending lowered to $1.5 trillion) would shave off $4 per share (3% decline). In our assessment, earnings estimates do not fully reflect the prospect of higher taxes and may not until passage becomes more imminent.

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The Biden administration's capital gains proposal would represent the largest single increase in history and the highest rate since the 1970s.

The proposed changes to the capital gains tax are also critical for investors. There have only been eight major changes to the capital gains rate since 1968, and those periods each had different dynamics as it relates to the details of the legislation, economic backdrop, monetary policy, and other macro factors. However, the Biden administration's capital gains proposal would represent the largest single increase in history and the highest rate since the 1970s.

Q: How may investor behavior and the market be impacted by the proposed increase in the capital gains rate and changes to treatment of stepped-up basis upon death?

A: The increase in the capital gains rate could cause market volatility if investors rush to realize gains ahead of the change, but an increase of this magnitude has also been linked (through historical and projected analysis) to a significant deferment of equity sales. Elimination of the basis adjustment could also add to market volatility.

Unlike other taxes, the timing of capital gains realization is largely voluntary (except for tax realizations associated with estate tax provisions), so individuals affected by the increase could either rush to realize gains ahead of the tax changes or push back asset sales in the hopes of an eventual change in the political landscape leading to more favorable tax rates. For this reason, it is no surprise to see that the maximum capital gains tax rate has generally been negatively correlated with the value of capital gains realized as a percentage of GDP in the U.S.

Historical evidence suggests pushing the maximum capital gains tax to 28% from 20% in 1987 (following the 1986 Tax Reform Act) was linked with a more than 20% reduction in capital gains realized as a percentage of GDP.[1] Conversely, leading up to capital gains tax rate increases in 1987 and 2013, realizations spiked ahead of time as investors locked in unrealized gains preemptively to avoid the anticipated increase. The Treasury Department has suggested that the Biden administration may propose implementing the higher capital gains rate retroactively this time around, which would eliminate the option to accelerate realizations before the change takes effect.

There is a wide range of estimates, but a variety of taxation authorities and researchers suggest that the revenue-maximizing rate is in the range of 28%–30%—absent, however, retroactive implementation and any changes in estate tax provisions including the step-up in basis.[2] While we view the proposed changes to basis adjustments as less likely to occur than tax rate changes, we believe the intersection of such a change with an increased capital gains rate could add to market volatility.

[1] Congressional Budget Office, Treasury Department.

[2] Congressional Budget Office, Tax Policy Center, Congressional Joint Committee on Taxation, Treasury Department.

Continued

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Figure 3

Combined national and sub-national corporate tax rates of top 20 of 38 OECD member countries

2017 (before TCJA)		
1	France	44.4%
2	Colombia	40.0%
3	United States	38.9%
4	Belgium	34.0%
5	Australia	30.0%
6	Costa Rica	30.0%
7	Mexico	30.0%
8	Japan	30.0%
9	Germany	29.9%
10	Portugal	29.5%
11	Greece	29.0%
12	New Zealand	28.0%
13	Italy	27.8%
14	Luxembourg	27.1%
15	Canada	26.7%
16	Austria	25.0%
17	Chile	25.0%
18	Netherlands	25.0%
19	Spain	25.0%
20	Korea	24.2%

2020		
1	France	32.0%
2	Colombia	32.0%
3	Portugal	31.5%
4	Australia	30.0%
5	Costa Rica	30.0%
6	Mexico	30.0%
7	Germany	29.9%
8	Japan	29.7%
9	New Zealand	28.0%
10	Italy	27.8%
11	Korea	27.5%
12	Canada	26.5%
13	United States	25.8%
14	Austria	25.0%
15	Belgium	25.0%
16	Chile	25.0%
17	Netherlands	25.0%
18	Spain	25.0%
19	Luxembourg	24.9%
20	Greece	24.0%

Source: The Organisation for Economic Co-operation and Development (OECD).

Combined rate reflects the combination of national (federal) and sub-national (state and municipal) tax rates after accounting for deductibility of sub-national taxes.

The technology, health care, and communications sectors are especially vulnerable, given that they currently enjoy the lowest effective tax rates in the S&P 500 and derive a large portion of revenues from overseas.

Q: Which sectors and types of companies could be most and least impacted by the proposed corporate tax increases?

A: Those sectors most exposed to the proposed tax increases include large multinationals, particularly in growth-related sectors like technology, communications services, and health care.

As proposed, multinationals would feel an outsized impact versus more domestically focused companies. This may seem counterintuitive, but the AJP tax plan takes aim at foreign revenue as a way to narrow the gap between the statutory and effective rates. More than half of estimated revenue from the proposed corporate tax increases would come from income earned outside of the U.S. The technology, health care, and communications sectors are especially vulnerable, given that they currently enjoy the lowest effective tax rates in the S&P 500 and derive a large portion of revenues from overseas. Smaller companies that receive fewer benefits from tax loopholes could be less affected.

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For more related to planning opportunities around possible tax changes, please see the latest thoughts from our wealth planning colleagues.

Q: How do the current and proposed corporate tax rates for the U.S. stack up versus other countries?

A: The proposed changes to corporate taxes would return the U.S. to near the top spot for corporate tax rates among Organisation for Economic Co-operation and Development (OECD) countries.

The TCJA lowered the federal corporate tax rate from 35% to 21%, taking the statutory U.S. rate from nearly the highest among OECD countries to one of the lowest. Corporations also pay state and local taxes that are often deductible from the federal tax, depending on the country. Considering those additional taxes and their deductibility, the OECD ranks the U.S. 13 as of 2020. The proposed hike to 28% would return the U.S. to nearly the top of the rankings. A rate in the mid-20% range, as we expect, would likely push the U.S. back to a top-10 ranking.

Q: What are some key dates/events to be watching in the months ahead?

A: Timing remains extremely uncertain, but Democrats are hoping for material progress and/or passage by mid-summer.

- **June:**
  Additional information on new spending proposals may be provided
- **July 4:**
  House Speaker Pelosi target date for passing infrastructure bill
- **July 30:**
  Beginning of August recess—may be viewed as a soft deadline to move a bill forward
- **September 30:**
  Federal Budget and Highway Trust Fund expires—may serve as a catalyst to move legislation forward in some form if struggling

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ASSET CLASS OVERVIEW

Taxable Fixed Income

Randy Vogel, CFA
Head of Fixed Income

	AS OF MAY 28, 2021		
	Month	YTD	Trailing 12-month return
Barclays U.S. Aggregate Bond Index	0.33%	-2.29%	-0.40%
Barclays U.S. Investment Grade Credit Index	0.72%	-2.74%	3.32%
Barclays Ba High Yield Index	0.25%	1.20%	12.41%
Barclays U.S. Mortgage Backed Securities Index	-0.18%	-0.73%	-0.47%

Sources: FactSet, Bloomberg. Investing involves risks and you may incur a profit or a loss. Past performance cannot guarantee future results. Indices are not available for direct investment.

What we are seeing now

Investment-grade corporate bond yields have risen from the start of the year driven by higher Treasury yields. While concerns about higher inflation drove long-term yields significantly higher during the first half of the year, short-term yields, which are controlled by central bank policy, remained essentially unchanged. The result was a significantly steeper curve. At the beginning of the year, the spread between the 2-year Treasury note and 30-year Treasury bond was 152 basis points (bps). By the end of May 2021, the spread differential had increased to 214bps. This steepening of the Treasury curve drove negative total returns for corporate bonds during 1Q 2021. Through May, the Bloomberg Barclays U.S. Credit Index posted –2.74% total return, driven by the long segment of the market, which posted a –5.84% total return. Although total returns were negative, investment-grade credit outperformed Treasuries during the year. The option-adjusted spread for the Bloomberg Barclays U.S. Credit Index tightened to 81bps from 92bps at the start of 2021 indicating very strong demand for investment-grade credit.

Despite negative total returns money continued to pour into investment-grade credit funds and ETFs. Through May 5, 2021, year-to-date flows into investment grade totaled approximately $150 billion, or 4% of assets under management. Modest outflows from long duration products were more than offset by flows into short- and intermediate-term maturities.

What's changing

Vaccination rates continue to climb in the U.S. leading to the lifting of restrictions on business activity and stronger economic growth. This should drive further improvement in corporate cash flows and continue to drive leverage lower from last year's elevated levels. Lower leverage and better fundamentals should be supportive for investment-grade valuations. However, some companies have taken advantage of favorable funding costs and issued new debt and delayed deleveraging. For example, Oracle issued $15.0 billion of new debt during the first quarter for general corporate purposes. This increased leverage and resulted in a multiple notch downgrade to Oracle's credit rating.

What we expect

We expect strong economic growth for the remainder of 2021 driven by declining COVID infection rates and increasing vaccination rates. Stronger economic growth and supply constraints should lead to higher rates of inflation and higher Treasury yields. We anticipate stronger economic growth will continue to lead to better corporate fundamentals through lower leverage and higher interest coverage. However, much of this is reflected in valuations with the OAS of the Bloomberg Barclays U.S. credit index near 10-year tights. Higher Treasury yields and tight credit spreads should result in a difficult backdrop for total returns in investment-grade credit. However, we continue to favor investment-grade credit over U.S. Treasuries primarily for their yield advantage and carry. Given current valuations, we expect any further tightening of investment-grade credit spreads will be modest.

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Investment Positioning

Portfolio targets effective June 1, 2021, for high-net-worth clients with Hedge Funds

Growth & Income

	Strategic Asset Allocation (long term)	Tactical Asset Allocation (short term)
Equities		
U.S. Large-Cap	31.5%	Overweight
U.S. Small-Cap	5.5%	Overweight
International Developed	16.0%	Overweight
Emerging Markets	5.5%	Overweight
Fixed Income		
U.S. Investment Grade–Tax-Exempt	28.5%	Underweight
High-Yield–Tax-Exempt	2.0%	Overweight
Real Assets		
U.S. Inflation-Linked Bonds	1.0%	Underweight
Global REITs	1.5%	Neutral
Other	1.5%	Overweight
Nontraditional Hedge	5.0%	Underweight
Cash & Equivalents	2.0%	Neutral
Total	100.0%	

Note: Totals may differ slightly from the allocation building blocks due to rounding.

TAA, or Tactical Asset Allocation, represents our *current recommendation* for each model strategy.

SAA, or Strategic Asset Allocation, represents our *current benchmark* allocation for each model strategy.

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For an overview of our asset allocation strategies, please see the disclosures.

Source: WTIA.

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Investment Positioning

Portfolio targets effective June 1, 2021, for high-net-worth clients with Private Markets*

Growth & Income

	Strategic Asset Allocation (long term)	Tactical Asset Allocation (short term)
Equities		
U.S. Large-Cap	24.3%	Overweight
U.S. Small-Cap	4.3%	Overweight
International Developed	11.6%	Overweight
Emerging Markets	4.1%	Overweight
Fixed Income		
U.S. Investment Grade–Tax-Exempt	24.7%	Underweight
High-Yield–Tax-Exempt	2.0%	Overweight
Real Assets		
U.S. Inflation-Linked Bonds	0.9%	Underweight
Global REITs	1.3%	Neutral
Other	1.3%	Overweight
Nontraditional Hedge	6.0%	Underweight
Private Markets	17.5%	Neutral
Cash & Equivalents	2.0%	Neutral
Total	100.0%	

Note: Totals may differ slightly from the allocation building blocks due to rounding.

TAA, or Tactical Asset Allocation, represents our *current recommendation* for each model strategy.

SAA, or Strategic Asset Allocation, represents our *current benchmark* allocation for each model strategy.

* Private markets are only available to investors that meet Securities and Exchange Commission standards and are qualified and accredited.

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For an overview of our asset allocation strategies, please see the disclosures.

Source: WTIA.

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Some investment products may be available only to certain "qualified investors"—that is, investors who meet certain income and/or investable assets thresholds.

Alternative assets, such as strategies that invest in hedge funds, can present greater risk and are not suitable for all investors.

Any positioning information provided does not include all positions that were taken in client accounts and may not be representative of current positioning. It should not be assumed that the positions described are or will be profitable or that positions taken in the future will be profitable or will equal the performance of those described.

Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs that will reduce returns.

An overview of our asset allocation strategies:
Wilmington Trust offers seven asset allocation models for taxable (high-net-worth) and tax-exempt (institutional) investors across five strategies reflecting a range of investment objectives and risk tolerances: Aggressive, Growth, Growth & Income, Income & Growth, and Conservative. The seven models are High-Net-Worth (HNW), HNW with Liquid Alternatives, HNW with Private Markets, HNW Tax Advantaged, Institutional, Institutional with Hedge LP, and Institutional with Private Markets. As the names imply, the strategies vary with the type and degree of exposure to hedge strategies and private market exposure, as well as with the focus on taxable or tax-exempt income.

Model Strategies may include exposure to the following asset classes: U.S. large-capitalization stocks, U.S. small-cap stocks, developed international stocks, emerging market stocks, U.S. and international real asset securities (including inflation-linked bonds and commodity-related and real estate-related securities), U.S. and international investment-grade bonds (corporate for Institutional or Tax Advantaged, municipal for other HNW), U.S. and international speculative grade (high-yield) corporate bonds and floating-rate notes, emerging markets debt, and cash equivalents. Model Strategies employing nontraditional hedge and private market investments will, naturally, carry those exposures as well. **Each asset class carries a distinct set of risks, which should be reviewed and understood prior to investing.**

Allocations:
Each strategy is constructed with target weights for each asset class. Wilmington Trust periodically adjusts the target allocations and may shift away from the target allocations within certain ranges. Such tactical adjustments to allocations typically are considered on a monthly basis in response to market conditions. The asset classes and their current proxies are: large–cap U.S. stocks: Russell 1000® Index; small–cap U.S. stocks: Russell 2000® Index; developed international stocks: MSCI EAFE® (Net) Index; emerging market stocks: MSCI Emerging Markets Index; U.S. inflation-linked bonds: Bloomberg/Barclays US Government ILB Index; international inflation-linked bonds: Bloomberg/Barclays World exUS ILB (Hedged) Index; commodity-related securities: Bloomberg Commodity Index; U.S. REITs: S&P US REIT Index; international REITs: Dow Jones Global exUS Select RESI Index; private markets: S&P Listed Private Equity Index; hedge funds: HFRI Fund of Funds Composite Index; U.S. taxable, investment-grade bonds: Bloomberg/Barclays U.S. Aggregate Index; U.S. high-yield corporate bonds: Bloomberg/Barclays U.S. Corporate High Yield Index; U.S. municipal, investment-grade bonds: S&P Municipal Bond Index; U.S. municipal high-yield bonds: Bloomberg/Barclays 60% High Yield Municipal Bond Index / 40% Municipal Bond Index; international taxable, investment-grade bonds: Bloomberg/Barclays Global Aggregate exUS; emerging bond markets: Bloomberg/Barclays EM USD Aggregate; and cash equivalents: 30-day U.S. Treasury bill rate.

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Disclosures Continued

All investments carry some degree of risk. Return volatility, as measured by standard deviation, of asset classes is often used as a proxy for illustrating risk. Volatility serves as a collective, quantitative estimate of risks present to varying degrees in the respective asset classes (e.g., liquidity, credit, and default risks). Certain types of risk may be underrepresented by this measure. **Investors should develop a thorough understanding of the risks of any investment prior to committing funds.**

Quality ratings are used to evaluate the likelihood of default by a bond issuer. Independent rating agencies, such as Moody's Investors Service and Standard & Poors, analyze the financial strength of each bond's issuer. Ratings range from Aaa or AAA (highest quality) to C or D (lowest quality). Bonds rated Baa3 or BBB and better are considered **Investment Grade.** Bonds rated Ba1 or BB and below are **Speculative Grade** (also **High Yield**.)

Definitions:

Alpha is a measure of performance on a risk-adjusted basis. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.

The Bloomberg Barclays US Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

Duration risk is the risk associated with the sensitivity of a bond's price to a one percent change in interest rates. The higher a bond's duration, the greater its sensitivity to interest rates changes.

Equity risk premium is the extra return that's available to equity investors above the return they could get by investing in a riskless investment like T-Bills or T-Bonds or cash.

Event-driven hedge fund strategies attempt to take advantage of temporary stock mispricing before or after a corporate event takes place. An event-driven strategy exploits the tendency of a company's stock price to suffer during a period of change.

Global intangible low-taxed income (GILTI) is a category of income that is earned abroad by U.S.-controlled foreign corporations (CFCs) and is subject to special treatment under the U.S. tax code.

HFR® (HedgeFundResearch) Indices are the established global leader in the indexation, analysis and research of the hedge fund industry.

LIBOR is the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another.

Macro hedge fund strategies generally focus on financial instruments that are broad in scope and move based on systemic or market risk (not security specific). In general, portfolio managers who trade within the context of macro strategies focus on currency strategies, interest rates strategies, and stock index strategies.

MSCI AC Asia ex Japan Index captures large- and mid-cap representation across two of three developed markets countries (excluding Japan) and nine emerging markets countries in Asia. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI China Index captures large- and mid-cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). The index covers about 85% of this China equity universe. Currently, the index includes large-cap A and mid-cap A shares represented at 20% of their free float adjusted market capitalization.

MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 902 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI EAFE Growth Index captures large- and mid-cap securities exhibiting overall growth style characteristics across developed markets countries around the world, excluding the U.S. and Canada.

MSCI EAFE Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across developed markets countries around the world, excluding the U.S. and Canada.

MSCI Emerging Markets Index captures large- and mid-cap representation across 26 emerging markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Europe Index captures large- and mid-cap representation across 15 developed markets (DM) countries in Europe. The index covers approximately 85% of the free float-adjusted market capitalization across the European DM equity universe.

MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese market. The index covers approximately 85% of the free float-adjusted market capitalization in Japan.

MSCI United Kingdom Index is designed to measure the performance of the large- and mid-cap segments of the UK market. The index covers approximately 85% of the free float-adjusted market capitalization in the UK.

Relative value hedge fund strategies cover a variety of low-volatility trading strategies with the consistent theme of attempting to reduce market risk, i.e., the manager seeks to generate a profit regardless of which direction the markets are moving. All relative value strategies minimize market risk by taking offsetting long and short positions in related stocks, bonds, and other types of securities.

S&P 500 index measures the stock performance of 500 large companies listed on stock exchanges in the U.S. and is one of the most commonly followed equity indices.

Stagflation is persistent high inflation combined with high unemployment and stagnant demand in a country's economy.

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