ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

The ongoing debate over the duration of inflationary pressures confronting the U.S. economy has occupied an inordinate amount of space. Will they be temporary, quasi-permanent, or permanent? While expansive fiscal and monetary policies have fostered rapid growth, shortages created during the pandemic have left many parts of the economy in various stages of "catch up."

The sustainability of these trends is unclear. With enhanced unemployment benefits scheduled to lapse in September, we are likely near the high point of government stimulus. However, the residual effect of policies, past and present, will still create an economy that is far from what it was pre-pandemic and what it will be a couple of years from now.

Trying to project the immediate trajectory of the U.S. economy seems impossible. I believe the more important questions are: What will the U.S. economy, and for that matter, the world economies, look like in 2024? And, what will be the most likely outcome of growth and inflation?

There is no doubt that economies have benefited enormously from the creativity made necessary to survive the pandemic. Systems and decisions have been pulled forward quite dramatically. The lessons learned will provide a major boost for future productivity growth. On the negative side, there is risk inherent in a globalized economy. For example, our ability (and willingness) to rely on "just-in-time" inventory management has certainly changed as a result of the pandemic-related shortages we've experienced. Companies will either bring their supply chains back to the U.S. or find countries other than China to provide the needed work. But China is not easily replaceable as a source of production, and trying to be less dependent on the world's largest exporter will have a cost. Companies will need to reconfigure delivery systems, but I still believe profit margins and productivity will be positives for the U.S. economy going beyond these next few years.

So what does this mean for inflation in the year 2024 and beyond? I stick to my thesis of the last 30 years, that inflation will be very subdued. Once the economic systems around the world adjust to the new normal, there is no reason that post-pandemic inflationary pressures will not go back to their long-term trend of 2% or less.

Some want to compare our situation today with that of the 1970s, when out-of-control inflation threatened the health of the U.S. economy. Those years were driven by cost-push pressures: the price of oil nearly quadrupled between late 1973 and early 1974. The fear was that dramatically rising prices would be a long-term drain on the system. As we now know, a seller is always dependent upon a buyer, and it became very clear that no one wins if the buyer is bankrupted. In the end, between the new efficiencies of consumption and sellers reducing their prices, we were again able to find balance and prosperity. It was a painful period, driven by escalating costs (cost-push inflation). That scenario is totally different from today's situation.

Today we are experiencing demand-pull inflation caused by pent-up demand and a shortage of goods. There is an inordinately high rate of savings today driven by the government's massive infusion of stimulus and the consumer's relative inability to spend during lockdown. As we emerge from the pandemic, an extraordinary demand for goods and services has been created (demand-pull inflation), which will dissipate as the economy normalizes.

This is why interest rates have risen only modestly. The bond market, in its sophistication, is looking beyond these next few years. Much criticism has been directed towards Federal Reserve officials, arguing that monetary policy should be tightened earlier than "planned,"

Continued on next page

INDEX PERFORMANCE — 6/30/21

	QUARTER	YEAR TO DATE
Bloomberg Barclays 10-Year Municipal Bond Index	1.14%	0.57%
Bloomberg Barclays Aggregate Bond Index	1.83%	–1.60%
Bloomberg Barclays High Yield Index	2.74%	3.62%
Dow Jones Industrial Average	5.08%	13.79%
S&P 500 Index	8.55%	15.25%
Russell 2000 Index	4.29%	17.54%
MSCI EAFE Index	5.17%	8.83%
MSCI World Small Cap ex USA Index	4.81%	9.92%
MSCI World Index	7.74%	13.05%
MSCI Emerging Markets Index	5.05%	7.45%

GW&K UPDATE — 6/30/21

TOTAL ASSETS UNDER MANAGEMENT	$55.6 billion
TOTAL EMPLOYEES	164
TOTAL INVESTMENT PROFESSIONALS	57

GW&K DIVERSITY & INCLUSION INITIATIVES

The principles of diversity, equity and inclusion have always been a part of the culture at GW&K, however, the events of 2020 raised the bar for us all to help support our communities, help to end discrimination and intolerance, and strengthen our industry through greater diversity. We are proud of the actions we have taken as an organization and our focus on these essential principles will continue.

Supporting the Greater Boston Food Bank
GW&K employees donated 138,000 meals in 2020 to support our local communities and help end the hunger crisis due to the impact of the COVID-19 pandemic.

Investment Advisor Association (IAA) Features GW&K's D&I Program
Article highlights some of our successful initiatives and we discuss how our focus on D&I is making a difference.

Signatory to the CEO Action Pledge for Diversity & Inclusion
GW&K proudly joins more than 2,000 CEOs of the world's leading companies and business organizations taking meaningful action to advance diversity and inclusion in the workplace.

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but committee members need to be concerned about the long-term health of the economy. Chairman Powell would love to see inflation hit his target of 3%, as he is still fearful of deflation. If the recovery is cut short, whether by moving rates too high or too fast, Powell knows that the tools at his disposal to revive the economy are limited. He will err on the side of being too late, rather than being too early, to avoid the risk of inhibiting the recovery.

One of the risks of keeping interest rates too low for too long is the emergence of speculation. But at these low nominal yields, the multiples on stock values are quite attractive. As earnings rebound this year, the S&P 500 multiple might drop from the present 20x earnings to 15x or 16x earnings. This equates to a 6% cap rate (internal rate of return).

Take a moment to reflect back on how the stock market discounted the pandemic. After the initial shock, it took the market only three months to find its footing. In its infinite wisdom, it viewed the crisis like a tsunami or a hurricane: however difficult the experience of living through it would be, it would pass. Remember, in those early months no one knew that the pharmaceutical companies would achieve a scientific miracle and create an effective vaccine within a year. Yet the stock market began to recover long before a vaccine was announced.

The lesson, learned over and over again, is that the collective wisdom inherent in capitalism gives it the incredible ability to correct itself. That is not just foolish faith or Pollyanna-speak. Unlike any of us who are slow to adjust when faced with a new reality, the capitalist system responds quickly.

I encourage you to not get stuck on the question of how the economy will play out in the next two to three exceptional years. Find comfort in the conviction that normalization will occur over this time period, bringing us back to a place very like the pre-pandemic years.

I encourage all of us to stay the course and continue to have diversified portfolios. There will be wonderful opportunities ahead as investors overreact to the volatility of the next few years. Use those moments with confidence, knowing that they are only temporary, and invest as others get bogged down in minutia. Stay above the fray and you may be well rewarded.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

SECOND QUARTER 2021

ECONOMY

- The economy boomed in the first half of the year thanks to widespread vaccine distribution, reopening of the services economy, robust monetary and fiscal stimulus, and a surge in consumer and business optimism amid record asset prices.
- GDP rose 6.4% in Q1 and likely grew at about a 10% annual rate in Q2 according to a Bloomberg survey. However, jobs growth disappointed market expectations and in May there were still about 7.6 million fewer jobs compared to February 2020.
- Inflation surprised to the upside, with the Consumer Price Index (CPI) for May up 5.0% from a year earlier. Many economists project that inflation will return to the low 2% level over the longer term as growth normalizes and pandemic-related supply disruptions ease.

FED ACTION

- The Fed remained accommodative, but the June FOMC meeting saw most members acknowledge upside inflation risks. As a result, the group shifted to projecting two 25 basis point rate hikes by the end of 2023, with seven members projecting liftoff beginning in 2022.
- The market agrees with the hawkish members, pricing in a 25 basis point rate hike in 2022 and three rate hikes through 2023. Asset purchases remain at $120b/month, but the Fed will discuss a strategy for reducing those purchases in coming meetings.
- The Fed's average estimate for GDP growth was adjusted from 6.5% to 7.0% for 2021. This year's inflation forecast went from 2.4% to 3.4%, but was projected to decline back to 2.1% and 2.2% for 2022 and 2023.

BOND MARKETS

- Fixed income markets rebounded solidly in Q2 following their worst selloff in decades.
- The Treasury yield curve flattened significantly as investors grappled with decelerating growth, the prospect of less accommodative monetary policy, and less ambitious fiscal stimulus.
- Corporate bonds tightened for a fifth straight quarter. Credit spreads compressed to levels last seen prior to the Great Financial Crisis, as robust appetite for yield and benign financial conditions supported demand for the sector.
- Municipal bonds posted solid Q2 returns, following the lead of the Treasury market, although not to the same magnitude.

DOMESTIC EQUITY MARKETS

- U.S. equity markets rallied higher in Q2, with the S&P 500 gaining 8.5%, as the economy reopened. Pent-up consumer demand, continued monetary and fiscal stimulus, solid economic data, and strong corporate earnings results pushed markets higher despite concerns around inflation, peak growth, and tax risk.
- Large cap stocks outpaced small and mid-caps in a reversal of Q1 trends (Russell 2000 +4.3%).
- Most large cap sectors delivered positive returns. Real Estate, Information Technology, Energy, and Communication Services performed best, while Utilities, Consumer Staples, and Industrials lagged on a relative basis.
- Growth stocks outperformed Value in the large cap indexes, though Value maintained leadership over Growth in the small cap market. Investors also demonstrated a preference for low-quality factors.

GLOBAL EQUITY MARKETS

- Europe topped non-U.S. developed market (DM) performance in Q2, as the region delivered a record setting Q1 earnings season. Canada also finished in the lead thanks to a sharp rally in oil prices. In Asia, a virus-related state of emergency weighed on Japanese equities.
- The MSCI World ex USA Index gained 5.6%, while the MSCI World Small Cap ex USA Index returned 4.8%.
- Natural resource rich countries—Brazil, Russia, and Saudi Arabia, for example—drove gains in emerging markets (EM). Asia trailed as investors rotated to commodity producing regions.
- The MSCI EM Index rose 5.0%, backed by currency strength in several countries.
- All DM small cap sectors advanced, led by Real Estate, Energy, and Health Care. EM sector leaders included Health Care, Industrials, and Energy.

MUNICIPAL BOND STRATEGIES

INVESTMENT TEAM

Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
Brian T. Moreland, CFA	Partner, Portfolio Manager
Martin R. Tourigny, CFA	Partner, Portfolio Manager
14 Municipal Investment Professionals	**23** Average Years Experience

GW&K MUNICIPAL BOND STRATEGIES

SHORT-TERM MUNICIPAL BOND

2–8 YEAR ACTIVE MUNICIPAL BOND ESG

2–8 YEAR ACTIVE MUNICIPAL BOND

MUNICIPAL BOND ESG

MUNICIPAL BOND

MUNICIPAL ENHANCED YIELD

Municipal bonds posted solid gains in the second quarter, riding the coattails of a Treasury rally that reversed much of the first quarter selloff in bonds. In many ways, the rebound in the broader market went against the grain of events. After all, during the quarter, unprecedented fiscal stimulus made its way through the economy, with the White House pushing aggressively for even more. A vaccine-led recovery across the U.S. unleashed a mountain of pent-up savings amid easing lockdowns, fueling an acceleration in growth. Inflation readings jumped to levels not seen in two decades, as job openings surged to record highs and supply chain disruptions caused widespread shortages. And yet, Treasury yields declined anyway. Disappointing employment data and a deceleration in retail sales and manufacturing activity called into question the strength of the recovery. Fiscal spending initiatives met stiff resistance in Congress. And the Fed surprised investors by easing off its ultra-accommodative stance on rates and asset purchases, signaling two quarter point hikes in 2023 and setting the stage for a future discussion on tapering. This combination of less-robust growth and a more vigilant Fed led to a significant flattening of the yield curve.

For most of the quarter, municipal bonds kept pace with Treasuries, as federal relief aid boosted credit quality while heightened demand for tax shelters drove record flows into mutual funds. In accordance with the American Rescue Plan, Congress began allocating $350 billion of direct assistance to state and local governments, most of which were already seeing a strong rebound in tax collections. High profile names like New Jersey and New York (city and state), downgraded during the pandemic, saw their outlooks revised higher during the quarter. Connecticut, which hadn't seen an upgrade in 20 years, earned one from each major rating agency. Even Illinois was upgraded, courtesy of Moody's in late June, as the rising tide indeed lifted all boats. These fundamental developments emboldened investors to more confidently reach for yield, driving credit spreads back to pre-pandemic levels. But as the quarter came to a close, long-dated municipal bonds lagged the post-FOMC rally of their Treasury counterparts. Heavy supply, rich valuations and emerging doubts on the inevitability of tax hikes all combined to inject the first hint of caution into a previously-indiscriminate buy side. While municipal bonds are still far ahead for the year, the cheapening of relative value ratios off record-low readings was a welcome development.

Heading into the deep summer months, the near-term technical backdrop for municipals should continue to be supportive. Over the next two months, seasonally-high coupon and maturity redemptions are estimated to outstrip gross supply by $25-30 billion. Secondary market activity, which ground to a two-decade low in the first half of the year, will likely remain depressed as scarce supply and embedded capital gains limit the incentive to sell. But even though June provided some relief from record-high valuations, ratios still begin the quarter richer than any level seen prior to 2021. With such little cushion, municipal bonds should more closely track the course of the Treasury market. That could translate into increased volatility, bearing in mind all the larger questions surrounding the transitory nature of inflation and the paths of fiscal and monetary policy. Municipal investors will also stay focused on the infrastructure debate in Washington, the ramifications of which could mean altered tax policy, more investment opportunities and the reinstatement of municipal financing tools ranging from tax-exempt advanced refundings to a revamped Build America Bonds program. Positioning in this environment is tricky given the potential impacts from a crosscurrent of variables. At this stage, managing risks feels more important than seizing opportunities. But often the former leads to the latter when the alert investor properly prepares.

Our second quarter trading activity was directionally similar to the positioning shift we executed in the first quarter. Recall, earlier in the year, we took advantage of a spike in rates to extend duration, aggressively selling bonds in the five-year area of the curve to reinvest in 10-to-15 year maturities. The idea was to capitalize on a window of heavy new issuance where deals were mostly priced to sell. We continued in that vein through much of April, throttling back only after rates had dropped and the curve had flattened. Credit spreads compressed further and seesawing ratios finished June well through fair value levels. While the technicals in the market suggest a strong third quarter for municipal bonds, we continue to hold a significant position of shorter-term bonds should the emergence of an unforeseen correction create an opportunity to exploit.

> "Heading into the deep summer months, the near-term technical backdrop for municipals should continue to be supportive."

TAXABLE BOND STRATEGIES

INVESTMENT TEAM

Mary F. Kane, CFA	Partner, Portfolio Manager
Stephen J. Repoff, CFA	Principal, Portfolio Manager
Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
14 Taxable Investment Professionals	**19** Average Years Experience

> "The question of whether inflation is structural or merely transitory is set to remain a dominant driver of rates in the near term."

GW&K TAXABLE BOND STRATEGIES

- SHORT-TERM TAXABLE BOND
- INTERMEDIATE TAXABLE BOND
- CORE BOND ESG
- CORE BOND
- ENHANCED CORE BOND ESG
- ENHANCED CORE BOND
- TOTAL RETURN BOND
- CORPORATE BOND OPPORTUNITIES
- SHORT-TERM FOCUSED HIGH INCOME

Fixed income markets rebounded solidly in the second quarter following their worst selloff in decades. The most prominent catalyst behind the first quarter rout—the threat of sharply faster economic growth and elevated inflation—proved far less menacing in light of lackluster data and a less dovish Federal Reserve. In addition to the overhang of COVID-19, including fears of new variants and the elusiveness of herd immunity, signs began to emerge that the pace of the recovery had peaked. Nonfarm payrolls posted successive disappointments, the manufacturing resurgence stalled, and retail sales slipped. Some of the more sensational commodity price spikes began to roll over as well, casting further doubt over the persistence of recent inflationary pressures. None of this suggests that the recovery is off track, but the bond market's stubborn resilience points to a marked revision of the timeframe for normalization.

The Treasury sector experienced a modest retracement after its first quarter decline. The yield curve flattened significantly as investors grappled with decelerating growth, the prospect of less accommodative monetary policy, and less ambitious fiscal stimulus. The most conspicuous driver of the move was the collapse in real yields, which tracked the growing skepticism about the momentum and durability of the ongoing recovery. Inflation breakevens played a smaller role, briefly climbing to their highest level of the last decade before retreating back to flat for the quarter. The most meaningful development, of course, was the Fed's June meeting and subsequent press conference from Chair Powell. The upward revision of estimates for the overnight rate in 2023 was perceived by the market as having a decidedly hawkish tilt, and even though Powell urged against taking the "dots" too seriously, the ensuing price action was fierce. Rates at the front end shifted higher, registering a faster pace of hikes in accordance with the Fed's projections, while intermediate and long rates rallied in a reflection of just how fragile investors believe the recovery is. Mortgages underperformed Treasuries, despite slower prepayment speeds and lower rate volatility, as focus shifted to the uncertainty around the eventual tapering of the Fed's buying.

Corporate bonds tightened for a fifth straight quarter. Credit spreads compressed to levels last seen prior to the Great Financial Crisis, as robust appetite for yield and benign financial conditions supported demand for the sector. Corporations guided to healthy revenue growth and showed few signs that input costs or supply chain disruptions would meaningfully impact margins. They also continued to take full advantage of wide open primary markets to raise liquidity, extend maturities, and reduce interest expense. Evidence of financial distress became increasingly scarce, even among the riskiest segments of the credit market, and the default pipeline was virtually nonexistent. Investors' sanguine attitude toward credit risk was most strikingly on display in the speculative grade market, which saw the sector's yield end the quarter at a record low.

The question of whether inflation is structural or merely transitory is set to remain a dominant driver of rates in the near term. Investors are likely to consider economic readings primarily through the lens of their impact on Fed policy, with significant implications for both the level and shape of the yield curve. The range-bound trading pattern of the last several months reflects how little conviction there has been on either side of the argument. With the market expecting four quarter-point hikes by the end of 2023 and the Fed projecting two, the bias across the curve certainly seems to be to the upside. But the potential for volatility along the way and the ultimate slope of the curve complicate the question of how best to position in advance.

We remain constructive on corporate credit and believe it continues to offer the best value in the fixed income market. Recent spread tightening does little to dim the sector's appeal, given its favorable profit outlook and broadly improved financial profile. Additionally, relative to the Treasury sector, corporates offer a buffer against rising interest rates and the opportunity to earn excess returns amid the unfolding recovery. We also continue to see value in the higher-quality segments of the high yield market, where spreads still sit wide of historical lows and many companies are demonstrating discipline in their efforts to continue improving their credit profiles after the challenges of the last year. We have a neutral view of the mortgage sector due to middling valuations and uncertainty with respect to the fate of the Fed's buying in the sector in the months ahead.

DOMESTIC EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Joseph C. Craigen, CFA	Partner, Portfolio Manager
Jeffrey W. Thibault, CFA	Partner, Portfolio Manager
Jeffrey O. Whitney, CFA	Partner, Portfolio Manager
Aaron C. Clark, CFA	Principal, Portfolio Manager
12 Equity Investment Professionals	**22** Average Years Experience

GW&K DOMESTIC EQUITY STRATEGIES

EQUITY DIVIDEND PLUS

DIVERSIFIED EQUITY

SMALL/MID CAP CORE

SMALL CAP VALUE

SMALL CAP CORE

SMALL CAP GROWTH

Little has changed over the past quarter, as equity markets continue to make record highs amid an economy rapidly reopening from its COVID-induced slowdown. Positive market drivers remain intact, as aggressive fiscal and monetary policy, substantial levels of savings and a strong economic rebound, especially in the U.S., drive earnings higher. Stocks of all sizes, styles and geographies posted gains again this quarter. However, the recovery theme got a little stale in the second quarter, as investors began to worry about peak growth, peak inflation, and peak policy initiatives, resulting in a shift in market leadership away from the more economically-sensitive sectors and back toward more organic-growth names. While inflationary pressures have become quite prevalent, the nature of the inflation wave remains unclear.

U.S. stocks, as measured by the S&P 500 Index, posted a gain of 8.5% in the quarter, with five consecutive record highs to finish the period, and the fifth consecutive quarterly gain following the 1Q20 market meltdown. All market sectors posted gains for the quarter, save for Utilities. Organic growth-oriented sectors such as Communication Services and Information Technology led. But Energy also remained strong among the continued rally in oil prices. Real Estate led the pack amid an improving rental outlook and the market's search for yield. Economically-sensitive cyclical sectors such as Industrials and Materials lagged, as did the more defensive Utilities and Consumer Staples sectors.

Among small caps, the Russell 2000 Index posted a 4.3% quarterly gain, with similar sector leadership as shown by large caps. Still rebounding from last year's near-death experience, Energy gained another 20%, and has now risen a whopping 70% year to date.

As investors questioned the durability of the economic expansion and interest rates dropped, the more value-oriented cyclical/economic recovery plays reversed course in the quarter, contributing to Growth's substantial 7% outperformance versus Value among larger cap names. Nonetheless, Value maintains a solid 4% advantage over Growth year to date. Among small caps, however, Value managed to further extend its lead over Growth in the quarter.

Little has changed fundamentally over the past few quarters as the combination of stimulus and reopening has driven the economy upward. ISM surveys in both Manufacturing and Services remain in expansion territory. Employment figures remain robust, as the unemployment rate continues to drop, while job creation is strong, job openings are in record territory and labor rates show impressive gains. Consumer spending also remains solid, while the Consumer Confidence survey remains strong. Housing demand is off the charts, while prices rise at double-digit rates in many markets. And this strength is being experienced before further fiscal spending plans make their way through Congress and the rest of the world catches up with our recovery.

With everything seemingly moving along swimmingly, what is the market worried about? The answer is clear: the three "peaks" mentioned previously: peak economic growth, peak policy initiatives, and peak inflation.

Our view is that we are indeed peaking in the rate of growth, but that is off the depths of last spring's slowdown. Slower growth does not mean we are in decline, and we expect a sustained period of moderate economic growth in 2022 and 2023.

We would welcome seeing a peak in fiscal and monetary policy initiatives, as a reduction in deficit spending would be good for the long term, while less dovish monetary policy would also return corporations to a more normal capital allocation decision making process.

Peak inflation is the more divisive issue. On the one hand we see inflationary pressures in nearly all inputs: energy, raw materials, labor and transportation. We also see businesses successfully passing on these cost pressures to customers in the form of price increases; readily accepted by buyers due to shortages caused by supply chain disruptions. Consumers, flush with cash and savings, receiving healthy government benefits and holding higher paying jobs, are also willing to pay higher prices for their goods and services, especially after a year of pandemic-induced quarantine. While supply chain issues will ultimately be resolved, their impact on prices in the out years is less predictable. Similarly, as labor rates increase, will inflationary wage pressures ease as demand slows to a more normal level?

Despite strong market gains, valuation levels have not moved up meaningfully, as earnings expectations rise in line with the market. We believe our Strategies have a good balance between cyclically exposed companies that will benefit from this current economic cycle and those with organic growth less impacted by the economy. But the common theme with all of them is quality. We rely on well-positioned companies with strong management teams to guide their businesses toward long-term success regardless of economic outlook.

> "Our view is that we are indeed peaking in the rate of growth, but that is off the depths of last spring's slowdown.…we expect a sustained period of moderate economic growth in 2022 and 2023."

GLOBAL EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Reid T. Galas, CFA	Partner, Portfolio Manager
Karl M. Kyriss, CFA	Partner, Portfolio Manager
8 Equity Investment Professionals	**24** Average Years Experience

GW&K GLOBAL EQUITY STRATEGIES

GLOBAL SMALL CAP

INTERNATIONAL SMALL CAP

"The takeaway is that these differences in the timing of economic recoveries are likely to provide both problems and opportunities for investors. While no one knows what the future holds, our approach has been to strengthen our commitment on investing in companies with strong business franchises and improving visibility, mostly independent of the broader economy."

Global developed markets advanced again this quarter, although there were some areas of relative weakness. The MSCI World ex USA and MSCI World ex USA Small Cap Indexes finished the quarter up 5.7% and 4.8%, respectively. After a rally last quarter the U.S. dollar weakened slightly, but is still higher on the year.

Markets were up across every region and sector, although there were some divergences by country. Asia was the laggard again this quarter, with Japan actually down –0.9%, while North America was up almost 10% and Western Europe was close behind. Israel, Denmark, and Italy led, while Japan was the notable outlier and the only country with a negative return. Unlike last quarter, the Japanese yen was not to blame as it was stable against the U.S. dollar. On a sector basis, Energy remained on top, followed by Real Estate and Health Care. Consumer Staples, Utilities, and Materials lagged, but were still higher. Energy diverging from Materials highlights how demand is recovering, while supply continues to be constrained.

After conversations with various company managements and listening to first quarter earnings calls it is clear that the market still faces two major sources of uncertainty: the timing of COVID-19 recovery and the path of inflation. The countries that did well at preventing COVID's spread early in the pandemic have generally performed poorly during the vaccination process. Inflation meanwhile is showing up everywhere in higher input costs, but the more sticky wage inflation and how likely companies are to pass along their cost increases differs by country. As a result, for the first time in about a decade, different countries are at different stages of the economic cycle.

China was the first to feel the impact of COVID, but has also been the first to recover. It experienced a strong recovery in mid-2020, but has since seen growth slow as government support has waned. A bit ironically, China is running the most orthodox monetary policy of any of the major economies. However, a slowing credit impulse, increasing regulations, and a post-peak economy have resulted in continued underperformance of its stock market.

After feeling the full brunt of the pandemic during 2020, the U.S. and UK led the major developed economies in vaccine deployment and have seen strong economic recoveries as a result. They will likely reach growth peaks in the second or third quarter of 2021. Europe fumbled its initial vaccine roll out, but has since improved. While its economy is behind by several quarters it's on the same recovery path. Also in Europe's favor is much of their fiscal EU support package has yet to be spent. As a result, Europe may become a driver of global economic growth just as the U.S. and China decelerate.

Japan did a remarkable job containing infections, however, their vaccination process has been almost embarrassingly inept. Though, they seem to have addressed the issues and will likely have the population vaccinated by the end of the year. The remaining countries fall into two categories: those like New Zealand or Australia, whose success in keeping out the virus will become a liability once the rest of the world reopens; and mostly emerging countries, which have yet to ramp vaccinations and will likely not see a recovery until 2022 or beyond.

The topic of inflation deserves its own note. Inflation and interest rates are likely to diverge based on local fiscal and monetary policies. For example, the U.S. used enhanced unemployment payments to support workers impacted by the pandemic, while Japan and Europe paid companies directly to keep workers employed. Now, during the recovery, U.S. companies are finding they need to increase wages to entice workers to return. In countries where the workers never stopped receiving paychecks, that problem doesn't exist. Given that wages are some of the "stickiest" prices there may be an element to inflation in the U.S. which is not seen overseas.

The takeaway is that these differences in the timing of economic recoveries are likely to provide both problems and opportunities for investors. While no one knows what the future holds, our approach has been to strengthen our commitment on investing in companies with strong business franchises and improving visibility, mostly independent of the broader economy. Where this is not possible, we have looked to invest ahead of expected recoveries where the long-term business prospects are strong, but the near term is uncertain. We expect patience and discipline to be rewarded.

EMERGING MARKETS EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Pablo Salas	Partner, Portfolio Manager
Nuno Fernandes, CFA	Partner, Portfolio Manager
Thomas A. Masi, CFA	Partner, Portfolio Manager
Bradley J. Miller, CFA	Partner, Portfolio Manager
William P. Sterling, Ph.D.	Global Strategist
18 Equity Investment Professionals	**28** Average Years Experience

GW&K EMERGING MARKETS EQUITY STRATEGIES

EMERGING MARKETS EQUITY

EMERGING MARKETS EQUITY ADR

EMERGING WEALTH EQUITY

EMERGING WEALTH EQUITY ADR

Emerging market (EM) equities posted a solid gain of 5.0% in the second quarter, marking the fifth consecutive quarter of gains. EM equities benefited from ample evidence that the global economy continues to recover from the pandemic shock. Also, as U.S. 10-year Treasury yields dipped back below 1.5% in the quarter, a basket of MSCI EM currencies gained 1.2% against the U.S. dollar, led by a 9.2% gain in the Brazilian real. However, the MSCI EM Index in the second quarter trailed the 7.7% gain in the MSCI World Index of developed market (DM) equities. For the year to date, that left EM equities up only 7.4% compared to a gain of 13.0% for DM equities.

The relative underperformance of EM equities in a global bull market appears to reflect numerous cross currents. First, America's exceptionally aggressive fiscal policy makes it likely that the U.S. will grow faster than China in 2021, especially since China is taking advantage of its early recovery to rein in credit growth. Second, many key EM nations have lagged behind the U.S. and Europe in vaccinations. As a result, many have struggled with episodes of renewed COVID-19 outbreaks and mobility restrictions to cope with more contagious new variants. That said, China made notable progress in the second quarter, with nearly 90% of its population having received at least one vaccine dose by mid-year.

A third important cross-current has been the emergence of inflationary pressures around the world as recovering demand has collided with disrupted supply chains and rising commodity prices. Although the main DM central banks including the Fed, the European Central Bank, and the Bank of Japan have taken a very patient approach toward adjusting monetary policy, a number of EM central banks have taken a more orthodox and hawkish approach toward signs of inflation. For example, Turkey has seen rates go up by 1,075 basis points this cycle, Brazil by 225 basis points, Russia by 75 basis points, and most recently Mexico with a surprise 25 basis point rate hike. Although rates in Turkey have probably peaked, further tightening seems likely in Brazil, Russia, and Mexico, as well as in a number of Eastern European economies. That said, EM nations that have been struggling with the Delta variant like India, Indonesia, the Philippines, and Thailand seem likely to maintain accommodative policy for longer.

Reflecting the buoyancy of the global economy, commodity prices like Brent crude and the CRB Raw Industrials Index rose by 17% and 7%, respectively, in the second quarter, and by 44% and 19% for the year to date. Against that backdrop, highly cyclical sectors like Energy, Materials, and Industrials were some of the top-performing sectors in the second quarter, although they were eclipsed by a robust 14% gain in the Health Care sector. The only EM sector to decline in the second quarter was Real Estate, which felt the brunt of China's credit squeeze. But sectors like Information Technology, Consumer Discretionary, Utilities, and Communication Services also lagged the market, with China's credit policy and anti-monopoly initiatives dampening prospects for some growth stocks.

Many of the cross-currents just mentioned were also reflected in the regional pattern of returns. Commodity-sensitive EM regions like Latin America and Europe, the Middle East, and Africa (EMEA) outperformed in the second quarter with gains of 15.1% and 11.3% respectively. In contrast, EM Asia lagged with a gain of only 3.8% in the second quarter. China's credit restraint and anti-monopoly initiatives dampened returns in Asia, as did the ongoing pandemic issues mentioned above.

Despite the uneven pattern of the global economic recovery, we remain optimistic that the most likely scenario for the world economy is for a multi-year expansion that will be constructive for EM equities. And while markets debate whether recent inflationary pressures are transitory or sticky, corporate earnings in both EM and DM seem likely to track the multi-year economic expansion and provide a positive tailwind to equity markets. The good news for EM investors is that EM valuations remain attractively valued versus U.S. equities, with a Shiller PE ratio for EM of 16.6x at the end of June compared to 33.1x for the U.S.

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