Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Second Quarter of 2021

Leigh Bivings, Ph.D., CFP®

Scott Gillespie, CFA

Artemis Financial Advisors LLC

115 Newbury Street, Suite 302
Boston, MA 02116
617-542-2420

Artemis
FINANCIAL ADVISORS LLC

Executive Summary

- The powerful reignition of global economic activity continued and broadened in the second quarter which, in concert with strong inflow into equity markets, resulted in quite a bit of volatility but ultimately very positive returns.

- Once again, the U.S. market outperformed those in other parts of the world due in large part to higher Covid vaccine rates and outsized fiscal and monetary support.

- The biggest winners this quarter were commodities (+13.3%) and global real estate (+10.4%), which continued their strong 2021 recovery, followed by large-cap U.S. stocks (+8.3%), emerging market equity (+5.7%), and international developed (+5.6%).

- Bond returns were mostly higher for the quarter as interest rates peaked in early March, with the 10-yr Treasury falling from 1.75% on March 31 to 1.44% on June 30th. TIPs (+3.3%) and real estate income (+4.9%) continued their strong trend while corporate bonds (+2.1%) and municipal bonds (+0.9%) slightly underperformed.

- In this quarter's report, we take a deeper dive into recent trends in sustainable investing. There is no shortage of items to report, and our letter focuses on the *explosive growth* in the space, *bonds going green, regulatory changes,* and the increasing success of *investor pressure* on companies to be more ESG-friendly.

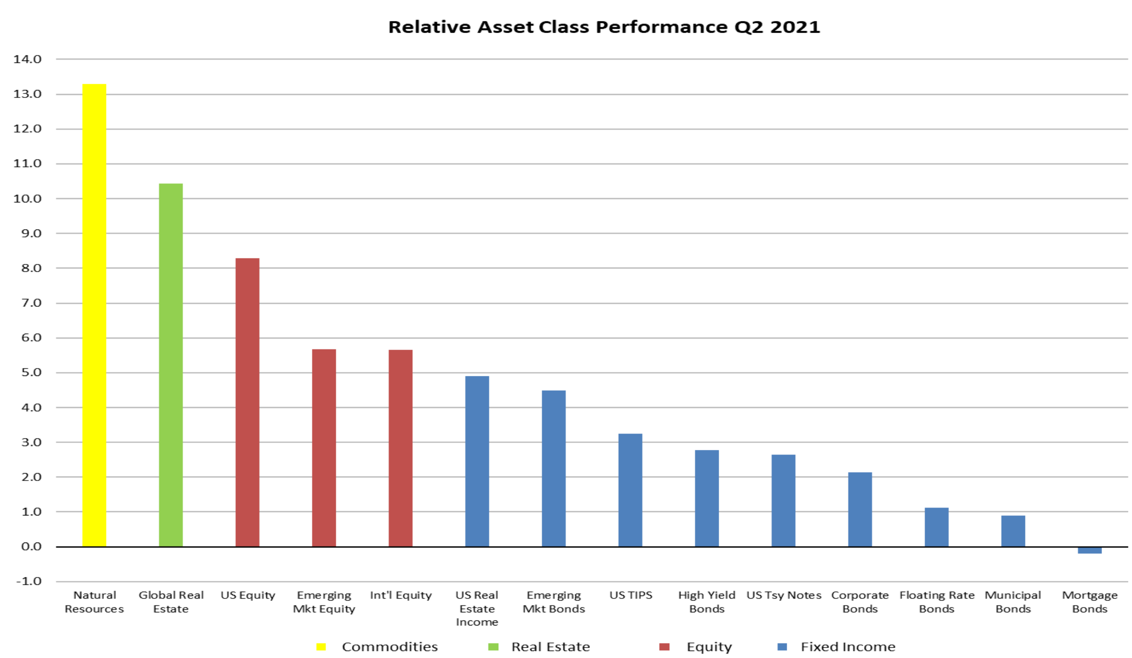
- **Artemis strategy.** Early this year we rebalanced client accounts and made a few tactical changes. This quarter market conditions continued to evolve as a post-Covid economy came to life. The reignition of the global economy in its fits and starts brings volatility, which is to be navigated and not feared as it is an expected part of the recovery. We are happy with our current positioning and are in a watch-and-wait mode as we write this report. We are unlikely to make any moves until the fall when volume returns to stock markets; however, we are cognizant that we can't ignore relative valuation signals forever and that growth is indeed very expensive. Hence, we are likely to further balance our portfolios between value and growth soon.

Markets in Review

The powerful reignition of global economic activity continued and broadened in the second quarter which, in concert with strong inflows into equity markets, resulted in very positive returns for the quarter. This quarter saw dialogue about the economy fluctuate between reopening challenges, excitement, bottlenecks, and the potential/likelihood of overheating growth. It became clear that, despite the Covid Delta variant, pent-up demand had cascaded back into many economies.

The biggest winners this quarter were commodities (+13.3%) and global real estate (+10.4%), which continued their strong 2021 recoveries, though it is important to distinguish between the near-term drivers of restart momentum in certain commodities (i.e., lumber) and the long-term equilibrium. Commodities and global real estate were followed by large-cap U.S. stocks (+8.3%), emerging market equity (+5.7%), and international developed equity (+5.6%). See Figure 1.

Figure 1. Asset Class Returns in USD for Q2 2021 (%)

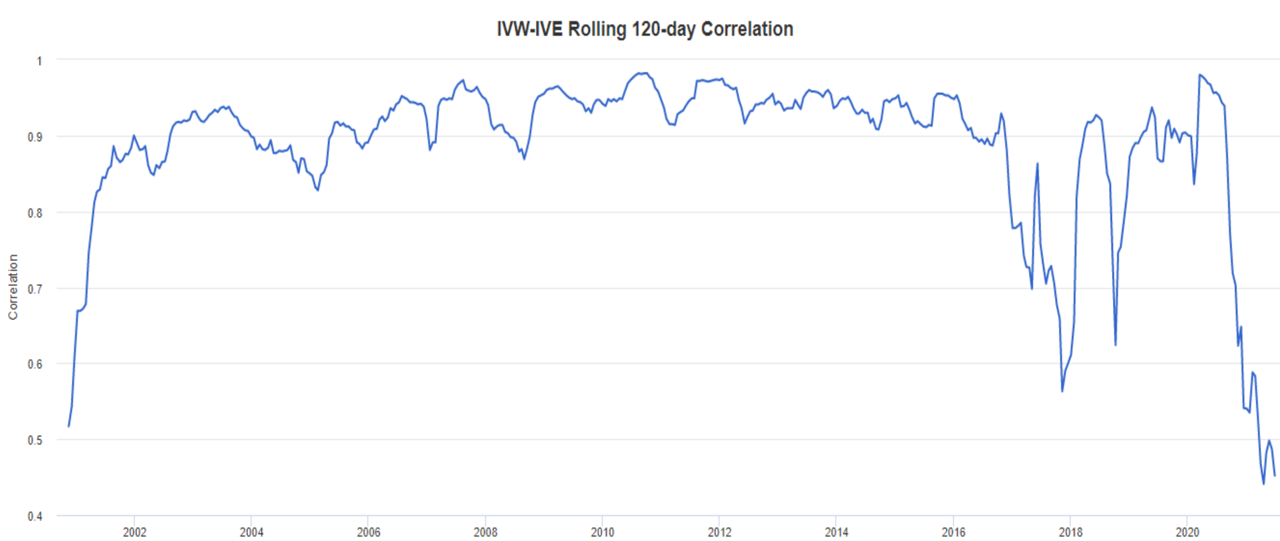


The Eurozone vaccine rollout gathered pace, but the highly contagious Delta variant spread and led to further challenges to re-opening. These pressures, along with regulatory pressures from the Chinese government on tech high-flyers, led international developed and emerging market equities to lag their U.S. counterparts.

A “peak growth” narrative has also begun to emerge that says the market will find it harder to keep rallying when economic growth and earnings growth may have peaked. Strong U.S. GDP growth that registered north of 6% in Q1 went above 10% in Q2, but many expect economic growth rates to moderate in the second half of this year. Estimates for 2021 GDP growth are around 5.5-6.5% for the year and 4% in 2022 as growth normalizes.

A key market dynamic that has taken shape over the past 18 months is the declining correlation between value stocks and growth stocks. It is not atypical for the two to have differing reactions to changes in various macroeconomic variables due to the differing characteristics of the underlying companies. For example, value-oriented companies in the financials sector tend to do better when interest rates are rising, while growth-oriented tech companies tend to do better when rates are falling. (See our report from Q1, which explains this phenomenon in more detail.) That said, the nature of the separation between the two has become unhinged in the past 18 months from longer-term trends, with some evidence that this has been building since 2017/2018. See Figure 2.

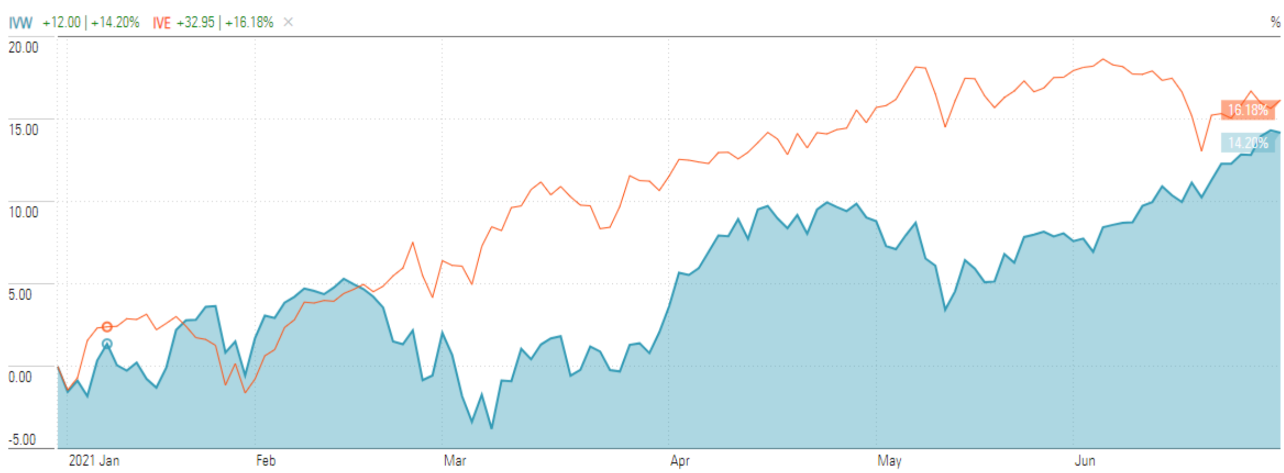
Figure 2. Rolling Correlation between US Large-Cap Growth and Large-Cap Value indices



As shown in the figure, the correlation between growth and value was above 80%, often trending as high as 90-95%, during the 15 years between the tech bubble and 2017. This quarter, the correlation fell below 50%, dropping almost as low as 40% on a rolling 120-day basis. What has become apparent in the last 18 months as this correlation unraveled, is the increasing sensitivity of the two asset classes to changes in expectations for three key economic inputs: interest rates, inflation, and economic growth. It should also be noted that value stocks have underperformed growth for a large part of the past decade, which many have blamed on falling bond yields, low inflation, and the scarcity of economic growth. The current environment lends itself to economic uncertainties, and this is a driving source of the current separation and volatility.

This past quarter, dramatic swings between value and growth occurred in May (3.5 percentage points in favor of value) and June (6.8 percentage points in favor of growth). For the quarter, growth took the lead +11.9% vs +5.0% for value; however growth is lagging YTD +14.2% vs +16.2%. See Figure 3. This is an important and evolving dynamic that will be key to watch as the economy moves from its initial wave of activity to subsequent stages of the recovery.

Figure 3. YTD returns of US Large-Cap Growth (Green) and Large-Cap Value (Orange) indices



The Federal Reserve also continues to be a dominant news cycle force, and investors are looking for any indication the Fed believes inflation is more than transient or growth is overheating. Thus far the Fed has placated markets with consistent messaging. With interest rates moving lower in Q2, at least for the moment, this messaging appears to have proven true.

Bond returns were mostly higher for the quarter as interest rates peaked in early March, with the 10-yr Treasury falling from 1.75% on March 31 to 1.44% on June 30. TIPs (+3.3%) and real estate income (+4.9%) continued their strong trend, corporate bonds (+2.1%) and the Barclays Aggregate Bond Index (+1.8%) had modest appreciation, and municipal bonds (+0.9%) slightly underperformed. High yield (+2.8%) and emerging market debt (+4.5%) also had slightly higher returns as risk assets broadly appreciated.

Recent Trends in Responsible Investing

As regular readers of our quarterly reports know, Artemis now fully embraces environmental, social, and governance (ESG) investing. As a reminder, ESG investing is all about taking ESG risk factors (e.g., climate change, worker safety, etc.) into consideration when making investment choices. There is an ever-increasing body of research that indicates that companies that are better stewards of the environment, their workers, and their communities are better, more promising (e.g., lower risk, better performing) long-term holdings.[1]

In this summer issue, we summarize recent shifts in ESG investing and what may lie ahead on the horizon. There is no shortage of items to report.

Explosive Growth

ESG investing is definitely experiencing explosive growth. The coronavirus, George Floyd's death, President Biden's renewed focus on the environment, some really awful recent climate events, and continued regulatory activity out of Europe are all propelling rapid growth in ESG investing. So, too, is the growing body of research referenced above that suggests that focusing on material ESG issues can drive better financial outcomes.

---

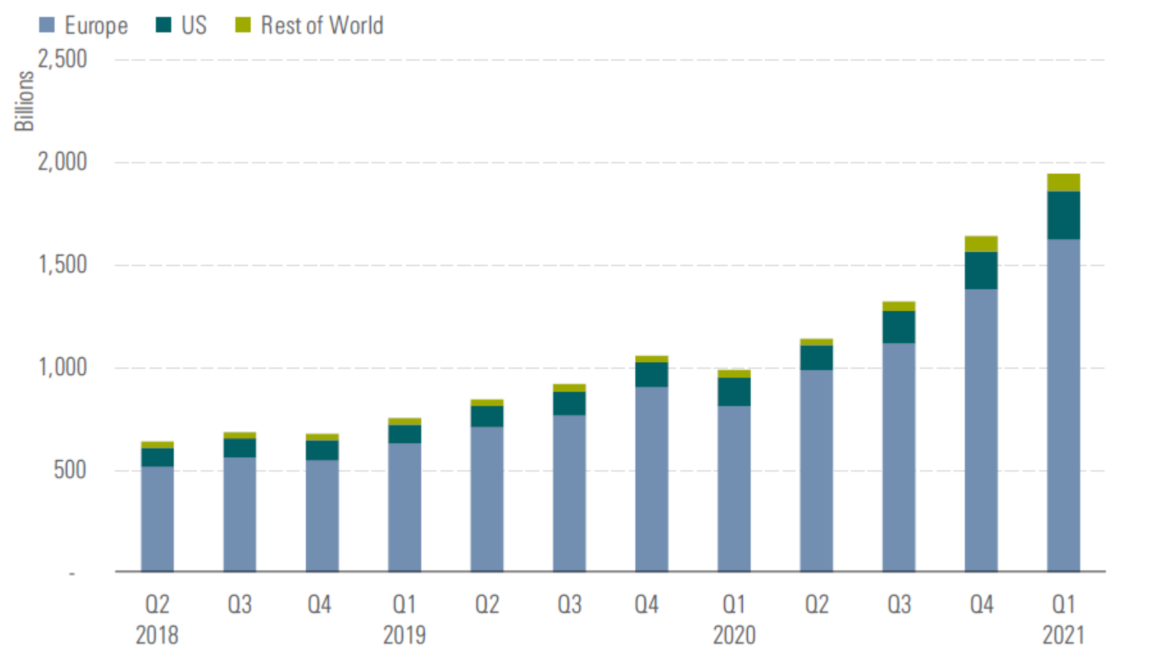
[1] Whelan, Tensie, Ulrich Atz, et. al. *ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015-2020*. New York University and Rockefeller Asset Management. February 2021.

As of the end of March 2021, global ESG fund assets had grown to just under $2 trillion, up 18% from Q4 2020, and doubling in value over the last 12 months. See Figure 4. Notably, European fund assets comprise a whopping 83% of the total, with the U.S. still far behind at 12%.

According to Morningstar, there are now just over 4,500 sustainable fund choices available globally, and this doesn't even count those managers who formally consider ESG risk factors but who do not explicitly constrain their funds.

ESG's growth suggests that investors are beginning to believe that considering ESG risk factors is as important as considering a company's pension obligations, investment plans, and other more traditional financial metrics when making investment decisions.

Figure 4. Quarterly Global Sustainable Fund Assets (USD Billion)



Source: Morningstar Direct, Manager Research. Data as of March 2021.

Bonds are Going Green

A second notable trend is the rise of ESG considerations in fixed income investing. While the vast majority of ESG funds on the market currently are equity funds, this landscape is rapidly changing with the introduction of so-called green bonds, social bonds, and sustainability-linked bonds.[2] In addition, more research that investigates the financial benefits of incorporating ESG considerations when evaluating standard corporate bonds is becoming available.

Green bonds are those issued to raise funds to invest in environmental or climate change mitigation, such as renewable energy or clean transportation. The green bond market has been around for about a decade, but few non-European investors purchased them and they often sold at lower prices than conventional bonds. This situation is rapidly changing as major issuers now include many non-European national governments, state and local authorities, and their agencies. The corporate sector has also become a much larger player, and about 50% of all new issuance is now corporate. Green bond issuance totaled just over $200 billion in 2020, but has already reached that amount in just the first six months of 2021. Analysts project issuance might more than double 2020's total by year end.

In theory, green and traditional bonds from the same issuer with the same maturity and coupon should have the same yields, as they have equal credit risk. However, some researchers are finding that investors are sometimes paying more for green bonds, reflected in lower borrowing costs for issuers (called a "greenium" by some analysts). This is likely due to current excess demand for green bonds, something that should change as more green issues become available. On the positive side, green bonds are proving more resilient compared with corporates. For example, the global (non-green) corporate bond index sustained significantly more damage during the Covid-related bond blowout early in 2020 than did the green bond index.

Green bonds are different than sustainability-linked bonds (SLBs). SLBs are government or general corporate debt instruments in which, unlike green bonds, the issuer retains full

---

[2] Social bonds are a form of debt that allow investors to help raise funds for projects with positive social outcomes that in some cases, provide an investment return. They include projects on improving food security and access to education, as well as health care and financing. They will be the subject of a separate quarterly report.

discretion for how capital will be allocated once it is raised. Instead, SLBs are designed to reward or penalize the borrowers (via the interest rate paid on the debt) for hitting or missing more general environmental goals set out in the bond offering. SLBs have only been around since 2019 and reached $11B of issuance in 2020 (less than 10% of green bond issuance), but they are garnering a fair bit of interest and some controversy.

A recent paper from Nuveen, a large asset management firm that specializes in fixed income, detailed some of the problems it is seeing with SLBs, such as the issuers gaming the goals in a way that makes them easy to achieve or creating penalties for non-achievement so small as to not incentivize management to comply. We tend to agree that investing in SLBs is not ready for prime time, but we are watching the space closely.

Finally, fund managers are increasingly incorporating ESG considerations into standard corporate bond portfolios. Incorporating ESG risk factors when evaluating corporate debt, in particular, is increasingly viewed as having the potential to identify non-financial risks that might be overlooked or minimized through traditional investment analysis. This is the conclusion reached in a major study completed last November.[3] The study found that incorporating ESG considerations in corporate fixed income helped to mitigate downside risk, and therefore ESG considerations complemented existing credit ratings. This is an important finding as bonds in general have limited upside, but in a negative scenario such as a bankruptsy investors can potentially lose all their invested capital.

Investor Pressure Making a Difference

Another trend is the growing success of shareholder activism as a tool to effect change within companies. In general, the premise behind ESG investing is to reward ‘good’ companies and punish ‘bad’ ones by withholding investment capital from them (and thereby increasing the price of borrowing). But investors have other ways to express their views and foment change such as through proxy voting and shareholder advocacy. Very recently, the ESG news has been dominated by investors scoring some big wins this way in Big Oil.

In May, shareholders at ExxonMobil backed an activist campaign by a tiny hedge fund to overhaul the company’s board, and three new directors were elected with a mandate to push a more aggressive strategy to drive down emissions. While the CEO of Exxon retained

[3] Mendiratta, Rohit, Hitendra D. Varsani, Guido Giese. *Foundations of ESG Investing in Corporate Bonds: How ESG Affected Corporate Credit Risk and Performance*. MSCI. November 2020

his seat on the board, he yielded to some of the activists' demands not only by adding the new board members, but also by pledging to slash spending on new oil and gas projects, disclosing for the first time emissions created by burning the company's products, and promising to increase spending on carbon capture and storage. Essentially, the vote reflected shareholders' belief that Exxon's energy transition strategy was falling short of what is necessary to ensure the company's financial resilience in a low-carbon economy.

Of note is that this vote came the very same week a Dutch court ordered Royal Dutch Shell to accelerate and deepen its emissions cuts. The case was brought to court by Dutch branch of the Friends of the Earth and the ruling effectively creates a precedent whereby a court can decide on the corporate strategy of a major emitter of greenhouse gasses and force an overhaul of its business. The company has since outlined its new plan.

And not to be missed – the same day ExxonMobil activists shook up its Board forcing extensive changes, shareholders at Chevron approved a measure to set strict emissions targets from products that it sells. As one commentator noted, "May 2021 was the month the petroleum-based economy began to unravel."

We could cite many more examples of how shareholder activism is having a transformative impact. At Artemis, we have long believed shareholder activism to be a crucial tool to effecting change, and for this reason we only use ESG products whose managers pledge to engage with the companies they are investing in on our behalf. One of our goals over the next year is to report to our clients on the successes our current fund managers are achieving with their efforts in this regard.

Regulation is Increasing

The final trend worth mentioning is the plethora of ongoing activity on how to better regulate the burgeoning ESG industry and compel companies to report more and better data on their material ESG risk factors. In this area, the European Union has long been at the vanguard. The big recent news on this front is that after almost three years of preparation, in early March of this year, the EU Sustainable Finance Disclosure Regulation (SFDR) took effect. The regulation aims to increase transparency about the integration of sustainability risks by fund managers by requiring them to classify their funds in one of three categories: non-sustainable, ESG aware, and ESG targeted, with the latter reserved for funds that are directly targeting sustainable investments. Starting in January 2022, fund managers will have to back up their claims with even more detailed disclosures, such as the policies they use to evaluate companies' governance practices. The rule applies to all asset managers that raise money in the European Union, whether they are based within its border or not and is designed to reduce 'greenwashing,' in which fund companies make misleading marketing claims to falsely suggest an environmental benefit or promote a false image.

Many believe this new regulation may turn out to be a milestone for the industry, with some form of the regulation being adopted in the U.S. Indeed, momentum is building. In March, the SEC established a task force to focus on climate and ESG disclosure at public companies and asked for public comment on tightening its rules in this area. and the SEC is now including ESG disclosure policy as a priority in its annual regulatory agenda. In addition, in June, the U.S. House narrowly passed a package of bills aimed at requiring companies to provide certain disclosures about their ESG policies. The bill has not yet come before the U.S. Senate.

In a similar vein, government representatives and central bank officials from a variety of countries announced in late May that they are nearing an agreement that would require all listed companies globally to disclose the risks they face from climate change in a standardized way. Such officials now believe that an international framework could be ready to be passed at November's UN COP26 climate conference in the Scottish city of Glasgow. The U.S. is signaling that it is likely to sign on to such a framework. This one is a big deal.

In summary, ESG investing is no longer a niche activity. Our view is that within a decade all investment managers will be compelled to take ESG considerations into account in their investment processes.

Artemis Strategy

We have been in a bit of a holding pattern this quarter on our own investment strategy for clients. As we wrote in our report last quarter, the compelling valuation differential between growth versus value, coupled with the momentum associated with reopening of the economy, indicated to us that more cyclical value stocks (e.g., industrials, financials) might outperform growth. Accordingly, in January and February, we took some profit from our outsized large growth allocation and used the proceeds to buy more cyclical recovery stocks, including smaller companies. This rotation helped portfolios as cyclical stocks did continue to outperform until the end of May. But as discussed in our market summary section of this report, starting in June that rotation reversed, in part due to investors gaining faith that the Federal Reserve is serious about keeping interest rates low, that the current burst of inflation may be transitory, and that growth may have peaked. Hence, while we were about to tilt even more toward cyclical stocks in June, we decided to wait, a move that boosted portfolios returns in June as growth surged again.

We are happy with our current positioning and are in a watch-and-wait mode as we write this report. We are unlikely to make any sizable moves until the fall when volume returns to stock markets; however, we are cognizant of the fact that we can't ignore relative valuation signals forever and that growth is indeed very expensive. Hence, we are likely to further balance our portfolios between value and growth soon.

Separately, we do plan to start using corporate and diversified bond fund managers that incorporate ESG factors into their investment processes; we have selected a few new funds that we like. We have no plans to directly invest in green or sustainability-linked bonds or bond funds, although this may change as the sector matures.

Finally, we are starting to get concerned about near-term prospects in many emerging markets where Covid is still raging and vaccination rates are low. Developing countries simply don't have the capacity to borrow and use fiscal and monetary policy to stimulate growth like more developed countries. They will also be negatively affected as developed countries start withdrawing their pandemic stimulus. As such, we may pare back our exposure on a tactical basis in favor of Europe, which is just now opening up despite the threat of the Delta variant of Covid.

Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of $150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **S&P Global REIT Index** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.