

THIRD QUARTER 2021

Investment Strategy Update

Global securities markets continued to trend higher during the first half of 2021, benefiting from the reopening of global economies and higher earnings growth, particularly in the U.S. Global economic data pointed to a continuation of the recovery in the first quarter, leading some economists to upgrade forecasts of global growth. At the same time, investor sentiment has been gradually shifting, as enthusiasm regarding the early cycle recovery has started to wane, and concerns about peaking economic growth in the U.S. began to surface. The U.S. economy grew at an annualized rate of 6.5% in the second quarter, falling short of expectations, primarily due to a decline in inventories and less government spending. On the other hand, personal consumption remains strong, with spending on services surging during the second quarter despite a material decline in the demand for goods. Despite the rise in cases of the COVID-19 delta variant, higher frequency indicators continue to show an increased degree of mobility, indicating that the impact on the consumption of services is likely to be limited. Furthermore, historically high job openings indicate that employment conditions should improve materially, which is also likely to be supportive of consumption. Nevertheless, the current labor shortage in the U.S. has implications on wages, particularly in the services sector, where most of the hiring is taking place today. This, in addition to persistent supply chain issues, indicates that inflation risk is elevated in the near-to-intermediate term. As these pressures settle over time, we may begin to see some offsetting structural factors, such as technology driven secular shifts that may continue to place downward pressure on prices over the long-term.

In this quarter's Investment Strategy Update, we take a deeper dive into the labor market, underlying indications of rising core inflation, interest rate expectations, equity valuations, and the recent change in sentiment in both equities and fixed income. We have become more concerned with interest rate risk and are directly reducing duration risk in portfolios and/or further reducing our allocation to core fixed income in favor of more flexible/alternative mandates that exhibit less duration exposure. We also continue to favor emerging markets and U.S. value equities, which are more attractively valued and are likely to benefit from a pro-cyclical/post-recessionary environment.

Investors have become fixated on monetary policy in recent months, as the prospect of a taper in the purchases of treasuries and mortgage-backed securities by the Fed becomes increasingly probable in late 2021 or early 2022. This may result in more volatility in the near-term as investors process this risk, however it's important to recognize that equities can appreciate while interest rates rise, provided that the economy is growing at a healthy rate. Wilshire continues to promote diversification and remains judicious in the allocation of our active risk budget, particularly given expectations of heightened volatility. We provide a summary of our rationale and supporting exhibits in the following sections.

Asset class	April	Change	July
Fixed Income vs. Equity	Neutral	≈	Neutral
Alternatives vs. Equity	Neutral	≈	Neutral
Alternative vs. Fixed Income	Overweight	↑	Large Overweight
Duration vs. Barclays Aggregate	Neutral	↓	Underweight
Credit vs. Government	Neutral	≈	Neutral
Investment Grade vs. High Yield	Neutral	≈	Neutral
High Yield vs. Bank Loans	Neutral	≈	Neutral
Emerging Markets Debt (EMD) vs. High Yield	Overweight	↓	Neutral
Large Cap vs. Small Cap Equities	Neutral	≈	Neutral
Growth vs. Value Equities	Underweight	≈	Underweight
Global ex-U.S. vs. U.S. Equities	Neutral	≈	Neutral
Emerging vs. Developed Equities	Overweight	≈	Overweight
Commodities vs. Global REITS/Equities	Neutral	↑	Overweight

Asset class	Change	View	Summary of rationale
Fixed Income vs. Equity	≈	Neutral	Despite a positive economic outlook, which would normally be expected to benefit equities coming out of a recession, valuations are not materially more attractive in equities vs. fixed income, resulting in a neutral posture.
Alternatives vs. Equity	≈	Neutral	We remain mindful of equity valuations, but we believe that equities will continue to be supported by the recovery in global growth and earnings in the near-to-intermediate term.
Alternatives vs. Fixed Income	↑	Large Overweight	Given the rich valuations of government bonds and significant compression in credit spreads over the past year, we have moved to a large underweight in traditional fixed income exposures and are favoring strategies that provide more flexibility and differentiated returns.
Duration vs. Bloomberg Barclays Capital Aggregate Bond Index	↓	Underweight	Given the recent decline in interest rates in midst of rising economic growth and inflation, real yields are near new lows and indicate very rich valuations for nominal bonds. Therefore, we are now reducing our duration exposure through a combination of our underweight to fixed income and/or through actively reducing the duration of our fixed income portfolios.
Credit vs. Government	≈	Neutral	Given the significant narrowing of credit spreads over the past year, we do not see a significant risk-adjusted return opportunity in credit relative to government bonds.
Investment Grade vs. High Yield	≈	Neutral	We do not see a meaningful valuation opportunity between investment grade and high yield.
High Yield vs. Bank Loans	≈	Neutral	We do not see a meaningful valuation opportunity between high yield and bank loans.
EMD vs. High Yield	↓	Neutral	We no longer see an attractive risk-adjusted return difference in EMD vs. high yield.
Large Cap vs. Small Cap Equities	≈	Neutral	We recognize that small caps are likely to benefit from an economic recovery, however given the dramatic level of recent outperformance in small caps, we believe that the early cycle recovery is mostly behind us.
Growth vs. Value Equities	≈	Underweight	U.S. value equities offer more attractive valuations and are expected to be the primary beneficiaries of a material recovery in earnings in 2021 and 2022. On the other hand, U.S. growth equities valuations are rich, and are likely to face relative headwinds from higher yields in the future. Therefore, we maintain our overweight view in value equities.
Global ex-U.S. vs. U.S. Equities	≈	Neutral	Despite somewhat attractive relative valuations in non-U.S. developed market equities, the U.S. continues to outperform its foreign counterparts in vaccinations, which has led to lower COVID cases and is supportive of a faster reopening and higher economic growth. Given the balance of the factors noted above, we are remaining neutral.
Emerging Markets vs. Developed Equities & U.S.	≈	Overweight	Emerging economies are forecasted to deliver somewhat stronger economic growth in 2021 and 2022, and have historically outperformed coming out of recessions. Furthermore, relative valuations are attractive and emerging markets will be a primary beneficiary of increasing consumer demand and manufacturing capex cycles as the global economy continues to exhibit above trend growth. Therefore, we maintain our overweight view in emerging markets.
Commodities vs. Global REITS/Equities	↑	Overweight	Inflation risk is elevated, particularly for commodities, as supply chain issues are likely to persist through 2022. Therefore, we are sourcing a modest allocation of capital away from global REITs and/or global equities in favor of diversified commodities exposure.

Macroeconomic Outlook: Growth is Peaking, but Expect Above Trend Growth

Second quarter global economic data indicates that global growth may be peaking, as the unprecedented economic recovery begins to level off. The IMF recently increased expectations for global growth to 4.90% in 2022 and continues to upgrade its forecast for U.S. growth (Exhibit A). Despite recent concerns about the impact of the COVID-19 delta variant, it is increasingly unlikely that global governments will impose another lockdown, particularly in developed nations with relatively high vaccination rates. Furthermore, measures of economic sentiment are continuing to indicate growth in both the services and manufacturing sectors, with nearly all of the developed world still signaling expansion (above 50), as shown in the PMIs in Exhibits B & C, respectively. We have been forecasting a shift in consumer preferences from goods to services, which is now coming to fruition based on the personal consumption data in the second quarter (Exhibit D). The continued increase in various indicators of mobility such as traveler throughput is an early indication of the growing demand for transportation services.

Exhibit A: IMF forecasts strong real GDP growth

	2021	2022
World	6.00%	4.90%
Developed Markets	5.60%	4.40%
United States	7.00%	4.90%
Japan	2.80%	3.00%
Canada	6.30%	4.50%
Australia	5.30%	3.00%
United Kingdom	7.00%	4.80%
Euro Area	4.60%	4.30%
Germany	3.60%	4.10%
France	5.80%	4.20%
Italy	4.90%	4.20%
Spain	6.20%	5.80%
Emerging Markets	6.30%	5.20%
China	8.10%	5.70%
India	9.50%	8.50%
South Korea	4.30%	3.40%
Brazil	5.30%	1.90%
Russia	4.40%	3.10%
Mexico	6.30%	4.20%

Exhibit B: Services PMIs continue to improve*



Exhibit C: Global manufacturing PMIs signal very positive sentiment*

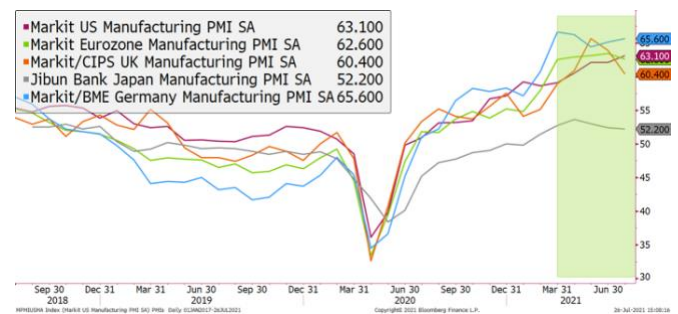
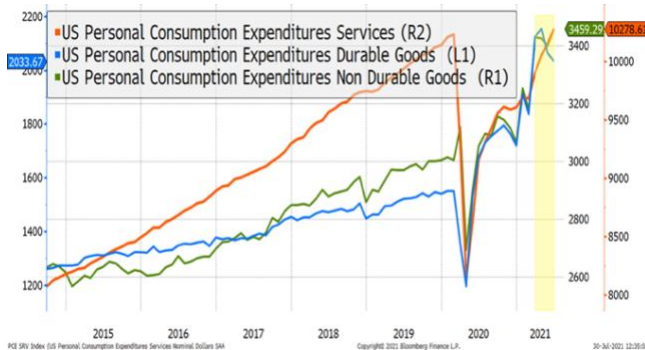
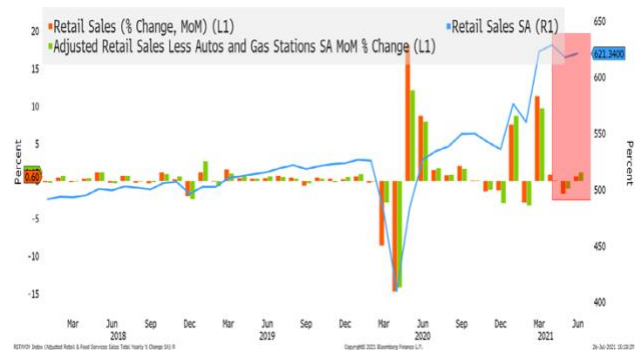


Exhibit D: Consumption of services to fuel growth*



* Source: IMF; Bloomberg

Exhibit E: Retail sales soften on weaker goods demand*



Furthermore, there has been a substantial pickup in spending on recreation, and food service and accommodations, which has fueled rather dramatic pricing pressures in these segments of the services industry, which we discuss in the succeeding segment. Unfortunately, the demand for goods has weakened materially, and is weighing on retail sales, a measure that is mostly comprised of goods related consumption (Exhibit E). Given the health of household balance sheets and the amount of pent-up demand for services (“experiences”), it is reasonable to expect persistence in the demand for services after peak consumption, even in the midst of higher COVID cases.

Measures of economic growth may be peaking, but the labor market has considerable room for recovery, and current indicators suggest that employment conditions are likely to improve significantly through the rest of 2021 and into 2022. Exhibit F highlights the significant jump in job listings on a year-to-date basis, which are well above pre-pandemic levels. Exhibit G plots the current level of U.S. job openings vs. historic levels of unemployment, with the most recent observation denoted by the red asterisk—the highest level of job openings seen in the past 30 years. Job openings at these levels have historically coincided with much lower levels of unemployment, an indication that employment conditions should improve materially. The current labor shortage in the U.S. has implications on wages, particularly in the services sector, where most of the hiring is taking place today.

We plot the trend in the Atlanta Fed wage growth tracker for the total workforce and the lowest quartile of earners in Exhibit H. It’s important to note that this calculation is a year-on-year (YoY) metric, so there are some base effects in this data as with other inflation metrics. Nevertheless, the exhibit indicates that the overall trend in wages is not higher and is actually trending lower. Furthermore, the data show that the bottom quartile of wage earners are now experiencing a meaningful pickup in compensation after experiencing a significant decline in wages in 2020. This rise in compensation is likely good for personal consumption, but may lead to inflation in services.

Exhibit F: Job listings have surged in 2021*

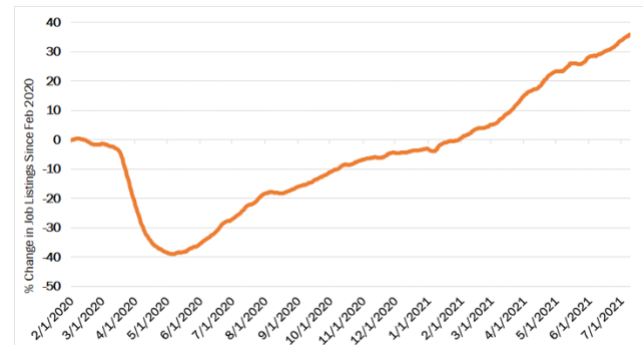


Exhibit G: Job openings indicate material improvement in unemployment ahead*

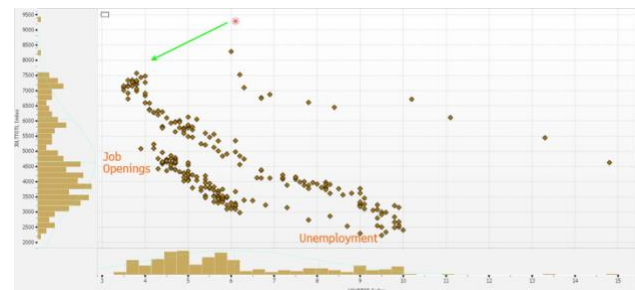
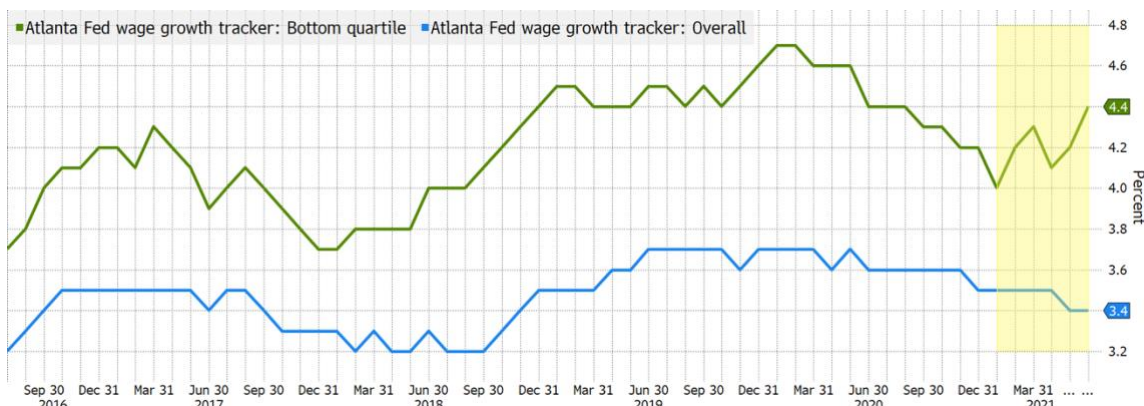


Exhibit H: Wage inflation is concentrated in the lowest quartile of earners*



* Source: Bloomberg data; Job listings sourced from https://github.com/hiring-lab/data/blob/master/US/aggregate_job_postings_US.csv

Macroeconomic Outlook: Inflation Risk is Elevated

In last quarter's Investment Strategy Update, we noted that "the risk of higher inflation should not be overlooked," specifically citing supply chain disruptions, the persistent rise in wholesale prices, and the implications of reopening the economy on the price of services. As one indication that supply chain issues are not subsiding, there has been a dramatic rise in shipping costs, as measured by the Shanghai Shipping Freight Index and the BDI Baltic Exchange Dry Index (Exhibit I). While not shown here, the ISM Manufacturing report also continues to indicate that purchasing managers are showing a very high percentage of slower deliveries (54%). These supply chain issues continue to have knock-on effects on wholesale prices, which have persistently risen on a month-on-month basis (Exhibit J). This serves as an indication of continued inflationary pressure ahead, particularly in Core Commodities, which have been the primary contributor to core-inflation on a year-to-date basis. Exhibit K shows the rolling YoY measure of core-inflation, and the underlying measures of core services and core commodities. While these metrics may appear unusually high due to base effects, skyrocketing prices of core commodities have clearly had an outsized impact on core inflation, despite representing only 25% of the weight in core inflation. While we recognize that these supply chain issues are unlikely to persist indefinitely, we could see these pressures persist through 2022.

The cost of services is also fueling higher levels of shorter-term inflationary pressure. As the economy continues to reopen, the prices of services have already increased significantly on high demand from consumer spending habits, which are favoring "experiences" over "things." Exhibit L highlights the recent trend in the month-on-month rise in services prices and used cars and trucks, which is spilling over to the cost of car and truck rentals. The costs for lodging away from home and airfares have also recently surged. The rate of inflation is beginning to slow for some of these metrics, and as summer comes to an end, vacation related travel is likely to slow and lead to a stabilization in prices. As these pressures settle over time, we may begin to see some offsetting structural factors, such as technology driven secular shifts that may continue to place downward pressure on prices over the long-term. Nevertheless, inflation risk is elevated, particularly in commodities. Therefore, we are sourcing a modest allocation of capital away from global REITs and/or global equities in favor of diversified commodities exposure.

Exhibit I: Shipping rates reflect supply chain issues*

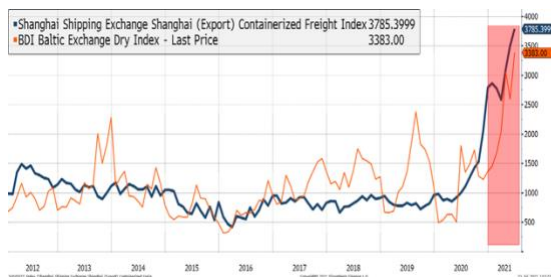


Exhibit J: Wholesales prices continue to rise*

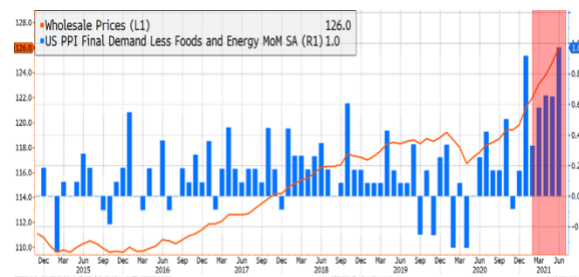


Exhibit K: Core inflation largely impacted by higher prices in core commodities as opposed to services*

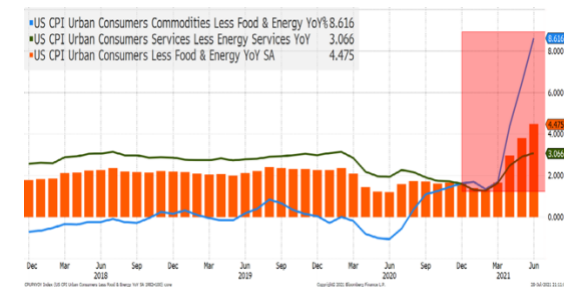
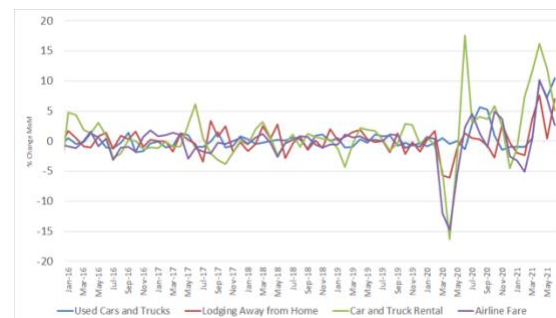


Exhibit L: month-on-month trend in prices for reopening related services may be peaking*



* Source: Bloomberg

Fixed Income View: Underweight Fixed Income vs. Alternatives, & Reducing Duration

Given the strong recovery in economic growth and inflation, the Fed has been evolving its communication to indicate a growing probability of tapering its bond purchases, specifically in mortgage-backed securities. Investor sentiment began to shift on concerns of rising cases of the COVID-19 delta variant, and the Fed's more hawkish tone stoked speculation that an earlier than expected reduction in accommodative policy may slow future economic growth. This fueled a bid for long-term treasuries, leading to a flattening of the U.S. yield curve since the end of the first quarter (Exhibit M). Despite these concerns, the move lower in treasury yields is counterintuitive in the face of strong economic growth and high levels of inflation. Given the US 10-year breakeven inflation rate of 2.42%, the U.S. Real 10-year yield is near record low levels (-1.15%), indicating that nominal bonds are now priced even more irrationally relative to both breakeven inflation rates and expectations of future economic growth. The long-term average 10-year real yield has been approximately 0.90% over a period in which we experienced far lower economic growth relative to the IMF projections of future growth in 2021 and 2022 (Exhibit O). Real yields at these levels continue to indicate signs of complacency regarding interest rate risk, despite renewed concerns about the impact of COVID on economic growth, and we are actively reducing duration exposure as a result. Not only do we find government bonds to be expensive, but we also see corporate credit valuations as being stretched, as option adjusted credit spreads have narrowed dramatically, offering investors much less compensation for accepting corporate credit risk (Exhibit N). With excessive valuations across most of the fixed income market, we are moving to a large underweight in core fixed income in favor of more flexible/alternative mandates that may exhibit less duration and credit exposure

Exhibit M: FOMC dot projections indicate risk of faster shift in policy*



Exhibit N: Credit spreads near record lows*



Exhibit O: Real yields are low vs. The long-term average, particularly given growth expectations*



* Source: Bloomberg

Equity View: Continuing to Favor Emerging Markets; Underweight U.S. Growth

Equity market return expectations are becoming increasingly reliant on earnings growth and low interest rates, with limited potential upside related to multiple expansion. Exhibit P plots the risk premium for various equity markets, as measured by the spread of the earnings yield of each market relative to the U.S. 10-year Treasury yield. Despite the move higher in equities on a year-to-date basis, valuations in some markets have improved, as the risk premium has increased due to declining interest rates in the second quarter and an improving earnings outlook. Specifically, developed and emerging markets valuations have decreased due a recovery in earnings growth expectations and a recent rerating of valuations on higher geopolitical risk, respectively. While equities are not necessarily attractively valued, current valuations are mostly consistent with pre-COVID levels, and we remain relatively constructive on equities given the expectations of a multi-year expansion in earnings growth.

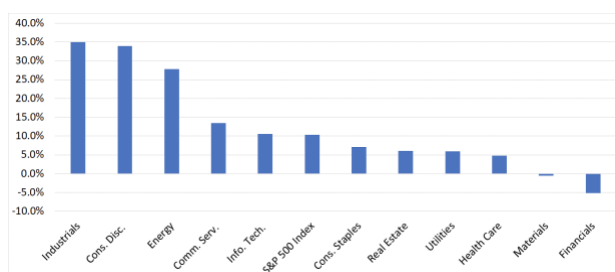
We seek to position portfolios in segments of the equity market which we believe are most likely to benefit from such an expansion. The risk premium (valuation) of emerging markets has become more attractive today relative to other foreign markets (Exhibit P), as sentiment has recently turned more negative. However, emerging markets typically benefit from global economic recoveries and the associated increase in demand and manufacturing capex. Consistent with this procyclical view, we continue to favor value vs. growth equities, as earnings growth expectations are more favorable for most cyclically sensitive sectors (Exhibit Q). Loftier earnings expectations for value equities, and the recent relative outperformance of growth sectors on the heels of historically negative real yields, has led to even more expensive relative valuations in growth equities (Exhibit R). Therefore, we maintain overweight views in value equities and emerging markets.

Exhibit P: Equity valuations are at pre-covid levels when adjusting for interest rates



Source: Bloomberg data

Exhibit Q: US equity earnings growth expectations for 2022 favor cyclically sensitive sectors



Source: Bloomberg data

Exhibit R: Forward p/e ratio of US large Cap Growth vs. Value equities



Source: Bloomberg data

Sentiment, Technicals, and Risk

Sentiment has been gradually shifting during the second quarter and into the third quarter, as enthusiasm regarding the early cycle recovery started to wane, and concerns about peaking economic growth in the U.S. began to surface. As one reliable metric of quality, Exhibit S shows the recent recovery of high profitability relative to low profitability companies. In our last Investment Strategy Update, we noted that “the early cycle recovery and rally may be behind us and there are likely better days ahead for high quality companies,” which has come to fruition.

Exhibit S: Recovery of profitability factor reflective of concerns regarding peaking growth, and mid cycle transition*

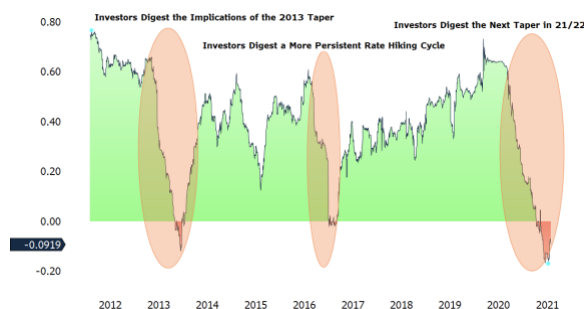


While we have been expecting this change in market leadership, we can't dismiss the impact of some of the recent tailwinds for the performance of high-quality equities, such as concerns regarding the COVID-19 delta variant and the prospect of less accommodative policy. Irrationally low nominal and real yields may imply that these concerns are overdone. It has become increasingly clear that the equity market is taking cues from the bond market, and as yields on U.S. Treasury bonds began to decline, investors began to favor higher quality “defensive growth” equities and secular growers, the latter of which are very supported by unusually low real yields.

As investors move past these concerns, we may again begin to see a preference reemerge in favor of more cyclically sensitive, reopening related sectors of the market, which may not bode well for high quality companies in the short-term. Nonetheless, it is beneficial for investors to maintain some degree of balance between quality and deeper value exposures, which may facilitate meaningful diversification benefits in portfolio structure, particularly at this point of the cycle.

Investors have become fixated on monetary policy in recent months, as the prospect of a taper in the purchases of treasuries and mortgage-backed securities by the Fed becomes increasingly probable in late 2021 or early 2022. Investor concerns are focused on two primary issues – (1) the risk that a less accommodative Fed will stymie the economic recovery and (2) higher interest rates will shrink the equity risk premium, both of which could negatively impact equities. Exhibit T shows the decline in the rolling six-month correlation between U.S. equities and the U.S. 10-year Treasury Yield, which reflects these concerns, as rising interest rates have been met with resistance for equity markets, while declining interest rates have been supportive of equity markets. We witnessed a similar decline in the correlation between interest rates and equities in the midst of the “Taper Tantrum” of 2013 and leading up to a persistent rate hiking cycle in late 2016.

Exhibit T: Declining correlation between U.S. Equities & the U.S. 10 year treasury yield mirrors historical transitions to less accommodative policy*



Investors often overreact to the idea of tighter monetary policy and fail to appreciate the fact that central bankers increasingly err on the side of caution, and that equities can rise while interest rates rise, provided that the economy is growing at a healthy rate. It's possible that this time the outcome may be different if inflation is in fact here to stay. Otherwise, history would indicate that while we may face some near-term volatility as rates rise, investors usually see through this risk to the other side. We will continue to assess this risk among other factors, to adapt portfolios to evolving conditions, while maintaining effective diversification to manage portfolio volatility through this phase of the market cycle.

* Source: Bloomberg

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