

SECOND QUARTER 2021

# Investment strategy update

Global securities markets continued to benefit from growing optimism as higher COVID vaccination rates and declining cases are increasing confidence in the reopening of global economies and higher earnings growth, particularly in the U.S. First quarter global economic data pointed to a significant recovery, leading economists to upgrade forecasts of global growth. Economic data continues to improve for both services and manufacturing, with higher-frequency indicators showing an increased degree of mobility and activity, thereby supporting further demand for the consumption of services. Despite the uptick in global demand and manufacturing, there are some indications of supply chain disruptions. While such effects could prove to be transitory, there has been a substantial rise in wholesale prices, which serves as an indication of pending inflationary pressure. Recent measures of core inflation are also elevated, particularly in the services sectors, and the potential for a rise in the velocity of money coinciding with an increase in the money supply is further supportive of inflation. There may be some offsetting factors to this inflationary pressure, and investors should be cautious not to extrapolate or to overreact to the shorter-term headline impacts from the base effect of comparisons to last year's very low prices. Nevertheless, the risk of inflation should not be overlooked.

In this quarter's Investment Strategy Update, we take a deeper dive into the health of the U.S. consumer, the pending recovery in the consumption of services, underlying indications of rising core inflation, interest rate expectations, equity valuations, and technical factors. We remain keenly aware of interest rate risk, and we continue to promote underweight exposure to core fixed income in favor of more flexible/alternative mandates that exhibit less duration exposure. Given the dramatic narrowing of credit spreads over the past year, we moved to a neutral position in credit vs. government bonds during the first quarter and remain neutral in portfolios today. We continue to favor emerging markets and U.S. value equities, which are likely to benefit from a pro-cyclical/post-recessionary environment, while U.S. growth equities are more likely to face relative headwinds from higher nominal and real yields in the future. The magnitude of the low-quality rally since the spring of 2020 may indicate that the early cycle recovery and rally may be behind us and there are likely better days ahead for high quality companies. As the economy begins to exit its early-cycle recovery and enter the mid-cycle, markets are pricing in lower volatility for equities and higher volatility for fixed income/interest rates. Investors should not dismiss the relationship between interest rates and equity valuations, as higher rates and tighter monetary policy could also trigger higher equity volatility. Therefore, Wilshire continues to promote diversification and remain judicious in the allocation of our active risk budget. We provide a summary of our rationale and supporting exhibits in the following sections

Asset class	January	Change	April
Fixed Income vs. Equity	Neutral	≈	Neutral
Alternatives vs. Equity	Neutral	≈	Neutral
Alternative vs. Fixed Income	Overweight	≈	Overweight
Duration vs. Barclays Aggregate	Neutral	≈	Neutral
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	≈	Overweight
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
Global REITS vs. Global Equities	Neutral	≈	Neutral
Commodities vs. Global Equities	Neutral	≈	Neutral

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 are 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	≈	Overweight	Given the rich valuations of government bonds and significant compression in credit spreads over the past nine months, we remain underweight in traditional fixed income exposures and are favoring strategies that provide more flexibility and/or potential for differentiated returns.
Duration vs. Bloomberg Barclays Capital Aggregate Bond Index	≈	Neutral	We believe that interest rates will likely continue to move higher, and although we remain neutral in duration, we express this view as an underweight to fixed income in favor of alternative income sources. We expect this positioning to result in less interest rate (i.e. duration) sensitivity in 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	≈	Overweight	High yield spreads have compressed, while EMD offers superior carry/supportive fundamentals and should directly benefit from economic re-openings and resurgence in global growth.
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 may be ending, as evidenced by the outperformance of low-quality companies.
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, particularly in Industrials, Materials, and Financials. On the other hand, U.S. growth equities are likely to face relative headwinds from higher nominal and real 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 have historically outperformed coming out of recessions. Furthermore, as economies re-open and global growth rebounds, emerging markets will be a primary beneficiary of increasing consumer demand and manufacturing capex cycles. Therefore, we maintain our overweight view in emerging markets.
Global REITs vs. Global Equities	≈	Neutral	While certain segments of the REIT market may be very challenged in this environment, the market is fragmented in terms of the impact of COVID, and the demand for higher yielding equities such as REITs is likely to increase due to very low government bond yields. Therefore, we remain neutral.

# Macroeconomic Outlook: Multi-Year Global Expansion Underway

First quarter global economic data pointed to a significant recovery, leading economists to upgrade forecasts of global growth. The IMF recently increased its expectations for global growth to 6.03% and 4.42% in 2021 and 2022, respectively (Exhibit A). This increase is largely attributable to higher growth expectations in the U.S., where COVID cases have declined rapidly and the services sector is beginning to show signs of a strong recovery relative to other foreign developed economies, as shown in the Services PMIs in Exhibit B. Personal consumption has continued to trend higher in 2021 on the heels of demand for durable goods, however services are likely to drive the next move higher in consumption (Exhibit C). The recent increase in traveler throughput (Exhibit D) is an early indication of the growing demand for transportation services, and the recent jump in retail sales (Exhibit E) was primarily concentrated in motor vehicles, gas stations, clothing/recreational/general merchandise stores, as well as food services & drinking places, all of which indicate a higher degree of mobility & activity, and higher demand for services.

Exhibit A: IMF forecasts strong real GDP growth\*

	2021	2022
World	6.03%	4.42%
Developed Markets	5.14%	3.63%
United States	6.39%	3.52%
Japan	3.25%	2.52%
Canada	5.04%	4.65%
Australia	4.54%	2.75%
United Kingdom	5.34%	5.07%
Euro Area	4.43%	3.82%
Germany	3.60%	3.42%
France	5.81%	4.22%
Italy	4.15%	3.60%
Spain	6.38%	4.70%
Emerging Markets	6.67%	4.98%
China	8.44%	5.57%
India	12.55%	6.93%
South Korea	3.58%	2.80%
Brazil	3.66%	2.56%
Russia	3.76%	3.75%
Mexico	5.00%	3.00%

Exhibit B: Services PMIs continue to improve\*

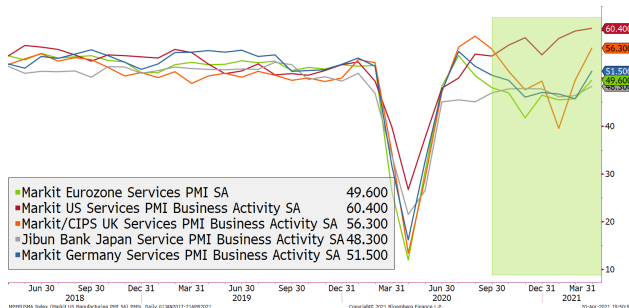


Exhibit C: Consumption of services to drive growth\*

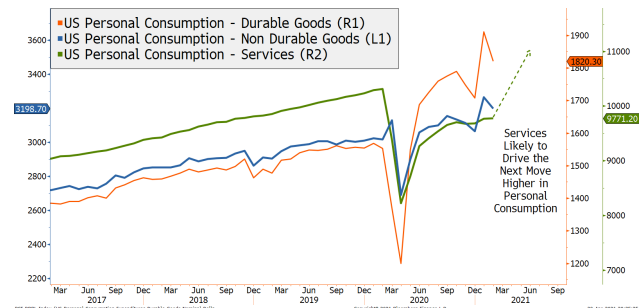


Exhibit D: Traveler throughput & flight activity indicate a pickup in transportation services

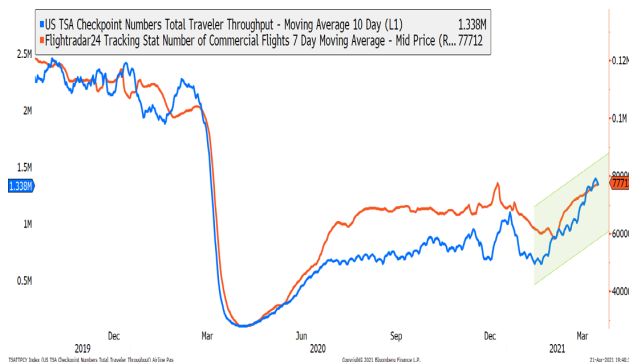
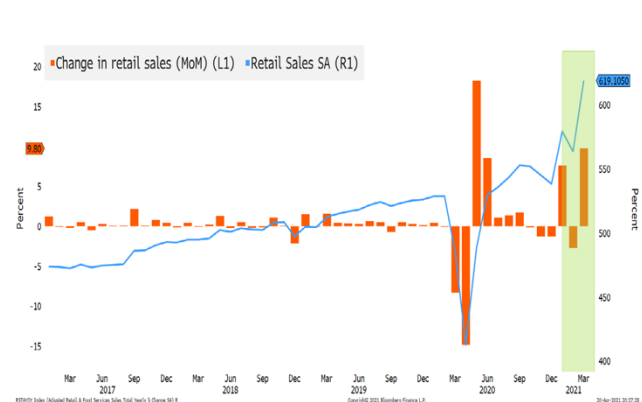


Exhibit E: Retail sales surge on stimulus boost\*



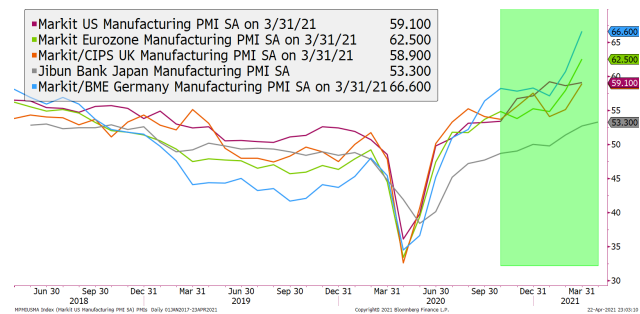
\*Source: Bloomberg

The recent surge in consumption is likely to have benefited from the massive amount of government stimulus provided to U.S. consumers, and credit card spending activity indicates that many consumers immediately spent stimulus checks, or some portion of it, in late March. Unlike the global financial crisis, however, household debt levels have declined significantly and there is a substantial amount of pent-up demand for services (“experiences”) that is likely to fuel persistence in consumption even after the initial tailwind of stimulus subsides.

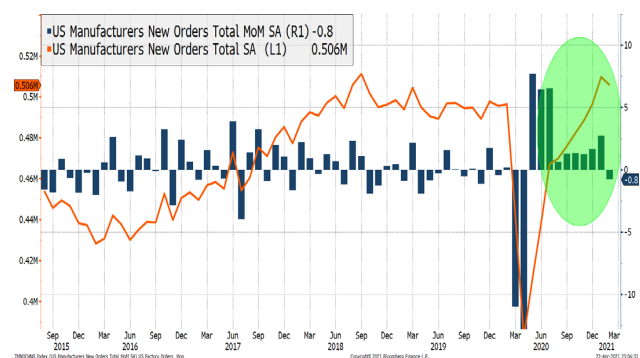
Global manufacturing PMIs have also continued to stage a V-shaped recovery, with all of the developed world still signaling expansion (above 50). U.S. manufacturing remains at elevated levels, and European economies are seeing a surge in manufacturing sentiment, with PMIs above 60 in the Eurozone, most notably in Germany. U.S. Factory Orders have exhibited persistent month-on-month increases, albeit with some recent moderation due to weather related factors. While not shown here, manufacturing job openings jumped to levels not reached since 2018, and are an indication of a pick-up in manufacturing activity and the potential for further improvement in the overall labor market. Given this recovery in manufacturing activity, in combination with the financial health of the U.S. consumer, we continue to expect very strong U.S. GDP growth in 2021.

Despite the uptick in global demand and manufacturing, there are some indications of supply chain disruptions. Exhibit H highlights the ISM Manufacturing report on business supplier deliveries, which shows that 55% of factory purchasing managers are reporting slower deliveries, levels consistent with those experienced at the depths of the COVID crisis, and prior to that, levels not seen since the oil crisis of 1979. This backup in deliveries may hinder some of the momentum in economic growth, while also leading to higher inflation due to a supply/demand imbalance. While such effects could prove to be transitory, wholesale prices have experienced a substantial increase, which we discuss in the next section.

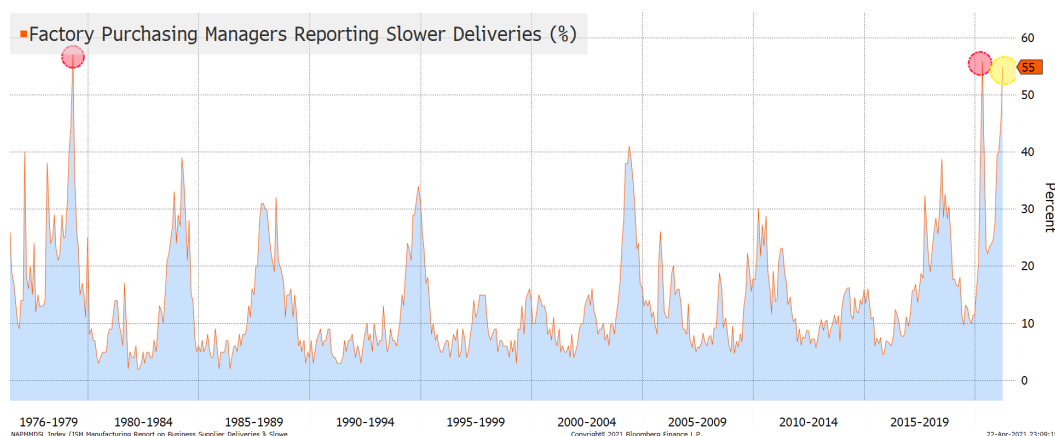
**Exhibit F: Global Manufacturing PMIs signals very positive sentiment\***



**Exhibit G: U.S. Factory orders continue to recover\***



**Exhibit H: ISM manufacturing report on business supplier deliveries highlights supply chain issues\***



\*Source: Bloomberg

# Macroeconomic Outlook: Inflation Risk Should Not Be Overlooked

Inflation proved to be somewhat resilient to the temporary shutdown of the U.S. economy, particularly relative to what the market priced-in during the spring of 2020. Realized inflation never actually experienced anything close to the deflationary pressure implied by the 2-year breakeven inflation rate, which indicated inflation of nearly -1% in March of 2020. More recently, the 2-year breakeven rate reflects inflation expectations of approximately 2.6%, and the 10-year breakeven is now above 2.3%. Fixed income markets are increasingly pricing in higher inflation, as the combination of a resilient U.S. consumer and extreme levels of government stimulus are likely to spark inflationary pressure not experienced in many years. The persistent rise in Wholesale Prices, as shown in Exhibit I, also serves as an indication of pending inflationary pressure, as producer prices are often a precursor to rising consumer prices. We expect this, in combination with the probable rise in the cost of services, to fuel higher levels of shorter-term inflationary pressure. As the economy reopens, the prices of services are already increasing significantly on high demand from consumer spending habits, which are shifting to favor “experiences” over “things.” Exhibit J highlights the recent trend in the month-on-month rise in services prices. Specifically, there has been a recent surge in costs for lodging, car & truck rentals, motor vehicle insurance, and public transportation, while airline fares may be just beginning to rise off of very low levels.

The potential for a rise in the velocity of money, in combination with a continued increase in the money supply, is yet another possible contributor to future inflationary pressure (Exhibit K). Velocity of M2 moderated late in 2020, however it is reasonable to expect a rise in the frequency at which money is used to purchase domestically produced goods and services in 2021, thereby fueling inflationary pressure. We may begin to see some offsetting factors, however. In addition to the technology driven secular shifts that may continue to place downward pressure on prices over the long-term, the recent rise in interest rates may start to weigh on housing demand, particularly if rates continue to rise. As shown in Exhibit L, we are seeing some recent weakness in both Pending and Existing Home Sales, which represents a very large share of home sale activity. Finally, investors should not extrapolate the shorter-term impact of the base effect from very low prices last year. This may lead to the appearance of unusually high inflation, the effect of which is likely transitory. Nevertheless, the risk of higher inflation should not be overlooked.

Exhibit I: Wholesale prices rise sharply\*

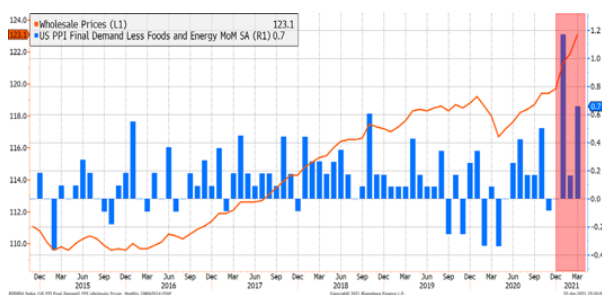


Exhibit J: Core services spark inflation\*

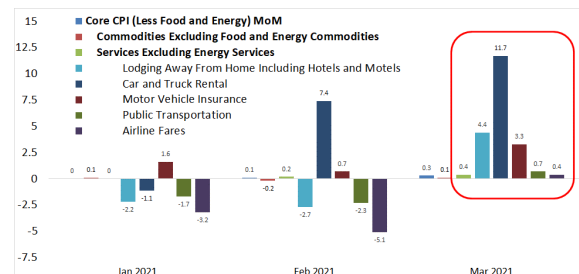
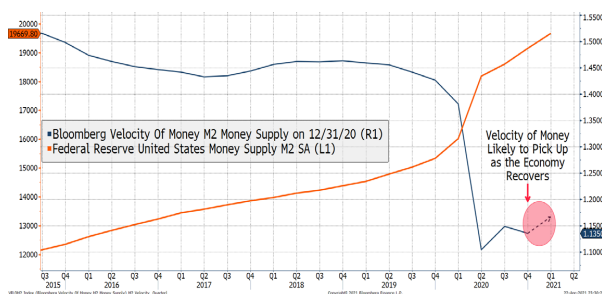
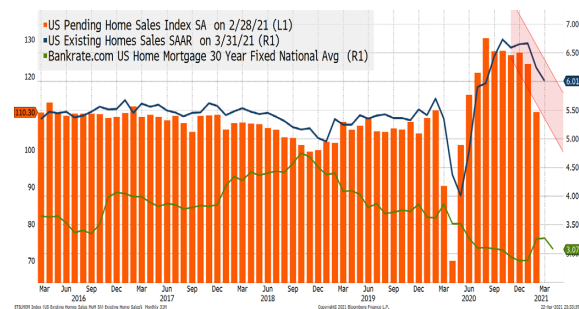


Exhibit K: Rise in velocity of money & money supply likely to spur inflation\*



\*Source: Bloomberg

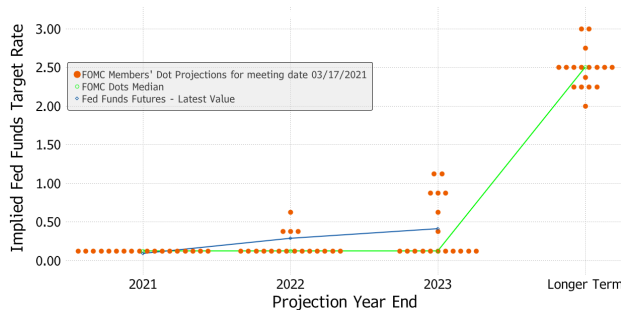
Exhibit L: Rising rates may begin to weigh on housing activity & home prices\*



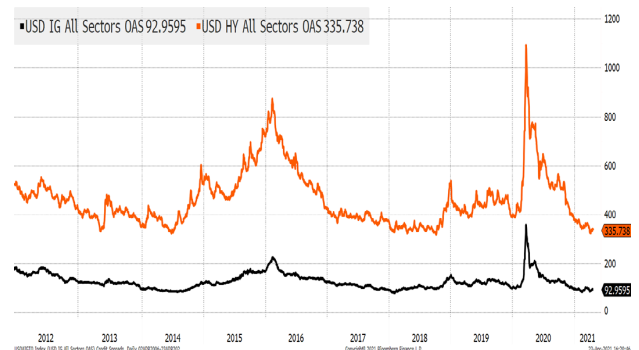
## Fixed Income View: Remaining Underweight to Fixed Income vs. Alternatives

The Fed's communication that it intends to maintain its current policy through 2023 has been supporting a high degree of complacency among many investors. While the FOMC Members' Dot Plot Projections have also resulted in the anchoring of Fed Funds Futures to a target rate of approximately 0.0% through 2023, there are indications of a gradual shift in sentiment on behalf of some members, which indicates a growing probability that the Fed modifies its interest rate policy sooner than expected (Exhibit M). We have been communicating our expectations of significantly higher yields since October of 2020, and while longer-term rates have risen substantially since then, nominal yields are still not reflecting the upside potential of future growth and inflation. The U.S. Real 10-year yield remains at very low levels (-0.78%), indicating that nominal bonds are still priced irrationally relative to both breakeven inflation rates and expectations of future economic growth. As shown in Exhibit O, 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. We acknowledge the impact of monetary policy on current interest rates, which has distorted real yields, however the Fed has not communicated any clear intent to further control longer-term bond yields. Therefore, real yields at these levels indicate signs of complacency regarding interest rate risk, particularly if we see economic growth and inflation expectations come to fruition. We have been keenly aware of interest rate risk, and we continue to promote underweight exposure to core fixed income in favor of more flexible/alternative mandates that exhibit less duration exposure. Given the dramatic narrowing of credit spreads over the past year (Exhibit N), we moved to a neutral position in credit vs. government bonds during the first quarter, and remain neutral in portfolios today.

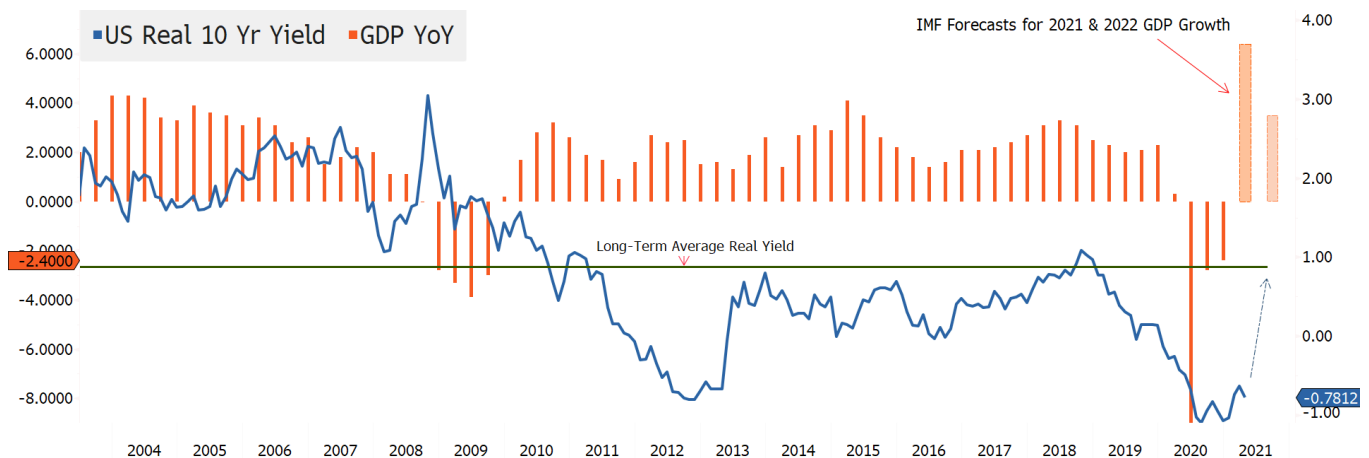
**Exhibit M: FOMC dot projections indicate risk of faster shift in policy\***



**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 markets have rallied to record levels well in advance of the global economy, which has certainly pulled return expectations for equities forward. Future equity returns are more likely to be the result of earnings growth as opposed to multiple expansion, balanced with the impact of interest rates on the equity risk premium. Despite lower expected returns we remain constructive on equities given the expectations of a multi-year expansion in earnings and economic growth, and we seek to position portfolios in segments of the equity market which we believe are most likely to benefit from such an expansion. Our global heat map (Exhibit P) highlights fundamental metrics on a cross-sectional basis over longer-time periods, and represents a portion of the many factors that we consider when determining our investment strategy. The heat map indicates rich valuations in the U.S. vs. foreign developed (EAFE) markets, which we believe is justified given higher vaccination rates, lower COVID cases, and the relative growth expectation in the U.S. vs. EAFE. While there is no meaningful difference in valuations between emerging markets (EM) and EAFE, emerging markets benefit from global economic recoveries and the associated increase in demand and manufacturing capex.

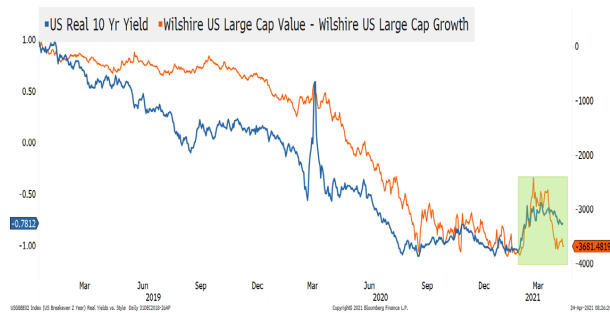
More noteworthy is that despite the recent recovery in the performance of value equities, U.S. large cap growth equities are still trading at 1.8 standard deviations above the long-term average forward valuation relative to U.S. large cap value equities. Furthermore, we see increasing risk related to a rise in real bond yields, which is likely to lead to further resistance for growth equities. Exhibit Q plots the trend in the decline in the U.S. Real 10-year yield next to the spread of Wilshire U.S. Large Cap Value vs. Growth Index levels. This trend indicates a clear relationship between the decline in real yields and the underperformance of value vs. growth equities. The recovery in value equities since September of 2020 coincided with the rise in real yields, and although we have seen this trend reverse during the month of April on technical support for nominal yields, we expect yields to begin to rise again as the economy continues to recover. We also observe a rising correlation between the value and momentum factors to levels not seen in over a decade, which may be indicative of further support for value equities from a technical perspective (Exhibit R). In summary, emerging markets and U.S. value equities are likely to benefit from a pro-cyclical/post-recessionary environment, while U.S. growth equities are likely to face relative headwinds from higher nominal and real yields in the future. Therefore, we maintain overweight views in value equities and emerging markets.

**Exhibit P: Wilshire global heat map – cross-sectional metrics**

	Dividend Yield			Profit Margin			Price to Sales			Price to Book			TR12M P/E			Forward P/E		
	Value	Z-5Y	Z-15Y	Value	Z-5Y	Z-15Y	Value	Z-5Y	Z-15Y	Value	Z-5Y	Z-15Y	Value	Z-5Y	Z-15Y	Value	Z-5Y	Z-15Y
US vs. EAFE	-0.8	1.7	1.2	3.3	0.6	0.7	2.0	1.4	1.8	2.4	1.8	2.3	0.8	-1.3	-1.0	1.3	0.9	1.4
EAFE vs. EM	0.4	-1.6	-1.1	-4.2	-2.2	-1.0	0.8	-2.1	-0.2	0.9	-2.0	-0.4	1.7	1.6	0.7	1.2	0.2	-0.1
US LC vs. US SC	0.5	-0.0	-0.4	11.3	0.4	1.3	1.9	-0.1	1.1	1.5	0.1	1.1	0.0	-2.2	-2.6	0.6	0.2	0.2
US LCG vs. US LCV	-1.2	0.2	-0.1	6.6	1.9	1.9	2.3	0.8	1.9	4.5	1.0	2.0	1.4	-0.2	0.4	1.6	1.1	1.8

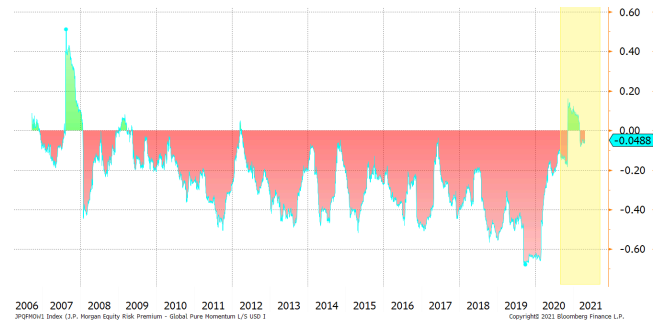
Source: Bloomberg Data

Exhibit Q: Negative real yields have been supportive of growth stocks



Source: Bloomberg Data

Exhibit R: Rising correlation between value and momentum factors



Source: Bloomberg J.P. Morgan Global Pure Factor Indices

## Sentiment, Technicals, and Risk

CEO Confidence has remained relatively elevated throughout this crisis, which is not surprising given underlying divergences in the economic recovery and that CEOs are likely more in tune with economic conditions/indicators and better able to look through short-term conditions. As discussed in our last quarterly letter, CEO Confidence had nearly fully recovered within two years following the depths of the global financial crisis, while Consumer Sentiment took much longer to recover (Exhibit S). Consumer sentiment has started to improve and this trend is likely to gain momentum as the economy reopens. Small Business Optimism, which was more directly impacted by the forced closures of food and beverage accommodations, will likely also recover quickly as these surviving establishments continue to reopen.

Exhibit S: CEOs more confident than consumers\*

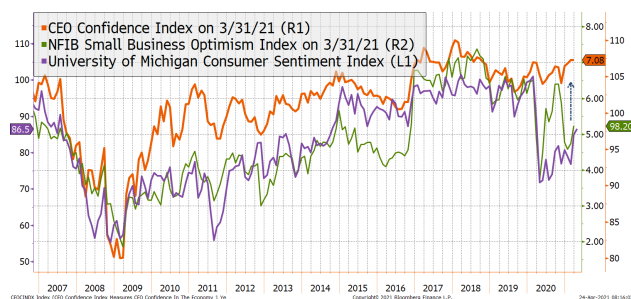


Exhibit T: Underperformance of profitability factor reflects early cycle low quality rally\*

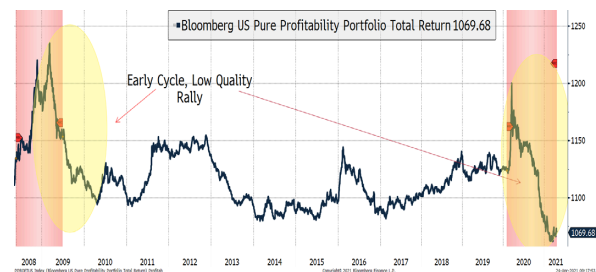


Exhibit U: Markets are pricing in lower equity volatility and higher rates volatility (Normalized as of 12/31/2020)\*



\*Source: Bloomberg

Given the enormous amounts of stimulus to support both the economy and asset prices, markets have experienced an unusually condensed early-cycle rally. It is common to see a low-quality rally in the early stages of an economic recovery, as low-quality companies are most negatively impacted by economic downturns, and may be priced with deeper discounts during recessions. Exhibit T shows the long-term performance of high profitability companies relative to low profitability companies. Similar to the global financial crisis, higher-quality companies have largely underperformed their lower-quality counterparts, which may indicate that the early cycle recovery and rally may be behind us and there are likely better days ahead for high quality companies. This, along with other metrics, is a technical factor that informs our decision not to spend active risk on lower quality exposures, such as small caps and high yield bonds. As we begin to exit this early-cycle recovery and enter the mid-cycle, markets are pricing in lower volatility for equities and higher volatility for fixed income/interest rates. Exhibit U plots the performance of the CBOE Volatility Index (VIX) relative to the ICE BofA MOVE Index, which measures the short-term implied volatility of the S&P 500 Index and a diversified mix of U.S. Treasuries across maturities, respectively. Markets appear to be rationally pricing in higher risk ahead for fixed income, given the expectations for economic growth, and the related need for the Fed to continue modifying its communication and eventually its policy. That being said, investors should not dismiss the relationship between interest rates and equity valuations, as higher rates and tighter monetary policy could also trigger higher equity volatility. We will continue to assess the economic environment, asset valuations, and government policy to adapt portfolios to evolving conditions, while maintaining effective diversification to manage portfolio volatility through what is likely to be a bumpy road ahead.

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