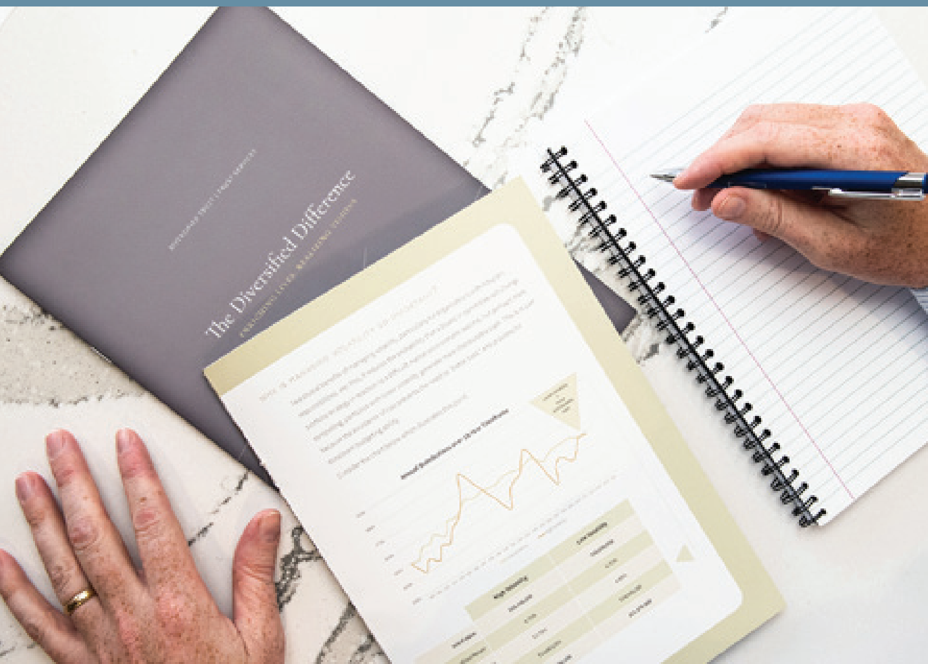
FIRST QUARTER **SUMMARY**

2021

DIVERSIFIED TRUST



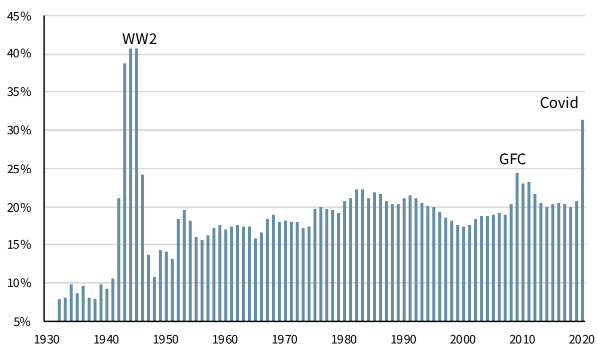
The first quarter of 2021 was a good one for equity investors, not so great for bond investors, and something of a ride for all of us. U.S. stocks were up over 6% for the quarter, with small cap outpacing larger cap stocks. International equities were up 3.5% in the quarter. The Bloomberg Barclays Aggregate Bond index was off 3.4%, while the Bank of America Merrill Lynch 1-12-year Municipal Bond Index was close to flat. More amazing is the trailing 12-month returns. U.S. stocks, as measured by the Russell 3000 Index, are up over 62%, international equities are up nearly 50%, and bonds are mostly even. While the recovery of the economy and normal life from the impact of the global pandemic is taking time, risk assets have not waited.

Underlying this recovery in equity valuations are several important storylines. First, while the impact to daily life - and by extension the economics that are the results of daily life - has been severe, we all have understood this to be a temporary condition. The expectation has been that normal life would return, and the consumption, employment and growth which have been missed over the last 14 months would come back. Expectations are that U.S. GDP in 2021 will be in excess of 6%, a number we haven't seen since 1984.

Second, that return in growth would lead to some increase in interest rates. Higher levels of economic growth tend to lead to higher interest rates as a natural reaction to the growth. More demand economically tends also to mean more demand for capital; more demand for capital tends to lead to a higher price for capital, which is the interest rate. Up to this point, the movement in real yields (the difference between the observed yield on Treasuries and the inflation rate) has been modest but positive. Finally, governments and central banks have been willing to step into the mix and provide significant levels of support. This has included monetary support from the Fed with its effort to keep short-term interest rates low, dropping the Fed Funds rate by 150 basis points.). While we have said it several times this year, the amount of stimulus has been truly incredible. The balance sheet of the Federal Reserve is currently $7.5 trillion and based upon the pace of buying, will be close to $9 trillion by the end of 2021, representing 30% of the entire U.S. economy!! That stimulus has made its way into financial assets and had supported the stellar returns over the last year.

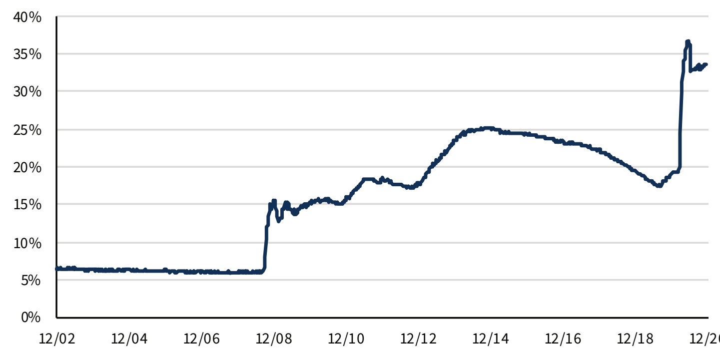
We have seen three Covid relief bills in the last 12 months (CARES Act in March 2020 of $1.8 trillion, the Coronavirus Relief Fund Deal in December 2020 of $900 million and the American Rescue Plan Act of 2021 of $1.9 trillion). President Biden also announced this month his plan for a $2 trillion infrastructure and jobs package, which has the potential to put more pressure on the Federal Reserve in terms of financing and floating the needed debt to initially fund the plan. We show the size and impact of this in the two charts below. The current spending, shown as a percentage of total GDP, is larger than anything in U.S. history outside of World War II. This has led the Federal Reserve's balance sheet to balloon to a size, again as a percentage of GDP, never seen before.

Total Government Outlays (Spending) as a Percentage of GDP



Source: The Office of Management & Budget

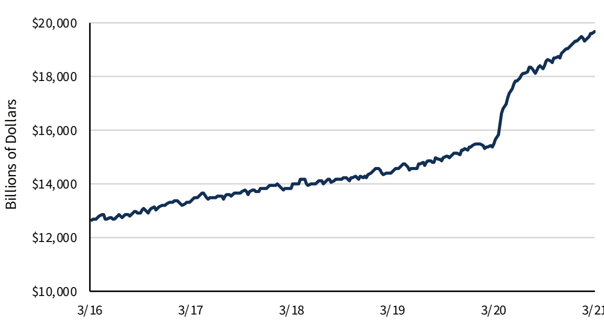
The Federal Reserve's Balance Sheet as a Percentage of Nominal GDP



Source: Federal Reserve, Bloomberg

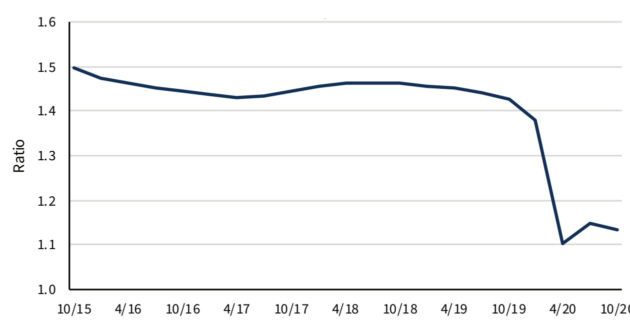
This level of government and central bank intervention brings a worry about inflation. This level of spending comes with the fact that more money will be pumped into the economy. More money without more demand for money can lead to inflation. The overall supply of money in the economy has expanded by 27% over the last year, while GDP actually shrank slightly. In other words, the economy didn't need the extra cash to support what was happening. What did happen was that a dollar made its way through the economy (the velocity of money) much more slowly. If a dollar changes hands less frequently, the impact of additional dollars in circulation is reduced. Thus, even though there was a 27% increase in the money supply last year, the velocity of that money dropped by over 30%, in essence offsetting each other.

M2 Money Stock



Source: Board of Governors of the Federal Reserve System (US)

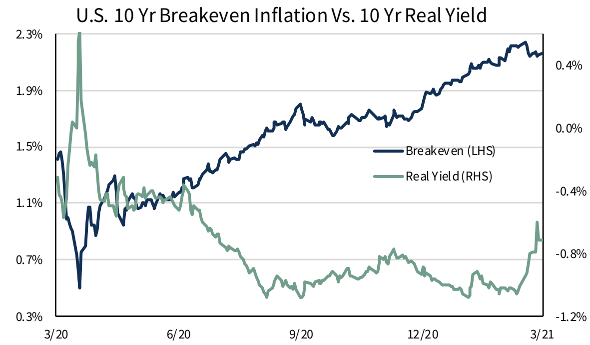
Velocity of M2 Money Stock



Source: Federal Reserve Bank of St. Louis

Today's outlook for the U.S. economy is strong. Nearly 45% of Americans have received at least one dose of a vaccine, the unemployment rate has declined to 6% in March from its high of nearly 15% a year ago, and we expect GDP growth, which may reach 10%. But the stimulus and monetary policy to date make inflation worries a real concern. Let's spend some time going through the worries and what they mean.

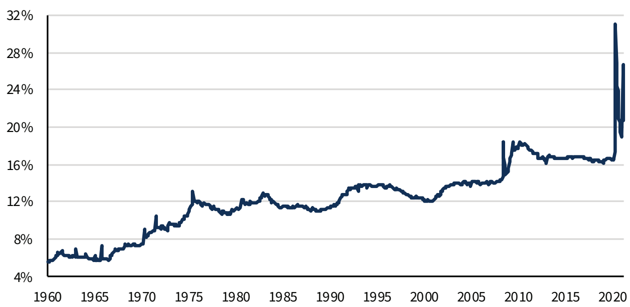
U.S. 10 Yr. Breakeven Inflation vs. 10 Yr. Real Yield



The 10-year U.S. Treasury has been yielding less than the rate of inflation for some time, thanks to the Federal Reserve and their effort to keep rates low. Even the rise in rates over the last year hasn't been enough to get us ahead of inflation. Looking at the rate of inflation implied in the 10-year TIPS market, we can see the expectation of inflation over the next decade has been trending higher. It is not too high, at about 2.4% currently, but it is higher than it has been since April of 2013.

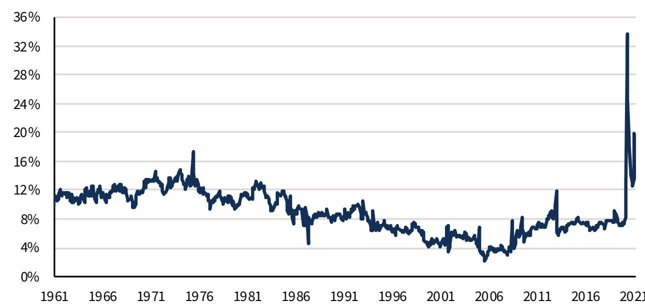
TIPS (Treasury Inflation Protected Securities) utilize the Consumer Price Index (CPI) to measure inflation, so the implied rate is the expected rate of change in the CPI. Looking at the longer horizon helps us because the year-over-year numbers will certainly be distorted. This is particularly the case of the next year because the significant pullback in consumption last year due to the virus and quarantine will overstate the increase in 2021 as people resume their spending. However, long-term inflation expectations are still well within the 1.75%-3.00% range, where they have been for most of the past 20 years.

Percentage of Personal Income Made Up by Government Transfer/Assistance Programs (SAAR)



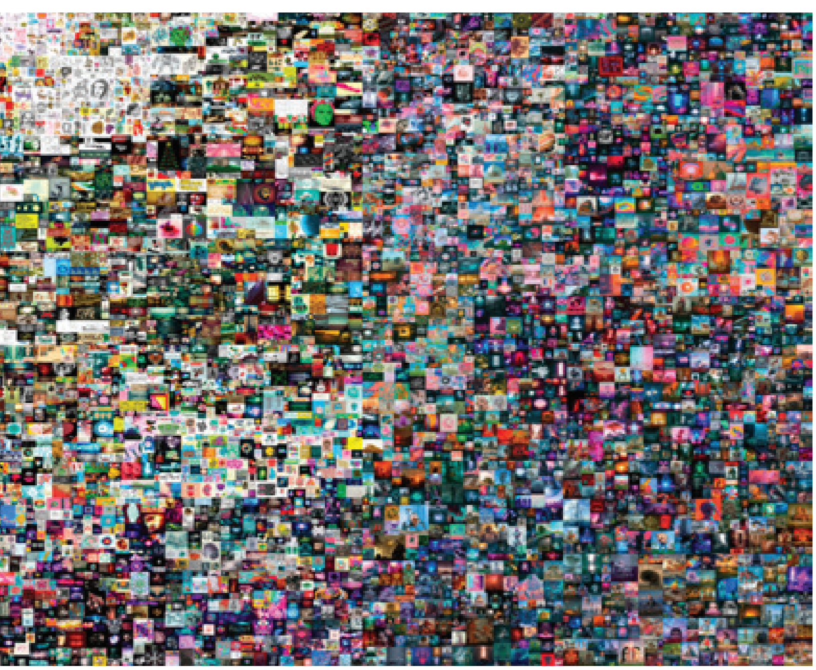
Source: Bureau of Economic Analysis, Bloomberg

U.S. Personal Savings Rate as a Percentage of Disposable Income



Source: Bureau of Economic Analysis, Bloomberg

Spending drives prices and the modest change in CPI so far reveals the slow transition back to our old habits as consumers. What is interesting is that at the household level personal income hasn't changed much over the last year. Even though unemployment spiked, household income actually increased on average due mostly to the trillions of dollars of Covid relief. The percentage of household income coming from the government is currently well over 20%, and will increase again in March due to the latest $1,400 checks, which were sent to 100 million taxpayers. Since there wasn't much to do outside the house, people tended not to spend this money and so savings went way up. This savings had to go somewhere, and with borrowing rates at all-time lows, much of it flowed into investments. This has fueled rising home prices and much of the speculative investing we have seen, such as GameStop, cryptocurrencies and Non-Fungible Tokens (NFTs). Crucially, this spending has driven asset prices higher, rather than consumption-oriented prices.



[1]This NFT by an artist named Beeple sold for $69 million.

This reads like a very long set-up, but we have finally arrived at the critical point. Does consumption behavior change from what we have been seeing to something different? And with that change, do we start to see inflation of a type and size that materially impacts our portfolios and our ability to support real spending in the future? Do households start to buy more vacations and dine out more . . . more clothing and vehicles, driving more and spending more on education and healthcare? Or, do they continue to save and buy assets, like upgrading their houses to allow for a better work-from-home experience, or saving for retirement or other future purchases?

Increases in asset prices, while a form of inflation in a technical sense since we experience higher prices due to demand, is not inflation in the classical sense. The reduction in the purchasing power of a currency is the key definition from economics and is our real (pun intended) concern as investors. Our focus for most portfolios consists of moving the ability to spend, in real terms, through time. Inflation is our headwind, reducing the value of the dollar we have invested, and requiring a greater nominal return to offset it. So, we are keenly interested in the behavior of consumers going forward.

We should also consider the behavior of the administration, guided by its new Treasury Secretary. We are seeing a significant move away from the supply-side, monetarist economics of the last thirty years and an embracing of new versions of neoclassic economics with government having a heavier hand in the way resources and wealth are allocated, relying less on markets to lead that process. This is playing out in the large deficits being anticipated, the higher taxes and more comprehensive tax regimes being suggested and the amount and size of transfer payments and stimulus being paid. We have written on Modern Monetary Theory in the past, which espouses a position that government spending does not create inflation and taxes should be used to make sure by siphoning off excess capital from the system. That appears to be the central test we will be watching over the next four years.

Secretary Janet Yellen has moved from a small government, low tax, market-based allocation of resource proponent early in her career to the position in which we find her now. She and the Federal Reserve have stated the following several times so far this year: (1) deficit spending and stimulus are needed to continue to drive the economy; (2) this deficit spending will not create inflation; and (3) the economy would lag behind its full potential without it. The various charts we have shown in this update should help to showcase the size of the effort so far and more spending is being advocated. This is shaping up to be a test that will be part of textbooks for decades to come.

Does all of this require us to take a position today in our portfolios, and what position should we bet on - inflation or no inflation? As it stands today, we don't think classic inflation is immediately on the horizon and will more likely be an issue for the second half of this year and going into 2022. It will take that long for the current process to work its way through. That process is the vaccine and reopening of the economy leading to increased activity and demand, leading to more goods and services, more revenue and profit for companies and more investment. Price increases will be at the backend of all of this. The actions and decisions of the administration will place the U.S. in a very small group of developed countries in terms of our global tax regime and high effective tax rates, and our stimulus is sized larger than most, even on a GDP basis. This could lead to us adding to our non-U.S. equity position as we look to diversify our exposures to different responses to the reopening of economies and their potential impact to currencies.

Because of the continued positive impact to investment assets that we are seeing and the positive potential for more benefit as reopening and growth continue, we want to maintain our current weightings to equity assets. Increased demand should lead to increased earnings and profits, and both dividend and earnings yields today look very attractive versus bond yields. We also expect that nominal interest rates have the potential to increase modestly going forward, leading to a tough environment for bonds. This will have us maintaining shorter durations in addition to seeking other ways to generate returns in fixed income space, with credit and other opportunities, including our diversifiers. Our objective is to participate as best as possible in the positive aspects of our return to normal, and be very wary of the longer-term consequences of the fiscal and monetary actions that helped bridge us to this point. Protecting what we have been able to claw back from the correction in 2020 is every bit as important.

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