GW&K®
INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW

3Q 2021

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ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

However much we plan, there are always unanticipated consequences. Sometimes the means justify the ends or, even when unlucky, the ends turn out better than foreseen. When the end is beyond our realm of expectations, however, then the consequences can be severe. In my lifetime, I have watched three U.S. presidents lose public opinion and the ability to lead because of foreign policy blunders. Lyndon Johnson chose not to seek reelection over Vietnam, Jimmy Carter lost the election over the failed coup in Iran, and now I see President Biden's diminished influence, stemming from the events in Afghanistan. I usually avoid political commentary, but I feel compelled to reflect on this latest incident.

We did not need to withdraw 2,500 troops from Afghanistan. We have set up tripwires all over the world, some with United Nations peace keeping forces, and others consisting of us alone. We have done this in the Suez Peninsula and throughout Europe and Asia. It works. When a country leans toward isolation, which the U.S. often does, these tripwires help our allies feel that in spite of shifting political winds, killing an American soldier is a very bad idea. Tripwires work. Alternatively, if President Biden had a deal with the Taliban to pull out completely, then I can't believe anyone reading this can understand the chaos created by our hasty retreat. It was embarrassing and the consequences will last throughout Biden's presidency. This subject will not be wrapped around yesterday's fish, as is so often the case with today's news. The aftereffects will bleed through again and again.

As I write this, the President again made a blunder by doing a deal with Australia for the delivery of submarines, snatching it from the arms of the French. So angry was the French government, they temporarily withdrew their ambassador to the United States. President Biden has some notion that our Pacific allies are more important than our European allies, that the threat to Taiwan by the Chinese will be the crisis to avoid. But China will likely succeed in bringing Taiwan under its control the same way it did with Hong Kong, over time and with political pressure. The world cannot tolerate an armed conflict between the U.S. and China. Yes, we will have cyber combat, fiscal maneuvering and political rhetoric, but no hot war.

What does this mean for GW&K and our clients? If President Biden's influence in his party has been compromised, his agenda could be altered. This might well include his spending budget and tax proposals. If he has been weakened, it may be serious enough to jeopardize the slight margin the Democrats hold in Congress come November of 2022. Time will tell. At a minimum, a damaged executive branch along with a dysfunctional legislative branch should translate into less extreme policy. A compromise or stalemate may be a relief for the financial markets that hate change more than anything.

If these assumptions are correct, then the Federal Reserve (Fed) will continue to leave interest rates very low, and a negative real return on cash will provide incentive to investors to continue to accept risk. A client sent me a text quoting hedge fund manager Ray Dalio: "cash is trash." A material rise in interest rates is a non-starter given the ever-increasing level of national debt. For many years I have compared the U.S. economy's direction to that of Japan. I never realized how right I would be. Like Japan, we are a mature economy with little immigration and population growth. It will be critical to keep borrowing costs low, if only to keep funds available for other government programs.

One of the other consequences of a weak central government is that the trend of wealth disparity will continue. As real assets grow and liquid assets decline, those able to participate in the capital markets will do well and those unable to will lose out. The disparity between the haves and the have nots will increase.

Another unintended consequence is the push to make major tax increases, both personal and corporate, more equitable.

Continued on next page

INDEX PERFORMANCE *9/30/21*

	QUARTER	YEAR TO DATE
Bloomberg 10-Year Municipal Bond Index	–0.15%	0.41%
Bloomberg Aggregate Bond Index	0.05%	–1.55%
Bloomberg High Yield Index	0.89%	4.53%
Dow Jones Industrial Average	–1.46%	12.12%
S&P 500 Index	0.58%	15.92%
Russell 2000 Index	–4.36%	12.41%
MSCI EAFE Index	–0.45%	8.35%
MSCI World Small Cap ex USA Index	0.72%	10.71%
MSCI World Index	–0.01%	13.04%
MSCI Emerging Markets Index	–8.09%	–1.25%

GW&K UPDATE *9/30/21*

TOTAL ASSETS UNDER MANAGEMENT	$54.6 billion
TOTAL EMPLOYEES	171
TOTAL INVESTMENT PROFESSIONALS	59

GW&K EXPANDS FIRM'S WEALTH MANAGEMENT CAPABILITIES

GW&K has proudly served individuals and families since our founding nearly 50 years ago, and our commitment to offering best in class wealth management solutions continues with the addition of two seasoned leaders to our Private Wealth Management team.

Daniel J. Fasciano, CFA, CMT, CAIA joined GW&K in the newly created position of Director, Private Wealth Management. With more than 30 years of experience in wealth management, Dan has the knowledge and appreciation for understanding the needs of clients, helping them to achieve their lifestyle and wealth transfer goals.

In addition, **Melissa F. Jacoby, Esq.** joins the team in the newly created role of Wealth Strategist. With more than two decades of experience in helping clients in the areas of financial, estate planning, and strategic wealth management decisions, Melissa has a deep knowledge of all facets of the private client relationship.

We are confident that the leadership, experience, and expertise Dan and Melissa bring to GW&K, along with the tireless innovation and commitment demonstrated by our Private Wealth Management group every day, will directly benefit our clients.

ECONOMIC COMMENTARY, continued from page 1

The degree of increase is critical. Some proposals will be non-productive, like taxing long-term capital gains at the same rate as short-term capital gains. The government should keep in place the current regime, which disincentivizes trading and speculation. In fact, long-term gains should be indexed to inflation, so the longer one owns a property the lower the tax rate.

The other tax idea I find poorly considered is the proposal to drop the estate tax exclusion per individual from $11.7 million to $5–6 million. With the exclusion amount cut in half, many more people will find themselves with a taxable estate. How will business owners with limited liquidity, such as car dealers, restaurateurs, small manufacturers, etc., whose families for generations built a business now worth over that amount, cover the tax due without liquidating or selling their family business? If your personal net worth is in excess of $5 million ($10 million per married couple) please be sure to pay attention to the possible upcoming tax changes! The chances of changing the estate exclusion are real and of great significance. As a money management firm, we take pride in helping our clients build wealth. There will be a 40% federal tax on your net estate, plus the possibility of an estate or inheritance tax at the state level (18 states, including Washington D.C.). Clients should consider reducing their family wealth through strategic and thoughtful estate planning, which takes precedence over asset allocation. Please be responsible—time is short as there will most likely be a tax hike enacted in 2022.

This country needed a president who was a leader, that represented the silent majority who are in favor of strong social programs, but with fiscal discipline; and one with the courage and willpower to defend America's ideals. Maybe President Biden can recover from these missteps. I sure hope so.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

THIRD QUARTER 2021

ECONOMY

- Following robust growth in the first half, the economy cooled in Q3 due to the rapidly spreading Delta variant, reduced fiscal support, and ongoing supply-chain and labor constraints.
- But signs that COVID-19 infections have crested, along with surging corporate profits and record household net worth, should support continuing economic expansion.
- Inflation has remained stubbornly high, with the Consumer Price Index for August up 5.3% from a year earlier. According to private-sector economic forecasts, inflation may take longer to return toward the Fed's 2% target than previously anticipated due to surging energy prices and ongoing supply disruptions.
- Fiscal policy is at a critical juncture, with Democrats aiming to pass both infrastructure and budget reconciliation bills soon, after avoiding a government shutdown and reaching a short-term compromise with the GOP on the debt-limit issue.

FED ACTION

- The Fed remained accommodative, but following the September FOMC meeting Chair Powell signaled that QE tapering is likely to be announced at the November meeting and be finished by mid-2022.
- That timetable for ending asset purchases could set the stage for the first 25 basis point rate hike in the second half of 2022, as anticipated by half of the FOMC members in their dot plot projections.
- The median dot plot now shows three rate hikes in 2023 (up from two in June) and an additional three rate hikes in 2024. The market is somewhat less hawkish than the median dot plot, pricing in only four 25 basis point rate hikes by the end of 2024.

BOND MARKETS

- Fixed income was essentially unchanged in Q3 despite a steady succession of headlines related to COVID-19, geopolitics, and price increases.
- Treasuries narrowly posted a positive return, but still sit decisively in negative territory for the year. The yield curve experienced a slight flattening in response to an incrementally hawkish stance from the FOMC.
- Corporate bond spreads continued to trade in a tight range and closed the period just a few basis points above historic lows. While credit markets generally tracked the volatility that drove equity trading, the magnitude of the moves was fairly muted by comparison.
- Municipal bonds posted modest losses in Q3, driven by a late September selloff in Treasuries and increased selling in the secondary market.

DOMESTIC EQUITY MARKETS

- U.S. equity markets moved higher in July and August, but sold off sharply in September, marking the weakest quarter for the S&P 500 (+0.6%) since the start of the pandemic. Concerns around inflation, rising interest rates, peak growth, the Delta variant, China's economic slowdown, worsening supply-chain challenges, and tax risk overwhelmed the positives that have fueled the market's YTD rise.
- Large-cap stocks outpaced small- and mid-caps in a continuation of Q2 trends (Russell 2000 –4.4%).
- Sector performance was mixed in the large-cap market. Financials, Utilities, and Communication Services performed best, while Industrials, Materials, and Energy lagged. Most small-cap sectors delivered negative returns.
- Growth stocks outperformed Value in the large-cap Indexes, though Value maintained leadership over Growth in the small-cap market. Investors also demonstrated a preference for high-quality factors.

GLOBAL EQUITY MARKETS

- Non-U.S. developed markets (DM) delivered mixed Q3 performance, as potential economic risks, including ongoing supply-chain bottlenecks and soaring European gas prices, triggered a September pullback.
- The MSCI World ex USA Index declined –0.7%, while the MSCI World Small Cap ex USA Index outperformed with a 0.7% gain. The U.S. Dollar Index rallied 1.9%.
- Beijing's regulatory offensive, the demise of real estate developer China Evergrande, and surprise power shortages saw MSCI China fall –18.2% in Q3. This shaped broader emerging markets (EM) weakness—the MSCI EM Index was down –8.1%, despite good returns in India, Eastern Europe, and Persian Gulf countries.
- Energy outperformed globally; DM Financials and Information Technology advanced. China dictated EM sector performance—Consumer Discretionary, Real Estate, and Communication Services declined sharply.

MUNICIPAL BOND STRATEGIES

INVESTMENT TEAM

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

GW&K MUNICIPAL BOND STRATEGIES

SHORT-TERM MUNICIPAL BOND

2–8 YEAR ACTIVE MUNICIPAL BOND ESG

2–8 YEAR ACTIVE MUNICIPAL BOND

MUNICIPAL BOND ESG

MUNICIPAL BOND

MUNICIPAL ENHANCED YIELD

"Looking forward, the recent backup in rates should come as a welcome relief for municipal bond investors.…Perhaps more important than the backup in rates has been the steepening of the curve, a dynamic we haven't seen in quite a while."

Municipal bonds posted modest losses in the third quarter, driven by a late-September selloff in Treasuries. For most of the summer, broader rates remained low and traded within a narrow range, despite solid economic data and rising inflation prints. The market, it appeared, was more focused on the longer term, taking supply-chain disruptions in stride and buying into the Fed's argument that price increases would ultimately prove "transitory." The spread of the Delta variant also helped to keep a lid on rates, as concerns about delayed reopenings dialed back expectations over the pace for global growth. But the markets received a jolt from the September FOMC meeting when a less dovish Fed indicated that the tapering program was likely to begin in November and finish next summer. Further, the accompanying dot plot reflected a more aggressive path for rate hikes, with liftoff potentially beginning next year, followed by three more hikes in both 2023 and 2024. The yield on the 10-year Treasury reacted with the single largest one-day jump since February. Meanwhile, Congress found it increasingly difficult to reach consensus on the infrastructure deal, which has been put on hold pending the outcome of a more contentious $3.5 trillion social policy bill. A debt ceiling debate and threats of a government shutdown only added to the apprehension and uncertainty. Over the final eight days of September, the 10-year Treasury yield rose nearly 20 basis points to finish roughly unchanged for the quarter.

Municipal bonds mostly tracked the path of Treasuries, but the September selloff pushed tax-exempt yields as much as 15 basis points higher for the quarter. A strong technical environment persisted over most of that stretch, however, as new cash continued to pour into the market from the sidelines. Industry mutual funds received nearly $30 billion of net inflows, bringing the year-to-date total to $88 billion, just shy of the $93 billion full-year record set in 2019. New issue volume was down 21% versus the third quarter of 2020, driven by a more severe drop in taxable origination. The vast majority of deals saw heavy oversubscriptions, allowing underwriters to routinely lower yields during order periods. The imbalance between supply and demand was so large that investors became reluctant to sell existing positions, for fear that suitable replacements could not be found. The result was a 22-year low in secondary market trading activity. But when Treasury yields started to rise in the last week of September, bid lists emerged, the secondary market loosened up and for the first time in a while, new issues needed price concessions to clear the market. The 10-year muni/Treasury ratio cheapened to levels not seen since February and finished the quarter within shouting distance of fair value.

Looking forward, the recent backup in rates should come as a welcome relief for municipal bond investors. After a brief selloff earlier in the year, most of the market action since has consisted of slowly declining yields and relentlessly tightening spreads, a frustrating combination that has made finding value increasingly difficult. The post-FOMC slide has helped to loosen the grip on what had been a one-sided market, awakening potential sellers and finally raising some doubts among potential buyers. Perhaps more important than the backup in rates has been the steepening of the curve, a dynamic we haven't seen in quite a while. The increased roll in the belly of the curve is starting to push expected returns toward 2% in key maturity areas. While it is too early to get excited about current valuations, the trend is encouraging. And with October being a historically poor month for bonds in general and municipal bonds in particular, we could see additional value created in the weeks ahead, especially with the uncertainty of Washington's legislative agenda, Fed tapering, the Delta variant and more. As usual, municipal bonds remain downwind of these macro variables, but as a market that is easily spooked, we wouldn't be surprised to see the current trend continue.

TAXABLE BOND STRATEGIES

INVESTMENT TEAM

Mary F. Kane, CFA	Partner, Portfolio Manager
Stephen J. Repoff, CFA	Principal, Portfolio Manager
Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
15 Taxable Investment Professionals	**18** Average Years Experience

GW&K TAXABLE BOND STRATEGIES

SHORT-TERM TAXABLE BOND

INTERMEDIATE TAXABLE BOND

CORE BOND ESG

CORE BOND

ENHANCED CORE BOND ESG

ENHANCED CORE BOND

TOTAL RETURN BOND

CORPORATE BOND OPPORTUNITIES

SHORT-TERM FOCUSED HIGH INCOME

"Fixed income markets were essentially unchanged in the third quarter despite a steady succession of headlines related to COVID-19, geopolitics, and price increases."

Fixed income markets were essentially unchanged in the third quarter despite a steady succession of headlines related to COVID-19, geopolitics, and price increases. Bond investors' largely sanguine response to these challenges suggests they have been able to look beyond near-term headwinds toward the next stage of the recovery. The Delta variant drove a massive surge in cases across much of the U.S., even as new prevention and treatment options continued to emerge and data suggest cases have crested. Chinese authorities enacted assertive regulatory changes and pursued efforts to reduce systemic leverage, while nevertheless framing both as necessary to achieve long-term stability and prosperity. Supply-chain constraints, energy shortages, and limited labor availability threatened to weigh on growth around the world, but there have been few indications that these market failures reflect any weakness in aggregate demand. On balance, these various obstacles seem to have been relegated to the category of one-time items, and the bond market has demonstrated little concern that they represent a meaningful threat to the current trading regime.

The Treasury sector narrowly posted a positive return, but still sits decisively in negative territory for the year. The yield curve experienced a slight flattening in response to an incrementally hawkish stance from the FOMC, which saw an uptick in its members' expectations for where the benchmark rate will be in 2022. This shift caused rates at the front end to push to new post-pandemic highs while keeping long rates in check on an increasingly murky growth outlook. The most pressing matter before the Fed is the timing and pace of the eventual taper, which is now expected to begin as soon as November and conclude in June of 2022 following a reset to a monthly cadence of declining purchases. This slightly accelerated timeframe has pulled forward market expectations of rate hikes, which are expected to commence in late 2022. Mortgage-backed securities slightly outperformed Treasuries, benefiting from superior carry, reduced taper uncertainty, and slower than anticipated prepayment speeds.

Corporate bond spreads continued to trade in a tight range and closed the period just a few basis points above historic lows. While credit markets generally tracked the volatility that drove equity trading, the magnitude of the moves was fairly muted by comparison. Robust cash generation and investors' fervent demand for yield have kept a ceiling on spreads over the last several quarters. Borrowers have used this favorable operating environment to improve their financial strength. Leverage across the quality spectrum has declined to pre-pandemic levels and companies' ability to service their debt has surpassed prior levels following a massive refinancing wave. New issuance maintained its torrid post-pandemic pace in both investment grade and high yield, with the largest share of proceeds still earmarked for replacing high-coupon debt even as the percentage used to fund M&A continued to rise. Among the best performing segments were the recovery-linked sectors, such as airlines, lodging, and energy, while the more traditionally defensive sectors like communications and technology were relative underperformers. Measures of financial distress remain benign, with the trailing default rate ticking lower yet again and declining to pre-COVID levels.

The increasingly hawkish tone of commentary from central banks around the world has raised the temperature of rhetoric on both sides of the transitory versus structural inflation debate. In the former camp are those who caution that responding too hastily to one-time, supply side-related shortages would result in a policy error; those in the latter camp fret that authorities are already behind the curve and that tapering should have begun months ago. The slope of the yield curve offers little clarity and points to a stalemate for now, sitting at or very near its multi-decade average (depending on which tenors you consider). While we recognize merits on both sides of the argument, we continue to see more risk to the upside in rates than the downside. We also see a more appealing risk profile in intermediate maturities in comparison to the long end, which would experience the greatest volatility in the event of a sharp move higher in rates.

DOMESTIC EQUITY STRATEGIES

INVESTMENT TEAM

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

> "The earnings outlook calls for exceptional year-over-year growth in 2021, followed by a more normal outlook for 2022 and likely beyond."

GW&K DOMESTIC EQUITY STRATEGIES

EQUITY DIVIDEND PLUS

DIVERSIFIED EQUITY

SMALL/MID CAP CORE

SMALL/MID CAP GROWTH

SMALL CAP VALUE

SMALL CAP CORE

SMALL CAP GROWTH

The quarter started on its familiar upward path through July and August, with markets hitting new highs behind solid earnings growth amid a strong economic recovery driven by fiscal and monetary stimulus, and strong consumption and investment spending. But we saw a marked change in tone in early September, as investors contemplated a laundry list of concerns: peak growth, inflation, supply-chain disruptions, the Delta variant, economic and regulatory concerns in China, rising interest rates, a surge in energy prices, imminent Fed tapering, a seemingly dysfunctional Congress impacting fiscal policy, and the likelihood of higher taxes. This pulled stocks of nearly all sizes, styles and geographies into the red for the quarter; a reversal from the previous quarter's strength. That said, nearly all markets, save China, remain firmly in positive territory for the year. To be fair, most of these fears are not new to September. Perhaps it was just time for markets to take a breather after registering consistent upward movement since the COVID-induced market meltdown of early 2020.

U.S. large cap stocks, as measured by the S&P 500 Index, were an exception to the quarter's downward trend, eking out a gain of 0.6% to register its sixth consecutive quarterly gain. Driven by a steeper yield curve and solid fundamentals, Financials posted sector-leading gains for the quarter, led by banks and insurance stocks. Utilities, Health Care, and the FANMAG-heavy Communication Services and Information Technology sectors also posted positive returns. Conversely, the economically-sensitive sectors, Industrials, Materials, and Energy lagged amidst concerns regarding the recovery.

Among U.S. smaller cap stocks, the Russell 2000 Index declined –4.4%, with few sectors posting positive returns. As with large caps, Financials posted gains. However, sector performance was otherwise quite different between large and small. Energy stocks led the way, as they have all year, given the year's 50% gain in oil prices. Communication Services was down in the mid-teens, although the impact of meme stock AMC, down by nearly one-third, explains much of this sector's weakness. The Health Care sector also posted a double-digit decline. While part of the blame falls on the volatile biopharma names, the weakness this quarter was quite broad across the sector.

Similar to last quarter, growth-oriented stocks posted stronger gains than value-oriented stocks within the large cap universe, driven by select FANMAG stocks within the Information Technology and Communication Services sectors. Yet in small caps, Value further extended its lead over Growth due to the strength of Financials, which is heavy weighted among value stocks, and weakness in Health Care, which is heavily weighted among growth stocks.

The positive outlook for equities has been well documented, as favorable policy initiatives and a steady return to economic normalcy have driven up earnings and the stock market. This can be measured rather empirically by the various surveys and statistics that we see regularly, including favorable wage, job and unemployment statistics, positive GDP growth, expansionary ISM Manufacturing and Services surveys, and a favorable Consumer Confidence Index. Some of these figures have slowed, but all remain in expansion territory. Similarly, risk factors weighing on equities more recently have also been well articulated, with numerous changes likely to government policy and pressures on the economy appearing as we enter the middle stages of the recovery. Will one of these scenarios overwhelm the other? We think not. It is part of the give and take by both politicians and businesses as we grow out of the unusual environment caused by COVID these past two years. Growth should continue, but it will be slower, as is normal at this stage of the cycle. Pressure on profitability may arise as supply-chain issues surface in the form of either shortages or inflationary pressures. Some may be sustained, but most will be resolved. The economy will keep moving forward.

The earnings outlook calls for exceptional year-over-year growth in 2021, followed by a more normal outlook for 2022 and likely beyond. While our outlook for both the economy and equities is subject to change, our fundamental bottom-up stock selection process is not. Our focus on management quality, consistent performance, market position and valuation lets our stock selection drive performance over the long term, regardless of where we stand in the economic cycle or how we may need to adjust our outlook.

GLOBAL EQUITY STRATEGIES

INVESTMENT TEAM

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

"While the current market is rewarding investment in extremes, we continue to focus on the rational middle where good businesses can be acquired at valuations that imply attractive long-term returns."

GW&K GLOBAL EQUITY STRATEGIES

GLOBAL SMALL CAP

INTERNATIONAL SMALL CAP

After continuing to rally in July and August, global markets backtracked in September to end the quarter just about where they started. The large cap MSCI World ex USA Index fell –0.7%, while the MSCI World ex USA Small Cap Index gained 0.7%. Underlying returns were a bit stronger, however, as the U.S. dollar strengthened by almost 2% during the quarter, retracing almost half of last year's losses.

Despite first appearances, under the surface there was significant movement in the global small cap markets this quarter. Two of the more value-oriented, cyclical sectors, Energy and Financials, lead the rally, while consumer facing Consumer Discretionary and Consumer Staples both fell. Interestingly, Materials, which often performs in line with Energy, was the weakest sector as iron ore and precious metal producers fell sharply with their underlying commodities. On a geographic basis, the Middle East led, followed by Asia. Europe delivered only modest gains and North America was down on the quarter. Within Asia, Hong Kong was noticeably weak, falling more than –13% on concerns about China, but that was more than offset by Japan, which continued to rally, hitting levels last seen in 1991. For those who consider a bear market intact until the prior peak is surpassed, note that Japan is still recovering and has another 40% to go before reaching the 1989 peak. European country returns varied significantly. Most of the outliers were smaller markets as the larger countries were all just slightly higher.

This quarter felt like markets had entered some kind of interregnum, suspended between the COVID containment era, initial recovery, and whatever is going to come next. And it is not just the markets, long-term political and monetary trends are changing as well. In Germany, Angela Merkel stepped down as Chancellor, a post she held since 2005. Think of all the changes that have occurred during those 16 years. What this means for Europe is not clear, but there does not appear to be anyone of the same stature waiting in the wings. Japan also just saw a change in Prime Minister with a contested LDP leadership election that ended with a status quo candidate, but showed a growing desire for generational change. Meanwhile, expansive regulatory changes in China clearly put an end to any hope that engagement will lead them towards a liberal democratic model. Xi is moving the country back towards a more explicit command economy, which raises risks for foreign investors as well as increasing geopolitical risks, with Taiwan the most likely flashpoint.

Monetary policy trends are also changing. The market consensus of when the Fed will begin raising rates is moving closer, with tapering now expected in 2022. Whether they are actually able to raise interest rates remains to be seen. Rates are already on the rise in other markets. Several emerging market central banks have been tightening, while Norway recently became the first developed country to raise interest rates. In the meantime, major markets are dealing with significantly negative real rates, and investors are stuck wondering just how transitory the current high rates of inflation will prove to be.

Which takes us to COVID. After a slow start, most developed markets have now passed the U.S. in vaccination levels and should see positive reopening benefits soon. Emerging markets continue to lag, but are also making quick progress. This dynamic sets up 2022 for an economic baton pass, as these markets experience their version of the recovery seen in the U.S. during 2021. However, there is growing concern about a sharp slowdown in the U.S. and China, at least when compared to the first half of 2021.

From a purely investment point of view, we are at crossroads. Many of the winners from 2020 have continued to give up their gains, while the re-opening beneficiaries have fared poorly of late, but also lack valuation support. Meanwhile, well-financed quality companies with sustainable, moderate growth potential trading at reasonable valuations, seem to have temporarily fallen out of favor. While the current market is rewarding investment in extremes, we continue to focus on the rational middle where good businesses can be acquired at valuations that imply attractive long-term returns.

EMERGING MARKETS EQUITY STRATEGIES

INVESTMENT TEAM

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

"Despite EM's recent disappointing performance, we remain optimistic that the most likely scenario for the world economy is for a multi-year expansion that will be constructive for EM equities."

GW&K EMERGING MARKETS EQUITY STRATEGIES

EMERGING MARKETS EQUITY

EMERGING MARKETS EQUITY ADR

EMERGING WEALTH EQUITY

EMERGING WEALTH EQUITY ADR

After five consecutive quarters of gains, emerging market (EM) equities lost –8.1% in the third quarter, led by an –18.2% loss in China. The third quarter loss more than offset first-half gains for the MSCI EM Index, leaving it down –1.2% for the year to date, compared to a 13.0% gain in the MSCI World Index of developed market (DM) equities. EM's third quarter loss came against a backdrop of flat DM performance, a modestly hawkish tilt by the Fed, broad-based weakness in EM currencies, a continuing surge in energy prices, and a spree of rate hikes by EM central banks.

With MSCI China representing about one-third of the MSCI Index, a perfect storm of China-specific factors was also key to EM's weak third-quarter performance. In rough order of importance these included: 1) a worse-than-expected regulatory clampdown, 2) a deepening property market credit crunch, 3) disappointing economic data associated with COVID lockdowns and rolling production cutback due to electricity shortages. Not only did these factors dampen the outlook for China's corporate earnings growth over the next twelve months, they also cut the multiples investors were willing to put on future earnings.

China's regulatory clampdown has been far-reaching, including curbs on internet platforms, fintech, video games, off-campus tutoring, ride hailing, data privacy, food delivery, crypto miners, and e-cigarettes. Perhaps most shocking was the government's decision in July to outlaw the for-profit, off-campus tutoring industry, which essentially zeroed out the future profits of a $120 billion industry with little warning to investors.

In contrast, China's efforts to curb lending to property developers has been no secret for many quarters. Despite current market jitters regarding the apparent insolvency of China's giant property developer, Evergrande, the government seems likely to step in to prevent disorderly debt recovery efforts, reduce systemic risk, and limit contagion in financial markets. But even an orderly resolution of Evergrande's liabilities risks collateral damage to China's economy since its outstanding debts exceed $300 billion (1.9% of GDP).

Against this backdrop, the underperformance of EM equities in the quarter reflects numerous crosscurrents. Not surprisingly, the crosscurrents in commodity markets have been substantial. Supply shortages and robust DM demand pushed crude oil and natural gas futures up by 5% and 61%, respectively; while peak growth worries and China-specific factors pushed lumber, copper, and iron ore futures down by 5%, 12% and 48%, respectively. Prospects for the Fed's QE tapering to begin this year have put pressure on EM central banks to continue to tighten policy, with notable rate hikes in the third quarter seen in Brazil, Colombia, the Czech Republic, Mexico, Russia, Pakistan, and Peru. Turkey was an exception to that trend, with its central bank delivering an unexpected 100 basis point rate cut in the face of increasing inflation.

Regional and sectoral performance patterns reflected these crosscurrents. On a regional basis, EM Latin America posted a loss of –13.3%, dragged down by a –20.2% loss in Brazil on investors' concerns about rising political uncertainty, falling iron ore prices, and the negative impact of aggressive monetary tightening. The next weakest region was EM Asia, weighed down by losses in China (–18.2%) and South Korea (–13.2%), but supported by gains in Indonesia (+9.4%) and India (+12.6%). Surging energy prices helped the EM region of Europe, the Middle East, and Africa (EMEA) outperform with a gain of 7.8%, led by gains in the Czech Republic, Russia, and Saudi Arabia. The energy price backdrop and rising interest rates helped sectors like Energy, Utilities, and Financials post positive performance, while China-specific factors triggered double-digit negative returns in sectors like Health Care, Communication Services, Real Estate, and Consumer Discretionary.

Despite EM's recent disappointing performance, we remain optimistic that the most likely scenario for the world economy is for a multi-year expansion that will be constructive for EM equities. EM's vaccinations should begin to catch up with DM's in the year ahead, with China on track to have 90% of its population fully vaccinated by the end of 2021 and EM overall on track for 70%. China is also set to provide additional monetary and fiscal stimulus that should help growth recover in coming quarters.

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