GW&K INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW 1Q 2021

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ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

The last year created great challenges and opportunities, sadness and awakening. The little corner of the world that we share, investments, was in some way a reflection of the larger environment: panic, fear, hope, reflection and then opportunity.

The Federal Reserve and Congress, having learned from the mistakes of the Great Financial Crisis, acted quickly and forcefully to create liquidity and stabilize markets. The safety net that the federal government provided afforded markets the time to digest and integrate this totally unpredictable event. In a relatively short period of time, investors saw the pandemic as a tsunami, and in time, the crisis was relegated to the rear view mirror. As asset values stabilized, stocks began to look past the pandemic, slowly at first, but as the hope of a vaccine became real, with increasing strength. From the bottom, equity markets had their strongest run since 1936:

ONE-YEAR RETURNS FROM MARKET LOW on 3/23/20	
S&P 500 Index	+77.8%
Russell 2500 Index	+116.7%
Russell 2000 Index	+120.7%
Russell 3000 Index	+85.3%
MSCI World ex USA Small Cap	+94.7%
MSCI Emerging Markets Index	+78.3%

As we enter the post-pandemic period, the challenge is how best to navigate the capital markets. In order to noodle through the myriad variables, I believe we need to divide our thoughts between the next year-and-a-half and thereafter. The Fed is now predicting 6% GDP growth for 2021, driven by the trillions in emergency relief aid provided by Congress, and the Fed's stated intention to keep short-term rates pinned at zero over the next year or two. There are many economists who believe that this combination of fiscal and monetary stimulus will accelerate growth in excess of the 6%, which in turn will create inflationary pressures well beyond the Fed's target of 2%. Historically the global economy has allowed companies to produce offshore, taking advantage of huge cost savings, resulting in minimal inflationary pressure. In many ways, this approach has become a problem during the pandemic, as huge supply chain disruptions have resulted in higher prices. The global economy has become less reliable, and concerns have surfaced that companies bringing manufacturing back to the U.S. will create higher costs that might be passed to the consumer.

But it seems to me that inflationary pressures will prove short lived, arising only as a consequence of too much government intervention at a time the economy was already facing pent-up demand, outsized savings and the momentum of a vaccinated population. This next year-and-a-half may be as unique as the year prior, and not particularly indicative of the economy's long-term trajectory. The inflationary experiences during the next year or two will be a direct result of liquidity being thrown into an already turbo-charged system, creating a short-term pop that will eventually settle back to pre-pandemic levels, with inflation staying at or below the target rate of 2%.

Standing at what seems to be an inflection point, there is a need to protect assets from a near-term explosion of liquidity and speculation. U.S. debt is running at 125% of GDP, and will probably push closer to 150% in the foreseeable future (Japan's debt is 250% of GDP). This is the highest ratio of debt-to-GDP since World War II, so even if interest rates stay near zero and inflation at 1%–2%,

INDEX PERFORMANCE *3/31/21*	QUARTER	YEAR TO DATE
Bloomberg Barclays 10-Year Municipal Bond Index	–0.57%	–0.57%
Bloomberg Barclays Aggregate Bond Index	–3.37%	–3.37%
Bloomberg Barclays High Yield Index	0.85%	0.85%
Dow Jones Industrial Average	8.29%	8.29%
S&P 500 Index	6.17%	6.17%
Russell 2000 Index	12.70%	12.70%
MSCI EAFE Index	3.48%	3.48%
MSCI World Small Cap ex USA Index	4.88%	4.88%
MSCI World Index	4.92%	4.92%
MSCI Emerging Markets Index	2.29%	2.29%

GW&K UPDATE	*3/31/21*
TOTAL ASSETS UNDER MANAGEMENT	$53.2 billion
TOTAL EMPLOYEES	161
TOTAL INVESTMENT PROFESSIONALS	57

STRENGTHENING OUR COMMITMENT TO GLOBAL EQUITIES
GW&K ANNOUNCES FOUR NEW PARTNERS

Nuno Fernandes, CFA, Equity Portfolio Manager
Karl M. Kyriss, CFA, Equity Portfolio Manager
Thomas A. Masi, CFA, Equity Portfolio Manager
Bradley J. Miller, CFA, Equity Portfolio Manager

These promotions demonstrate our deep commitment to our clients, peers and process. Each of these professionals has played a pivotal role in driving competitive performance in emerging and international markets. We are fortunate to have such high caliber professionals and are confident that their global investment knowledge, analytical skills and experience in what have proved to be very dynamic global markets will continue to serve our clients well. We look forward to their continued success.

Our team of global specialists seek to uncover quality companies that have a sustainable competitive advantage and that may be undervalued, underappreciated or misunderstood by the market.

We believe having exposure to international and emerging markets is important to building a well-diversified portfolio for many clients. Please contact us to learn more about our global equity strategy options.

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there is little protection from currency devaluation. As long as the U.S. dollar is the trading currency of the world, the U.S. government will get away with unbridled spending and diminish the value of the dollar. Under these circumstances, we need to convert our currency into assets.

One of the saving graces is that there is a growing global economy. Middle class values are spreading around the world, as is the desire to have a quality of life similar to the West. Global growth will allow even mature economies to grow, aided by science and technology. Even as the U.S. economy reverts to pre-pandemic levels of slow growth, there are many opportunities in the global markets. The expanding global middle class is accelerating the demand for goods and services, and well-managed companies here and abroad are prepared to meet those growing needs. The ability of businesses to leverage resources around the world in order to drive efficiency and to stay productive will hold down inflationary pressures.

If interest rates respond to inflationary fears by rising over the next year or two, I believe this will provide a wonderful opportunity to lock in higher yields. Because before too long, and I do believe the risk is that it will come sooner than most think, the bond market will realize that the forces driving current inflationary concerns are not here for the long haul. At that point, rates will stabilize and/or fall back. In the meantime, stock values will continue to expand with an accelerating economy.

Important keys to investment success will be diversification and the willingness to endure volatility. Although those factors have always been true, they seem to be even more important as we enter these next two phases; post-pandemic and post-post-pandemic.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

FIRST QUARTER 2021

ECONOMY

- The economy started the year on a positive note, as vaccines were more broadly distributed and businesses continued to reopen. An accommodative Fed, fiscal stimulus, pent-up demand combined with elevated savings, and record asset prices were key factors that propelled a reflation narrative.
- GDP rose 4.3% in Q4. The Atlanta Fed estimates 6.0% GDP for Q1, which would be the best figure since 2003. Numerous economists are forecasting even higher growth for all of 2021.
- Manufacturing climbed to its best level since 1983 and has expanded for 10 straight months. Services logged its fastest growth since data began in 1997. The labor market improved markedly, adding 916k jobs in March, the most since August. The unemployment rate fell to 6.0%, but there are still approximately 8 million fewer jobs compared to February 2020.

FED ACTION

- The Fed remained accommodative, both on rates and other policy tools. The fed funds rate is projected to stay at its 0.00%–0.25% range through at least 2023, although some members pulled forward their hike projections. The market is more hawkish, pricing in four 25 basis point rate increases over that period.
- Asset purchases were kept at $120b/month and the program will persist "until substantial further progress has been made toward the" FOMC's "maximum employment and price stability goals."
- In other forecast updates, the Fed's average estimate for GDP was adjusted from 4.2% to 6.5% for 2021, while unemployment went from 5.0% to 4.5%. The Fed believes conditions have improved, but aims to keep its current policy in place until the economy reaches full employment and inflation averages 2%.

BOND MARKETS

- Fixed income markets posted their worst returns since 1981 amid a sharp rebound in growth expectations and burgeoning fears of higher inflation.
- The Treasury sector sold off notably as the curve extended its recent steepening. The front end remained anchored by Fed policy, including monthly asset purchases. Long rates continued to surge to pre-pandemic levels.
- Corporates were subdued beyond the impact of the rates selloff, tightening only slightly. Credit conditions continued to improve, as defaults slowed to a trickle, distress ratios fell to multi-year lows, and ratings upgrades outpaced downgrades.
- Municipals posted negative returns for the quarter but outperformed Treasuries, benefiting from strong demand, improving fundamentals and federal stimulus.

DOMESTIC EQUITY MARKETS

- U.S. equity markets rallied higher in Q1, with the S&P 500 Index gaining +6.2%. Vaccine progress, unprecedented monetary and fiscal stimulus, improving economic data, and better-than-expected corporate earnings results pushed markets higher despite growing concerns around rising interest rates and inflation.
- Small cap stocks outpaced large and mid-caps during the period (Russell 2000 +12.7%) following record outperformance in Q4.
- All large cap sectors delivered positive returns. Value and cyclical groups including Energy, Financials, and Industrials performed best amidst a continued rotation of market leadership. Interest-rate sensitive and growth-oriented groups such as Consumer Staples, Information Technology, Utilities, and Health Care lagged on a relative basis.
- Value stocks markedly outperformed Growth in Q1. Investors also demonstrated a preference for low quality factors.

GLOBAL EQUITY MARKETS

- A surprising U.S. dollar rally, triggered by higher growth, inflation and interest-rate expectations, tempered strong local gains in non-U.S. developed markets (DM). Northern European countries led the continent's performance. In Asia, Hong Kong benefited from robust mainland China investment flows.
- The MSCI World Ex USA Index advanced +4.0% USD, while the U.S. Dollar Index climbed +3.7%. The MSCI World Small Cap ex USA Index returned +4.9% USD.
- Emerging market (EM) performance was modest by comparison, as U.S. dollar strength caused marked declines in several EM currencies and dented risk sentiment. In addition, profit taking and regulatory concerns weighed on Index heavyweight China. The MSCI EM Index rose +2.3%.
- In DM, Energy, Financials and Consumer Discretionary were sector leaders. Materials, Communication Services, and Information Technology led EM sectors.

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

Municipal bonds fared better than most fixed income alternatives in the first quarter, but ultimately could not escape the gravitational pull of a bond market selloff that saw Treasury yields surge to their highest levels of the pandemic era. The major catalyst came in January, when the Democrats unexpectedly secured control of the U.S. Senate, clearing the way to add a $1.9 trillion fiscal stimulus package to an economy already buoyed by the momentum of a successful vaccine rollout. Investors responded quickly, repositioning for a sharp acceleration in growth and a revival of long-dormant inflationary pressures. The yield on the 10-year U.S. Treasury shot up 82 basis points over the quarter and the curve steepened significantly, as the futures market pulled forward by a year the date of a first rate hike. But the Fed pledged patience and dismissed pricing pressures as temporary. While inflation expectations had pushed to decade-highs, policymakers emphasized that over half of the increase in nominal yields was driven by a surge in real rates, a welcome reflection of investor confidence in the recovery.

For much of the quarter, the municipal bond market ignored the weakness in Treasuries, focusing instead on the windfall coming out of Washington. Few asset classes benefited more from the American Recovery Plan, which sent hundreds of billions in direct aid to states, local governments, school districts, universities, airports, toll roads, mass transit, you name it. These same entities were bolstered further by the knock-on effects from individual stimulus checks and roaring capital markets. Meanwhile, proposals to increase taxes had investors scrambling to gobble up municipal bonds to avoid Uncle Sam's reach. Money poured into the space in breathtaking fashion. Mutual funds saw more inflows to start the year than any on record. Credit spreads contracted to pre-pandemic levels. By mid-February, tax-exempt rates were still unchanged for the year despite a sharp selloff in Treasuries, leading to unsustainably-low relative value levels. As a result, when Treasuries continued to weaken, municipal bonds were forced to follow suit. Even so, for the quarter, tax-exempt rates rose less than half of what we saw from Treasury yields.

Our trading activity in the first quarter reflected the changing dynamics of the market. Higher rates, steeper curves and irrational valuations created an opportunity to shift our positioning. When the five-year muni/Treasury ratio dropped to the low-40s (it would bottom at 38% on February 16, 2021), we decided to give the market what it demanded, targeting for sale bonds that matured in 2025 and early 2026. As the quarter progressed, issuance accelerated as relative value cheapened, providing a favorable window to reinvest. We put the proceeds back to work in 10–15 year maturities, capitalizing on a new issue market where bonds were priced to sell. By moving out on the curve, we were able to pick up over 100 basis points of yield, improve expected return from bond roll and lock in wider credit spreads. While we have extended duration modestly, we still have plenty of dry powder in the short-end of the curve that can be deployed in similar fashion should conditions warrant.

The fundamental outlook for municipal bonds continues to brighten. Trillions in federal stimulus aid, with the possibility of more to come later this year, has helped offset the revenue hit from the pandemic, even for the hardest hit credits. As the economy rebounds with the help of a successful vaccination campaign, finances should only mend further. As it is, rating agencies have already moved most sectors to stable from negative and the chaotic selloff of last spring seems a distant memory. While still low in absolute terms, yields have risen significantly off the rock-bottom levels of the summer (the 10-year has nearly doubled). The yield curve has steepened meaningfully and, as of quarter-end, stood more in line with its historical averages. This has increased the attractiveness of longer maturity debt, as the expected return from bond roll becomes far more prominent. Relative value ratios remain fairly expensive, but the odds for a substantial cheapening seem minimal. More likely, ratios will stay in a narrow channel, held in by a combination of improving credit metrics, tight supply and the prospects for higher marginal tax rates.

"The fundamental outlook for municipal bonds continues to brighten. Trillions in federal stimulus aid, with the possibility of more to come later this year, has helped offset the revenue hit from the pandemic, even for the hardest hit credits."

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
14 Taxable Investment Professionals	**19** 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 posted their worst returns since 1981 amid a sharp rebound in growth expectations and burgeoning fears of higher inflation. The success of the nationwide vaccine rollout, a rapidly healing labor market, and swelling consumer confidence continued to drive the reflation narrative. Further support came in the form of a $1.9 trillion fiscal stimulus package on top of a commitment to ultra-loose monetary policy from the Federal Reserve. And beyond that, investors were confronted with the possibility of yet more fiscal support with a proposal of more than $2 trillion of infrastructure spending. This combination of factors amounted to nothing less than a wholesale regime shift for a bond market that until just a few months ago struggled with an anemic growth outlook and fears of deflation. Nevertheless, worries over new variants, challenged vaccine rollouts, and isolated instances of supply constraints might present challenges in the months ahead.

The Treasury sector sold off sharply as the curve extended its recent steepening. The front end remained anchored by the Fed's accommodative policy stance, including $120 billion of ongoing monthly asset purchases. Long rates, meanwhile, continued to surge to pre-pandemic levels. Notably, the uptick in inflation expectations that brought breakevens to their highest level in more than a decade was only part of the story. It was actually the rise in real yields that was responsible for the majority of the move, as investors began pricing in the long-term implications of several trillion dollars of stimulus and a normalization of economic output. The mortgage sector performed in line with Treasuries, as elevated prepayment speeds and heightened rate volatility were offset by continued technical support from the Fed's purchasing 40% of supply.

Corporate bonds were remarkably subdued beyond the outsized impact of the rates selloff, tightening only slightly on the quarter. The sector was unable to enjoy the rally in risk assets despite the improving fundamental backdrop due to massive levels of new issuance. Companies rushed to market in anticipation of higher rates in an effort to extend maturities and lower interest expense, with nearly 80% of proceeds earmarked for refinancing. Investment grade primary activity was second only to last year's record-setting, pre-lockdown binge, while high yield set a decisive quarterly record. Credit conditions continue to improve amid this flood of liquidity: the default pipeline slowed to a trickle, distress ratios fell to multi-year lows, and credit ratings upgrades continued to outpace downgrades.

The gap between the market's expectations of the first rate hike and the Fed's projected liftoff has widened since the end of last year as the recovery has unfolded. Investors cite the threat of inflation and the size of recent stimulus in wagering that the first hike will occur in late 2022. The FOMC, on the other hand, has downplayed these instances as transitory and emphasized the need to achieve inflation above 2% on a sustained basis. While there is room to debate the pace of rising rates, we may be entering a period of heightened volatility in the coming quarters.

In light of the various structural forces aligned to promote a robust recovery, we continue to believe corporate credit offers the best value in the fixed income space. Not only does the sector stand to benefit from capital markets awash in liquidity and a constructive earnings outlook on the economic reopening, it also provides a buffer against rising interest rates and a compelling opportunity for excess returns. The Treasury market on the other hand, even after its recent selloff, offers historically unattractive yields and continues to sit at the mercy of inflation expectations and real yields—both of which are being targeted aggressively by monetary and fiscal authorities. Consequently, we remain overweight credit. Within the space, we continue to favor companies that trade wide of their pre-pandemic levels, but which we believe are likely to benefit from a return to normalcy, including companies in the consumer cyclical, transport, and leisure/hospitality industries. In the mortgage sector, our exposure is still close to neutral. Valuations are not particularly impressive despite the ongoing technical support from the Fed, given prepayment speeds that remain elevated. Within mortgages, we continue to prefer higher-coupon, seasoned pools with more attractive convexity profiles.

"In light of the various structural forces aligned to promote a robust recovery, we continue to believe corporate credit offers the best value in the fixed income space. Not only does the sector stand to benefit from capital markets awash in liquidity and a constructive earnings outlook on the economic reopening, it also provides a buffer against rising interest rates and a compelling opportunity for excess returns."

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
12 Equity Investment Professionals	**22** Average Years Experience

GW&K DOMESTIC EQUITY STRATEGIES

EQUITY DIVIDEND PLUS

DIVERSIFIED EQUITY

SMALL/MID CAP CORE

SMALL CAP VALUE

SMALL CAP CORE

SMALL CAP GROWTH

"As the pandemic slowly fades and the world returns to more solid footing, pent-up demand should drive strong results in the consumer economy, while resolving supply chain issues and restocking inventories should drive the industrial economy. In this environment, we continue to move toward more economically-sensitive names and those likely to benefit from the post-pandemic recovery."

The surprising Democratic sweep in Georgia's Senate runoff races, all but assuring continued massive fiscal stimulus, set the tone early in the quarter, as cyclical recovery plays continued their market dominance. Stocks of nearly all styles, sizes, geographies, and sectors posted gains in the quarter. The positive market drivers have remained rather intact for just about a year now: aggressive fiscal and monetary stimulus, vaccine development/deployment, and economic reopening leading to surprisingly strong and accelerating profit growth expectations in 2021 and beyond.

Reflecting this optimism, U.S. stocks, as measured by the S&P 500 Index, increased 6.2%, hitting another all-time high just before quarter end. All market sectors posted gains, although those sectors benefiting from higher interest rates and the cyclical recovery easily led the pack. Energy posted a second consecutive quarter at the top, gaining 31%. Financials, Industrials, Materials, and Real Estate posted respectable high single-digit to low double-digit returns. As investors rotated toward these beneficiaries of the recovery, the more defensive sectors and those seen as having higher organic growth became a source of funds, with Consumer Staples, Information Technology, Utilities, Consumer Discretionary, and Health Care posting more modest low single-digit gains.

Small cap stocks, as measured by the Russell 2000 Index, viewed as the clear winners in an economic recovery, gained 12.7%. In addition to the same leadership sectors as large caps, small cap Consumer Discretionary and Consumer Staples names also performed quite strongly, as the composition of these sectors in the small cap universe is heavily skewed toward recovery names in retail, restaurants and leisure industries. Lagging sectors also mimicked those in large cap, with Health Care hit particularly hard by weakness in Biotech, one of very few industries to show a decline in the quarter.

On top of substantial relative performance gains last quarter, small caps continued to hold their advantage over large caps, outperforming by 6.5%. Economic recovery plays are particularly overrepresented in Value sectors, thus Value outperformed Growth in the quarter; by over 10% in large caps and over 16% in small caps.

The positive scenario for economic growth has been well discussed and outlined above: stimulus plus reopening equals a strong recovery. Key surveys including ISM Manufacturing, ISM Services and Consumer Confidence are all at strong levels, signaling growth. The March employment report showed a solid increase in jobs, while the unemployment rate fell to just over 6%. GDP growth in the mid-high single digits is at levels not seen in well over a decade. Housing demand remains robust, and prices continue moving up. And all of this is before we have seen the full impact of the latest pandemic relief programs or the full reopening of the economy, not to mention the $2 trillion infrastructure bill being discussed in Washington.

So it is abundantly clear what will go right with this economy, but as good analysts we must ask ourselves what can go wrong. In the short term, supply chain issues have caused shortages and higher prices on everything from skilled labor to commodities to finished goods to distribution. But as supply chains are reestablished over the course of the next year, we will be back to a world of adequate global supply. There is no doubt an inflation scare or two are likely, but for the longer term we remain sanguine. We do not expect a return to a world of zero inflation, but a manageable range of 2–3%, as the Fed has promised, is likely.

Despite the continued upward movement in the stock market, valuation levels have actually declined modestly as earnings expectations have risen more than stock prices. This is not an uncommon development at this stage of an economic recovery.

As the pandemic slowly fades and the world returns to more solid footing, pent-up demand should drive strong results in the consumer economy, while resolving supply chain issues and restocking inventories should drive the industrial economy. In this environment, we continue to move toward more economically-sensitive names and those likely to benefit from the post-pandemic recovery. We feel confident we can do such without moving away from our conviction in owning well-managed companies with strong market positions and strong financial characteristics.

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

GW&K GLOBAL EQUITY STRATEGIES

GLOBAL SMALL CAP

INTERNATIONAL SMALL CAP

"…while we believe the world has changed, our approach to investing has not. We will remain flexible, looking globally to find quality businesses with strong balance sheets and management teams, able to take advantage of the changes we expect will be upon us soon."

Global developed markets continued moving higher in the first quarter, although with little of the prior quarter's exuberance. The MSCI World ex USA and MSCI World ex USA Small Cap Indexes finished the quarter up 4.0% and 4.9%, respectively. Of particular note this quarter is the one-year anniversary of the Small Cap Index reaching its COVID-19 low on March 23. It rallied a remarkable 94.7% in the year since, something no one predicted at the time. Meanwhile the U.S. dollar had a dramatic volte-face; after weakening in 2020 it has rallied 3.7% year to date in 2021.

Markets were again up across every region and sector, with the notable exception of interest-rate sensitive Utilities. Geographically Asia was a laggard, while North America and Europe led. Hong Kong, the Netherlands, and Ireland were strong performers, while Australia, Sweden, and New Zealand lagged. On a sector basis, economically-sensitive Energy and Financials highlighted the change in leadership, as Health Care and Information Technology lagged along with the previously mentioned Utilities.

After decades of global convergence, 2021 is going to mark the shift towards divergence.

On December 11, 2001 China was admitted to the World Trade Organization. Given its low cost labor, undervalued currency, pro-growth government policies (land, financing, regulations), and scale, it quickly became the go-to destination for developed market outsourced manufacturing. Companies around the world took advantage by "optimizing" supply chains for efficiency. Then came the global financial crisis which sent central bank policy rates converging towards zero. Low rates and abundant liquidity were now available everywhere at the same time. The net result was a truly global world where major markets, both financial and physical, moved in synch.

While it started earlier, 2020 will go down as the year it became clear convergence peaked. At first, the pandemic was the ultimate manifestation of global convergence as the whole world shut down together. But it also highlighted that along with convergence comes dependence, and that optimized supply chains are fragile supply chains. This was compounded in November when the first vaccine approvals produced new global "have and have-nots" and a sudden recognition that local supply is important, even if not as efficient. This move towards divergence will play out over the years with many implications for the world and the market.

One clear implication is an increase in regionalization of supply chains. For markets this will show up as increased capital spending and likely lower profit margins. However, the COVID-induced shortages in critical healthcare products and recent bottlenecks in semiconductor chip suppliers (both critical for a modern economy) will likely result in policies supportive of supply chain localization. Companies that are able to address these shortages will benefit. In particular, we presume suppliers to the semiconductor industries and capital equipment companies will see strong demand.

We also expect a divergence in the timing of recovery. The U.S., UK, China, and other countries leading in the vaccine race should see strong growth, maybe too strong. Just as stocks were priced for disaster in March 2020 they are now priced for guaranteed recovery in 2021. Just as the former was not true, we expect that neither is the latter. From an equity investor's point of view the vaccine laggards may actually be attractive investments given low valuations, against the potential for policy reversals where the economies are running too hot.

Complicating factors abound. If globalization was deflationary then regionalization should be inflationary. Most believe that aging demographics should be deflationary (at least they were in Japan). However, if demographic trends lead to a shortage of workers, raising the cost of labor, is that not itself inflationary? The fact is the world has never been through a period that looks quite like today. There is no historical play book on how to manage the coming changes, but they are coming.

We have talked about a few of the likely changes in a diverging world, but there will be many others in time. Diversification should again pay dividends as will active management. In the end, while we believe the world has changed, our approach to investing has not. We will remain flexible, looking globally to find quality businesses with strong balance sheets and management teams, able to take advantage of the changes we expect will be upon us soon.

EMERGING MARKETS EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Pablo Salas	Partner, Portfolio Manager
Nuno Fernandes, CFA	Partner, Portfolio Manager
Thomas A. Masi, CFA	Partner, Portfolio Manager
Bradley J. Miller, CFA	Partner, Portfolio Manager
William P. Sterling, Ph.D.	Global Strategist
18 Equity Investment Professionals	**27** Average Years Experience

GW&K EMERGING MARKETS EQUITY STRATEGIES

EMERGING MARKETS EQUITY

EMERGING MARKETS EQUITY ADR

EMERGING WEALTH EQUITY

EMERGING WEALTH EQUITY ADR

Emerging market (EM) equities posted a modest gain of 2.3% in the first quarter. That reflected increasing optimism for a robust global recovery tempered by rising long-term interest rates and weaker EM currencies. That mix of forces left the MSCI EM Index trailing the MSCI World Index of developed market (DM) equities, which gained 4.9% in the quarter. A basket of EM currencies lost 1.7% in the quarter, led by a 9% drop in the Turkish lira and a 6% drop in Latin American currencies.

A relentless rise in U.S. bond yields helped boost the dollar and draw capital away from EM, with the yield on the 10-year U.S. Treasury bond rising by 82 basis points to 1.74%. Commodity prices also continued to rise in the quarter, with Brent crude oil gaining 23% to $63 a barrel while the CRB Raw Industrials Spot Price Index gained 11%. Widespread reports of supply-chain disruptions and shortages associated with the pandemic also fueled rising inflation expectations in many nations.

The quarter began with investors not knowing that Democrats would win control of the Senate. That allowed the Biden administration to push through a bigger stimulus package than many had expected. With the passage of the $1.9 trillion American Rescue Plan in February, U.S. bond yields rose as forecasts for the U.S. economy were revised up substantially.

The Fed now projects 2021 real GDP growth of 6.5% for the U.S. economy, which would be the strongest since 1983. Economists at J.P. Morgan are using a similar forecast for the U.S. economy and project 7.7% growth for EM nations and 9.5% for China. The cycle of upward revisions to global growth has been reinforced by upbeat purchasing managers' surveys (PMIs), with J.P. Morgan's Global Manufacturing PMI reaching a healthy level of 55.0 in March. To be sure, considerable uncertainty remains about the future path of the pandemic. The recent acceleration of COVID-19 cases in some nations and the uneven global vaccine rollout remain as risk factors, with EM vaccination rates lagging DM rates by wide margins.

Weaker EM currencies have resulted in higher import prices, higher consumer price inflation, and rising bond yields in a number of EM nations. That has put pressure on some EM central banks to begin to hike interest rates, with Brazil, Russia, and Turkey having raised their policy rates in the first quarter by 0.75%, 0.25%, and 4.0%, respectively.

After leading global markets in 2020, EM Asia took a break in the first quarter with a rise of only 2.2%. That reflected a slight loss in China of –0.4% offset by gains in Taiwan, India, and Thailand of 10.9%, 5.1%, and 4.1%, respectively. Despite solid economic data, China's market was pressured by a global selloff in growth stocks prompted by rising global bond yields and by concerns about the government's plans to curb debt growth. Europe, the Middle East, and Africa (EMEA) was the strongest EM region in the first quarter, led by double-digit gains in commodity producing nations like Saudi Arabia, United Arab Emirates, and South Africa. Turkey bucked the trend in EMEA, with a decline of –20.4% as its respected central bank governor was fired by the president after only four months on the job. Latin America was the weakest EM region, led by double-digit declines in Brazil, Columbia, and Peru as each nation faced fiscal and political pressures associated with severe public health crises.

EM equity sector performance was decidedly mixed in the first quarter, with highly cyclical sectors like Materials and Real Estate leading with gains of 9.1% and 5.9%, respectively. The more growth-oriented sectors like Consumer Staples, Consumer Discretionary, and Health Care lagged with losses of –2.8%, –3.1%, and –5.6%, respectively. Reflecting these trends, the MSCI EM Value Index gained 4.0% in the quarter, compared to a gain of only 0.5% by the MSCI EM Growth Index.

We continue to believe that global economic recovery is the most likely scenario for the next several years, which should provide a constructive environment for EM equities. That said, the sharp rise in U.S. bond yields and related upward pressure on the dollar is creating near-term headwinds for EM nations that depend on foreign capital inflows. Although these headwinds could well continue for the next few quarters, EM equities remain attractively valued versus U.S. equities.

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