CHEVY CHASE TRUST
INVESTMENT ADVISORS

Investment Update—April 2021

This is a quarterly update of economic conditions and investment strategy.

Trauma. Mania. What's Next?

The S&P 500 Index finished 2021's first quarter at 3,972, generating a total return for the quarter of 6.2%. But it's more meaningful to think of the quarter not as the beginning of a new year, but as the end of an extraordinary 12-month period of trauma and mania.

In last year's first quarter, of course, a novel coronavirus named SARS-CoV-2 began spreading in the U.S. Businesses and schools shut down to contain this new disease bringing economic activity to a near halt. The S&P 500 fell sharply to a low of 2,237 on March 23, 2020.

In response, governments opened their purse strings to support their citizens and corporations through the crisis. Central banks slashed interest rates and instituted massive bond purchase programs. Due to these aggressive actions, financial markets soared. Since its March 2020 low, the S&P 500 has gained nearly 80%. The NASDAQ Composite, the Korean Stock Exchange and the Russell 2000 Index have all doubled.

Interest Rates Firmly in the Driver's Seat

Interest rates represent the difference between the certain value of something today and its uncertain value tomorrow. As a result, assets that pay off far in the future, such as Growth stocks, are more sensitive to changes in interest rates than assets that pay off near term. That sensitivity was on display as market sentiment – and rates – swung rapidly from fear to euphoria due to expectations of a rapid recovery. (See Display 1)

Relationship between Growth and Value Equities and Long-Term Interest Rates (Display 1)

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Interest rates were near historic lows globally *before* the pandemic began, reflecting deep cuts made to restore the global economy after the 2008 Global Financial Crisis ("GFC"). As a result, pre-pandemic stock valuations were already high, and Growth stocks had already outperformed Value stocks by the widest margin in history.

When the pandemic struck and economic activity came to a standstill, interest rates plunged even further. The U.S. 10-year Treasury bond yield reached an intraday low of just 0.32% in March 2020. Rates remained near rock bottom levels through the end of the third quarter of 2020. This led to further Growth outperformance and sky high valuations as investors embraced long-term "dream" stocks and shunned the more economically sensitive Value sectors.

However, in Q4 of last year, news of breakthrough vaccines and hope for even more stimulus buoyed investors' expectations for stronger economic growth. Interest rates began to climb amid concerns about potential inflation, and Growth stocks began to lag Value stocks.

40-Year Bull Market in Bonds Facing Headwinds

Bond yields have been falling for the better part of 40 years. The Fed Funds rate peaked at an all-time high of 20% in 1980; now it is pegged between 0 and 0.25%. With falling yields, prices rose, leading to a bull market in bonds that has spanned more than four decades.

During the past six months, however, long-term bond yields have more than doubled, rising from 0.69% to 1.74%, leading to negative mark-to-market returns for the past two quarters.

As a reminder, at Chevy Chase Trust, we hold almost all bonds in client portfolios to maturity and invest in relatively short-term, high quality bonds. While many clients are not accustomed to seeing negative returns in the fixed income portion of their portfolios, these merely reflect current market prices, not the values realized when the bonds mature.

Rapid growth and inflation ahead?

Few things are sure in investing, but booming U.S. economic activity in 2021 comes close. The Federal Reserve is purchasing large amounts of Treasury and mortgage bonds and promising to keep short-term rates close to zero for the foreseeable future. Fresh fiscal stimulus of nearly $2 trillion is entering the economy now. Household net worth is at an all-time high of $130 trillion. With vaccination rates accelerating and the prospect of full economic reopening approaching, it would be shocking *not* to see nominal GDP growth in 2021 approach 10%—higher than at any time in the past 35 years.

For the first time in over a decade, we believe that this economic growth may lead to near-term inflation. There are many reasons why; here are three:

1. The fiscal plan has a high multiplier. The American Rescue Plan is skewed toward low- and middle-income households, who tend to spend unexpected money faster than higher-income households. This multiplies the impact of the stimulus on the overall economy. The Tax Foundation estimates that the Plan will raise the after-tax income of households in the bottom quintile of the income distribution by somewhere between 11% and 25%, while income for the highest quintile of earners will increase 2%.

2. Pent-up demand. U.S. households had been restraining spending for more than a decade before the pandemic began. After the GFC, households and companies were forced to reduce their debt levels. U.S. household debt-to-disposable income fell to 97% by the end of 2019, its lowest level since early 2001. Since then, this ratio fell further, to 92.5%, with roughly a third of COVID relief payments used to pay down debt. U.S. household savings increased by $1.6 trillion last year, due to fiscal largesse coupled with the reality that there wasn't as much to buy.

The dynamic was similar for companies. Corporate cash on hand now tops $7 trillion for the S&P 500 alone. As the economy reopens, some of these funds will be put to work, potentially quite quickly.

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3. Limited capacity. Some of the hardest hit industries will likely find themselves with more favorable pricing dynamics when economic activity returns to pre-pandemic levels. Last year, over 110,000 restaurants closed in the U.S., and most of the closed restaurants do not plan to reopen. Separately, travel restrictions and shutdowns disrupted supply chains for many industries, wreaking havoc on previously finely tuned, just-in-time operations. Recently, for example, semiconductor shortages led to shutdowns of automotive and consumer electronics factories on multiple continents. It will take time to restore operations to pre-pandemic levels. Until that time, suppliers of a wide range of scarce goods and services will likely be able to raise prices without worrying about losing sales.

After the Boom...

While soaring economic growth is highly likely in the short- to medium-term, the combination of unprecedented fiscal stimulus, extremely easy monetary policy, economic reopening and pent-up demand cannot last indefinitely.

Our base case is that gargantuan stimulus will likely lead to a multi-quarter burst of growth that will cause interest rates and inflation to rise, but higher rates, higher inflation and a lack of additional fiscal stimulus will eventually slow real economic growth. We believe that economic growth will revert to pre-pandemic levels faster than many currently expect, driven by structural constraints that currently limit the economic potential of the U.S.

Potential economic growth is a function of labor force growth and productivity growth, and right now, both of these factors leave the U.S. with quite low long-term economic potential. Demographic trends strongly indicate the U.S. labor force will grow less than 1% a year. Productivity growth won't be much higher, after years in which the U.S. (and many other countries) underinvested in infrastructure, and companies bought back stock instead of investing to expand and improve their businesses.

In our opinion, the impact on financial markets of a strong economic growth spurt followed by a subsequent slow down depends on how long higher inflation persists.

If inflation peaks during 2021 in the range of 3%-4% and then reverts to the Federal Reserve's long-term target of 2%, interest rates will likely continue to rise in the short-term, but the pace of the increase should slow considerably. In this scenario, equity markets may continue to favor Value stocks over Growth stocks for a few more quarters, but we are unlikely to see a sharp sell-off.

However, if inflation is stickier than the Fed expects, and prices do not decline as economic growth slows, we may enter a period of stagflation. In this scenario, interest rates are likely to climb higher than most investors currently expect, and equity markets will suffer. This is not our base case, but it is a risk we're monitoring closely.

Portfolio Positioning

Contrary to popular opinion, markets don't respond to current economic conditions, they are leading indicators of them. A year ago, the stock market was pricing in an economic shutdown and earnings slump. Today, stock market pricing reflects the strong economic and earnings growth likely in 2021, and bond yields reflect higher inflation ahead.

We expect interest rates to rise further and Value stocks to continue to outperform Growth stocks in the short term, but we do not believe that inflation will spiral out of control. In the second half of this year, we expect equity markets to begin to reflect economic conditions in 2022 that will be more like those in 2019 than in the 2021 boom. Investors will also likely price in fiscal policies that are far less supportive of economic growth next year. Tax increases may be under discussion. Finally, earnings

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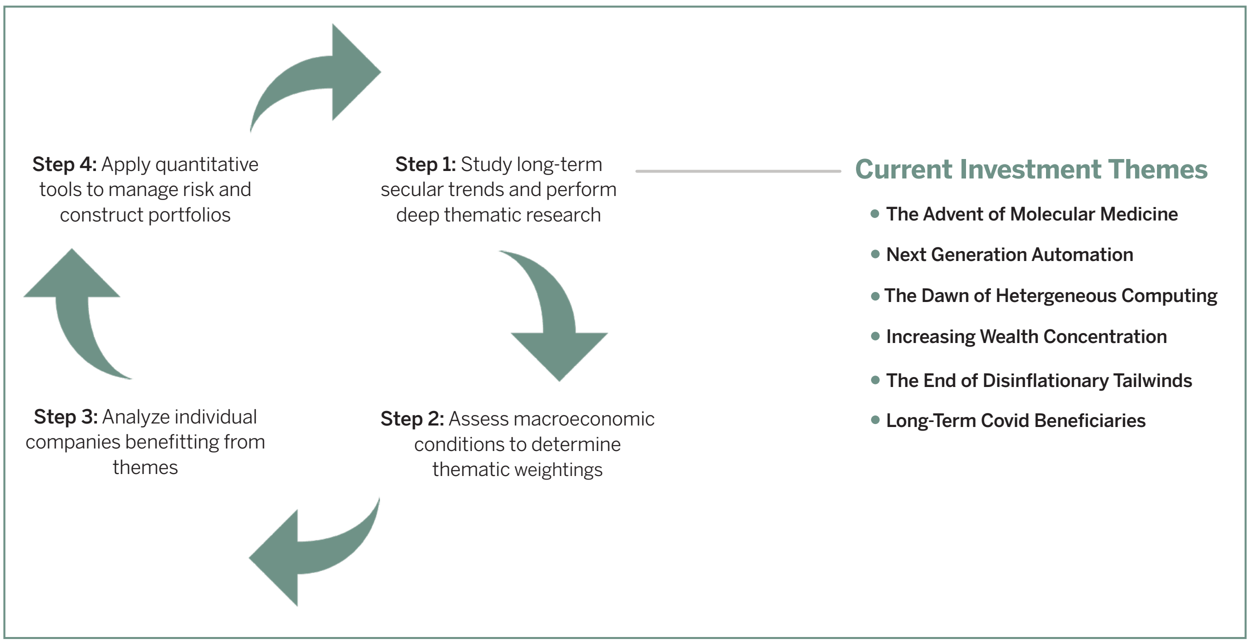
growth forecasts for 2022 won't look great, when compared to the surge in earnings created by pent-up demand in 2021.

One of the most challenging aspects of investing is balancing long-term trends with the short-term outlook for macroeconomic conditions. We tackle this challenge directly in the first two steps of our four-step investment process. (See Display 2)

Thematic Investment Process **(Display 2)**



Our first step is to identify long-term, secular trends that we believe will play out over years, if not decades. These trends typically lead us to companies with strong growth potential that will persist through cyclical swings in the economy. Our second step incorporates our assessment of where we stand in the economic cycle, allowing us to adjust portfolios to offset the short-term impact that cyclical headwinds may have on our themes.

When our long-term positioning aligns with the portion of the economic cycle most favorable to Growth companies, our portfolios have tended to do well. We were in this sweet spot for most of 2020. However, toward the end of the third quarter, we began to anticipate the cyclical changes currently underway and selectively repositioned portfolios to increase their weights in traditional Value sectors, such as Financials and Energy.

In many cases, these portfolio adjustments meant trimming or selling some investments that had appreciated significantly and, therefore, recognizing relatively large capital gains. In retrospect, it was the correct thing to do. Since September 2020, the Energy sector has outperformed the NASDAQ 100, a proxy for Growth stocks, by over 50%. That's a useful reminder that even in taxable portfolios, trimming or selling appreciated stocks, in favor of higher-conviction investments, is often wise and can lead to higher after-tax wealth.

As always, we will follow our process, guided by our long-term conviction in Thematic investing, while remaining vigilant and nimble in response to an uncertain world. We are navigating unchartered waters, but our process has successfully guided us through difficult times in the past. We believe it will do so again.

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