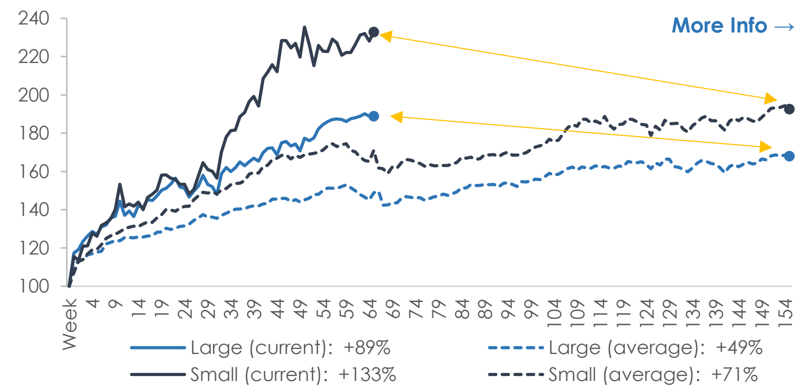
Note: This excerpt from the 3Q 2021Asset Allocator's Guide discussed our Large Cap overweight rating.

Size — Large Caps vs Small Caps

► **Upgrade Large Caps to OW; Downgrade Small Caps to Neutral.** The Russell 2000 outperformed the S&P 500 by 21% over the past 12 months. The current bull market is significantly outperforming prior bull markets, leaving equity markets vulnerable to shifting sentiment. Small caps appear even more vulnerable due to rising inflation, and history shows small caps statistically underperform after the 10Y yield surges higher. With the uncertain outlook, we prefer large caps' relative safety. We are capturing small cap gains from our Dec. 2020 upgrade and rotating back into large caps.

Figure 12: Current Bull Market Returns vs Average Historical Returns



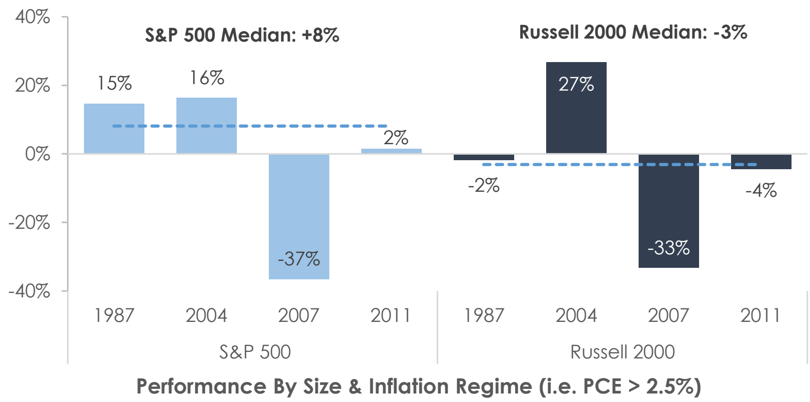
Source: MarketDesk Research

Large and Small Cap Stocks Have Already Priced in a Robust Recovery …

● Equity markets have covered a lot of ground since their pandemic trough. The strong returns leave stocks, especially small caps, vulnerable to a decelerating recovery and fading risk sentiment.

● Figure 12 charts the current bull market return (solid lines) against the average 3-year bull market return (dashed lines). Large and small cap returns are both nearly 2x their average returns at this point in the bull market. Returns also sit above the average full 3-year bull market return -- after only 1.5 years. Click 'More Info' to see large and small cap return paths across historical bull markets.

Figure 13: Large & Small Cap Performance Across Inflation Regimes



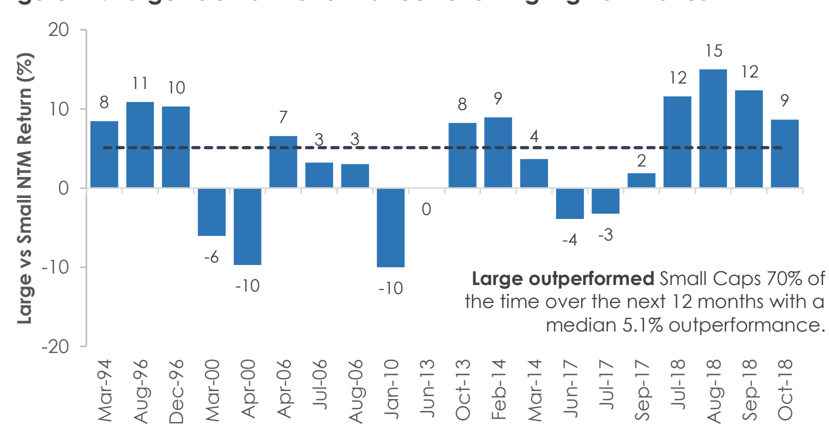
Source: MarketDesk Research, U.S. Bureau of Economic Analysis. ***Note****: Periods -- May 1987-June 1993, May 2004-Aug. 2006, Sept. 2007-Oct. 2008, and May 2011-Feb. 2012.*

Small Cap Stocks Have Less Pricing Power than Large Cap Peers …

● Pricing power is a key differentiator as costs rise. Compared to small caps, large caps are more likely to be protected by legal contracts and have the ability to push back against price increases by threatening future business relationships.

● Figure 13 compares large and small cap returns after PCE inflation rises >2.5%. Small caps traded lower 3 out of 4 times but outperformed by 11% in 2004. The tight gap between PPI and PCE in 2004 suggests pricing power was strong in the mid-2000s. We have doubts about companies' pricing power today, especially within goods as demand switches to services. Small cap margins could face pressure.

Figure 14: Large vs Small Performance Following Big 10Y Moves



Source: MarketDesk Research, U.S. Treasury. ***Note****: Analysis compares S&P 500 returns against Russell 2000 returns.*

Large Caps Historically Outperform After the 10Y Yield Surges Higher …

● The 10Y Treasury yield's surge over the past 12 months represented a +1.2std event (refer to Fig 27). The outsized move pointed to a significant sentiment and positioning shift ahead of the reopening. However, markets tend to overshoot, and prior moves have represented sentiment extremes with important performance implications.

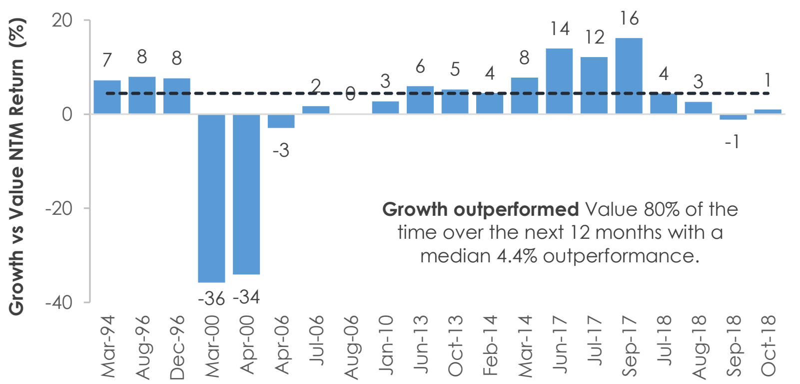
● Small caps surged during the recovery, but history points to large cap outperformance ahead. Figure 14 shows the next 12-month large vs small performance gap after prior +1.2std moves on the 10Y yield. Large caps biggest underperformance occurred around the dot-com bubble and January 2010 (i.e., early in the post-2008 bull market cycle).

Factor Tilts — Growth & Dividends/Buybacks

► **Upgrade Growth to OW; Downgrade Value to Neutral:** This upgrade should be considered a 'slight OW' rather than a normal OW as recent market noise and a lack of investable signals are clouding the outlook. The key question is whether investors will rotate back to the reflation trade. We are relying on statistics, which favor Growth over the next 12 months.

► **Tactically Emphasize Dividend & Buyback Factor within Large Caps:** Corporate cash balances sit near a record high, and we expect returning capital to shareholders will be a significant theme over the next 12 months. *Dividend & Buyback Factor* : DIVB. (Note: Invesco's PKW only focuses on buybacks and ignores dividends, which results in higher Financials and lower Tech sector exposure.)

Figure 15: Growth vs Value Performance Following Big 10Y Moves



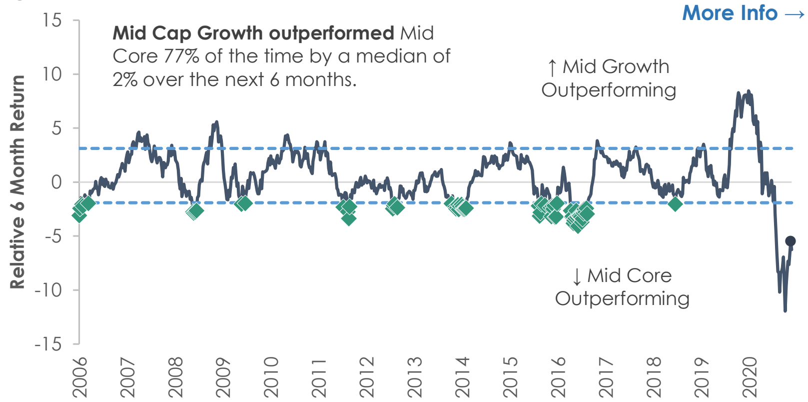
Source: MarketDesk Research

Growth Stocks Historically Outperform After the 10Y Yield Surges Higher …

- Figure 15 is the same analysis as Figure 14 but focuses on Growth vs Value. Growth historically outperforms Value 80% of the time after the 10Y yield experiences a +1.2std move (refer to Fig 27).
- Similar to Large vs Small, we are answering Growth vs Value by using the 10Y yield's surge to highlight extreme sentiment. Value already prices in a robust recovery, and statistics indicate it is time to pull gains off the table. As an additional catalyst, we view a Growth OW as a tactical opportunity to protect against market uncertainty and an overheated market.

Figure 16: Favor Mid-Cap Growth Over Mid-Cap Core

More Info →

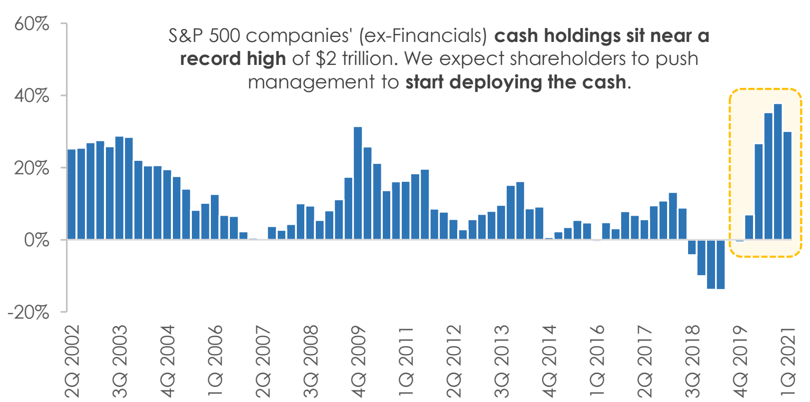


Source: MarketDesk Research. ***Note*** *: Analysis uses IJK and IJH as proxies.*

Tactically Emphasize Mid-Cap Growth Over Mid-Cap Core …

- Figure 16 charts the rolling 6m performance gap between mid-cap growth and mid-cap core. Mid-cap growth significantly underperformed over the past 6 months, which we attribute to its technology OW and regional bank UW.
- With expectations for the reflation trade to lose steam, we favor tilting away from mid-cap core toward mid-cap growth. Figure 15 above indicates growth is expected to statistically outperform, and a stalling 10Y yield could weigh on mid-cap core's regional bank exposure. We view mid-cap growth as a tactical risk mitigation measure.

Figure 17: Y/Y Growth in Corporate Cash on Balance Sheets



Source: MarketDesk Research

Focus on Dividends and Buybacks as Companies Prepare to Return Capital …

- Figure 17 shows corporate cash balances grew significantly the last 12 months. We expect shareholders to push companies to return capital over the next 12 months. Refer to Figure 3 in the 6/18/21 *Strategy Snapshot* for further commentary.
- iShares' DIVB invests in companies that return capital through dividends and buybacks. DIVB's top three sector weights are: 24.5% Tech, 19.9% Financials, and 13.2% Health Care. DIVB's sector exposure resembles a hybrid growth/value approach, which helped DIVB outperform both the core and value S&P 500 ETFs YTD. With the hybrid sector exposure and capital return focus, we are initiating a 2.5% DIVB tactical tilt within large caps.