WRIGHT
INVESTORS' SERVICE, INC.

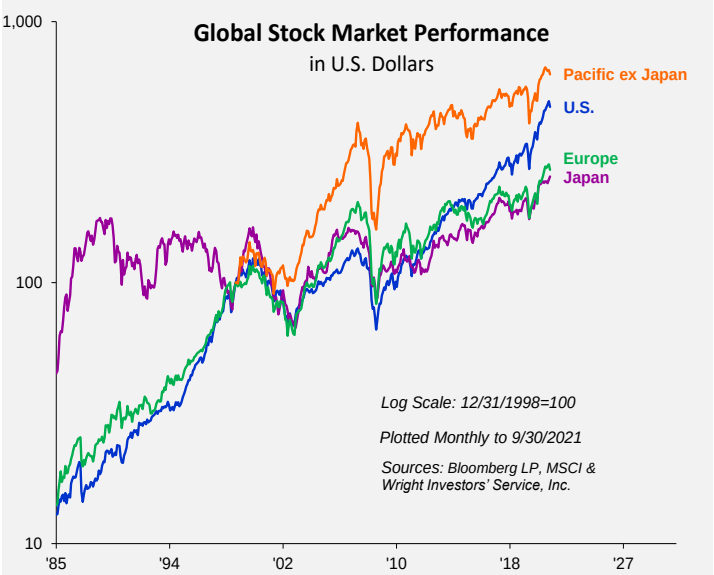
Quarterly Investment Report

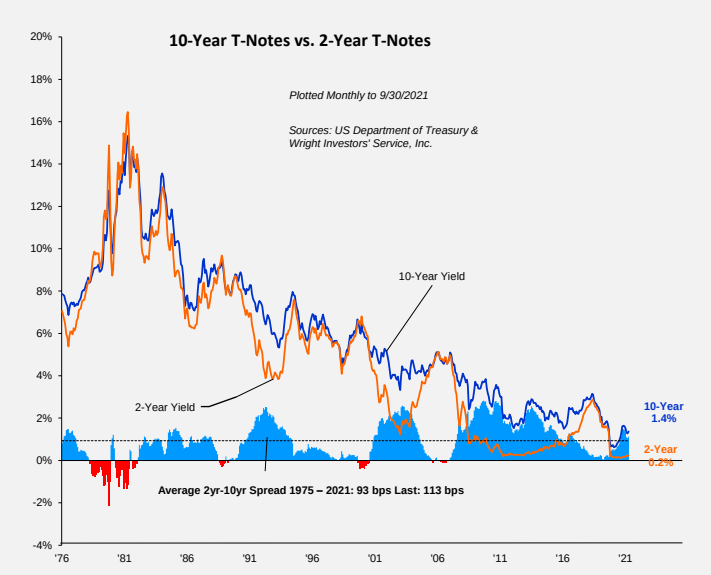
October 2021

SUMMARY*: : Stocks absorbed a mini-correction in September as the Federal Reserve signaled that it is about ready to begin tapering its massive asset purchase program. Bond yields spiked on the prospect of higher interest rates and rising inflation that could prove less transitory than the Fed believes. The economy continued to rebound strongly despite a shortage of workers and supply bottlenecks. Jerome Powell's renomination as Fed chair started to look a bit tenuous just as several seats on the Fed became vacant. How those seats are filled—and how they affect future Fed policy—will be closely watched by the markets.

Stocks had their first negative month since January and their weakest quarterly return since the beginning of 2021 as the prospect of higher interest rates and reduced support from the Fed persuaded some investors to take profits. NASDAQ recorded the biggest drop in September, falling 5.3%, while the Dow Jones Industrial Average and the S&P 500 fell 4.2% and 4.7%, respectively. For the S&P 500 it was the worst month since March 2020, when the market plunged at the outset of the coronavirus pandemic. For the third quarter, results were mixed, as the S&P 500 recorded a 0.6% gain while the Dow and NASDAQ were off by 1.5% and 0.2%, respectively. Nevertheless, returns this year remained well into the double digits. Year to date, the S&P 500 has returned 15.9%, followed by NASDAQ at 12.7% and the Dow at 12.1%. Smaller cap stocks did marginally better last month but slightly worse for the quarter compared to the big cap indexes. The S&P 600 Small Caps and the S&P 400 Mid Caps fell 4.0% and 2.4%, respectively, for September, and for the third quarter the indexes were down by 1.8% and 2.8%. So far this year, small caps have returned 15.5% and mid caps are up 20.1%.

Energy stocks were the sole positive performers in September among the 11 S&P 500 sectors, rising 9.4% to pad their market-leading 43.2% year-to-date return. Oil prices, which are up nearly 55% so far this year, gained another 9.5% last month amid increased demand from the reopening world economy and concerns that supplies may be tight this year as winter approaches. Natural gas prices were also sharply higher, climbing 34% last month and more than 60% for the quarter, having more than doubled since the beginning of the year. Financials were the next best performers in September, falling a relatively modest 1.8%, and the second-best performer so far this year with a 29.1% return as rising interest rates promise to





boost bank profit margins. Financials were also the best performers for the third quarter, rising 2.7%. Performance among the S&P 500's 11 sectors was mixed for the quarter, with six up, four down, and one unchanged.

Dollar returns on foreign stocks were also mostly negative in September and the third quarter but remained well into the green for the full year. Eurozone stocks fell 5.5% last month and 1.9% for the quarter but held onto a 9.5% gain for the year to date. Like its U.S. counterpart, the European Central Bank said it would continue its asset purchase program but at a "moderately lower pace," gradually reducing its support for the economy, although ECB President Christine Lagarde indicated that the bank will retain its accommodative monetary policy. Chinese stocks, the worst performers so far this year with a negative 16.7% return, lost another 5.0% in September and 18.2% in the third quarter as the government continued its crackdown on technology firms, property developers, and other private businesses. The collapse of one of the country's leading home builders, China Evergrande Group, worried investors even outside China as it remained unclear if the government would step in to prop up the debt-laden company. Emerging markets were down 4.0% last month and 8.1% for the quarter, pushing them into the red by 1.2% for the full year period. Japanese stocks bucked the downtrend, however, rising 2.8% for the month and 4.6% for the quarter to raise their 2021 return to 5.9%.

BONDS

Bonds performed slightly better than stocks in September and the third quarter even as yields started to rise in response to higher inflation and in anticipation of the Fed reducing its asset purchases. The Bloomberg U.S. Aggregate gained 0.1% for the third quarter despite a 0.9% decline in September, leaving it down 1.6% for the year-to-date period. The yield on the 10-year Treasury note briefly spiked above 1.50% in late September before closing the quarter at 1.49%, up 18 basis points from the end of August but up only slightly for the quarter. Since the end of 2020, however, the yield on the benchmark security is up nearly 60 basis points, from 0.91%. Other U.S. fixed income indicators were mixed. The Bloomberg U.S. Credit index fell 1.1% in September but was unchanged for the quarter and is down 1.3% for the first nine months of the year. High-yield bonds were unchanged last month and up 0.9% for the quarter, raising their 2020 return to 4.5%. Outside the U.S., the Bloomberg Global Aggregate ex-U.S. index fell 2.5% for September and 1.6% for the third quarter and is down 5.9% for the year to date in U.S. dollar terms; the dollar has remained firm against most other foreign currencies this year, reducing dollar-based returns.

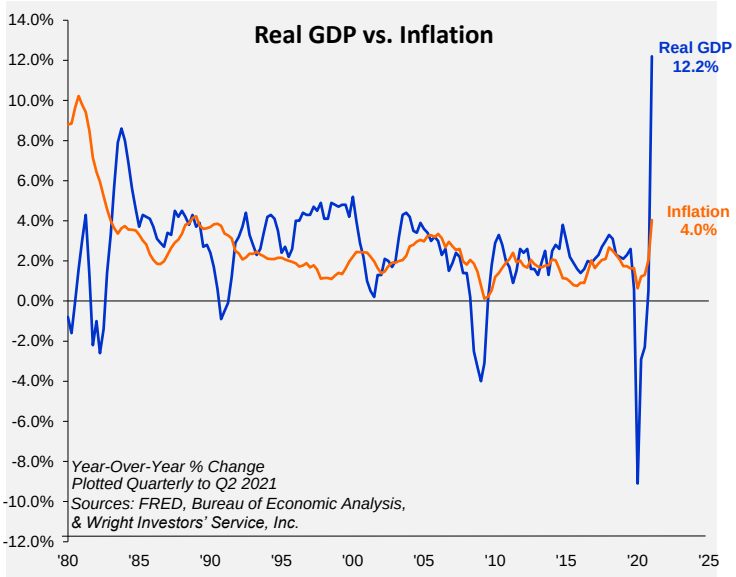
THE U.S. ECONOMY

The U.S. economy continued its post-lockdown rebound despite being held back by a worker shortage, supply chain bottlenecks and rising prices.

Global Investment Returns In U.S. Dollars

	Q3 2021		Trailing 12 Months	
	Stocks	Bonds	Stocks	Bonds
U.S.	**0.3%**	**0.1%**	**29.9%**	**-0.9%**
Canada	-2.5%	-2.7%	33.9%	1.0%
Mexico	1.4%	0.1%	51.1%	9.1%
Japan	**4.6%**	**-0.4%**	**22.1%**	**-5.5%**
Pacific ex Japan	-4.4%	0.2%	25.8%	6.4%
Australia	-3.0%	-3.5%	31.7%	-1.7%
China	-18.2%	2.2%	-7.3%	11.6%
Hong Kong	-9.4%	0.0%	15.0%	-0.4%
Europe	**-1.6%**	**-2.3%**	**27.3%**	**-2.2%**
France	-2.0%	0.1%	34.3%	4.5%
Germany	-4.3%	-2.4%	16.5%	-3.7%
Italy	-1.1%	0.9%	33.4%	10.0%
Netherlands	3.4%	-2.5%	46.0%	-4.1%
Spain	-3.3%	-1.8%	31.4%	-1.3%
Switzerland	-3.3%	-1.4%	14.4%	-2.9%
U.K.	-0.3%	-4.0%	31.2%	-1.2%
World	**0.0%**	**-0.9%**	**28.8%**	**-0.9%**
World ex U.S.	-0.7%	-1.6%	26.5%	-1.2%

Sources: MSCI Stock & Bloomberg Barclays Bond Indexes as of 9/30/2021



The main driver is once again the consumer, either restocking following the pandemic or stocking up in anticipation of possible scarcities of goods in the months ahead. The final reading of U.S. GDP for the second quarter showed the economy growing at an annual rate of 6.7%, powered by a 12% increase in personal consumption expenditures. For the full year, the latest Federal Reserve forecast is calling for 5.9% growth, down from its June projection of 7.0%. The Fed's latest Beige Book covering July and August said economic growth "downshifted slightly to a moderate pace," but "looking ahead, businesses in most districts remained optimistic about near-term prospects, though there continued to be widespread concern about ongoing supply disruptions and resource shortages, as opposed to softening demand."

Retail sales rebounded 0.7% in August after falling 1.8% in July despite a big drop in auto sales, the result of inventory shortages and shipping delays. Excluding vehicles and gasoline, however, retail sales were up a full 2.0%. Personal consumption expenditures, a broader category, were up 0.8%. Nevertheless, the Conference Board's consumer confidence index dropped nearly six points in September as "the spread of the Delta variant continued to dampen optimism," suggesting that consumers "have grown more cautious and are likely to curtail spending going forward." But other indicators picked up steam. Leading economic indicators rose by 0.9% in August, the biggest gain in three months. The Institute for Supply Management's manufacturing composite index rose to a better-than-expected 61.1 in September from 59.9 the prior month, its best reading since May. Industrial production rose 0.4% in August while durable goods orders jumped 1.8%, also the biggest increase since May; the core capital goods component increased 0.5%.

The jobs report for August was a big disappointment, but there are some hopeful signs that more people will soon be joining a labor force that is currently starved for workers. The economy added just 235,000 jobs in August, the worst performance since the beginning of the year and down from July's 1.1 million and 962,000 in June. However, the most recent unemployment claims report showed the number of continuing claims dropped by more than half in early September, to 5.0 million from 11.3 million the prior week, as special federal pandemic programs began to expire. That may force more people back into the workforce and alleviate the severe shortage of workers affecting many industries.

Housing market indicators were mostly positive even as home prices continued to rise sharply. Sales of existing homes fell 2% in August from the prior month to an annual rate of 5.88 million units after rising the prior two months, but pending home sales rebounded a strong 8.1% after falling by 2.0% in July; both figures lagged year-ago figures. Meanwhile, home prices continued to skyrocket, climbing 19.7% year-on-year according to July's S&P CoreLogic Case-Shiller National Home Price Index, the highest annual growth rate since the index began in 1987. A report from the Atlanta Fed said home affordability is now at its lowest point since the 2008 financial crisis. Sales of new homes rose 1.5% to an annual rate of 740,000, as the median price of a new home held steady at a record $390,900. Housing starts and permits were both higher in August.

INVESTMENT OUTLOOK

The Federal Reserve is poised to undergo some big changes over the next several months, both in terms of policy and personnel, which could have an impact on the market. Following its September monetary policy meeting the Fed announced that "a moderation in the pace of asset purchases may soon be warranted" by a stronger economy that no longer appears to need as much Fed support, as well as concerns about rising inflation. Although the Fed didn't specify how much it planned to trim its current $120 billion a month bond purchases or how long it would last, Fed Chair Jerome Powell said at his post-meeting news conference that the tapering process would likely "conclude around the middle of next year." While largely expected and well telegraphed by the Fed, the news was likely behind the spike in bond yields at the end of September. So were recent inflation reports, which showed little respite in the pace of price increases. In congressional testimony following the Fed meeting, Powell backed off a little from his belief that inflationary pressures are transitory, acknowledging that "these effects have been larger and longer-lasting than anticipated," although he believed "they will abate, and as they do, inflation is expected to drop back toward our longer-run 2% goal." Whether that turns out to be accurate remains to be seen.

Of greater consequence, perhaps, is who will lead the Fed over the next several years and how that might affect monetary policy and therefore the financial markets. While Powell would likely be confirmed by the Senate for another term as Fed chair, there's still no guarantee that he will be nominated by President Biden, who is under pressure by progressives in his party to pick someone else more to their liking. One of those progressives, Sen. Elizabeth Warren, D-Mass., told Powell at a hearing in late September that she would oppose his nomination, calling him "dangerous" for what she perceives as his too-soft stance on bank regulation. The terms of both Powell and Fed Vice Chair Richard Clarida end early next year, while Randal Quarles' term as vice chair for supervision ends this month. Biden also has a chance to fill an unfilled seat on the Fed board. At the same time, the presidents of the Dallas Fed, Robert Kaplan, and the Boston Fed, Eric Rosengren, resigned following the disclosure of their stock and real estate trading that raised eyebrows about whether the trades were appropriate given their role in directing U.S. monetary policy. The Wall Street Journal called filling their seats "an opportunity to bring some much-needed intellectual diversity to the central bank's policy deliberations."

How that plays out in future Fed policy and its effect on the market remains to be seen. As we know, the markets could not have asked for a more friendly Fed chair than Powell, who has helped guide the economy through the Covid-19 pandemic with an extraordinary amount of monetary accommodation and quantitative easing, flooding the economy with trillions of dollars of cheap dollars, boosting asset prices in the process. While some of that process may be coming to an end as the pandemic eases, the unwinding of it will likely take years to accomplish, just as it did following the 2008 financial crisis—indeed, it never really ended before Covid hit. The Fed will likely still play an outsized role in the economy and financial markets for years to come, no matter who is Fed chair, with monetary policy likely remaining easy. The Fed still has an $8.5 trillion balance sheet that is continuing to grow, and a rise in interest rates off zero will likely be slow and deliberate. New projections released at the end of the last month's meeting showed the Fed not likely to raise rates until sometime next year, which is slightly earlier than their previous expectations. However, we don't believe that any increase in rates from such a low base will have too much of a negative impact on either economic activity or market psychology. As a result, we remain optimistic about the investment outlook, with an emphasis on diversified, high-quality assets held for the long-term.

The U.S. Economy 2019–2022

		% Change In			End of Period Rates	
		Real GDP*	PCE Core Deflator*	Profits from Operations#	90-Day T-Bills	10-Year T-Notes
2019	Q1	2.4%	1.1%	14.7%	2.4%	2.4%
	Q2	3.2%	2.3%	8.7%	2.1%	2.0%
	Q3	2.8%	1.8%	1.2%	1.8%	1.7%
	Q4	1.9%	1.4%	1.0%	1.5%	1.9%
2020	Q1	-5.1%	1.7%	-4.5%	0.1%	0.7%
	Q2	-31.2%	-0.8%	-14.4%	0.1%	0.7%
	Q3	33.8%	3.5%	-15.6%	0.1%	0.7%
	Q4	4.5%	1.2%	-17.3%	0.1%	0.9%
2021	Q1	6.3%	2.7%	-2.5%	0.0%	1.7%
	Q2	6.7%	6.1%	27.3%	0.0%	1.5%
	Q3	5.0%	3.5%	40.8%	0.0%	1.5%
	Q4 e	5.1%	3.7%	51.0%	0.2%	1.6%
2022	Q1 e	4.2%	3.5%	39.8%	0.2%	1.7%
	Q2 e	3.3%	2.5%	21.1%	0.3%	1.8%
	Q3 e	2.9%	2.1%	14.9%	0.4%	1.9%
	Q4 e	2.4%	2.1%	11.7%	0.4%	2.0%

e: Bloomberg Consensus Estimates; *: Annual Rates; #: Year-Over-Year Change in S&P500 EPS
Sources: Bloomberg LP, Wright Investors' Service, Inc.