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Investment Committee Perspective

Third Quarter 2021

Our Investment Committee meets no less than quarterly to evaluate asset class performance, analyze macroeconomic data and trends, and review asset class valuations and risks in order to refine our market outlook and tactical portfolio positioning. This letter summarizes the topics discussed during those investment committee meetings and provides guidance on our outlook and corresponding tactical investment strategy.

Quarterly Commentary: From Early-to-Mid Cycle: The New Paradigm of Economic Transitions

As we grow older, we all experience the daunting feeling of time speeding up. The days, weeks, months, and years tend to go by at a faster rate than before, a phenomenon best encapsulated by the concept of age relativity. At age 10, one year passing represents an increase of 10% of our total life experiences (holidays, birthdays, etc.). On the other hand, at age 50, one year passing represents just a 2% increase in our total life experiences. As a result, each passing year becomes an ever-increasingly smaller proportion of our collective experiences, creating the psychological effect of time snowballing before our eyes.

Similarly, the snowball or compound effect has a profound influence on the advancement of economic and financial systems. For instance, in 1602, when the Dutch East India Company established the world's first stock exchange in Amsterdam, buyers and sellers negotiated stock transactions face-to-face in open-air markets or within the close confines of local shops. Today, more than 400 years later, buyers and sellers are anonymous to one-another, as trades are instantaneously routed by brokers to order matching engines at the New York Stock Exchange and the NASDAQ. Over four centuries, the advancements in technological processes that would have been incomprehensible to the early traders that roamed the Amsterdam streets have transformed and transcended financial markets and the human perception of the passage of time.

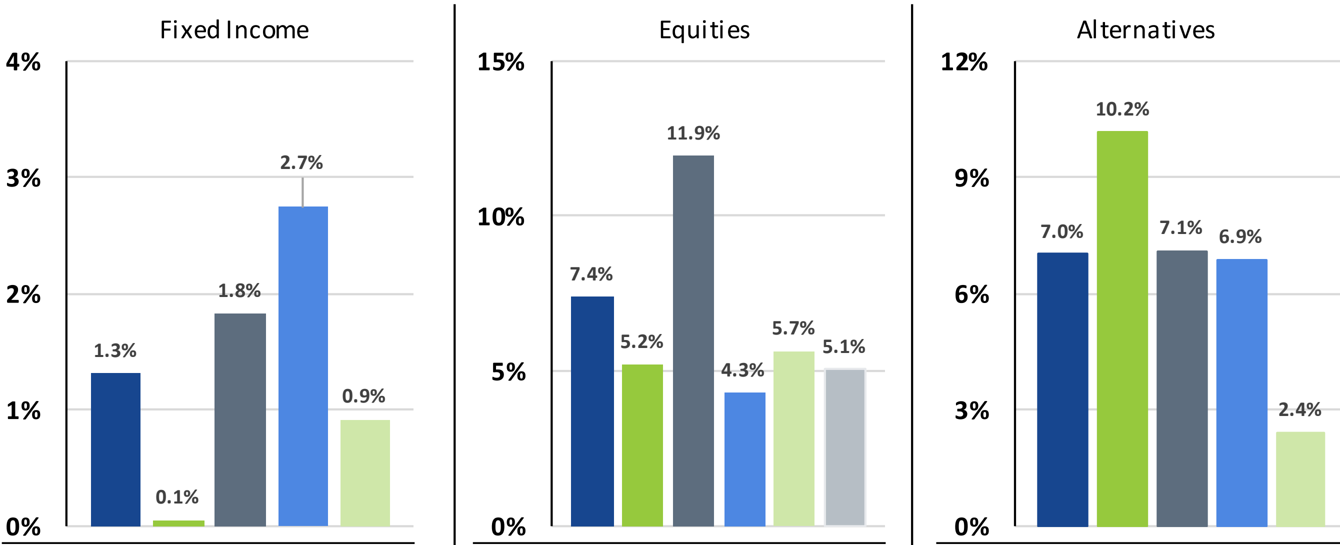
Even compared to other significant market events that have transpired over the past 20 years, the unrivaled speed of markets today is incredible. The -34% decline in the S&P 500 from February through March of 2020 stands to be the shortest bear market in history. Over the same two months, the U.S. entered and exited an economic recession in record time, as recently announced by the National Bureau of Economic Research. In comparison, the 2008 "Financial Crisis" and the 2001 "Tech Bubble" took 348 days and 363 days, respectively, to reach a -30% decline in the S&P 500 and coincided with economic recessions that lasted 18 months and 8 months, respectively.

We have discussed in prior Investment Committee Perspective Letters, ad nauseam, about the impact central banks and fiscal policymakers have had on backstopping markets and supporting the global economy. We will touch on this once again in our market outlook section later in this letter, as all those points remain crucially relevant to the speed of the recovery thus far. However, another significant driving factor of the global market recovery is the raw efficiency and speed that market participants are able to process and act upon material information. Relatedly, the wide-scale usage of highly automated trading systems that can execute trades to reflect new information the instant it becomes available creates a self-perpetuating cycle that can cause flash crashes like the multiple 7%+ declines during the COVID-19 bear market and subsequent rallies like the immediate +10% recovery when President Trump declared COVID-19 a national emergency.

As a result, the transition in the economic cycle from "recovery" mode to "slowdown" mode (or from early to mid/late cycle) has taken form much earlier than what would be expected from the archetypal cycle. The average economic cycle lasts around 5 years but given the incredibly short duration of the U.S. COVID recession and the generous policy support along the way, the early stage of this economic cycle – associated with strong and rebounding growth/inflation and a stable environment for borrowers and creditors – occurred more rapidly than anticipated. In turn, the market has begun to supply various signals indicating a likely economic slowdown (shifting from early-to-mid/late cycle) in the form of declining long-term interest rates. The Federal Reserve sparked the move by signaling that interest rate hikes may occur sooner than initially anticipated, communicating to the market that peak accommodation and therefore, peak growth, are nearing an end.

Second Quarter 2021 Asset Class Performance

EXHIBIT 1: Second Quarter 2021 Total Returns



Global Bonds	1.3%
Short-Term	0.1%
Intermediate-Term	1.8%
High Yield	2.7%
Foreign	0.9%

Global Equities	7.4%
U.S. Value	5.2%
U.S. Growth	11.9%
U.S. Small	4.3%
Developed Int'l	5.7%
Emerging Markets	5.1%

Alternative Blend	7.0%
Real Estate	10.2%
Nat Resources	7.1%
Infrastructure	6.9%
Low Correlation	2.4%

Fixed Income

After one of the largest quarterly declines in recent history during the first quarter (-4.5%), the Fixed Income market found a bottom and rallied over the course of the second quarter (+1.3%). Short-term bonds gained +0.1% behind the tightening of credit spreads at the front-end of the yield curve. Intermediate-term bonds returned +1.8% as the 10-year treasury yield retreated from its post-COVID high of 1.74% at the start of the quarter down to 1.45% by June 30. High Yield bonds advanced +2.7% and Foreign Bonds rebounded marginally by returning +0.9% after weathering the largest decline in fixed income in the first quarter.

Equities

Global equity markets generated yet another period of historically strong returns during the second quarter (+7.4%). U.S. Growth stocks made up lost ground against U.S. Value stocks by returning +11.9% while U.S. Value stocks posted a respectable +5.2%. U.S. Small-cap stocks, after a very strong first quarter, represented the laggard during the quarter, returning +4.3%. Developed International and Emerging Markets did not fare as well as the overall equity market in the U.S. though were still able to eke out positive gains by returning +5.7% and +5.1%, respectively.

Alternatives

The alternative asset class exhibited an impressive display of performance in the second quarter (+7.0%) as the inflation-hedging stalwarts "Real Assets" (Real Estate, Natural Resources, and Infrastructure) awoke from a long slumber. Real Estate led the charge by returning +10.2% in the second quarter. Natural Resources gained +7.1% as oil increased from $59/barrel at the start of the quarter to $74/barrel by June 30. Infrastructure followed suit by returning +6.9% in the quarter. Low Correlation, though not a direct hedge against inflation, returned +2.4% in the quarter. Despite the fact that Low Correlation achieved lower returns than their "Real Asset" cohort(s), it did manage to produce higher returns than core fixed income validating our tactical overweight to these strategies in lieu of traditional core Fixed Income investments.

Market & Economic Outlook

With the global economy on a sustainable path to recovery, equity markets posted another strong quarter of positive returns (+7.4%). The reopening theme seen over the first quarter, with cyclical value stocks and small cap stocks outperforming growth stocks, reversed course behind a precipitous drop in the 10-year Treasury bond yield. The S&P 500 Growth Index outperformed the S&P 500 Value Index by 6.7%, reflecting a potential shift from early-to-mid cycle positioning. The Federal Reserve sparked the reversal by indicating that interest rate hikes may come sooner than the end of the 2023. This signals to the market a possible tapering of the generous policy support provided since the onset of the COVID-19 pandemic.

With the potential for accommodative monetary policy dissipating, and fading momentum on the fiscal stimulus side, markets are worried that the economy has moved beyond a period of peak growth rates. Investors tend to reach for higher growth asset classes as a defensive proxy for lower economic growth. However, as discussed in our Second Quarter 2021 letter, we still believe U.S. growth stocks present unfavorable valuations relative to value, small-cap, and non-U.S. stocks. As a result, we have further tactically reduced portfolio allocations to U.S. Growth stocks given this concern over the past quarter.

As vaccinations and immunity continues to spread across the world, we expect the global economic recovery to continue which will be supportive of strong corporate earnings growth and should bode well for global equity markets over the near-term. Our tactical portfolio positioning reflects this view with a modest overweight to global equities. We believe non-U.S. equities, which are more economically sensitive and have more attractive valuations, are likely to outperform. Despite the second quarter decline in long-term interest rates, we still believe the path for interest rates is higher due to increasing rates of inflation and the eventual normalization of Fed policy. Within Fixed Income, we have allocations to flexible, active bond funds that invest more broadly across the Fixed Income opportunity set and have recently added floating-rate loan funds back to client portfolios that we expect will fare better than core Treasury bonds as interest rates start to rise again.

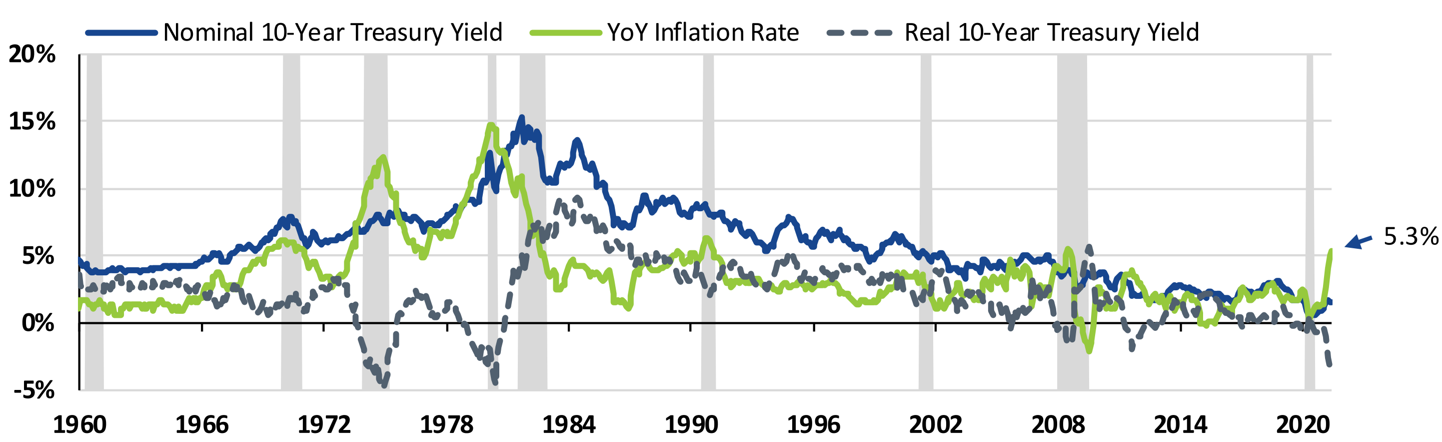
The pace of interest rates increasing is likely going to be driven by inflation. We have seen a meaningful increase in inflation since last summer. Inflation matters for two reasons:

1) **Loss of Purchasing Power**: Inflation erodes the value of one's money as consumers are no longer able to buy as much product or service with the same amount of money. To put this into perspective, at a 3.0% rate of inflation, it cuts one's purchasing power in half (50%) every 24 years. Long periods of high inflation can have a detrimental impact to both the economy and one's personal financial plan as expenses grow too fast relative to assets.

2) **Driver of Nominal Interest Rates**: Inflation and nominal interest rates historically have a strong positive relationship as investors demand higher *nominal*, before inflation, yields as inflation increases to derive the same *real*, after inflation, rate of return as can be seen in Exhibit 2 below.

The recent consumer price index (CPI) inflation data has increased to levels we have not seen in over 20 years. The June 2021 year-over-year CPI inflation rate was 5.3%! The main drivers of the June inflation spike were used car prices and a sharp rebound in prices for travel and leisure services. These are clearly driven by pandemic disruptions and are likely temporary.

EXHIBIT 2: Relationship between Inflation and 10-Year Treasury Yield



Note: Inflation is year-over-year core inflation, measured monthly. The 10-year treasury yield is a constant maturity rate, measured monthly.
Source: Bureau of Labor Statistics (BLS), Board of Governors of the Federal Reserve System (US)

The Federal Reserve has consistently messaged that they believe the recent spike in inflation to be "transitory" (i.e. temporary). If the recent inflation increase turns out to be temporary, and falls back in line towards the Fed 2.0% target, then the Fed can continue on its *gradual* unwinding of its accommodative monetary support. This would be the best outcome for the economy and the financial markets broadly. However, if the increase in inflation turns out to be stickier than the Fed anticipates, they are likely to expedite the unwinding of their accommodative policies starting with tapering its quantitative easing (likely later this year) followed by increasing short-term interest rates (before 2023) faster than the market currently anticipates.

Whether or not this recent inflation spike means a sustained period of higher inflation it is too early to tell. The U.S. economy appears to have significant slack in it before aggregate demand would start overwhelming the economy's productive capacity. If labor markets continue to improve and the Fed continues its accommodative policies, it could lead to economic overheating that could cause significant, sustained, and broad-based inflation. We are hopeful that the recent sharp price increases will prove to be temporary as supply shortages catch up to demand as the pandemic recedes. However, if inflation does quickly come back down, we think it will likely tip the Fed's hand to shift the supportive monetary policy more quickly than the markets anticipate resulting in market volatility and likely a sharp correction in both core Fixed Income and Equity markets broadly. If inflation surprises to the upside, the Fed may be inclined to raise rates higher and faster than the market currently anticipates. This could cause equity markets to decline steeply in the short-term (10% to 20%) given relatively high current absolute equity valuations.

As once stated by William McChesney Martin, past Chairman of the Federal Reserve, who served from April 1951 to January 1970 under five different presidents; the job of the Federal Reserve is "to take away the punch bowl just as the party gets going, that is, raise interest rates just when the economy reaches peak activity after a recession." The Federal Reserve has indeed spiked the punch bowl. The financial markets are partying – dancing and having fun – largely aided by both monetary stimulus from the Federal Reserve and fiscal stimulus from Congress. However, if inflation runs too hot, for too long, the Fed is likely to reverse course and take away the punch bowl.

The other major source of recent economic support, fiscal stimulus, is also less certain given the political dynamics and polarization issues we face. However, the expiration of the pandemic support programs will turn from a fiscal boost to a fiscal drag later this year (and into 2022) but this should hopefully lead to increased labor supply which should help mitigate wage inflation pressures from driving up inflation.

Conclusion

With the likelihood of a recession low, absent an external shock, we see little risk of a significant decline in global equities. However, we would not be surprised to see a 10%+ stock market correction as the odds of a typical mid-cycle market correction are high given the market has gone straight up for 15 months. Further, the uncertain inflation outcome and related impact to Fed policy are likely to create more financial market volatility in the coming months. Despite elevated S&P 500 valuations and a likely deceleration in earnings growth, we believe global equities have additional return potential this cycle.

We are pleased with the performance during the first half of 2021 on top of very strong returns seen in 2019 and 2020. Looking forward, we anticipate more muted and likely below-average returns in the coming years due to the Fixed Income headwind of rising interest rates (i.e. very low returns) and current elevated Equity valuations (i.e. low returns).

We believe portfolios are well positioned for a continued recovery while at the same time positioned appropriately for a rising interest rate and inflationary environment through our underweights to Fixed Income, addition of floating rate bonds, and our overweight to Natural Resources and Infrastructure investments. Low correlation investments will also continue to play an important role in portfolios for the near future and we are committed to retaining meaningful allocations to these strategies to serve as a stabilizer in portfolios to protect against downside risk.

As always, we believe it is important to meet or teleconference with our clients regularly to address any questions about portfolio performance or longer-term investment and financial planning. Please do not hesitate to contact our office to schedule a review meeting or time to talk.

Cordially,

Causey Demgen & Moore Investment Committee
- Robb Stone, Nathanael Koch, Stephen Warren, Paul Demgen and John Connell

Tactical Asset Allocation Outlook

Please find below our Tactical Asset Allocation outlook as of June 30, 2021. The Investment Committee made a few noteworthy adjustments to our tactical framework during our July 2021 meeting, including (1) increasing the allocation to alternative assets (particularly Low Correlation strategies), (2) decreasing the allocation to short term bonds, and (3) taking U.S. Growth to the maximum underweight per Investment Policy and, in turn, upgrading U.S. Value to a slight overweight. Looking out over a three-to-five year tactical horizon, the major risks we see are elevated U.S. stock valuations, in particular U.S. Growth stocks, higher and longer than expected inflation, and rising interest rates.

	Underweight					Overweight			
	- - - -	- - -	- -	-	Strategic	+	+ +	+ + +	+ + + +
OVERALL POSITION									
Cash	●								
Fixed Income	●								
Equities						●			
Alternatives						◆	●		
FIXED INCOME									
Short Bond	●		◆						
Intermediate Bond	●								
High Yield Bond						●			
Foreign Bond				●					
EQUITIES									
US Value					◆	●			
US Growth	●		◆						
US Small Cap									●
Developed Int'l						●			
Emerging Markets							●		
ALTERNATIVES									
Real Estate				●					
Natural Resources									●
Infrastructure									●
Low Correlation							◆		●

Current Outlook	●
Prior Outlook	◆

Underweight:

- **Short/Intermediate Fixed Income** (i.e. Treasury bonds) due to our outlook and concern for rising interest rates; further allocating to active, flexible bond strategies to mitigate risk and improve return.
- **U.S. Growth stocks** as their valuations are extremely elevated (back to "tech bubble" valuations for many of them).

Overweight:

- **Senior Loans/Floating Rate bonds (within High Yield)** as the interest rates/coupons reset monthly or quarterly and are therefore not negatively impacted by rising interest rates.
- **U.S. Value stocks** as they look relatively attractive (compared to U.S. growth stocks) and are poised to outperform as the economy continues to recover.
- **U.S. Small-cap stocks** as they look relatively attractive (compared to U.S. growth stocks) and are poised to outperform as the economy continues to recover.
- **Developed & Emerging International stocks** as they are historically undervalued relative to U.S. stocks and are well positioned to also outperform as the global economy recovers.
- **Natural Resources** as an inflation-hedge due to the unprecedented amount of Fiscal and Monetary stimulus.
- **Low Correlation strategies** to replace "core" fixed income for safety ("ballast") as their absolute return strategies should do well regardless of how Fixed Income (rising interest rates) or Equities (expensive valuations) perform.