Rose Capital Advisors Q3 2021 Market Commentary

October 2021

<u>Where We Are</u>

In financial markets, October often contains consequential elements of transformation, passage, and change, with its four weeks ranking only ninth out of 12 months in the S&P 500 index's average percent change (with a gain of +0.4%) over the years from 1928 through 2020. In 2021, the S&P 500's close on Monday, October 4th (4300.46) finally ushered in a -5.2% correction — the first time the S&P 500 index had fallen as much as -5.0% in almost a year — from its all-time record closing high of 4536.95 reached on Thursday, September 2nd. And also at its October 4th closing of 14255.48, the technology-heavy Nasdaq Composite index had declined -7.3% from its September 7th record closing high of 15374.33.

Beneath the surface of the headline S&P 500 index (which had been up until then held aloft by a handful of mega-cap technology and social media stocks), as of October 4th, a significant amount of price deterioration had already taken place, as depicted in the table below:

Index	% of members with at least -10% correction from YTD high	Average member decline from YTD high
S&P 500	91%	-17%
NASDAQ	90%	-38%
Russell 2000	98%	-34%

Source: Charles Schwab, Bloomberg, as of 10/4/2021. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. Past performance is no guarantee of future results.

It can be seen that, when the stock market's closing bell rang on October 4th, 91% of the S&P 500 companies had experienced a correction of at least -10% from their year-to-date high, with the average decline from each member's respective peak amounting to -17%. Similarly, 90% of the Nasdaq Composite companies had experienced a correction of at least -10% from their year-to-date high, with the average decline from each component's respective peak amounting to a meaningful -38%. And constituents of the Russell 2000 index of small- and mid-cap companies were not spared, with 98% of the Russell 2000 companies having endured a correction of at least -10% from their year-to-date high, with the average decline from each member's respective peak amounting to a substantial -34% setback.

And as shown in the nearby chart of Monthly and Year-to-Date price performance, in September, the S&P 500 declined -4.8%, its worst month of the year (and the worst monthly price decline since March 2020, when the S&P 500 fell -12.5%), with the NASDAQ Composite retreating -5.3%, also its worst month of 2021. After declining -3.6% in July and gaining +2.1% in August, the Russell 2000 index of small and mid-cap companies fell -3.1% in September.

Monthly and Year-to-Date Price Performance

Index/Commodity	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	YTD (through 9/30)
S&P 500	-1.1%	+2.6%	+4.2%	+5.2%	+0.5%	+2.2%	+2.3%	+2.9%	-4.8%	+14.7%
Nasdaq Composite	+1.4%	+0.9%	+0.4%	+5.3%	-1.5%	+5.5%	+1.2%	+4.0%	-5.3%	+18.1%
Russell 2000	+5.0%	+6.1%	+0.9%	+2.1%	+0.1%	+1.8%	-3.6%	+2.1%	-3.1%	+11.6%
Gold	-2.6%	-5.9%	-1.6%	+3.6%	+7.9%	-7.3%	+2.6%	+0.1%	-3.4%	-7.3%
West Texas Int. Oil	+7.5%	+18.0%	-3.8%	+7.3%	+4.4%	+10.8%	+0.6%	-7.4%	+9.5%	+54.6

Source: *The Wall Street Journal, and Yahoo Finance.*

Over the course of September, West Texas Intermediate crude oil prices rose +9.5%%, from $68.50 per barrel on August 31st to $75.03 per barrel on September 30th. With the global oil *demand* side reflecting economic recovery, fuel shortages, and precautionary buying, on the *supply* side: (i) facing pressure from investors to moderate growth and address their emissions amid concerns about increasing regulations and climate change, large U.S. and European oil companies continue to spend sparingly to boost production; (ii) consolidating U.S. shale producers have exercised financial discipline and exerted capital spending restraint; and (iii) following the 21st OPEC and non-OPEC ministerial meeting on October 4th (and a post-meeting ratification of new output quotas for selected countries), the group (which includes Saudi Arabia, Russia, the United Arab Emirates, Kuwait, Iraq, and other countries) agreed to maintain output increases of 0.4 million barrels per day per month from October until December 2021, aiming to fully phase out production cuts by September 2022. The next OPEC+ meeting is scheduled for Thursday, November 4th.

During September, the U.S. dollar gained +1.6% versus the DXY index, comprised of six major currencies (Euro, Japanese yen, British pound, Canadian dollar, Swiss franc, and Swedish krona). On August 31st, the DXY index was 92.71 and on September 30th, the index closed at 94.23, up +4.8% year-to-date from its close of 89.93 on December 31st, 2020.

In part challenged by competition from higher interest rates over the course of the month, the daily spot gold price (as logged by USA Gold) closed at $1,753.14 per troy ounce on September 30th, down -3.4% from its close of $1,814.56 per troy ounce on August 31st.

In the accompanying chart, month-end closing yield levels are shown for 2-year, 10-year, and 30-year U.S. Treasury securities, and these data are used to compute the month-to-month 2021 yield level changes (expressed in basis points), also shown nearby.

Year-End 2020 and 2021 Month-End Treasury Securities Closing Yield Levels

Security	Dec. 31	Jan. 29	Feb. 26	Mar. 31	Apr. 30	28-May	Jun. 30	Jul. 30	Aug. 31	Sep. 30
2-Year	0.13%	0.11%	0.14%	0.16%	0.16%	0.14%	0.25%	0.19%	0.20%	0.28%
10-Year	0.93%	1.11%	1.44%	1.74%	1.65%	1.58%	1.45%	1.24%	1.30%	1.52%
30-Year	1.65%	1.87%	2.17%	2.41%	2.30%	2.26%	2.06%	1.89%	1.92%	2.05%

Source: *The Wall Street Journal*, and Yahoo Finance.

Month-to-Month 2021 Yield Level Changes (in Basis Points)

Security	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.
2-Year	-2	+3	+2	0	-2	+11	-6	+1	+8
10-Year	+18	+33	+30	-9	-7	-13	-21	+6	+22
30-Year	+22	+30	+24	-11	-4	-20	-17	+3	+13

Source: *The Wall Street Journal*, and Yahoo Finance.

As depicted nearby, for 2-year U.S. Treasury securities, after rising 11 basis points in June and declining six basis points in July, yields rose by one basis point in August and eight basis points (0.08%) in the most recent month, to close September 30th at 0.28%, where they are up 15 basis points (0.15%) since their closing level of 0.13% on December 31st, 2020.

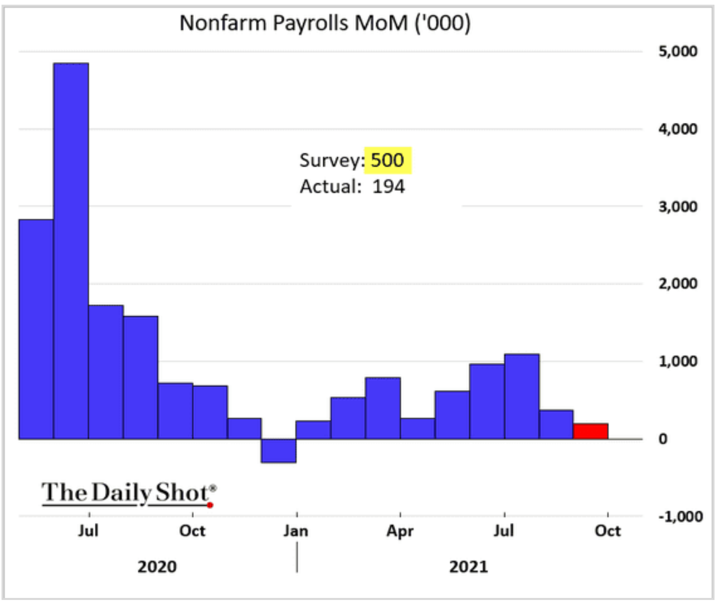
For 10-year U.S. Treasury securities, after declining 13 basis points in June and another 21 basis points in July, yields rose by six basis points in August and 22 basis points (0.22%) in the most recent month, to close September 30th at 1.52%, where they are up 59 basis points (0.59%) since their closing level of 0.93% on December 31st, 2020. It can be seen in the charts that this year's upward move in 10-year U.S. Treasury yields has essentially taken place in the January, February, and March time frame.

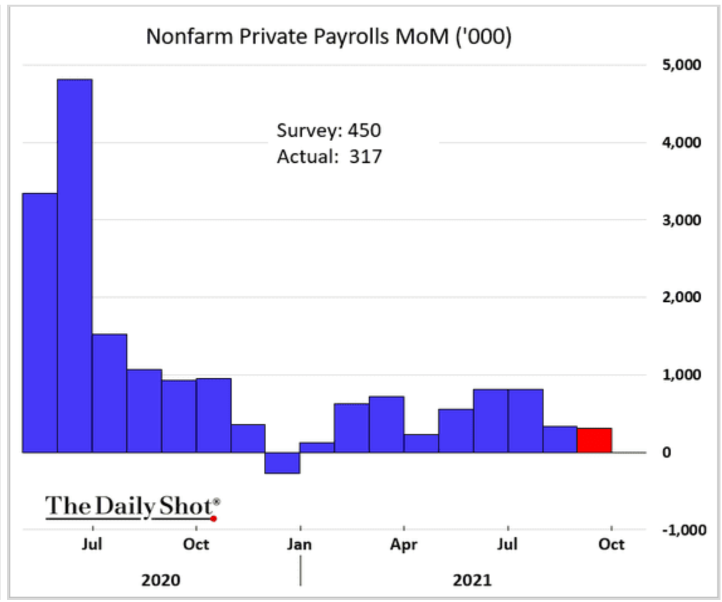
A somewhat similar pattern to this year's path of 10-year U.S. Treasury yields has evolved in the yield levels of 30-year U.S. Treasury securities. For 30-year U.S. Treasury securities, after declining 20 basis points in June and another 17 basis points in July, yields rose by three basis points in August and 13 basis points (0.13%) in the most recent month, to close September 30th at 2.05%, where they are up 40 basis points (0.40%) since their closing level of 1.65% on December 31st, 2020. It is worth noting in the charts that this year's upward move in 30-year U.S. Treasury yields has also essentially taken place in the January, February, and March interval.

The following sections review several of what in our opinion represent important Financial Asset Tailwinds (defined as "a force or influence that advances progress toward an improved condition") and Financial Asset Headwinds (defined as "a force or influence that inhibits progress") likely to affect financial asset prices in the period ahead.

Financial Asset Tailwinds

Monetary Policy: At his press conference following the September 21-22 Federal Open Market Committee (FOMC) meeting, Fed Chair Jerome Powell opined that a "reasonably good" employment report would be needed for the FOMC to commence tapering its $120 billion in monthly securities purchases. Chair Powell also indicated that inflation was staying higher for longer than he anticipated, while at the same time stating that he still believes that inflation is transitory. On the surface, the September jobs report (the "Establishment Survey," conducted monthly by the Bureau of Labor Statistics in the U.S. Department of Labor) appeared to be a disappointment, with just +194,000 jobs added, well below consensus estimates of +500,000 jobs growth — as shown in the left panel of the charts below, a distinct slowdown from the prior two months.





In our opinion, several positive elements within the overall September employment report may well keep the Fed on track to begin tapering in November or December of this year. They include, among other elements:

i. The +526,000 jobs gains reported by the "Household Survey," conducted monthly by the U.S. Census Bureau in the Department of Commerce (which reaches self-employed and small family businesses which the Establishment Survey does not);

ii. The robust revisions of +169,000 to the prior two months of Establishment Survey data;

iii. The +317,000 September gain in private sector payrolls (shown in the right panel of the charts above);

iv. A decline in the September unemployment rate ("U-3") to 4.8% versus 5.2% in August;

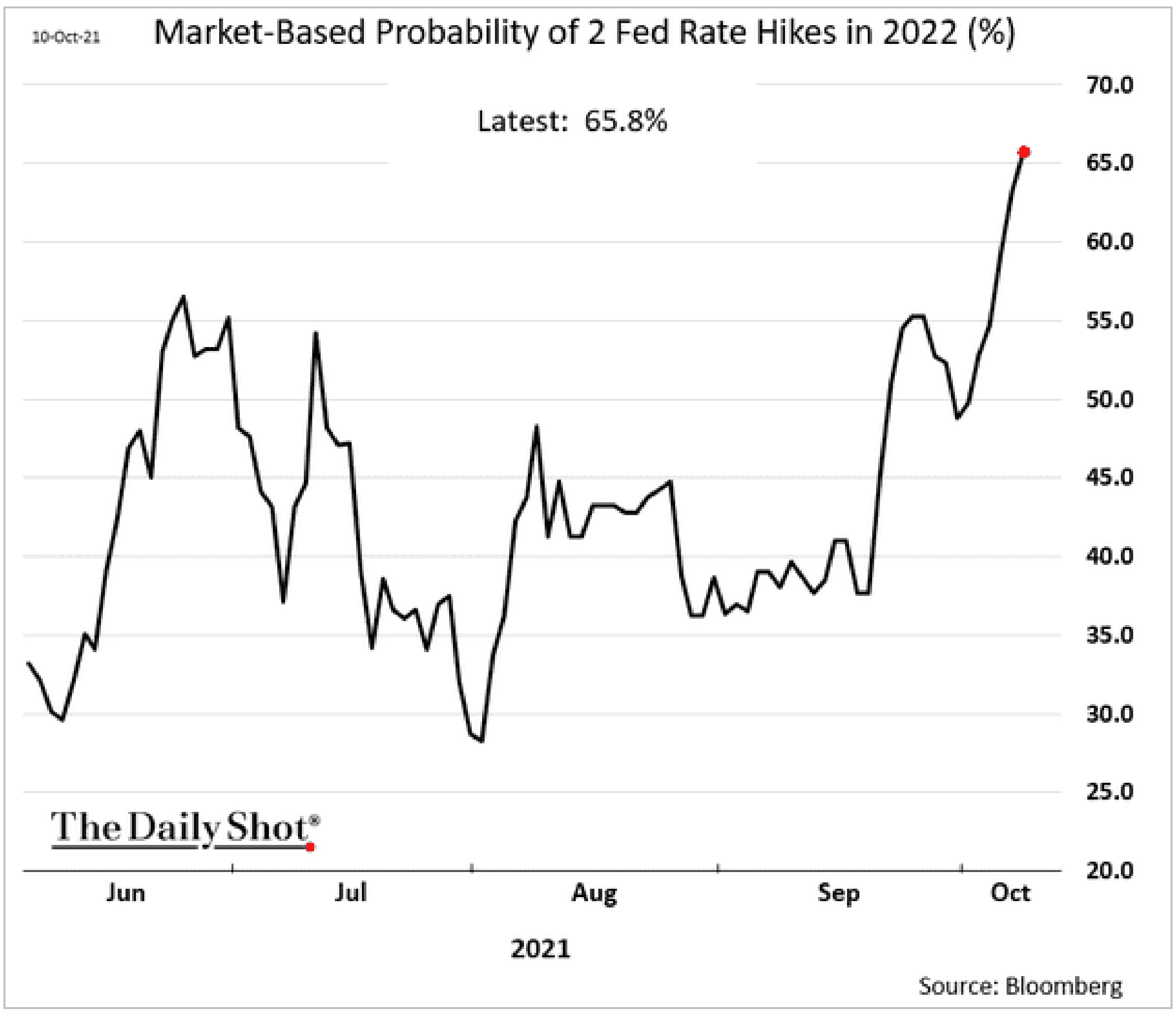
v. A decline in the underemployment rate ("U-6") from 8.8% in August to 8.5% in September;

vi. Week-by-week reductions in the number of Americans filing for initial unemployment claims (a proxy for layoffs) indicating that the number of job openings continues to outpace the number of unemployed workers, with many employers reporting strong demand for workers and difficulties in filling open positions;

vii. An increase in Average Hourly Earnings (well distributed across wage cohorts and industry sectors) of +0.6% in September, increasing the year-over-year rate to +4.6% (with six-month annualized wage growth coming in at +6.0%);

viii. A robust increase of +9.6% over the past 12 months in the Aggregate Income Proxy (defined as hours worked x hourly wages = actual total take home pay); and not least, (ix) our expectation of continued employment progress in coming months, driven by strong labor demand, coupled with easing labor supply constraints and improving Covid-19 infection rates.

We believe that equity valuations will be meaningfully influenced by the level of policy interest rates set by the Fed, as well as by the slope of the U.S. Treasury yield curve. As shown in the nearby chart, as of October 10th, the pricing of fed funds futures indicated a 65% probability of two fed rate hikes in 2022, up from a 40% probability as recently as early September. If the Fed raises its policy rates by only a modest 25 basis points each time it makes a rate hike, and the yield curve does not steepen dramatically, 10 year U.S. Treasury Yields could theoretically remain in the 2.00-2.50% range.



With rapidly rising energy prices and wage growth affecting inflation expectations, it is quite plausible that 10-year U.S. Treasury yields could rise beyond this range. Additional important factors to monitor closely at this point include:

i. Not only the *level* of yields, but the *speed* of yield changes;

ii. Whether financial market participants are confident that Fed policy officials have an adequate understanding of ongoing inflationary pressures; and

iii. Financial markets' interpretation of who will be appointed (or reappointed) to the following Fed positions: (a) Fed Chair Jerome Powell — his term as Chair expires in February 2022; (b) Fed Vice Chair Richard Clarida — his term as Vice Chair expires in September 2022; (c) Fed Vice Chair for Supervision Randal Quarles — his term as Vice Chair for Supervision ends in October 2021; (d) Boston Fed President Eric Rosengren — his position has been vacant since September 30th; and (e) Dallas Fed President Robert Kaplan — his position has been vacant since October 8th.

Economic Growth: Following 1Q21 GDP growth of +6.4% annualized and 2Q21 GDP growth of +6.7% annualized, slowing rates of consumer spending have led to downward revisions to estimated 3Q21 GDP growth. With 3Q21 consumer spending estimated to be growing at a +1.4% annual rate, as of October 8th, the GDPNow forecasting model of the Federal Reserve Bank of Atlanta was estimating a +1.3% annualized rate of GDP growth in the third quarter.

As of September 15th, the Conference Board forecasts that 2021 U.S. real GDP growth, after declining -3.4% in 2020, will come in at +5.9% (year-over-year), a downgrade from their August outlook and incorporating the larger-than-expected effects that the Covid-19 Delta variant has had on the economy. Looking beyond 2021, the Conference Board forecasts that the U.S. economy will grow by +3.8% percent (year-over-year) in 2022 and +3.0 % (year-over-year) in 2023.

Among the constructive factors reflecting and affecting U.S. economic growth are:

i. The September Empire State General Business Conditions index was 34.3, versus 18.3 in August;

ii. The September Philadelphia Fed Business Outlook index was 30.7, versus 19.4 in August;

iii. August Retail Sales rose +0.7% month-over- month, versus -1.8% in July and +0.9% in June;

iv. The August NFIB Small Business Optimism index was 100.1, versus 99.7 in July;

v. August Durable Goods Orders rose +1.8% month-over-month (and were up 15 of the previous 16 months) versus +0.5% in July;

vi. July Home Prices rose +19.7% (the fourth consecutive month in which the rate of home price appreciation set a record);

vii. August Personal Income grew +0.2% month-over-month versus +0.8% in July, and August Personal Consumption Expenditures gained +0.8% month-over-month versus -0.1% in July;

viii. September's ISM-Manufacturing index registered a robust 61.1 versus 59.9 in August;

ix. September's ISM-Services index registered an impressive 61.9 versus 61.7 in August; and

x. The August Lead Economic Indicators gained +0.9% versus July's +0.8% and June's +0.6%.

Among the worrisome factors affecting U.S. economic growth are:

i. September's Conference Board Consumer Confidence reading fell to 109.3 versus 115.2 in August, below expectations and suggesting that companies have become more cautious amid concerns about the Delta variant of the coronavirus and the economic outlook;

ii. August's construction spending was virtually unchanged versus +0.3% in July, and January through August year-to-date came in at +7.0%, as increased activity in public sector projects was offset by private sector weakness; and

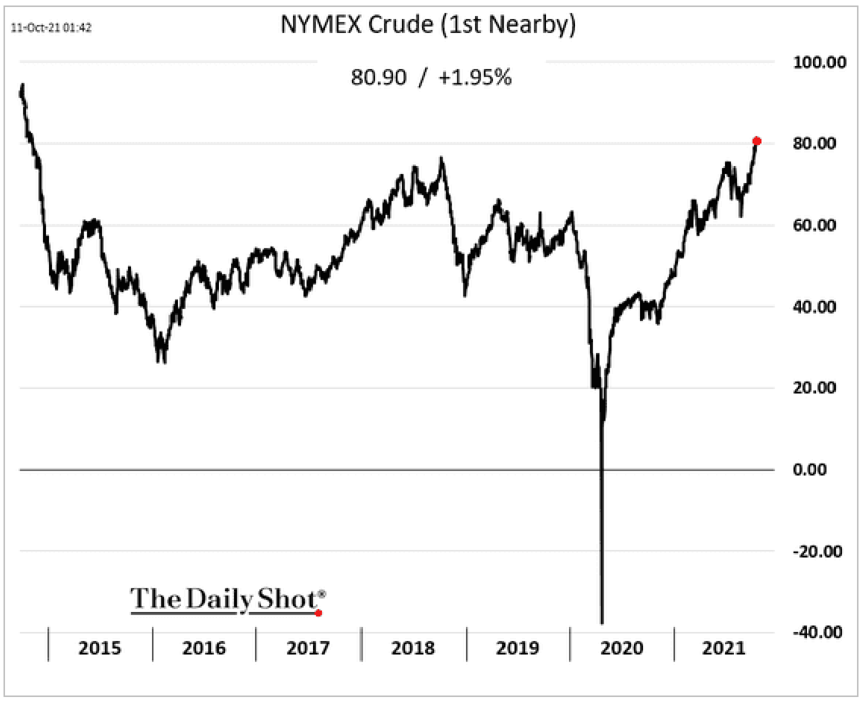
iii. Economic activity has downshifted in China, the world's second largest economy, with August's Industrial Production +5.3% year-over-year versus +6.4% in July, August's Retail Sales +2.5% year-over-year versus +8.5% in July, and the January-August year-to-date Fixed Asset Investment +8.9% versus +10.3% in the previous interval.

Our base case view remains that the U.S. economy is continuing on a positive growth trajectory, as the growth rate slows somewhat from the rapid rates of recovery experienced late last year and early this year. Labor shortages, logistical bottlenecks, Delta variant disruptions, and cost pressures have dampened the growth outlook for the second half of 2021, with the shortfall from prior full year growth estimates being partially added to full year GDP growth estimates for 2022. The rebound in private business investment, an important component of helping to ease supply bottlenecks, remains in its early stages and is subject to reductions reflecting the uncertain outlook for final demand.

Corporate Profits: During the current 2021 third calendar quarter earnings reporting season, investors need to play close attention to corporate CEOs' and CFOs' revenue and earnings comments — with particular focus on: (i) profit margins; (ii) pricing experience (prices paid as well as prices received) for labor, logistics, transportation, and raw materials; and (iii) the forward outlook from economy-sensitive sectors such as airlines, credit card companies, theme parks, cruise lines, restaurants, and numerous other industry groups leveraged to the economic recovery and reopening. Given that a good deal of the anticipated positive profits news may already be reflected in equity valuations, of critical importance in the period ahead will be the magnitude and direction of analysts' earnings revisions, not only for 4Q21, but also for each quarter and the entirety of calendar year 2022. With year-over-year economic growth projected to slow in the coming calendar year, profits growth in the first half of 2022 is likely to be considerably less robust than in the second half of 2021. Judicious discernment will thus be critical in the selection of sectors, companies, and investment managers. For more of our thinking, please refer in the Portfolio Positioning Tactics section of this *Commentary*, to "Equity Emphases and De-emphases," "Focus on Strength and Quality," and "Balancing Growth and Value Sectors."

Pandemic Attenuation: According to the Centers for Disease Control and Prevention, the U.S. seven-day average of daily new Covid-19 cases (adjusted for holiday anomalies) peaked at 166,105 on September 1st and by October 6th, the seven-day average of daily new Covid-19 cases had fallen -39%, to 101,262. Over the same time frame, hospitalizations declined -30%, and mortalities (which usually change direction a few weeks after cases) had declined -13% from September 20th through October 6th. As the Delta variant of Covid-19 shows signs of receding, over 80% of the total American population has received at least one shot or has reached natural immunity due to having contracted the coronavirus. With 6.8% of the total American population under five years old and thus not vaccinated, in the aggregate, at least 87% of the U.S. population has had a shot, has attained natural immunity, or is under five years of age. Including boosters, 800,000 vaccinations are being administered per day, with various corporate and governmental employers' mandates requiring more individuals to get vaccinated. Allowing for our distinct lack of epidemiological competence, at this point it is possible that the virus will surge again, while it is also possible that the U.S. population has developed sufficient immunity that the Delta variant will prove to have been the last major wave of the pandemic. In early October, after its oral antiviral drug (molnupiravir) was shown in a late stage trial to cut the risk of hospitalization or death in Covid-19 patients by close to 50%, the pharmaceutical company Merck requested FDA emergency use authorization to treat mild to moderate Covid-19 in adults who are at risk for developing a severe form of the disease. If cleared by the regulators, the drug will represent the first oral antiviral which would allow patients contracting Covid-19 to avoid hospitalization. Further impetus for suppressing the pandemic, lifting restrictions, modulating shutdowns, and amplifying economic activity should come from the availability and application of molnupiravir.

Energy Supply and Demand: In many parts of the globe, governments, businesses, consumers, and investors have vividly taken note of shortages, supply-demand imbalances, and rising prices for oil, natural gas, coal, and certain other energy sources. The accompanying chart shows that the nearby NYMEX Crude Oil futures contract has been on an upward path for a good part of 2021 — and as of October 11th, had reached $80.90 a barrel, a price last seen seven years ago, at the end of 2014.



In September, the S&P 500 Energy Sector rose +9.3% — the only S&P 500 sector in positive territory — with June 2008 the sole previous time the S&P 500 Energy Sector was the only sector up in a month. U.S. natural gas futures rose +60.7% in September and as of early October, U.S. gasoline prices averaged $3.29 a gallon, up $1.00 per gallon versus October 2020 (and the highest in seven years). In Europe, the United Kingdom, China, India, and Brazil — among other countries — users of energy have faced rationing, some episodes of panic buying, power cuts, and blackouts. To a certain extent, energy output from these sources has been constrained by financial conservatism, government policy, capital spending discipline, and an increased emphasis on renewable sources of energy. Recognizing that these conditions may persist for some time in the future, our investment posture continues to favor selective exposure both to fossil fuel-based producers and to renewable energy sources. It is worth remembering that elevated energy prices can inhibit consumer and business spending as they may represent a form of "tax" that reduces disposable income.

Financial Asset Headwinds

Political Developments: For some degree of historical perspective, from 1936-1920, the S&P 500 index has averaged +6.7% per year (total return) during the first year of a four-year presidential term, +8.7% per year during the second year, +18.5% per year during the third year, and +9.8% per year during the fourth year.

In recent weeks, financial asset markets have been meaningfully affected by Democrats' and Republicans' serious intra-and inter-party disputes over programs and issues including: (i) passing a budget to fund the federal government on a timely basis (and thus avoiding a government shutdown); (ii) raising the nation's debt ceiling (to avert a default by the United States and risk missing payments to Social Security recipients and the military, among other parties); (iii) proposed sweeping overhauls of America's physical and social infrastructure; and— possibly critically important for financial asset prices — (iv) consideration of increased corporate and personal top bracket tax rates, potentially accompanied by the re-introduction of full state and local tax ("SALT") write-offs.

Perhaps the elevated degree of political deadlock, brinksmanship, and acrimony can be traced to the passionate views held on either side of the aisle and the difficulties of passing sweeping legislative actions given the narrow margin in the national elections held on November 3rd, 2020. In the current 117th U.S. Congress, the 435-member House of Representatives consists of 220 seats held by Democrats and 212 seats held by Republicans, with 3 vacancies, and the Senate is tied, with 50 seats held by Democrats and 50 seats held by Republicans; by contrast, the 88th U.S. Congress was able to pass the Great Society programs in 1964 with Democrats having large majorities in the Senate, 68-32, and in the House of Representatives, 295-140.

A debt default could: (i) spark significant volatility in U.S. and global equities, fixed income, and currency prices; (ii) risk a downgrade to America's credit rating (even as Fitch Ratings Inc. and Moody's Investors Service have continued to rate U.S. debt as triple-A, Standard & Poor's — citing the degree of domestic lawmakers' dysfunctional discord — lowered the United States' debt rating from AAA to AA+ on Friday, August 5th, 2011); and (iii) cast serious doubt on the U.S. dollar's preeminent role in global trade and finance. In view of the widespread comprehension of the extraordinarily negative consequences of a U.S. Treasury debt default, we assign a very low (although not zero) probability to such an event, even as significant market-moving histrionics and rhetoric are likely to be witnessed prior to raising America's federal debt ceiling.

On Thursday, October 7th, the U.S. Senate voted 50-48 to raise the debt ceiling through early December, and on Tuesday, by a vote of 219-206, the House of Representatives passed the bill and forwarded it to President Biden for his signatures. The stopgap nature of this debt ceiling postponement sets up another consequential deadline for what U.S. Treasury officials estimate will be around Thursday, December 2nd or Friday, December 3rd.

Because it would remove some degree of persisting uncertainty, our view holds that if and when a more lasting debt ceiling deal is finally struck, financial market participants would likely view such an outcome in a positive light. Nevertheless, it is possible that in late November or early December —after engaging in the same disputatiousness drama all over again — the participants may find themselves unable to reach a compromise agreement, therefore avoiding the politically fraught decision and producing another "postponement-style" outcome.

Inflation: Due to surging demand (associated with the economic reopening and trillions of federal aid dollars flooding through the economy), constricted supplies of virus-sensitive components and other materials, labor shortages, food and fuel price increases, and ongoing supply chain issues, the growth rate of consumer prices and producer prices has remained higher than government officials, the business sector, and the public at large have anticipated. For instance, as calculated by the Federal Reserve Board and the 12 Federal Reserve District Presidents, the median estimate of the Personal Consumption Expenditures inflation rate for 2021 as a whole was +1.8% as of December, +2.4% as of March, +3.4% as of June, and +4.2% in September. Moreover, an increasing number of corporate executives have indicated that they expect higher costs to endure longer than they had previously thought.

The nearby table displays August and September inflation in consumer and producer prices.

Comparative Inflation Rates

	September		August	
	Month-Over-Month	**Year-Over-year**	**Month-Over-Month**	**Year-Over-year**
Headline CPI	+0.4%	+5.4%	+0.3%	+5.3%
Core[1] CPI	+0.2%	+4.0%	+0.1%	+4.0%
Headline PPI	+0.5%	+8.6%	+0.7%	+8.3%
Core[1] PPI	+0.1%	+6.8%	+0.3%	+6.7%
Headline PCE	Released at 8:30 AM		+0.4%	+4.3%
Core[1] PCE	Eastern Time on 10/29/21		+0.3%	+3.6%

[1]Excluding food and energy prices
Source: *The Wall Street Journal* .

It can be seen that on a year-over-year basis in September, the headline Consumer Price index rose +5.4% (close to the highest in 12 years) and the core (excluding food and energy) Consumer Price index increased +4.0%. Similar, in September the headline Producer Price Index rose +8.6% and the core (excluding food and energy) Producer Price Index increased +6.8%. The Federal Reserve Board's preferred inflation measure, the core (excluding food and energy) Personal Consumption Expenditures index, rose +3.6% year-over-year in August. The September Personal Consumption Expenditures index data are scheduled to be released at 8:30 AM Eastern time on Friday, October 29th.

In his late-September Congressional testimony, Fed Chair Jay Powell indicated that the increase in the inflation rate is likely to be more persistent than previously expected. At the same time, he reiterated his expectation that the elevated inflation rates will ultimately turn out to be transitory.

As many Inflation measures have moved from signaling price stability to signaling acceleration in underlying inflation, financial market participants have been attempting to gauge just how enduring these high inflation rates will be as the economy continues to recover from the pandemic. In our opinion, investors should expect inflation to remain elevated until the bottlenecks in the global supply chain are alleviated, thus helping supply rise to meet high demand levels and theoretically bring down the rate of gain in prices. Such more balanced supply-demand conditions now currently appear likely to take several months or longer.

China's Economy: In the 2003-2009 decade, China's real GDP growth averaged +10.4% annually, and during the 2010-2019 decade, annual real GDP grew by an average of +7.7%. For calendar year 2021, China has established a 2021 growth target of "at least +6.0%" after registering its lowest rate of real GDP growth in four decades, +2.5% in 2020.

As of 2021, China's national priorities had decisively shifted from the "Growth at any Cost" objectives of two or three decades earlier to a number of other goals, including: common prosperity through societal redistribution of resources; achieving self-sufficiency and leadership in many advanced technologies; environmental awareness and energy transitioning; balanced economic growth and stability; establishing primacy in the world of central bank digital currencies; data ownership and data privacy; emphasis on measures to promote fair competition, crack down on corruption, and strengthen the role of state-owned enterprises; and not least, emphatically reining in the power of Big Technology companies and the financial industry.

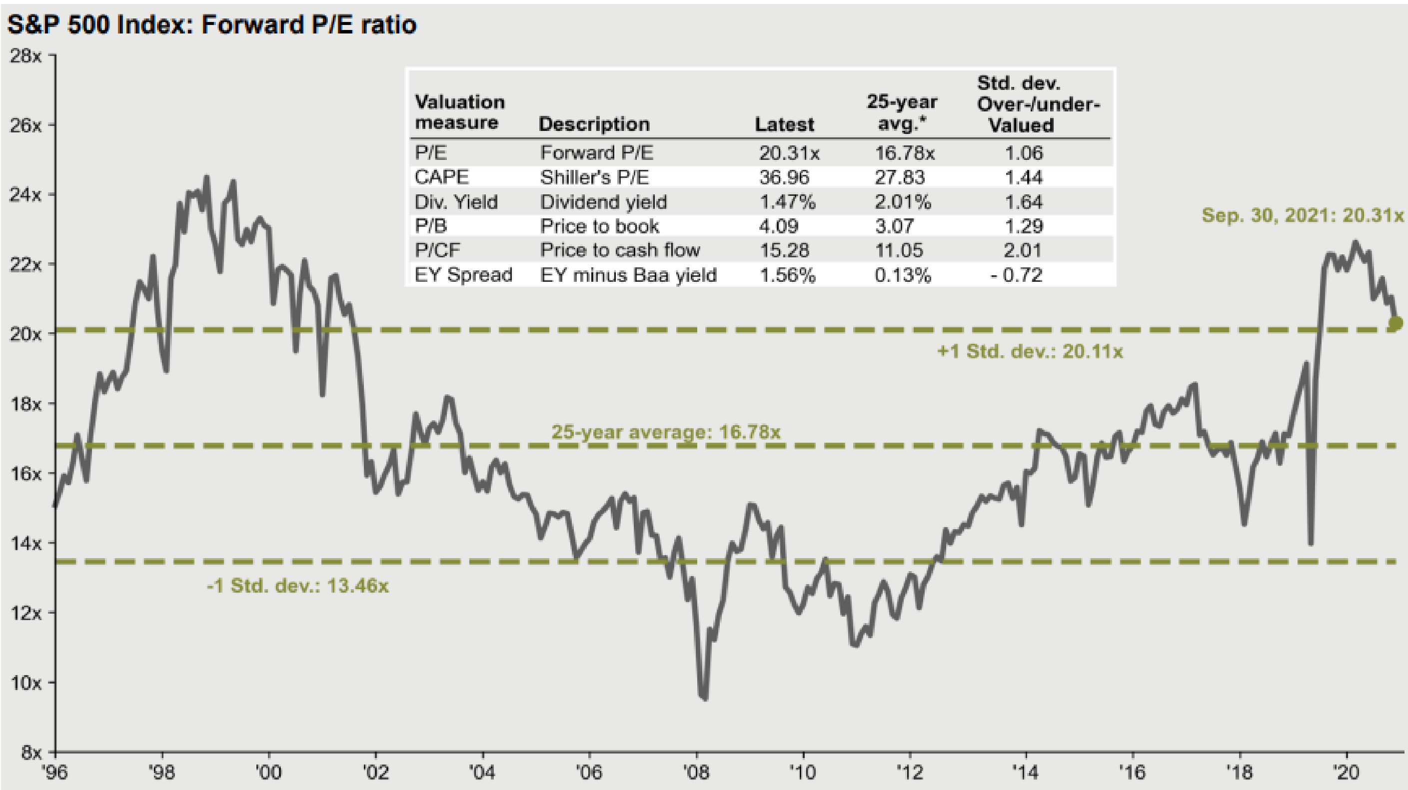
China's real estate sector — with indebtedness (estimated by Nomura Securities) of $5.2 trillion contributes 29% of the nation's GDP and appears to have become so overbuilt that it risks morphing from being an engine of growth to becoming a brake on the country's advance. In 2020, via initiatives intended to address concerns relating to financial, economic, and social stability, to reduce reliance on the real estate industry for sustainable economic growth, and to curb excesses in the property sector, the government announced "three red lines:" (i) the ratio of liabilities to assets must be below 70%; (ii) the ratio of net debt to equity must be below 100%; and (iii) the ratio of cash to short-term debt must be at least 100%.

Investors are seeking to grapple with the question of whether the significant liquidity and solvency issues associated with the China Evergrande Group (and to a growing degree, for similar enterprises in the real estate sector) will (i) remain primarily a China-specific issue, or (ii) influence investor psychology and asset prices across China's borders via some form(s) of economic contagion, financial contagion, or portfolio flows contagion. At the core of Evergrande's problems are its massive liabilities, which as of the middle of 2021, amounted to approximately $304 billion (of which $20 billion represented offshore dollar-denominated bonds — on September 23rd, the company failed to pay $83.5 million in interest due on some of its dollar-denominated debt, with a 30-day grace period before its nonpayment constitutes a default on these bonds). Other signs of financial stress emerged on numerous Chinese property firms' bonds as beleaguered issuers sought to delay payment deadlines and/or effectuate distressed debt exchanges.

In our opinion, a systemic crisis in China's financial sector currently appears to be a low probability event (yet potentially possible and by no means not *de minimis*). With events in a considerable degree of flux, it could happen that the Authorities' response to the problems of the highly indebted real estate sector actually leads to an acceleration of the reflationary policy measures that are already being pursued. Although at this point the issue does not seem to be a bearish game-changer, at the same time it calls for close monitoring, vigilant prior thought given to hedging strategies, appropriate husbanding of liquidity, and defensive asset allocation maneuvers.

Valuations: As can be seen in the nearby chart, relative to their 25-year average, as of September 30th, several mainstream valuation measures for the S&P 500 index appear overvalued. Two that we look at in particular are the forward price-earnings ratio and the Cyclically Adjusted Price Earnings ratio (also known as the CAPE price-earnings ratio, or the Shiller price-earnings ratio, calculated by dividing price by 10-year average inflation-adjusted earnings).

At a forward price-earnings ratio of 20.31 times earnings, the S&P 500 is 21% above its 25-year average of 16.78 times, or 1.06 standard deviations above its 25-year average. And at a Shiller price-earnings ratio of 36.96 times earnings, the S&P 500 is 33% above its 25-year average of 27.83 times, or 1.44 standard deviations above its 25-year average.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	20.31x	16.78x	1.06
CAPE	Shiller's P/E	36.96	27.83	1.44
Div. Yield	Dividend yield	1.47%	2.01%	1.64
P/B	Price to book	4.09	3.07	1.29
P/CF	Price to cash flow	15.28	11.05	2.01
EY Spread	EY minus Baa yield	1.56%	0.13%	- 0.72

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Mindful of the lessons of the late 1990s dotcom bubble, the late 1980s Japanese equities bubble, and the late 1960s "nifty-50 one-decision stocks" bubble, we emphasize that although valuations are never a trigger for causing major upward or downward moves in financial asset prices, over the long term, valuations ultimately determine Investment performance. The S&P 500 index appears essentially priced for perfection, with very little margin of safety or room for predictive error. Assuming a 20 times price-earnings multiple on potential 2022 earnings of $220 for the S&P 500 equates to a price level of 4400, a gain of only +1.1% from its October 12th closing price of 4350.65.

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The following sections contain a discussion of our current thinking about and approach to Portfolio Positioning Strategy, Portfolio Positioning Principles, and Portfolio Positioning Tactics.

PORTFOLIO POSITIONING

Portfolio Positioning Strategies:

In the current slowing yet still relatively robust economic expansion and upwardly-trending inflation and yields environment, we believe that careful thought, planning, and attention needs to be devoted to the investor's most appropriate forms and vehicles for implementing the fundamental elements of Asset Allocation and Investment Strategy, which include:

i. **Diversification:** while it doesn't guarantee a profit or ensure against a loss, diversification means having sustainably low- and negatively-correlated investment exposures that truly counterbalance price movements in other assets, particularly during times of great financial stress and/or market volatility;

ii. **Rebalancing:** which encompasses using concepts of reversion to the mean to trim exposures to assets that have grown to represent too large a portion of the overall portfolio, while at the same time, adding exposure to *high-quality assets* that have fallen out of investor favor and suffered significant, though deemed not permanent, price declines vs. intrinsic value;

iii. **Risk Management:** which involves recognizing when markets have become consumed by meme securities, momentum plays, "story stocks," and information overload — a situation that has pertained in recent experience to more than a few companies in the technology space — and understanding the degree of liquidity, the true pricing realism, and the appropriate roles of short-term liquid securities, real assets, financial assets, and alternative assets in decades-long (or longer) regimes of inflation, stagflation, deflation, monetary disruptions, and currency resets;

iv. **Reinvestment:** which encompasses knowing when to emphasize and trade off income return versus capital growth, all the while keeping in mind the critical importance of discipline, equanimity, patience, tax awareness, and longevity in capturing and compounding dividend, coupon, rental, and other income flows; and

v. **Asset Protection and Husbandry:** which encompass considerations of current and likely future income and capital gains taxation at the state, local, federal, and possibly international level; estate planning; relevant insurance design and structuring; cybersecurity shielding; portfolio monitoring and reporting; administrative costs; forms, frequency, and means of asset access; and asset custody.

Portfolio Positioning Principles:

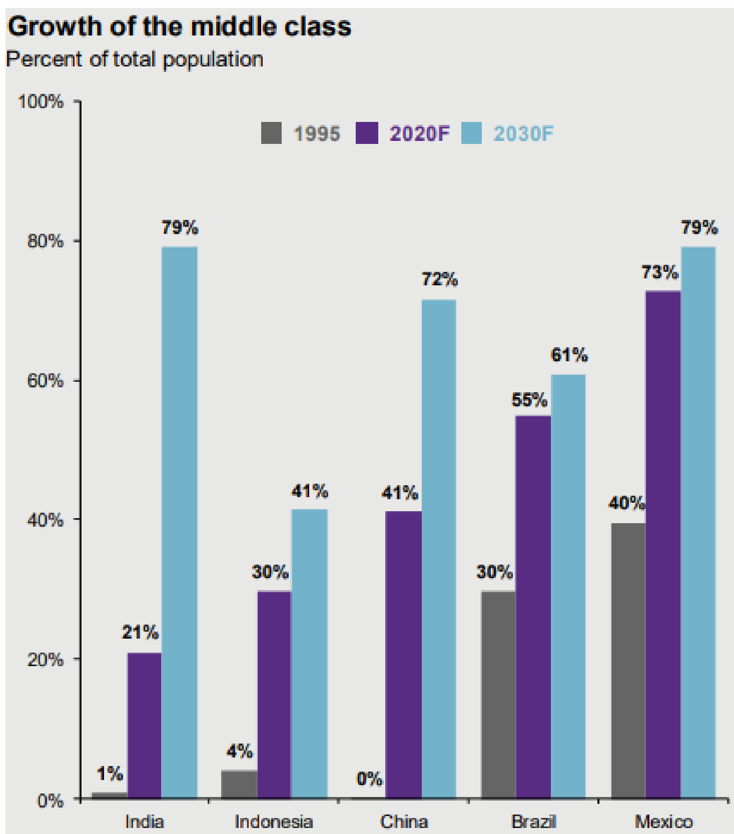
We continue to allocate to a considered and considerable exposure to equities, with judicious shifts between styles, sectors, geographies, and — where appropriate from a cost, timing, tax, liquidity, and size standpoint — public versus private markets. Expressed below are a number of themes that we believe should be taken into consideration over the next few years in selecting asset categories, asset classes, asset managers, sectors, companies, and security types:

i. **Paying Attention to the Value of Money**: Taking advantage of (rather than being taken advantage of by) the likelihood of money printing, internal and external currency debasement, government debt monetization, and the 'Modern Monetary Theory' approach that to some degree in the pandemic-response era has been pursued by the Authorities — within shifting money and credit cycles — to service America's massive *explicit* government and corporate indebtedness and the enormous *implicit* obligations of pension and healthcare promises;

ii. **Concentrating on "All-Weather" Sectors and Companies**: Seeking investments with balance and flexibility, that are able to thrive regardless of: which political persuasion informs the thinking and policies of the White House, Congress, the nation, and the regulatory authorities; evolving Environmental, Social, and Governance (ESG) priorities and values; wealth distribution initiatives and public health conditions; and wider socioeconomic trends;

iii. **Distinguishing Between Temporary and Permanent Change**: Focusing on the commercial and financial implications of new social and political power structures, alliances, and geopolitical relationships; new energy sources and resources; new trade patterns; new on- and offshoring channels; new "WFH" and "WFA" (Work From Home and Work From Anywhere) employment modalities; and new business models, pathways, digitalizations, and forms of person-to-person and business-to-business work, leisure, learning, and wellness activity;

iv. **Taking Advantage of Demographic Tailwinds**: Through U.S. and select non-U.S. companies, gaining exposure to, and meeting the rising needs, aspirations, and not overly ostentatious spending power of, the rapidly expanding global middle class, especially in Asia (Please see the nearby chart for data on the past projected growth of the middle class as a percent of the total inhabitants in five large population countries);



Source: Brookings Institution, J.P. Morgan Asset Management.

v. **Comprehending and Verifying Past Success**: Emphasizing companies and sectors that have demonstrated successful track records and past experience in: competitive preeminence; abundant free cash flow generation; capital allocation; balance sheet strength; risk management; sustainably defendable business models; and the ability to sustain high multiyear returns on equity (derived from revenue growth and favorable margin preservation, rather than through inappropriately high levels of leverage) meaningfully above the companies' and sectors' weighted average cost of capital; and

PORTFOLIO POSITIONING

vi. **Identifying Innovative and Disruptive Technology Hegemons**: Focusing on technology enablers, disrupters, and dominators in biotechnology, diagnostics and therapeutics based on CRISPR (Clustered Regularly Interspaced Short Palindromic Repeats), weight management and wellbeing, public health, medical nutrition, regenerative medicine, artificial intelligence, data analytics, machine learning, 5G cellular network technology, the Internet of Things, infrastructure, robotics, retraining, quantum computing, battery inventions, alternative energy, electric vehicles, and cybersecurity, while not least, also taking account of the Environmental, Social, and Governance (ESG) risks, aspirations, and initiatives of companies in these and other fields.

Portfolio Positioning Tactics:

1. **Keeping Things in Perspective**: Many of the overarching themes and conditions that influence our intermediate- and long-term asset allocation and investment strategy emphasize the need to recognize that the concepts and implementation methods intended to achieve safety, balance, purchasing power protection, diversification, and liquidity are likely to face evolving (and sometimes, rapidly shifting) taxation regimes, regulatory architectures, social priorities, geopolitical power relationships, price level changes, demographic trends, indebtedness levels, technological penetration and usages, and importantly, perceptions of the definition, role, degree of physicality, embodiment, and value of money itself.

2. **Flexibility versus Conviction in Formulating Investment Thinking**: In seeking to determine when to adhere to, and when to lean against, prevailing consensus views (sometimes pejoratively referred to as "groupthink"), it is important to critically question the soundness and durability of the reasoning and assumptions underlying a given investment framework and positioning at any point in time. While it may not make sense to hold out-of-consensus views just for the sake of doing so — often expressed as "fighting the tape," — at other times — especially at major cyclical or secular turning points (at a significant asset top, when reality is finally found to fall *short of prevailing overly optimistic expectations*, or a major asset bottom, when reality is shown to be worth considerably *more than prevailing overly pessimistic expectations*), the rewards of implementing a contrarian stance can be quite meaningful.

3. **Enhancing and Preserving**: While we admit to a continuing degree of unease over this year's manifestations of investor exuberance, and the popularity of certain stocks and sectors considered to be "forever holdings" — our short-term inclination at this juncture is to take note of the Federal Reserve's lessening support of financial asset prices while taking advantage of episodes of strength to continue the course of upgrading positions — offloading lower-quality, higher-risk assets and with timing and price discipline, adding to attractively-priced, higher-quality assets on equity market pullbacks. It is worth keeping in mind that the average year includes three separate -5% or more pullbacks for the S&P 500, with only one transpiring thus far in 2021 (and no -10% correction has taken place thus far since March 2020). With a likely Fed tapering later this year, slowing in China, and view of our expectation of increased volatility in the remainder of 2021, prudence counsels being vigilantly aware of the increasingly narrowing market breadth and taking advantage of such retrenchments before committing significant amounts.

4. **Equity Emphases and De-emphases**: Particularly in the current conditions of rising (even though low, from a historical perspective) U.S. Treasury interest rates, and given the likely focus areas of government spending initiatives, to us it appears likely that cash-generating, financially-stable companies with robust growth prospects, which are able to operate and thrive in the digital sphere as they continue to enhance

their business models, deserve to retain some degree of a valuation premium. Within equities: (i) we suggest continuing to gradually shift emphasis from Growth sectors, companies, and managers towards the inclusion of select Value sectors, companies, and managers (with a focus on financials, industrials, materials, Covid-recovery, reopening, and consumer sectors); (ii) we continue to counsel selectively adding small- and mid-cap companies (or investment managers specializing in and with good track records in this space) to our primary yet gradually lessening emphasis on large-capitalization enterprises; and (iii) for the time being, while we continue to prefer a tactical overweighting to U.S. domestic equities — with any pullbacks currently viewed as an opportunity to judiciously add equities, particularly those sectors and companies likely to benefit from an economic recovery —we also espouse holding (or gradually building) relatively modest allocations to emerging market equities and developed international markets.

5. **Focus on Strength and Quality**: Our long-term equity portfolio weightings continue to emphasize asset managers, sectors, and specific companies that can benefit from the major sustained trends of the 2020-2030 decade, including: (i) incremental growth in a wide range of economic circumstances; (ii) a focus on economic repair, digitalization, e-commerce, personal wellness, safety, domesticity, home improvement, infrastructure spending, and sustainable consumer demand; and (iii) advantageous capture of benefits from onshoring, supply chain redesign, and deglobalization as important drivers of capital spending and disruptive innovation. At the company level in equities, we emphasize identifying and building long-term exposure to firms possessing fortress-like, cash-rich balance sheets, prudence in balance sheet utilization, limited debt, consistency and durability of positive free cash flow generation, dividend strength, and competitive business models with sustainable competitive advantages (high barriers to entry, low threat of substitute products, and viable pricing power vis-à-vis suppliers and/or customers) that over a long time frame can generate high returns on equity (as mentioned above in "Comprehending and Verifying Past Success," through revenue growth and enduring profit margins, rather than through inappropriately high levels of leverage). At the current time, we suggest that consideration be given to top-quality companies in the healthcare, consumer staples, and financial sectors.

6. **Balancing Growth and Value Sectors**: Through Thursday, September 30th, the total return of the Russell 1000 Growth index (including companies in sectors such as technology, healthcare, and communication services) was (according to *The Wall Street Journal*) +14.3% year-to-date, while the total return of the Russell 1000 Value index (including companies in sectors such as financial, real estate, energy, utility, and industrial businesses) was (according to *The Wall Street Journal*) +16.1% year-to-date. This 1.8 percentage point (1.8%) Value minus Growth returns differential appears to argue for some degree of balanced exposure in selected Value sectors, companies, and managers as well as selected Growth sectors, companies, and managers. As this process continues, it is worth keeping in mind that true value investing represents identifying assets that are trading for less than they are actually worth, not assets that are merely inexpensive. Many superficially inexpensive assets may very well be inexpensive for a reason, and can very well remain so or deteriorate further.

7. **Fixed Income Securities**: Bond prices persist at elevated price levels, with ultralow yields across the maturity spectrum; even though yield movements have been modest in the past two months, they have risen somewhat since year-end 2020 (with, according to Bloomberg in mid-July, an extraordinary total of $16.5 trillion, up from $12 trillion in mid-May, in global negative-yielding sovereign — and some corporate — debt outstanding). We prefer issuers at the high-quality end of the rating spectrum, both in taxable investment grade and high-yield bonds and in tax-exempt bonds (where we continue to see

some pockets of value on a taxable equivalent basis). We see fixed income securities as continuing to be subject to price risk due to our expectation of somewhat higher yields in the fourth quarter of 2021, and thus we prefer maturities and durations along the short-to-intermediate portion of the yield curve spectrum.

8. **U.S. Dollar Outlook**: After declining -9.9% in 2017, appreciating +4.4% in 2018, marginally gaining +0.4% in 2019, and declining -3.4% in 2020, the DXY U.S. dollar index measured versus a basket of six major currencies — the euro, Japanese yen, Swedish krona, British pound, Canadian dollar, and Swiss franc — had as of its market close of 94.23 on September 30th, appreciated +4.8% year-to-date in 2021. Over the next few quarters, we believe the U.S. dollar may begin to trace a gradual path of weakness as — due to the likelihood of other major central banks becoming more assertive in their asset-purchase tapering, combined with the magnitude of the U.S. current account payments deficit.

9. **Alternative Investments and Real Assets**: In alternative investments, we continue our multi-quarter focus that has for some time emphasized exposure to: (i) commodities and real-asset sectors of the economy including industrial metals, agriculture, and materials, (ii) gold and/or gold mining ETFs/shares (particularly those miners with reserves in stable geographic locations, capital discipline, and cash flow growth); (iii) high-quality master limited partnerships with strong business models and sustainable dividend-paying capacity; (iv) select investments in private credit and private real estate; (v) and opportunistic strategies that are positioned to selectively derive meaningful value from the dislocations created by the coronavirus pandemic and the economic and profits recovery that we expect in the year ahead.

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