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Mid-Year 2021 Investment Letter by Erik Ridgley, CFA July 15, 2021

We wish all our clients and friends a safe Summer. Below we provide a review of the markets in the 1st half year-to-date (YTD) as of June 30th and our thoughts for the 2nd half of 2021. We work hard on delivering superior long-term after-tax returns for each of our clients per their customized investment policy statements, and we are grateful for the trust and confidence our clients have placed in us.

Asset Class Benchmark Index Returns – Year-to-Date (YTD) as of 6/30/2021 and 2020 and 2019

YTD	2020	2019	Asset Class
YTD: +12.30%	2020: +16.25%	2019: +26.60%	Global Equities: MSCI All Country World Index (ACWI)
YTD: +1.06%	2020: +5.21%	2019: +7.54%	Municipal Bonds: Bloomberg Barclays Muni Bond Index
YTD: +6.68%	2020: +10.73%	2019: +17.07%	50/50 Blend Portfolio: 50% ACWI / 50% Muni Bond
YTD: +15.25%	2020: +18.40%	2019: +31.49%	U.S. Large Cap Equities: S&P 500 Index
YTD: +17.54%	2020: +19.96%	2019: +25.52%	U.S. Small Cap Equities: Russell 2000 Index
YTD: +8.83%	2020: +7.82%	2019: +22.01%	Foreign Developed Equities: MSCI EAFE Index (EAFE)
YTD: +7.45%	2020: +8.31%	2019: +18.42%	Emerging Markets Equities: MSCI Emerging Markets Index
YTD: +21.70%	2020: -7.52%	2019: +24.45%	Real Estate: S&P U.S. REIT Index
YTD: +3.62%	2020: +7.11%	2019: +14.32%	Junk Bonds: U.S. Aggregate Corporate High Yield Index
YTD: -1.60%	2020: +7.51%	2019: +8.72%	U.S. Fixed Income: U.S. Aggregate Bond Index (AGG)

Inflation and The Liquidation of Government Debt

I was a panelist at three different investment industry conferences recently, and the topic which was most heatedly debated was inflation. The relevant formula is nominal interest rates minus inflation equals real interest rates. (Nominal interest rates are what you see on account statements.) Using current actual numbers, if the Fed Funds Rate (nominal) is 0%, and CPI inflation is +5% (rounded), then the real interest rate is -5%. Even if today's inflation is "transitory" and falls back to the Fed's target of +2%, real interest rates would still be -2%. Why might the Fed be OK with this? *The Liquidation of Government Debt*, an academic research paper by Carmen Reinhart, World Bank chief economist and Harvard professor of international finance, provides a plausible answer: "A subtle type of debt restructuring takes the form of 'financial repression'…Low nominal interest rates help reduce debt servicing costs while a high incidence of negative real interest rates liquidates or erodes the real value of government debt. Thus, financial repression is most successful in liquidating debts when accompanied by a steady dose of inflation. Inflation need not take market participants entirely by surprise and, in effect, it need not be very high (by historic standards). For the advanced economies in our sample, real interest rates were negative roughly ½ of the time during 1945-1980. For the United States and the United Kingdom our estimates of the annual liquidation of debt via negative real interest rates amounted on average from 3 to 4 percent of GDP a year."

The U.S. government is over-indebted. The situation is manageable, but there are consequences, the most important of which is slower long-term growth. It is reasonable to compare the financial burdens of the pandemic response to those of World War Two (WWII), which left the U.S. with similarly high ratios of debt to GDP. The CARES Act was signed into law on March 27th of 2020, after 96-0 Senate approval,

which authorized financial relief checks to be deposited directly into checking accounts of tax filers, and as a result, individual personal incomes were higher in 2020 than 2019, which has never happened before during a recession. While too much debt is dis-inflationary over the long-term, an increase in the deficit can provide a brief economic acceleration. The CARES Act was entirely deficit financed, so the debt incurred must be repaid, which means that demand has been pulled from the future into the present.

How Transitory Are the Recent Spikes in Inflation?

Significant and lasting inflation results from demand for goods and services meaningfully exceeding supply, leading to undesirably high price increases year after year after year. So far, the three latest monthly CPI reports were above 4%, 5%, and 5%, respectively, and each report was comparing to prior year monthly CPI reports of less than 1%. "Transitory" will probably end up meaning another six to nine months of high monthly CPI reports, after which time economic growth will have slowed down and monthly CPI reports will be comparing against high prior year numbers. The Fed has proven tools to defeat inflation, which unfortunately are to raise interest rates until it causes a recession (or preferably a "soft landing"), so investors are hoping that "transitory" inflation does not turn into "lasting" inflation.

How Did the Fed Grow its Balance Sheet to $8.1 Trillion?

The Financial Services Regulatory Relief Act of 2006 authorized the Federal Reserve Banks to pay interest on balances held by or on behalf of depository institutions at Reserve Banks, subject to regulations of the Board of Governors, effective October 1, 2011, and then The Emergency Economic Stabilization Act of 2008 accelerated the effective date to October 1, 2008. This legislation massively transformed the powers of the Fed in the early days of the 2008 Great Financial Crisis (GFC), and it explains how the Fed can purchase and hold $8.1 trillion of assets on their balance sheet while keeping the Fed Funds Rate at 0.00%-0.25%. Prior to Oct 1, 2008, the Fed's balance sheet was quite small in comparison to today. Far more importantly, prior to Oct 1, 2008, Fed balance sheet expansion directly caused the Fed Funds Rate to decline (potentially uncontrollably to well below zero), and vice versa (i.e., Fed balance sheet contraction directly caused Fed Funds Rate to increase). For example, Atlanta Fed researchers publish the Wu-Xia Shadow Federal Funds Rate, which estimates what the Fed Funds Rate would be without this legislation, and the current estimate is -1.83%. Although the mechanics are too involved for a complete discussion here, this legislation gave the Fed the authority to pay interest on reserves (IOR) to commercial banks that park deposits (risk-free) at the Federal Reserve Banks, which enables the Fed to expand or contract its balance sheet without directly causing the Fed Funds Rate to decline or increase, respectively. This legislation literally re-wrote the rules for central banking in the United States, and the rest is history.

How Can the Fed Print New Money Without Causing Inflation?

The economic term for this is "sterilization," which refers to Fed policies that cause newly injected money to be set aside as a store of value (non-inflationary), rather than circulate as a medium of exchange (inflationary). One can think of IOR as a policy where the Fed pays banks to hold the new money being injected into the economy, rather than have it move out into circulation. Prior to 2008, new injections of money quickly found their way into circulation. That's because banks could earn a positive interest rate on safe assets such as T-bills, but the Fed paid no interest at all on bank reserves. Thus, banks got rid of excess reserves (beyond their legally required reserves) as quickly as possible, like a hot potato. Once the Fed began paying IOR at a rate slightly higher than T-bill yields, however, it became much more attractive

for banks to hold excess reserves. The policy of IOR is a way of sterilizing all the new money that is being injected into the economy for the purpose of rescuing the banking system. [Endnote 1.]

Before the Pandemic, The Fed Raised its Inflation Target to Drive Lower Unemployment Rates

The Fed raised its inflation target in 2019. Inflation has remained below the Fed's *old* target of +2.0% (a ceiling) for many years, and the Fed has announced it is willing to allow inflation to rise above its *new* target level of +2.0% (on average) "for a sustained period" before feeling compelled to react with additional rate hikes. This new inflation target will lead to moderately higher inflation over the long-term.

Fed leadership now believes that highly flexible U.S. labor markets in an open global economy facing rapid technological innovations can run at much lower unemployment rates than were previously thought possible without triggering higher CPI inflation. This is a powerful insight (and mindset) that could have profoundly positive long-term impacts on U.S. productivity, U.S. GDP growth, and federal deficits (and the well-being of American society.) Fed Chair Jay Powell and Treasury Secretary Janet Yellen have explicitly adopted this mindset, which might become their legacy at the Federal Reserve Bank system.

Lessons Learned by Policy Makers During the Pandemic

Although this pandemic-induced recession and subsequent recovery feels unprecedented, the dynamics we are seeing in financial markets have many important parallels to those of prior recessions and recoveries. The Fed response to the market instabilities, disinflationary forces, and job losses brought about by the very severe economic recession and bear market of 2020 was to roll out the same liquidity programs used by the Fed in 2008-2009, including extraordinary asset purchase programs (APP) and aggressive quantitative easing (QE). However, this time the response was much bigger and faster, and central banks in Europe, Japan, and elsewhere reacted similarly. It worked in 2008, and it worked even better in 2020. As such, it is likely this will be the preferred Fed playbook for dealing with future severe recessions.

Based upon ample empirical evidence since 2008 that the central banks in Japan, Europe and U.S. have been unable to raise inflation up to their preferred targets, the Fed has become more concerned with fighting disinflation than inflation. Simply put, central banks have shown they can defeat inflation, but they have not solved disinflation, so now disinflation is the more dangerous foe.

Monetary policies and fiscal stimulus implemented by central banks and credible governments with the power to print money and/or borrow seemingly unlimited amounts of money can significantly raise price levels of assets across global markets. This "wealth effect" on asset prices is important to both borrowers and lenders because it props up collateral values and thus supports the viability of loans of all types.

Future U.S. Treasury Secretaries should have significant financial crisis management credentials and deep technical understanding of central banking fundamentals and financial system plumbing, in addition to their other qualifications. Treasury Secretary Janet Yellen, who was Chair of the Federal Reserve, is a precedent setting example of this.

Review of 1st Half of 2021: 1st Qtr Earnings +48.3% and 2nd Qtr Earnings +60.5%...Enough Said!

The S&P 500 index of stocks rallied 15.25% in the 1st half of 2021, including dividends, from 3,756 to 4,298. 10-year Treasury yields rose from 0.91% to 1.47%, after peaking at 1.74% on March 31st. West Texas Intermediate (WTI) crude oil prices per barrel increased from $48 to $73. The US dollar currency index strengthened from 89.94 to 92.44. U.S. unemployment rates improved from 6.8% to 5.9%. 5-yr breakeven inflation rates increased from 1.95% to 2.46%, after peaking at 2.72% on May 12th.

U.S. economic recovery re-accelerated in the 1st half of 2021, as new daily Covid-19 cases, hospitalizations, and deaths declined from pandemic highs (new daily U.S. deaths peaked on Jan 17, 2021). The U.S. economy (real GDP, QoQ% SAAR) grew +6.4% in 1Q21 and +9.2% in 2Q21, after decelerating from +33.4% in 3Q20 to +4.3% in 4Q20.

Outlook for Markets in 2nd Half of 2021: Growth Decelerating Towards a "Normal" Year in 2023

Earnings growth is peaking, but earnings are not peaking. U.S. GDP growth is peaking, but U.S. GPD is not peaking. CPI inflation rates are peaking, but consumer prices are not peaking. All three of these metrics will be correlated as the U.S. economy decelerates along a glide path to a normal 2023, if the Fed can successfully navigate through the cacophony of data and market fluctuations.

Consensus estimates for S&P 500 EPS growth are +37.8% in 2021 (up from +24.4% in Feb), and +11.7% in 2022, per I/B/E/S data by Refinitiv. 2021 EPS estimates are now +18.6% higher than 2019 EPS actuals. Year-over-year EPS actuals were +48.3% in 1Q21, and estimates are +60.5% in 2Q21, +22.9% in 3Q21, and +16.6% in 4Q21. Year-over-year EPS actuals were -15.4% in 1Q20, -32.3% in 2Q20, -8.2% in 3Q20, -4.6% in 4Q20, and -13.9% for FY2020.

S&P 500 revenues per share are forecasted to grow +8.7% in 2021 and +6.7% in 2022, after falling -2.8% in 2020. Net profit margins are projected to expand to 12.6% in 2021 and 13.2% in 2022, after declining from 11.5% in 2019 to 10.2% in 2020, per I/B/E/S data by Refinitiv.

The highly respected UCLA Anderson Economic Forecast predicted in June that U.S. real GDP will grow by +7.1% in 2021, and +5.0% in 2022, and +2.2% in 2023. Wall Street's full year consensus forecast for 2021 U.S. real GDP is +6.6% (up from +3.9% in Feb) in 2021, +4.1% in 2022, and +2.4% in 2023. Europe's economy is forecasted to grow +4.6% (up from +3.9% in Feb) in 2021, and +4.7% (up from +4.2% in Feb) in 2022 (per ECB), vs. its trend rate of +1% growth, and Japan's economy is forecasted to grow +5.0% (up from +4.1% in Feb) in 2021, and +2.6% (up from +1.7% in Feb) in 2022 (per JCER), vs. its trend rate of +0.5% growth, after declining -5.6% in 2020.

Price/earnings (P/E) multiples are 22.0, 15.8, and 13.6 for U.S., foreign developed, and emerging markets, respectively, where E is EPS on next four quarters (NFQ), per Bloomberg consensus. The long-term average for U.S. NFQ P/E multiples is 15 ½. Thus, U.S. equity valuations are 42% above average, which in our view is the primary risk to stock markets, although most researchers would say that the lower interest rates we have today (and those forecasted for the future) should allow for higher P/E multiples, all else being equal. The counter argument to this would be that lower U.S. Treasury bond yields are signaling lower future GDP growth, which should dampen future EPS growth, but this would be less valid under "financial repression" conditions (see p. 1). Given the enormous fiscal stimulus being proposed by

the Biden administration (i.e., almost 9% of US GDP), it is plausible that 2021 EPS could end up being almost 20% higher than estimates from the start of the year.

The yield curve is currently pricing in the Fed Funds Rate to remain at 0% to 0.25% for one year, and 10-year Treasury yields of 1.50% at year-end 2021 (per Bloomberg FWCM). More importantly, the yield curve is priced for 10-year Treasury yields to remain below 2.60% for at least the next 15 years. The Treasury yield curve represents the "real money" pricing of many trillions of dollars of U.S. Treasury securities across maturities from 7 days to 30 years, based on bond investors' expectations for the future, which is why it commands the respect of equity investors and the Fed. Of course, the yield curve always reserves the right to change its mind.

The yield curve is steep, with 10-year Treasury yields higher than 2-year Treasury yields by 113 basis points (bps), which is a reliable leading indicator of future economic growth. However, 10's to 2's steepness peaked at 155 bps near the end of the 1st quarter.

High yield bond spreads (over Treasuries) peaked at 1100 bps (or 11%) in March 2020, and settled down to 235 bps since then (down from 334 bps in Feb), indicating that credit markets have priced in a full recovery to better than pre-pandemic levels.

Repeatable Processes: Portfolio Rebalancing, Tax Loss Harvesting, and Tax Deferral

Portfolio rebalancing is a useful tool for long-term investors because it serves two important purposes. First and foremost, it keeps asset allocations in line with targets that have been codified in clients' investment policy statements (IPS). Second, it can be a mechanism to naturally "buy low, sell high", because it involves adding to an asset class that has decreased in price (e.g., >10%) relative to the overall portfolio, and cutting back an asset class that has increased in price relative to the overall portfolio. Good judgment, disciplined decision-making, and operational excellence are necessary to obtain the best results for every client from portfolio rebalancing.

Another proven methodology for long-term investors to take advantage of market volatility is tax loss harvesting. Unlike tax loss selling, tax loss harvesting precludes adverse impacts to investment returns, by simultaneously replacing the sold securities with very similar securities, while avoiding IRS wash sale rule violations. We actively implement tax loss harvesting throughout the year whenever material market declines create opportunities.

Tax losses provide economic value because they can be used to offset capital gains tax, and unused tax losses can be carried forward into future years until they are fully used. The maximum federal tax rate on short-term capital gains is 40.8%, including the 3.8% net investment income tax, and for Californians the maximum combined state and federal tax rate is 54.1%. Although no one likes down markets, tax loss harvesting can effectively reduce negative returns by up to 54.1%, without sacrificing full participation in the inevitable market recovery for long-term investors.

Tax deferral strategies involve delay or even avoidance of realization of capital gains through judicious planning and portfolio management. Unrealized capital gains can be permanently eliminated over time with prudent trust & estate planning, via step up in cost basis when wealth transfers from one generation to the next.

Long-Term Investing

To paraphrase Warren Buffett, successful investors need to invest for the long-term and avoid being swayed by the fear and greed of others that can cause irrational swings in the market. We do not let the daily noise and volatility of the markets deter us from our mission to be faithful stewards of our clients' capital. As long-term investors, we and our clients have committed ourselves to adhere to well-defined investment policy statements, which have been custom-built for each individual client, in order to achieve their long-term investment objectives, while accepting the inevitable price fluctuations of the public markets.

As fiduciaries, we relentlessly seek out the lowest costs and best terms for our clients. As trusted advisors, long-term relationships are of primary importance to helping our clients achieve successful outcomes through personalized planning and disciplined implementation.

Risk Management

Asset allocations should be based on well-designed investment policy statements to enable investors to get through bear markets without selling equities, by using fixed income or cash to draw upon until stock markets have recovered, which is common sense short-term risk management. However, comprehensive risk management should also account for the long-term shortfall risk of not achieving long-term portfolio growth objectives due to sub-optimal asset allocations and portfolio construction. Along the way, contingency risks (i.e., low probability and high impact) need to be efficiently managed with various tools including adequate liquidity, appropriate insurance protection (note: we do not sell insurance), coordination with clients' trusts & estate attorneys, and proactive tax planning with clients and their CPAs.

Conclusions

We are optimistic that developed global economies will grow at historically high rates in 2021 and 2022 due to vaccines/re-openings and fiscal stimulus, and open-minded to the case that this will lead to actual EPS continuing to significantly beat estimated EPS throughout 2021, thus driving up EPS estimates for 2022. Equity P/E multiples often look over-valued when earnings estimates are too low and will be revised upwards. However, we are concerned about much higher-than-average U.S. P/E multiples (helpfully, foreign developed and emerging markets P/E multiples are not as significantly elevated) and recently bursting bubbles in some areas of the markets (cryptos, SPACs, unprofitable & very high price-to-sales firms).

Markets already seem to be transitioning from the early-stage to the mid-stage of the business cycle, even though global economies and stock markets are only in their second year of their recoveries from a very severe recession and the steepest bear market >30% since 1929. In our investment committee meetings, I have hypothesized that 2013 (the year of the "taper tantrum") would be the best historical precedent for 2021 (i.e., in narrative and market direction more so than magnitude). Back in 2013, Fed Chair Ben Bernanke broached the topic of tapering down bond purchases by the Fed, which triggered 130 bps of increases in 10-year Treasury yields over less than four months, from 1.7% to 3.0%. For what it's worth, the S&P 500 index total return in 2013 was +32.39%, although at least five market sell-offs occurred as the stock market had to climb the proverbial "wall of worry." In both 2013 and 2021, the markets were reacting to faster than expected economic growth.

One of the impediments to much higher Treasury yields is that most institutional fixed income investment managers think that the next recession will bring about another round-trip back down to 0% Fed Funds Rate and lower than 1% 10-year Treasury yields. Fortunately, we do not see evidence of the next recession any time soon. However, we do see the possibility of a scenario where delta variants of coronavirus slow down the re-openings around the world, which would have the effect of extending the length of "lower for longer" interest rates policies.

We wish all of you a healthy and safe Summer. Please let us know if you have any questions. Thanks!

Best Regards, Erik

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Selected to Los Angeles Business Journal's List of Leaders of Influence: Wealth Managers in 2021, 2020 & 2019

Endnote 1: *Should the Fed Pay Interest on Bank Reserves?*, September 2019, by Scott Sumner, PhD, Ralph G. Hawtrey Chair of Monetary Policy at the Mercatus Center at George Mason University

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