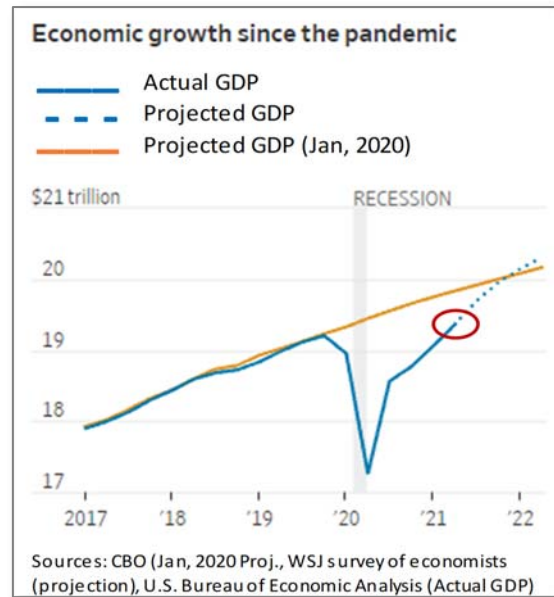


From: Aequitas Investment Advisors

Re: **Economic Headwinds and Tailwinds**

Wagner
Spencer *(pm)*

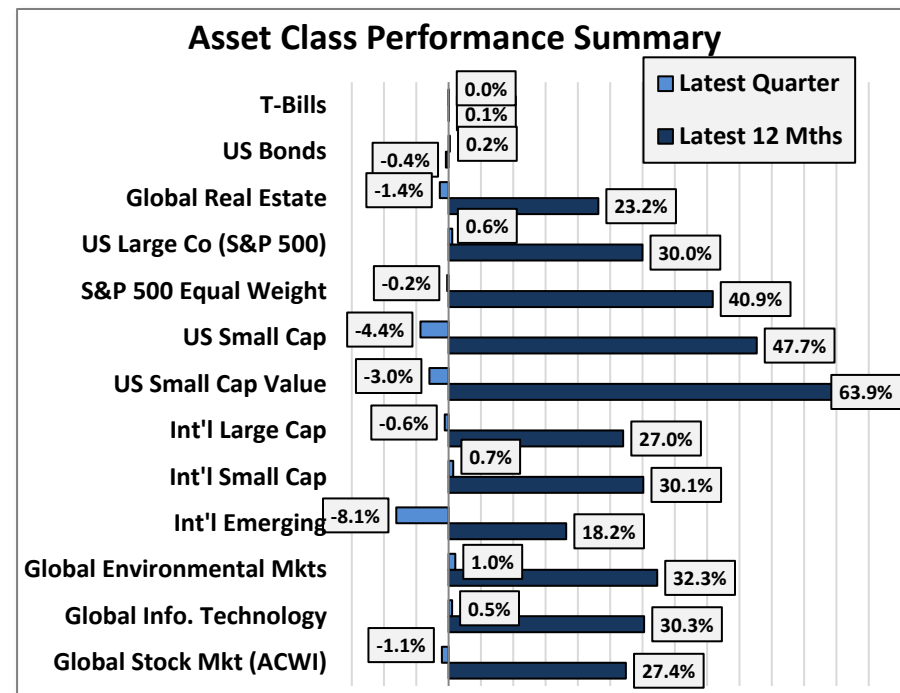
Over the past eighteen months, we have experienced one of the fastest economic recoveries in history due largely to massive monetary and fiscal support and the rapid development of vaccines. The U.S. economy, as measured by Gross Domestic Product (GDP), is expected to fully recover back to the pre-pandemic growth trendline in 2022 (note the dotted blue line in the graph below). The pace of the recovery, however, slowed in the third quarter primarily as a result of supply chain bottlenecks and the spike in COVID-19 cases over the summer months. While there is good reason to feel optimistic about the fight against the pandemic, these bottlenecks may take another twelve months to be resolved and we will have to live with elevated prices and shortages of some goods for the time being. This leads us to the topic of higher inflation which has spiked to the highest level in more than fourteen years and is forcing the Federal Reserve to carefully balance its dual mandate of achieving full employment (we're not there yet) and keeping prices stable (obviously not there either). We will discuss the Fed's balancing act and potential repercussions further on in this letter. First, however, we'll review the favorable performance of the various asset classes over the past twelve months which have benefited from the tailwinds of low interest rates, fiscal and monetary support from the government and continued progress against the pandemic.



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Asset Class Performance Review

Over the trailing twelve months ended September 30th, the impact of the economy's reopening around the globe is clearly seen with all of the major stock asset classes posting remarkable gains ranging from 18.2% to 63.9%. The all-encompassing Global Stock Market advanced by 27.4%. U.S. Small Cap stocks posted the strongest gains with U.S. Small Cap Value stocks leading the way (+63.9%). U.S. Bonds and T-Bills were essentially flat.



For the latest calendar quarter, there were more negative returns than positive with the Global Stock Market retreating by 1.1% (the aforementioned third quarter economic slowdown was the primary catalyst for the stock market pullback). Emerging Markets stocks (-8.1%) suffered the most due primarily to rising uncertainties about China which is the world's second largest economy (for greater insight on developments in China, please visit the research page of MatthewsAsia.com). In the other stock asset classes, the returns ranged from -4.4% (U.S. Small Cap stocks) to +1.0% (Global Environmental Markets). T-Bills

eked out a small gain for the quarter (+0.1%) while U.S. Bonds declined by 0.4%. One might view the results of the third quarter as either a pause for the stock market or, perhaps, the beginning of a long-awaited correction. (As of this writing, the Global Stock Market is up close to 5% for the month of October.)

A Few Words on Small Cap Value Stocks

Given their remarkable rebound over the past twelve months (+63.9%), we thought it appropriate to comment on the U.S. Small Cap Value asset class which has been an important component in our recommended portfolio structure since our founding in 1991. As its name implies, this asset class encompasses stocks of smaller U.S. companies which are trading at less expensive valuations relative to their earnings and growth potential. The long-term performance results for this asset class have been impressive; since 1991, the representative Dimensional Small Cap Value Index has posted an annualized return of 15.4% compared to 11.1% for the S&P 500 Index (i.e., U.S. Large Cap stocks). One dollar invested in these two indices beginning in 1991 would have grown to \$7,988 today for the Small Value Index compared to just \$2,466 for the S&P 500 Index. On the other hand, the last ten years have been less favorable for Small Cap Value stocks, but they nonetheless generated a very healthy average annual gain of 13.5% since 2011 versus 16.3% for the S&P 500. Of course, Small Cap stocks entail more risk from a volatility standpoint, but history has demonstrated that over the long run, investors have been rewarded with higher returns.

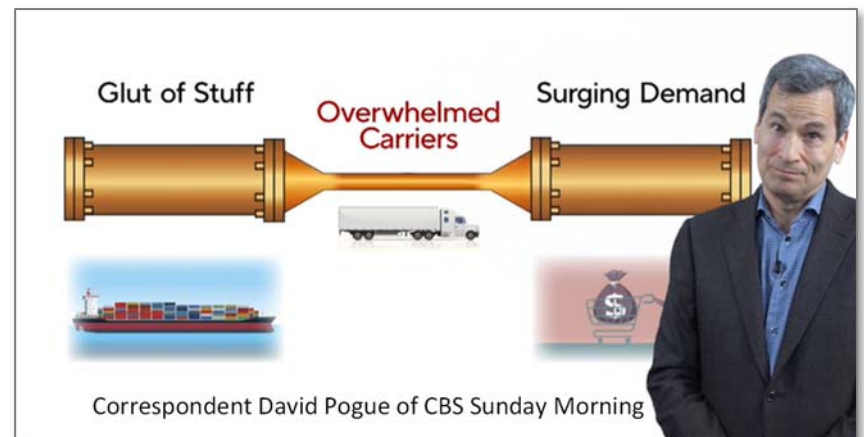
Examples of Small Cap Value Companies

Company	Business	# of Trailing 12 Mth	
		Employees	Stock Return
First Horizon Corp	Founded in 1864, the largest bank in Tennessee and the 4th largest regional bank in the Southeast	5,600	+79%
Advance Auto Parts	Automotive aftermarket parts provider serving both professional installer and do-it-yourself (DIY) customers	66,000	+38%
First Solar	Manufacturer of solar panels and provider of photovoltaic power solutions	6,400	+44%
Arrow Electronics	Fortune 500 company specializing in electronic components, including developing semi-autonomous mobility (SAM) solutions for disabled individuals	19,000	+43%
Athene Holding Ltd	The company issues, reinsures and acquires retirement savings products (focused on annuities)	1,350	+102%

What are some examples of Small Cap Value companies? We certainly know the names of the largest companies in the S&P 500 Index, including Apple, Microsoft, Amazon, Facebook and Google, but few can recite the largest companies in the Small Cap Value Index. The table to the bottom left of the page is a sampling of some the largest holdings in the DFA US Sustainability Targeted Value fund which is an important component of our model portfolio (the fund invests in more than 1,100 small companies which are trading at relatively low valuations). In this list, one can find a regional bank, a national auto parts company, a solar panel manufacturer, an electronics component distributor, and a retirement services company (these five companies have a combined workforce more than 81,000). Small and mid-sized companies represent the economic backbone of the economy given that they employ *more than 80% of the entire U.S. workforce*. While it's understandable why investors are more focused on the largest publicly traded companies in the stock market, the success and financial health of smaller companies probably has a far greater impact on the U.S. economy.

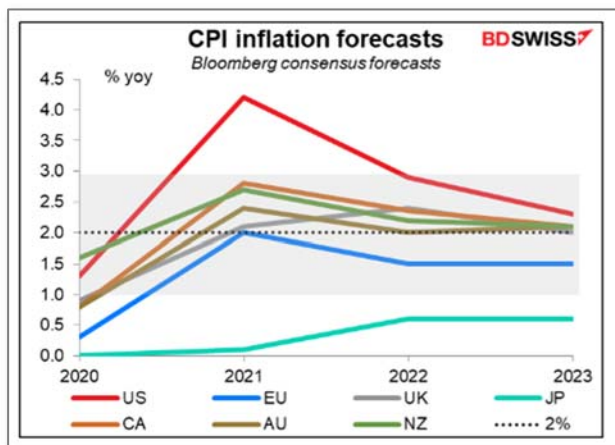
The Supply Chain Headwind

The economic slowdown in the third quarter of 2021 has been attributed to both the spike in COVID-19 cases over the summer as well as supply chain bottlenecks. The chart below illustrates the problem. We have a “glut of stuff” inside containers aboard ships, or piled up in ports, as well as a surging consumer demand for those products. One major constraint is that we have too few dock workers and too few truck drivers (and trucks) to deliver the goods to consumers and businesses. This logistical nightmare contributes to inflationary pressures given greater demand for limited supplies. Recently, Fed Chair Jay Powell bemoaned the fact that “transitory” inflation was lasting longer than originally



anticipated due mostly to supply chain constraints. Unfortunately, the supply chain bottlenecks cannot be fixed quickly, although the constraints may gradually recede over the next twelve months, or so.

The Inflation Headwind

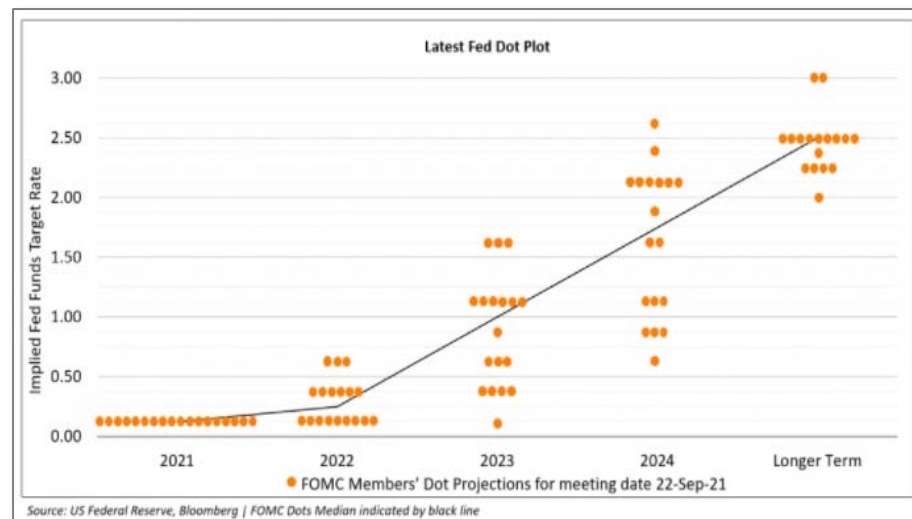


As mentioned previously, the Federal Reserve has a dual mandate: (1) to implement monetary policies to achieve “maximum sustainable employment” which the Fed currently defines as an unemployment rate of less than 4%; and (2) to implement policies to keep prices stable which the Fed currently defines as an inflation rate of 2% (i.e., their long-term inflation target). The Fed appears to have been caught off guard when the year-over-year U.S. inflation rate recently spiked to 4.3% representing the highest rate in more than fourteen years. Fed Chair Jerome Powell concedes higher inflation may persist for a while until supply chain bottlenecks recede, but the Fed is standing by its view that the inflation rate will eventually revert toward its 2% long-term target. According to a poll of economists conducted by Bloomberg (the chart above), most agree with the Fed’s longer-term forecast, although it’s interesting to note that inflation appears to be running much “hotter” in the U.S. than abroad.

The Fading Tailwind of Low Interest Rates

The strongest economic tailwinds we’ve benefited from since the depths of the pandemic recession have been both the monetary policies implemented by the Federal Reserve and fiscal policies enacted by the federal government. Most economists have concluded that without these programs, the recession would have been far more severe than we experienced. Given that the employment picture is headed in a positive direction (the unemployment rate is now 4.8% compared to 15% at the depths of the pandemic recession), the Federal Reserve recently announced that it will begin “tapering” its bond purchase program which would have the likely effect of putting upward pressure on intermediate- and longer-term interest rates, including home mortgages (for those considering

refinancing or buying a home, now might be a good time). Beyond ending its bond purchasing program, the Fed has also announced it may begin raising short-term interest rates as early as the end of 2022. In the chart below, the orange dots indicate the “predictions” of future interest rates by each of the eighteen individual policy committee members of the Federal Reserve Board. The dots relate to the Federal Funds Rate, or the interest rate at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed Funds Rate has a direct impact on the prime interest rate which impacts consumer borrowing rates, credit card rates, adjustable-rate mortgages, as well as the yields investors can earn on money market funds, savings accounts, CD’s, short-term bonds, etc. As can clearly be seen in the Dot Plot, the consensus is that rates will gradually rise from their current near-zero level to about 2.5% over the next 4-5 years (the Fed Funds Rate stood at 2.4% in April of 2019 before plummeting to near-zero in March of 2020). For investors in cash and short-term instruments, a return to higher yields would be most welcome!



The Potential Tailwind from Consumer Demand

The Federal Reserve’s rationale in tapering its bond purchases and gradually raising interest rates is due to their assessment that the economy will eventually be strong enough to stand on its own without significant monetary support and it can then shift its attention toward keeping prices stable. Although there are about 5 million fewer jobs today than immediately prior to the pandemic, there are also more than 10 million job openings. The Fed expects that most of the job openings will be filled by the end of 2022, and that the consumer will be able to carry the load in order to sustain economic growth (think of this as the Fed passing the

baton to the consumer).

An interesting article recently published in the [Harvard Business Review](#) (“The U.S. Economic Recovery is Slowing Down. Don’t Be Alarmed.”) outlined several factors which support the argument that consumers can pick up where the Fed leaves off in terms of driving the economy. The following are four factors:

- Households and companies have adapted and learned to live with the virus, including the Delta variant. Even states which were hit hard by the Delta variant, such as Florida, there was no sharp decline in economic activity.
- The labor market is “booming”, and households are now in a stronger position to replace fading government stimulus with job growth and higher wages.
- The current elevated rate of inflation is likely transitory and wage and productivity gains remain strong.
- Consumers have accumulated high levels of cash providing ample capacity to bolster the economic growth.

According to the authors, “If the hand-off to consumers is successful, we project year-over-year growth will slow from as high as 7% in 2021 to perhaps 2.9% in 2022. What looks like a brutal deceleration, however, is in fact necessary. (The economy should not overheat too much.) Plus, the projected 2.9% would leave the U.S. economy still operating comfortably above its trend growth of around 2%.....”

Other Headwinds We’re Continuing to Monitor

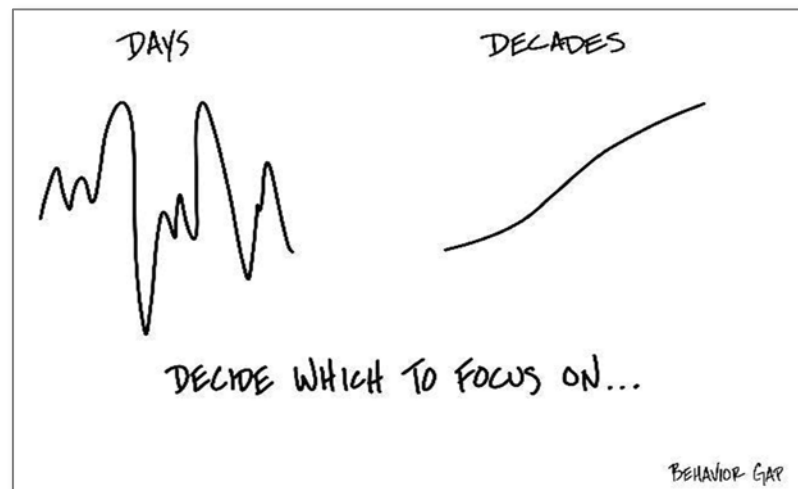
High Stock Valuations: In our previous quarterly letter, we discussed the precarious state of the U.S. stock market which some argue may be due for a correction, especially for Growth Stocks where valuations are significantly higher than their historic averages (of note, valuations have improved somewhat due to September’s selloff and improving corporate earnings). Low interest rates have been a tailwind for the stock market up to this point, but as interest rates begin to rise, downward pressure may build on stock prices which is why we favor areas in the stock market where valuations appear more attractive, including U.S. Value stocks and non-U.S. asset classes. For example, foreign stocks are currently trading for about 30% less than U.S. stocks based upon a comparison of Price-to-Earnings Ratios (as of September 30th, the U.S. stock market was trading at a P/E Ratio of 20.9x compared to 14.3x for non-U.S. stocks). This is more than double the average discount over the past 20 years.

Developments in China: We have been engaged in discussions with experts on Asia regarding China’s abrupt regulatory clamp down and their real estate development bubble. While we remain optimistic about investment opportunities in the Asia Pacific region and the Emerging Markets in general, we recently adjusted our model portfolio targets to effectively reduce the allocation to China down to about 5% of the total allocation to equities. We will continue to monitor future developments.

Tax Legislation: Shortly, we will be emailing clients with an outline of some of the potential changes to the tax code being considered in Washington. While the details are uncertain at this time, we’re reminded of Benjamin Franklin’s words, “nothing is certain except death and taxes.”

We Can Decide What to Focus On

We thought the following illustration and commentary on the next page from sketch artist and fellow financial planner Carl Richards would be an appropriate closing to this quarterly letter. We’ve included sketches from Carl in past letters and you may have seen some of his previous work in the “Sketch Guy” column in the “Your Money” section of the *New York Times*. Carl’s message reinforces our firm belief that having a sound financial plan, making appropriate adjustments to the plan as circumstances change, and maintaining a focus on the long term are the best ways to deal with short-term distractions and achieve long-term financial success. We look forward to continuing our work together into the future!



Greetings, Carl Richards here.

What I'm about to tell you is going to sound crazy... but bear with me because it's definitely true.

Ready? Here it is...

We get to decide what we focus on.

Hold on... let me repeat that in case you missed it:

We. Get. To. Decide. What. We. Focus. On.

When it comes to investing, that means you have a choice.

1- You can tune in to the financial pornography network, go through endless cycles of "buy buy, sell sell," obsess over the latest IPO, and deal with the apocalypse du jour while cycling through all the emotions that come with it.

OR...

2- You can focus on what actually matters when it comes to investing. And that's time. A very long time: decades.

If you choose to focus on days, you are signing up to make yourself miserable. And for no good reason. There's actually no benefit to that. I can handle pain that leads to gain, but this is just pain that leads to more pain.

On the other hand, when it comes to investing, we actually get rewarded for ignoring the daily noise. As Morgan Housel says in his book *The Psychology of Money*, "Warren Buffett is a phenomenal investor. But you miss a key point if you attach all of his success to investing acumen... His skill is investing, but his secret is time."

And you know what Buffett said?

"Benign neglect, bordering on sloth, remains the hallmark of our investment process."

Does that sound like the type of guy who is constantly refreshing CNBC?

Remember, you actually have a choice. Days or decades. What's it going to be?



Carl Richards is a Certified Financial Planner™ and creator of the Sketch Guy column, appearing weekly in The New York Times since 2010. Carl has also been featured on Marketplace Money, Oprah.com, and Forbes.com. In addition, Carl has become a frequent keynote speaker at financial planning conferences and visual learning events around the world.