

3Q2021 Market Commentary

Adjusting to a Rapidly Changing Economy



As we emerge from what was an explosive V-shaped recovery, we are faced with new complexities in navigating this rapidly changing economy. Though the ongoing supply chain debacle, global energy crisis, and accelerated inflation threaten the investing environment, we do believe that the economic expansion will continue. The challenge for investors is to find value, be patient, and to set expectations for growth to be somewhat turbulent—uneven and volatile. There are unique investment opportunities available, we just need to look harder to find them. So let's unpack what happened in 3Q 2021 and our strategy to move forward into the fourth quarter.

While global equities shrugged off growing concerns for most of 3Q21, the seasonally weak month of September proved challenging for investors. Interest rates began rising to reflect the inflation threat and the Federal Reserve's eventual end to nontraditional monetary policy (i.e., tapering quantitative easing). As a result, most U.S. indices posted their worst one month decline since the depths of the pandemic (March 2020) and select emerging market regions slipped into contraction territory (a drop more than 10%). Commodities left the quarter unscathed as supply concerns collided with pent-up demand, pushing the Bloomberg Commodity Index to nearly a seven-year high.

After the euphoria-driven economic rebound out of the pandemic, in 3Q21 Americans began feeling the painful ramifications of actions taken to avert a global depression. The money supply in the U.S. is approaching 100% of nominal GDP. Inflation has emerged with core consumer prices (PCE core year-over-year) growing at the fastest pace since the early 1990s. The global

supply chain is in disarray as rolling lockdowns, container scarcities and labor shortages have clogged U.S. ports. Manufacturers are reporting that delivery times for parts are the worst seen since the 1970s. Even consumer confidence started to fade in 3Q21 as Americans absorbed higher prices on everyday essentials like food and energy

U.S. Economy – Assessing the Risks to the Economic Expansion

Many of the supportive factors that helped the U.S. recoup the economic growth lost in the pandemic remain intact. Despite the expected gradual removal of emergency measures, the Federal Reserve remains highly

accommodative with the real fed funds rate likely to remain in negative territory through at least 2023. **(Chart 1).** The American consumer is still spending despite the rising cost of living. Consumer spending on

Chart 1

Fed Support to Slow, Not Disappear for Some Time

Estimates are using Bloomberg estimates as of October 5, 2021, using PCE Core (YoY). Estimates go out to 1Q23.

Data Source: Bloomberg Finance LP, Verdense Capital Advisors.



discretionary items (e.g., electronics, furniture, restaurants) is growing at a double-digit pace over last year's pent up demand surge. **(Chart 2)**. Manufacturing is expanding at a robust pace as companies feverishly work to replenish depleted inventories. The U.S. economy has recovered 17 million of the 22 million jobs lost during the pandemic, while the most recent wave of COVID cases is rolling over. Lastly, capex spending is accelerating globally as businesses try to address product shortages. **(Chart 3)**. All these factors should keep the economic expansion advancing but we would be complacent if we did not address the headwinds that the economy will face in 4Q and into 2022.

Chart 2

Discretionary Spending Still Solid

Discretionary spending includes spending on autos, furniture, electronics, sporting goods, general merchandise, department stores, internet shopping and restaurants. All categories in the monthly retail sales report. Data is as of August 2021. Data Source: Bloomberg Finance LP, Verdense Capital Advisors.

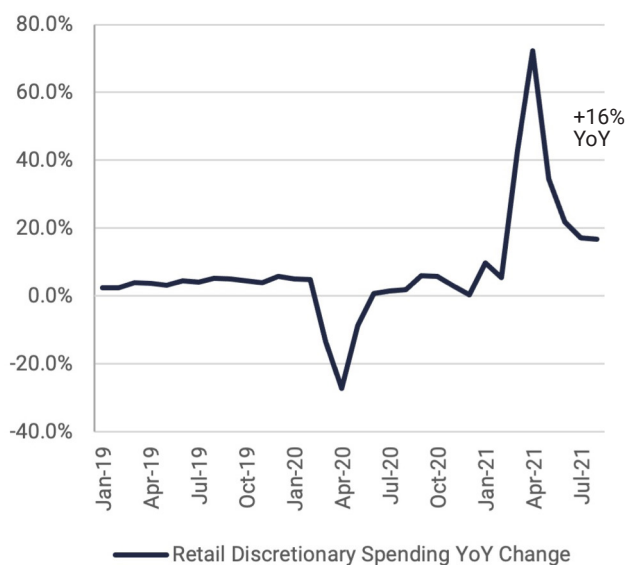
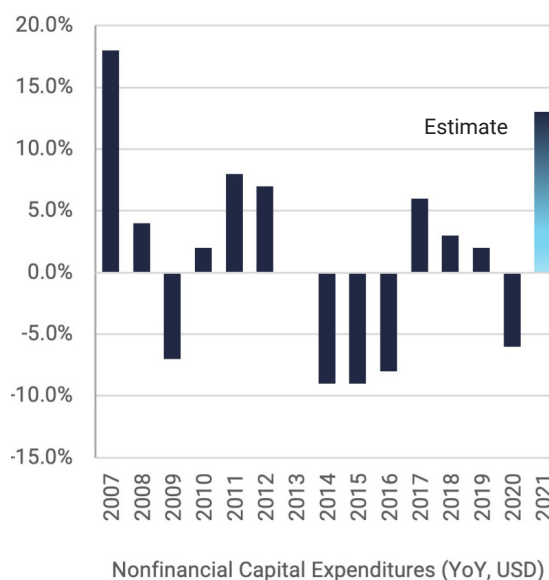


Chart 3

Businesses Spending Like Before Great Recession

As per S&P Global Market Intelligence as of September 2021. Universe of Global Capex 2000. Data Source: bloomberg.com, S&P Global Market Intelligence, Verdense Capital Advisors.



These top risks to the economic expansion are worth monitoring:

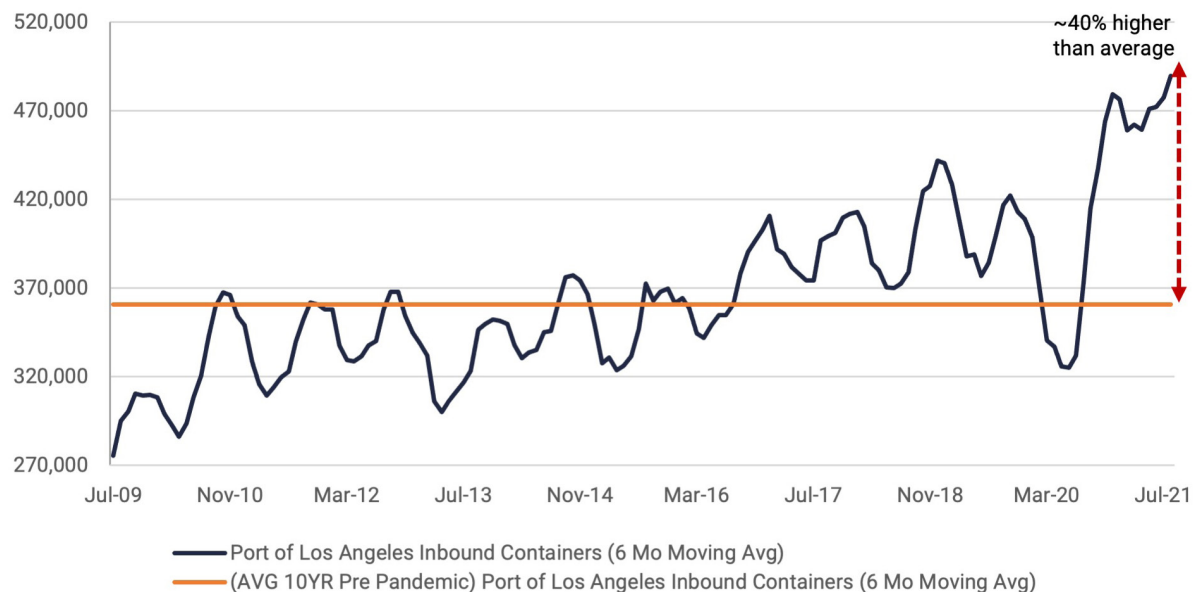
1. Supply chain needs time to normalize: The environment for the global supply chain is nothing short of chaotic. There are many factors that we could pinpoint that are fueling this unprecedented environment. A shortage of workers, consumers shifting from service spending to goods spending during the pandemic, COVID related slowdowns (e.g., lockdowns) and container and storage scarcities are some of the forces colliding with a seasonally strong period for imports (i.e., holiday demand). The bottlenecks at U.S. ports are getting worse. California's biggest port (Port of Long Beach/LA) has been seeing anywhere between 65-70 containers ships anchored or adrift waiting to unload in the port (a record high). Typically, there is zero to maybe one ship waiting.* In addition, there are ~500K containers waiting to be unloaded, nearly 40% more than the historical average. (Chart 4). Ports are in dire need of workers to unload and truckers to move them and

better infrastructure to handle (more cranes) the unloading of products. However, the ports are not the only obstacle. The global supply chain is a game of dominos. If one manufacturing plant in another country is temporarily locked down due to COVID or facing less workers, those components are delayed, and they could be the crucial component to finish the production of another good. One delay can have ripple effects across many different manufactured products. There is no easy and/or quick solution to this problem. The Port of Los Angeles has committed to temporarily expanding their gate hours to include weekends, the Port of Savannah approved an expansion project at their port, while the Federal Government has created a Supply Chain Disruptions Task Force. These are steps in the right direction, but time is the only solution to clear the bottlenecks. This will likely be an economic challenge that extends into 2022.

Chart 4

Bottlenecks at U.S. Ports

Data is monthly and as of August 2021. *As per BBC.com news. Data Source: <https://www.bbc.com/news/business-58643717>, Bloomberg Finance LP, Verdense Capital Advisors.



2. High oil prices threaten consumers: The supply shortages extend beyond consumer goods. We are seeing supply constraints in the global energy market. While hurricane related disruptions impacted the U.S. crude market, even with those refineries coming back online we are seeing crude inventories near a three-year low which has pushed the price of oil close to a seven year high. (Chart 5). Now we are seeing panic buying and some hoarding in other energy commodities that are necessary for winter heating needs. For example, Europe is dealing with a massive energy crisis as natural gas prices have skyrocketed and supply has been slow to increase from its major supplier (i.e., Russia). In the U.S., the price of gasoline has jumped ~\$1.00 this year alone. (Chart 6). It is a general rule of thumb that for every \$0.01 increase in the price of gasoline, it reduces the annual spending power of the U.S. consumer by \$1 billion. Therefore, the jump in gasoline prices has likely reduced the annual spending power of consumers this year by \$100 billion.

Chart 6

Price of Gasoline a Headwind for Consumers

Footnotes: Data is daily and as of October 10, 2021.

Data Source: Bloomberg Finance LP, Verdense Capital Advisors.

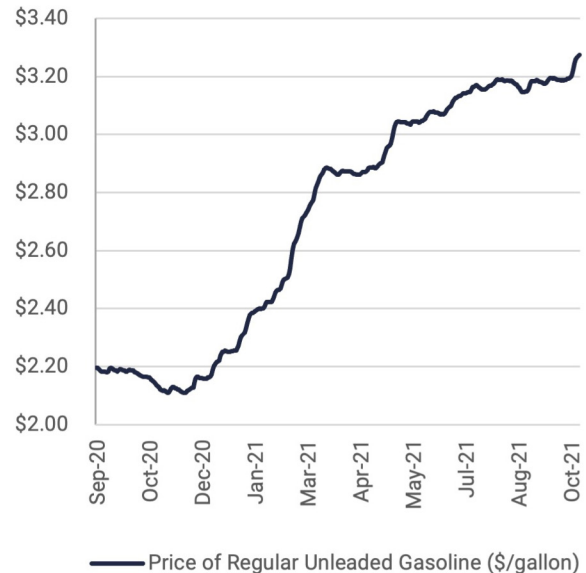
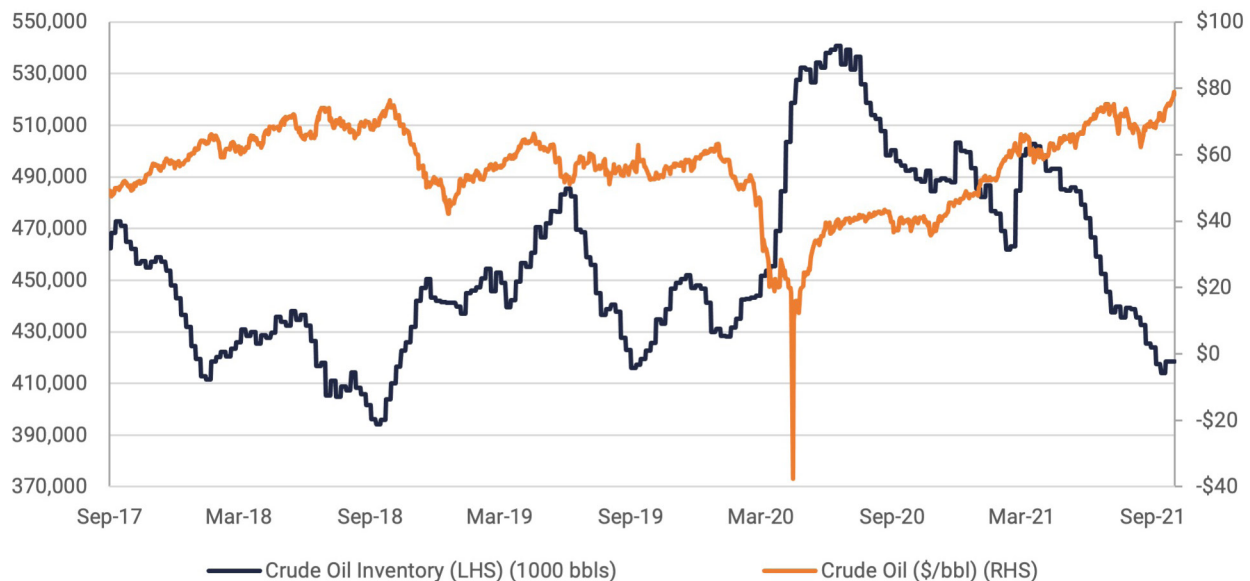


Chart 5

Limited Crude Oil Supply Driving Prices Higher

Data is daily and as of October 6, 2021. Data Source: Bloomberg Finance LP, Verdense Capital Advisors.



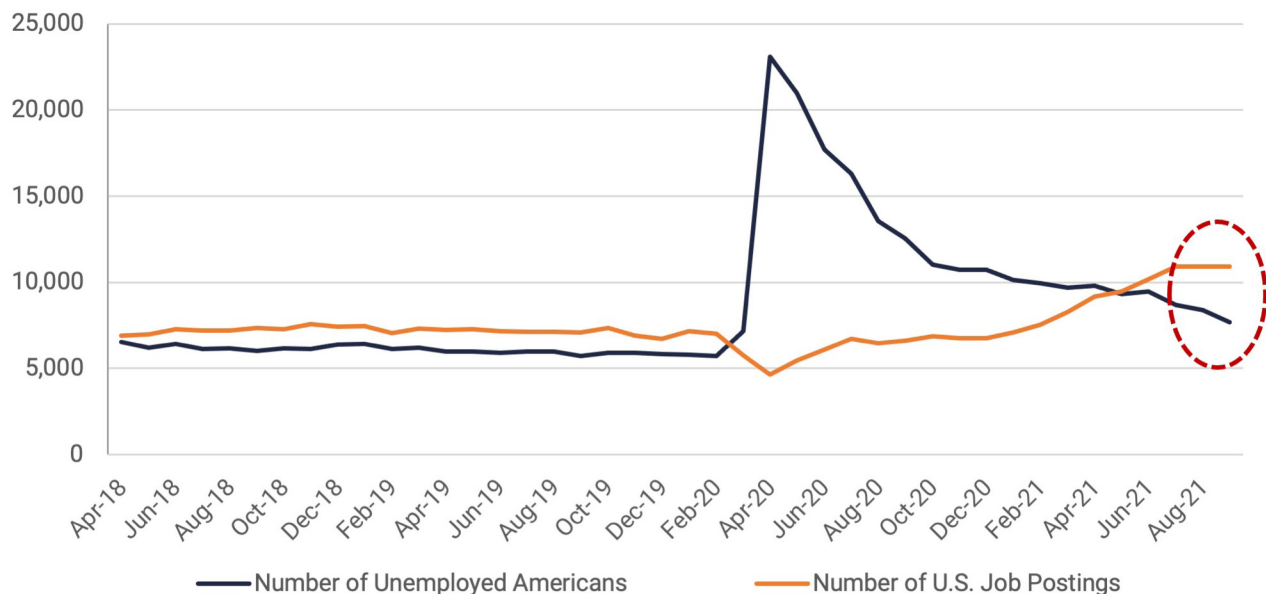
3. Labor market needs to speed up recovery: The U.S. economy has gained nearly 80% of the jobs lost during the pandemic. However, the surge in pent up demand has caused labor shortages across nearly every area of the U.S. economy. While consumer spending in restaurants is up nearly 20% above pre-pandemic levels (using retail sales from February 2020 to August 2021) the number of employees in restaurants is 6% below the pre-pandemic level. Sim-

ilarly, housing starts are above the February 2020 level, but the number of construction workers is still ~3% below the pre-pandemic level. Americans have been slow to return to the workforce for several reasons including extended unemployment benefits, fears of COVID and childcare constraints with schools reopening with great unpredictability. At this point there are ~11 million job postings in the U.S. economy for the 7.6 million unemployed. (Chart 7).

Chart 7

Labor Market Needs to Recover Faster

Data is as of September 2021. Source: Bloomberg Finance LP, Verdense Capital Advisors.



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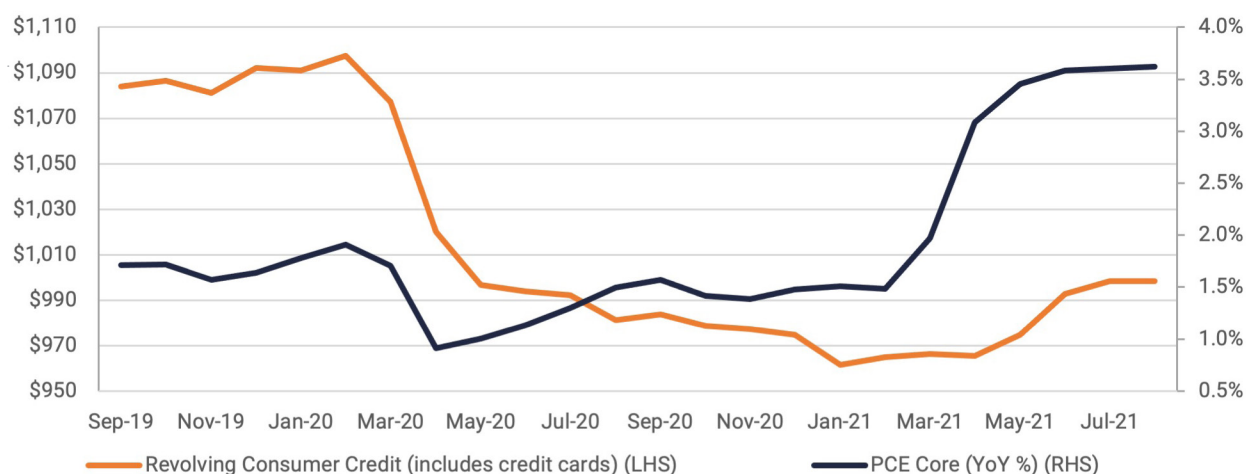
There are several things that could get Americans back into the labor force. The recent wave of COVID has turned over dramatically and 56% of the eligible U.S. population is fully vaccinated with another 9% having received at least one dose. There is also evidence that Americans need to start to get back to work. The sav-

ings rate remains elevated but has come down substantially. This leaves little room to pay for the added cost of select necessity items (e.g., gasoline and food). In fact, as core consumer prices have been increasing, we have begun to see credit card debt increase as well. (Chart 8).

Chart 8

Consumers Needing to Tap Credit

Data is as of August 2021. Data Source: Bloomberg Finance LP, Verdense Capital Advisors.



Economy bottom line: We believe the economic expansion will continue through 2022 at least. However, we acknowledge that risks are emerging that will likely result in a slower rate of economic growth than we have seen coming out of the pandemic. Monetary and fiscal policy will be less impactful as we enter 2022 but we do not see that disrupting the economic expansion. Some of the headwinds (e.g., supply chain, labor shortages) should fade as we move into 2022.

Global equities – Selectivity is Crucial as Volatility is Here to Stay

Despite making its 56th record high in 3Q21, the MSCI AC World Index capitulated to political uncertainty in the U.S., banking fears in China and an energy crisis in Europe to post its first quarterly decline since the start of the pandemic (1Q20). While the U.S. was able to deliver a modest gain for the quarter, most other global indices fell sharply with the broad emerging market index nearing correction territory. (Chart 9).

While we acknowledge that global economic growth will likely slow over the next year, we maintain our overweight to global equities especially relative to bonds. However, selectivity and patience will be important in an environment of declining monetary support, rising interest rates, margin pressures and inflationary concerns. In addition, having liquidity to take advantage of opportunities that arise in what we expect to be a volatile environment for equities is important.

Currently, we recommend that investors consider the following allocation:

- **International developed equities attractive:** We continue to favor developed international equities over U.S. equities. Developed international equities have more attractive valuations and are historically cheap relative to U.S. equities. In fact, on a relative basis developed international equity valuations are the cheapest compared to the U.S. that we have seen since the Great Recession. (Chart 10, next page). In addition, international developed equity markets have more exposure to the cyclical areas of the market that we tend to favor at this stage of the economic expansion rather than the U.S. tech heavy market.

Chart 9

3Q21 Total Return by Region

Data is as of September 2021. Data Source: Bloomberg Finance LP, Verdense Capital Advisors.

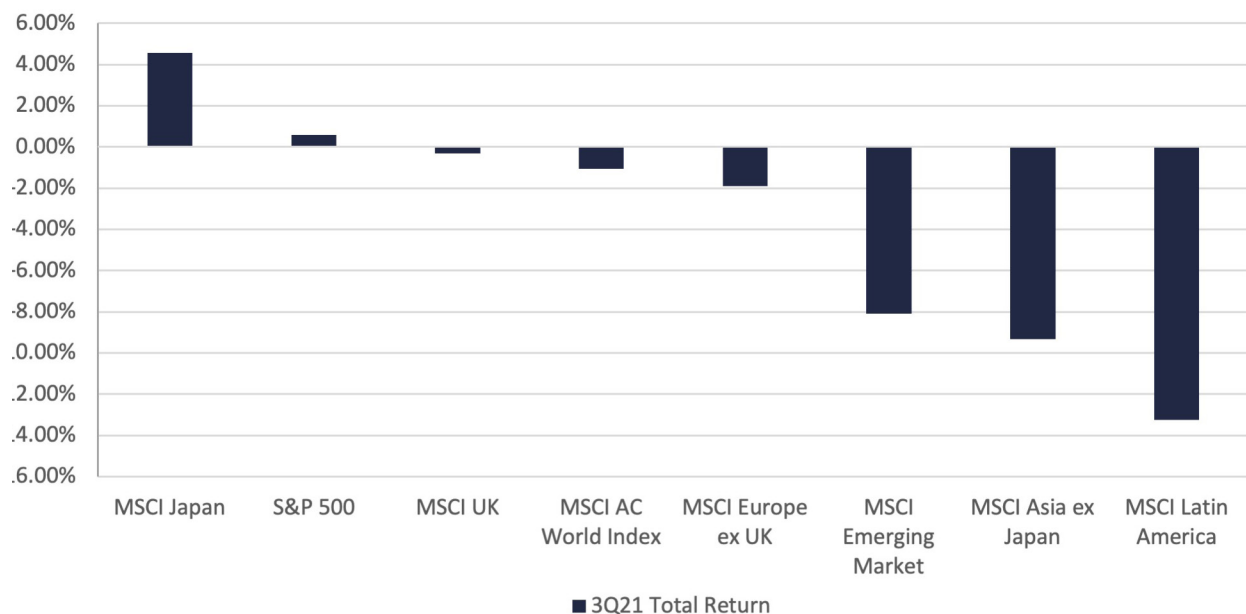
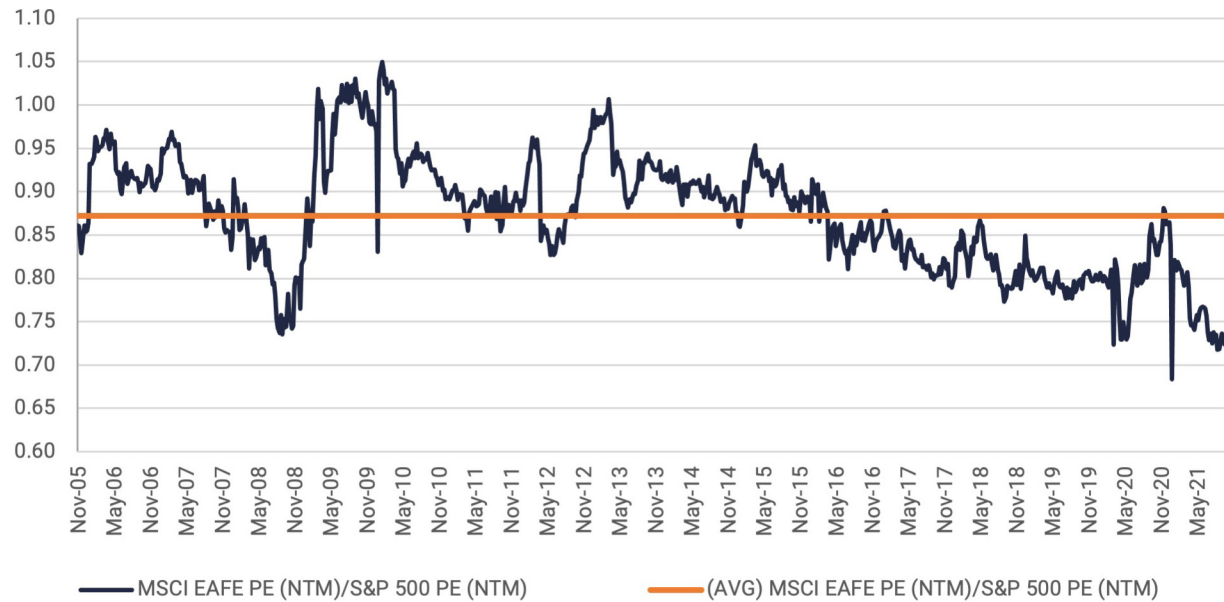


Chart 10

International Equities Attractive Compared to U.S.

Data is as of September 2021. Data Source: Bloomberg Finance LP, Verdense Capital Advisors.

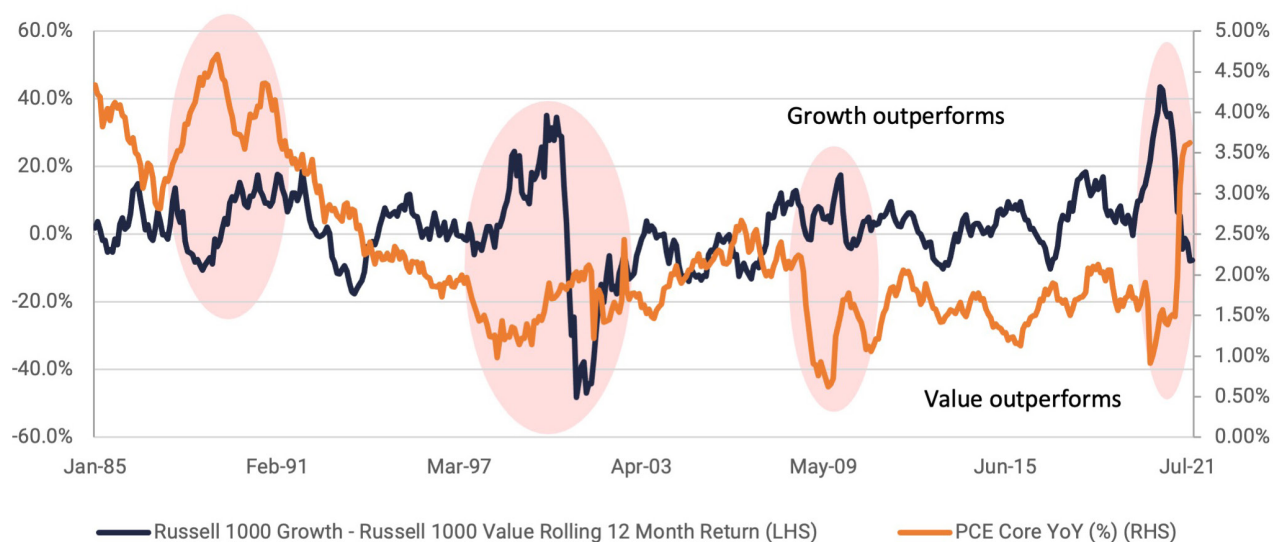


- In the U.S., cyclicals over expensive growth:** While growth stocks took the lead over value stocks in 3Q21, we believe this is unsustainable and will be challenged by higher interest rates and inflationary pressures. Historically, expensive growth sectors underperform value stocks with more reasonable valuations as inflation pressures emerge (**Chart 11**). We also favor an overweight to small and midcap equities that should benefit from the economic expansion and whose price to earnings multiples are trading at a discount to the large cap market and to their own historical averages.
- Patience in emerging market equities:** We continue to believe that emerging markets can benefit more than the U.S. from a return to more normal levels of global trade. In addition, we believe that emerging markets offer the most attractive long term return potential. However, there are near term risks that may not be fully reflected in prices at these levels (e.g., banking, and regulatory concerns in China, less flexibility with monetary policy and food inflation), so we remain patient. We will continually assess the situation and look for potential opportunities.

Chart 11

Favor Value over Growth

Data is as of September 2021. Data Source: Bloomberg Finance LP, Verdense Capital Advisors.



Equities Bottom Line: We continue to believe that equities offer the best long-term return potential for investors, especially compared to bonds. As we navigate from recovery to economic expansion, we expect increased volatility. Due diligence and patience are crucial. We recommend holding excess cash to take advantage of opportunities.

Fixed income – Setting Up for Higher Interest Rates

For most of 3Q21, long term bond yields were grinding lower, and we even saw the 10-year yield on the U.S. Treasury note drop to a five-month low. There was little explanation behind the stubbornly low level of interest rates through the summer months, especially with inflation rising and economic growth robust. Once the Fed and other global central banks made it clear that a reduction of key emergency measures is around the corner and energy prices started spiking, yields had nowhere to go but higher.

Fixed income bottom line: The economic expansion has room to run and interest rates at current levels appear to be unsustainable. Fixed income generally offers value as a portfolio diversification mechanism, but we see little return potential over the coupon. We would consider remaining defensive and invest in short maturity or floating rate bonds.

We believe the trajectory for yields is still higher. Yields at current levels do not reflect the inflation or economic growth environment. Instead, they have been depressed due to ongoing monetary support which is likely to start fading before year end. While we will always view fixed income as a portfolio diversifier and a potential hedge if economic growth takes an unexpected turn lower, we would be defensive with our bond allocation and recommend the following:

- **Short duration is the key to being defensive in a rising rate environment:** While the Fed remains committed to keeping the rise in interest rates orderly, the reality is that over the next 12-18 months interest rates across a variety of maturities are likely to rise. Therefore, investors may want to be defensive with their bond exposure and focus primarily on short duration fixed income. In addition, we believe that floating rate notes offer an opportunity for bond investors. As the Fed begins to raise rates (likely 4Q22 or early 2023) these bonds should adjust to reflect the higher interest rate environment.
- **Do not reach for yield; risk/reward minimal:** While higher yielding fixed income carries a lower duration given its high coupon, we would exercise caution. The extra yield investors gain to buy high yielding debt compared to a Treasury bond is at the lowest level seen since before the Great Recession while absolute yields are near a record low. This offers little reward for the additional risk when investing in high yield bonds.

Alternatives: Looking Beyond the 60/40 Portfolio When Traditional Assets are Over Valued

As we navigate through the economic cycle and experience stretched valuations in the public markets, it reminds us of the importance of alternative investments in portfolios. We are in a period where equity markets are stretched globally, volatility is expected to remain high, Governments must pay for records amount of debt, Central Bank intervention has resulted in a substantial amount of negative yielding debt and many public inflation hedges (e.g., TIPS) look expensive.

Therefore, the traditional benefits one may receive from a simple 60/40 portfolio of stocks and bonds may not offer the same diversification or return opportunities as has been experienced historically. It is also likely to produce more volatility than an investor is accustomed to. In contrast, for qualified investors, investing in the private market removes the daily volatility, typically offers low correlations, and attractive risk adjusted returns, and may be a better way to hedge against inflation.

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opportunities**

The Verdence View

It is important for investors to decipher between an economic slowdown and a contraction. It is true that the easy rebound after a record decline in economic growth and earnings is behind us. However, that does not mean that the expansion is coming to an end. There are many forces that should continue to support the economic expansion. These include monetary policy, solid corporate balance sheets, a healthy consumer, a prolonged manufacturing expansion to clear up the surge in pent-up demand and our expectation that we can get more Americans back to work in the coming quarters. This does not mean that we are not closely monitoring the risks of inflation and supply chain constraints. These factors can weigh on sentiment, spark short term volatility but also present opportunities to adjust asset allocation. While we favor an overweight to global equities, it may be prudent to hold excess cash with valuations at current levels. Having the flexibility and liquidity offers investors the chance to take advantage of volatility that is likely to arise as we move into the economic expansion phase.

If you have any questions or comments, please feel free to reach out to your financial advisor.

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