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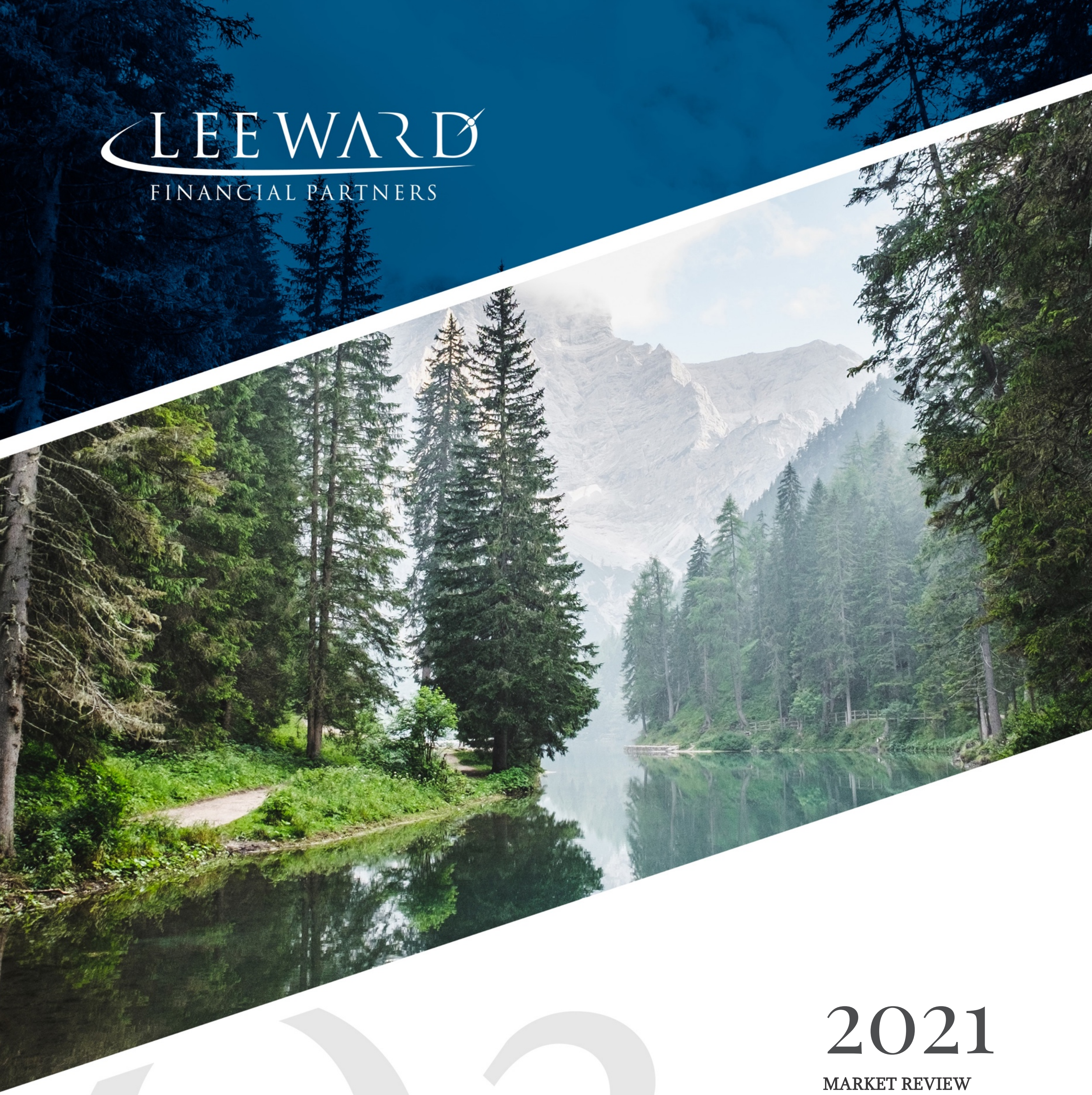

Q3 2021

MARKET REVIEW

Markets produced meager gains in 3Q as investors digest decelerating growth and prepare for a mid-cycle environment.

3Q2021 Quarterly Review

LEEWARD FINANCIAL PARTNERS

Markets started out strong in the third quarter (Q3), with the S&P 500 Index topping a 100% return since the March 2020 lows, but ended with meager gains due to a late September rollover. Overall, equity asset classes were flat in Q3, while a steepening yield curve pushed fixed-income investments into the red. Despite the lackluster performance, stock valuations improved slightly behind significant earnings growth. We believe this dynamic – strong earnings but tepid stock returns – signals a move into the middle period of the economic cycle. Growth is slowing from recovery highs and settling to normalized levels. While it feels early to be talking about the mid-cycle, the economic recovery was fast, taking only 16 months to eclipse pre-crisis highs. A whole year faster than any other U.S. recession since 1980.

Solid financial reports pushed markets higher to start the quarter. In July, the S&P 500 Index saw most companies beat estimates by a wide margin, with annualized growth reaching close to 90%. Guidance cuts were uncommon, with fewer than 4% of companies reducing forward numbers. By August, earnings exuberance started to wear off, and markets began to slow. Concerns of the Delta variant's surge, a spike in interest rates, and the chaos from Chinese policymakers and large Chinese companies replaced the euphoria of 2Q's earnings season. September continued the decline, ending with a whimper as the S&P 500 declined -4.8% in the month, snapping a 7-month positivity streak and erasing July and August's gains.

Asset Performance

Amid the peak in earnings, leadership among growth, cyclical-value, and defensively oriented sectors was mixed. U.S. large-cap stocks were flat for the quarter, with the S&P 500 Index up (+0.6%) and the Nasdaq Composite down (-0.2%). U.S. Small-Cap Stocks were down (-4.4%). Developed International stocks were in line (-0.1%), but emerging markets fell (-8.1%) on weakness from Chinese shares. At the sector level, returns were muted but relatively consistent. Leadership areas included Financials (+2.7%), Communication Services (+1.6%), and Health Care (+1.4%). Laggards were Industrials (-4.2%), Materials (-3.5%) and Energy (-1.7%).

In fixed income asset classes, adjusted spreads remain near cyclical lows. U.S. bonds were flat (+0.1%) after yields recovered late in the quarter but remained slightly negative (-1.6%) for the year. High-yield bonds were up slightly (+0.9%), supported by limited credit concerns. The U.S.

dollar rose in the quarter, finding support from the relatively more hawkish Fed and comparably higher U.S. rates. The stronger dollar hurt international bond returns, with developed bond markets contracting (-1.9%) and emerging market bonds (-3.15%) down even further. Commodities rallied for the sixth straight quarter, led by natural gas and oil. Real Estate Investment Trusts (REITs) saw modest gains on strength in the Industrial and Residential segments, despite the spike in COVID-19 cases weighing on Office, Healthcare, and Hotel REITs.

Threading the needle

As we enter the fourth quarter, it feels like we've been here before. While the news cycle revolves around the health crisis, possible Fed tapering, the U.S. Federal Debt Ceiling, the fundamental drivers of markets are well intact. The economy is firmly on positive footing, default rates are low, and investors' appetite for equities remains unwavering. Employment is improving, job growth continues, and consumer spending is intact. This environment has been relatively consistent since early spring.

What has changed is the rate of overall improvement. With the initial impact of reopening now behind us, growth rates are moderating, and the margin for error has narrowed. The skew of risks around global growth has shifted from widespread optimism and upside in 2Q to a more sober assessment of the outlook. So, while economic numbers haven't changed all that much, there's been an important change in the narrative. The specter of a more challenging growth/inflation mix, increasing tax rates, and a less certain outlook for monetary policy is of particular concern.

Inflation is still an issue.

Despite peaking earlier in the year, inflation pressures remain stubborn and may continue into 2023. Federal Reserve Bank (Fed) Chairman Powell has repeated that rising prices—much hotter and persistent than economists and policymakers predicted—are transitory. During his Sept. 28 testimony, he said, "if sustained higher inflation were to become a serious concern, we would certainly respond and use our tools to ensure that inflation runs at levels that are consistent with our goal." By 'tools,' he means higher interest rates. By 'goal,' he means full employment and 2% inflation over the longer run.

From our perspective, the spike in inflation is primarily the product of a narrow group of goods and services that have been directly affected by the pandemic and the reopening of the economy. Supply chains have buckled and will take time to correct to meet demand. Looking under the hood, most of the recent inflationary pressure is driven by Transportation Goods, up over 17% in August. If we remove Transportation Goods from the equation, core CPI (Consumer Price Index) falls from 4.0% to 2.7%, much closer to the Fed's goal. And while not always off to the races, U.S. stocks have been resilient through inflationary environments. Since 1948, the S&P 500 has averaged 2.6% per quarter when inflation ranges between 0-2%, up 2.7% per quarter when inflation ranges 2-4% and up .8% per quarter when inflation is above 4%.

The Fed should be able to cope.

The Fed's ability to manage inflation issues will be vital to sustaining economic growth. Fortunately, the Fed has a lot of credibility to spend here, with a track record of working through inflation challenges for over 40 years. Most investors expect the Fed to look through reopening pains, with tapering beginning in the Q4 but rate hikes not expected until 2023. And when a hike finally does occur, the news will be a non-event, as the move will be the most telegraphed and expected tightening move in history.

Unlike the U.S., Emerging Markets are more challenged when managing inflation due to the structure of their economies and country debt priced in U.S. dollars. Central banks in those regions are forced to respond to inflation by raising rates more quickly than in the United States. In Brazil, for example, rates are on pace to double and potentially triple from where they were a year ago. In Poland and Mexico, the story is similar. In those regions, rapid increases in rates are tightening financials and stalling growth. For these reasons, Emerging Markets present less attractive investment opportunities in a rising rate environment.

Tax adjustments are coming by year-end.

With public spending at record highs and tax rates at historically low levels, taxes are expected to move higher in the future. Centrist Democrats will shape the outcome in the Senate. That means a big chunk of what's creating headlines today will be seriously scaled back, in our opinion, as progressive goals meet the reality of the Democratic Party's slender majorities in Congress. For example, the Biden administration has proposed to raise the top capital gains rate to 43.4%, but we believe that value will most likely get negotiated down to 28%. A level that has historically generated the largest amount of revenue for the Federal Government.

Even though tax code adjustments need to be in place before year-end to be enforced next year (there is little precedent for retroactive tax increases), the contentious nature of tax code modification means law is typically not finalized until the last minute. We expect increased visibility into the final changes before year-end, but perhaps not until after Thanksgiving. Higher taxes will reduce take-home dollars and corporate net margins, but tax increases should not materially impact market performance. Typically, investors move past tax increases quickly. For example, after the last eight corporate tax rate increases, the S&P 500 has increased 87% of the time.

Goodbye September, Hello October

Until September, markets had been relatively stable for the year. That changed at the end of Q3 when the S&P 500 fell over 5%. Part of this weakness is due to seasonal factors that have historically dogged investors in September. Part is due to slowing economic growth. For these reasons, we would not be surprised to see the volatility continue throughout October. While October hasn't been the strongest month over the last 100 years, it has still eked out an average gain of +0.21%. November and December have traditionally been better months, up +1.28% and +1.51%, respectively. Lastly, in years where the S&P 500 is up solidly year-to-date heading into Q4, investors usually see continued gains in Q4. These data points suggest managing through near-term volatility and maintaining exposure to risky assets.

Another factor to consider is that markets haven't been volatile in a while. The last time we saw a 5% correction was in October 2020, over 45 weeks ago, a long period by market standards. The S&P 500 has historically sold off 5% every nine weeks on average since 1928, with an average intra-year drop of 14.3%. Despite this intra year volatility, annual returns were positive approximately 75% of the time. We expect the same to play out this year, with markets choppier due to seasonality, slowing growth, and inflation, but still producing gains for the entire year. So, while a 5% pullback may not feel great, it is a frequent occurrence and necessary for markets to move higher.

We still like equities.

The fourth quarter is shaping up to be the start of a deceleration trend. Real GDP is expected to drop to 4% in 2022 and then slow further to 2.5% in 2023. This is not a pessimistic forecast: Earnings and GDP are expected to maintain growth levels well above pre-COVID trends. But deceleration can be an uncomfortable place for markets.

We expect elevated asset valuations to remain in the U.S., and we have been increasing our focus on REITs and domestic stocks with inflation-linked revenue streams. (Equities and tangible assets have historically delivered solid performance in periods of rising prices.) Absent renewed recessionary factors, we do not expect a re-pricing of assets and would look to be buyers on any short-term weakness. Globally, we see opportunities in developed markets where cash flows create more underlying value, and prices are reasonable. Conversely, we do not believe

Emerging Markets are as attractive as they may remain depressed due to supply chain disruptions and a stronger U.S. dollar.

In client portfolios, we reduced our consumer-cyclical and emerging market exposure, shifting focus to high-quality domestic equities. In portfolios with high risk tolerance, we initiated small semi-conductor positions and reduced exposure to online services. We remain underweight fixed income assets in most accounts. We expect to maintain that position into next year. Where we own bonds, our focus has been to keep bond durations short and credit quality high. In taxable accounts, we have engaged in tax-loss harvesting where available, and tried to upgrade portfolios, emphasizing high margin, low capital-intensive investments.

Earnings growth may have peaked earlier this year, but the economy remains robust, valuations are more palpable, and the environment for further market appreciation appears attractive to us. As always, we remain vigilant, looking for new risks in the market while focusing on efficiently growing our clients' portfolios.

Please do not hesitate to reach out with questions and comments.

Sincerely,

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