Q3 2021 Market Synopsis

Economic & Market Update:

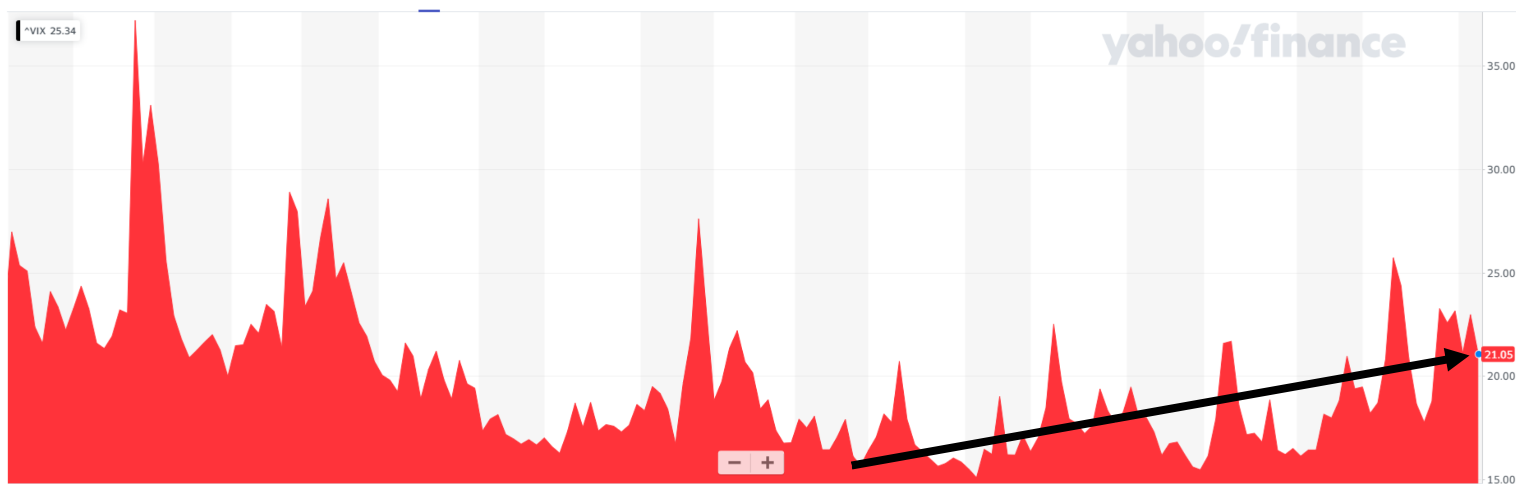
The third quarter was uneventful for most financial assets and markets. If one stopped watching the markets over July 4th weekend and came back at the end September, they would have hardly noticed any movement in most asset prices. All major asset classes and markets we track returned within 2% either side of breakeven during the quarter outside of emerging markets stocks which were down around 8%. This 8% loss overall in emerging stocks was mainly a result of Chinese stocks plummeting 16% with unprecedented societal and financial moves by the Chinese federal government. We do not have any exposure to emerging markets or Chinese stocks for any of our clients.

The lackluster financial market performance should not have been unexpected after the incredible run over the prior five quarters for risk assets. This 'market breather' allows the fundamentals, corporate earnings, and overall positive economic conditions to catch up with much higher stock and real estate prices. Most bonds were little changed in the period, the global stock market (ACWI) was down 1.6%, with US stocks/real estate right at breakeven.

Select 2021 YTD Asset Class Returns (9/30/2021)	
Nat Gas/Oil Pipeline Companies (TPYP)	+ 30.7%
Alternative Lending (LENDX)	+ 26.4%
DJ US Real Estate (US Real Estate)	+ 21.2%
S&P 500 (US Stock Market)	+ 15.9%
Private Real Estate Equity (TIPWX)	+ 13.0%
MSCI EAFE (Foreign Developed Stock Market)	+ 9.9%
Middle Market Lending (CCLFX)	+ 8.0%
Private Farmland, Timberland, Infrastructure (VCRRX)	+ 5.7%
TIPS (Treasury Inflation Bonds)	+ 3.2%
High Yield Bonds	+ 3.0%
Insurance Linked Securities (XILSX/SHRMX)	+ 1.5%
Municipal (Tax Free Bonds)	+ 0.5%
MSCI Emerging Market (Emerging Stock Market)	+ 0.3%
Investment Grade Corporate Bonds	- 2.2%
US Mid/Long Treasury Bonds	- 3.4%

** GPB Holdings II, Mosaic, BREIT, and KKR Fund Performance included within the private investment section on page 6*

Below: ***Year to Date measure of stock market volatility (VIX)***



The chart above shows US stock market volatility **(VIX)** from January 2021 through early October. After an extremely volatile 2020, volatility gradually declined until July and then has been increasing since, with a very choppy market in September. Early autumn has historically been the most volatile for the US stock market and this September was no exception. Despite a flat quarter overall, the SP500 was down 4.7% last month alone.

Despite September's poor performance, 2021 remains a very good year for the vast majority of stocks and alternative/private investments outside of emerging market/Chinese securities. Bonds continue to struggle with higher interest rates relative to 2020, causing almost all bond classes to be near breakeven or down on the year.

We think the next month or so could continue to be volatile as the market deals with the debt ceiling deadline, legislative uncertainty, possible tax reform/increases, seasonality, and earnings that could reflect some delta variant challenges. At the same time, once we get through this period and these events are behind us that will provide better clarity on many fronts. This improved vision combined with a positive economic backdrop could set up a good end to the year.

Despite the poor/volatile month and flat quarter for stocks and flat or down year for bonds, our alternative/private suite of investments continue to perform very well. **Overall, our alternative/private suite of investments *(depending on exact client allocation)* is up between 2.0% and 3.5% with virtually no correlation or volatility during the period.** This has proven to be very powerful in providing positive client portfolio returns despite all traditional

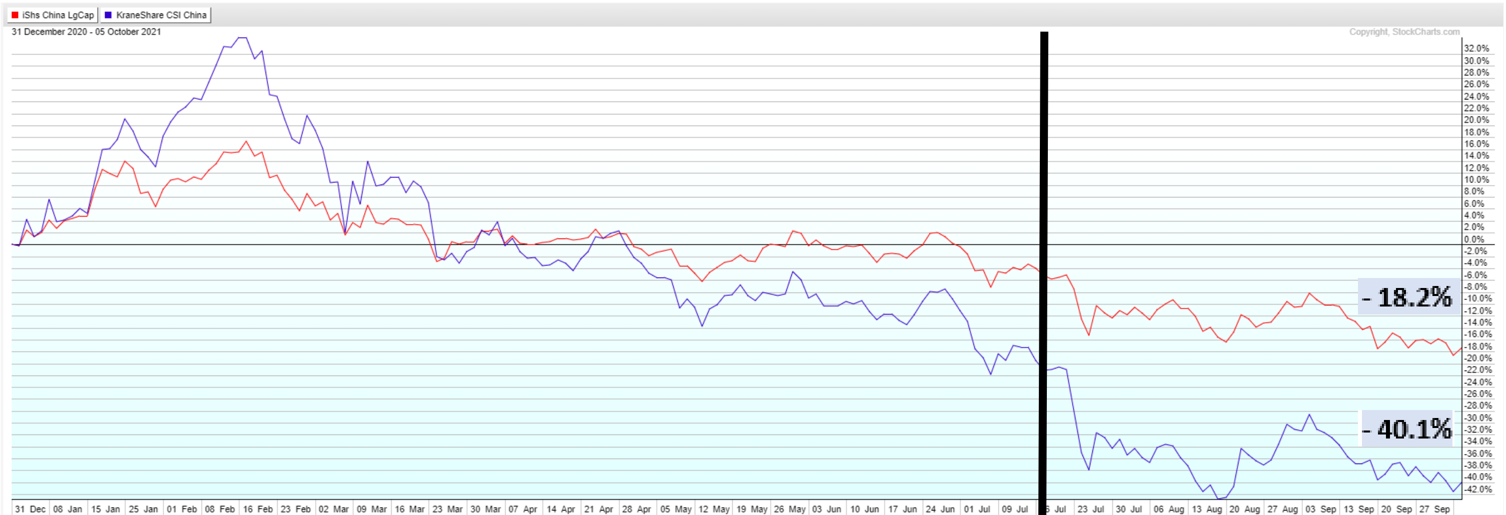
investments being flat or down in the period with elevated volatility. **Through September our alternative/private investment suite is up around 10% for the year.**

The major factors which impacted markets in Q3 2021 are highlighted below:

- **Rising Interest Rates/Inflation Expectations:** Although rates only rose slightly through the quarter from 1.46% on July 1st to 1.53% at the end of September; a contributor to the volatility we have seen last month was a quick rise in rates from 1.25% at the end of August to 1.6% as we write this letter. Although these rates are still low and a move to near 2.0% should be expected, financials markets rarely react positively to a rapid move in rates. Expected inflation over the next 10 years also rose to an eight year high of 2.45% over the past couple days. Interest rate and inflation sensitive securities are now in the process of digesting these higher rates and inflation trends.

- **Chinese Government Societal & Economic Shift:** China is the second largest economy in the world and by many aspects also the second most powerful nation on Earth. Starting in the spring/early Summer the Chinese government pivoted in terms of societal and economic policy, regulation, and messaging. These changes range from forcing technology and other companies to completely alter their business models, limiting profits for many corporations, limiting video game playing time for children, curtailing private education, and even prohibiting certain men's clothing and hair styles. These changes have scared many global investors out of Chinese markets during 2021. Several years ago, Traphagen concluded that investing any material amount in emerging market or Chinese stocks (outside of smaller tactical trades) was not advisable in most client portfolios. Amazingly if one invested in the Chinese stock market in 1992 and held through today, their return over the period would have been only 2.2% per year. An investor purchasing a **risk free** 30-year US Treasury bond in that same year returned around 8.0%/yr. during that time. It is no surprise we continue to believe Chinese stocks are essentially not investable at the current time.

Below: ***Chart of Chinese Stocks (Red) & Chinese Technology Stocks (Blue) over the course of 2021***



- **Likely Passage of Tax Reform, Infrastructure Legislation:** The House and Senate continue to work towards some compromise on three significant legislative and governance issues. First, raising the debt ceiling is becoming a very high-profile struggle with the President and all leaders in Congress weighing in. Although it would certainly be a negative (and embarrassing) to technically default, we think there will be a 'last minute' solution to this with no long-term impact. More importantly, the probable $2T - $3T physical and 'social' infrastructure bills along with the accompanying corporate and individual tax reform/hikes will likely have both positive and negative impacts for markets. Any corporate, individual income, or capital gain tax hikes will act as a net negative for the stock market, but the combination of increased infrastructure and social spending and better clarity will act as a net positive. Traphagen is of the opinion, regardless of the ultimate details of the legislation, once the passage is behind us, businesses will be in a better position for future planning as we move into 2022.

Traphagen 2021 Portfolio Changes & Performance Update

Through the first three quarters of 2021 client portfolios (outside of the most conservative) are up between 7% and 12% net of fees. Traphagen views client portfolios in a unique position with significant inflation protection, essentially no interest rate risk (with the combination of our alternative suite and a recent sale of all government bonds), portfolio cash flow yields well above market levels (generally between 2.4% and 3.1%), and reasonable long term growth potential.

The most recent changes made in client portfolios are highlighted below:

- **Allocation to the Diversified Private Credit Fund (NICHX):** As we brought up briefly in the prior newsletter, we were very pleased to get an allocation to this fund for our mid-range and conservative clients as a bond replacement. We made the purchase in July/August and although it is very early, we are happy with the investment to this point. It has not experienced one negative day since we purchased the fund, has no correlation to stocks or rising rates, and returned around + 3% while stocks were down roughly 4%. We are currently looking at the possibility of adding this fund for some of our more aggressive portfolios as well.

- **Addition of a Broadly Diversified Alternative Fund (SRDBX):** For many of our clients who could not invest in our traditional alternative suite, we have vetted an investment which combines 7 unique alternative strategies within one fund. These strategies include some that our in our main alternative suite (insurance securities, consumer lending, etc.) along with others that are specific to this fund (bitcoin option selling strategy, healthcare royalties, etc.) We purchased this fund for select clients over the past couple weeks so it is too early to make any judgement. However, over the past 30 days, the SP500 is down 3.5% with a maximum drawdown of 5.5%, while this fund returned + 1.5% with a maximum loss of only 0.3%. This is also used as a bond replacement.

- **Broad sale of all US Treasury Bonds:** Given that short and intermediate term bonds only yield around 1% or so per year and inflation (measured by CPI) is running anywhere from 4% to 5% we do not currently view these as attractive investments. If you buy and hold these until maturity you are locking in a negative real return versus inflation. In addition, we view the likelihood of rates increasing into year-end as elevated. If that were to occur the value of these bonds would decrease, wiping out any yield return. Right now, this allocation is held in cash, but over time we may repurchase bonds if and when higher yields are available, hold cash for a period of time, or allocate to another alternative if we find a good opportunity.

- **Allocation to Digital Assets (Bitcoin, Ethereum, etc.) in our most aggressive portfolios:** For the most aggressive client portfolios we recently entered a 2% portfolio allocation in a digital asset 'index' fund. We believe digital assets such as Bitcoin, Ethereum, and other select tokens along with some stocks that are involved in the space are poised for very high growth/increasing adoption over the next 3-5 years and beyond. Although the volatility within these assets is extreme,

correlations to stocks and bonds are low and we can use this volatility to trim exposure when we get extreme up movements and add on any large corrections. We are of the view digital assets will disrupt many industries/assets such as gold, finance, investments, art, music, insurance, real estate, among several others. Bitcoin is currently trading at around $54,000, up 83% year to date.

In addition to the recent portfolio changes recently made, we continue to look for additional investments that can improve client portfolios in this unique period of ultra-low yields.

Dynamic Treasury Fund	Exposure to the 10 Year yield (currently 1.6%) while attempting to harvest significant additional returns from bond price movements
Lower Risk Cat Bond Fund	Exposure to 'far out of the money' cat bonds with a 5% - 6% yield and exposure to only the largest of natural disasters
Real Estate Credit	Private credit secured by real estate where we can get a 6% to 8% yield with little/no interest rate risk

With the recent changes made within portfolios over the past couple of months we are quite happy how client funds are currently positioned. As always, we continue to look for additional opportunities, and if and when the above research areas (or others not mentioned) bear fruit in the form of additional investments we feel offer superior risk adjusted returns, we will certainly add to client portfolios in our goal of adding returns while retaining our risk mandate to all investors.

Q4 2021/Q1 2022 Market and Economic Outlook Update:

As we pointed out in the last newsletter it certainly appears the worst of the delta variant is behind us as cases and deaths are now in a clear downtrend across the country. As we move forward with increased vaccination rates, higher natural immunity, and the recent Merck treatment news, it seems the pandemic will slowly but surely continue to slide into the background from an economic point of view.

With an unemployment rate of just 4.8%, robust demand across the economy, a very strong real estate market, and continued strong corporate earnings we continue to view the short/intermediate term as positive. Our Traphagen Recession Index (TRI) currently is indicating a low (but somewhat increased) reading of just over 20%, so we view the chance of a recession or significant slowdown remaining slim over the next 9-12 months.

Over the next 4-6 weeks we will continue to monitor Washington and see what comes out in terms of the final physical infrastructure and tax reform/social infrastructure bills. This could be material in terms of high net worth/income individual client's tax planning, but we do not think (given current information) the final details would have any large negative consequences to the stock market over the long term.

We hope all have enjoyed a more normal and fun-filled summer and are ready for the heart of football season, autumn leaves, and the upcoming holidays.

As always, we thank you for the continued trust you place in us as a firm, and we are always here for any additional questions you may have.

Best regards,
Your Traphagen Investment Team