PRIVATE CAPITAL MANAGEMENT

Q3 2021 Commentary

October 2021

"The supply chain stuff is really tricky."
- Elon Musk

Global equity markets had a mixed quarter as investors grew weary of continued supply chain issues, higher than average inflation, a sluggish unemployment rate, and a surge in the delta COVID-19 variant. Business activity and consumer spending remain high while corporate America surpassed pre-pandemic levels of revenues and earnings per share in the quarter. U.S. monetary policy continues to be accommodative but is anticipated to tighten in the coming year to address stubbornly high levels of inflation. Investors reacted ahead of the Federal Reserve's official statements as longer dated yields began to climb mid-July anticipating future increases in benchmark policy rates. Politics in Washington had an outsized effect on capital markets for the quarter with investors digesting U.S. debt ceiling talks, the $1 trillion bipartisan infrastructure spending bill, and prospects of a multi-trillion-dollar reconciliation spending bill.

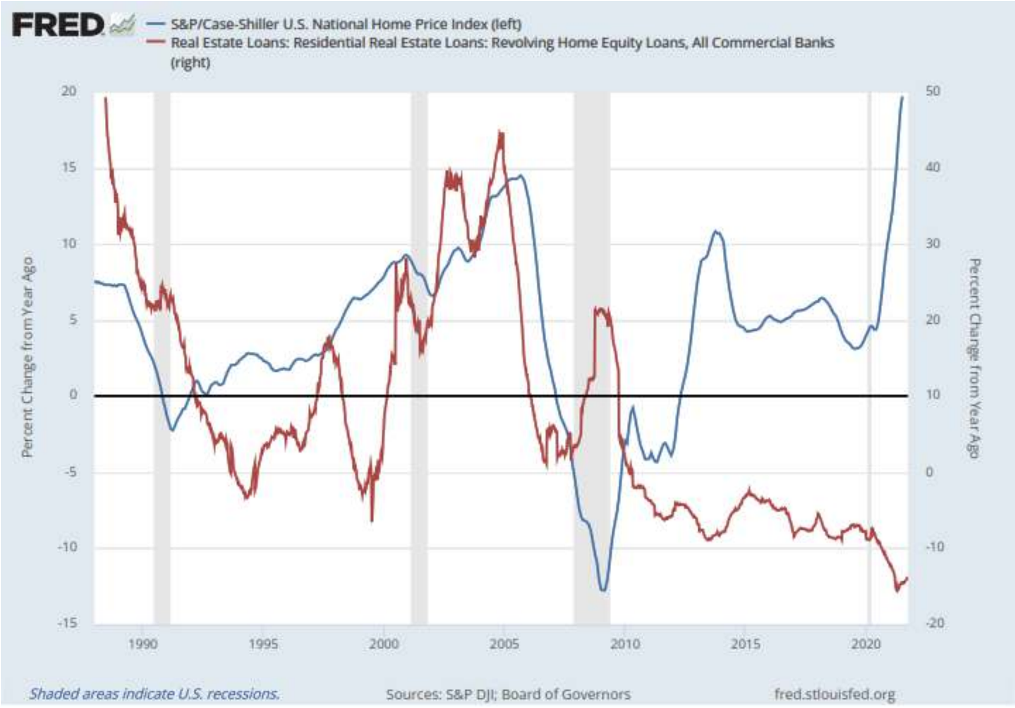
For the quarter, U.S large cap equities outperformed small caps, growth outperformed value, and emerging market equities underperformed considerably relative to domestic equities as the U.S. dollar strengthened. Concerns about systemic risk related to Chinese property developer conglomerate, Evergrande, as well as enhanced regulatory crackdowns on private enterprise in China further accelerated declines in emerging market equities. Despite last month's sell-off, global equity markets have delivered above average year-to-date returns and are trading near all-time highs. U.S. fixed income returns were largely flat for the quarter with modest outperformance in high yield and floating rate loans. Despite rising risks to our economy, credit spreads remain near all-time lows suggesting fear of an economic slowdown hasn't yet outweighed the demand for yield in our low interest rate environment. Commodities continued to perform well for the quarter driven by a resurgence in consumer demand.

Asset Class	Benchmark	September	Q3 2021	YTD	12 Months
U.S. Large Cap Stocks	S&P 500 TR USD	-4.7	0.6	15.9	30.0
U.S. Small & Micro Cap	Russell 2000 TR USD	-3.0	-4.4	12.4	47.7
Intl Developed Stocks	MSCI EAFE NR USD	-2.9	-0.5	8.4	25.7
Intl Dev Small & Micro Stocks	MSCI EAFE Small Cap NR USD	-3.6	0.9	10.0	29.0
Emerging Mkt Stocks	MSCI EM NR USD	-4.0	-8.1	-1.3	18.2
Global Stocks	MSCI ACWI NR USD	-4.1	-1.1	11.1	27.4
U.S. Municipal Bonds	BBgBarc Municipal 1-10Y Blend 1-12Y TR	-0.5	0.0	0.4	1.3
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	-0.9	0.1	-1.6	-0.9
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	0.0	0.9	4.5	11.3
U.S. Bank Loans	S&P/LSTA U.S. Leveraged Loan 100 TR	0.6	1.0	3.2	6.7
Intl Dev Bonds	S&P International Sov Ex-US Bond TR	-2.9	-2.1	-7.9	-3.5
Emerging & Frontier Bonds	JPM EMBI Global Diversified TR USD	-2.1	-0.7	-1.4	4.4
U.S. REITs	MSCI US REIT NR USD	-5.7	0.8	22.2	35.8
Ex U.S. Real Estate Securities	S&P Global Ex US REIT TR USD	-5.6	-1.6	8.4	24.9
Broad Commodity Futures	Bloomberg Commodity TR USD	5.0	6.6	29.1	42.3
Energy Partnerships	Alerian MLP TR USD	3.0	-5.7	39.4	84.6
Gold	DJ Commodity Gold TR USD	-3.4	-1.0	-7.9	-8.3

Source: Morningstar as of 09/30/2021

ECONOMIC OBSERVATIONS

High frequency data suggests that the hardest hit industries such as airlines, restaurants, and hotels nearly fully recovered from pandemic lows in July only to face more difficult operating conditions following the delta variant surge. Movie theatres are still struggling as attendance remains approximately 50-60% below pre-pandemic levels.[1]



Residential real estate continues to appreciate at a torrid pace; according to the S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index, single family homes increased 19.95% year over year ending in July which is almost three times greater than the 10-year average. Certain regional markets were even higher. In the Phoenix metro area, home prices increased at a staggering 32.1% year over year.[2] In 2020, the average Arizona homeowner owed approximately $210,000[3] on real estate worth an average of $280,000.[4] For those keeping score, this translates to an eye popping 128% return on equity over the past year. At the same time, outstanding home equity loan balances continued to fall suggesting homeowners are not repeating the same mistake leading up to the 2008 crisis. Rising home equity generally acts as a tide that lifts all boats benefitting many industries. This bodes well for sustained consumer demand driving future economic gains.

Robust consumer demand on a stressed global supply chain has led to persistently high inflation lasting longer than expected. The U.S. Consumer Price Index reached its highest level since 2008 at 5.3% followed by two months of slightly declining prints.[5] The ‘core’ Personal Consumption Index, the Federal Reserve’s preferred inflation metric, has plateaued at 3.6% in year-over-year gains for the past several months.[6]

In hindsight, one can argue that the current bout of above average inflation was inevitable. In response to the pandemic recession, the U.S. Treasury and the Federal Reserve aggressively injected trillions of dollars into the U.S. economy via robust fiscal spending, zero-bound interest rates, subsidized loan programs, and quantitative easing. As the economy recovered (thanks in large part to the Herculean efforts by the global medical community), the money supply skyrocketed, asset prices spiked higher, and many demographics ended up wealthier than prior to the recession. As the pandemic waned and

[1] First Trust Recovery Tracker. https://www.ftportfolios.com/common/contentfileloader.aspx?contentguid=78eacf61-1c26-40f4-ae6b-025fb63fb478. Accessed 10/7/2021.
[2] S&P CoreLogic Case-Shiller Phoenix Home Price NSA Index. July 2021. https://www.spglobal.com/spdji/en/indices/indicators/sp-corelogic-case-shiller-phoenix-home-price-nsa-index/#overview. Accessed 10/8/2021.
[3] Mortgage Debt Sees Record Growth Despite Pandemic. https://www.experian.com/blogs/ask-experian/how-much-americans-owe-on-their-mortgages-in-every-state/. Accessed 10/7/2021.
[4] Zillow Phoenix Home Values. https://www.zillow.com/phoenix-az/home-values/. Accessed 10/7/2021.
[55] US Consumer Price Index Data. https://www.bls.gov/cpi/. Accessed 10/8/2021.
[6] Bureau of Economic Analysis, PCE Price Index excluding Food and Energy. https://www.bea.gov/data/personal-consumption-expenditures-price-index-excluding-food-and-energy, October 8, 2021.

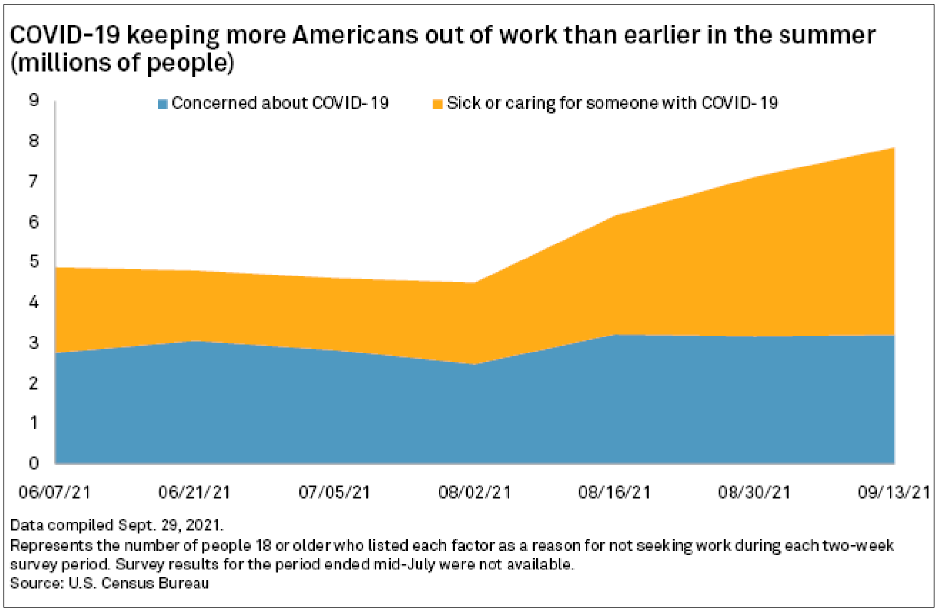
government related shutdowns lifted, consumer demand surged back to life. Yet, pandemic related closures continued to affect global supply chains resulting in higher material costs and fewer goods being produced. Classic demand-pull inflation.

Yes, hindsight is 20-20, but high inflation going forward isn't guaranteed. The Federal Reserve has come to terms with 'transitory' inflation running higher than target. Tightening monetary policy is expected to follow which will reduce the money supply and should help tame inflation. Interestingly, despite inflationary metrics rising since Q1 2021, the 5-year inflationary breakeven rate (the rate market participants expect inflation to be in the next five years) has been range bound, hovering around 2.6%.[7] This suggests capital markets don't expect runaway inflation like what we experienced in the 1970s and 1980s.

Energy prices remain high which may naturally slow economic growth. Higher energy prices are largely a function of demand outstripping supply, but other interesting dynamics are at play. U.S field production of crude oil remains approximately 13% below pre-pandemic levels. Meanwhile U.S. crude oil stockpiles are 40% below inventory accumulated last year.[8] Oil and gas executives are quick to quip that investors have generally punished domestic overproduction, so energy markets are increasingly at the mercy of OPEC+ direction. At the same time, energy shortages persist in Europe and China driving natural gas above seasonal averages.

WHERE ARE THE WORKERS?

Slack in the labor market continues. The unemployment rate declined .2% to 5.2% in August with approximately 8.4 million unemployed workers.[9] Yet, there remains an estimated 10.9 million job vacancies in the U.S.[10] Wage growth for the high school educated workforce is as strong as it has been since before the Global Financial Crisis. Why are workers taking so long to re-enter the workforce? An easy scapegoat, enhanced unemployment benefits, expired at the federal level in September, which should help absorb job vacancies. The spread of the delta variant continues to dramatically influence labor trends preventing millions of working age Americans from re-entering the workforce; as reflected in this U.S. Census graphic, a September 2021 survey showed a sharp increase of workers suffering from or caring for someone with COVID-19 as the reason they are not in the workforce.



[7] Federal Reserve Bank of St. Louis, 5-Year Breakeven Inflation Rate [T5YIE], retrieved from FRED, Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org/series/T5YIE. October 8, 2021.
[8] U.S. Energy Information Administration, U.S. Field Production of Crude Oil. https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=mcrfpus2&f=m, October 8, 2021.
[9] U.S. Bureau of Labor Statistics, Employment Situation Summary. https://www.bls.gov/news.release/empsit.nr0.htm, October 7, 2021.
[10] U.S. Bureau of Labor Statistics, Job Openings and Labor Turnover Summary. Job Openings and Labor Turnover Summary (bls.gov). October 7, 2021.

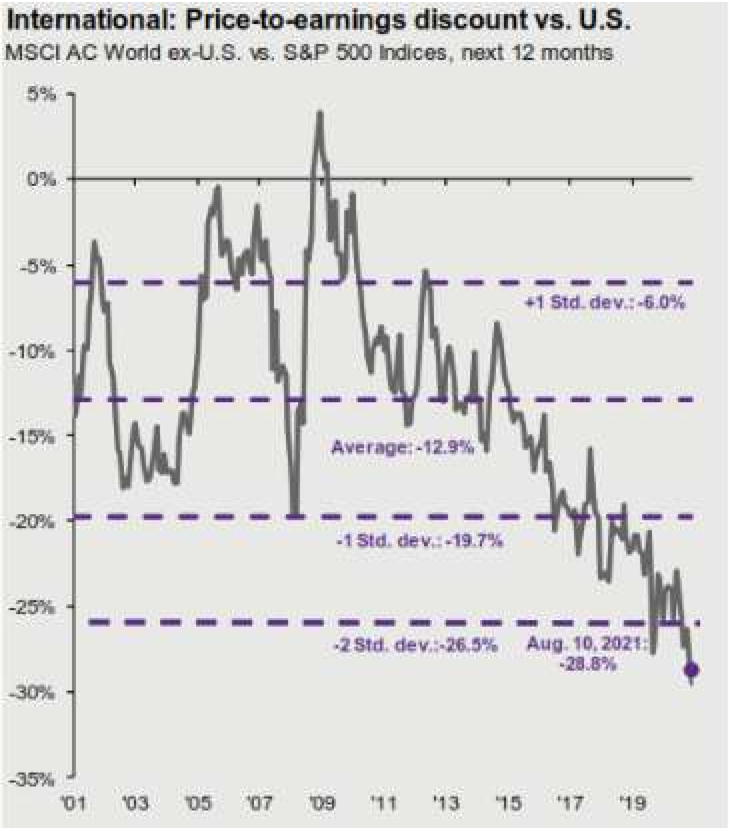
Assuming the delta variant wave continues to wane, and global health authorities approve vaccinations for kids, many economists are projecting the labor slack will tighten considerably in the next six months which bodes well for continued economic growth.

MONETARY POLICY AND INTEREST RATES

September's FOMC meeting delivered no changes to current monetary policy but did portend quite a few changes in the coming years. Economists expect the Federal Reserve will announce a plan to slow its asset purchases, currently at least $80 billion in U.S. Treasuries and $40 billion in agency MBS, next month with actual tapering to start shortly thereafter. The FOMC believes the economy is strong enough to grow without significant ongoing quantitative easing. Second, expectations for future rate hikes as evidenced by the 'dot plots' increased for 2022 as the Fed is now evenly split with half of the policymakers projecting zero rate hikes and the other half at least one hike. Longer term dot plots increased as well. It is expected rate hikes would not occur until after the tapering program concludes sometime in the middle of 2022. Remember the Fed recently adjusted its long-term inflation target from a static 2% to an average 2% target meaning it will let inflation deviate above and below 2% naturally before changing monetary policy.

CORPORATE EARNINGS AND VALUATIONS

Corporate America is expected to report continued earnings growth for second half of 2021 before tapering off in 2022 due to difficult comps. According to FactSet, expected year over year Q3 earnings growth for the S&P 500 is approximately 27%, representing a 2.9% increase in bottom-up earnings per share growth since the start of the quarter. As opined by FactSet, optimism among analysts and companies is high with the S&P 500 expected to deliver the third-highest year-over-year growth in Q3 earnings since 2010. Looking at the top-line, S&P 500 companies are expected to grow revenue by almost 15% year-over-year which would mark the second highest rate since 2008. Forward looking expectations remain high as well with an expected 20% year-over-year earnings growth rate for the fourth quarter. This puts the forward 12-month price to earnings ratio for the S&P 500 at approximately 20.1, which remains elevated relative to historical standards.[11] Earnings growth for overseas companies has been less robust. As reflected in the FactSet International Price-to-earnings discount vs U.S. chart, valuations for overseas companies remain at multi-decade lows as compared to U.S. corporations.



Source: FactSet, MSCI, Standard & Poor's, J.P Morgan Asset Management. Guide to the Markets – U.S. Data are as of August 10, 2021.

[11] FactSet, Earnings Insights. https://www.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_100121.pdf. October 8, 2021

PORTFOLIO POSITIONING

While September's equity market drawdown wasn't the largest percentage decline on record, the dollar losses were painful as investors' wealth is at all-time highs. With interest rates anticipated to rise over the next several years, many investors are wondering how to position portfolios going forward. Our view is that global economic growth will continue with above average inflation tapering down to long-term averages over the next few years.

U.S. equity valuations remain high, which could result in more muted equity returns going forward (sound familiar?). Based on government reaction to the recent delta variant wave, it appears widespread lockdowns are largely behind us. Additionally, COVID-19 seems likely to fade from being a pandemic to being endemic within our society. Commodities and other real assets should benefit if inflation runs hotter than expected. As always, we recommend our clients stay invested in diversified portfolios suitable for their personal risk tolerance and financial goals. We also support adding income producing real estate and private credit to a well-diversified stock and bond portfolio where appropriate.

Thank you for your continued support and trust.

Sincerely,
The Private Capital Management Team