Peak Asset
MANAGEMENT

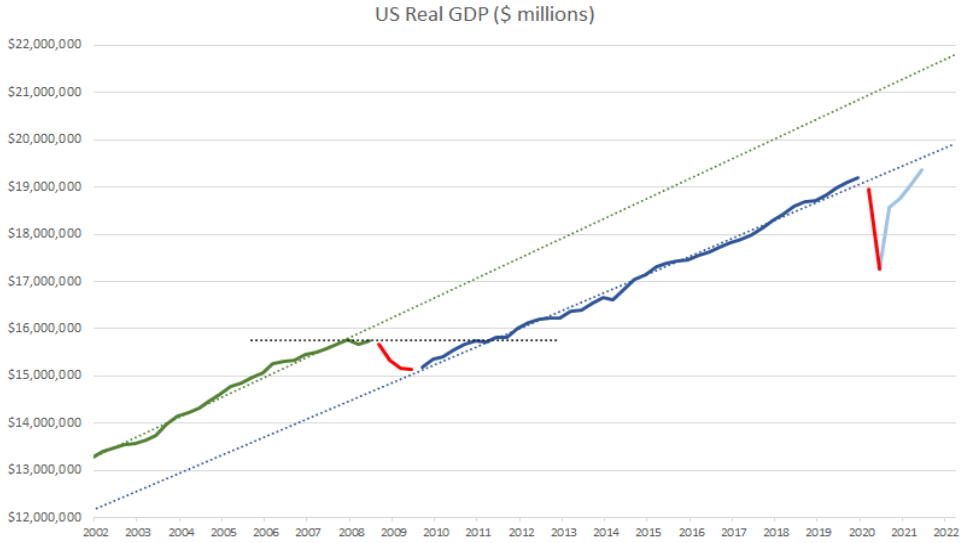
3RD QUARTER 2021 UPDATE

October 14, 2021

Risk and time are opposite sides of the same coin, for if there were no tomorrow there would be no risk. Time transforms risk, and the nature of risk is shaped by the time horizon: the future is the playing field.

Peter Bernstein, *Against the Gods*

U.S. Economic Output Surpassed the 2019 Pre-Pandemic Level: We have updated the chart that I put in our 1st Quarter Client Letter to illustrate the continued recovery in the U.S. economy. Real Gross Domestic Product (GDP) officially climbed above its previous all-time high from 2019 in the 2nd quarter of this year. The 3rd quarter estimates for growth remain positive but have been trending lower. Clearly, between the Covid-19 Delta variant wave here in the U.S. and other outbreaks around the world, the pandemic continues to disrupt the global economy. We have achieved an important milestone, but our growth rate, at least for now, has slowed.



The Stock Market Finished the 3rd Quarter Close to Flat: After the S&P 500 crested to multiple new highs in July and August, it had its first 5% drop of the year in September and finished with a total return of +0.58% on the quarter and +15.92% on the year. As has been the case since the end of the 1st quarter, a rotation into big cap blue chip stocks (technology companies plus others) has held up the S&P 500, while much of the broader stock market has been chopping sideways and many of the more speculative stocks have been trending down. For example, the Russell 2000 Small Cap Index closed down (-4.36%) on the quarter but is still up +12.41% on the year, finishing the 3rd quarter at the same level as in early February. Outside the U.S., international developed markets have also stalled with the EAFA Index down (-0.45%) on the quarter and up +8.35% on the year, finishing at the same level as mid-April.

In 2020, the stock market primarily traded based on the economic impacts of the pandemic along with the fiscal and monetary policy responses. That is, stocks plunged and then soared. This year it has gotten more complicated. 2021 is all about transitioning to whatever "normal" might be, in fits and starts. We have the vaccines, but we also have run into all kinds of real-world constraints – the Delta variant, global supply chain disruptions, labor shortages, inflation, absurdist government shutdown theater, etc. I recently read a nice turn of phrase from Tom Lee in the *FSI First Word* newsletter that I thought summed up where we are: "the quantity (not necessarily quality) of risks had risen considerably." In general, while I think the U.S.

economy has more growth ahead and will fully recover back to our former growth trendline sometime next year, I also think the rate of earnings growth for stocks has peaked and, accordingly, the market is trying to adjust. More sideways churning for the stock market would be a graceful bow after a great run from the pandemic lows.

The Bond Market Finished the 3rd Quarter Flat: The Barclays Aggregate Bond Index was down (-0.01%) on the quarter and (-1.67%) on the year. In general, municipal bonds, mortgage-backed bonds, leveraged loans, and high yield corporate bonds earned positive total returns on the quarter and year-to-date, while U.S. Treasury bonds and investment grade corporate bonds had negative total returns in both time periods. With guidance from the Federal Reserve, market participants in bonds and stocks are now anticipating a reduction in monetary stimulus. First, "tapering" of bond purchases (or quantitative easing/QE) is likely to start in November or December, with the complete elimination of purchases by mid-2022. And second, the consensus of the Fed Governors is that interest rate hikes on the Federal Funds overnight rate (currently set at 0%-0.25%) will begin in late 2022. The Fed has bent over backwards to say there is no connection between QE ending and interest rate hikes beginning, but the history of the financial markets is to throw "taper tantrums" as the Fed tries to reduce QE purchases – and for the Fed to blink. The major difference between now and past reductions in QE is that inflation is running hot, potentially reducing the Fed's flexibility.

Inflation is Here: From Jerome Powell, the Fed Chair himself, in his 9/28/21 congressional testimony, "The current inflation spike is really a consequence of meeting very strong demand, and that is associated with the reopening of the economy, which is a process that will have a beginning, a middle and an end." In general, I agree that the markets will eventually resolve the current disequilibrium between supply and demand, but I also see some stickiness, or longer-tail inflation, as asset inflation in housing prices works its way through upward rent adjustments over time, and from the cycle of increased wage demands to meet employees' real increased cost of living from this "transitory" period. Eventually, I do think we will get back to the pre-pandemic division of inflation/deflation, where things like housing, education, medical care, etc. increase at an above "average" rate while technology drives down costs and increases productivity in other areas.

Opening Quote: A few weeks ago, Liz Ann Sonders, Charles Schwab's long time Chief Investment Strategist, put out a piece where she reminisced about some of her mentors from her 35 years in the investment business. She also included some of her favorite quotes from her stable of classic investment books, including the quote that opens this letter. I too have a copy of Peter Bernstein's *Against the Gods* on my bookshelf, and seeing his name was a good reminder of how often I rely on the concepts around risk that he outlines in his book – particularly, per the above quote, on the intrinsic link between risk and time. Along with the practical application of the concept in portfolio management, when I think about risk and time in terms of living through a pandemic, at least for me, the complexity of the relationship between the two is brought into striking focus. My takeaway, or my existential silver lining, is that the pandemic has actually helped me be a bit more thoughtful and present with others and more intentional about finding the joy in each day.

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We hope this letter finds you and your family well. We appreciate your business and we continue to work hard to earn the trust that you have placed in us. Please let us know if you have a friend or a family member that could use our assistance.

John McCorvie, CFA

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