CRYSTAL WATERS PARTNERS

Market Outlook

October 2021

Growth Outperforms in October

New fears were in the market during October including, tensions with China and predictions about what Fed chair Jerome Powell might say at the November meeting of the FOMC. Regardless of the latest bricks in the wall of worry, investors bought growth stocks at an accelerating pace into the end of the month.

Growth stock buying has been driven by increased liquidity and more clarity around the Feds plan to slowly reduce asset purchases by $15 billion per month. If the pace of reductions is maintained every month the Fed should end asset purchases in June of 2022. Should the Fed need to continue tightening the next action they would take would be to raise rates, but the litmus test for raising rates is much stricter than the one used to reduce asset purchases.

Portfolio Weighting

The most disruptive companies with the most business upside ahead of them over the next 5-10 years continue to be growth companies in technology and healthcare, particularly those who are advancing human genomics that cure disease. We are also seeing rapid advances in the financial sector, particularly among FinTech companies gaining market share. These companies typically get rewarded for their growth disproportionately when interest rates are low since a large part of their value comes from future earnings discounted at a lower interest (discount) rate. As rates rise, these future cash flows get discounted more, and value investors are willing to pay decreasing prices for the stocks.

We are still in a low-interest environment with the Federal Reserve aiming to keep rates low for at least another year or more. The Fed has begun to signal that they will begin tapering asset purchases after the November 2021 meeting but that the test for raising rates is far more stringent. Tapering would only begin if employment were to pick up substantially and show that employees are staying at their jobs.

If rates remain low, the fund will favor quality disruptive companies that are innovating in the technology, healthcare, and FinTech sectors. As we see a higher likelihood of rates increasing, we will modify the allocation accordingly.

Return To Growth

Last month we discussed growth vs value investing and the events that transpired over the past year that influenced investors to move assets into value stocks. We also discussed at length why we felt that was the wrong move and that the trend would be short lived. While one month isn't a trend, October proved to be the month where growth and value swapped positions and growth stocks are once again leading the market higher.

Tom Lee, Fundstrat Research Managing Partner has called this the "*Everything Rally…*" and that "*…markets are positioned to continue rallying into year-end*". The bond market has been signaling equities have more room to run higher. The combination of declining 10-year bond yields, a week GDP and productivity read out, increasing vaccination rates, and Pfizer's COVID-19 pill combined to give investors the optimism that the economy will continue to strengthen.

Our view of this market was and is instructed by these four data points:

1) S&P profit margins would survive, in fact they outperformed. Consensus is for S&P earnings next year around $220; we would consider $230-$240 reasonable.
2) There was lots of pent-up demand in the economy.
3) Relative value. Investors are paying about 64 times earnings for a 10-year bond, and 25 times earnings for a high-yield bond vs about 18 times earnings for stocks. Stocks are still cheap making stocks the best recipient for idle cash.
4) Investors have been sitting on a significant amount of cash, some hopeful for a 10% or better pull back in the market that never came, and now that cash can be put to work.

We see the market continuing to rise into year-end, driven by demand, earnings and added liquidity. Growth stocks should receive a disproportionate number of investors dollars.

Economic Outlook

October started out a bit volatile but by month end all indexes were 4% to 7% higher with the technology heavy NASDAQ leading the way. The small cap Russell 2000 index is still trailing the NASDAQ, DOW and S&P 500 which bodes well for a strong rally in all those fast-moving growth stocks. Regardless of the volatility, Fed decisions, inflation worries and politicians blocking the $1.75 trillion infrastructure and social spending bill, Lipper found that for the week ending October 27th, global equity funds saw an additional $24.5 billion in inflows, the most since mid-March, with more than half of those inflows going to U.S. equity funds. Idle cash if flooding into stocks and equity funds and hedge funds are expecting more.

New home sales in September rose 14% to a seasonally adjusted 800,000, well above the expected 760,000. The number was likely constrained by a lack of supply in the new home market. We note that new home sales not started year-over-year were down 17.6% and completed new home sales were down 35.9% YoY. The rise in September was impressive considering the materials shortages that restricted builders and buyers from completing transactions.

The Conference Board's **Consumer Confidence** for October rose to 113.8 from 109.8 vs an expectation for a decline to 108.3. The percentage of consumers all planning to buy autos, homes, and major appliances all increased in October.

The National Retail Federation is forecasting an 8.5% to 10.5% YoY increase in holiday spending. This forecast is significantly higher than the previous 4%-5% increase.

Weekly jobless claims fell to a new 19-month low of 281,000. The four-week average has dropped below 300,000 for the first time since March 2020.

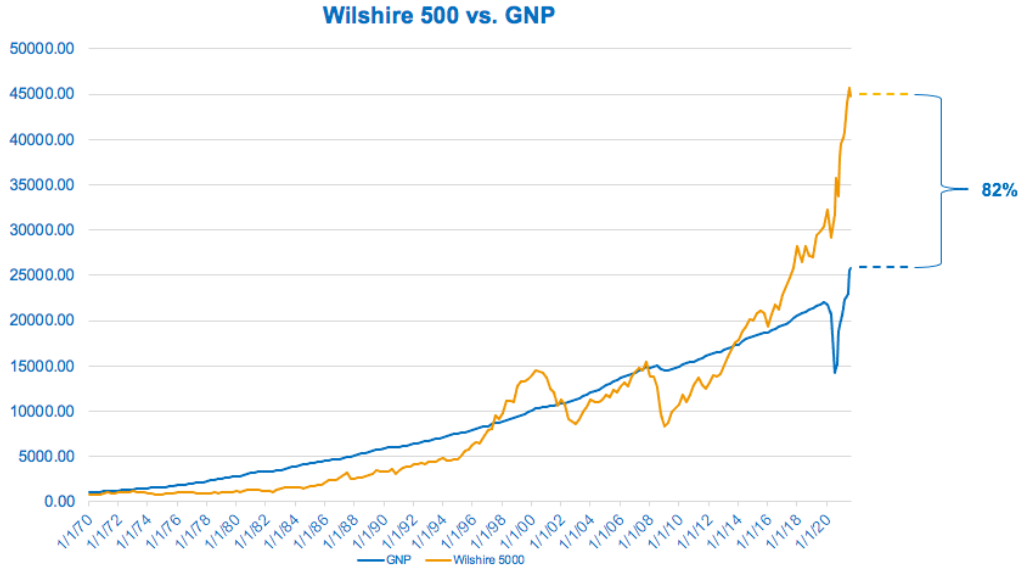
The preliminary GDP reading for the third quarter 2021 was a huge disappointment at only 2.0%, missing the expected 3.5% consensus forecast.

Personal income came in lighter than expected, likely driven by the end of pandemic stimulus checks. **Real personal spending** increased 6.2% YoY even though real disposable income was down 2.0% YoY. Consumers are either spending the last of their pandemic checks, or they are saving what they have for the holiday shopping season. Either way, we are squinting a little at the National Retail Federations numbers.

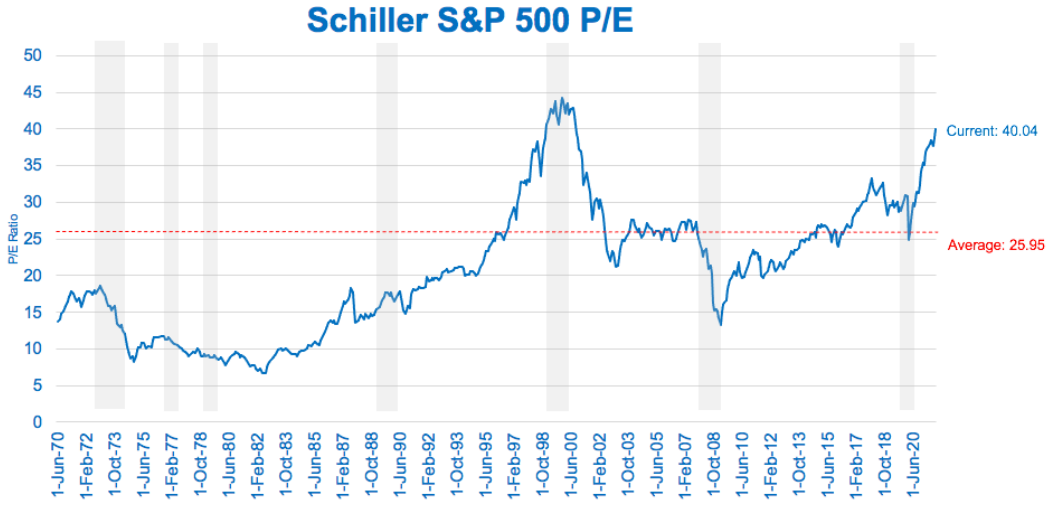
November will be exceptionally busy with company earnings reports and a slew of new economic data from the U.S and all around the world.

Market Valuation

The Wilshire 5000 is 82**%** higher than the US GNP, which is a slight narrowing of the gap. With projected GNP growth of 6.6% this year, we expect the gap to continue to close over time for the Wilshire 5000 index to be above GNP as long as interest rates remain relatively low.



Despite low interest rates, the Shiller P/E Ratio, which adjusts earnings for inflation and interest rates, continues to climb. Part of this is due to faster projected growth rates for the index companies and the economy as a whole, but we are in overvalued territory. This kind of momentum can produce outsized returns, but we are keeping a close eye on growth rates to ensure any premium is justified.



Earnings are expected to grow significantly over the next 1-2 years, which should drive the ratio down, but we are at valuation levels that have our full attention. We are confident that we own high-quality companies that will fare better than the broader market in the long run.

What Excites Us

Growth at Reasonable Prices

Growth companies have sold off drastically since March this year. Yet, many of these companies are the fastest growing and most profitable companies with large competitive advantages that give them decades of future above-average growth. At the previous highs, we would have been hesitant to add and increase our cost basis. However, without taking too much risk, we see the current selloff as an opportunity to continue to build the portfolio's positions where we have the strongest convictions.

Amount of Money Still on the Sidelines

Personal and corporate disposable income is at an all-time high. Some disposable income will go to purchases and capital investments, but some will find their way into the equity market as well. Consumer purchases and corporate capital investments will continue to drive economic growth, while any inflow to the equities market will add further support for stocks. We are conscious that too much liquidity can create a speculative frenzy, but as long as our companies have solid fundamentals, we see the added capital as a benefit to the fund and its L.P.s.

Depressed Investor Sentiment

Depressed investor sentiment is a contrarian indicator followed my analysts and large fund managers alike. The absence of euphoria has historically led to bull markets. The increasing breadth in stock ownership is indicating that investors are looking for places to hide-out in safety until more clarity shows up. Google search terms for the market are down 32% in September suggesting retail investors are taking a time out. Fundstrat's Tom Lee echoed that these indicators are suggesting the S&P 500 could surge to 4,700, nearly 7% upside from todays close.

What Keeps Us Up at Night

Infrastructure & Social Spending Bill

A lone holdout in the Democratic party is driving a reasoned debate about what this bill should include and exclude. Free college for all is out. Paid family leave is teetering on the fence as discussions about funding persist. We would prefer to see infrastructure alone approved while the rest is debated but progressives won't agree to that strategy.

Semiconductors

The chip shortage continues while a herculean effort to build new foundries is underway. Some of the largest are being built in Arizona by Intel and Taiwan Semiconductor. Biden has committed $50 billion to the effort while Korea and the EU have committed far more, leaving the U.S investment looking a bit pathetic. This is a national imperative for our supply chains and a major national security issue that must be resolved.

Global Conflicts Impact on U.S. Interests

Two things cause the most upheaval in markets and increase inflation, 1) Interest rate hikes, 2) Wars. According to the Global Conflict Tracker at https://www.cfr.org/global-conflict-tracker/?category=us; there are five critical Conflicts, twelve significant conflicts, and ten limited conflicts that all have a direct bearing on U.S. interests. These are ongoing and will probably be on our radar for months to come. Tensions between the U.S and China, Taiwan, Iran and now between the US and France over a military contract that was shifted to Australia didn't help our relations in Europe. The deal with Australia looks like a message being sent to China that we will defend global interests in Taiwan. Taiwan being the largest semiconductor producer in the world.