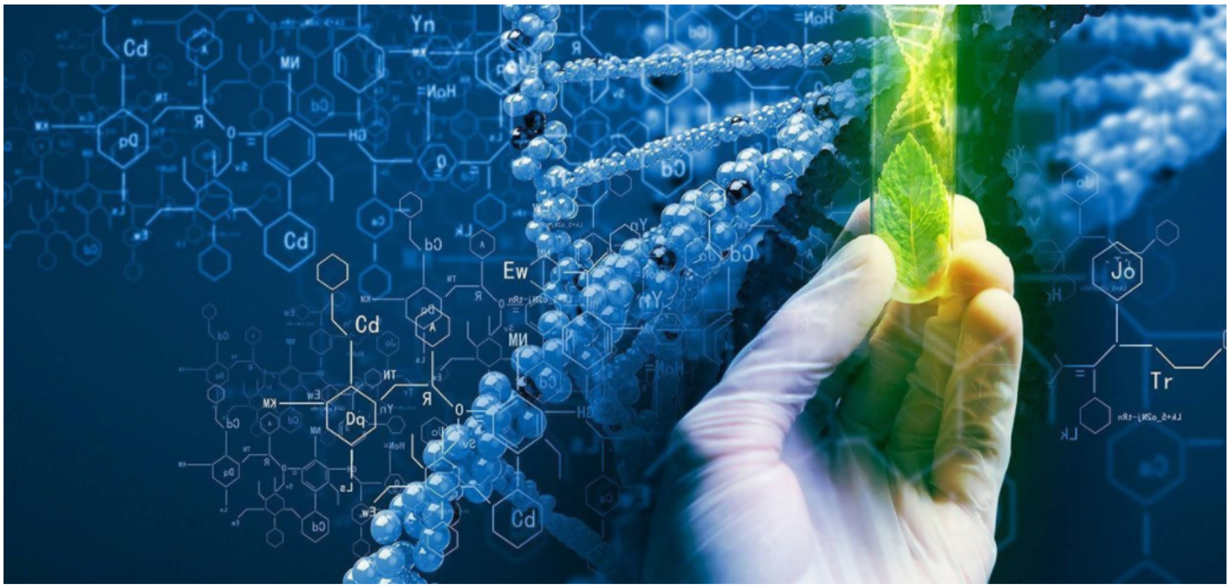
CRYSTAL WATERS PARTNERS

Market Outlook

July 2021



Investments & Vaccines for The Long Haul

The fund's holdings remain focused on faster-growing companies that have a large addressable market and many years to enjoy above-average growth.   Valuations on growth companies are always higher than the broader market, but with inflation fears lingering, investors remain hesitant rewarding growth with the same multiples as before, which has impacted us since March of this year. However, COVID lockdowns have created significant pent-up consumer demand and caused supply chain issues globally that have still not been fully resolved. Neither is permanent, and we continue to believe inflation in transitory. Additionally, interest rates are still the lowest in decades, and our portfolio companies' business are all booming. Until we see signs that inflation is more permanent, rates increasing materially, or business actually starts to slow, we are comfortable owning what we own rather than chase the market.

Biotech in Focus again – VBI Vaccines

- **Small speculative positions provides good risk reward**
- **Need longer time horizon**
- **With infectious diseases on the rise, VBIV is a vaccine behemoth in the making**

Bigger Returns Require More Patience & Different Thinking: VBI Vaccines (VBIV)

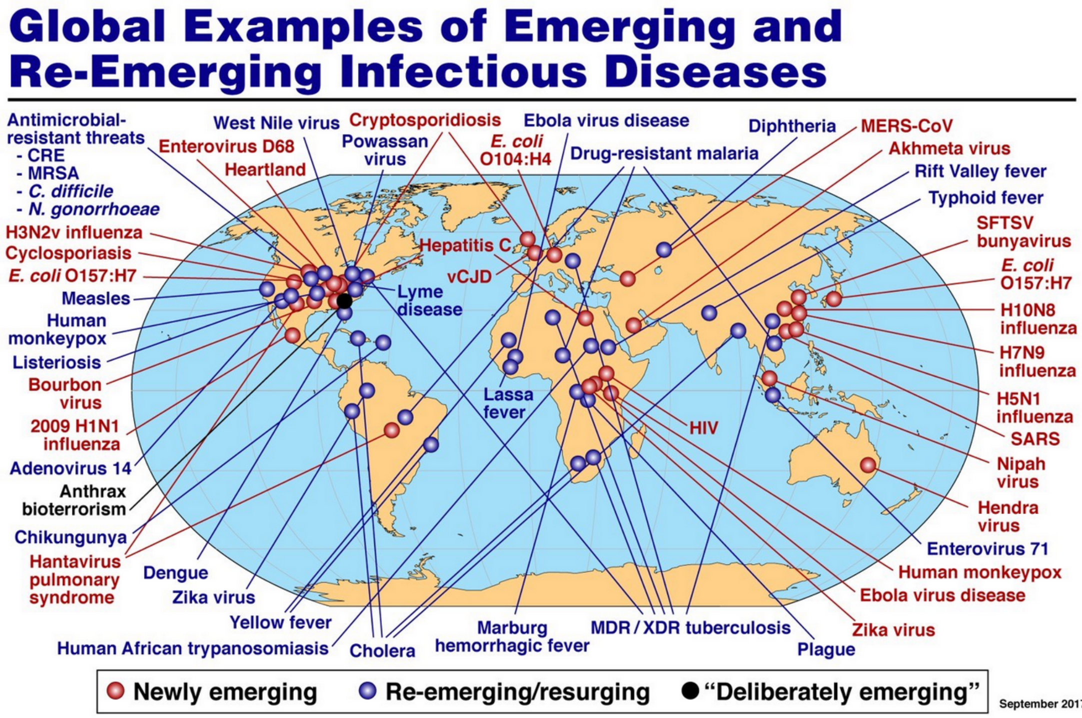
The CWP portfolio consists primarily of high-quality mid and large cap companies that have fast-growing commercial businesses that are likely to continue for many years. We evaluate the industries and competitors, and analyze companies' revenue, earnings and all the factors that affect them to understand valuation and reasonably assess progress each quarter.

However, a small portion of the portfolio is dedicated to smaller speculative companies going after very large addressable markets with disruptive new science and technology. Rather than looking at current financial metrics, we apply more lateral thinking, focusing on what parts of the world might look like if we did things in new ways. Small, early-stage companies with differentiated products are the kinds of companies that produce exponential returns many times over as the investment thesis plays out.

That said, larger forces often cause early-stage companies to fall short, so there is real investment risk that every thesis won't play out in full or that it will take a long time and won't contribute to the fund's month-to-month performance just yet. As a result, we take small positions. This means we can expose our limited partners to the truly outsized long-term returns without taking too much risk. Much of the fund's outsized returns in our early years came from smaller investments in early-stage companies that doubled and tripled many times over, and as long as we make sound investment decisions, our long-term focus makes us well-suited to continue to be patient and let these investments mature on their own schedule. Returns are a little lumpier, but we usually like the end results. We own a handful of these more speculative companies, and this month we are featuring one of them, VBI Vaccines.

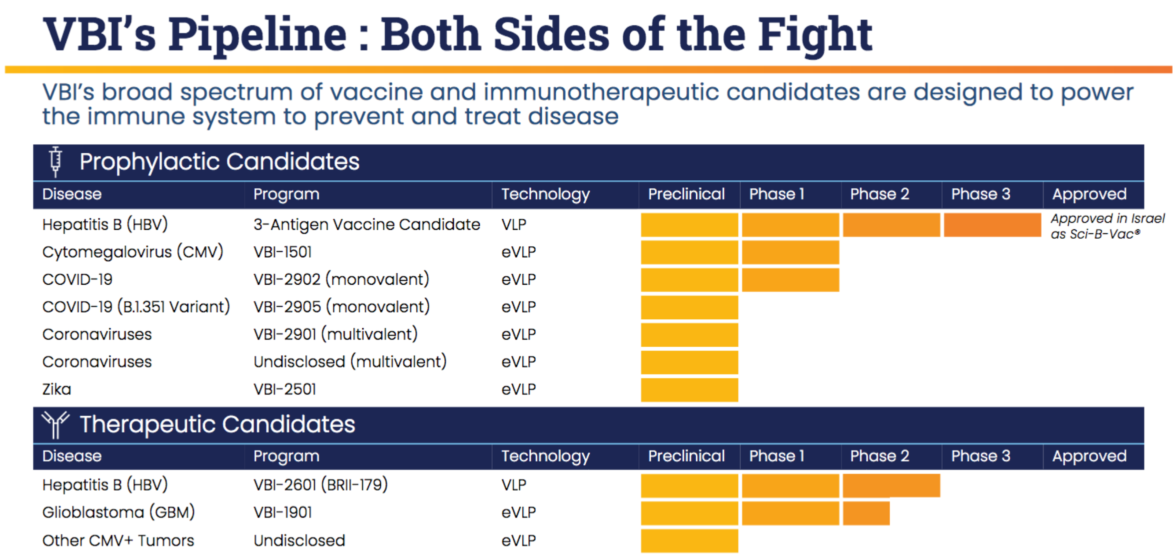
VBI Vaccines (VBIV) – A Platform for Fighting Infectious Diseases

When Anthony Fauci became director of the NIAID in 1984, he drew a map of the world for presentation at a congressional hearing that showed a single notable emerging infectious disease threat without a vaccine: HIV. Since then, he has continually updated the map, which now shows the emergence of so many infectious disease threats that we can hardly keep count (see below).



As the world population grows and our proximity to each other (and to wild animals) becomes much smaller, the threat of infectious diseases becomes more the norm than the exception. As COVID has illustrated, the need to develop safe and effective vaccines is rapidly becoming paramount.   Enter VBI Vaccines.

VBI Vaccines is a clinical stage vaccine developer. Through its proprietary enveloped virus-like particle (**eVLP**) platform it is focusing on both prophylactic and therapeutic vaccines for Hepatitis B, Glioblastoma (brain cancer), Zika virus, Cytomegalovirus, as well as a myriad of coronaviruses and their variants (including COVID-19). The vaccines are in different stages of development and each of them addresses multi-billion-dollar markets. However, the eVLP platform itself is receiving a lot of attention for its value to serve as the developmental foundation for scientist to develop any kind of future vaccine in a fraction of the time. The platform is essentially the delivery vehicle with the antigen of choice where scientists can swap out one antigen for another.



Prior to COVID-19, VBI's primary focus was on Hepatitis B and Glioblastoma. However, when COVID hit in early 2020, it became clear to the company and many scientific agencies that the eVLP platform and earlier work done on other coronaviruses such as S.A.R.S and M.E.R.S. made it uniquely qualified to develop a potent vaccine quickly. In fact, as countries scrambled to secure vaccines, the Canadian government provided VBIV with more than $50 million in strategic funding to begin an accelerated COVID-19 vaccine program, and CEP (Coalition for Epidemic Preparedness Innovations) provided an additional $33 million to the company to develop a vaccine candidate.

Early results for its COVID vaccine have produced an order of magnitude greater number of neutralizing antibodies at a fraction of the dose versus other vaccines on the market. More than that, analysts believe that as VBI optimizes the adjuvant (molecules that boost the effectiveness of a vaccine), it's possible that the company's vaccine could end up being 2 orders of magnitude more potent (100x more effective than Pfizer, Moderna, Astra Zeneca, etc).

However, VBIV has progressed slightly slower than the large multinational pharmaceutical companies. As such, the company is looking beyond the initial batch of vaccines and positioning itself for a much bigger target. There's ample data that the virus will find a way to mutate, and what is really needed longer-term is a vaccine that can protect against all beta corona viruses, the family of viruses that also birthed SARS, MERS and varieties of the common cold. VBI's plan for a pan-coronavirus vaccine is deceptively simple. All coronaviruses have a spike protein that enters the cells when infected. If you think of each of those spike proteins as a color, you can make antibodies see blue, yellow and red. However, you can also teach the immune system to see something that's slightly between the blue and yellow, and now you have antibodies that see green, effectively protecting you against viruses that don't even exist yet. The company has shown in early tests that this actually works, which places VBIV in a position to be among the companies the world will look to for solutions to all the COVID variants and outbreaks of new unknown viruses.

The VBIV Opportunity

VBIV is still only at the clinical stages with lots of work ahead. VBIV has no revenue, yet and still sports a $750 million valuation. However, its pipeline of drugs is impressive, and as it approaches commercialization, this is where it gets interesting for investors. The eVLP technology is proving to be a valuable platform for developing potent vaccines quickly, and the company's individual vaccines have highly promising results and large addressable markets. Analysts expect VBIV's Hepatitis B vaccine to generate peak revenue of $400 million, should the FDA approve it in November, and the market for Glioblastoma treatment is expected to reach $3.3 billion in 2024, a year or two after VBI is expected to have a therapeutic vaccine approved.

A pan-coronavirus vaccine would be multiples bigger than anything else in the pipeline. Pfizer generated $3.5 billion from its COVID vaccine in just the first three months this year, and any vaccine with broader benefits may have a more protracted rollout but will generate similar levels of revenue.

The road ahead for VBIV is long and investors need patience. It will be another 6-12 months before we see any meaningful revenue, but even if the company is partially successful, the valuation should be multiples of where it is today.

Economic Outlook

These days, we are seeing some of the classic indicators of a transition into the middle phase of an economic cycle: Year-over-year comparisons of growth measures and corporate earnings are cresting.

As economic growth moderates, investment uncertainty has increased, and a narrative has begun to take hold among some investors. The market's rotation toward defensive and secular technology stocks indicates that investors' outlook on economic growth is definitely dimming. There also seems to be a worry that the Federal Reserve might start to taper its stimulative asset purchases earlier than expected, which would further slow growth. A small fraction of economists have even warned of a return to 1970s-style stagflation, a difficult period of high inflation and slow growth.

When you are dealing with people's hard-earned money, you should always be vigilant and on the lookout for potential risk. However, we remain convinced that the scare of a slowdown is overblown, and we are in a new growth cycle. There are some ups and downs, but the general direction is up. Here is why:

- **Growth is certainly slowing, but only from the extreme comparisons of last year's trough. Through a normal lens, growth remains solid.** Preliminary estimates for second-quarter gross domestic product (GDP) growth came in at 6.5% and Morgan Stanley's Chief Economist, Ellen Zentner, which has so far been spot-on, forecasts third-quarter annualized GDP growth of 6.1% as supply-chain pressures continue to resolve and fiscal spending prospects turn up. Strong fundamentals also underpin this forecast. Recent data updates saw U.S. manufacturing activity grow, housing prices rebound and durable goods orders advance.
- **Second-quarter corporate earnings validate the growth.** As of July 30, 88% of public companies have reported earnings that came in above analysts' expectations. Looking ahead, analysts are projecting double-digit earnings growth for the remaining two quarters of 2021.
- **Consumer confidence remains high.** U.S. consumer confidence as measured by the Conference Board Consumer Confidence Index inched up slightly in July, to 129.1, the highest since February 2020. Stable confidence and rising wages, together with growing household wealth and ample savings, should keep consumer spending high.

Still, the economy and markets do face headwinds. Uncertainties remain around the Delta coronavirus variant. While we think the virus' impact on corporate profits or intermediate-term economic growth will likely be limited, it could weigh more heavily on the labor market recovery, thus affecting Fed policy choices. With the central bank emphasizing its goal of maximum employment and sticking to its view that inflation will be transitory, there is a growing possibility of a policy error.

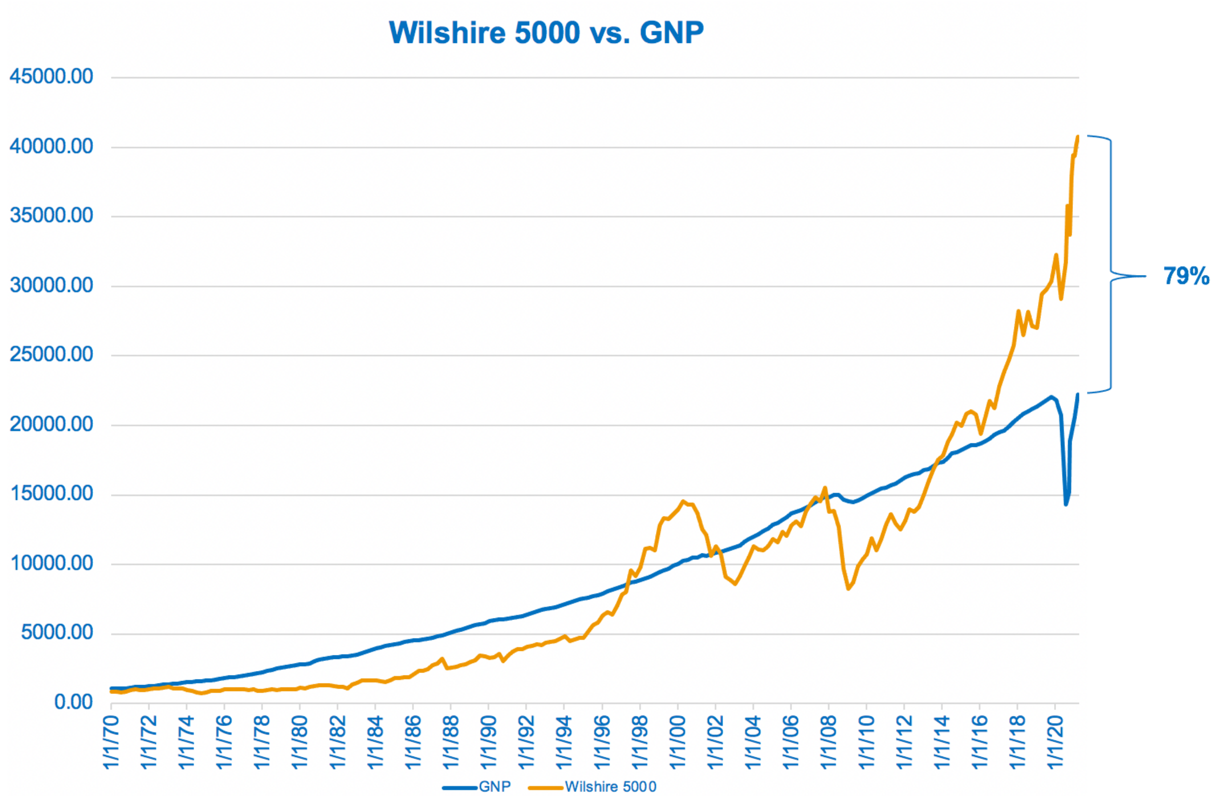
Another risk comes from China, which recently stated it wants to improve stability in its domestic financial markets and establish self-reliance in high-tech industries, making clear it plans to grow on its own terms, not those of the West. Longer term, this pivot may weigh heaviest on multinationals and U.S. secular growth companies that have long depended on globalization generally and China specifically for their growth. The semi-conductor industry is most at risk from China, principally because of Taiwan's exposure to China policy. Taiwan is the largest manufacturer of semiconductors in the world and manufactures the most sophisticated chips. Any disruption to the global supply chain due to China policies will have dramatic effects on the global economy.

Any transition into the mid-cycle phase is likely to come with uncertainty and volatility. There is an unusual amount of money on the sidelines and the extreme levels of liquidity searching for a home in today's markets only complicate that picture as disproportionate inflows and outflows can push the market around more than usual.

Market Valuation

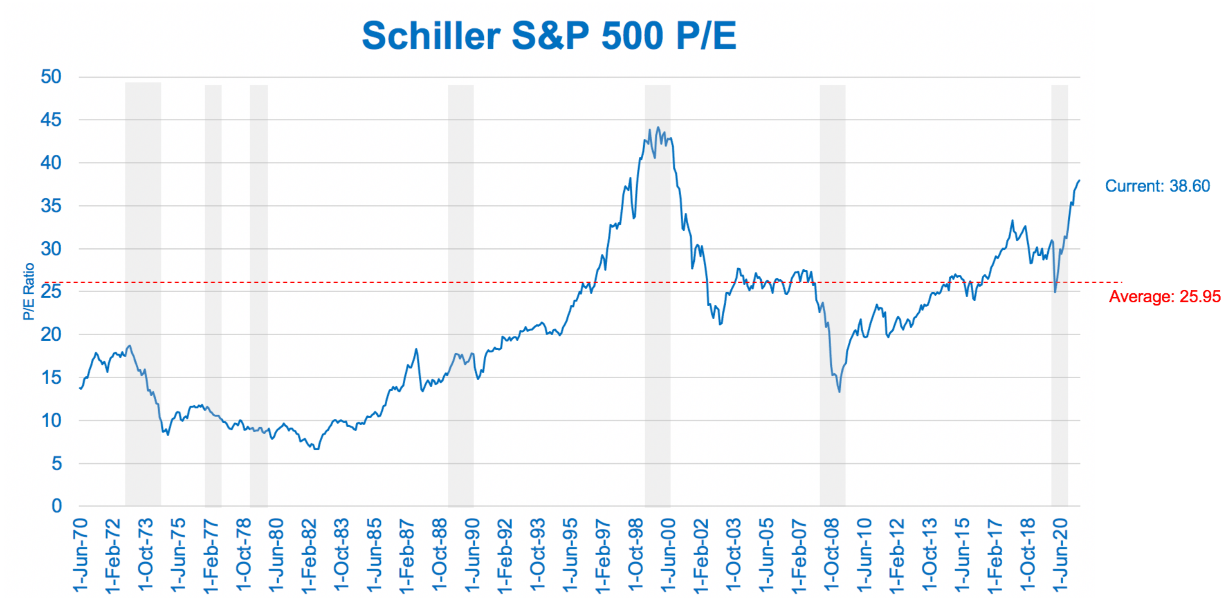
The broader market has continued its steady march upward, but economic growth as measured by GNP has grown even faster, narrowing the gap between the Wilshire 5000 and the nation's output.

The Wilshire 5000 is now 79**%** higher than the US GNP, which compares to a **92%** divergence in June. While we are still in overvalued territory, a 14% decline in one month is significant, but we have strong economic growth supporting the market. The gap may never fully close, but the risk of a major correction based on business fundamentals is being reduced every month.



The Bureau of Economic Analysis forecasts that US Real GDP growth will rise 6.6% or more in 2021. The gap should continue to close unless the broader market exceeds GDP growth from here.

Interest rates remain at all-time lows, but even the Shiller P/E Ratio which adjusts earnings for inflation and interest rates show that we are at levels that are historically not sustainable.



The caveat here is that stock prices are forward-looking and earnings in the ratio use the historical 10-year average. 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 same 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 are at an all-time high. Some will be spent on purchases and capital investments, but some will find its 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 cognizant that too much liquidity can create a speculative frenzy, but as long as our companies have solid fundamental, we see the added capital as a benefit to the fund and its LPs.

The Delta Variant

Investors need more clarity before the Delta variant overhang will be removed. If investors get good reasons to look past Delta, the market will turn into an everything rally. Re-opening stocks should come back strong, commodities may surge again, and consumer spending should grow to historical highs. Come the Fall, when kids are back to school, the historically high job openings will begin to diminish. The faster positions are filled the less employers will have to pay up to hire the people they need, raining in the inflation predictions.

What Keeps Us Up at Night

Virus Variants drive higher infections

COVID-19 variants are driving infections higher, not only in the US, but globally. Any reversion back to last year's lockdowns could be devastating for economic growth, but even if lockdowns do not occur, large pockets of infections are impactful enough to disrupt supply chains and keep inflation lingering. Vaccination rates remain too low for herd immunity, and we would like to see the US continue to make progress, especially in the southern states, on vaccinations.

Rotation to Value Stocks

Money has continued to move to large value-based companies with high current free cash flow and lower growth. Primarily, this is in anticipation of inflation running wild and the Fed having to raise interest rates significantly. We see both inflation and the rotation to value stocks as transitory, but we are on alert to any signs of permanent supply/demand imbalance that will drive inflation to levels where the Federal Reserve have to raise rates.

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; there are 5 critical Conflicts, 12 significant conflicts, and 10 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.