CRYSTAL WATERS PARTNERS
Market Outlook

June 2021

New Business Boom

The fund continues to favor faster-growing companies. We continue to believe the inflation rise is transitory and the fear of rising rates to a point that will hurt equities long term is vastly overstated. The majority of the fund's holdings are high-quality companies positioned to disrupt their industries and outperform over the next 5-10 years. As inflation fears plateau, the growth of our portfolio companies should drive returns well-above the indexes.

We are now beginning to see the signs of our thesis playing out. Technology companies, in particular, reported great earnings and offered strong guidance. Rates remain low and the bond market is signaling transitory inflation with the 10-year Treasury yield moving below 1.4% from a high of 1.7%. We have a lot of work to do but are optimistic about the rest of the year.

Growth vs Value

The market continues to have a **growth vs. value tug-of-war** as investors keep moving money into both growth and value stocks. We think investors tried to outsmart themselves and forgot to look at the long-term performance of growth stocks over value stocks. The last time this tug-of-war occurred was during 2003-2005 in the post dot-com era. The fund always maintains a few value stocks in key sectors to help reduce volatility, but we did not change our overall strategy or our thinking about where the biggest growth will come from over the next few years.

Legend: black (S&P500), Blue (Energy), Purple (Financials), Pink (Technology), Red (Biotech)

New Business Boom

- **New business formation**
- **New Business Growth 135%**
- **Invest in Growth**

What is New Business Formation?

When new businesses formally startup they apply for permits at city, county, state and sometimes the Federal level. Submitting an application for an Employer Identification Number (EIN) typically separates hobby businesses from formally organized businesses. The chart on the next page includes all applications for an EIN, except for certain unique applications and for those in agriculture, forestry, fishing and hunting. New business formation is crucial for economic growth. New businesses rent commercial space, buy computers, furnishings, supplies, they buy commodities, manufacture products, provide essential services, hire employees, provide insurance and other benefits to households, and of course they pay taxes.

New Business Growth 135%

Over the past decade, new business formation in the U.S has been on a steady climb from about 186,000 to 312,000, roughly 68% increase over 10 years. When COVID-19 hit, new business formation declined to the mid-range around 240,000. Between April and July 2020, entrepreneurs got busy, sending new applications to an all-time high of over 551,000, a 135% increase in just four months. The surprise came as new applications surged again in January through May 2021 setting the economy up for substantial growth. The rate of growth since 2004 has been fairly steady. Not even the financial crisis and great recession did much to stifle new business formation. COVID-19 was estimated to have killed 7.5 million jobs and ushered in the "work-from-anywhere" era. In the last jobs report we learned that there are over 9 million jobs available, indicating that the U.S economy is booming on new business formation. The chart below from the St. Louis Federal Reserve dramatically illustrates the growth in new business formation.

A recent survey noted small business owners have many plans to grow their businesses in the coming year. 49% plan to increase staff and expand or remodel their business. 55% will increase investment in digital marketing. 27% will be investing in IT infrastructure, while 22% will invest in business services like SaaS software to manage payroll, accounting, and inventory management. The age of new business founders can be instructive. The last few years have seen a shift from small business owners who are Baby Boomers (41 percent) to those who are Gen X (46 percent). Right now, Millennials make up 13 percent of small business owners, while only one percent are Gen Z, or "Zoomers." The Millennial through Gen Z generations are more likely to buy Apple products, implement technology from the start, use cloud based solutions over on-premise legacy systems, and most importantly have a much longer lifespan to grow their businesses than Baby Boom generation owners making this a long-term theme.

Invest In Growth

There was enough 'connect-the-dots-data' available to give us conviction over the last six months to repeatedly say the second half of 2021 should prove to be a period of big growth. This one exceptional chart from the FRED is another confirmation of our prediction.

Translating economic growth data into investable ideas is challenging. Since the vast majority of these new businesses are small businesses and not publicly traded, we have to look at the businesses that will serve all this growth. Companies like Visa, Mastercard, Square, PayPal, Shopify, Affirm, Plaid and SoFi should benefit from payments and lending. Ford and GM will benefit from sales of pickups, vans and other lighter duty trucks. Don't forget what all those trucks run on, we would look to the oil companies like Phillips 66, Conoco and Devon Energy for well-run operations. Uniform companies like Cintas, Aramark and newly IPO'd premium healthcare attire and lifestyle brand Figs. We're also looking at cloud services, tools and security companies like Adobe, DocuSign, Salesforce, Crowdstrike, Zscaler, Fortinet, Paycom, ServiceNow, Okta, Twillio, Facebook, Alphabet, Paychex and Intuit. Crystal Waters is actively hunting the boom for our investors.

Economic Outlook

As we entered July the stock market climbed to all-time highs again. While the company-specific news has been limited, the macroeconomic readings have largely been in line to better-than-expected. The macro data is helping give investors' confidence that interest rates will not be rising anytime soon, and that inflation will not be as bad as predicted. The bond market continues to advise the stock market that inflation fears are overdone, and growth stocks can continue to go higher in a low-rate environment. Since our investment decisions are influenced by the macro economic data, below are some of the metrics that we track.

The **ADP National Employment Report** (NER), a report driven by ADP paycheck data, revealed a gain of 692,000 jobs in the private-sector, seasonally adjusted payrolls for June, exceeding expectations for an increase of 600,000 jobs.

The National Association of Realtors reported that its **Pending Home Sales** Index rebounded 8.0% in May to 114.7, noting "the highest reading ever for the month of May since 2005." With May's reading, pending home sales are up 13.1% year-over-year.

The Institute of Supply Management (ISM) reported that the **purchasing managers' index (PMI)** for June decreased 0.6 percentage points to 60.6%, short versus expectations of 60.9%, however, marking the 13th straight month of expansion in both the manufacturing sector and the economy overall. To put the new number in perspective, from July 2020 through June 2021, the PMI reached a high of 64.7%, a low of 53.7%, and averaged 59.1%.

The Department of Labor reported that **initial jobless claims** for the week ended June 26 were 364,000, a decrease of 51,000, better than expectations for 388,000 claims. The four-week moving average for claims was 392,750, a decrease of 6,000 from the previous week. The Labor Department also reported that the U.S. economy added **850,000 jobs in June**, a beat against expectations for an increase of about 706,000.

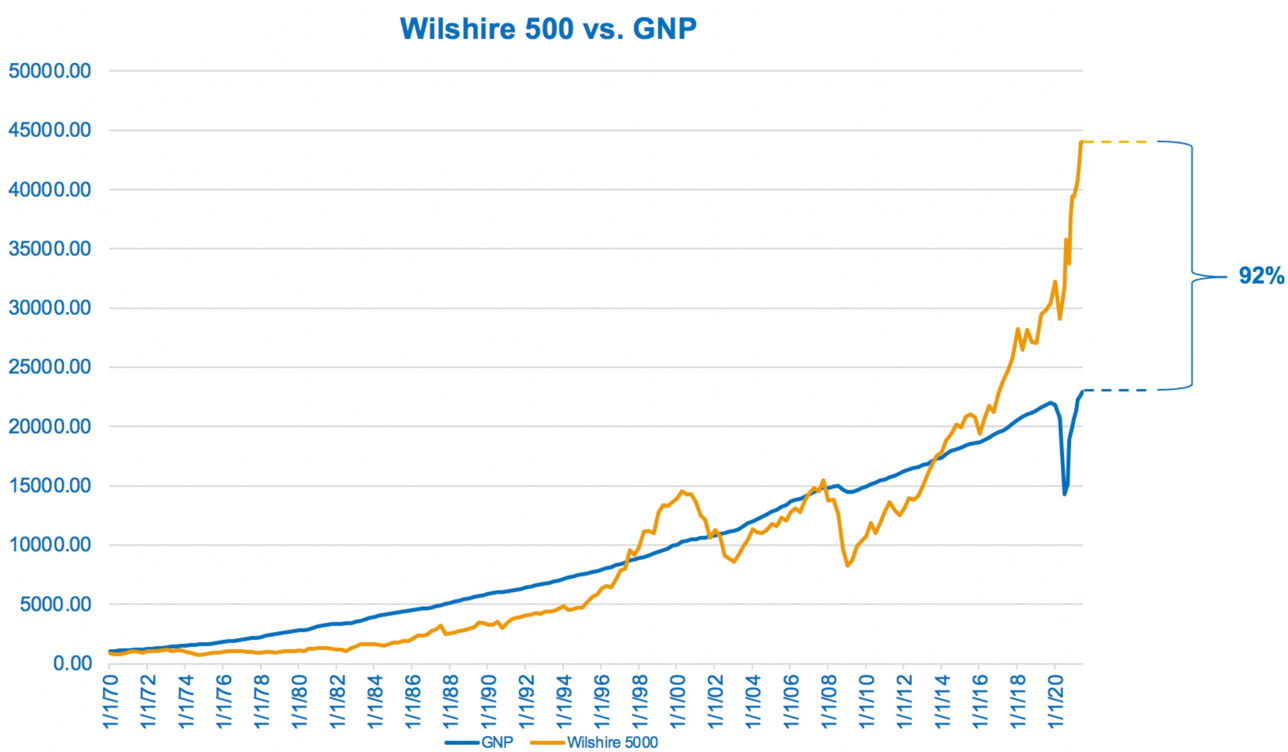
The June **average hourly earnings report** for all employees increased to $30.40 per hour, representing an increase of about 3.6% YoY, which is solid but still not too hot and a sign of concern.

The U.S. Commerce Department reported that **new orders for manufactured goods**, both durable and nondurable, increased 1.7% in May. **Shipments** rose 0.7%, **unfilled orders** of manufactured durable goods increased 0.8%, and **inventories** rose 0.9. **New orders of core capital goods** increased 0.1% in May, better than expectations for a 0.1% decline. **Shipments of core capital goods** increased 1.1% in May, following a 0.9% increase in April and a 1.6% increase in March.

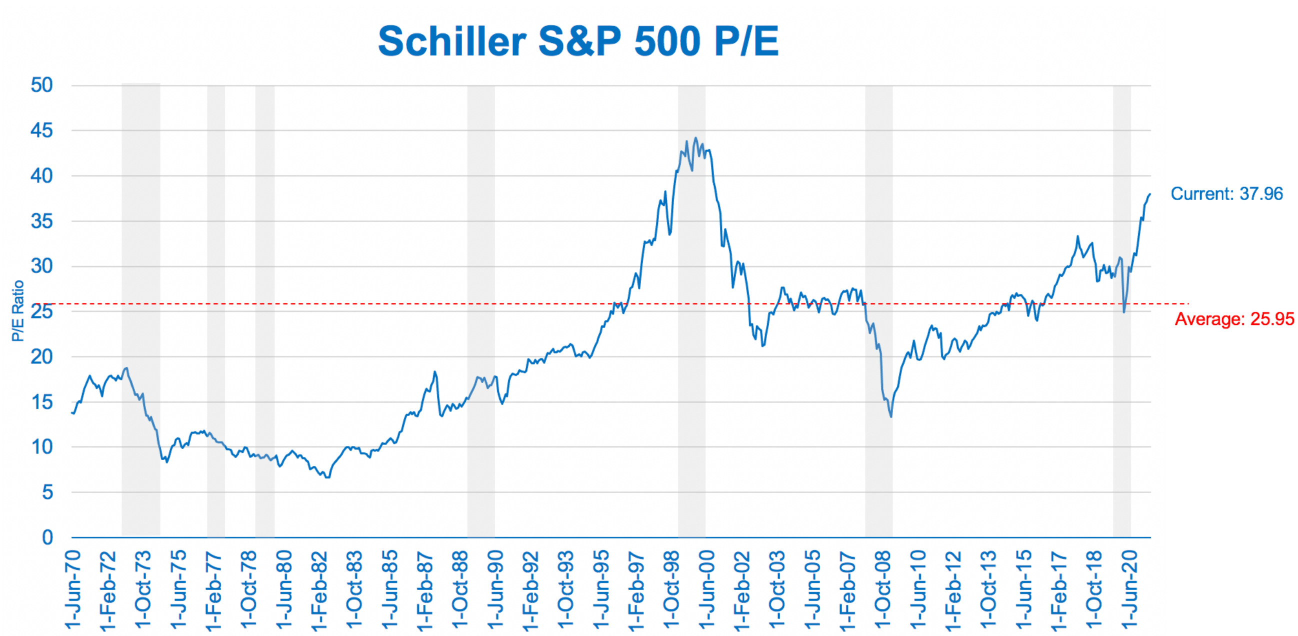
Market Valuation

Since 2009 growth stocks have significantly outperformed value stocks, but as we discussed in previous newsletters, growth and value appear to be converging, providing opportunities for all investors in both types of equities. Year-to-date, value stocks have outperformed growth, which is partially because they lagged growth, and they are simply catching up. The increase in broad market valuations in 2020 was largely driven by growth stocks which received a disproportionate amount of investor money. Now that value stocks have caught up, there are few undervalued sectors and company valuations will most likely grow commensurate with actual earnings growth. As such, we continue to believe growth companies are the best way to position investors for above-market returns.

The Wilshire 5000 is now **92%** higher than the US GNP, which compares to a **83%** divergence last month, so by traditional measures, we remain in overvalued territory.



Interest rates remain at all-time lows and despite longer-term inflation fears which could drive up rate, the current yields warrant much high valuations compared to a high-interest rate environment. The Shiller P/E Ratio adjusts earnings for inflation and interest rates, which allows us to accurately compare earnings over periods with differing interest and inflation rates. The average adjusted P/E ratio since 1970 is ~26, a level we hit in March last year. Since then, the ratio has been moving up and is now at 37.96, over 40% above the average, which confirms that we are at elevated levels until earnings catch up or we see some sort of correction in the market.



A drastic rise in inflation and a sudden increase in rates by the Federal Reserve could trigger a more extensive correction, and we monitor these key macro-economic indicators closely. However, we have been at these elevated levels for a while, and we are reminded by Peter Lynch from Fidelity Management who famously said and echoes our own sentiment that

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

- Peter Lynch,

This does not mean we take a laissez-faire approach to the fund and the market's valuations. We are as much risk managers as we are investment managers. However, we will not try to time the market with large sweeping action in anticipation of certain moves. We know what we own is of high quality and will weather any correction better than the broader market like we did in 2020's 1H downturn.

What Excites Us

Economy Reopening

Many of the fund's positions stand to benefit as the economy reopens. While we are thrilled with the short-term growth, we remain focused on the tremendous growth ahead as our major themes continue to unfold. With 70% of the economy dependent on consumer spending, reopening is an essential catalyst for growth.

Growth at Reasonable Prices

Technology stocks in cloud software and semiconductor spaces are coming down to more reasonable prices and earnings are increasing above expectations. We see tremendous opportunity in several positions where our downside risk is minimal, and the upside could be enormous. The recent decline in chip stocks presents new opportunities in a large growing market that cannot currently meet demand. All the most significant growth sectors rely on semiconductors. There are overlooked parts of the market where significant growth remains to be captured.

Amount of Money Still on the Sidelines

Many investors are still sitting out in the current market. Last month there was still roughly $5 Trillion sitting in cash accounts. This is over 30% more than the 10-year historical average, and for many institutional investors, earning 1% or less on cash isn't a long-term option. Investors are rightfully careful, but with low interest rates and GDP on the mend, this cash will be invested to the benefit of current investors who are already fully invested. We expect to see significant amounts of idle cash flow into the stock market via individual traders, institutional investors, 401Ks, and pension funds during the second half of 2021.

What Keeps Us Up at Night

Cyber Security

The latest attack on 1,500 small businesses by Russian hacker group REvil is the largest in history and has heightened concerns in the White House over our national security. Hackers have disrupted the largest pipeline in the U.S. and a large portion of the beef supply. Now a global attack on 1,500 small businesses suggests a misinterpretation of Biden's comments that 16 industries that are off limits. The ability for hackers to disrupt large portions of the economy is a systemic risk. Companies and cyber security firms can only do so much, this requires an alliance of governments and the most severe punishments they can administer. This is a war, treat it like one.

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.

Inflation

We discussed why we don't think inflation will get out of control and believe inflation will remain around the Feds target of 2% - 2.5%. However, inflation is a major risk to the markets, and we remain focused on the macro factors that could lead to rising inflation.

Vaccine Distribution & Variants

Last month we cited our concerns at the rate of vaccine distribution and that only 42.6% of the U.S population was vaccinated. 56% have now received one dose and 48% are fully vaccinated. Vaccination numbers would be higher if not for the large numbers of people opposed to vaccination. Variants have become a bigger concern, especially the Delta Variant.