CRYSTAL WATERS PARTNERS

Market Outlook

September 2021

Growth at Reasonable Prices

Investors had several new worries during September, including the debt ceiling limit, tensions with China, Taiwan, and comments from Fed chair Powell that "*rising inflation has been frustrating*." The uncertainties saw markets selloff in growth stocks while bond owners sold bonds and bought dividend-paying value stocks. Bond selling rallied interest rates and further increased fears of owning growth stocks. These short-term fears are creating opportunities for growth investors. Third-quarter earnings have just begun, and we expect the results to be a mixed bag with estimates down and comps very low. The bar isn't high for companies to beat estimates, and we think investors are pricing this in.

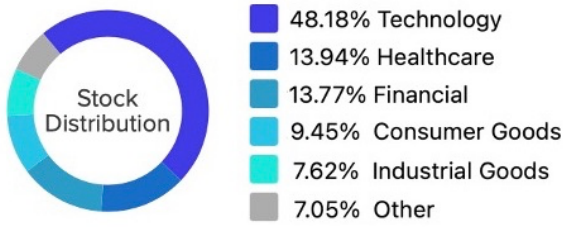
Portfolio Weighting

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 advancing human genomics that cure disease. We also see 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 start 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.

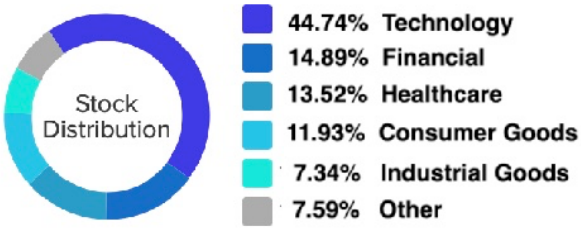
If rates remain low, the fund will favor quality disruptive companies innovating in the technology, healthcare, and FinTech sectors. As we see a higher likelihood of rates increasing, we will modify the allocation accordingly.

Stock Distribution by Sector

August Stock Distribution



September Stock Distribution



Growth at Reasonable Prices

- **Why growth investing has trailed all the indexes**
- **The Case for Higher Rates**
- **The Case for Why Inflation is Transitory and Rates Will Not Increase Materially**
- **The Confidence in CWP's Approach**

Why Growth investing has trailed all the indexes

Growth investing is a lot easier (and more fun) when growth is in favor – when investors can see beyond the wall of worry and imagine how companies will change the world in 3, 5, or even ten years. We are unashamedly a growth fund with a 3-to-5-year outlook on our investments, and while 2021 has so far proved a more complicated year to find yields. This year, most growth funds have trailed the broader indexes as a sector rotation has investors shifting from growth to value stocks, as shown in Figure 1. However, we are finding that quality still performs while many of the companies that have sold off deserve to do so; many others present opportunities for investors to establish long-term positions at reasonable valuations.

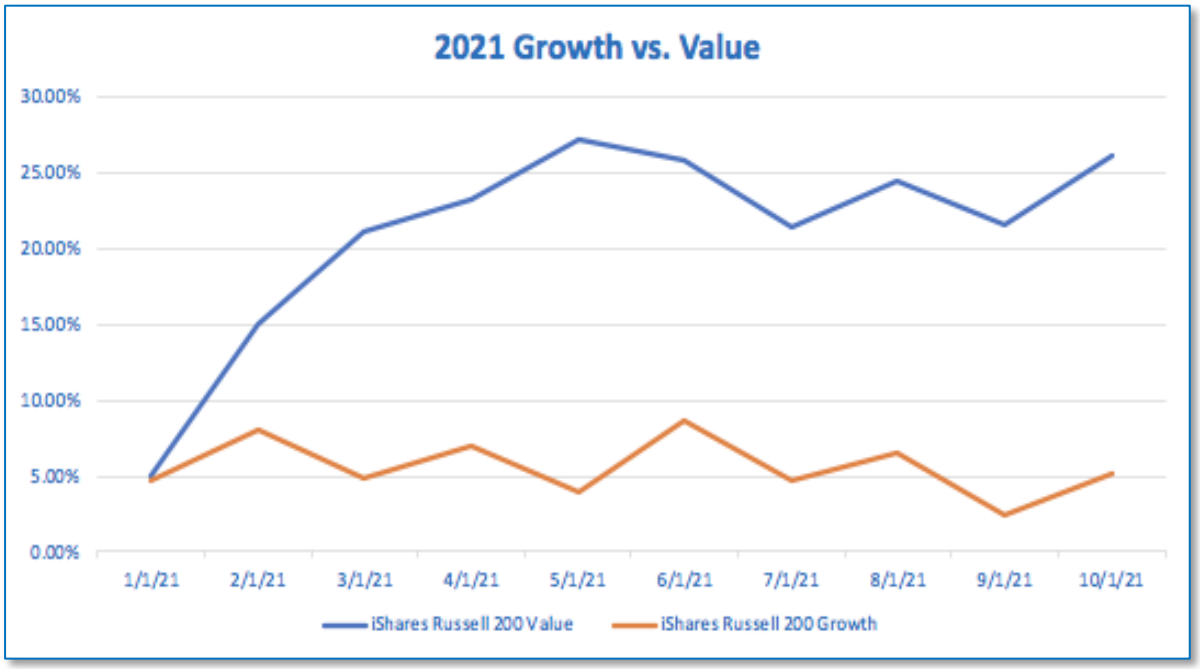


Figure 1.

Most of the pullback in growth stocks can be attributed to rising inflation and a belief that strong earnings growth is not sustainable. Figure 2. on the next page shows the inverse relationship between S&P 500 earnings and inflation since 1970 and explains much of investors' challenges right now.

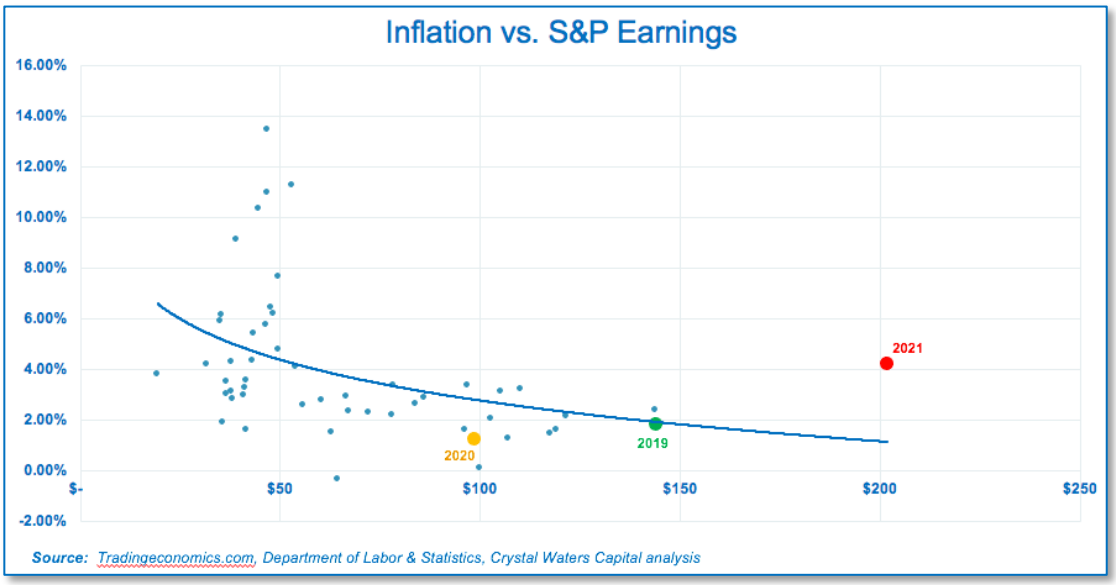


Figure 2.

Earnings tend to be clustered along the trend line, increasing as inflation decreases. Since 2009, S&P earnings grew steadily every year through 2019 but decreased over 30% in 2020 due to the COVID-19 pandemic. However, most industries have bounced back strong, and projected 2021 S&P 500 earnings are now around $200. What is surprising is that inflation, which has hovered between 1.5% - 2.0% for the last decade, has jumped as high as 5.4% this year and is expected to finish around 4.2% by year's end. This year, S&P 500 earnings and inflation have moved in tandem and are so disconnected from their historical relationship that one of them has to change over the following 6-12 months. As a result, investors are divided into two camps:

1) Inflation is transitory and comes back down, which makes the current S&P 500 earnings projection less of an outlier, or
2) Inflation proves to be persistent or permanent and may even go higher, in which case the future earnings of the S&P 500 will come down materially.

Investors who are "revaluing" and selling shares of growth companies see inflation at 4% or higher as a new normal, which will significantly affect long-duration stocks. These are fast-growing companies where most of the valuation comes from future projected cashflows that will now have to be discounted using a higher interest rate, which in turn lowers the present value. If they're right, future earnings will come down, and growth investors will have a longer-term challenge on our hands since valuation will also come down if they haven't already. However, suppose inflation is transitory and eventually stabilizes closer to 2%, the long-term target of the Federal Reserve Bank. In that case, earnings of healthy growth companies are sustainable, and valuations are set to go much higher from here. To be fair, both sides make rational decisions based on how they see the world and interpret the data available to us all.

Our thesis is that the sector rotation is not permanent and will soon shift back to growth.

Sector Rotation is Not Permanent

Investors who believe interest rates and inflation are rising will usually buy U.S. Treasury Bonds. However, bonds pay so little that investors have instead sold bonds and bought dividend aristocrats as bond market proxies. Investors with large positions in growth stocks have been trimming those positions to buy value stocks. This practice of sector rotation has been accelerated by the advent of Sector ETFs that enable rapid shifts from one sector to another. Growth stocks are more sensitive to interest rate changes. Figure 3. below shows the shift in assets under management when interest rates more than doubled between Nov 2020 and March 2021, causing a dramatic shift from growth to value.

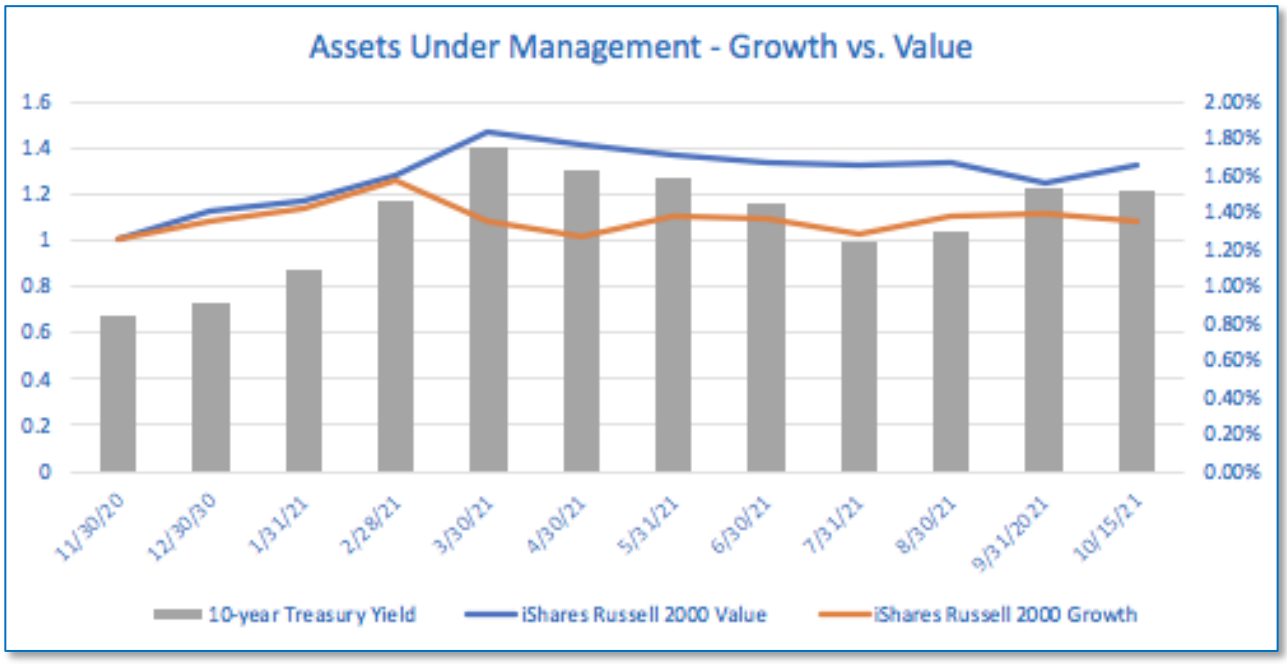


Figure 3.

When treasury rates spiked and inflation appeared to be growing fast, investors shifted portfolios from growth to value. Investors with short-term obligations and objectives do this to mitigate risk and buy some time while assessing whether the interest rate increase is transitory or more permanent. The current rotation will not last as interest rates stabilize and money shifts back to those companies that still have growth and reasonable valuations with a long runway of potential outperformance through technological advantages and by disrupting whole market sectors longer term.

Looking at legacy businesses represented by value stocks, we see that they have spent too much capital buying back stock and paying dividends. In the first half of 2021, S&P 500 companies spent more money on share buy-backs than capital expenditures. According to The Wall Street Journal, "*Share repurchases at companies in the S&P 500 increased to $370.4 billion, up 29% from the first six months of 2020. Capital spending—which usually goes toward assets such as land, buildings, and*

technology—rose to $337.17 billion, up 4.8% from the year-earlier period." Those share buy-backs are occurring at companies who have stopped innovating or whose businesses are slowing.

The Case for (and Fear of) Higher Rates

The threat of rising interest rates is at the core of the growth equities selloff. If they keep growing, fast-growing companies with sustainable business models will look very different 10 or 20 years from now. Investors give these companies credit for this future business. In many cases, a large part of a growth company's valuation is predicated on the earnings and cashflows many years in the future. These cash flows are then discounted using today's interest rates to arrive at a present-day value that investors should be willing to pay. When interest rates are low, the present value is higher and vice versa. Inflation and interest rates move in tandem, and with sharp inflation spikes this year, many investors think that rising rates (and lower equity valuations) are not far behind.

We believe the current inflation is an abnormal response to unusual and temporary circumstances, and we will lay out why this is transitory, and inflation fears are exaggerated, but below are the main drivers of investors' fear.

- **Fear of Higher Inflation**
  Rising inflation leads to rising interest rates, which bring down equity prices, so at first glance, it may seem reasonable that the market has responded the way it has over the last six months. Inflation went from just north of 1% to a high of 5.4% earlier this year in a matter of months. Economic stimulus increased disposable income while supply chain constraints and limited availability of services increased demand for goods. The result is we have an environment where there is more demand than supply, which always leads to higher prices.

Figure 4.

Anyone seeing the chart in figure 1. above would likely believe we have a new plateau for inflation, and they should take action accordingly. If this is an investor's long-term view of inflation, selling off long-duration assets (e.g., anything with lots of future value such as growth stocks) is a sensible and very rational thing to do.

- **Fear of the Federal Reserve Unwinding Quantitative Easing**
  When Ben Bernanke was Chair of the Federal Reserve, the Fed's balance sheet was about $800B before the financial crisis. During the financial crisis in 2008/2009, Bernanke started Quantitative Easing (Q.E.), which bought up treasuries and mortgage-backed securities, increasing the balance sheet by over $4 trillion—buying those assets removed toxic securities from the market and provided a path for investors to put money to work in higher quality investments. Q.E. most likely saved the U.S. and the global economies from a depression like we've never seen. Under Janet Yellen, the balance sheet continued to grow. Today, under Jerome Powell, the Fed's balance sheet stands at nearly $8.5T due to the continued purchasing of assets to counter the economic shutdown caused by COVID-19. With the Feds balance sheet at roughly 40% of US GDP, investors are nervous about any attempt to unwind and the impact that could have on driving interest rates higher.

- **Fear of COVID-19 and Supply Chain constraints**
  COVID-19 has disrupted supply chains everywhere. Airports and shipping ports were closed or drastically reduced operations. Workers globally were confined at home. Inventories were stuck in place until the global economy could mobilize again. Perishable products rotted on ships, docks, and warehouses, and in a world of just-in-time deliveries, many large commercial projects were disrupted. Today we are still struggling with significant supply chain issues. Shipping containers are in the wrong parts of the world and are in short supply, limiting what can be shipped. Shipping container freight costs reached a peak on Sept 10, 2021, at $11,109, a 426% increase from 1 year earlier.

Figure 5.

On March 24, 2021, the Evergiven, one of the largest container ships, ran aground, blocking the Suez Canal, causing more delays, and adding costs for all other ships. In a world where everything is tightly linked, the cascading effects are still being felt six months later. Ports

worldwide can't unload or load fast enough due to labor shortages and COVID restrictions, and trucking companies struggle with a driver shortage. It's always hard to see the future as different from the current reality, and a shortage of products now has led many to fear that the imbalance will persist and drive prices higher.

The Case for Why Inflation is Transitory and Rates Will Not Increase Materially

The Federal Reserve has kept interest rates low in response to an unusual environment caused by a global pandemic. However, the economy is rebounding, and it is a fair assumption that rates should increase. Should rates ease up to accommodate a long-term improved economic outlook that no longer needs the stimulus of cheap money, or should they triple or quadruple because inflation seems out of control? Based on everything we see from the Fed and consumer demand, we do not see long-term inflation continuing to rise. As economic growth and supply chains stabilize, we expect inflation and interest rates to plateau somewhere between 2% and 3%.

The Federal Reserve and U.S. Treasury See Lower Inflation Coming

The Federal Reserve and the U.S. Department of Treasuries have all acknowledged the inflation spike but have also provided projections and reasons for why they see inflation going back down to around 3% by the middle of next year (see figure 2. below)

Figure 6.

If the Federal Reserve and the Treasury were both seeing persistent inflation and simultaneously taking steps to raise rates to address inflation, we would indeed be worried. However, their forecast is for lower inflation, and they have no near-term plans to increase rates.

The Fed will be Accommodative Longer than Expected

Businesses adopted technology at an unprecedented pace during COVID to do more with fewer people and enable work from anywhere. The second wave and the Delta variant kept people at home longer and slowed the return to school. In response, businesses kept investing in technology.

We believe that the slow job recovery will last longer than expected. The Fed may taper asset purchases somewhat, but raising rates is a long way off. When investors have clarity that rates will remain low, money will flow back to growth stocks. There are nearly 11 million job openings and not nearly enough workers to fill all those positions.

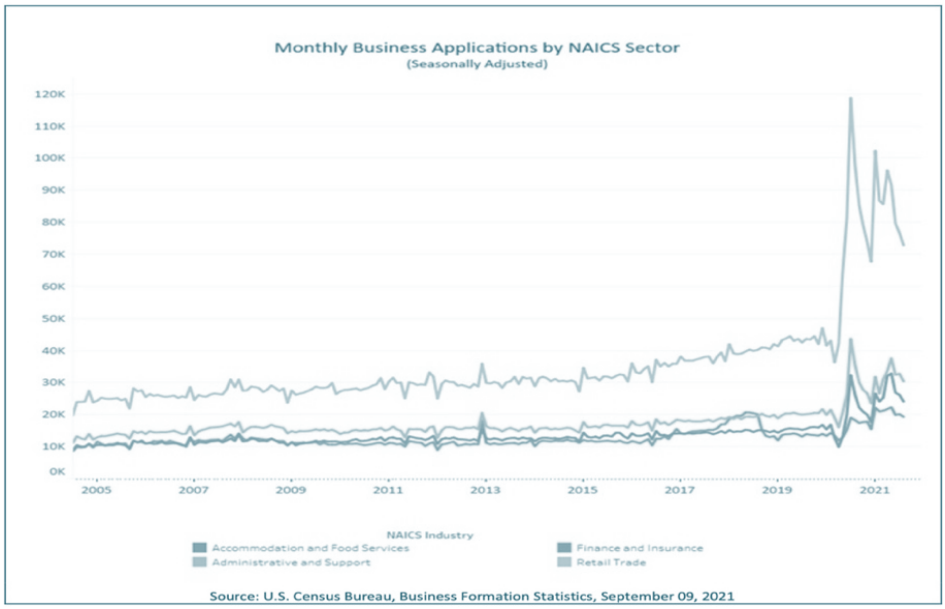


Figure 7.

The labor participation rate has been declining for decades and fell yet again in the last job report. As illustrated in the chart above, COVID produced a record number of new business applications, primarily for retail businesses that will need employees that simply are not available. Even if 50% of those new businesses fail, the new job openings will still be far above trend. U.S. immigration policy will have to adapt to meet the demand for employees or see GDP decline. Changing immigration policy is a long political battle that will likely drag out the job recovery. The Fed will likely be forced to keep rates low for the foreseeable future. Overall, this benefits growth stocks as companies will adapt by investing in technology to do more with fewer people.

Interest Rate Increase has not come from the Fed

We have watched rates rise from near 0% to just above 1.5%, but what's important to note is that bondholders, not the Fed, caused the rise in rates. Institutional investors have sold a disproportionate amount of bonds as they have searched for higher yields in value and dividend-paying stocks. The selling of bonds is causing long-term rates to rise, and it is not a signal that the Fed sees a need for higher long-term rates. The bond market is telling us it doesn't see inflation ahead.

Demand for Products Will Ease (as will prices)

In December 2019, manufacturers' inventories peaked at $713 billion and declined to $698 billion during the pandemic. Today, inventories stand at $750 billion. If the consumer demand is high and disposable income is up, why are inventories growing? Logistical constraints are one answer, but the bigger issue is that consumers already have what they need. During the pandemic, they bought cars, electronics, appliances, and other durable goods, remodeled their homes, and bought up every form of recreational vehicle and device imaginable to get through a lengthy, stay-at-home lockdown and work from anywhere environment. Demand for raw goods has been fulfilled. Next, consumers are going to want services over products. The increase in inventories and a consumer loaded with new products and automobiles will lead retailers and manufacturers to lower prices to unload excess inventories. Discount selling will, in turn, tamp down inflation and continue to improve consumer balance sheets with lower prices. The big question now is whether consumer spending on services will overheat the economy and force the Fed to raise rates - something we are keeping an eye on. However, we must assume that manufacturers and retailers will not continue to add employees in the face of declining sales of goods. It's possible that this could lead to a prolonged labor shortage which should keep rates lower for longer.

The Confidence in CWP's Approach

Being long disruptive innovation is the best place to be for growth investors. CWP chooses to be long companies and management teams changing the world, increasing productivity, and developing innovative business models. Change doesn't scare us - we invest in it. Understanding the macroeconomic environment is essential, but unless there is anything that fundamentally breaks our long-term thesis for holding an investment, such as a shift to permanently higher inflation and interest rates, we are likely agnostic to rotations and other upheavals and simply make sure we exercise patience and sit tight with companies in which we have strong conviction. The following things are what drive the fund and give us long-term confidence in materially outperforming the market.

A 3-5 Year Investment Horizon

The fund is focused on companies that can compound returns over longer periods, and we have a minimum 3-5-year outlook for all the companies we hold in the portfolio. We will invest in a business only if we are willing to own it for five years or longer potentially.

A thesis with a long-time horizon is essential for several reasons

1) It ensures we focus on quality businesses whose fundamentals are likely to persist over time. We will think long and hard about resilience in alternative future outcomes (say, in times of regulatory, economic, or competitive stress),
2) We know the economy moves in cycles, and we are neither too worried nor too excited by the prospect of getting rewarded based on how an asset ought to be valued by economic fluctuations or specific catalysts in the medium term – and we also don't want to deceive ourselves into believing that we have any expertise in being able to do so,

3) Taking a long view also gives us the advantage of a less crowded spot as many institutional investors often manage performance to quarterly or annual goals that drive their compensation. While we do report monthly, our focus is much longer, and if deployed well, is designed to help us deliver superior outcomes over half a decade or longer. Having a good five-year plan is not the same as having five good one-year plans.

Focusing on our long-term themes

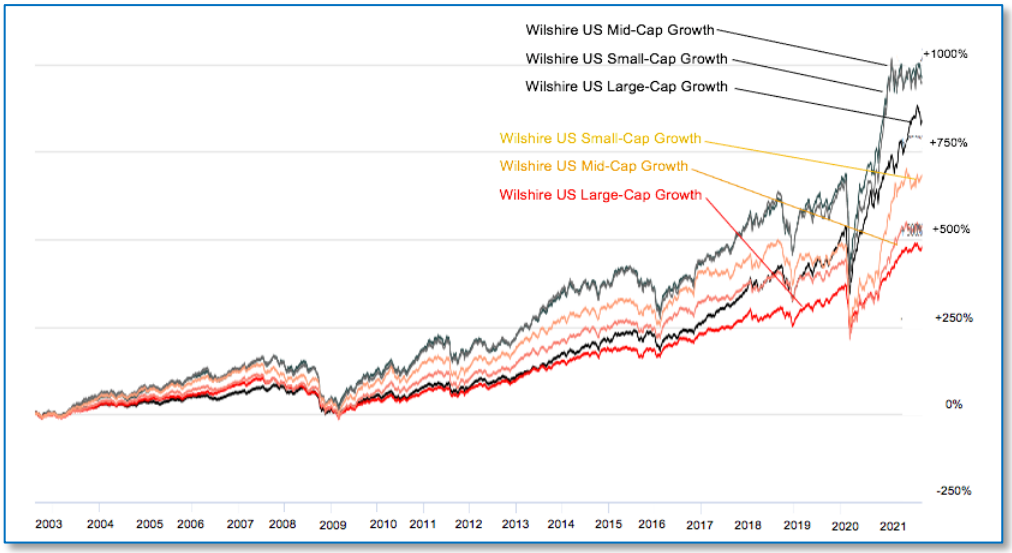
The most significant transformations in the economy are happening in Renewable Energy, Biotech, especially Genomics, and Cloud computing that enables work from anywhere on anything, Financial Technology, Artificial Intelligence, Robotics, Autonomous mobility, and Entertainment and Recreation. These themes represent areas where we are witnessing a once-in-a-generation shift. Within each theme are sectors where we look for the fastest-growing companies that can outperform over our time horizon of 3-5 years.

1. **Renewable Energy:** Wind, Solar, Hydrogen, E.V.s, and Battery Storage
2. **Healthcare:** Biotechnology, Genomics, DNA sequencing, and editing, Devices
3. **Cloud Computing:** Disruptive internet innovation that is digitizing business
4. **Financial Technology:** Banking, Cryptocurrencies, new money technology
5. **A.I., Robotics, Autonomous:** Smart connectivity and automation of everything
6. **Entertainment & Recreation:** Space travel, Recreation Revolution, Gaming

Growth Outperforms Value, Given Enough Time

Growth stocks tend to outperform value stocks materially. Growth stocks can have higher volatility because of their sensitivity to interest rates, but the long-term risk is no higher. There is a significant opportunity cost of not having enough exposure to growth equities.

Figure 8.



The recent stretch of underperformance of growth stocks already ranks among the largest in magnitude tracked by Goldman Sachs, and we expect to see a rotation back to growth as interest rates and inflation fears stabilize.

Economic Outlook

Markets were volatile in September and pulled back in the final days of the month as the speed of the rally in Treasury yields unnerved investors who are thinking that inflation may be stickier than previously thought. While there are many factors to consider when examining inflation, supply chain challenges in port congestion and labor shortages are front and center and have investors worried that third-quarter earnings and fourth-quarter profit guidance could disappoint. Our view is that the uncertainty surrounding inflation is more potent than any actual inflation and that once children are fully back to school, workers will flood into the job market, which should slow wage inflation.

The Commerce Department reported that the preliminary reading for new orders for manufactured durable goods climbed 1.8% in August. This followed a 0.5% advance in July (revised higher from a 0.1% decline previously reported) and was better than expectations for a 0.6% monthly advance. New orders for durable goods are up 24.7% from the same time last year. With demand for goods still rising, we anticipate prices will continue to rise to exacerbate the inflation numbers for a while longer.

Shipments for manufactured durable goods were down 0.5% in August to $256.1 billion, while unfilled orders increased 1.0% in August, and inventories increased 0.8% to $457.9 billion. With August's readings, shipments are up 14.1%, unfilled orders are up 4.0%, and total inventories have grown by 7.2% from the same period last year. This is concerning as a decline in shipments and an increase in inventories tell us that supply chain disruptions have not improved.

The National Association of Realtors reported that its Pending Home Sales Index advanced 8.1% in August to 119.5. The reading exceeded expectations for a 1.3% monthly advance. Pending home sales are down 8.3% year-over-year, matching expectations. Home sales drive several industrial sectors and usually indicate family formation, which is good for the broad economy.

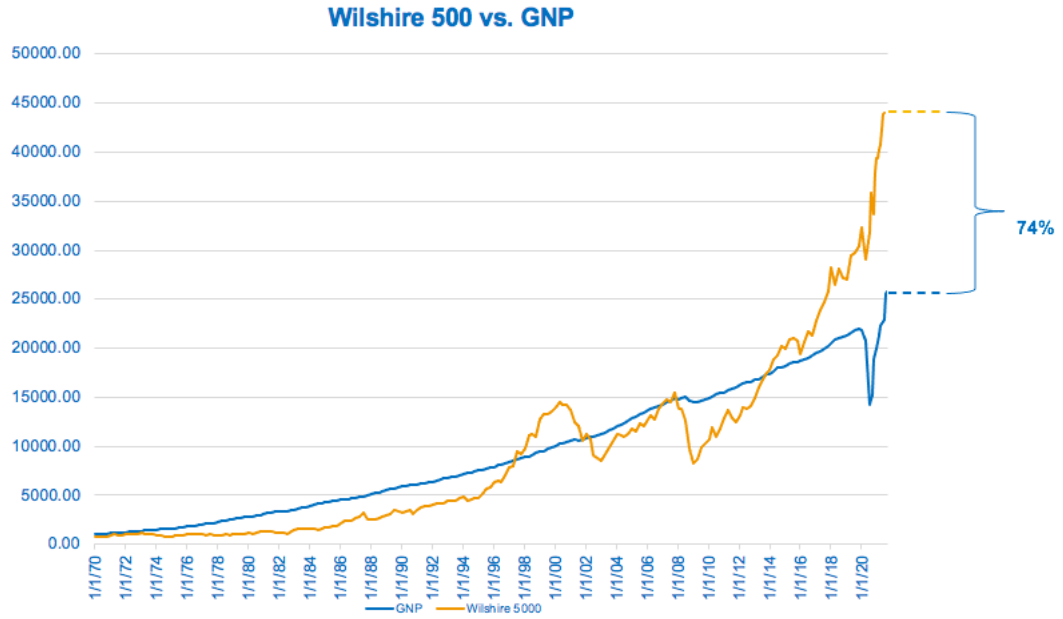
The Bureau of Economic Analysis reported, in its "third" reading, that real Gross Domestic Product adjusted for inflation increased at a seasonally adjusted annual rate of 6.7% in the second quarter of 2021, outpacing expectations for a 6.6% increase. This follows a 6.3% advance in the first quarter of 2021. The economy is showing excellent resiliency to inflation, supply chain, and labor constraints.

The Department of Labor reported that initial jobless claims for the week ended September 25 were 362,000, an increase of 11,000 from the previous week's 351,000. Expectations were for 330,000 initial claims, indicating that labor shortages will continue. We think that the labor shortage trend will continue until we reach higher levels of vaccinations in children and school staff.

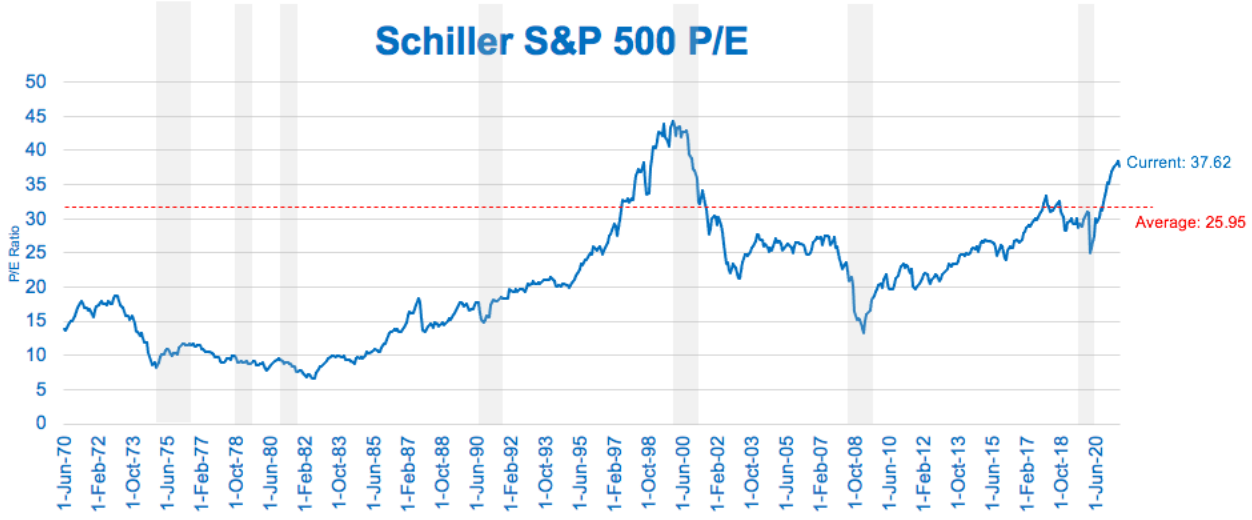
The Institute of Supply Management reported that September's purchasing managers' index increased 1.2 percentage points to 61.1%. This was better than expectations for 59.6% and marked the 16th straight month of expansion in the manufacturing sector and the economy overall.

Market Valuation

The Wilshire 5000 is 74**%** 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, but 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, shows that the broad market valuation remains well-above 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 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 by analysts and large fund managers alike. The absence of euphoria has historically led to bull markets. The increasing breadth in stock ownership indicates 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 suggest the S&P 500 could surge to 4,700, nearly 7% upside from today's close.

What Keeps Us Up at Night

Debt Ceiling

Investors should be looking past this issue because it comes around every two years, and the result is always the same. However, the stalemate has rocked markets. We think the debt ceiling should be eliminated to get rid of the political football and brinksmanship. Janet Yellen happens to agree.

Rotation Out of Bonds

Money has continued to move out of bonds and into stocks. Most of that money is being invested in dividend-paying value stocks, which might be considered safe-haven stocks. Frankly, it looks like big firms are making sure they deliver on their returns to collect fees and bonuses. This is not a growth strategy to be mimicked. The stress here is that selling bonds increase long-term yields. Rising yields frighten equity investors and trigger sell-offs—eventually, growth stocks win for those with a longer investment outlook.

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 U.S. 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 to defend global interests in Taiwan. Taiwan is the largest semiconductor producer in the world.