

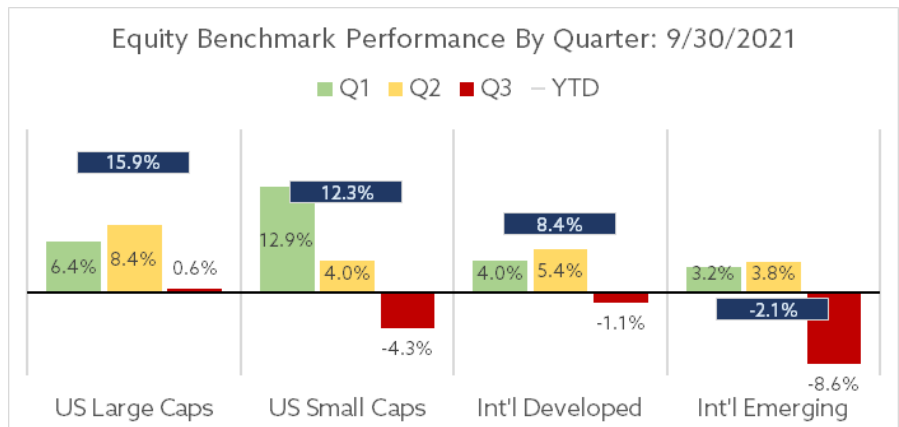
Pendleton Street Advisors
3rd Quarter 2021 Investment Commentary
October 15, 2021

Index Returns	3 rd Quarter	Year to Date	Trailing Twelve Months
S&P 500 US Large Cap Stock Index	0.6%	15.9%	30.0%
Russell 2000 Small Cap Stock Index	-4.4%	12.4%	47.7%
MSCI All Country World Ex-USA Stock Index	-3.0%	5.9%	23.9%
Barclays Capital US Aggregate Bond Index	0.1%	-1.6%	-0.9%
US Core Consumer Price Index - (Inflation)	1.3%	3.5%	4.0%

After above-average gains over the first half of 2021, equity markets weakened in the 3rd quarter as investors began to come to terms with increasingly strong headwinds. Attention has shifted from concerns about a prolonged COVID-induced reduction in consumer demand, to concerns about global supply chain constraints. With the holidays and Black Friday shopping around the corner, we expect developments related to the supply chain to take center stage as a market driver through year-end, even as the direct economic effects of the pandemic linger, Congress continues to chew its cud on the Biden administration's Build Back Better plan, and the Fed prepares to cut off the stimulus spigot by ramping down bond purchases and eventually raising interest rates. Markets are as dynamic as ever, but our focus remains on what those dynamics mean for our clients' portfolios and long-term objectives.

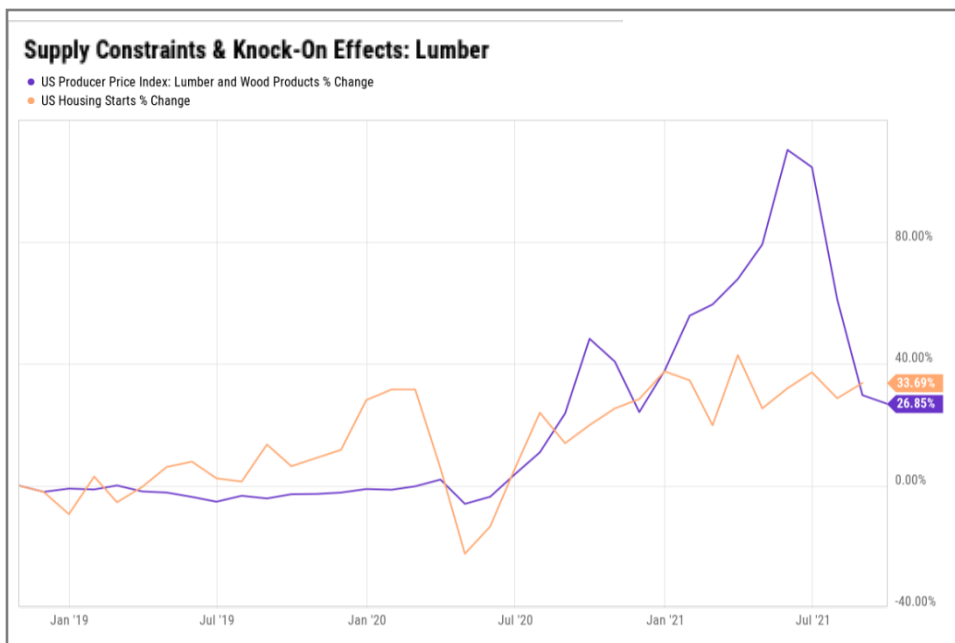
Markets:

Year-To-Date, performance remains above the historical average for most segments of the stock market. But, as mentioned above, momentum slowed substantially in the 3rd quarter. While it is impossible to narrow down one cause, we can point to a handful of newer developments that have increased uncertainty in the markets, and therefore reduced investors' risk appetites over that time:



- 1) [Evergrande & China](#): Evergrande, a residential real estate conglomerate in China, has defaulted on some of its bond payments. Evergrande's default directly impacts investors, vendors, and customers of the company via investment losses, unpaid invoices, and unfinished projects. The concerns for markets more broadly are twofold:
 - a. [Market Mechanics](#): Losses for large holders of Evergrande's debt or equity could cause "market contagion," which results from Evergrande investors selling quality assets to cover losses. The sale of those higher-quality holdings by Evergrande investors could start a chain-reaction of selling by other investors as they become skittish about a wider-reaching problem, sending markets into a broad downturn. This has not happened in earnest, and at the moment it appears that China has been able to contain the risk. But, it is not over yet.

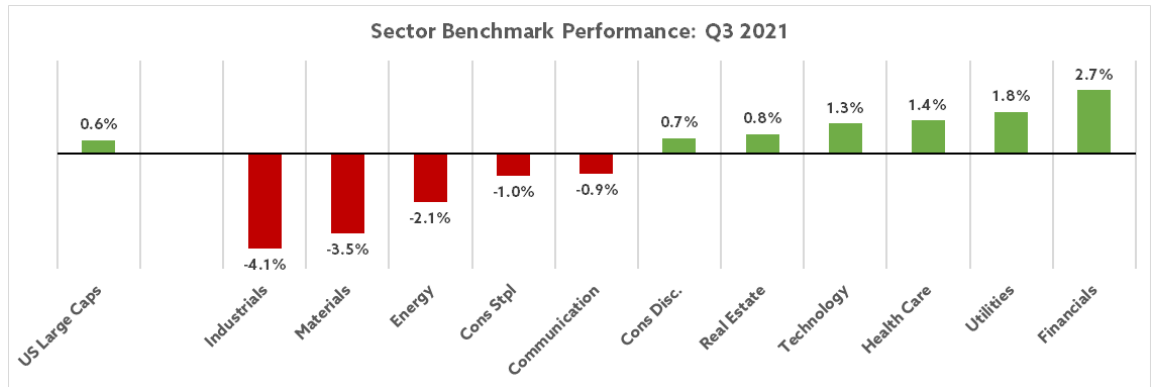
- b. [Real Estate and Misaligned Incentives](#): No system is perfect, but Evergrande's circumstances can be directly traced back to China's policies emphasizing the importance of sustaining relatively high GDP growth in parts of the economy where supernormal growth is not sustainable; and setting the system up to overcapitalize the real estate market leading to oversupply. With an Evergrande-sized chink in its armor, investors are right to question whether it is an isolated failure or the rest of the Chinese property market has reached a turning point as well.
- 2) [Fed Taper Talk](#): The Fed has hinted at interest rate increases late in 2022, but at its September meeting it committed to reducing its \$120 Billion/Month bond purchases by \$15 Billion/Month beginning in Mid-November and continuing until the purchases end altogether in June, 2022. The immediate effects are a reduction of liquidity in the bond markets, but the bigger development is the move from *talking* about reducing monetary stimulus to *doing it*. So far, we are not convinced the market has adequately prepared for a shift in Fed behavior. For context, in \$-terms the Fed's balance sheet has grown 3 times as much since the beginning of COVID as it did over the same length of time after the beginning of the '08 financial crisis when Quantitative Easing was used for the first time in earnest by the Fed. Similarly, money supply (M2) has grown 7 times as much as it did during the financial crisis.
- 3) [Tax Increase](#): Legislation currently in negotiation introduces potential increases in personal and corporate tax rates. Proposals include increasing the corporate tax rate from 21% to 26.5%; increasing the top marginal tax rate for individuals from 37% to 39.6%; and increasing the top capital gains rate from 20% to 25%.
- 4) [Debt Ceiling](#): In what has become an unfortunate annual tradition, Congress spent months arguing about whether or not to raise the debt ceiling until October 7th when the deadline was officially extended to December 3rd. The debt ceiling puts a limit on how much debt the Treasury is allowed to create in the form of bonds, the proceeds of which are used to cover deficit spending. If the ceiling is not raised by the deadline, the government shuts down until members of Congress remember they depend on constituents for their jobs.
- 5) [The Weakest Link](#): This is the first time in a long time that sales growth across many industries has depended more on supply than demand. For example, a 100%+ increase in the price of Lumber through June, 2021 is



one major reason why Housing Starts have remained relatively flat since late 2020. Demand for new homes was strong... to a point. As homebuyers abandoned the quest for a new-construction homes, they looked to the market for existing homes, pushing inventory down and prices up. The numbers indicate that with existing home inventory so low and both new and existing home prices so high, many homeowners have put their plans to move on ice. But, how long can demand be deferred?

We see this pattern repeating across various industries, as surging prices for energy, raw materials, and transportation hit each: Strong demand drives increased production and producer growth expectations → Input prices rise unexpectedly and rapidly, jeopardizing producer profitability → Producers raise prices to maintain profit margins → Consumers shift to the used market which drives prices up significantly and rapidly → Consumers abandon purchasing a new or used product all-together and instead repair existing products if/until a component shortage emerges → Consumers attempt to find substitutes until the supply/demand dynamic normalizes.

The critical question as we see it is: Will demand remain strong when supply returns? How long will consumers wait for a product or service before they learn how to live without it?



Stocks' performance between economic sectors during the third quarter lines up with this view: Prices for stocks in sectors that are closer to and/or more sensitive to raw inputs stalled or fell as investors worried that companies will be unable to meet demand due to supply constraints, or unable to pass increased costs down the supply chain. If supply chain issues continue, and businesses are not able to raise prices enough, we would not be surprised to see an increase in the number of red bars in the chart above.

Portfolios: Aside from monthly portfolio rebalancing, we did not significantly change allocations at the asset-class or market-sector levels. Changes were made primarily in the individual stock selection in fully-diversified portfolios. Given the diverging paths of companies as they each put their own spin on managing in a changed world, we have expanded our stock selection criteria to include small and mid-capitalization stocks as opposed to our previous limitation of large caps only. In connection with the addition of more volatile small and mid-cap stocks, we have also put into place very specific risk controls around individual stock holdings going forward, requiring us to exit a position if it reaches a pre-determined price below our entry point. Since we implemented this change¹:

- We have initiated positions in 13 stocks.
- We have exited four of the 13 that declined to our exit level, with an average price decrease from the entry price of -15.5%.
- Since we exited those four, the prices of all but one have continued to decline.
- We continue to hold nine of the 13, with an average gain of 18.6%.

Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. Our client-service staff will be reaching out to you as usual to schedule a meeting. If you would like to set up a meeting sooner, please contact us at your convenience. We look forward to hearing from you.

Contact: Matt A. Morley
Chief Investment Officer
Pendleton Street Advisors
Website: www.pendletonstreetadvisors.com

¹ Figures presented are based on our summary of activity across all portfolios. Performance of individual portfolios may vary.