EAMON CAPITAL MANAGEMENT

THIRD QUARTER 2021 COMMENTARY

The quarter can be summarized by continued premium valuations in equity markets, a sideways trading fixed income market, and increased interest rate volatility. These descriptors remain accurate as we move into the fourth quarter.

Fundamentals have been largely ignored in favor of buying and selling news events contributing to significant noise in short-term performance. However, for long-term investors, we believe this presents opportunities to deploy sideline cash in a methodical manner as more attractive entry points must eventually present themselves.

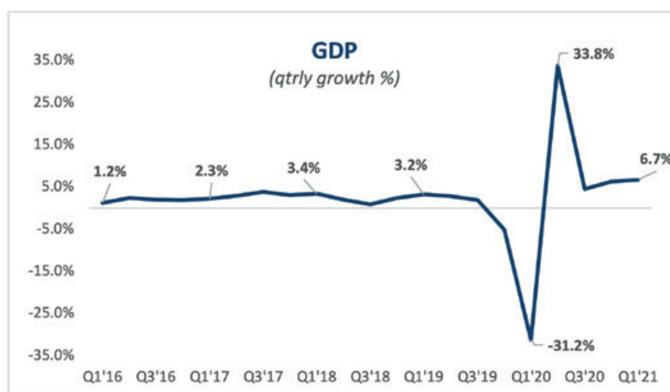
The third quarter was wrought with exogenous variables impacting the financial markets and investor behavior. The overarching themes continue to be COVID-19 resurgence, accelerating inflation, labor force participation rate, the potential removal of monetary stimulus by the Fed, and most recently, the Congressional debt ceiling debate. While many have become accustomed to seeing these variables in the headlines, the financial markets struggle to find a firm footing against the backdrop of such lingering uncertainty.

From an asset class perspective it was a tale of positive correlations as both equities and fixed income delivered lackluster performance. U.S and international developed market equities started strong, only to stall, and give up most of the gains to end the quarter. Fixed Income, a traditional safe haven during equity market volatility, delivered bumpy results in the face of economic instability domestically and across the globe. However, despite these less than stellar results, U.S. fixed income did outperform its equity counterparts by ending in positive territory. The top performing sector across both equity and fixed income were inflation-linked and corporate bond strategies while the worst performing sector was emerging market equities.

Economy

GDP

The large increase in household savings seen during the 2020 lockdown has been a key contributor to the supernormal growth seen since the reopening in the U.S. The Q2'21 GDP growth rate was 6.5%, roughly in line with the Q1'21 rate of 6.4% and well below the anomalistic Q3'20 rate of 33.1%. Revised forecasts for the full year growth have been adjusted downward to 5.9% to end 2021 and 3.8% to end 2022. These above trend growth rates have caused significant kinks in the supply chain driven by the robust demand pull from consumer consumption. Forecasts show growth rates returning to pre-pandemic normals of around 2% by 2023.



Soure: FRB St. Louis, FRED

Inflation

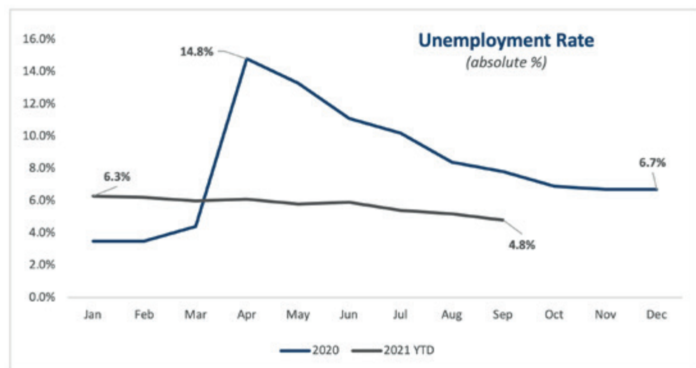
The supply chain has felt the brunt of the reopening trade as the industrial and distribution complexes have been taxed due to the massive spike in consumer demand. The scarcity of resources and labor has crippled the "just in time" inventory management systems of most companies and the ability of those same systems to catch up with large order backlogs. This paradox has caused inflationary

pressures to push Core CPI above 3% (year-over-year change) per month since April 2021 with expectations for this to continue into mid-2022.

Source: BLS

Unemployment

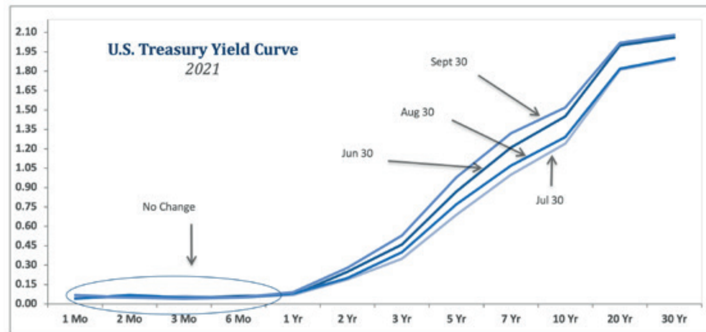
While labor shortages continue to plague businesses large and small, the unemployment rate has shown a downward trend, albeit at a muted pace, as many workers continue to exit the workforce and total job postings surpass available worker supply. The pandemic unemployment rate peaked in April 2020 at 14.8% with it dropping to 4.8% in September 2021. As the supply chain remains under pressure, causing an increase in production costs, high demand for workers on the labor side is putting upward pressure on wages adding to the rise in costs. September saw average hourly earnings rise 0.6%, making the year-over-year increase 4.6%. On average, average hourly earnings increases have not exceeded 4% since well before 2006.



Source: BLS

Interest Rates/Yield Curve

As the bond markets try to digest a swath of macroeconomic and policy variables, rates bounced around throughout the quarter. The market has essentially priced in Fed monetary tightening activity in 2022, equivalent to two rate hikes before it has even started the tapering discussed at its last two FOMC meetings. In our opinion these increases seem a bit excessive, however are in line with previous overreactions by the market in the lead up to any Fed activity over the last four decades. In September alone, we saw significant moves higher in key benchmark rates. The "belly" of the U.S. Treasury curve, 1-year to 10-year maturities, saw the largest moves higher while longer dated issues moved lower over the same period, i.e., a flattening of the curve.



Source: U.S. Dept of The Treasury

Markets

U.S. Equities

In the U.S., equity markets started with mixed results as **growth** outperformed **value** and **large-cap** outperformed both **mid-cap** and **small-cap** through the end of August. However, September saw a significant spike in volatility to the downside turning all sectors negative for the month. To put it in perspective, the *Russell 1000 Growth Index* was up +7.2% through the end of August to end September only up +1.2%.

Outside of **large-cap**, all U.S. equity markets ended in negative territory with the worst performing capitalization being **small-cap**. **Small-cap growth** posted the worst performance of all capitalizations as shown by the *Russell 2000 Growth Index* down -5.7%.

The best performer was **large-cap growth** as shown by the *Russell 1000 Growth Index* up +1.2% for the quarter.

Developed and Emerging Market Equities

Signs of significant deterioration in many core European markets and the Evergrande debt default in China were factors that drove lackluster performance in the international equity markets for the quarter. Economic conditions in both the U.K. and Germany continue to be constrained by elevated COVID-19 infections with supply chain issues hitting these economies harder than other developed markets. In China, the world's most indebted company Evergrande, with close to $305B in outstanding liabilities, missed interest payments on current debt due in September. This led to cautious investor behavior as many speculated as to whether or not there would be a state sponsored financial backstop for the real estate developer in the coming weeks and months.

Overall, **developed** outpaced **emerging** by a large margin with **developed growth** being the top performer as shown by the *MSCI EAFE Growth Index* up +0.1% and the *MSCI Emerging Markets Index* being down -8.1%. **International small-cap** was the second best performer with the *MSCI ACWI ex. U.S. Small Cap Index* ending flat at 0.0% for the quarter.

Fixed Income

Inflation concerns, the Congressional debt ceiling debate and Federal Reserve tapering concerns caused various parts of the yield curve to see increased volatility throughout the quarter. After rates saw a significant drop through both July and August, the positive performance was all lost in September as rates spiked in the last week of the month. The **10-year U.S. Treasury** yield moved +0.23% from 1.31% on September 22nd to 1.54% on September 28th.

Broader fixed income, as shown by the *Bloomberg U.S. Aggregate Bond Index*, was relatively flat returning +0.1% for the quarter. Investors attempting to insulate against accelerating inflation, while also looking for higher yields, pushed up prices of inflation-linked and high yield corporate bonds, making these the top performers as shown by the *U.S. TIPS Index* +1.8% and *BofA U.S. High Yield Corp Index* +0.9%. As the COVID Delta variant uncertainty remained and supply chain issues rippled across the globe, export driven economies felt the brunt with U.S. dollar-denominated and local currency emerging market debt being the worst performers as shown by the *JP Morgan EMBI Global Diversified Index* (USD) -0.7% and *JP Morgan EMBI Global Diversified Index* (foreign currency) -3.1%.

Outlook

Macroeconomic: "You Only Reopen Once"

As excess demand makes its way through the economic system and supply chain issues correct themselves, we expect GDP, inflation and unemployment to normalize from current elevated levels. We are beginning to see forecasts for growth and inflation revised as the FOMC adjusted its near-term expectations downward for both 2022 and 2023 at its most recent meeting.

However, the labor market could take much longer to recover as there are still 5 million workers unemployed. For September's jobs report, only 194k new jobs were added, significantly missing consensus forecasts for 500k new jobs. Assuming the economy continues to add jobs at a pace of 250k-500k a month, it will take around ten to sixteen months to reach pre-pandemic employment levels.

We expect a bumpy road for the next couple of quarters as investors pay close attention to economic indicators with subsequent adjustments to fresh data causing volatility across asset prices. Further, as the FOMC continues to signal a start of tapering in mid-November, any change or delay, while unlikely, would lead to additional pressure on asset prices across the board. As such, we anticipate continued interest rate, equity, and other risk asset volatility to end 2021 and to start 2022.

We do see potential for equities to go higher from here, however, on a risk-adjusted basis, we do not see any incremental upside from current levels as an appropriate reward relative to the risk/reward tradeoff seen over the most recent market cycle.

Investment Strategy/Asset Allocation

We continue to be cautious on **equities** resulting in an **underweight** position in favor of an **overweight** to **fixed income**. In examining the broader asset class trade off, a somewhat lesser of two evils at the moment, we prefer fixed income on a relative basis. We see fixed income as having limited downside from a price perspective, while generating current income, versus the premium valuations and potential for substantial price volatility, and limited growth, in the near-term with equities.

As GDP slows, supply chain issues remain, and interest rates move higher, we expect pressures to mount on company earnings creating a bumpy trading profile for “priced to perfection” equities. All eyes will be on Q3’21 earnings results and subsequent guidance for Q4’21 and further out into 2022. While expectations remain for strong earnings growth, the focus will be on the quality and source of earnings.

On the asset allocation side, portfolios invested entirely in fixed income outperformed relative to those holding any amount of equity. A blended 90% Equity/10% *Fixed Income Index* was down around -2.0% while a 100% *Fixed Income Index* was down only -0.2% (see Benchmark Performance). Further, as the yield curve crept up across intermediate to long-term maturities, fixed income allocations benefited from monthly income distributions being reinvested at higher yields, despite the offsetting decline in corresponding bond prices. We do see potential for equities to go higher from here, however, on a risk-adjusted basis, we do not see any incremental upside from current levels as an appropriate reward relative to the risk/reward tradeoff seen over the most recent market cycle.

Overall, where allowed, we are maintaining “dry powder” in the form of shorter-term fixed income and core-bond holdings. We favor holding conservative, lower-risk instruments earning incrementally higher yields versus cash-only holdings as we wait for opportunities to deploy into equity markets. We expect interest rates to remain volatile into 2022 creating pockets of value in the fixed income portion of investor portfolios. We remain allocated to strategies favoring a long duration stance as we do not see rates, while increasing at the moment, to remain elevated at these levels going forward. However, given the short-term spike in rates, we have hedged where appropriate to help reduce the impact on the portfolio. As long-term investors, we are willing to accept short-term underperformance in exchange for longer-term outperformance as the markets sift through the noise and reprice assets.

> “When investors are greedy, we are fearful....when investors are fearful, we are greedy”
>
> — Warren Buffett

THIRD QUARTER 2021 BENCHMARK PERFORMANCE

Returns as of 9.30.21 [1]

	MTD %	QTD %	YTD %	Trailing[3] 1-Yr %	Trailing[3] 3-Yrs %	Trailing[3] 5-Yrs %
Blended Benchmarks [2]						
90% Equity / 10% Fixed Income	-3.8	-1.7	10.3	29.4	36.7	72.6
80% Equity / 20% Fixed Income	-3.2	-1.1	9.0	24.4	39.2	71.5
70% Equity / 30% Fixed Income	-2.8	-0.7	8.2	21.7	37.0	64.9
60% Equity / 40% Fixed Income	-2.6	-0.8	6.6	18.3	33.5	55.6
50% Equity / 50% Fixed Income	-2.3	-0.5	5.3	14.6	31.7	49.7
100% Fixed Income	-1.0	-0.2	-1.3	0.5	14.8	13.8
U.S. Large Cap Equity						
S&P 500 Index	-4.7	0.6	15.9	30.0	56.1	118.3
DJ Industrial Average Index	-4.2	-1.5	12.1	24.2	36.8	107.2
Russell 1000 Index	-4.6	0.2	15.2	31.0	57.8	120.3
Russell 1000 Growth Index	-5.6	1.2	14.3	27.3	81.6	179.7
Russell 1000 Value Index	-3.5	-0.8	16.1	35.0	33.4	68.0
U.S. Mid Cap Equity						
Russell Mid Cap Index	-4.1	-0.9	15.2	38.1	49.0	95.8
Russell Mid Cap Growth Index	-4.8	-0.8	9.6	30.5	69.1	141.3
Russell Mid Cap Value Index	-3.7	-1.0	18.2	42.4	34.1	65.4
U.S. Small Cap Equity						
Russell 2000 Index	-2.9	-4.4	12.4	47.7	35.1	87.9
Russell 2000 Growth Index	-3.8	-5.7	2.8	33.3	39.4	104.1
Russell 2000 Value Index	-2.0	-3.0	22.9	63.9	28.0	68.7
International & Emerging Market Equity						
MSCI EAFE Index	-2.9	-0.4	8.3	25.7	24.7	52.5
MSCI EAFE Growth Index	-3.9	0.1	6.9	20.9	40.2	71.6
MSCI EAFE Value Index	-1.8	-1.0	9.6	30.7	9.4	33.6
MSCI Emerging Markets Index	-4.0	-8.1	-1.2	18.2	28.0	55.5
MSCI ACWI ex. U.S. Small Cap	-3.0	0.0	12.2	33.1	34.3	63.1
Fixed Income (U.S. & Emerging)						
Bloomberg US Agg. Bond Index	-0.9	0.1	-1.6	-0.9	16.9	15.6
Bloomberg US Agg Int. Bond Index	-0.5	0.0	-0.8	-0.4	13.8	13.0
Bloomberg US Int. Corporate Index	-0.5	0.1	-0.5	1.1	17.6	18.7
Bloomberg US Long Corporate Index	-1.9	-0.1	-2.6	2.5	35.1	35.8
ICE BofA US High Yield Corp Index	0.0	0.9	4.7	11.5	21.2	36.1
Bloomberg US TIPS Index	-0.7	1.8	3.5	5.2	24.0	23.6
JPM EMBI Global Diversified Index	-2.1	-0.7	-1.4	4.4	17.9	21.0
JPM GBI-EM Global Diversified Index	-3.4	-3.1	-6.4	2.6	11.4	10.7

[1] ***Source: Morningstar***
[2] ***Source: BridgeFT***
[3] ***Non-Annualized***

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