

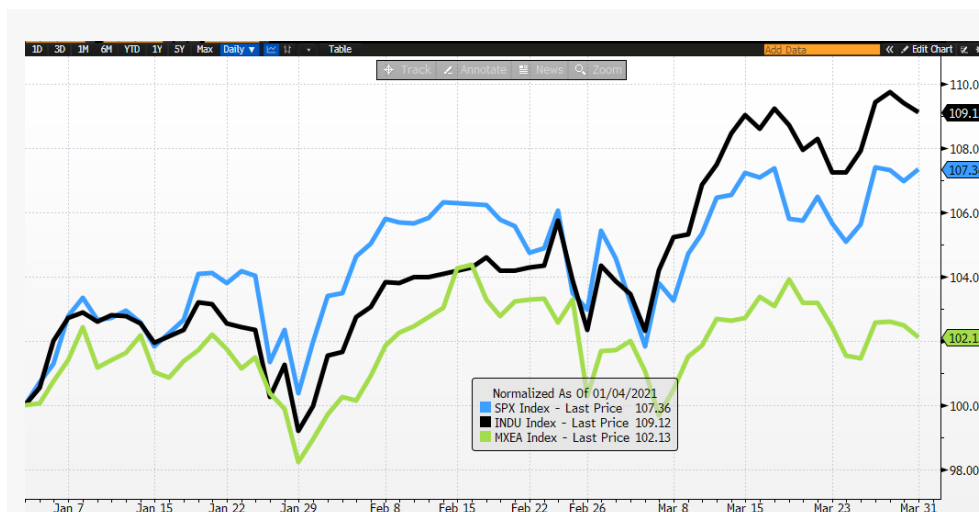


QUARTERLY NEWSLETTER

2Q 2021

STRETCHING THE RUBBER BAND

 **Chart 1.** Index Performance as of 03.31.2021



INDEX PERFORMANCE

Returns as of 03.31.2021

S&P 500 (SPX)	6.17%
Dow Jones Indus. Avg (INDU)	8.29%
MSCI U.S. Value	10.40%
MSCI U.S. Growth	0.58%
MSCI EAFE (Non-U.S.) (MXEA)	3.61%
MSCI ACWI (Non-U.S.)	4.67%
U.S. Corp High Yield	0.85%
Alerian MLP	21.87%

Source: Bloomberg as of 03.31.2021

Fed Chairman Jerome Powell loves the idea of transitory inflation. It does sound good. In a 2019 Fed meeting, he described low inflation as “transitory” and would consider a future policy move if low inflation proved to be “persistent.” Of course, that was pre-COVID and now it seems like we live in a different world. Chairman Powell is now talking about the possibility of a significant bump up in inflation throughout 2021 due to the economy reopening, but that it will only be *transitory*. In addition, he expects the Fed to remain patient on policy, and if long-term inflation expectations or current inflation emerges, then the Fed will take action. “If we do see what we believe is likely a transitory increase in inflation, where longer-term inflation expectations are broadly stable, I expect that we will be patient,” Powell [said](#) during a Wall Street Journal conference earlier last month.

Like many in the industry, we anticipate a significant economic boom throughout the rest of 2021 as life begins to return to normal after a year of pandemic-forced closures to global economies. The question for investors to consider however is, **what is already priced into the market?** In this newsletter, the Investment Committee will address one of the most pressing themes confronting economic expectations and growth opportunities for investors - inflation.

HIGHER INFLATION?

Higher inflationary concerns and those in the industry worried about inflation causing the market to derail, are abound. The main concerns are:

1. The massive amount of liquidity that has been injected into the financial system
2. Households with high cash and savings
3. The Fed's willingness to let inflation run and become a permanent buyer of debt
4. Potential cost-push inflation from supply constraints
5. Historically low commodity prices, that may have bottomed and are trending up, illustrated in Chart 2 to the right.



Chart 2. S&P GSCI Index



Source: Bloomberg as of 03.31.21

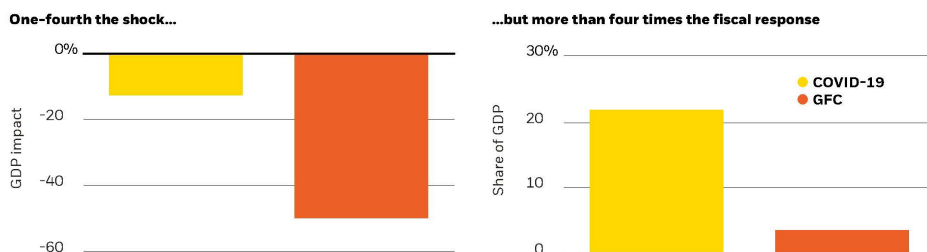
INFLATION CONCERNS

Each of the concerns mentioned gives us pause because they indicate that there is plenty of dry powder to potentially chase too few goods, which is the definition of inflation – too many dollars, chasing too few goods. This in-turn could cause the Fed to taper earlier than expected, adding to more market uncertainty, and as we are all aware, the market does not like uncertainty. Below we look at these concerns in more detail.

LIQUIDITY



Chart 3. U.S. cumulative GDP loss and fiscal support, COVID-19 vs. Global Financial Crisis



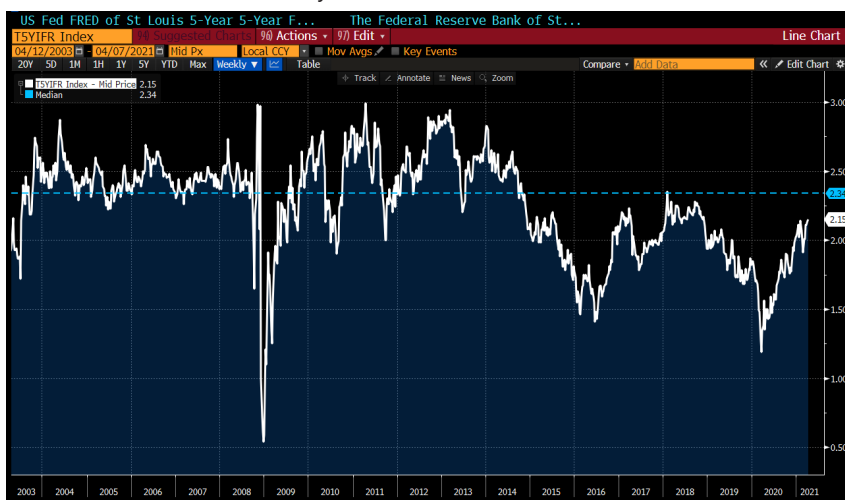
Source: BlackRock Investment Institute, with data from Haver Analytics as of 03.31.21

In a recent BlackRock newsletter, titled Taking Stock Q2 2021, BlackRock Managing Director, Tony DeSpirito, puts recent stimulus into perspective. Chart 3 to the left shows the massive amount of stimulus in response to the COVID-19 crisis compared to the Global Financial Crisis. Even though we do acknowledge that fighting the Fed is a bad idea, the question is if the Fed can keep the impending fire under control. In our opinion, the Fed is in a good position, but inflation, inflation expectations, growth, and interest rates should be watched very closely.

Chart 4 to the right shows the St. Louis FED 5-year forward inflation expectation rate with the median as a blue dash. It is a metric Chairman Powell has said we should watch as it is off the bottom but still below the long-term median level. In addition, an elevated Producer Price Index (PPI) and its components are more concerning, in our opinion (see plywood Chart 5 below). The question is if these producers will or can pass higher prices on to consumers. We believe in our opinion that companies with high gross margins, that can pass on these higher prices and maintain profitability, may present an investment opportunity.



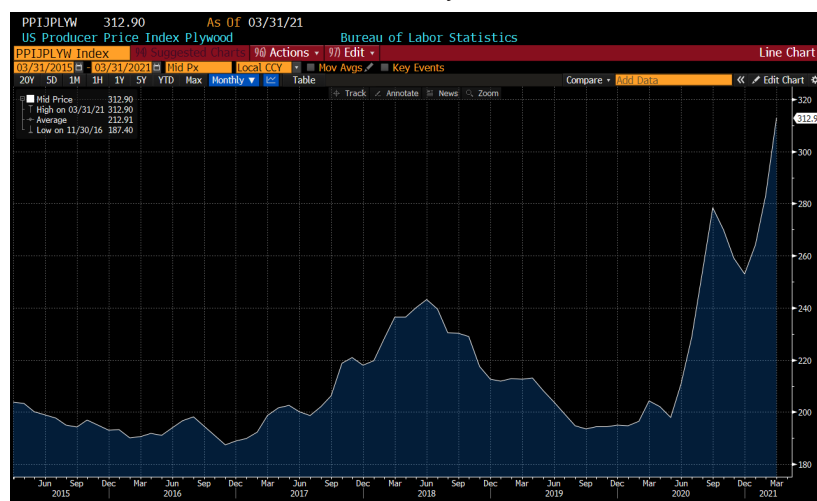
Chart 4. St. Louis FED 5-year Forward Inflation



Source: Bloomberg as of 03.31.21



Chart 5. U.S. Producer Price Index Plywood



Source: Bloomberg as of 03.31.21

INFLATION OUTLOOK AND IMPACT ON GROWTH

Circling back to the question posed initially; will the growth and inflation we usually see coming out of a recession be transitory or more persistent? **Has the Fed stretched the rubber band too far?** Will it break or snap back in-line? Chart 6 to the right shows the NY Fed Weekly Economic Indicators (WEI), a group of short-term measures that was created to gauge economic activity during COVID.

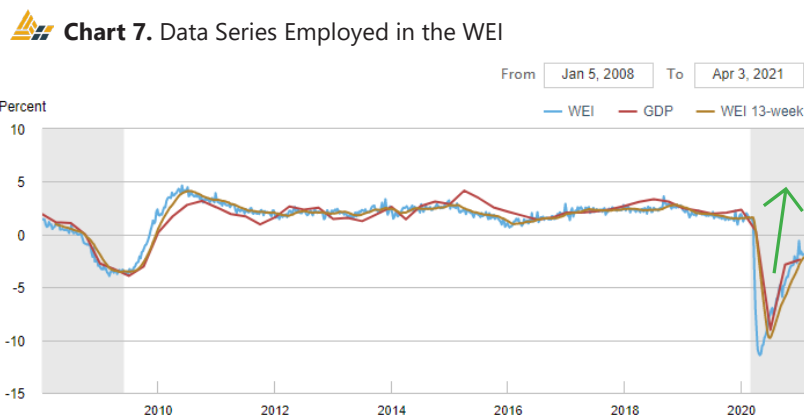


Chart 6. Data Series Employed in the WEI

Redbook Research: same-store retail sales average	Measures year-over-year same-store sales growth for around 9,000 general merchandise stores in the United States
Unemployment insurance: initial claims	Reports the number of people making new unemployment insurance claims from state unemployment offices
Unemployment insurance: Continuing claims	Reports the number of people making unemployment insurance claims for a continuing spell of unemployment from state unemployment offices
American Staffing Association: Staffing Index	Tracks temporary and contract employment with data coming from a large panel of staffing companies
Rasmussen Consumer Index	Constructed with a daily survey of 1,500 American adults using questions about personal finances and the economy more broadly
Raw steel production (from American Iron and Steel Institute)	Estimates the weekly production of raw steel from domestic producers
Electric utility output: United States ex. Hawaii and Alaska (from Edison Electric Institute)	Measures electricity output for the United States excluding Alaska and Hawaii
U.S. fuel sales to end users (our calculations based on underlying data from the U.S. Energy Information Administration)	Estimates gasoline, diesel, and jet fuel sales to retailers and end users
U.S. railroad traffic	Tracks total freight transported as reported by railroad companies to the Association of American Railroads
Federal withholding tax collections (Booth Financial Consulting)	Measures Treasury receipts of income and payroll taxes withheld from paychecks, filtered and adjusted for policy changes.

Source: Federal Reserve Bank of New York as of 03.31.21

As long as the rubber band does not "snap" through economic response and/or Fed management, then we believe the green light for growth remains as reflected in the significant increase of economic activity illustrated in Chart 7 to the right.



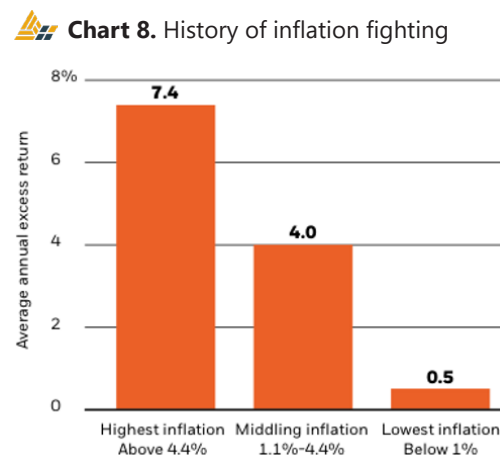
Source: Federal Reserve Bank of New York as of 03.31.21

INFLATION AND VALUATION

Why is inflation a **valuation** concern? Usually, when someone is speaking about short versus long duration assets, it is a fixed income investment. We also know that when interest rates go up, the price of a bond goes down, and vice versa. In addition, the longer the duration or maturity, the more the price of a bond goes up or down in response to a change in the prevailing interest rates, which, we'll touch more on later in the newsletter. This being said, what about equities?

We would all likely agree that a business trading at a 5 P/E (Price/Earnings) ratio would be considered a value stock. Let's look at a very simplified example. If an investor spent \$100 to buy a business at a P/E ratio 5X earnings, that means the company is earning \$20 per year. It also means an investor will recoup his/her investment after five years; a relatively short duration. On the other hand, an investor who buys a growth business at a high P/E, for example 20X, with \$5 in earnings, will have to wait much longer to recoup the original investment, perhaps up to 20 years.

As we can see with a much longer duration investment, and in an inflationary environment, the future dollars recouped are worth less, which only increases the payback period even more. This is why value stocks are considered a short duration asset and a growth stock is a longer duration asset. From a time value of money perspective, it is clear that a dollar now is worth more than a dollar later, and in an inflationary environment, this is amplified. Over the last 20 years, market participants have not been that concerned about inflation, thus growth or long duration stocks led value by a large margin. While this is only one dimension of the growth outperformance scenario, in our opinion, it is an important one. In Chart 8 to the right, we see the historic relationship between inflation, value, and growth equities.



Source: BlackRock with data from Kenneth R. French Data Library and Robert J. Shiller as of 03.31.21

During the next 12 months, we will be watching these relationships closely and believe that increased volatility will also be the norm as we see the continued tug of war between value and growth, opening and closing names, interest rates, and inflation. We can likely anticipate that when interest rates increase, growth will underperform value, and vice versa. Similarly, when we receive good news or bad news on COVID, the market will undoubtedly respond in a very short-term manner, and not on long-term valuation. In our opinion, this plays into our hand and we believe we are positioned very well for the long-term. Our equity portfolios focus on valuation, and even in the LFCM US Large Cap Growth portfolio we are going to have a more **value** and **quality** bias than most other growth managers. We believe our bottom up fundamental approach will give us the

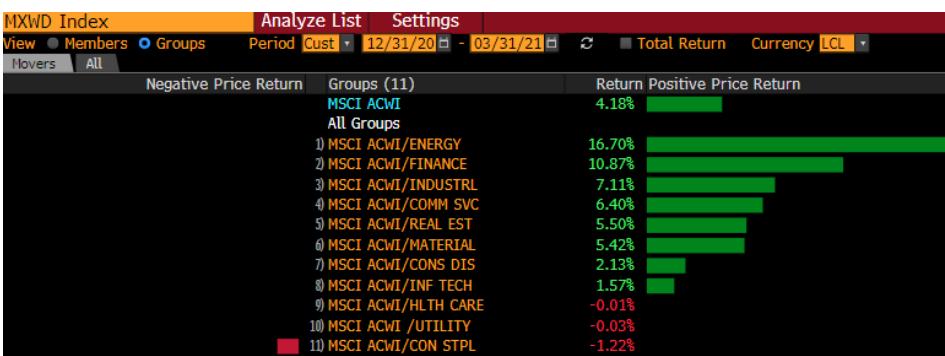
potential to perform in the current environment, as active management will continue to come to the forefront over passive. **Let's hope inflation is transitory and growth is permanent.**

INTERNATIONAL VIEW

In the first quarter, the fragility of global supply chains became evident as countries scrambled to jumpstart their economies. At the heart of the issue resides contrasting strategies that governments decided to adopt to tackle the COVID-19 pandemic. In fact, while countries like Sweden opted for herd immunity, other countries such as France tightened restrictions and imposed nationwide lockdowns. The vaccine distribution faced unforeseen hurdles, with supply-side manufacturing capacity constraints causing delivery delays, and the reliability of the AstraZeneca shot funneling some concerns. In Europe, the United Kingdom stood out with a clear recovery plan and a smooth vaccine rollout. As of April 48% of the British population received at least one COVID-19 dose, versus 15% of the European Union, according to Bloomberg. Yet, British stocks underperformed the Euro STOXX index in the first quarter (3.9% vs 8.9%).

In Asia, China was in the news for geopolitical tensions and its internal crackdown on technology companies for monopolistic practices. The Emerging Asia index underperformed the MSCI ACWI index (2.16% vs 4.18%) dragged by China (-3.13%). The biggest outflows came from Chinese technology companies amid the risk of delisting from U.S. exchanges and rising interest rates. In Japan, the mild infection rate affected the government's sense of urgency regarding the vaccination rollout, as only 0.46 doses per 100 people were administered according to Bloomberg. The Nikkei 225 Index gained 6.32% last quarter, led by cyclicals. The Suez Canal blockage by a cargo ship exacerbated supply chain issues and created short-term inflation. Global treasury yields crept higher, and Brent found comfort in a well-defined area of consolidation between \$60 and \$65. The U.S. dollar firmed up, challenging the rally into commodities. Looking forward, Latin America looks like a region to monitor given their current growth and inflation outlook.

 **Chart 9. MXWD Index**



Source: Bloomberg as of 03.31.21

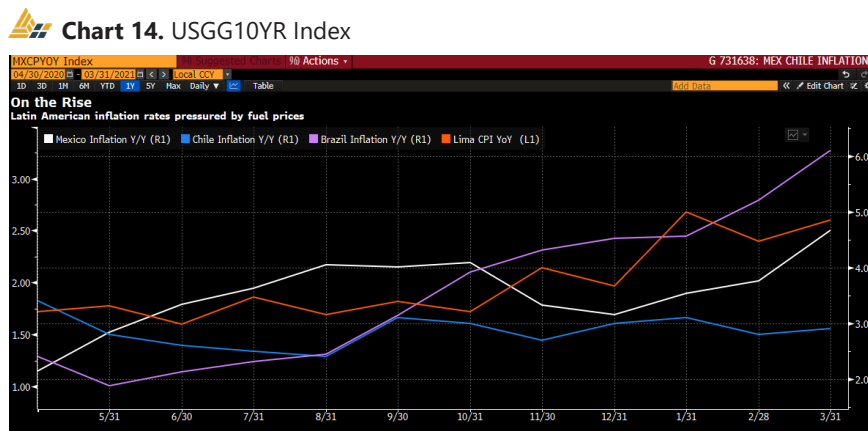
IS IT LATIN AMERICA'S TIME TO SHINE?

Following the U.S. presidential elections, investors crowded into the so-called reflation trade, which consisted of rotating from growth to value, favoring cyclicals, and shorting the U.S. dollar in anticipation of an increase in government spending. We saw this dynamic play out globally, and one of the byproducts was the emerging markets bet. As a result, in the fourth quarter of 2020, the MSCI EM Index surged 19.34%, led by information technology (33.8%), materials (29.3%), financials (23.7%), and industrials (20.9%). During this period, the MSCI EM Latin America index jumped 34.11%, versus 18.58% for the MSCI EM Asia index. Through this trade, investors repositioned their portfolio to withstand higher growth and higher inflation. In the first quarter of 2021, growth stocks were a drag to performance as global yields started to rise. Emerging Asia returned 1.9%, while the MSCI EM Latin America index was down 6.1%. The performance of Latin American countries was somewhat counterintuitive given the inflation expectation and the weight of commodity producers in the index. Historically, the outperformance of this region has always been tied to the inflation story as well as the dollar story.

THE INFLATION STORY - LATIN AMERICA

From 2004 to 2007, it was the perfect storm for Latin American economies. Global GDP averaged 4.26% during this period, well above the 30-year average GDP growth of 2.63%, while global inflation averaged 4.05%. Brent prices bottomed at \$29 in January 2004 and peaked at \$95 in November 2007. We also witnessed wild swings in other commodities as demand outpaced supply. The Bloomberg Commodity index rose from 135 in 2004 to 184 in 2007. As of April 2021, the same index trades around 85. Latin American equities delivered 75% average annual return from 2004 to 2007. This perspective is helpful because the IMF projects that the global economy will grow at 6% in 2021 and 4.4% in 2022. Global inflation is forecasted to be above 3% for the coming years. It could potentially be a goldilocks scenario for Latin America.

Research firm Variant Perception made the case in its October 2020 white paper that the world is entering a “commodity supercycle”. According to its findings, “commodities are generationally cheap, both compared to themselves and to other assets”. The market has started to address some of these price distortions. Besides, the fundamentals are starting to match the inflation narrative, especially in Latin America. Case in point, last month, Brazil’s CPI grew 6% year-over-year, while Mexico’s CPI grew 4.6%. The Brazilian Central Bank raised interest rates and announced additional hikes in May to contain inflation. As of April 2021, the Brazilian 10-year yield is over 9.6%, higher than it was at the peak of the COVID-19 pandemic (9.52%). A fair read of these rising yields is that the market is pricing in inflation, currency depreciation, or both. The direction of the U.S. dollar will be correlated with outsized standard deviation moves.



Source: Bloomberg as of 03.31.21

THE DOLLAR STORY

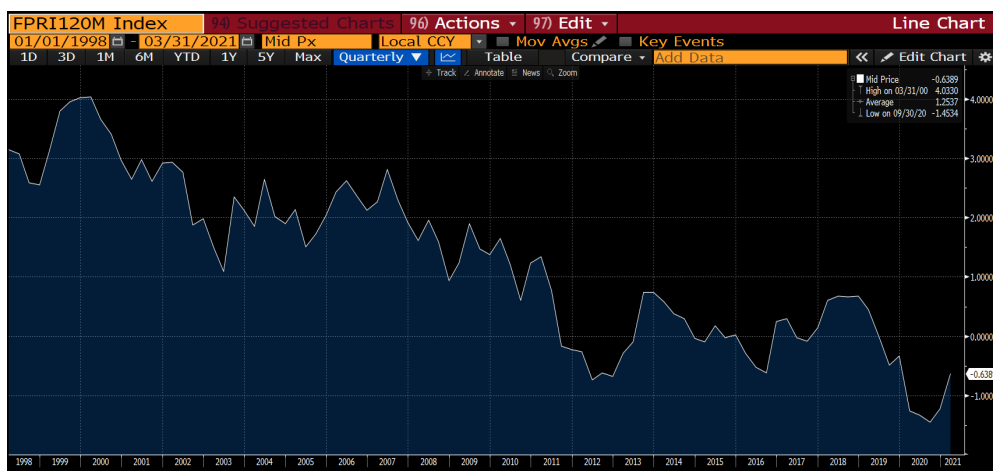
The emerging market rally was halted in the first quarter of 2021 by the abrupt rise of the U.S. dollar. From January to March, the dollar index moved from 89 to 93. Chilean stocks managed to post 17% gains in the quarter, helped by the solid performance of financials. Copper miners lost their momentum to the upside in February, as the U.S. dollar strengthened and copper prices stabilized in a tight range. In April, we are witnessing a trend reversal, with the dollar moving lower as the U.S. government ramps up spending. From 2004 to 2007, the dollar index peaked at 92 in November 2005 and bottomed at 74 in November 2007. We do not expect such drastic drawdown, but sentiment can shift quickly.

Traders are currently net long U.S. dollar according to Bloomberg data, but short positioning is accelerating since the beginning of the second quarter. If this trend persists, it will be a tailwind for emerging markets. With U.S. markets trading at all-time high, emerging markets make a compelling case for a value bet. However, it is not without risks, as these countries have a history of political, fiscal, and social turbulence that may stain the investment appeal. As a reminder, the volatility in these markets is not for the faint-hearted. Currency risk is also a huge factor to take into consideration in position sizing. We will continue to monitor these markets and hunt sources of alpha for our strategies.

ASSET ALLOCATION VIEW - "WHAT'S INTERESTING ABOUT RATES?"

A key aspect of inflation concerns is the influence on interest rates, particularly on longer dated debt. As inflation and inflation expectations rise, interest rates tend to rise as well. However, rates are driven by more than just inflation. As we look at this, we will observe several reasons why we feel fixed income is a challenged asset class in the current environment. Below we'll look at a deconstruction of interest rates for some classes of 10-year bond rates as of March 31st.

 Chart 11. FPRI120M Index



Source: Bloomberg as of 03.31.21

The **real interest rate** serves as the basis or foundation of an interest rate structure. This is the expected bond return once all other constituents are removed. Left is a chart of 10-year real interest rates over the last couple decades. Note in Chart 11, the 10-year real interest rate is currently negative (-.64% as of 3/31/21).

Add to this the **expected inflation rates**. In the United States, CPI is often used as a proxy here; note, these future rates range from 1.9% to 2.5% (Chart 12).

 Chart 12. USGG10YR Index



Source: Bloomberg as of 03.31.21

The result when combined, represents the return of a "risk free" bond such as the U.S. Treasury (1.74% as of 3/31/21) as illustrated in Chart 12 to the left.

To get an approximate yield of any other class of bonds, we then need to add the spread above treasuries. The spread represents the “extra” a bond investor is paid over a risk-free bond for such things as liquidity and credit risk. The spread between a 10-year U.S. Treasury and an average of a 10-year high yield bond would be a good example. An expected yield of a 10-year “average” high yield bond might be around 4.23% as of 3/31/21.

FIXED INCOME CHALLENGES

There are several reasons we believe fixed income is challenged as an asset class in the current environment. These include:

- Low yields in general
- Negative real yields
- Historically low spread for investment grade and high yield bonds
- Potentially increasing inflation

An increase in real yields, inflation, or spreads will be negative for fixed income investors. As a result, we advocate a tactical approach to fixed income management, limited duration/credit exposure, and selection of the best managers to pursue the best possible return in this challenging environment.

Current asset allocation positioning:

We continue in a risk-on financial market with potential higher volatility. Continued fiscal stimulus is likely and Central Banks will likely hold rates and bond purchases steady through any “transitory” inflation. As vaccination rates increase and restrictions are lifted, we should see increased demand for goods and services coupled with constrained supplies, as referenced earlier, which may increase inflation.

In accordance with this view, we currently see the following indications for asset allocation:

General Allocation – In the first quarter, equity markets continued a choppy rally with the MSCI ACWI up 4.57%, while the fixed income markets saw a significant pullback of -3.37%. In the fixed income markets, the interest rate spreads have continued to tighten from already tight levels, and in some cases have approached the lowest levels since 1987. We recommend a quality core of equity focusing on companies with strong balance sheets and strong cash flows and a good balance between growth and value. For fixed income, we recommend a mix of core, multisector, and floating rate/inflation protected allocations, though we believe fixed income will remain challenged from both a return and risk reduction perspective. We also believe the potential for further spread tightening is quite limited. Accordingly, we believe the equity markets continue to have greater potential for return than the fixed income markets. We believe that the Fed will be patient before removing monetary support, directly affecting the fixed income markets and indirectly affecting all other markets. We remain vigilant regarding our indicators and will modify overall allocations as these indicators and the market environment dictate.

Equity Allocation – We continue to monitor financial conditions and market returns to determine our optimal equity asset allocation. Relative to benchmarks, we are currently overweight in equities relative to fixed income. We remain slightly overweight with U.S. equities, as we believe that consumer demand in the U.S. will recover more quickly than the rest of the world. We are constructive regarding select small/mid-cap equities. We continue to emphasize high quality

and high cash flow equities as we believe those type of companies should emerge from the current crisis in the most favorable condition to take advantage of the recovering economy. We continue to monitor international markets, and see opportunities there, though the slow rollout of vaccinations may delay opportunities in Europe relative to the developed Asia. We see opportunity in emerging markets, especially those in East Asia that continue to handle the COVID-19 pandemic well.

Fixed Income Allocation – We believe fixed income going forward will be challenging. In response to the current crisis, the Federal Reserve has indicated continued low interest rates and bond buying activities to support economic growth. The effects of these actions will likely be lower rates for longer. The Fed has begun managing the U.S. Treasury market as the large amount of current and future issuance will likely require the Fed to continue to increase the size of their balance sheet to ensure stability in these markets. Due to current yield levels, higher quality and higher duration fixed income may have limited upside and provide lower yields. There is an unlikely tail risk of much higher rates in the event of a Fed miscalculation. Longer-term rates may simply rise with the improving economy, the existing debt level, and increased future debt needed to fund Social Security and Medicare as more Boomers retire. All of this indicates a tactical approach of fixed income management as we expect limited opportunities and significant risks in this area. We continue to monitor company health and interest rate movements closely and will adjust positioning in accordance with the evolving economic and interest rate environment.

Liquid Alternatives – Liquid alternatives were helpful in reducing portfolio volatility and improving risk-adjusted returns during the recent market volatility. We may consider alternatives as an option to reduce portfolio volatility. Given the limited return potential of fixed income, we may similarly consider liquid alternatives as an alternative to a portion of a traditional fixed income allocation.

Thank you for the continued confidence and trust. We appreciate your business.

Thank You,
Level Four Capital Management Team

IMPORTANT INFORMATION

The opinions articulated in this document are for general information only. This information is not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States. With over 1,000 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The CBOE Volatility Index® (VIX®) is meant to be forward looking, showing the market's expectation of 30-day volatility in either direction, and is considered by many to be a barometer of investor sentiment and market volatility, commonly referred to as "Investor Fear Gauge".

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. Price-weighted means stocks with higher share prices are given a greater weight in the index. The DJIA is a stock market index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company.

The Russell 1000 Index is a market capitalization weighted stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The Russell 1000 is a subset of the Russell 3000 Index. It represents the top companies by market capitalization. The Russell 1000 typically comprises approximately 90% of the total market capitalization of all listed U.S. stocks. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays U.S. Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly issued, non-investment grade debt.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

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