



# QUARTERLY NEWSLETTER

3Q 2021

## DON'T GET HIGH ON YOUR OWN SUPPLY

*Elvira Hancock to Tony Montoya in the 1983 film, Scarface*

 **Chart 1.** Index Performance as of 06.30.2021



### INDEX PERFORMANCE

#### Returns as of 06.30.2021

|  |        |
|--|--------|
| S&P 500 (SPX)                                  | 8.55%  |
| Dow Jones Indus. Avg (INDU)                    | 5.08%  |
| Bloomberg 1K Growth                            | 10.45% |
| Bloomberg 1K Value                             | 5.22%  |
| Bloomberg Developed Ex North America & Mid Cap | 5.25%  |
| Bloomberg World Index                          | 7.46%  |
| U.S. Corp High Yield                           | 2.74%  |
| Alerian MLP                                    | 21.23% |

Source: Bloomberg as of 06.30.2021

Investors are facing a wall of worry with Inflation, the Delta Variant, China, and U.S. Fed policy being top of mind. The wall of worry is indeed real, yet even in the face of these headwinds, markets continue to remain resilient. Throughout the second quarter, market participants grappled with these themes dominating headlines, with each emerging at different times. In this newsletter, we focus on **inflation risks**, as all of the issues mentioned above are linked to one another and affect future capital market returns.

## THE CURRENT COVID NARRATIVE

COVID-induced supply disruptions, coupled with massive government stimulus on the demand side, have led to an increase in prices that could lead to permanent inflation. The rising inflation scenario could push the U.S. economy into a double dip recession if the U.S. Fed is forced to act earlier than anticipated by reducing the amount of the bond purchases and/or raising interest rates. While this narrative plays out, markets are yawning, and we ask, "Is inflation the time bomb the media believes it is, or truly a transitory phenomenon?" Let us not forget that we would absolutely expect to see some transitory increase in prices coming out of such a deep global recession.

Anyone who took an economics class is familiar with supply and demand, as well as the concept that these two magical forces explain the interaction between buyers and sellers, and therefore determine prices, wages, and just about anything that can be traded. From a macroeconomic, and specifically, a growth policy perspective, we talk frequently about the supply-side and demand-side of economic policies.

Furthering the current COVID narrative, we will examine these theories and COVID-induced supply disruptions in table 1 below.

 **Table 1.** COVID induced supply disruptions

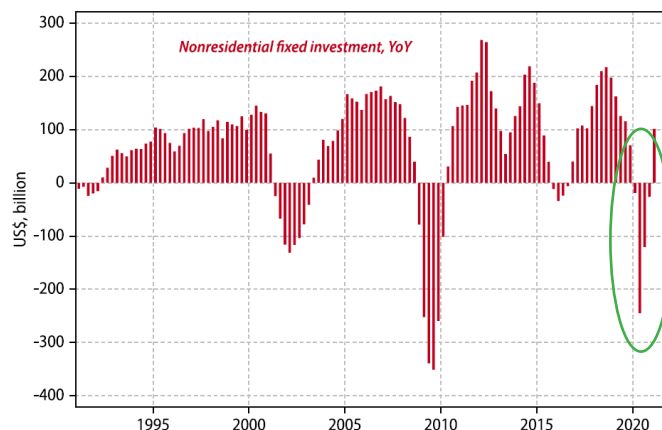
| SUPPLY SIDE                          | DEMAND SIDE                       |
|--------------------------------------|-----------------------------------|
| De-Regulation                        | Monetary policy-cut rates         |
| Investment in education and training | Fiscal policy-cut taxes           |
| Flexibility in labor markets         | Devaluation-reduce currency value |
| Reduced tax rate                     | Quantitative easing               |
| Reduce trade union power             | Increase money supply             |

Source: LFCM, Bloomberg 2021

In table 1 (above), the supply side examples are meant to drive growth through investment, and therefore technological innovation. The demand side seeks to lead the way to growth by increasing overall demand, and then expecting investment to follow. It also makes sense the demand side is government-driven, while the supply side is more business driven through technology innovation and investment.

The current worry is that inflation will not be transitory and the supply problems we experienced due to COVID-19 will stick around. In other words, the supply shock we experienced will not be offset by merely increasing demand through unprecedented stimulus, and the supply issues, due to failing to properly incentivize the long-term investment needed to keep prices under control (See Chart 2 to the right), will not materialize. Supply could be the answer to the inflation question, but the signal could be what the markets are telling us, and most significantly, the bond market. Why are yields trending lower when we are experiencing massive government fueled demand and significant supply shocks? ***Could the markets be telling us technological advances are filling the supply gap?***

 **Chart 2.** U.S. Investment declined for four quarters in a row



Source: Gavekal Research - Ideas as of 07.06.21

## TECHNOLOGICAL ADVANCES

Technology is broad and disruptive, and in the investment committee's opinion, economists and economic models might still be figuring out how to truly measure its effects. Technology affects everything from transportation, media, education, finance, retail, and professional services. In addition, for years now, our economy has been transitioning away from manufacturing which historically is more directly impacted by classic investment measures. From a valuation perspective, the accounting treatment of R&D and other intangible investments similarly misses the point. Technology advancement increases the productivity of assets in place and incremental investment. We think the structural shift and technological shock we have seen for years may not be fully appreciated on the supply side.

As always, we will continue to look for clues from market participants, and continue to believe that government bond yields will probably give us the best read on inflation, and therefore when the Fed will have to act on rates or quantitative tightening. The key is how measured these moves will be.

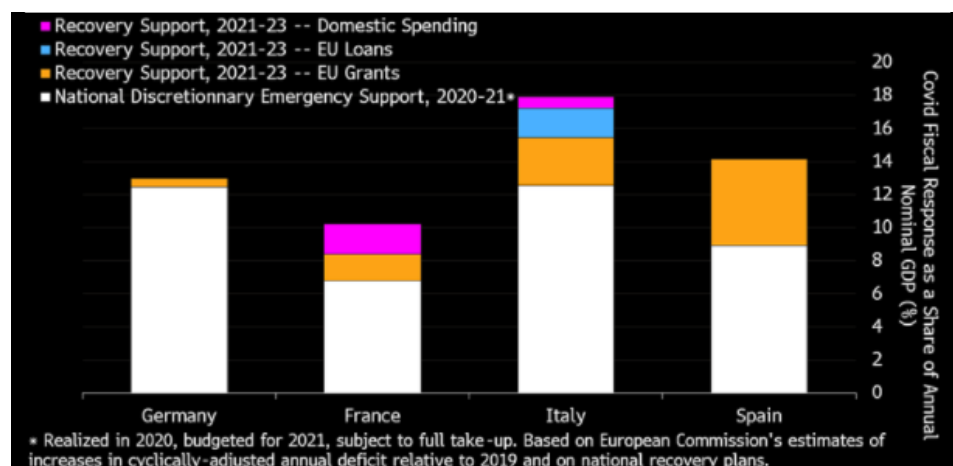
## NON-U.S. MARKETS

In the second quarter, global economic growth strongly rebounded due to synchronized monetary and fiscal stimulus efforts. For this newsletter, we are focused on Europe and Emerging Markets given their contrasting approach to monetary policy in the context of rising inflation. Indeed, Europe decided to remain patient regarding its interest rate policy, while Latin American policy makers decided to take proactive steps to cool down inflation. The effectiveness of these policies will have direct market implications, as companies will face tougher year-on-year comparisons in the second half of the year.

## PATIENT APPROACH TO ECONOMIC RECOVERY

In Europe, the European Central Bank (ECB) maintained its benchmark interest rates in the lower bound throughout the second quarter, as the Eurozone annual inflation growth remained below its 2% target. The Governing Council increased the pace of net asset purchases under its Pandemic Emergency Purchase Programme (PEPP) to provide liquidity to the financial system and facilitate the recovery.

 **Chart 3.** Largest Share of Funding goes to Southern France



ECB President, Christine Lagarde, emphasized that the goal was to avoid unnecessary tightening of financial conditions that would offset recovery efforts. European Union (EU) members juxtaposed monetary support with fiscal packages of various sizes to support individuals and businesses affected by the pandemic. Chart 3 to the left displays COVID fiscal response as a share of annual nominal GDP.

Source: Bloomberg, European Commission, National Recovery Plans as of 07.31.21

The Euro STOXX index advanced 4.6% in the quarter, with glaring weakness in the travel and leisure industry, as well as auto and parts amid travel restrictions and supply chain disruptions. Retail stocks surged 16.94%, while technology and banks added 6.58% and 6.35% respectively. The Markit Eurozone Composite PMI expanded from 53.20 in March to 59.50 in June.

The strong economic rebound was distributed between a heating manufacturing sector struggling to keep up with demand, and a service sector recovering from lockdowns. The Eurozone Consumer Confidence ended the quarter at the highest level since 2018. On a similar note, the Deloitte European CFO survey conducted in the second quarter showed that 45% of businesses were planning to increase their CapEx in the next 12 months. Mission accomplished for the ECB.

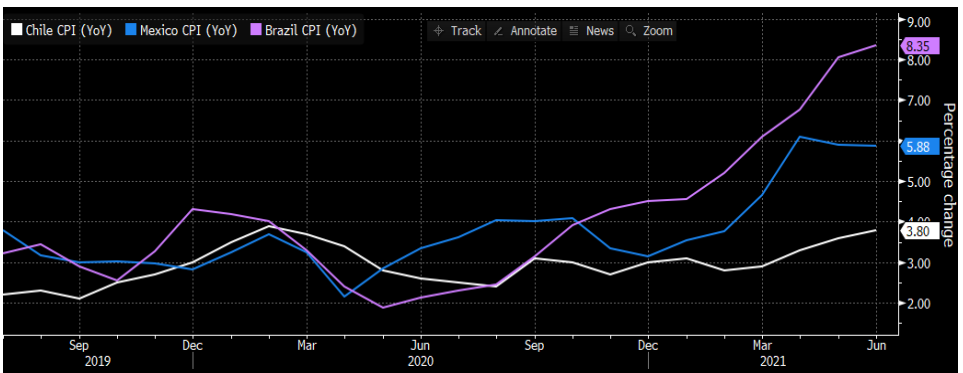
## PROACTIVE APPROACH TO RISING INFLATION

In Brazil, rising consumer prices triggered several interest rate hikes from Central Bank of Brazil throughout the quarter. In fact, in the span of three hikes, policy makers took the Brazil Selic target rate from 2% to 4.25%. The Brazil Composite PMI surged during the same period from 45.10 to 54.60. Brazilian stocks advanced 8.72%, led by banks and energy stocks. Concurrently, the Brazilian Real rallied as S&P Global maintained its long-term Brazil credit rating at BB- with a stable outlook.

Moreover, consumer confidence climbed to a seven-month high during the quarter and inflation expectations eased after peaking in May. Finally, the FGV Brazil Business Confidence index rose to the highest level since 2013. This litany of economic data suggests that the Central Bank of Brazil's textbook response was effective even though inflation remains a concern. Chart 4 below shows that the phenomenon was widespread across Latin America.

In Mexico, policy makers remained neutral during the second quarter, before lifting the overnight interest rate target by 25bps to 4.25% in June. The Mexico Manufacturing PMI slightly improved during the quarter, although it remained below 50.0, as the shortage of chips affected auto manufacturers. Mexican stocks gained 6.44%, boosted by cyclicals. The Mexican Peso gained 15% against the U.S. dollar, with a quick 3% appreciation following the June rate hike.

 **Chart 4. Pressure Rising.** Consumer prices are above target across Latin America



Source: Brazil, Mexico and Chile National Statistics Institutes as of 07.31.21

Additionally, consumer and business confidence rose to pre-crisis levels as economic conditions improved. Even though the Mexican Central Bank raised interest rates at the beginning of June, it is safe to conclude that the response was appropriate. Fiscal spending remains relatively high; therefore, it will be interesting to monitor how the economy reacts to a shift towards fiscal conservatism. Bond yields remain at elevated levels in emerging markets despite inflation mitigation measures.

Two opposite monetary policy decisions in different regions had similar economic effects as they were tailored to their stakeholders. Financial markets are complex and we believe over-indexing to simplistic one-size-fits-all frameworks could be costly.

## ASSET ALLOCATION VIEW - "FIXED INCOME - CAUGHT IN THE CORNER"

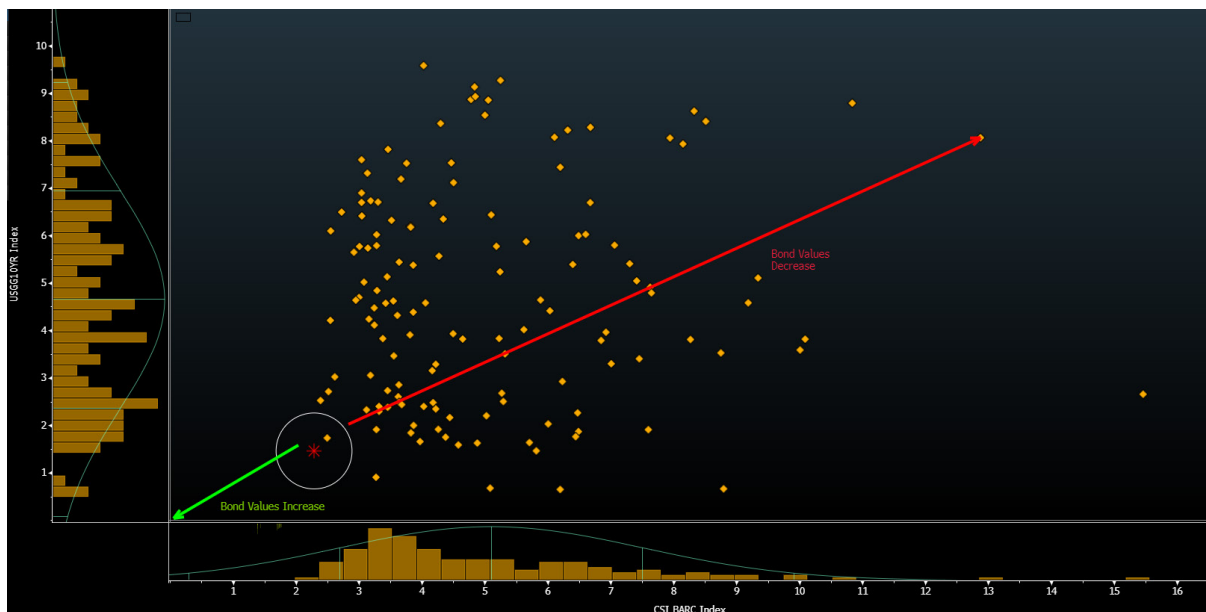
Management of fixed income allocations is one of the most currently discussed topics regarding portfolio positioning. As a result of recent actions taken by the Federal Reserve and other Central Banks, along with longer-term demographic trends such as the aging population worldwide, the traditional bond markets have "pushed bonds into a corner".

In a client's overall asset allocation, fixed income investments are intended to accomplish a couple of primary goals. Not surprisingly, the first is to provide income. As many bonds have a fixed coupon, a given fixed income investment in a portfolio will generate a steady rate of income based on the coupon or interest rate associated with that bond. For a mutual fund or ETF, the income from fixed income will generally equal a weighted average of the investments currently held. In fact, assuming no default, the total return of an individual bond purchased at any given time and held to maturity can be determined precisely at the time of purchase. There are however risks to a bond's value at any point in time relative to current interest rates and credit spreads. Generally, the current value of a bond will vary based on the current interest rate, as compared to the interest rate when the bond was purchased. The longer it takes to get to maturity, the more this will vary. This is what is known as the duration of the bond. When interest rates rise, value of bonds decrease and vice versa.

The second aspect of fixed income is portfolio protection. The so-called "core" bond asset category tends to move in the opposite direction of equity markets such that when equity markets decline, bond values tend to rise, reducing overall risk and volatility of a given investment portfolio. Most large bond issues have a credit rating which reflects the risk to the bondholder not getting paid back (interest and/or principal). One measurement of this is the amount of extra interest a bondholder is paid relative to U.S. Treasuries (which are considered risk-free). The riskier the bond, the higher this interest rate spread is.

So where do we find ourselves today in regards to these aspects of fixed income? Unfortunately, we are in "the corner". In Chart 5 below, quarterly data since 1986 shows the high yield (junk) bond spread, which is the extra an investor is paid for risk along the horizontal axis, and the interest rate paid on the 10-year U.S. Government bond on the vertical axis. The circled red star represents the latest data point, reflecting both low overall interest rates and very tight bond spreads. Relative to the position on this chart, bond values will increase corresponding to moves in the direction of the green arrow. If the move is upward and/or to the right (red arrow), bond values will decline. Note that there is not much room left to move in the "good" direction, but plenty of space in the "bad" direction.

 **Chart 5.** Quarterly data since 1986



Source: Bloomberg as of 06.30.2021

As of this writing, currently the investor is:

- Not getting paid a high rate of interest (1.24% 10-year U.S. Treasury yield)
- Not getting paid a high spread for holding risky debt (2.69% spread over treasuries)

The implications of this are as follows:

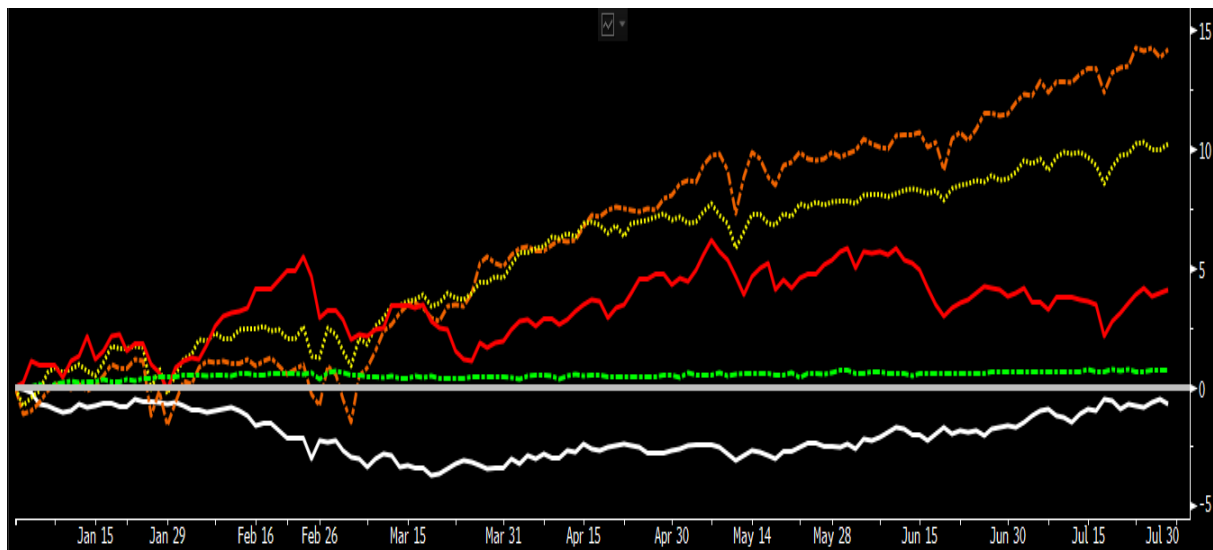
- If interest rates rise, as often happens when the economy improves, the investment loses value.
- If spreads widen, as often happens in economic uncertainty or recession, the investment loses value.

We believe that as fixed income is currently not as well positioned to fulfill its function as in the past, the following are some options that could be considered:

- High quality floating rate bonds – these will provide a source of income that will vary with current interest rates. Therefore, if interest rates rise, income will increase and the price of the bond will move less a similar fixed rate bond.
- Equity allocations with options overlays – depending on construction, these can lower volatility (risk) of the equity exposure or provide a good level of income distributions.
- Certain alternative investments – many of these have a historically low correlation with equities and can lower overall portfolio volatility, provide income, or both.

The following chart shows an example of the year-to-date total return of some of these compared with the white line representing the Barclay's Aggregate bond ETF (AGG). Note that each has provided a rate of return higher than the AGG, while fulfilling some of the functions of traditional fixed income.

 **Chart 6.** Year-to-date Total Return



Source: Bloomberg as of 06.30.2021

- |   |   |  |
|---|---|--|
| <input type="checkbox"/> Barclays AGG ETF   | <input type="checkbox"/> Investment Grade Floating Rate ETF | <input type="checkbox"/> Multi-Sector Alternative Fund |
| <input type="checkbox"/> Hedged Equity Fund | <input type="checkbox"/> Option Overlay Income Fund         |  |



***Current asset allocation positioning:***

We continue in a risk-on financial market with potential higher volatility. Continued fiscal stimulus is expected and Central Banks will likely hold rates and bond purchases steady through any “transitory” inflation. Although many COVID-related restrictions have been lifted, we are closely watching what effects the Delta variant may have on ongoing economic activity and government policy.

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

**General Allocation** – In the first quarter, equity markets continued to rally with our equity benchmark up a 7.39% while the fixed income markets increased 1.83%. In the fixed income markets, the interest rate spreads touched historically low levels. 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 volatility in the fixed income markets may increase, both in terms of overall interest rates and spreads. 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 with equities relative to fixed income due to limited potential for returns regarding fixed income going forward. We remain slightly overweight U.S. equities, as we believe that consumer demand in the U.S. will continue to 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 those types 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; particularly in Europe as their vaccination progress improves. We see opportunity in emerging markets, but are cautious regarding China due to increased involvement of their government in respect to capital markets.

**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 largest amount of current and future issuance, and 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.

*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.

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The Bloomberg US 1000 Value and Growth Indices (B1000V & B1000G) are screened from the Bloomberg US 1000 Index (B1000) and are constructed based on a linear combination of risk factors. The four factors are: 1) Earnings Yield, 2) Valuation, 3) Dividend Yield and 4) Growth. The factors are equally weighted when forming a composite signal where Growth is considered to be a negative indicator and thus flipped to be a negative. The Indices are market-capitalization-weighted. The current price is used to calculate the price-based ratios. For detailed information, review the index methodology document.

Bloomberg Developed Markets ex N. America Large & Mid Cap Price Return Index is a float market-cap-weighted equity benchmark that covers 85% market cap of the measured market.

Bloomberg World Large & Mid Cap Price Return Index is a float market-cap-weighted equity benchmark that covers 85% market cap of the measured market.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

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).

## DISCLOSURE

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