QUARTERLY REVIEW AND OUTLOOK
July 2021

- It was a good quarter for most risk assets: global equities were positive, with the MSCI ACWI returning +7.1%. Large cap equities within developed markets saw the best performance as growth stocks rebounded and vaccination efforts continued to progress.

- While the 1st quarter equity market was led by “value”, with recovering cyclical and industrial sectors, technology and communication services sectors came back in favor and outperformed.

- The quarter finished with good momentum for US stocks, with the S&P 500 pushing towards an all-time high. US equities outperformed, as the S&P returned +8.5% while international equities gained +5.2% (MSCI EAFE Index).

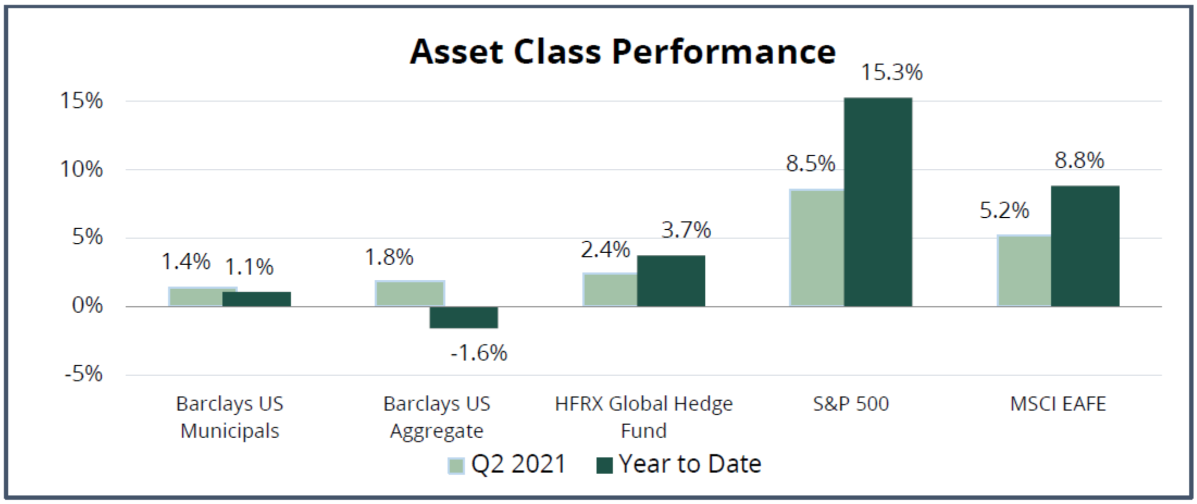
- Interest rates retreated during the quarter: the 10-Year Treasury yield ended June at 1.45%, down markedly from levels earlier this year. This allowed investment-grade fixed income to recover some of its loss from the first quarter.

- Hedge funds in aggregate, as represented by the HFRX Global Hedge Fund Index, gained +2.4%. Directional equity managers continued to outperform during the quarter, returning +5.1%, as equity beta helped this subset move higher.

Market Commentary – Economic Backdrop

The uptrend in global equities continued as strong earnings, supported by strong investor risk-taking confidence, moved equity markets to new highs and credit spreads to historic lows. The attractive backdrop of a post-COVID economic recovery, continued easy monetary conditions (low interest rates and liquidity), and stable inflation spurred investor confidence and willingness to continue buying equities.

Interest rates fell during the quarter, belying a succession of good economic reports. Those numbers included jobs: 850,000 added in June, while the unemployment rate was little changed at 5.9% while more people (re)entered the labor force. The strength of the S&P 500 around the jobs report may be a sign the market thought those numbers were good but not *too* good, suggesting that the Federal Reserve can remain measured with respect to future rate hikes.



Source: Bloomberg and hfr.com. Not independently verified.

Wage gains have been particularly pronounced in services, notably leisure and hospitality. 25% of new jobs over the past month were at restaurants and bars; hourly wages in that sector are 7.9% higher than before the COVID-19 dislocations. This upswell in hourly employment may accelerate through the summer, anticipating the expiration in September of the $300/week stimulus benefit to unemployed workers. Notwithstanding the recent employment demand, these areas remain highly dislocated. Leisure and hospitality employment levels are still roughly 2MM jobs before its peak—this sector comprises a full 30% of the overall jobs lost since the start of COVID. Still, we have seen it can ramp up quickly—as tourism resumes through the summer and fall, these areas will likely see rapid growth in hourly employment.

Another positive sign for the US economy is the again burgeoning trade deficit—the trade gap grew by 3.1% over the past month. A growing trade deficit is seen as an indication that the US increasing purchases of raw materials and finished products (as the US has been a net importer for many years, increased consumption means more imports). At the same time, the supply bottlenecks hampering the global economy in the first and second quarters may be dissipating: high frequency data on semiconductors, used cars, shipping costs, and lumber prices (all areas that were feeling a squeeze earlier in the year) have clearly started to ease.

The 12-month CPI inflation as of May 2021 was high at 5%. This was largely attributed to price increases in energy commodities, notably gasoline/motor fuels. However, food and energy are often ignored when inferring long-term inflation patterns, as they tend to be wildly volatile. Other than food and energy, used vehicle prices, transportation and housing/rent costs contributed an unusually large portion of the cost-of-living increases, categories which tend to suggest temporary demand/supply mismatches. Those would tend to argue against the risk of inflation staying uncomfortably high over the longer term.

Halfway through the year, we are pleased with the way portfolios have performed. We were very active throughout 2020, attempting to use the volatility and dislocation to our advantage. Some of the rotations we effected—such as an overweight to MLPs and small cap stock—really showed their worth as we moved through the year. We started to reverse those in the first quarter of 2021 and now have more neutral positioning. Other portfolio strategies we have built into many portfolios in 2020, such as global trading, should remain prominent for the foreseeable future as risks to volatility in equities increase while bonds remain a losing proposition.

WHAT WORKED AND WHAT DIDN'T

Equity Strategies

US large cap equities were the top performing segment within the asset class, climbing +8.5%. These securities were buoyed by strong corporate performance, with first quarter earnings growth reaching nearly +50% YoY, as well as by the potential for more fiscal stimulus, including the current administration's infrastructure deal. Through the first half of the year, the segment has gained +15.3%. The S&P 500 is now 92% above its level during March 2020—a remarkable feat and one of the most dramatic rallies ever seen.

Earnings have clearly improved (a lot) over that time, but the forward P/E, which was 19.2 X last March is now 21.5 X. Equities are expensive from a multiple perspective, but the dividend yield of 1.4% is now meaningfully higher than the 10-year Treasury yield (roughly 130 bps as of this writing). Also, the earnings yield spread (comparing earnings yield to Baa bond yields) is a good bit cheaper than the 25-year average. The upshot is that equities are expensive relative to their own history, but arguably cheap compared to Treasurys and Corporates. Pick your poison.

Smaller US companies posted more muted gains than their large-cap counterparts, with US mid cap and small cap stocks returning +3.6% and +4.3% during the quarter. Given their significant rally earlier in the year, these segments are still the top performers within equities YTD, having gained +17.6% and +17.5%. It has been a tremendous six months for small cap value in the US. The S&P 600 Value Index (the dedicated small cap value index) is up over 30% thus far this year and over 75% over the past 12 months, it has outpaced almost all other equity investments. Most US industries and sectors participated meaningfully along with broader indices.

Developed non-US equities also saw strong returns, gaining +5.2% as economies continued to re-open and certain leading economic indicators (such as PMI) reached multi-year highs in many countries. The segment has returned +8.8% YTD.

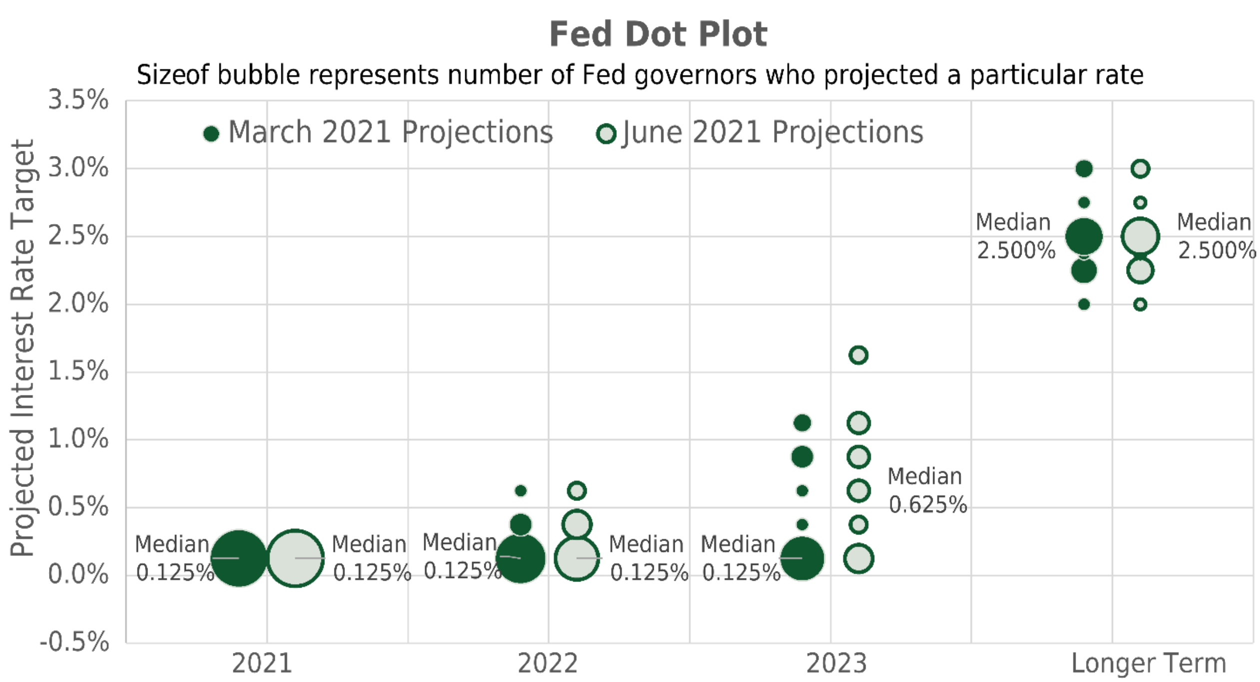
Emerging market equities lagged slightly, returning +5.0%. Year-to-date, the segment has gained +7.5%. Developing nations continue to trail the developed world in regard to vaccine progress, and infection rates remain quite high in specific countries, most notably India.

Fixed Income Strategies

All fixed income segments saw positive returns last quarter, with both investment-grade (IG) credit and opportunistic securities posting low single-digit gains. Yields declined, with the 10-Year Treasury yield falling roughly 30 bps, driving prices for investment-grade fixed income (both taxable and tax-exempt) higher by roughly +1.5%. Following the segment's decline in the first quarter of this year, taxable IG credit is still underwater YTD (-1.6%), while municipal securities are up +1.1%.

Opportunistic fixed income produced similar gains as investors sought income in the current low-yield environment, with floating rate and high yield returning +0.8% and +1.7%, respectively. For the year, the segments have gained +1.7% and +2.3% respectively.

Regarding rates, all eyes remain on the Fed; their public statements remain open to interpretation. The June meeting seemed to have been seen by the market to forecast a change in the future path of rates. The yield curve shifted meaningfully, especially shorter maturities, pointing towards an expectation of the first rate hike being pulled forward about six months into 2022.



Source: Bloomberg

Fed governors continued to revise their interest rate projections upward, notably for 2023, where the median expectations rose from 0.125% to 0.625%, though still low by historical standards.

Another development at the June meeting was that 13 of 18 governors warned of near-term inflation risks, up materially from the five that expressed those sentiments in March. The year-end "core" inflation estimate was ratcheted up to 3% from 2.2% at the last meeting. At the same time, 30-year rates fell 18 bps after the meeting suggesting that longer-term, inflation expectations are rather modest.

Non-traditional Assets

Hedge fund and managed futures managers produced positive returns in aggregate, gaining +2.4% and +3.0%, respectively and are up +3.7% and +11.0% through the first half of the year. Hedge funds have been competitive versus other asset classes (e.g., bonds) year to date and have provided additional diversification benefits to portfolios. We are cognizant of the potential for embedded equity beta risk in these strategies and continually monitor how our underlying hedge funds are positioned.

Real assets continued to post significant gains alongside the ongoing economic rebound. REITs gained +11.6% as investors sought income as well as a hedge against potential inflation. Energy prices continued to recover as travel resumes and supplies run lower: oil prices have reached levels not seen since October of 2018. At the same time, US shale producers have been acting cautiously, not reflexively ramping up production as they have done in the past, which has reduced the spread between US WTI and Brent crude to a relatively tight $2.1 (WTI has been selling at more of a discount in recent years.)

Accordingly, commodities and MLPs saw very strong returns, climbing +15.9% and +21.2%, respectively. Year-to-date, REITs, commodities, and MLPs have returned +21.4%, +31.0%, and +47.8%. That said, other commodities such as precious metals, which arguably are more explicitly associated with inflation expectations, eased materially in June, down mid to high single digits. Conversely, natural gas saw one of the largest up moves, gaining over 22% as demand for electricity, for which natural gas is a key marginal input, skyrocketed along with record heat in the US west.

Residential real estate is bonkers. Fed Chairman Powell observed recently that "it's going to be a tight housing market for some time now because demand is just very high". The YoY percentage change in existing home prices exceeded 23%, fueled by cheap money, limited supply, and the impetus to make lifestyle changes in response to different working arrangements and/or a desire to reconsider the five-day workweek in city centers. There has been recovery even in harder-hit markets like New York, but so far there seems to be a pronounced "appreciation gap" with less dense urban and suburban homes increasing in price much faster than dense urban locations. This is a reversal of the patterns seen five years ago.

Other real estate is still under pressure, with office REITs about 20% below their pre-COVID levels. We have favored more specialized asset types for real estate and continue to see strength in one of our favorites: self-storage properties. Self-storage REITs have produced a total return of 36% through the first six months of the year.

WHAT SHOULD YOU EXPECT GOING FORWARD?

The US economy continues to rapidly recover from the pandemic: GDP grew at 6.4% in the first quarter (quarter-over-quarter, annualized) and measures of industrial activity remain squarely in expansion territory. Business confidence is high: the Conference Board's indicator is at its highest level ever, going back to 1976. However, we must remind ourselves that equity markets have already priced in the rapid recovery and strong economic backdrop we are enjoying today. The question that must remain top of our list is at what point will the markets begin to look ahead for a change economic conditions?

Obviously, equity valuations are rich from a historical perspective. The S&P 500 is currently trading at 37 times its cyclically adjusted price-earnings ("CAPE") ratio, which is second highest reading, just short of the heights of the dot-com bubble in 2000. There are reasons to accept higher valuations: the risk-free rate below 1%, all-time high net income margins in the first quarter (according to BofA Global Research), and overall corporate company strength with 86% of reporting companies in the S&P 500 beating consensus earnings estimates so far.

However, history should not be forgotten and should inform our understanding of what could happen. History tends to repeat itself and animal instincts always drive markets *and* risks much higher than warranted. One example of this is record high margin debt, which currently stands at $822BN, close to $350BN more than a year ago, according to London-based ABP Invest. That amounts to almost 4% of GDP and doesn't consider the massive swap and derivative positions that can obscure or amplify actual notional exposures. During the Global Financial Crisis and the dot-com bubble, margin debt was 3% of GDP. It seems to us that the easy monetary conditions and constant flood of money into the system from the Federal Reserve is clearly a key driver to these excesses. But this is also not unprecedented over the last couple of decades.

Equities

While high forward P/E ratios are surprisingly not strongly predictive about equity returns one year out (perhaps momentum and other technical factors are more important in the short term), longer term they tend to be. Historically, 21.5 times P/Es have produced relatively negligible equity returns over a longer-term five-year forward horizon. Therefore, the key for equities to perform in the future is for earnings to continue their march higher, allowing multiples to moderate.

This is not that far-fetched. It has already been happening: we have had nearly 20% earnings growth in the S&P 500 thus far this year, but the price return for the index was under 15%. The missing piece in this equality is the change in multiples—they've gone down. Earnings ahead look very strong—after dipping below $125/share for the S&P 500, consensus estimates point towards earnings per share increasing each of the next three years to get to $225/share. The point is that even with high multiples today, we can still see good equity returns *if* earnings come through.

While US equities are indeed expensive, international equities continue to appear more attractively valued from both an absolute and relative perspective, particularly when compared to smaller US companies. We are cognizant of this differential, and last quarter reduced our US SMID exposure in favor of developed non-US equities—a trade which has been additive to date.

Fixed Income

While investor sentiment among retail and institutional equity buyers remains rather bullish, sentiment for bonds is quite the opposite. JP Morgan's recent weekly Treasury investor sentiment report indicated 42% of respondents were short. An analogous BofA survey shows investors are the most underweight high-grade bonds relative to historical allocations they have ever seen. While we are very mindful about extremes in sentiment in either direction, with the 10-year yield at 1.45% and credit spreads historically tight, we also want to avoid bonds (while acknowledging that skewed investor sentiment can produce higher volatility and some reversals against trends that point strongly in one direction).

Credit market volatility is close to all-time lows, similar to what was last seen in 2016. Historically, volatility this low has been followed by choppiness over the next quarter or so, pushing spreads out to wider levels. Nonetheless, credit continues to see mad issuance. Through June, LBOs (leveraged buyouts) are tied for the second highest level in history at just over $69BN. These are levels last seen prior to the 2008 credit crisis.

Certain structured credit still look attractive, particularly relative to high yield credit. We continue to favor allocations to managers that can participate in CLOs and other securitized strategies where yields are more favorable per unit of risk, particularly compared to US investment grade and high yield all of which are trading near the tightest spread to worst in the past 15 years. Adding insult to injury, the duration of the investment grade corporate bond market is 8.7 years, well above its average of 6.4 years from the past three decades. To summarize where corporate bonds are: 1) historically tight spreads, 2) historically tight base yields, and 3) historically high duration. Russian Roulette would be a more attractive bet!

Alternative Assets

We continue to structure our hedge fund exposure as a combination of directional equity, tightly-hedged market neutral equity, multi-strategy, and global trading; all of which when combined offer diversification benefits to the equity investments we make on behalf of our clients. We believe the combination of the strategies will provide risk mitigation to the portfolio when capital markets move against investors, while still providing competitive returns over full market cycles. We believe this is a very important allocation during periods where risk is on the higher end in both the credit markets and the equity markets.

Asset Allocation Review and Guidance

Our allocation guidance has been consistent over the previous quarters as we continue to believe the liquid fixed income and corporate credit markets are overpriced and not worth the expected return, particularly after taxes and inflation.

Equity exposure is more difficult to assess as equities are priced to perfection. Optimism is high, and monetary and economic conditions currently support higher valuations. However, as history has proven time and time again, this is not a period to be aggressive nor complacent with embedded risk in portfolios. We will remain invested, but are weighing risk, opportunity, and the tax impacts to effect prudent rebalancing.

We remain relatively underweight non-US equity in favor of US and emerging markets equities. Our portfolios continue to hold marketable alternatives at a neutral weight given the diversification benefits and competitive expected returns over full market cycles.

Asset Allocation Guidance

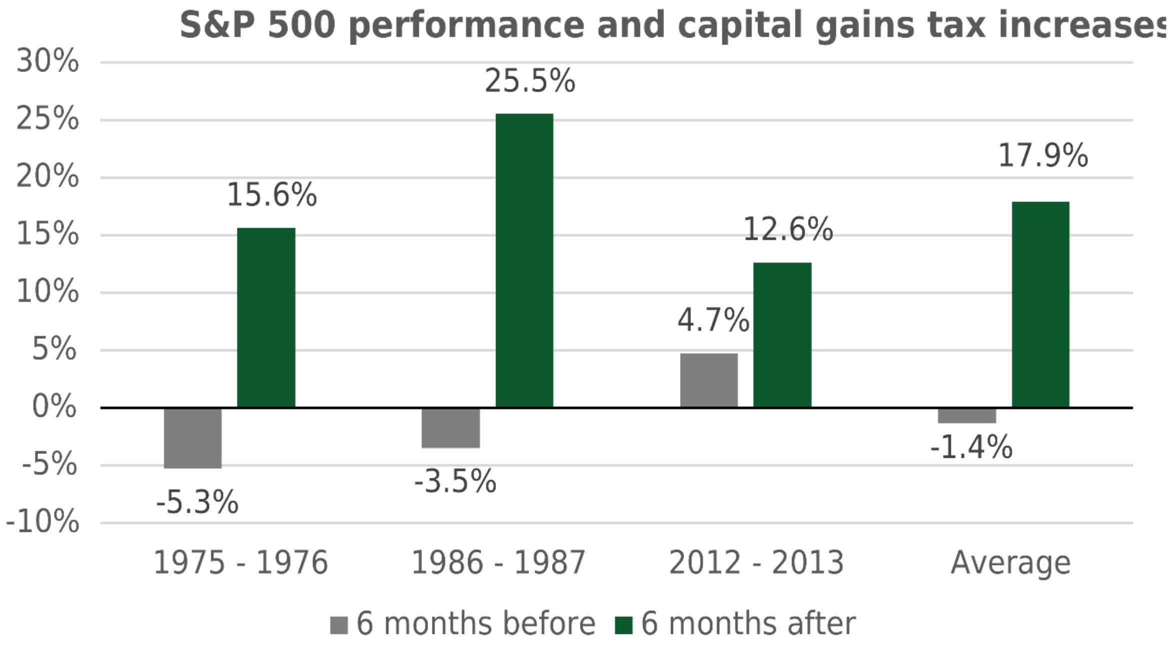
Asset Class	Underweight	Neutral	Overweight
Cash			✓
Taxable Fixed Income	✓		
Non-Taxable Fixed Income	✓		
US Equity		✓	
International Equity	✓		
Emerging Market Equity		✓	
Marketable Alternatives		✓	

Tax Policy

We have previously written of the surfeit of tax proposals being bandied about in Washington, DC. While there is not yet clarity on anything, one of the newer announcements over the quarter was the proposal among the G-7 and the US to implement a global minimum corporate tax rate. US policymakers are clearly thinking that a more level playing field would provide more covering fire for their proposals for US corporate rates. But, while the G-7 may be more harmonious, the broader G-20, with more emerging market countries included, may not be as eager to play ball.

In terms of where we go from here in the US? We reiterate the fact that US long-term capital gains rates are currently rather low from a historical perspective. At around 18%, we are well below the long-term average of 24%.

That is the good news. However, it is not just the level of capital gains tax rates that could have an impact, but actually just the fact they change. Surprisingly, hardly in the way one might expect. Perhaps in the same way that a change from a Republican to a Democrat presidency produces better equity returns than a transition the other way, equity returns have averaged *higher* across previous increases in capital gains rates (and lower before them.)



Sources: Bloomberg, Tax Policy Center, JPMorgan

Perhaps part of the intuition here is that investors sell in anticipation of the change, leading to downward price pressure, that is relieved if/when investors buy back at a higher basis. In any case, while we are not advocating for changes to capital gains rates, we note that 1) they are currently rather low, and 2) a change may constitute a good time to buy equities, particularly if tax considerations are secondary to the investment case.

Summary

We have also been very active with our new partners at Stanhope. Our integration continues to go extremely well, and our teams in the US and Europe have been extremely enthusiastic about the collaboration and collegiality. The whole is more than the sum of the parts; we expect this to continue to accelerate.

One of the first impactful areas of collaboration has been to use our combined buying power and relationships with the most esteemed venture capital platforms to create a unique hybrid venture strategy for our clients. Together we have been able to open a lot of doors to sponsors that have not taken on new investors in years. Now, we can provide access to their funds while also integrating a sleeve to make direct investments in select private companies, sourced through our sponsor partners, our clients, and our networks. In our opinion, this is a new, superior way to invest in venture capital; we look forward to discussing the vision with you.

As always, we are grateful for our partnership with our family office clients. We are striving every day to get better at what we do—investments and service. Please let us know how we are doing.

Respectfully,
The FFT Team

Appendix:

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