



QUARTERLY REVIEW AND OUTLOOK

October 2021

- The global equity markets finished the quarter in negative territory, giving up early gains as September proved to be much more challenging. The global equity index (MSCI World) finished Q3 down -1.0%, while the US equity market (S&P 500) was up +0.6% for the quarter.
- Volatility in risk assets was experienced across most developed markets, stemming from concerns around the US debt ceiling drama, continued supply chain disruptions, dampened earnings revisions, and China's unexpected regulation of large, publicly-traded tech companies.
- Small cap stocks and emerging market equities experienced the worst of the selloff, led by China and other Asian markets. While developed markets remain in positive territory year-to-date, emerging markets are now in negative territory following this difficult quarter.
- Interest rates were quite volatile during the quarter, resulting in a lackluster showing for high quality corporate bonds, municipals, and US Treasury bonds.
- Hedge funds in aggregate, as represented by the HFRX Global Hedge Fund Index, finished the quarter flat (-0.1%) and are up +3.6% year-to-date. September offered an example of the benefits of this important asset class in our portfolios.

Market Commentary

US large cap equities were one of the few asset classes to stay in the black for the quarter. The S&P 500 finished up +0.6%, but small cap and mid cap US equities generally lost ground. Non-US stocks also fell behind, dragged down by emerging markets—particularly China. The MSCI ACWI ex-US fell by -3% while the emerging markets equity index dropped over -8%. While the broader backdrop was challenging, most of our active equity managers performed well, demonstrating the importance of more nimble positioning when markets start to turn.

In addition to the concerns in China, the fiscal and monetary challenges in the United States caught the attention of investors and initiated more volatility in the commodity and bond markets. Investors rapidly expressed what might be considered a tilt in expectations: that the inflationary conditions may not be transitory, and that the authorities might be the last to act. This led to difficulties for bonds, other than the junk bond market, as interest rates moved up quickly, thus driving prices down.

Source: FactSet and HFR. Not independently verified.

As a result, market volatility has returned. Not in terms of large moves up or down necessarily, but rather with respect to markets that have lost the persistent forward momentum experienced in the first half of the year. This quarter brought back into focus the importance and benefits of well-crafted portfolios with deliberate risk exposures.

We have been happy with the results from our portfolio management and are pleased to have implemented several longer-term strategic investments across private real estate and world-leading venture capital sponsors. This mix of long-horizon investing, and tactical nimbleness, is an important mindset for more uneven periods in the markets.

The US federal debt, while an old story that has not yet had a clear negative economic impact, has never been this high. Even more striking is the fact that it has moved from \$4 trillion to about \$8 trillion over the past 18 months. The significant catalyst that can upset this economic recovery is a tapering by the Fed and the inflationary conditions that the Fed considers temporary, becoming stickier and longer-lasting. The Fed's September meeting indicated that half of the FOMC members expect an interest rate increase before the end of next year. This would turn the tables on a recovery and pose significant risk to the capital markets, both credit and equity.

We keep an eye on various economic, credit, and equity factors to gauge our comfort level with risk assets. Interest rates do seem to take up a lot of our time, as they should, when considering risk in portfolios. The 10-year Treasury (as of this letter) is 1.5% and our view is the market can handle a move higher, even to 2% or more, with little consequence. However, if the market forces dictate the 10-year Treasury to trade at 3% or more, while not high from a nominal perspective, it likely will trigger a reassessment of risk for equities and credit investments.

Inflation fears are back! Inflation has moved much higher than it has in many years. It has surged in some of the developed economies over the last twelve months. The challenge is to understand if this inflationary period is here to stay or if it is temporary. When you have a combination of heavy stimulus, low interest rates, and, at the same time, pandemic-related supply shortages, it makes sense inflation should spike. However, we do expect, as many do, inflation to fall from recent high levels and to remain range-bound over the coming years, which would be a manageable backdrop for markets. The risk of inflation getting out of control on the high side appears unlikely.

WHAT WORKED AND WHAT DIDN'T

Macro: China and US Supply Chain

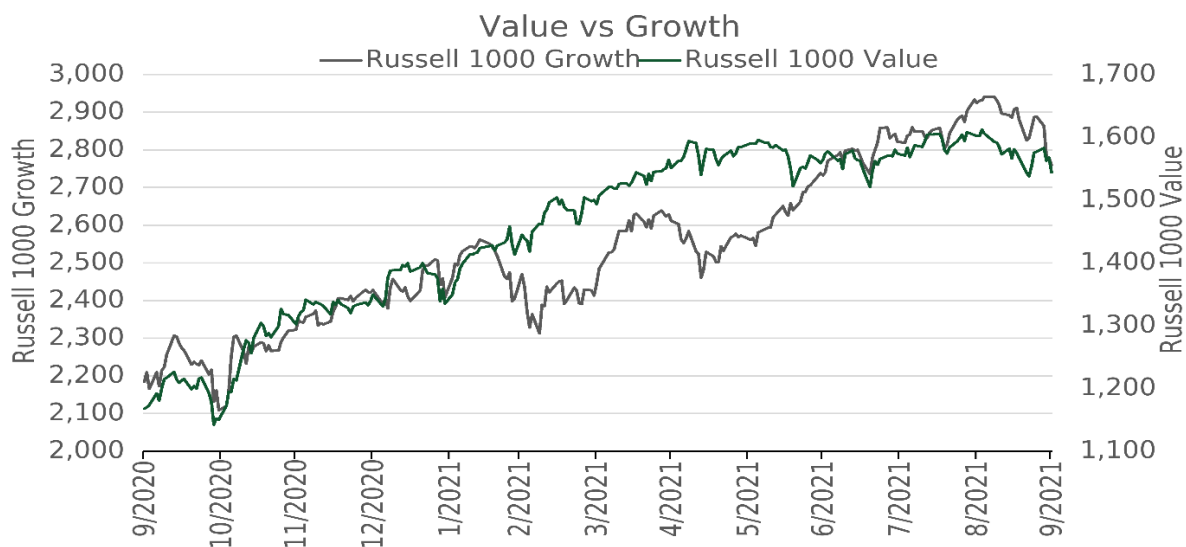
Globally, the biggest news for equities in the 3rd quarter was from China. All eyes were locked on gigantic Chinese property developer Evergrande, whose credit woes cast a shadow across the entire Chinese market and beyond. Real estate in China is notable as it accounts for nearly 20% of GDP. Sales in the largest cities are down over -30% in the last two months; more worrisome is the complete seize-up in land sales by local governments, which account for a meaningful component of their revenues. Simply put, a dependency on real estate pervades the Chinese economy both publicly and privately. There is likely a lot of deleveraging around the corner. The China stumble will affect others as well, particularly their import partners like Germany, where a slowdown in new orders may already be evident.

The equity advance may have been slowed by the surfeit of supply chain frictions that have been building over the past year. These have stymied international trade and produced an outsized impact for export-heavy economies as well as larger importers (like the US.) These frictions will surely persist through the end of the year, causing some worry to retailers and consumers about a frustrated holiday shopping season. On the other hand, there is a really good basis to consider these hold-ups as being transitory, and while potentially impactful through year-end, portend a demand rebound in 2022.

Earlier this year, as the economy started up again, we observed some of the highest number of ships ever waiting to unload in West Coast US ports. That dissipated somewhat in early summer but has since come back with a vengeance. According to one research shop, there are currently 70 containerships in the queue off of Los Angeles, while spare shipping capacity has dropped to 3%. These logjams are being seen around the world. At the same time, the Baltic Dry Index of shipping costs has neared \$5,000 per 40-foot box, up from around \$2,000 before the onset of the COVID dislocation. This of course is consistent with the recent spike in prices across most commodities as inflation continues to run hot.

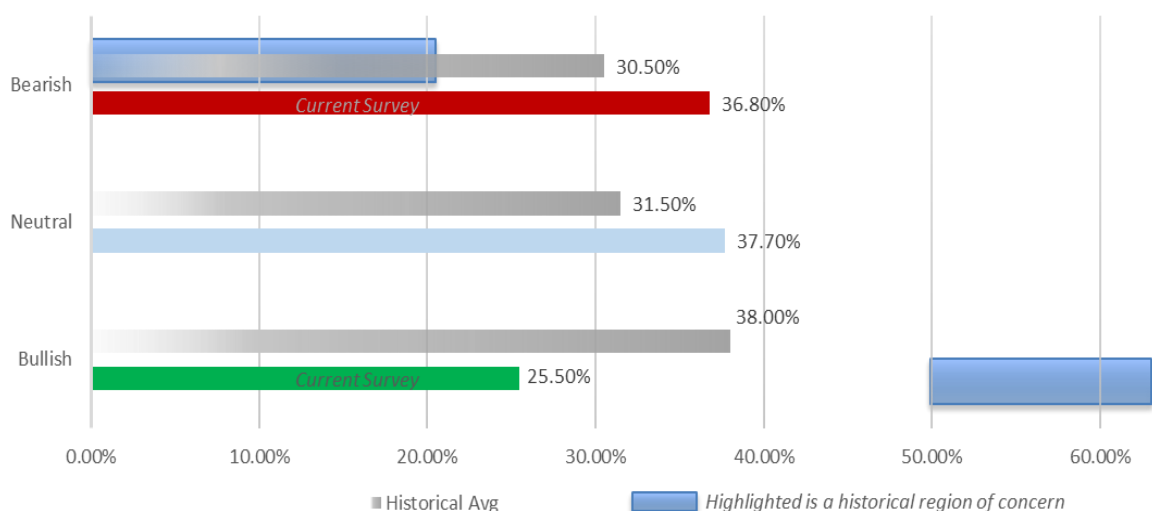
Equity Strategies

The value/growth divide has gotten much more interesting. The shift in dynamic in favor of value stocks in the beginning of 2021 faded back to growth stocks in the 3rd quarter. However, in recent weeks inflation fears have caused yet another shift.



Source: Bloomberg

From a technical point of view, we continue to monitor sentiment and the options markets to provide an indication of implied risks. The put/call ratio on the S&P 500 index is currently 2:1, and the AII Investor Sentiment Survey shows a significant level of bearishness by individual investors.



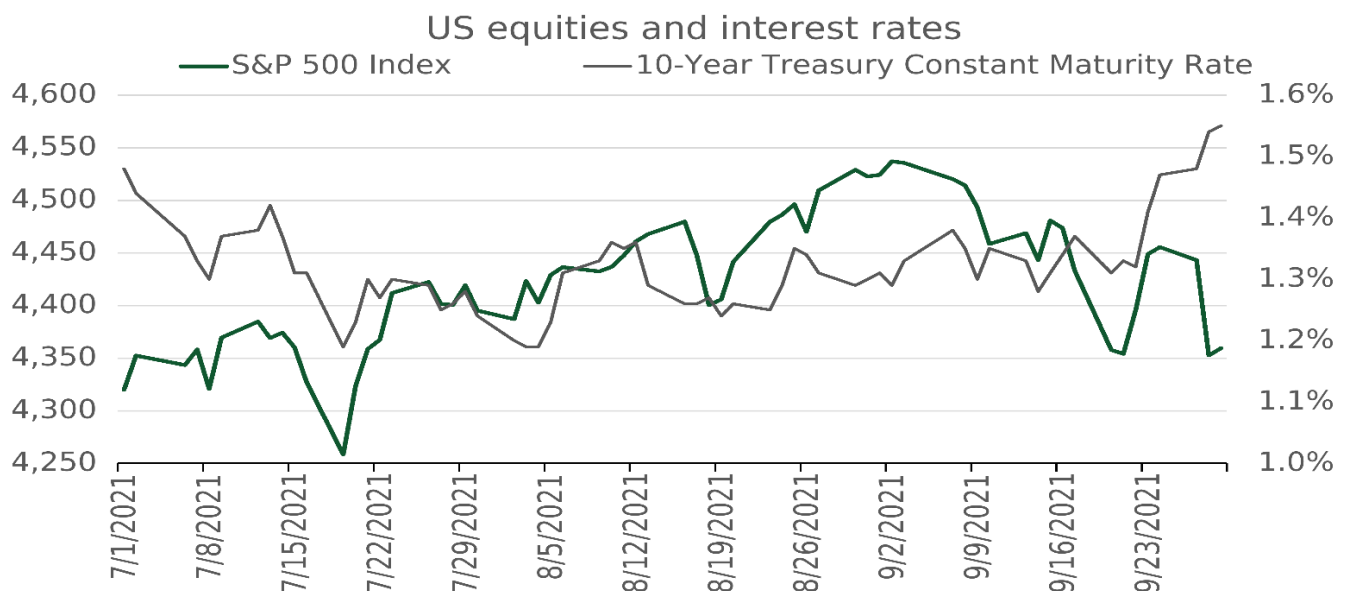
Source: AII Sentiment Survey as of 10/7/2021.

Broadly speaking, this suggests macro-level unease associated with tapering talk, China concerns, etc., driving fear in market sentiment. This should provide some level of comfort that the markets are not overly optimistic or sitting in the “greed” category which often precedes a market meltdown.

Fixed Income Strategies

Fixed income didn't move much for the quarter, with the 10-year yield back to around 1.5% which is where it was a few months ago. However, there's been more volatility recently: the Barclays Aggregate Index dropped almost -1% in September, and longer duration Treasuries were off commensurately more—nearly -3% for certain maturities. Much of this happened in the last week with the largest moves at the longer end of the yield curve. We think the relative stability of fixed income recently belies the true risks that the last few weeks may be pointing towards.

Also, it is interesting to note that while over time there is no statistically significant relationship between interest rate changes and equity prices, over certain shorter time intervals, particularly if moves are sharp and sudden, an inverse relationship appears. This was the case toward the end of September, when US equities fell in sympathy to the rise in long-term rate. This is something to heed as rates evolve in the future as it would lead to a failure in allocation models that hold bonds to diversify the portfolio equity risk.



Source: NASDAQ, FRED

Non-traditional Assets

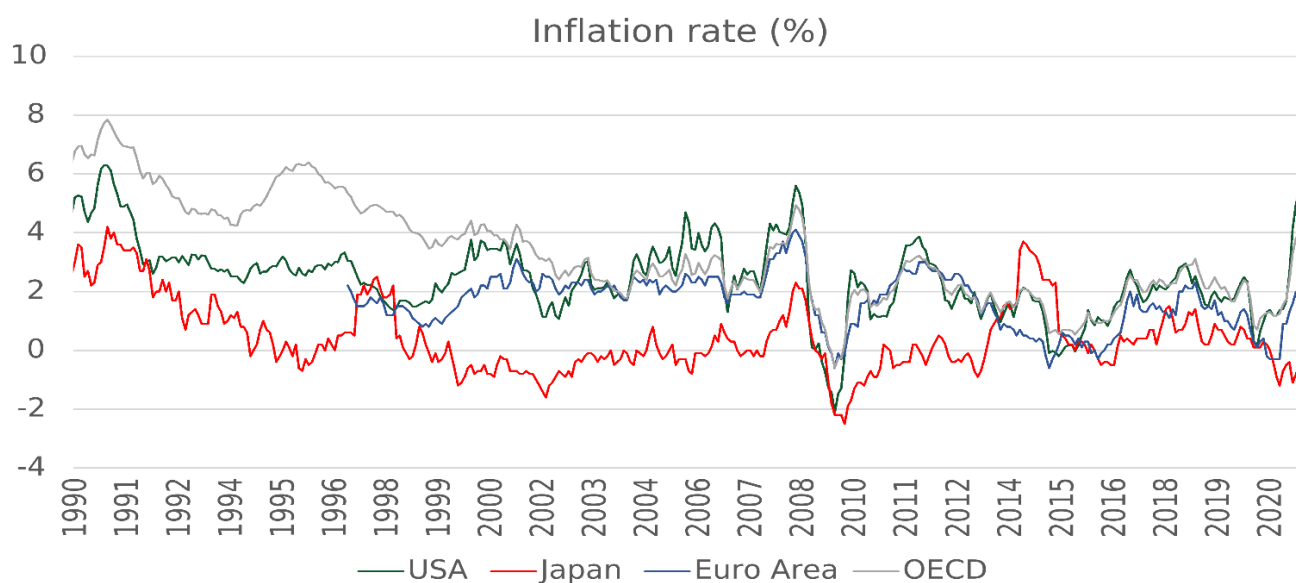
Marketable Alternatives: Hedge Funds and Global Trading

Hedge fund performance for the quarter had a wide variation of results depending on the underlying portfolio's exposure. In aggregate, traditional long/short directional equity managers finished down in September but in most cases ended the quarter in positive territory. Managers that focus on diversification by trading strategy, and or limiting equity risk in portfolios, held up very well during the September market selloff. FFT's exposure to multi-strategy in aggregate was flat for the quarter (as represented by the AM Global Core Fund) and has captured approximately 60% of US equity positive returns year to date.

One notable point around our decision last year to increase our diversification in portfolios was with the addition of the Optima Global Trading Fund¹. That strategy is working as we expect. The Fund has been able to earn a competitive return during the "quiet" market periods, but more importantly has offered strong benefits when equity markets have been unstable. For example, the Fund provided a strong diversification benefit to our portfolios in September, finishing the volatile month up +0.6% compared to a decline of -4.7% in equities.

Real Assets

The debate about the persistence of the recent changes in commodity prices continues apace—we don't know whether, or how, these price levels will evolve in coming quarters, but we do draw attention to the fact that we are in a new phase. The chart below highlights the recent upswing.



Source: OECD

Rising commodity prices don't always trickle down to the consumer and are often excluded from core inflation, but some economists now believe that the current food inflation spike could have long-term effects on purchasing power. This could limit the length of time inflation conditions exist as the key metric that needs to be present during inflationary regimes is rising wages aggressively across the economy. We do not see this, and our impression is that the Federal Reserve will begin to remove monetary stimulus before wages run hot. We will continue to focus on this going forward.

Energy has been on fire: Brent crude crossed over \$80 in September, the highest level in three years (and a shocking recovery from the depths of the COVID shock in March/April of 2020). There's no single factor that explains its torrid pace, but rather a variety of supply and demand impacts around the world. Hurricane Ida, which while fortunately not nearly as destructive as Katrina, followed a similar track through the Gulf and into Louisiana. This disrupted refinery activity, which has been wobbly for some time. The (temporary) blow to supply has been estimated from 30 million barrels up to 55 million barrels.

Energy isn't the only commodity that is seeing volatility. Industrial metals have had a wild ride, and lumber, until recently, an extremely sleepy, low-volatility market, is tilting again. We recall that building materials shot through the roof earlier this year as homeowners engaged in a flurry of building and remodeling activity. On top of supply bottlenecks, lumber futures hit exceeded \$1,700 per thousand board feet, before precipitously crashing. But, over the past few weeks, they have climbed \$100 and are now around \$627.50 per thousand board feet, nearly as expensive as they ever were before COVID. We see this volatility as a sign that supply chain issues haven't really abated.

Also, within real assets, we've been pleased with certain private real asset exposures found in portfolios such as self-storage and industrial, final mile facilities. Both assets continue to provide inflation protection through pricing power, and offer good current yield via operating income, re-finances and property dispositions, and overall increased consumer and business demand with limited new supply in target markets.

WHAT SHOULD YOU EXPECT GOING FORWARD?

The third quarter had a very different feel than the ebullience of the start of the year. Investors took note of a variety of challenges and started to anticipate an inflection point of sorts as we move from the aftermath of COVID in the direction of a more normal steady state. On balance, we see a heightened sense of the risks in both credit and equity markets, which we feel is warranted. However, this does not mean there is urgency to reduce the exposure in our portfolios to equity positions at this moment. Why?

Currently, we see market sentiment as more bearish than bullish, which gives us some comfort that “greed” is not gripping market psychology. Also, the recent pop in the exuberance bubble in SPACs and newly funded unicorns is comforting to see as investors take a reality check, finally! On top of the more supportive psychological factors, we also expect economic growth to remain strong in 2022. Surprise could be on the downside with earnings and margins as input and employment cost continue to move higher. This is one of the key indicators we will monitor closely moving forward.

We have considered how our investment approach will manage an environment of high level of inflation witnessed over the last year. We will continue to act proactively with investment decisions as we try to do in all environments. However, at this early stage in the inflation story, we are comfortable with our position for two reasons. First, our portfolios have strategy allocations that will adjust exposure if inflation becomes more of a hindrance to financial assets & second, we will be able to track and adjust as we see more evidence that this is more than a short-term issue. If the inflation currently tagged as “transitory” becomes long lasting, we’d expect the bond market to experience significant price declines, potentially spilling over to risk asset prices as well. This is something many of us are watching closely. To date, we have not seen the inflation bug move to wage growth, which likely needs to happen before we declare this high inflation a long-term phenomenon that investors should prepare for.

Equities

The S&P 500 is trading at ~38x cyclically-adjusted price-to-earnings (CAPE). In order for the S&P 500 to get back to its historical average of 21x, the market would need to fall over -40%. We are not calling for this, but it is something we must consider as a tail outcome when considering our risk weighting in equities. Currently most financial analysts are extrapolating a continued increase in earnings next year and beyond.

However, we have experienced this optimistic bias in years past and caution that there are headwinds to this thesis. For example, companies are experiencing record high profit margins. This will likely change as the risk of input cost/expenses rise faster than consumers’ willingness to accept continued price increases. If this were to happen in 2022 and we see a significant increase in corporate taxes, analysts will have to lower their forecasts on corporate earnings growth rates.

Outside the US, the emerging markets and Asia equity markets are more attractively priced versus developed markets, having had a steeper decline over the last few months. China risk remains, but we believe the long-term economic growth story along with a growing middle class of consumers will lead to emerging markets having their day in the sun. We continue to be cautious but do expect to add exposure in this asset class over time.

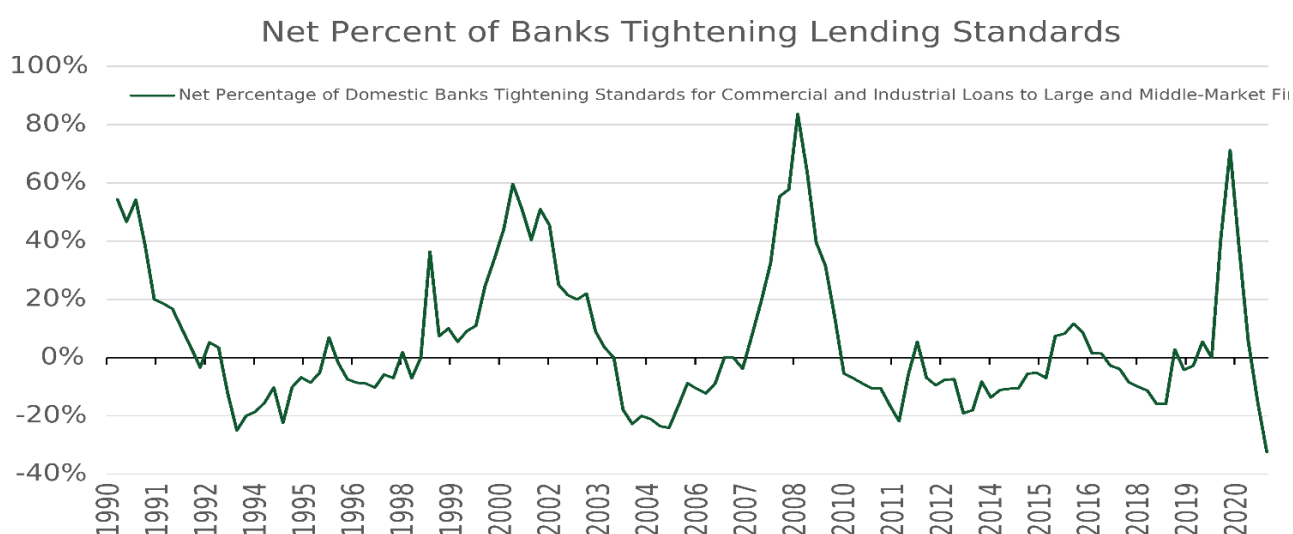
Fixed Income

We've maintained very limited taxable "core" fixed income exposure in most accounts by design. The recent rate spike, which may just be a prelude to a more sustained move up, highlights the merit of that approach. As always, we are monitoring the Fed's posture closely. The September 22nd FOMC meeting revealed steady sentiment in favor of future interest rate hikes.

However, since the meeting, two Fed presidents resigned following revelations of insider stock trading during the COVID-19 crisis. The replacements of the two Fed voting members, who had weighed in generally hawkish positions, could reverse the Fed's overall stance on near-term interest rate hikes. This messiness against a backdrop of fractiousness in the halls of Washington DC just highlight how uncertainty and surprises can occur in the midst of pretty strong trends.

Given yields, and the balance of risk and reward, it is hard to advocate for any traditional fixed income exposure for many investors. Instead, we've looked to build into positions in the global trading strategy, which is designed to profit from changes in equilibrium—moves in rates, price levels, and volatility. We regard this as a very good solution, but it may not be relevant in every circumstance. Therefore, we've been doing a lot of work to develop an alternative to the long credit/rate exposure afforded by core fixed income, through a strategy that can be nimbler and less one-directional. This is a solution we will look to introduce in portfolios as we move into the new year.

The fever of easy credit, originally seen in lower-quality debt, has reached bank loans, and we continue to worry about the direction of credit over the next year. A survey by the Federal Reserve showed that banks have recently been loosening lending standards for commercial and industrial loans at historic speed, amid pressure to boost business as the following chart highlights. The key finding here is that this behavior among lenders has historically acted as a "canary in the coal mine" to credit market tops leading to significant credit market declines. We are watching this very closely.



Source: US Federal Reserve

Alternative Assets

We continue to view our hedge fund exposure as a combination of directional equity, tightly hedged market neutral equity, multi-strategy, and global trading; all 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 the needed risk mitigation to portfolios 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.

Our view on equity exposure is more difficult to assess as one would expect when equities are priced at these record valuations. The macro uncertainties that persist typically lead one to reduce risk. However, there are other important considerations that lead us to pause on reducing equity exposure. Sentiment is not overly optimistic, interest rates are still very low, companies are running at high profit margins, and our portfolios have some built-in diversification benefits that help mitigate the risk of being too heavily invested in equities at this point. We will remain invested, but are weighing risk, opportunity, and the tax impact of any portfolio rebalancing that we believe is prudent.

We remain underweight Developed Non-US equity in favor of US and Emerging Markets. In addition, 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			

Summary

Our firm continues to do well, and we are seeing great results from ongoing collaboration between our teams in the US and Europe. Truly, the whole is more than the sum of the parts as we glean insights from earnest discussions within our team, bringing together diverse voices, with insights from our clients across different industries and geographies. While we will always maintain bespoke solutions that are tailored for clients in a particular geography, our now global intelligence means that these allocations are even better informed.

We look forward to sharing these evolving insights as we have conversations with all of you as we move towards the end of the year and beyond. Please continue to bring your questions, concerns, and ambitions to the table—and we will work to achieve these goals together.

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:

Disclosures

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