EQUITY MARKET UPDATE

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Stock indexes were mainly negative in November. Investors pulled back on risk taking after receiving numerous headlines regarding the Fed and COVID. The lower index returns don't tell the whole story. When digging deeper into the numbers, the carnage was much worse as many highflyer growth stocks lost more than 30% for the month! Economic data continued to confirm that inflation is running hotter than Fed estimates. Shortages in labor, parts, and energy persist. The inability to secure enough products or workers is dampening economic activity worldwide. Investors fear the situation could get worse as COVID-19 cases rose in many regions of the world, and scientists identified a new variant with several mutations that may weaken the protection from vaccines. Meanwhile, in Washington, President Biden nominated Jerome Powell to another term as Fed Chairman. He also signed his infrastructure package into law. Debate on the "human infrastructure" initiative continued, while Congress came to an agreement to keep the government funded until February 18th.

Risk Taking Plunges on COVID and Fed Taper Concerns

The S&P 500 declined 0.83% in November. Returns were aided by large gains in Apple and NVIDIA. Minus those two stocks, the S&P 500 would have dropped by over 2%. Technology and Consumer Discretionary were the only positive sectors, yet the gains in those groups were entirely explained by increases in Apple, NVIDIA, Amazon, and Home Depot. Year-to-date, the S&P 500 is up 21.59%. Microsoft, Alphabet, Tesla, NVIDIA, and Apple account for over 40% of the gains, while the result is over 50% when you include energy and financials.

The Dow Jones Industrial Average fell 3.73% last month. Large declines in Goldman Sachs, Visa, Disney, and American Express hurt performance versus the S&P 500. Year-to-date, the Dow is up 12.67%. A lower allocation to technology, along with negative performance from Boeing, Visa, and Disney have impacted results.

The NASDAQ was the only positive performer among the major indexes, increasing 0.25%. As stated above, the result is misleading. It would have dropped by almost 2% if you back out Apple, NVIDIA, Amazon, and Tesla. Of the major indexes, the NASDAQ saw the largest range on monthly total returns among its constituents. Dozens of high growth darlings in tech lost over 30% in November with well-known names like Zillow and Peloton erasing more than 50% of their value in a single month! The number of companies sitting at 52-week lows is the highest since March 2020. The NASDAQ still trails the S&P 500 in 2021 with a total return of 20.56%.

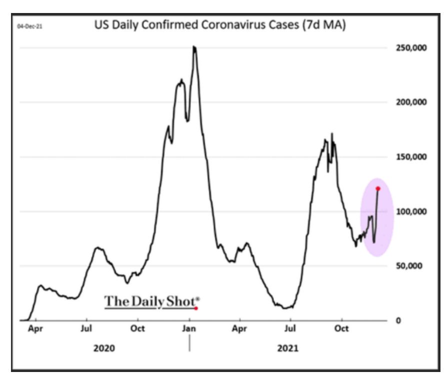
Mid-to-small sized companies also declined for the month. The S&P 400 Mid-Cap Index fell 3.06%, while the S&P 600 Small-Cap Index dropped 2.42%. With the absence of big tech, both indexes paint a more accurate picture of investor sentiments. Thus far in 2021, mid and small-sized companies have rallied 17.43% and 20.04%, respectively. As stated in previous months, the small-cap index has benefited from meme stocks, like AMC Entertainment and GameStop, as retail investors chase ideas being spread on the social media platform Reddit. However, both mid-and-small cap indexes trail their S&P 500 large cap peer in 2021.

International & Emerging Market Stocks Underperform US as COVID Cases Rise

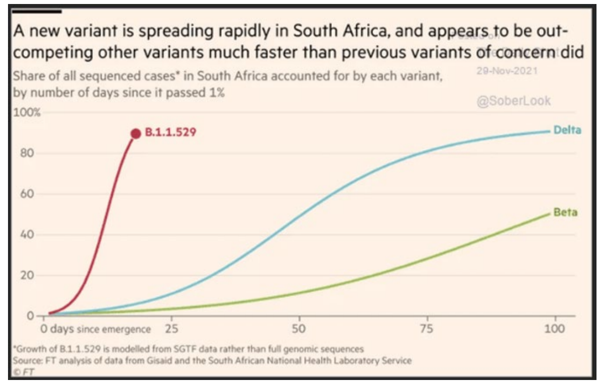
The Eurozone reopening hit a snag last month due to inflation and COVID-19. First, consumer prices were 4.9% higher than one-year ago. This was the fastest annual rise in inflation since records began in 1997, and it was more than double the ECB's 2% target. Shortages in parts, labor, and energy were the key drivers. However, core inflation, which strips out food and energy prices, was still 2.1%. The ECB insists the elevated prices are temporary and likely to fade in 2022. At their most recent meeting, the central bank vowed not to raise interest rates in 2022 despite running negative interest rates for over seven years. The IHS Markit European PMI Index was 55.4, a strong reading. Services continued to improve, while manufacturing held steady. As the month came to an end, investors were spooked by a sharp rise in COVID-19 cases. The Austrian government responded with a nationwide lockdown that closed all restaurants, retailers, and entertainment venues until December 12th. Germany tightened restrictions on the unvaccinated by banning them from most public places. These measures are expected to slow economic activity, so the MSCI EAFE Index declined 4.79%. Year-to-date, the index is up 3.55%.

The MSCI Emerging Markets Index fell 4.14% as Chinese economic activity slowed once again. COVID-19 and supply chain disruptions continued to weigh on activity. Exports were a bright spot growing 27.1% year-over-year. This signaled strong global demand for finished products. However, most of those gains were erased by a 20.6% increase in imports. The Chinese government boosted their year-over-year coal and oil purchases by 292% and 56%, respectively. For the last three months, I have written that many Chinese cities are critically low on energy leading to occasional brownouts and declines in factory activity. This has caused inflation to skyrocket at the producer level, crimping profit margins. Worries about real estate prices and tighter regulations from President Xi have also dampened investor enthusiasm. Finally, the emerging markets remain vastly below the developed world in vaccination rates, and they have been the source of most variants. Year-to-date, emerging markets are the only major index in the red with a loss of 6.11%.

FDA Approves Boosters for All Adults, New Infections Rise, and Omicron Emerges

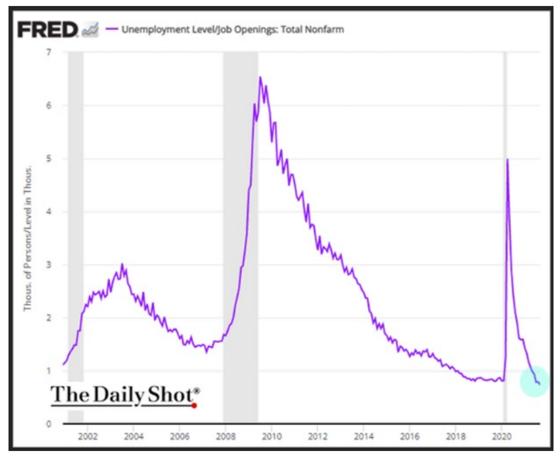


The decline in new daily COVID-19 infections from the past two months reversed in November. Many parts of Europe are experiencing another surge. Even in the United States, new daily infections increased from 60,000 per day to over 120,000 by month-end. Over 99% of new cases in Europe and the United States are the Delta variant of COVID-19 that originated in India during the summer. Progress continues to be made in therapeutics. Pfizer announced its COVID-pill, Paxlovid, reduced the risk of hospitalization or death by 89% for patients suffering from severe COVID-19. The FDA is currently reviewing the data. The agency did approve Merck's pill despite final studies showing less than 50% efficacy against hospitalization and death. Eli Lilly's monoclonal antibody drug was cleared for usage in children under age 12. Finally, the FDA approved booster shots for all adults who are more than six months removed from their 2nd shot. Boosters have taken on increased importance given the emergence of a new variant from South Africa called Omicron (B.1.1.529). The variant has 32 mutations of the spike protein alone compared to 9 for Delta. It also spreads many times faster than the Delta variant, which is remarkable considering Delta was 70% more transmissible than original COVID-19. Thus far, data from Israel shows Omicron cases are mostly mild among vaccinated people. This makes boosters a top priority for medical experts since CDC data shows less than 25% of US vaccinated people who are more than six months removed from their 2nd shot have gotten a booster. We also need to increase the number of people vaccinated. As I mentioned above, the percent of vaccinated people in the emerging markets is less than 30% due to lack of vaccine access. These regions have been the home for the recent variants. Also, in United States, where access to vaccine is not a problem, the unvaccinated continue to account for almost all the hospitalizations and deaths.



US Economy Improves, Labor Continues to Tighten, and Inflation Forces the Fed to Accelerate Tapering

The US economy continues to show broad based signs of recovery. First, consumer demand for goods and services is robust. Personal consumption data is running well above pre-COVID trends. Retail sales rose 1.7%, and early data indicates consumers are spending more and earlier for the holidays. The heavy level of shopping is making a lean inventory situation worse. Businesses are responding by increasing orders for nondefense capital goods. That is keeping the ISM Manufacturing PMI Index (61.1) firmly in expansionary territory. As consumers become less afraid of COVID, they are also boosting spending on services. This has lifted the ISM Services PMI index to an all-time high of 69.1. With continued supply chain disruptions, prices paid by producers are increasing. Some of the inflation is bleeding over to consumer prices as the CPI rose by 6.2%, the fastest 12-month pace since 1990.



To alleviate the situation, most firms are trying to hire additional employees, but they are experiencing difficulties. Last week, jobless claims fell to the lowest level in 52 years! November non-farm payrolls only grew by a seasonally adjusted 210,000 jobs. This was well short of the 550,000 jobs forecast. Unemployment fell to 4.2% despite an additional 600,000 people entering the workforce. All these indicators point to an economy that is growing too fast in comparison to the size of its qualified workforce. There are more open positions on Indeed (11.2 million) than there are total unemployed people (7.4 million). This is leading to higher wages, which in turn is causing the quit rate to explode. The most recent jobs report showed wages are up 4.8% from one year ago. But wages are 13.7% higher for leisure and hospitality (i.e. restaurants and hotels) and 8.9% higher for transportation and warehousing. These two segments don't require a high level of employee skillset, and they are primarily competing against one another for the same pool of employees. However, as the wages for those positions increase, they are beginning to closely compete (and in some cases exceed) with the entry level jobs that do require additional education or work experience. We are also seeing an increase in companies conducting nationwide job searches for work-from-home positions for employees

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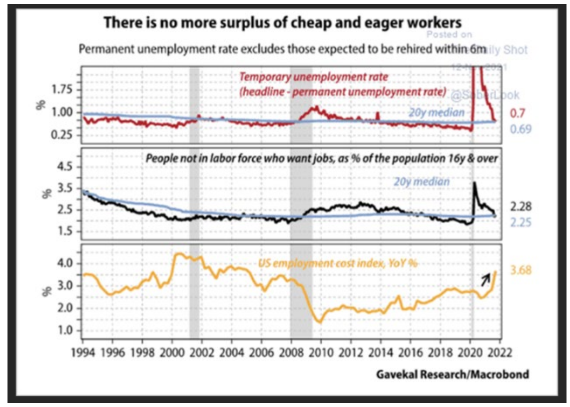
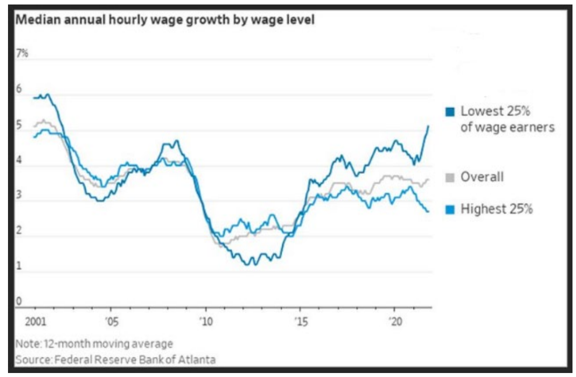
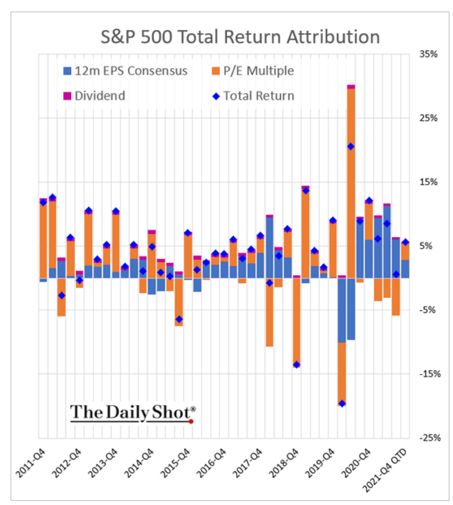


whose work is primarily intellectually based or can be done completely over the internet. With so many employment opportunities, a record 4.4 million Americans quit their job last month citing better pay and benefits offered elsewhere. Economists are labeling this "The Great Resignation," and it shows no signs of stopping. We saw early signs of this during the Trump administration where employers were struggling to find qualified employees; however, the pandemic has caused it to go into overdrive. Part of the problem is the economy is growing faster than the size of the labor force, but the biggest problem is due to demographics. As I have written for the past several months, labor force participation continues to improve among prime aged workers (25-54 years old); however, the number of people over the age of 55 that are electing to retire is far above historical trend. Longer-term, to stem the wage inflation tide while allowing the economy to expand, we need to increase productivity among existing workers (we are seeing businesses increase their spending on technology). We also need to retrain the unemployed to possess the skills needed by the modern workforce, and we need Congress to pass immigration reform to increase the size of the labor pool.



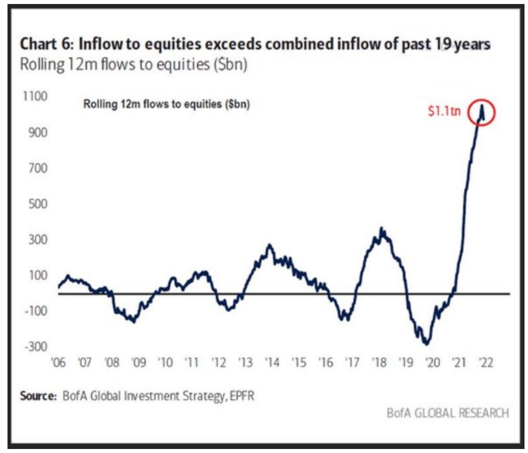
The persist inflationary data is putting more pressure on the Fed. At their most recent meeting, they unveiled a plan to begin reducing monthly bond purchases by $15 billion each month starting in November. At that pace, the program would sunset by mid-2022. However, later in the month, Jerome Powell testified to Congress that the Fed will consider speeding-up the pace of tapering in response to the inflationary data. In what I consider to be an "earth moving event," Mr. Powell told Congress it was "time to retire 'transitory' from describing inflation." This was the first admission by the Fed that parts of the inflationary data may in fact be structural. This statement accelerates the timeframe for potential rate hikes, and it has caused a flattening in the yield curve, which has been the source behind much of the recent market volatility as investors worry that the Fed could make a policy mistake. What seems odd to me is the Fed linking the end of its QE program with immediate rate hikes without discussing shrinking their balance sheet. It appears to me they are skipping an important step; however, it could be interpreted they now believe they are well behind the curve in combatting inflation.



__Volatility is Rising as Valuation Remains Elevated__

Currently, the S&P 500 trades at 21.93x 2021 EPS estimates. This is far better than the 25.27x trailing earnings reading, and it shows how rapidly corporate profitability has improved. However, even if earnings forecasts come to fruition, stock valuations remain pricey. If you fast forward to the 2022 and 2023 profit forecasts, the index trades at 20.43x and 18.68x, respectively. All these valuations are well above the 5-year average of 17.48x and the 10-year average of 16.86x.

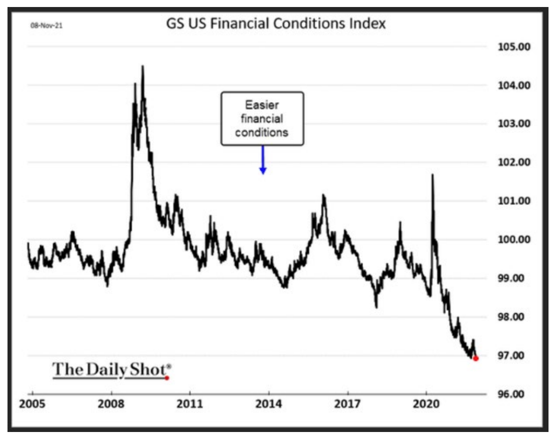
The number of places to hide is limited. According to Morgan Stanley strategist Mike Wilson, over 70% of S&P 500 industries are currently trading in the top 25% of historical PE observations, and all but 5 industries are above the average multiple since 2010.



The above average valuations are a result of record inflows into the stock market. According to Bank of America, in the past 12-months, $1.1 trillion has been invested into stocks, more than the previous 19 years combined! Investors are holding a record percentage of their total investments in stocks compared to bonds. The valuations can be justified by low interest rates and the enormous amount of liquidity in the system. However, the Fed and other global central banks have announced reductions in their asset purchase plans as the global economy reopens and inflation readings remain elevated. This makes stocks ripe for increased volatility, especially among the higher valuation growth names. With stocks near all-times highs, the market is vulnerable to further consolidation or pullbacks in the next few months.

Our Outlook & Strategy

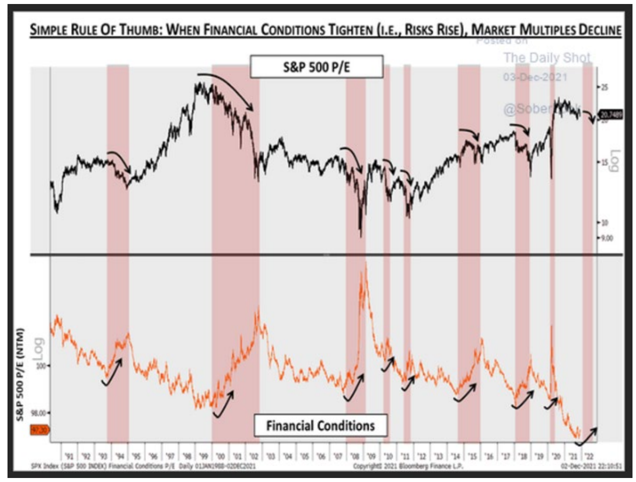
The stock market has operated under three very different climates thus far in 2021. For the first five months, investors' willingness to take risk was high, and they preferred the most economically sensitive stocks. That trend reversed itself during the summer months as the Delta variant spread across the globe and consumers spent their stimulus checks. This led to a rotation towards quality. As we near year-end, worries about Omicron, inflation, and the Fed's removal of liquidity has placed a premium on well capitalized, defensive companies.



Even though global central banks are starting the process of scaling back stimulus, they have vowed to go slow and proceed with caution, although Mr. Powell's announcement of a possible acceleration in tapering took the market by surprise. This caused long-term interest rates to fall last month, and the yield curve flattened. Bonds still trade at negative real yields (the rate on a bond minus the inflation rate) and credit spreads are historically tight. Therefore, the bond market is providing little competition to stocks, which is supporting the higher valuations.

I have said many times that the yield on the 10-year US Treasury has become the most important price indicator in the world. The correlation between bonds and stocks is high; therefore, providing less diversification benefits than the past. The excess liquidity is inflating all assets to levels that have historically indicated below average forward one-year and five-year returns. This means volatility will likely remain high. It also makes inflation readings and the Fed's reaction to the data very important to watch. The future path of interest rates and the speed in which they change will determine whether growth (led by technology) or value (led by financials and energy) will serve as market leadership.

We are living in very unique times. First, the effects of COVID-19 have created a new "normal" for investors and society. We have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, doctor visits, etc. We have also adapted to a non-centralized workforce. The rush to develop a vaccine has brought many new healthcare related technologies to the marketplace. We have seen from the past two administrations that the United States wants to encourage domestic manufacturing of semiconductors, medical equipment, and other items deemed to be of national security importance, which has the potential to be inflationary given the lack of labor and the mismatch in skillsets. These events are occurring at the same time when government deficits are exploding, and the Fed is trying to remove excess liquidity. The proposals from the Biden administration are the largest social spending measures we have seen as a percentage of the total economy since LBJ's Great Society programs of the 1960s. During that era, the combination of technological breakthroughs, massive government deficits, negative real yields, and above average PE ratios resulted in below average total returns for stocks with large swings in value as resources became scarce. With valuations and debt levels even higher than the late 1960s, the need for diligence is very important.



As we evaluate our roster of holdings across our equity styles, we remain highly selective about which companies to own. Collectively, all the items I have written about in this letter strengthen the case for a market multiple de-rating back towards the historical averages. This will place greater emphasis on stock selection in 2022 as we believe overall market volatility will be high.

We are constantly searching for companies that will benefit from long-term secular trends that can produce top-line revenue growth and sustainable cash flows. This naturally leads to overweight positions in technology and healthcare. These stocks are negatively impacted when interest rates rise, so we have boosted our holdings in energy and financials to offset this risk should inflation readings remain hot for longer than expected. Despite our search for growing businesses, we refuse to sacrifice financial quality, which is important to own during volatile moments in the market.