ASHTON THOMAS
PRIVATE WEALTH

ASSET ALLOCATION PLAYBOOK

INTRODUCTION

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Asset Allocation Team

MIKE SERIO CFA®, CAIA®, MBA

Director of Wealth Management

Mike is focused on ensuring access to high-quality advice for our advisors and their clients. He supports the Asset Allocation and Advanced Planning teams by weighing in on the financial markets and economy, investment due diligence processes, and overall plan development for the firm's top clients.

ADAM HOFFMAN CFA®, CAIA®

Director of Investments and Trading

Adam directs the Asset Allocation Team and supports advisors through monitoring financial markets and economic data, interfacing with third-party money managers, and overseeing trading functions. He also writes commentary on the markets and economy for the firm.

CLAUDIU BARBOS

Director of Fixed Income, Portfolio Manager

Claudiu helps create and oversee tailored fixed income strategies designed to address specific client situations. He is also part of the firm's Asset Allocation Team, which provides investment, financial market, and economic guidance to the firm's advisors and their clients.

KODI THRUSTON

Investment Analyst

Kodi assists the Asset Allocation team with research related to the financial markets, economy, and the firm's institutional asset managers. He also supports the firm's trading functions.

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FIRM VIEWPOINT

Looking backward, few analysts predicted the strength of the capital markets in the first three quarters of 2021. Patient, long-term investors have been rewarded with attractive gains in higher-risk asset classes. However, because the windshield is bigger than the rear-view mirror, it is much more important to look forward than spend too much time looking behind you.

As in every market, there are issues which concern us, such as the massive fiscal spending being proposed in Washington. Equity valuations, particularly given growth forecasts and interest rates, look attractive in some sectors, but are robust at the index level if one compares them to historical averages. Inflation is turning out to be less transitory than most predicted, and there are signs of excesses in the system, such as the volatility in cryptocurrencies, and the unexplainable runup in non-fungible tokens (NFTs).

However, at Ashton Thomas we are seeing things which cause us to maintain our full equity weightings and take a pro-risk stance as of early 4Q2021. With the Fed "tapering" in the wings, the question is not if, but when these purchases of intermediate securities will start to fall off. The last time the Fed did slow down its purchases, the stock market went through a bout of volatility before working its way through the Fed's "put option." At this time, we believe the economy will continue to exhibit its post-pandemic recovery, as will the stock market longer-term, as investors once again focus on positive company earnings.

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POTENTIAL CONCERNS

Having said this, we have gone through a number of potential outcomes, and their potential effects on the liquid markets.

- **The Roaring 20s:** The economy does well due to rising productivity with contained inflation. This would be bullish for stocks and neutral for bonds.
- **Back to Trend Growth I:** Both fiscal and monetary policy lead to a return of pre-COVID growth. If the Fed understands the economic landscape properly and moves in a timely manner, we will see inflation rise, but only moderately. Bullish for stocks, neutral for bonds.
- **Trend Growth II:** Should the Fed tighten too late, we will see inflation rise and interest rates surge. Bearish for stocks, neutral for bonds.
- **Trend Growth III:** This is a 1929 redux with asset bubbles rising, possibly leading to a financial crash of some sort. At this time, given the political stalemate and policy responses out of D.C., we believe it is the lowest probability outcome. The scenario would be bearish for stocks, neutral for bonds.
- **Post 2008 Recovery:** As in the post-Great-Financial-Crisis period, we could see deleveraging and weaker growth with low and falling inflation. Monetary policy would continue to be a driver of the markets. Bullish for stocks and for bonds.

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CONCLUSIONS

The scenarios on the prior page do not encompass all possible outcomes, as exogenous, unpredictable events sometimes drive economies to unforeseen outcomes. Absent any unforecastable events, we believe investors should continue to be fully invested in risk assets and stay with their plan. However, our wealth advisors have been trimming positions to put portfolios back in line with client goals, as the rebalancing function is one of the most important exercises in portfolio management. It may seem strange that we continue to recommend fully-invested equity portfolios and trimming equities when above asset allocation targets. However, being somewhat contrarian in this business leads to the best results longer term.

Our current outlook assumes the Fed will taper, supply shortages will work themselves out, valuations will come back to normal and inflation will, at the worst, be hedged out by our advisors. As always, we urge clients to stay within the parameters of the goals set out in their financial plans.

A quote attributed to Winston Churchill sums up our feelings: "Americans can always be trusted to do the right thing, once all other possibilities have been exhausted."

Economic Dashboard

Key Economic Data	Dec 2020	July	August	September	Change
Employment					
Total nonfarm Payroll Employ Change	-306,000	1,091,000	366,000	194,000	194,000
Unemployment Rate	6.7%	5.4%	5.2%	4.8%	-0.4%
Inflation: Consumer Price Index (CPI-U)					
Month over Month % Change	0.2%	0.5%	0.3%	0.4%	0.1%
Year over Year % Change	1.4%	5.4%	5.3%	5.4%	0.1%
University of Michigan Survey of Consumers					
Consumer Sentiment	80.7	81.2	70.3	72.8	2.5
Current Economic Conditions	90.0	84.5	78.5	80.1	1.6
Consumer Expectations	74.6	79.0	65.1	68.1	3.0
Housing Data					
New Home Starts	1,661k	1,562k	1,580k	1,555k	-25k
Existing Home Sales	6.70MM	6.00MM	5.90MM	6.30MM	0.40MM
Home Prices					
National Median Price	$309,200	$359,500	$357,700	$352,800	-$4,900
Year Over Year % Change	12.6%	17.6%	15.2%	13.3%	-1.9%

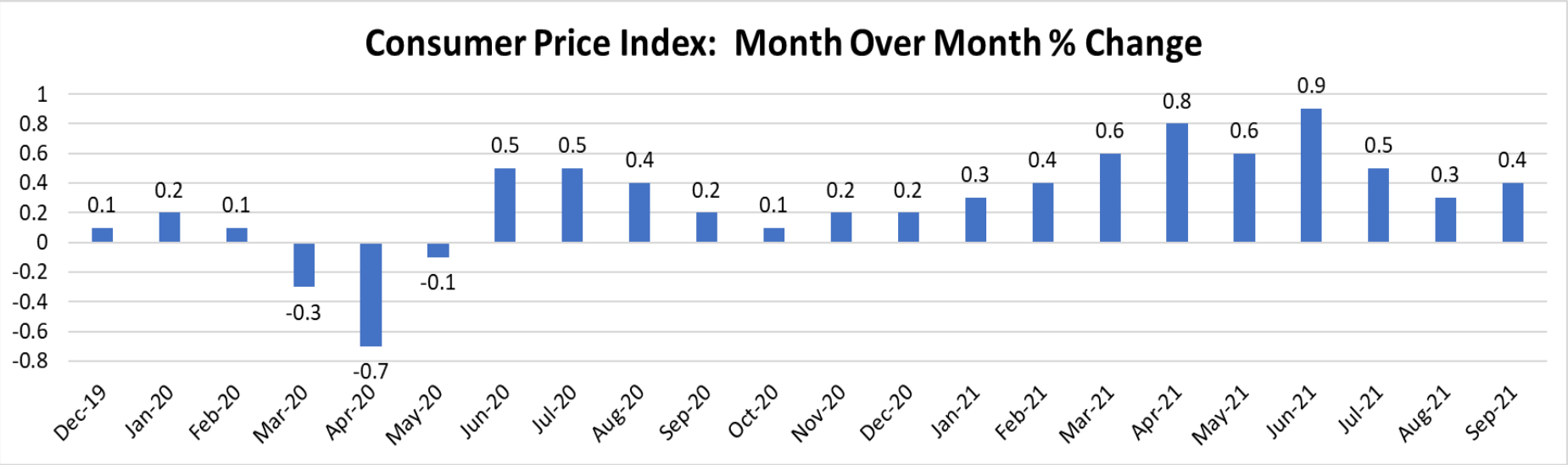
Source: Bloomberg, LP

Inflation

The economic story of the year is if inflation is going to be transitory or if this is the start of a new regime of trending higher prices. Large increases in the Consumer Price Index began in March with an increase of 0.6% in that month alone. These large monthly increases continued into the third quarter. On a year over year basis in September, CPI-U increased 5.4%.[1]

The one thing that we can definitively state is that there is inflation! The debate over if this is transitory or a new inflationary regime remains to be answered in the future.

Market based inflation metrics are indicating that inflation will be transitory. The 5-year breakeven rate is lower than the 10-year rate. The 5-year breakeven rate at the end of the third quarter was 2.53% meaning that the expected annual rate of inflation will be 2.53% over the next five years. The 10-year rate is 2.38%. Also indicating that the rate on inflation will slow in the future is the 5-year/5-year forward breakeven, which estimates the rate of inflation from September 2026 to September 2031, will average 2.35%.[2]



Source: Bloomberg, LP

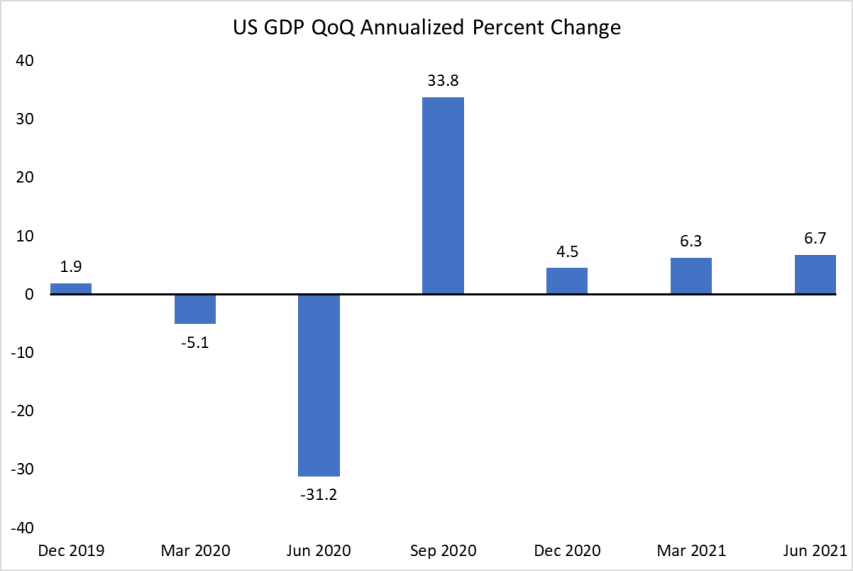
Supply Chain

The rapid rise in prices intuitively makes sense. We went from an economy that was at a complete standstill during the second quarter of 2020 to re-opening in March of this year. Once the economy began to re-open, a surge of demand was unleashed. The annualized quarter over quarter change in GDP highlights this switch being flipped. The economy went from being off to on in a short period of time.

Disruptions or logjams in the supply chain are a frequently cited as a driver of inflation. This intuitively makes sense as the supply of inputs into the manufacturing process are scarce resulting in lower output. Returning to Econ 101, low supply paired with high demand leads to higher prices. The IHS Markit PMI survey of businesses is recording the highest rate of increase in input prices in the history of their data with logistics, material shortages, and increased shipping costs as being the primary drivers.[3]

The reality is that the supply chain is currently running as fast as it possibly can to catch up to the increase in demand. The ports of Long Beach and Los Angeles are operating 24 hours a day, seven days to help ease congestion. One of the problems that they are running into is that there are not enough trucks, drivers to haul the containers to their destinations.[4] This has led to 100 vessels anchored off these two ports waiting to be unloaded.[5]

Very simply, the supply chain has reached its capacity. More ports, more trucks, more planes cannot be built over night.

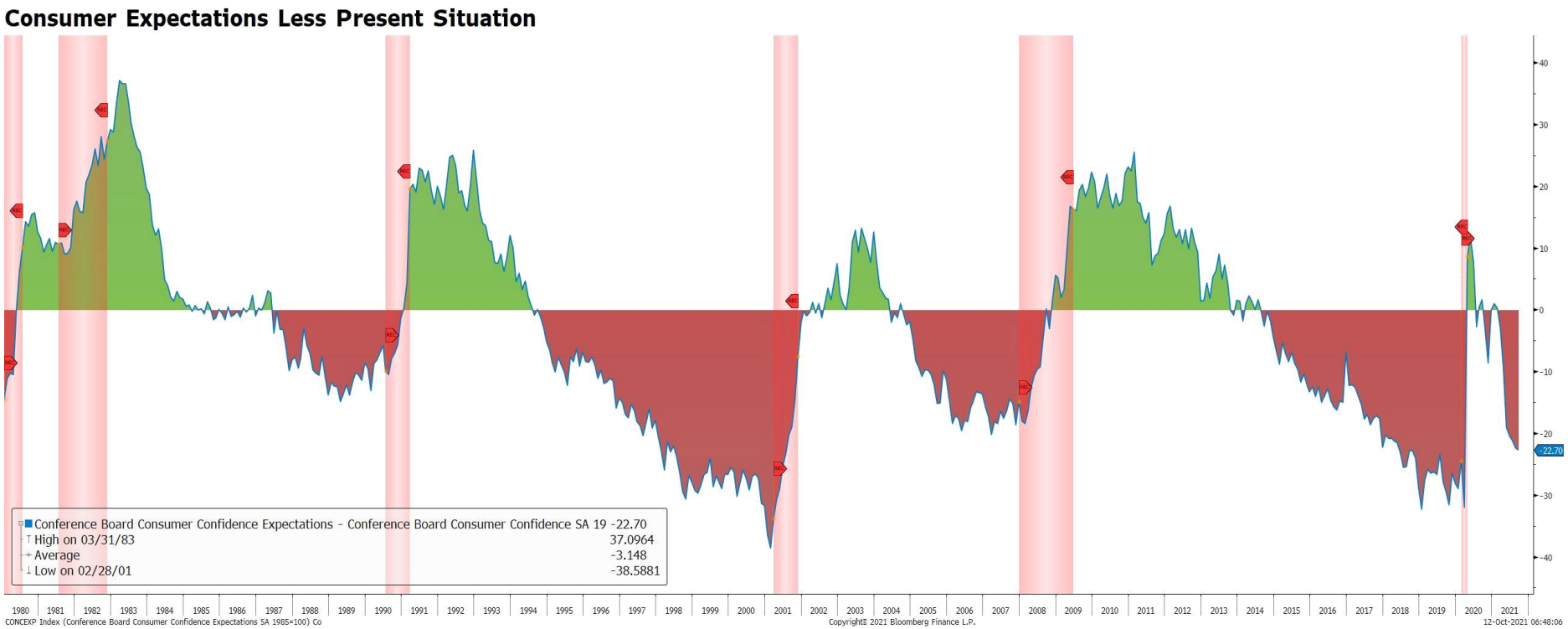


Source: Bloomberg, LP

The cure for higher prices is higher prices!

Prices are likely to continue to rise in the short-term, and this will alleviate the stress on the supply chain as demand declines. This decline in demand will allow for the supply chain to eventually catch-up.

Consumer Sentiment



Source: Bloomberg, LP

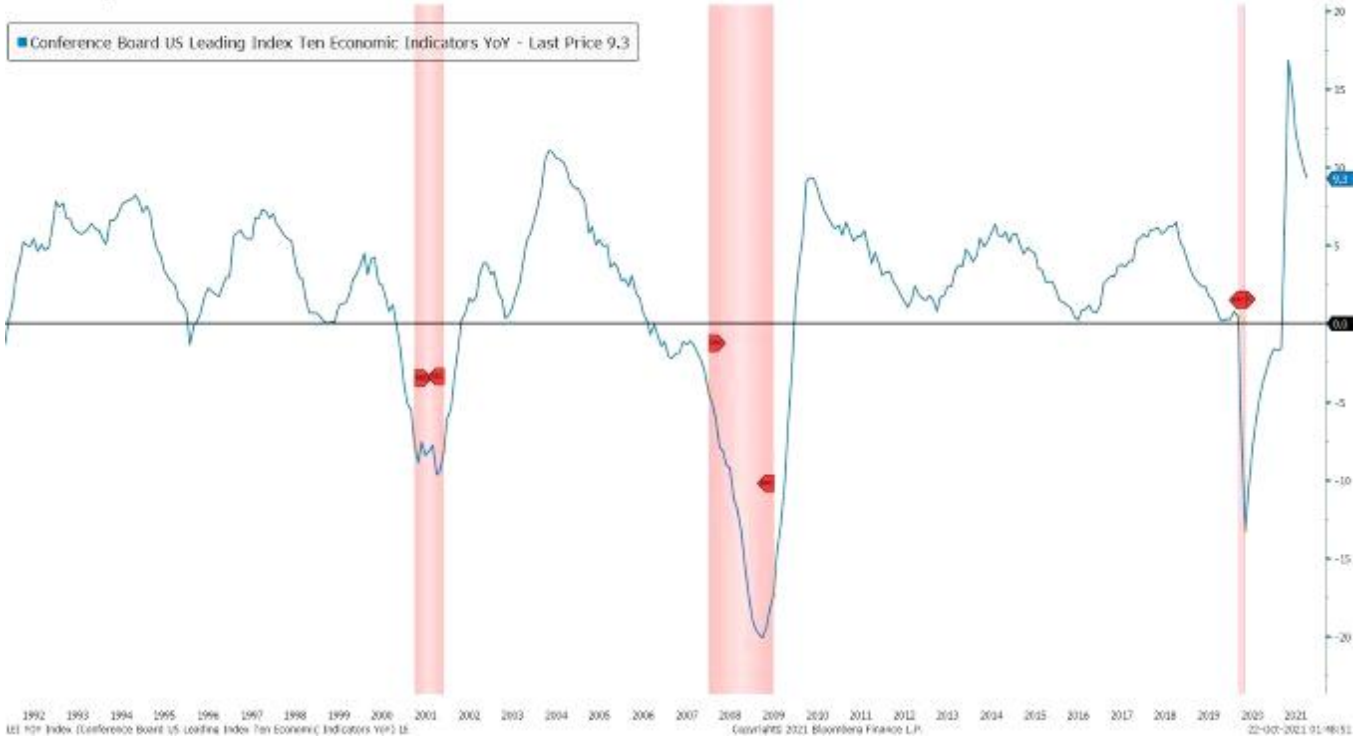
The chart above is the difference between consumer expectations of economic conditions one year in the future and current economic conditions. This indicator could be signaling that trouble is on the horizon as consumers are becoming more pessimistic about the future, and in the past when this has persisted a recession has followed. Diving deeper into survey or everyday people, 69% feel that it is a bad time to buy a vehicle and 62% feel it's a bad time to buy a house.[6] The number one reason for this sentiment was related to higher prices, and this was cited "more frequently than anytime since inflation peaked at 10% in 1978-1980.[7]

Leading Economic Indicators

In contrast to consumer sentiment, The Conference Board's Leading Economic Index is not currently indicating signs of duress in the economy. This index looks at ten key economic components the cover a broad range of economic data from employment, manufacturing, housing, business conditions, housing, and market data.[8] A broad range of economic data is utilized in the series to smooth out volatility of individual data points to provide a holistic picture of the economy.

This index is still positive on a year-over-year basis. When this indicator has turned negative on a year-over-year basis, a recession has followed.

Leading Economic Indicators YoY



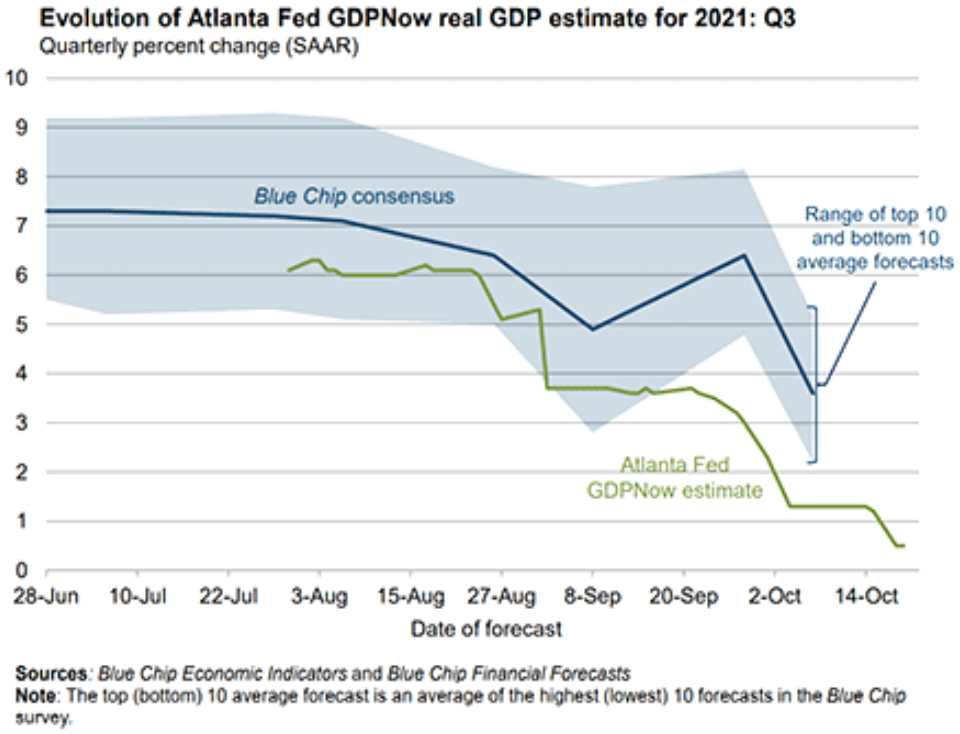
Source: Bloomberg, LP

Economic Growth

Snarls in the supply chain are likely to impact future economic growth. 71% of companies in the S&P 500 have cited supply chain disruptions and rising costs are having a negative effect on current earning or on earnings in future quarters.[9] This echoes the impact seen in the PMI survey data. These higher prices are impacting the profit margins of business if they are not able to pass on these higher costs to the end consumer. Consumers are already indicating through the consumer sentiment surveys that rising prices are a concern and already impacting their spending.

At the end of July, Atlanta Federal Reserve GDPNow forecasts for third quarter GDP growth began at 6.1%. Their forecast moderate slightly through the month of August as more economic data was released until it decline substantially at the beginning of September. The estimate declined to 3.7% based upon declines in manufacturing and auto sales. There was another substantial drop in their GDP estimate at the beginning of October with further declines in manufacturing and auto sales to 1.3%. The most recent estimate of GDP growth as of October 19th is 0.5% which was driven lower by industrial production data.[10]

The Bloomberg survey of economists exhibited a similar pattern. At the end of July, economists were forecasting GDP for the third quarter would increase 7.1%. This declined to 5.0% on September 10th, and continued lower to its current estimate of 3.4% as of October 22nd.[11]



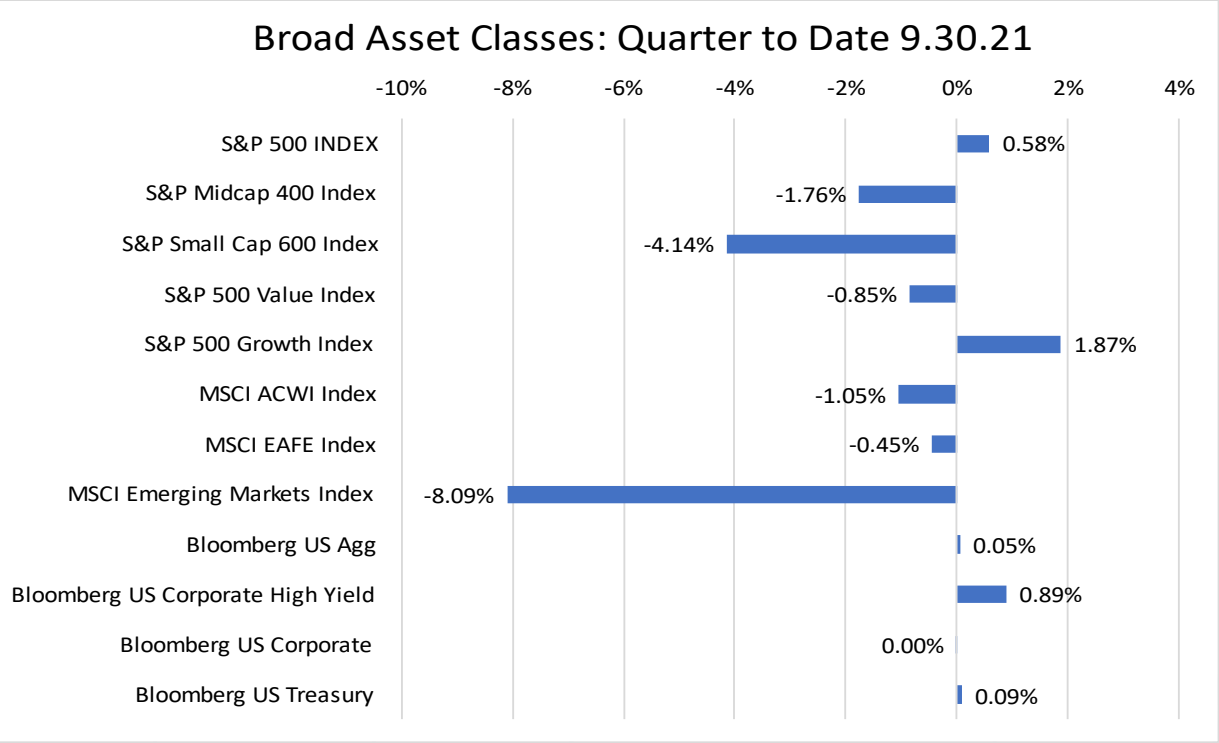
Source: Atlanta Federal Reserve

Overview

The US equity markets continued their streak of outperforming the international markets. For the third quarter, the S&P 500 was up 0.58% while the international markets declined with developed countries declining 0.45% and emerging markets falling 8.09%.

Equity markets encountered their first set of headwinds in 2021at the tail end of the third quarter. The S&P 500 saw its largest drawdown of the year declining 5.06% from its peak to end the third quarter.[12] International markets followed with the MSCI All-World ex-US declining 5.74% from its high.[13]

Prior to the end of September, the S&P 500 has not had a decline of 5% or more since October 30, 2020, which was a span of 211 trading days.[14] Putting the relatively low downside volatility into perspective, there have only been three years since 1980 that have had intra-year declines of 5% or less (1993, 1995, and 2017).[15]



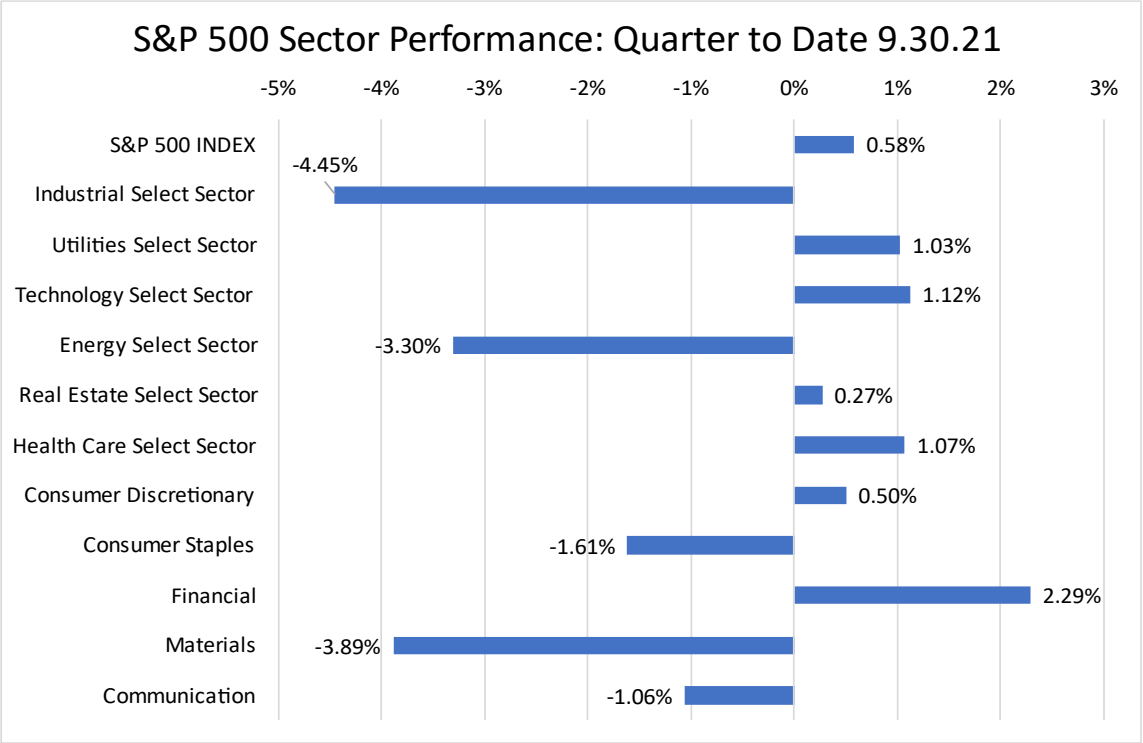
Source: Bloomberg, LP

S&P 500 Sector Performance

Equity markets noticeably declined in September as investor risk appetite declined with the release of mixed economic data and downward revisions of future expected growth. In September, the number of jobs added to payrolls were below consensus estimates, consumer sentiment is negative for big ticket items, and inflation continues to persist at high levels.

These factors bring into doubt the ability of consumers to be able to continue to spend as the prices of items continue to increase. Rising prices are also impacting the balance sheets of companies as their input costs have increased substantially and are now trying to navigate the difficulties of passing these costs onto the end consumer.

Political and monetary uncertainty also played a role in the decline in late September. On September 28, Treasury Secretary Janet Yellen wrote a letter to Congress warning about a possible breach of the debt ceiling on October 18th.[16] On September 22nd, Federal Reserve announced that it "may soon be warranted" to reduce their bond purchases causing concerns that there might be another taper tantrum.[17]



Source: Bloomberg, LP

Valuations

In looking at a broad set of fundamental valuations for the S&P 500 as of the end of the third quarter, they are indicating that the market is overvalued. However, this alone does not indicate markets are due for a correction.

It is important to keep in mind that the stock market is a forward-looking mechanism. We can return to the period when the economy was in the midst of lockdowns and shutdowns in March and April of when GDP declined 31.2%,[18] the S&P 500 rocketed up 39.31% from the market low on March 23, 2000 to the end of the 2nd quarter on June 30, 2000.[19] If the S&P 500 was a current indicator of the economy, it should not have increased as much as it did during the heightened uncertainty and economic damaged inflicted by response to slow the deadly, virulent spread of Covid-19.

The primary driver which will continue to push the US and Global markets higher is the expectations of future growth. These expectations are built upon continually improving economic growth. While there are conflicting data points with some pointing to headwinds (most notably inflation and its corresponding impact on consumer spending), there are also tailwinds filling the sails of the economy pushing it forward.

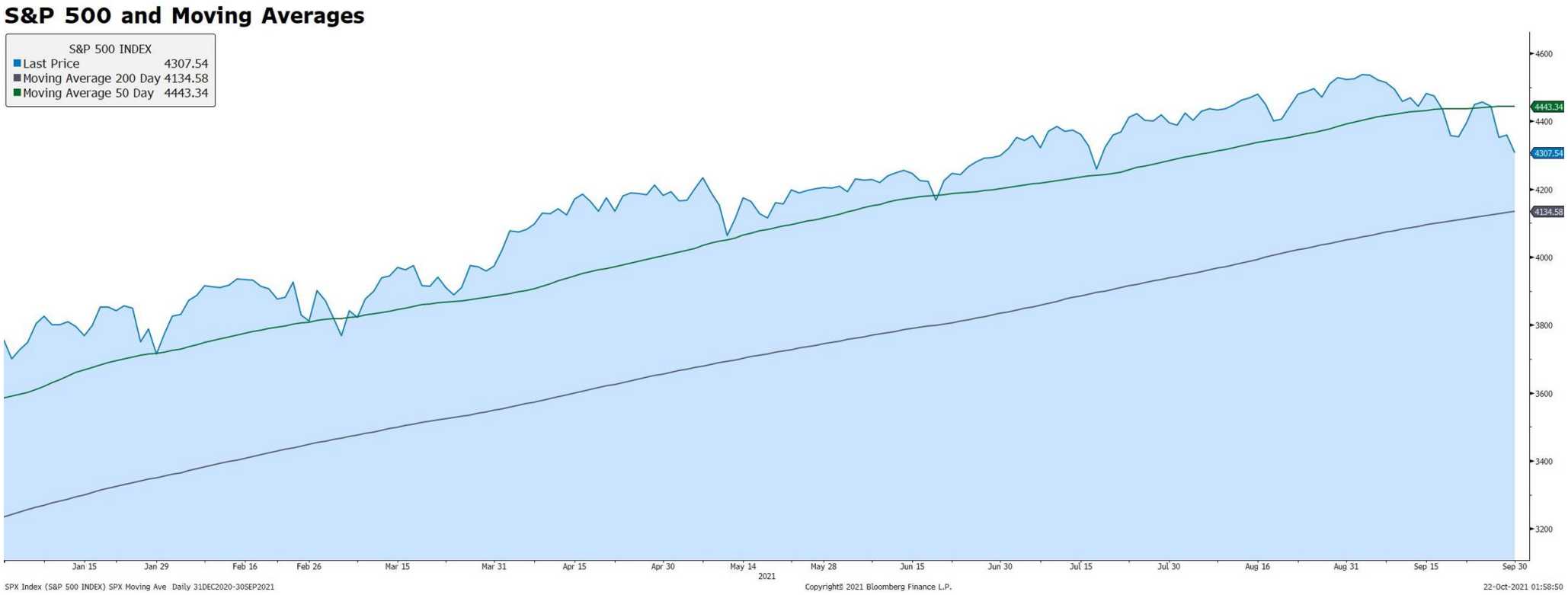
S&P 500 Valuation Measures

Valuation Measure	Description	Latest	25 Year Average	Std Dev Over / Under Valued
P/E	Forward P/E	20.31	16.78	1.06
CAPE	Shiller's P/E	36.96	27.83	1.44
Div Yield	Dividend Yield	1.47%	2.01%	1.64
P/B	Price to Book	4.09	3.07	1.29
P/CF	Price to Cash Flow	15.28	11.05	2.01
EY Spread	EY minus Baa Yield	1.56%	0.13%	-0.72

Source: JP Morgan

Driving the markets forward has been some of the highest earnings growth rate since the depths of the Great Financial Crisis in 2008-2009. For the 3rd quarter, FactSet is estimating that earnings growth rate for companies in the S&P 500 will be 30.0%.[20] This would be the third highest year-over-year growth rate since 2010 only surpassed by earnings growth seen in the 1st and 2nd quarter of this year. In the 1st quarter, S&P 500 earnings increased 52%[21] and this was followed by a 91% increase in the 2nd quarter.[22]

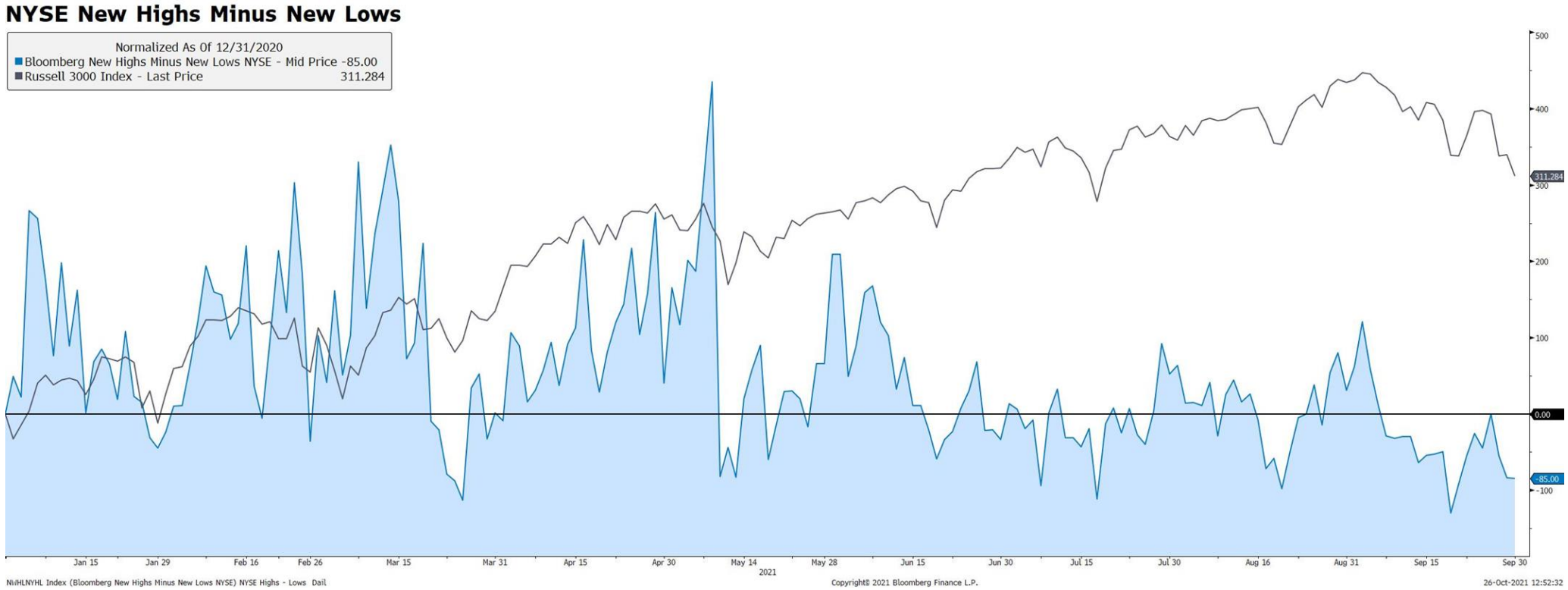
Market Technicals and Sentiment



Source: Bloomberg, LP

Another set of technical indicators that are utilized to gauge sentiment are price and momentum linked. Moving averages are the average price of a stock or an index over a set time period. Two of the most highly used moving averages are the 50 day and the 200 day. When the price declines below the moving average, this is considered a bearish signal. On September 17th, the S&P 500 broke below its 50-day moving average and proceeded to decline -2.83% to the end of the quarter.[23,24] Drilling further down, the number of stocks inside of an index trading above or below moving averages are also indicators of the market's tendency towards speculation or risk aversion. At the end of the quarter, the percentage of stocks trading above their 200-day moving average in the S&P 500 and Nasdaq Composite Index were 65% and 41%, respectively.[25]

Market Technicals and Sentiment



Source: Bloomberg, LP

In the chart above, the grey line is the Russell 3000 index and the blue line is the difference between the number of stocks on the New York Stock Exchange reaching new 52-week highs and lows. When the number of stocks making new 52-week lows exceeds those making new highs, this has typically signaled that the market has become risk averse. On September 8th, this indicator turned negative with 29 more stocks hitting new lows than highs.[26] From this date to the end of September, the S&P 500 declined by 4.50%.[27]

Outlook

The equity markets are driven by both fundamentals and feelings. In the long-term, fundamentals will drive the markets such as earnings, profitability, and broad economic data. In the short-term, investor sentiment and risk appetite will drive the day-to-day movements in the markets. It is important to point out that even "irrational exuberance" of the markets can persists for several years.

In the Second Quarter ATPW Playbook, a study of investor expected returns by Natixis Investment Management was highlighted to illustrate the dispersion in expected returns between investors and investment professionals. According to Schroders Global Investor Survey, investors are expecting to average 11.3% over the next five years.[28]

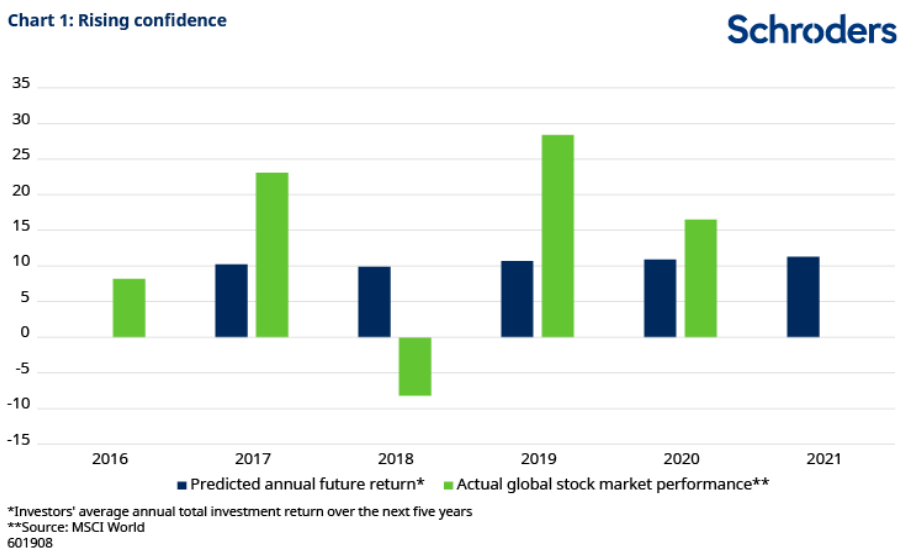
The investor estimates of expecting to earn double digit returns are not inline with the expected investment returns over the next decade from Vanguard.

Behavioral biases are likely the driver for this disconnect, primarily anchoring and recency biases.

This leads to the classical phrase mandated by the SEC:

"Past Performance Does Not Necessarily Predict Future Results"

As we move into the last quarter of the year, the primary drivers of market returns are going to be jobs, interest rates, and inflation. It is likely that we will experience more volatility heading to the close of 2021 due to the uncertainty of tapering from the Federal Reserve and uncertainty of the passage and size of an infrastructure bill in Congress.



Source: Schroders

Equities	Return Projections
US Equities	2.4% - 4.3%
US Value	2.9% - 4.9%
US Growth	-0.6% - 1.4%
US Large-Cap	2.4% - 4.2%
US Small-Cap	2.1% - 4.1%
US REITs	2.2% - 4.2%
Global Equities ex-US	5.1% - 7.1%

Source: Vanguard

Overview

The third quarter of 2021 was highlighted by volatility in both the equity and fixed income markets. The 10-year Treasury Note fluctuated been a low of approximately 1.17% (August 3) and a high of approximately 1.53% (September 28), finishing the quarter at 1.48%, up approximately 2 basis points for the quarter. Rates are still historically low by almost any measure and look to remain that way for the foreseeable future. While that may seem like a boring quarter, nothing could be further from the truth.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.32	0.06	0.04	0.20
5-year	1.06	0.13	0.10	0.70
10-year	1.61	0.15	0.13	0.70
30-year	2.17	0.14	0.12	0.52

Source: Bloomberg L.P., 08 Oct 2021. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.18	0.01	0.01	0.04
5-year	0.52	0.01	0.02	0.30
10-year	1.18	0.04	0.04	0.47
30-year	1.69	0.02	0.02	0.30

Source: Bloomberg L.P., 08 Oct 2021. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	73
30-year AAA Municipal vs Treasury	78
High Yield Municipal vs High Yield Corporate	77

Source: Bloomberg L.P., Thompson Reuters, 08 Oct 2021. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg High Yield Corporate Index. **Past performance is no guarantee of future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	1.16	–	5.22	-0.15	-0.16	0.63
High Yield Municipal	3.18	169[1]	6.56	-0.26	-0.30	6.21
Short Duration High Yield Municipal[2]	2.71	184	3.71	-0.14	-0.13	4.95
Taxable Municipal	2.31	72[3]	9.72	-0.97	-0.63	-0.13
U.S. Aggregate Bond	1.63	33[3]	6.75	-0.77	-0.50	-2.05
U.S. Treasury	1.07	–	7.03	-0.80	-0.51	-3.00
U.S. Government Related	1.47	41[3]	6.09	-0.64	-0.45	-1.74
U.S. Corporate Investment Grade	2.22	86[3]	8.66	-1.16	-0.77	-2.03
U.S. Mortgage-Backed Securities	1.89	25[3]	4.86	-0.43	-0.25	-0.92
U.S. Commercial Mortgage-Backed Securities	1.64	60[3]	5.11	-0.53	-0.31	-0.84
U.S. Asset-Backed Securities	0.66	28[3]	2.31	-0.13	-0.08	0.15
Preferred Securities	3.10	176[3]	4.89	-0.62	-0.64	2.78
High Yield 2% Issuer Capped	4.18	296[3]	4.01	-0.33	-0.33	4.20
Senior Loans[4]	4.81	437	0.25	0.11	0.12	4.77
Global Emerging Markets	4.28	303[3]	6.94	-0.83	-0.79	-1.92
Global Aggregate (unhedged)	1.22	33[3]	7.55	-0.66	-0.36	-4.41

1 Yield difference between the Bloomberg High Yield Municipal Index and the 20-year AAA MMD scale. **2** Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. **3** Option-adjusted spread to Treasuries. **4** Spread refers to the 3-year discount margin. Duration is estimated based on the frequency of the reset date.

Source: Bloomberg L.P. and Credit Suisse, 08 Oct 2021. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg. All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account.

Source: Nuveen Interest Rate Insight

Overview

On August 27, Federal Reserve Chairman Jerome Powell spoke at the Jackson Hole Economic Symposium. The three main highlights from that speech were:

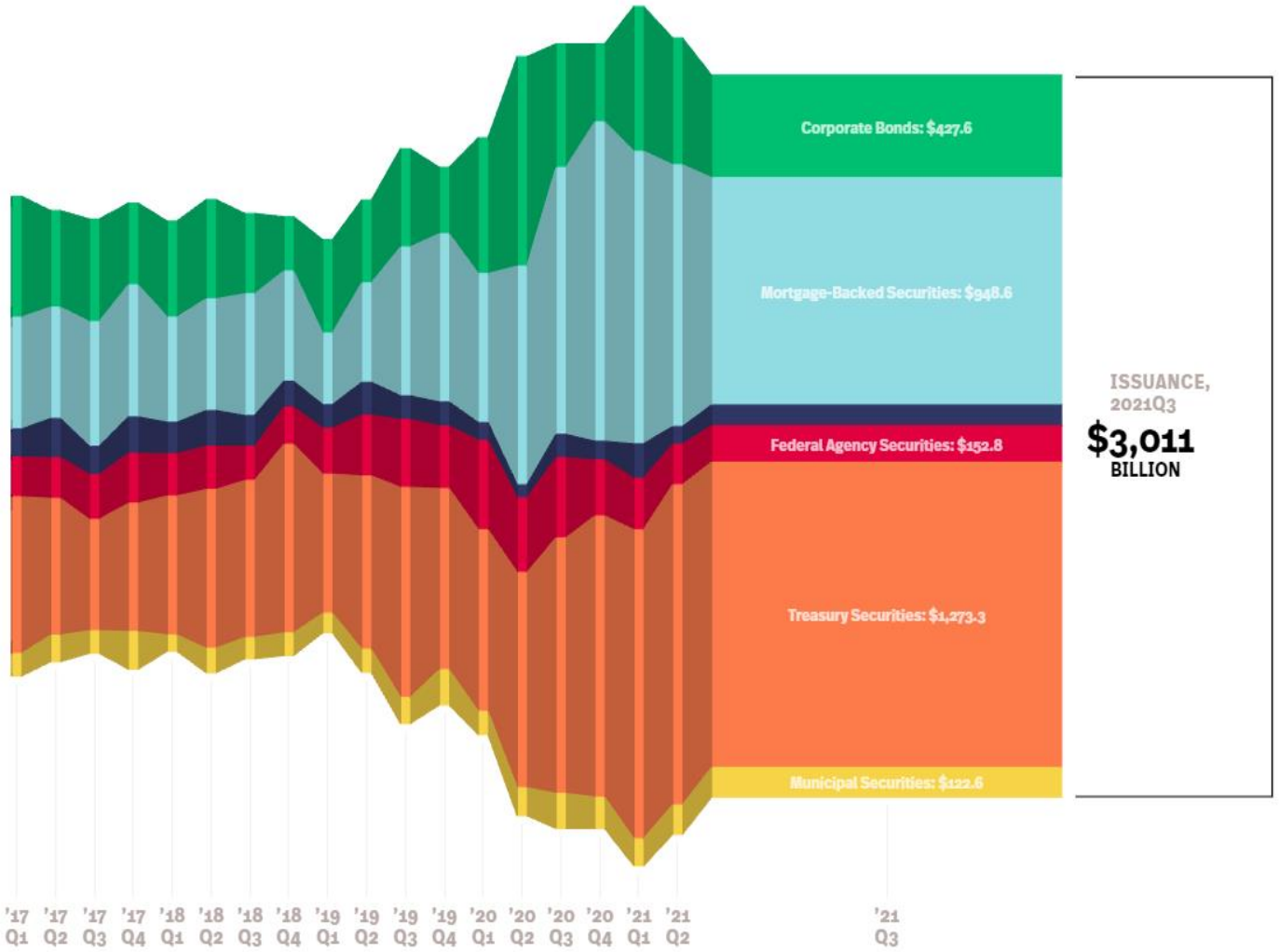
- Job Recovery – According to Powell, the rebound in the job market has exceeded expectations, with output rising. At the time of the speech, the unemployment rate stood at 5.4% (currently it is 4.8%). Powell indicated there was still room for further improvement, with approximately 5 million fewer people employed now than in February 2020.

- Inflation – This has been harder for the Fed to both predict and control. In March 2021, the Fed estimated inflation would rise by about 2.4% for the year, a figure which turned out to be significantly lower than the latest Consumer Price Index reading of 5.3% on September 14. The Fed still believes this is transitory and that, once supply chain bottlenecks alleviate, the figure should return to a more manageable level of 2% to 2.5%.

- Tapering & Rate Hikes – Although there was no formal announcement of a Tapering of the Fed's current $120 billion per month bond buying program,[29] based on Powell's comments at Jackson Hole and after the September 22nd FOMC meeting, there is an expectation that a formal announcement will happen at the November 3rd FOMC meeting, especially if job gains and inflation pressures persist. The Taper is expected to conclude in early-to-mid 2022. There was no formal announcement of any future rate hikes, but many market observers, including the CME Group, who publishes probabilities of interest rate hikes, believe that at least two .25% hike could come in 2022, followed by an additional hike of .25% in 2023.[30]

- Flight To Quality – The turbulence and volatility in equities has spilled over into fixed income, as market participants shift from Risk On (equities) to Risk Off (bonds and cash). Fixed Income, especially Treasuries, are still seen as the place to run and hide when equities sell-off.

Market Drivers



https://www.sifma.org/resources/research/fixed-income-chart/

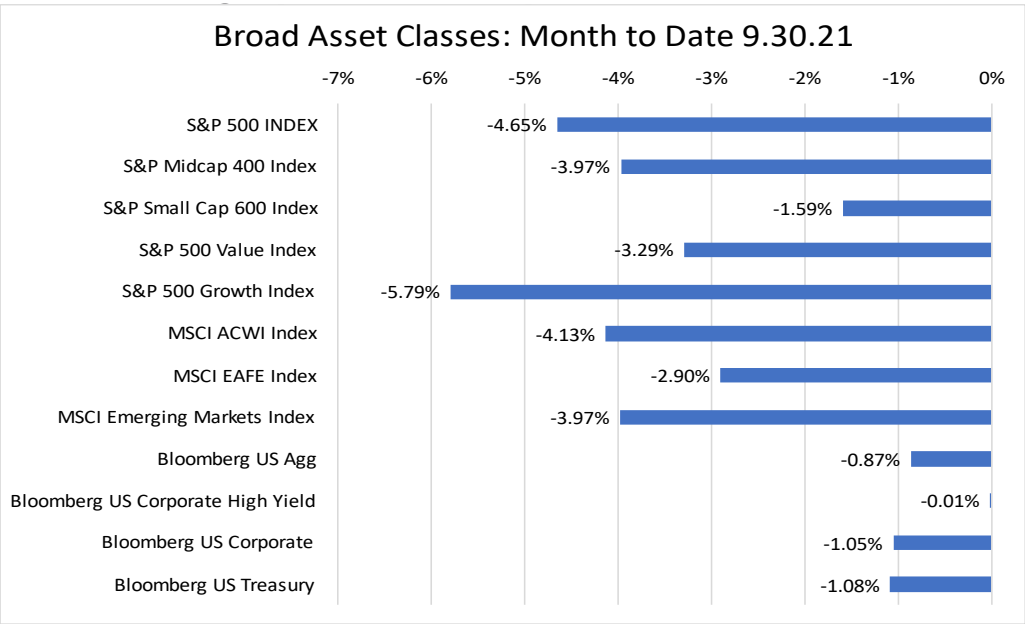
In a recent Deutsche Bank survey of 600 market participants, Covid was among the top 3 biggest risk factors going forward for the first time since the pandemic began. The major drivers mentioned were higher-than-expected inflation/bond yields, central bank policy errors and global growth slowing.

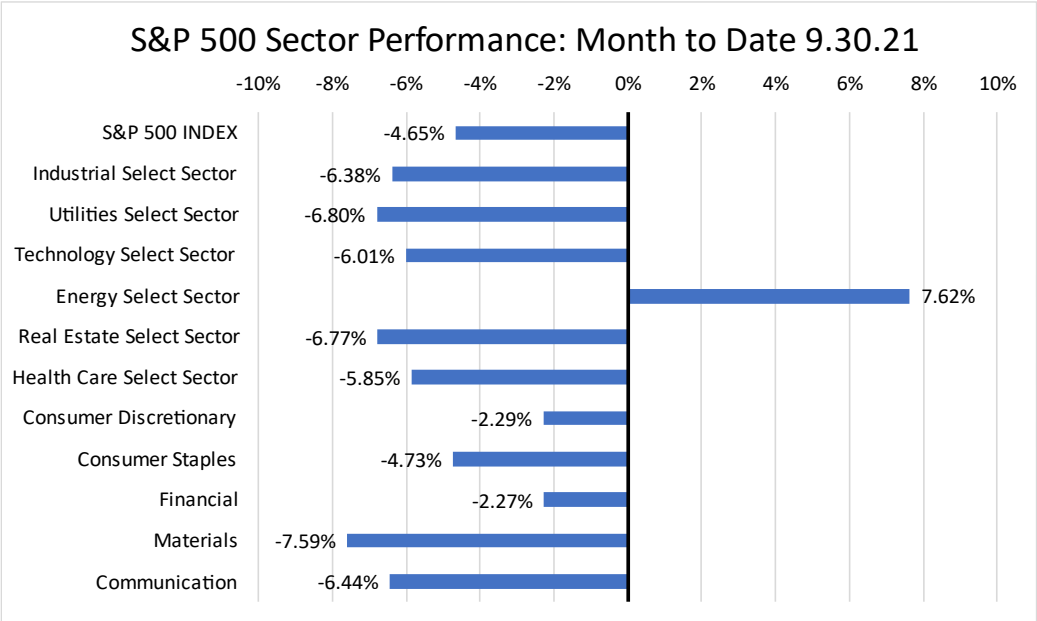
- Inflation – At its current rate of 5.3%, the CPI is significantly higher than The Fed would like to see. If the current elevated level persists and the "transitory" narrative falls apart, the Fed may be forced to raise rates sooner than they would like. Supply chain bottlenecks have had a lot to do with this, as producers are having a hard time finding workers (to produce their goods) and transportation (to get those finished goods to consumers).

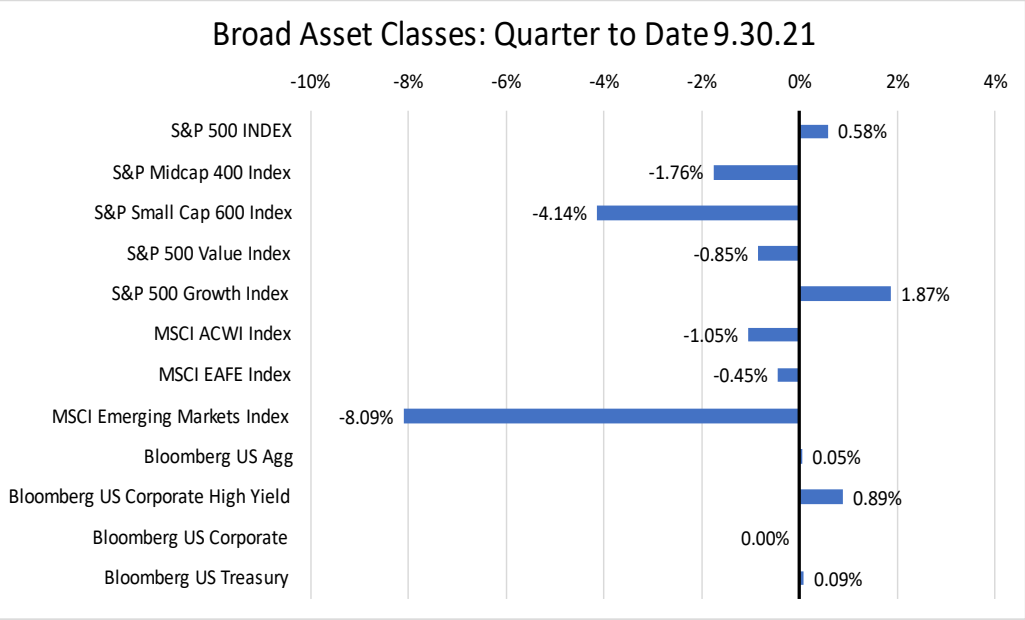
cont'd →

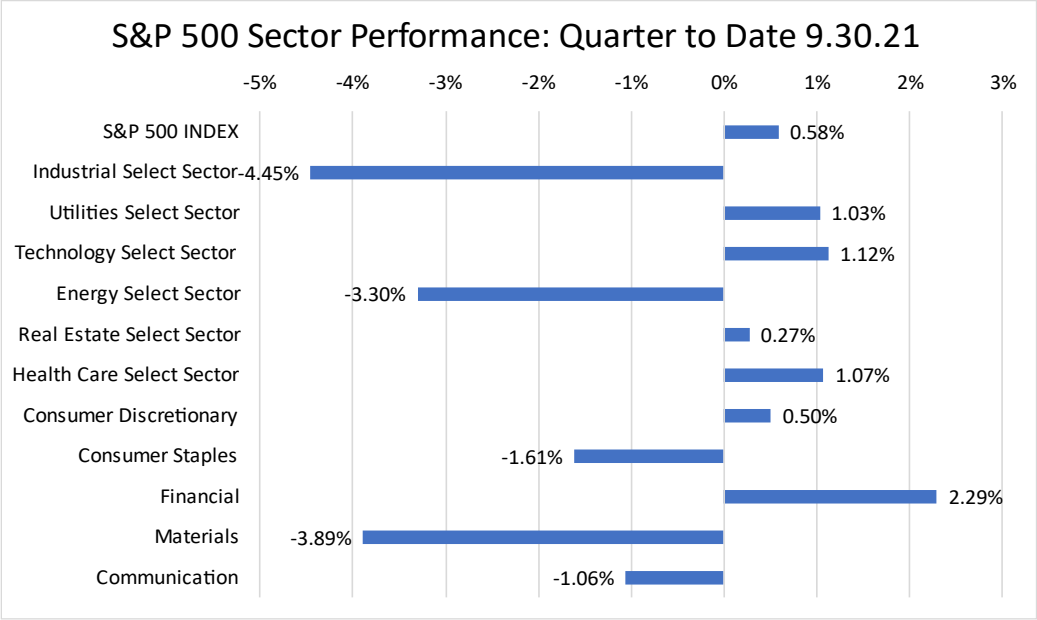
Market Drivers

- Bond Yields – If yields spike upward dramatically, it could mean much higher costs for the Treasury to finance its current debt, higher costs of borrowing for consumers and institutions and higher mortgage rates, which could cool off the housing market (up approximately 20% year-over-year nationwide according to the Case-Schiller Index of 20 major metropolitan areas).
- Central Bank Policy Errors – Everyone is looking at the Fed and how they will remove stimulus from the economy (Taper). If the Fed acts too quickly or too slowly (in the eyes of the bond market), the reaction could be an extreme one to either end of the yield spectrum. Additionally, if they raise interest rates too soon or too late, the bond market could react negatively. The yield curve is a key chart everyone will be watching.
- Slowing Growth – It's no great secret the US consumer (approximately 70% of GDP) is currently suffering from a lack of confidence, whether from seeing higher prices (and feeling their effects at the gas pump, grocery store, etc.) or from the fact that there are currently more job openings than people looking for work. If consumers cannot or will not spend, then an economic slowdown is inevitable. Many firms have downgraded their growth expectations not only for the latter part of this year, but also for 2022.
- Stagflation – Characterized by rising inflation and falling or no economic growth. If the fear of Stagflation becomes dominant in the market, the Fed could have its hands tied (raising rates stifles growth, lowering them can feed inflation). This narrative, along with the other factors listed above is what we will be watching in the fourth quarter of this year.

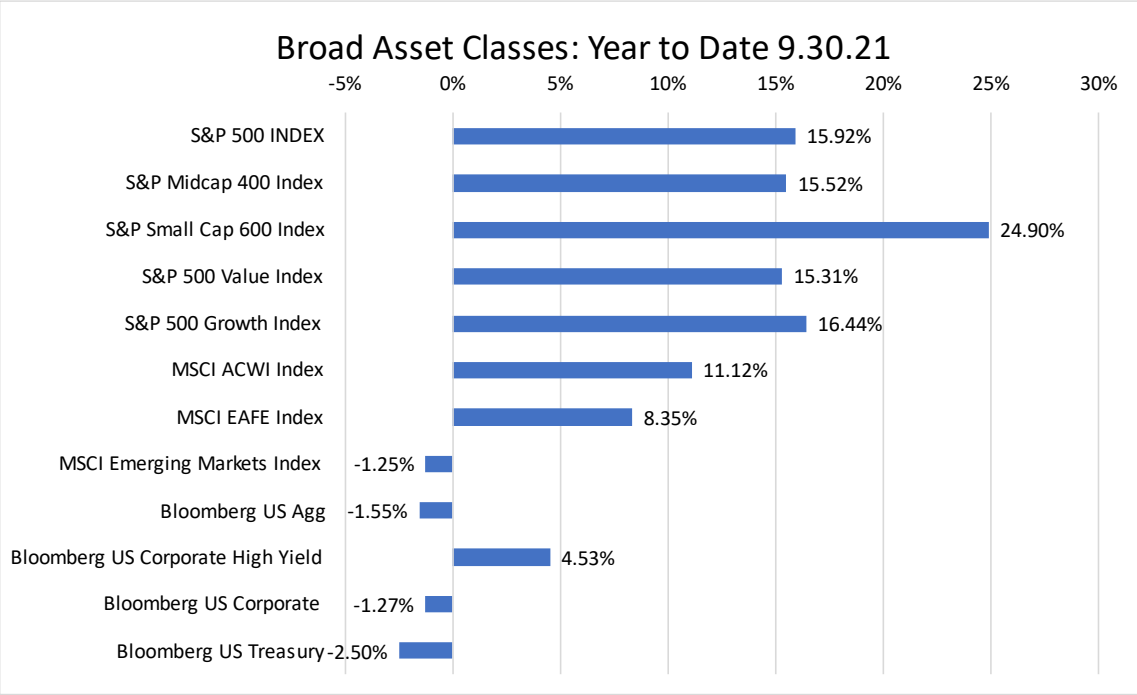


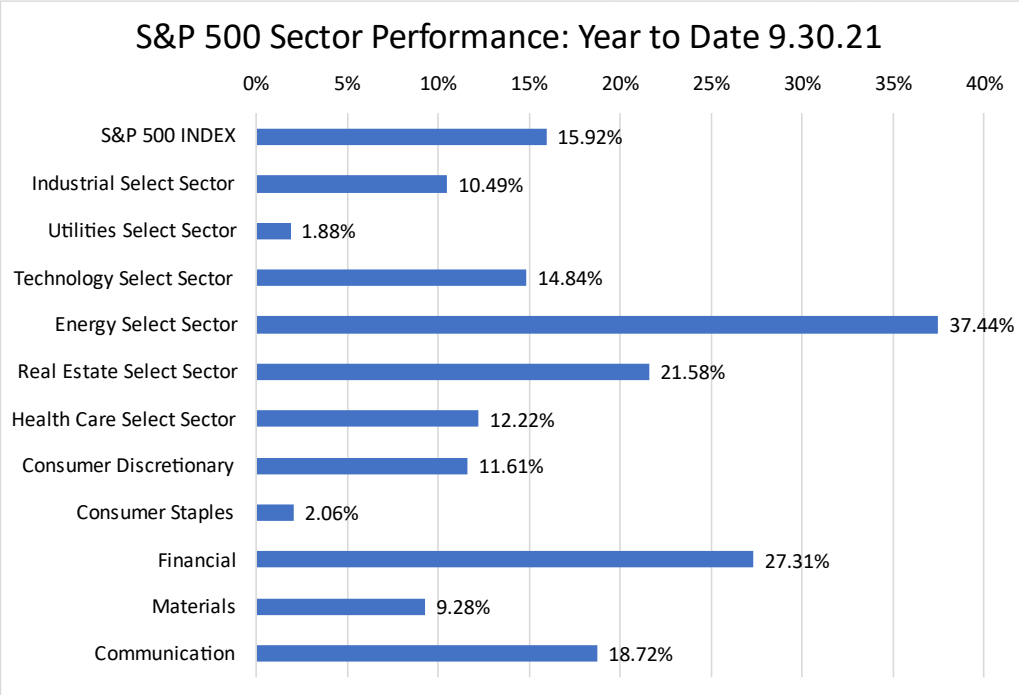






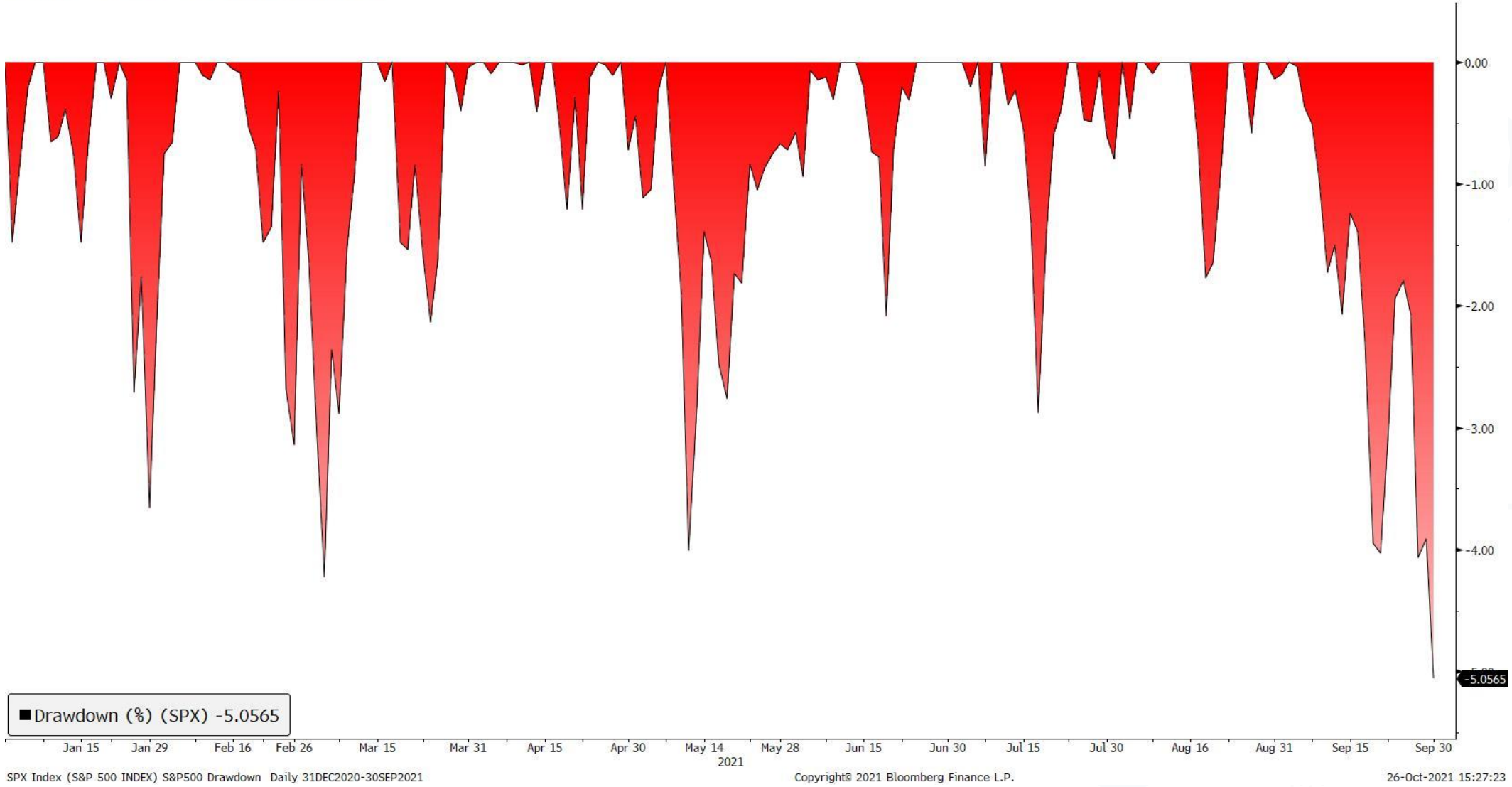
Source: Bloomberg, LP





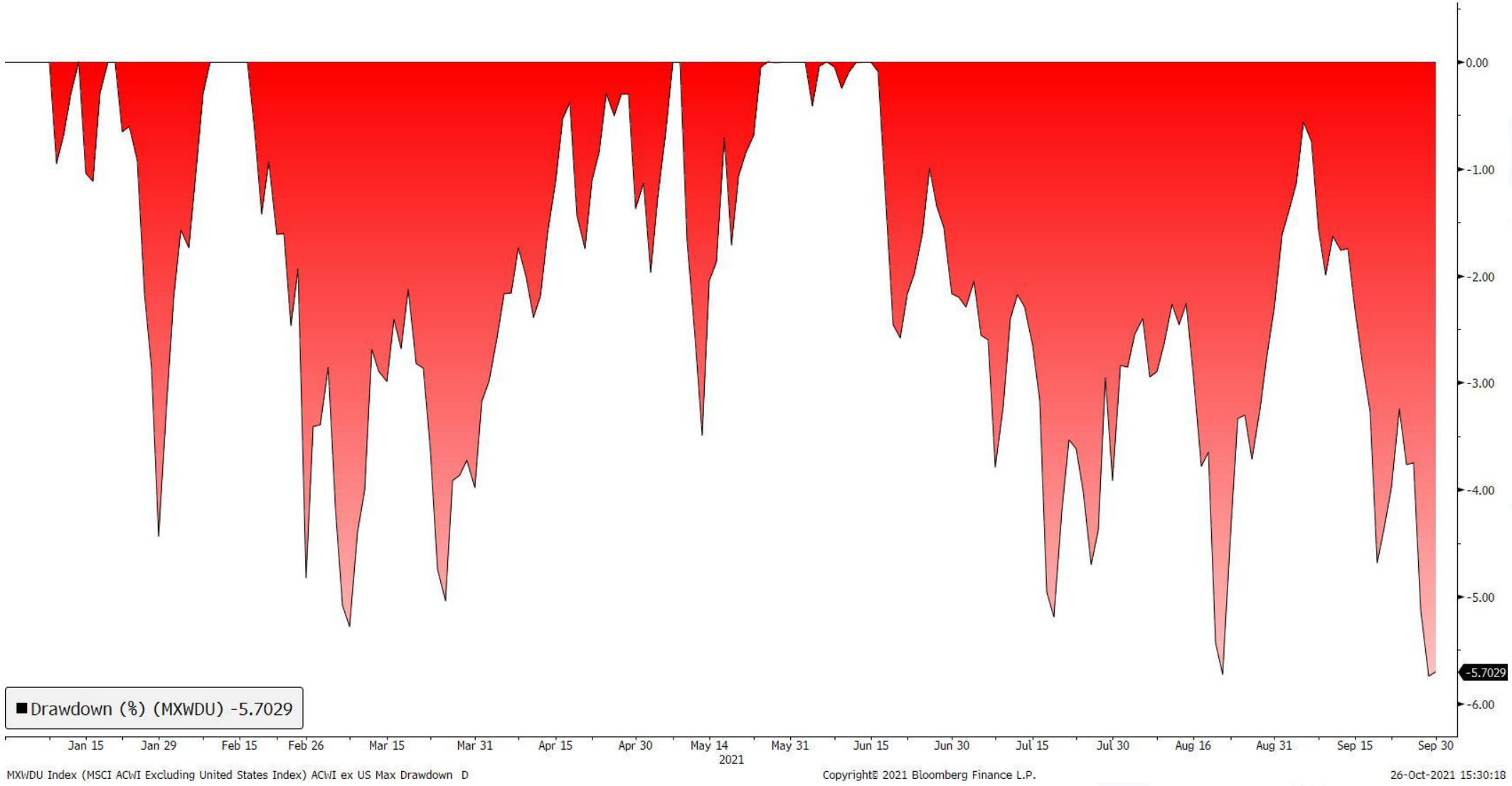
Source: Bloomberg, LP

S&P 500 Drawdowns



Source: Bloomberg, LP

ACWI ex US Drawdowns



Source: Bloomberg, LP

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