FAIRCOURT
Asset Management Inc.

3rd Quarter Commentary – 2021

Quick Summary:

A combination of high debt levels and inflation that is far from transitory have increased market risks but the near term still looks bullish as COVID fears recede and economies continue to reopen and pent up demand results in higher economic growth. We are positioned for continued inflation and growth while remaining vigilant of the market risks.

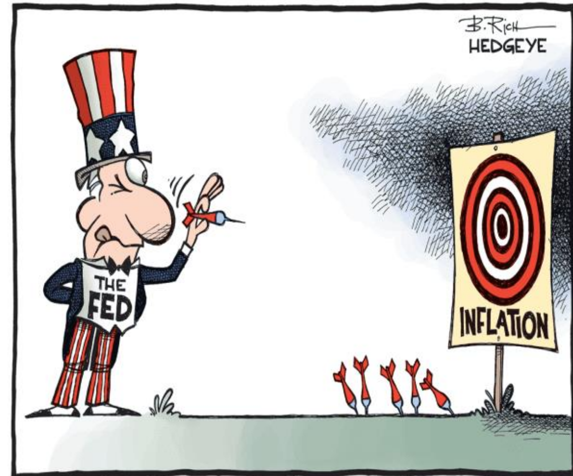
Since the second half of 2020 global growth and inflation have been accelerating on a trending basis. Propelled by exuberance around reopening and mass vaccinations, it has been an extraordinary one sided market for all major equity indices. Year to date ended September 30th 2021, the S&P 500 was up +15.9%; the NASDAQ +12.7%, and the S&P/TSX +18.0%.

Narratives grabbing the attention of investors include markets reaching all time highs while Wall Street consensus positioning remains bearish; COVID cases beginning to fall worldwide; fears of slowing growth and rising inflation; treasury yield rates are rising; the US Federal Reserve and most of Wall Street finally acknowledging they were caught off guard by rising inflation; and finally after 20 months expiring government led social assistance payouts. On top of all that, concerns about China's real estate meltdown, the political battles in Washington, and the possible Federal Reserve taper announcement (reduced bond purchases) dragged global markets in the latter half of September.

Beyond market headlines, US Congress' legislative agenda includes negotiations on three separate, but related mandates to the President's

economic plan: (1) a vote to increase the debt ceiling to avoid a threat of default, then subsequently funding the government to avoid a shutdown, (2) The House planned vote on the infrastructure bill, and (3) negotiations on the proposed $3.5T spending bill on healthcare, education, and climate initiatives. Washington has a busy Q4 ahead as it deals with large spending proposals on the Biden agenda and calls for an insider trading investigation at the Federal Reserve, plus looming fiscal debt concerns. Shocking news of Federal Reserve officials day trading and front running their policies is inexcusable. The systemic aspects of these actions by the Fed officials is a story on its own (some have already resigned).

As can likely be remembered from our previous quarterly updates we tend to approach macro and Fed forecasts with some degree of skepticism. The US Federal Reserve has become a less reliant institution when it comes to forecasting inflation. It's attempt to condition investors to believe inflation was transitory and not trending while it's ability to forecast with accuracy is dreadful. Dismissing inflation up until now has been embarrassing to the Central Bank and White House.



Because we have written about the inflation / deflation debate extensively in past commentaries we will keep our discussion on the topic relatively short only to say the Federal Reserve has finally admitted what has been blatantly obvious to anyone paying attention, that is, inflation has been trending since June of 2020. Commodity inflation is evident. More fiscal stimulus, such as the infrastructure plan, is inflationary. Higher energy prices which we have been witnessing since mid 2020 is inflationary. Rising rents is inflationary. Rising food prices is inflationary. Also,

deglobalization is inflationary and that seems the route most countries are taking. So we should likely get used to the idea of inflationary spikes or scares without the corresponding interest rate increase as a defence. Our role as portfolio managers is to determine if trending inflation is sustainable and whether capital markets are mispriced on this narrative. Inflation seems harmless when under control, however, it quickly becomes painful and uncomfortable when unmanaged. History has shown that too much inflation is detrimental to an economy. Currencies fall, consumers stockpile goods in anticipation of higher prices, consumer spending trends lower, and less consumer and business spending forces governments to run budget deficits and limit social services. Inflation may well be decelerating over the next several quarters from cycle highs, however it is stubbornly sticking at a much higher level than any modern-day U.S. central banker has ever had to contend with.

By understanding the ins & outs of inflation and reckless monetary policies, we can better protect wealth. Our forward interpretation is that with no reprieve for supply-demand imbalances in sight and the PPI-CPI gap (PPI inflation front runs CPI inflation) at its highest level in over 40 years, elevated inflation prints will persist until at least the 1st half of 2022 at which point it may abate. Investors need to stop thinking inflation is not a global problem and that it is transitory. As long as central banks and governments around the world continue with money printing and social support it is a global issue and it is sticking around.

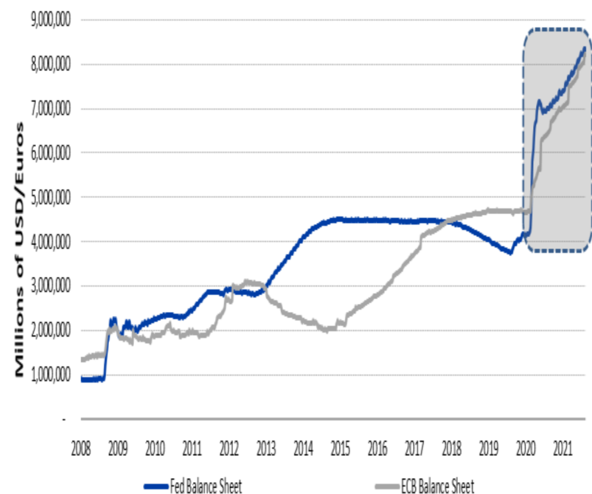
Risk happens slowly at first and then all of a sudden. To protect against inflation-driven loss of purchasing power, our mandates will continue to own assets that appreciate with inflation continuing to add assets as a prudent measure to protect portfolios from the tail-risk that inflation runs out of control. Needless to say, there is no telling what lies ahead, but the best way to navigate sticky elevated inflation is by owing it. We will stay long

trending inflationary assets until the data tells us not to, that is until it begins deaccelerating on a rate of change basis.

In capital markets there a few narratives at play, one being interest rates and debt levels, two being the the beginning of removing excess liquidity by the Federal Reserve ("Taper"), and lastly the effect of the Delta virus on the economy. Each of these individually can be handled by the markets but with all three happening the market may negatively react to this bundled uncertainty so we will see whether this recovery continues to gain traction or begins to unwind next year.

On the aspect on interest rates and debt levels, we are in uncharted territory. Since the Great Financial Crisis, America's appetite for debt has become concerning, with the U.S Federal Reserve the primary buyer of Treasury issuance. The private sector and foreign governments are no longer the largest buyers especially since they are yielding below the inflation rate. The beneficial impact on the economy of the Fed's massive easing policies are limited, if any at this point, while the risks to economy and the financial system continue to mount.

Central Banks' Balance Sheets



Source: Factset

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Treasury yields are moving up in tandem with trending inflation, currently around 1.60%, but the top of the band is approximately 2.25%. At 130/140 percent debt to GDP the US economy has much less capacity to absorb rate hikes. If treasury rates were to rise to uncomfortable levels, the Fed would be forced to intervene and cap bond yields leading to negative real rates which would be bullish for hard assets and gold. As we have been saying for some time now, central banks, particularly the Fed, are effectively trapped with how they navigate through economic cycles, managing employment and counter acting trending inflation. Their ability to increase interest rates further diminishes as debt levels increase. The US is following the path of Europe and Japan where rates will stay low and inflation will be trending. Temporary policies have become permanent, unconventional easing has become conventional easing, temporary lower rates have become lower rates for longer, and spend and borrow leading to devaluation and inflation has become the normal everyday policy coming out of Washington. Central bank independence seems to have disappeared and one can speculate their actions are now by instruction from the Treasury Department. This relentless approach to avoiding short term pain, irresponsible levels of money printing and no longer acting independent of government and capital markets has left our financial system prone to increasing bouts of volatility.

On September 22nd we got a slightly more hawkish Fed with Chairman Powell giving an explicit indication that the tapering process (less bond purchases) could start soon and would likely conclude around the middle of next year but Powell once again

maintained optionality about the exact timing. Unless the economy and labour market materially surprise to the downside, the expectation is an announcement by November. In any event, while seen as unpopular, the pace of the taper will likely be at glacier pace to protect risk markets. The first interest rate hike is expected towards the end of 2023, with several hikes expected for 2024. The Fed Chair made a point of separating the move toward tapering from interest rate hikes that would normally follow. He stated that "the timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test." His messaging is clearly meant to avoid the market tantrums that followed the first taper announcement in 2013 under then-Fed Chairman Ben Bernanke and Powell's own experience in the fourth quarter of 2018.

The biggest risk factor in the market today out of the Fed is tightening policy heading into a probable economic slowdown in 2022. It could be the worst possible move at the worst possible time. All indications are they will begin in November to taper and then they will be bound to continue with it and may be politically unacceptable to reverse course (US midterms). The logic, we can only assume, is that their taper announcement is one of the few remaining tools to manage capital markets. As we have been saying the system is quite fragile and overlevered. Capital markets has the ability to control Fed actions so when it feels the Fed is moving along too quickly it will have a tantrum and the Fed will roll back its decisions. Any form of higher interest rates would prick asset bubbles exposing systemic risk, accelerating currency devaluations, currency wars and trade wars and exponential inflation. The idea that some investors or economists are now calling for monetary normalization is something that is likely no longer available. It will be very difficult and unpopular for the Fed to follow through on its restrictive messaging.

We had been suggesting the reflation trade, which paused in Q2 of this year was complete and we would be returning to a challenging economic cycle, first with stagflation (rising inflation and falling growth) appearing in Q3, which it did, before inflation trends beginning to fall on a rate of change basis and bringing into the discussion the increasing possibility of a recession most likely in the second half of next year (falling inflation and falling growth). Government spending and support announcements and continued Fed easy money policy will delay the systemic risk building and push our thinking further out. For the time being we invest in the cycle we are in, being mindful of the risk that is building. This brings us to the Delta variant and how it has shifted the macro environment.

Lockdowns remain the greatest threat to the recovery. The Delta virus seems to have changed our thinking by at least another quarter. Media speaks to COVID daily and people tend to default to fear but from a data process daily cases globally are falling. While the drops are different in each country, they are directionally consistent. COVID fatigue has set in and we expect increased mobility as a result.

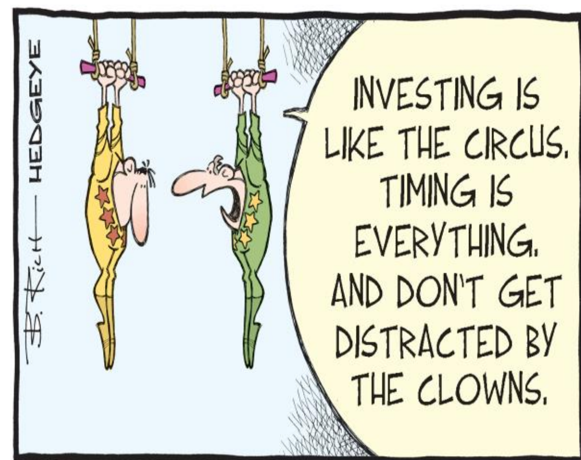
As Covid cases are reduced and more normalized activity is combined with pent-up demand, this will drive the probability for economic growth to accelerate in the fourth quarter. The economy is learning to cope with the pandemic by not locking down any further. The more reopening we get, the more hiring that takes place, the more income acceleration comes with it, the more capacity that gets unlocked all leading to growth improving from Q3 into Q4. Some signals seem to be confirming this, whether it being the 10 year yield

rising, gold prices beginning to fall, and the Russell 2000 beginning to rise, an indicator of the risk on trade. We are reminded that capital markets front run the future, they are not trading the past. While we still expect disappointments to materialize, Delta has pushed it out a bit further to a 2022 event.

Despite the risks we have outlined, the market setup right now still seems to be too bearish. Consensus positioning tells us the most popular trade is long USD$ and long term Treasuries but this is indicative of investors who have been calling for a significant correction since the end of Q2. It is important for equity investors to listen to the messages coming from the bond market, treasury market, corporate spreads and cross asset volatility. The bond market began signaling a break out in yields again, and that only happens when we are in a cycle where real growth outperforms and inflation is elevated. The bond market is telling us economic expansion has a longer tail. Cross asset volatility, collectively, currencies, fixed income, high yield, and treasuries have remained relatively benign. Equity volatility continues to decay although being in the mid / late teens makes it vulnerable for spikes. However, every spike in equity volatility (VIX) and the related spikes in volatility of volatility (VVIX) has been to lower highs this year. Our current interpretation of cross asset volatility indicators and daily trading volume metrics indicate to us, for the time being, we will be active buyers of our preferred sectors on drawdowns, especially on decelerating volume. The broader takeaway is the market is poised to continue upwards with risk on.

In summary, we will continue to accumulate equities only if they continue to be in our favour and we will divest from risk when we think its going against us. As we continue into the fourth quarter the US dollar will continue to be the key macro variable as assets are priced in dollars and its moves must be understood to allocate capital. The Fed tapering is concerning as it seems to be coming and being accelerated as global growth is set to be contracting in 2022. The Fed seems committed at this point and this is what we need to risk manage. The key

takeaway here is tapering in of itself is not the issue. The Fed balance sheet will continue to expand, it will expand at a de-accelerating pace. The issue comes down to liquidity being removed which since 2008 has led to asset price appreciation so it is only rational to expect this being not well received by leveraged market participants. The market thought they would have more time in this favourable liquid market and the Fed seems to have pulled forward the timing. The equity market has learned to manipulate the Fed. If it shows cracks it will invite further measures. The all time highs on the S&P 500 have resulted with the help of Janet Yellen and Jerome Powell having been successful at supressing market volatility. The law of diminishing returns tells us to be cautious. We will stay invested by navigating the economic cycle we are in, preserving capital, looking for opportunities in the options market, making decisions based on risk tolerance and return expectations and compounding returns on a risk adjusted basis. We will continue to construct portfolios that are both positioned for risk on and risk off based on our data driven process in assets that are more long inflation. We remain disciplined and from a factor perspective have our preferences. This is an incredibly difficult time for pure defensive strategies but given the fragility of the system and the gathering risks we are mindful. Our portfolios will have asymmetric setups. Investing in 2022 will be challenged not just for the inflation and growth outlooks but for the fact 2022 will be comping against 2021 (re-opening) which was comping the low 2020 quarters (lockdown). The rate of change dynamics will be challenging leading us likely more on the side of disappointment. For the time being we invest in the cycle we are in, however mindful of the risk that is building.



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Sincerely,

Christopher Panagopoulos, CPA, CA, CFA

The Portfolio Management Team

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