HOLLENCREST
CAPITAL MANAGEMENT

100 Bayview Circle, Suite 500
Newport Beach, CA 92660-8903
Main: 949.737.7700
Fax: 949.737.7703
clientcommunication@hollencrest.com

Q4 2021 Outlook

October 1st, 2021

Economy: Expect moderation of growth in the US as pressures from the supply-side of the global economy and the passing of peak pent-up demand combine with the Fed tapering its injections of liquidity into the financial system.

- Our outlook on US GDP growth in 2021 has fallen, now expecting 5% to 6% for the year.
- Inflation must be monitored closely by investors and policymakers alike. We are moving past the months of most obvious "base effect" driven readings where high inflation year-over-year was attributable to sector-specific deflation during last summer's shutdown. Supply issues including input and energy shortages, labor market inefficiencies and logistics backups are showing themselves to have an impact on prices for certain goods that now have limited inventory available for sale. Other markets, such as housing, where different forms of imbalances have emerged, have also seen upward volatility in prices. We expect it will take some time to resolve these issues, but inflation will not rise to a spiraling, problematic level. We expect readings to continue above the long-term trend in coming quarters, but inflation should settle back in at just over 2% in the intermediate term with appropriate Fed and fiscal policy. We still believe productivity-led economic growth will prevail over the coming years. Deflationary forces including demographics, technology, debt and globalization remain as the overriding trends that will check inflation over the long term. Market-based indicators, namely the 10-year Treasury trading around 1.5%, tell us that inflation is not yet an issue of great concern.
- The fiscal stimulus bill currently under discussion in Congress should bolster economic growth going forward. If allocated prudently, the US Government has the opportunity to efficiently invest in growth that could expand economic capacity without further pressuring inflation.
- We expect "stagflation" will become a topic popular for discussion. Stagflation involves inflation running well above long-term trends and weak or negative GDP growth. This scenario was last seen in the US in the 1970s and does not bode well for many investment assets. Although this could occur for a brief period, we expect inflation will abate and real economic growth will be sustained as covered above. We are already positioned in investments that have strong relative performance in this type of environment such as real estate, material and industrial stocks, and tech sector companies that can sustain growth in a weak economic environment.
- We are monitoring the situation in China closely, having taken the opportunity to reduce emerging market exposure on an early September rally, and believe recent political and economic decisions by China's leadership could negatively impact their growth to an extent that world trade could be moderately impacted. If this trend continues, it will be increasingly difficult to do business in, or with, China and will hamper globalization's deflationary impacts and be a net negative for global economic growth.

This exhibit contains content written by Hollencrest and may include additional information supplied by third party research providers. The views and opinions expressed are subject to change without notice. This material is provided for informational purposes only and does not constitute an offer or solicitation to purchase or sell any security or commodity or invest in any specific strategy. It is not intended as investment advice and does not take into account each investor's unique circumstances. Information has been obtained from sources believed to be reliable, but its accuracy, completeness and interpretation cannot be guaranteed. Past performance is no guarantee of future results.

Stocks: Our base-case S&P target for the end of 2021 has moved to 4,700. Our upward revision is not due simply to the fact that the S&P reached that level in Q3, but more so that corporate earnings and their forward expectations have risen, forcing expectations for the stock market higher all else being equal.

- Despite the largely unabated march higher in stocks the past few quarters, valuations (price/earnings) have remained mostly steady due to companies beating earnings forecasts and analysts increasing forward expectations. In other words, the recent gains have been more fundamentally driven then a reflection of increasing overvaluation.

- Our indicators point to continued advances in the market, but seasonality and traditional market dynamics suggest that a correction followed by an end-of-year "Santa Claus" rally will be the most likely path to ending at 4,700 or higher on the S&P.

- Signs of excessive optimism persist, but we see examples of rational behavior in certain areas that tell us we are not yet at a top. For example, the pullback in SPACs this summer, after investors realized some of the shortcomings in that market, displayed prudent behavior often not present in a topping market. We also track lending activity among banks closely. We still see most financial institutions as operating conservatively, holding too much cash and offering loans without taking meaningful risk. A change in this behavior often precedes top-inducing cracks forming in the financial system.

- There are any number of things that could provide a cover story for a meaningful correction in Q4 that would extend the technical correction already occurring at the end of Q3 – China, stagflation, COVID variants, and political gridlock are just a few. Arguably the most significant, a plateauing of earnings expectations, could lead to what we call an "Echo Bear" market – a drop in stocks correcting overextended gains that have occurred coming out of a recessionary bear market's low. Earnings expectations ceasing their rise could trigger the market's realization that bullish macro conditions and growth rates experienced immediately after the recession are not repeatable, causing a readjustment in prices. We have already seen companies in certain sectors negatively alter their guidance due to supply issues in the global economy.

Bonds and Rates: Rates will continue to be anchored at the short end of the yield curve for the forecastable future, but we expect to see some moderate curve steepening occur as the Fed's taper allows rates to rise on the longer end.

- The Federal Reserve should begin to taper asset purchases in Q4. Their decision will not be a reason to sound cautionary alarm bells or throw a "taper tantrum." Instead, the beginning of the taper is the Fed's signal that the economy is, without question, strong enough to continue growing at its trend rate without this support. Based on data from this summer, it is likely already strong enough to do just that. Remember, tapering does not mean the Fed is withdrawing liquidity or shrinking their balance sheet – they are just growing at a slower rate.

- There is a chance asset prices see a negative adjustment, with effects felt more in the areas where purchases are reduced first, but the economy is strong enough to overcome.

- After the Fed has completed their taper and stopped expanding their balance sheet, they will raise short term rates, which will help to discourage borrowing and further unnecessary growth of debt in the financial system. We expect the Fed will begin to raise rates at the start of 2023 but could move up the decision a couple meetings depending how impactful the taper becomes.

- We still see an appropriate yield for the 10-year of 1.75% to 2% exiting 2021. The Fed has been able to keep this rate lower by targeting it with their purchases, and once the taper begins market equilibrium pricing will come back into play, pushing the yield closer to its fair value.

This exhibit contains content written by Hollencrest and may include additional information supplied by third party research providers. The views and opinions expressed are subject to change without notice. This material is provided for informational purposes only and does not constitute an offer or solicitation to purchase or sell any security or commodity or invest in any specific strategy. It is not intended as investment advice and does not take into account each investor's unique circumstances. Information has been obtained from sources believed to be reliable, but its accuracy, completeness and interpretation cannot be guaranteed. Past performance is no guarantee of future results.