November 2021

SOL CAPITAL MANAGEMENT COMPANY

Client Investment Letter

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After a strong start to the year, global equity indices took a small step back in the third quarter as a variety of risks (some existing, some new) converged (see Exhibit 1). Spikes in COVID-19 cases from the delta variant and the uncertain direction of interest rates continued to disturb markets. Lingering supply chain disruptions and labor shortages, coupled with rising energy prices, kept upward pressure on prices in many countries. Meanwhile, stark regulatory changes in China triggered heightened volatility as investors processed what their true impact on earnings potential and valuations might be. While most markets recovered nicely throughout the month of October, the risk factors investors navigated last quarter still remain.

Most major economies (with a few notable exceptions) find themselves in the middle stage of the business cycle, when growth rates tend to peak (see Appendix A). In fact, activity indicators in the U.S. are already suggesting we may have passed the summit. However, a peak in the acceleration of economic activity does not necessarily herald the end of a cycle. Stages of the business cycle tend to last for several years and given the current fiscal and monetary backdrop, there is the opportunity for several more years of economic expansion.

That said, mid-cycle is historically when equity market corrections are most frequent (see Appendix B). Market volatility is nothing new, yet we would remind all investors (new and experienced alike) to always focus on long-term fundamentals, not short-term turbulence. Market corrections are common, tend to be short-lived, and offer opportunities to build up stakes in quality businesses at discounted prices. While we would advise our clients to prepare for increased volatility, it is important to remember that diversification serves as your protector in market corrections, significantly reducing the risk of the permanent loss of capital.

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Financial Markets Performance

“The pandemic continued to have substantial implications on economic activity, and by extension, stock prices. Persistent supply chain disruptions were blamed for the rising costs of inputs and finished goods.”

Equities

Stock prices in the U.S. fell in September, but three-month performance for the S&P 500 ended the quarter slightly positive. The pandemic continued to have substantial implications on economic activity, and by extension, stock prices. Persistent supply chain disruptions were blamed for the rising costs of inputs and finished goods. Inflationary pressures intensified as demand for post-pandemic services, such as travel and recreation, pushed prices higher. However, a new wave of delta variant cases in June appeared to cool both growth and inflation rates. A weak jobs report released in September (for the August period), worries about a peak in corporate profit growth, diminishing hopes for fiscal stimulus, and delays in raising the federal debt ceiling all contributed to late-quarter weakness.

Large-cap stocks led performance in the U.S. market, as mid- and small-caps both lost ground. Growth stocks, benefiting from historically low yields, generally outperformed value over the quarter, except within small caps. Quarterly performance dispersion among S&P sectors was modest; financials led, benefiting from rising rates, as materials and industrials declined.

Equities in developed markets outside the U.S. also had a mixed performance. European shares reached record levels during the first part of the quarter on hopes of a continuing economic recovery, but gains evaporated by quarter-end as growing worries about inflation and central banks’ response sent stock prices lower. Major indices in France, Italy, and the U.K. declined marginally, and German shares were somewhat weaker after the center-left Social Democratic Party (SPD) won a plurality in the federal election. Japanese equities rose after prime minister Yoshihide Suga resigned, raising hopes that his successor would enact new fiscal measures to boost the local economy. Japan’s belated, but rapidly accelerating, COVID-19 vaccination program also improved investor sentiment.

Emerging markets stocks lost all year-to-date gains during the third quarter, as Chinese stocks (the most prominent component of the index) declined 18.3% during the period.[1] A slew of new regulatory requirements targeting internet platforms, private education, online gaming, video streaming, and ride hailing (among others), left investors uncertain about which sectors would be targeted next. Other factors contributing to the downward pressure were weaker than expected economic growth figures and the ongoing Evergrande default crisis. Brazilian shares also weighed on broad emerging market returns as allegations of corruption related to purchases of COVID-19 vaccines and budgetary tensions surrounding assistance to lower-income families spooked investors. Still, markets in India, Russia, and Indonesia advanced strongly as COVID-19 cases declined.

Fixed Income

The broad fixed income market was mostly unchanged during the third quarter (see Exhibit 2), though yields moved rather sharply intra-period as

1 As measured by the MSCI China Index.

Financial Market Performance Cont.

Exhibit 1

Total Return* for Selected Equity Indices	Third Quarter (06/30/21 to 09/30/21) %	Year-to-Date (12/31/20 to 09/30/21) %	Year-to-Date (12/31/20 to 10/31/21) %
S&P 500 Index	0.58	15.92	24.04
S&P 500 Growth Index	1.87	16.44	27.02
S&P 500 Value Index	(0.85)	15.31	20.61
Russell 3000 (Total U.S. Market) Index	(0.10)	14.99	22.77
Russell 2000 (Small-Cap) Index	(4.36)	12.41	17.19
Russell 2000 (Small-Cap) Growth Index	(5.65)	2.82	7.64
Russell 2000 (Small-Cap) Value Index	(2.98)	22.92	27.60
MSCI All Country World ex-U.S. Index (Net)	(2.99)	5.90	8.43
MSCI All Country World ex-U.S. Growth Index (Net)	(3.62)	2.66	5.84
MSCI All Country World ex-U.S. Value Index (Net)	(2.32)	9.11	10.90
MSCI EAFE (International) Index (Net)	(0.45)	8.35	11.01
MSCI Emerging Markets Index (Net)	(8.09)	(1.25)	0.27
MSCI ACWI Commodity Producers (Net)	(2.03)	20.57	27.19

Source: Bloomberg LP. *Includes price appreciation plus dividends and/or interest.

investors shifted positions in reaction to the potential for sustained inflation, the delta variant, and slowing growth in China. Performance was also flat across the U.S. Treasury yield curve, but yields moved higher after the Federal Reserve indicated at its September meeting that it would soon consider tapering its purchases of Treasuries and mortgage-backed securities.

Prices of investment-grade bonds in the U.S. and Europe were also little changed for the period, as lower-grade bonds slightly outperformed high-quality securities. Meanwhile, high-yield bonds continued their outperformance over investment-grade, posting mild gains. Return came mostly from coupon payments, as price appreciation was generally flat. Within the high-yield sector, higher-rated securities in the U.S. outperformed, while the reverse was true in Europe.

Global government bond indices finished the period flat in aggregate as Asia, Pacific, and peripheral Europe posted small gains, while other developed markets slightly declined. Emerging market sovereign debt was slightly weaker during the quarter – both in U.S. dollars and local currency, while corporate debt managed a small gain.

"Performance was also flat across the U.S. Treasury yield curve, but yields moved higher after the Federal Reserve indicated at its September meeting that it would soon consider tapering its purchases of Treasuries and mortgage-backed securities."

Financial Markets Performance Cont.

Exhibit 2

Total Return* for Major Fixed Income & Hedge Fund Indices	Third Quarter (06/30/21to 09/30/21)	Year-to-Date (12/31/20 to 9/30/21)	Year-to-Date (12/31/20 to 10/31/21)
	%	%	%
Bloomberg Barclays U.S. Aggregate Bond Index	0.05	(1.55)	(1.58)
Bloomberg Barclays U.S. Government/Credit Index	0.04	(1.93)	(1.88)
ICE BofAML 1-3 year U.S. Broad Market Index	0.08	(0.10)	(0.41)
ICE BofAML U.S. High Yield BB-B Bond Index	0.93	3.87	3.70
JP Morgan Non-U.S. Global Bond Index (GBI) Hedged	(0.03)	(2.78)	(3.93)
JP Morgan EMBI Global Index in USD (Emerging Markets)	(0.53)	(1.53)	(1.47)

Source: Bloomberg LP. *Includes price appreciation plus dividends and/or interest.

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"Though activity rates appear to have passed their peak, a robust consumer sector is supporting economic growth. Consumers' balance sheets remain in quite good health, currently at their lowest debt-service obligation on record."

Global Economic Update

United States

U.S. economic growth slowed to a 2.0% annual rate in the third quarter, but the economy remains firmly in the middle stage of the business cycle. Supply constraints and disruptions (due to continued virus outbreaks) as well as severe weather reduced some growth momentum, but not enough to stop policymakers from considering a move toward less accommodative monetary and fiscal policies. In September, in addition to tapering, the Fed signaled it may begin to raise the Federal Funds rate next year. On the fiscal front, after accounting for the social and infrastructure spending bills still meandering their respective ways through the halls of Congress, we expect less fiscal support next year.

Though activity rates appear to have passed their peak, a robust consumer sector is supporting economic growth. Consumers' balance sheets remain in quite good health, currently at their lowest debt-service obligation on record.[2] That strength plus continued pent-up demand should fuel economic activity for some time.

Conditions in the labor market remain tight, further contributing to inflationary pressures. Firms have posted the highest rate of job openings in 20 years, and small businesses are raising wages at rates not seen in decades, yet unemployment rates remain elevated. Now that the long-term unemployment benefits initiated at the pandemic's outset have expired, conditions may start to improve, but there is a risk many workers that left the labor force in the last 18 months (particularly older workers) may not return (see Appendix C).

While the headline-grabbing inflation rates we have been witnessing in recent months should decrease as we move into 2022 (as the base effects drop off), supply-chain disruptions, depleted inventories, and backlogs of orders are

[2] Fidelity Investments

Global Economic Update Cont.

likely to keep inflation elevated in the near term (i.e., well above post-2008 levels). As of late October, Goldman Sachs estimated over $24 billion worth of goods were sitting off the California coast. The ports of Los Angeles and Long Beach (which combined service 40% of all shipping containers arriving in the U.S.) are currently running 24/7 to clear the backlogs, nevertheless, we expect shipping delays to remain until after the U.S. holiday season and Chinese New Year. Once into the spring, U.S. import volumes may start to normalize given waning fiscal stimulus and a seasonal rotation back toward services consumption.

Fortunately, one key contributor to the backlogs and pricing pressures, the global shortage of semiconductor chips, should begin to improve. Factory production in Southeast Asia is set to restart in the fourth quarter of this year (as the delta wave subsides) and expanded production capacity is scheduled to go live in the second half of 2022.

Europe

The European economy in aggregate also continues to enjoy mid-cycle economic growth (trailing the U.S.), but the region is also plagued by supply shortages and soaring energy prices. As such, we do not expect any tapering decisions from the European Central Bank at this time. Instead, similar to the Fed earlier this year, they may opt to keep policy loose to mitigate any short-term headwinds to economic growth and maintain an eye on transitory inflation.

In combination with easy monetary policy, the continent continues to benefit from a fiscal tailwind. Peripheral countries in the south are receiving transfers from the European Union's Recovery Fund, and the story is similar in the core. Germany's next government (most likely an SPD-led coalition) is likely to increase social spending, a stark contrast from the more austere budgets of outgoing Chancellor Merkel. While share prices of German companies wavered on the uncertainty of tax and regulatory policy under a new SPD government, increased fiscal spending from the Union's largest economy may have significant economic ramifications across the continent.

China

Meanwhile, China continues to decelerate into a growth recession. After a strong recovery out of the pandemic, GDP growth continues at a relatively anemic pace, slowing to an annualized 4.9% in the third quarter (below consensus estimates). Regulatory tightening to contain leverage and financial risks, reduce property speculation, decarbonize the economy, and achieve other societal goals hindered growth across several sectors, as have sporadic lockdowns due to resurgence in COVID-19 cases. All industries, with the exception of agriculture, are currently growing at or below their respective growth trends. Despite the slowdown, policymakers appear unlikely to intervene to ease conditions unless growth were to deteriorate sharply ahead of February's Winter Olympics in Beijing or the 20th Party Congress next autumn.

"While share prices of German companies wavered on the uncertainty of tax and regulatory policy under a new SPD government, increased fiscal spending from the Union's largest economy may have significant economic ramifications across the continent."

Investment Strategy

"…high valuations do not presage a coming correction or bear market, but they do suggest more muted returns going forward. However, long-term investors also need to consider what their alternative is. With 10-year Treasury bonds yielding only 1.6%, equities (even at current valuations) still offer a significant return premium over bonds (see Appendix E)."

Equities

It is no secret that equity valuations are high when compared to historical averages – we have commented on this for several quarters. The price-to-earnings ratio of the S&P 500 Index at the end of October was 21.4X, more than one standard deviation above its long-term average (see Appendix D). If you remove the top ten holdings (which make up 30% of the index), that ratio declines, but only slightly to 19.7X.[3] Importantly, high valuations do not presage a coming correction or bear market, but they do suggest more muted returns going forward. However, long-term investors also need to consider what their alternative is. With 10-year Treasury bonds yielding only 1.6%, equities (even at current valuations) still offer a significant return premium over bonds (see Appendix E).

Within clients' equity portfolios, we continue to strike a balance between growth and value and seek to make sure they are well diversified and less beholden to momentum stocks that we believe are overvalued. Therefore, we continue to include allocations to mid- and small-caps, real estate, as well as non-U.S. developed and emerging market equities.

As we enter the final quarter of the year, we are keeping a watchful eye on the distributions of income and capital gains from mutual funds. Per the estimates we have received so far, we anticipate a higher-than-normal distribution rate from many actively managed equity funds. When investing new capital in the interim, we are (where appropriate) trying to keep tax-efficiency top of mind until distributions have been paid out. The proceeds received by year-end should also provide ample dry powder for regular portfolio rebalancing.

Fixed Income

In comparison to an equity market that is slightly overvalued, the broad fixed income market remains quite expensive. Yields are meager, prices are high, credit spreads are tight, and the risk of nominal interest rates rising outweighs the risk they continue to fall to the zero-bound, in our opinion. However, fixed income still plays an important role in diversified portfolios, especially for investors with lower risk tolerances or near-term liquidity needs. For those portfolios that require an allocation to fixed income, we continue to barbell portfolios between very short-term, high-quality bond funds and flexible credit managers that seek to maximize yield while maintaining a certain level of duration and default risk.

[3] JP Morgan

In Conclusion

Lingering aftereffects of the pandemic continue to leave their mark on the global economy. While we expect some of the shortages and transitory inflation pressures to ease in the coming months, the trajectory of fiscal and monetary policy in many countries remains in a state of flux. As the global economy continues to navigate mid-cycle growth amid policy uncertainty, we expect increased volatility in financial markets.

If there are any changes in your risk tolerance, liquidity needs, and/or investment goals, please let us know so that we may ensure your portfolio is invested appropriately for your unique financial situation. If you have any questions about financial markets or would like to discuss your portfolio in more detail, please do not hesitate to call us at +1 (301) 881-3727 or email us at client.services@sol-capital.com.

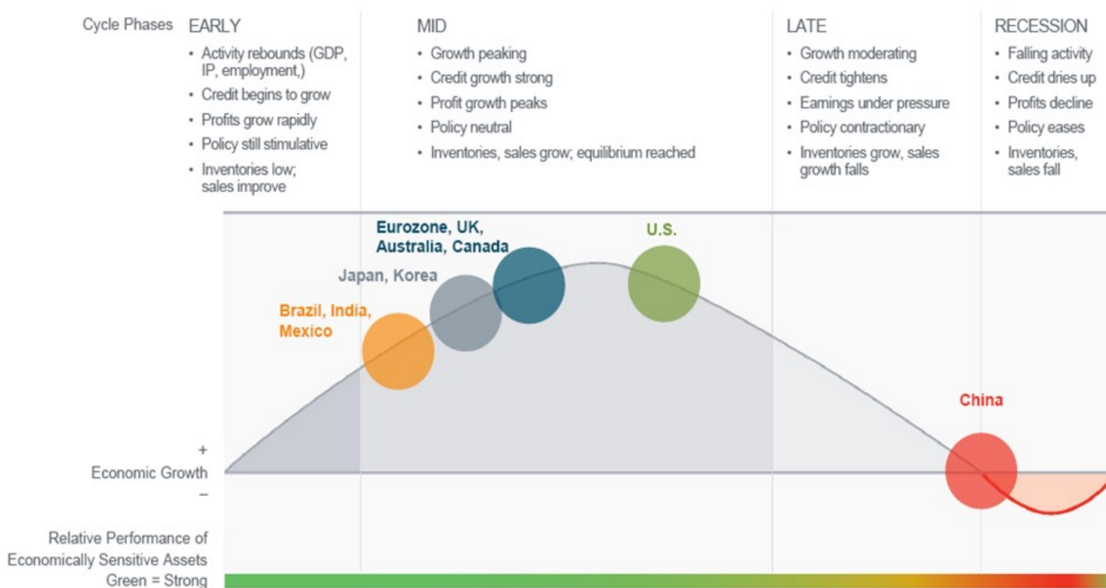
With our best regards,

SOL Capital Management Company

"If there are any changes in your risk tolerance, liquidity needs, and/or investment goals, please let us know so that we may ensure your portfolio is invested appropriately for your unique financial situation."

Appendices

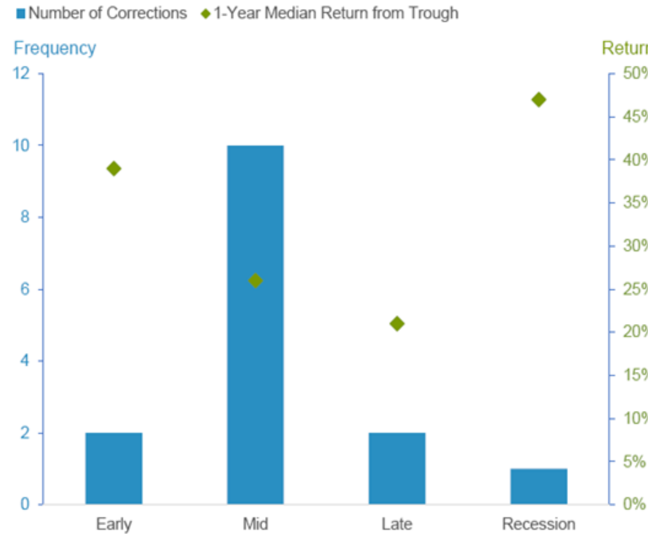
Appendix A: Business Cycle Framework



Source: Fidelity Investments. Data as of 30 September 2021.

Appendices

Appendix B: Stock Market Corrections Common in Mid Cycle

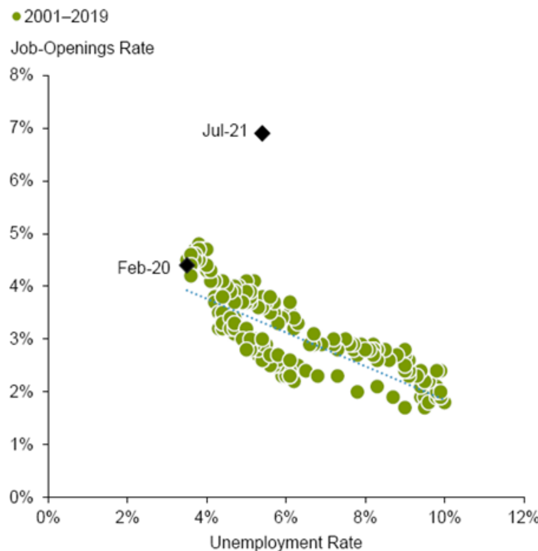


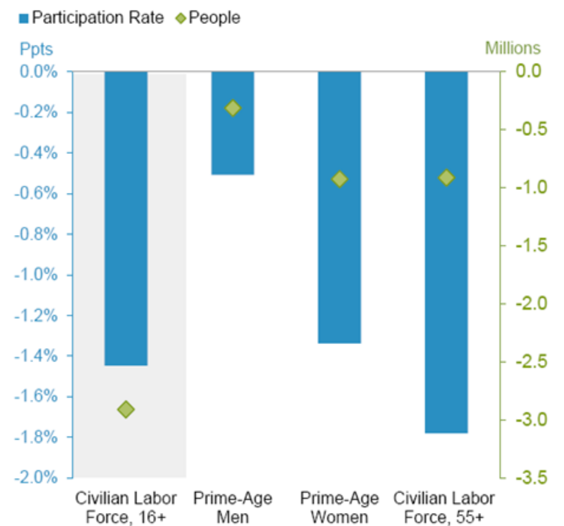
Mid-Cycle Corrections

Short, Frequent, and Opportunistic
Average duration 4 months peak to trough
Average 13% drawdown
67% of corrections during mid cycle
8 market corrections over last two mid cycles
26% median 1-year return from trough

Source: Fidelity Investments. Data as of 30 September 2021. A market correction is defined as a price decline of at least 10% from the market's most recent peak. Since 1950, the S&P 500 Index has experienced an average of 10 market corrections while the U.S. economy has been in middle stage of the business cycle. For the same time period, the median one-year return from the market bottom has been approximately 26%.

Appendix C: The U.S. Labor Market

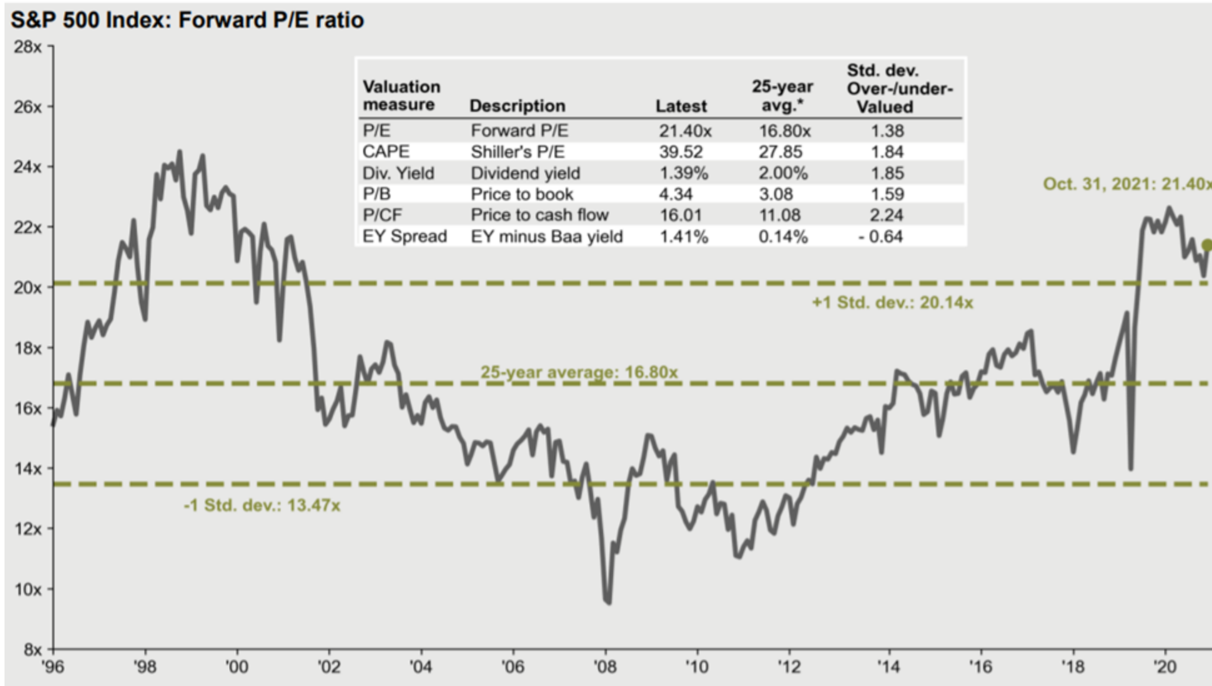




Source: Fidelity Investments. Data as of 31 July 2021 (LHS) and 31 August 2021 (RHS). The labor force participation rate is the sum of all employed workers and workers actively seeking employment, divided by the total civilian working population. For reference, the U.S. labor force participation rate in February 2020 was 63.3%, but in the 18 months that followed, the rate declined by more than 1.4 percentage points. Source: the U.S. Bureau of Labor Statistics.

Appendices Cont.

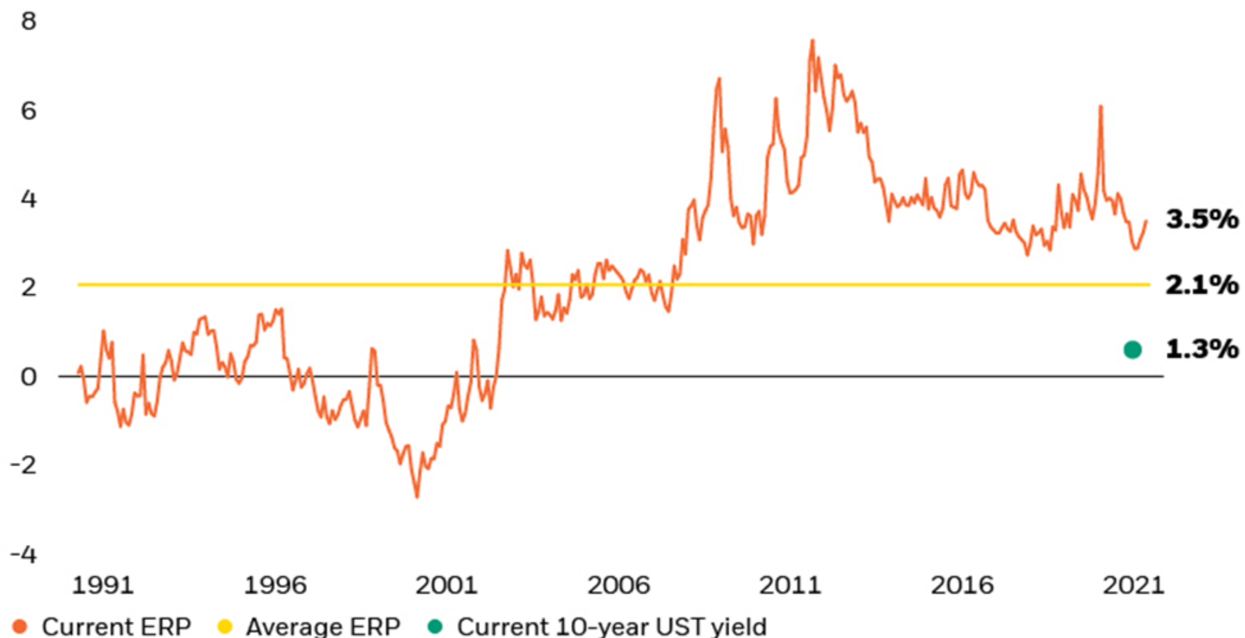
Appendix D: S&P 500 Valuation Measures



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.40x	16.80x	1.38
CAPE	Shiller's P/E	39.52	27.85	1.84
Div. Yield	Dividend yield	1.39%	2.00%	1.85
P/B	Price to book	4.34	3.08	1.59
P/CF	Price to cash flow	16.01	11.08	2.24
EY Spread	EY minus Baa yield	1.41%	0.14%	- 0.64

JPMorgan Asset Management. Data as of 31 October 2021.

Appendix E: S&P 500 Equity Risk Premium



Source: BlackRock. Equity risk premium (ERP) is calculated using the S&P 500 earnings yield and subtracting the 10-Year Treasury Constant Maturity Rate. Data as of 31 August 2021.

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Disclosures

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