COLORADO
FINANCIAL
MANAGEMENT®

Economic & Market Review

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Partner & Chief Investment Officer

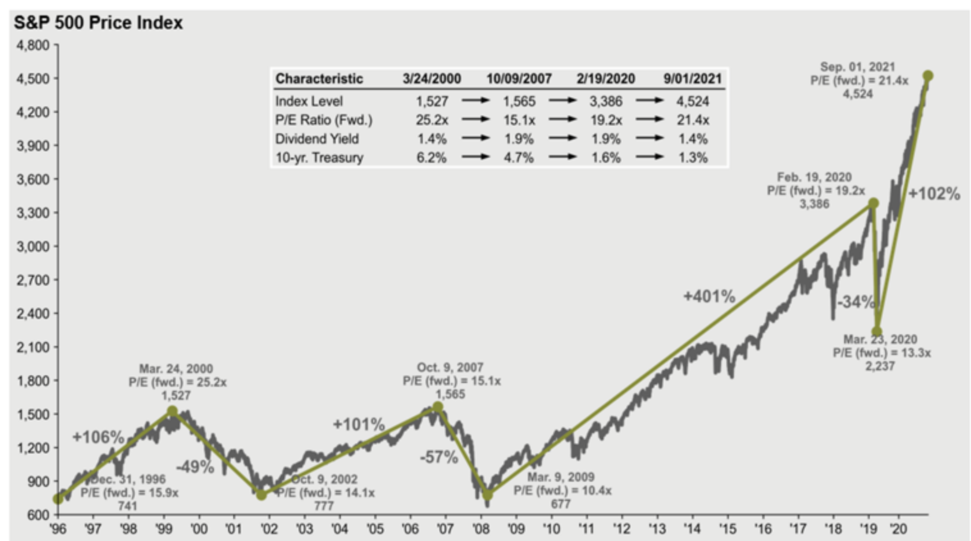
September 2021

As Of 08/31/2020	Year to Date	Last 12 Months	Last 5 Years (Annual)
60/40 Balanced World Index (VSMGX)	9.4%	18.0%	10.5%
World Equity Index (ACWI)	16.1%	30.1%	14.6%
U.S. Large Cap Equities (S&P 500)	21.2%	30.6%	17.0%
U.S. Small Cap Equities (Russell 2000)	15.8%	47.1%	16.5%
Foreign Equities (ACWI-ex U.S.)	9.4%	24.9%	11.1%
U.S. Bonds (AGG)	-0.7%	-0.08%	3.0%
Global Bond Index (BNDX)	-2.3%	0.52%	2.3%
Cash & Equivalents (VMFXX)	0.02%	0.06%	1.1%

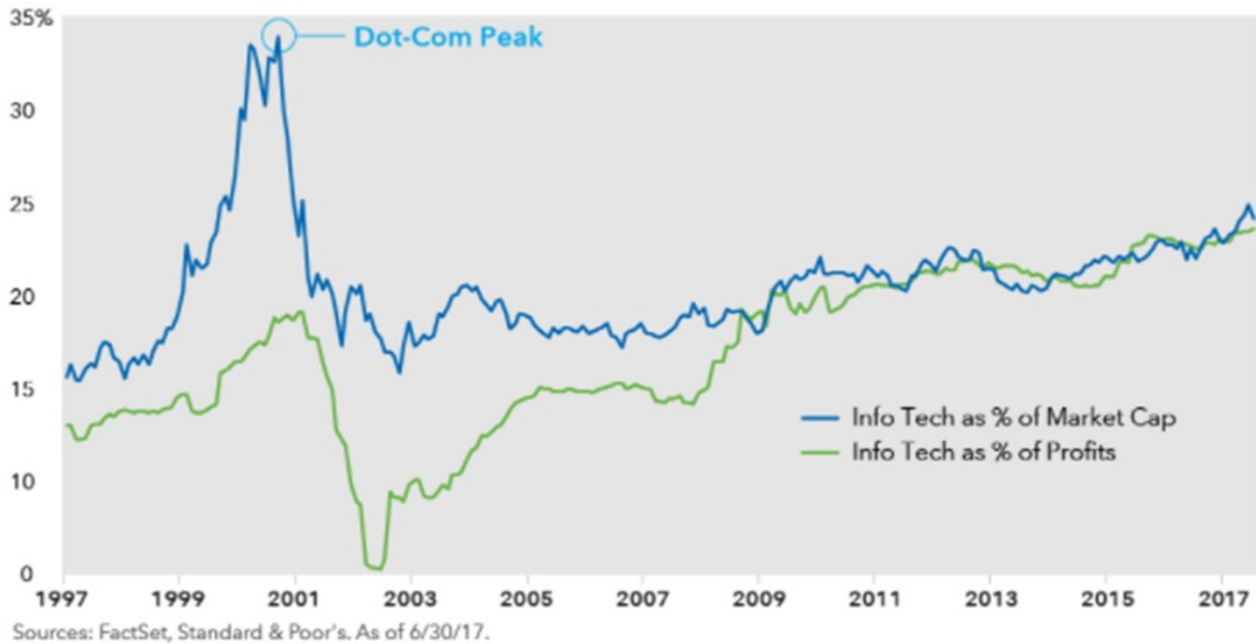
Dear Clients and Friends,

As the great Yogi Berra said, “It’s like déjà vu all over again”. What this period reminds me of, I am afraid to say, is the late 1990s. There are many, many differences; and I do not believe we are in a similar bubble. But the parallel I see is the expectation that returns will always be this high. A recent survey from Natixis found that wealthy Americans expect to earn 17% above inflation. Five years ago, that same survey had investors expecting 9%. During the 1980s and 1990s stocks had an average annual return of 18%. It should have been no surprise that after 20 years of high returns investors would expect them to continue, but what happened was much different. The decade of 2000 to 2010 was essentially flat.

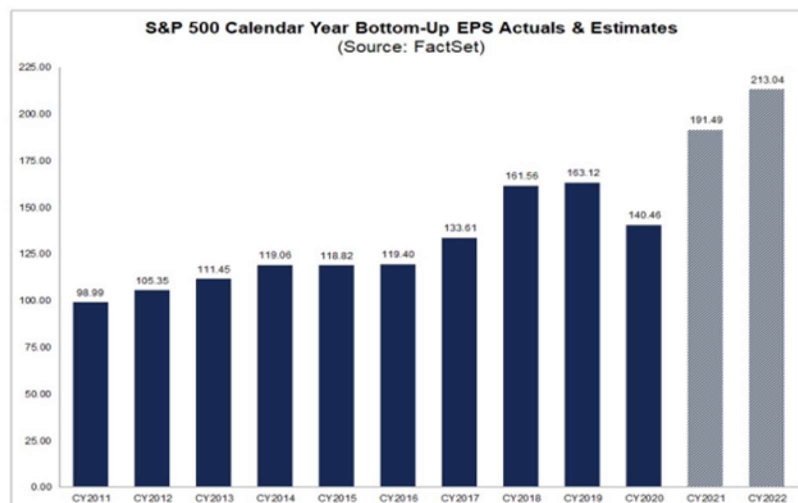
There are a number of differences between events today and prior years. As most people know, the stock market peaked in late 1999 / early 2000 in what is commonly referred to as the tech bubble. Valuation was very high with the S&P 500 trading at 25x forward earnings. Today, that forward P/E is 21x… high but not as high. The tech sector is where the real bubble was, with the P/E ratio at 62x earnings at the end of 1999, and many companies had no earnings.



Today, earnings are growing at about the same rate as tech stocks as shown in this chart:



But… (there is always a 'but') in addition to the tech bubble, the reason returns were so high in the 1980s and 1990s is that the P/E ratio began the period at around 8x and finished at 25x. Interest rates began at 15% and fell to 5%. Multiples are inversely related to interest rates. Falling rates means rising multiples and vice versa. What is the situation today? Nothing is impossible, but multiples are not likely to quadruple and go from 20 to 80. Interest rates could stay low for a long time, but they are already near zero. They are more likely to rise than fall.

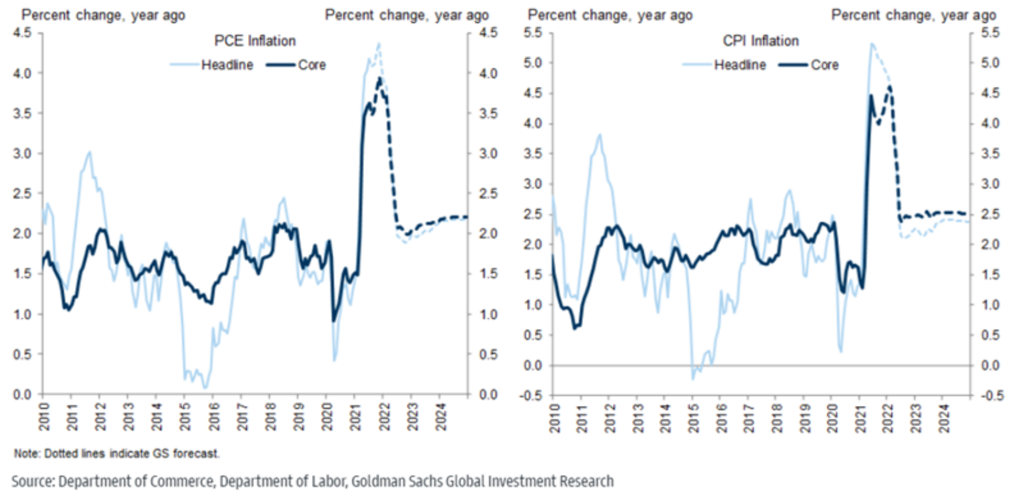


Expected EPS Growth for Calendar Year 2021 is 36%.

Expected EPS Growth for Calendar Year 2022 11%.

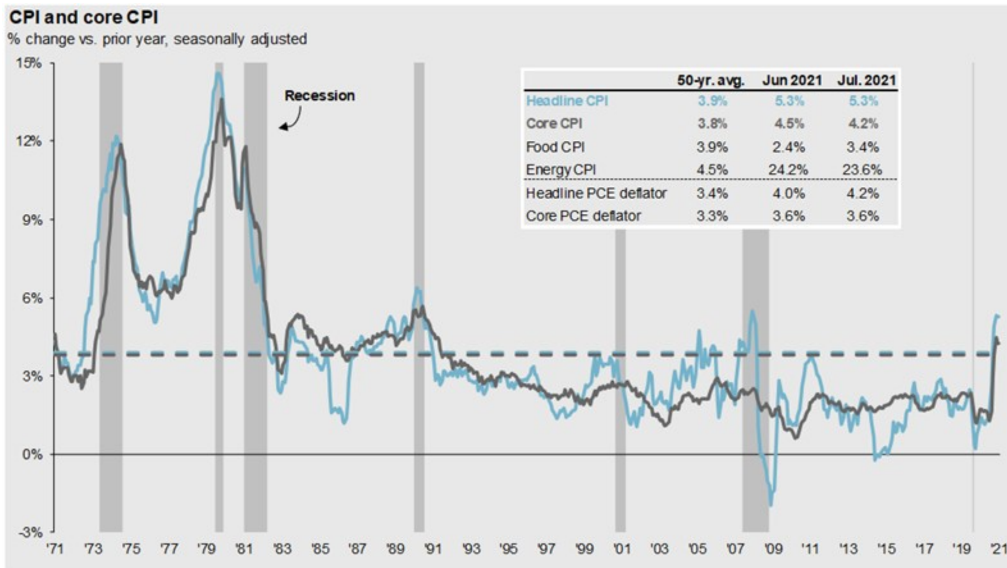
The late 1990s saw the creation of the internet; so there was this combination of falling inflation and interest rates, rising multiples, and exuberance about this new technology. The reality of the internet has probably been even greater than the hype, but it took longer than expected to achieve. We could be on the cusp of another leap forward in technology like in the 1990s. The creation of the COVID vaccines in such a short period of time, for example, could not have happened without the advancements in gene sequencing. Technology is changing our economy faster than we can comprehend, making companies more profitable than ever. Earnings are rising this year even more than expected, and next year should see another healthy increase. Longer term, we could have earnings growth at a sustainably better rate than in the past, but it's near impossible to imagine having the tailwind from rising multiples as in that previous period.

What about inflation? A sustained rise in inflation would appear to be the biggest risk to the economy. The latest inflation readings are in the 3% to 5% range, which is much higher than we have seen in a long time.



We fall into the camp that believes this is temporary. The economy went through an unprecedented process of shutting down and then re-opening. There are so many bottlenecks and supply issues that there are shortages of everything. It may take another year before things normalize.

However, there may be some generational shifts happening that lead to a higher level of inflation. For 40 years businesses have had the upper hand, but today they are having such a shortage of labor they are raising salaries and paying bonuses for new hires; and there just might be a difference between Baby Boomers and Millennials. Millennials expect more of a work / life balance. Could this change the dynamic between labor and businesses? Housing is another issue. It is in short supply for many reasons, and some are not temporary. A shortage of land is not a supply chain issue. It's a zoning and scarcity issue.

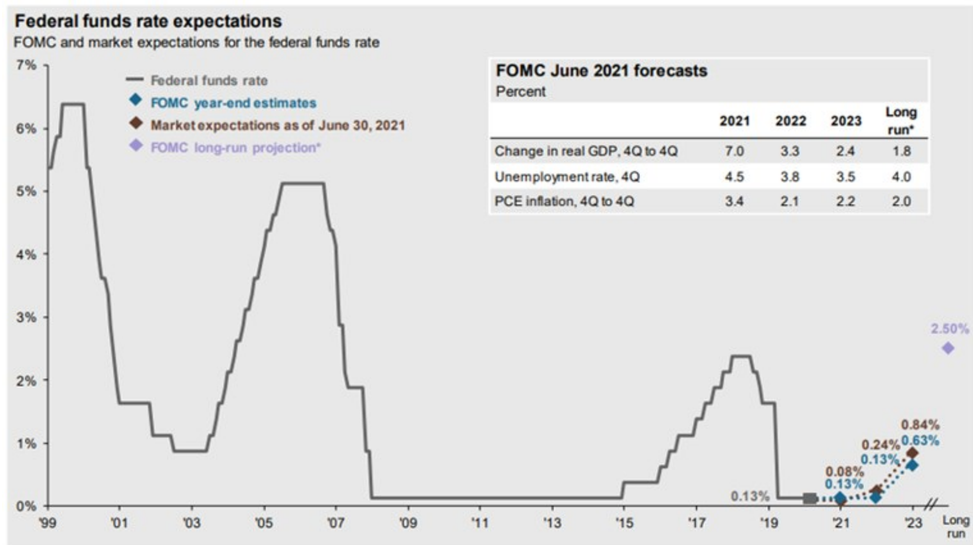


	50-yr. avg.	Jun 2021	Jul. 2021
Headline CPI	3.9%	5.3%	5.3%
Core CPI	3.8%	4.5%	4.2%
Food CPI	3.9%	2.4%	3.4%
Energy CPI	4.5%	24.2%	23.6%
Headline PCE deflator	3.4%	4.0%	4.2%
Core PCE deflator	3.3%	3.6%	3.6%

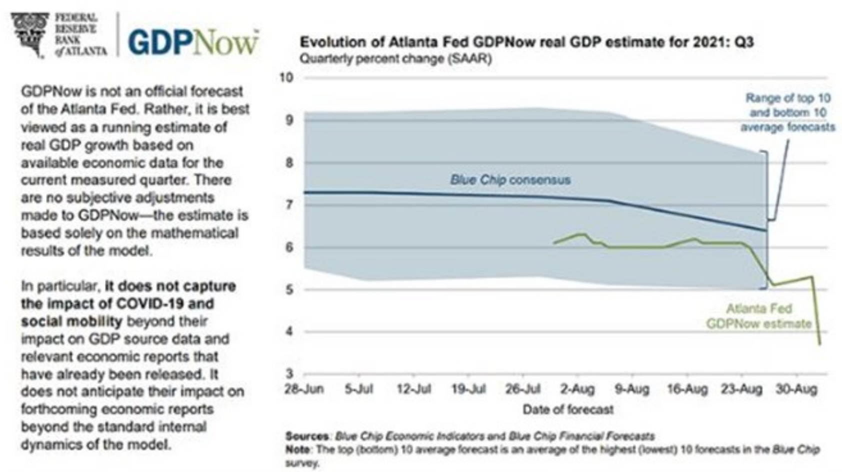
Still, it is a little early to call a long-term shift. Inflation has been below 3% for 30 years and if you look even further back, the 70s and 80s were the anomalies. I once attended a lecture by an economist (whose name I can't remember) who said something very simple, but to me it was profound. He said, "every period is built on the preceding period". The inflation we had in the 1970s and 1980s developed because of events preceding it and the circumstances of the time. It is unlikely to be repeated.

If inflation is only temporarily rising, then the Fed can keep rates low and be patient in raising them. That is what they expect and have signaled to the markets. Of course, the facts will dictate what

actually happens. Rising rates are often what ends an economic growth period and a bull market. We will keep watching but the Fed is probably a year or so away from beginning to raise rates.



We have covered three of our investment pillars: inflation and interest rates, earnings growth, and valuation. The most important factor driving these things is the economy. We believe there is little chance of a recession in the near future, but the rate of growth is slowing. Peak growth was probably in the 2nd quarter, or maybe in the present quarter. As we go forward, government stimulus wanes, and while job growth will continue, it will slow. The Delta strain of COVID may slow things a little but is not expected to result in anything like the shutdowns we saw before. All things considered, we expect a strong economy as we head toward winter and into the new year, but not as strong as the last 3 or 4 quarters.



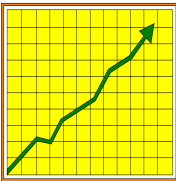
This brings us to our least favorite and the least important economic factor, the geopolitical situation. While Afghanistan was front page news for a few weeks, and we are saddened by the loss of our soldiers and Afghan citizens, its impact on the global economy is very limited. The hurricane that hit Louisiana has a much bigger impact on the economy. The Port of South Louisiana stretches for 54 miles along the Mississippi River and is the largest tonnage port district in the western hemisphere. Fortunately, the ports have re-opened after Ida but many of the oil refineries have not. There will probably be some ripples through the energy markets until everything gets back online, and hurricanes and fires are not over.

The partisan divide in our country is not improving much, and while it is disheartening it doesn't have much affect on the economy or investing. The infrastructure bill that was passed by the Senate is generally considered to be a good bill. Whether that gets passed in the House, and whether there is another, larger bill attached to it is an open question. The analysts we follow believe both will get passed later this year, but much watered down from the $3.5 trillion proposed. From a personal financial planning perspective, an increase in income tax rates and / or capital gains rates are the most impactful. Again, analysts we follow expect much smaller increases than proposed. There is also a chance corporate tax rates will rise, which would affect expected earnings. None of these changes are market friendly in the near term. We are not concerned enough yet, and there is not enough information to make any changes to our investment strategy, but it bears watching closely.

Finally, regarding market trends and sentiment, we call this the Eveready Bunny market. It just keeps going and going. We haven't seen a meaningful correction since last November. When everything is quiet, and everyone is complacent, that is often when something happens. So be prepared, but don't lose your head. As we have discussed, the fundamentals are sound so any correction should be temporary and not too deep. We'll let you know if the facts change.

Have a great autumn! As always, thank you for your continued confidence.

Happy returns,



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Index Definitions & Disclosures:

Standard and Poor's Index

- **S&P 500:** The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available US market capitalization.
- **60/40 Global Balanced Growth Index:** The index is rebalanced in March and October and is comprised exclusively of exchange-traded funds (ETFs) from a list of eligible ETFS. The determination of the weights of the instruments representing the various asset classes is done based on a review of the relative market capitalization of certain benchmark indices as of the rebalancing reference date. For equities, 60% of the index is comprised of any or all of the following ETFs: iShares Core S&P 500 ETF, iShares Core S&P Mid-Cap ETF, iShares Core S&P Small-Cap ETF, iShares Core MSCI Intl Developed Markets ETF, iShares Core MSCI Emerging Markets ETF. For Fixed income, 40% is comprised of any or all of the following ETFs:iShares Core Total USD Bond Market ETF and iShares Core International Aggregate Bond ETF.

Morgan Stanley Capital International (MSCI)

- **MSCI All Country World Index:** The MSCI ACWI Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets. As of September 2018, it covers more than 2,700 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is often used as a benchmark for global equity portfolios. Investments in international and emerging markets include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.
- **MSCI All Country World Index Ex US:** The All Country World Index Ex-U.S. (MSCI ACWI Ex-U.S.) is a market-capitalization-weighted. It is designed to provide a broad measure of stock performance throughout the world, apart from U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments.

Bloomberg Barclays Indices

- **Bloomberg Barclays Global-Aggregate Total Return Index (Hedged):** The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- **Bloomberg Barclays U.S. Aggregate Bond Index:** The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).
- **Barclays Capital 1-3 Month U.S. Treasury Bill Index:** The Barclays Capital 1-3 Month US Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and nonconvertible.

Other Indices

- **Russell 2000® Index:** The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set
- **Vanguard Federal Money Market Fund** invests at least 99.5% of its total assets in cash, government securities, and/or repurchase agreements that are collateralized solely by government securities or cash (collectively, government securities). As government agency securities, the fund's holdings have very high credit quality, although most are not backed by the full faith and credit of the U.S. government. The average maturity typically ranges from 30–60 days, and the fund maintains a dollar-weighted average maturity of 60 days or less, and a dollar-weighted average life of 120 days or less.
- **Vanguard Total World Bond ETF** seeks to track the performance of a broad, market-weighted index that measures the investment return of investment-grade U.S. bonds and investment-grade non-U.S. dollar-denominated bonds.

Performance Calculation Disclosures: a) Time weighted returns are used; b) Cash and equivalents are included in the balanced composite, but not in the equity or fixed income composite; c) Gross figures do not reflect the deduction of investment advisory fees for all clients. Therefore the return would be reduced by the advisory fees in some cases. d) Returns are not GIPS compliant; e) Total return includes the reinvestment of dividends and capital gains.

Past performance is not to be construed as a guarantee of future performance. Returns are presented for the period shown and may differ for future time periods. Composite is a broad reflection of performance. Prospective clients should recognize that each client's account is customized and performance can vary widely.

References to specific investments should not be construed as a recommendation by Colorado Financial Management to buy or sell securities.

Past performance is not an indication of future results, and as is the case with all investment advisors that concentrate on equity investments, future performance may result in a loss. Portfolio holdings and weightings are subject to change at any time due to ongoing portfolio management. Portfolio returns given are after trading costs but not after fees. Returns do not reflect the holding of cash in the account, if any. This report is for informational purposes only.

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