STRATEGIC OUTLOOK

Strategic Frontier Management

Q1 2021

Everybody, Look What's Going Down

- Roaring 2020s was a catchy US investing theme a year ago, but 2020 proved to be a challenging year for investors. Volatility proved costly to those that let fear and emotion overwhelm portfolio decision making, if not heartbreaking for others that missed out on recovery, much like in 2009/GFC. Wild swings in equities and interest rates again provided tactical opportunities, while reinforcing the importance of strategy discipline and rebalancing in the face of global economic uncertainty and geopolitical turmoil.

- Transitional economic recession resulted from *artificial and self-imposed lockdowns, rather than financial or economic imbalances, thus t*he GFC playbook (new normal, fiscal and monetary stimulus) was ill-conceived. Government decisions to shut-down *non-essential* businesses and other activities, including education, travel, entertainment, services, and socializing caused a steep short-lived recession.

- Economic growth accelerated in 2H/2020, but 2020 growth was still just modestly negative (-2.4%). Pent-up consumption demand and earnings growth should to continue to rebound as the output gap has closed quickly. Economic and financial market rebound followed rapid development of multiple vaccines and therapies coinciding with learned smarter approaches to slow infection.

- *US Monetary Normalization* of hiking interest rates and reducing central bank holdings was a theme we identified in 2015, and observed steady progress from mid-2016 until economic wreckage in the wake of the global pandemic. Central banks believed they must support financial markets, but emergency stimulus ceased to be needed last Fall. Central Banks should end *explicit moral hazard* of bond market manipulation by maintaining negative real interest rates, quantitative easing, and forward guidance. Excessive fiscal and monetary stimulus can drive inflation expectations that are more difficult to contain.

- If infrastructure goes forward, alternative funding paths are likely that few seem to appreciate yet. The US government has amassed non-strategic land, property, buildings and other assets that can be privatized or sold to fund project development. Asset owners' hunger to invest in infrastructure, and Public-Private Partnerships provide better outcomes with alignment for commercially competitive returns. There are much better ways to achieve infrastructure development goals at 1/10th the cost without massive government spending costing trillions that we can't afford after more than $5 trillion in pandemic stimulus.

- We are not embarking on a new business or market cycle, rather observe an interrupted and still extended cycle given a transitional artificial recession due to economic wreckage of lockdowns. Talk of shifting toward an investment playbook consistent with early cycle recovery is misguided. Instead, later cycle behavior of higher inflation, lower growth, and declining profit margins might be aggravated by adverse fiscal, regulatory, energy, and trade policies.

- The extended cycle overlapping with disinflationary forces of the *Fourth Industrial Revolution* raised little concern about inflation, but maturing forces will give way to higher labor, food, energy, and housing costs that drove inflation before 2020. We expect CPI inflation will pick up where it left off trending toward 2.5-3.0%. Stronger growth drives higher inflation and interest rates. Emergency monetary stimulus is no longer needed and reinforces inflation expectations.

- Global equity valuations are less compelling as equity indices recovered ahead of earnings, causing an inflection point in our equity forecasts. Earnings yields will deteriorate further if bond yields increase, as we expect. We observe the first inflection point of weakness of our global tactical equity and US dollar forecasts in nearly two decades. Pension funds and retirement savings will suffer if equities and bonds lag inflation due to deteriorating economic conditions.

- Our updated strategic allocation forecasts reflect similar valuation, inflation, and interest rate concerns of our tactical forecasts. Global bond markets remain stretched with marginal or negative real yields. Its time to L*ook What's Going Down* regarding whether new policies can support potential growth and profit margins to deliver sufficient earnings growth beyond recovery. Manipulated interest rates for an extended period increase explicit moral hazard of extended market manipulation. Cash or short-term and floating rate bonds are better cheap *alternative investments*.

Brighter Side of Life—A Year Later

Our title this quarter comes from Buffalo Springfield's classic song written by Stephen Stills, *For What Its Worth*, calling for peace inspired in the wake of the 1966 Sunset Strip riots. There are many political and social challenges ahead in 2021. Investors need to stop and *look [around at] what's going down* with economic uncertainty and potential for adverse policy reform with a progressive agenda regarding energy, regulatory, and tax policies that will likely boost inflation, reduce potential growth, and compromise national security (inc., defense, terrorism, immigration, reset of NATO & UN, Israeli-Arab peace progress), while targeting *outcome equality* and *equity* at the expense of *equal opportunity*. At risk is enhanced global competitive advantages secured in new trade agreements rooted in *bilateralism*, while de-emphasizing *multilateralism* and *globalist agendas*.

Last year was not the kind of year we anticipated. We expected 2020 S&P 500 earnings growth to exceed 8.3%, supporting an equity return of at least 8% (S&P500: 3450) with continued normalization of US interest rates and higher Treasury yields. After the global pandemic took hold, everything changed. Lockdowns caused a rapid decline in economic activity, and was implemented without much evaluation of the consequences of social distanced isolation. We expected the precipitous economic decline to reverse quickly once lockdowns were relaxed given the *transitional* nature of this health crisis. Economic recovery was remarkable once lockdowns moderated—unemployment plunged as retail sales, business activity, and construction rebounded in just a few months, not years as observed in 2009-2011. The turning point in this transitional recession coincided with a smarter approach to lockdowns with progress on development of vaccines and therapies effective against the coronavirus, which boosted business and consumer sentiment.

Global equities experienced a volatile ride, while US bond yields plunged well below 1% by April and central banks cut rates. The S&P 500 tumbled 35% through March 23rd, reversing just days after our March 16th publication of: *Fear Itself of Geoeconomic Panic*. With a remarkable recovery in the US economy, equity indices soared beyond our capital market return expectations by year-end, rising to 3756 for a remarkable 18.4% return. Valuations are now more stretched than before the pandemic as equity indices soared to new highs despite a -13% earnings decline during 2020. Even if earnings grow 25% in 2021, it will only narrow overvaluation somewhat. On the other hand, bond yields remained low after the Federal Reserve cut rates, restarted bond purchases, and said they expected to keep interest rates low for the foreseeable future. The BBG Aggregate Bonds returned just 0.7% in 2020, thus not much more than less risky short-term bonds or even cash.

The S&P500 equity index rebounded from March lows, and even exceeded our 2020 target, but we observed decoupling of equity and bond markets with US 10yr Treasury yields closing below 1% (*Equities Are From Mars, Bonds From Venus*, 1Q 2020). Real interest rates are still negative across the US yield curve, as Treasuries were unresponsive to normalizing growth and inflation. The Federal Reserve continues to purchase bonds, maintain near 0% interest rates, and manipulate forward guidance continuing emergency monetary stimulus for the foreseeable future. Eventually investors will demand higher bond yields to compensate for interest rate risk, if not a credit concern about spiraling the US debt burden. We think global bond returns will struggle to earn a positive real return over the next 5 years do to extended central bank market manipulation. Rising interest rates will limit equity returns with such stretched valuations. This can be devastating for retirement savings, pension funds, and other asset owners depending on a positive real return objective.

The global economic recession was unlike any other in terms of its precipitous decline over just three months, and just as spontaneous recovery beginning by June. No country avoided the economic or humanitarian impact of COVID-19. Lockdowns of nonessential businesses and activities strangled a thriving US economy, which caused a recession unlike any other due to self-inflicted transitory effects of quarantine through social distancing. Lockdowns initially made sense given uncertainty about the virus, but eventually we learned a lot about differences in who is most susceptible, and how differing government strategies affected infection rates and mortality. Without consensus among experts, politicians struggled to make reliable and effective policy decisions that balanced needs of all interests. We better appreciate economic, welfare, and social consequences of extended physical distancing.

A key issue for investors is to consider, as we said last March: "*This threat is not a financial crisis, but a health security crisis unlike any other crises—investor panic has been unprecedented given equity volatility, despite inevitable transitory economic consequences.*" Typical economic recessions depend on various economic factors, trends, or imbalances that were not reversed. Restarting a new cyclical clock may offer comfort to some, but 2020 wasn't a classic recession of natural causes that tends to clear out imbalances. The cyclical snapback is welcome, but we believe this period is still a *late-stage economic cycle* with many imbalances and increased inflation risk. Manipulated interest rates and super-sized fiscal stimulus precluded a new business cycle, resulting in an interrupted and still extended cycle. Talk of transitioning to an investment strategy playbook consistent with early cycle recoveries is misguided. Our concern focuses instead on the adverse economic and financial consequences of a US policy pivot underway.

The most important contribution to global society may have hinged on accelerating development of vaccines and therapeutics with just $11 billion from discretionary funding in the CARES Act for *Operation Warp Speed,* modeled after various war-time research programs. The Administration directed accelerating research and development of at least 7 promising COVID-19 vaccines and various curative therapies in private-public partnerships, then allowed emergency FDA approvals within 6-8 months, rather than typically 10 years presumed by experts last Spring. Rapid distribution of vaccines was the most effective way to eradicate the virus, particularly for those most at mortal risk. Successfully marshalling the biotech industry was a marvelous contribution to global society that will snuff out the virus and restored confidence sooner to safely re-open economic activity, increase travel, and boost trade.

Excessive fiscal stimulus, including unnecessary and ill-considered stimulus of another $1.9 trillion on top of the $900 billion fillip passed before year-end and $2.2 trillion CARES Act imperils fiscal options for future crises. In total, over $5 trillion dollars in stimulus spending is a mind-blowing 6X greater than $850 billion appropriated for the 2009 GFC stimulus. Government entitlements have replaced earmarks to curry political favor, but drove soaring government debt into the abyss exceeding 100% of US GDP. Clinton Treasury Secretary Larry Summers thinks the US will pay the price of the "least responsible" or imprudent macroeconomic policy in 40 years. The bill soon comes due in the next budget cycle with an ever-narrowing share of the discretionary budget, which should trigger need for federal spending and entitlement reforms with greater oversight targeting waste, fraud and abuse of all programs, including stimulus programs.

Elections have policy consequences, but legislative and regulatory changes tend to be slow and take awhile to be economically impactful. America cherishes fair play and equal opportunity, particularly with regard to voting rights, free speech, and democracy. However, political peril can result from a calculated power grab viewed unfavorably by voters, including ushering in new rules (filibuster), granting Washington DC statehood (skew number of senators), attempting to unseat a duly elected Congresswoman (IA-2), or legislating anti-democratic voting rules, such as H.R.-1: *For the People Act*[1]. The partisan effort to rewrite the rules of our political system includes a long agenda of liberal activist dreams. Such actions could backfire by being so offensive as to trigger a midterm 2022 Red Sweep. The progressive majority may regret unilaterally suspending the filibuster or imposing partisan rule changes with majority control at risk in 2 years given a narrowly divided Congress.

Economic Outlook

Unlike disorderly natural causes of typical recessions and financial crises, the recessionary forces caused by pandemic lockdowns were *transitional*. Once relaxed, a rapid "V-shaped" equity market rebound anticipated economic recovery that took many by surprise. US large-cap growth companies led the way, but still low Treasury yields have not responded to economic recovery or rising inflation. Company earnings plunged with decreased sales and increased operating costs, but recovery that began with large-growth stocks now drives small-cap.

As a matter of public policy, arbitrarily deemed *essential businesses* generally retained or increased revenue levels under lockdown orders, while some businesses found new lucrative niches. Broad-based draconian lockdowns failed to extinguish the virus, yet had crippling side effects for society, mental health, wellness, and the economy. We are only beginning to appreciate the humanitarian toll on society of greater depression, anxiety, addiction, isolation, and disruption. A set-back in K-12 public education of a lost year or more will never be overcome, undermining equal opportunity. Overcoming the pandemic required balancing health, economic and societal trade-offs. Solutions that minimized health risks had undesirable economic, social, welfare, and mental health consequences. Decisions to minimize economic risks had adverse consequences in other ways.

Over 118 million people have been infected, tragically resulting in more than 2.5 million deaths globally. At least 29 million or 8.8% of Americans were infected with a mortality rate of about 1.8%. Combined with accelerating vaccination rates (17.5% overall, >50% over 65), infection rates, hospitalizations, and deaths have plunged from the latest peak in January. Yet, China with 1.4 billion people reports just 132,000 infections and 4,849 deaths, or less than half that observed in smaller neighboring Nepal, but how is this possible in the country of origin, which failed to quarantine itself? Skepticism of Chinese government data is not surprising, but without investigative access, the source and how the virus was released worldwide is still not known. The US limited virus exposure by restricting travel from China of non-US citizens on January 31, 2020, despite political opposition and global criticism—other countries followed suit.

Society's challenge how best to manage this crisis may be an irreconcilable dilemma. Disagreement among health experts about how best to manage this health crisis raised complex ethics issues about balancing the greater good. In a federal republic, US states adapt locally to provide an incubator of different approaches.

[1] HR-1 unconstitutionally eviscerates state voting laws, provides federal matching political contributions, undermines voting integrity, and undermines democracy.

Analyzing alternative strategies, there appears no statistical relationship to different lockdown rules.

The moral challenge for political leaders is that there wasn't universal agreement among experts about how to balance health objectives to limit infection rates and mortality *versus* economic and wellness consequences of lockdowns. Unintended consequences of prolonged social isolation were never weighed against consequences of soaring addiction, abuse, anxiety, suicide, depression, social unrest, idleness, and crime. Economic impact of job loss, furloughs, loss of benefits, failing business, decline in retirement savings, human capital, continuing education, and property loss, etc. were greater than ever imagined. Deferred medical tests, health maintenance, or even loss of health benefits had debilitating injurious consequences.

We learned a great deal about ways to slow the spread of infection and treat the disease effectively. The observed COVID-19 fatality rate was much lower than expected overall, although it rises exponentially for older individuals. A unique challenge of tracking this virus is that 80% of infected people are asymptomatic or have mild indistinguishable common flu-like symptoms. We know that older age and compromised health, raspatory, or immune deficiency are risk factors for higher mortality and worse symptoms, while those below 40 years old are often asymptomatic. We avoided rationing of care and hospitals were never overwhelmed, nor experienced shortages of life-saving equipment, including ventilators. We also discovered significant dependency on foreign sources for critical pharmaceutical ingredients and other strategic necessities. Agencies seek to minimize risk of foreign reliance on strategic goods and services.

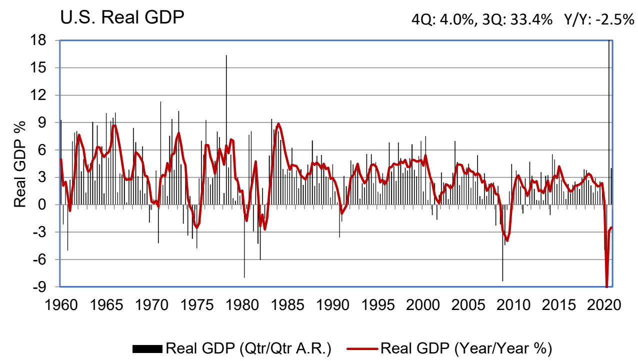
There was no optimal national response to eradicate this infectious virus quickly with so many unknowns, much like *Star Trek's Kobayashi Maru* leadership challenge of a no-win scenario. The next pandemic probably won't be as benign, nor as discriminating being able to identify those most at mortal risk, but we've learned a lot about how to manage future epidemics and developed various effective vaccines and therapeutics, which will be useful fighting future coronaviruses and inevitable pandemics.

We raised our US potential growth estimate in 2018 to 2.7% based on constructive tax, trade, regulatory, and energy policy reforms. Increased investment (inc. research and development), higher profit margins, and global competitiveness were a logical consequence of sweeping tax reform, including repatriation of foreign income that remained offshore for decades. Our concern is that anticipated adverse US policy changes stall the recovery at a lower level of potential growth closer to 2%, undermining earnings growth and increasing inflation.

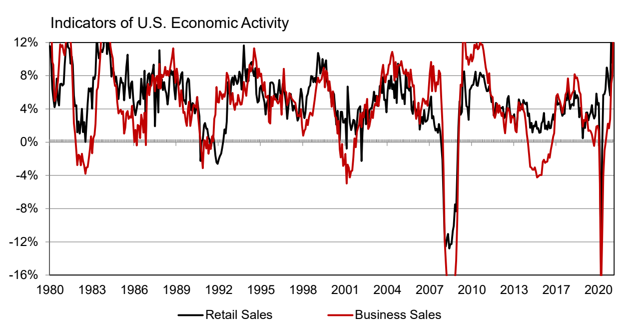
Economic Forecasts	**2018**	**2019**	**2020e**	**2021e**	**2022e**	**2023e**
GDP Growth (Y/Y Real)	3.0	**2.4**	**-2.5**	**4.0**	**3.0**	**2.5**
S&P500 Earnings Gr.	22.7	**0.6**	**-13.1**	**24.2**	**11.4**	**7.0**
CPI Inflation (Y/Y)	1.9	**2.3**	**1.5**	**2.5**	**3.0**	**3.3**
Unemployment	3.9	**3.5**	**6.5**	**5.5**	**5.0**	**5.5**
Fiscal Deficit (vs.GDP%)	-4.2	**-4.7**	**-15.0**	**-9.0**	**-7.0**	**-7.0**
Fed Funds Target[1]	2.50	**1.75**	**0.25**	**0.75**	**1.75**	**2.75**
10y Treasury Notes	2.69	**1.92**	**0.91**	**1.80**	**2.75**	**3.50**
S&P 500 Target	2507	**3231**	**3756**	**3950**	**4150**	**4350**

Source: Strategic Frontier Management

Our US economic and earnings growth forecasts seem encouraging, consistent with recovery from the transitional recession of the global pandemic. We observed a *Whiplash,* but no double-dip most strategists expected despite second (Fall 2020) and third (Dec-Jan) spikes in inflections. The key to dampening the amplitude of inflection spikes is to continue vaccinating those willing beginning with individuals most at risk, health care workers, and first responders.



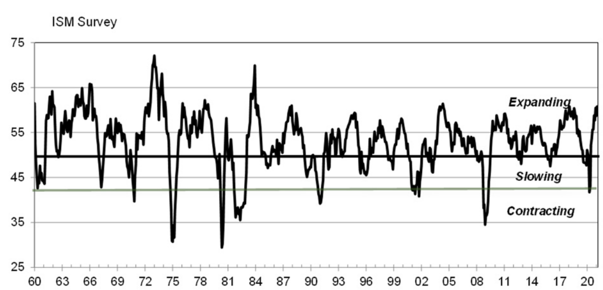
Given a continuing economic and financial market recovery, neither additional monetary nor fiscal stimulus is needed. Change in retail sales over the last year increased 8.2%. A strong 2H/2020 closed the yawning output gap with real GDP of -2.5% in 2020. Economic acceleration and plunging unemployment diminish any notion that the economy could have been managed better, particularly relative to conditions in Europe, Japan, and elsewhere.



Source: Refinitiv DataStream & Strategic Frontier Management

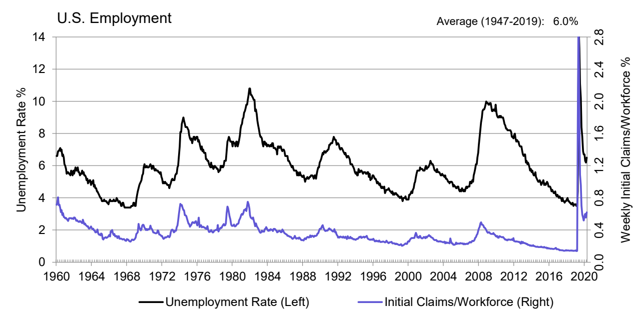
Monetary policy has failed for a decade to compensate for poor policy decisions and deteriorating demographics that limited global growth. So, government bond markets remain overvalued as a result of central banks' manipulation across the yield curve with QE and forward guidance for an extended period. Persistent emergency monetary policy only reinforces explicit moral hazard for households, businesses, and investors with increasing financial imbalances. Overreliance on unconventional monetary policy stimulus leaves little room to address future crises. Eventually the Federal Reserve balance sheet must decline toward $2 trillion, but this likely will cause liquidity issues with sustained negative money supply growth required to normalize the balance sheet. Now is the time to let refunding of maturing bonds naturally reduce the Federal Reserve's balance sheet.

The ISM Survey is one of the best leading indicators for the US economy, and suggests recovery should extend beyond 6-12 months. A recovery in business sentiment began last June. Economic volatility is artificially induced and transitory, therefore should be short-lived. This economic indicator suggests little need for further monetary or fiscal stimulus, so. And it is not surprising that US equity market sentiment has shifted to fully anticipating recovery and then some. Wall Street strategist sentiment has swung from near universally bearish to bullish in a year with a strong economic recovery followed by earnings rebound, but we are more cautious now and believe equity markets are likely overshooting, particularly as interest rates rise.



Source: Institute for Supply Management (ISM)

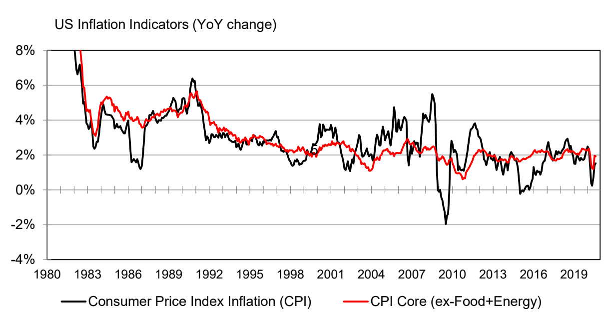
The unemployment rate jumped from 3.5% in February 2020 to 14.8% by the end of last April, near the trough of the recession. As states re-opened to varying degrees, business activities rebounded and unemployment has plunged to just 6.2% by February 2021—quite a round-trip in just a year, despite an unusual seasonal drag on payrolls with delay in public school opening and still furloughed nonessential government workers. Compare this job recovery to the four years required during the Obama-Biden Administration to drive unemployment below 8%. The current US unemployment rate of 6.2% is just above the 70-year average unemployment rate of 6.0%. This is a more appropriate basis for judging full employment, rather than the tight labor market of 2019 to justify further monetary and fiscal stimulus. Unemployment claims have fallen to 4.6million after peaking over 23 million. Typically, 2 million people are transitionally unemployed, similarly to December 2019, despite a low 3.3% unemployment rate. It is noteworthy that US employment increased 6.1 million between Dec. 2016 and December 2019.



Source: Refinitiv DataStream & Strategic Frontier Management

We expect sequentially positive quarters for the foreseeable future without much risk of a double-dip recession. Monthly economic indicators like industrial production, retail sales, consumer confidence, housing and the unemployment rate all traced the *V-shaped* decline and recovery of US economic activity. Equity markets correctly anticipated these trends, but bond markets remain disconnected, following forward guidance and decoupling from inflation dependency. This can't be sustained for an extended period, and extended bond investors are forewarned in this regard.

CPI inflation should continue to rise toward at least 2.5%, with core CPI (ex-food, energy) already increasing 1.7% over the last year. Listening to the Fed, you might assume extended deflation has overcome the economy. Yet, fundamental forces still underpin inflation, including housing, wage growth, utilities, food, and now increasing demand for basic resources and energy. Fuel consumption is increasing with traffic, as companies call back employees. Travel picked up with unbelievable low fares and hotel room rates. The economic recovery is under way now, so our focus shifts to how quickly can we recover, and minimize permanent losses.

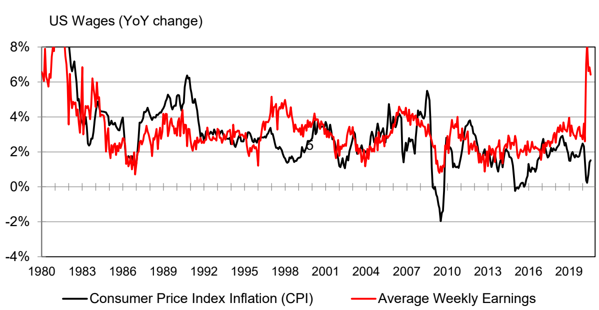


Source: Refinitiv DataStream & Strategic Frontier Management

We believe disinflation is not secular, but symptomatic of the now maturing *Fourth Industrial Revolution*, driving creative destruction of technology innovation and other consequences of reduced labor, basic material, and energy intensity. Over the last 20 years or so, we have grown accustom to disinflation or lower than average inflation. Persistent easy monetary policy since 2008 hasn't triggered the kind of inflation most economists expected, but attribution can be complex.

Disinflation extended because rising aggregate demand for labor, materials, and energy never really exceeded the increase in economic growth, between efficiency gains and offshoring manufacturing of an increasingly service oriented economy. Thus, naive central banks and legislators will pay a price for inducing explicit moral hazard when rates rise sooner than expected. The maturing *Fourth Industrial Revolution* will cause further moderation of disinflationary tailwinds since 2005, as our *Future Themes suggest*. Too many seem to mistake lower for longer cyclical inflation as a *new regime*.

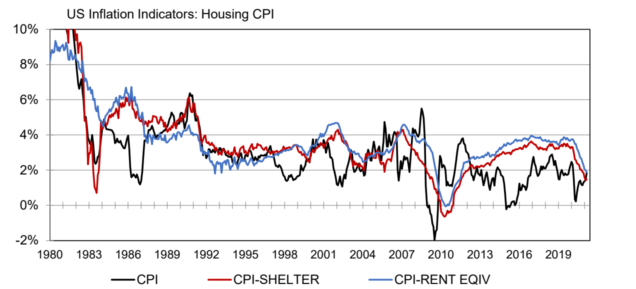
Consumer inflation is always a function of changing wages, basic resource prices, housing cost, and taxes, as well as money growth, fostering available credit. Today at least three of these key forces driving inflation are in play. However, this was the first recession that household income *increased* during recession (compare 2008-09) given government stimulus checks plus unemployment insurance benefits, which replaced up to or more than 100% of wages for many. Logically, there is always a high correlation between CPI inflation and changes in wages.



Source: Refinitiv DataStream & Strategic Frontier Management

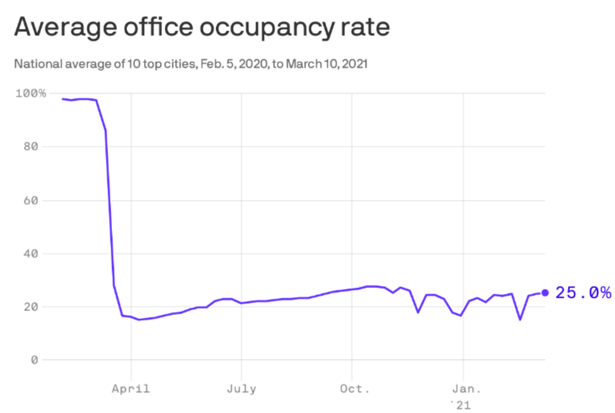
A national minimum wage increase from $7.25 to $15/hour should result in higher inflation, as did state and local minimum wage increases. We must *look around what's going down* when tax rate increases coincide with minimum wage increases, which tend to reinforce cost-of-living increases. Feedback compounding consumer price changes is difficult to moderate once higher inflation expectations take hold.

Existing home sales plunged last Spring to the lowest level since 2008-2011 or about a 4 million annual rate, but rebounded since July to the best level since 2005 or about 7 million annually. A tightening housing market, including second or vacation homes, has driven up home prices, and thus CPI inflation of rent equivalent or shelter. It takes time for housing starts and permits to drive new home supply coming off a recession. We expect home prices to increase further until higher mortgage rates (bond yields) limit affordability.



Source: Refinitiv DataStream & Strategic Frontier Management

The pandemic accelerated secular change, which has rebalanced workforce needs of businesses while some stable career paths are no longer secure. Automation advanced with accelerated creative destruction and enabling technology of remote workforce needs—application adaptive robotics with advanced sensors, drones, and machine learning (artificial intelligence) are obvious key themes. With permanent downsizing office space requirements, an office space glut and rising vacancies will likely drive commercial office rents and valuations lower. We also expect rising retail and mall vacancy rates with rapidly increasing online shopping and so many small business failures, particularly retail.



The pandemic increased residential housing demand from moving to the suburbs, upsizing to a bigger home, home improvement, or even buying a second home. These are logical given increasingly permanent working from home. Managing teams and individuals working remotely has increased the many challenges of how maintain or reinforce desired corporate culture and employee development, while bolstering productivity. Naturally many workers remain reluctant to return to the office or be accountable as before given the option. The chart below will be concerning to any office real estate investor—higher vacancy rates drive declining rents. We've never seen any secular change like this before.

Even with rising inflation, employees benefited from foregoing commuting, parking, work clothing, coffee and lunch indulgences, as well as other personal services. Companies also benefited from lower fixed costs (inc., rent, travel, phone, subscriptions, marketing, and entertainment expense), but maintaining collaboration, effective management, connection, culture, employee development, and productivity is ever more challenging.

Commodity disinflation, including energy, persisted for 15 years since we identified lower energy demand and greater supply as a consequence of Conservation, Substitution, and Innovation—we termed *CSI*. Lower energy demand intensity drove consumption decline below global growth. Transportation fuel need has slowed with increased fuel economy, more electric and alternative fueled vehicles as workforce trends—accelerated by the pandemic--reduced commuting and travel for in-person meetings. Southern California traffic at 9am still looks like 9pm in 2019, suggesting miles driven was reset to a much lower level. Energy supply also increased with greater recoverable oil and gas reserves do to fracking. Oil prices peaked in April 2011 ($113), but has since declined with supply and demand effects through March-April 2020 (WTI: $18).

Simply underweighting Energy has explained more than ESG risk factor performance over the last six years. Lower energy prices drove down book value of reserves, resulting in negative earnings. Recent relative energy sector performance can be mistaken for environmental impact alpha. Yet, volatility in energy and basic resources generally drive relative sector performance, and recovering growth should drive higher energy and commodity prices, which will boost inflation. We caution that claims Brand-X's *sustainability ratings outperformed those companies with poorer ratings* is considered misleading advertising for funds or products under the SEC's investment adviser marketing rule. Measuring impact is more aligned with earnings or revenue growth of risk factors, rather than stock performance, which is subject to swings in sentiment or fund flows having nothing to do with evaluating ESG or sustainability.

There is a similar problem regarding safe harbor (or lack thereof) in the DOL's *ESG Rules for ERISA Fiduciaries*[2] concerning duties of prudence and loyalty in setting investment guidelines, product or security selection, exercising shareholder rights (inc. proxy voting policies), and monitoring of investments or related decisions. As much as President Biden's DoL would like to revoke this rule, it will take some time and effort to reverse restrictions on *non-pecuniary considerations* in security or investment selection, which outlaw ESG guidelines in the best interest of retirement and pension plans. Imposing ESG guidelines in ERISA plans run afoul without regulatory safe harbors to immunize fiduciaries.

In 2018, we raised our US potential growth expectation from 2% to 2.7% given improving US competitive advantages from fiscal, trade, energy, and regulatory policy reforms, particularly relative to Europe and Japan. Reliance of the *Fourth Industrial Revolution* on key future themes has been key to understanding potential growth, inflation, productivity, and profit margin trends, but some moderation coincides with forces driving higher inflation.

Lower *Energy* costs due to greater efficiency, conservation, less energy intensity, and new supply has moderated with greater regulation and rising production costs. The *Communications Revolution* (ubiquitous computing, cloud, and analytical big data) is becoming more mature, but future themes in *Advanced Materials, Security, Democratizing Education, Longevity,* and *Manufacturing Renaissance* may still have further to run.

Emerging Market industrialization, urbanization, and irrepressible demand were key themes implying greater secular growth, but are offset by rising adaptive robotics, as well as reversing globalization and offshoring trends. Limited profit margins and productivity in Emerging Market sill struggled with a *Manufacturing Renaissance* that is reversing offshoring due to advances in artificial intelligence, sensors, additive manufacturing, and adaptive robotics, which undermines their lower labor and overhead cost advantages.

Earnings

Economic growth translates revenue into earnings growth through profit margins. Lower tax rates can drive up profit margins (lower costs, which pass through to consumers in competitive markets), as productivity increases with increased or incentivized investment and R&D spending. US companies will struggle to grow into the current valuation with a S&P 500 earnings decline of -13.1% in 2020. Despite our expected earnings growth of 24% in 2021, we think the equity market is ahead of itself, particularly if interest rates begin to rise with normalizing inflation. It is hard to imagine much upside to earnings growth exceeding our strong expectations.

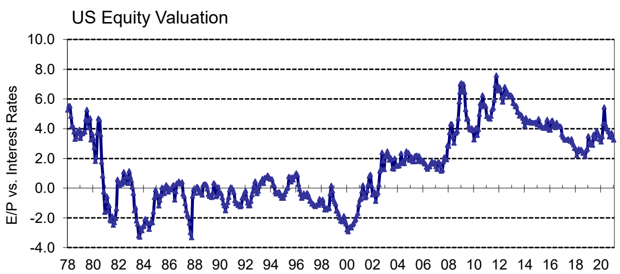
Operating Earnings	2022e	2021e	2020	2019	2018
IBES Consensus	202.11	175.40	140.85	162.17	161.93
Growth	15.2%	24.5%	-13.1%	0.1%	22.7%
Strategic Frontier Mgmt	195.00	175.00	140.85	162.17	161.93
Growth	11.4%	24.2%	-13.1%	0.1%	22.7%
S&P 500 @18x SFM TE	3510	3150	2535	2919	2915
SFM Target S&P 500	4000	3950	3756	3231	2507
SFM S&P 500 P/F12E	19.17	19.49	21.46	22.94	15.46

Source: I/B/E/S and Strategic Frontier Management

Despite marvelous headline growth in earnings and GDP expected in 2021, P/E valuations on trailing and forward

[2] DOL's investment duties regulation: 29 C.F.R. 2550.404a-1

earnings are still stretched. As long as interest rates remain low, the S&P 500 earnings yield can be constructive, as suggested below, but any meaningful increase in interest rates or bond yields can flip valuation more quickly now. Beyond recovery, we think that 2022 earnings could disappoint and a 20x-plus normalized forward operating earnings multiple will prove too rich.



Source: Strategic Frontier Management

Increasing global competitive advantage supported US outperformance versus more modest earnings growth and profit margins in China, Japan, and Europe. The S&P 500 profit margin increased to 13% by the end of 2019, translating modest revenue growth plus buybacks into greater operating earnings leverage. But, as we *Look What's Going Down*, we are concerned profit margins will decline by as much as half, although that may still exceed Europe, Japan, and China.

Will Interest Rates Rise Again in 2021?

Global central banks hoped to prevent a broader financial crisis by dropping interest rates back toward 0% and increasing quantitative easing (buying government bonds), while offering forward guidance that they will keep rates low for the foreseeable future. Concern about risk of *debt cancellation* arises with soaring government debt and increasing debt burdens as interest rates rise, coinciding with expanding central bank holdings.

We expect the Federal Reserve to begin raising interest rates later this year, in spite of its *forward guidance*. It may allow inflation to run a bit before hiking rates or reducing its balance sheet, but maintaining emergency monetary stimulus given economic conditions is not prudent. Once inflation expectations begin to rise as companies pass through expected tax, basic material, and labor cost increases, the Federal Reserve will be *well behind the (yield) curve*, scrambling to normalize policy without spiraling into a bond market *taper tantrum*.

Interest rates and central bank holdings must eventually normalize as economic conditions normalize. We believe likelihood of rate hikes by July or October has increased, as well as suspending asset purchases (QE), if not reducing bond holdings. US history suggests if CPI inflation averages 2.5%, then policy interest rates should average about 3.5%, and 10-year Treasuries should average 4.7-5.0%. We expect yield curves will steepen with higher bond yields.

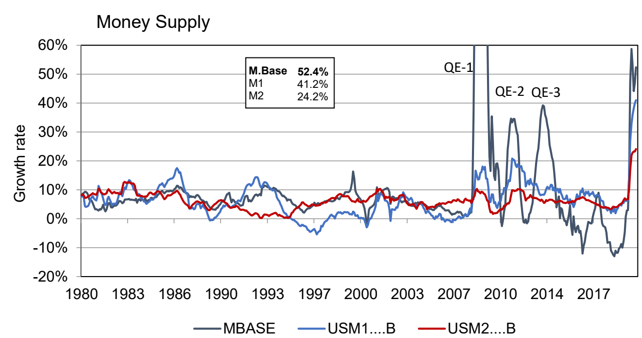
Median Forecast							LongRun Forecast	
U.S. Fed %	**2018**	**2019**	**2020e**	**2021e**	**2022e**	**2022e**	**Fed**	**SFM**
GDP	3.05	2.15	-3.70	4.00	3.00	2.50	1.80	2.70
U.Rate	3.70	3.55	7.60	5.50	4.60	4.00	4.10	4.50
PCE	1.85	1.45	1.20	1.70	1.80	2.00	2.00	2.50
Core PCE	1.85	1.50	1.70	1.80	2.00	0.00	2.00	2.50
Implied CPI	2.35	2.00	2.20	2.30	2.50	0.00	2.50	3.00
Federal Funds	2.38	1.85	0.10	0.10	0.10	0.10	2.50	3.25

Interest Rates	2018	2019e	2020e	2021e	2022e	2022e	Longer Run
FOMC Avg.	2.38%	1.63%	0.13%	0.13%	0.15%	0.26%	2.49%
SFM[1]	0.25%	1.75%	0.25%	0.75%	1.75%	2.75%	3.25%
Rate Change	1.00%	1.50%	-1.50%	0.50%	1.00%	1.00%	

1. Top-end of indicated Fed Funds range

Source: U.S. Federal Reserve and Strategic Frontier Management

The FOMC can lose credibility by suggesting long-term inflation declined to 2% or about half the rate for the last 50 years. The Federal Reserve changed its measure of inflation in January 2012 from the consumer price index (CPI) to a new personal consumption expenditure (PCE) index. How convenient to redefine a new inflation target of 2% using an index without much out-of-sample history and no other country or US agency uses, moreover calculated by the Federal Reserve itself. Any US inflation target is contrary to the Federal Reserve Act, Section 2A: Monetary Policy Objectives, which by statute pursues *maximum employment* and *stable prices*, with *moderate interest rates*. This objective has been consistent with maximizing the economy's long run potential growth, in contrast to inflation targets of other central banks.

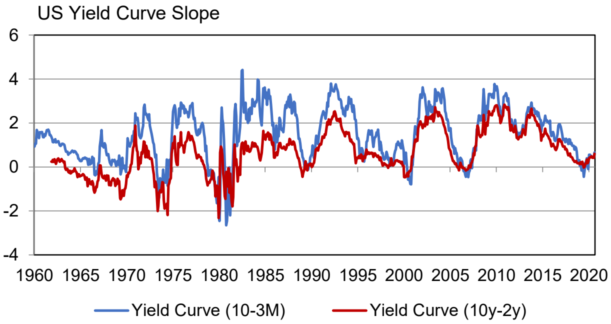


Source: Refinitiv DataStream & Strategic Frontier Management

Bond market manipulation results from keeping interest rates too low, expanding bond purchases (QE), and forward guidance *for an extended period*. Explicit *moral hazard* results in flatter yield curves than natural market conditions would dictate. Forward guidance hasn't provided any measurable stimulus effect in a decade, but publication of Federal Reserve forecasts suggests they hope to keep rates near 0% through 2023. This could be difficult if CPI inflation rises above 2.5%, as we expect.

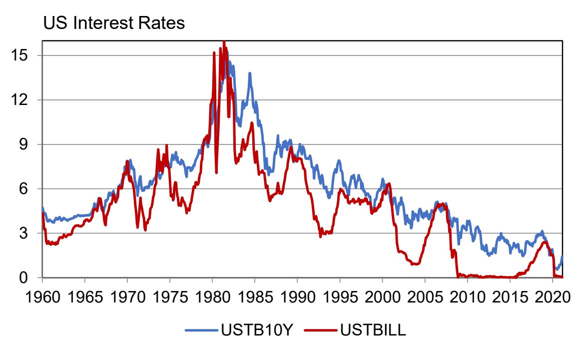
Global bond yields should rise as the yield curve steepens with higher inflation. We anticipate interest rate hikes (2 x ¼%) beginning in 2H/2021, as well as ending

QE bond purchases. Bond market *manipulation* is. Low cost of debt encourages imprudent leverage and risk-taking, thus foster financial imbalances. A global bond correction after a decade of manipulation could trigger the next financial crisis.



Source: Refinitiv DataStream & Strategic Frontier Management

We saw previous yield curve inversion differently with regard to recession risk. We rightly argued that inversion was a transitory consequence of external forces, rather than endogenous economic decline. Global economic conditions in 2019 did not justify negative real interest rates or bond yields, so when the pandemic hit, Japan and European Central Bank had little room to maneuver, while the US, UK, Canada, and Australia cut rates.



Source: Refinitiv DataStream

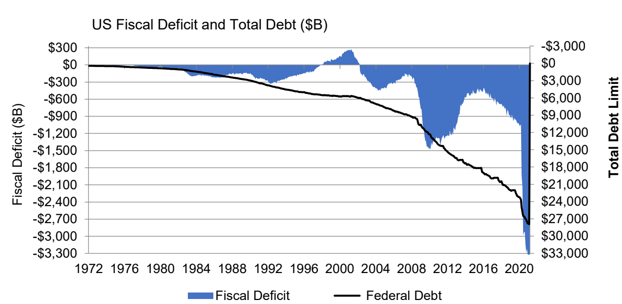
Bond market risk has increased with duration (interest rate risk) and higher convexity (change in interest rate risk) with such low rates. Is it rational for investors to assume such risk without being compensated for it, or even pay interest to lend money with negative rates? Normalizing bond yields will eventually result in colossal losses for investors, sovereign wealth funds, family offices, central banks (taxpayers), retirement plans, and particularly pension funds—particularly those with leveraged bond holdings. We prefer short-term corporate credit or even leveraged loans.

Japan and other Eurozone countries with burdensome fiscal debt are of increasing concern. Europe and Japan face difficult fiscal challenges with little room for crisis stimulus spending. They have teetered on recession before 2020, burdened by already high tax rates and excessive regulation. Fiscal deficits will increase further with rising interest rates. Japan's chronically low potential growth combined with a lower profit margin risks a value trap, particularly as the BoJ extended asset holdings to over 80% of Japanese listed equity ETFs or 5% of the total equity market. Japan's equity ETF purchases is treacherous for taxpayers on the hook for speculative losses, and the BoJ's is the only central bank holding equities. The BoJ is the largest domestic market shareholder, exceeding Japan's GPIF. Explicit moral hazard is acutely problematic for bond investors as the BoJ's holdings increased to about 50% of government debt as Debt/GDP exceeds 250%. We see no obvious pathway to normalize BoJ holdings or interest rates, increasing risk that Japan cancels its debt. Financing costs can soar if investors lose confidence in Japan's ability to repay debt or its credit rating deteriorates.

Government Debt and Fiscal Deficits

The CARES Act was exceptional in the size of economic stimulus spending in excess of $2.2 trillion, equivalent to 64% of 2019 tax revenue. Haste makes waste, and these programs have already shown to be prone to fraud, misappropriation, and abuse, notwithstanding a terrible precedent it set. Last years' nearly $1 trillion fiscal deficit rose to 4.5% of GDP. Supplemental unemployment insurance benefits of $600 per week had unintended consequences of increased government dependency—workers resisted returning to work as 68% of claimants earned more on unemployment insurance.

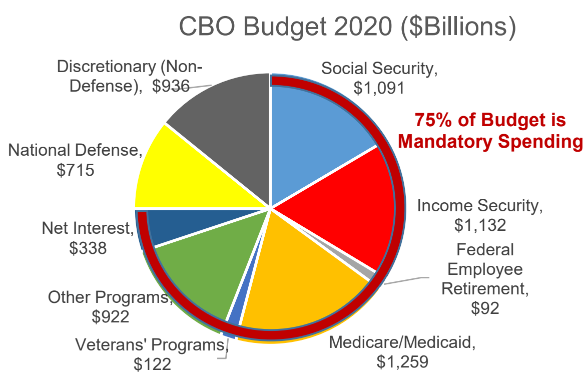
Total FY 2020 budget outlays were forecasted to be $4.8 trillion versus just $3.7 trillion in tax revenue. The fiscal deficit had exceeded $1 trillion even before over $5 trillion in COVID-19 stimulus. The critical issue is how the interest burden will soar if Treasury yields overshoot the CBO's 2% rate forecast—we think Treasury yields will likely exceed 5.0% assuming just 2.5% CPI inflation. Total outstanding Treasury debt is $27.7 trillion through year end, not including massive state and local government debt or social security liability, versus US GDP of $21.5 trillion.



Source: Refinitiv DataStream & Strategic Frontier Management

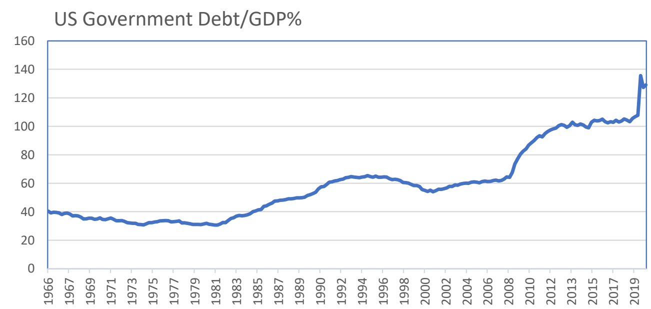
Another $1.9 trillion stimulus program follows a $900 billion COVID-19 relief bill signed December 27th to extend unemployment benefits and provide additional direct individual cash payments. Unfortunately, at least 80% of funding is unrelated to direct COVID-19 relief, such as: state and local government grants ($350 B), future public schools funding ($128 B), expanded Obamacare subsidies ($45 B), “socially” targeted 120% farm or ranch debt forgiveness ($4 B). and paid leave for Federal employees. The economy already reaccelerated and nearly fully recovered, so further fiscal stimulus beyond the CARES act was unnecessary, imprudent, unjustified, and inflationary. Moreover, oversight failed to address chronic fraud and abuse observed historically in prior stimulus programs.

Growth in mandatory government spending, including Social Security, Medicare, Medicaid, unemployment insurance, Obamacare, federal employee retirement, and other nondiscretionary programs, plus *interest on our debt* are compounding much faster than inflation, having increased to 75% of total spending in 2020. Total COVID-19 stimulus spending in excess of $5 trillion has already driven US federal debt/GDP well over 100%--debt service on $5 trillion will exceed $150 billion/year (3% financing cost), displacing other discretionary needs, such as national defense and homeland security.



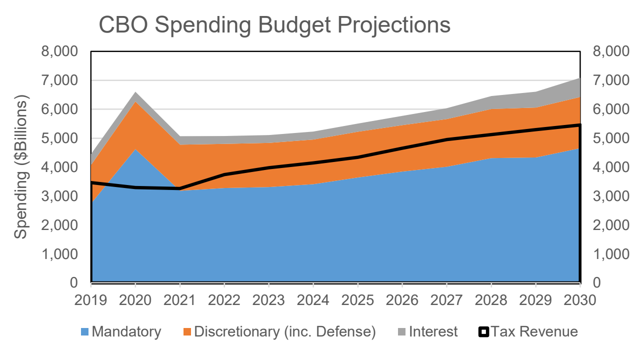
That little blue sliver expands quickly if we anticipate 5% bond yields versus 2% or less budgeted for most of the next decade. Rising bond yields increase interest expense, but the US Treasury hasn’t taken advantage of low bond yields to extend longer bond maturity issuance. The current average US Treasury maturity is under 6 years with federal debt exceeding $27 Trillion, up $3.7 trillion in 2020. This doesn’t include rising state and local municipal debt. The Federal Reserve currently holds about 15% of US debt outstanding, but is unsustainable.

The interest burden will rise significantly with reversion to normal 3¼% interest rates and 5% 10-year Treasury yield, but tends to be ignored with near 0% interest rates. When the yield curve is relatively flat, US Treasury should favor issuing longer bond maturities, exceeding the 65-month average outstanding. US Government Debt/GDP now exceeds 129%, which is unsustainable and will rise even higher between the recent $1.9 trillion stimulus and 2021’s fiscal deficit. If that isn’t concerning, then the additional estimated $70-100 trillion off-balance sheet liability, including Social Security, Medicare, federal housing loan guarantees, US federal pensions, and other unfunded non-budgeted federal liabilities, which is actually a multiple of public US Treasury debt.



Source: FRED, Federal Reserve Bank of St. Louis

Expanding Treasury issuance must surely crowd out corporate and mortgage debt issuance, resulting in higher borrowing costs and increasing taxpayer interest burdens as interest rates normalize. The black line in the chart below is tax revenue, which is well below total spending, before CBO included additional stimulus—who would run a household or business with spending so far in excess of total income?



Social Security trust fund reserves are expected to be exhausted in 2037 according to Trustees, as Medicare’s Hospital Insurance Trust Fund, will be insolvent by fiscal year 2024 according to the CBO. *Medicare for All* is clearly not feasible without doubling tax collections. Spending reform is always politically difficult, and has the opposite effect of stimulus handouts to curry voter favor.

We can’t rely on just the wealthiest 10% to continue to finance over 50% of federal spending. In 2018, the top 1% of all taxpayers earned 21% of national adjusted gross income, but paid 40% of all federal income taxes. In America’s progressive tax system, the wealthiest households pay more than their fair share, even after 2017 tax reform. In states like California and New York, total income taxes can exceed 50% of income in federal, state, and local taxes. In 2020, the California assembly proposed increasing the highest-in-the-nation 13.3% top state income tax rate to 16.8% and considered a new wealth tax of 0.4% per year, including real estate already being assessed. Many high tax rate states also struggle with poor public schools and massively underfunded public pensions, some well below critical 60% levels. Higher tax rates don't correlate with better public policy outcomes. No wonder residents and businesses are fleeing California, Illinois, New Jersey, and New York for lower tax rate states of Texas, Nevada, Arizona, and Florida that were fiscally better managed.

We simply can't afford President Biden's plan to spend another $10 trillion (Tax Foundation) in new entitlements and programs on top of over $5 trillion already spent in just the last year. Just a few of the more expensive programs include: $1.4 trillion to expand Obamacare (public option), $300 billion to reduce Medicare eligibility age to 60, $3 trillion for infrastructure (inc., *Green New Deal and other domestic* objectives*)*, $1 trillion to extend Social Security solvency, $1.5 trillion for free tuition, $550 billion for expanded family leave, $700 billion in "Buy America" investments, and $640 billion for low-income housing. The excessive fiscal stimulus has limited flexibility to address future economic crises, just as Europe struggled given its indebtedness. After three very expensive fiscal stimulus programs, the need for US fiscal nondiscretionary spending reform only increased.

Public Infrastructure and Other Domestic Needs

President Biden is now seeking public funding for massive spending on infrastructure and "other domestic needs" ranging up to $3 trillion. This idea has been under consideration since the 2016 US election, when most expected an upper end of $1 trillion. What is to be included and how it should be financed are still not clear. Repairing roads, highways, bridges, shipping ports, airports, rail terminals, and railways are probably the first to come to mind, followed by essential services such as: water, sewer, electricity transmission, pipelines, power plants, and telecommunication (wireless, internet, cable, etc.) utilities. It is remarkable that one of President Biden's first actions was to suspend the construction permit of the largest current infrastructure projects, namely the privately financed Keystone Pipeline, which employs thousands of union workers. Pipelines also are more environmentally efficient and safer than rail and truck transport, so we are baffled by this decision. We expect legal challenges to dozens of unprincipled and indefensible executive orders by state governments.

Voters assume infrastructure should be paid for by the government, but we are already running a nearly $1 trillion fiscal deficit that exceeds the entire discretionary budget. Most types of American infrastructure projects are privately developed, owned and operated, charging user utility service fees for: airports, ports, pipelines, railways, transmission lines, power plants, and even essential services, such as water, sewer, trash, electricity, natural gas, and telecommunication (i.e., phone, internet, cable) of mostly publicly traded utilities. Funding highways and bridges also are subject to user fees. Generally, fuel taxes, plus toll, tire, and heavy vehicle taxes funds most of it. The federal government funds only about 26% of total highway construction and maintenance, with state and local agencies funding the rest. More than 80% of the Highway Trust Fund comes from a federal excise fuel tax per gallon, last increased in 1993. State and local fuel taxes average nearly double federal taxes. Raising federal fuel taxes is more than adequate to increase highway and bridge funding.

America's unique approach to funding infrastructure project development, operating, and maintenance costs are largely the responsibility of utility companies or agencies. Global spending comparisons that suggest the US is lagging in this regard are misleading, but that is the point—why should we depart from this approach that minimizes federal taxpayer burden and outcomes tend to be better managed? Instead, we should limit government to incentivizing infrastructure development by easing permitting and regulatory requirements, expanding private and public research funding, while providing loan guarantees to reduce financing costs.

The conversation about financing continues to evolve. *Modern Monetary Theory* suggests governments that control their own currency can spend freely, as they can always create more money to pay off debts in their own currency without adverse economic consequences. After MMT was universally discredited and voters expressed skepticism, progressive advocates (Senators Sanders & Warren) pivoted to suggest instead a new wealth tax, which would serve a higher purpose to restore wealth and income equality by redistribution. A federal wealth tax[3] is unconstitutional, as is any *direct tax* on people or property (See *16th Amendment*).

If infrastructure must go forward under US government control, an alternative funding path is likely that few seem to appreciate yet. It is not fiscally prudent to further increase federal debt to be carried by future generations. The US government has amassed tremendous non-strategic land, property, buildings and other assets that

[3] A federal wealth tax is impractical to manage, assess, or enforce and is unconstitutional. Valuing illiquid private business interests, real estate, collectables, farms, and other unlisted assets annually is complex and expensive. Other countries (most recently France) have failed, showing money flees quickly and tax avoidance schemes are very creative. Appropriating 2% of net worth each year soon leaves little left in the end. A tragic retirement savings crisis already on the horizon would accelerate for most households, as we live longer and rely increasingly on defined contribution plans, IRAs, and other savings accounts. Narrowly targeted populist tax schemes always broaden out, trapping ever larger populations than envisioned.

can be privatized or sold to fund project development without further burdening taxpayers. Federal debt reduction can be addressed this way, as well. States also have accumulated significant underutilized property assets that must be maintained or managed, which they can tap too. Government is always a reluctant seller, but many buildings and vast land holdings are underutilized and exceed strategic needs.

The US Government has acquired land and property at an astonishing rate unlike any other country at a cost of significant debt, particularly during the Obama-Biden Administration. Federal holdings tend to limit commercial development and natural resource extraction. The U.S. Government now owns half of the Western United States and 28% of all land area, including 85% of Nevada, 64% of Utah and Idaho, and 60% of Alaska (State of Alaska also retains 28%). Our National Parks are magnificent assets, but are just 13% of 609 million acres the U.S. Government holds. The U.S. Land and Conservation Fund still budgets $900 million/year for acquisition, yet struggles to maintain existing land, buildings, parks, monuments, and forests. Privatizations were popular in the 1990s, particularly among developing economies, but have stalled with governments' reluctance to relinquish control. Privatization can fund infrastructure investment—even if we just swap ownership to facilitate desired development of strategic public assets.

The U.S. Government faces many challenges managing its holdings, including upkeep and managing properties, if not underutilization. Agencies argue against disposal, except under dire circumstances. Property disposals can reduce debt and operating expense, or provide capital needed to develop new projects. Increased privatization also might help satisfy growing investor demand, but few large infrastructure assets ever change hands to date. Facilitating an expansive P3 infrastructure program but the US could change that—those of us that spent some time with large Canadian and Australian asset owners (pension funds and SWFs) know this to be true.

Another source of financing is private investment capital. Asset owners—such as pension and sovereign wealth funds--have long been successful partnering to take advantage of their scale, financing flexibility, and longer time horizon in infrastructure, as with real estate. While investment demand has increased, the number and size of deals remains limited driving high valuations. Thus, consider public-private partnerships to finance projects.

Fiscal stimulus programs are inefficient, prone to fraud and abuse. Private investor accountability improves project cost and development management, particularly for those financed through Public-Private Partnerships. P3 should be more popular out of fiscal necessity, reducing taxpayer cost and better aligning private operators to efficiently develop and productively manage assets. Real property disposals can fund new projects to balance social good with fiscal prudence. Tax incentives can enhance investor returns, thereby increasing project valuation and limiting taxpayers' burden. P3 projects tend to be better managed during development and operational life at lower cost.

Many projects may not require government outlay of funds—this idea is not obvious to the public yet. Relaxing permitting and administrative hurdles, as well as providing government lending or tax credits can bolster project returns, and attract investors. Regulatory relief for commercially compelling projects, as well as research and development incentives and financing concessions (government guarantees lower financing cost), could provide $1 trillion in economic development for less than $100 billion of taxpayer money.

Most of the infrastructure needs discussed are typically privately held in the US. Bridges, highways, pipelines, railways, airports, power plants (inc.: nuclear, coal, gas, wind, solar, etc.), fiber networks, transmission lines, electricity grids, tollways, dams, water treatment, or desalinization can recover construction costs from benefiting companies or consumers. Consider why does the US have such a uniquely vibrant and competitive industry of defense contractors, while our greatest military advisories rely on socialist government development and manufacturing?

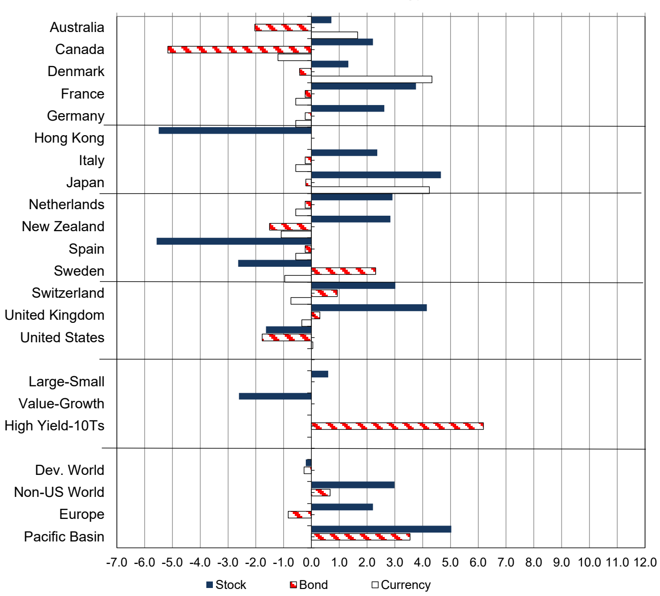
With so many ways to finance infrastructure, a program of project initiatives and an investment framework should be more likely than an infrastructure bill per se if the need was true. Politicians too often cite flawed statistics of our relative infrastructure investment, but realize that many utility and essential services are publicly owned in other countries, but privately developed in the US. Progressive and democratic socialist politicians favoring central planning and government ownership of essential services will never appreciate the strength of our unique private sector model, rooted in free market capitalism and more efficient developing strategic projects at lower cost to taxpayers, still waiting for *shovel-ready jobs*.

Infrastructure investment need coincides with strong demand for private investment opportunities. Instead of increasing the fiscal deficit, it is logical to leverage low-cost financing costs (bond yields are very low) and support private sector development without further burdening taxpayers. If physical asset and technological infrastructure projects must meet a higher standard of yielding a commercially compelling return, held accountable by investors, then America can achieve its infrastructure development objective without accruing even more debt. There is no economic multiplier on stimulus funds—we've proven that time and again, including appalling consequences of Obama-Biden's $850 billion ARRA stimulus blunder of 2009. Already heavily indebted governments shouldn't be borrowing to fund infrastructure spending, rather then letting eager investors finance private investment opportunities. Alternative financing can increase investment at lower taxpayer cost with less concern of fraud, waste, and mismanagement with aligned investor oversight. We can't spend our way into enhanced productivity any more than we can tax an indebted society into prosperity.

Global Tactical Asset Allocation Strategy

Global tactical return forecasts offer objective guidance in challenging periods such as this. We argued that after the steep decline through March 23rd, global equity returns should far exceed government bond returns over the next 12-18 months. At the recession trough, we were extremely bullish, particularly on US equities. However, US equity returns have outpaced the earnings recovery, causing P/E ratios to stretch beyond a year ago for both trailing and forward operating earnings. On a valuation perspective, 1998-2001 was the last time we observed valuations approaching current levels. We don't expect the remaining recovery in earnings will be sufficient to justify higher S&P 500 index levels, even growing 25% this year. US equities will struggle to return eve 2/3rds of the 8.8% A.R. observed for the S&P 500 over the last 60 years with low dividend yield and limited P/E upside.

Tactical 3-Month Return Forecasts %



Global Tactical Asset Allocation Quarterly Forecasts(%)

			Local Markets		In (US$)		US$
MSCI	WrldGvt	Mar 2021	Equity	Bond	**Stock**	**Bond**	Currency
100%	100%	World	-0.4	-0.9	**-0.2**	**-0.3**	0.2
18%	39%	Europe	2.7	-0.1	**2.2**	**-0.8**	-0.6
9%	21%	Pacific Basin	2.1	-0.4	**5.0**	**3.5**	3.4
31%	62%	Non-US World	2.5	-0.4	**3.0**	**0.7**	0.5
69%	38%	US	-1.6	-1.8	**-1.6**	**-1.8**	
		Cash		0.0		**0.0**	

	Lg-Sm	Va-Gr	High Yield - 10yT
US Style	0.6%	-2.6%	6.2%
	Large -	*Growth*	*HighYld*

Source: Strategic Frontier Management, January 2020

We still expect global stocks to outperform Treasury bonds, but we highlight an important change in our view. Return to US equities will struggle to beat inflation from here given our 3950 S&P 500 target. Our tactical equity forecasts suggest wide dispersion across countries and currencies. Depending on still uncertain changes to US policies, the downside risk to US equities hasn't been greater in a long time. Small-cap and value risk premiums may run further, but both should outperform if inflation rises and the US dollar firms.

Earnings growth for the S&P 600 (small-cap stocks) tumbled -51% as many smaller businesses failed without sufficient financial resources, but the earnings recovery is increasingly visible. Lagging small-cap stocks narrowed relative size valuations, so a stronger small-cap earnings recovery still supports greater upside to outperform large-cap equity. If there isn't much gross return difference between listed smaller companies versus private equity and venture capital, then listed small-cap stocks (S&P 600 or Russell 2000 indices) will outperform private equity and venture capital on net return with much greater liquidity. The illiquidity risk factor is assumed positive, but could be perceived increasingly as negative, as some academic studies now suggest. Stretched valuations in what we termed the "crowded sandbox" has been a chronic issue for some time. This seems intuitive, but also empirically observed.

In fixed income, we recommend favoring shorter maturity and floating rate debt. Short-term bond funds with higher credit exposure enjoy higher current yield without much interest rate risk, particularly as credit spreads widened. We don't expect much volatility in the US dollar. We remain overweight cash, which is the only true safe haven for investors—not gold or bitcoin, and certainly not commodities. These speculative securities are neither a store of value, nor do provide for costless exchange like classic currencies with the benefit of a *fixed income* (interest). Money market funds still charge high fees given such low interest rates. We prefer higher yielding minimal interest rate risk of short-term bond index funds, assuming rate hikes are limited to ¼-½% in 2021.

The stock market doesn't always track the economy, and the economy doesn't always respond to policy changes as expected, even with a long lag. Yet, there is still value in trying to forecast asset returns and risk—the discipline of doing so is both instructive and insightful. Direction can be valuable, even if magnitude and timing are allusive. Extreme equity volatility can provide tactical allocation opportunities, as suggested earlier this year.

We've observed anomalous returns to investment styles (i.e., risk factors: value vs. growth, large vs. small, momentum, minimum volatility, etc.), sectors, countries, and currencies. Upside-down performance of risk factors, such as value and small-cap premiums, reached new extremes after persisting longer than ever observed.

The long draught in value investing surely has had an impact on active management—more than a few notable value managers closed their doors last year. If value doesn't matter, how else can a portfolio manager differentiate good from bad? We've seen it before in 1998-2001 (Tech bubble) and 2007 (Quant Quake), but never has value underperformance persisted long enough to turn 10/20/30-year risk factor premiums negative. Of course, the eventual reversal in small-cap and value from 2002-2005 was breathtaking. The lesson for investors is that risk factor investing may yield long-term benefit, but can be cyclical yet try our patience for quarters, if not years or even a decade.

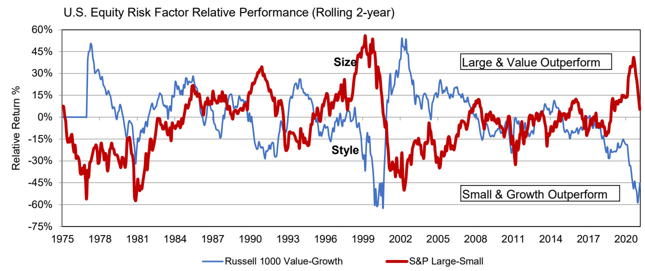
Extended value and small-cap factor underperformance turned 10/20/30-year risk factor premiums negative—these are fundamental tilts that intuitively and historically paid-off for investors. We expect they should do so in the future, in just as breathtaking fashion as small-cap and value reversals of 2002-2005. Style and size tilts began to reassert leadership in Q4, but can extend for some time to come. Rising interest rates and higher inflation should be supportive of this trend that favors cyclical industries and narrowing valuation vs. large-cap growth.

Total Return	1-Yr	3-Yr	5-Yr	10-Yr	20.Yr	30.Yr
S&P 500 Index	18.4	14.2	15.2	13.9	7.5	10.7
NASDAQ Composite	44.9	24.1	21.8	18.3	9.7	13.6
Russell 2000	20.0	10.2	13.3	11.2	8.7	10.8
Russell Value-Growth	-35.7	-16.9	-11.3	-6.7	-1.5	-1.0
Non-US (World xUS)	8.1	4.8	8.2	5.7	5.1	6.2
Emerging Markets	18.7	6.6	13.2	4.0	9.9	9.3
Small-cap Global	18.4	9.3	11.4	10.0		
US 10-Year Treasury	12.6	7.2	4.9	4.8	5.2	6.1
US Aggregate Bonds	7.5	5.3	4.4	3.8	4.8	5.9
BAML High Yield Bonds	6.2	5.9	8.4	6.6	7.6	8.8
Short-term Bonds	4.7	3.7	2.6	1.8	3.0	4.2
JPM Non-US Bonds	10.5	4.6	5.1	1.9	4.7	5.3
Cash (US T-Bills)	0.4	1.5	1.1	0.6	1.4	2.5
US Dollar (TWI)	-3.31	0.1	-1.1	1.9	-0.8	0.3
CRB Commodity Index	9.4	3.0	3.9	-3.1	3.6	2.3
WTI Oil (US$)	-21.0	7.2	5.4	-6.2	3.0	1.1
Gold (US$)	24.8	13.3	12.3	3.0	10.2	5.2

Note: Periods greater than a year annualized thru December31, 2020

Source: Strategic Frontier Management

Typical equity risk factors include value vs. growth, size (large vs small-cap), dividend yield, quality, momentum, or even low volatility. In the table below, historical returns over various time horizons offer interesting observations: (1) US equity returns exceed bond returns over all key horizons (2) Remarkable unintuitive divergence of *Value* and *Small-cap Equity* risk premiums, (3) *Emerging Market* risk-adjusted returns lagged expectations for a decade, (4) US equities outperformed non-US equities, (5) *US dollar* hasn't undermined competitiveness, (6) Oil remains volatile, but cheap below $50, (7) Gold is too volatile to be a safe haven and expensive over $1800.



Equity investors have shied away from lagging small-cap (-3.8% A.R. vs. large-cap) and value (-7.3% A.R. vs. growth) *over the last decade,* given the dominance of large-cap technology titans. We observed a similar divergence in 1998-2001 that didn't end well for investors. We have touted the importance of *future themes* tied to US technology innovation. However, their secular growth has slowed and earnings became more cyclical, suggesting high P/E ratios are difficult to justify. We also observe that US value and small-cap risk factor trends aligned in other countries too, but this is less common then presumed, and why we believe *Countries Still Matter* for portfolio diversification benefits.

Thomas Jefferson in 1786 wrote: "Our liberty depends on the freedom of the press, and that cannot be limited without being lost." A free press and free speech of individuals are two essential fundamental pillars our society that reinforce individual liberty and freedom, democracy, equal opportunity, and rule of law. It is an indispensable need to inform the public so that citizen voters can participate in democracy.

Innovation disrupts industries and change economics of business models. Society generally benefits from ever cheaper or free[4] internet and/or digital services offered at little or no marginal cost per user—the Internet has had a tremendous impact on journalism and media over the last 30 years. The internet was envisioned as a resource hub of communication and accessible repository of information (virtual library) to promote a more collaborative society. Advancement of mobile telecommunication made it universally ubiquitous for anyone at anytime or anywhere at ever lower cost. It also transformed our access to news with our reliance on search engines and social media platforms. It is not surprising our laws may need to adapt to new realities.

The rise of citizen or blogger journalism has become widespread. News sources proliferated with social media, redefining access to global news now accessed predominately online. Network broadcast TV is dwarfed by cable channels, streaming services, and interactive

[4] Alternative revenue: ad-based or monetized users

gaming. Given the breadth of media sources and linked content (text, streaming video, podcast, sound recordings), the rise of content aggregators or platforms redefined delivery of media content and its searchability. Collection of user information and their responsive behavior became valuable commodities that could be resold, analyzed, targeted and even stolen, sparking increased individual privacy concerns. Our greater concern is the increase in censorship and bullying of ideological cancel culture.

However, these internet and social media platforms have become oligopolies that choose to manage or bias the flow of news and information without little competition—innovative upstarts were quickly acquired. Paywalls for traditional radio, newspapers and periodicals limit access, driving users toward alternative free news sources and podcasts increasing platform engagement. Consequently, #FAAATcats Facebook, Amazon-AWS, Alphabet (Google, YouTube), and Twitter are in the bulls-eye for increasingly censoring, restricting, or biasing available content while banning certain users or creators. Although they are private companies that have the right to limit user access, their positioning as an oligopoly media utility raises constitutional issues by censoring content flow they deem “offensive”, while seeming inconsistent on “obscene” content.

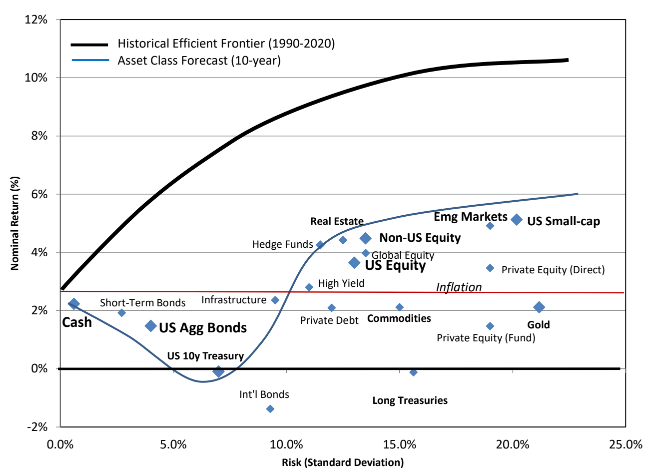
Their action exceeds Title 47-*Electronic Communications Privacy Act*: §230’s purpose and intent with regard to simply limiting *obscene content* for which they were granted liability protection. Adjudicating opinion and factchecking sources became a slippery slope. Individuals have the right to decide what they want to read or publish. Given how technology has reshaped media and new access, unconstitutional and anticompetitive behaviors jeopardize their utility platform business models reliant on analyzing and reselling user (customer) information.

America still enjoys broad freedom of traditional press, but the emergence of *cancel culture* has restricted free speech in arbitrary interpretation of their *terms and conditions of service*. We shouldn’t restrict the right of private businesses to manage services or products they provide, and the customers they serve. However, platforms and even internet service providers increasingly operate as media utilities—we’ve noted that companies become price setters, rather than market price takers (competitive free market), when brands become a verb – i.e., Tweet or Google vs. post or search.

We failed to manage mergers that too narrowly defined markets for anti-trust, but we don’t believe the answer to is to break-up the #FAATcats or cancel Section 230. Platforms should have the right to control or remove undesirable content deemed *obscene, lewd, criminal, threatening or otherwise objectionable, whether or not such material is constitutionally protected*, so they can’t be held liable for such actions. The assumption under Section 230 was this right can be exercised in extreme situations, otherwise would not need to censor posted content. The Internet was to be a place of inclusivity and free expression of individual opinions and views, as well as host free global debate of theories, opinions, or ideas. Actions taken also must consider the global impact.

Instead, we expect greater competition with legislative correction or judicial interpretative scrutiny regarding under what conditions might negate liability protection to reduce interpretive bias and restore free speech, opinion, and expression, while limiting further election biased interference. Consumers are smart enough to appraise opinions and accuracy of commentators, journalists, critics, posers, politicians, even celebrities and influencers—most with no more insight than you or me. As a consequence, overvalued large-cap growth stocks may suffer (slower growth, fewer users) if #FAATcats’ issues result in greater anti-trust action or limiting monetization due to unconstitutional practices. Competition should increase and expect their valuations could normalize with extended underperformance.

We expect negative real (if not nominal) bond returns for 10-year Treasuries over the next five years with rising inflation and increasing government debt of fiscal deficits, as bond refunding of central bank holdings exacerbate a correction in overvalued global bonds. Normalizing Treasury bond yields should rise beginning from negative real yields. The hiatus from monetary normalization that began in 2016 should get back on track in 2021, beginning with two rate hikes and suspending bond purchases.



Source: Strategic Frontier Management

Years of bond market manipulation caused a remarkable dislocation with negative real yields for an extended period. The risk for extended fixed income investors is significant. There is potential peril for those that dismiss overvaluation of global bonds and the eventual normalization that is likely to wreck havoc on portfolios, leaving pension funds and retirement savings worse off. There is no alternative asset class without material correlation to some combination of global equities and bonds, except real estate and hedge funds. Portfolios that drifted overweight with rising equities should rebalance to target, as they should have done last March, as well. Our previously overweight global tactical equity allocation has declined to the lowest level since the turn of the century (1999), *Roaring '20s* be damned!

Portfolios including significant alternative strategies (inc., private equity, venture capital, private debt, real estate, hedge fund, infrastructure, gold, and commodities) haven't performed any better than a mix of listed global stocks and bonds, but limited by management fees and higher transaction costs, foregoing any rebalancing opportunity with limited liquidity. Net returns remain inferior on average to simple global balanced portfolios on a *true* risk-adjusted basis. Lack of timely marked-to-market valuations of private market securities heighten anxiety of wealth uncertainty. The myth of positive illiquidity and unlisted/non-public risk premiums remains illusive, never visible or diversifiable for capacity constrained private market assets, as discussed in: *Alternative Reality*.

Balanced 60/40 strategic asset allocations may need some tuning (i.e., shorter maturity, less overvalued large-cap growth), but investment managers of alternative products suggesting the balanced portfolio are dying or dead begs the question, what is the alternative? How can alternative products exceed return of public market asset class combinations, off which they're priced and to which they are correlated? There is no alternative asset allocation that has beaten a global balanced strategy on a risk-adjusted basis, certainly net of all fees and costs. Even if future returns to equities and bonds are likely to be lower, so will likely returns of all alternative strategies.

Clash of Ideology in the Changing Balance of Power

In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could. **— Rudi Dornbusch**

Although President Biden enjoys majority control of Congress, House (222-213) and Senate (50-50) majorities are as tenuous as ever observed. With a *Blue Sweep*, rather than a *Blue Wave* election expected, no clear policy mandate exists beyond the *Democratic Party Platform* and *Unity Agreement*, struck with Democratic Socialist Senator Bernie Sanders. Failure to articulate clear political objectives forfeited any mandate. The Biden Administration can drive its agenda within limits of its political capital, but the slimmer its majority the more challenging this becomes. Voters will likely hang any economic or national security decline on partisan dismantling to the extent they drive misguided legislative policies or clearly flawed executive orders. Monetary populism is expensive, yet too soon politically forgotten at just $1400—indeed, the latest stimulus bill targets just 19% of 1.9 trillion toward direct COVID-relief with a potpourri of other progressive wanna-haves. We expect states will challenge various border/immigration and energy permitting initiatives on a constitutional basis, including orders without much consideration simply targeting *America First* policies during the first 60 days.

A meaningful shift in the US balance of power that results in regretful policy decisions that limit US potential growth, global competitiveness, profit margins, or individual security. US policy changes usually take some time to have an effect, but anticipation of tax legislation and well articulated regulatory changes reduced the usual lag in policy effects. Policy changes with known economic consequences will be discounted more quickly as businesses anticipate expected effects. Remember the speed and breadth of tax, trade, energy, and regulatory policy reforms were unprecedented, and business owners correctly assumed a constructive economic effect. President Trump achieved much of his promised agenda quickly with majority control of both houses and seemingly limitless political capital within the framework of legislative and executive branches, as we foretold. This allowed him to pursue various policy issues simultaneously and appoint a record number of judges.

Donald Trump lost a personality election, rather than President Joe Biden winning a policy mandate. Consider down ballot results in contrast to the Presidential ticket. But in 2022, both houses of Congress will be up for grabs, presenting a clear and present danger for politicians wishing to change institutional rules, such as the Senate filibuster or enshrined democracy of voting to pursue a questionable agenda that American voters are narrowly divided, if not opposed to. Time will tell, but we have suspected that Joe Biden was not fit, nor inspired with a unifying American vision, nor has what it takes intellectually for the leadership demands of the office, which would inspire confidence here or abroad.

Economic risk pivots to potential adverse policy effects due to a *Blue Sweep* in the US balance of power. Progressive reform policies can be consequential to future potential growth, inflation, global competitiveness, and profit margins with adverse agency policy and legislative changes to tax rates, fiscal budget priorities, regulation, trade objectives, energy independence, and national security. Soaring debt and rising fiscal deficits suggest fiscal spending and entitlement reform is desperately needed—higher targeted tax rates typically reduce tax revenue (ref: Hauser's Law), and tend to actually increase income gaps, but that won't dissuade them from trying. Raising federal corporate taxes to 28% would reduce competitiveness becoming again the highest statutory tax rate globally—21% rate is just above average globally.

Parting Thoughts: ***Look What's Going Down***

It was a difficult year for households and businesses given indiscriminate economic losses. Untimely asset allocation shifts tended to lock in losses as investors reduced equities when volatility spiked, but remained skeptical to re-engage until well into the fourth quarter. Seemingly arbitrary political decisions shutdown *nonessential* activities, rather than focus on minimizing risky points of contact and pursuing a smarter approach to *physical distancing*. Small businesses failed at a much faster rate than necessary under a smarter approach.

Many missed out on the equity market recovery selling out into March volatility. Some institutional investors *selling leveraged short volatility* seeking income also got whipsawed, forgetting low volatility can revert quickly—crowded volatility trading exceeded $1.5 trillion exposure last March, replaying similarly horrific losses of February 2018's *inverse volatility ETF collapse*. Readers know well our concern about perils of expected higher volatility-of-volatility, given remarkably low equity volatility of <10% in 2019. It is remarkable institutional investors do dumb things too, even repeat past mistakes. This global pandemic was not a financial crisis as noted in *Fear Itself of Geoeconomic Panic*, but a health security crisis unlike any other crisis—investor panic was unprecedented given transitory consequences.

We expected adverse economic effects would be transitory, but the equity market rebounded even more quickly. Directed lockdowns of non-essential activities were not endogenous to fundamental forces or financial imbalances typical of cyclical recessions. Permanent effects of business closures, lost jobs, stalled education, and lost opportunities slow cyclical recovery, but secular potential growth, inflation, and profit margins should be relatively unphased longer-term. Reforms providing US competitive advantage through 2019 will help America lead the global economy forward from this crisis.

We learned a lot battling the COVID-19 pandemic, and the world will benefit from rapid US government-funded research, development and distribution of at least a half dozen vaccines and various effective therapeutics. Workforce trends, in our *Future Themes,* accelerated as we adapted technology enabling greater remote access by necessity, rather than for just efficiency and convenience. We learned who are our friends and foes, but the world view of China will not be easily redeemed in the foreseeable future. That will have trade consequences for them and create many challenges for their China 2025 vision. Best practice for tackling a global pandemic is more nuanced today. President Biden is finding out quickly about the consequences of accountability for misguided executive decisions.

The global financial crisis playbook that so many seemed to adopt a year ago has proven wrongfooted. The effect of a transitory self-directed shutdown of deemed non-essential activities is quite different than any previous natural causes of cyclical recessions. So, we think the long-extended business and market cycle were simply interrupted, therefore early cycle playbook is misguided. Not only are we tracking typical forces of a later cycle, we are concerned about the new direction of adverse US fiscal, energy, regulatory, national security, and trade policies already evident and increasingly anticipated.

As we *Look What Is Going Down*, executive decisions made and social justice policies pursued should keep in mind the clairvoyant and still perceptive words of Adam Smith that made visible a remarkable force of the invisible hand: *As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value, every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.* – ***The Wealth of Nations*** (1776)

America's retirement savings, dependent on future equity and bond returns, is still insufficient with ever increasing life expectancy. Consequences of populist activism seeking to reform tax-deferred retirement savings plans and introduce unconstitutional wealth taxes are foolish and economically disastrous. Partisan election and political reforms are disguised power plays that run afoul of legitimacy, fair play, and Congressional legislative precedent. Spending more than we can afford on new government programs from excessive fiscal stimulus of $5 trillion to a $3 trillion infrastructure boondoggle limiting prosperity and opportunity of future generations, stuck with a bill they can't afford to repay. Fraught executive decisions and partisan legislation have political and economic consequences with Congress so narrowly divided, and brings new meaning to: *if you break it, you own it.*