DANN ASSET ADVISORS, LLC

Third Quarter 2021 Update

October 11, 2021

3Q21 Highlights

- S&P 500 manages a sixth straight quarterly gain despite a September decline
- Government funding and debt limit politics may have contributed to September volatility
- Interest rates rise as Fed signals reduced asset purchases and inflation concerns continue
- International stocks again trail the U.S.

The table below summarizes the performance of some key indices during the third quarter and year to date:

Market Performance Index	% Ch. 3Q21	% Ch. YTD
S&P 500	0.6	15.9
MSCI All Country World ex US	-3.0	5.9
MSCI Dev. Markets (ex US)	-0.5	8.4
MSCI Emerging Markets	-8.1	-1.3
US Aggregate Bond	0.1	-1.6
Liquid High Yield	0.7	3.7

Source: Morningstar, iShares

Equities. The S&P 500 index eked out a small gain for the quarter even with a 4.7% decline in September. The index's 0.6% return masked significant volatility under the surface. Higher quality stocks did well relative to more volatile, cyclical stocks early in the quarter as interest rates were flat to down and the Delta variant slowed economic growth. As rates rose late in the quarter and especially following the Fed's September 22 meeting, this trend reversed with higher quality stocks and the technology sector in particular selling off.

Other sectors of the market had tougher quarters. The Russell 2000 index of smaller company stocks fell 4.4% during the quarter and is now trailing the S&P 500 by 351 basis points (a basis point is 1/100th of one percent) year to date. Small company stocks had led the market as stocks recovered from Covid-induced shutdowns – for the four quarters ending March 31, 2021, the Russell 2000 had returned an exceptional 95% compared with 56% for the S&P 500. The recent underperformance of small company stocks may reflect some combination of slowing U.S. economic growth and substantial supply chain/labor availability issues, with the latter often having a bigger impact on smaller vs. larger companies.

International stocks continued to trail the U.S., with the emerging markets index negatively impacted, we believe, by Chinese actions regulating the country's large tech companies. Looking more broadly and much longer term, we note that over the past ten years international stocks (as measured by the iShares MSCI All Country World ex U.S. index) have compounded at only a 7.5% annualized rate compared with 16.6% for the S&P 500. Prior to the past decade international stocks had at times outperformed the U.S. for substantial periods. Because of this, and for diversification purposes, we always have had a small international allocation for most clients. We believe this remains the right strategy but it's becoming increasingly frustrating.

Fixed income. Ten-year treasury yields declined from 1.44% to as low as 1.17% in early August as investors focused on the impact of the Delta variant on the economy. Rates then moved up rapidly following the Fed's meeting that ended on September 22, with the 10-year yield rising 20 basis points in just seven trading days and ending the quarter at 1.53%. During the September meeting the Fed accelerated its timeframe for ending asset purchases (a form of stimulus for the economy) to mid 2022 and, based on individual member votes, implied it might start raising rates by the end of 2022. Two-year treasury yields rose from 0.25% to 0.29%, still very low by historical standards but the highest level since the beginning of the pandemic.

With the increase in rates, it was another challenging quarter for investment grade fixed income, with the Barclays U.S. Aggregate Bond index roughly flat and still down for the year. High yield had a relatively better quarter, consistent with year-to-date results. However, the spread between high yield and investment grade bonds remains at historically low levels, with just a 3.15 percentage point difference on September 30[(1)].

Market sectors[(2)]. Although there were wide swings among sectors during the quarter, at September 30 the dispersion among sectors was one of the narrowest we've seen in recent periods. The best performing sector was financials (+3%) and the worst industrials (-4%). Ironically, these sectors often move together with both usually being dependent on a strong economy to generate good results. The financials were boosted late in the quarter by the rise in interest rates.

The second and third best performing sectors were utilities and technology (each up about 1%) and the second and third worst were communications and materials, down just under 2% and 4%, respectively. Given the tightness of these ranges, we don't read too much into the quarter's sector results.

Portfolio Positioning

We made no significant changes to fixed income allocations during the quarter. As has been the case over the past year, risk/reward tradeoffs in fixed income seem generally unattractive to us. For equity-only accounts, we sold a U.S. focused mutual fund that had been a large position for most clients. We had bought the fund believing it would hold up better than the broad market if stocks were to decline. However, in the few small declines that we've had since the market bottom in March 2020, the fund did not perform as well as we'd expected. Accordingly, we sold, with proceeds into existing positions and two new mutual funds.

Analysis and near-term outlook. The economic and market downturns caused by the pandemic may have been unmatched for the combination of their severity and speed. Likewise, the combination of unprecedented monetary and fiscal stimulus and vaccines has led to an incredibly large and rapid recovery, such that many businesses have surpassed 2019 revenue and profit levels. And on September 30, 2021, the S&P 500 was 33% above its December 31, 2019, level – not something most people would have predicted on March 31, 2020.

In our opinion, the most important risk for the market is that inflation remains higher than expected. The Fed recently has been noting this as an increased risk, but they still seem to feel that inflation issues will subside once supply chain problems are resolved and the burst of demand following the economy's reopening has run its course. We note that certain commodities (copper and lumber, for example) have had big run ups that can lead to temporary price pressures, but of much more concern for us are currently rising labor costs.

From the press to public-company presentations to people we work and speak with – everyone is complaining about the difficulty of finding good employees and the need to pay up to get and retain them. If labor cost inflation becomes persistent, the Fed could be forced to raise rates more than currently expected. For the market, that could mean pressure on stock prices, especially for more expensive, higher growth stocks. For the economy, it could mean that the Fed is more limited in its ability to lower rates to try to stave off the next recession.

In a more positive scenario, inflation could subside as the Fed expects, more of America could get vaccinated and economic growth could continue, even though at lower levels than during the summer. In this case, the market could work through current volatility and potentially begin moving higher again. But to move significantly higher we believe that the market will need positive data showing that inflation is moderating.

(1) From FRED (Federal Reserve Bank of St. Louis economic data), displaying ICE BofA US High Yield Index Option-Adjusted Spread data.
(2) Market sector performance numbers based on Vanguard sector ETFs' performance.
(3) Technology and communication services represented only 12% of VDG's June 2021 portfolio compared with 38% for the S&P 500.