November 5, 2021

"Sometimes you gotta run before you can walk."

– Tony Stark, Iron Man

Dear Client,

While the reflation trade continued in the third quarter, the recovery trade paused and to some degree reversed. Commodities (the reflation portion) were up 4.8% from June to September. On the equity front (the recovery portion), the largest capitalization securities barely held their ground – the S&P 500 was up just 0.6%. More broadly, global equities and the smallest US equities were both down. The All-Country World Index fell 1.3% and the Russell 2000 small capitalization index dropped 4.3%. "Safe haven" assets offered little portfolio help in the three-month stretch. Long-dated US Treasury bonds were up just 0.4% and gold was down 0.9%.[1]

The pause in the recovery trade was challenging for Grey Owl's All-Weather strategy. The strategy was down 4% for the period as our exposure to cyclical energy and small capitalization equities took a toll. Through the first three quarters of the year, the Grey Owl All-Weather strategy was up 4.4%. In comparison, a 60/40 benchmark was up 5.9%.[2]

But, as fall began and leaves changed colors, the market environment also shifted again. Both the S&P 500 and the Russell 2000 were up meaningfully in October: 7.2% for the S&P 500 and 6.9% for the Russell 2000. The recovery trade is back! **Provisionally, the Grey Owl All-Weather strategy is up 8.7% for the year through the first week in November as the recovery trade appears back in full force.**

[1] We refer to US equities, long-dated US Treasury bonds, gold, and commodities as "primary" asset classes borrowing the language of HCWE & Company. The idea is that these four assets best capture two variables that explain a significant amount of asset price movement: global growth (explained by investor risk sentiment) and inflation. This framework is the basis for a permanent portfolio, an "all-weather" portfolio, risk-parity, etc. US equities and commodities are "risk" assets, while US Treasury bonds and gold are "haven" assets. The market (or asset class) returns are measured on a total return basis using index exchange traded funds (ETFs): SPY for the S&P 500, ACWI for the MSCI All-Country World Index, GSG for the S&P GSCI Commodity Index, TLT for 20+ Year Treasury Bond index (i.e. "long-dated" US Treasury bonds), and GLD for gold.

[2] The Grey Owl All-Weather strategy performance is taken from an individual representative account. The 60/40 benchmark is 60% ACWI and 40% AGG for the iShares Core U.S. Aggregate Bond ETF.

The Recovery Trade is Back and the Reflation Trade Persists

Why do we think the recovery is back? For starters, the rise in "delta" Covid cases in the US peaked on September 14 and has been in a steady downtrend.

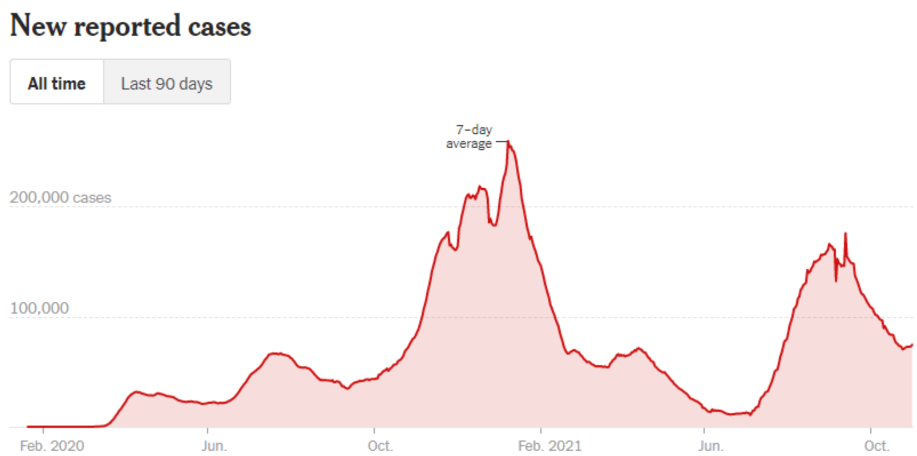

Figure 1 - US Covid-19 Cases; [NY Times]

In addition, the yield on the 10-year Treasury resumed its rally in the late-August to early-September period.

Figure 2 – 10yr Treasury Yield; [St. Louis Fed FRED]

The recovery trade is back from a stock market perspective as both the S&P 500 and the Russell 2000 markets look "healthier" today than they did just a few months ago. Breadth and momentum have both improved. Internal damage was done when the larger number of small capitalization stocks sold off during June, July, and August. But that damage began healing in September and continued throughout October. There are many ways to measure market internal health, but Lowry's Buying Power and Selling Pressure indices are straightforward summaries encapsulated in just two numbers. Note that Selling Pressure overwhelmed Buying Power for much of the summer months, but since the middle of September, Buying Power has been in an uptrend and Selling Pressure has been in a downtrend.

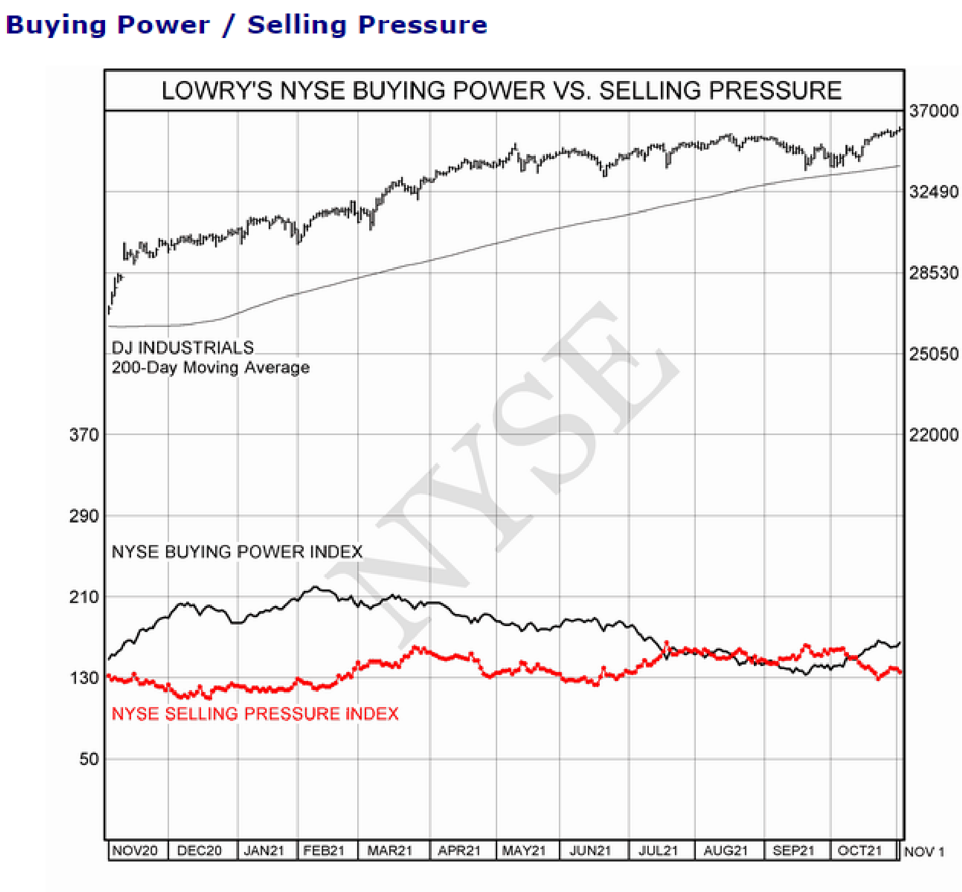

Figure 3 – Buying Power & Selling Pressure; Lowry on Demand

Finally, we can look at the spread between the highest quality bonds and those at the bottom of investment grade. Those spreads increased during the summer (a sign of investor risk aversion), but like many of the other indicators, began to decrease modestly, but consistently since the middle of September. This is an indication investors are growing more willing to take risk.

Figure 4 - Corporate AAA / BAA Yields; [St. Louis Fed FRED]

All of these indicators appear in the recent economic data as well as broad economic forecasts. While real growth decelerated meaningfully in the third quarter, it is now accelerating again. All the while, inflation continues its rise.

THE CONFERENCE BOARD US ECONOMIC OUTLOOK, 2020-2021-2022-2023
Percentage Change, Seasonally Adjusted Annual Rates

	2020				2021				2022		2020*	2021	2022	2023
	I Q*	II Q*	III Q*	IV Q*	I Q*	II Q*	III Q	IV Q	I Q	II Q	ANNUAL	ANNUAL	ANNUAL	ANNUAL
Real GDP	-5.1	-31.2	33.8	4.5	6.3	6.7	3.5	5.2	3.4	2.9	-3.4	5.7	3.8	3.0
Real Disposable Income	3.1	48.5	-16.6	-8.3	54.7	-30.2	-3.3	0.0	1.0	1.5	6.2	2.3	-2.0	1.0
Real Consumer Spending	-6.9	-33.4	41.4	3.4	11.4	12.0	1.0	4.1	4.2	3.5	-3.8	7.9	3.9	2.8
Residential Investment	20.3	-30.8	60.0	34.4	13.3	-11.7	-6.0	3.0	2.0	3.0	6.8	9.5	0.3	1.3
Nonresidential investment	-8.1	-30.3	18.7	12.5	12.9	9.2	-2.3	5.1	5.0	5.2	-5.3	7.0	4.3	4.4
Inventory Change (bln chn '12$)	-30	-253	25	89	-88	-169	20	100	90	60	-42	-34	60	15
Total Gov't Spending	3.7	3.9	-2.1	-0.5	4.2	-2.0	2.0	2.0	2.5	3.0	2.5	0.9	2.5	4.3
Exports	-16.3	-59.9	54.5	22.5	-2.9	7.6	3.0	5.1	6.1	7.1	-13.6	4.6	5.7	4.7
Imports	-13.1	-53.1	89.2	31.3	9.3	7.1	7.1	6.1	7.1	6.1	-8.9	13.6	6.2	4.1
Unemployment Rate (%)	3.8	13.1	8.8	6.8	6.2	5.9	5.2	4.8	4.4	4.1	8.1	5.5	4.1	3.4
PCE Inflation (%Y/Y)	1.7	0.6	1.2	1.2	1.8	3.9	4.2	4.5	4.0	3.2	1.2	3.6	3.0	2.0
Core PCE Inflation (%Y/Y)	1.8	1.0	1.5	1.4	1.7	3.4	3.6	3.9	3.7	2.8	1.4	3.1	2.8	1.8

Figure 5 - Conference Board US Economic Outlook; [Conference Board]

Cannabis Position Update

One notable detractor to performance has been our position in the Cannabis ETF, MSOS. MSO is an acronym for Multi State Operator (indicating corporations that operate in multiple US states, but also distinguishing these companies from their Canadian peers). The stocks have declined back to November 2020 levels, despite Cannabis being the fastest growing industry in North America according to Needham & Company research. FactSet estimates recently indicated that US publicly traded cannabis stocks are on track to increase sales by 87% in 2021. Research firm BTIG estimates that industry sales will clock in at $23B in 2021 and grow to $60B in 2025, a 27% compound annual growth rate. Finally, Alliance Global Partners estimates that illegal marijuana sales are 2x the size of legal sales, so there is a big market that remains to be captured.

States are taking matters into their own hands. Currently medical Marijuana is legal in 36 states and 13 of the remaining states allow sales of CBD oil. It is legal for recreation in 19 states and has been decriminalized (all or in part) in 14 other states. There is widespread support for legalization of marijuana – a recent Gallup poll indicates that 68% of voters support it.

The adoption curve and growth dynamics we just described would normally have investors drooling. But there are two big drawbacks: federal legalization and banking laws.

Federal legalization and banking restrictions have been the big (maybe only) driver of the stock prices. The illegal nature of the Cannabis business at some levels of government has restricted federally chartered banks from supporting the industry. Several big broker-dealers associated with banks instituted restrictive policies, and institutional investors have been largely prohibited from owning the US-based stocks. Uncertainty surrounding these hurdles, along with year-end tax loss selling, have beaten down the stocks to current levels. It is also uncertain how long this will persist.

Similar to Alcohol, Gaming, and Tobacco, we believe the battle cry of safety, jobs, and taxes will drive political motivation to federally legalize and regulate the Cannabis industry. This will be a game-changer for the industry. The question is when? If it becomes clearer that the timeframe for resolving these issues will be stretched, we may decide to sell some or all of our position. Stay tuned for further updates.

Positioned for (at least a short period of) Accelerating Growth

While we trimmed our "reopening basket" into the third quarter, we maintained a core position of cyclical and small capitalization stocks that should benefit from the completion of economic reopening – both in the US and abroad. The second quarter GDP growth rate was likely the fastest growth we will experience in our lifetime. Given that difficult comparison and the spread of the “delta” variant, hindsight tells us we should have been even more cautious and more aggressively trimmed exposure to the riskiest equities. More recently, the reacceleration of economic activity in the beginning of the fourth quarter and the continued rise in inflation has helped the riskier portion of our portfolio that we retained. We continue to keep “all-weather” aspects to our portfolio, but believe a slightly more aggressive posture will perform well into year end.

Like Tony Stark trying to fly in his Iron Man suit for the first time, the global economy is lurching, moving in fits and starts, as it attempts to regain balance after almost eighteen months of forced closure. The increased economic volatility requires more tactical portfolio management. For now, real economic growth is reaccelerating, and inflation continues to trend higher. We are positioned for both.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,
Grey Owl Capital Management
Grey Owl Capital Management, LLC

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