

# CRYSTAL WATERS PARTNERS

## Portfolio Update and Market Outlook

February 2021

### Rates Are Revealing

---



The market is going through a rotation to dividend-paying value-stocks as long-term bond rates rose over 35% in February as a result of an improving economy and foreign sovereign pension funds selling treasuries. The Congressional Budget Office estimates Real GDP will reach 3.6% by year-end. Analysts at Goldman Sachs, JP Morgan, and many other research firms are much more bullish and see GDP in the 7% to 10% range. We are on the bullish end of the spectrum, but do not expect a straight line up. If past bull markets are any indication, we should see a significant pullback between February and April of up to 10%. Our sights are focused on evolving opportunities across a variety of sectors and a strong second half of 2021.

On a long-term basis (YTD, one-year, and longer), the fund continues to take far less risk than the benchmark indexes (as measured by volatility), which is key to repeatable long-term performance.

# Market Moves

---

We continue to see the best investment opportunities in Technology and Healthcare that lie within long-term, transformational trends. We've been increasing our positions in financials which will benefit from rising rates and the transformation of finance as a result of the way millennials bank, borrow, and invest. Careful selection of long-term winners will prove critical, as will cautiously weighing our most volatile positions.

Despite many of the uncertainties in the economy right now, the market's general direction is favorable. We have been putting more cash to work, but our cash position remains strong as we anticipate lots of volatility in the first half of 2021, and we will continue to add positions where we see the most long-term value.

## **Fund exposure to China**

Crystal Waters Partners started our first long position in a Chinese company in December. We have previously been cautious due to the US-China trade war and other geo-politics dynamics but are eyeing more interesting opportunities that fit the fund's long-term focus and risk profile.

# Revealing Rates

---



- Long-Term Rates and CWP
- Will Rising Bond Rates Push Inflation Too High?
- Where Do We Go From Here?

*"It all comes down to interest rates. As an investor, all you're doing is putting up a lump-sum payment for a future cash flow."*

- Ray Dalio

## Long-Term Rates and CWP

Long-term interest rates, most notably the U.S. 10-Year Treasury, have been soaring in recent weeks. The stock market has reacted by selling off growth stocks and buying up value stocks, cyclicals, and quality dividend payers. With disproportionate exposure to fast-growing companies, the fund saw tremendous gains early in the month, only to have the selloff erase those gains in the latter part of the month. The pendulum always swings too far in either direction. We certainly didn't expect to have positions up 20%+ in the first month-and-a-half of the year, but we also don't expect the selloff to last. However, interest rate changes do move the stock market and are essential to understand, and we want to explain our view and expectations going forward.

To clarify what we mean when we talk about interest rates (at least for now), we are talking about U.S. Treasury rates, such as the 10-Year U.S. Treasury note. Treasury notes issued by the U.S. government and traded in the bond market where prices and yields (rates) are set by investors based on specific expectations about the economy. The federal funds rate also receives significant attention but is not our current focus. The federal funds rate is the short-term interest rate the Federal Reserve Bank charges commercial banks to borrow money. By making money cheaper or more expensive, the Fed can control the money inflow and outflow in the economy.

In February, Federal Reserve Chairman Jerome Powell continued to reiterate that the Fed will keep the federal funds rate at current levels (between 0% - 0.25%) and allow inflation to run above 2%. The U.S. economic recovery is progressing well, but it needs more time (and money) to stand on its own. Independent of the federal funds rate, the 10-Year U.S. Treasury has also remained low for a while. It's been below 1% since March of 2020 and bottomed around 0.53% in July last year. However, by early August, as the economy began to recover in earnest, the 10-Year started rising. Businesses' confidence grew about the future, and the bond market reflected this. Rising rates in a growing economy is a good thing as long as rates don't rise too fast and don't indicate runaway inflation.

While investors have noticed the rise in treasury rates, the rate of change in February spooked everyone. Rates jumped over 50% from around 1% to 1.50%. If you extrapolate that kind of rapid rise out over the rest of the year and beyond, some investors will take this as a sign of runaway inflation, especially since the price of lumber, corn, wheat, oil, gasoline, and copper all rose materially at the same time. If inflation increases quickly, so will interest rates and bond yields. As long-term interest rates rise, large investors like pension funds who require a specific return can now get some of that return from bonds, allowing them to shift large sums of money out of equities and into the bond market, resulting in lower stock prices. The shift usually happens in higher-value, volatile growth stocks first, precisely what we saw in late February.

### **Will Rising Bond Rates Push Inflation Too High?**

The recent rise in long-dated bond yields is not forecasting super high inflation, in our opinion, but is indicating an improvement in the economy. The global economy reopening coinciding with large bond sales by other sovereign nations, most notably Japan, caused a one-time acceleration in rates.

Japan is the single largest foreign holder of U.S. government debt. Japan's Government Pension Investment Fund (GPIF) is the largest public pension fund globally, with over \$1.5 trillion in assets. As part of a large re-allocation of securities, GPIF recently sold large stakes of U.S. Treasuries and announced in parallel that they would be buying other U.S. Treasuries worth up to almost 12 trillion yen (over a hundred billion dollars) over the next several years. Keep in mind that when bond prices rise, the rate declines, and when bond yields rise, the price declines. Another way to say this is when bond owners sell long-term bonds, the yield rises. The more selling there is, the faster the rate will rise. Likewise, when bonds are bought, the yield declines. Just as the recent GPIF sales of U.S. Treasuries drove up rates, their large long-term purchases will stabilize or drive rates back down.

The Fed has assured us that the federal funds rate will remain low to ensure a steady money supply for a recovering economy. However, as more individuals and businesses feel more confident about the future and look to borrow, long-term interest rates will rise. Demand for loans has been increasing, and that demand is also increasing rates, another sign of a strengthening economy.

Despite high unemployment, the economy is getting stronger, and the economic stimulus in 2020 and the recently passed stimulus bill for \$1.9 trillion will make it even stronger. Some people argue that the stimulus is too much money and will cause higher-than-desired inflation with too much money chasing too few goods.

There is no reasonable math we can offer in this newsletter to prove that the stimulus will cause runaway inflation, but it's essential to keep it in perspective. The U.S. national debt is currently \$27 trillion, and the authorization of \$2 trillion more (spent over several years) isn't going to move the needle much. The Federal Reserve has said as much, and officials worry that hitting their inflation target of 2% - 2.5% may still be a challenge.

If inflation were a concern, gold would be soaring; it is not. After closing at \$2,089/oz. in Aug, on Friday, it closed at \$1,729/oz. Since March 2020, several commodities have rallied sharply and broken out to multi-year highs. Commodities are negatively correlated with the U.S. dollar, and since March 2020, the Dollar has declined sharply. Gold trading at a multi-month low is not a sign of inflation; it's more likely a sign of reduced fear. In August 2020, the market's collective wisdom realized that quantitative easing and government stimulus won't lead to high inflation or hyperinflation.

As equity growth investors, the question we need to consider is whether the market has underestimated how much interest rates could rise in 2021. The U.S. bond market is 30% larger than the stock market, so it's essential to understand that bonds can push the market around more than stocks. The Fed has said that they're going to keep the federal funds rate low until they see inflation above 2%-2.5% and stabilizing at those higher levels before they even think about raising rates. It's important to remember that when mortgage and auto loan rates rise, they're not dependent on the federal funds rate. These rates tend to move in the same direction over time, but one is not tied to the other. The stimulus being injecting into the economy will push prices higher, but that may be just one lever and not enough by itself to have pushed rates from .53% to 1.5% and higher.

### **So Where Do We Go From Here?**

The increase in interest rates was not a surprise to us - we have been expecting a rise for a while. What was surprising was how quickly rates increased, and the reaction investors had. Short-term investors and traders have been looking to take profits in growth stocks, and rising rates were as good a reason as any to sell. As rates increase, companies' valuations are adjusted accordingly, and short-term investors usually choose to take profits. The In-and-Out rotation strategy is not an approach we take at Crystal Waters Partners. Chasing the rotation and looking to time their entry and exit is very challenging to get right. Investors making the shift now are late to the trade and

will likely be late to return to growth. What's worse is they will pay a premium come tax time next year.

Crystal Waters Partners' focus is longer-term with a 3-to-5-year time horizon guiding our decisions. We look for evidence that the economy's structural thesis and our portfolio companies are intact and remain disciplined, aiming to keep the funds turnover as low as possible. Interest rates will be volatile but won't continue to rise to the stars. Owning high-quality companies with large competitive advantages and disruptive characteristics will provide far higher returns and greater tax efficiency for our L.P.s in the years to come.

# Economic Outlook

---

## Forecast

From a macro-view, not much has changed in our view; we are still in the early stages of a new bull market and period of economic expansion that will likely last for 3 to 4 years. Our annual letter discussed our view of the market in 2021 and set a \$170 year-end earnings target for the S&P 500 or 4,420 by year-end.

## Economy

The Institute for Supply Management (ISM) reported that the **Services PMI**, which tracks the economy's service sector, fell 3.4 percentage points in February to 55.3%, missing expectations for a 58.7% reading. The **Purchasing Managers Index** report, which outpaced expectations, came in at 60.8% vs. 58.6% expected. The **ADP National Employment Report** (NER) revealed a gain of 117,000 jobs seasonally adjusted payrolls for February, missing expectations for an increase of 200,000 jobs. January's ADP report saw an upward revision, indicating that the economy added 195,000 jobs last month, up from a gain of 174,000 jobs previously reported. Personal income increased 10.0% (or \$1,954.7 billion), exceeding expectations for a 9.5% increase, following a 1.6% increase in December. Personal consumption expenditures (PCE) - i.e., personal spending, which accounts for over two-thirds of U.S. economic activity - increased 2.4% (or \$340.9 billion) in January, below expectations for a 2.5% increase. When adjusted for inflation, real PCE increased 2.0% monthly, below expectations for a 2.2% advance, following a 0.8% decrease in December. New orders for manufactured durable goods increased 3.4% in January, following a 1.2% rise in December (revised up from +0.5% previously reported) and exceeded expectations for a 1.1% advance. The durable goods number follows on the back of new home sales in January, which advanced 4.3% month-over-month (+19.3% YoY) to a seasonally adjusted annual rate of 923,000. The reading was well above expectations for an increase to an 856,000 seasonally adjusted unit rate. December's estimate was revised higher, to an 885,000 unit rate, up from 842,000 previously reported.

During the first two months of the first quarter, analysts increased earnings estimates for companies in the S&P 500 for the quarter. The Q1 bottom-up EPS estimate (which is an aggregation of the median EPS estimates for Q1 for all the companies in the index) has increased by 5.0% (to \$39.50 from \$37.61) this period. How significant is a 5.0% increase in the bottom-up EPS estimate during the first two months of a quarter? How does this increase compare to recent quarters? The first quarter marked the second-highest increase in the bottom-up EPS estimate during the first two months of a quarter since FactSet began tracking this metric in Q2 2002.

## Markets

Our traditional metrics tell us that we are currently in an overvalued market but not necessarily at a euphoric top. That last point makes us look more in-depth at valuations. For a bull market to continue over long periods, we need to see real earnings improvement, and as noted above, we have that. The long-term, interest rate adjusted S&P 500 Price/Earnings multiple is 26. The current multiple is about 38, up from 35 last month. For comparison, the P/E's all-time high was 44.19 in 2000, just before the DOT COM crash; and in 2009, at the bottom of the financial crisis, it was 15. That historical perspective is instructive, but it doesn't tell us the whole story. The next gauge to look at is cash; specifically, is there cash to invest? Yes, there is a record \$5 trillion in cash accounts. The third gauge to check is the Inflows/Outflows gauge. Inflows/Outflow is a way of looking at liquidity in the market and where investors are putting their money. \$4.7 billion a day. That's how much money investors put to work in U.S.-listed ETFs during February—a blistering pace that summed to \$88.7 billion over February's 19 trading sessions. That \$88.7 is the second-largest monthly haul for U.S.-listed ETFs ever, behind only the \$91.2 billion record set last November. Stocks continued marching to a record high during February, mostly unfazed by a late-month interest rate spike. Beneath the surface, there was a bit of a rotation from growth to value and large caps to small caps, but nothing signified a major trend change.

For the most part, the "everything rally" remained in-tact during February. The only exception was bonds. The iShares 20+ Year Treasury Bond ETF (**TLT**) dropped more than 9% in the year-to-date period through the end of the month. The iShares iBoxx USD Investment Grade Corporate Bond ETF (**LQD**) and the SPDR Bloomberg Barclays High Yield Bond ETF (**JNK**) saw some of the largest outflows of the month.

## Disaster Relief

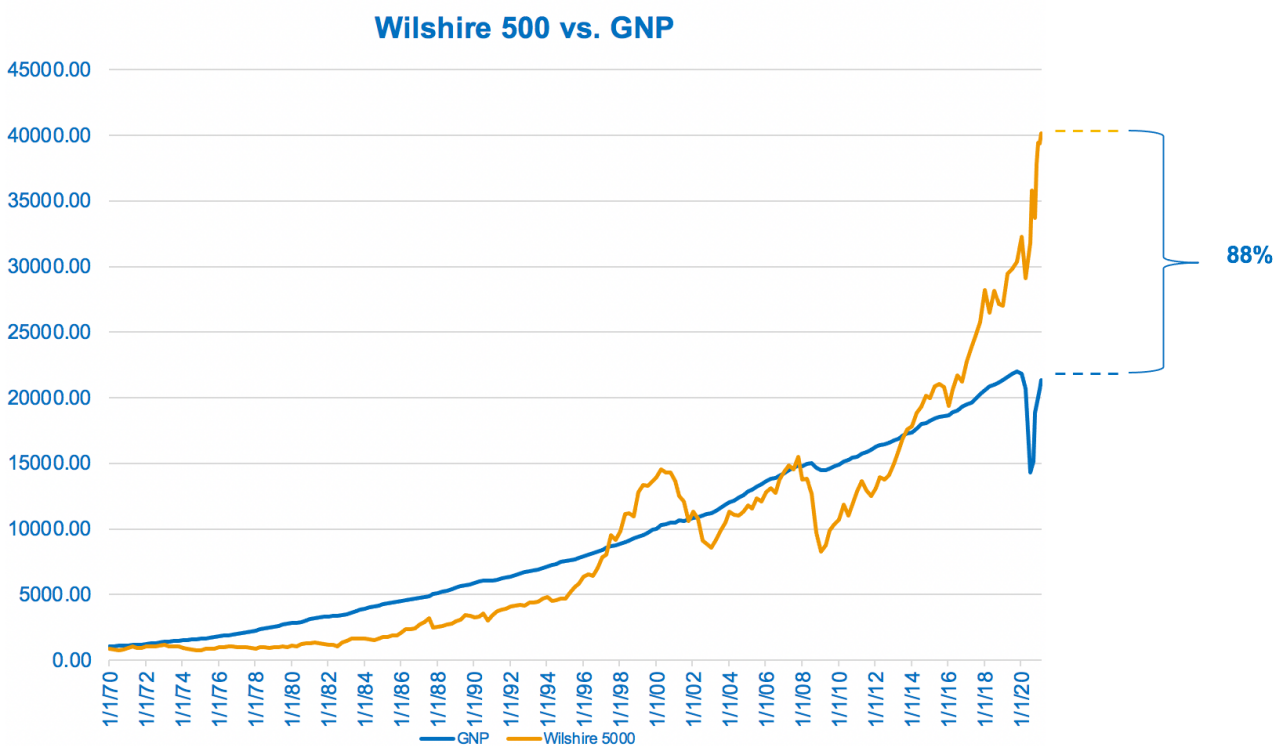
President Biden's proposed \$1.9 trillion package of pandemic relief has passed the House and is on its way to the President's desk. We're sure that the Senate will make changes and continue to state that the relief isn't required, but in the end, the Senate will likely approve a version of the bill. Incoming Treasury Secretary Janet Yellen has stated that the U.S. can return to full employment in 2022 if this relief bill is approved. Yellen's concern is that failing to act quickly with a significant relief package will allow unemployment to remain high and become a drag on the economy for years.

The greater concern we have regarding the relief bill is not the amount of money, or when it will be approved, or who the money gets distributed to, but can the money be distributed efficiently and totally. Time will tell, but we will be monitoring closely on specific areas on spending that directly impacts the fund.

# Market Valuation

February saw the Dow Jones Industrial Average gain **+3.17%**, the S&P 500 gained **+2.78%**, the NASDAQ gained just **+0.93%**, and the Russell 2000 gained **+6.14%**. Within the DOW, investors were buying large-cap, dividend-paying, value stocks and, in the Russell, small-cap value. These moves were driven by rising interest rates, which we feel is not the right approach for long-term investors.

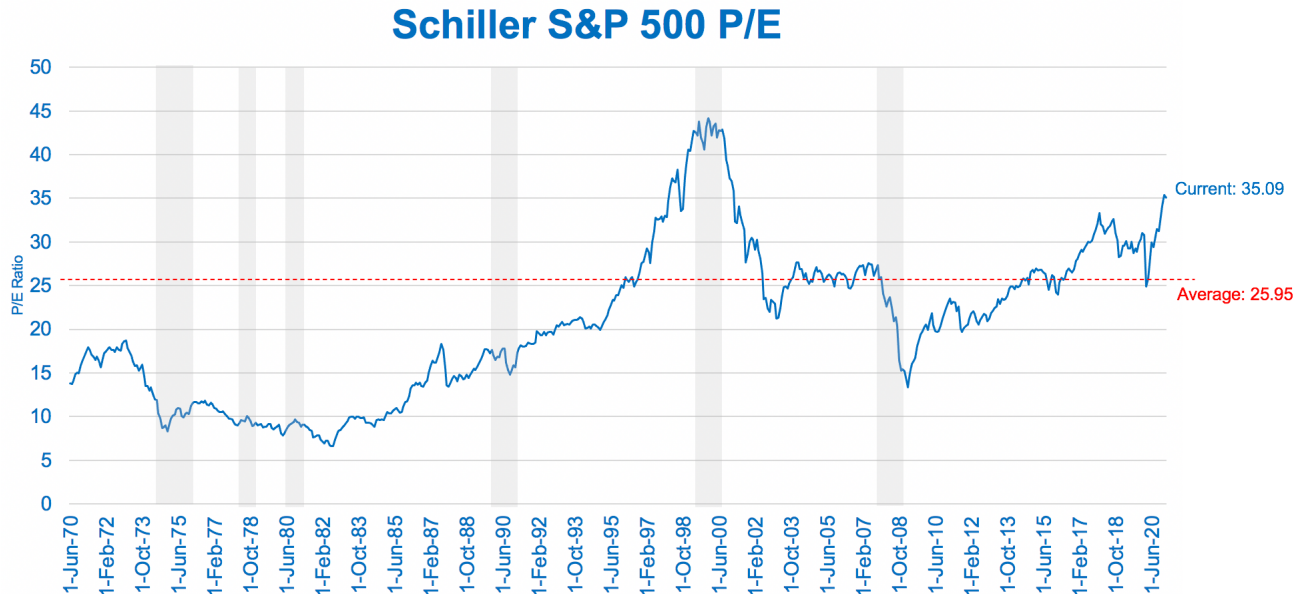
The Wilshire 5000 is now **88%** higher than the US GNP, which compares to a **90%** divergence last month, so while a slight improvement, at first glance, we are indeed in overvalued territory.



That said, we continue to believe markets will remain elevated until we see higher inflation, higher interest rates, a reduction or complete halt in Federal Government stimulus, or disappointing corporate earnings growth. The FOMC members reiterated in February they would hold rates near zero until the labor market reaches maximum employment, inflation remains above 2%. These events are likely 3-4-years away, and the low rates will help keep markets at somewhat elevated levels. However, with a built-in valuation buffer, any economic hiccup is likely to cause more panic than otherwise, and we expect to see several corrections.

Low inflation and low-interest rates both warrant a premium on equity prices, and we have been maintaining that the current financial environment, as well as rising earnings, justify a lot of the rise in equities.

The Shiller P/E Ratio adjusts earnings for inflation and interest rates, which allows us to better compare earnings over periods with differing interest and inflation rates. Since March last year, the ratio has been moving above the historical average of ~26x and is now at 35.09, over **35%** above the average.



We need to see aggregate earnings grow faster than equity market prices while interest rates remain low, or we will remain flat or even see a correction beyond what we saw in the latter half of February. We would be happy with a bit of both, but investors should expect earnings to significantly increase in 2021 as COVID-19 vaccine distribution accelerates and more of the economy opens up. Until then, we remain cautious about the broader market and see the current environment as best suited for stock pickers. In this environment, the selection of specific equities becomes increasingly more critical for investors.

Our broader view is that corporate earnings will increase in 2021 and 2022, and at least \$1 trillion of the \$5 trillion currently on the sidelines in retail and commercial brokerage accounts will come back into equities. As money flows into stocks and earnings improve, we will see the market multiple compress.

## What Excites Us

### Economy Reopening

Many of the fund's positions stand to benefit as the economy reopens. While we are thrilled with the short-term growth, we remain focused on the tremendous growth ahead as our major themes continue to unfold. With 70% of the economy dependent on consumer spending, reopening is an essential catalyst for growth.

### Growth at Reasonable Prices

Technology stocks in cloud software and semi-conductor spaces have pushed those stocks to astronomical levels. We see tremendous opportunity in several positions where our downside risk is minimal, and the upside could be tremendous. Our investment in these companies is equivalent to owning private equity traded on the public exchanges. We hope that we can deliver private-equity size returns from some of these holdings.

### Amount of Money Still on the Sidelines

Many investors are still sitting out in the current market. Last month there was \$4.6 to \$4.8 Trillion sitting in cash accounts. In November, we see about \$5 trillion. This is over 30% more than the 10-year historical average, and for many institutional investors, earning 1% or less on cash isn't a long-term option. Investors are rightfully careful, but with low-interest rates and GDP on the mend, this cash will be invested to the benefit of current investors who are already fully invested.

## What Keeps Us Up at Night

### Politics

Joe Biden has been quickly working on vaccine distribution, manufacturing, and getting a relief bill passed. One initiative is a national \$15/hour minimum wage, or \$30,000/year gross. The non-partisan Congressional Budget Office estimates that this will cause a loss of 1.4 million jobs. Given the significant differences in the cost of living across the country, the states need to have greater control over minimum wage levels.

### Federal Stimulus

Amid a GDP contraction, U.S. disposable income has risen substantially, primarily due to Federal stimulus. The extra money has supported the continued buying of products and services from businesses but also equities. Congress has passed a second relief bill, and some portion found its way into the stock market. With a third relief bill in the works and an additional \$1 trillion to \$1.9 trillion on the way, U.S. markets will experience unprecedented inflows to stocks, bonds, retail purchases, and travel. The big question is, can the government distribute that much money?

### COVID-19 Vaccines Hype

With three vaccines approved and distribution underway, our concern has migrated from worrying about getting a vaccine developed to worrying about how many people will take the vaccine. The Federal Government, individual states, and the pharmaceutical industry have done, in our opinion, a poor job of communicating why we were able to develop a vaccine as quickly as we did, which breeds skepticism. Outwardly it looks like we cut corners when in reality, it's due to new technology. Will the skepticism translate into people being unwilling to take the vaccine?