CRYSTAL WATERS PARTNERS

Market Outlook

October 2020

Public Safety Makes for Good Investing

After a multi-month recovery since March, equity markets have begun to plateau and retreat some as valuation of technology and healthcare companies are mostly tapped out, and companies in other sectors such as retail, travel, and entertainment are still impacted by restrictions from COVID-19.

As we get further clarity on the US election, including policies around new COVID-19 restrictions and additional financial stimulus, as well as updates on early vaccines, we continue to position the fund for a gradual rebound in reopening while taking advantage of long-term trends that are still accelerating in technology, energy and healthcare.

Interest rates are expected to remain low for the next 3-4 years with favorable tax treatment to spur additional growth, and we are likely in the early stages of a new bull market. The fund has exposure to sectors where we anticipate growth and positions that provide support during times of market rotation and uncertainty.

Market Moves

During the current global pandemic, we continue to see the biggest investment opportunities in Healthcare, Biotech and Technology companies. As the world struggles to cope medically and quickly begins to adjust to a new normal where daily work, shopping, and entertainment happens at home, these activities require a new level of internet access, security and collaborative applications. Despite many of the uncertainties in the economy right now, the general direction of the market is positive. However, our cash position remains strong as we anticipate lots of volatility in the second and third quarter and will continue to add positions where we see the most long-term value.

Fund exposure to China

Crystal Waters Partners held no long positions in Chinese companies during the month of October. We find the market less transparent and the geopolitical climate far too risky for our limited partners money despite some good companies.

Notable Holdings and Developments

NASDAQ: AAXN

Technology for Public Safety

Axon Enterprise (AAXN) is one of our earliest investments and has been rewarding the fund all through 2020. While many industries have struggled through the pandemic year, Axon Enterprise has thrived by being right at the epicenter of one of the biggest challenges we've all witnessed this year.

On May 25, Minneapolis police officers arrested George Floyd after a convenience store employee called 911 and told the police that Mr. Floyd had bought cigarettes with a counterfeit $20 bill. Within minutes, Mr. Floyd was unconscious and pinned beneath three police officers, showing no signs of life. The New York Times combined videos from bystanders and security cameras, reviewed official documents and consulted experts to reconstruct the events leading to Mr. Floyd's death. In 8 minutes and 15 seconds our nation pivoted on a tragedy that erupted in protests, violence and a call for change. Axon has been delivering that change to police departments, governments, first responders and communities since 1993 but is really beginning to hit its stride as a maturing product line begins to meet the increasingly complex needs of police departments. Axon, formerly known as Taser International, originally focused on the development of non-lethal weapons for law enforcement but quickly expanded their vision to technology solutions for public safety. Today Axon delivers products in three integrated categories 1) Smart Weapons, 2) Cameras, 3) Software.

Our thesis on Axon was initially rooted in the company's business model where we saw a disrupter that would become a long-term trend. Axon customers purchase cameras, weapons and software that are all part of an interconnected network. The investment of time, money and data collection simply makes the business 'sticky'; customers don't switch to a competitor because it's a little cheaper. The value for the officers, community, courts, victims and defendants is so large, that the cost is secondary.

Product Line

TASER – The new TASER 7 is Axon's latest smart weapon designed to de-escalate violent situations and prevent the use of lethal force. The TASER 7 is the first to be wirelessly connected to the Axon Network to upload usage logs and assign weapons to officers.

Cameras – Axon cameras have been developed for many situations, including body cameras, in-car video, drones, and Axon Interview which can store weeks of continuous audio and video with annotation, bookmarks and commentary features.

Software – The real power of Axon's products is the software that connects everything into an integrated network. Axon Records for fast and accurate record keeping, Axon Evidence to streamline management and storage of digital evidence, Axon Standards for internal affairs investigations, Axon Evidence for Public Defenders and Prosecutors provides access to digital evidence, Axon Performance ensures teams are operating within all guidelines and policies, Axon Commander for cloud-based evidence storage, Axon Respond for Real-Time operations situational awareness, Axon Respond for dispatch, Axon Capture app for evidence capture anywhere with a smart phone, and Axon Citizen for securing evidence from the community in three clicks.

Financials

Gross profit margin is high at 61%. Revenue growth from the same quarter last year increased 27%. The stock trades at only about 12 times Sales and about 8 times book value. Debt is very low with Debt/Equity at just 0.56%. With Levered Free Cash Flow of $87 million, Axon has the ability to keep investing in its own business out of operations without taking on significant debt. Axon is not profitable yet because the company is in its growth investment phase. Our hope is that management continues to invest in the business.

Economic Outlook

Forecast

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. The expansion continues to be driven by low interest rates, low inflation, historic federal liquidity and all-time highs in money sitting on the sidelines; we see tremendous growth in the markets ahead. The S&P 500 is currently around the 3,600 level, we project that the S&P should reach 3,800-3,900 by year end for about a 5%-8% increase from current levels.

Markets

In the last week of October, the major indexes returned to the September lows as corona virus cases surged in the United States and Europe. Congress has still not passed an emergency relief package and investors keep looking for signs of a deal. Lack of relief caused significant volatility in the markets. We were pleased with third quarter earnings results, especially considering the headwinds from COVID-19.

Election

Now that the election is over, we can focus our investing on a more predictable future. We say more predictable because the House and Senate are more balanced and will be forced to work on issues that are more centrist. The days of tweets causing stock market rallies and declines should be behind us. Extremism within the two parties we hope will subside as the next few years unfold with progress on big issues that benefit the majority. While we have received great news about progress on a vaccine from Pfizer, there are still major issues to address; trade war, national security, COVID-19, negative rates, unemployment, immigration and more.

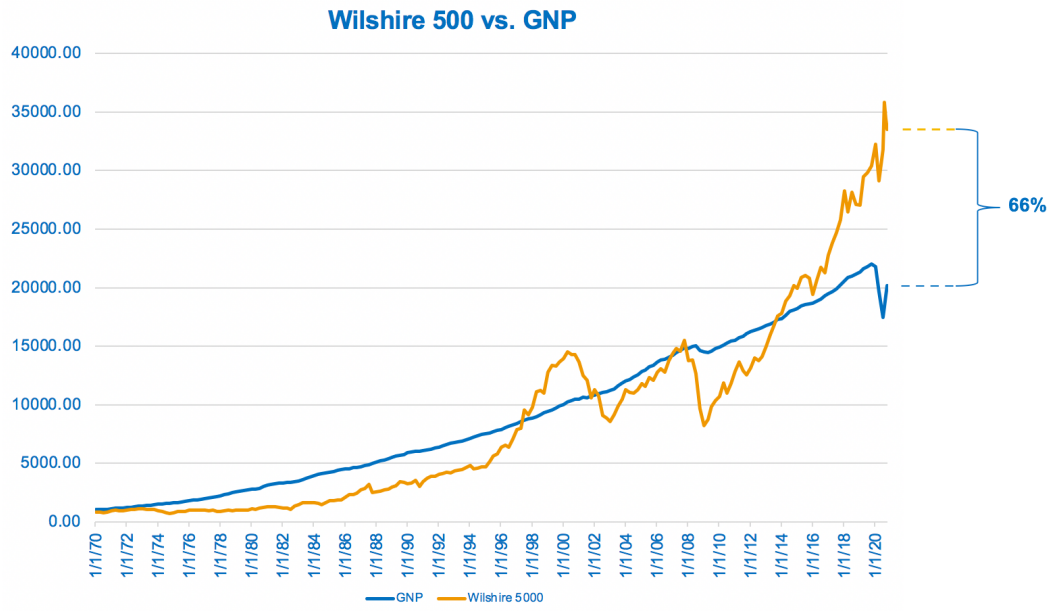
Targeted Relief Needed

The language in the news seems centered around the "Need for Stimulus", but in actuality, the economy doesn't need stimulus, it needs major disaster relief. Millions are unemployed and small business failures have been catastrophic. Small business accounts for about 50% of employment and 44% of business activity. According to a July U.S. Chamber of Commerce Survey 58% of small business owners say they fear closing permanently; and many already have. A survey from the National Restaurant Association estimates 40% of restaurants won't make it another six months and will likely close forever. Small business failure statistics are fairly consistent, but this level of failure is not due to a lack of business acumen; small businesses are failing due to a lack of revenue caused by COVID-19 and a forced government shut down. While Large companies can file Chapter 11 to restructure and reorganize, small businesses simply need revenue and financial assistance to be able to get loans and pay bills. If a restaurant can't survive because the dining room is forced to stay closed, how does the owner go about getting loans to buy a food truck or convert the operation to a take-out only business. The answer is, most will simply close and try to make minimum payments on their debts.

Market Valuation

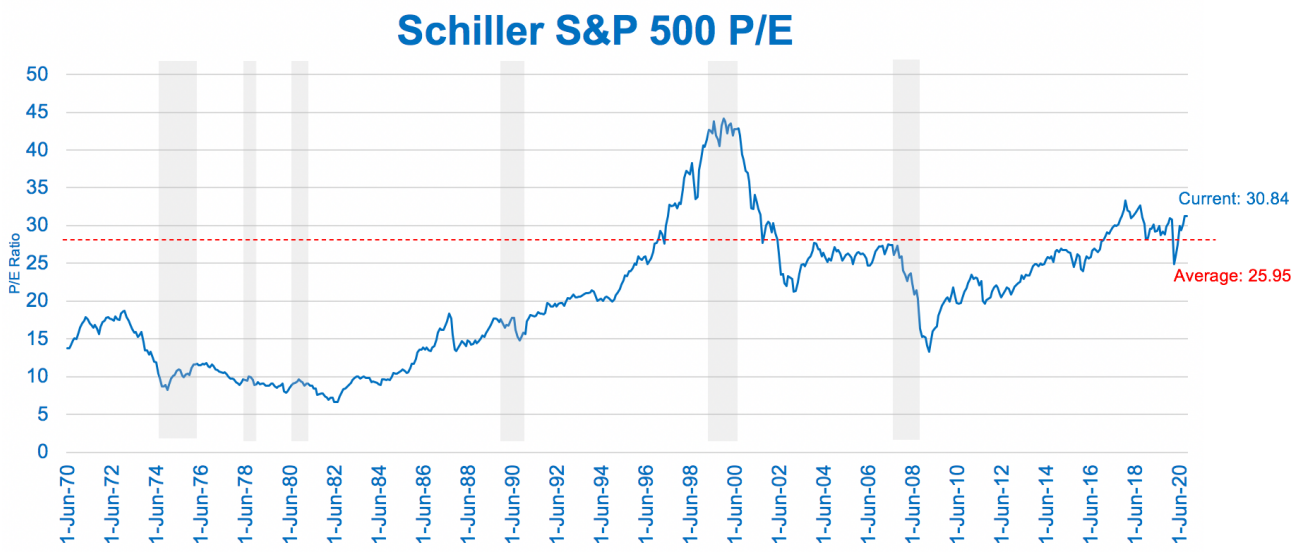
Equity markets are at historic highs but will likely remain elevated until we see higher inflation, higher interest rates, and a reduction in Federal Government stimulus. FOMC members agreed in September to hold rates near zero until the labor market reaches maximum employment, and inflation reaches 2%+, and the economy shows it is on track to moderately exceed that goal for some time, all of which are 3-4-year away. As far as additional stimulus, we need to wait and see, but Congress is likely to pass some form of additional financial relief to both individuals and businesses in Q4 or early in the new year.

Comparing the Wilshire 5000 vs. the U.S. GNP is a useful measure of where valuations stand at any given moment in time. The Wilshire 5000 has been far outpacing GNP since 2014, which was exacerbated by a sharp drop in GNP in the first half of 2020. The gap between the index and GNP rose to over 100% in August, but as GNP begins the grow and the market plateaus or even retreat a little, the gap has narrowed to 66%.



This divergence is large but should begin to narrow further as economic growth rebounds at a faster pace than equity prices. This suggests that at some point, equity prices broadly will produce lower returns and selecting individual companies will become more important. Low inflation and low interest rates both warrant a premium on equity prices. Using the Shiller P/E Ratio to gauge valuations is helpful as it adjusts earnings for inflation and interest rates. The ratio as of August was 30.84, or ~19% above its historical average, confirming that market values are above historical averages relative to inflation-adjusted earnings, although not as much as the Wilshire/GNP

comparison indicates. Many companies have found ways to operate leaner during the pandemic and many are still managing to produce good earnings.



With solid earnings and low interest rates still in place, this would indicate that we are likely not due for a major crash again, but rather a calibration for the rest if the year where earnings begin to grow faster again and prices for the broader market pause or come down some.

While the economy has technically been in a recession for the first half of 2020, a substantial part of the equities market, particular the technology, ecommerce, real estate, construction, and healthcare sectors, have seen extraordinary demand. The government stimulus has been one of the key drivers for demand and has supported company earnings this year. Should Congress fail to pass and distribute a second stimulus before the economy organically reaches full strength again, we could see earnings drop and P/E ratio increase to higher levels.

What Excites Us

Economy Reopening

Crystal Waters Capital is not just a one-sided investment in technology and healthcare that benefits from the hard times caused by COVID-19. Many of the fund's positions stand to benefit greatly as the economy reopens and the demand for energy, traditional in-person shopping, and travel improves. We continue to have a waterfall of catalysts in our holdings, as we signs of the virus fading, we have several investments that stand to benefit disproportionately.

Growth at Reasonable Prices

As much of the economy slowed down earlier this year investors chased growth in a handful of sectors. With a big concentration of capital for a limited set of stocks, valuations, specifically in the technology sector, ballooned well above what we believe the underlying businesses are worth, even with accelerated growth and expanded markets. We felt the prudent thing would be to trim and lock in profits for the fund for several of these companies to redeploy the capital elsewhere. All of the companies in question are long-term winners with nice growth. Any trimming was simply done from a valuation perspective. The recent pullback in many of the technology names has given us an opportunity to reenter or add to these positions with far greater upside than where we sold for the simple reason that the cost basis is lower.

Amount of Money Still on the Sidelines

Many investors are still sitting out the current market. Between $4.6 to $4.8 Trillion is currently sitting as cash in deposit accounts (checking, savings, mutual funds, etc). 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 obviously and rightfully being careful, but with low interest rates and GDP on the mend, this cash will soon be invested, to the benefit of current investors who are already fully invested.

What Keeps Us Up at Night

Politics

Joe Biden has been declared the winner of the US presidential election and has unofficially begun his transition process. Officially, the states have not yet ratified the election results, and the Trump campaign is challenging the election. Additionally, several Senate seats still hang in the balance pending a runoff and will directly determine which party controls the Senate. While political gridlock usually means more of the status quo for the markets, a lot of investor capital will continue to be sidelined until there is clarity on the political front.

Federal Stimulus

In the midst of a GDP contraction, US 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 provided extra liquidity to the equities market. The Stimulus passed in March expired at the end of July, and Congress has yet to pass a second relief bill, despite high unemployment and GDP still negative for the year. The economy and the financial markets need a second stimulus. The Fed is mostly out of ways to help and has strongly urged Congress to step in with targeted financial relief. Should Congress fail to pass a bill of any substance, the economic recovery will sputter, and the markets will respond accordingly.

COVID-19 Vaccines Hype

Getting back to normal will require herd immunity to COVID-19, but to get to herd immunity we need a vaccine. Pfizer announced positive phase 3 results for their vaccine with lots of fanfare. However, it is still months away from review and approval, and distribution requires freezers that can store the vaccine at minus 70 degrees Fahrenheit, something that isn't realistic for most hospitals, doctors' offices or drug stores. Other vaccines are still in development, but will take longer than most people think, making 'normal' a late 2021 or early 2022 event.