CRYSTAL WATERS PARTNERS

Market Outlook

September 2020

Power in Patience

As the economy recovers from a severe contraction while COVID-19 still forces intermittent business shutdown, markets will be volatile as September showed. Rates are set to remain low for 3-4 years and we are likely in the early stages of a new bull market.

Large institutional investors seem to agree as well. While September was tough, hedge funds saw an increase of **$15.1** billion in net inflows as big investors saw the decrease more as an opportunity than a threat.   Crystal Waters Partners was no different as we have seen our assets under management (AUM) increase **+130%** since the beginning of the year.

We expect the months ahead to be bumpy but remain bullish for the second half of the year. 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 September. 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

GENERAC

NYSE: GNRC

The Future of Power

Over the past two years Generac has been acquiring and developing technology to create and manage a fully integrated power solution for the residential market.

In August of 2020 Generac announced their PWRcell product, the first and most powerful, fully integrated power solution. PWRcell combines a stand-by generator, solar panels, battery storage and a software management application. Generac took a giant step forward when on October 6th the company announced that it is acquiring Enbala Power Networks. Denver-based Enbala provides software that enables utility grid operators to pool power from generators, solar and battery storage. The company's Concerto platform is used by utilities and energy retailers around the world to leverage the power from these sources. We think that the U.S and Europe are on the leading edge of a transformation of the electrical grid. We are quickly moving from a centralized power distribution model to one that will be digitized, decentralized and more resilient. By using the Enbala software, owners of generators, solar panels and battery storage can register to participate in energy aggregation and control programs. This means otherwise dormant back up power generation assets can come online as part of a distributed energy solution and generate revenue for the owner.

Founded in 1959, Generac was the first to engineer affordable home standby generators, along with the first engine developed specifically for the rigors of generator use and is now the #1 manufacturer of home backup generators. Generac manufactures the widest range of power products in the marketplace with 5700 employees and doing business in 150 countries. Their omni-channel distribution model which includes dealers, wholesalers, retailer and e-commerce, makes access to products easier than competitors. Homeowners can pick up a generator at Costco, Wal-Mart, Home Depot, or call a dealer for sales, installation and service.

Our thesis on Generac is rooted in six key trends; 1) Technology is disrupting the traditional electrical utility grid, 2) Expectation of more severe weather driving power outages, 3) Huge supply of natural gas makes it the fuel of the future, 4) Legacy infrastructure will require decades of major investment, 5) Telecommunications infrastructure requires significant improvement, 6) Millions working, learning, shopping, entertaining from home. All of these trends will require reliable power that can run on any fuel source and customers will require integration of all power sources. Generac's sales as a result of fires in the western United states and hurricanes in the east are proving our thesis. We think Generac is perfectly positioned to take advantage of all these trends.

Broad Product Line

In addition to permanently installed generators, Generac's offers a mobile line for job sites, trailer-mounted mobile generators, power washers, battery operated yard tools, mowers, wood splitters, pumps, that benefit from long term trends in moves to the suburbs. The companies industrial solutions provide reliabile power to data centers, hospitals, municipalities, telecom companies, universities, manufacturing and small businesses.

Financials

Gross profit margin is high at 41%. Net profit margins of 12% exceeded the industry. Net operating cash flow increased over 1,165% from the same quarter last year. Debt to equity is very low at 0.82 and Net Sales for the trailing twelve months were $2.214.83 billion. Companies with higher EBITDA rates are outperforming those with lower rates; Generac's EBITDA growth rate is about 21.54%, while competitors and industry peers are significantly lower or negative. With a P/E ratio of about 52, Generac trades more like a technology company than an industrial, which we think is appropriate. But with a forward P/E of only 27, the stock trades more in line with the overall market making the company look cheap on a forward earnings basis.

Economic Outlook

We are unquestionably in the early stages of a new bull market and period of economic expansion that will likely last for 3 to 4 years. 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 third quarter has come to a close and markets for the week managed to close higher in what was a volatile week that culminated in a selloff Friday on the news that President Trump tested positive for COVID-19.

Considering the depth of this recession due to the COVID-19 shutdown, it's instructive to look at corporate earnings. With second-quarter earnings season completed, over 80% companies reported a positive EPS surprise. For the second quarter, earnings were down roughly 30% year over year. Revenues for the S&P 500 are down 8.7%. 13.6% missed the mark and 3.2% were in line with consensus. On a year-over-year comparison basis, 38.6% beat the prior year's EPS results, 59.8% came up short and 1.6% were virtually in line. The best performing sectors have been Information Tech, Healthcare and Materials while the worst performing have been Consumer Discretionary, Energy and Real Estate.

The change is being made simply because as Powell noted, "*if inflation runs below 2 percent following economic downturns but never moves above 2 percent even when the economy is strong, then, over time, inflation will average less than 2 percent.*" The takeaway here, and what drove the markets following Powell's speech, is that even if the economy starts to show signs of improvement, the Fed is prepared to let the economy run hot for a period of time before pumping the brakes by raising interest rates. The impact of executing on this new approach to managing inflation could be dramatic and should benefit traditional savers as much as stock market investors.

With a lot of the economy is still in first or second gear, and a second wave of the virus hitting many U.S. states and foreign countries, there is a lot of risk to both the U.S. and global economy right now. Amidst all the bad news there are some green shoots to help us be optimistic, but the overall picture is a mixed bag of improvement and declines.

Durable Goods Manufacturing: The Commerce Department reported new orders for US manufactured durable goods rose 0.4 percent month-over-month in August of 2020, well below an upwardly revised 11.7 percent jump in July and lower than market forecasts of a 1.5 percent raise. Still, it was the 4th straight month of improvement in orders. New home sales increase: Sales of new single-family homes in the United States jumped 4.8 percent from the previous month to a seasonally adjusted annual rate of 1,011 thousand in August of 2020, surprising markets that were expecting a fall to 895 thousand. It is the highest reading since September of 2006 as the housing market continues to recover. The National Association of Realtors reported that its Pending Home Sales Index increased 8.8% in August to a record high of 132.8, exceeding expectations for a 3.1% monthly advance.

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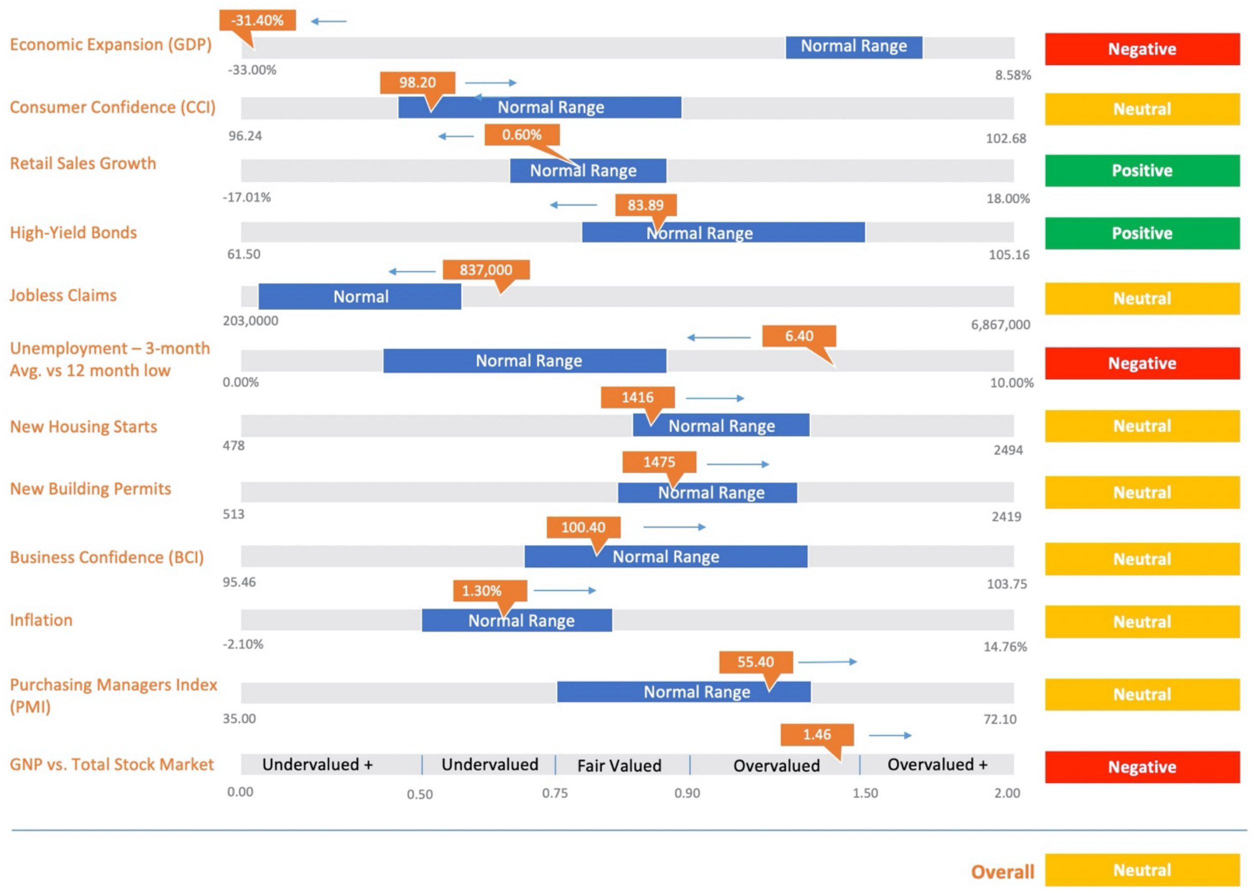
Jobs: The Labor Department reported that the U.S. economy gained 661,000 jobs in the month of September, a miss against expectations for a gain of 800,000. The unemployment rate declined 0.5 percentage points to 7.9%, slightly better than expectations of around 8.2%. The labor force participation rate, which accounts for the number of Americans looking for work or currently working, decreased 0.3 percentage points to 61.4%, reversing the previous month's trend and serving as a sign that people left the workforce. A different, broader measure of unemployment and underemployment, known as the U-6, which accounts for those working part-time because they are unable to find full-time work, fell to a seasonally adjusted 12.8%, down from 14.2% in August.

The dollar index has remained weak, sitting at about the 93 level for most of September. Gold prices declined about 4% in September to $1,887 per ounce. Our gold position has helped reduce volatility but is also a meaningful contributor to portfolio returns with a total gain of over 16%.

GDP is still running very negative. Retail sales growth declined significantly but is in the normal range now. A portion of retail sales has been made up of online ordering. Consumer confidence is back in the normal range. Business confidence is back in the normal range. We see high-yield rates as an important sign of business confidence and liquidity, the high yield HYG is back into its normal range. Housing starts and new building permits are up driven by low rates. Equities as a whole appear **Overvalued** which is an improvement from the **Overvalued+** state.

Economic Dashboard



** Reported Quarterly*

*** Normal economic cycle is considered between 75-100*

**** <300K is indicates expansion, >300K indicates contraction*

***** 3-month average of* 0.50 percentage points above the trailing 12-month low is considered recessionary

Economic Positive   Economic Neutral   Economic Negative

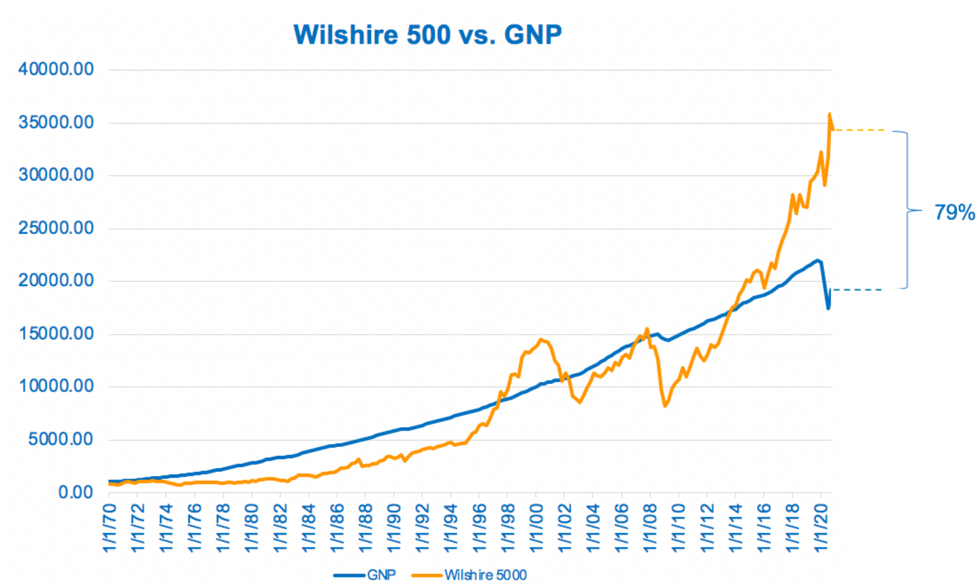
Market Valuation

Despite a sharp economic slowdown in the first half of 2020, the broader equity market is at historically high levels. The primary drivers of this are lower interest rates which are increasing stock valuations and added liquidity in the economy; and both are occurring simultaneously.

This year alone, the Federal Reserve has cut rates to near zero percent and provided a slew of credit and lending programs that have injected up to $6 trillion into the economy and provided substantial support for the market. Congress has additionally passed $2 trillion in rescue efforts and may pass more still. Federal stimulus has provided tremendous support, and it is likely that equity markets will remain at these levels until we see a sustainable change in inflation, higher interest rates, and a reduction in Federal Reserve 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. Forecasts also showed Federal Reserve Bank officials didn't expect the economy to reach those targets until 2023 or 2024, and we are likely in the early stages of a 3-4 year bull market with low rates and high equity valuation

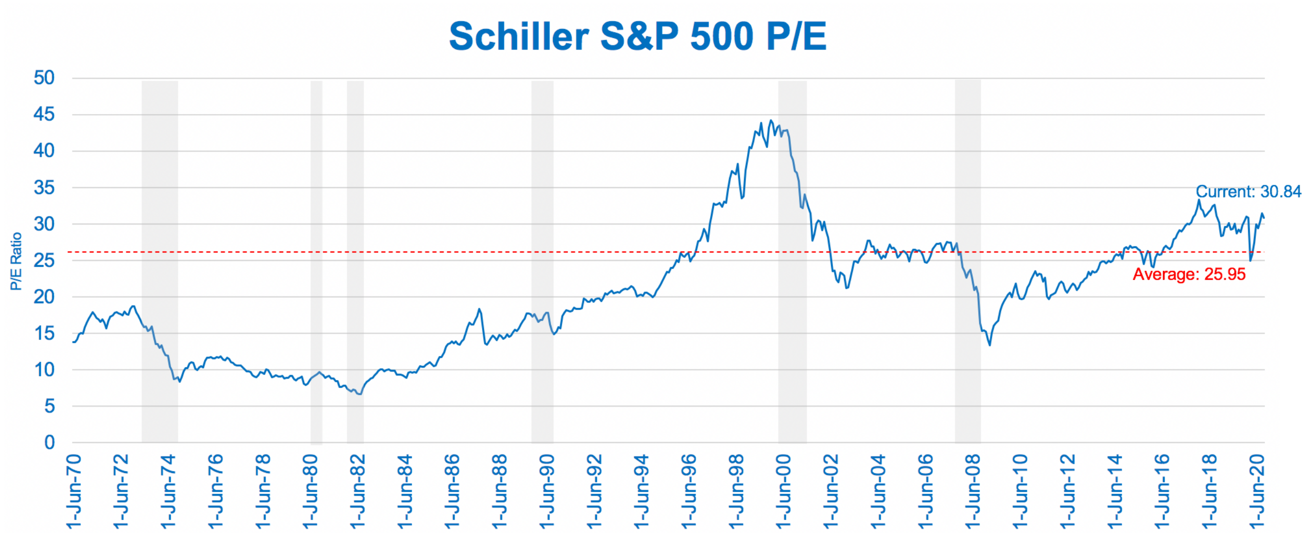
Having already emphasized that overnight rates will be pinned to zero percent for years, policy makers might also shift some current bond purchases away from securities maturing in less than three years and toward those due over longer periods, which will help lower longer-term rates.

Comparing the Wilshire 5000 vs. the U.S. GNP is useful to measure of where valuations stand at any given moment in time. The Wilshire 5000 has been growing faster than GNP since 2014, but with the recent sharp uptick since March while the GNP is drastically down, the Wilshire 5000 is now almost 80% higher than the GNP.



This divergence is indeed large, and definitely unprecedented. As the COVID-19 pandemic ends, or even if we can begin to see the end, the economy is likely to resume growth quickly and GNP will grow rapidly in 2H 2020 and partially close the gap. However, we would also expect equity prices to also begin to regress towards the mean, i.e. we will see a downward correction in prices.

Low inflation and low interest rates both warrant a premium on equity prices and using the Shiller P/E Ratio to gauge valuations is also helpful since it adjusts earnings for both inflation and interest rates. The ratio at the end 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.

What Excites Us

2H 2020 catalysts for CWP holdings

Alternative energy, biotech, electric vehicles, and digital commerce have long been the core of CWP's holdings. Yet as commonplace as these industries feel, they are still very small, but with exponential growth ahead.

We are only just beginning to scratch the surface for curing some of the world's most deadly and debilitating diseases; Solar and wind energy still only represents ~3% of total energy consumption; Less than 1% of all vehicles on the road today are electric; and only 10% of all retail is digital.

The emergence of new science gives us a real shot at curing some of the world's most deadly diseases. Plunging prices for solar and wind energy as well as lithium batteries is setting the stage for 15x-20X growth in alternative energy over the next decade. EVs will make up over half the cars on the road, and the maturation of both digital payments and rapid delivery infrastructure will help grow digital commerce multiple times over in the next decade.

While we have strong conviction in these industries, timing is impossible to pinpoint exactly. As a result, we want to be in early with larger positions, rather than chasing increasing prices later for less impactful returns.

While we wait for some of the more transformative events, most positions will trade closer to the rest of the market. The fund is still well ahead of the broader market, but nowhere near where we see it going over the next 5-10 years.

A confluence of developments has now moved some of our biggest investment themes closer to being high growth that is less connected to the rest of the market, and we are truly excited about the years ahead.

What Keeps Us Up at Night

Macro forces - Market Valuations

We like (ok, maybe we love) how the portfolio is positioned for specific secular growth, but in the short-term, we continue to see volatility and some uncertainty, both from political events, COVID-19, as well as the market itself.

Politics

Investors hate uncertainty, and the 2020 US presidential election creates enough uncertainty to last us a lifetime. Our biggest secular trends will happen regardless, but short-term exuberance or fear could dominate for several months if either candidate is elected. Our investment focus is apolitical, but we are prepared for market chaos if either candidate is elected.

Federal Stimulus

Much of the current equity market strength is due to federal stimulus and interest rate cuts. The Federal Reserve has cut and injected up to $6 trillion into the economy in addition to the $2 trillion CARES plan from Congress. However, as COVID-19 continues to put a brake on a lot of commerce, more help is still needed. We need low rates in place for several years, and families and businesses alike need additional financial assistance. Should any of this fail to happen, we will see a slow and protracted recovery that could push equity returns further out.

COVID-19 Vaccines

A vaccine to COVID-19 is not a magical wand. Some may not work as well as expected and many people may not take it. However, it will provide a light at the end of the tunnel for individuals and businesses alike, and the optimism will feed on itself and help speed the economic recovery. Should several of the vaccines fail or be materially delayed, the optimism will fade, and business activity will falter.