OUT OF THE BOX

INVESTMENT COMMITTEE UPDATE

2021 Q3

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BOX FINANCIAL

Our Mission is to help people with complex financial needs experience an **EXCEPTIONAL** life.

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Our Investment Committee

Each quarter our Investment Committee meets to review the markets and economy. At this meeting, three voting members review significant market data and hear from current advisors and appropriate support staff. When necessary the Committee adjusts the model portfolios managed by the firm. Our quarterly newsletter represents the Committee's general thoughts behind any adjustments.

Our Team

This month 10 of our 18 team members came together to pack food for hungry children in Haiti. While there we learned about Charles the founder of a Feed My Starving Children's partner, Light Up Our Youth Foundation. Growing up as an orphan in Haiti, Charles ate MannaPack™ Rice at school, but he never knew where it came from. Years later, he was packing these meals at the Schaumburg, Illinois packing site. The moment he tasted the sample at the end of the session, he knew these were the meals he ate as a child. For more information about this organization, please visit www.fmsc.org.

SUNNY DAYS & STORM CLOUDS

Labor Day marks the final hoorah before we say goodbye to summer and hello to the rhythm of the school year. It hopefully means a sunny day with clear skies and a subtle breeze, perfect for grilling and hitting the lake. Sometimes, even the sunniest of days can have some ominous looking clouds which threaten to turn into a storm. While we are enjoying the sunny day of today's economy, we are still paying attention to the possible storm clouds in the distance.

KEY IDEAS

- **Equity markets climbed higher in the second quarter with growth stocks running faster than value stocks.**
- **Treasury yields fell after a sharp run-up in the first quarter.**
- **Inflation data confirms prices have been rising as the recovery takes hold and demand outpaces supply.**
- **Overall, we remain optimistic about the outlook of the economy and subsequently the markets.**

ECONOMIC COMMENTARY

A look at What **Was**, What **Is**, and What **Could Be**

What Was

One major theme in our last paper was inflation, and it has played the star role over the last quarter. We reported in March, CPE (inflation index) was at .6% or 7.2% annualized. Since then, each month afterwards has recorded .5% or more. Although inflation is entirely personal and it is based on what you consume, we all have seen it or felt it. Lumber prices were up as much as 288%, Oil prices were up nearly 82%, and national housing prices were up 16.6% year over year. The supply chain problems were only magnified by a meteoric rise in consumer demand. Rising demand and crimped supply have resulted in the Federal Reserve coining the new buzzword "Transitory Inflation".

As inflation begins to emerge, economists and market experts are paying close attention to how the Federal Reserve communicates around when they will begin to slow down on asset purchases and begin to raise interest rates. These are two actions that typically follow an economy which is beginning to heat up too fast. We have seen the market already react when the Federal Reserve mentioned, it may be time to at least think about, talking about tapering our $120 billion in monthly Treasury bond and mortgage-backed securities purchases. Just thinking about it caused the market to initially pull back, but as time went on, the market showed resilience to the idea of "thinking about" tightening monetary policy and continued to grind higher. Not even the IMF warning about inflation persistence caused much disruption to the stock market due to the strong earnings.

Why does this matter so much? At the beginning of the year, the ten-year treasury yielded .93%, but by March it was at 1.74%. Treasuries and Growth stocks were down, but value stocks rallied. As the 10-year treasury trended lower to 1.25% today both treasuries and growth have come back in vogue. Safeguarding and adjusting the portfolio in this market has been exceedingly challenging because we do not concede to short-term knee-jerk reactions, but instead lookout for long term trends.

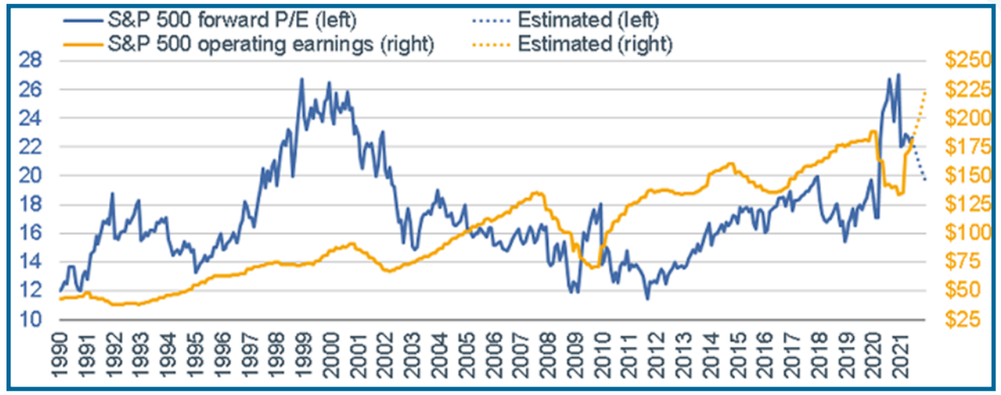
What Is

One natural consequence of rising inflation is luring employees back to work by raising wages. The Economic Policy Institute measures wage growth and reports the April 2021 wage growth was at 0.4%. As of June 2021, it has already grown to 3.6% (Economic Policy Institute). We believe the combination of businesses struggling to find workers plus inflation in consumer prices will become a major factor.

The question will be how small businesses navigate rising expenses as inflation and wage growth create pressures around profit margins. As overhead costs begin to rise, we expect them to navigate by raising prices as well as running their staff short while figuring out how to operate on a smaller budget.

We will watch Q2 earnings closely as the barometer tells us how healthy companies are amongst these pressures. Second quarter earnings are off to a great start; 88% are beating estimates with an impressive growth rate of over 74.2% year over year, but much of this was expected. It will be more important to observe how companies are revising earnings moving forward, because the strength in earnings has continued to alleviate some valuation pressures. Coming off the March 2020 lows and through the end of last year, the S&P 500's forward price/earnings (P/E) ratio soared to its highest since the dot-com bubble in the late-1990s, as earnings (the denominator) fell sharply, and stock prices (the numerator) rebounded swiftly. This year, earnings have been explosive, which has helped bring down the forward P/E.

Corporate earnings are a key metric we use in pricing the stock market to see if it is overvalued or undervalued. 2019 S&P 500 actual earnings were at $163/share, today it is $225/share. That is a 38% jump in earnings, but the S&P is only up 31%. It is argued the largest components of the S&P 500 were



largely unaffected by the pandemic. Just imagine what earnings would look like when all the companies represented in the S&P 500 are able to be fully open and staffed.

What Could Be

We have three worries moving into the second half of the year: higher interest rates, waning demand, and another shutdown of the economy.

As previously stated, it is possible the Federal Reserve will begin raising interest rates sooner than expected. May's 5% year over year CPI reading was a big deal. As interest rates rise, our concern is that market valuations begin to adjust and we see price corrections in the market. Much of valuing companies comes from discounting the future cash flows you can expect from the company. As interest rates rise, the value of these future earnings diminishes, creating a lower value for the same stock you are holding. We do not believe interest rates are going to be materially moving any time soon, as the Federal Reserve has shown reluctance to even talk about the subject, but market perception is key. If investors think interest rates could be moving sooner than expected, valuations may change even if rates never do rise.

As consumers return to their new normal, we wonder if the initial surge of demand will last for some time or if demand will fizzle out. Currently, we believe the valuations for companies are already priced to perfection and a wane in demand could cause market volatility.

Lastly, the arrival of the COVID-19 Delta variant, which is more transmissible than its predecessor, could cause markets to shut back down as they try to contain the spread of the virus. (Yale Medicine) Another shutdown would be debilitating to a lot of companies who are finally able to get back up and running after a year and a half of struggling through. We have already seen more shutdowns in places like Sydney and Tokyo. This is something we are aware of and watching closely, however between vaccination rates and the far more effective and better treatments; we believe the United States is much stronger equipped to handle any variations of the virus we may encounter.

While these three things could be harmful to the amazing progress our economy has made, we do believe these risks remain outliers. The fact remains that consumer spending continues to stay high, and more people are coming off unemployment and getting back to work. In the United States, consumer demand is the ultimate driving force for both the economy and stock market, and we believe the undeniable health and strength of the consumer will continue to extend our recovery.

FINAL THOUGHTS

Overall, we are watching a few potential storm clouds in the economic environment, but we remain cautiously optimistic about the situation. We also anticipate the robust goldilocks economic environment we have experienced over the last 12 months will gradually taper down over the next 12. In conclusion, inflation will be the next important storm, but unlike storms the process is usually gradual, not a single big event. As such, we believe it's too early to consider substantial changes to the portfolios. Remember the taper tantrums which were largely a non-event? Even if inflation does happen, history shows the beginning of an inflationary process is not life threatening. For example, inflation started to accelerate in the mid-1960s when the 10-year treasury was in the 3% range, but the U.S. stock market was largely unaffected until 1972 representing five or six years of inflation picking up gradually before it became threatening enough for the market to respond negatively. Yes, that was 50 years ago, and information and market changes are much faster now, but inflation is not an event it is a process.

We have always strived to view the market with a nuanced view, and we believe there is still more room to run in this expansion and continue to be optimistic about the short-term trajectory of the United States economy for the next 6-12 months. After all, we forecasted in January a staggering 6% GDP growth rate by year end. At the time it was considered too aggressive since for the last 10 years we have averaged less than 2%. As of today, we may have underestimated the US GDP growth potential and although the Q2 was lighter than expected it was due to continued bottleneck problems with inventories. Moving into next year, it may just be the next stage of growth looks more like an older rabbit vs. the record crushing energetic hare.

P.S. For all those who have read the last quarter OOB newsletter and wanted to know if Austin found a car, he did! He has also joined the workforce taking one more "help wanted" sign down. But what he plans to do with his earnings is the real insight.

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