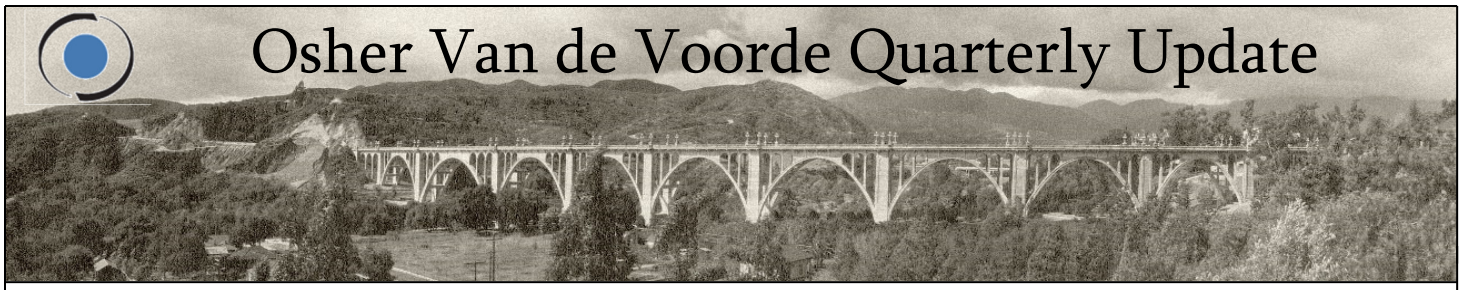


In the Fed We Trust

July 2021

Despite long awaited signaling by Chairman Powell that the Federal Reserve is finally "talking about talking about tapering" its massive bond buying program, the stock market rally continued through the end of the second quarter. The S&P 500, Dow Jones Industrial Average and NASDAQ Composite have respectively advanced 14.41%, 12.73% and 12.54% for the first half of 2021.

Much of the strength in the stock market can be attributed to the ongoing V-shaped economic recovery. First-quarter GDP increased at an annual rate of 6.4% after increasing by 4.3% in the fourth quarter of 2020. Median existing-home sales prices topped $350,000 for the first time in May – this was almost 24% higher than a year ago and the biggest annual increase in more than two decades. And the typical home sold in May spent only 17 days on the market, matching the record low set in April. With the markets for stocks and real estate both red-hot, U.S. household net worth has soared over $142 trillion, amplifying the so-called "wealth effect" as Americans spend more and boost economic activity.

The economy's rebound from the pandemic is simultaneously driving the biggest surge in inflation in 13 years, with consumer prices rising in May by 5% from a year ago. The core-price index (which excludes often-volatile food and energy costs) jumped 3.8% in May, the largest year-over-year increase since June 1992. This surprising uptick in inflation prompted the Federal Reserve to adjust their "dot-plots" with the Fed now expecting to raise interest rates by late 2023, sooner than they had anticipated in March. More importantly, Fed officials also discussed an eventual and perhaps imminent reduction (tapering) of its $120 billion monthly bond buying program. The Fed revised its 2021 expectations for inflation by a full percentage point to 3.4% and its projection for full-year GDP growth to 7% from 6.5%. The Fed maintains that the current spike in inflation is "transitory" as the base effect coming out of the cyclical lows of the pandemic wears off. Indeed, compared with two years ago, overall prices rose a more muted 2.5% in May. Further, prices most impacted by the pandemic are now having a disproportionate share of the rise in inflation. For instance, prices for used cars and trucks leapt 7.3% from the prior month and drove one-third of the rise in the overall index. While Fed policy may have pivoted, it remains extraordinarily dovish.

With such a surge in economic activity and inflation, many market participants are surprised by the lack of urgency in the Fed's projected policy changes. If inflation were to exceed 2% by too much for too long, it might lead businesses and consumers to anticipate higher inflation in the future which can become a self-fulfilling prophecy. Evidence of escalating inflation expectations would likely require the Fed to tighten policy sooner or more aggressively than what is currently planned. Despite these risks, the Fed is mostly sticking to its script of letting inflation run hot so that it averages 2% over an extended period. With inflation fears rampant, despite the Fed's rhetoric, we would have expected bond yields to rise, especially in anticipation of a sooner-than-expected end to QE.

Instead of the type of "taper tantrum" observed in previous episodes of Fed policy pivot where yields rise markedly in anticipation of future rate hikes, bond yields have plummeted. After rising from just under 1% at the end of 2020 to 1.75% a few months ago, the yield on the benchmark ten-year Treasury has sunk again to 1.3%. Lower yields mean investor appetite for bonds has increased, not what might have been expected given the surge in inflation and economic activity. The steady decline in yields after the June Fed meeting is a conundrum worth further exploration.

Already the largest overseas owner of Treasuries, Japan's buying of U.S. debt has accelerated in the past few weeks. Pension and fund flow data reveal that Japanese investors have been rebalancing their portfolios in favor of bonds. And with the yield gap between the German and U.S. ten-year bonds having reached its widest margin since before the pandemic, it stands to reason that European investors have followed suit with their Japanese counterparts. As we have consistently mentioned in previous articles, the U.S. is the cleanest shirt in an otherwise dirty pile of laundry, making U.S. debt much more attractive than comparable debt of other developed nations. In addition to strong demand from foreign investors, short covering has also played a role as many hedge funds had shorted bonds in anticipation of higher rates and lower bond prices.

Another factor to consider is that it is becoming more probable that the current spike in inflation is truly transitory as Chair Powell wants us to believe. In addition to the explanation how certain anomalies such as the pricing of used cars have disproportionately driven inflation higher, there is growing debate about whether a strong labor market will spark inflation as in previous economic recoveries. Even as the U.S. has added over 1.5 million new jobs in the past two months, average hourly earnings growth has been scant and below expectations. The fact is that 2.6 million Americans have retired between February 2020 and April of this year and a steadily aging population, with 10,000 baby boomers turning age 65 every day, suggests limited scope for reversing this trend. Chair Powell admitted as much in recent testimony that "we've seen a significant number of people retire so we don't actually know what labor-force participation will be as we go forward." Despite better hiring, U.S. unemployment unexpectedly rose to 5.9% from 5.8% in May.

Further, while labor is the biggest cost for the U.S. economy, businesses have been able to cut countless other costs though efficiency improvements and productivity growth, allowing them to increase worker wages without having to raise prices. Wage growth does not necessarily imply higher inflation as we witnessed throughout the 1990s.

Another idea worth consideration is that the markets are increasingly skeptical that the Fed will ever be able to normalize interest rates. The elephant in the room is the massive indebtedness our country now faces. Federal debt has risen to $28 trillion ($8 trillion of which stands on the Federal Reserve's balance sheet) and is expected to rise further under Biden deficits estimated at $3 trillion for the year. U.S. household debt, including mortgages, student loans, credit cards and car loans, is estimated at $24 trillion. Corporate debt has climbed to $11 trillion and municipal debt is pegged at $4 trillion. This amounts to over $67 trillion of total debt and does not include the gargantuan $50 trillion plus unfunded liabilities for Medicare and Social Security. Please check out www.usdebtclocl.org for a stunning real-time view of U.S. debt obligations.

If the Fed tightens, this massive debt pile becomes more expensive to service and hampers economic growth. If the Fed does not tighten, the debt will continue to grow and make it even more difficult to adjust rates higher. Consider that the Fed was unable to lift rates higher than 2.5% during the last tightening cycle and we have amassed multiple trillions of dollars of debt since then. U.S debt to GDP stands at approximately 128%. Japan's debt to GDP is estimated at 257%. With its aging and shrinking population, Japan's economy has been mired in a slow/no growth economy for decades. The evidence suggests we may be destined to follow the Japanese path.

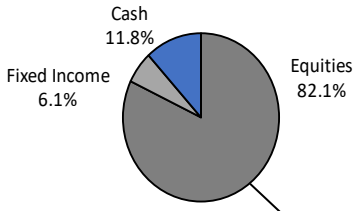
Finally, another factor to consider is that the economy may have already peaked, and the bond market is already sniffing out the other side of this cyclical recovery. President and Chief Economist of Rosenberg Research David Rosenberg opines that the "bad news" for bonds – enormous fiscal and monetary stimulus, double-digit economic growth, reports of widespread wage gains, expectations for infrastructure spending and the new roaring 20s reopening theme – was already priced in by the market when the ten-year Treasury rose to 1.75% earlier this year. According to Rosenberg, "what isn't priced in is a second-half growth relapse in the economy." Perhaps the bond market sees a higher propensity for Fed policy error that kills the recovery and throws the U.S. back into recession.

While we have little certainty about what the Fed's next move might be, we are definitively certain that we would not be buyers of bonds here. Should interest rates remain low or move lower still, asset classes such as growth stocks and real estate will continue to perform well. What is also certain is that financial markets' sensitivity to monetary policy has never been higher. In the Fed we trust, God bless the Fed.

Investment Strategy Summary

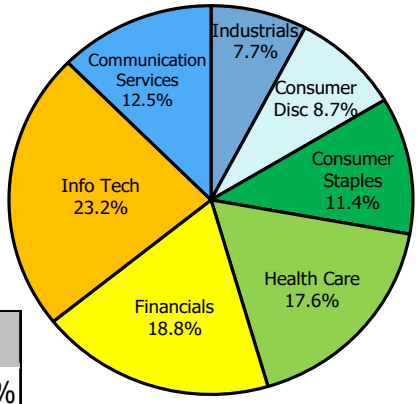
As of June 30, 2021

Firmwide Asset Allocation



OVIM Equity Composition	
International Core	9.4%
U.S. Core	90.6%

Equity Sector Allocation

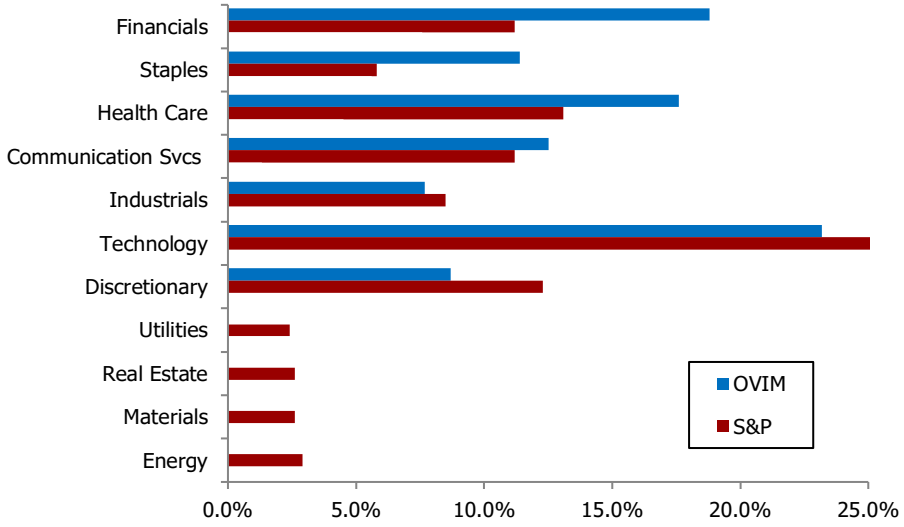


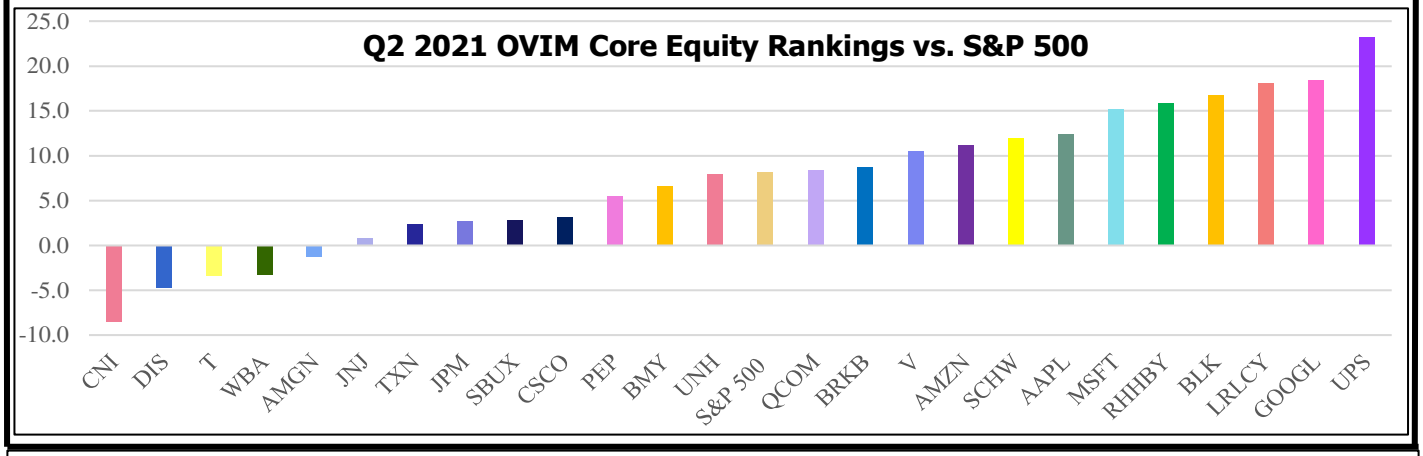
Top Core Global Equity Holdings

Alphabet Inc. Class A	GOOGL
BlackRock Inc.	BLK
Charles Schwab Corp.	SCHW
United Parcel Service Inc.	UPS
JP Morgan Chase & Co.	JPM
Amazon.com Inc.	AMZN
Walgreens Boots Alliance Inc.	WBA
Starbucks Corp.	SBUX
Berkshire Hathaway "B"	BRKB
Texas Instruments Inc.	TXN
Walt Disney Co.	DIS
Qualcomm Inc.	QCOM
Cisco Systems Inc.	CSCO
UnitedHealth Group Inc.	UNH
Microsoft Corp.	MSFT
Apple Inc.	AAPL
Bristol-Myers Squibb Co.	BMY
PepsiCo Inc.	PEP
L'Oreal ADR	LRLCY
Visa Inc.	V
Johnson & Johnson	JNJ
Roche Holding AG	RHHBY
Amgen Inc.	AMGN
Canadian National Railway Co.	CNI
AT&T Inc.	T

Sector Weightings Relative to S&P 500

Ranked by Largest Overweight

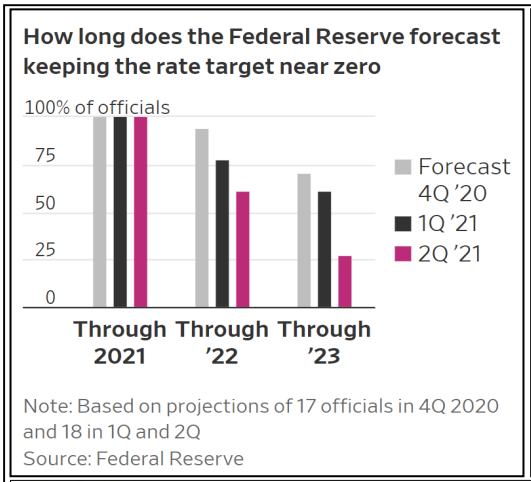


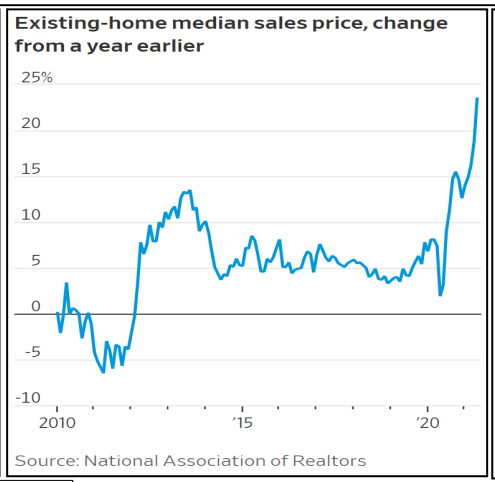


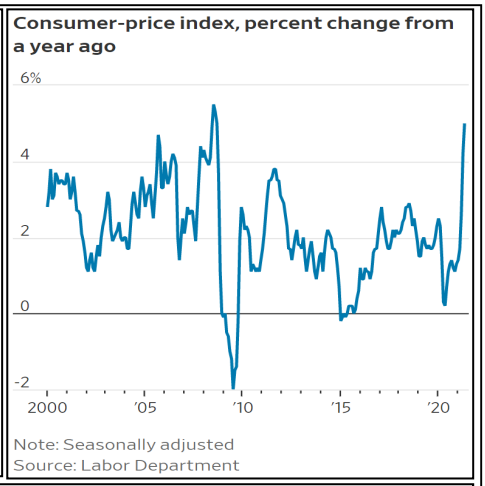
This presentation is solely for informational purposes. Data is pulled from sources believed to be reliable, but not independently verified. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by Osher Van de Voorde Investment Management unless a client service agreement is in place. Please contact us at your earliest convenience with any questions regarding the content of this presentation and how it may be the right strategy for you. This data is representative of all equity securities held across Osher Van de Voorde's client accounts, however portfolios are tailored to meet specific client objectives and actual client holdings will vary.

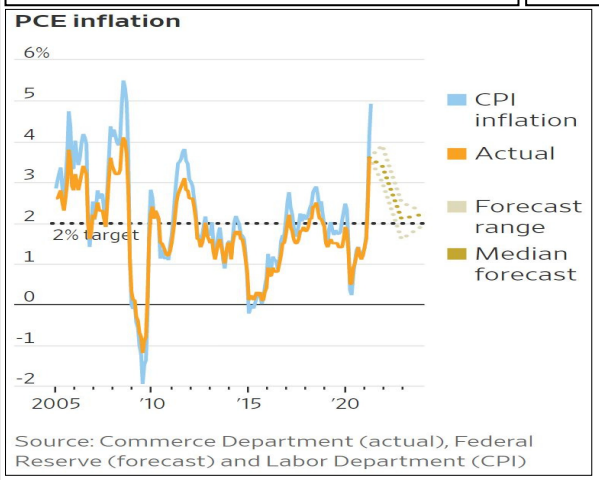
The S&P 500 Index or the Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies. The S&P 500 is a float-weighted index, meaning company market capitalizations are adjusted by the number of shares available for public trading. Note: Investors cannot invest directly in an index. These unmanaged indices do not reflect management fees and transaction costs that are associated with most investments.

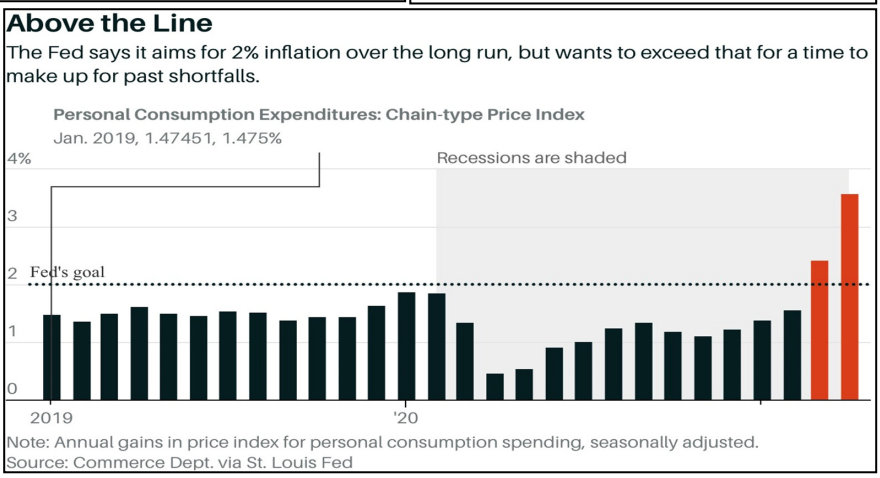
Charting the Markets

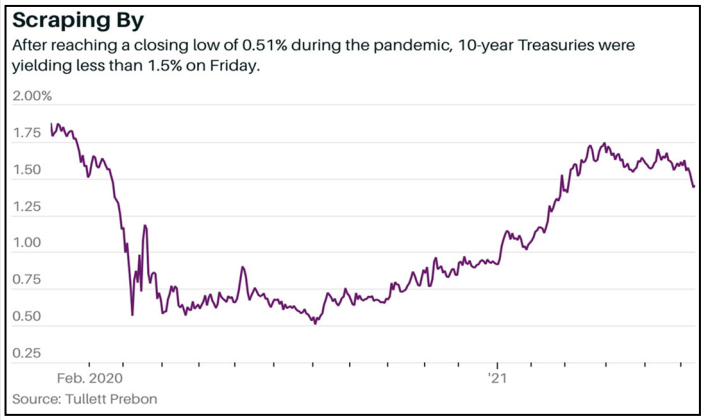


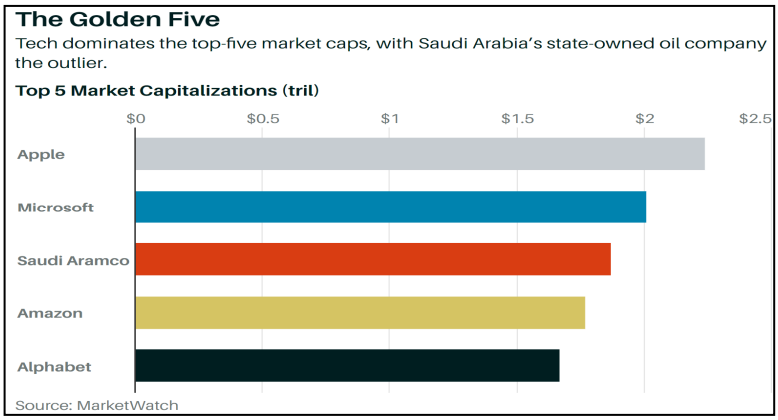


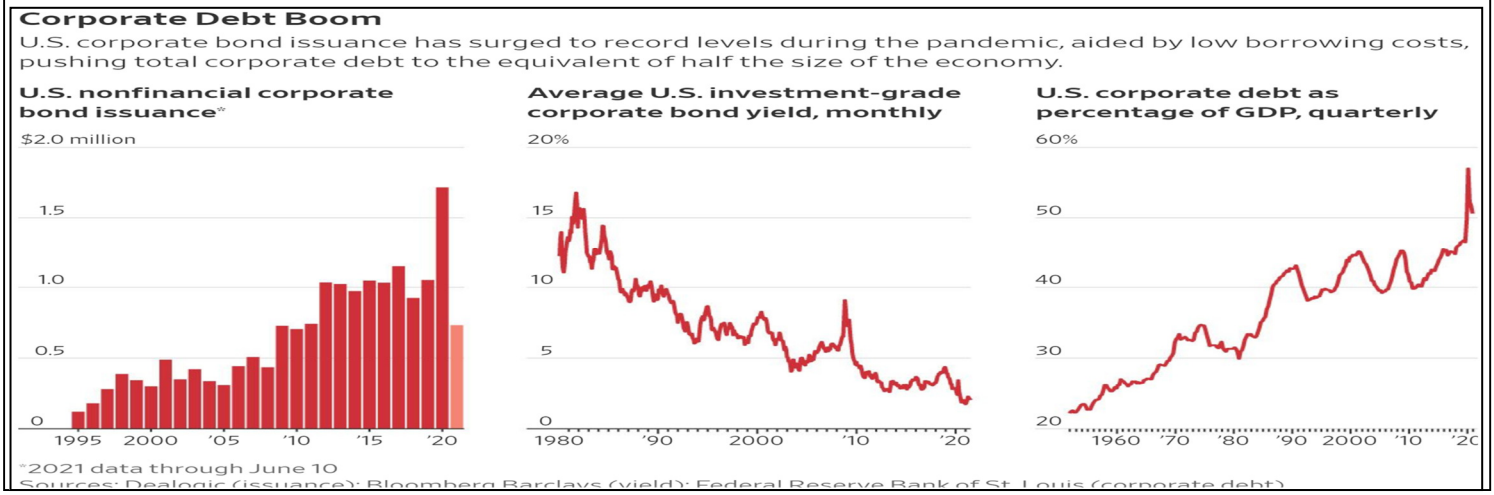












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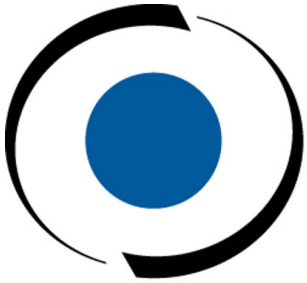

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Proposition 19: Benefits and Pitfalls

On November 3, 2020, California voters approved Proposition 19 which changes the rules for property tax assessment transfers. While the new law serves to benefit those who wish to sell or downsize *and* stay in California, the law presents new challenges for those inheriting property.

For those who wish to move without paying higher property taxes, Proposition 19 is good news as it allows homeowners over age 55 to sell their primary residence and transfer the property tax assessed value to a newly purchased home *anywhere* in California. This benefits homeowners who have owned their home for decades with current market values that far exceed property tax assessed values. With Proposition 13 capping increases in property tax assessed value to 2% annually and a booming California real estate market, the assessed value of a home for property tax purposes is significantly less than the current market value for most California homeowners.

Further, there is no limit to the market value of the replacement home. If the new home is more expensive, the difference will be added to the original home's assessed value. For example, let's consider a home with an assessed value of $200,000 and market value of $1,000,000 that is sold and replaced with a home worth $1,500,000. In this case, $500,000 will be added to the original assessed value of $200,000 resulting in a new assessed value of $700,000. If the new home is less expensive or of equal value to the original home, the assessed value of the original home will transfer with no adjustment. To qualify, the home must be purchased or newly constructed within two years of the sale of the original home, qualify as a primary residence eligible for the homeowners' exemption, an application must be filed to transfer the original home's assessed value and the number of times an assessed value can be transferred is limited to three.

For those inheriting property, Proposition 19 allows the transfer between parents and children without causing a change in the property's assessed value, only if the home is used as primary residence by the child who inherits the property and if the market value of the home upon transfer meets a value test. The value test is met if the home's property tax assessed value at the time of transfer plus $1,000,000, is equal to or lesser than the current market value. If the assessed value plus $1,000,000 is less than the current market value, and the home is used as a primary residence, the child inheritor will retain the parent's assessed value. Any market value exceeding the original assessed value plus $1,000,000 is added to the property tax assessed value for the child inheriting the home. As Proposition 19 eliminates the exclusion for real property not used as a principal residence, rental property that is inherited will be fully reassessed for property taxes.

The California State Board of Equalization has oversight in ensuring compliance with property tax laws and assessments and provides a Proposition 19 Fact Sheet which is available at www.boe.ca.gov/prop19/Proposition-19-Fact-Sheet-February-1-2021.pdf.