

October 7, 2021

With the turn toward Fall frequently tripping markets, it's hard to see recent events as much of a surprise but rather consistent with a normal, seasonal breather. As we write, there's a reason why this time might be different, but more likely bad news simply sells. For our part in seeking to capitalize on infrequent market dips to acquire shares, we welcome the turn. Thus, while we're as averse to weak prices as anyone, we see the present state more as an opportunity than a threat.

Our Three Take-a-ways:

- Stock prices have advanced over the past three years with client holdings marking a 95% rise since year-end 2018 against 80% for the benchmark S&P 500. Markets have been good to us!
- Collective profit-taking means capital gains will likely run ahead of last year's by some measure. **Please avoid surprises and review your attached statement with your tax advisor.**
- For now, we're sanguine the markets remain bowed, but not broken. We expect that as the early "frost" in Washington lifts, our Quality Growth Stocks will keep pace and renew their solid path.

Current Quarter-End Reflections:

- Covid's Re-Open SURGE ran headlong into 2nd quarter constraints that accelerated in the third.
- Fears of a 1970's style stagflation where wage growth exceeds sales and profits have weighed on Stocks even as supply chains proved unable to make deliveries and employers failed to fill openings.
- Recovery and shorter-term inflation are now forcing a rethink of Fiscal and Monetary stimulus underlying policy and market prices for most of the past decade.
- As this reaction unfolded, we raised cash reserves to stand at 15% as September closed with Portfolios averaging a 1.3% Stock return for the Quarter slightly edging the S&P 500 Index.
- Comparing the retreat over the past four months in individual issues peak-to-trough, the S&P 500 averaged a drop of 18.4% while that for Carderock client holdings measured just 14.8%.
- We conclude:
 - Growth stocks reacted more to the late September change in Fed policy while other issues weakened on earlier factors- supply chain issues, Covid, et. Al.
 - Our Quality Growth issues became relatively more attractive recently, while offering less volatility.
 - The breadth of the market decline by issue (18.4%) looks overdone and ripe for a rebound.
 - Better bond yields will attract less enthusiasm, but still offer opportunity.

Our Outlook and Game Plan for the Next Quarter:

- Though China's growth may slow, the sluggish Sino-US decoupling may be offset by renewed US investment and boost to productivity and run less significantly than expected.
- Similarly, changes in stimulus from the Fed and US Fiscal spending could wind up much smaller and less disruptive than investors anticipate.
- We expect the Bullish consensus will survive to drive the Re-Open at a pace slowed by shortages and Covid. Nevertheless we think the negatives and resistance will lift in due course.
- With digitalization of the broader economy solidly in the driver's seat, efforts to push away from (Quality) Growth and Tech will come up short.

For Carderock clients, the September bump means less than the noise suggests. The year has been good, and prospects remain positive. We will continue to work broader in diversification, favor stocks and keep bond durations short. As always, should you wish to review your investment progress, plans and prospects, please feel free to call at your convenience.

Warmest Regards,



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Random Gleanings

“The economic decoupling from China is simply not happening. Indeed, in some critical dimensions China’s integration into the global economy continues to deepen. The US and China have a mutual interest in continuing financial interdependence. But the global financial alchemy whereby the relatively poor Chinese help finance rich countries’ pensions is no longer a given.” John Plender, “*Market Jitters Only Underscore China’s Importance to the Global Economy*”, **Financial Times**, August 1st.

“Xi regards all Chinese companies as instruments of a one-party state. Investors buying into the rally face a rude awakening.” George Soros, “*Investors in Xi’s China Face a Rude Awakening*”, **Financial Times**, August 30th.

“Inflation is not the question: The point at issue is how long it lasts. Not knowing, we offer three alternatives: 1) It’s a flash in the pan; 2) Consumer prices push higher into 2022 but the inflation boom-let proves short-lived as it did in 1946-1948 rather than the marathon of 1965-80; and 3) The strength and persistence of inflationary forces unleashed by years of radical monetary measures reveals a Fed whose weakness lies in its economists thinking the same thing at the wrong time.”

James Grant, “*Groupthink meets overthink*,” **Grant’s Interest Rate Observer**, July 23rd.

“Inflation comes in different forms. There’s the financial-asset variety of inflation, and the kind you meet at the checkout counter. There’s hidden inflation (builders of price indices and designers of consumer packaging can make it seem to disappear), and the kind of inflation that investors see but refuse to believe. Unusually, today, each variety is on the wing.”

James Grant, “*Paper money’s golden anniversary*,” **Grant’s Interest Rate Observer**, August 6th.

“A robust corporate profits recovery is igniting optimism that US equities will extend their bull run even as investors question whether companies can eclipse a high bar for earnings growth and margins. The latest quarter saw US corporate earnings, revenues and profit margins expand at the strongest pace since 2008. That performance helped drive US equities to fresh peaks, with the S&P500 up more than 18% so far this year. And the index has roughly doubled from its March 2020 lows when pandemic lockdowns resulted in chaos. ‘Economic growth is running at the best pace seen in decades’ yet ‘multiples have been flat with less upside and more downside for disappointments.’” Michael Mackenzie and Adrienne Klasa, “*Wall Street predicts that equity bull run will continue*,” **Financial Times**, August 13th.

“We now know, that over the past 120 years diversified portfolios of equities in developed markets have done staggeringly well. The geometric mean annual REAL return has run 5.4% (6.6% for the US and 5.4% for the UK). This massive outperformance of equities occurred despite two world wars, communist revolutions, the Depression, hyper-inflations, the great inflation of the 1970’s and the global financial crisis of the 2000’s. Of course, a global thermonuclear war or catastrophic climate change would be worse. But bonds would not bring safety. Nothing would. Global disaster is not insurable. All of this supports the view that holding a widely diversified portfolio of equities is far and away the best long-term investment strategy in our uncertain world. But much as equities may offer a free lunch, you must be able to wait for the meal. With today’s elevated prices, there’s a danger of investors losing their room to maneuver before their investments pay off, or fears of a huge bear market luring many into bond or cash traps.” Martin Wolf, “*Equities are the only sensible foundation for private pensions*,” **Financial Times**, July 11th.

“The United States is the unmistakable winner of the past decade. It recovered steadily from the 2008 crisis and never looked back – even accounting for the pandemic-induced recession. Today amid talk of decline, most Americans would be shocked to hear that their country has about the same share of global GDP as it did 40 years ago – 25%. Its companies dominate the world like never before: Seven of the top 10 companies by market cap are American. The US continues to lead in most of the industries of the future, from biotechnology to nanotechnology to artificial intelligence. The dollar is dominant as a global reserve currency like no other in history, being used in almost 90% of international transactions. And it has the healthiest demographics of any of the world’s five biggest economies thanks to immigration” Fareed Zakaria, “*The US economy soars as American politics craters*,” **Washington Post**, October 1st.

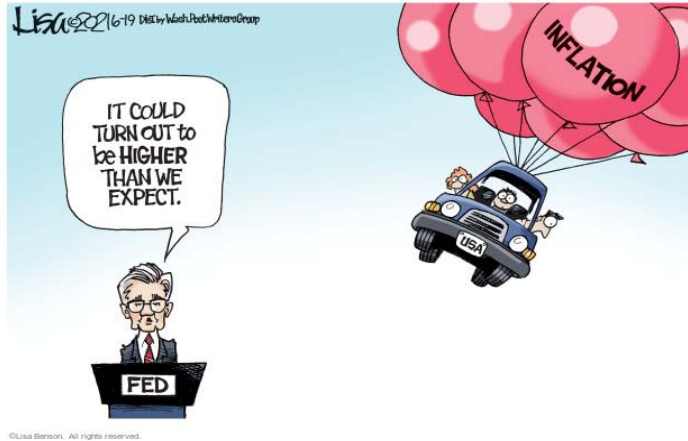
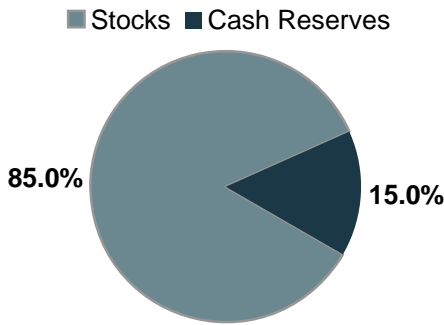
“Doom sells as making predictions of impending disaster is something of a competitive sport with permabears famous for predicting 20 of the last three recessions and pundits devoting a lot of energy to warnings about stuff that can go wrong. Those of a more cheerful disposition get less of a look-in. Though the list of reasons not to be cheerful is particularly nasty at the moment and the quarter just ended a little challenging, markets are still up 70% since March last year, and have seen the longest positive run for shares without a pullback of more than 5% since the early 1980’s.

Yet those demurring that they’re ‘fully bullish on equity markets’ are few and far between. ‘The digitalization of everything seems to outweigh debate about inflation, next steps from the Fed, and macro doesn’t matter. The pandemic has accelerated a process that could triple the market in the 2020’s.’ Others urge their readers to focus on the extraordinary resilience of stocks and ‘whenever markets panic, buy equities on the dip if you can, or buy them high. It doesn’t matter in the end. Equities remain the best escape from severe financial repression.’ ‘Today, there’s like four of us at the bull party. Nobody. That makes us even more confident we’re correct. When it gets too full, we’ll sell, but I don’t think that will be until the 2030’s.’” Katie Martin, “*The Optimists Still at the Bull Market Party*,” **Financial Times**, October 1st.

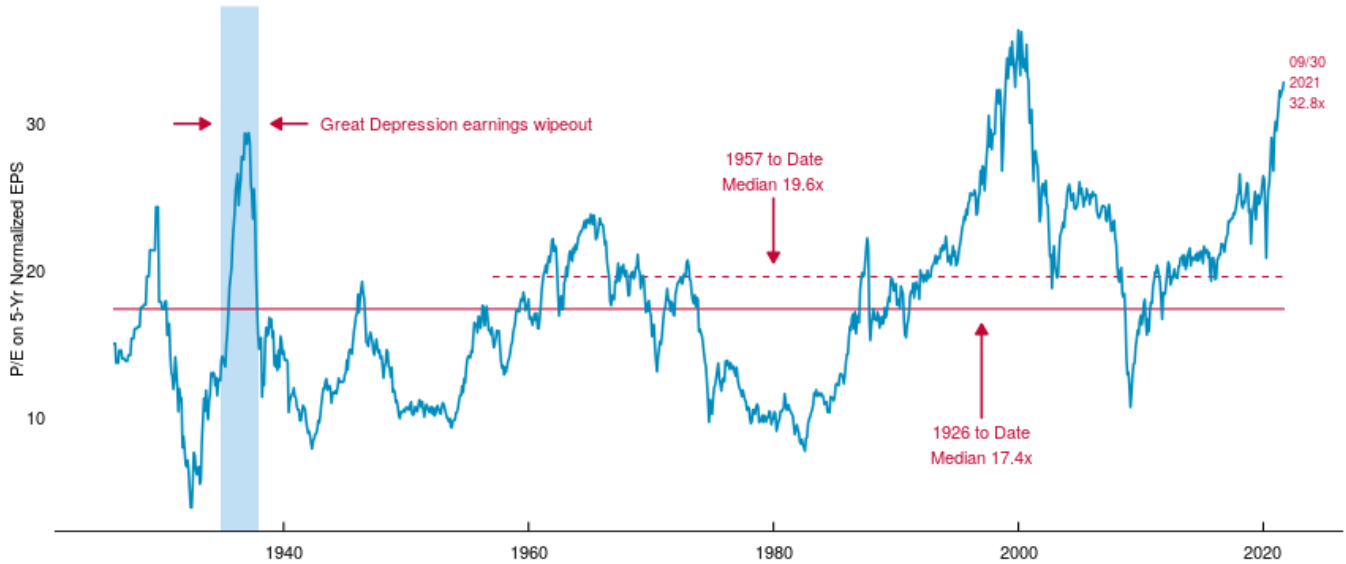
“Joseph Wang notes that the Fed has kept rates low in order maximize employment. But another effect of low rates is to increase the wealth of the top half of the wealth distribution (especially the top quarter). This might make these well-to-do individuals less inclined to work, because their houses and their stock portfolios have made them rich (or at least richer). He suggests that if the ‘wealth effect has structurally changed the labor market, the Fed’s view of employment may be outdated, and the real problem may be that monetary policy has made rich folks lazy?’”, Robert Armstrong, “*Reflation or Stagflation*,” **Financial Times**, September 29th.

“Investors should view social media as a technological innovation with negative productivity growth in that it has contributed to policy mistakes – such as fiscal austerity and protectionism – that have acted as shocks to aggregate demand over the past 15 years and slowed growth. Political polarization in a rapidly changing world is the root cause of these policy shocks, but social media likely facilitated and magnified them. Traditional journalism declined and was replaced by a confusion of unreliable alternatives that enabled a misguided austerity. In turn, these feed movements that led to the UK’s Brexit and US’s Trade War. These shocks strongly contributed to the subpar growth profile of the last economic expansion.” LaBerge, Barnes and Dilmohamud, “*Special Report: The Social Media Magnification Effect: Austerity, Populism and Slower Growth*,” **The Bank Credit Analyst**, August 2021.

Carderock Equity Target Allocation



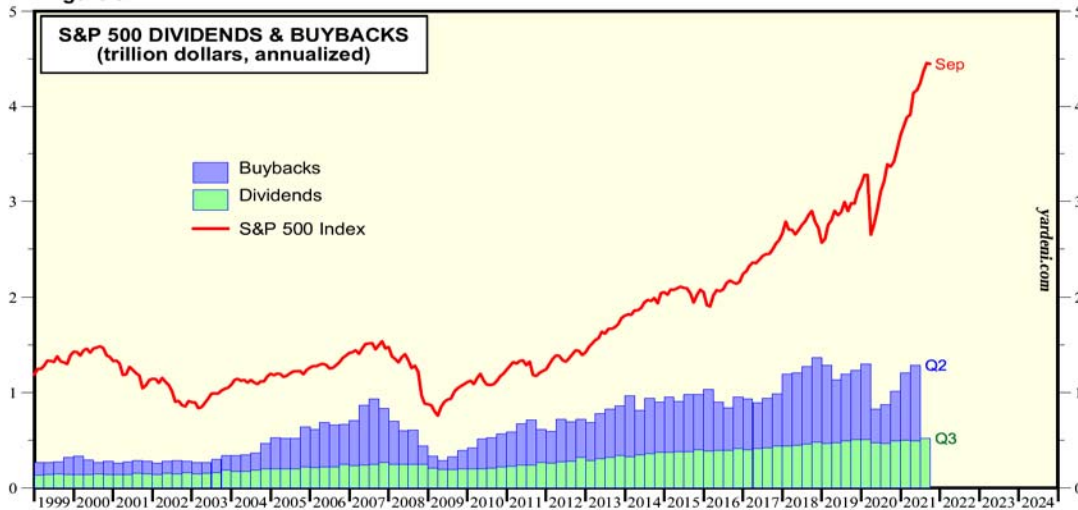
S&P 500 P/E On 5-Year Normalized EPS
1926 to Date, Monthly



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Buybacks & Dividends

Figure 5.



Source: Standard & Poor's.