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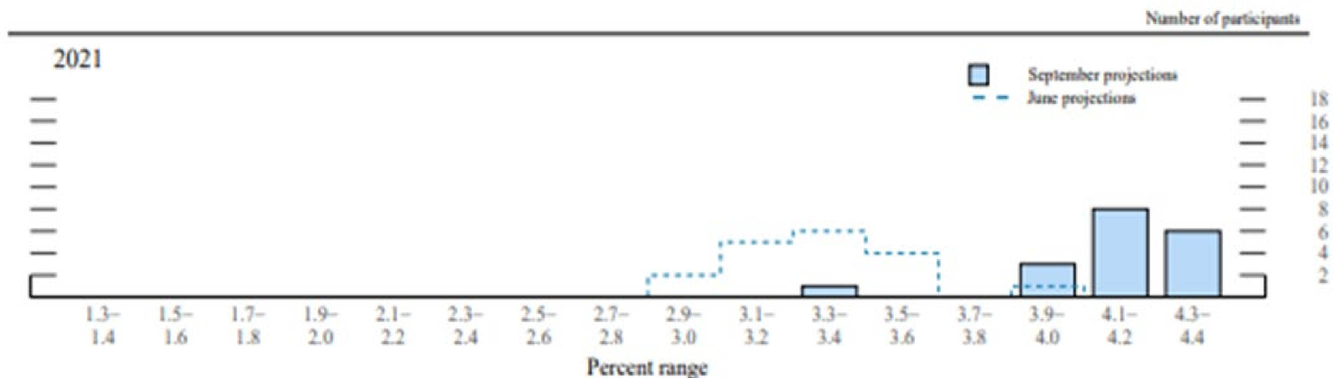
Market Update

The world is continually adjusting to life post the COVID-19 pandemic. Excitement for the world to get back to normal and reopen during the summer months was quelled by renewed fears of a shutdown as a mutation of the original strain, classified as the Delta variant, spread throughout the globe. Due to these fears, the equity markets traded relatively sideways with some rotation within market capitalizations and regions. The S&P 500 was up .58% for Q3, putting the year-to-date return at 15.92%. A similar story can be told in interest rates. Despite the spike higher in Q1 of this year, interest rates ended Q3 essentially where they were at the end of Q2. The 10-year Treasury rate ended Q2 at 1.47% and despite moving to its lowest point during the quarter at 1.175%, it trended higher towards the end of Q3 to 1.49%. The recovery from the pandemic has played out asynchronously, as some parts of the country are doing better than others. Nevertheless, overall job growth has been solid for the quarter and economic indicators remain in expansion territory after peaking in the first half of the year.

The inflationary story continues to consume the major headlines, as price increases from supply issues across the world have impacted the population. However, the cost-of-living increases have been coupled with asset inflation, as house values, stock values, and other asset values have increased, creating a wealth effect for many across the country. It seems likely that these price increases will stabilize and possibly come down, but the timing may be further out than what the Federal Reserve is comfortable with. Throughout the year, they have remained consistent on their transitory inflation claim and have held steady with their monthly purchases of $80B of Treasury securities and $40B of Mortgage-Backed Securities (MBS). Recently though, it seems the Federal Reserve has recognized that this higher level of inflation might last slightly longer than originally anticipated. The easing of supply chains has been more difficult, as production from global partners that have experienced shutdowns from the virus has had trickle down effects to U.S. companies. As of the last meeting in September, the Federal Reserve seems to have understood these dynamics by raising their median projection for headline PCE inflation, from 3.4% in June's projections to 4.2% in September's projections [Figure 1].

Post 2021, the Federal Reserve still remains steadfast that this inflation will dissipate and move closer to their 2% average target range. Nevertheless, all indications from the last Federal Reserve meeting are that tapering of its Treasury and MBS purchases are right around the corner. As always, a watchful eye on Federal Reserve policy is mandatory to gauge the effects their movements and decisions will have on interest rates and equity markets.

Figure 1: Distribution of participants' projections for PCE inflation, 2021-24 and over the longer run



Source: www.federalreserve.gov, Date: 9/22/2021

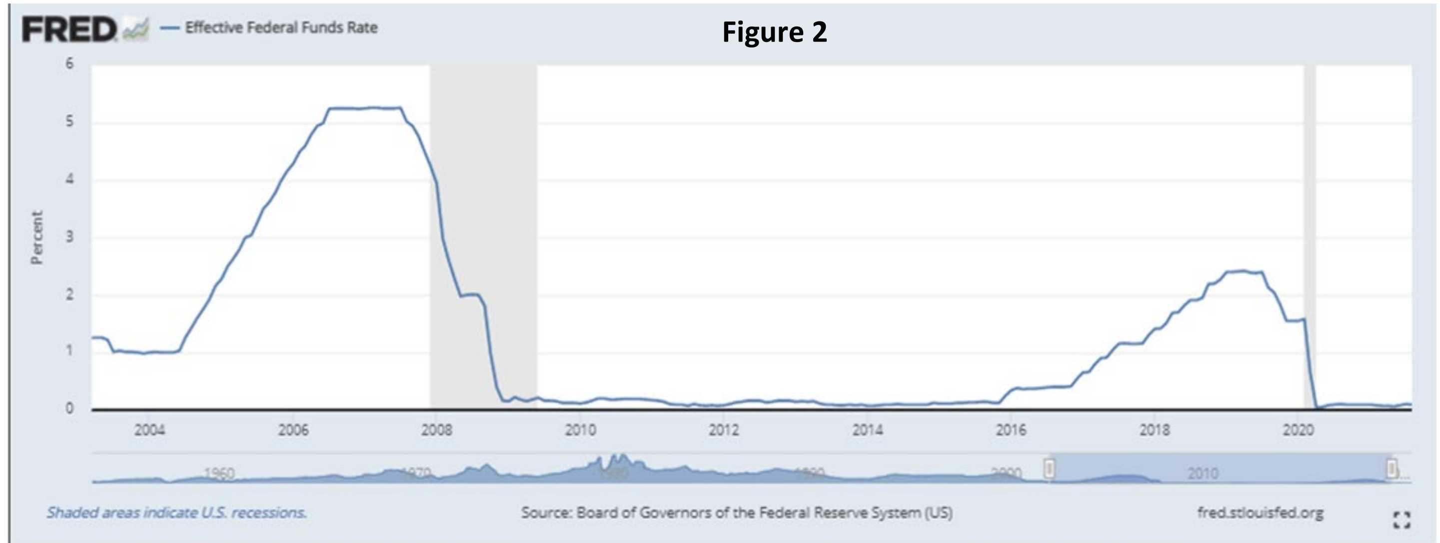
Transitioning to the fiscal front, President Biden's infrastructure agenda is taking shape. An initial $1.2 trillion infrastructure bill consisting of approximately $550B in new spending to invest in and rebuild roads, bridges, ports, broadband, and airports has been accompanied by a larger $3.5 trillion bill designed to bring broader changes to social programs. The exact benefits and ramifications from the President's agenda are still unclear as political parties continue to debate and haggle over the concepts and dollars. This could be setting up for a reverse of the old adage "buy the rumor, sell the news" type of situation, where the continued debate by both political parties around figures and the overall uncertainty in the specifics may force market participants to wait until the exact details are disseminated to make maneuvers within markets and portfolios. At any rate, continual monitoring of the final passage of the President's agenda will be necessary to determine the aspects that will greatly impact corporations and people of the country.

Major developments in China have brought that region into focus. A watchful eye must be kept on how the Chinese government navigates its social and economic agenda and how its policies could affect global growth. Concerns around the region could reflect well for capital flows into U.S. markets, thus assisting the Federal Reserve achieve a soft landing as it readies the markets for less accommodative policies.

Overall, monetary policy, fiscal agendas, and international developments all play an important role in our decision making within client portfolios. One overriding theme though has been the strength of the U.S consumer. Personal balance sheets have been refortified since the Global Financial Crisis and aided by fiscal stimulus through the pandemic. Couple that with an above trend economic picture heading into 2022 and there is a cautiously optimistic viewpoint on the future state of markets.

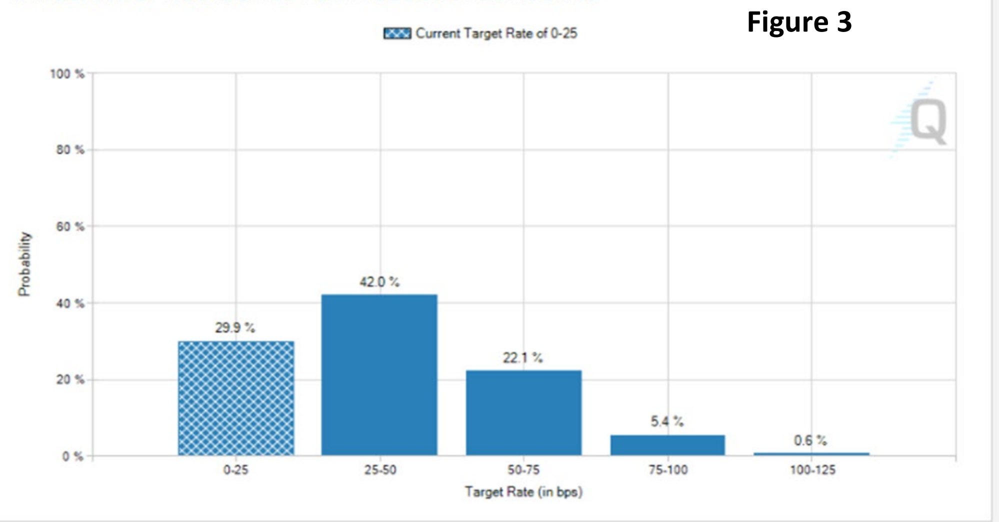
Tier 1 : Short-Term Fixed Income

Short term rates were lowered by the Federal Reserve during the pandemic and they have left the Federal Funds rate in the 0%-.25% range, focusing on achieving full employment and hoping low rates will help fuel the economy [Figure 2].



Source: www.fred.stlouisfed.org, Date: 10/4/2021

Market pundits have concentrated their research on the timing of the tapering of Federal Reserve monthly purchases. Expectations are for a late Q4 announcement, but naturally this is a fluid situation as pandemic related concerns still exist and could affect economic activity. The Fed confirmed this in their September 22nd statement, "The path of the economy continues to depend on the course of the virus." They followed by saying "If progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted."[1] If the economy continues its path forward, tapering could be followed by eventual rate hikes. As of the writing of this article, the markets were setting a 42% probability that the Federal Funds rate would sit between .25% and .50% at the time of their December 2022 meeting [Figure 3].



Source: CME Group Countdowm to FOMC, CME FedWatch Tool, https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html, Date: 10/4/2021

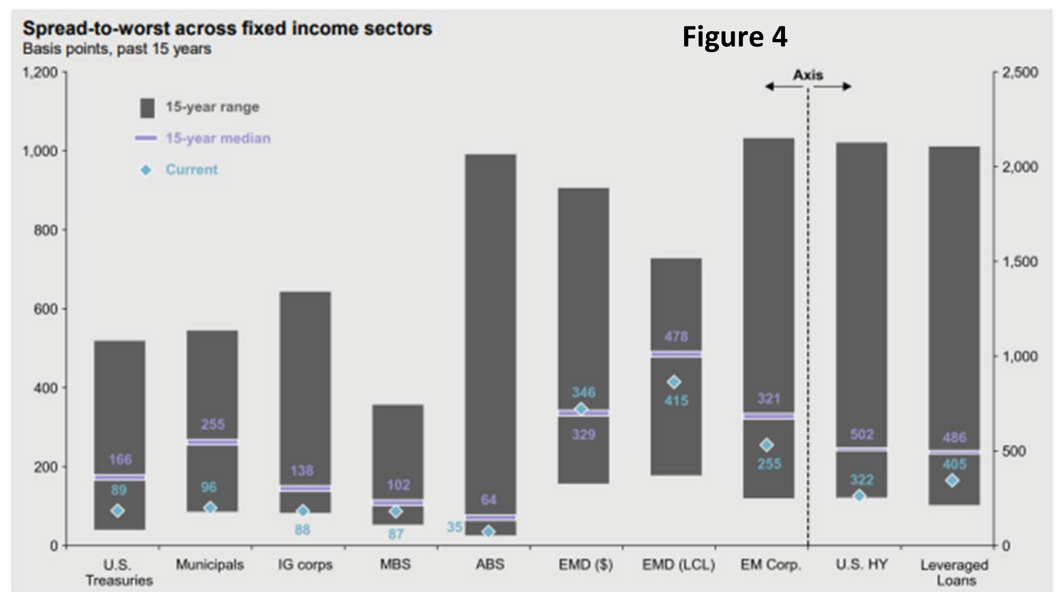
Sometimes regarded as unexciting, short term fixed income has been a major focus for investors. Although the expected path of rates is upward,

[1]https://www.federalreserve.gov/monetarypolicy/files/monetary20210922a1.pdf – *Federal Reserve Sepetmber 21-22 Statement*

other developments could derail those expectations. U.S. government budgetary issues, tax implications from the President's agenda, or China slowdown spills over to the rest of the world are all concerns that can keep interest rates lower for longer. However, when you compare the current interest rate levels relative to historical levels, they are still low. We are not making a call on the movement of interest rates. We are simply trying to make sound risk management decisions and feel the most substantial risk for fixed income investing is interest rate risk, the risk that bond prices decrease when interest rates increase. Over the past 18 months, we have made a conscious effort to allocate fixed income portions of portfolios into shorter duration strategies to help mitigate that interest rate risk. Mentioned earlier, Federal Reserve decisions are always being monitored and Tier 1 strategies are typically the direct benficiaries of a less accomodative Fed. If interest rates start to move higher in the future, fixed income allocations could change. Nonetheless, at this current state of interest rates we feel a shorter duration profile is prudent within client portfolios.

Tier 2:
While the Federal Reserve impacts the front end of the yield curve, market participants traditionally have the most direct effect on intermediate and long term bond investing. Even though a recovery from the pandemic has not been fully executed, economic activity is at a growing pace and at healthy levels. One would think interest rates should be higher than where they currently sit, but two forces seem to be keeping rates low. First, the Delta variant has caused an increase in cases, leading to concerns regarding a full reopening. Certain foreign nations look to be affected more than the U.S. Nonetheless, it is obviously a major concern and one that has to be monitored in the near future. Second, foreign demand for U.S. fixed income markets may be contributing to the continued low level of interest rates. Some international countries' sovereign debt yields are currently trading at a lower level than the U.S.', with some persistently in negative territory. As long as an international investor can hedge the cross currency risk, they will be able to generate a pickup in yield in their portoflios, thus providing capital flows into the U.S. bond market. Naturally, fixed income investors are hoping for the first factor to abate, but as everyone knows COVID related issues are extremely difficult to predict and forecast, leaving a level of uncertainty that was not present before early 2020. We are and will continue to monitor those developments on a daily basis.

Overall, interest rate risk affects all fixed income investing. Tier 2 is where this risk sits the most.

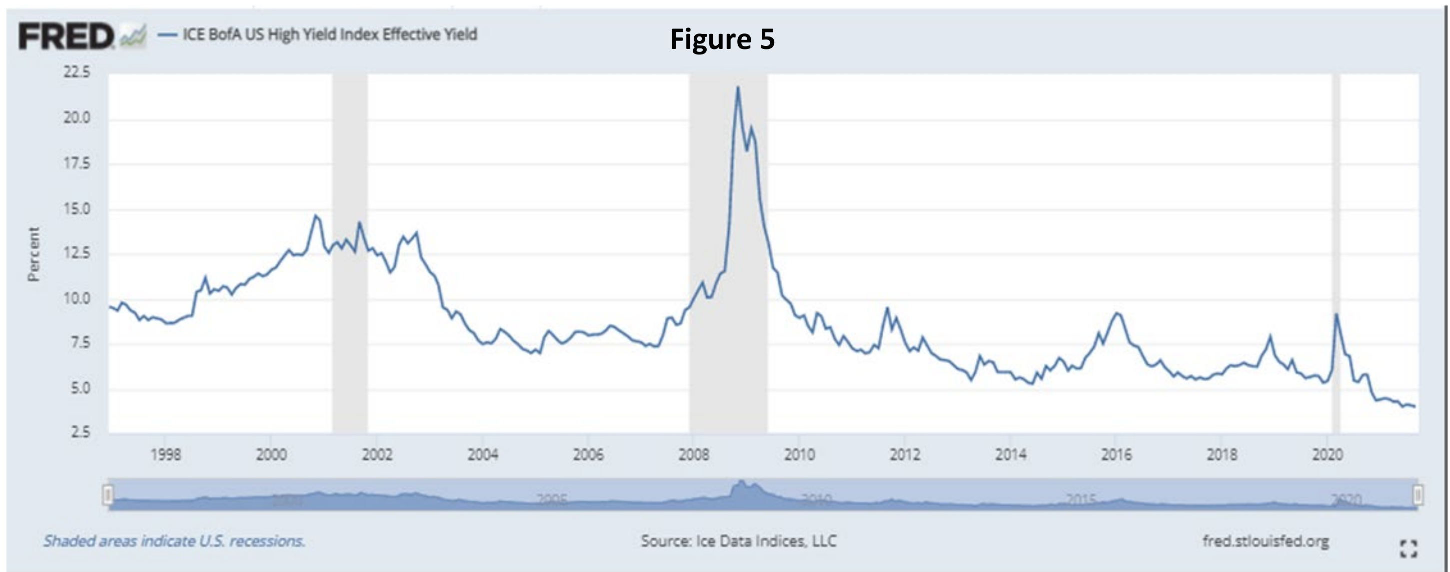


Source: JP Morgan Guide to the Markets, Date: 10/1/2021

These strategies tend to invest in intermediate to long-term bonds that are more susceptible to movements in interest rates. Moreover, certain subsectors of fixed income investing are trading at rich valuations relative to history. Bonds are typically valued differently than stocks. Analysts look at a bond yield relative to a U.S. Treasury bond with the same maturity. When that spread between the actual bond's yield and the U.S treasury bond yield is wide and/or widens, that generally means the specific bond lost value. When it narrows or is narrowing, that means it is gaining value. From a valuation perspective, when the spread is wide it looks relatively cheap to analysts and when it is narrow it looks expensive. The current tight spreads or rich valuations we are seeing have positive and negative outcomes [Figure 4]. While it displays a healthy funding environment for corporations and businesses to assist in financing operations, on the other hand it makes it difficult for investors, as most areas to invest in look relatively expensive compared with the historical spreads.

From our perspective, we prefer to invest in active strategies that are buying bonds with collateral behind them. Although not fail-proof, asset-backed securities and mortgage-backed securities have assets behind the bonds and can provide slightly higher yield than traditional treasuries or corporate bonds. Along with this preference, our strong commitment to maintaining a short duration profile for the reasons outlined in the Tier 1 section is displayed in Tier 2 as well. A majority of the strategies we invest in deliver a shorter duration than the primary fixed income index, the Bloomberg Barclay's Aggregate Index. At this time, we feel the combination of short duration and collateral-backed bonds provides a conservative approach to fixed income investing in what is shaping up as an extremely challenging fixed income environment. If market dynamics change and we feel an alteration to this profile is necessary, we will disseminate that change through future communications.

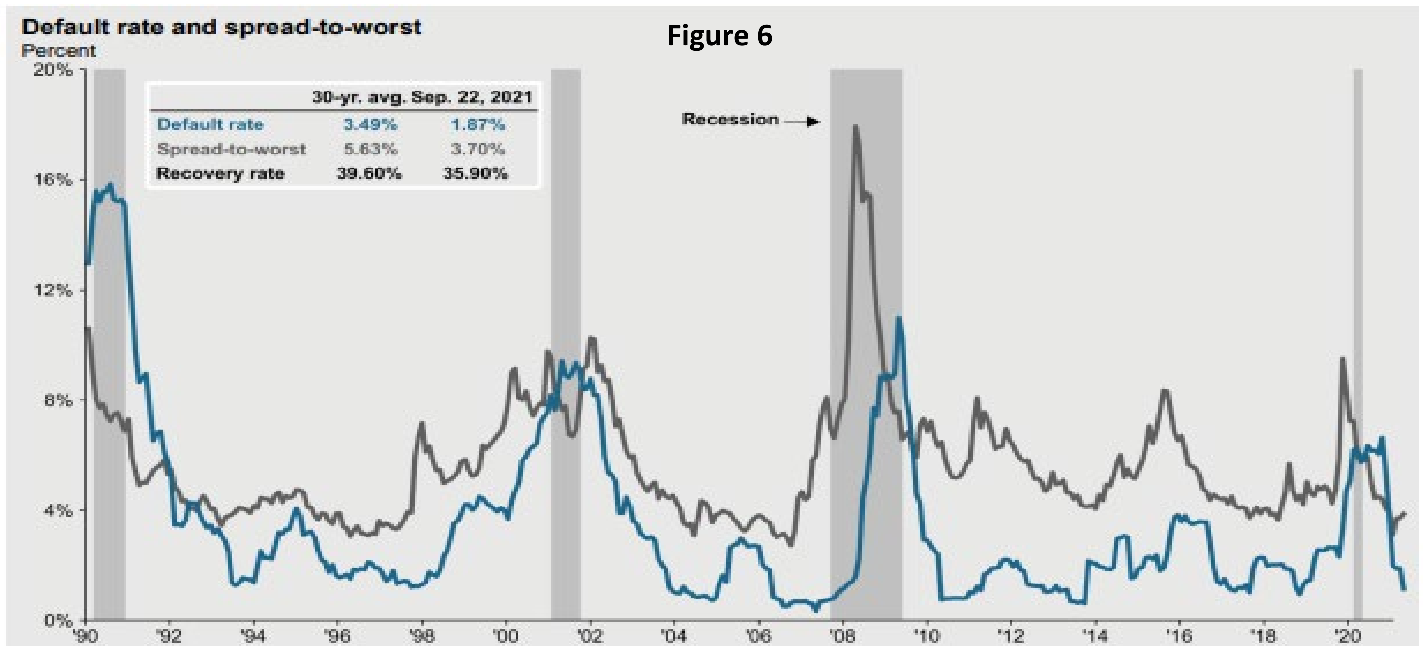
Tier 3:
High yield bonds; are they even high yield anymore? Even though we write that jokingly, there is some truth to that joke. The current yield on the high yield index is approximately 4%, a level that has never been seen before [Figure 5].



Source: Federal Reserve of St. Louis, www.fred.stlouisfed.org, Date: 10/4/2021

Maybe this should have been expected. During the pandemic, the Federal Reserve put into place liquidity facilities to backstop the bond markets. High yield, or riskier corporate bonds, was a direct and indirect beneficiary of them. Yes, a facility was created to purchase certain corporate bonds and Exchange Traded Funds (EFTs). However, only a small dollar amount was ever purchased, thus indirectly it seems market participants perceived the liquidity facilities as an expression of full support by the Federal Reserve. This produced a high level of demand for these bonds, causing the effective yields to lower to what we see now and also default rates to be at extremely low levels [Figure 6].

Even though it is proving to be challenging, high yield bonds historically have had a higher correlation to the equity markets than other bonds. With that backdrop, our positive thoughts on the opportunities in the equity markets has some associated properties to the high yield space. Although we are not relying on the implicit backing of the Federal Reserve, we have felt this area of investing can help produce excess returns for a portfolio, specifically on the fixed income side. Our preference is to allocate to managers that can find opportunities to invest that are logical from a fundamental risk return perspective, while always maintaining a short duration profile. We feel the



Source: JP Morgan Guide to the Markets, Date: 10/1/2021

Similar to Tier 2, the difficulty in the analysis of these securities is present as the figures display a healthy and robust financing environment for these corporations and their businesses, but a challenging place to invest for market participants.

short duration profile is imperative even in this tier because of the interest rate risk dynamics mentioned earlier in this article. Balancing the opportunity and risk in this space is our top priority. If you have any questions please reach out to your advisor.

Tier 4:

Equity markets traded sideways for the third quarter, as concerns regarding the Delta variant overshadowed above trend economic activity. Back in Q1 of this year, vaccination rollout had created high hopes for the reopening themed sectors of the economy. Traditionally those sectors fall into the value style of investing and lower in market capitalization. With COVID cases increasing from the Delta variant, market participants trimmed those positions in Q3. Nevertheless, year-to-date returns for the small and mid cap value style of investing have outpaced the overall market, as seen in the table below [Figure 7].

Figure 7	Q3 2021	YTD 2021
	7/1/2021	**1/1/2021**
	9/30/2021	**9/30/2021**
Name	Return (Cumulative)	Return (Cumulative)
Russell 1000 Growth TR USD	1.16	14.30
Russell 1000 Value TR USD	-0.78	16.14
Russell 2000 Growth TR USD	-5.65	2.82
Russell 2000 Value TR USD	-2.98	22.92
S&P MidCap 400 Growth TR USD	-1.95	10.09
S&P MidCap 400 Value TR USD	-1.60	21.01
Benchmark 1: S&P 500 TR USD	0.58	15.92

Source: Morningstar Direct, Date: 10/1/2021

Maintaining our high level of diversification and risk management, we began allocate to those areas in the beginning of the year but also kept a meaningful weighting to the large cap growth style of investing, essentially creating a form of a barbelled allocation between small and mid cap value and large cap growth. Growth companies, such as Facebook, Apple, Google, Amazon, and Microsoft, benefitted from the pandemic as they became newly classified as the “work-from-home investments”. They were able to experience substantial growth during that time, and it was exhibited in their stock performance in 2020. Not that last year’s performance for these companies was a new dynamic, as the growth style of investing has enjoyed a great run since the Global Financial Crisis (GFC). Nevertheless, their outperformance was extended by the crisis.

Our thesis for the barbelled allocation between large cap growth and small mid cap value consists of a valuation perspective, an index earnings composition viewpoint, and a picture of economic uncertainty stemming from subsequent events from the pandemic. From the valuation charts below, small and mid cap look relatively cheaper than the large cap growth style [Figure 8]. With these statistics, we believe the opportunity for the markets to reprice the small and mid cap companies is present.

At the same time, most of the growth stocks, such as those techonolgy and social media stocks mentioned earlier, now represent a large portion of the S&P 500. One must look underneath the hood of the index to get a glimpse into a reason why they have that large representation. As you can see from the chart, the top 10 stocks in the index, which those stocks are the top 5, make up almost 30% of the indexes’ value, but also almost 30% of the earnings contribution [Figure 9].

Trends can change, competition can arise out of nowhere, and antitrust concerns are factors we have and will continue to monitor going forward, but at this current time these companies maintain a competitive advantage within their respective industries and based on a couple of the portfolio managers we allocate to have strong, quality fundamentals. Lastly, the decision to create more of a barbelled equity allocation mentioned earlier was

influenced by the virus. If vaccination rollout reached a certain level and brought upon herd immunity, it seems logical that the smaller capitalized cyclical companies, which fall on the value side of investing, would benefit. If the Delta variant took hold and forced major shutdowns in large parts of the country, then those work from home investments would benefit. Although we track and monitor covid case data from some of our research partners, we recognize like most people that we are not scientists and attempting to forecast the path of the virus is a futile exercise. With that in mind, it cemented our belief in attempting to create this barbelled domestic equity allocation.

International markets are an area of equity investing that provide diversification benefits. Although it has underperformed for some time, active managers that have the ability of navigating developed markets can find fruitful opportunities to invest in. For example, European luxury goods and EM Asia tech have kept pace with U.S. growth companies since 2014 [Figure 10].

Figure 8

Current P/E vs. 20-year avg. P/E

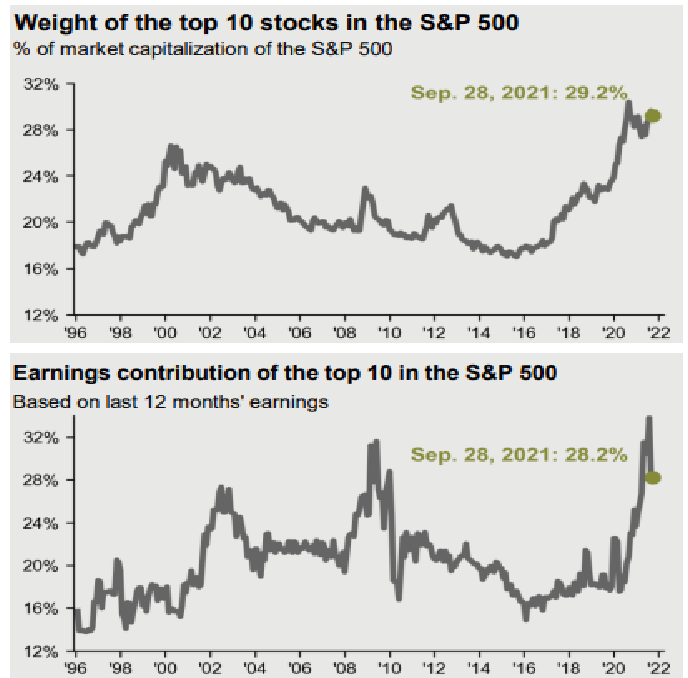
	Value	Blend	Growth
Large	16.2 / 13.7	20.5 / 15.5	29.7 / 18.5
Mid	16.4 / 14.5	20.7 / 16.4	36.9 / 20.4
Small	17.3 / 17.0	26.4 / 21.4	52.5 / 35.5

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	118.1%	134.1%	160.6%
Mid	113.7%	126.3%	180.7%
Small	102.0%	123.6%	148.1%

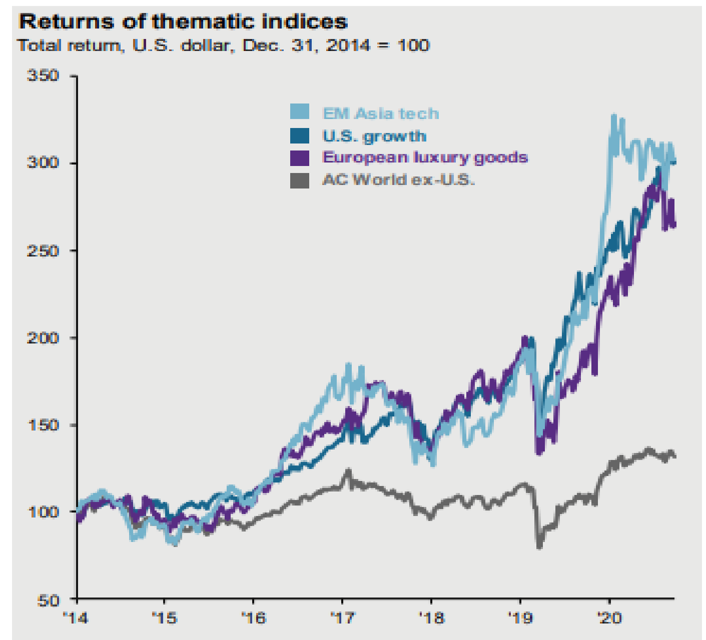
Source: JP Morgan Guide to the Markets, Date: 9/28/2021

Figure 9



Source: JP Morgan Guide to the Markets, Date: 9/28/2021

Figure 10



Source: JP Morgan Guide to the Markets, Date: 9/28/2021

Again, we cannot stress enough the necessity for active management in international investing due to a higher probability for price inefficiencies in these areas of the world. Emerging markets have been an interesting place to invest in this past year. While support from the global reflationary trade looked to be occurring in late 2020 to early 2021, recent news out of China has created some nervousness. Chinese government regulatory reforms for social, political, and economic reasons have created some volatility within the country. Negative financial developments surrounding one of the countries' top real estate development conglomerates added to some of the concerns. Volatility is no stranger to emerging markets; however, it looks to be at an elevated level lately due to these events. Similar to international developed market investing, active managers that have in depth knowledge of and experience with the government structures and specific companies in the region are our preferred way to invest in this space. It is also imperative for proper sizing of these strategies due to the heightened volatility and also being tactical with the right manager can help add positive returns to a portfolio.

Challenges and opportunities always accompany investing. We have been and will always be looking to mitigate risks through those challenges and take advantage of those opportunities when they present themselves. All of those tactical maneuvers are secondary to maintaining a strategic, long-term allocation that will help our clients meet their financial goals. If you are interested in learning more about what we are seeing across the investment landscape, do not hesitate to contact your West Capital Management Team.

Planning Update

End of Year Planning Recommendations

As the end of this year approaches, we would like to remind you of a few ways to take advantage of tax and estate planning opportunities before the hustle and bustle of the holidays takes over and the ongoing COVID-19 pandemic begins to give us a variety of reasons to put things off until next year.

Exclusion Gifting. First, consider making annual exclusion gifts to children, family, or other beneficiaries. For the 2021 tax year the annual gift tax exclusion remains at $15,000 to each donee which means married couples can elect to gift up to $30,000 to anyone they choose without a tax consequence.[2] Making yearly gifts under the annual threshold is an excellent opportunity to reduce a potentially taxable estate. The federal estate tax exemption has increased to $11.7 million per individual, though it is likely to revert back to pre-2018 levels which were approximately half that amount if Joe Biden's proposed tax plan is voted into law later this year. The exemption may be subject to other changes and state law may also have an impact, therefore estate reduction may be beneficial even for estates well below the current threshold. For younger beneficiaries, using the annual gift tax exclusion to make contributions to a 529 or other educational savings plan is a great way to offer a gift while ensuring its use is limited to qualified educational purposes.

Pay Beneficiary Expenses Directly. In the event a family member, friend, or other intended beneficiary incurred significant medical expenses during the year, you can help them while reducing your estate by paying the costs for them. So long as the payments are made directly to the institution

[2] *26 U.S. Code § 2503(b)(2)*

providing medical care or the company providing medical insurance, medical expense payments are excluded from any federal gift tax. Similarly, if a beneficiary you would like to help is continuing their education, payments to a domestic or foreign educational institution will avoid any federal gift tax if they are made directly to the institution and constitute payment for tuition only.[3]

Retirement Contributions. The end of the year is also the time to maximize retirement account contributions. The limit for contributions in 2021 has increased to $19,500 for traditional 401(k) plans (with an additional $7,000 catch-up contribution limit for those aged 50 or older)[4] and the limit on traditional and Roth IRAs is $6,000 (or $7,000 for those aged 50 and older).[5] Be sure to confirm whether you are able to deduct traditional IRA contributions or make Roth IRA contributions because eligibility phases out at higher income levels. SEP and Simple IRAs are also good options for those self-employed or employed by a small business, and both plans saw modest increases in their contribution limits this year. You can make salary deferrals of up to $13,500 to a SIMPLE IRA plan and the lesser of 25% of compensation or $57,000 to a SEP-IRA.[6]

Roth IRA Conversions. Another great tax planning opportunity to consider is converting a traditional IRA, or other qualified retirement account, to a Roth IRA. Individuals who believe they will be in higher tax brackets in the future than the present can convert funds in their pre-tax qualified retirement plan accounts to a Roth IRA. Roth IRAs are not subject to required minimum distributions, qualified distributions are not taxed, and you may choose to convert all or only a portion of the funds in your qualified retirement account in a given tax year. Be aware that the amount converted will be subject to income tax in the year of conversion, but there is a tax advantage to distributing in a beneficial tax year.

Charitable Gifting. Many people include charitable gifting as part of their overall estate plan. Year end is the perfect time to fulfill these gifting plans and to determine whether any additional charitable gifts may be desired. Temporary legislation associated with the COVID-19 pandemic allows individuals to deduct up to 100% of AGI for qualified charities, so this may be a great year to consider making such additional gifts.[7] Typically it is best to gift highly appreciated securities to remove the potential future taxable income from the estate. While charitable gifts are often most beneficial as itemized deductions, the significant increase in standard deduction amounts and the reduction or elimination of other previously available itemized deductions will be impactful. Many individuals who itemized in the past have not found it beneficial since the Trump administration passed the Tax Cuts and Jobs Act which doubled the standard deduction and that remains true for 2021. If you will not itemize, benefits may still be available by making charitable donations from alternative sources. Donating directly from an IRA reduces AGI, which impacts the calculations associated with various other tax thresholds and may reduce related costs like the net investment income tax, Medicare Part B

[3] *26 CFR § 25.2503-6 – Exclusion for certain qualified transfer for tuition or medical expenses.*

[4] *https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits*

[5] *https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits*

[6] *https://www.irs.gov/retirement-plans/how-much-can-i-contribute-to-my-self-employed-sep-plan-if-i-participate-in-my-employers-simple-ira-plan*

[7] *Tax Cuts and Jobs Act of 2017, P.L. 115-97, Sec. 11023.*

premium, or state taxes. Qualified charitable donations are available to those already taking required minimum distributions, up to a maximum of $100,000 in total gifts.

Required Minimum Distributions. The end of the year is typically the time to ensure any required minimum distributions have been taken but it's important to note that due to the current pandemic, RMD requirements have been waived this year. In addition, under new changes to the law RMDs are not required to be taken until you have reached age 72 so long as you were not yet 70½ by January 1, 2020. Distributions are required in 2021 and must be made by year end. Required distributions from IRAs which are not taken are subject to some significant penalties and if you do not need the income you can direct the distribution be donated directly to charity.[8] While direct donations are not tax deductible, they will avoid impacting your income level and help to continue an annual charitable gifting plan. Distributions from IRAs may be aggregated so long as the total amount required is distributed from at least one account. 401(k)s work a bit differently and although they are also subject to RMDs, distributions are not required while you continue to work for a current employer beyond 72 (unless you own 5% or more of the company). Any 401(k) which has not been rolled over to a current employer remains subject to distribution.

Estate Planning Updates. Beyond tax planning we encourage you to consider any changes that may have occurred during the year to help determine what, if any, updates may be appropriate for your estate plan. Whether you or a family member got married or divorced, welcomed a new child or grandchild, lost a loved one, realized a significant increase in wealth, or moved during the year, some revisions could be in order.

These are just a few of the things to consider for end of year tax and estate planning. Refer to the West Capital Management Tax Guide and End of Year Planning Checklist for additional considerations. We will also send a summary of any new tax law which is enacted prior to year-end to highlight other important changes that could be impactful. Please don't hesitate to contact us to discuss in detail whether these or other planning opportunities may be appropriate for you and your specific situation.

If Your Filing Status Is...	And Your Modified AGI Is...	Then You Can Take...
single or **head of household**	$65,000 or less	a full deduction up to the amount of your contribution limit.
	more than $65,000 but less than $75,000	a partial deduction.
	$75,000 or more	no deduction.
married filing jointly or **qualifying widow(er)**	$104,000 or less	a full deduction up to the amount of your contribution limit.
	more than $104,000 but less than $124,000	a partial deduction.
	$124,000 or more	no deduction.
married filing separately	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.
If you file separately and did not live with your spouse at any time during the year, your IRA deduction is determined under the "single" filing status.		

Source: www.irs.gov

[8] *https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-distributions-withdrawals*

2021 Federal Estate Tax Exclusion Amount

11.7 Million	23.4 Million
For an Individual	For a Married Couple

Source: https://opelon.com/federal-estate-tax-exemption-amount/

Final Thoughts

As you know, we've been working hard over the summer on a technology upgrade and have started to return to our office space in Philadelphia on a limited basis. It's now Fall and the holidays are right around the corner, along with many year-end planning items that West Capital is here to assist you with. Our annual Tax Guide and Planning Checklist will be distributed within the next month. Please reach out to us with any questions!

All our best,

Your West Capital Management Team

WEST CAPITAL MANAGEMENT

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