Sentinel Trust
Together, families prosper℠

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

October 12, 2021

Q3 Market Review and 2021 Year-End Outlook

Executive Summary

- Most assets finished the third quarter close to flat, but this belies the volatility experienced by investors over the quarter. The "everything" rally started the quarter off strong, fueled by investors viewing the world as just right and looking past various looming risks. Almost every asset class generated positive returns in Q3 through the end of August.
- We noted in July that while we were not turning bearish, we found it prudent to begin paring risk, slowly raising cash, and preparing for a day when investors might turn more pessimistic. September gave us a small dose of what this pessimism might look like as most asset classes save for energy fell.
- We now appear to be in the midst of a long overdue correction with the S&P 500 just ending its fourth-longest streak without a 5% pullback in half a century. Investors appear to be waking up to a number of the risks we have previously noted, along with several new risks. We generally like volatility, see some reasons for cautious optimism and are likely to be buyers on deeper pullbacks.

Cash, Bonds and Inflation

Cash continues to be abundant and earned nothing on the quarter, even before considering taxes or inflation. Tax rates may soon be on the rise and inflation continues to run hot, but nominal cash yields will likely remain near zero for the foreseeable future. While this leads many to view cash as "trash," we instead continue to see it as a useful tool that can be deployed to buy higher yielding assets during bouts of fear. In September, when most every asset class depreciated in value, the US dollar stood relatively strong. Broadly speaking, we continue to hold a slight overweight to cash in US dollars, as shelter against some of the various risks on the horizon.

Bonds were also relatively flat on the quarter, but took investors for a wilder ride. Inflation fears appeared to subside in July with the 10-year US Treasury yield moving quickly from 1.5% to 1.2%. After Labor Day however, concerns around the debt ceiling, continued deficits and tapering by the Federal Reserve led to a near-full-round trip with the 10-year closing the quarter back at 1.5%. We share these concerns, remain underweight the space, and continue to be uneasy lending money to Uncle Sam at just 1.5% when inflation is running closer to 4%. For now, we prefer an allocation to mortgages, which eked out a small but less volatile return in Q3.

We started Q3 near neutral to investment grade municipal bonds, but used the bond rally in July to reduce our positioning – which we are holding at a small underweight for now – before municipals ended the quarter flat. With the potential for higher taxes and rising interest rates, we also pivoted our internal bond portfolio from an in-house buy-and-hold strategy to an externally-managed strategy focused on tax loss harvesting. While high-yield municipals were also essentially flat on the quarter, we continue to like the space. It has delivered some of the best results for bonds year-to-date and continues to offer relatively attractive tax-free yield in a low-yielding world. We similarly remain convicted in our selection of active managers focused on taxable, high-yield American bonds and largely continue to eschew emerging market bonds which struggled in Q3 against rising inflation. In contrast, US high-yield debt delivered small, but positive returns on the quarter, outpacing each of the aforementioned bond sub-classes. This type of behavior is generally consistent with a growing economy.

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

Public Equities

As with many other asset classes, stocks jumped broadly at the outset of Q3 but reversed course in September, and US stocks ended the quarter flat. Again, we used the summer rally to lighten exposure at a time when most investors felt everything was just right in the world. We are now in the midst of a long overdue 5% selloff with investors worried about rising inflation, supply chain bottlenecks, slowing growth, increased regulatory risk and heightened geopolitical uncertainty. We will be watching Q3 earnings season closely and have already seen some of the Q1 meme stock darlings, like Bed Bath & Beyond, stumble back to earth on these concerns.

While we have long been cognizant of these looming risks, we are likely to increase exposure to US equities on any more meaningful weakness because we still see some signs for optimism. Investors are much less bullish than they've been recently and we typically like to buy when we see fear in the markets. The recent 5% dip has left the broad market trading at 20X next year's estimated earnings, which equates to a 5% earnings yield. We find this attractive relative to the ultra-low yields on cash and bonds above. The spread of the COVID delta variant appears to be slowing in the US and Merck's new antiviral pill could be a powerful new tool against the virus. American consumers, the engine that drives much of the global economy, are on generally strong footing. With emergency unemployment benefits rolling off and the latest delta wave subsiding, we could certainly see a second and potentially larger reopening of the US economy.

International equities were the worst performing asset class on the quarter, falling roughly 2.5% in US dollar terms. We remain near neutral to the space and see some signs for optimism here as well. First, most international markets delivered flat-to-positive returns in their own currencies, but fell in America due to the strong US dollar. With the US continuing to run large twin deficits on the fiscal and trade fronts, we think there is a good chance this dollar headwind turns to a tailwind. Second, international and emerging economies are beginning to catch up and surpass the US in terms of numerous COVID recovery measures. There is a good chance we see a global economic recovery in the near future and this typically bodes quite well for international stocks. Finally, much of the damage in Q3 came from emerging markets and specifically China. Our active long-only, China-focused managers weathered this storm relatively well and now see a rich opportunity set following the recent bear market in Chinese equities.

Alternative Assets

Hedge fund returns for September are still coming in, but we estimate the space, like most asset classes, was close to flat on the quarter. Given the host of risks, but also opportunities (especially with meme stocks coming back to earth), we remain relatively neutral to hedge funds. We continue to cast a wide net, while being highly selective given the large number of players, the illiquidity and fees.

We continue to favor private equity strategically and made our first commitment in our newest private equity vehicle. We continue to review many opportunities, but remain highly selective and patient. Our older vintages of private equity continue to benefit from a robust market and we have generally harvested more capital than we've put back to work in 2021. The results we have seen to-date suggest that private markets continue to do well and have largely outpaced the blistering returns from public markets so far in 2021.

Real estate and real assets were arguably the most exciting and most volatile assets on the quarter. Publicly traded real estate jumped over 5% in July and August, before giving back nearly 6% in September to close the quarter at a small loss. The losses in September for the space broadly suggest that real estate cannot be relied upon, carte blanche, as an inflation hedge. We think active managers focused on assets in high

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

demand in sectors like e-commerce-linked industrial warehouses, single- and multi-family residences, and farmland are well positioned to raise rents and pass on higher inflation. Gold also finished the quarter relatively flat, but we continue to like it and believe that it, too, would benefit from a weaker dollar.

Energy-related stocks also made a round trip in Q3, but fell just over 10% in July before recovering most of these losses in August. We have generally been net buyers of energy-related stocks over the past year and are spending even more time on the space recently. The potential for a global economic recovery at a time when many investors are stepping away from funding traditional energy projects and governments are increasingly pushing de-carbonization makes for an interesting opportunity set. There are very few experienced managers left in the space and we believe that a handful may be able to navigate, quite profitably, what we expect to be a long and volatile energy transition.

Conclusion

While markets and most asset classes finished the quarter flat, there was a palpable change in investor sentiment in September. Investors returned from a summer where all seemed right with the world to the post-Labor Day reality of the risks lurking on many major fronts. Investors broadly seemed to be worried about rising inflation, decelerating growth and a host of geopolitical risks. Outside of energy and cash, there were few places to hide in September and most assets gave up their earlier Q3 gains. In the midst of this selloff, we see reasons to be optimistic and will likely put the cash we raised earlier in the year back to work should we continue to see broad, indiscriminate selling and fear.

This material is published solely for the interests of clients and friends of Sentinel Trust Company, L.B.A. and is for discussion purposes only. The opinions expressed are those of Sentinel Trust Company management and are current as of the date appearing on this material and subject to change, without notice. Any opinions or solutions described may not be suitable for all investors nor apply to all scenarios. The information does not constitute legal or tax advice and should not be substituted for a formal opinion. Individuals are encouraged to consult with their professional advisors.

The material is not intended to be used as investment advice, nor should it be construed or relied upon, as a solicitation, recommendation, or any offer to buy or sell any securities or products. Any offer may only be made in the current offering memorandum of a fund, provided only to qualified offerees and in accordance with applicable laws. Each type of investment is unique. This material does not list, and does not purport to list, the risk factors associated with investment decisions. There can be no assurance that any specific investment or investment strategy will be profitable and past performance is not a guarantee of future investment results. Before making any investment decision, you should carefully review offering materials and related information for specific risk and other important information regarding an investment in that type of fund.

Information derived from independent third-party sources is deemed to be reliable, but Sentinel Trust cannot guarantee its accuracy or the assumptions on which such information is based.