Dear xxxx;

The US stock market was slightly more volatile in the most recent quarter as compared to the first half of 2021. Both July and August delivered one relatively small yet marked drawdown that was quickly reversed. By the beginning of September, the US had reached a new all-time high. September, a traditionally bearish month, lived up to expectations. During September the US stock market as measured by the Wilshire 5000 dropped 4.53% finishing up the month 5% below its all-time high.

When looking at the third quarter in aggregate, the only true bright spot was commodities (+5.12%). The other major assets classes, fixed income (+0.05%), US stocks (-0.58%), international stocks (-3.62%), delivered less exciting results. This letter will provide an analysis of the major geopolitical, financial, and thematic events that shaped the quarter as well as our predictions for how those events will play out through the remainder of 2021 and beyond.

Federal Reserve & Inflation

Biden Political Agenda & US Debt

Covid-19 Update & Omicron

Profit Taking

A Look Toward 2022

Conclusion

China Reform Spree & Evergrande

Throughout 2020 and 2021, Xi Jinping, the President of China, General Secretary of the Chinese Communist Party, and Chairman of the Central Military Commission, has introduced a multitude of new economic regulations. Officially, the goal of these new regulations, fines, and laws, is to increase “common prosperity” and to shrink the country’s income and wealth disparities. However, we believe these new laws are an attempt to stifle capitalism while allowing Xi Jinping to further consolidate his power.

Each anti-capitalist rule change has choked the Chinese stock market. After Jack Ma, the founder of Ant Group and Alibaba, made negative comments about Xi Jinping and the Chinese government, the Shanghai Stock Exchange suspended his pending $34 billion IPO. Soon after this suspension, China introduced new anti-monopoly laws enabling the Chinese government to pursue legal action against their domestic big technology companies. Just days after listing its US IPO, Chinese regulators announced a cybersecurity review of Didi Global and banned their app from the country’s app stores. Unsurprisingly, Didi’s market cap has dropped by 50% since this inquiry began.

In the third quarter, Xi Jinping abolished for-profit education companies, causing those companies to either shutter or convert into to not-for-profit organizations. In a move against the video game industry, children under the age of 17 have been prohibited from playing video games during the week and are only allowed one hour per weekend. Later in the quarter the People's Bank of China doubled down on previously negative cryptocurrency statements by banning all cryptocurrency transactions and banning foreign companies from providing cryptocurrency services to Chinese citizens. Regulations from earlier in the year had banned domestic companies from providing cryptocurrency services to Chinese citizens.

Finally, at the end of September, it became clear that Evergrande, China's second largest property developer, was on the verge of insolvency. Evergrande employs more than 123,000 people, is running 1300 projects in 280 cities, and carries a $310 billion debt load. Most of the debt is owned by Chinese individuals, institutions, and suppliers, and substantially all their ongoing projects are within China. There was a massive US selloff on September 20th when the world's media picked up the Evergrande story. However, upon further analysis of the company, while the looming default and bankruptcy would be devastating for China, we do not believe it will spread across the world and negatively impact the US or European markets.

When compared with the US stock market which has gained 14.68% in 2021, the Chinese stock market has gained just 2.74%. This divergence is even more astronomical when you consider that China has all but eradicated COVID-19. The WHO reports that in 2021, while China has seen just 892 deaths from COVID-19, the US has seen 350,000. Normalizing for differences in population, 1661 times as many Americans have died from COVID-19 than Chinese in 2021 alone.

US Real Estate Boom Drives US Equities

During the depths of the initial stock market reaction to the COVID-19 pandemic, US real estate prices as measured by the Federal Reserve Economic Data (FRED) declined by 2%. This pales in comparison to US equities which declined by more than 33% from peak to trough. Through the close of the 2nd quarter of 2021, average US homes had increased by more than 16%. Zillow, which provides more up-to-date readings, shows the steady increase in prices continuing through the 3rd quarter. Alternatively, US equities have increased by almost 100% since their March 23, 2020, trough.

Rising home prices coupled with low interest rates have caused a dramatic uptick in refinances. 2020 saw record mortgage origination and refinance statistics. While not yet over, 2021 has continued this trend. Equity has been removed from homes not only to build improvements like home offices and playrooms, but also to fund stock market investments. With fixed income yields remaining low across the globe, equity investments are the only game in town. With equities booming, profit-takers are looking toward residential real estate both to diversify and to improve their own living conditions.

As the Federal Reserve eventually ends its quantitative easing and begins raising rates, this phenomenon of rising home prices and soaring stock market equity valuations should subside.

Federal Reserve Quick Update

In statements made throughout the quarter, the Federal Reserve maintained their position that US inflation and supply chain bottlenecks are frustrating yet transitory. They further emphasized that the emergence and persistence of the Delta variant required the continued monthly purchases of $80 billion of Treasury Securities and $40 billion of mortgage-backed securities. Jerome Powell indicated the Fed would begin scaling back its asset purchases in November with a full stop occurring in mid-2022. Once the tapering has ceased the interest rate hikes will commence.

From our perspective, the roaring economy and stock market could have already sustained the reduction of quantitative easing and potentially interest rate hikes as well. Even with the Delta variant, many economic metrics are at or close to their pre-pandemic levels. If Powell's term is not renewed upon its 1/28/2022 expiration, President Biden could nominate a new Federal Reserve chairperson who might throw a wrench in the timeline laid out by Jerome Powell.

Infrastructure Proposals & Proposed Major Tax Changes

There are two infrastructure bills currently working their way through Congress, a $3.5 trillion democratic proposal, and a $1.2 trillion bipartisan proposal which contains just $550 billion of new spending initiatives. The bipartisan bill will pay for improvements to roads and bridges, railroads, the power grid, and broadband among other areas. The democratic initiative is largely focused on projects (healthcare, labor, education, housing, and tax reductions) aimed at those Americans earning less than $400,000 per year.

The bipartisan bill would be paid for using previously allocated and unused COVID-19 relief funds, changing cryptocurrency tax reporting requirements, and imposing new Superfund fees, among others. This bill would not increase taxes paid by US citizens or corporations. The primary tax law changes required to pay for the democratic-led bill include increasing in the top federal income tax bracket back to 39.6%, increasing the top capital gains tax to 25% from 20%, and increasing the corporate tax to 25% from 20%. This is not an exhaustive list as there are many nuanced tax law changes that will be required to fund such a large spending bill. Both bills will likely undergo significant changes before either is passed.

Debt Limit & Looming US Default

Once again, the US Congress waited until the last possible day to pass a bill to keep the government open and funded. As has become typical, the proverbial can was simply kicked down the road. Based on the specifics of this bill, the US government faces another shutdown on December 3rd. However, the real concern is the US debt ceiling.

As Janet Yellen mentioned on Wednesday, "the federal government could run short of cash to pay its bills by October 18 unless Congress acts quickly to increase the government's borrowing authority." A failure to reach a deal to raise the debt-ceiling would cause the US to default. A US default would be the end of financial markets as we know them. The US Dollar is based by the "full faith and credit of the US government." If the government defaults the US Dollar will have no or substantially less value.

The last time the US came this close to a default was July 2011 when the US credit rating was downgraded by S&P. This turmoil and downgrade caused the US stock market to plummet by 17% in under 3 weeks. It took more than 6 months for the S&P to make up that loss, and this was without an actual default.

There is no precedent for what a US default would look like, nor is there any way to predict the chaos and destruction it would cause to world order.

The US will not default. Even if Congress fails and can't come to an agreement, President Biden has four options, and he will use one of them to prevent the catastrophe of a US default.

There is a federal law giving the US Treasury Secretary the power to issue platinum coins of any value she wishes. Janet Yellen could issue a $2 trillion coin, deposit it at the Treasury's account at the Fed and use the funds to sustain the government until the debt ceiling is raised.

Biden could invoke the 14th amendment declaring the debt ceiling unconstitutional.

Congress has given the President three mandates: to spend the amount Congress authorizes; to tax the amount Congress authorizes; and to issue as much debt as Congress authorizes. When the debt ceiling is breached, it becomes impossible for the President to obey all three of these legal requirements. Biden could simply declare that he is ignoring the debt ceiling because having a debt ceiling does not allow him to honor the mandate of the Office of The President.

The Treasury Department could create a special purpose entity to issue new securities that are distinct from traditional Treasury Bonds and use those proceeds to pay government expenses. This is what states and municipalities currently do to get around their own state debt limits.

COVID-19 Update

It is truly unfortunate that midway through the second half of 2021, we are still talking about COVID-19. This virus finally has a vaccine and yet 30% of Americans are still making it a partisan issue. Currently, the largest threat to the American economy is the unvaccinated. As foreign countries begin to vaccinate the majority of their citizens, travelers may prefer visiting countries that do not have all their ICU beds occupied by COVID-19 patients. This unwillingness to vaccinate could ultimately lead to a pullback in the US stock market.

On the other hand, vaccinated individuals will be allowed to begin traveling to the US in November, and vaccinated Americans are already welcome in most foreign countries. Domestic travel has increased by approximately 250% from 2020 and is almost back to 2019 levels as measured by the TSA. This increase in travel brings with it a much-anticipated economic boon for the tourism-related sectors hardest hit by COVID-19 (restaurants, hotels, leisure activities, airlines, etc.)

Conclusion

The third quarter was more volatile than the first half of 2021 and we expect heightened volatility moving into the fourth quarter. Continued animosity and uncertainty in Washington will wreak havoc on the US stock market. China and Xi Jinping will continue to take anti-capitalist steps that inflict self-harm. Should everything pan out without amplified partisan bickering, the US will face diminished quantitative easing and another risk of a government shutdown in early December. However, until interest rates increase in developed nations, there remains no better place for both existing and new investments other than real estate, some commodities, and US equities.

Client Referral Network

One of the oldest and most successful methods to grow a business is through word of mouth. GA Pincus Funds has been fortunate and has grown substantially due to referrals made by you and your fellow clients. We would like to use our future quarterly newsletters to return the favor to our clients. We plan to dedicate a section of our newsletters to our client's businesses. Rather than list your name or company name, we will instead indicate the category of business and location where you operate. For example, Real Estate Professional in Chicago, or Employment Lawyer in Georgia, or Public Relations Professional in New York, etc. If you would like to participate in this program, please let us know. This referral program is **free marketing** for your business. **We will not accept payments for these referrals.**

Performance Calculations

The performance of your accounts is calculated daily, taking into consideration daily deposits and withdrawals, and those daily returns are combined to form your quarterly, YTD, and since inception returns. When we round off this enhanced precision it may shift your performance by 0.01-0.02% when compared to the calculation ((end date value – start date value)/start date value). Please note, the performance figures on your statement are accurate and are GIPS (Global Investment Performance Standards) compliant.

It is impossible to predict whether and by how much the market will increase or decrease. Our algorithm rebalances your accounts according to changes in the relative weightings of the securities you hold. As one security becomes too heavily weighted the algorithm sells shares in that security. Conversely, as one security becomes too lightly weighted, the algorithm purchases shares of that security. Instead of rebalancing based on time (as most managers do), this algorithm rebalances based on a securities' relative weighting in the portfolio. This gives GA Pincus Funds a long-term advantage. No matter what the market does in the future or has done in the past, if your time horizon is long enough (>1 year), this algorithm has proven itself to be successful.

Please stay safe and healthy. I am always available to answer any questions you may have.

Best regards,

Gabriel

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