April 7, 2021 | Scott Carmack (Portfolio Manager)

WHEN THE RATE SPIKE IS REAL

TREASURIES LOG THE WORST QUARTER SINCE 1980

The first quarter was largely a continuation of the recovery from the March 2020 lows for many asset classes. The S&P 500 was up 6.17%. The Nasdaq lagged, but was still up 2.96%. The more cyclical plays were up substantially more – the Russell 2000 increased another 12.69% and the Dow registered an 8.29% gain. Commodities were broadly higher as the reflation trade remained fully intact. Perhaps most notable was the acceleration of the sell-off in U.S. Treasuries which logged their worst performance since 1980! Most of the pain was felt on the long-end of the curve as the curve steepened markedly. The difference between the 30-year yield and 2-year yield expanded by 73 basis points during the quarter. The difference between the 10-year yield and 2-year yield broadened by 78 basis points, and the difference between the 30-year and 5-year yield increased by a more muted 19 basis points. The fixed income market is starting to price-in Fed tightening in the back-half of 2022 in response to rising inflation and this is being reflected in the 5-year treasury yield and hence the more muted steepening between 30's and 5's. It is also the reason we are more cautious on corporate steepeners whose coupons adjust based on these rates. It is also the reason that the Holbrook Income Fund is investing fund inflows, as well as call proceeds into high quality floating-rate instruments – typically rated AAA and AA. They currently do not offer high coupons, but they will prepare the portfolio for the next tightening cycle and rising yields on the short-end of the curve. The time to seek high nominal returns was last year, and we positioned the portfolio accordingly. Now is a time to insulate the portfolio from what we see as the largest risk to the fixed income market – RISING RATES!

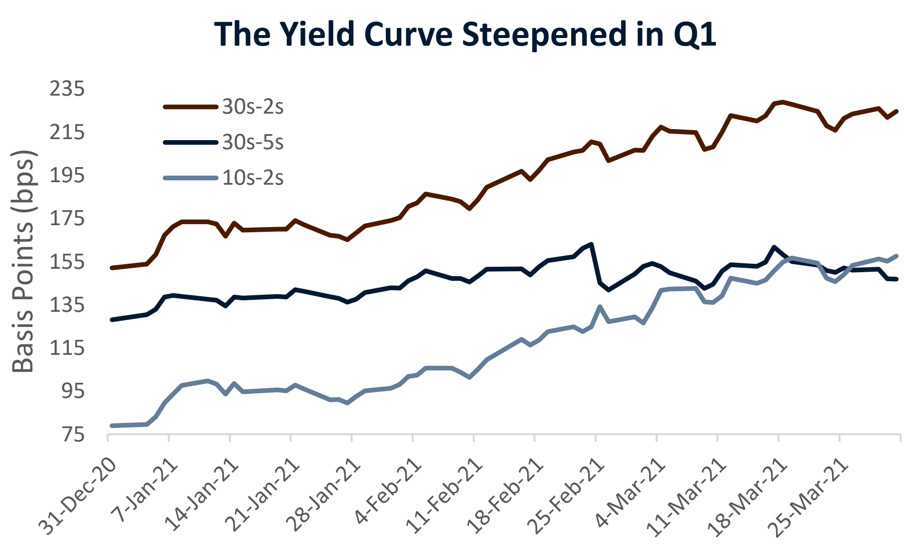

Figure 1 – Source: Bloomberg 4.7.2021

Our base-case scenario is still that the Fed will drag its feet into the next tightening cycle, and as a result we still think the "steepening trade" has legs. The Quantitative Easing cycle initiated in March of 2020 is unrivaled in magnitude by any previous Fed regime. The sheer size of their purchases in March and April last year were so immense that it was realistic to expect diminished buying over the next twelve months. So, although the Fed is still buying MBS and Treasuries it is, in effect, already "tapering" their program. Still, it is beneficial to look at the Taper Tantrum of 2013 as an analog to handicap yield curve prospects after an abrupt change in Fed course. Whereas the abrupt change in May of 2013 was the tapering of Fed purchases, we believe the next abrupt change to Fed policy will be a deceleration of Fed purchases or a potential outright termination of QE. At this time, we believe this is the first step to tightening monetary policy rather than raising short-term rates – mostly because the latter has more broad implications for dollar strength. As you can see in the following chart, which tracks the yield curve from 2013 to 2015, the curve

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continued to steepen for approximately seven months after the Fed announced it would be tapering its QE purchases. You will also observe that the 30-year minus 5-year portion of the curve was relatively flat over this period of time – another reason we are cautious on steepener positions that adjust based on this portion of the yield curve.

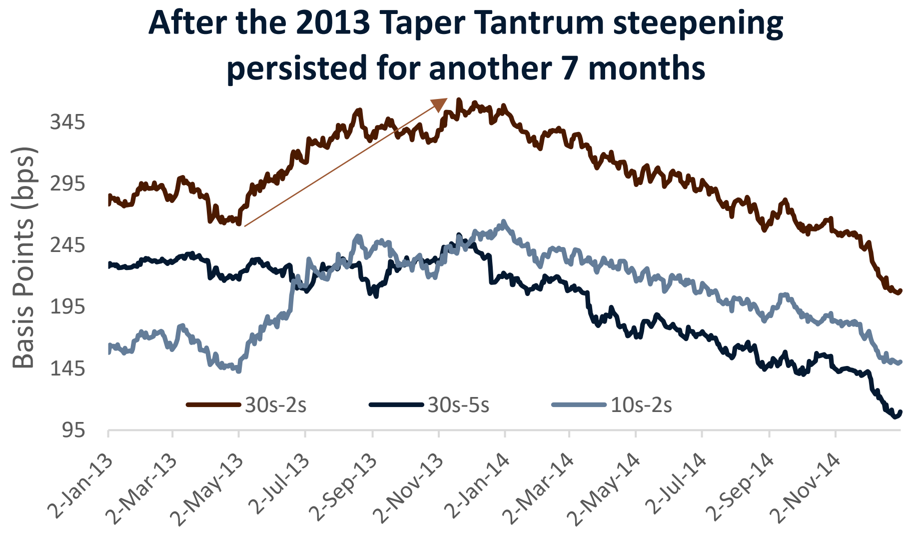


Figure 2 – Source: Bloomberg 4.7.2021

Another notable difference between the steepening that we have experienced over the last year and that experienced after May of 2013, is the deconstruction of that steepening. As you can see in the following chart, much of the steepening in 2013 was due to an increase in real interest rates (the rate investors demand above the expected rate of inflation). During the last year, the spike in the 10-year yield has been almost exclusively due to future inflation expectations.

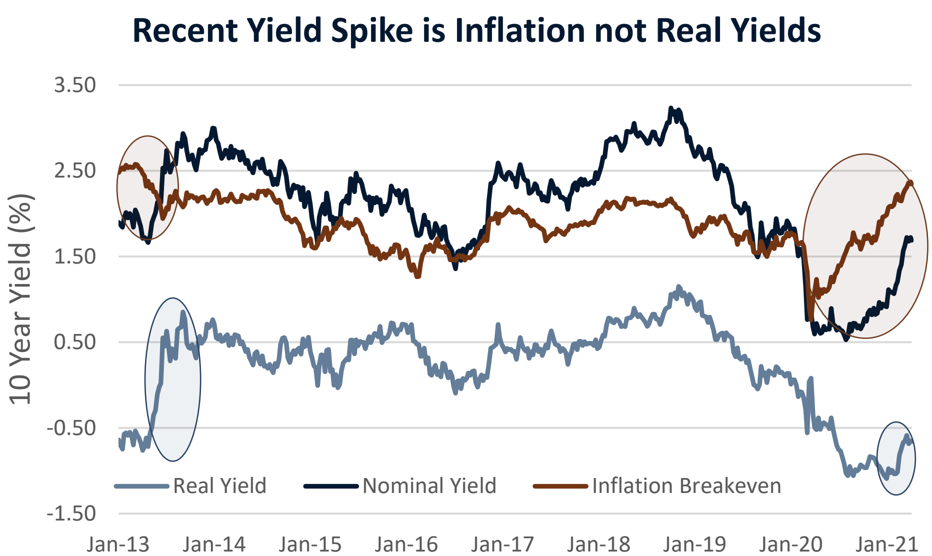


Figure 3 – Source: Bloomberg 4.7.2021

Inflation expectations are increasing, and for good reason. Fiscal stimulus, designed to create a bridge between Covid-19 shutdowns and reopening has been directly paid into the accounts of consumers. Meanwhile, vaccines are being administered ahead of schedule and appear to be working as intended -- the national shutdown could soon be a relic of the past. The re-opening of the economy, coupled with a savings glut among consumers, a weakening dollar, and a series of supply chain disruptions could mean that this upward trend in inflation expectations continues unabated for the foreseeable future. The trend could accelerate if the Federal Reserve does not give a proper nod to its second mandate, price stability. If CPI starts to consistently register readings above 2.5% and the Fed continues to view such inflation as "transitory" in its statements the Bond market will likely do much of the tightening for the Fed in the form of accelerated steepening.

The other factor to consider is the long-term complacency of the Treasury market. We have, for all intents and purposes, been in a 40-year bull market for treasury bonds, accompanied by disinflation. The chart on the subsequent page tracks the 10-Year term premium over the past 60 years. Simply stated, this is the extra yield that a 10-year treasury investor demands to take on the added volatility of owning a ten-year bond rather than simply reinvesting 3-month T-Bills for ten years (at rates projected by the forward interest rate curve). Historically, treasury investors have, on average, demanded an additional term premium of 1.5% to 2.0%. As you can see, over the decade following the Great Financial Crisis, this term premium plummeted and spent much of the last 3 years negative. Intuitively, a negative term premium indicates that investors were actually paying for the right to own a security that has more volatility, interest-rate risk, and inflation risk – which makes little sense. In any case, the term premium is now positive, although well below historical levels. Mean reversion alone, Ceteris Paribus, could bring the 10-year treasury yield well above 2.5%. Furthermore, this does not account for the possibility that the market is underestimating the long-term neutral short-term interest rate. If rate-hikes follow an accelerated path and move higher than expected, AND term-premiums mean revert, investors will want to stay away from longer duration assets. In the short-term, given that this current rate spike is entirely driven by inflation expectations, what happens to investor portfolios when the Fed acquiesces even a little bit, and the rate spike becomes REAL?

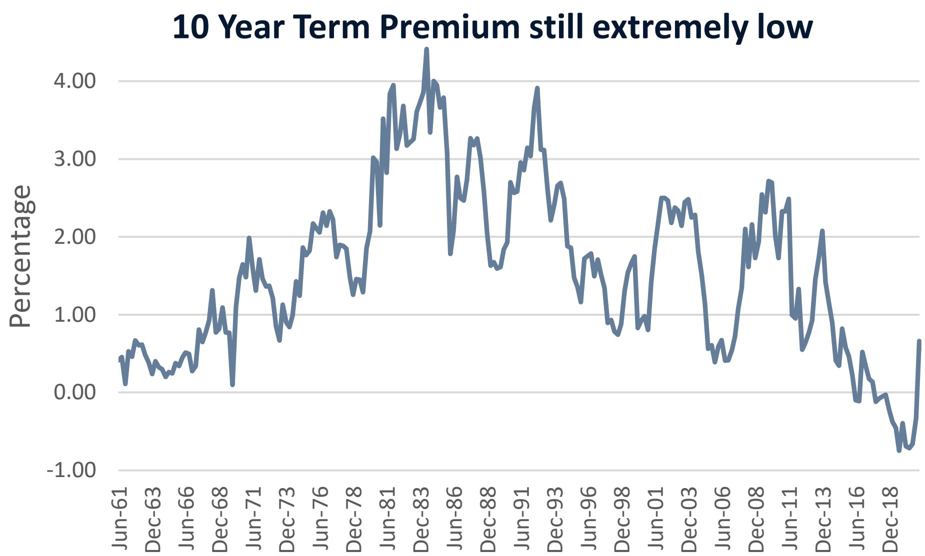


Figure 4 – Source: Bloomberg 4.7.2021

THE ECONOMY WILL LIKELY BE EXTREMELY STRONG IN 2021 – BUT THE ECONOMY IS NOT THE STOCK MARKET

The Atlanta Fed is forecasting 6.2% Real GDP Growth in the first quarter. Many Bank economists are estimating 2021 growth between 7% and 10%. The ISM Manufacturing Survey registered 64.7 this month – the highest since its inception in 1997. The economy added 916,000 jobs in March. Consumer Confidence surged to a one year high, handily beating analyst expectations. Job Openings are already at pre-pandemic levels. With all of these bullish economic headlines, the equity markets will just be on cruise control, right? As most savvy investors already know, the economy is NOT the market. It was only twelve months ago that economic projections and coincident macro data were falling off the proverbial cliff – only to be met with surging asset prices. The S&P 500 is up over 85% since last year's low. The equity markets are an efficient discounting mechanism and all of the macro data that we are currently applauding was priced-in to the market last year. And historically, go-forward returns are significantly less for equity markets when the economy is strong – which is where we find ourselves today. The paradoxical relationship between the economy and the markets is time-tested, and it is precisely why I am as cautious as I have been over the last decade for the risk-reward proposition that risk-assets currently offer.

Let's dig into the numbers, with the personal confession that I do not know how long and how far this Bull market ultimately goes. As I am writing, the S&P 500 Index stands at 4,075. Analysts estimate that Earnings per Share over the next 12 months will be $182 which puts the forward price-to-earnings multiple at 22.4x. Moreover, $182 of earnings would represent 48% growth over the next year. Such growth is certainly possible in the economic climate we find ourselves in, however, such ebullient projections leave little

S&P 500 Change based on Earnings and Multiple Change

Change in Multiple	Change in Forward Earnings Estimates: -10%	-5%	-1%	1%	5%	10%
-10	-50%	-47%	-45%	-44%	-41%	-39%
-5	-30%	-26%	-23%	-21%	-18%	-14%
-1	-14%	-9%	-5%	-3%	0%	5%
1	-6%	-1%	3%	5%	10%	15%
5	10%	16%	21%	23%	28%	34%

Figure 5 - Source: Bloomberg 4.7.2021; Past Performance is not indicative of future results; Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges; For illustration purposes using author's calculations

margin of safety to the downside. Even more worrisome is that earnings aren't even my primary concern – it is multiple contraction. Consider the chart above. The chart plots the change in forward earnings estimates versus the change in the multiple paid for those earnings and the concomitant S&P 500 returns that would result. As you can see, in the second row, even if forward earnings were ratcheted up another 10% from already high levels, the S&P 500 would still be down -14% if multiples contracted from 22.4x to 17.4x. Alternatively, earnings estimates could fall 10%, and if multiples expanded to 27.4x, the S&P 500 would enjoy a 10% gain. The point here is that in the short-run, equity markets are driven by sentiment more than earnings. In the long-run, that is not true – earnings ultimately determine long-term value.

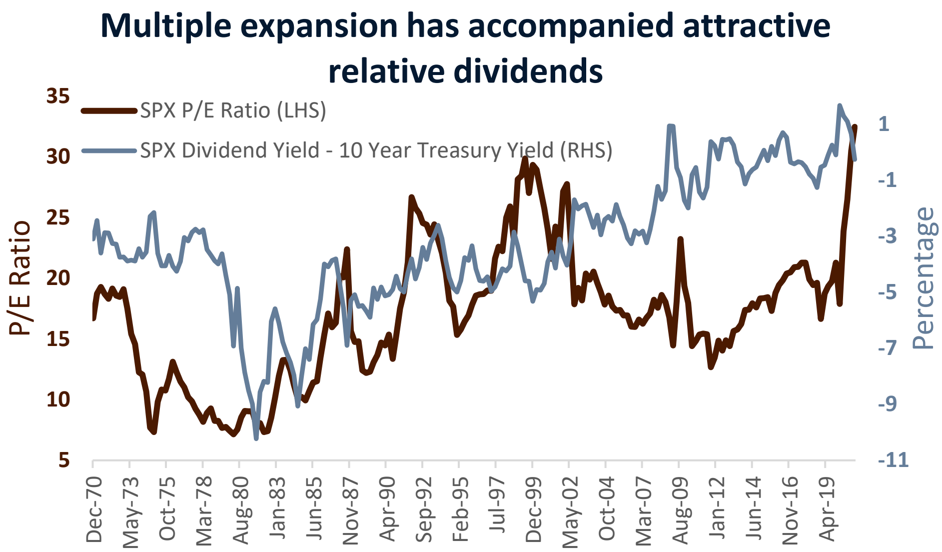


Figure 6 - Source: Bloomberg 4.7.2021

Speaking of long-term value, I want to specify that I do not believe, given the current rate environment, that equities are overvalued. In fact, the case can be made that they are still undervalued. There are a plethora of analysts and financial pundits that seem to think equities should be valued relative to themselves historically. P/E ratios are in the 99th percentile historically, as are price-to-sales, and any number of other metrics. But newsflash – they have been at these levels for 10+ years! And they have prevented many an investor from benefitting from the astronomical gains over the past decade that equity markets have provided. The one model that has worked, and will continue to work in my opinion, is a yield-differential model of valuations. This model favors relative valuation of equities to fixed income and adjusts proper P/E multiples relative to the underlying risk-free rates. It is far superior, in my opinion, to valuing equities relative to themselves. After all, economies change. As you can see in the chart above, Price-to-Earnings ratios have increased alongside dividend differentials (S&P 500 dividend yield minus the 10-year treasury yield). The correlation is not perfect as there are a number of other variables, but you can see that the general relationship is intact over longer periods of time. Perhaps an even better model charts the S&P 500 earnings yield differential (S&P 500 earnings yield minus the 10-year treasury yield). The chart on the right illustrates this. The red-line tracks the earnings yield differential for the S&P 500 relative to the ten-year treasury yield over the last 60 years. By this measure, equities look fairly valued, maybe even cheap.

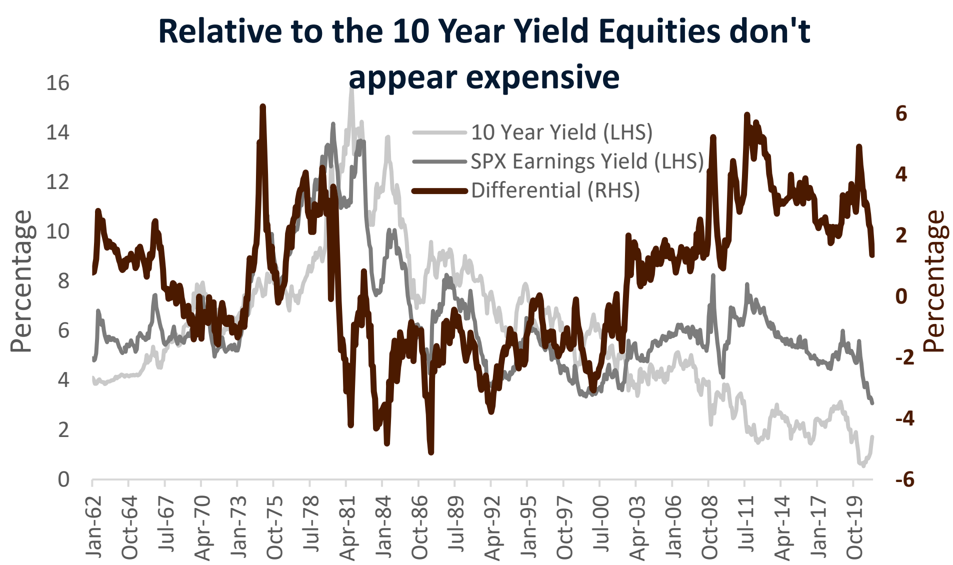


Figure 7 - Source: Bloomberg 4.7.2021

But remember, this model is a relative one. It assumes rates stay where they are. If they do, this Bull market in equities likely has legs. But in here lies the rub. I see a number of fundamental and technical reasons why rates can spike from here – perhaps significantly. If that happens, suddenly equities go from cheap to expensive – and they do so against a backdrop of exuberant earnings estimates and an economy that is already strong and will have less of an upward bias. History shows that when multiples lose their support, they rarely stop at "historical value." I have been resolute in my assertion over the last decade that ultimately rates will be the straw that breaks the equity market's back. And they are just beginning to be a headwind, in my opinion.

SECULAR DEMOGRAPHIC HEADWINDS HAVE THE OPPOSITE IMPLICATIONS FROM WHAT YOU'VE HEARD

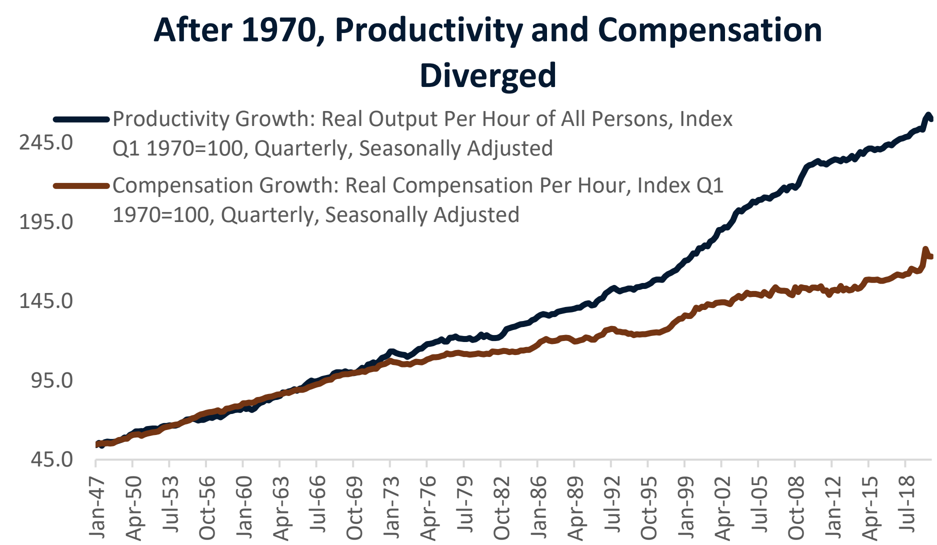


Figure 9 - Source: St. Louis Fed 4.7.2021

The chart to the right is by far my most favorite economic chart – it encapsulates many apropos themes that are manifesting themselves in the political realm today – income inequality, unionization, female participation, globalization, aging demographics and more. On the surface it illustrates one simple point: After 1970, something changed. Productivity growth in the United States (real output per hour worked) continued unabated. However, compensation growth for workers dramatically slowed. The question is why? And through the exploration of this question, a myriad of social, economic, and political themes emerges – hence my obsession with this chart. The most obvious implication of the chart is income and wealth inequality. Somebody is reaping the benefits of productivity growth. If not workers, who? Corporations. Owners of capital. It is my belief that the bifurcation of corporate profitability and worker compensation can mostly be explained by a labor supply glut that emerged in the early 1970's. In the U.S., aging baby-boomers expanded the labor-force population after 1970. Rising female participation rates exacerbated labor oversupply. And finally, globalization gave U.S. companies access to a massive pool of cheap labor overseas. Unionization also fell dramatically as bargaining power against corporations waned. By the time stagnant wages had become fully entrenched in the economy in the mid-80's, disinflation took root. After all, it is personal income growth that ultimately drives sustainable inflation.

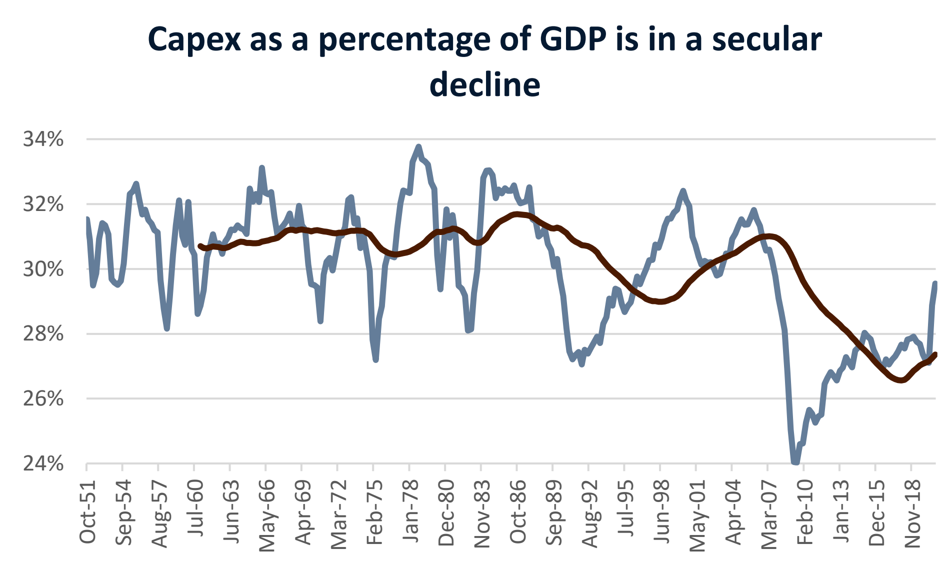


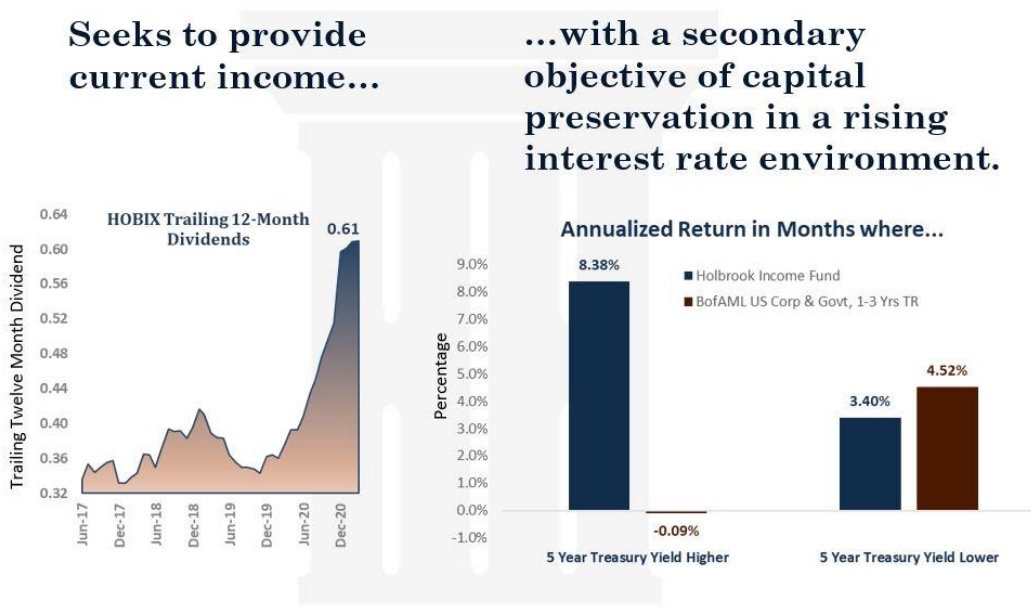
Figure 8 - Source: St. Louis Fed 4.7.2021

Fast forward to 2021. It is my belief that all of these demographic forces are reversing, and the implications for the economy, interest rates, inflation, social upheaval, and politics will be enormous. The female participation rate topped out in 2000, and the overall working-age population in the United States has been falling since 2007. Outsourcing is less profitable as the cost of labor in emerging economies catches up to that of the U.S. As the labor glut transitions to a shortage, wages will likely breakout of their multi-generational doldrums, and disinflation (and falling yields) will be a relic of the past. Corporate margins will compress and Income and wealth inequality will lessen. Union strength will re-emerge as their bargaining power increases.

In terms of aging demographics -- On the surface it might seem that older cohorts consume less. However, from a money flow perspective, this is not always the case, especially in what I forecast to be the political environment moving forward. Older cohorts have a higher marginal propensity to consume. That is, they spend a higher percentage of their income. And while a growing percentage of their income will be sourced from transfer payments (Social Security, Medicare etc.) all of that is spent and recycled into the economy. Whether it is financed by savers via taxes (the working-age cohort) or with more sovereign debt, it doesn't matter, both are inflationary. And as the working age cohort (as a percentage of the population) falls, we will be faced with an economy that is producing fewer goods, and more money chasing those goods. This is the simplest definition of inflation. Higher productivity *could* offset this, to some extent. However, the chart on the previous page shows that Capital Expenditures, necessary for future productivity growth, are in secular decline. I will leave Federal Reserve policy critiques and discussions on moral hazard for another time, but you can intelligently infer whom I blame for this.

THE HOLBROOK INCOME FUND OBJECTIVES

My secular view on demographics and labor trends should shed some light on why I launched the Holbrook Income Fund in 2016 with two objectives: seeking to generate income and to preserve capital in a rising interest rate environment. Its second objective is unique and intimates that I believe fixed-income managers are going to have a difficult time during the next secular bear market in treasuries. Investor assets have been funneled into huge trough of products that are dependent on low and falling rates for outperformance – and for good reason. After all, we have experienced a forty-year bull market in bonds. I firmly believe there will always be a need for income generating assets, and I believe it is my mandate to navigate the markets when the fixed income tide recedes, and yields move higher. I will continue to measure the Holbrook Income Fund's success based on our two prospectus objectives. To those ends, the below slide is something I will continue to track and revisit. The first chart illustrates our trailing twelve-month dividend. The second chart shows the annualized return of the Fund and its benchmark in months when the 5-year treasury yield moves higher, and in months when the 5-year treasury yield moves lower. Given the secondary objective of the fund, I would expect outperformance in falling rate environments and underperformance in rising rate environments —and this is what we have seen since the inception of the fund.



Past Performance is not indicative of future results; Investors cannot invest directly in an index. Data is taken from monthly returns and sorted by months where the five-year treasury yield increased and decreased. Monthly performance is then averaged and annualized. Performance data is reflective of all full month returns since the inception of the fund 7.6.2016 through 3.31.2021.

There is no guarantee that any investment strategy will achieve its objectives, generate profits, or avoid losses. Liquidity does not ensure profit or prevent losses.

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Risks:

Investments in mutual funds involve risk including possible loss of principal. There is no guarantee that any investment strategy will achieve its objectives, generate profits, or avoid losses. The Fund invests in closed end investment companies or funds. The shares of many closed end funds, after their initial public offering, frequently trade at a price per share that is less than the net asset value per share, the difference representing the "market discount" of such shares.

The Fund may be adversely affected by new (or revised) laws or regulations that may be imposed by government regulators or self-regulatory organizations that supervise the financial markets. CLO debt securities are limited recourse obligations of their issuers and may be subject to redemption. Holders of the CLO debt being redeemed will be repaid earlier than the stated maturity of the debt. The timing of redemptions may adversely affect the returns on CLO debt. The CLO manager may not find suitable assets in which to invest during the Reinvestment Period or to replace assets that the manager has determined are no longer suitable for investment.

The value of securities issued by the U.S. Government generally fluctuates in response to inflationary concerns and may differ in their interest rates, maturities, times of issuance and other characteristics.

The risk that the Fund could lose money if the issuer or guarantor of a fixed income security is unwilling or unable to make timely payments to meet its contractual obligations. The risk that foreign currencies will decline in value relative to the U.S. dollar and adversely affect the value of the Fund's investments in foreign (non-U.S.) currencies. The derivative instruments in which the Fund may invest for hedging purposes may be more volatile than other instruments.

The Fund invests in fixed income securities or derivatives, the value of your investment in the Fund will fluctuate with changes in interest rates. These risks could affect the value of a particular investment by the Fund. Investment in or exposure to high yield (lower rated) debt instruments (also known as "junk bonds") may involve greater levels of interest rate, credit, liquidity and valuation risk than for higher rated instruments. When the Fund invests in other investment companies, including ETFs, it will bear additional expenses.

The Fund has a limited history of operation. In addition, the Adviser has not previously managed a mutual fund. The risk that investment strategies employed by the Fund's adviser in selecting investments for the Fund may not result in an increase in the value of your investment. The Adviser's use of computer trading modeling systems may perform differently than expected as a result of the factors used in the models.

Investors should consider the investment objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other important information about the Fund. For a current Prospectus, call 1-877-345-8646 or go to www.holbrookholdings.com

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