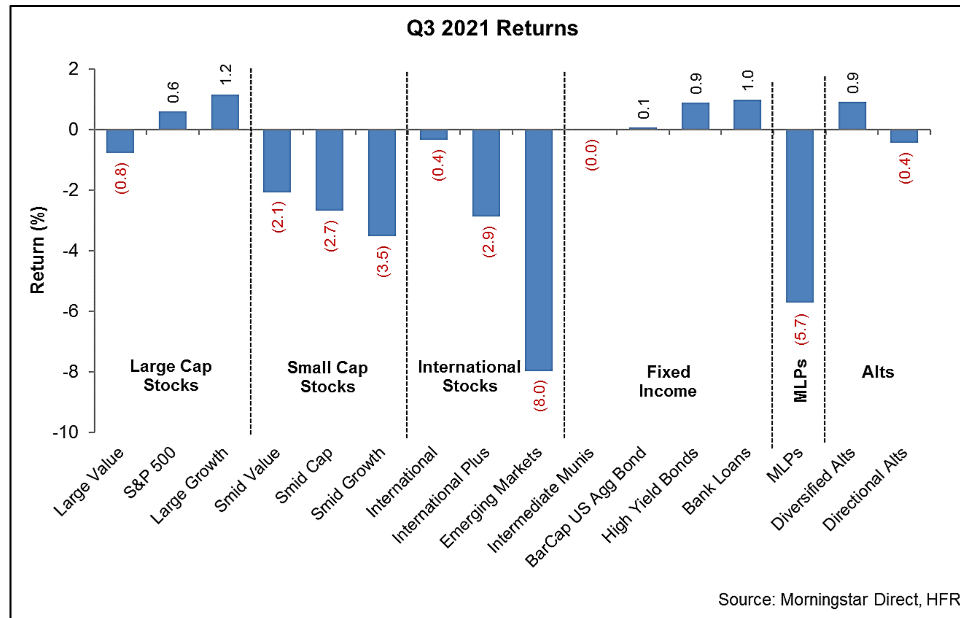
NEXT CAPITAL

Next Capital Management, LLC
Eleven Times Square, 15th Fl
New York, NY 10036
O: 212.433.1111
F: 212.382.2080
www.nextcapitalmgmt.com

Third Quarter 2021 Investment Review & Outlook



EXECUTIVE SUMMARY

Q3 2021 Recap:

- Financial market returns were mixed across asset classes during the third quarter. The S&P 500 posted a meager gain of 0.6%.
- A strong surge in Covid cases due to the Delta variant resulted in slower growth and weighed on more cyclical areas of the market.
- Emerging market equities suffered from increasingly hostile regulatory action on the part of the Chinese central government and concern over the country's property market.

NEXT Outlook:

- The commencement of Fed tapering will likely take place in Q4, generating volatility in the rate market and further upward momentum in the intermediate portion of the yield curve.
- A reconciliation bill from Congress appears targeted by year end, which could further investor concerns surrounding inflation and reduced earnings expectations.
- With Delta having peaked in the US, we expect cyclical stocks to regain momentum as we head into the close of the year.

To Our Clients and Friends,

After five straight quarters of strong gains on the back of the pandemic-related drawdown, markets took a breather in the third quarter. The S&P 500 followed a near-record start to 2021 during the first half of the year with a muted gain of 0.6%.

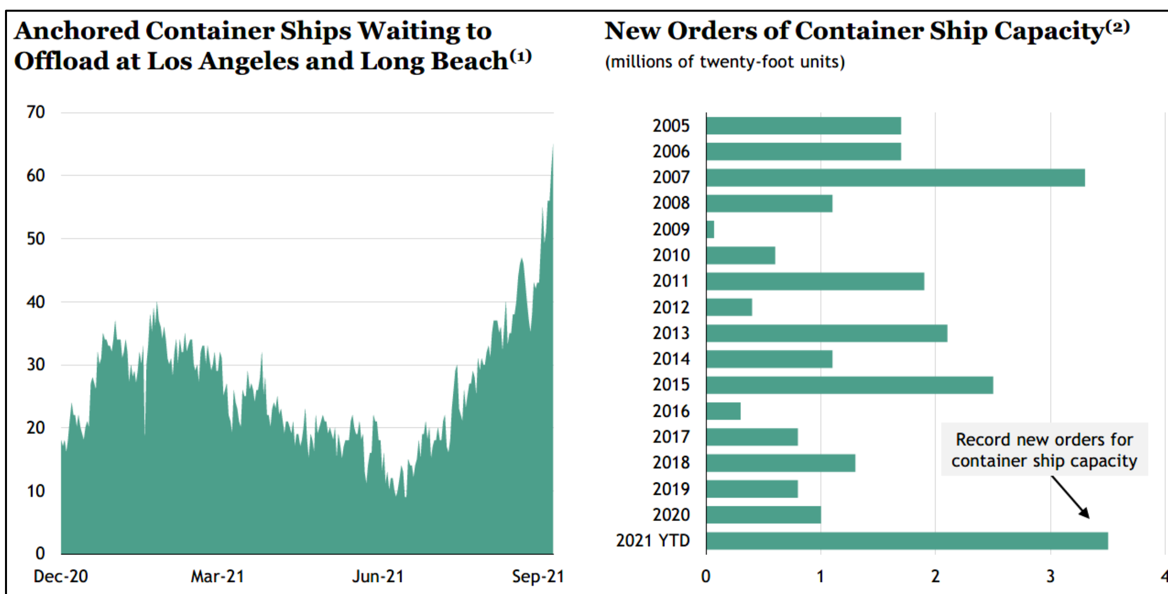
As a resurgence in Covid cases swept across regions and threatened the economic recovery, investors turned to the high quality, higher growth segment of the market over the past quarter – leading to outperformance from large growth stocks. That segment of the market led performance with a return of 1.2%, versus that of -0.8% for more cyclically-oriented large cap value stocks. Nevertheless, with Delta variant cases appearing to have peaked, we expect this trend to reverse during the final quarter of the year as the re-opening resumes and makes up lost ground.

While we remain constructive on the US re-opening, there are more concerns overseas, specifically surrounding China. Emerging markets lagged this past quarter in large part due to regulatory actions against large Chinese tech firms. The root of the sell-off lies in the Chinese government's wariness towards ever-expanding platform companies whose business models either threaten the government's control and/or policies that they have begun to approach with renewed vigor (e.g., worker's rights, equality of education, and income inequality). The Nasdaq Golden Dragon Index, which tracks 98 of China's largest firms experienced its largest two-day selloff since 2008 on the heels of these actions.

While the Chinese Communist Party maintains a strong commitment to furthering economic growth, it recognizes that many social imbalances were exacerbated by the stellar growth it enjoyed over the past two decades. New regulations were instituted to ameliorate such issues: instituting minimum wages and full benefits for gig workers, applying more stringent financial regulations on Fintech platforms, and breaking

down barriers to entry to foster competition against the largest tech giants. Structural changes such as these make the potential opportunity in Chinese stocks murky; we suspect authorities don't favor completely undermining their most successful companies, but there is no question those companies' earnings power has been affected.

In addition to regulatory headwinds, the Chinese economy has begun to suffer from the same global supply chain constraints that are rippling across economies globally. During the third quarter, the bottlenecks that many believed would dissipate throughout 2021 continued to worsen. Internationally, shipping costs per container continue to reach new highs, while a record number of new orders has already been reached – just nine months into the year. In the US, distribution companies are struggling to get enough trucks on the road and container capacity on rail, while storage suppliers are closing warehouses to new inventory due to space constraints. Domestic labor market tightness has been adding to the strain on supply chains as firms are having trouble filling open jobs.

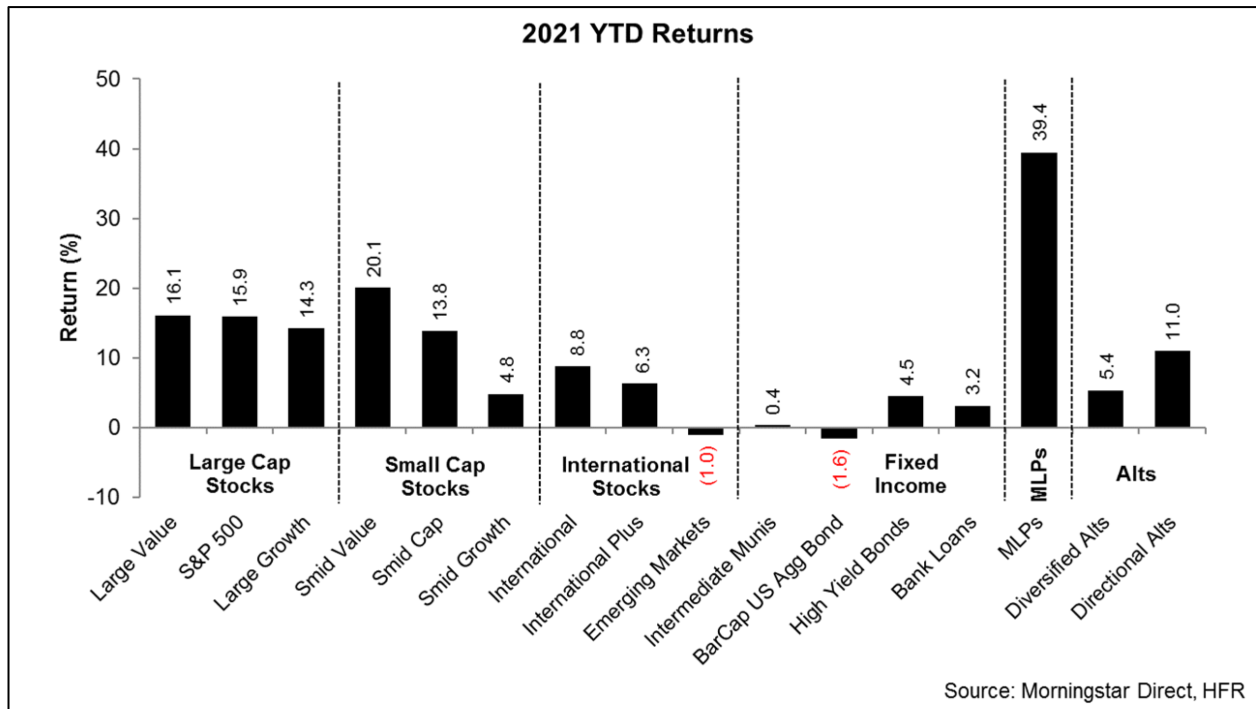


This continuation of supply chain bottlenecks has caught many forecasters off guard, including the Federal Reserve, who has since increased their inflation expectations. At their last FOMC meeting, the board members pushed their FY 2021 Core PCE projection up to 3.7% from 3.0%, and their FY 2022 number to 2.3%, from 2.1%. The Fed also alerted market participants to the fact that asset purchase tapering could begin as soon as this coming quarter. Chairman Jerome Powell has been preparing markets for this moment over the course of this year; however, heightened volatility as expectations turn to reality.

Rates have already seemingly begun to react to this slight change in posture from the Fed, with the 10-year rate rising from a quarterly low of 1.19% in July to 1.58% today. The increase in inflation expectations and imminent start of tapering surely have played a role in this most recent move upward after the 10-year rate had been relatively range bound for a handful of months. We expect rates to see continued upward pressure as the Fed slowly begins to reign in its historically accommodative program and reduces liquidity in the system.

Market Recap…

Third quarter performance was largely a continuation of the longer-term trend which regained footing during Q2. US equities outperformed their developed international and emerging market counterparts, while large cap growth stocks led domestically over value and small caps. Nonetheless, on a year-to-date basis large value stocks still have a leg up over large growth, having returned 16.1% and 14.3%, respectively. The market leader continues to be small cap value stocks, which have returned 20.1% for the year.



While large cap growth stocks outperformed the broader market, at a sector level performance was led by the more traditional sectors of Financials and Utilities. The aforementioned increase in rates will be accretive to net interest margins for big banks, and this dynamic will likely persist for quite some time. Utilities finally caught up to the broader market to some degree, but still lag all other sectors on a year-to-date basis. Some of the stalwart sectors from early in the year – Industrials, Materials, and Energy – lagged all sectors for the quarter.

As discussed during our last commentary, non-US equities have posted poor relative performance numbers this year, and the discrepancy vis-a-vis US equities widened during the third quarter. International stocks ended the quarter down -0.4% while emerging market equities tumbled -8.0%. In emerging markets, the main issues were those related to Chinese regulations and business crackdowns as mentioned in our introductory comments. Towards the end of the quarter, however, consternation regarding Chinese equities worsened as news broke out that the country's largest property developer, Evergrande, would default on its debt. The news highlighted an overly levered property market, with multiple developers and construction firms managing precarious debt balances. The degree to which Evergrande's default may prove to be systemic is unknown, but many forecasters have begun to reign in their growth estimates for Chinese GDP during the next 12-24 months.

On the fixed income front, the last quarter was mostly quiet with low volatility. With rates slowly marching back upward, the Bloomberg Aggregate Bond Index (the "Agg"), a proxy used for the broad bond market,

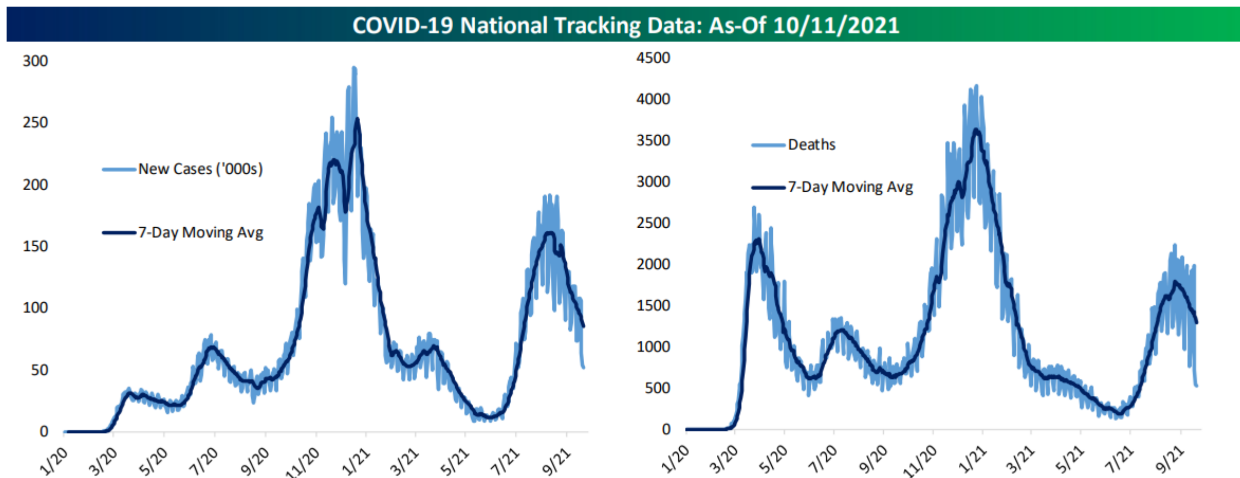
was flat (posting a gain of 0.1%), while high yield bonds ended the period just short of a 1.0% gain. On the year, the Agg remains in negative territory with a -1.6% loss. This puts the Agg on pace for its first annual loss since 2013.

Other segments of the fixed income universe – those that are more credit oriented – have been faring better over the course of the year. High yield bonds and bank loans are up 4.5% and 3.2% respectively since the start of 2021. These types of securities are generally shorter duration in nature than more traditional high-quality securities such as Treasuries and investment grade corporate bonds. This means that the price of the securities themselves is less sensitive to fluctuations in interest rates. Privately originated loans have also posted strong returns this year, with the Cliffwater Direct Lending Index up 7.2% through the second quarter (and with expectations for a strong third quarter as well since there is a lag in reporting for these private assets).

Other non-traditional sectors have done fairly well throughout the course of the year. In particular, Private Real Estate has stood out having gained 6.1% through the end of Q2. Third quarter returns for the asset class are also expected to be strong as leasing rates have been robust, and supply/demand dynamics across most sectors continue to push cap rates into lower territory. Private Equity returns are also expected to be strong, as the index started the year with a 10.4% gain during Q1. Lastly, hedge funds have had a decent year up to this point, with diversified and directional strategies up 5.4% and 11.0% respectively through Q1.

Outlook…

As we enter the final quarter of the year, we remain constructive on the broader market environment. The biggest headwind to equities over the past three months had been surging Covid cases resulting from the higher spread rate associated with the Delta variant. With Delta seemingly peaking across the US, and vaccination rates continuing to increase with about 57% of the US population fully vaccinated, we believe that the market rally will regain its legs albeit with somewhat heightened volatility. We expect cyclical sectors to once again catch a bid as the economic re-opening resumes in full force.



Nevertheless, there are a handful of risks on the horizon. Key to market performance over the next three months will be the investor reaction to Fed tapering. As mentioned earlier, the Fed has signaled that it plans to begin tapering its asset purchase program sometime in the fourth quarter amidst a backdrop of stronger than anticipated inflation and economic growth. One group of pundits will argue that tapering bond

purchases will be a net positive as it will help combat the inflation threat that has dominated the minds of many market participants, while others will argue that it will commence the end to the massive wave of liquidity that has helped bring markets to their current levels. The tapering question will be a classic case of "good or bad news?"

On the legislative front, all eyes will be on Washington as Democrats juggle raising the debt ceiling, a massive reconciliation bill, and moving forward on infrastructure spending. With respect to the reconciliation bill (the Build Back Better Act), the $3.5T proposal is set to provide a variety of social services that range from Medicare expansion to two free years of community college, as well as efforts to combat climate change. If enacted, the proposed legislation is said to be paid for by considerable tax hikes: the corporate tax would rise from 21% to 26%; the top income tax rate would rise from 37% to 39.6%; and the top capital gains rate would rise from 20% to 25% (28.8% including ACA surtax). In particular, the increase to the corporate rate would hit expected corporate earnings for 2022, serving as a legitimate risk for the current market level.

Nevertheless, the actual proposals included in the bill will likely shift around over the coming months, as moderate and progressive Democrats have yet to agree on the scope of the package. This debate has also paused any progress towards a vote in the House on the $1T Infrastructure Bill which has already passed through the Senate in bi-partisan fashion. Market sectors like Materials and Industrials were bid higher earlier this year in part due to the expected boost from the infrastructure package, and any further delays or changes to the bill as part of a bargaining process on reconciliation could prove to be detrimental to those equities.

Final Thoughts…

While we will be closely watching how the spending and tax provisions of the aforementioned bills change over the coming quarter, we have also stressed to our clients the importance of preparing for the proposals regarding family estates and retirement planning. As of today, it appears as though the lifetime exemption for the estate tax is set to be lowered, and grantor trusts will no longer be serviceable vehicles for transferring assets out of one's estate among other provisions.

With respect to the market, we continue to maintain a cautiously optimistic stance as valuations for both equities and fixed income are still at elevated levels. While the equity market's Forward P/E has come down from its recent highs in 2020 as corporate profits and margins have expanded, it still remains slightly over one standard deviation from its 25-year average. Furthermore, rates are still hovering just above all-time lows and credit spreads remain historically tight. We believe that our clients can be fully invested despite this expensive environment by supplementing traditional portfolios with non-traditional assets in alternatives, real estate, and other private investments.

As always, if anything has changed in your financial life, or you feel that your tolerance for risk has change, please call or email us at your earliest convenience.

Sincerely,

Your Investment Team

10/13/2021

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Next Capital Management, LLC [“Next]), or any non-investment related content, made reference to directly or indirectly in this commentary will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this commentary serves as the receipt of, or as a substitute for, personalized investment advice from Next. Next is neither a law firm, nor a certified public accounting firm, and no portion of the commentary content should be construed as legal or accounting advice. A copy of the Next’s current written disclosure Brochure discussing our advisory services and fees continues to remain available upon request. ***Please Remember:*** *If you are a Next client, please contact Next, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. Unless, and until, you notify us, in writing, to the contrary, we shall continue to provide services as we do currently.* ***Please Also Remember*** *to advise us if you have not been receiving account statements (at least quarterly) from the account custodian.*

Historical performance results for investment indices, benchmarks, and/or categories have been provided for general informational/comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. ***Please Also Note****: (1) performance results do not reflect the impact of taxes; (2) comparative benchmarks/indices may be more or less volatile than your Next accounts; and, (3) a description of each comparative benchmark/index is available upon request.*