2021 Mid-Summer Update

Dear Members of Flower City Capital,

We hope you are enjoying a safe and healthy summer with your families. Below we endeavor to provide a greater understanding of the current environment and where we could go from here.

A quick business update. We continue to make major improvements to our platform. Thank you to those of you who have provided kind feedback to our new team members Kara and Jake. They are making a big impact and are wonderful additions to the team. We also recently completed a major cybersecurity project with a national partner in an ongoing effort to keep our data secure.

Executive Summary

What's Going On?

- We did it! The US economy has recovered to its pre-Covid levels
- The stock market has doubled from its March 2020 lows to all-time highs
- Though it's hard to complain about that, there is a general sense of unease with this rapid change
- Lower interest rates have helped the market recover, but they have also help to make assets more expensive and raised the prospect of inflation
- It is fairly clear that many assets are expensive at the moment, and it is only logical to expect lower returns in the near future
- Low returns do not mean no returns – investing is better than sitting in cash
- Though market corrections are frequent and healthy, earnings growth has actually made the market cheaper this year potentially lowering the odds of any major crashes

How Are Our Portfolios Positioned?

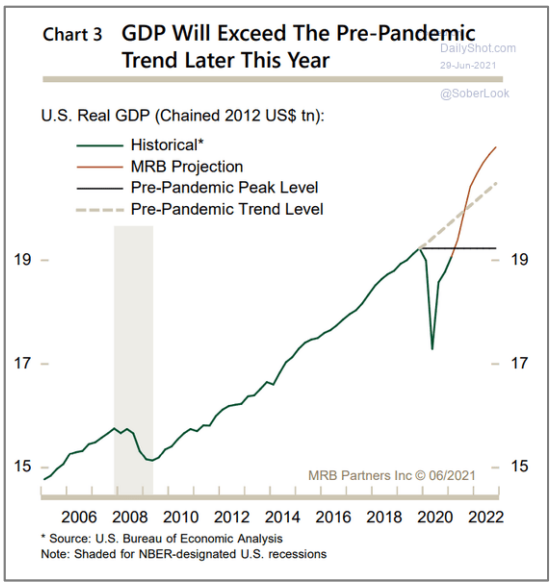
- Record highs over the previous quarter provided a window to exit the opportunistic positions we added during the pandemic
- The proceeds included significant profits and were put to work in our core bond holdings de-risking portfolios
- Real Estate exposure was added in the spring and has helped to increase growth and yield in the portfolio
- We remain neutral on stocks with the market up over 100% since the lows last year
- We remain shorter term in our bonds to protect against a potential increase in interest rates and retain exposure to some credit (riskier bonds) as financial conditions remain accommodative

Will Taxes Increase?

- It's hard to know what will come out of Washington these days
- As of now no new tax laws have been written
- The ones that have been proposed would not impact most people
- For those who could be impacted we will monitor and keep you updated
- Any potential tax increases would only make our current tax management practices more valuable; we don't anticipate needing to make any major process changes

What's Going On?

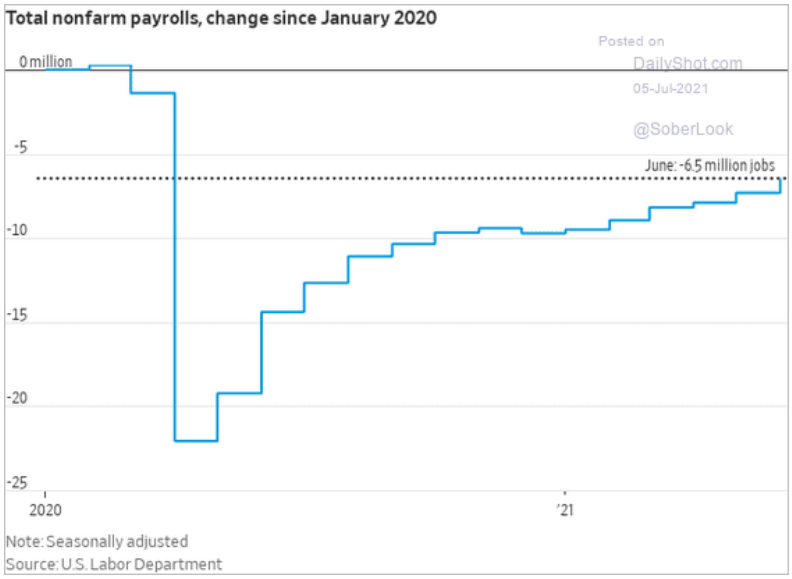
First and foremost, we did it! The US economy is back to its pre-Covid levels. Also, thanks to significant stimulus, many forecasts predict growth should be above its pre-covid trend over the next couple years.



The stock market has doubled from its March 2020 lows to all-time highs, with an improving economy and easy money from global central banks.

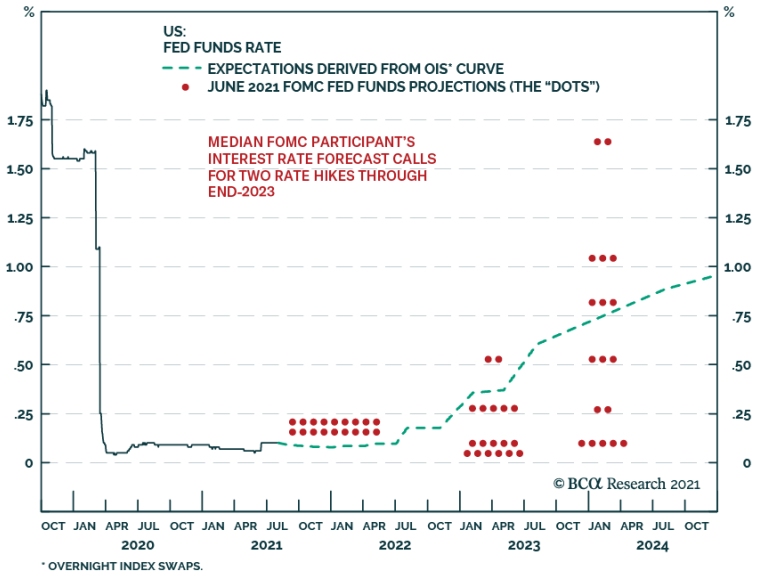
While no one is complaining when looking at their account balances, there is a general sense of unease with this rapid change, especially given the events of the last 18 months. Therefore, we thought it was appropriate to delve into how we got here. Only then can we answer what everyone really wants to know, will there be another crash?

Though it's hard to appreciate today, last year the US economy lost over 20 million jobs in a matter of months. Suffice it to say things were pretty bad.

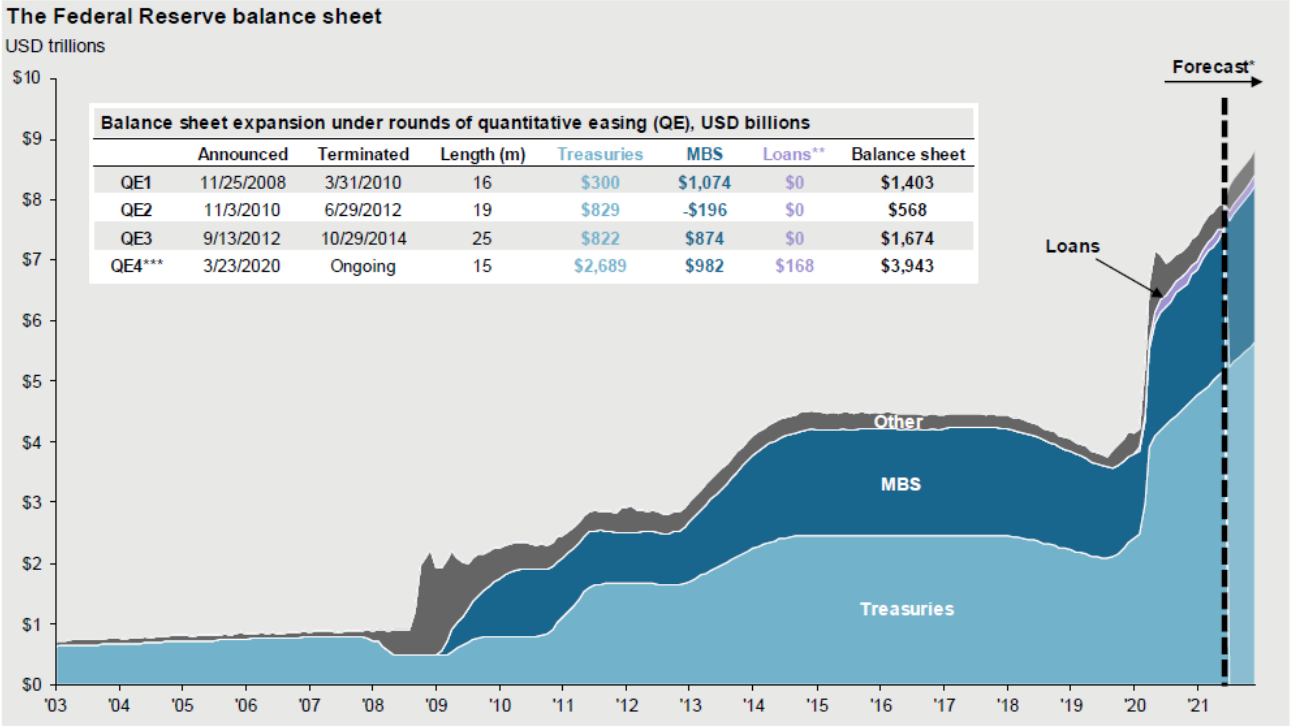


People are generally familiar with the stimulus checks and other government programs in the story of how we got to where we are, but the role of the Federal Reserve is likely less familiar. The Fed is the bank to all US banks and plays a key role in setting interest rates and other monetary policies for the economy.

To help combat the crisis, the Fed (along with other central banks) cut short-term benchmark interest rates to zero. All things equal, lower interest rates and excess cash systemwide is positive for the economy compared to the alternative (higher interest rates and a shortage of money).



The Fed also launched an aggressive bond buying program. By aggressive we mean purchasing trillions of dollars of Treasury and Mortgage bonds in less than a year.



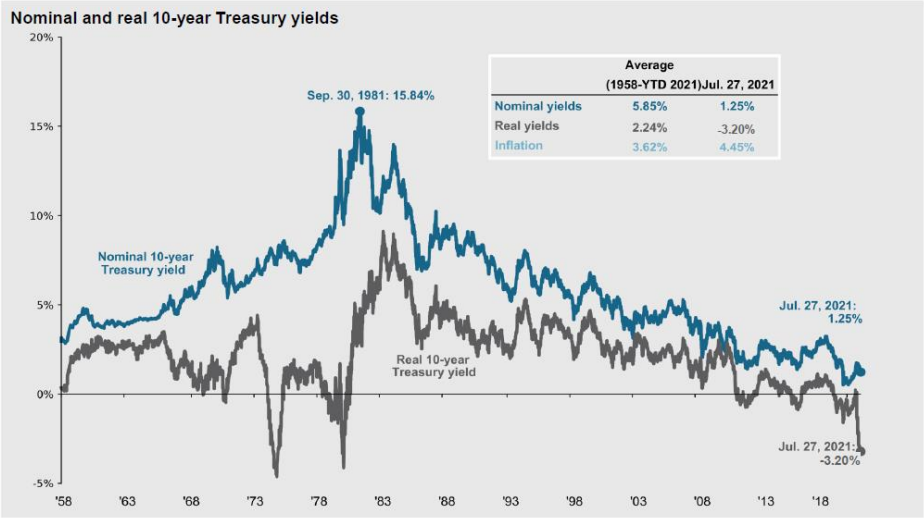
Balance sheet expansion under rounds of quantitative easing (QE), USD billions

	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4***	3/23/2020	Ongoing	15	$2,689	$982	$168	$3,943

Source: FactSet, Federal Reserve, J.P. Morgan Investment Bank, J.P. Morgan Asset Management.

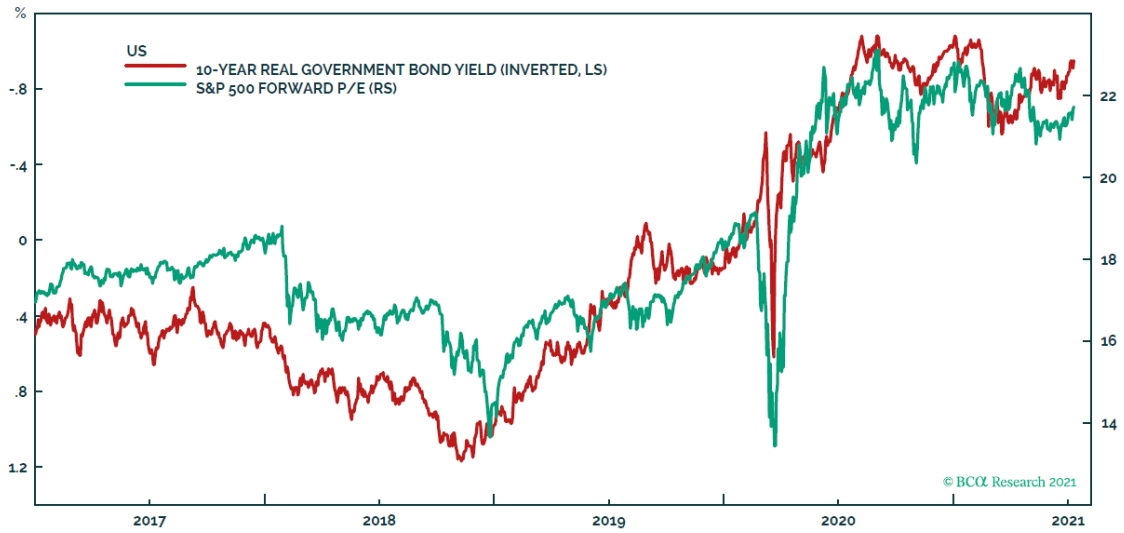
Not surprisingly record monetary stimulus resulted in significantly lower bond yields – the lowest yields in most of our lifetimes.

Low interest rates are good from a borrower's perspective. From an investor's point of view low interest rates imply lower rates of returns. This is because they can inflate asset prices. Look around: cars, houses, etc. When interest rates are low people are willing to pay more for things, the most relevant being stocks.



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.

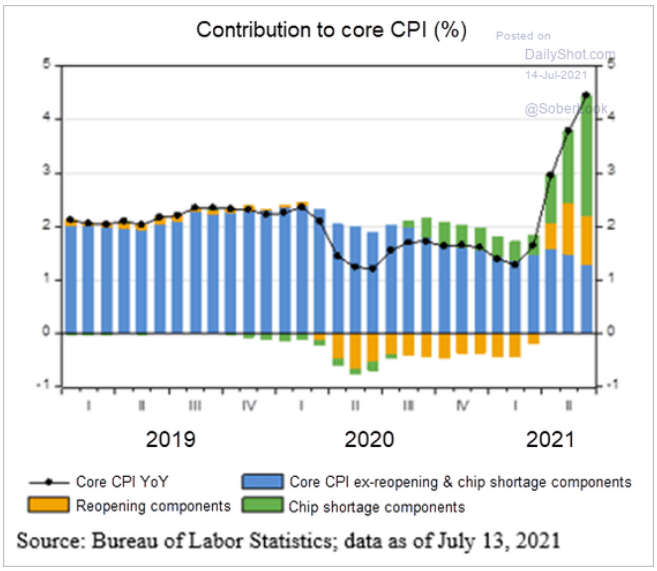
This should make sense. Which investment would you rather own? A bond with a yield of 1.3% that could decline in value if interest rates rise back to average, or a stock that yields 2% and could appreciate 3-4%/year for the next decade. Per the chart below there is a strong relationship between the price people are willing to pay for stocks and interest rates.



This leads us back to the prevailing sense of unease. What happens to asset prices if some of the monetary policies put into place to combat Covid are reversed? To answer this question, we first must understand the Fed's goals. The Fed has a dual mandate: 1) full employment and 2) stable prices.

Let's start with full employment. As we already saw, the labor market suffered severe losses due to the pandemic and has not yet fully healed. As of July, we were still down ~6 million jobs since before Covid. With a record 10+ million job openings a recovery is already in the works. The economy is adding roughly ¾ of a million jobs a month now and is expected to be back at full employment by the middle of 2022.

So why is the Fed keeping interest rates at 0% and buying $120 billion of bonds each month? Well, recoveries are fragile, and you would prefer to no to harm them while they're still taking root. This happened in 2018 when the Fed raised interest rates pre-maturely and the market dropped 20%. There are other risks as well. The delta variant, geopolitics, etc., and so it appears the Fed is content to wait until there is more clarity on the labor market recovery.



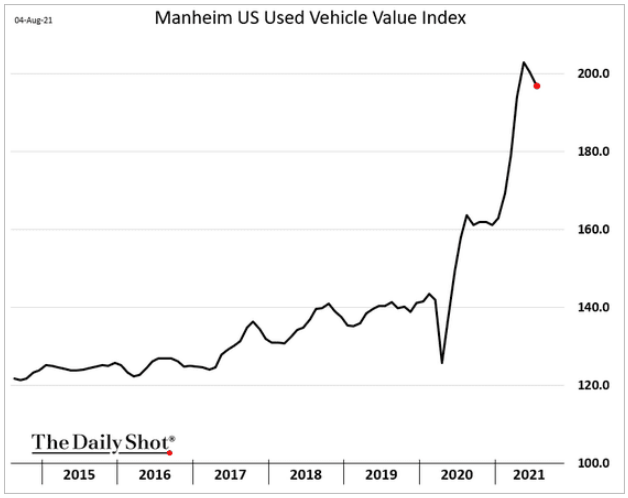
This would be a much simpler problem if the Fed's only directive was to achieve full employment. While easy money policies are effective tools on that front, the ensuing inflationary forces threaten their second mandate of maintaining stable prices.

Inflation has grabbed investor's attention recently. It's hard not to notice it in everyday life. Seemingly everything we buy has gotten more expensive or is on back order. The market moves every time there is an update to inflation or employment data indicating when the Fed will start to unwind its programs.

It is worth noting that low interest rates by themselves do not lead to inflation. Look at the last 10 years in the US. Short-term rates were near 0% most of that time and inflation averaged 1.8%. Another example is Japan where 0% interest rates have coincided with almost no inflation for 20 years. Instead supply and demand pressures on the economy structurally drive inflation. Prices raise when there is more demand than an economy can produce. Likewise, if there is excess supply then prices stay flat or decline.

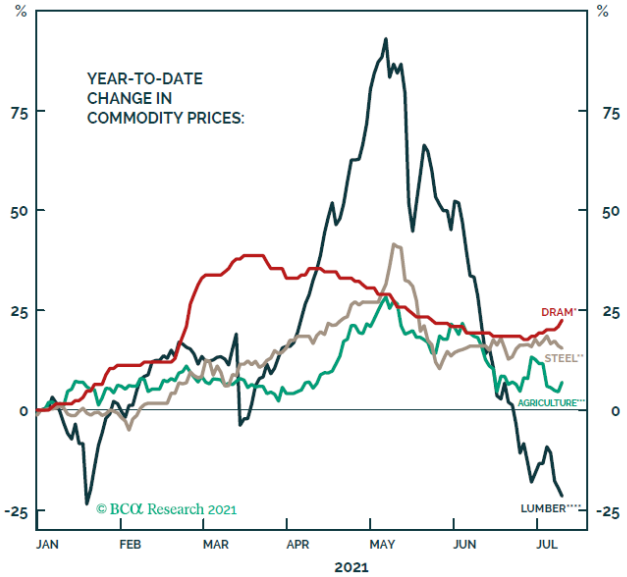
What's different this time around? The whole population was asked to stay home, and many were provided additional income through stimulus checks and other direct payments which was then spent and recirculated into the economy. Factories, contractors, and transportation companies dealing with lockdowns could not and are still struggling to keep up with surging demand.

Recent data as measure by the Consumer Price Index (CPI) show a rapid increase in inflation. Looking under-the-hood though most of this can clearly be attributed to specific reopening related sectors. You can see similar supply constraints and demand surges at restaurants, hotels, etc. The largest one is chip shortages for autos. In North America alone, there are over 1 million cars waiting on chips to be completed. Absent these key reopening related sectors, inflation is actually running below trend.



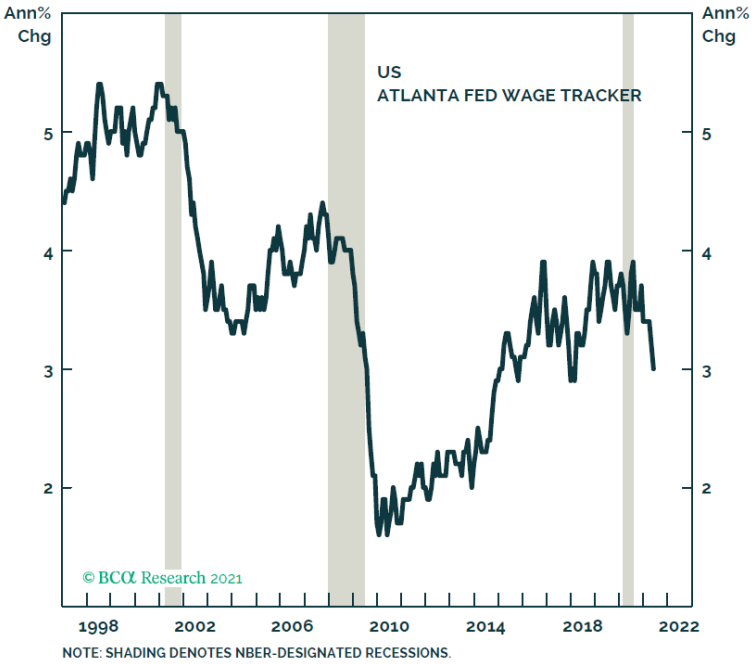
We've joked several times in the last month that we missed one of the best investments last year due to a mismatch in supply and demand: 1994 Toyota Corollas. It's looking like this phenomenon is about to rollover as carmakers catch up and bring balance back to the market.

Lumber prices have also rolled over this year after a big swell. As in many markets the cure for high prices is high prices either through a creation of additional supply or a reduction in demand. Not many people want to pay 50% more than last year to build a house with surge lumber and surge labor pricing.



We also haven't seen much wage inflation outside the high demand sectors such as restaurants and hospitality. An important qualifier is the recent increases in housing prices which won't start to show up in the data for another couple months. Therefore, it's reasonable to expect a floor underpinning moderating inflation levels for the next 1-2 years.

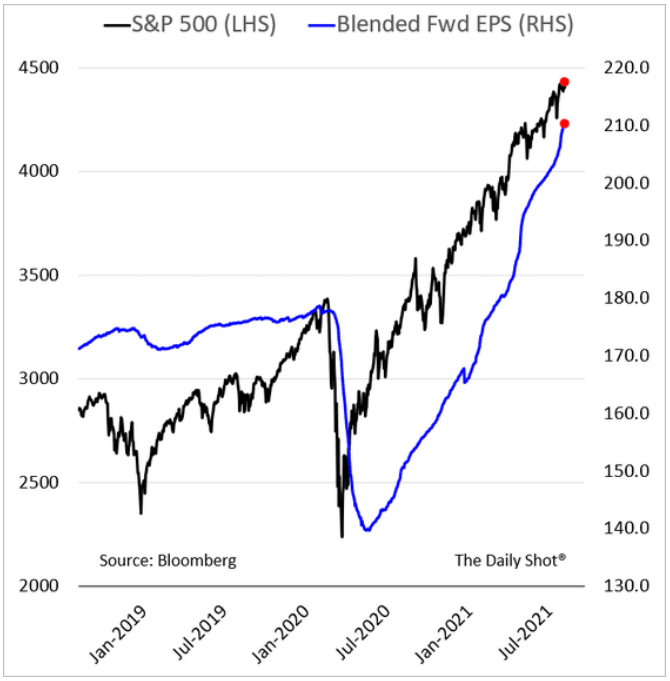
We've established that lower interest rates and easy money policies have helped the US economy to recover from a massive shock. The question for markets now is how if ever things will get back to normal. Said more simply the market is concerned about two things 1) the Fed raises rates too quickly and kills the recovery in the name of overheating inflation or 2) it waits too long to raise rates and inflation gets out of control, and then a much bigger reversal would be required to stomp their foot on the economic brake.



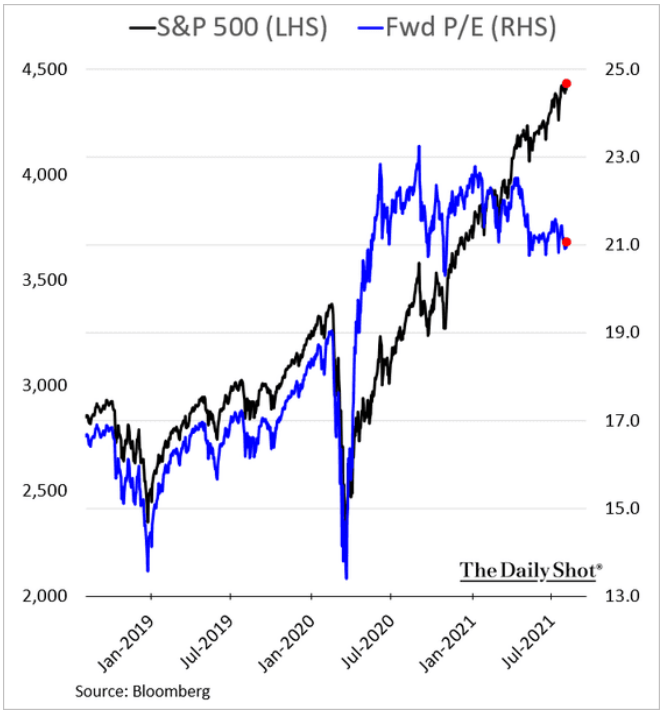
The market is currently pricing in somewhat of a 'goldilocks' scenario. In this sequence of events the Fed threads the needle quite well by raising rates at the just the right pace to keep the recovery going until we're back to full potential, but not too late such that inflation takes hold.

The current narrative outlines the Fed announcing a tapering of their bond buying program near the end of 2021 subsequently going into effect in 2022. Then they would start to raise benchmark interest rates in late 2022 or early 2023. Obviously any surprises to that narrative would have an impact, but logically one can imagine that would allow the economy to fully heal and some of the Covid related inflation surges to settle down.

But what about a potential market crash? As always, the answer is *we don't know*. Market corrections can and do happen on a regular basis. Given the rapid pace of appreciation any corrections could actually be regarded as healthy in the near-term. What we do know is that this growth in market value has not occurred without merit. The market is now trading alongside a strong improvement in corporate earnings.



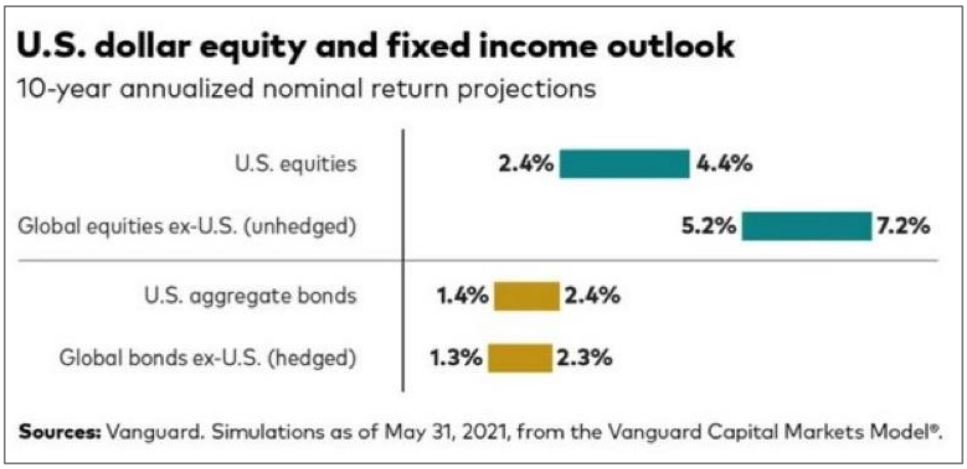
In fact, the market has become less expensive this year as the growth in earnings has outpaced the change in price. Valuations clearly remain above long-term averages. Earnings will need to continue to be strong in order for market prices to regress to the mean without a market crash.



We return to the analysis we created for our very first newsletter to illustrate how this could play out for the S&P 500 Index. We assume earnings growth moderates to a long-term average of 6% and the price multiple investors are willing to pay for the earnings settles to 18x (slightly above long-term average of 16-17x to account for greater proportion of tech stocks that tend to trade at higher multiples.) With a dividend rate approximating the yield on the 10-year treasury bond rising to 2%, this projection leads to a 5-year annualized expected return of 3.2%.

	S&P 500 Index Returns							
	2018	2019	2020	2021	2022	2023	2024	2025
Stock Price (Year End)	**2,607**	**3,278**	**3,794**	**4,400**	**4,557**	**4,370**	**4,389**	**4,652**
% Change		*25.7%*	*15.7%*	*16.0%*	*3.6%*	*-4.1%*	*0.4%*	*6.0%*
Trailing Earnings	$162	$163	$140	$200	$217	$230	$244	$258
% Growth Rate		*1.0%*	*-13.9%*	*42.4%*	*8.5%*	*6.0%*	*6.0%*	*6.0%*
Price / Earnings	16.1x	20.1x	27.0x	22.0x	21.0x	19.0x	18.0x	18.0x
Dividend	**$54**	**$60**	**$60**	**$58**	**$68**	**$76**	**$88**	**$93**
Dividend Yield	2.09%	1.83%	1.58%	1.31%	1.50%	1.75%	2.00%	2.00%
Cash Flows				**($4,400)**	**$68**	**$76**	**$88**	**$4,745**
Rate of Return	**3.2%**							
Multiple on Investment	**1.1x**							

This dovetails nicely with Vanguard's capital markets outlook and appears to be what the market is pricing in. Of course, it is precisely wrong as it is impossible to know what will ultimately occur. All things equal, higher starting prices (market valuations) lead to lower returns. Lower returns do not mean no returns. Cash is not a very appealing alternative as you are guaranteed to lose your purchasing power over time due to inflation even if it does start to slow down.



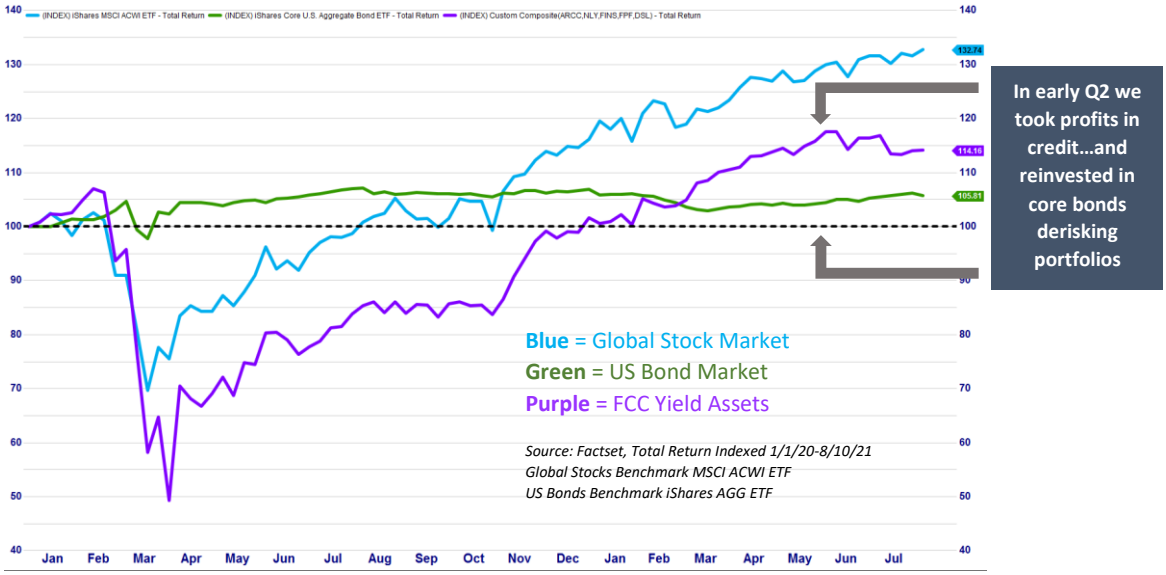
As we mentioned in our last newsletter, the double digit returns of the last 5 years have been great. It would not be realistic to expect them to continue at the same pace. That's why we build our long-term plans on realistic returns expectations instead of blindly extrapolating the past. All things equal though our clients would prefer to have a higher balance in their accounts now and lower expected returns vs lower balances and higher expected returns.

We continue to closely monitor these growth and inflation dynamics. We have added some new subscriptions and research services to monitor how changes could impact our asset allocations. Many professionals are unsure as to the direction markets could take and we agree with their advice.

Our Portfolios

We are maintaining a neutral stock/bond positioning at the moment. Within bonds we were able to successfully take profits into the record price levels of Q2 and completely exit the outright credit (risky bonds) investments purchased during last year's sell off. We followed the playbook by re-deploying those funds back into core bonds and de-risking our overall portfolios. Our core bond sleeve maintains a modest credit tilt to provide yield enhancement.

Also within bonds we continue to keep our interest rate exposure lower than benchmark parameters to protect against rising rates. This had a slightly negative effect in recent months as rates have gone the opposite way and fallen, but we are taking the view that if some of the unprecedent monetary policy is unwound we could see higher interest rates in the intermediate-term. Overall, a typical client's core bond allocation is roughly flat this year while benchmark bond indexes are down 1-2%.



We have also re-deployed some core bond funds into a custom real estate sleeve developed in partnership with an industry leading research service. This decision has proven accretive to portfolios relative to bonds and real estate benchmarks.

Given record high valuations in public markets we continue to look for private market opportunities for qualified clients. We do see some opportunities appearing again in public markets and remain disciplined buyers. We will continue to follow the process laid out in prior communications. Be patient and own the market during normal times ready to be proactive when things change.

Are Tax Increases Coming?

No one likes to pay taxes and certainly not more taxes. That is why it is easy to react to headlines suggesting higher tax rates. Though sensible headlines don't sell papers, a more accurate version would read something like this "in order to pay for contemplated legislation there is a proposal to raise taxes on high earners and businesses from the current multi-decade low rates."

An overly simplified version of the proposed tax increases is as follows:

- For those making more than $400,000
    - Levying social security taxes on income above that level
    - Increasing the maximum tax rate from 37% to 39.6%
- Increase the capital gains rate from 20% to 39.6% for those with income in excess of $1 million
- Other possible changes
    - Removing the step up in basis at death
    - Potentially lowering the estate tax exclusion levels
- Corporate taxes
    - Increase the rate from 21% to 28%
    - Remove international tax loopholes

It's unclear what will or will not become law. We will continue to monitor and update anyone who could be impacted as information is available. That being said, we don't expect to need to change many of our current processes. In fact, we built our portfolio management and tax planning processes to be as tax efficient as possible. High potential tax rates would just serve to make these processes more valuable.

Here is a summary of our current tax minimization processes:

- **Tax loss harvesting** – you may have noticed a lot of trading in March of last year when then market dropped, in addition to the opportunistic investments we were also busy swapping out positions and harvesting losses to offset gains and reduce future taxes.
- **ETFs instead of mutual funds for stocks** – Exchange traded funds are significantly more tax efficient than their mutual fund counter parts. The value has to do with how they are able to swap low basis positions when new shares are created. The outcome is that our core stock holdings tend not to generate any capital gains taxes unless we sell them, allowing money to compound over longer periods of time and giving us control when to take the gains.
- **Asset location** – we seek to put the least tax efficient investments such as high yielding bonds in tax deferred accounts such as IRAs to lower taxable income and tax bills.
    - We typically extend this to 401K assets as well
- **Ongoing tax planning** – we seek to take as many allowable deductions as possible each year: 401K contributions, Health Savings Accounts (HSAs), IRAs, etc.
- **Timing of retirement draws** – we optimize when best to take pensions, social security and retirement account required minimum distributions (RMDs) each year, we'll also consider harvesting gains by pulling them forward if it looks like it will reduce the overall tax burden in coming years
- We structure business sales in light of current tax laws

Suffice it to say. We are prepared and ready to confront any potential tax changes.

Please do not hesitate to contact us with any questions, investment or otherwise.

Michael Rizzolo	Thomas Hawks III	Vince Crane	Kara Hayward	Jake Moshier
Managing Partner	*Senior Partner*	*COO/CCO*	*Client Services Manager*	*Analyst*

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