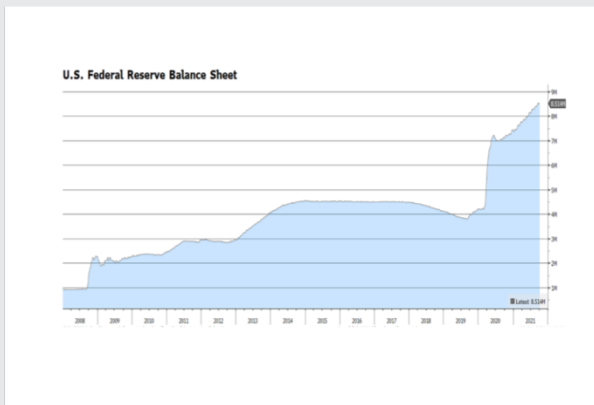


NEWSLETTER AND CAPITAL MARKETS REVIEW

3RD QUARTER 2021

We leave the third quarter of 2021 behind in a state of heightened uncertainty. The global economic restart has gone from welcome to problematic as lingering kinks in supply chains have led to shortages in a variety of goods and resources as demand returns. Services have been similarly affected as competition for workers to (re)fill low-wage and unskilled jobs heats up. Meanwhile, US legislators cannot come to accord on ambitious and even aggressive spending proposals and economic policymakers are contemplating how to bring an end to more than a decade of central bank intervention without completely letting the air out of the proverbial tires. This push-pull of largess and restraint and supply and demand has largely held the economy and markets in place, but everything is on a hair-trigger. Prices are quickly jumping higher on items that are only temporarily in short supply only to fall back almost as precipitously, and the markets flinch when Fed Chairman Powell reaches for his dot plot. The gathering concern is now whether flashes of inflation in specific areas of the global economy could manifest more system-wide and persistent inflation. In this newsletter we explore different aspects of the inflation challenge from a macro and ESG perspective, all with the appreciation that it does not have to be rational to be real.



The US Federal Reserve balance sheet currently stands at \$8.51 trillion, doubling in size since the pandemic began. The Fed has recently suggested that it may begin to taper the current \$120 billion monthly purchases of Treasuries and mortgages as soon as the November 2nd-3rd meeting. Progress in employment is a potential trigger cited by Chairman Powell for tapering, even considering September's

lackluster jobs report. It is important to note that the Fed will likely continue to expand the balance sheet. What they are talking about is lowering the amounts of new monthly purchases over time, so expanding less fast. Still, a reduction in monetary liquidity. Of bigger concern are the inflationary trends that may force the Fed to introduce less accommodative or even restrictive monetary policy. Prices seem to be increasing nearly everywhere, from energy to food to wages, and the Fed's preferred inflation gauge, the PCE Deflator, is up 4.3% year-over-year as of August. A combination of higher policy rates and lower liquidity would pose a serious challenge for capital markets. [chart courtesy Bloomberg LP ©2021]



Natural gas prices around the globe are elevated, and as the colder winter months in the Northern Hemisphere approach, prices will likely remain so. An unfolding potential crisis is most acute in the Eurozone where natural gas futures prices have increased over 500% in the past year, and conditions in the rest of the world are not much better. Calmer weather in Europe and thus lower wind turbine energy production has been cited as one reason for elevated prices, and rising demand for natural gas as a lower-carbon transitional fuel away from coal and oil is another. Unchecked, the higher price environment may lead to blackouts, heating shortages in colder regions, and forced plant shutdowns, and may exacerbate current and broader inflationary trends. Also, higher utility prices are effectively a tax on consumers (hitting lower wage earners the hardest) hastening an end to the global economic recovery that may be already moderating or even stalling in some parts of the world.



Ultimately, we have to look at the bottom of Maslow’s Hierarchy of Need, and pay close attention to food and shelter, where the effects of inflation are the most regressive and harm the most marginalized first and most. Where access to nutrition is concerned, both the UN’s World Food and Agriculture Organization and Bloomberg’s Agriculture Spot Price Indices have soared since the onset of the pandemic. It is difficult to envision food prices declining or even stabilizing given the challenges facing farmers in terms of labor, and suppliers in terms of higher transportation costs and a shortage of truck operators.



Portfolio Positioning

Stability seems to be the current state of affairs after a chaotic 2020, with an expectation that resurgent developed economies tempered by ongoing challenges in the developing world will be generally good for equities. Central bank policy and the whiff of inflation pose challenges but not a crisis for fixed income. We continue to hold an overweight allocation to equities overall as well as a modest underweight in fixed income, also leaving cash meaningfully underweight. Within global equities, we are overweight with respect to the US, underweight in Emerging Markets, neutral with respect to Eurozone stocks and underweight Japan. Within fixed income, we are overweight in the US with a preference for mortgages and investment grade corporate credit. We have little to no exposure to non-US fixed income except through Green Bonds in our ESG series portfolios. All portfolios holding fixed income maintain lower duration than the benchmark.

Risk Outlook

- Concerns about inflation have loomed over the market in recent months, although not so much so that asset prices have been adversely affected or that central banks have taken action. There have been flashes of what would, under ordinary

circumstances, signal inflation. We have seen spikes in prices of building materials and scarcity of new cars for purchase as examples. But, while we cannot discount those observations entirely, we principally see them as graphic examples of how interdependent world economies and supply chains are and how fragile they were with just-in-time inventory management. While investors have extolled just-in-time since Toyota popularized it, it introduced an inelasticity into global supply chains that was not capable of absorbing the blow of COVID. This was further exacerbated by climate-related issues with beetle infestation and fire affecting Western timber stocks and storms knocking petro-chemical production capacity off line among several other challenges. The results were issues such as a microchip shortage affecting the ability of factories to finish automobiles for delivery. We believe as major parts of the global economy get back on pace that the current situations will self-correct, but as investors and market watchers we are looking longer term at the confluence of business practices that are not sustainable, resilient or adaptive and externalities like global health and climate change which can and will disrupt businesses and markets again.

- Benign conditions do not always result in benign outcomes. As discussed elsewhere, even a slight normalization of the rate environment, which would reflect stabilizing economic conditions, could have profound effects in fixed income markets, severely dragging down assets like 30-year Treasury Bonds which are normally seen as safe harbors from risk. Wall Street has been cautioning about the risk of rising rates since the end of the Financial Crisis in 2009, but we have yet to actually have to live with those risks because a slow grind recovery followed by a series of crises including COVID have conspired to hold central bank policy where it has been – accommodative. A mild turn of phrase by the Fed Chair has resulted in temporary shocks in the bond and even equity markets, so we can anticipate that rising rates are not welcome in markets that have enjoyed easy money for more than a decade now. This compels us to think about risk in globally diversified portfolios differently, where the traditionally more conservative parts of asset allocations may actually represent more material risk in the nearer term.



Risk Outlook [cont'd]

- Big questions about the social contract will continue to play out in the months ahead. The ratio of constructive to destructive discourse and activism will weigh heavily on the impact to investors and the economy. Advancements in diversity, equity and inclusion, civil debate about justice reform, building back better and stronger as part of the COVID recovery, and improving participation in the US (and global) economy will be positive drivers. Putting that at risk, and with it capital formation and job creation, would be more violent and destructive actions that focus attention and resources away from serving and supporting the individuals and communities and their families, businesses and livelihoods who are struggling everywhere from the urban Northeast to the rural Southwest.
- It may not be a risk per se, but we are mindful of the legislative efforts around major spending initiatives coming out of Washington DC, starting with infrastructure. Discussions around infrastructure have been increasingly bipartisan and bicameral, suggesting there is a political and practical will to see it done. The additional and larger spending programs that are being discussed are not directly related to the \$1 trillion infrastructure play, but Beltway politics being what they are, the dependencies can be manufactured, with the party in power (Democrats) holding up a popular bill both parties like to try to drive progress on other parts of the legislative agenda. Meanwhile the party in the minority (Republicans) could threaten to drop support for infrastructure if the majority pushes too hard on the rest of their wish list. As we have been saying since the election, an evenly split government means a lot of triangulation and not a lot of surprises, so we do not think the market will either jump or drop materially on the outcome.
- We are now looking at the global transition of SARS CoV-2 and COVID-19 from pandemic to endemic, and what that means for progress and prosperity in developed and developing economies. Vaccine deployment continues and close on its heels the promise of new therapies in pill form that may make addressing severe illness as simple for COVID as Tamiflu does for influenza. As we have previously expressed, this still leaves the global community

vulnerable to a have/have-not dichotomy based on access to these resources. Indications are that pricing will be calibrated according to economic capacity, which is a promising development that may help to reduce the gap between developed and developing nations in the same way COVAX is working to do so through access to vaccinations. With these developments we may be less than a year away from COVID being a meaningful factor in global economies.

- One of our long-term risk themes continues to be our focus on Chinese Communist Party actions which have not materially shifted for the better in the COVID era. From aggression in the Asia-Pacific region to military tension along the border with India to suppression of Hong Kong citizens' rights and the interests of the Uighur population and the lack of contrition for their early role in failing to stop COVID-19 in its tracks, all may contribute to China-directed backlash or retaliation. There does seem to be regional coherency in the response as nearly all Pacific nations have aligned with the US against Chinese aggression. From lack of respect for intellectual property rights to involvement in global criminal drug trafficking to financial crimes and human rights abuses bordering on genocide, the country is finding it harder to get the global community to look the other way. We view this as a risk to investment in China and investment in companies reliant on a Chinese supply chain, but likely bullish for other parts of the Asia Pacific interested in usurping China's role as the manufacturing floor for the world.



ESG Considerations

The overarching theme for this newsletter is the specter of inflation, and we will carry that through our ESG discussion as well. With increasing frequency, fingers are being pointed at ESG-centric activities and policies as being contributors to inflation. In some regards, this may be true. Part of ESG practices is pricing unpriced risk and discounting in externalities that have historically been excluded from the P&Ls and balance sheets of businesses and economies. Environmental risks, for instance, had since the Industrial Revolution been “externalized”, or in less jargon-y terms, offloaded on the public. We measure the cost of those externalities in human and monetary terms. Cancer clusters, undrinkable water, oil spills, heavy metals in seafood, high incidence of asthma in urban centers, extreme storm damage, drought, fire, and inundation.

What does this have to do with inflation? It comes down to the question of who pays. Spoiling an aquifer or dumping carbon into the atmosphere is just transferring cost from the private to the public ledger. A mining company might be more profitable but healthcare costs for neighboring communities rise. An oil company or an airline might have better operating margins but communities get wiped out in more frequent storms and property & casualty insurance companies and Federal, State and local governments take a hit.

We are increasingly seeing a reallocation of those burdens back to those who profit from the activities behind them. In many cases that may drive up operating costs and increase prices. Owning your environmental footprint, eliminating human trafficking from supply chains, and providing equitable and competitive wages and benefits likely puts upward pressure on prices for goods and services. It also flows through to lenders and investors who, through an ESG lens, are reassessing the cost of capital to include factors traditionally treated as off-balance sheet.

But at a global level, that is not inflation. That is changing the column the liability sits in, which does affect prices of certain goods and services but decreases the societal taxes paid by other companies and communities that end up carrying the load otherwise. It may not be completely zero-sum, but there are legitimate offsets. However, the calculation of inflation also does not price in those externalities, so the headline figure picks up rising costs for building materials, food, and energy, but not falling costs for community health or disaster recovery.

Blaming ESG and sustainable business practices can also be a red herring. A fair amount has been said and written about rising energy prices globally, particularly in Europe, including in our own commentaries. We have observed that, with some regularity recently, blame is being cast on the shift to a low-carbon future that increased costs and introduced inelasticity into the energy supply. The numbers and history do not, however, really support this assertion. The global energy mix is shifting, but not as fast as prices are rising, as much as environmental policy makers would like the growth rate of renewables to be keeping pace with prices. In fact, the expansion of renewables has probably restrained those prices since they introduce competitive alternatives for at least a part of the global energy budget.

According to Eurostat, as of 2019 the aggregate overall share of energy from renewables in the EU-27 was around 20%. Sweden landed in the high 50's while Germany, the largest industrial complex in Europe, tallied below 20%. Eurostat characterizes the renewable mix as wind power, solar power (thermal, photovoltaic and concentrated), hydro power, tidal power, geothermal energy, ambient heat captured by heat pumps, biofuels and the renewable part of waste. The mix is diverse enough and a small enough percentage of the overall EU energy budget that challenges in even a couple segments cannot really explain a 5X hike in natural gas prices.

Little more than a year ago you could not give away a barrel of oil largely driven by the collapse in the transportation sector as global populations stopped traveling during the pre-vaccine days of the pandemic. At the same time, there were offsetting shifts in demand for electricity as usage concentrated in the home environment while business and education shifted online. But still, overall demand did fall as compared to 2019 levels. According to “Impacts of COVID-19 on energy demand and consumption: Challenges, lessons and emerging opportunities”, January 9, 2021, from the National Library of Medicine, National Institutes of Health, “The latest data in July 2020 shows that, compared to the same period in 2019, the peak reduction rates of electricity consumption (weather corrected) in France, Germany, Italy, Spain, UK, China and India during the lockdown period were more than 10%. The weekly energy demand was estimated to be cut by ~9% under limited restrictions, ~17% under partial lockdown and ~24% under full lockdown.” Demand did fall.



ESG Considerations [cont'd]

According to the IEA in Global Energy Review: CO2 Emissions in 2020 published March of 2021, "As primary energy demand dropped nearly 4% in 2020, global energy-related CO2 emissions fell by 5.8% according to the latest statistical data, the largest annual percentage decline since World War II. In absolute terms, the decline in emissions of almost 2 000 million tonnes of CO2 is without precedent in human history – broadly speaking, this is the equivalent of removing all of the European Union's emissions from the global total. Demand for fossil fuels was hardest hit in 2020 – especially oil, which plunged 8.6%, and coal, which dropped by 4%. Oil's annual decline was its largest ever, accounting for more than half of the drop in global emissions. Global emissions from oil use plummeted by well over 1 100 Mt CO2, down from around 11 400 Mt in 2019. The drop in road transport activity accounted for 50% of the decline in global oil demand, and the slump in the aviation sector for around 35%. Meanwhile, low-carbon fuels and technologies, in particular, solar PV and wind, reached their highest ever annual share of the global energy mix, increasing it by more than one percentage point to over 20%."

With a subsequent economic restart returning the world to levels of economic activity more akin to 2019, and renewables climbing only 1% in the global energy mix in that time, why then are energy prices soaring well beyond 2019 levels? It may be prudent to look beyond sustainable energy sources to energy markets themselves. We have seen this play out before, in 2000, 2005 and 2008, and as far back as the 1970's. Over that period of time, proven and accessible reserves of oil and natural gas have improved with exploration and technological advancements, renewables have added to the world energy mix, and consumption has changed as more efficient motors, lighting, and other industrial technologies have taken hold. What was consistent in its inconsistencies were the influences of geopolitics, oil cartels, and market behavior (even manipulation). It is true that Germany's move to decommission their nuclear energy infrastructure after Fukushima Da'ichi in Japan took an important buffer out of the mix, but there seems to be a greater correlation with the gamesmanship of the Russian bear and how collegial he is feeling where gas supplies through Nord Stream 2 are concerned than with the contribution of renewables.

"Old carbon" will stay the dominant part of the global energy mix for years to come, and free markets being

what they are, higher prices will bring more production capacity online, popping the bubble as it has every time previously. That boom/bust cycle will actually begin to subside as renewables become more and more consequential because, despite the Bond villain aspirations of figures like Vladimir Putin and MBS, they cannot control how much the sun shines. Energy production and distribution infrastructure will be more distributed and localized and more resilient, and the arch plans of cartels and the effects of storms knocking refining capacity offline will drive the price of the next kWh less and less.

Again, we are working on multiple time horizons, but on balance an emphasis on environmental, social and governance factors in business operations and the flow of capital may create concentrated blooms of inflation in specific industries, sectors or geographies, but on a global systems level, it all evens out and may even take the inflationary stick out of the hands of parties that do not know how to play nicely with others.



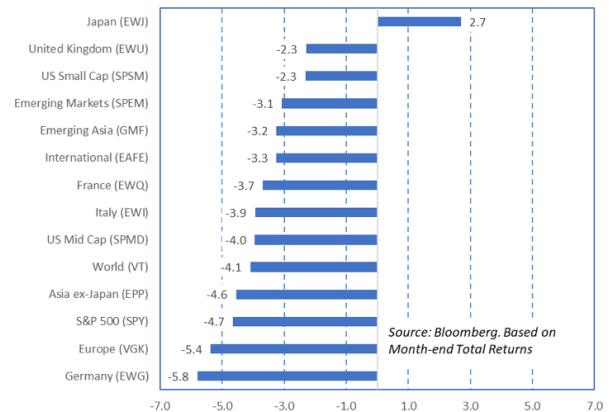
Q3 2021 Capital Market Review

So far, inflation has been concentrated and causal. There are specific and explainable situations like the spike in lumber prices, tightness of availability of new and used cars to lease or purchase, or backups in the ability to procure kitchen appliances. For the most part these situations have not arisen because of an overheating local or global economy, but because of specific supply chain issues that have touched off price increases. In a free and competitive market, those situations should sort themselves out as we work our way through COVID-triggered disruptions. Our concern is that the persistence of these issues in fundamental parts of the economy like housing, transportation and food can turn episodic price rises into system-wide inflation. The Fed is maintaining its stance that these inflationary pressures will ease, but the Fed also must prepare for the possibility inflation becomes persistent. If that comes to pass and the monetary response becomes more restrictive, capital markets will react adversely as they did in anticipation in September, impeding consumer confidence and ending what appears to be a tepid recovery.

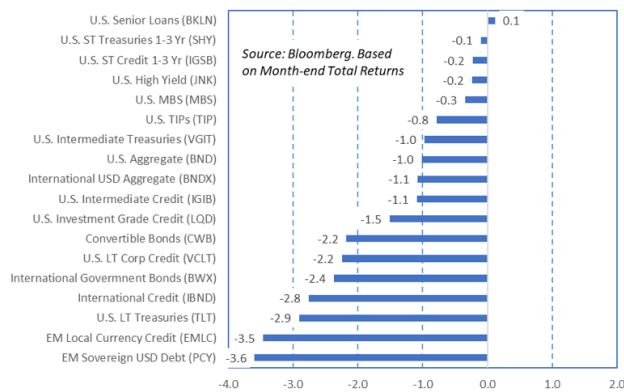
Equity Markets

It was a challenging end to the quarter for global equities, with Europe leading the way down for the month of September posting a -5.4% return, heavily weighted by Germany's -5.8%. Japan managed to buck the trend, coming in at 2.7% while its Asian neighbors went the other direction with a -4.6% return led by reactions to China's longer-term economic challenges as expressed by the debt debacle with Chinese real estate conglomerate Evergrande. Within the US, smaller companies held up slightly better for the month declining -2.3% while the large capitalization companies fell -4.7%.

Global Equity ETF Performance
September 2021



Global Bond ETF Performance
September 2021



Bond Markets

Bonds did not provide safe harbor for investors in September as equities fell. In some cases bond markets fell just as much as equity counterparts, such as Emerging Markets credit at -3.5% in local currency terms while EM equity offered a -3.1% return. Interestingly, in a down market for equities we would expect equity-sensitive bond sectors like High Yield to track, but High Yield held up relatively well at a mere -0.2%. Convertibles, which also carry equity-like attributes, did not fare as well, falling -2.2%. In most cases, the safer the harbor, the worse the flood, with Long Term US Treasuries turning in a -2.9% result.

The returns cited reflect total return performance of exchange traded funds listed in the corresponding bar charts



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