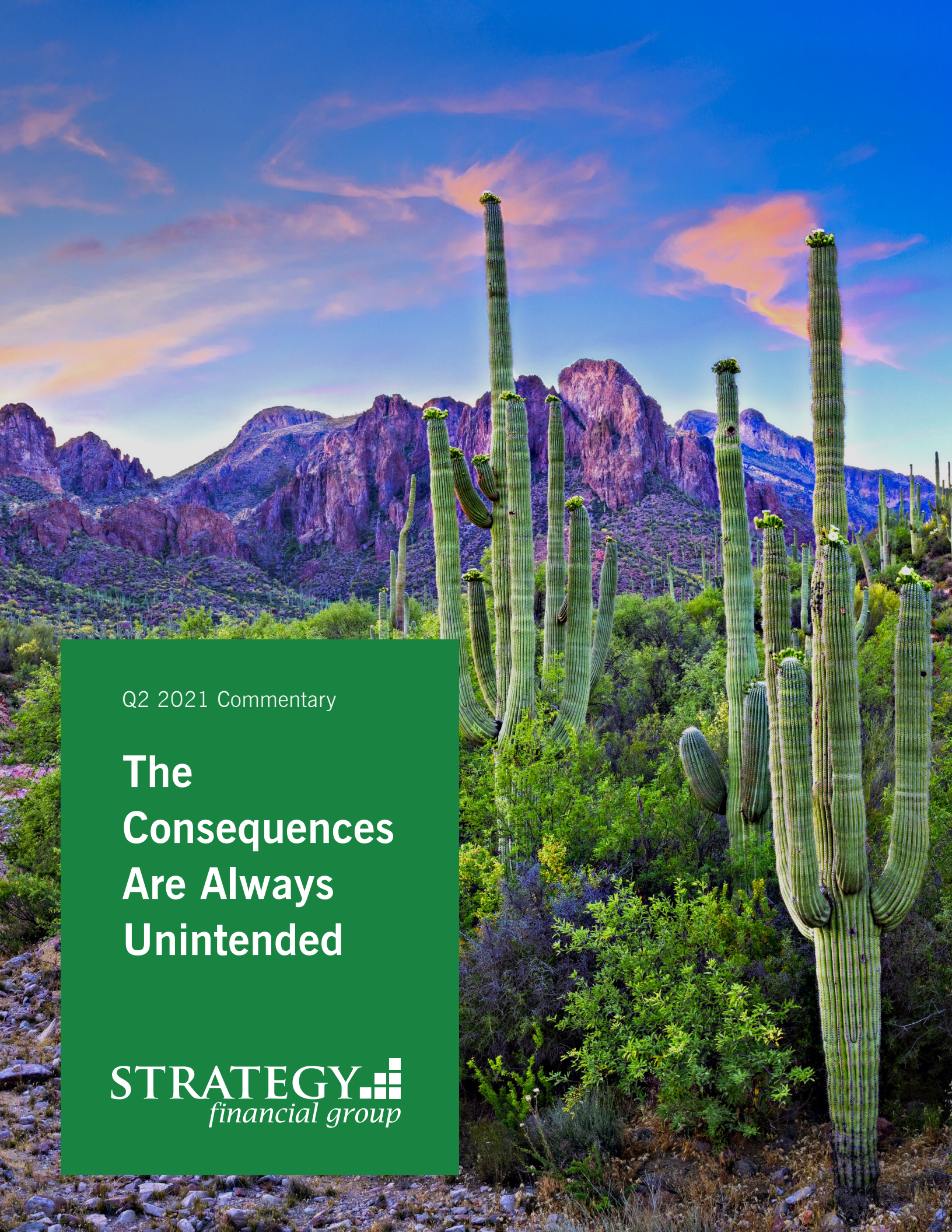


Q2 2021 Commentary

The Consequences Are Always Unintended

STRATEGY financial group

The second quarter of 2021 continued the upward market trends of the first quarter, propelled by several of the same powerful forces: sustained stimulus spending, continued accommodative Federal Reserve policy, and further "reopening" activity amid an expansive rollout of COVID-19 vaccines.

Just a year ago, the waters were still choppy from the steep, quick drop of March 2020. Given those recent experiences, it is remarkable to see how far the markets have come. However, while backward-looking performance reports might seem to put things in perspective, the current, never-before-seen market environment makes it difficult to meaningfully relate historical trends to the present. This makes a focus on managing risk that much more valuable.

STRATEGY financial group
RETIREMENT WEALTH ADVISORS

Enjoy the Ups, Prepare for the Downs

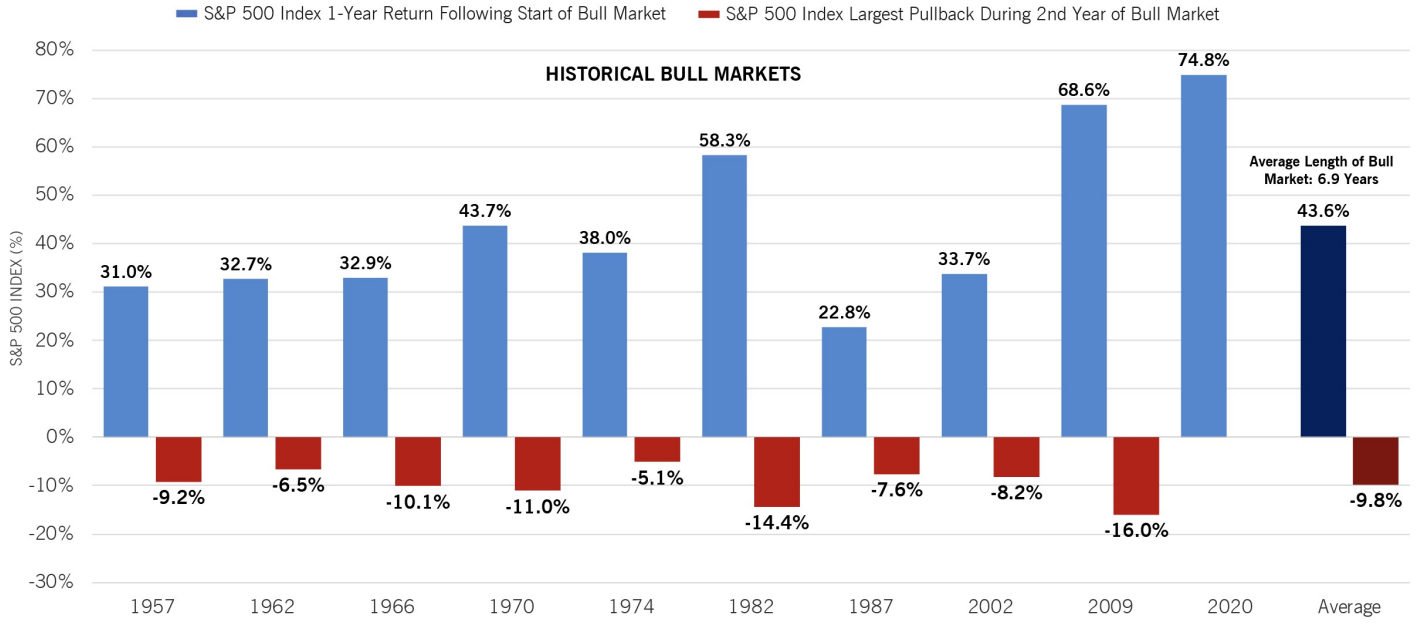
Despite global economies still dealing with the aftermath of the pandemic, consecutive quarters of positive GDP growth formally ended the U.S. recession in April. The expanded vaccine rollout and public capacity restrictions expiring combined to rapidly accelerate business activity. Output from U.S. manufacturers and service providers reached a record high and U.S. new-home sales rebounded to the highest level since 2006.

Risk markets climbed worldwide in Q2 2021. U.S. equity indices set new highs as the planned stimulus continued: the S&P 500 rose 8.55% in Q2. International equities, while lagging, also ended higher. The MSCI ACWI ex US gained 5.62%. Yet the recovery has not been without hiccups.

Job creation was below expectations, leaving millions of roles "lost" in the pandemic. The Fed gave no immediate indication of tapering asset purchases and a stimulus-driven demand for goods and services stress-tested the supply chain. Furthermore, inflation fears and an extremely low-yielding bond market limited choices for investors.

Unfortunately, a surging stock market raised barriers to entry for many investors who have been sitting on the sideline without a strategy, still in shock from the massive 2020 selloff. Our quantitative **RiskFirst®** process helped us participate in risk markets in Q2, having been fully invested since the second half of 2020. However, we recognize markets do not go straight up. With such a strong rally, it is reasonable to expect downside volatility – and critical to have a strategy to mitigate risk.

Markets Don't Go Straight Up



Sources: Bloomberg, Redwood. Data as of 6/30/2021. For illustration purposes only. An investor cannot invest directly into an index.

What, Exactly, Is "Inflated"?

While the narrative around monetary and fiscal stimulus policies receded somewhat during the buoyant second quarter, chatter about higher expected inflation emerged. After all, money continues to be injected into the economy at high levels and a rapid pace.

Inflation is the decline of purchasing power of a given currency over time. One key inflation measure is the Consumer Price Index (CPI) – a "basket" pricing typical household goods and services over time. The CPI calculation factors in the cost of food, energy, and other items such as furniture, medical care, and public transportation. In purely economic terms, inflation is a function of basic supply and demand. Generally, when the supply of money rises, the value of money declines.

In an effort to stimulate the economy, since March 2020 the Federal Reserve has increased U.S. money supply by more than $4.8 trillion and climbing without significant concern for inflation. However, over the last twelve months through June, the CPI has increased 5.4% (non-seasonally adjusted), which is the largest 12-month change since a 5.4% increase for the 12 months ending August 2008.

Fed statements have labeled inflation pressures as "transitory." Yet the Fed recently raised its inflation projections for 2021 and moved up when it expects to begin raising the Federal Funds interest rate from 2024 to 2023. So only time will tell if the recent inflationary pressures are truly transitory.

Will Inflation Stay Relatively "Low"?

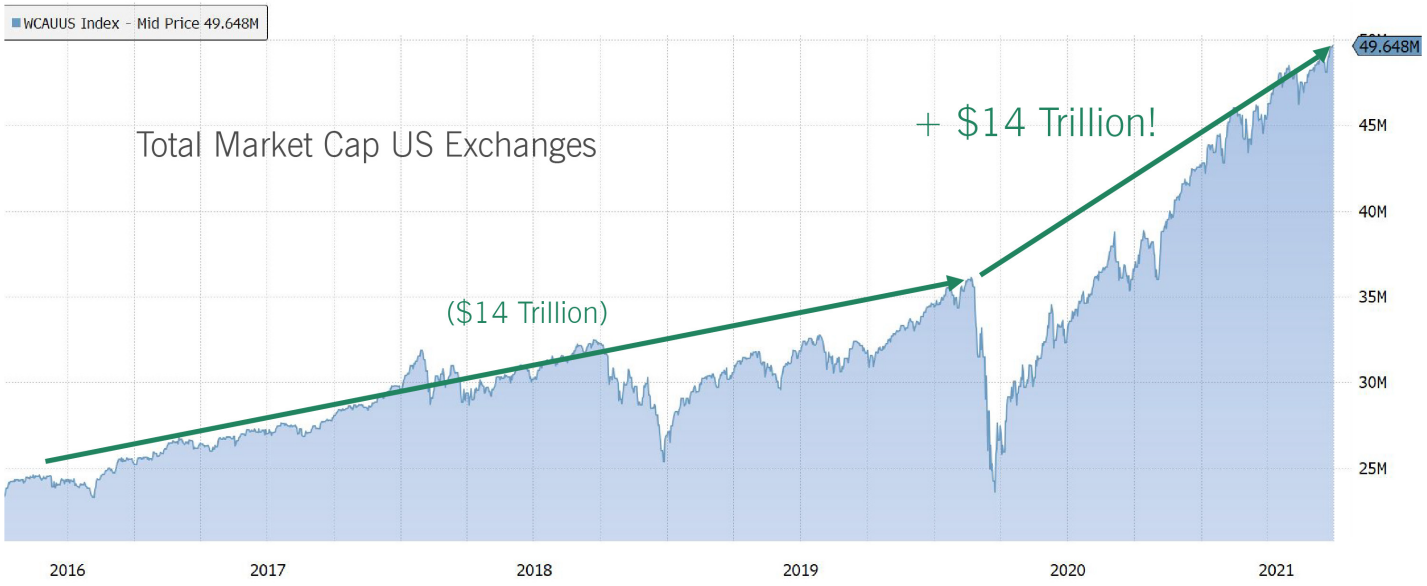
Sources: Bloomberg, Redwood. Data as of 6/30/2021. For illustration purposes only. An investor cannot invest directly into an index.

Prices of a Suspicious Origin

For a finite supply of assets to rise in price, there must be enough money circulating to buy the assets. In other words, for prices to rise, there must be buyers with the money to actually buy. While most investors are enamored by the stock market's percentage increases, it is interesting to observe the change in notional dollar values.

In fact, since pre-pandemic highs, the total market capitalization of securities traded on U.S. exchanges rose by $14 trillion. Apple and Microsoft each topped $2 trillion market capitalization in Q2 and Amazon was fast approaching.

An Exaggerated Notional Value Creation?



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*Some perspective: While this recent $14 trillion market cap increase occurred over 17 months, the previous $14 trillion market cap increase took more than six years. That previous period of market cap appreciation was during an economic environment of **real** growth and expansion – not just a recovery. It is difficult to understand how this magnitude and speed of value creation is possible, but it happened.*

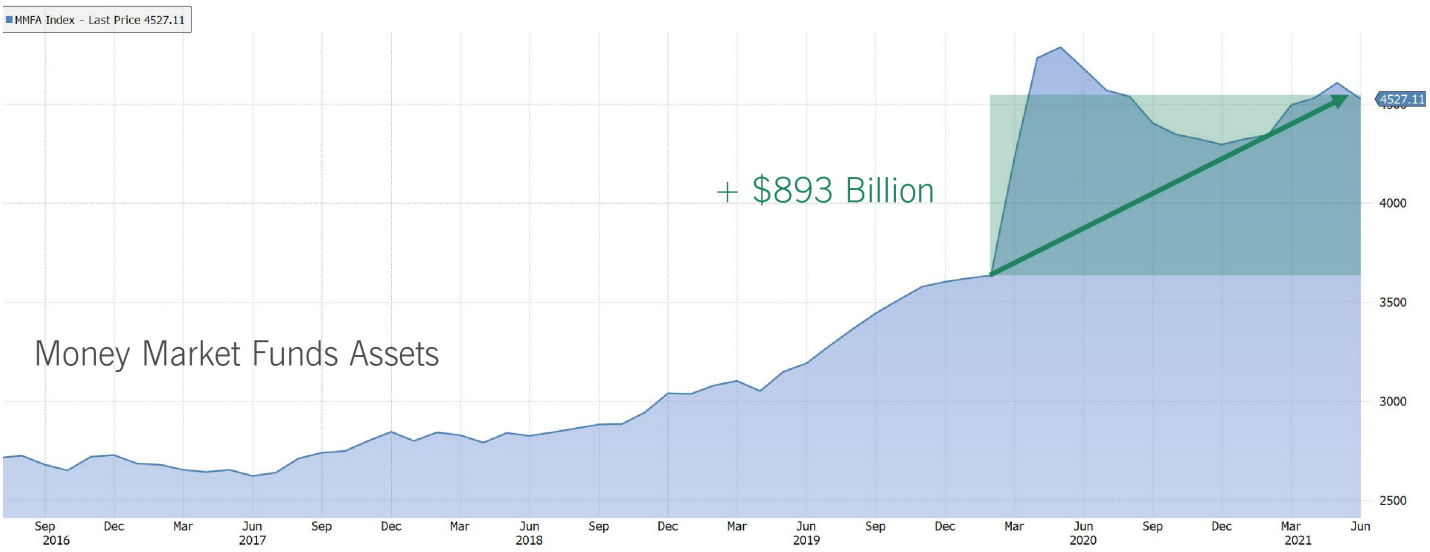
Nobody Moves, Nobody Gets Hurt

It is easy to surmise that investor euphoria is driving these high asset prices. Backed by a belief in virtually unlimited support from the Fed, have investors become overconfident in buying risk assets? After all, margin debt, which measures brokerage account debt that investors can use to buy more stocks, spiked to the highest level since the last two recessions.

However, despite markets surpassing highs and the significant margin debt increase, investors overall still seem to be holding onto their cash, as evidenced by money market fund assets being over $800 billion higher than pre-pandemic levels.

The fact that cash balances remain so high and so many investors are not making moves suggests there are signs of lingering pessimism regarding risk assets.

Investors Continue to Hold Cash



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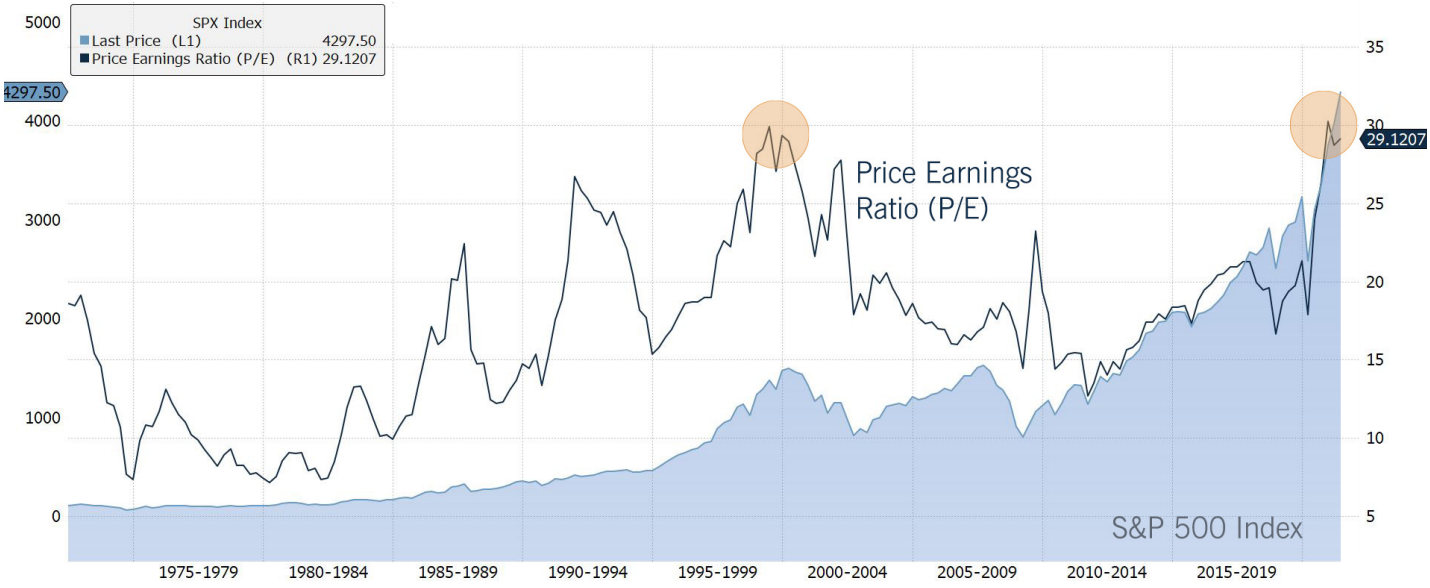
What Fundamentals Are Relevant?

Traditional stock market valuation metrics look ridiculous, with price-to-earnings (P/E) ratios at all-time highs, surpassing the dot-com bubble of the late 90s. Market observers often point to the P/E ratio to assess whether markets are overvalued.

However, for analyzing the current environment, the usefulness of the P/E ratio is limited. One problem is that overvalued markets can persist over time – climbing irrespective of any fundamental measures – and become even more overvalued.

A Case for a Market Not Overbought



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*A second, larger challenge: this is the first and only time the Fed has pumped **this** much money into the system (multiples of the quantitative easing of 2008) – and it seems like this is the new strategy for keeping things afloat.*

The Fed Is All In

The Federal Reserve has the authority to create U.S. currency. The way that the Fed injects additional money into the economy is through lending to banks and through open-market purchases of securities. This process of creating money and purchasing assets reached heights never previously seen and the Fed's balance sheet has continued to swell as a result.

It's important to understand what "the Fed is printing money" means.

The "New" Monetary Policy

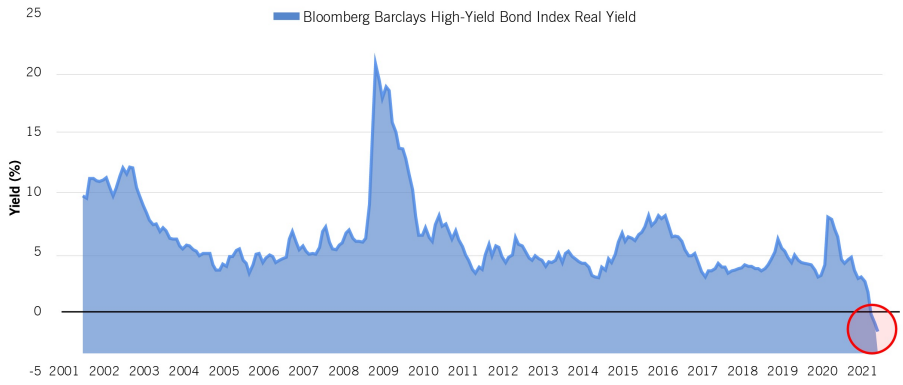
Sources: Bloomberg, Redwood. Data as of 6/30/2021. For illustration purposes only. An investor cannot invest directly into an index.

Nobody Gets Left Behind (Except Bonds)

As a result of the Fed's bond-buying program and near-zero rates, bond yields have fallen to all-time lows. In addition to record low yields, investors now must worry about inflation. For example, real yields (yield adjusted for inflation) of investment-grade corporate bonds have fallen below zero. In addition, high-yield bonds have fallen to negative real yield.

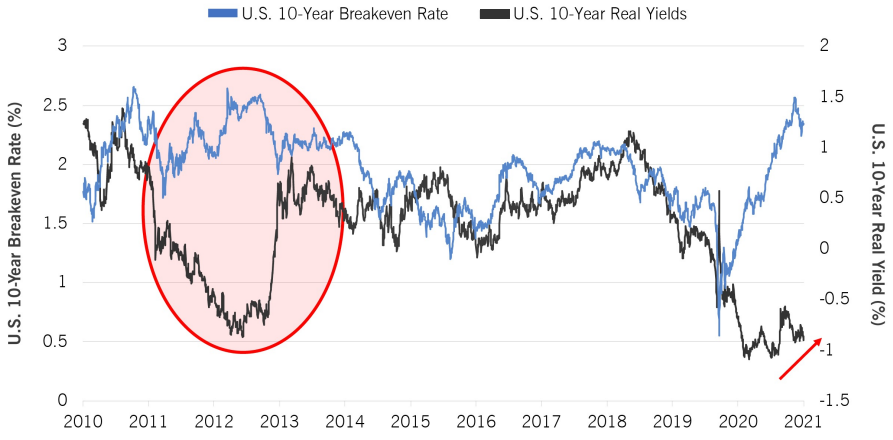
Sources: Bloomberg, Redwood. Data as of 7/16/2021. For illustration purposes only. An investor cannot invest directly into an index.

Real(ly) Low Yields



Low yields present another challenge in fixed-income investing: interest rate risk. This became a point of concern in the immediate wake of the 2008 financial crisis, but current yields and real yields are at an even lower point. Furthermore, low return opportunity doesn't necessarily mean low risk.

A Risk of Normalization



The "Taper Tantrum" arose out of fear of Fed policy reversal following the 2012 divergence in the U.S. 10-Year Real Yield and U.S. 10-Year Breakeven Rate. The recent divergence is eerily similar, suggesting the possibility of additional risk to bonds.

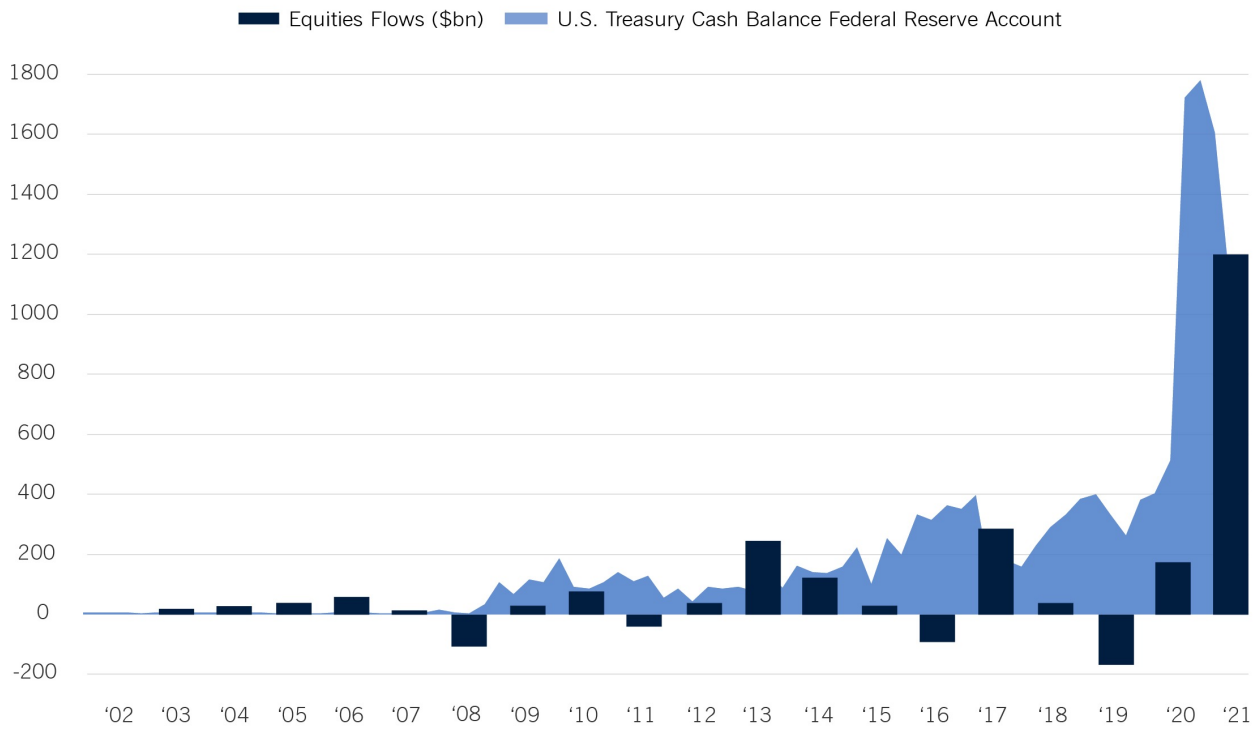
Sources: Bloomberg, Redwood. Data as of 7/2/2021. For illustration purposes only. An investor cannot invest directly into an index.

Unintended(?) Consequences

While the Fed's mandate does not allow them to purchase stocks, the results of their bond-buying program – extremely low bond yields and freeing up cash that can be invested in other risk assets – certainly contributed to stock price movements. As the markets rallied in the first half of 2021, inflows into equities already have exceeded the highest level in any previous full calendar year this century!

Equity fund flows hit $1.2 trillion, and it isn't just the money that left the markets in 2020 that is coming back. So, while direct Fed action does not occur in stocks, it's clear that the Fed actions are essentially supporting the stock market.

A Fed-Driven Rally



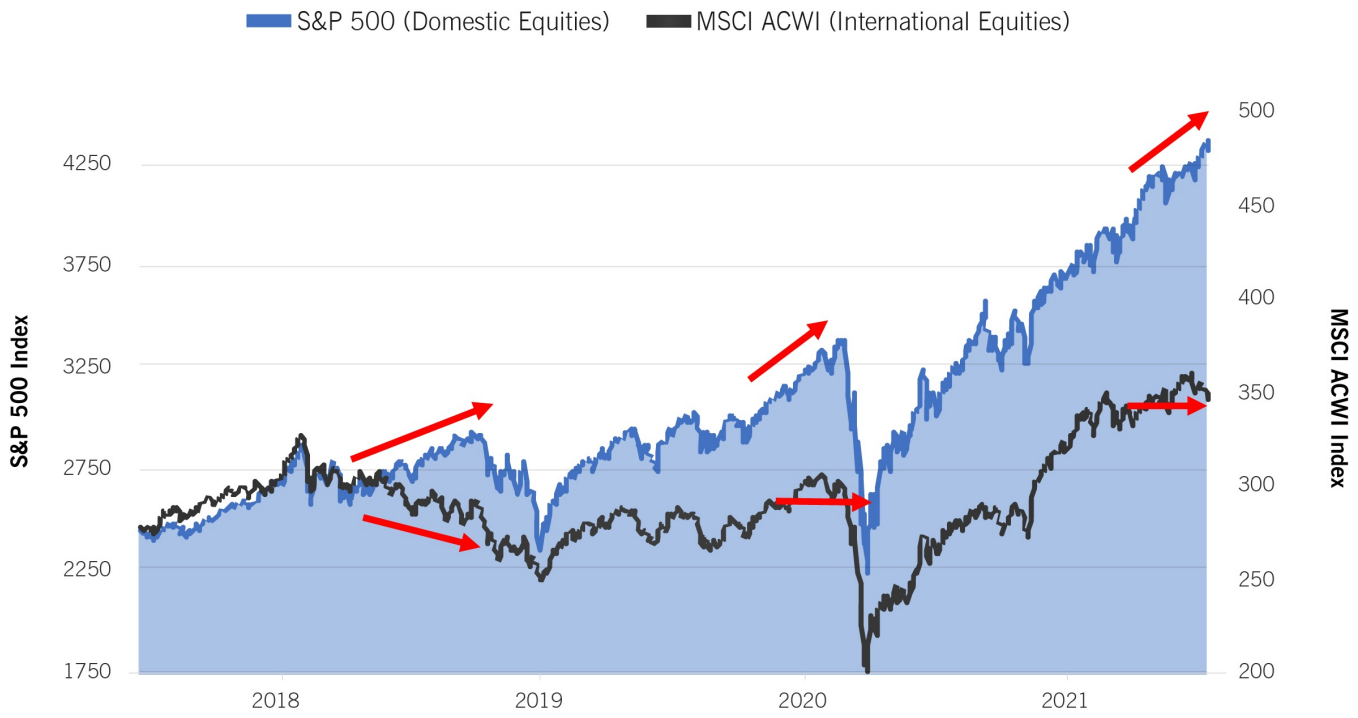
Sources: Bloomberg, Redwood. Data as of 6/25/2021. For illustration purposes only. An investor cannot invest directly into an index.

Valuation Clues Beyond the Fed

International equity markets provide insight into the dynamics of risk asset prices without massive air support from their central banks. While U.S. equities marched higher in step with Fed stimulus, international equities, without the same degree of central bank stimulus, lagged. International equity prices have recovered from the 2020 pandemic decline and made new all-time highs, but at levels close to the previous high of 2018.

More recently, international equities have been going sideways. While there is no direct causal relationship, weakness in international equities has been a leading indicator for the last two major drawdowns in risk markets.

What Happens When International Equities Lag?



Sources: Bloomberg, Redwood. Data as of 7/9/2021. For illustration purposes only. An investor cannot invest directly into an index.

Portfolio Recap: Changing Dynamics

Over the past year, some investors sold out of fear, hesitating to re-invest until the next "inevitable" drop. Others have lingered on the sidelines, tempted, but unmoved, by a market grinding ever higher. Meanwhile, it is hard to justify investing in long-only bonds. All this has led to a bigger conundrum for investors: if you are not "in" equities already – how do you participate in this environment?

This scenario is why we believe it is important to have an unbiased, objective process. The Engineered Risk-Budgeted Portfolios have a primary focus of minimizing drawdown risk. Of course, the ultimate goal of any investment portfolio is to appreciate in value. The dynamic ERB portfolios participate in appreciation where it can be found, while striving to manage the one controllable variable: risk.

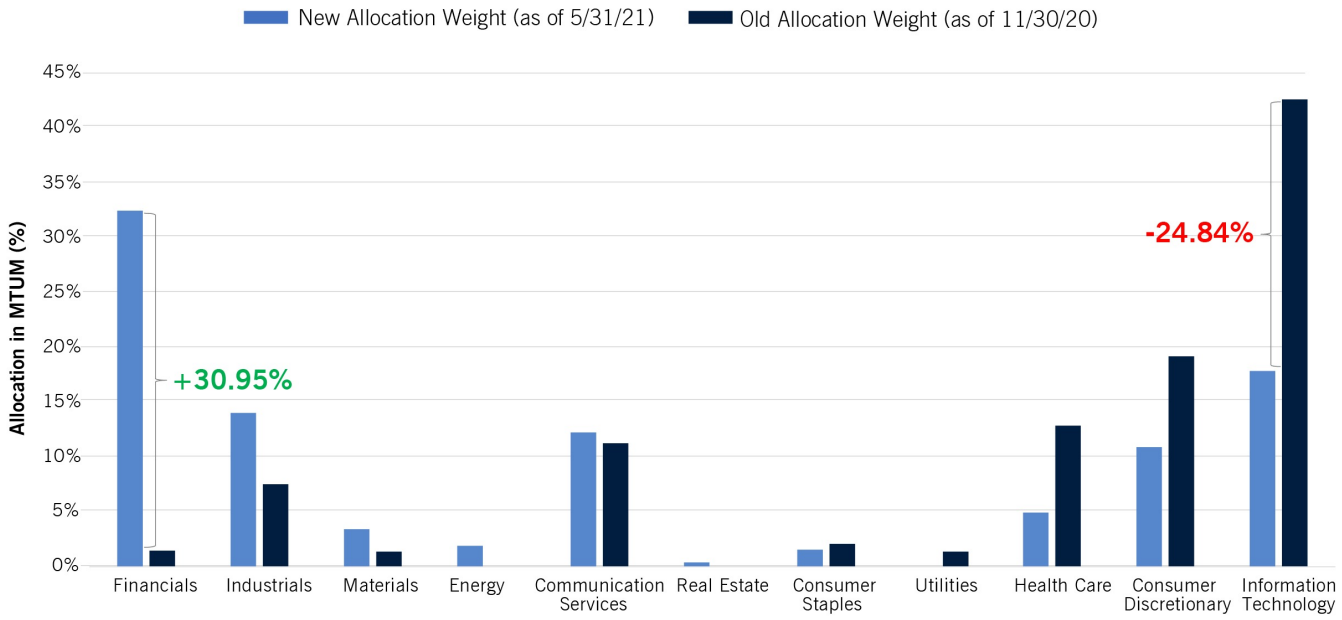
In portfolio management, it is important to monitor and respond to the impact of new environments. Observation of the "momentum" factor in stocks offers a good example. For more than a decade, momentum has been synonymous with the growth factor.

The MCSI US Momentum Index's latest rebalance saw a major shift in allocations. Strong performance in value stocks and underperformance in growth stocks have driven a 31% weighting increase in the financial sector and a 25% decrease in Information Technology (IT). Investors holding "momentum" -based ETFs or funds may be caught unaware. The Engineered Risk-Budgeted Portfolios have stayed risk-on for the entirety of the quarter. But some changes were made at the end of Q2 to respond to the market environment:

- The strategic fixed-income portion of the portfolio has been enhanced with a new ETF to provide more flexibility to manage yield and duration.
- Each of the models has increased equity exposure; to help balance the additional equity risk, we increased longer-term treasury exposure in fixed income.
- International equity exposure was slightly reduced.

Even with these enhancements, the **RiskFirst®** philosophy and drawdown objectives remain intact, and we will continue to execute our risk-managed approach.

"Momentum" Flips Around



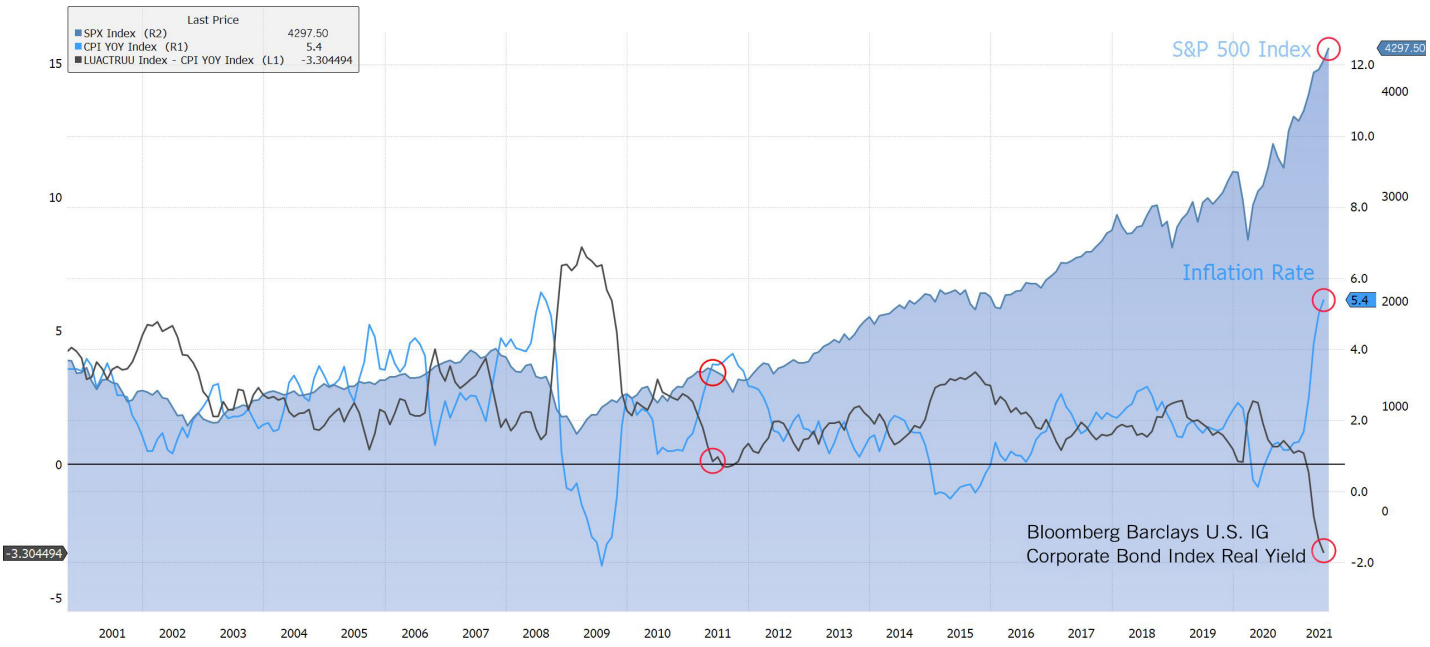
Sources: Bloomberg, Redwood. Data as of 6/30/2021. For illustration purposes only. An investor cannot invest directly into an index.

Conclusion

It's a tricky scenario for investors: stocks look expensive, bond yields are anemic, and inflation is rising. This environment is causing several pain points: pricing investors out of the market, limiting options for price-sensitive investors, and perpetuating the trap of trying to guess the next drop, which can lead investors to exit the market too soon.

For those mulling greater participation, the looming question remains: can markets keep it up? If the Fed sustains its level of intervention, it's entirely possible. But what about real return? Historically there have been long periods like this: meager equity returns, cash losing to inflation, and bonds yielding negative (as they are right now).

Familiar Factors, Uncharted Waters



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And then, there is the question of where, exactly, $14 trillion of value creation came from. Perhaps "inflation" has been absorbed by risk assets. The current market environment, with extreme levels of Fed accommodation, is in uncharted territory, making it difficult to discern what exactly is overvalued or overpriced – and if or when prices revert to fairly valued.

Because we are fundamentally unbiased, we utilize a proven, quantitative approach to navigate the noise and uncertainty of markets. We evaluate market reality and let our models indicate appropriate levels of exposure. This discipline facilitates consistent focus on our goal of delivering consistent, positive, enduring investment success.

General Disclosures

The market commentary is for informational purposes only and should not be deemed as a solicitation to invest, or increase investments in Strategy Financial Group ('SFG') products or affiliated products. The information contained herein is not intended to provide any investment advice or provide the basis for any investment decisions. Please consult a qualified professional before making decisions about your financial situation. Information and commentary provided by SFG are opinions and should not be construed as facts. There can be no guarantee that any of the described objectives can be achieved. Past performance is not a guarantee of future results. Information provided herein from third parties is obtained from sources believed to be reliable, but no reservation or warranty is made as to its accuracy or completeness.

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Indices are shown for informational purposes only; it is important to note that SFG's strategies differ from the indices displayed and should not be used as a benchmark for comparison to account performance. While the indices chosen to represent broad market performance of each asset class, there are report limitations as to available indices and blends, which index can be selected, and how they are presented.

Definitions and Indices

Federal Reserve (Fed) is the central bank of the United States that raises or lowers interest rates. **S&P 500 Index** is a stock market index based on the market capitalization of 500 leading companies publicly traded in the U.S. Stock market, as determined by Standard & Poor's. **MSCI ACWI ex US** index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the US) and 26 Emerging Markets (EM) countries. The index covers approximately 85% of the global equity opportunity set outside the US. **Risk markets** pertain to assets that may pose higher levels of volatility such as equities, commodities, high-yield bonds, real estate, and currencies. **Value** is reference to a security that appears to trade at a lower price relative to its fundamentals, such as dividends, earnings, or sales, making it appealing to investors. **M2 Index** is known as the money supply, which refers to the total volume of money held by the public at a particular point in time in an economy. **CPI YOY Index** known as the Consumer Price Index is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. Changes in the CPI are used to assess price changes associated with the cost of living i.e. inflation. **SMAVG** or Simple Moving Average, is a widely used indicator in technical analysis that helps smooth out price action by filtering out the "noise" from random price fluctuations. **WCAUUS Index** is the Bloomberg United States Exchange Market Capitalization Index which measures the total market value of the U.S. stock market, and includes only single name actively traded, primary securities on U.S. exchanges while excluding ETFs and ADRs. **MMFA Index** is a statistic that is put out periodically by the Investment Company Institute, which calculates the total assets in money market funds for the week. **Fed Balance Sheet** is a financial statement published once a week that breaks down the assets and liabilities held by the Federal Reserve (Fed). The report, formally known as the "Factors Affecting Reserve Balances," essentially outlines the factors that affect both the supply and the absorption of Federal Reserve funds, and helps to shed light on the means the central bank uses to inject cash into the economy. **FARBAST** Index is the U.S. Condition of All Federal Reserve Banks Total Assets, and tracks the aggregate assets and liabilities of banks within an economy, which include private or commercial banks, and Central banks). **Investment Grade Bond** is a bond with a credit rating of BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's. It is judged by the rating agency as likely enough to meet payment obligations that banks are allowed to invest in it. **Bloomberg Barclays High Yield Bond Index** measures yields of investing in lower credit quality fixed income securities with varying maturities. **Taper Tantrum** refers to the 2013 collective reactionary panic that triggered a spike in U.S. Treasury yields, after investors learned that the Federal Reserve was slowly putting the breaks on its quantitative easing (QE) program. **The U.S. 10-Year breakeven rate** serves as an indication of the market's inflation expectations over a 10-year horizon and measures the spread between the U.S. 10-year Treasury yield and the 10-year Treasury Inflation Protected Security (TIPS). **The U.S. 10-Year real yield** is the difference between the U.S. 10-Year Treasury yield and the U.S. 10-Year breakeven rate, which is used as an estimate of the true yield of a bond after adjusting for inflation. **Drawdown** is a measure of peak to trough loss in a given period; a maximum drawdown is a measure of the maximum peak to trough percentage loss in a given period. **MSCI ACWI** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

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