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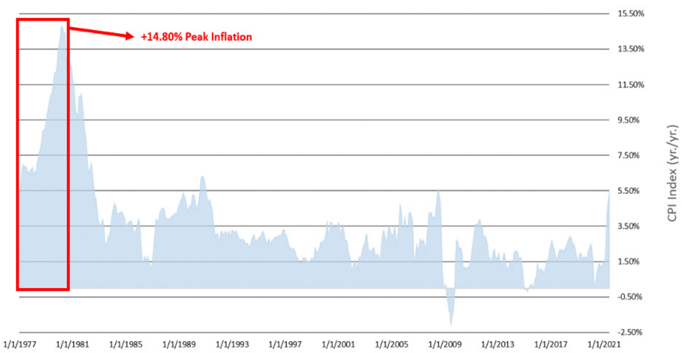
Disco & Debt: Are We Headed for 1970's Inflation and an Aggressive Fed Response?

As we noted might be the case in our February Market Corner the equity market has become fixated on inflation. This was clearly reinforced by the munificent spending in Washington over the last 1-2 years, regardless of who was at the White House. Additionally, at least until the Fed's June meeting, we saw a clearly dovish central bank, with Chairman Powell seemingly unworried about inflation, consistently using the adjective "transitory" and most other FOMC members concurring. In that context, we thought it useful to think through the issue of ***how much*** rates might need to rise to truly put the brakes on the economy should inflation prove problematic.

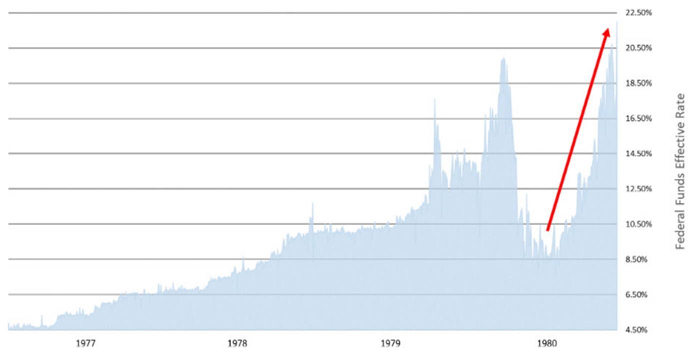
As investors, we really have not been in this position for 40+ years, so the playbook probably needs some dusting off. Then Fed Chairman Paul Volker had to deal with runaway double-digit inflation when he took office in the late 1970's. More specifically, the Consumer Price Index (CPI) for the 5 years preceding the Fed's peak in tightening had averaged 9.3% with a peak rate of 14.8%, roughly 3x the current "transitory" levels.

Figure 1: The 1970's Saw Runaway Double-Digit Inflation, Something We Haven't Seen for 40 Years Since



Source: Bloomberg, U.S. Bureau of Economic Statistics

Figure 2: The Federal Reserve Broke 1970's Inflation with Dramatically Higher Interest Rates



Source: Bloomberg, Federal Reserve Bank of New York

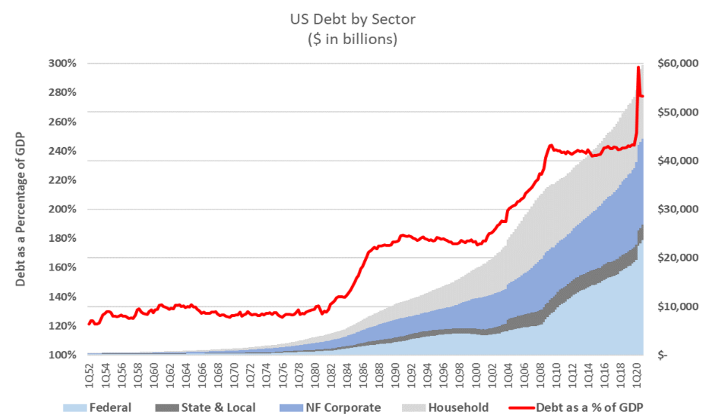
Volker reacted by pushing through monster increases in over-night bank lending/borrowing rates at the Federal Reserve, as illustrated in Figure 2. The Effective Fed Funds rate jumped up almost 1800 basis points between the December 1976 trough at 4.07% and the December 1981 peak of 22.0% (Bloomberg) which led to a recession and likely contributed to the extended banking crisis in the U.S. in the 1980's and early 1990's.

Net net, a post-World War II record level of inflation led to a historically large move in short term interest rates that disrupted the U.S. bond, equity and banking markets. It's unclear to us if that of kind of inflation is really that likely right now given massively different demographics (an aging U.S. population with a lower birth rates) and the naturally deflationary forces of technology on the modern economy. That said, the historical context of a very painful dislocation to the U.S. economy and markets to conquer runaway inflation is likely what colors today's worries for market participants. In that context, we think it's helpful to think through the scenarios and assume the need for a clear Fed response in the form of high interest rates and see what that might look like in the modern context.

As we have noted previously, significant changes in interest rates are highly important in the investment context because the level of rates instructs the markets on how to discount expected cash flows of various investments resulting in apparent changes to value. In general, higher rates = lower valuations. However, this also affects allocations between bonds & equities and can also impact the equity market's relative affection for things like "Growth" & "Value" as we discussed in our last Market Corner.

But a factor that we think needs to be examined here is debt. More specifically there is **a lot more debt in the U.S. economy than the 1970s** as we illustrate in Figure 3. We are currently at about $60 trillion nominally across all non-financial sectors. While debt has been on the rise for a while, the high levels of government spending since the Global Financial Crisis of 2008 and repeated on an even greater scale in response to the COVID-19 pandemic have massively ramped up the leverage in the economy.

Figure 3: Debt Levels Relative to U.S. GDP Are Now More Than 2x the 1970's



Source: U.S. Federal Reserve, Bloomberg

While it may not be intuitive at first, this is actually a good thing in terms of taming inflation, though it carries a host of other risks. Namely, the Fed does not really have to move rates all that much to produce *a very significant drag* on the U.S. economy. Per our math a +150 bps upward shift in the yield curve fully priced through the short and long ends would produce a $978 billion (almost a trillion!) dollar drag on U.S. economy annually as debt payments increase with rates. We acknowledge the worrisome debt levels in the US, at roughly 3x GDP, carry additional risks to the U.S. economy over the long-term which we will eventually have to deal with. However, the math of such high levels of leverage implies that the Fed has a much larger stick to hit inflation this time around.

In conclusion, one can set their own expectations on how much economic drag you think the Fed will need to quell higher inflation. But at a nearly $1 trillion of annual economic drag (or ~5% of the U.S. economy) per 150 bps of higher rates we don't see a high likelihood of interest rates in the double digits (or even the upper half of the single digits), even with some "sticky" inflation in the mix.

Our current expectations are to see the short end of the curve to settle in between 1.75% and 2.0% and the long end at perhaps 2.75% to 3.0%, but over the course of the next several years. These levels remain well below long-term averages and are unlikely, in our view, to massively change the investment landscape. We could always be wrong of course, but that would likely be in the context of much, much higher inflation than the economy is currently registering which in turn would likely shift our portfolio positioning. To paraphrase Gloria Gaynor: we will survive.

2Q21 Performance Update for the Merlin Wealth Management Equity Strategies

The second quarter of 2021 saw improving absolute performance for our 3 equity strategies, and also significant positive relative performance versus benchmark for one. More specifically in 2Q21 our Dynamic Core (CORE) strategy composite was up +12.41% on a net of fees basis, well ahead of the +8.55% total return for the S&P 500, while the Sustainable Income strategy composite (INC) was up +2.83% net of fees trailing the Russell 1000 Value Index, which gained 5.21%. The New Era strategy composite (ERA) was up +11.59% in the second quarter net of fees, only a touch below the Russell 1000 Growth total return of +11.93% over that period.

Figure 4: MWM Equity Strategies Performance Versus Benchmarks

	2Q21
Dynamic Core (Net)	12.41%
S&P 500 Total Return	8.55%
Relative	3.86%
Sustainable Income (Net)	2.83%
Russell 1000 Value Total Return	5.21%
Relative	-2.38%
New Era (Net)	11.59%
Russell 1000 Growth Total Return	11.93%
Relative	-0.34%

These were Improvements versus 1Q21 performance where growth and quality factors appeared to have been punished versus in favor of more cyclical companies that typically carry more leverage. We continued to see some drag due to our avoidance of heavy exposure to the Energy Sector, which remained one of the better performers again in 2Q as shown in the S&P Sector Performance table below. Additionally, sector leadership in the S&P 500 shifted to Real Estate in 2Q, another highly-levered sector where we remain underweight. Notably Information Technology and Communication services did perform better in 2Q than 1Q and this tended to help our performance given some higher levels of exposure there especially in the CORE and ERA strategies.

Figure 5: S&P 500 Sector Performance Shifted Some

	YTD	1Q21	2Q21
Real Estate	23.30%	9.02%	13.09%
Information Technology	13.76%	1.97%	11.56%
Energy	45.07%	30.84%	11.29%
Communication Services	19.67%	8.08%	10.72%
Health Care	11.85%	3.18%	8.40%
Financials	25.60%	15.90%	8.36%
Consumer Discretionary	10.27%	3.11%	6.95%
Materials	14.50%	9.08%	4.97%
Industrials	16.40%	11.41%	4.48%
Consumer Staples	5.02%	1.15%	3.83%
Utilities	2.38%	2.80%	-0.41%

Source: Bloomberg

As far as individual position contributions to second quarter performance, in the CORE strategy the largest contributors were from our healthcare exposures with ResMed (RMD) up +27.1% in the quarter and Intuitive Surgical (ISRG) up +24.4% as both saw some rebound in activity as hospitals and doctors were less overwhelmed with pandemic response. While the Delta variant may crimp things again, though likely to a lesser degree, we don't think it creates a permanent change in long term expectations for either company. On the negative side of the ledger, we saw some drag out of the position in HDFC Bank (HDB) -5.9% and Disney (DIS) -4.7% during the quarter. Both continued to see some impact from COVID-19 dampening near-term results, especially given how heavily the Delta variant ravaged India, HDB's home market. However, we expect both companies to remain forceful in their industries and geographies so are comfortable with our positioning.

For the Sustainable Income strategy (INC), the largest contributor to performance was from Novo Nordisk (NV0) +24.3% as it saw an acceleration in sales on the back of its GLP-1 diabetes offering and the new Wegovy obesity product. Conoco Phillips (COP) +15.0% remains our sole exposure to the traditional Petroleum industry, as its strong balance sheet allowed for a well-timed acquisition of Concho Resources. The drags on second quarter performance for INC were Intel (INTC) -12.3% and Volkswagen -9.4% with the former in a period of heavy reinvestment under a new CEO and the latter giving back a bit of the strong performance in 1Q21. We continue to like both positions.

Finally, for New Era strategy (ERA), the largest contributor to performance was from Moderna (MRNA) +79.4%, which we recently trimmed given an apparently extended valuation and Nvidia (NVDA) +49.9% which continued to lead the growing market of AI acceleration chips. We saw some drag out of our positions in Vertex Pharmaceutical (VRTX) -6.2%, and Ball Corp (BLL) -4.4% and have added to the positions recently.

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Performance information provided herein is for the Merlin Wealth Management – Dynamic Core Composite, Merlin Wealth Management – New Era Composite, and Merlin Wealth Management – Sustainable Income Composite for the periods presented and is supplemental to the information contained in the GIPS® Compliant Report for such composites. Strategy characteristics are provided for the Strategy's representative account. The performance and characteristics of individual accounts within a particular strategy will vary. Returns were calculated using daily, true-time weighted total returns in U.S. dollars that include unrealized and realized capital change and income earned from underlying holdings. Composite returns are calculated based in daily, asset-weighted individual portfolio returns using beginning-of-period values and net external asset movements. Trade date accounting is used for valuing positions. Dividends are recognized in accounts on an ex-date basis. Performance results reflect the effect of cash and cash equivalents. Periods greater than one year are annualized. Net of fee returns are calculated using actual account fees. All accounts included in the composites are charged wrap fees. The wrap fees are all inclusive and cover advisory, asset management, custody, bill pay, cash management and trading services & expenses which cannot be dis-aggregated. The standard fixed management fee for accounts with assets under management of up to $25 million is 1.00% per annum; 0.85% from $25 million to $50 million; 0.70% from $50 million to $100 million; 0.50% thereafter. Please note this fee schedule includes non-asset management fees inclusive of cash management, client advisory, and estate planning; fees may be negotiated. Portfolio returns, characteristics and holdings are for the time periods or dates shown, are subject to change at any time and may not be representative of current or future returns, characteristics and holdings. Company references and portfolio characteristics are provided for illustrative purposes only and should not be construed as investment advice or a recommendation to purchase, sell or hold any security. A complete list of holdings is available upon request. The investment return and principal value of an investment will fluctuate and may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted.

All investing involves risk. Principal loss is possible. The Strategy is susceptible to adverse economic, political, tax, or regulatory changes which may magnify other risks. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Capitalization Size Risk (Small/Mid): Small- and mid-cap stocks are often more volatile than large cap stocks. Smaller companies generally face higher risks due to their limited product lines, markets and financial resources.

Benchmark Definitions: The S&P 500 Index measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy. The Russell 1000® Growth Index measures the performance of the large- cap growth segment of the U.S.equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected and historical growth rates. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group. Indices are unmanaged and do not reflect commissions or fees that would be incurred by an investor pursuing the index. It is not possible to invest directly in an index.

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GIPS Composite Reports:

Composite: Dynamic Core	Reporting Currency: USD
Composite Inception Date: February 1, 2020	**Creation Date: October 30, 2020**

Year End	Total Firm Assets (USD Millions)	Composite Assets (USD Millions)	Number of Accounts	Composite Pure Gross Return*	Composite Net Return	S&P 500 Total Return	3-Year ex-post Std. Deviation Composite	3-Year ex-post Std. Deviation S&P 500	Composite Dispersion
2021**	1,360	554	837	12.6%	12.1%	15.3%			0.93%
2020***	1,242	492	818	25.1%	24.0%	18.5%			1.02%

* Pure Gross Returns are Supplemental Information

**Time Period is from 01/01/2021 - 06/30/2021

***Time Period is from 02/01/2020 - 12/31/2020

Merlin Wealth Management claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Merlin Wealth Management has been independently verified for the period February 1, 2020 through December 31, 2020. The verification reports are available upon request.

A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides the assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

Merlin Wealth Management (MWM) is a private wealth practice with a proprietary investment unit embedded within. MWM is part of Rockefeller Capital Management (RCM). MWM has its own investment team which conducts research and due diligence and makes investment decisions for the MWM investment strategies. RCM has no influence over MWM's investment process, research, or decisions. Merlin Wealth Management was acquired by Rockefeller Capital management in January of 2020. In conjunction with that acquisition, all of the portfolio management team and virtually all of the accounts in the three equity strategies and two fixed income strategies were transferred to Rockefeller Capital Management and continued to be managed under the same strategies, using the same process and by the same team that was primarily responsible for the performance at the prior firm. The prior firm was not GIPS compliant. We are not claiming GIPS compliance on performance prior to February 2020

Dynamic Core utilizes a fundamental approach in order to identify high quality companies that we believe will grow consistently and outperform over time. Our investment process focuses on filtering for great businesses at good valuations and understanding the long-term prospects of each. A full list of composite descriptions is available upon request. The benchmark for Dynamic Core is the S&P 500 Total Return Index.

Merlin Wealth Management's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. The minimum portfolio size for inclusion in the composite is $25 Thousand.

Returns are presented pure gross and net of fees. Pure gross of fee returns are calculated gross of all wrap fees. Net of fee returns are calculated using actual account fees. Internal Dispersion is calculated using the standard deviation of the returns of the accounts present for the full year (or partial year when a full year is not shown) where all accounts are equally weighted. This metric uses pure gross returns.

All accounts included in the composites are charged wrap fees. The wrap fees are all inclusive and cover advisory, asset management, custody, bill pay, cash management and trading services & expenses which cannot be dis-aggregated. The standard fixed management fee for accounts with assets under management of up to $25 million is 1.00% per annum; 0.85% from $25 million to $50 million; 0.70% from $50 million to $100 million; 0.50% thereafter. Please note this fee schedule includes non-asset management fees inclusive of cash management, client advisory, and estate planning; fees may be negotiated.

Composite: Sustainable Income	Reporting Currency: USD
Composite Inception Date: February 1, 2020	**Creation Date: October 30, 2020**

Year End	Total Firm Assets (USD Millions)	Composite Assets (USD Millions)	Number of Accounts	Composite Pure Gross Return*	Composite Net Return	Russell 1,000 Value Total Return	3-Year ex-post Std. Deviation Composite	3-Year ex-post Std. Deviation RLV	Composite Dispersion
2021**	1,360	322	653	11.5%	11.1%	17.1%			0.76%
2020***	1,242	282	641	4.7%	3.8%	5.0%			0.61%

* Pure Gross Returns are Supplemental Information

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Sustainable Income focuses on high quality, established companies with above average and growing dividend yields. The combination of stable growth and dividend payments provides total return with less risk. Our investment philosophy involves identifying companies with a high dividend yield and earnings yield, thus creating an expectation of both growth and income. The benchmark for Sustainable Income is the Russell 1,000 Value Total Return Index.

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Composite: New ERA | **Reporting Currency: USD**

Composite Inception Date: February 1, 2020 | **Creation Date: October 30, 2020**

Year End	Total Firm Assets (USD Millions)	Composite Assets (USD Millions)	Number of Accounts	Composite Pure Gross Return*	Composite Net Return	S&P 500 Total Return	3-Year ex-post Std. Deviation Composite	3-Year ex-post Std. Deviation S&P 500	Composite Dispersion
2021**	1,360	168	452	13.1%	12.6%	13.0%			2.12%
2020***	1,242	146	418	50.4%	49.2%	18.5%			2.45%

* Pure Gross Returns are Supplemental Information

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The goal of New Era is to identify emerging growth companies in the accelerating phase of their life cycle as well as contrarian companies that we believe will be turn around opportunities. Younger or smaller companies often experience significant profit growth. Contrarian companies may experience renewed growth through company specific events. The benchmark for New Era is the Russell 1000 Growth Total Return Index.

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As of March 31, 2021, the benchmark was retroactively changed for all presented periods from the S&P 500 to the Russell 1000 Growth. Due to the growth focus of this strategy and the long-term return correlations, it was determined the Russell 1000 Growth is a more appropriate benchmark.