ADVOCATE CAPITAL MANAGEMENT, LLC

The Leading Edge of the Rising Rate Tsunami is Here! Advocate to Launch Rising Rate Hedge ETF Shortly

It was the best of times, it [could soon be] the worst of times…
It was the spring of hope, it [may soon be] the winter of despair

- *A Tale of Two Cities by Charles Dickens (With some light Advocate edits)*

Since our recent article ("The End of the Beginning"), interest rates have risen more than 30bps. We make use of a tsunami analogy to gain insight into the current environment. Recent developments that could further sustain the rising rate phenomenon lead us to conclude that the leading edge of the rising rate tsunami has arrived.

To help investors navigate these challenging times, Advocate will be launching its Rising Rate Hedge ETF which will trade under the ticker "RRH" on the NYSE. RRH utilizes a multi-strat, multi-asset portfolio approach to generate return during times of rising rates. RRH offers a differentiated approach from typical rising rate products which can have high negative carry from shorting bonds or buying options. RRH may be useful to investors searching for protection against either rising rates or higher inflation.

Rates Have Bottomed and Are Starting to Rise

After peaking recently at the end of March, interest rates reversed lower until July. Since then, rates have been mounting a comeback. 10yr Treasury yield now stands at 1.65%, having recovered more than half of the peak-to-trough decline (from March to July).

FIGURE 1. HISTORICAL 10YR TREASURY YIELD, JAN 2021 – OCT 2021

Data as of 19 Oct 2021. Sources: Bloomberg, Advocate

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We gain some perspective into the current interest rate environment by using a tsunami as the model for the recent rate behavior.

Tsunami – A Model for these Challenging Times

The various phase of a tsunami offers some keen insights into the current interest rate environment

1. Inception: An earthquake or landslide in the deep ocean creates the precondition and the energy required to sustain the tsunami. The tsunami wave in deep ocean appears little more than a ripple on the surface.
2. Initial (paradoxical) reversal: As the tsunami approaches land, the water level initially and paradoxically recedes.
3. Leading edge of the tsunami arrives: The leading edge of the tsunami wave brings the water back to the beach as the water level rises after the tsunami reaches shallow waters.
4. Wipeout: The main body of the tsunami wave hits the shore, reaches peak height and moves inland, devastating structures in its wake.

We map the ongoing rising rate saga and the various factors supporting higher rates to the various phases of a tsunami. The tsunami analogy provides a good context to view recent rate developments.

FIGURE 2. MAPPING RECENT MACROECONOMIC DEVELOPMENTS TO THE PHASES OF A TSUNAMI

Phases of Tsunami / Rate Rise	***Tsunami Analogy***	***Actual Event***	***Time***
1. Inception	*Initial factors (earthquakes, landslides) that will power the tsunami / rate rise*	*Fed Monetary Stimuli* *Fiscal Stimuli* *Fiscal Deficits* *Pent-up consumption*	*Mar 2020 – Feb 2021*
2. Initial Reversal	*Paradoxical reversal of tsunami/rate rise*	*Bond market rally, rates drop*	*Mar 2021 – Jul 2021*
3. Leading Edge Arrives	*The tsunami / rate rise arrives. Water level/ rate rises back up*	*Rates rebound higher from lows*	*Jul 2021 – Now*
4. Wipeout	*The main body of the tsunami / rising rate reaches land and unleashes destructive forces*	*Rates eclipse highs set in March 2021, driven much higher by existing stimulus and recent developments*	*Soon*

Source: Advocate

The rising rate tsunami was initially powered by the unprecedented fiscal and monetary stimulus that governments and central bankers put in place as a response to the Covid pandemic. While those forces are already enormously powerful drivers of rising rates, recent developments are helping to further strengthen and sustain the rising rate tsunami. These include:

1. The Impending End of Fed Quantitative Easing
2. Rising and Non-Transitory Inflation
3. More Fiscal Stimulus (?)

1. The Impending End of Fed Quantitative Easing (QE)

The FOMC stated at its September meeting that, barring an unforeseen weakening of the economy, it is poised to begin winding down the largest Fed QE program in history. The wind-down would result in a tapering of the Fed purchase of Treasuries ($80Bn/month) and agency mortgage-backed securities ($40Bn/month) down to zero by the middle of 2022. That would remove $960Bn of support for Treasury bonds (and $480Bn agency MBS) per year.

We expect the likely chain of events will be:

- November FOMC Meeting: Fed announcement that tapering will begin in December
- December 6: Actual start of tapering
- July 29, 2022: End of tapering

Based on the minutes from the September FOMC meeting, there would be an eight-month tapering schedule that would reduce the Fed's purchase of Treasuries by $10Bn per month and agency MBS by $5Bn per month. Assuming a taper start in the first week of December, this schedule would result in Fed's Treasury and MBS purchases reaching zero by the end of July. We note that even after the completion of the taper, Fed will continue to reinvest maturing principal and interest payments.

The end of the Fed QE means that, per annum, $960Bn of Treasuries and $480Bn of MBS would have to find a new home with price-sensitive investors. Advocate's rule of thumb is that every $100Bn of net new Treasury supply would eventually drive rates higher by approximately 10bps, meaning **the end of Fed QE could drive interest rates up by as much as 1% over the course of the ensuing year.**

2. Rising and Non-Transitory Inflation

The Fed's assertion that the recent rise in inflation is transitory is increasingly being called into question. While some inflationary pressure may be transitory, many factors are proving to be far more sustained and pernicious. A perfect storm in inflation may be occurring, driven by the confluence of:

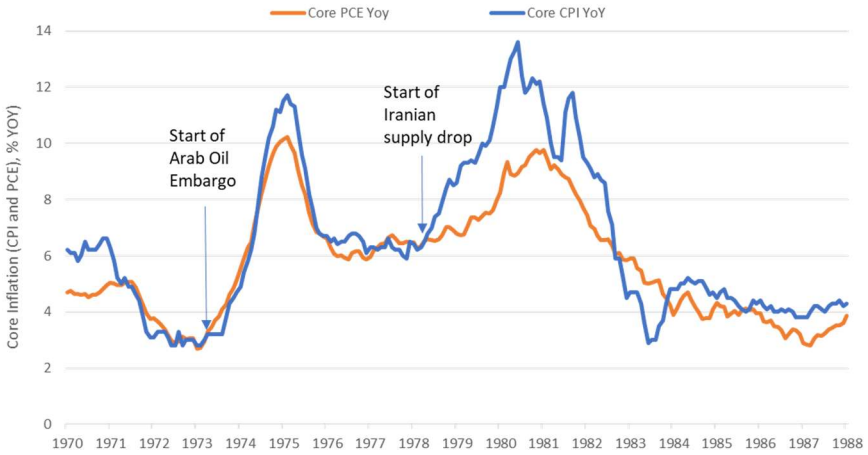
1. Labor Shortage (Supply Shock)
2. Disruption of the global supply-chain (Supply Shock)
3. Energy and food and raw material shock (Supply Shock)

Unlike previous episodes of inflation, the current forces driving higher inflation are mostly from the supply side rather than the demand side. This makes the Fed's inflation fighting task even more

difficult as its monetary weapons mainly target the demand side of the equation rather than the supply side. In other words, raising the target rate could quell demand and slow down the economy, but inflation could remain stubbornly high due to supply-driven constraints.

We believe the convergence of these supply-shock inflation drivers makes the Arab Oil Embargo and the cutback in Iranian oil output during the 1970s a good model for the current environment. The inflationary aftershocks of the two events proved to be incredibly difficult for the Fed to combat and it was at least a decade before the Fed could finally bring core CPI and PCE down to pre-Arab oil embargo levels.

FIGURE 3. U.S. CORE CPI AND PCE, 1970 - 1987

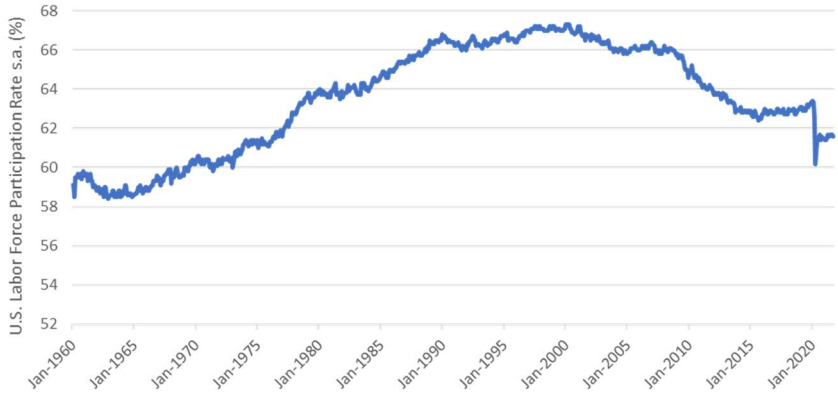


Sources: Bureau of Labor Statistics, Bureau of Economic Analysis

Labor Shortage

Labor shortage in the U.S. and other countries is quite real and, in our view, systemic. U.S. Bureau of Labor Statistics data on labor force participation rate (seasonally adjusted) shows that the post-pandemic recovery has stagnated at a level about 1.5-2% lower than pre-pandemic levels.

FIGURE 4. U.S. LABOR FORCE PARTICIPATION RATE



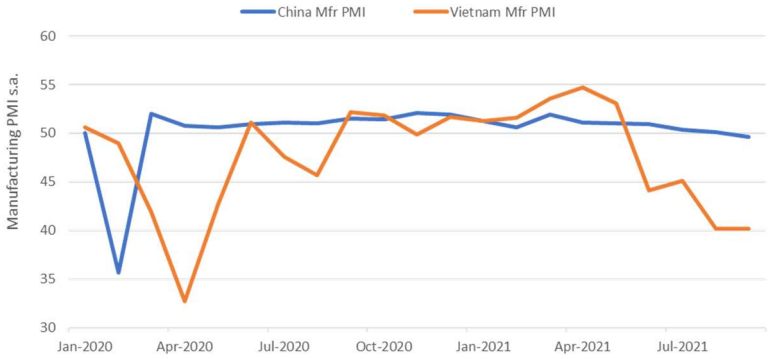
Data as of 30 Sep 2021. Source: Bureau of Labor Statistics

The current labor force participation rate (LFPR) of 61.6% is among the lowest since the mid-70s, a dismal statistic. After an initial rebound from the Q1-2020 pandemic shutdown, LFPR has stagnated at between 61.4 to 61.7% over the last 16 months. This drop in LFPR is looking increasingly non-transitory with each passing month and may reflect a new post-pandemic normal. Contrary to expectations, the September LFPR data dropped by 0.1% to 61.6% despite the expiration of state and federal unemployment supplemental benefits and students returning to school. The labor shortage is looking to be more and more systemic with every passing month.

Supply Chain Snafu

The global supply chain is stressed in many areas as economies reopen. Problems with manufacturing at the factory level, unfinished goods supply disruptions and shipping cost are wreaking havoc on finely-tuned global supply chains. In addition, some Asian countries continue to employ the "zero Covid" policy to deal with Covid outbreaks. This policy results in periodic city and factory lockdowns. September China manufacturing PMI contracted for the first time since March 2020 while Vietnam (a key manufacturer of household goods) manufacturing PMI has been in contraction since June 2021.

FIGURE 5. CHINA AND VIETNAM MANUFACTURING PMI, 2020-2021



Data as of 30 Sep 2021. Sources: China Federation of Logistics and Purchasing, Markit

Transportation bottlenecks are also adding to the global supply-chain snafu as ship bookings now have months-long waiting lists and the cost of shipping has risen to the highest since 2008.

FIGURE 6. SHIPPING TRANSPORTATION COST (BALTIC DRY INDEX) IS AT THE HIGHEST SINCE 2008

Data as of 30 Sep 2021. Source: Baltic Exchange

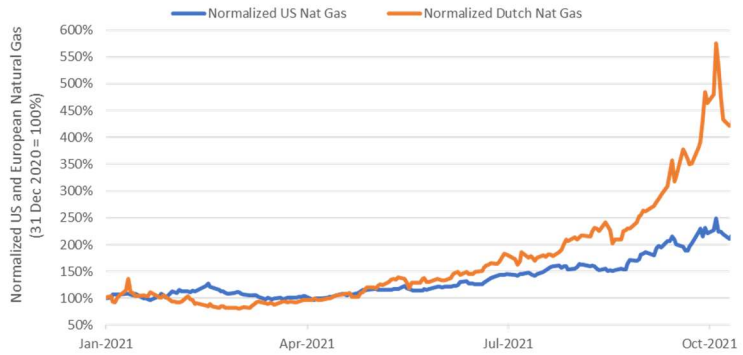
During last two episodes of rapidly rising Baltic Dry Index (2003, 2006), BDI remained elevated for 2-3 years before declining to pre-rise levels. This is to be expected as it takes a significant amount of time to resolve logistics snafus. Wholesalers and retailers may initially absorb some of the elevated transportation cost, but at some point the added costs would be passed onto consumers.

A final point on global supply chain stress - even a supply chain expert like Apple Inc. cannot escape the global supply chain snafu. Bloomberg reported on October 13 that Apple is cutting its iPhone 13 production target by 10 million units in 2021 as a result of semiconductor shortage.

Energy Shock

The world seems to have gone too far, too quickly in discarding out-of-favor ways to generate electricity. Coal use has dropped precipitously and many countries also closed down nuclear power stations without considering how peak demand could be met with their newly green energy mix (apparently with great difficulty). The result is a systemic increase in demand for "green" power generation commodities such as natural gas and an sharp jump in their prices. European natural gas prices rose as much as 450% in 2021. The U.S. took a more moderate approach to the greening of its energy supply, but nevertheless U.S. natural gas price rose by as much as 150% in 2021.

FIGURE 7. DUTCH AND U.S. NATURAL GAS BENCHMARK PRICES IN 2021



Data as of 19 Oct 2021. Source: New York Mercantile Exchange, ICE Futures

U.S. crude price breached $80 per barrel for the first time since 2014 and is up over 65% year-to-date.

FIGURE 8. U.S. CRUDE OIL PRICE IN 2021, WEST TEXAS INTERMEDIATE ($/BBL)

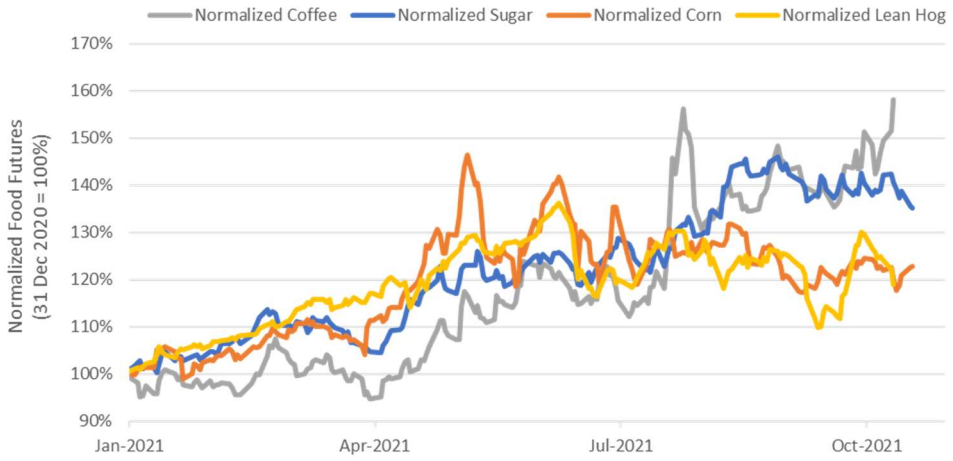
Data as of 19 Oct 2021. Source: New York Mercantile Exchange

While global central banks are focused on "core inflation" to exclude food and energy prices, a sharp rise in energy prices has direct input into transportation costs and must eventually feed through to other non-energy sectors. This will only further exacerbate core inflation and supply-chain snafus that companies are already wrestling with.

Food and Raw Material Shock

We conclude the inflation discussion with food and raw materials. Food price inflation has become commonplace as shoppers encounter sharply higher prices on staple goods. Coffee, sugar, corn and pork prices (using futures market data) are up 60%, 42%, 23% and 20% respectively in 2021

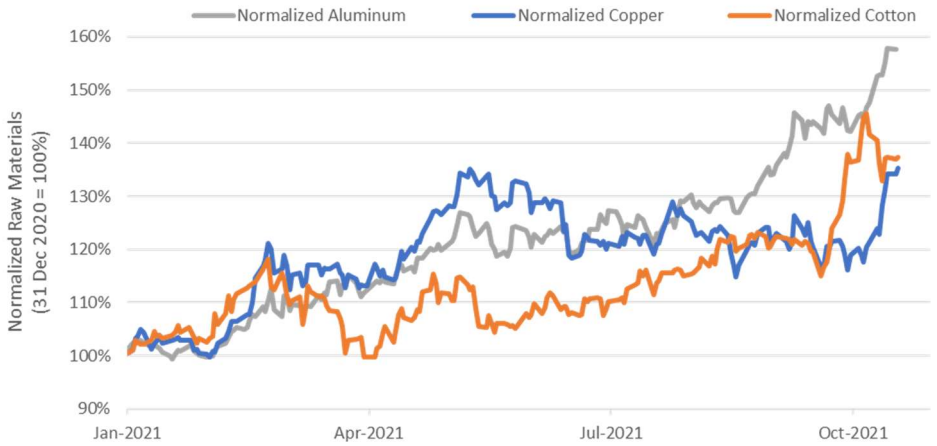
FIGURE 9. NORMALIZED COFFEE, SUGAR, CORN AND PORK PRICES FROM FUTURES MARKET IN 2021



Data as of 19 Oct 2021. Source: New York Mercantile Exchange, Chicago Mercantile Exchange, ICE Futures, Chicago Board of Trade

Raw material costs are rocketing upward as well. Cotton rose 38% this year to reach is highest levels in ten years while aluminum and copper prices have risen 52% and 24% respectively in 2021.

FIGURE 10. NORMALIZED ALUMINUM, COPPER AND COTTON PRICES FROM FUTURES MARKET IN 2021



Data as of 19 Oct 2021. Sources: London Metal Exchange, CMX, ICE Futures

Can all these higher prices be blamed on "transitory" bottlenecks that will resolve themselves smoothly over time? We are highly skeptical of that assertion and are fully in agreement with Atlanta Fed President Bostic, who stated on October 12 that the "intense and widespread supply-chain disruptions – will not be brief" and that "by this definition, then, the forces are not transitory".

3. More Fiscal Stimulus(?)

President Biden's signature stimulus plan has encountered significant Congressional headwinds (from both parties). While the bipartisan infrastructure plan was passed by the Senate, it has been held up in the House which also wants a vote on the Biden stimulus plan. We see two potential outcomes:

- More fiscal stimuli eventually pass: Result – Up to another $2Tn of fiscal stimulus could be forthcoming if the Biden plan were whittled down to $1.5Tn, on top of the net $500Bn stimulus from the bipartisan plan. U.S. economic rebound would be well-supported by this stimulus, but greater fiscal deficits are inevitable. Greater fiscal deficits to fund these programs would directly result in increased issuance of Treasury bonds.
- No more fiscal stimuli: Result – Possible economic slowdown with persistent inflation. If no additional economic stimulus is forthcoming, the sugar high from past economic stimuli may begin to wear off while inflation could remain elevated from the aforementioned supply-side shocks. A dangerous (but low probability) outcome could be stagflation.

Stagflation

As we noted previously, the current rise in inflation is mostly supply and not demand-driven. This makes it the perfect ingredient for a stagflation scenario where the economy and demand weaken from a lack of additional fiscal stimuli, but the supply-shock driven inflation remains stubbornly high. At the present time, we believe that stagflation remains a low probability scenario. If stagflation were to occur, it could pose a serious test of the Fed's ability to walk the twin tightropes of maximum employment and stable inflation.

Whether or not additional fiscal stimuli can be passed, the two possible outcomes of either more fiscal deficit (and more Treasury supply) or potential economic slowdown with stubbornly high inflation are both supportive of higher rates.

To Help Investors Navigate These Challenging Times, Advocate is Launching its Rising Rate Hedge (RRH) ETF in the Fall

To help investors and risk managers navigate the dangerous rising rate environment, Advocate is launching its Rising Rate Hedge ETF which will trade under the ticker "RRH" on the NYSE in the fall. While there are many rising rate products in the market, most have high negative carry due to their typical strategies of shorting bonds or buying options. This could result in adverse performance if those products are held for an extended period of time or if investors were unable to accurately time their investment to coincide with the rising rate period.

Advocate RRH employs a unique multi-strat portfolio-based approach to benefiting from rising rates. RRH's portfolio-based approach is quite different than existing rising rate products which predominantly short bonds or buy options. RRH's unique design means investors could invest in RRH over a long period of time as a core holding to help improve their portfolio's efficient frontier and mitigate risk during a current rising rate environment.

RRH may be beneficial to investors who wish to protect against either rising rates or rising inflation. If inflation does rise systematically, longer-term interest rates would inevitably rise as nominal interest rate is, by definition, the sum of inflation expectation and real yield. The chart below shows that the current levels of real yields are close to all-time historical lows. This supports our view that interest rates are likely to rise in concert with higher inflation, perhaps with even higher betas if real yields rise back towards historical norms.

FIGURE 11. REAL 5Y AND 10Y TREASURY YIELD FROM THE TIPS MARKET, 1997 - 2021

Data as of 19 Oct 2021. Source: Bloomberg LP

Even if inflation does not rise, there are many factors other than inflation (fiscal stimulus, fiscal deficit, consumer spending, end of Fed QE) that could drive interest rates higher. With RRH, inflation hedgers could benefit even if their core higher-inflation view does not transpire.

Final Thoughts – The Rising Rate Tsunami Has Arrived. Time for Fight or Flight

We believe the leading edge of the rising rate tsunami has arrived. The lower rate environment of the second quarter is rapidly receding as interest rates mount a new push higher. Rates have ample room to rise substantially given the powerful combination of fiscal and monetary stimuli already in place, the impending start of the Fed QE, potentially non-transitory higher inflation, and more future fiscal stimulus (or not). Investors who choose to do nothing as interest rates continue to rise may soon be faced with a much more difficult environment.

Advocate's impending RRH ETF product will employ a portfolio-based approach that differentiates it from existing rising rate products. Please contact us if you have any questions or would like additional details. Information on the RRH ETF will also be available on our website (www.advocatecapmgt.com) after the launch.

Scott Peng
Chief Investment Officer
Advocate Capital Management

To determine if the Fund is an appropriate investment for you, carefully consider the fund's investment objectives, risk, and charges and expenses. This and other information can be found in the fund's prospectus, and the fund's Statement of Additional Information (SAI), which can be obtained by calling 866-234-5426 or by visiting the fund's website at www.advocatecapmgt.com. Please read the prospectus, carefully before investing.

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