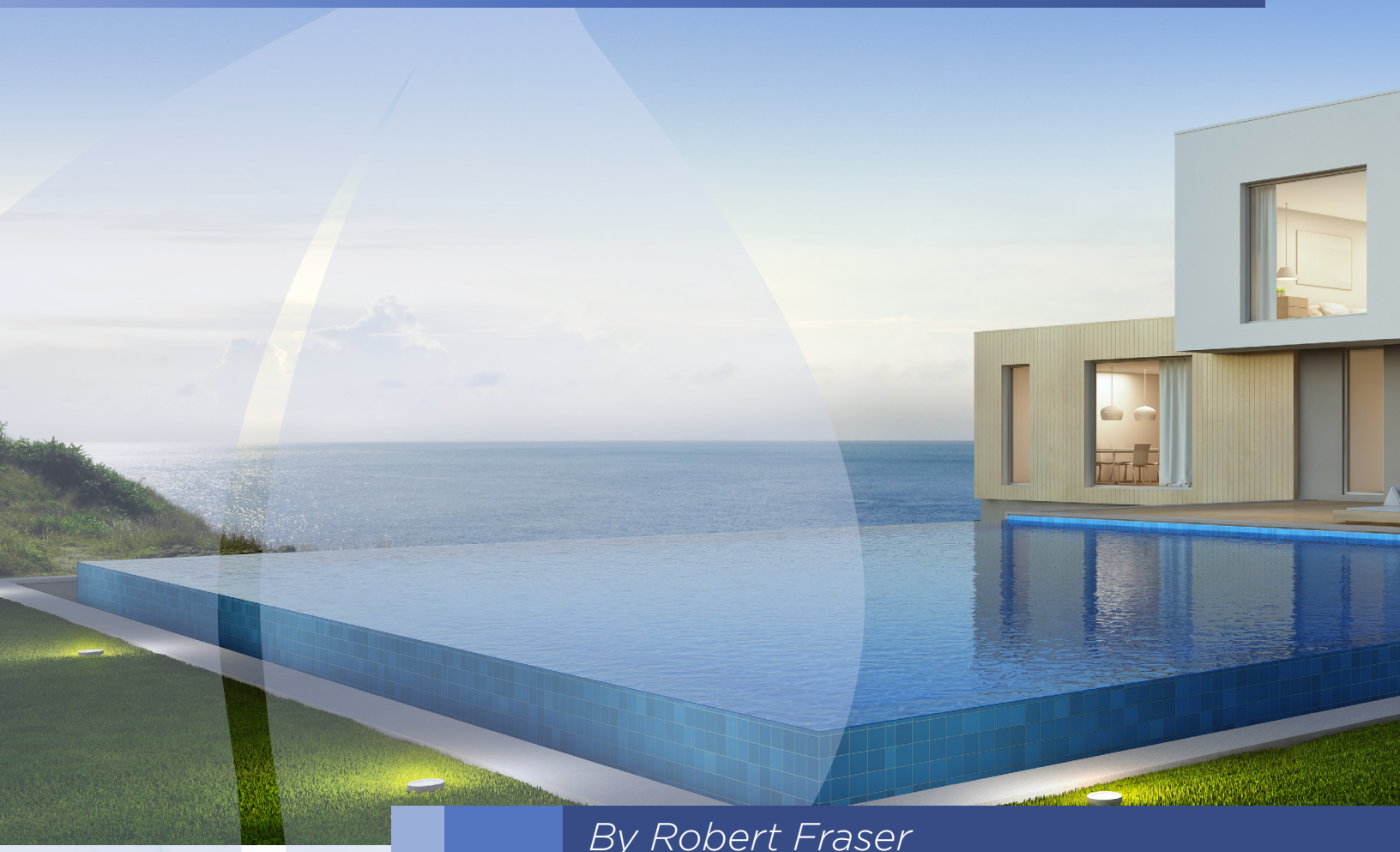
ASPEN FUNDS®

2022 SPECIAL ECONOMIC REPORT

THE GREAT RESIGNATION, RAMPED-UP INFLATION & WHAT IT MEANS FOR INVESTORS



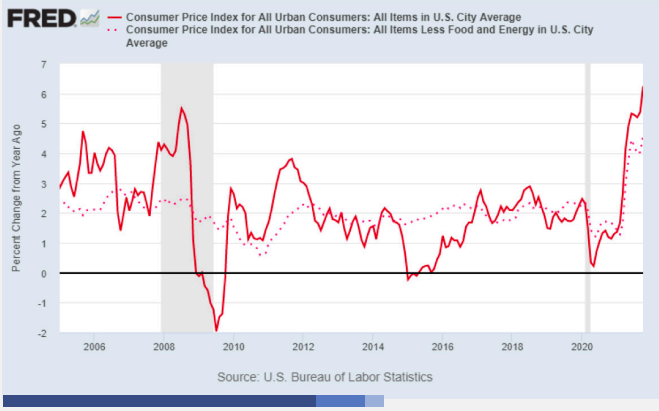
By Robert Fraser

Recent inflation numbers are causing alarm bells to go off, making investors scramble to determine how best to prepare. Here, I break down the underlying factors causing this spike in inflation, and the unintended consequences of "The Great Stimulus" and "The Great Resignation." Learn about why this is happening, why this is mostly a US phenomenon, and how investors can best profit.

INFLATION: TRANSITORY OR HERE TO STAY?

Headline inflation is now at over 8% growth, which is concerning to investors, as it should be. A quick note here: at Aspen, we want to understand the larger macroeconomic trends. Investors are always more successful when investing with the trends than if they try and resist them. We're passionate about analyzing the data to understand what's happening beneath the surface so that we can invest with the trends.

This chart shows 15 years of inflation data from The Great Recession to today. You can see inflation has held steady in the 2-3% range until 2021.



In 2021, inflation has suddenly ticked up powerfully to over 8%.

Earlier last year, the headlines were, "Inflation is just transitory" and expected to dissipate quickly. There's a lot of nuances at play here, but we believe that inflation has both transitory and persistent components. Let's break them down.

In our view, there are three drivers of this current inflationary surge:

1. Supply chain issues caused by COVID
2. Booming consumer demand
3. Wage inflation driven by what has come to be known as The Great Resignation and the worker shortage

Let's look at all three of these components individually and gauge their impact; whether or not they are transitory.

SUPPLY CHAIN ISSUES IMPACTING INFLATION

In our view, the supply chain issues are enduring longer than most anticipated, but are waning. An extreme example of this was lumber prices in 2021, which increased 5-7x. But as supply chain issues resolved, prices returned to normal.

Business owners and entrepreneurs are going to figure out a way to solve a problem. If you are a sawmill and you can sell lumber at 7x what it sold for a year ago, you're going to figure out how to ramp up your lumber production!

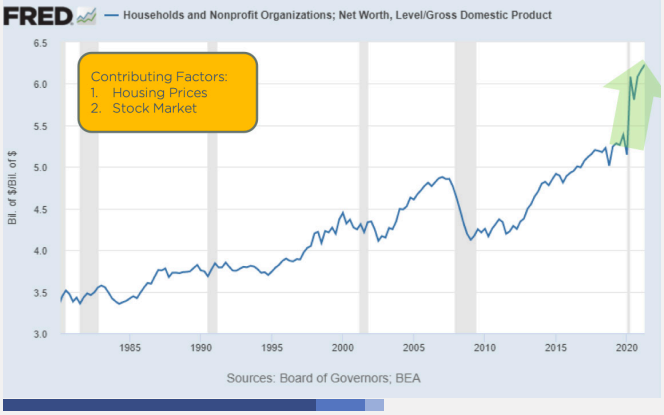
Another example is the chip shortage. Intel is building two new chip factories in Arizona. It takes a while to build a chip factory, so this is not instantaneous in most cases, but we are going to see the supply chain issues easing throughout 2022.

We are seeing lots of companies implementing various supply chain, inventory management, and re-shoring solutions to solve the current crisis and mitigate risk from future shocks. In the 1980s, supply chains were revolutionized with the "just-in-time" philosophy. The doctrine was this: have little or no inventory in stock, and get everything delivered "just-in-time." This system reduced costs, but introduced today's supply chain vulnerabilities. Now companies are aggressively reversing this trend. They are expanding local warehouses, identifying local suppliers, and shifting from outsourcing back to "insourcing." Again, these shifts are not quick, but are already impacting supply chains and will continue to through 2022-2023.

Our opinion: the supply chain issues are transitory and resolving in 2022-2023.

CONSUMER DEMAND'S IMPACT ON INFLATION

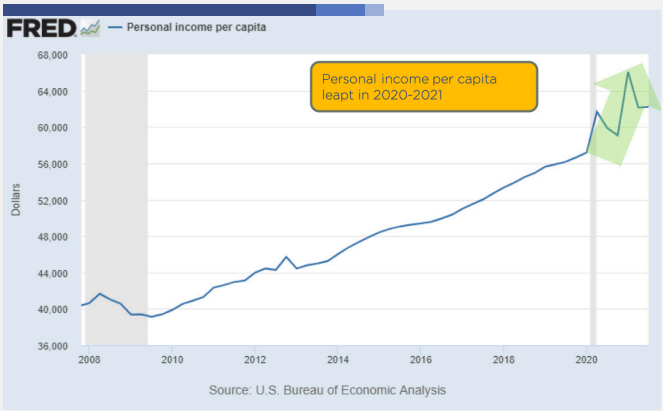
One of the strongest components affecting inflation is booming consumer demand. There are several factors at work here. The first is deferred demand created by COVID. People are locked in their houses, pining for their favorite restaurant or their favorite brew or their favorite travel destination. When restrictions are lifted, there's massive deferred demand. This is exactly what we saw in the summer and fall of 2021 as restrictions eased in many locations.



The second factor driving this demand surge is that consumers are suddenly in incredibly good financial shape. This was very surprising to me when I looked at the data, but this data is clear.

First, look at household net worth. The chart above shows household net worth in the US suddenly jumped in 2020. This has been primarily driven by surging stock market and housing prices. Strong household net worth indirectly affects consumer spending through something called the 'wealth effect:' when people feel wealthy, they want to spend money.

Second, we're seeing record personal income per capita. This is also quite shocking, but during COVID, in spite of some of the news headlines about the suffering and the need for the stimulus packages and all that, we saw personal income per capita take a quantum leap higher.

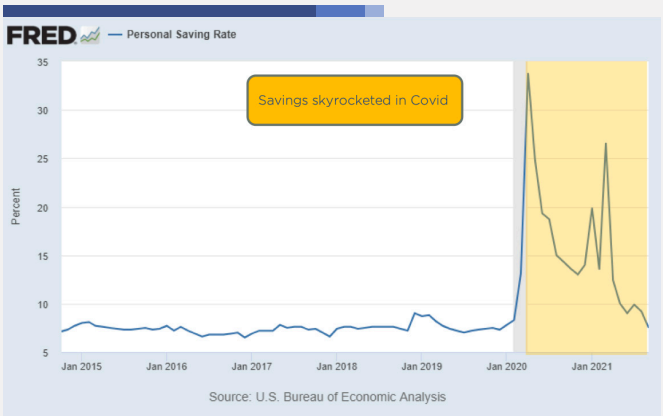


People are earning more money than they ever have. Analysis of these numbers from the US Bureau of Economic Analysis shows the increase was entirely due to transfer payments, including the direct stimulus payments.

When Ben Bernanke was involved with the Federal Reserve, there was a lot of concern about deflation.

He made a very famous speech called the Helicopter Speech. He said in essence, "You should never fear deflation. If I wanted to stop deflation, I could simply drop cash from helicopters and we could stop deflation." He's right – and today's inflation is proof.

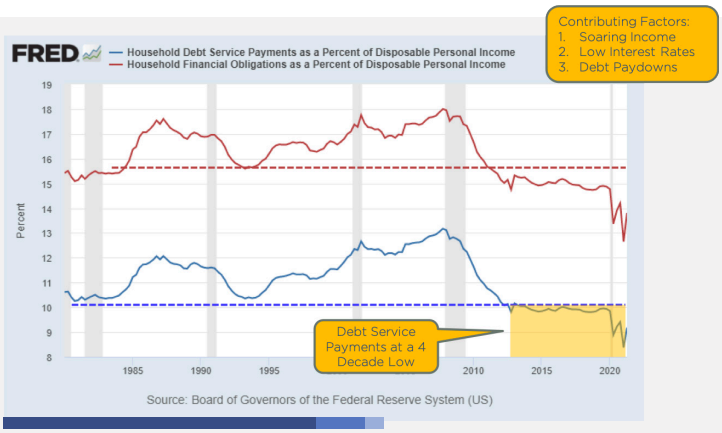
In the past, stimulus measures were always in the form of tax breaks or lowering interest rates, which helps businesses and has more of a trickle-down effect over a longer period of time, not directly affecting individuals. Direct payments to individuals had never been tried until now. It is now clear that direct payments to individuals has a powerful and immediate effect, much more than other indirect stimulus measures.



Another surprising trend is that savings skyrocketed in COVID. With this excess income and wealth, and reduced consumption during COVID, people paid down debt and saved at never-before-seen levels. This resulted in very healthy balance sheets for consumers.

This reduced debt load, combined with low interest rates and soaring income, has produced the lowest debt service ratios in the last 40 years. The blue line here is debt service as a percent of disposable personal income.

The red line in the chart represents individuals' total financial obligations relative to their income. This includes things like rent and autos and everything else. Consumers are in very, very good shape.



Where is consumer demand headed?

So, is booming consumer demand likely to be transitory or persistent? Here are the factors that are going to cause easing in consumer demand:

1. The stimulus is over, and there is no more stimulus coming, at least in the form of direct payments to individuals.
2. Deferred demand is waning or we are at the tail end of that.

Factors that may cause consumer demand to remain strong are:

1. Income gains
2. Wealth effect
3. Low debt service
4. High confidence in the job market
5. Strong GDP growth

All these factors would indicate that high consumer demand is here to stay.

Given that 70% of the GDP is consumer spending, it's no surprise that GDP growth is strong as well. We've learned what happens when you make direct payments to individuals... it's like a shot of adrenaline directly to the heart of the economy. Its effects are powerful and immediate – there's no trickle down.

These two factors alone, booming consumer demand in the face of supply chain shortages have combined into an inflationary perfect storm. Let's look at the third factor driving today's inflationary surge.

THE GREAT RESIGNATION CONTRIBUTES TO INFLATION

The final factor in this inflation scenario is what has come to be called the Great Resignation — the great masses of people leaving their jobs, causing worker shortages and wage inflation.

It's been this very unique thing to witness in the economy from pre-COVID to post-COVID. Pre-COVID era, we were already operating at a very low unemployment rate and then COVID hit and unemployment spiked. You'll remember there was a lot of concern about where the economy was going to go. Restaurants and retail were shutting down.

The economy eventually opened back up and now we're through the worst of it.

Now you walk down the street and virtually every retail store and restaurant has a 'now hiring' sign. We saw Domino's is doing a $3,000 one-time sign on bonus to deliver pizzas. There's an enormous need for workers. The simple question is, where did all the workers go?

There are a lot of nuances to the shortage of workers, which we found as we dug into it. There was a great piece in the Wall Street Journal that delved into this.

Dropping Participation Rates

We're going to plot some of these pieces of information, but what's interesting is that the unemployment rate is low again. We are back to where we were before the pandemic, but the real big difference is the labor participation rate. This metric measures all the workers that are considered in the workforce – those who are working or want to work.

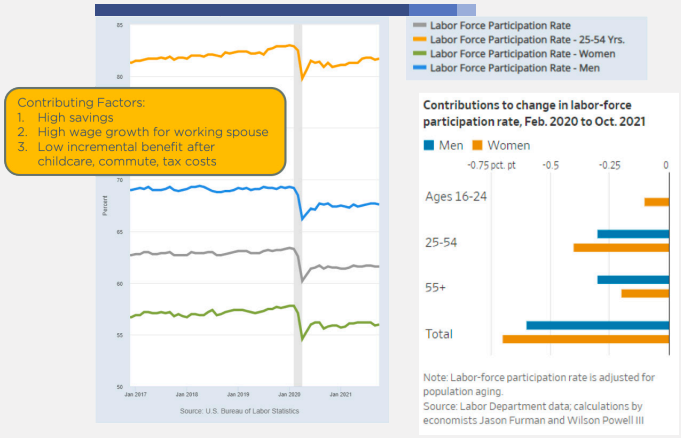
The percentage of the population that wants to work has shrunk dramatically. They decided to retire, stay home with their kids, or do a side hustle.

We're seeing a massive amount of people that have simply left the workforce, about 4.3 million, according to the WSJ article.

4.3 million is a very big number. In many cases, Baby Boomers that are close to retirement age decided to retire early, in part because the stock market has been doing well and everyone's household net worth is booming.

You also have dual income families where both spouses are working and there's been a huge issue in daycare staffing, which has led to raising rates for daycare. Many in this position, who may have also seen an increase in their own wages, found it made sense for one of the spouses to stay home. The marginal income gains after paying the additional daycare, commute and taxes simply weren't worth it.

Drops in labor participation rates are also pretty uneven.



We're seeing outsized drops in the participation rate particularly for women, workers without a college degree, and in low-paying service industries. On the chart here, you can see the prime age participation rate (the orange line), the drop during COVID, and the slow recovery. It's been recovering, but not that strongly, especially among women (the green line).

THE GREAT RESIGNATION IS A US-ONLY PHENOMENON

We wish to avoid this article making political opinions, but we do want to comment on policy. It's very difficult to separate economics and policy, because every policy has an economic impact.

It is important to note that this participation rate drop is an entirely US phenomenon. We're not seeing this anywhere else. That's because it is primarily US policy-driven.

Worker resignations among dual-income families is a predictable impact of increased earnings and progressive taxation. Progressive taxation penalizes incremental dollars earned. Add that to daycare and commute costs, and it often makes sense to stay home.

The same factors apply to retirement-age workers, or people thinking about becoming self-employed. The wealth effect, combined with the penalization of incremental earnings, leads many to exit the workforce.

Also, a less contributing factor, especially for frontline retail or hospitality jobs, are immigrant workers. The borders have been closed because of the pandemic and a lot fewer people are coming in.

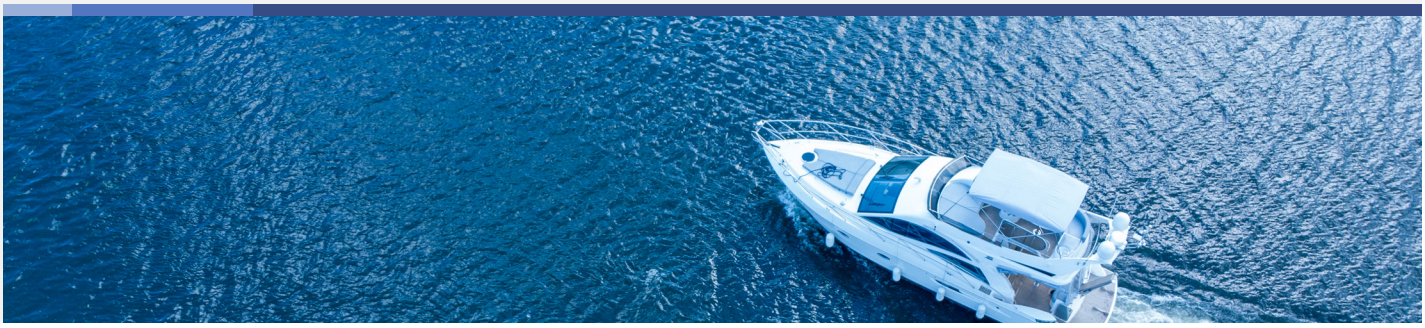
Again, speaking to policy, America needs a smart immigration policy. Neither "left-right" extreme is helpful.

We need a smart open border where people who are not criminals and who want to work, and who are not going to burden the social welfare system, and who are knowledge workers and are hard workers, are welcome to come in. It's good for them and for us. We need politicians that will implement a smart immigration policy. It's super important to alleviate the worker shortage and counter slower population growth in the US.

REAL INTEREST RATES ARE NEGATIVE

For investors, one of the most important results of inflation is its impact on interest rates. Because of the high inflation rates, real interest rates, which are already negative, have turned even more negative.

Nominal interest rates are the headline interest rates, but real interest rates are interest rates minus inflation. Inflation expectations can be measured by the ten-year breakeven rate, and is the investors' view of expectation of inflation. Essentially, this metric is what large investors are betting that the inflation rate is going to be. Right now, it's just over 2.5% and is approaching 3%, high, but not close to the 7% metric we're seeing in headlines.



With nominal interest rates currently at 1.7% (10-year US treasuries), the difference is negative. Negative real interest rates mean that the value of cash is decreasing, it is being inflated away. If you put that money in a bank to earn interest or you buy a treasury bond, you're earning less than inflation and every day its value is shrinking.

We can't overemphasize how important this is. The net effect of negative real rates is to create a massive demand for assets. If you've got savings that is literally decreasing in value every day versus an asset such as real estate that is increasing in value with inflation, you are going to turn your cash into hard assets. That's exactly what we're seeing in this environment and why real estate is in such high demand.

THE WONDERS OF DEBT

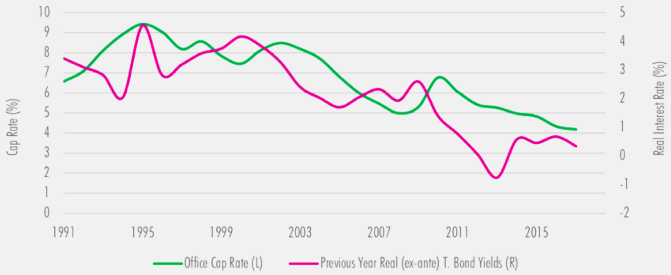
One of the greatest and often missed opportunities for making money in an inflationary environment is to borrow money. If cash is shrinking in value, then it makes sense to owe as much as you can, if you can borrow at fixed rates. This is one of the greatest secrets of government debt and why it is not a major problem. For example, at a 7% inflation rate, in 10 years the value of debt owed would have dropped by 50%; and in 20 years, by 75%. One of the best ways to make money today is to borrow as much fixed-rate money as possible and buy real estate, especially inflation-responsive real estate. You make money on both sides – the value of your owed principle shrinks, while the value of your asset grows.

It is important to note that historically, negative real interest rates are a very rare phenomenon. It points to a golden age for leveraged real estate, and smart investors will get rid of their cash, borrow as much as they can, and buy real estate.

Cap Rates

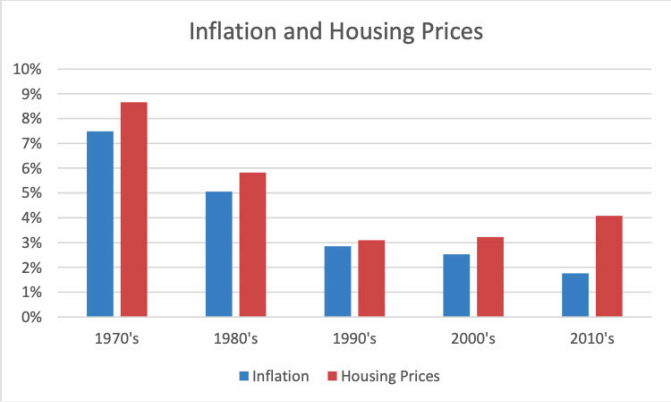
Historically, commercial real estate is priced based on cap rate, which is a multiple of operating earnings. So, for example, an apartment complex that earns $100,000 per year, at a 5% cap rate, is worth $2m (100,000/5%). Cap rates are highly correlated to real interest rates, not nominal interest rates. You can see this in the chart below.

Today, cap rates now are being driven lower, which correlates to higher prices. That is likely to continue.

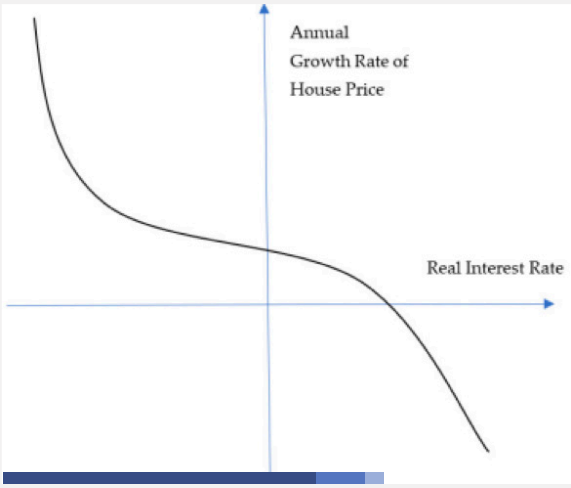


As cap rates are tied to negative real interest rates, higher inflation will continue to drive cap rates lower.

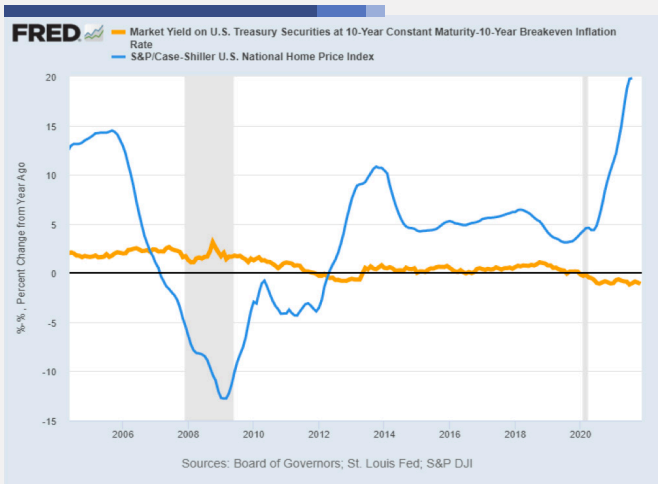
Housing prices, too, generally track inflation. This chart shows the relationship between the two over the last 5 decades.



There was a great study done recently that showed that when real interest rates go negative, housing prices spike, and when real rates go very high, housing prices drop. This data also points to housing as a good investment.



Here you can see the phenomenon in real data. The orange line shows real interest rates, and the blue line is the change in housing prices. Notice what happens to housing prices when the orange line goes negative.



RECAP

To recap, the inflation due to supply chain disruption and supply chain issues is transitory. We're going to see these being solved gradually throughout 2022.

The inflation due to consumer demand will continue to stay high, but ease. The stimulus is done and deferred demand is waning, but all the other drivers of an extremely healthy consumer are not going away.

Wage inflation due to the Great Resignation is also continuing, but easing at a slower pace. As people run out of cash and as the savings diminish, people are going to look at entering the job market again.

Finally, let's look at the outcomes that we're expecting in this time and the investment strategies that will have the greatest payoff.

BOTTOM LINE: MY ECONOMIC PREDICTIONS FOR 2022

- **As we've learned since 2009, inflation must be bifurcated into CPI and API.** When the Fed responded to the Great Financial Crisis with unprecedented monetary easing in 2009, most expected high inflation to result. But CPI never budged. Inflation did happen, but as Asset Price Inflation (API). The stock market, real estate and most assets have had record price gains.

- **Interest rates are unlikely to be raised to match inflation. I believe the Fed is going to be very much pressured to raise interest rates,** with inflation now hovering above 8% inflation. They're going to be highly pressured to ease the overheated economy.

  However, they're going to be limited by midterm elections coming up in 2022. Politicians won't want to raise rates in front of that. In 2024 as well, when Biden's coming up for reelection again, I see the same issue.

In the past, the Fed has not been as politicized. Since the Volcker days in the '70s, the Greenspan days in the '80s and '90s, the Bernanke days, the Fed chair position has gradually become more politicized because they're appointed by the president.

In the past, the role of the Fed chairman was viewed more as a banker/technocrat, but today monetary policy has taken center stage and become more closely aligned with political policy. Our guess is they will probably try to raise rates or raise rates slightly, but they're not going to be able raise them very much.

- **GDP is going to continue to see strong growth.** Because consumer's income statements and balance sheets are so healthy, we will continue to see strong consumer spending, and consumer spending is 70% of the GDP.

- **Negative real rates will drive up asset prices.** We are going to see asset prices continue to rise, including the stock market, and possibly Bitcoin, gold, silver, but especially real estate.

- **CPI will continue high, but uneven.** Locally-produced goods and services are going to continue to be the hardest hit. You'll see restaurants raising rates, cutting hours, trying to survive in this difficult environment and implementing lots more automation to try and stay in business.

- **You're going to see anything that can be offshored being offshored.** Asia is seeing none of the inflation happening in the US, and Mexico and Europe, inflation is around half the US numbers. Wage inflation is spiking in the US, but nowhere else in the world. So, commodities and labor will be much when sourced outside the US.

- **Our final prediction is that we're going to see a reshoring boom.** This sounds funny after the last bullet point, but bear with us. We'll see a reshoring boom in strategic goods, things like chips, where the cost of that chip is little, but its strategic value is high. We're going to see strategic reshoring of various rare earth metals and chips and other things will be re-shored to the US to eliminate supply chain issues from continuing. We'll see all of that.

FOUNDERS

BOB FRASER

Mr. Fraser has 20+ years' experience in finance, investing and technology and has held several CFO and CTO positions. Fraser is a former E&Y Entrepreneur of the Year winner when he founded a technology company that became one of the fastest growing companies in the Midwest reaching 250+ employees. He was Magna Cum Laude graduate of U.C. Berkeley's computer science program.

Read more about his background here

JIM MAFFUCCIO

Mr. Maffuccio has 30+ years full-time experience in real estate investing and an award-winning developer. Maffuccio is an expert in mortgage notes and is deeply networked in the secondary mortgage industry, holding key relationships with primary sources, note buyers and sellers, and service providers.

Read more about his background here

ABOUT

Aspen Funds was started by Bob Fraser and Jim Maffuccio in early 2012 to take advantage of a unique opportunity in residential real estate notes. Experiencing the volatility of the stock market, and seeing investors take large losses in their portfolios, Bob and Jim were determined to design an investment fund that would provide alternatives to the stock market with excellent investor returns, but without the volatility of traditional investment options. Aspen Funds has grown tremendously since then, now managing 5 funds, and recently being included on the Inc. 5000 list of fastest growing private companies in the U.S.

10+YEARS
TRACK RECORD

100+YEARS
TEAM REAL ESTATE EXPERIENCE

3000+
TOTAL LOANS PURCHASED

50+
NUMBER OF STATES INVESTED