Green Drake™ Advisors, LLC
175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

www.greendrakeadvisors.com

Views From the Stream

August, 2021

The Monthly Letter covers two topics this month. First, we provide Part 2 of our Global Economic Quarterly. Global Central Banks continue to line up to tighten monetary policy over the next year. Just as they one-by-one loosened, adopting aggressive monetary easing not seen in decades, so they are lining up to tighten, removing the aggressive easing of the past 18 months over the next 12 months. While making sense from any one Central Bank's viewpoint, their collective action, coupled with a serious slowdown in China, likely will produce a bigger impact than expected. And Second, in Part III of our Global Economic Quarterly, we provide short snippets of observations on countries and regions around the globe. And Third, as always, we close with brief comments of interest to our readers.

Global Economic Quarterly Part 2: The Central Banks Go Marching One By One, Hurrah! Hurrah!

"The ants go marching one by one, hurrah, hurrah,
The ants go marching one by one, hurrah, hurrah,
The ants go marching one by one,
The little one stops to suck his thumb,
And they all go marching down,
To the ground, to get out of the rain.
Boom! Boom! Boom!"

Children's Nursery Rhyme
Origins Uncertain

The Global Economy continues its rise from the depths of March 2020. Over the past 17 months, the Global Economy posted some of its best growth statistics in many years as governments moved to fill the gap and Central Banks served up gobs of money. Developed Markets (DM) recovered their GDP losses with many Emerging Markets (EM) not far behind. The following chart of US Real GDP demonstrates that Q2 2021 GDP exceeded its prior peak of Q4 2019:

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175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

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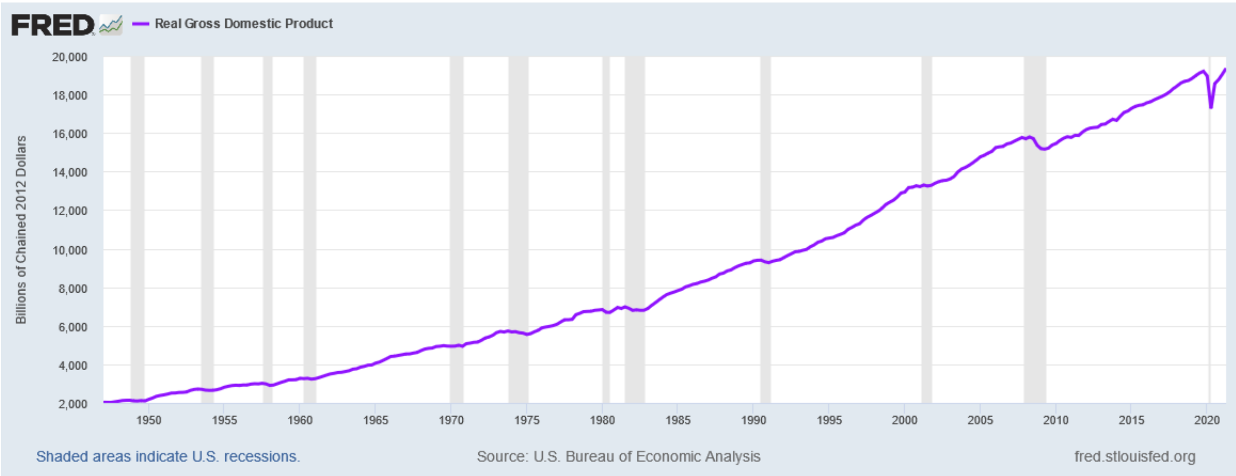

A chart of EU GDP would reveal a similar message. As of the end of Q2, EU GDP stood within 1% of its Q4 2019 peak. And so, one could travel around the world, for the most part, with a similar outcome. This rapid recovery, more reminiscent of economic recoveries prior to 2008, occurred in a classic manner over the traditional 4 – 8 Quarters, taking 6 Quarters to exceed its prior height. And the expected Early Cycle areas led the Global Economy out of its depths: Autos, Housing, and Manufacturing coupled with the need to rebuild Inventories.

While all good and well for the economy, the rapid recovery creates issues for Central Banks. Having provided gobs of liquidity, last seen during the Great Depression, full economic recovery over just 6 Quarters poses a challenge. The first challenge stands Inflation. Unless someone spent the past 12 months living on the planet Pluto, price inflation for goods stares one in the face. While blamed on global supply chain disruption, the real culprit stands demand. Demand for global goods overall exceeds its pre-pandemic level by 20%+. With little to no capacity added over the past year and manufactures rushing to have capacity catch up with demand, capacity utilization reached levels consistent with past episodes of manufacturers raising prices aggressively. Whether for containerboard to move goods or for insulation in new construction, prices for goods accelerated upwards given the supply-demand imbalance. Central Banks have hitherto used words like "transitory" to justify inaction in the face of clear data. However, should inflation prove sticky, there will come a tension between the goals of Central Banks and the goals of governments. Central Banks typically focus on price stability and economic growth, assuming some natural growth rate for the economy. They primarily focus on economic growth while controlling inflation. If inflation exceeds "acceptable" levels, they step on the monetary brakes. Governments, on the other hand, want to deliver strong growth that will underpin their political fortunes. So what, if this produces some inflation as long as growth stays strong. Then there exists the Pandemic hangover. Governments took on significant debt during the Pandemic to fight the Recession and the lockdowns.

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(610) 300-3211 Fax

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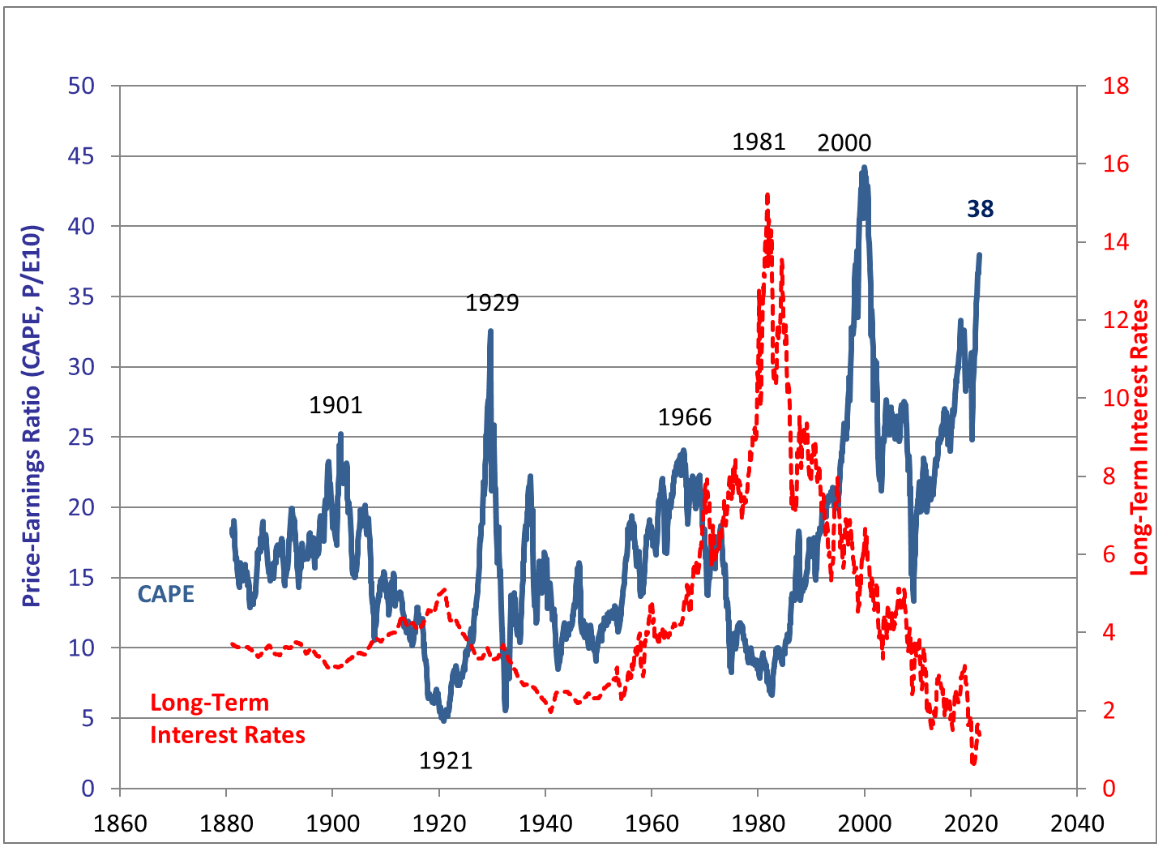
This drove budget deficits through the roof across the globe and public debt to GDP ratios upward. Governments now desire strong Nominal GDP Growth to bring debt to GDP ratios in line. Anything less will create financial limits down the line. Thus, a little more inflation stands a good thing from this perspective. Given the incompatible policy goals, tension between Central Banks, tapping the brakes, and Governments, focused on growth, will rise as the economic recovery continues.

The second challenge for Central Banks stands Inflated Asset Prices. Early in a recovery, liquidity finds its way into the financial markets. Then, as the real economy responds to Central Bank actions, the real economy demands the liquidity, draining a portion out of the financial markets. The following chart from Robert Shiller with his famous CAPE Ratio makes clear just how much record liquidity from Central Banks led to near record valuations in the Equity Markets:



Equity valuations appear on the way to equaling or exceeding their peak in 2000. These types of excesses in Equity Markets possess a long history and even a recent history such as 1999 – 2000, 1987, and 1972 –

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175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

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1973. (In 1973, the excess was concentrated in the Nifty 50, which saw their valuations collapse in the 1973 – 1974 Bear Market.) In each of these periods equity prices disconnected themselves from reality briefly only to come back to earth in a jarring fashion. Such likely will become the outcome here given the starting point. Other financial markets already have begun a rotational correction as liquidity moves to the real economy. For example, lumber rose 4x from its pre-Pandemic level over the past year then fell rapidly back to where it started:

Chart courtesy of tradingeconomics.com.

Fortunately, lumber prices do not represent a worry for Central Banks, as they represent the type of commodity speculation seen at various points in markets as diverse as coffee, tin, rubber, corn, oil, and copper over the past 50 years. (One can examine prices over the past 200 years as well with similar results.) Nothing new for commodities. But, given the influence of equity prices on consumers, a normalization here could deliver real economic consequences.

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175 Strafford Avenue, Suite One
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(610) 687-7766 Voice
(610) 300-3211 Fax

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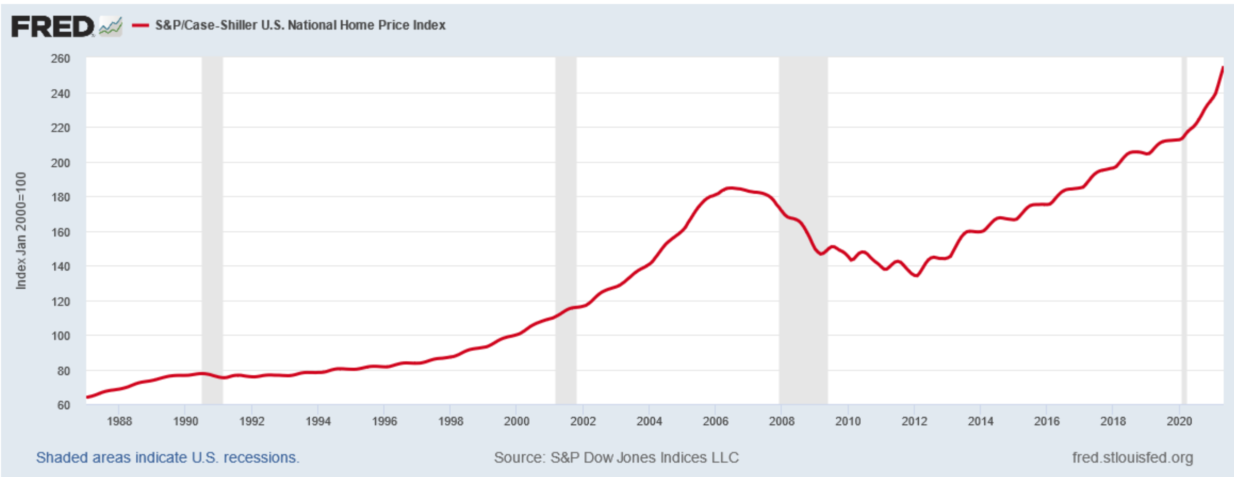
In addition to the financial markets, this excess liquidity found its way into Real Asset markets, such as Housing. The following chart shows just how far Housing prices traveled this recovery as well as the parabolic movement in prices since the recession in Q1 2020:



Of course, with investors piling into homes to create portfolios of rental properties, Housing became a speculative asset class. And with real rates at decades long lows, cheap financing allowed investors to pay more and more for the same asset. This runup in Housing Prices creates a real economic issue for Central Banks as they normalize interest rates and financing costs. How to deflate the excess without creating large problems in the credit markets, banking system, and the real economy from spillover effects? And how not to harm legitimate homebuyers while tamping down the speculation of the buy-to-rent investor? There exists no simple answer. But, Central Banks began to act over the past few months. Whether in New Zealand or Norway or Chile or other countries around the world, Central Bank actions to lower liquidity additions and/or raise rates appear underway with numerous other Central Banks ready to follow their lead. This, over the next 12 months, should move financing costs back towards the range they held from 2009 – 2019, which would represent a shock to current asset values. To soften the impact on certain classes of asset owners, such as homeowners, options exist to alter banking regulations to favor owner occupied homes over investor rental homes. This becomes a likely Act II to restore balance to voters over investors and tamp down the animal spirits let loose over the past two years.

This backdrop leads to the bigger question as the tsunami of liquidity subsides and Central Banks return to more traditional monetary policy. How will this reduction in monetary stimulus impact the real economy? For insights into this impact, China may provide a glimpse of the future. The following chart shows Chinese Real Money Growth Year-Over-Year (YOY) adjusted for PPI Inflation:

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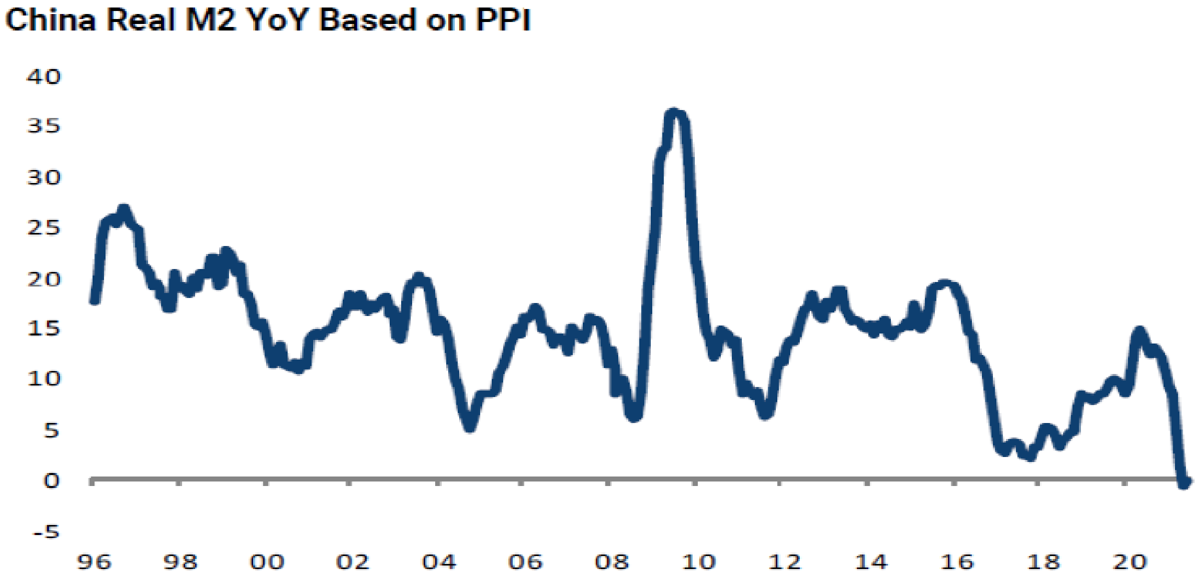

Chart courtesy of Jefferies, LLC.

Chinese money growth actually turned negative in real terms due to the massive increase in the PPI. Recently, forecast economic growth for China came under pressure for H2 2021. This stands the expected outcome when a Central Bank tightens policy, even if due to reasons outside its control. Economic growth will decelerate. Projections of H2 Chinese growth dropped from 6.5% SAAR to just 4.3% SAAR. In addition to economic slowing, typically, credit stresses rise when monetary tightening occurs. China's largest bad debt fund just received a government injection of capital to keep it afloat. If not for this injection, the fund would have collapsed, leading to a run on bad credits in the financial system. As The Central Banks Go Marching One By One down this pathway, the likely outcome stands economy after economy will slow. And, inevitably, as a consequence, Global Growth will come under pressure, even excluding the negative feedback loops from trade. Given these facts and the typical coordinated movement of central bankers across the globe, Global Growth likely slows more than expected in 2022. Hurrah! Hurrah!

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Global Economic Quarterly, Part 3: Scenes From Abroad

Dragon Maturity

For China, economic growth stands as a mantra: "The economy shall grow 6.5% or better. The economy shall grow 6.5% or better. The economy shall grow 6.5% or better. …" As with any command economy with central growth objectives, China continues down the path of managing its economic growth both to meet various policy objectives and to meet economic growth goals. However, despite the best efforts of those in Beijing, economic reality intruded into the central planners' goals. First, the Chinese economy only grew 2.3% in 2020 due to the Pandemic, despite the best efforts of those in charge. Second, despite the boost from Pandemic recovery, the Chinese economy continues to slow fundamentally as the law of large numbers impacts the economy. Third, foreign countries no longer will accept Chinese imports targeted to displace domestic industry and began to move to ban these products through both tariffs and import bans. The sum impact of this can be seen in the 2 Year Quarterly Economic Growth Numbers, which normalize for the Pandemic:

	China GDP Year Over Year Growth Rate			*2 Year Growth Rates*			
				2019 – 2020		*2020-2021*	
	2019A	***2020A***	***2021A/E***	***Actual***	***CAGR***	***Actual***	***CAGR***
Q1	***+6.3%***	***-6.8%***	***+18.3%***	***-1.0%***	***-0.5%***	***+10.3%***	***+5.0%***
Q2	***+6.0%***	***+3.2%***	***+ 7.9%***	***+9.4%***	***+4.6%***	***+11.4%***	***+5.5%***
Q3	***+5.9%***	***+4.9%***	***+ 4.1%E***	***+11.1%***	***+5.4%***	***+ 9.2%***	***+4.5%***
Q4	***+5.8%***	***+6.5%***	***+ 4.5%E***	***+12.7%***	***+6.2%***	***+11.3%***	***+5.5%***

Data from National Bureau of Statistics of China and Green Drake estimates.

In addition to these three country specific factors, there exists a fourth factor that will impact China. Global Goods Production stands 20% above trend due to the Pandemic. As a result, after the global inventory restocking ends in 2022, global consumer demand for goods will normalize as consumers return to spending money on services. Data already supports this outcome as consumer demand for goods as diverse as toilet paper and personal computers, which benefitted from the Pandemic, turned negative on a year-over-year basis.

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175 Strafford Avenue, Suite One
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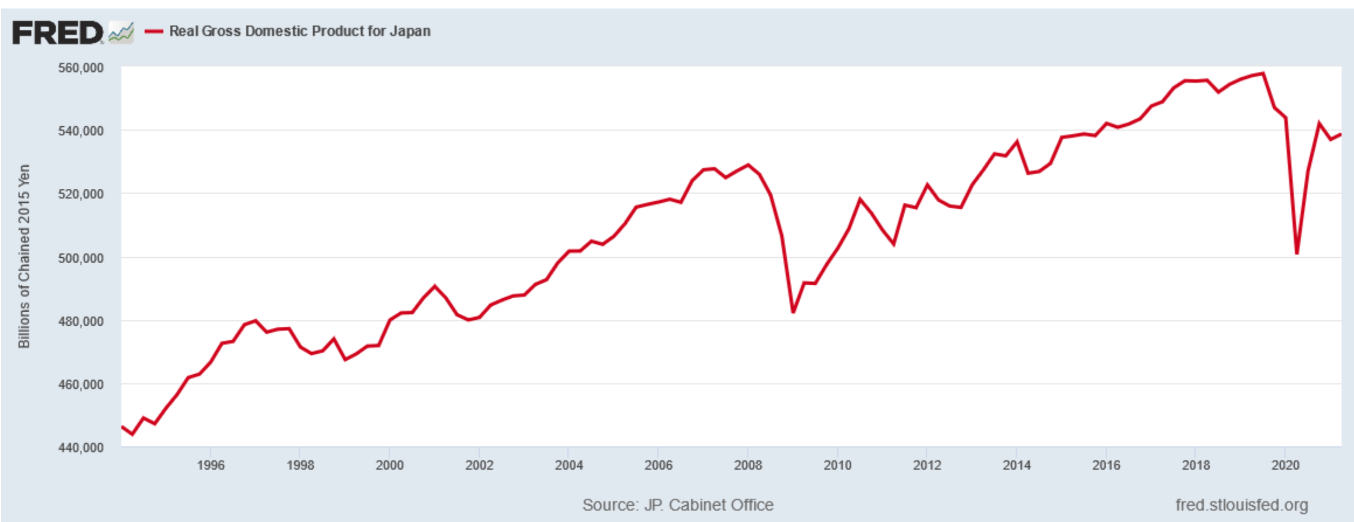
If China possessed a large Consumer market which could absorb its massive goods production, this would not be an issue. China would move to have Consumers consume the excess domestic production, displacing foreign imports. However, with China already practicing massive import substitution, possessing the #1 share of Global Exports, and having few industries left to displace, this path stands unavailable. Furthermore, with 40% - 45% of its economy manufacturing related, China faces another fundamental problem. A modern economy with up-to-date plant only needs 20% - 25% of its economy focused on manufacturing to provide self-sufficiency. As foreign countries move to limit Chinese imports, the extra 20% of GDP in manufacturing will become a drag on future economic growth. Thus, Chairman Xi moved to push "Common Prosperity". With this, he seeks to follow the successful path of South Korea in creating income for the average Chinese worker. South Korea focused on acceptable returns, wealth taxes, and income disparity in managing its chaebols to make the transition to slower growth. Such appears the path President Xi chose over the past year to deal with Dragon Maturity. This path also will provide an avenue for Chairman Xi to consolidate his power, enabling the government to sideline and marginalize all those who could challenge his power.

Eclipse of the Sun

Japanese economic growth continues to underperform. Unlike, the US and Europe, Japan's GDP still remains almost 3.5% below its Q3 2019 peak.



More alarmingly, it stands no higher than it did in H1 2015. Even prior to the Pandemic, Japanese GDP faced serious growth challenges. In the 5 Year span from Q3 2014 to Q3 2019, Japanese GDP

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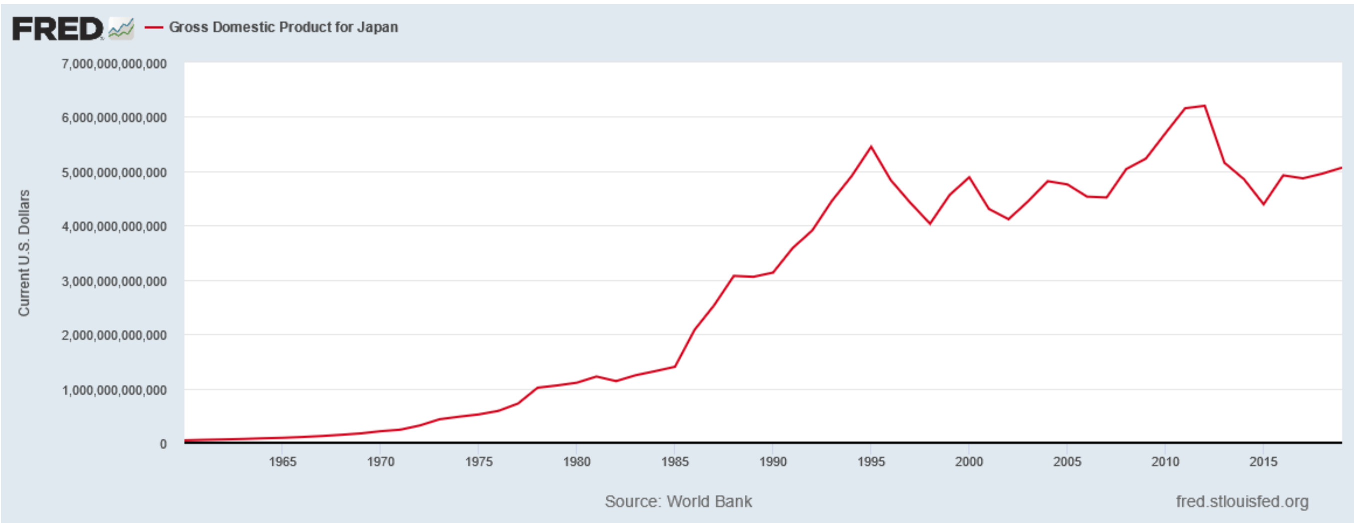
175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

www.greendrakeadvisors.com

compounded at just 1.15%. And for the 10 Year period, Japanese GDP compounded at just 1.27%, using a starting point of Q3 20009, near the bottom of the prior recession. Lastly, if Japanese GDP gets normalized into US Dollars, there exists no growth at all:



A fundamental issue underlies the poor growth, one that China faces today. Japan built its economy in the 1960s, 1970s, and 1980s on exports. Using an undervalued currency, it drove its global export share upward. However, when the US and other countries reacted and began to limit Japanese import growth, the Japanese economy stalled. And it never recovered from this mortal blow as other countries, such as China, Malaysia, Indonesia, Namibia, …, followed the Japan and South Korea playbooks to grab global market share. For Japan this produced a 20 Year Eclipse of the Sun. Over the past 5 years, Japan began to put in place a fundamental restructuring of the economy. Today, the economy continues to shift towards production supported by domestic consumption and lowered export dependence. While a work in process, continued focus on a fundamental restructuring already shows promise as the domestically oriented sectors continue to outgrow the more export oriented ones. With the passage of time this coming decade, the actions to refocus the economy should finally shine forth, putting an end to the Eclipse of the Sun.

Elephant Trumpets

For India, after a second bout with COVID that laid the economy low, growth came roaring back. Second Quarter growth exceeded 20% Year-Over-Year (YOY) for India, putting the country on track for GDP to reach new heights. The following chart shows Real GDP in US Dollars through the end of 2020:

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175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

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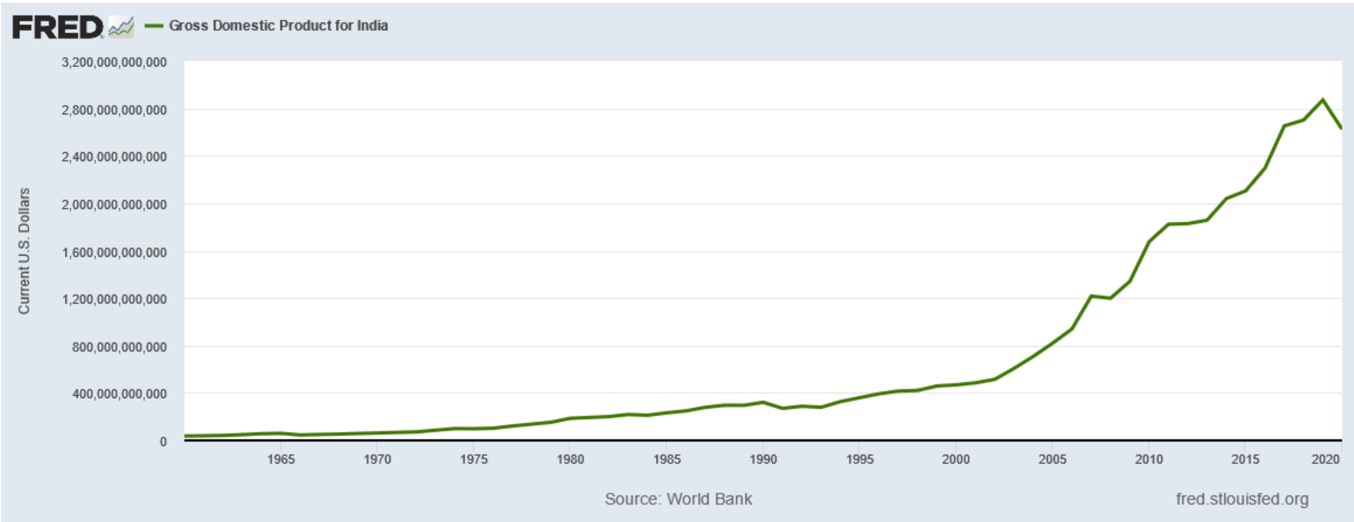

Should India's GDP continue its snapback, the Year 2021 will end with record GDP for the country. In addition, India continues to invest massively into its economy. Gross Fixed Capital Formation (GFCF) to GDP continues to run in the mid-30s, as the following chart indicates:

And this level of Investment stands before an additional $1.25 trillion in Investment planned for the next 3 years. In addition to the strong Investment growth, the Royal Bank of India (RBI) continues to provide copious amounts of liquidity. The RBI's balance sheet expanded 41% over the past year and its holdings

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175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

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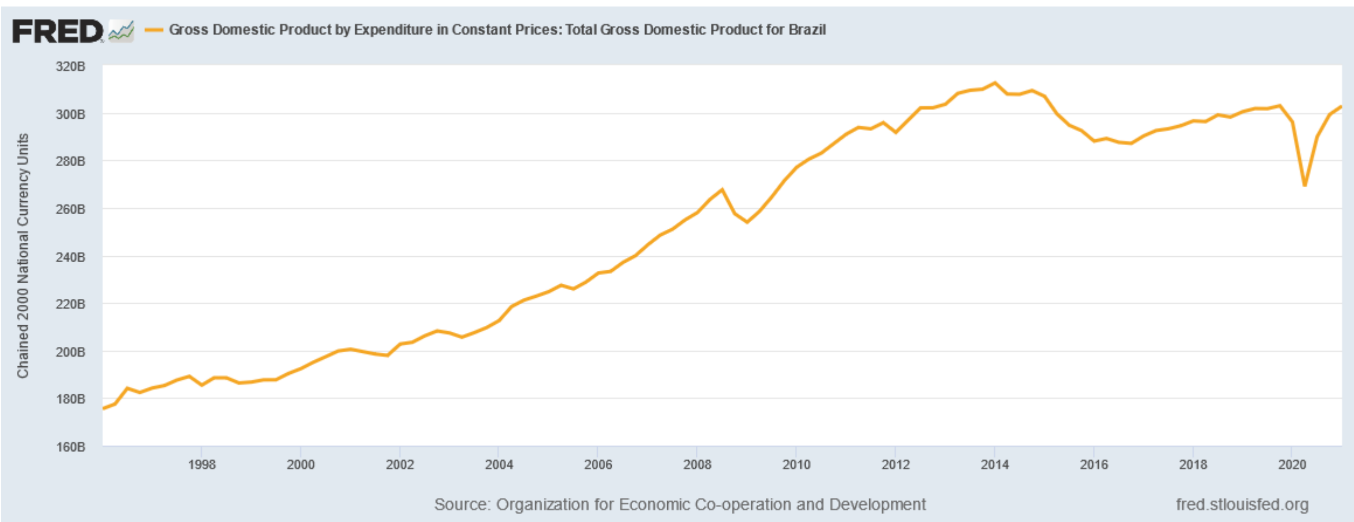
in Rupee Securities rose 47%. In total, the RBI Balance Sheet grew from 22% of GDP to 30% of GDP. At the same time, the RBI kept the repo rate at just 4%, the lowest level in years. This liquidity surge coupled with the massive Investment proposed should underpin strong GDP growth over the next few years as Elephant Trumpets sound loud and clear.

Samba Ahead

For Brazil, recovery from COVID continues at a rapid rate. The Service Sector exceeded its pre-Pandemic level in June, as the country lifted most restrictions. Foreign Direct Investment accelerated to $6.1 billion or 4% of GDP Annualized. Portfolio Investment registered its 4th positive month in a row with +$3.2 billion. In addition, Brazil received its allocation of SDRs from the IMF. Given all this, when viewed in local currency, it appears Brazil finally will break out of the flat GDP pattern since the end to the commodity bull market:



And in real terms, in local currency, this likely will occur. The short term looks good. But, this misrepresents the core economic issue for Brazil. Reality, in the form of translating the Brazilian Real into US Dollars, reveals a very different picture:

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175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

www.greendrakeadvisors.com

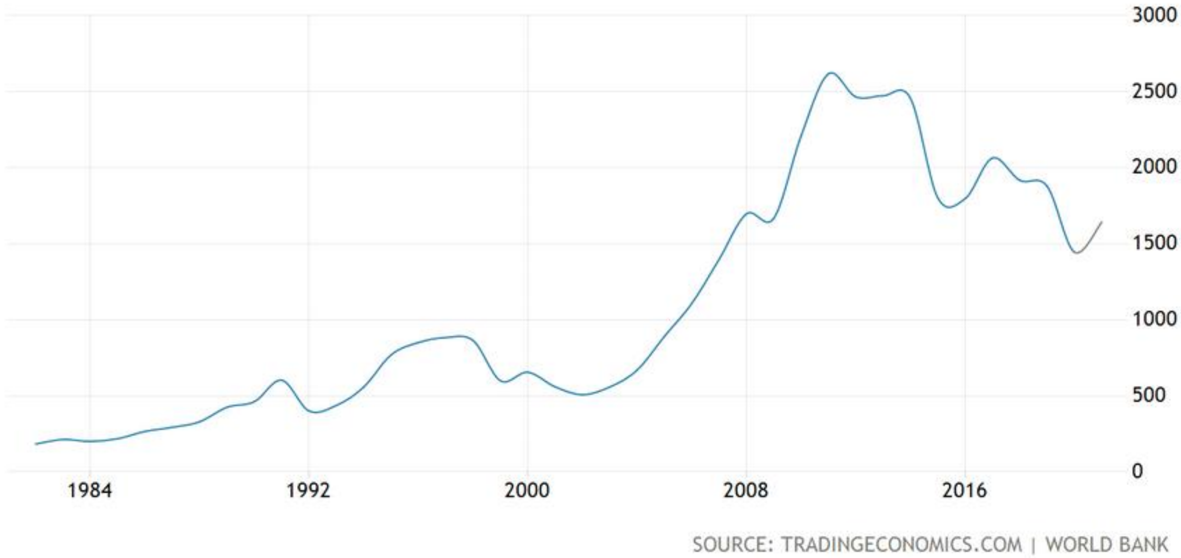

Chart courtesy of www.tradingeconomics.com using World Bank data.

As this chart demonstrates, Brazilian GDP stands over 30% below its level in 2014. In other words, despite its attempts to diversify its economy, it still depends heavily on commodities such as iron ore, soybeans, and energy. And with the collapse in its key commodities prior to the Pandemic, it's GDP took it on the chin. However, with the recent recovery in commodities and the likely long term commodity upturn that should occur over the next decade, Brazil would find itself well positioned after a difficult decade. And, its GDP in real terms, as measured in US Dollars, could find itself rising to new heights. With this potential in the works, there appears a Samba Ahead.

The Old Man Rises

For the EU, GDP continues its strong recovery, now standing just below its prior peak in Q4 2019. As with the US, this recovery stands driven by the traditional early cycle sectors such as Housing, Autos, and Industrials. Despite those worrying about the Delta variant of COVID, recent economic data in the EU continue to support growth that will allow GDP to reach new heights before year end. The following chart illustrates how far the EU travelled over the past year and how little it must travel to attain this goal:

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175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

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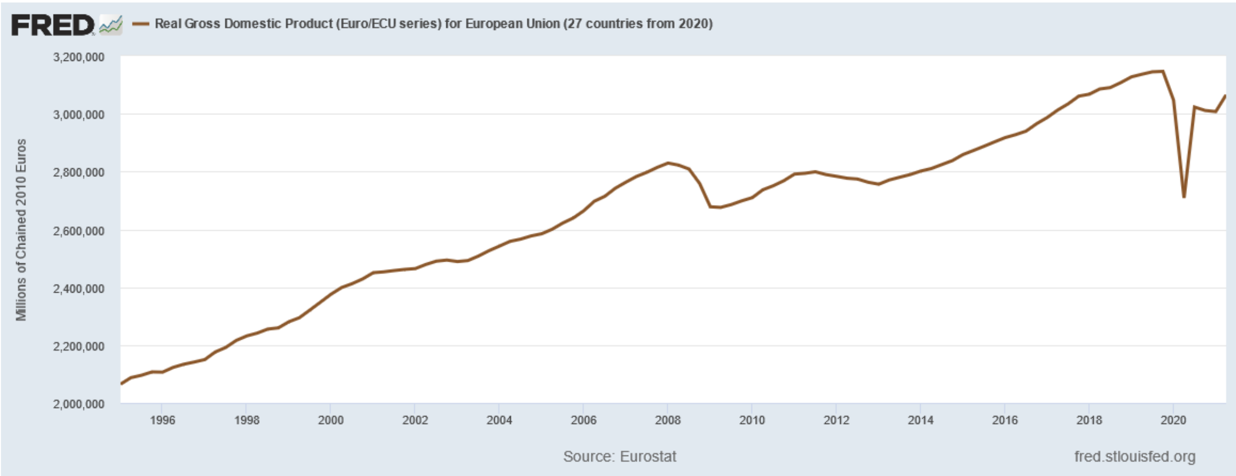
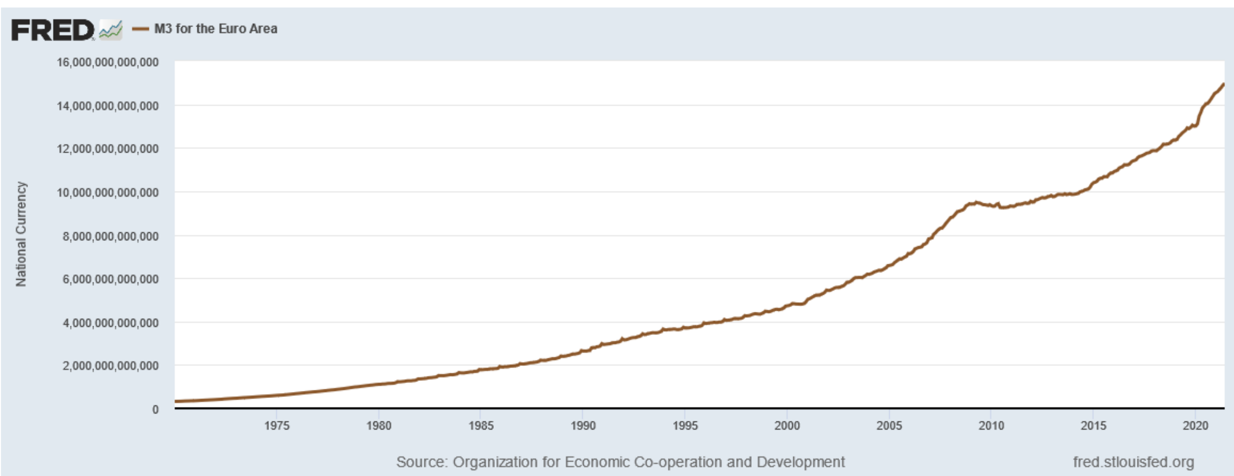


The real fireworks will occur at the European Central Bank (ECB). The following chart demonstrates the massive growth in EU M3, one of the key monetary aggregates, since 2014:



And the following chart shows the significant slowdown in money growth already underway, although hidden by the promises to keep Quantitative Easing in place through 2022:

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175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

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While the ECB may think its job is done, the political environment might weigh into the discussion with a very different conclusion. In order for the EU to remain intact, the economy must grow faster than before the Pandemic. And for this to occur, monetary growth cannot decelerate too quickly, less it create a drag on the overall EU economy. While the Old Man Rises, it remains to be seen whether he holds together.

Continuing The New Climb

For the US, Delta or no Delta, recovery continues at a rapid pace. GDP already exceeded its pre-Pandemic peak and growth estimates for the second half range from 5% to 6%+, despite the Q3 impact from the COVID variant. For 2022, torrid growth should continue at over 5% year-over-year. However, under the surface a major change should occur as the US economy moves from Early Cycle to Mid Cycle and those industries that disproportionately benefitted from the Pandemic see business normalize. With the U.S. recovery unfolding as a classic economic cycle with a few differences, the economy will move from Recovery to Expansion. For areas that enjoyed explosive growth over the past 18 months, such as Housing and Autos, growth should decelerate. For classic Mid Cycle areas, such as Capital Spending and Infrastructure investment, growth should accelerate. And for the classic lagging areas, such as Commercial Construction, which typically bottom 2 years after an economic recovery begins, downturns should end and new upturns begin.

Housing stood the big winner this cycle. Unlike the last economic downturn, consumers possessed strong balance sheets entering the economic shutdowns. With a positive demographic tailwind, as Millennials moved into their prime home buying years, coupled with the flight from cities due to the Pandemic,

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175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

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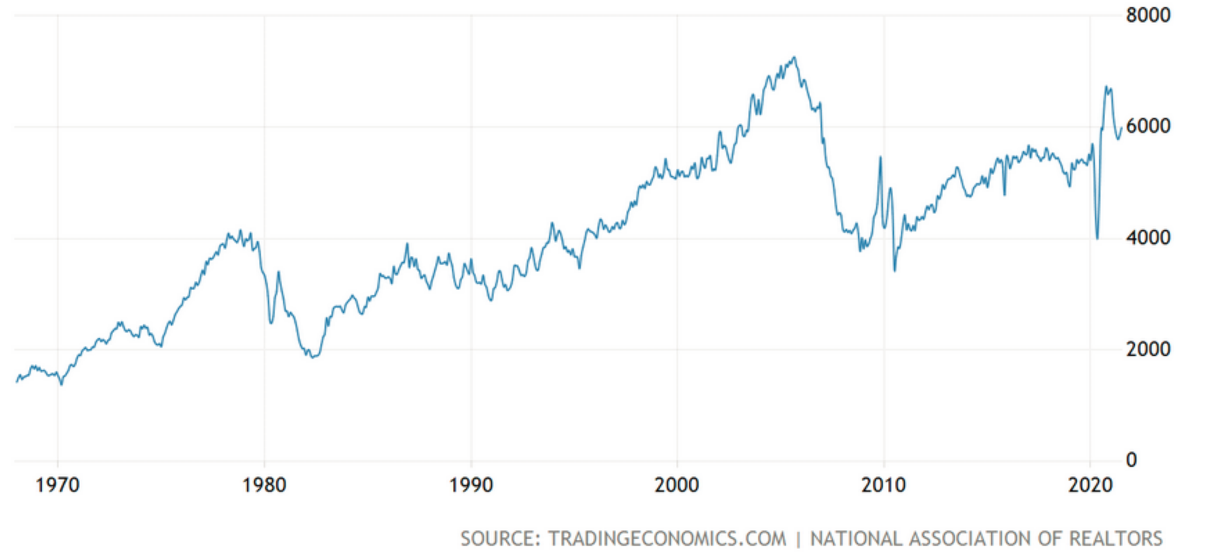
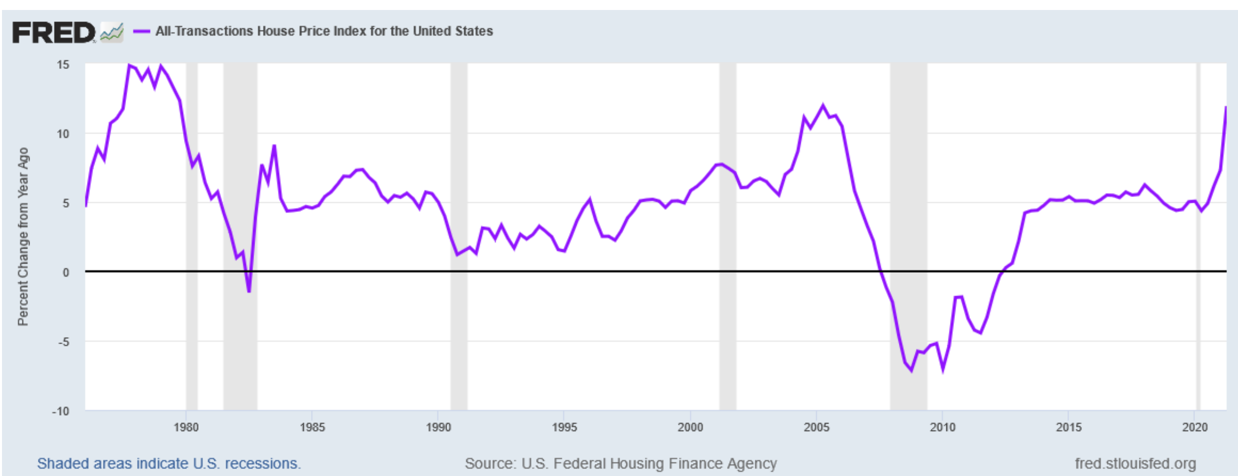
Housing demand accelerated. In fact, it spiked well above the average turnover of 5.5 million that held from 2014 – 2019 reaching a 6.7 million annual rate in October 2020:



Since then, sales have cooled as prices moved up significantly over the past 9 months. In fact, prices have accelerated in a similar fashion to 2003 – 2006:



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175 Strafford Avenue, Suite One
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(610) 687-7766 Voice
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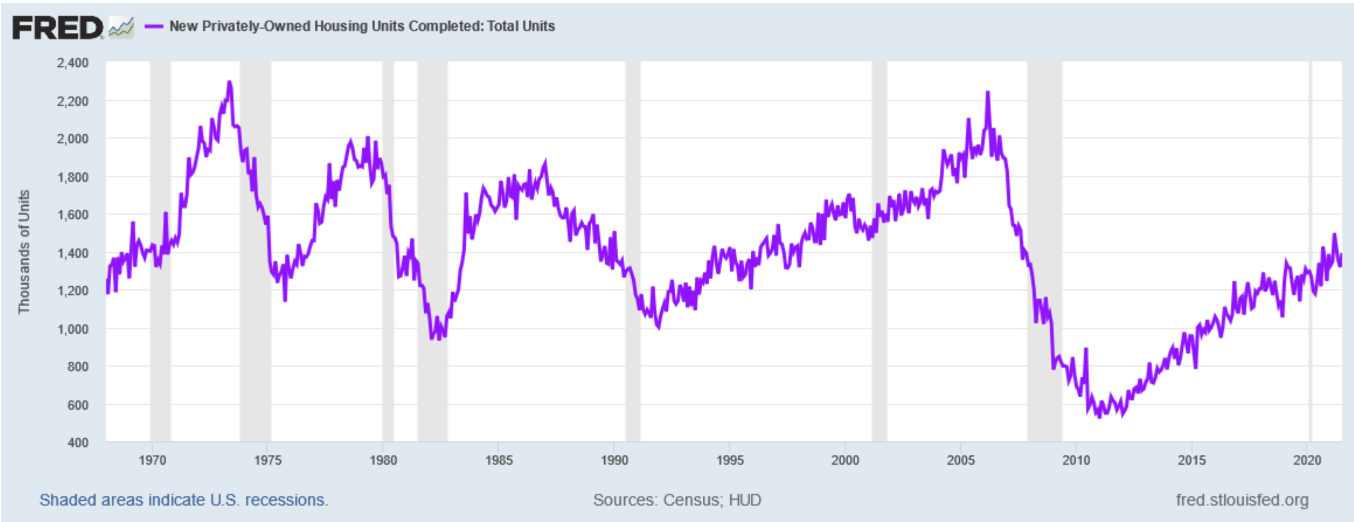
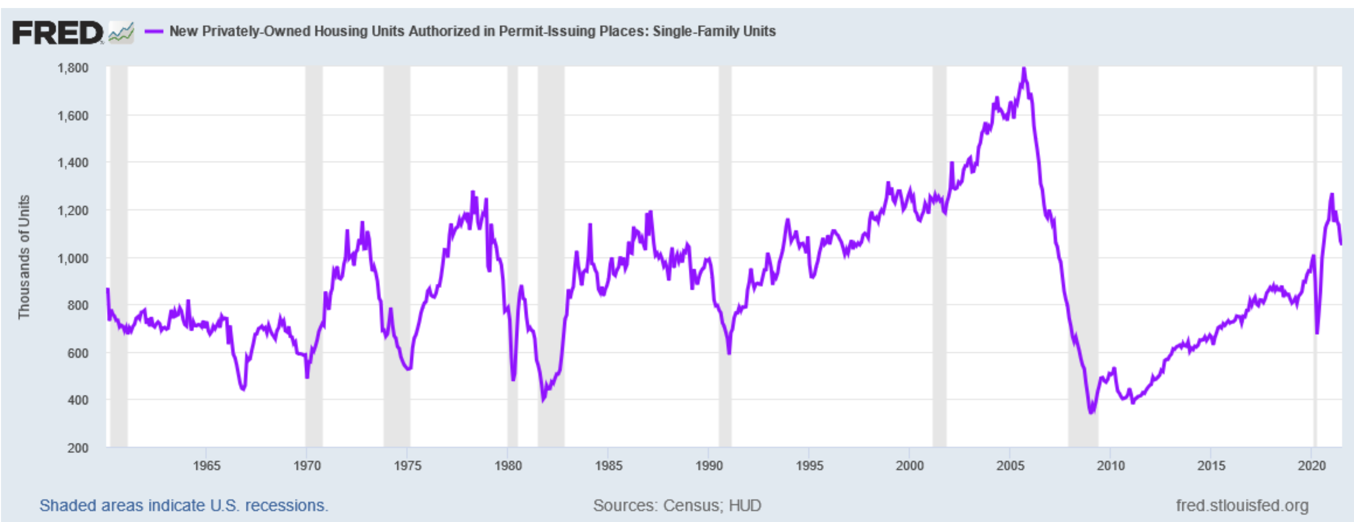
However, the laws of supply and demand have yet to be repealed. The runup in prices encouraged an acceleration in Housing supply. Housing Completions rose to their best level in years:



And Housing Permits, representing future Starts and Completions, exploded upward:



With more homes coming to market and prices rising, demand slowed, as the drop in Existing Home Sales illustrates above. This allowed Months Supply of Homes to return to normal:

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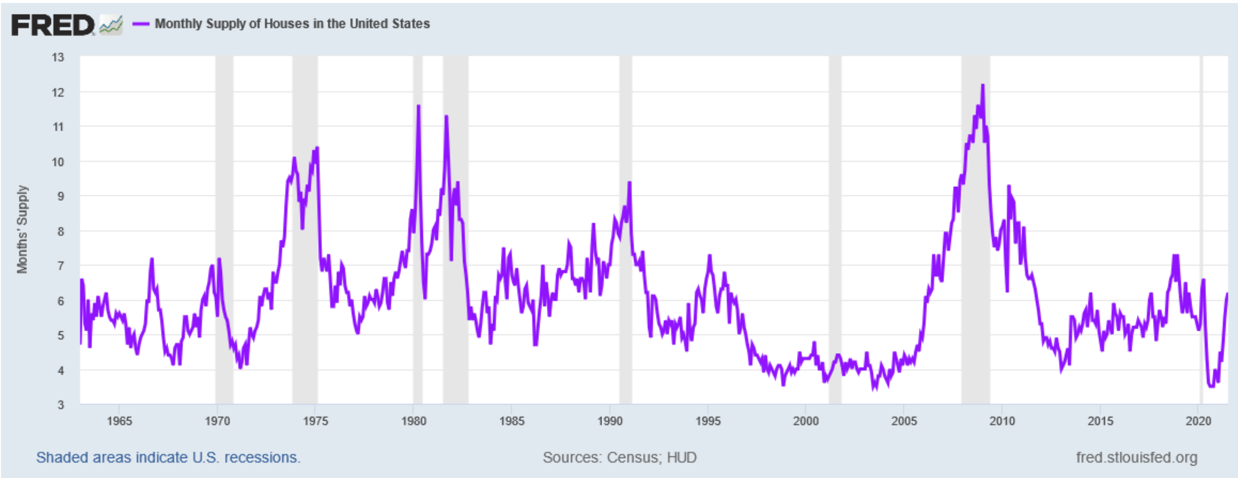

At a minimum, as Existing Home Sales head back to the 5.5 million level and Housing Completions continue to rise, the market should continue to loosen, slowing home price increases or actually flattening them.

This, of course, comes before two other important factors. The first stands the Mortgage Foreclosure Moratorium. At the height of the downturn, over 6.5 million mortgages stood in forbearance under various government initiatives. Today, that number totals 2.2 million. With the end to the Foreclosure Moratorium as of July 31, lenders can once again initiate actions to take control of properties and evict homeowners. Given the normal time lags in the judicial process, foreclosures should start to come to the market in late Q4 2021 or early Q1 2022, amplifying the new Supply to the market, just in time for the Spring Housing Market. Even if just an incremental 300,000 units comes to market next year, it would represent a 5.5% addition to supply. And this excludes any incremental Housing Completions that would occur.

The second factor is Mortgage Rates. Mortgage Rates stand at record lows. The following chart illustrates how far they have come since their peak in 1980:

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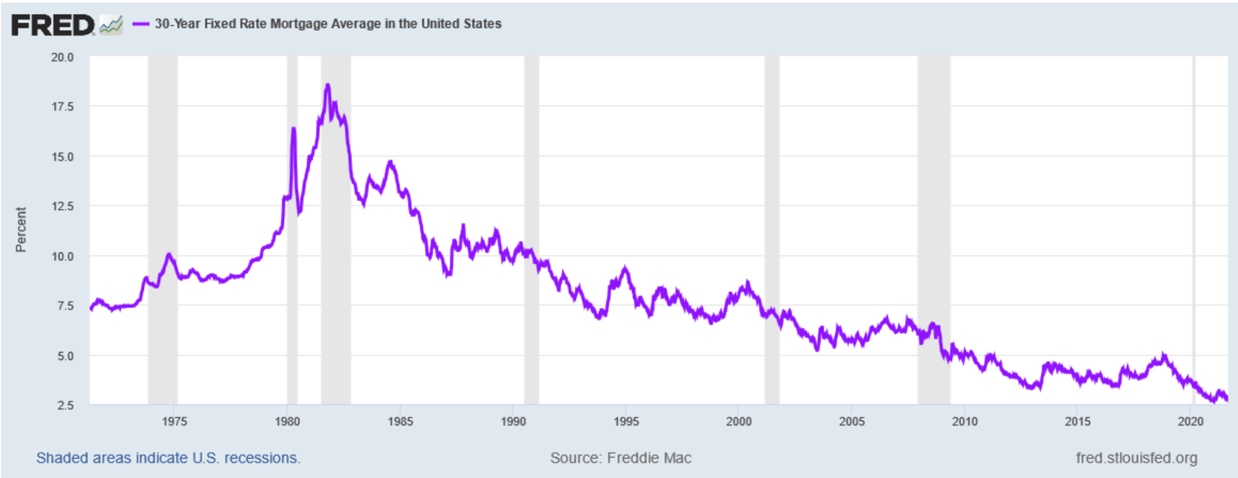
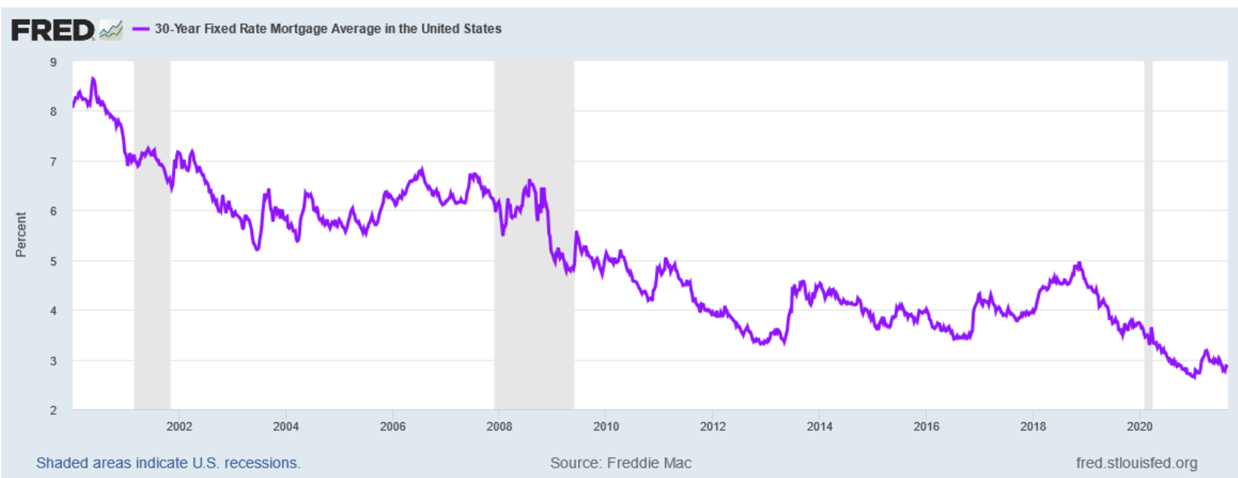


While the one below illustrates their drop over the past 20 years:



Prior to the Pandemic, 30 Year Mortgage Rates average 4.00%+, in a range of 3.50% to ~5.00%. Today, they stand at less than 3.00%. The curious part of this stands Mortgage Rates in relation to Inflation Expectations. With underlying Inflation running at 5%+ in 2021 and likely to stary relatively strong in 2022, Consumer Inflation Expectations returned to the levels they held before the Pandemic and then rose to levels last seen in 2011 and 2008:

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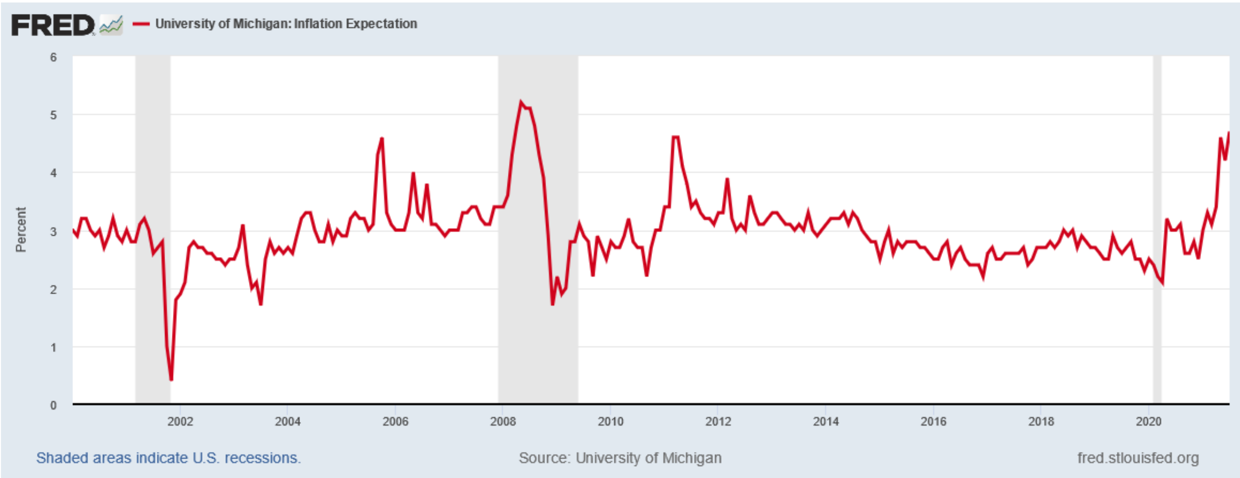
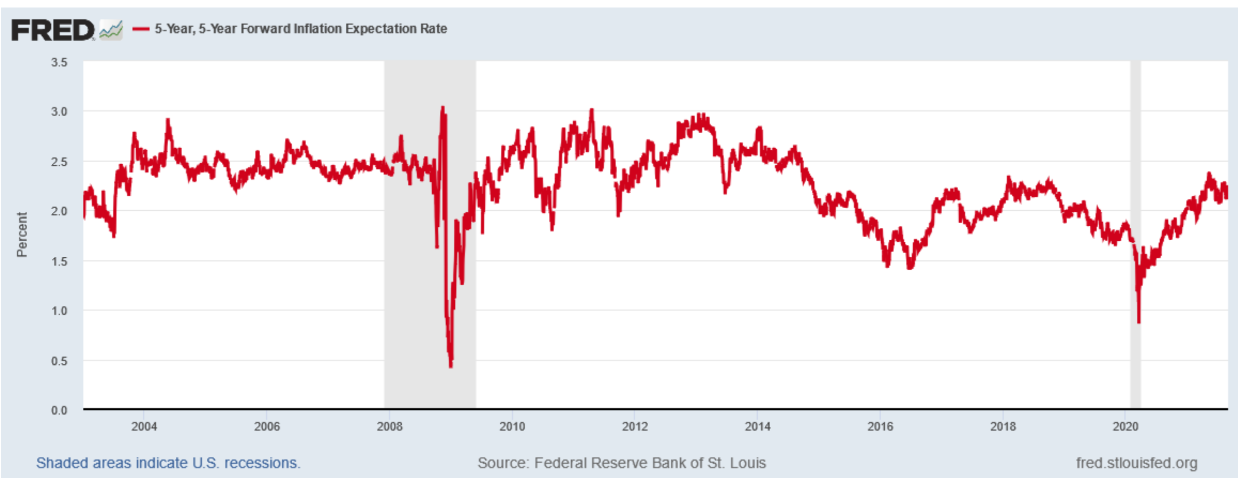


Of course, professional expectations stand lower, but still returned to their 2018 levels and not much below those from 2004 to 2014:



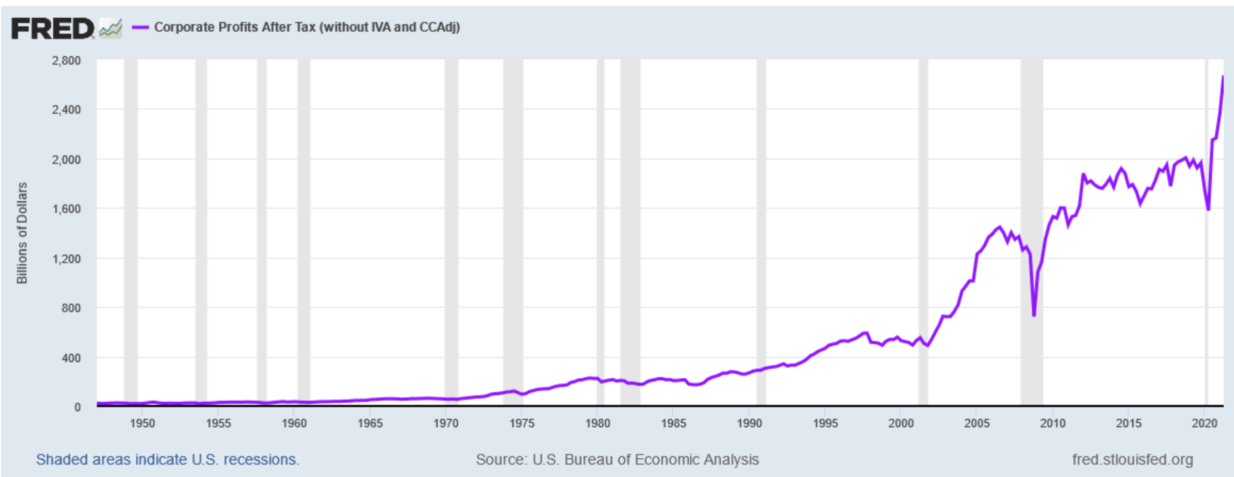
In 2018, Mortgage Rates ranged from 4.00% to 5.00%. In 2011, Mortgage Rates stood between 4.50% and 5.00%. And in 2008, Mortgage Rates averaged 6.00%. Today, Mortgage Rates stand at less than 3.00%. The Federal Reserve announce that it will begin "Tapering" this fall. In other words, it will stop buying mortgage bonds over the next 9 months bit by bit. At a minimum, this will leave more supply for the public markets to absorb, likely leading mortgage rates to drift upward. A 1% drop in mortgage rates enables a buyer to pay 13%+ more for the same home. A 1% rise in mortgage rates creates the opposite effect. If a rise in Mortgage Rates occurs at the same time as Foreclosures come to market and Housing

Green Drake™ Advisors, LLC
175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

www.greendrakeadvisors.com

Completions continue to rise, the Housing Market could see a significant slowdown in H2 2022 and 2023. This would represent the classic transition from Early Cycle to Mid Cycle that usually occurs in Year 2 and/or Year 3 of a recovery.

Corporate Capital Spending should offset this slowdown. Corporate Profits continue to rise at a rapid pace. And when Corporations earn more money, they spend more money. Corporate Profits exploded upward as corporations leveraged technology to drive productivity and they benefitted from the typical early cycle surge that occurs:



In fact, After-Tax Corporate Profits stand 35% above their 2019 level. This contrasts with Corporate Capital Spending which barely exceeds its pre-Recession level:

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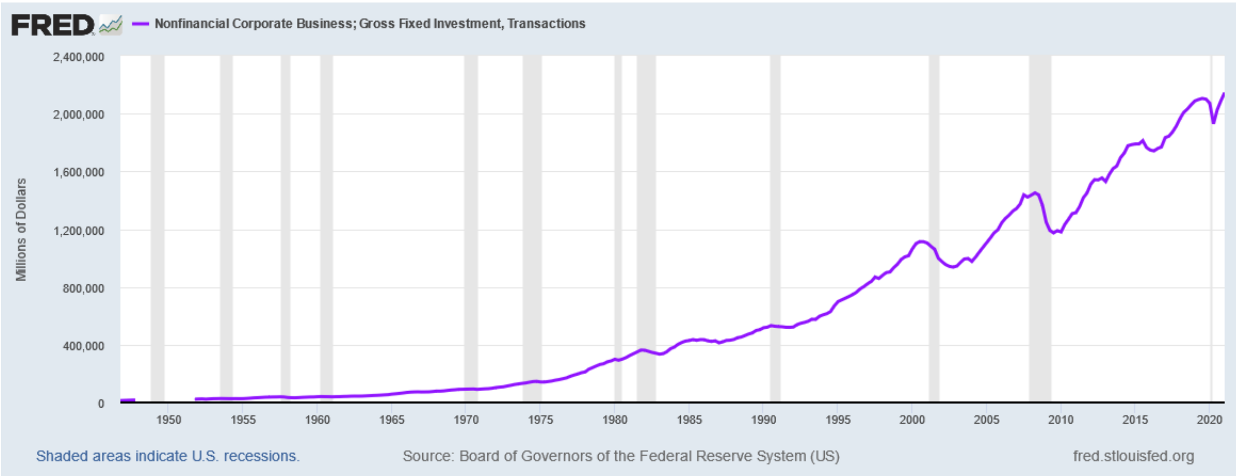

Should Corporate Capital Spending match the percentage rise in Corporate Profits, this would add over $700 billion in spending or over 3% to GDP. This alone should more than offset the slowdown in Housing. And should Infrastructure accelerate, much needed Investment would drive growth.

The US economy stands on the cusp, ready to make the transition from Early Cycle to Mid Cycle growth. Areas that typically lead the economy out of Recession, such as Housing and Autos, stand at or above trend, after strong recoveries. Lagging areas, such as Corporate Capital Spending, continue to pick up steam. Government spending on Infrastructure stands ready to accelerate. And other areas that continue to drag on the economy should bottom, adding to economic growth. With numerous levers set to offset slowing areas, growth should continue at a rapid pace enabling the United States to Continue The New Climb.

Decarbonization Really?, Out and About, and The Nanobots Are Coming!

Finally, we close with brief comments on Decarbonization Really?, Out and About, and The Nanobots Are Coming! First, China announced that it plans to become carbon neutral by 2060, that does not mean the country will decarbonize any time soon. In fact, China's provinces are planning to put in place over 100 GW of coal fired power over the next few years. With actions speaking louder than words, it appears the appropriate view is: Decarbonization Really? Second, eating out came roaring back in 2021. Consumers are expected to spend over 90% of what they spent in 2019 on restaurants this year. This represents over 20% growth. The industry expects to exceed its 2019 levels in 2022. Given this, we see the Consumer Out and About. And Third, nanobot technology use continues to explode. Already a $120+ billion industry in 2020, outside projections put industry growth at 25%+ for the next 5 years.

Green Drake™ Advisors, LLC
175 Strafford Avenue, Suite One
Wayne, PA 19087
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These nanoparticles possess large applications in medicine and biomedical engineering. For example, scientists at Cornell University invented nanoparticles called Smart Dust that can operate in the blood stream and assemble to form a collective function. The Smart Dust can be programmed to locate, remove, and destroy cancer cells, for instance. The Israeli company Nanomedic created a breathable skin that can be applied to treat burns and wounds. It has proven highly effective for facial wounds and for foot ulcers for diabetics. With 10+ mighty nano-products being introduced every week, for the world it is: The Nanobots Are Coming!

In Closing

Should you have any questions on how the above issues or the items discussed in our accompanying cover letter impact your family's financial position or your business's future as well as the potential actions you could take in response, please do not hesitate to contact us. We welcome the opportunity to discuss this with you.

Yours Truly,

Paul L. Sloate
Chief Executive Officer
& Senior Advisor