SEQUELS & SEAT BELTS

JUNE 30, 2021

DEAR FELLOW PARTNERS & FRIENDS,

It is no great revelation that today's market environment bears a strong resemblance to the late 1990s. There are important differences between the two periods, as I have previously written, but things are now getting quite silly. An IPO bubble, SPACs, meme stocks and perhaps Dow 36,000 too? Is there no originality in what folks will do? I thought this lack of imagination was confined to Hollywood with their endless sequels and remakes but, alas no. The same applies to investor psychology.

In both eras, the definition of risk was greatly twisted by novel theories such as that espoused by the authors of the book *Dow 36,000*, published in 1999. Risk back then was thought of as "losing out" rather than just "losing." Consequently, the premise of *Dow 36,000* was easy for the average investor to accept, especially when everyone else was doing the same. The basic idea was that stocks are essentially risk-free when measured over a long enough period. After all, stocks had virtually gone straight up for more than two decades, starting in the late 1970s, with the only major hiccup being the 1987 stock market crash. With the certainty of past performance behind them, retail investors dominated the action and sensible people were kicked out of the theatre. No one wanted to hear a contrary opinion or a voice of caution. On the one hand, I cannot believe it has been over 20 years. On the other hand, I wish it would have just stayed there. I do not care for sequels; they are never as good as the original.

The past quarter, in relative terms, was thankfully not too exciting. Even my father asked if something was wrong with the pricing of the Centerstone Funds as the Centerstone Investors Fund (CENTX) had remained nearly unchanged for an entire week. While global equity markets generated a positive return, they did so without a lot of drama. Sometimes, though, the surface calm hides cautionary signals below the surface, even while equities have been enjoying their time in the sun. We are seeing some cautionary signals arise, primarily related to market expectations. Normally I would not concern myself with the market's expectations, but bottom-up factors are leading our cash reserves higher and the coincidence is worth exploring.

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Caution Signs

While investors seem aware of the inflation pressures in the economy, many may be unaware of the early indication of a deteriorating backdrop for growth and profitability. No one knows if there is a major shock ahead. The risk in these scenarios is that expectations are potentially too far from reality. How potentially serious is the risk? It is like traveling in a commercial jet at 30,000 feet on a clear cloudless day. It is tempting to unbuckle your seat belt, but anyone who has flown through clear-air turbulence knows that it can strike at any time and with little warning. It can be surprising and uncomfortable but rarely dangerous. That is the kind of risk I am referring to.

The caution signs fall into a few related areas—inflation pressures, supply chain shocks and rebalancing of spending from goods to services. It is probably obvious that widespread shortages are driving prices to spike for anything that is a hard good. Part of the explanation is that the global economy is built on an intricate and interlocked chain of inventory supplies that work on a "just-in-time" system. In this system, inventory is the "hot potato" no one wants to hold because it requires space and is a drag on cash flow. Goods are manufactured as close in time as possible to the order. The system has worked almost flawlessly since it was widely adopted decades ago but those efficiencies depend on the predictability of orders.

Many economies these days are stop-and-start based on local COVID infections, not an optimal environment for a "just-in-time" supply chain. On top of this, western economies are diversifying their supply chains away from an almost singular reliance on China and now there are capacity problems with the semiconductor industry. When we combine the stop-and-start nature of post-COVID economies with these other factors, we simply overwhelm the capabilities of the modern inventory and logistics systems.

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Transitory?

There are reasons to agree with the Federal Reserve's assumption that higher inflation rates will be transitory. I liken it to the weather. The ingredients for a major thunderstorm are sufficient moisture and instability of airflow. Whenever those two conditions are met, the odds increase for a storm. However, without also having a lifting force such as a cold front or mountainous terrain, the result is rarely severe. In other words, a severe storm is dependent on a force to catalyze the ingredients. Inflation is similar.

In the 1970s, the US had many ingredients in place: high government borrowing (due to the Vietnam War and New Deal entitlements), a rigid labor pool and supply-demand imbalances as the Baby Boomers cohort, which is concentrated in its age distribution, grew into the age of family formation and home buying. The ingredients were there, the "pipeline" to transmit inflation existed. The catalyst was the oil shock at a time when the US was highly dependent on oil imports to grow its nominally fast-growing economy. This time around, many of the ingredients exist such as supply-demand imbalances and a tight labor pool but the "pipeline" is not as robust. Mainly, the labor pool is highly fragmented and the cost of automation is equivalent to human labor in many cases. Furthermore, outside of the COVID-led supply shortages, the world's problem long-term is capacity utilization rather than capacity itself. Global manufacturing capacity is well in excess of what is required as for decades the global economy, outside of the US, has resorted to export models to fund development. With the US as the world's major net importer, almost every other export country has built more capacity than is required for domestic use.

The normalization of activity is undoubtedly causing all kinds of crosswinds in the short-term. For instance, the global auto industry has reduced production by an amount equivalent to a serious recession due to a microchip shortage. Now the US is not the only net importer of this basic good. This affects every company in the chain of production and has the side effect of increasing the prices of used cars and creates employment volatility. People also are less likely to trade in their cars which increases the demand and price for maintenance and repair. The same dynamic holds for housing and other goods. The situation should abate as trade patterns return to normal and prices for electronic goods should resume to their long trend of declining prices.

As the economy opens-up, the assumption is that pressure on prices will soften. As prices spike, we have already seen people delay or defer their spending on goods. Therefore, it seems likely consumer spending will shift to a more normal mix of goods versus services and that price pressures on goods will abate. However, the demand for services may not recover as quickly as needed due to a similar dynamic playing out in the services industry. In this case, the culprit is not inventory but rather labor supply. As of this writing, continuing unemployment claims are still double the level of a normal environment. We will see what happens when/if the COVID-relief benefits drop later in the year. My early guess is that this environment will last through at least the beginning of next year. This would mean that inflation remains elevated but also that the economy begins to soften soon. The latter piece is what is missing from market expectations and together it is not an especially welcoming weather pattern. I do not think it is worth looking much further ahead because we all know in that scenario, Congress will feel the need to "do something." But it does introduce the possibility of some clear-air turbulence as the summer arrives. It may be prudent to make sure your seat belt is fastened and secure.

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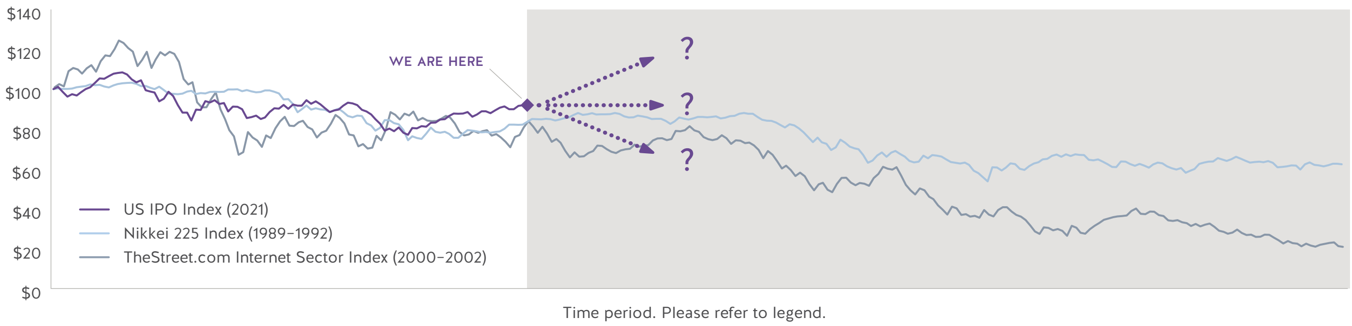
Buckle-Up

Among the other interesting items of note, is the pattern being established by some of last year's momentum stocks, captured by an index of recent US IPOs. I mentioned in last quarter's commentary, *Value Investing Canceled?*, the pattern one would expect to see in a longer-term liquidation scenario for these stocks. And indeed, the pattern has been holding. If it continues, one would expect to see waves of buying and selling until the crescendo stage where the bear "raids" begin. Japanese stocks followed a similar pattern after peaking in 1989, trending down for the next 15 years, as did US stocks after the peak of the dot-

ANOTHER SEQUEL?



Past performance is no guarantee of future results. Investors cannot invest in an index.
Source: Bloomberg, Centerstone Analysis; Note: Values indexed to 100

com bubble. There is a great temptation to "bottom fish" after these periodic declines, especially in brand name stocks like Tesla, but I would caution against doing so unless it is with play money. In this situation, the risk is not uncomfortable turbulence but rather a bird striking the engine. A completely different risk category.

While all this is playing out, the Centerstone portfolio has had three material transactions which combined amounted to nearly 10% of each Fund. We also pared back some holdings as their share prices reached intrinsic values. As a result, the Centerstone Investors Fund (CENTX) has a more typical balance of equities, cash and gold while the Centerstone International Fund (CINTX) remains fully invested. As previously noted, Kerry Logistics[1] was taken out at a significant premium earlier this year. Additionally, FirstGroup[2] finalized the sale of its core US school business this quarter, resulting in several billion pounds of value, some of which will be distributed to shareholders via dividend later in the year. Lastly, Grupo Televisa[3] announced the sale of its content segment to Univision. Our research process has yielded several replacement candidates for these investments. However, I am mindful that this level of M&A typically implies we are late-cycle. With consideration to the cycle position and the concerns raised above, we are deploying cash at a prudent and thoughtful pace.

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Although we do see some potential for short-term challenges which is a change from the "blue sky" scenario we have been writing about for the past year, we believe the long-term prospects for our style of investing have only been enhanced in the past year. Investors in the Funds should expect us to react to any upcoming challenges as we have in the past. I am optimistic that our strategy will continue to reward the patient.

Thank you for your support and interest. We hope you have a safe and healthy summer.

Sincerely,

Abhay Deshpande, CFA
CHIEF INVESTMENT OFFICER

1 Post-takeout 0.85% position in the Centerstone Investors Fund and 0.93% position in the Centerstone International Fund as of March 31, 2021. Pre-takeout 3.17% position in Centerstone Investors Fund and 3.55% position in the Centerstone International Fund as of December 31, 2020

2 4.27% position (including Coast Capital Mercury Fund) in the Centerstone Investors Fund and 6.61% position in the Centerstone International Fund as of March 31, 2021

3 0.23% position in the Centerstone Investors Fund as of March 31, 2021

Important Risk Information and Disclosure:

TheStreet.com Internet Sector Index was known as the DOT Index, which investors used to track the performance of Internet sector stocks.

The Nikkei 225 Index is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange.

The US IPO Index (The Renaissance IPO Index) reflects approximately the top 80% of newly public companies based on full market capitalization, is weighted by free float capitalization and imposes a 10% cap on large constituents.

The commentary represents the opinion of Centerstone Investors as of June 2021 and is subject to change based on market and other conditions. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Any statistics contained here have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security.

An investment in the Funds entails risk including possible loss of principal. There can be no assurance that the Funds will achieve their investment objective.

Past performance is no guarantee of future results.

The value of the Funds portfolio holdings may fluctuate in response to events specific to the companies or markets in which the Funds invest, as well as economic, political, or social events in the United States or abroad. The impact of the coronavirus (COVID-19), and other epidemics and pandemics that may arise in the future, could affect the economies of many nations, individual companies and the market in general in ways that cannot necessarily be foreseen at the present time.

Value investing involves buying stocks that are out of favor and/or undervalued in comparison to their peers or their prospects for growth. Our value strategy may not meet its investment objective and you could lose money by investing in the Centerstone Funds. Value investing involves the risk that such securities may not reach their expected market value, causing the Funds to underperform other equity funds that use different investing styles.

Investments in foreign securities could subject the Funds to greater risks including, currency fluctuation, economic conditions, and different governmental and accounting standards. Foreign common stocks and currency strategies will subject the Funds to currency trading risks that include market risk, credit risk and country risk. There can be no assurance that the Funds' hedging strategy will reduce risk or that hedging transactions will be either available or cost effective. The Funds use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments.

Domestic economic growth and market conditions, interest rate levels, and political events are among the factors affecting the securities markets in which the Funds invest.

Large-cap company risk is the risk that established companies may be unable to respond quickly to new competitive challenges such as changes in consumer tastes or innovative smaller competitors. Investments in lesser-known, small and medium capitalization companies may be more vulnerable than larger, more established organizations. Securities in small and mid-cap companies may be more volatile and less liquid than the securities of companies with larger market capitalizations.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Centerstone Funds. This and other important information about the Funds are contained in the prospectus, which can be obtained by calling 877.314.9006. The prospectus should be read carefully before investing. For further information about the Centerstone Funds, please call 877.314.9006. The Centerstone Funds are distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC. Centerstone Investors, LLC is not affiliated with Northern Lights Distributors, LLC.

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