Market Review & Outlook

October 2021

After a mostly steady climb since March 2020 when the pandemic began, stocks hit a patch of weakness near the end of the quarter as all the major indices suffered losses in the month of September and were flat to slightly down for the 3rd quarter. This was not entirely unexpected as the September-October timeframe has historically been a challenging seasonal time for markets. Not only that, but growth in the US slowed during the quarter as inflation continues to surprise to the upside and will continue to be a key macroeconomic issue for the foreseeable future, regardless of the Fed's statements that the price increases we are witnessing across a wide range of goods and services are "transitory". Until this recent spate of weakness, stock volatility had been subdued for much of the year, and there had not even been a 5% correction since October 2020. For a closer look at how various asset classes performed in recent periods, please refer to the table.

Index	Sept 2021	3rd Qtr. Perfomance	1 Year Performance	Description (what the index is comprised of)
S&P 500	-4.65%	0.58%	30.00%	Large cap US stocks
DJ Industrial Average	-4.20%	-1.46%	24.15%	Large cap US stocks
NASDAQ Composite	-5.27%	-0.23%	30.26%	Large & mid-cap US tech stocks
Russell 1000 Growth	-5.60%	1.16%	27.32%	Large cap US growth stocks
Russell 1000 Value	-3.48%	-0.78%	35.01%	Large cap US value stocks
Russell 2000 Growth	-3.83%	-5.65%	33.27%	Small cap US growth stocks
Russell 2000 Value	-2.00%	-2.98%	63.92%	Small cap US value stocks
MSCI EAFE	-2.90%	-0.45%	25.73%	Foreign developed stocks
MSCI EM	-3.97%	-8.09%	18.20%	Emerging markets stocks
Credit Suisse High Yield	0.53%	1.92%	10.25%	US High Yield Bonds
Bloomberg Barclays US Aggregate Bond Index	-0.87%	0.05%	-0.90%	Primarily U.S. Government Bonds

September was the worst month for the market since March 2020, but the decline has been mild compared to the crash we experienced then. At the end of the quarter, all the major US indices sat between 5-7% off their all-time highs. Volatility picked up during the last week of the quarter as interest rates rose sharply and markets experienced some jitters as Congress squabbled over raising the debt ceiling, something that needs to be resolved by October 18 to avoid a default. The last time Congress fought over the debt ceiling back in 2011, stocks tumbled nearly 20%. Most likely, the politicians will come to an agreement that avoids serious economic and market consequences, but it is a risk, and as the quarter ended, nearly a quarter of Nasdaq 100 stocks were trading 20% or more off their highs.

Fed officials have finally admitted that the reversal in inflation is going to take longer than previously thought, perhaps a lot longer. The central bank recently raised its estimate of average inflation this year to 4.2% from 3.4% using its preferred inflation gauge, the personal consumption expenditure index (PCE). It was just 10 months ago that the Fed was expecting inflation to average 1.8% this year. A more widely known inflation measure, the consumer price index, shows inflation trending at an even higher 5.3% annual pace. It is likely that the true inflation number is even higher, as these inflation barometers do not accurately reflect the basket of goods and services the average person is consuming.

Few are forecasting a 1970s style bout of inflation, but the risk of higher, more persistent inflation is rising, and the International Monetary Fund just trimmed its global GDP forecast for 2021, citing inflation as one of the key risks to growth. Inflation can also be a big risk for investors, as it can meaningfully put a damper on returns. As an example, the nominal yield on the 30-year Treasury Bond currently sits at about 2.1%. However, if inflation is 5.1% or 6.1%, then the real yield is -3% or -4%, so this can become a big concern for bond investors, who already face the challenge of yields being historically low. As we have mentioned in past missives, the Fed is attributing the inflation spike to supply chain bottlenecks caused by the pandemic, as well has elevated demand driven by stimulus. One could also note the amount of money printing the Fed has engaged in since the spring of last year, but that inflation driver is rarely mentioned in the financial press.

If the Fed does its job, it will be forced to combat inflation should it persist at these higher levels, and it really only has one tool to fight inflation, which is raising interest rates. Back at the beginning of the 1980s, the Federal Reserve led by Paul Volcker was widely credited with curbing the rate of inflation as well as expectations that inflation would persist. Volcker achieved this by raising short-term interest rates to levels that would seem unthinkable now. Nominated by

President Jimmy Carter to lead the Fed in 1979, Volcker had raised the federal funds rate to a peak of 20% by June 1981. US inflation, which peaked at 14.8% in March 1980, fell below 3% by 1983. Curtailing inflation was not without costs though, as the high interest rates led to a double-dip recession during the 1980-82 period. Nonetheless, these policies set the stage for a strong economic expansion that lasted into the next decade.

Contrast that with the current situation, as monetary policy is still extremely accommodative. The Federal Funds Rate currently sits at 0% (officially it's 0%-0.25%), and the Fed has pledged not to raise rates until the end of next year, or maybe even not until 2023. The Fed has been purchasing $120 billion/month of treasuries and mortgage bonds in the open market as another way to suppress rates and stimulate economic activity. At a speech in August, Fed Chair Jerome Powell said it "could be appropriate to start reducing the pace of asset purchases this year." Powell stated that the economy has met the "substantial further progress" conditions, prompting the Fed to evaluate a taper. In a following press conference, he added that the tapering would likely conclude by the middle of 2022. While possible, this tapering schedule seems overly optimistic compared to how long it took the Fed to taper asset purchases following the Great Financial Crisis. With government, corporate and personal debt levels at record levels, the Fed must be mindful of interest rates drifting too high, as this could seriously impair the ability of the government and other debt holders to service their debt. At the same time, any possible reticence to raise rates seems at odds with the Fed's mandate of price stability if inflation continues to be a problem.

Because of the unusual nature of everything that has happened since early 2020, determining where we are in the business cycle is even more challenging than usual, given that some data points suggest we are early in the cycle while others are more indicative of late cycle dynamics. For the most part, corporations have been resilient through the pandemic, and EBITDA (earnings before interest, tax, depreciation, and amortization) rose 30% during the recovery. Free cash flow grew 12.4% during that time and EBITDA margins improved to 20% from 17%. On the other hand, labor costs are on the rise, and leverage on corporate balance sheets is at or near all-time highs depending on the exact data point in question. Spreads between corporate and treasury bonds are historically narrow as well, a sign that corporate bonds are priced for perfection and generally a late cycle indicator.

While Congress is still negotiating an infrastructure bill, the final bill could be much smaller than initially proposed and regardless of the outcome, peak fiscal and monetary stimulus is undoubtedly behind us, which will be another drag on growth prospects. GDP growth has been 6%+ for two consecutive quarters and while expectations for 3rd quarter GDP growth were in a similar range a month ago, forecasts have been coming down. The Atlanta Fed's GDPNow tracker now estimates that 3rd quarter GDP growth will come in at just 1.3% as of Oct. 5, down from 2.3% just four days earlier. Private forecasts are generally higher in the 3-7% range.

We would be remiss not to mention extreme market valuations, valuations that rival anything in stock market history. The meteoric rise of speculative investments like NFTs (non-fungible tokens), meme stocks, and cryptocurrencies like Bitcoin suggest an abundance of optimism and a lack of discipline on the part of many market participants, all hallmarks of a market cycle in its very late stages. Of course, various pundits have warned about valuations for years as the market has advanced ever higher, fueled by loose monetary policy and non-stop flows into index funds. These same pundits are quick to point out that high valuations don't mean that stocks must necessarily decline, but if market psychology changes, stocks could experience a meaningful sell-off.

What could change market psychology? Investors got a slight taste a couple weeks ago as the Chinese property developer Evergrande missed some payments on its debt and is scram-bling to sell assets to pay creditors. Once China's top-selling developer, the company is facing one of largest debt restruc-turings in Chinese history as it struggles with more than $300 billion in liabilities. There have been concerns that a default on this debt could be a "Lehman moment" for China, refer-ring to the Lehman Brothers' 2008 bankruptcy that was one of the key events during the Great Financial Crisis. It's pos-sible an Evergrande default there could lead to contagion in global inancial markets, but that has not happened yet.

However, this is a reminder that all investors should be comfortable with the positioning in their portfolios because we never know when an unforeseen event might lead to volatility and declines in stocks. We encourage everybody to review their portfolios and to please contact us if you need assistance with this process.

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