Market Commentary

Third Quarter 2021

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Financial markets faced a wave of cross currents during the third quarter. A combination of higher inflation, increases in COVID-19 infections, and the looming announcement of Federal Reserve tapering kept investors on edge during the past three months. Exacerbating the jittery markets toward quarter end was the risk of an approaching debt ceiling limit and possible government shutdown. Despite the heightened risk factors and the late September sell-off, US equity markets as measured by the benchmark S&P 500 rose a modest 0.6% during the recent three-month period. This brought the benchmark's total return for the 9-month period to 15.9%. While investors tend to always focus on the immediate past, we look at an S&P 500 that has registered 51 record high closes thus far in 2021, has risen an astounding 97.3% on a total return basis from the March 2020 lows, and is a mere 5% below its all-time high reached on September 2nd this year. Pessimists point to the recent 5% decline while optimists (and investors who understand market volatility) will look fondly on the near doubling in the benchmark over the past 18 months along with six consecutive quarters of positive returns. Perspective is critical during times of volatility to prevent getting whipsawed by the markets.

Fixed income yields moved lower during the first half of the three-month period on fears of a slowing economy, only to rebound during the latter half of the period as the Fed made it clear they were getting close to slowing their bond buying program. The Fed has been telegraphing that it would taper its $120 billion in monthly bond purchases beginning as soon as November and may look to begin raising short-term interest rates in 2022. While this has been our forecast for many months, we still believe the Fed risks waiting too long and allowing inflation to remain higher than current forecasts. The 10-year note ended the quarter at 1.52%, slightly higher than the 1.44% yield on June 30 but meaningfully higher than the 0.92% yield on December 31. As we have written for the past few commentaries, the Fed is leaning hard on the yield curve with its prodigious monthly purchases. Absent Fed purchases, we believe rates will drift higher along the entire yield curve, although the extent of the increases will depend on the rate of economic growth and inflation over the coming quarters. We have long believed if interest rates are rising due to strong economic growth that is a positive. However, if rates are rising solely because inflation expectations are increasing, that is a negative for equities.

Oil prices declined for most of the first two months of the quarter on fears of demand declines due to COVID increases before snapping back over the last six weeks. The price for benchmark West Texas Intermediate began the quarter at $73.47 and declined to $62 by late August before rebounding. Oil prices ended the quarter at $75.03, up a modest 2%. We continue to watch US production declines along with OPEC production changes to determine the supply/demand balance for oil. After producing 13.1 million barrels per day as recently as February 2020, US production has declined to an estimated 10.6 million barrels per day in September 2021. This is one of the factors driving oil prices higher. With prices significantly higher than a year earlier, we would expect more US production, but this has been hindered by permitting and other barriers from the current administration. If oil prices were to rise meaningfully from current levels it could present another headwind for economic growth.

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Economic and Market Outlook

The past three months have seen significant changes in investor sentiment along with modest changes in our economic outlook. Although little has changed in our forecasts, we recognize a noticeable increase in wariness among investors. Inflation expectations are modestly higher than they were three months ago. Corporate earnings estimates have also risen along with expectations of continued economic growth through 2022. There are several concerns to counter the positive economic forecast, although we posit that none of these are new or should be considered surprising. Congress continues to bumble and stumble with budgeting, the infrastructure packages, debt ceiling limits and a litany of other issues. On the last day of the quarter, Congress narrowly avoided a government shutdown by agreeing to fund the government into early December. These short-term maneuvers do nothing to assuage investor concerns about our malfunctioning government. We may be cynical but looking back at history, we have had 21 government shutdowns, and none have brought any long-lasting economic effects. The two parties posture and preen for cameras while accomplishing nothing. Most investors are astute enough to realize the shutdowns will end eventually, funding will be provided, and the effects quickly forgotten. It is not optimal way to govern, but it is yet another factor we consider when formulating our outlook. As stated earlier, interest rates appear to be headed higher as investors worry about the Fed ending its bond buying program, even though it was started as an emergency measure at the depths of the COVID downturn. With the economy showing a 40-year high in growth during 2021, the economic crisis is long past, and the emergency measures should rightly expire.

We believe we have likely seen the highest inflation readings during this cycle over recent months, although inflation will remain meaningfully above the Fed's 2% target for some time as supply chain disruptions, a lack of skilled workers, and commodity price increases flow through corporate income statements. The Fed seems more focused on the employment side of its dual mandate, choosing to allow inflation to run higher than their target range for the intermediate term. The risk is they delay fighting inflationary pressures for too long allowing inflation to become structurally imbedded in the economy.

Current estimates for US GDP growth in 2021 approximate 6% which is slightly below the 6.6% estimate three months prior. Next year should see growth above 3% which is well above the average for the past decade. A strong economy tends to produce strong corporate earnings, although there are some headwinds that companies face over the next 18 months. The higher inflation readings we discussed are flowing through income statements and could lead to margin pressure. Many companies have announced their plans to pass through cost increases to consumers which alleviates some of this concern. We are also watching the budget plans working through Congress along with proposed changes in corporate tax rates. An increase from the current 21% rate to the discussed 26.5% rate will haircut corporate earnings, although until the final plan is released it is difficult to determine the exact effect. Earnings estimates for the S&P 500 continue to move higher despite concerns about the Delta variant and its potential effect on economic growth. In the past three months, 2021 S&P 500 earnings estimates have moved to $200, higher by about $5, with an expected increase of 10% in 2022. The main variable in determining where the market will be 12-18 months hence is the multiple that investors are willing to pay on those earnings, particularly in a rising interest rate environment. While interest rates have moved modestly higher over the past several weeks, fixed income yields remain near the decades low levels we have witnessed for the past two years, leaving few alternatives for investors to garner returns that surpass expected inflation levels to maintain or increase their purchasing power. A "safe" return of 1% is little benefit if prices are rising by 3 or 4% annually. Stocks continue to serve as an inflation hedge with current yields above that of Treasury bonds with dividend increases expected to rise 10% or more annually over the next two years.

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Portfolio Positioning
As we have for most of the past year, we continue to maintain client portfolios near their stated asset allocation guidelines. This has required a modest trimming of those equities that have gained the most with proceeds reinvested in fixed income. While some question the logic of holding fixed income in a low interest rate environment, we remind everyone of the purpose of these holdings. They are ballast in portfolios to prevent large market declines from causing severe damage to portfolios. In a recent meeting with a client, we likened fixed income to life insurance. We cannot think of a single person who pays their life insurance premiums being frustrated that they didn't get to use that insurance! Fixed income stabilized client portfolios during the 34% equity market collapse in the winter of 2020 and will continue to ameliorate large market swings.

We believe equities can move higher during the next 12 to 18 months, although risk and volatility have increased over the past few months. We see no signs of an impending bear market, provided earnings continue to increase. Pullbacks are to be expected and we note the near doubling of the S&P 500 over the past 18 months has occurred without a single pullback of 10% or more. It is rare to see a market rise of this magnitude without a hiccup or two along the way and this time is no different. Pullbacks (as opposed to bear markets) are times to reexamine what one owns and look to pick up assets on the cheap, selling those that held up better during the downturn.

Conclusion
As we enter the final quarter of 2021, we look to the future with hope. While not minimizing the human toll COVID has inflicted, it is becoming more evident the pandemic has morphed from an economic problem to a healthcare issue. Continued increases in vaccination rates will help reduce future cases and widespread outbreaks. As people resume more normal lives, employment should continue to increase, productivity will lead to wage growth and the economy will benefit. The past 18 months have been difficult for many, and to say we are back to normal means different things to different people. Through the entirety of the pandemic, we have counseled clients to stick to their individual asset allocation and remove emotion from investment decisions. In closing, we hope you and your families remain healthy as you look forward to the approaching holiday season. Please contact us if you have any comments or questions about your investments.

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