Q3 2021
Investment Perspectives

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- **SEPTEMBER SWOON:** After hitting another all-time high earlier in the month, the S&P 500's run of strong performance fizzled during the latter half of September. Investors began to question whether growth would be constrained due to higher input costs and a fickle labor market, breaking a streak of seven consecutive monthly gains.
- **POLICY LIMBO:** Democrats in DC continued to negotiate various components of their infrastructure and budget reconciliation bills. As the progressive and moderate wings of the party attempted to find common ground over new spending measures and higher taxes, urgency also grew to address the looming US debt ceiling.
- **TAPER TIME:** Feeling content that the economic recovery had reached exit velocity and that the labor market was on the path to full employment, Fed officials telegraphed intentions to begin tapering their quantitative easing program toward the end of the year. Some Fed members also expressed concerns that rate hikes may be necessary sooner than expected as inflation continued to run at stubbornly high levels.

Market Recap

Global markets saw mixed returns in Q3 as investors grappled with a variety of potential setbacks to the economic recovery. In the US, inflation accelerated to the upside as supply chain concerns stoked fears of rapidly rising prices. The specter of higher corporate taxes also caused unease, but dissent among the Democratic ranks left the legislative outcome far from certain. Abroad, Chinese authorities continued their crackdown on large tech companies and social media platforms while a leading real estate developer teetered on the brink of insolvency. Around the world, the delta variant of the COVID virus raised fears that social distancing measures could be reimposed and hamper economic activity.

US large cap stocks regained their leadership position in Q3 as the S&P 500 advanced a modest 0.6% in the quarter. The return helped extend the index's year-to-date advance to nearly 16%. Since rocketing higher in Q4 2020 and Q1 2021, small cap stocks have essentially marked time in recent months. The more economically sensitive Russell 2000 Index traded down modestly in

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FIXED INCOME

Index	USD Total Return (%) Q3	YTD
Barclays 1-10 Yr Muni	0.0%	0.4%
Barclays US Agg. Bond	0.1%	-1.6%
BofA/ML HY Master II	0.9%	4.7%

EQUITIES

Index	USD Total Return (%) Q3	YTD
Russell 3000	-0.1%	15.0%
S&P 500	0.6%	15.9%
Russell 2000	-4.4%	12.4%
MSCI All Country World	-1.1%	11.1%
MSCI EAFE	-0.4%	8.3%
MSCI Emerging Mkts	-8.1%	-1.2%

Source: Bloomberg (Data as of 9/30/2021)

Q3 and has failed to notch a new all-time high since March. In keeping with the theme of investors gravitating toward the relative safety of large caps versus small caps in the period, growth stocks bested more cyclically oriented value stocks in Q3 and nearly closed the YTD performance gap.

Non-US equity markets saw substantial performance dispersion during the quarter as developed market equities outperformed their emerging markets brethren by nearly 8%. Markets like Japan and the UK posted modest gains as vaccine rollouts helped their economic reopening efforts gain steam, whereas emerging markets such as China and Brazil suffered steep declines. China's outsized weighting in the MSCI Emerging Markets Index dragged the benchmark's YTD returns into negative territory, making it the only major equity index that failed to notch a gain over the first nine months of 2021.

After dropping nearly 0.3% at the beginning of the quarter, the 10-year Treasury rate finished Q3 little changed at roughly 1.5%. Risk-free rates showed few signs of concerns despite elevated inflation readings and the Fed suggesting that they would begin paring back their asset purchase program toward the end of the year. The Bloomberg Barclays Aggregate Bond Index stumbled into quarter-end but still finished in the black for Q3. The modest advance helped pare the index's YTD losses, but it remains underwater in 2021 and over the past 12 months.

The BofA/ML High Yield Index extended its year-to-date rally in Q3, bringing YTD gains to nearly 5%. Investors continued to flock to credit markets in search of higher yielding assets, underpinned by a belief that the economic recovery will remain on track and keep defaults muted. As evidence of investors' conviction in the junk bond recovery, the lowest rungs of the credit quality spectrum (CCC and lower) have advanced nearly 30% in 2021 and roughly 73% over the last year.

CHINA'S CRACKDOWN

News of China's ongoing efforts to exert control over a variety of key sectors—including technology, e-commerce, and social media—and the potential failure of a key real estate developer caused significant consternation among investors during the quarter. Chinese investors swiftly shifted to a "risk off" mode and unwound all of the MSCI China Index's gains over the prior year. While the headlines were new and the market correction was steep, China's broader regulatory headwinds may have been brewing beneath the surface for a few years. As an example, the chart below shows the annual growth rate of so-called "shadow banking", or lending that occurs outside of the traditional financial system in China. After allowing a massive amount of leverage to accumulate in the early 2010s, Chinese authorities began to clamp down on borrowing after 2018. What began as an attempt to rein in financial excesses has now expanded into a broader reassertion of the Communist Party's power over the country's corporate sector.

Source: Bloomberg (Data as of 9/30/2021)

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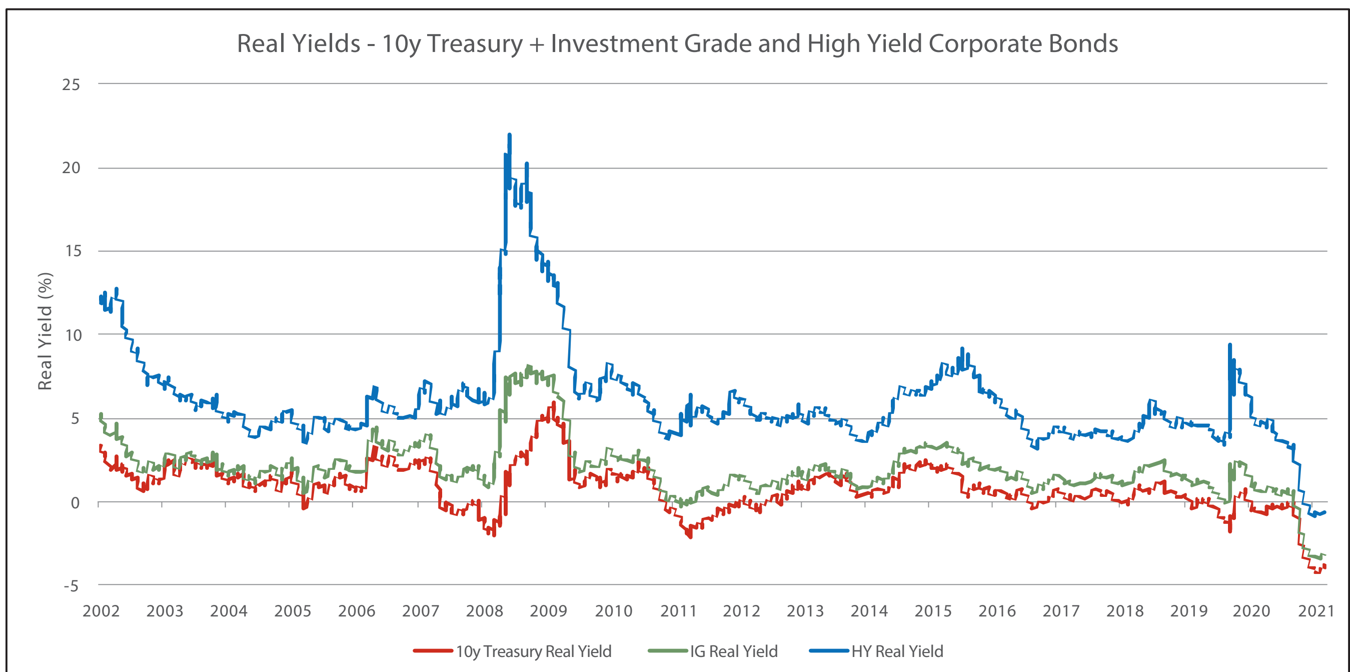
What the Chinese government does from here remains to be seen. One school of thought is that the government cannot risk societal unrest resulting from sluggish growth and rising unemployment. That would raise the odds of liquidity injections and/or a broader stimulus effort to combat deteriorating economic conditions—a scenario that could underpin a market rally. Alternatively, the recent actions may mark a paradigm shift for the country under President Xi Jinping, representing a pivot from the "growth at all costs" approach in prior years. The direct effects on Chinese markets would be profound, and the derivative effects on other emerging markets, commodity prices, and the broader global economy could be material.

LET'S GET REAL

With short-term rates stuck at ultra-low levels thanks to the Fed's extremely accommodative policy settings, investors have continued to push portfolios out the risk spectrum in an effort to generate more yield. As evidence of this move into lower quality issues, consider that credit spreads—the incremental yield that investors receive relative to a risk-free asset—for investment grade and high yield corporate bonds recently hit their lowest levels in decades. With consumer prices accelerating to the upside as rates moved lower, "real yields", or the yield after subtracting inflation (CPI), have plunged into negative territory. The chart below shows this move lower for the 10-year Treasury (red), investment grade corporate bonds (green), and high yield corporate bonds (blue). The high yield market recently joined the others in negative territory, and each of these measures are at their lowest levels in 20 years—by a substantial margin.



Source: Bloomberg (Data as of 9/30/2021)

The effects of inflation can be insidious; it is not explicitly debited from an investor's interest payments and aggregate measures of inflation often fail to capture investors' individual experiences. For that reason, it is possible that this dynamic will persist for an extended period. Eventually, financial markets orthodoxy would suggest that investors will command higher real yields to offset the erosion of their purchasing power. Either the Fed will be correct in their view that elevated levels of inflation will ultimately revert to longer-term trends, or yields will have to reset higher to sufficiently compensate investors. The latter scenario can be a messy process as bondholders may see negative price returns resulting from higher yields.

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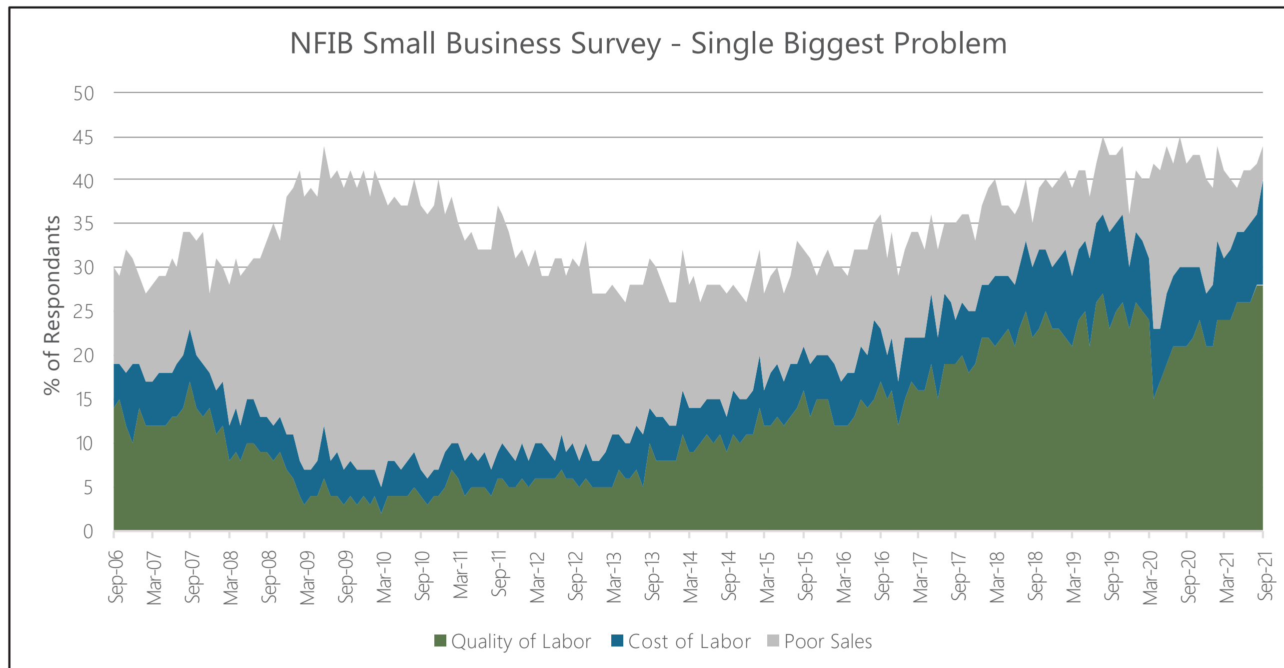
LABORING LABOR MARKET

Despite expanded unemployment assistance generally being phased out over recent months, the labor market continues to be a source of consternation for companies. The chart below shows survey data from small businesses ranking their single biggest problem (shown as a percentage of total respondents). In the early 2010s, businesses were still facing an economic crisis and reckoning with a lack of demand; the gray area on the chart shows the percentage of companies citing "poor sales" as their top concern, which nearly reached half of all respondents in 2009. As the economy continued to recover in the late 2010s, the dynamic shifted. "Quality of labor" (green) and "cost of labor" (blue) have become two of the biggest concerns, reflective of a supply constrained economy struggling to meet plentiful demand.



Source: Bloomberg (Data as of 9/30/2021)

From an investor's perspective, with more businesses expressing a need to find higher quality employees, it is reasonable to assume that labor costs will be on the rise. In turn, corporate profit margins—currently sitting near all-time high levels for the S&P 500—may be squeezed unless companies are able to pass the effects of higher wages through to their customers. More broadly, the current environment has the potential to mark a reversal in the balance of power between labor and capital, a trend that had been moving in favor of capital for several years. The process will likely be slow to unfold—if it does at all—but the chain reaction of higher labor costs leading to lower corporate profitability could ultimately result in lower equity valuations, marking a key risk to the current high valuation landscape.

SHOW ME THE MONEY

Despite the modest correction for stocks in September, some commentators continue to express concern about speculative excesses building in equity markets. One way to objectively assess the level of investor enthusiasm is to simply look at their actions as indicated by flows into mutual funds and ETFs. Specifically, the chart on the following page shows the cumulative amount of money going into stock funds (green) and bond funds (blue) over rolling 1-year periods. If investors were blindly ignoring risks and buying stocks as a result of "animal spirits", it stands to reason that money flows into equity funds would be extraordinary.

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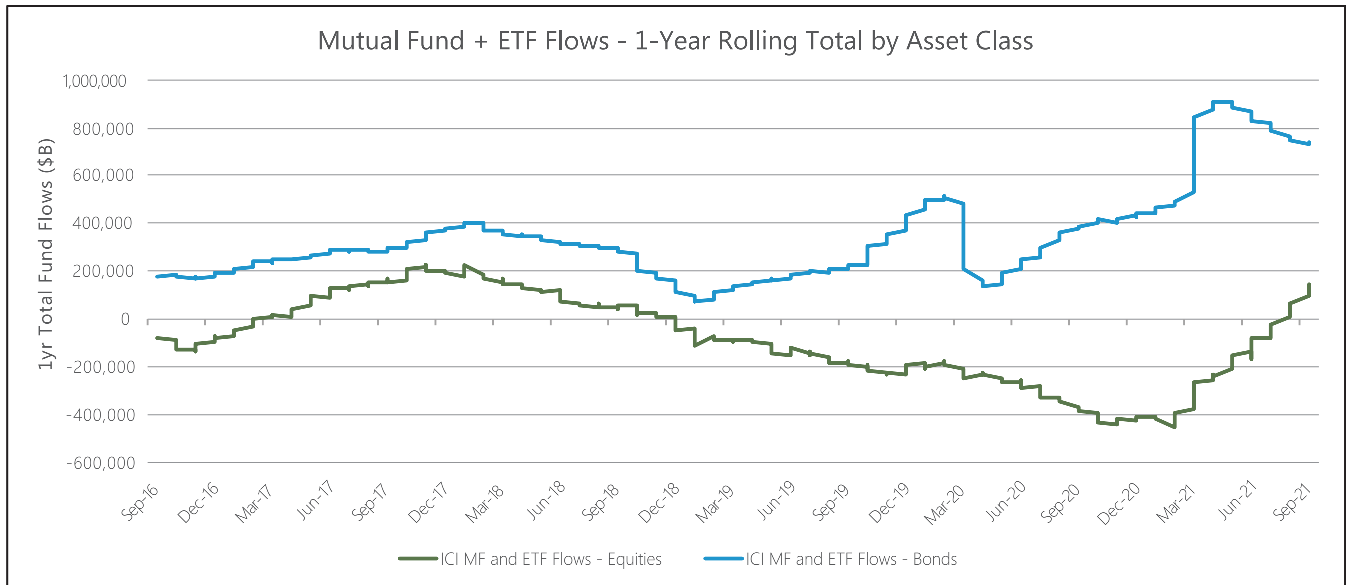

Source: Bloomberg (Data as of 9/30/2021)

As you can see, the chart tells a very different story. Stocks saw persistent outflows for nearly three years starting at the end of 2018, and only recently did net flows turn positive for equity funds. This does not suggest a level of crowding that would intuitively raise fears of irrational exuberance. Conversely, fixed income funds have consistently received net inflows from investors and spiked significantly higher post-COVID. As discussed in the prior section about negative real yields, perhaps calls of a bubble would be better served for fixed income markets. ●

Charting the Course of Inflation

As Fed Chair Powell and other members of the central bank continue to express their belief that the current bout of inflationary pressures will be transitory, investors may rightly wonder exactly what "transitory" means. After all, from a philosopher's perspective, all things are transitory on a long enough timeline.

There is a market adage, "When in doubt, zoom out", that encourages investors to look at the longer-term trend rather than getting stuck in the day-to-day price action and narratives. Rather than trying to constantly forecast short-term economic or market oscillations with precision, we often prefer to revisit the broader context with the goal of being directionally correct. To that end, the charts below can offer some useful perspective.

1) In keeping with the "When in doubt, zoom out" philosophy, the chart on the following page shows a 30-year view of the Consumer Price Index (blue) relative to its long-term trendline (dotted red). It is notable that the recent CPI uptick barely qualifies as noteworthy. Of course, naively extrapolating the past indefinitely into the future can cause problems for investors; COVID could conceivably mark the beginning of a new regime. However, the same could have been said when the Fed began its ultra-accommodative programs in the global financial crisis. Inflation ebbs and flows, but as an adaptive system, the economy has successfully found its way back to a supply/demand equilibrium over the last 30 years.

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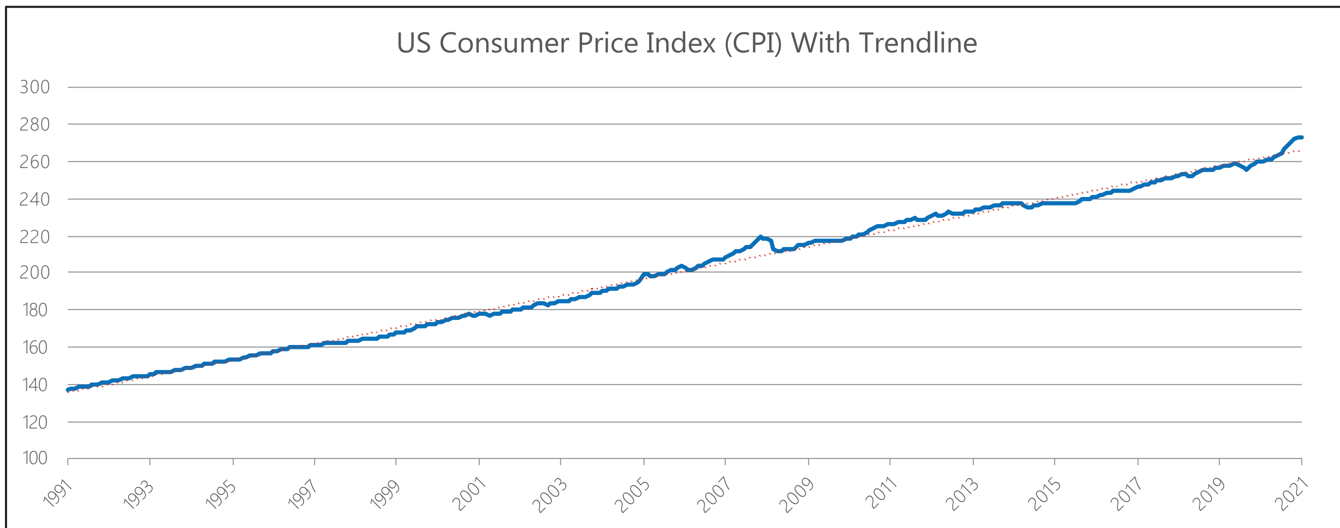
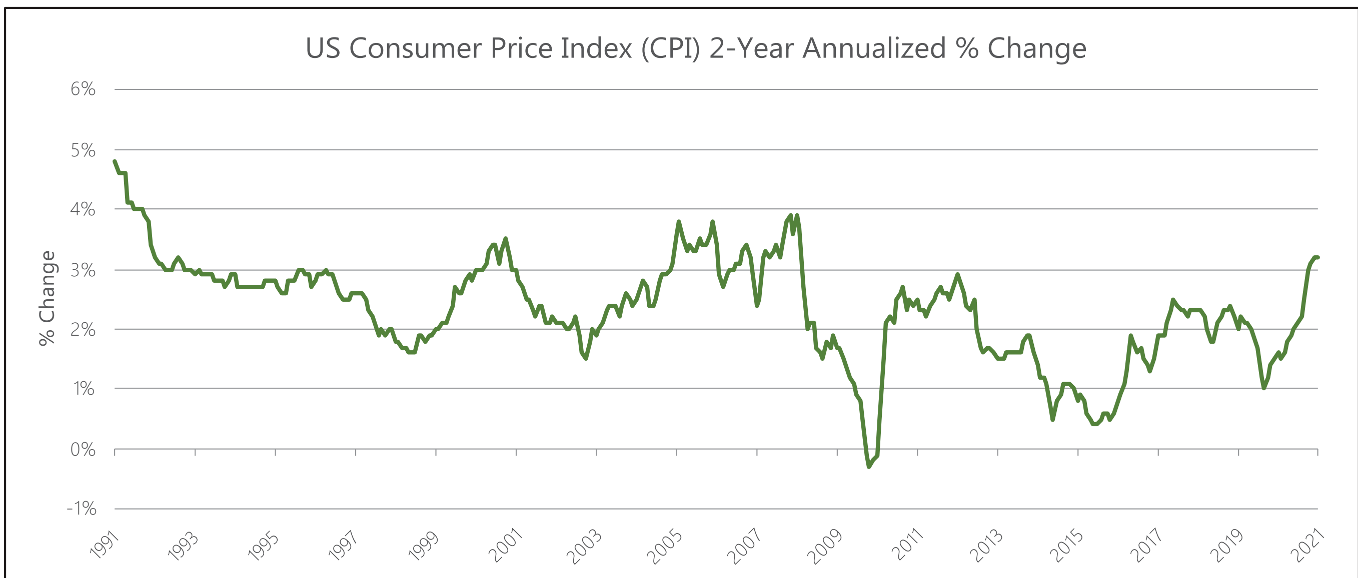


Source: Bloomberg (Data as of 9/30/2021)

2) Rather than looking at inflation on a year-over-year basis—which can be prone to distortions from base effects, or abnormal readings from a prior period—the chart below plots a two-year annualized rate of change to smooth some of the anomalous data points. As you can see, the current reading is elevated, but it is far from extraordinary in the context of the last 30 years.



Source: Bloomberg (Data as of 9/30/2021)

3) Perhaps the "stickiness" of inflation can be estimated by the degree to which it enters the public discourse and creates a sense of urgency around buying goods and services now rather than later. The chart on the following page attempts to capture this dynamic by looking at the number of news stories that reference the terms "inflation" or "supply chain" over the last five years. Clearly the trend has been higher post-COVID, but the staying power of these measures at elevated levels may be the key tell on whether inflation is truly permeating everyday decisions.

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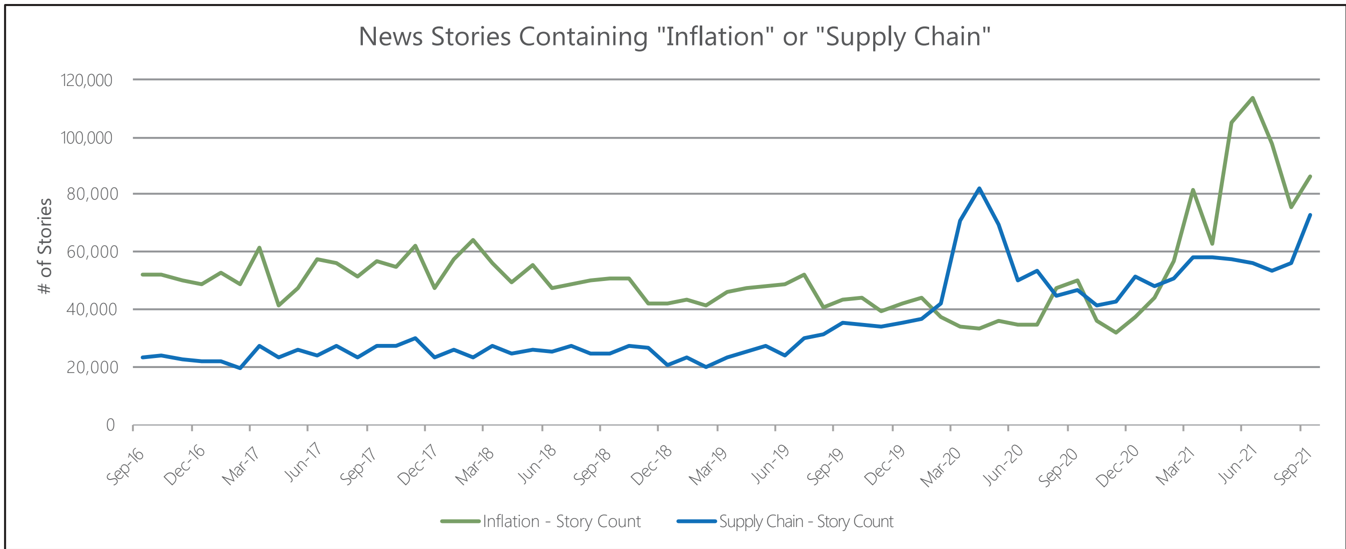
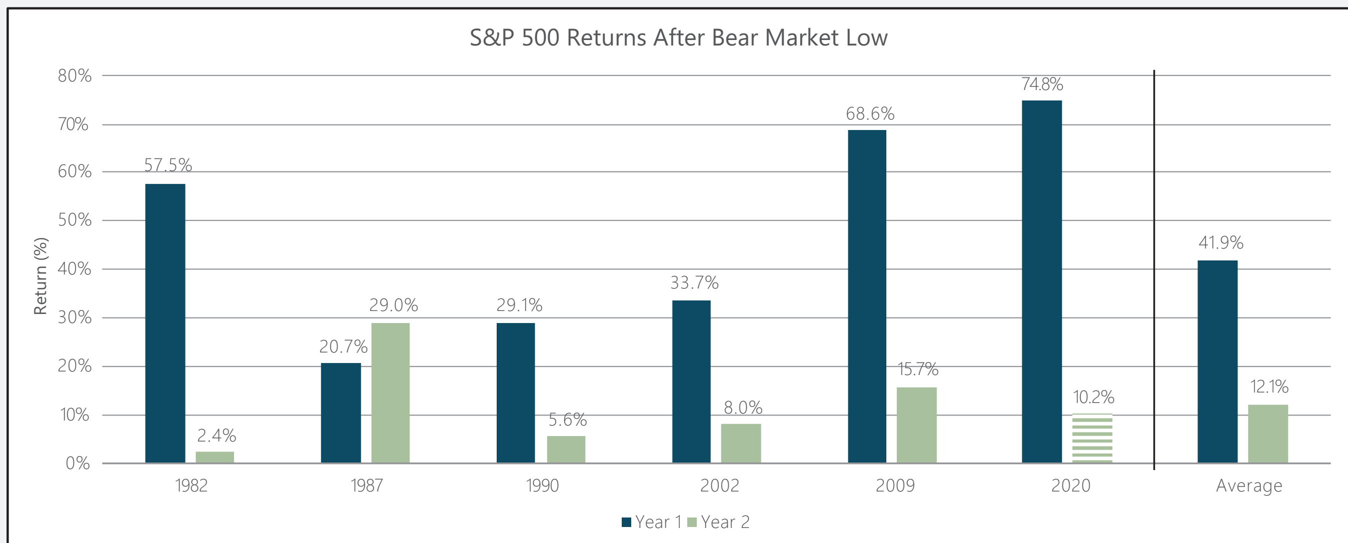


Source: Bloomberg (Data as of 9/30/2021)

Clearly, there have been disinflationary forces at play for decades, keeping inflation from consistently accelerating higher. Technological innovation will remain a constant, but perhaps other disinflationary forces like globalization will reverse course in a post-COVID world. Investors would be wise to respect the potential for a regime change but should avoid losing sight of longer-term trends and resist reactionary moves based on short-term data. ●

Chart of the Quarter

After posting the first lackluster quarter since the worst of the COVID crisis was unfolding, investors may be wondering if Q3 was an early warning that the economic and market recovery may be stalling out. The Q3 Chart of the Quarter (below) offers some historical context around recoveries following bear markets in the S&P 500 since 1980. Specifically, we show the S&P 500 returns in the first and second years immediately following a bear market low. The navy bars show performance for the first twelve months and the green bars show performance over the next twelve months.



Source: Bloomberg (Data as of 9/30/2021)

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With the caveat that this analysis relies on a sample size of six (five and a half, technically), we can identify a couple of important takeaways. For starters, it seems safe to conclude that the first year after a bear market low is the most fruitful phase of the recovery. Trying to identify the nadir in real-time is never an easy task, but the prospects of a substantial rebound off the lows should encourage investors to stay invested—even in the most challenging moments.

Second—and more germane to the present environment—is that year two of a bear market recovery has historically offered much more muted results than year one. Increasingly difficult year-over-year growth comparisons and less accommodation from monetary authorities could pose fundamental impediments to stock prices. Technical and behavioral factors could have an impact as well; investors may be more apt to sell as they approach prior high-water marks or inclined to forego additional purchases until they get a chance to "buy the dip".

One could be excused for dismissing historical context altogether given the unprecedented nature of the last 18 months, but a "history doesn't repeat, but it rhymes" perspective usually offers helpful guideposts. In this case, expectation management is key—i.e., do not expect a repeat of the prior 12 months—and all signs suggest that we are well within the realm of reasonable based on the S&P 500's 10% advance in the first six months of year two following the March 23, 2020 low. ●

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