Third Quarter 2021 – Investment Commentary

Since March 31, 2020, the S&P 500 Index has risen fourteen of the last eighteen months gaining +66.7% in price appreciation. The gains were driven by strong consumer and business demand emanating from a very accommodating Federal Reserve (Fed) monetary policy, six pandemic economic relief and stimulus packages, a rise in consumer and business confidence with the vaccine roll-out, a strong housing market, and a stellar rebound in corporate earnings. After a slow start in January this year, the S&P 500 Index rose seven consecutive months before retreating in September as mounting headwinds took center stage.

Table 1 – Stock Index Total Returns - as of September 30, 2021

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
S&P 500	-4.65	0.58	15.92	30.00	15.99	16.90	16.63
S&P 400	-3.97	-1.76	15.52	43.68	11.08	12.97	14.72
NASDAQ	-5.27	-0.23	12.66	30.26	22.67	23.37	20.93
Russell 2000	-2.95	-4.36	12.41	47.68	10.54	13.45	14.63
Dow Jones Industrial	-4.20	-1.46	12.12	24.15	11.00	15.68	14.72
MSCI Developed	-2.90	-0.45	8.35	25.73	7.62	8.81	8.10
MSCI Emerging	-3.97	-8.09	-1.25	18.20	8.58	9.23	6.09

Many of the aforementioned catalysts that drove stock markets higher since March 2020 have waned or are expected to do so in the coming months. Furthermore, the spread of the Delta variant, supply disruptions, prolonged higher inflation rates, labor shortages, and stretched valuations are added concerns. These concerns are setting the stage for what should be a volatile fourth quarter for stock markets.

With the onset of COVID shutdowns and subsequent full to partial re-openings, six pandemic relief and stimulus packages totaling $5.7 trillion were passed by Congress to help consumers and businesses stay afloat during the pandemic.

- $8.3 Billion - Coronavirus Preparedness and Response Appropriations Act – March 2020
- $192 Billion – Families First Coronavirus Response Act – March 2020
- $2.2 Trillion – CARES Act – March 2020
- $484 Billion – Paycheck Protection Program and Health Care Enhancement Act – April 2020
- $900 Billion – Consolidated Appropriations Act – December 2020
- $1.9 Trillion – American Rescue Plan – March 2021

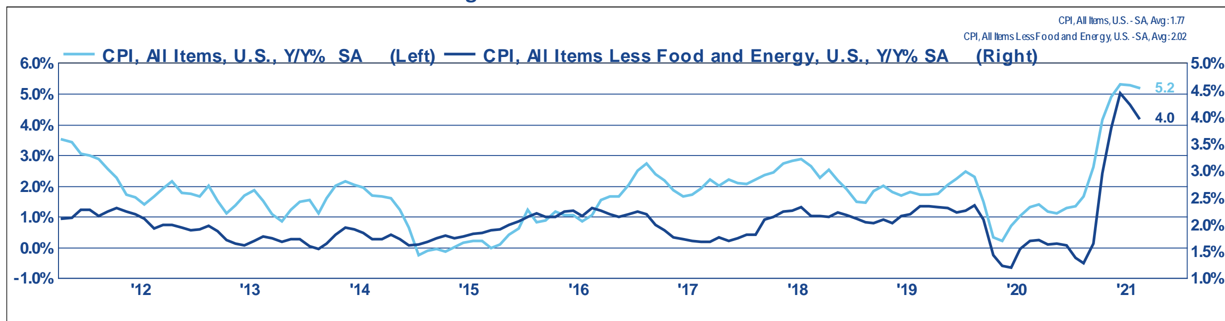
This enormous level of fiscal pandemic relief and stimulus propelled and sustained consumer and business demand during the pandemic and provided enthusiastic support to equity markets. With the economy experiencing a strong V-shaped recovery, many of the programs and initiatives associated with the fiscal relief packages have lapsed, or are expected to lapse soon, including federal pandemic unemployment assistance programs, housing and student loan forbearance programs, and housing eviction moratoriums. Some fear that if such initiatives are cut off too quickly it may dampen economic growth. Others contend it should spur stronger employment gains and help to expedite improvement of supply disruptions.

Since the re-opening of the U.S. economy last spring, labor shortages have been widespread by industry and state. The August 2021 Fed report, The Beige Book, cited, “the demand for workers continues to strengthen, but all Districts noted extensive labor shortages that were constraining employment and, in many cases, impeding business activity. A number of Districts reported an acceleration in wages, and most characterized wage growth as strong.” Concurrently, the July 2021 U.S. Bureau of Labor Statistics report, The Job Opening and Labor Turnover, highlights there were 10.9 million jobs available. Yet, businesses large and small struggle to find available labor to keep up with steady demand exacerbating the supply and demand imbalance.

The COVID lockdowns abruptly halted the complex global supply chain and countries worldwide have struggled with supply and demand imbalances ever since, including the U.S. You have likely experienced the shortage of a good or service during the past year. To get a sense of the magnitude of the supply and demand imbalance and the challenges companies are currently facing, look no further than recent earnings guidance from Costco, Fed Ex, Nike, and General Mills. Some of the challenges include: shipping container shortages; port delays; COVID/Delta variant disruptions; shortages of raw materials, parts, labor, and transportation; and longer delivery lead times from suppliers and third-party vendors. These and other challenges are leading to processing and production inefficiencies, inventory scarcities, and steady climbing of operating and labor costs which are being offset by price increases.

More and more, both companies big and small, are raising prices to cover increasing input and wage costs. The August 2021 Small Business Optimism survey from the National Federation of Independent Business revealed that 49% of small businesses are passing on price increases which is the highest level since 1981. Consumer confidence surveys indicate consumers are becoming increasingly concerned about inflation and growing more cautious.

Chart 1 – U.S. Consumer Price Index – as of August 2021



As inflation rates have moved sharply higher earlier this year, the Fed along with many economists forecasted inflation to be transitory and lessen by year's end to near the Fed's 2.0% inflation target goal rate. Headline and core (excluding food and energy) inflation rates peaked last June but increasingly it is looking as though inflation will be higher for longer due to hourly wage gains and persistent supply chain bottlenecks. The Fed has already had to upwardly revise their 2021 inflation forecast three times this year and will likely have to revise their 2022 forecast as well, which currently stands at 2.2%. With inflation on the rise, longer-dated bond yields have moved higher but remain well below inflation rates. Bonds yields and prices are inversely related.

Table 2 - Bond Index Total Returns – as of September 30, 2021

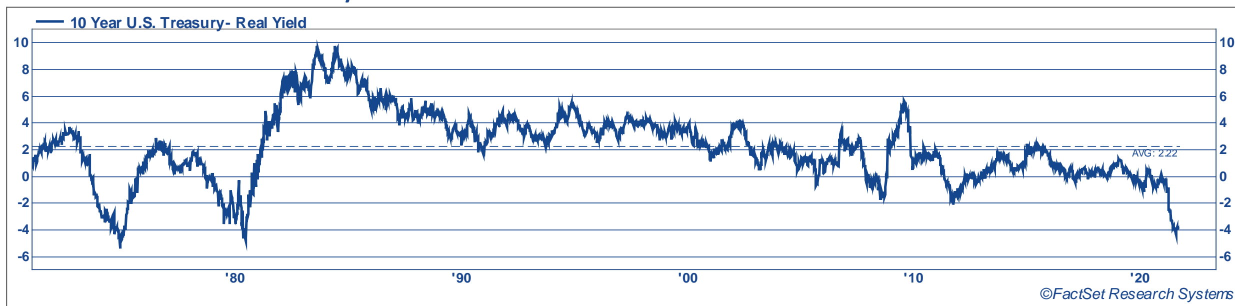
Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays High Yield	-0.01	0.89	4.53	11.28	6.91	6.52	7.42
Barclays Municipal	-0.72	-0.27	0.79	2.63	5.06	3.26	3.87
Barclays Inter Gov't/Credit	-0.57	0.02	-0.87	-0.40	4.63	2.60	2.52
Barclays Aggregate	-0.87	0.05	-1.55	-0.90	5.36	2.94	3.01

On December 31, 2020, the yield on the 10-year treasury bond was 0.92%. As inflation concerns rose early this year, the yield on the 10-year treasury climbed and peaked at 1.74% on March 31, 2021. While monthly inflation rates were cresting April through June, bond yields perplexingly moved sharply lower with the 10-year treasury reaching 1.16% in early August. Bond yields dropped on concerns surrounding the spread of the Delta variant and its potential impact to derail the global economic recovery. The bond market was correct about the Delta variant's economic impact, but it was a double-edged sword as lockdowns in several

Asian countries paused production of essential parts, like semi-conductors, and raw materials, which ironically served only to intensify supply disruptions while demand remained strong, likely leading to prolonged higher inflation rates.

Real yields, which are nominal interest rates less the rate of inflation, have turned decidedly negative. As the chart below depicts, the real yield on the 10-year treasury stands at the lowest level since the stagflation era of the late 1970's and early 1980's. Historically, real interest rates average 2.2% above the rate of inflation. Many economists suspect the Fed is behind the inflation curve and should have started bond purchase tapering earlier this year so that they could begin raising short-term rates in early 2022.

Chart 2- Real U.S. 10-Year Treasury Yield



It is widely expected that the beginning of the end for the Fed's accommodative monetary policy will commence with the tapering of bond purchases in November 2021 and the end of the bond purchase program sometime in mid-2022. This sets the stage for Fed Fund rate increases in late 2022 or early 2023. We expect bond yields to rise across the yield curve well into next year.

In my thirty-plus years in investment management, I've never seen inflation rates rise and bond yields fall simultaneously, especially at the front end of what appears to be a higher inflation cycle. I have never seen negative real yields on high-yield or non-investment grade bonds, or seen the unemployment rate increase during a widespread labor shortage. These are only a few examples of the abnormalities associated with the COVID era, and more will likely follow. Due to the lack of any comparable precedent and the extensive complexity of how people and businesses may respond to COVID related restrictions, mandates, and policies, the uncertainty encompassing COVID remains a primary risk.

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Sources: FactSet, The Federal Reserve, National Federation of Independent Business, U.S. Bureau of Labor Statistics, U.S. House of Representatives, U.S. Senate, Costco Wholesale Corporation, FedEx Corporation, Nike, Inc, General Mills, Inc., The Conference Board, and The University of Michigan – Go Blue!

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