Third Quarter 2021
Quarterly Letter to Clients
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October 15, 2021

The third quarter of 2021 was a bit of a roller-coaster ride for the markets. The S&P 500 hit new all-time highs, as investors brushed off a fourth wave of COVID-19 cases in the U.S. and instead focused on the resilience of the economic recovery, strong corporate earnings, and ongoing support from the Federal Reserve. Unlike the COVID-19 wave of 2020 and early 2021, government authorities did not re-impose severe restrictions in response to the rising cases across the U.S., which allowed the economy to continue its march towards a "new normal."

However, the resilience of the capital markets should not be taken as a signal that risks no longer remain. Following a strong July and August, September saw the market struggle with volatility due to rising uncertainties. Investors are increasingly concerned about everything from an economic slowdown, inflation, supply-chain disruptions, a global energy crunch, politics, rising interest rates, fading fiscal stimulus, and the ongoing pandemic. In addition, the Federal Reserve signaled its intention to wind down its stimulus measures and raise interest rates in 2022.

Due to these factors, the economic outlook is starkly different from the outlook just a few months ago. The market will have to face the resolution of numerous macroeconomic unknowns in the fourth quarter, so continued volatility would not be surprising to see.

Economic Overview

Real gross domestic product (GDP) increased at an annual rate of 6.7% in the second quarter, which was well below the Atlanta Fed's earlier estimate of 8.6%. The growth surge was primarily driven by solid consumer spending, which rose at a 12.0% annual rate and followed 11.4% in Q1. Current estimates of consumer spending suggest that growth slowed in the most recent quarter, as the impact of fiscal stimulus is expected to fade sharply from the Q2 peak. As a result, the Atlanta Fed is now forecasting real GDP growth in the third quarter of 1.3% versus their initial estimate of 6.1% at the start of the third quarter.

The labor market weakened as the quarter progressed. In July, August, and September, the economy added 1.1M, 366K, and 194K. The trend went against expectations as employers added the fewest jobs since the beginning of the year. Although job growth wasn't strong, it was broad-based with gains in leisure/hospitality, professional/business services, and retail. The unemployment rate fell to 4.8% from 5.9% over the three months and the number of Americans seeking assistance is down to just above four million – compared to 25 million a year ago. Finally, the extended federal unemployment benefits expired on September 6th which could provide further strength the job recoveries in the coming quarter

Recent wage gains provided more fuel to the argument that the current pace of inflation could run longer than anticipated. Over the past six months, wages are running at an average annual gain of nearly 6%. During the third quarter, wages rose by more than 4% in each month. Yet, employers are having a hard time finding the help needed to meet a surge in demand. The number of "quits" hit a high going back to December 2000, as 4.3 million workers left their jobs. Quits are seen as a level of confidence that workers can find employment elsewhere. The strong wage gains cast doubt that inflation will fade anytime soon.

The infusion of trillions of dollars into the financial system through fiscal and monetary policy raises further concerns about inflation. The recovery in demand, coupled with supply disruptions across the world, has pushed inflation to its highest level in more than 30 years. Consumer prices rose 0.4% in September, pushing the year-over-year gain to 5.4%. That marked four straight months of annualized inflation above the 5.0% level, with the largest contributions coming from energy, food and shelter.

Retail sales fell by 1.1% in July and grew 0.7% in August, both moving in the opposite direction from what was expected by economists. According to recent estimates, retail sales are expected to climb by 0.5% before accounting for inflation, which would be sharply lower than the increase we saw in the first and second quarters of +11.4% and +12.0%, respectively.

The consumer confidence index declined in September for the third straight month to end the third quarter at 109.3, below market expectations of 115.0. Overall, the index fell by approximately 20 points in the third quarter, as a rise in COVID-19 cases stifled attitudes along with higher prices for a broad spectrum of goods and services. Additionally, spending intentions for homes, autos, and major appliances all retreated from their exuberance in early 2021. Finally, the labor market outlook continued to deteriorate as well – hitting the lowest level since the pandemic outbreak.

According to the ISM Manufacturing Index, manufacturing expanded for the 16th consecutive month and remained near historically high levels during the quarter. However, companies continue to struggle to meet demand due to shortages and difficulties in finding labor. Transportation congestion at ports in China and the U.S. continues to be one of the biggest challenges for U.S. manufacturers. The bottlenecks are putting pressure on prices due to the imbalance between supply and demand.

Soaring energy prices are raising concerns about inflation and the economy. The higher prices are driven by rising demand and tight supplies, amid a global energy crunch. Oil prices, in particular, have been bolstered by OPEC's supply discipline and the industry's reluctance to invest more in new drilling, given the push for renewables. Crude oil and natural gas prices have both soared to seven-year highs in recent weeks. Prices at the pump are up nearly a dollar over the last 12 months to a national average of right over $3 a gallon. The increasing energy costs are starting to eat into consumers' disposable income. Even coal, which was left for dead in the name of renewables, is near record highs.

Federal Reserve:

The Federal Reserve's Open Market Committee (FOMC) met in September to discuss how to steer monetary policy as we move into the fourth quarter of 2021. The FOMC finds itself between a rock and a hard place with economic growth slowing and inflation rising to near 30-year highs. Waiting too long to raise rates could result in runaway inflation, while moving too early could stall the economic recovery.

The FOMC voted unanimously to hold its Fed funds rate in the range of 0% to 0.25% after the two-day meeting. However, half of the Committee now believes at least one interest rate hike will be warranted in 2022, up from 7 out of 18 members in June. The median forecast for the Fed funds target rate (30-day rate) at the end of 2023 also increased to 1.0%. The FOMC also raised their median forecast for core personal consumption expenditures or PCE (the Fed's preferred measure of inflation) for 2022 to 2.3% from 2.1%, suggesting longer-lasting inflation. The increase was attributed to pricing pressures due to complications with global supply chains.

The Fed also made it clear that it plans to taper its asset purchases – known as quantitative easing – provided the economy continues to improve broadly as expected. The central bank only has two more meetings this year, in early November and mid-December, to announce a taper. In theory, the policy shift should result in less liquidity and higher interest rates, all else equal. Tighter monetary policy measures could be a net negative for the equity markets if combined with slowing growth.

Stocks:

US equities notched a small positive return in Q3. Strong earnings lifted U.S. stocks in the run up to August, which was when the Federal Reserve seemed to strike a dovish tone and confirmed its hesitance to tighten its monetary policies. However, growth and inflation concerns late in the quarter caused equity prices to retreat from all-time highs in early September as investors digested the weaker outlook combined with rising interest rates. In addition, investors face the prospects of the Federal Reserve beginning to wind down its stimulus measures.

As a result of these factors, the S&P 500 Index tumbled by 4.7% in September to snap a seven-month positive streak, which marked the worst month for the S&P 500 since

2011. Yet, the index managed to eke out a gain with a return of 0.58% for the third quarter. Year-to-date, the benchmark index is up 15.92%.

The Dow Jones Industrial Average (DJIA), comprised of 30 blue-chip stocks suffered a 4.3% decline in September as investors rotated back into growth stocks. The DJIA index ended the third quarter down 1.46%. Year-to-date, the DJIA index is up 12.12%. Finally, the tech-heavy NASDAQ declined by 5.31% in September and declined by -.38% during the third quarter, as interest rates climbed late in the quarter causing investors to sell tech shares.

According to FactSet, S&P 500 companies are expected to report earnings growth of 27.6% and revenue growth of 14.9% during the third quarter. Full-year 2021 earnings are expected to increase by 42.6% on revenue growth of 14.9%. Supply chain constraints are hampering companies' ability to meet demand while capping sales growth and adding to costs. As a result, companies could see profit margins contract in in the coming quarters.

According to the Wall Street Journal, the S&P 500 currently trades at a forward price/earnings ratio of 21.5x, down slightly from last quarter's 22.6x. The P/E ratio fell for the second quarter in a row on higher than expected corporate earnings, but the ratio remains above the long-term historical average. If growth decelerates and financial conditions tighten, valuations could fall from their lofty levels.

Bonds:
Most bond indices saw strong gains through mid-September as investors rotated to safety following the rise in COVID-19 cases in July and August. However, in late September, rates spiked after the Fed signaled it might begin "tapering" its $120 billion in monthly purchases of U.S. Treasuries and mortgage-backed securities at their next meeting in November. Combined with still-high inflation, the signals weighed on fixed income markets, and erased most of the quarter-to-date returns.

However, the late September spike in yields wasn't enough to offset the substantial gains in July when Treasury yields broadly declined (when yields fall, prices increase). As a result, bond performance was mixed for the quarter. The Bloomberg Barclays U.S. Aggregate Bond Index, a proxy for U.S. core bond exposure, gained only five basis points for the third quarter – compared to 1.8% in the second quarter. The U.S. benchmark 10-year Treasury yield rose four basis points to end the third quarter at 1.49%, which is notably below inflation. Overall, the yield curve steepened and the 2-10 spread increased by 14 basis points, usually positive indicators for the economy.

High inflation readings continued to drive demand for U.S. Treasury Inflation-Protected Securities (TIPS). As a result, TIPS were the best performing fixed-income asset in the third quarter, as measured by the Bloomberg Barclays U.S. TIPS Index, returning 1.75%. Finally, investors reaching for yield via riskier assets led to strong performance in the high yield bond sector as the Bloomberg Barclays U.S. Corporate High Yield Index returned 0.89%.

By most measures the U.S. economy has made tremendous progress year-to-date. However, risks remain, as they always do. As such, we will continue to navigate this challenging investment environment by adhering to our long-term investment philosophy. Regardless of the day-to-day gyrations of the market, we will continue to seek out investments that meet our strict criteria, without sacrificing quality. We will then use those investments to custom-tailor your portfolio to meet your long-term goals.

We thank you for your ongoing confidence and trust. If you have questions or comments, please don’t hesitate to contact us.