Worries Over Inflation, Supply Chain and Labor Shortage Drive Market Pause
October 2021

My Dear Client:

Markets were mixed in the third quarter with a downward bias as there were ample items to worry about.

The U.S. equity market was relatively flat for the quarter, with developed markets down modestly and emerging markets down noticeably. The latter was partially due to a sell-off in Chinese equities following broad and continuing regulatory pressures in that country, along with the collapse of a major real estate holding company in China. September worldwide was an interesting month as equity markets sold off wholesale and inflation worries came back into focus.

In the U.S., the Delta variant caused consumers to slow spending in such categories such as travel and dining, but it did not knock the recovery off its course. As case counts and hospitalizations have already peaked in this wave, economic growth is expected to reaccelerate during the fourth quarter; growth forecasts for next year have been revised higher, too.

As in last quarter, Value stocks underperformed Growth across all asset sizes except Small, where Value again beat Growth. Small Cap as a whole (-4.4% Russell 2000) still measurably lagged Large Cap (.58% S&P500).

Inflationary pressures remain a key macroeconomic theme. Personal consumption expenditures inflation, the preferred gauge of the Federal Reserve (Fed), reached 4.3% in August and marked a 30-year high. New COVID case waves disrupted supply chains and led to broader supply bottlenecks. Furthermore, consumer spending has significantly outpaced overall economic growth this year, driven by the confluence of vaccine distributions, business re-openings and trillions in emergency federal aid sent through the U.S. economy.

While the Fed has broadcasted that these pressures are transitory, it seems that the agency may be more concerned with inflation's upside risk and has accepted a level of uncertainty of when exactly these pressures will abate. The U.S. 10-year Treasury yields rose higher from the previous quarter, ending September at 1.52% as the number of "transitory inflation" doubters grew.

The labor market continued to improve. With the addition of about 5 million jobs this year, the U.S. unemployment rate has declined from 6.7% in January to 5.2% in August. The pre-pandemic unemployment rate was 3.5%.

The labor market has remained uneven, nevertheless, creating supply shortages. During the quarter, job openings exceeded the number of unemployed. Although this has occurred before, it's unusual during a period of economic recovery. Several factors are involved: health concerns, lack of childcare for families, workers changing industries and the skills gap.

Labor market improvements are seen as probable because pandemic-related, extended benefits lapsed in September and job seekers are more likely to fill open positions in the coming months. Theoretically, this should alleviate some of the supply-demand imbalance in labor markets that has been a large contributor to bottlenecks and inflationary pressures.

With inflation persisting and labor markets improving, the Fed indicated that it is likely to announce tapering monthly asset purchases by the end of the year.

There's an old saying: *When the Fed is not worried about inflation, the market should be worried.*

Domestic equity market

The third quarter of 2021 saw Large Caps solidly in the lead as the Standard & Poor's 500 was up barely 0.58% while Small Caps via the Russell 2000 were down -4.4%. Growth beat Value across all asset classes except Small. The Russell 1000 Growth Index, with a total return of 1.2%, was the only size and style segment with a positive return in Q3. The Russell 1000 Value Index fell (-0.8%), as did the Russell 2000 Value (-3.0%) and Growth (-5.7%).

Seven of the 11 S&P 500 sectors were positive in Q3 yet returns were tempered. Financials (+2.7%), Utilities (+1.8%), Communication Services (+1.6%), Health Care (+1.4%) and Information Technology (+1.3%) were the leading sectors, with Industrials (-4.2%), Materials (-3.5%) and Energy (-1.7%) being the weakest.

According to data courtesy of Bloomberg, 92.6% of the stocks in the S&P 500 Index traded above their 200-day moving average at the end of Q2. Yet when Q3 closed, only 64.6% traded above their 200-day moving average. When we looked deeper down the market cap spectrum at Small Caps, we found the Russell 2000 Index ended Q3 with fewer than half of its companies trading above their 200-day moving average. This was significantly less than the 78.7% of these stocks above their 200-day moving average at the end of Q2.

The summer of 2021 to the end of the year has been and will be a wrestling match between rotation to companies that benefit from reopening, value stocks generally, inflation beneficiaries or market-dominating growth companies. Investors are not unified on a single idea surrounding the economic trajectory. The result is narrow market depth with a few large companies propping up the market amid increased uncertainty.

International markets

International equities experienced declines in both Developed (-3%) and Emerging (-8.1) markets. Unlike market leadership in the U.S., Growth style underperformed Value style across equities markets and asset classes. This was a likely and somewhat expected result of rising energy and commodities markets along with upward inflation and interest rate-sensitive stocks.

Eurozone equities were flat in Q3. The Energy sector was one of the strongest performers, as was Information Technology, with semiconductor-related stocks seeing a robust advance. Consumer discretionary stocks were among the weakest for the quarter, with luxury goods companies under pressure amid suggestions that China could seek greater wealth redistribution, which could hit demand.

The eurozone economy has expanded strongly in recent months, driven by higher consumer spending as containment measures have been rolled back. The European Central Bank (ECB) expects the eurozone economy to return to its pre-pandemic level by the end of the year, which is much earlier than expected but still behind the recovery in the U.S.

Inflation in Europe reached 3.4% in September, the highest rate in more than a decade but (as in the U.S.) one viewed as a temporary phenomenon linked to reopening. Also, the ECB updated its policy framework to allow temporary overshoots for its 2% inflation target. Overall, this signals a nod to be in step with Fed policy: a longer period of accommodative policy that can provide additional stimulus to the economy.

A sell-off in Chinese stocks drove the Emerging market equities' Q3 decline, which also showed concern over continued supply chain disruptions and worries over the implications of higher food and energy prices for some markets. Regulatory actions in China were the initial trigger for market weakness. These worries were compounded by re-imposition of some Covid-19 restrictions and by supply chain disruptions in August in Southeast Asia. September saw possible systemic financial system risks stemming from the potential collapse of Evergrande Group – China's second-largest property developer in sales terms – and power shortages, with many parts of China suffering outages. (Rising U.S. bond yields and a surprisingly strengthening dollar towards the end of the quarter further dampened results.)

In Japan, inflation was mired in negative territory, unlike in the U.S. and Europe. Also, the economic recovery has been much more lukewarm since emergency curbs to contain the Delta variant restricted the rebound in consumer spending. Supply chain disruptions have added further complications to an export-led rebound.

Due to low growth and low inflation, the Bank of Japan will continue an accommodative policy stance. Or, simply, Japan appears stuck with its continuing experiment with monetary policy, hoping it will overcome an aging society that has a negative birth rate and that restricts immigration of new, younger citizens.

Bond markets

Despite late-quarter rate volatility, the yield curve flattened slightly quarter over quarter as the 30-yr. Treasury declined 4 basis points and yields at most other segments marginally increased. The broad U.S. bond market, measured by the Bloomberg Barclays Agg Index, was flat in 3Q21, up just 0.05%.

As is typical, the action at Fed led the bond market and influenced the future direction for the economy. This quarter, however, the Fed's members garnered more attention personally than as policy makers. The heads of two regional Federal Reserve Banks, Robert Kaplan (Dallas) and Eric Rosengren (Boston), each resigned after coming under scrutiny for securities trading. Each appeared to have personally made investments that benefited from actions taken and/or proposed by the Fed during the early days of the pandemic.

Additionally, Chairman Powell came under fire both for his oversight and handling of the two Fed governors and his stance on regulating the banking industry. Sen. Elizabeth Warren called him a "dangerous man to head up the Fed" due to his handling of financial industry regulation; she also promised to oppose Powell if he is renominated.

Returns in all bond market sectors were negative in September as rates rose, stayed mixed for the quarter and are generally negative for the year. The best-performing sectors for the quarter were TIPS (+1.75%) and HY Corporates (0.89%), while the worst-performing sector was EM

Debt (-1.57%).

Powell noted during Congressional testimony that tapering of quantitative easing (i.e., a slowdown in the pace of asset purchases) will be announced at the November meeting and be completed by mid-2022. The Fed is currently buying $120 billion worth of bonds ($40 billion Agency MBS and $80 billion Treasuries) for its balance sheet every month.

Powell re-emphasized that tapering is not a direct signal of interest rate increases. Meanwhile, the Fed's funds future rate projections (dot-plots) now show a faster rate-hiking schedule than they did in June. The median rate expectation for the number of interest rate increases in 2023 moved up to three hikes from the two estimated in June, with three additional hikes in 2024. Fed officials were evenly split (9-9) on a rate hike in 2022.

The other elephant in the room regarding interest rate levels and direction is the burgeoning size of the federal debt. It is almost certain that President Biden's initial $3.5T Build Back Better plan will come in at around $2 trillion and get paired with an infrastructure bill of about $1.5 trillion.

While the reduction in size is significant (and due to Sen. Joe Manchin and Sen. Kyrsten Sinema), the final size of these bills will still exceed anything the country has ever seen that was not an immediate response to war or another crisis. The dual mandate of the Fed is to control price levels (inflation) and seek maximum sustainable employment. Currently, inflation, whether transitory or not, is quite elevated; the jobs market is far from maximum sustainable employment. Because of this, the Fed continues the path of monetary stimulus, policy actions aimed at increasing economic activity to further spur employment.

A Look Ahead

During the third quarter of 2021, worries included but were not limited to: China's regulatory actions; high and rising fuel and food prices; labor shortages; inflation or stagflation; the effect of Federal Reserve tapering; disrupted supply chains; potential default due to another debt-limit standoff; and the ongoing dysfunction and polarization in Washington. All of these were on market participants' minds intermittently.

During the great post-war period, the U.S. stock market has gone up in almost 70% of the years because the American economy grows most of the time. While it is foolish to try to guess exactly when one of those down years in the 30% is coming, we can prepare a plan for it.

My portfolio recommendations remain relatively unchanged from last quarter, as adjustments to enhance your asset allocations remain at the policy level. Maintain a risk-balanced focus, multi-asset class approach, evaluate opportunities and be ready to invest when larger short-term declines occur. Consider:

- Maintaining overall equity allocation to portfolio targets and below maximum range;
- Continue raising cash from Large Cap growth stocks and private U.S. equity distributions for increasing investments in Emerging and International stocks;
- Increasing allocations to Small Cap and Mid Cap core;
- Sustaining the underweighting of fixed-income portfolio allocations and maintaining diverse high-quality bond portfolios paired with proven opportunistic credit strategies for yield;
- Seeking niche alternatives, including early and late stage venture capital and co-investments, as well as opportunistic and secondary private investments (be careful of paying premium prices);
- Investigating real estate opportunities, both equity and debt, in private and public space (logistics, warehouses, data centers, infrastructure and so on); and
- Continuing rebalancing overall asset allocation to target ranges – and when assets aren't cheap, cash inside your portfolio is still a good idea.

Finally, many investors' interest in the "E" for environment (as well as in "S" for social and "G" for governance) of ESG continues to grow. Please know that this has and always will be a deeply imbedded part of our firm's philosophy that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

Appreciatively,
Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board.