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2021 FOURTH QUARTER OUTLOOK

A Watched Pot Never Boils

At-A-Glance

The global economy appears to have hit peak growth and the rate of growth is starting to slow. The pace in U.S. is already slowing from high levels as the next phase of the expansion takes hold.

The Fed has one eye on inflation and another eye on Congress, trying to weigh its next move which will likely be bond tapering in December and raising rates by the end of next year.

Many equity investors are looking at the growing risks and waiting for a correction that seems overdue, yet volatility remains at low levels.

Bond investors seem relatively complacent with the risks, and bond yields and spreads remain near all-time lows.

Risks are growing in both equity and bond markets and we do expect volatility to rise at some point. Predicting when is difficult, so having a balanced portfolio is more important.

We continue to recommend diversifying across and within asset classes, along with a focus on long-term objectives and not getting caught up in day-to-day fluctuations and noise.

Overview

Watching financial markets recently, you might be reminded of when you were a child watching a pot of water boil at your grandma's house. "A watched pot never boils," your grandma may have told you. If you were a stubborn child, you will know that the water did eventually boil, but it seemed to take forever.

With high valuations, peak economic and earnings growth, fading stimulus, supply disruptions and looming Delta variant fears, many investors are watching for a correction, defined as a 10% fall in stocks. Corrections are normal—they happen roughly every eight months on average going back to 1928. Legendary investor Peter Lynch once said, "More people lost money waiting for corrections and anticipating corrections than in the actual correction." Sticking to long-term risk and return objectives is still prudent.

The economy appears to be slowing from peak growth in the second quarter and the size of the overall economy has surpassed pre-pandemic levels. With the headwinds mentioned above, growth will slow from currently unsustainable levels. The Fed is looking at tapering its bond purchases and eventually raising rates. Inflation is currently high but expected to moderate. The question is, at what level inflation will stabilize? We expect it will likely settle somewhere above pre-pandemic levels, but lower than where it is today.

Before the Fed starts to decrease stimulus, officials may want to make sure the economy is on sound footing. The problem is that short-term inflation ticked up again due to temporary supply side constraints caused by the Delta variant. Fed prognosticators can't get an accurate temperature reading on inflation and don't want to overreact, as tightening financial conditions too fast may cause a slowdown, potentially hurting the economy and labor markets.

In stocks, investors are looking at the same data and trying to gauge what the Fed will do. See our Fed Monitor as we try to gauge the Fed too. Stocks remain expensive relative to their projected future earnings. Additionally, the S&P 500's largest drawdown in 2021 was only 4.23% (as of this writing) and it occurred in March. Meanwhile, volatility remains relatively low in the face of all these risks. So naturally, many investors are waiting for the pot to boil (a stock market correction), but of course that takes time.

Bond investors are probably even more worried about what the Fed will do but seem to have faith that tapering and rate increases will come in a slow and dovish fashion. Inflation is retreating, which gives the Fed some room to take a wait-and-see approach to raising rates.

We reiterate our recommendation to diversify across asset classes, sectors and countries, while adhering to long-term risk and return objectives. We remain cautiously optimistic, but risks are increasing and therefore we are more balanced in our outlook. Your financial professional can help you stay on track and keep focused on your long-term plans. For a more detailed version of our fourth quarter outlook, click here.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating and an investment grade rated country of risk. Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.