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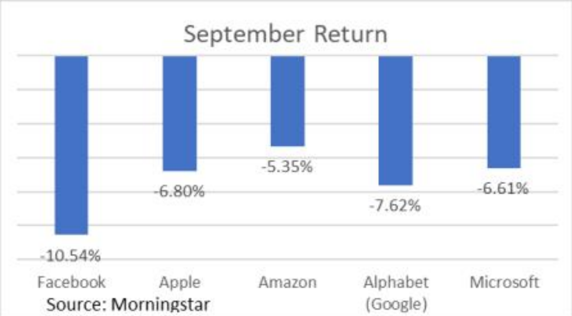
Quarterly Update & Economic Commentary—September 30, 2021

Quarter in Review

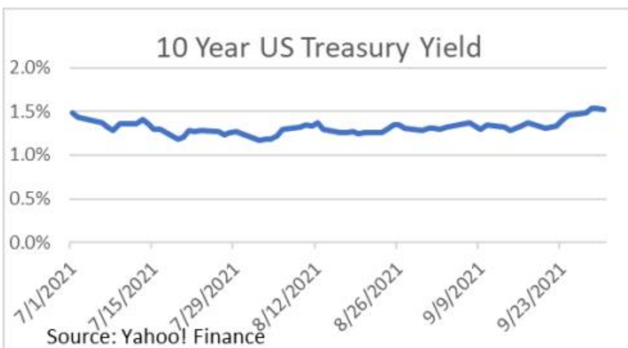
For the most part, markets were having a good third quarter until September. Most broad-based indexes, including bonds, were negative for the month. In most cases the September swoon brought indexes negative for the quarter, except for the S&P 500. During September we saw interest rates spike and the growth rally took a breather. Some of the names that have been driving up the S&P 500 since March fell in September, bringing the index return with it. The top five S&P 500 holdings, making up 22% of the index, Amazon, Apple, Alphabet, Facebook and Microsoft were all negative in September. Amazon lost 5.35%, Facebook lost 10.54%, Alphabet (Google's parent company) lost 7.62%, Apple lost 6.80% and Microsoft lost 6.61%; both Amazon and Facebook were also negative for the quarter. The S&P 500 was off 4.65% for September but was positive in the third quarter by 0.58%. Both U.S. mid-cap and small-cap stocks lost less than the S&P 500 in September but underperformed the S&P 500 in the third quarter and were negative. Benefiting from rising interest rates, the Financials sector was the best performing sector for the quarter, up 2.74%, followed by Utilities, positive 1.78% and Communication Services, positive 1.60%. The worst performing sector for the quarter was Industrials, down 4.23% and Materials, off 3.51%.



Source: Morningstar

Like U.S. stocks, developed international stocks had a difficult September, leading to a negative quarter. The MSCI EAFE lost 2.90% in September and 0.45% during the third quarter, but is positive by 8.35% year-to-date. The top performing developed market countries were Japan (4.03%), Austria (3.96%), Israel (2.86%) and Ireland (2.21%). Chinese stocks had a bad month of September but an even worse third quarter. The iShares China Large ETF fell 4.95% in September and lost 15.91% during the third quarter, bringing the year-to-date return to negative 16.70%. China makes up over 30% of the Emerging Markets Index and was the main contributor to the lower Emerging Markets return. The MSCI Emerging Markets Index lost 3.97% in September and 8.09% for the third quarter. The year-to-date return for the EM Index is also now negative. It was not all bad for Emerging Markets; the MSCI Emerging Markets ex China Index lost 3.43% for September and 2.03% during the third quarter, but is positive by 8.80% year-to-date. Some of the top Emerging Market country performers during the quarter were India (10.40%), Russia (8.49%), Indonesia (8.12%) and Qatar (6.85%).

As was mentioned earlier, interest rates spiked during the latter part of September, but the move higher was only mild for the quarter. During July and August interest rates fell but around September 22nd interest rates began to spike. The 10-year note had a yield of 1.46% on July 1, 1.31% on September 22nd and closed the quarter yielding 1.49%. The 30-year bond finished the quarter with a yield about 1 basis point higher than where it started the quarter. The yield started at 2.06%, traded as far down as 1.82% on September 22 and then spiked back to 2.07% by the end of September. The Bloomberg Barclays Agg Index had a negative 0.87% return for September but finished the quarter positive by 0.05%. The Bloomberg US Government Intermediate Index lost 0.60% in September and was flat for the quarter. High-yield bonds performed better, posting a positive 0.89% return for the third quarter and are positive by 4.53% year-to-date.



Source: Yahoo! Finance

Natural Gas prices soared during the third quarter. Driven by a supply shortage in Europe and China, Natural Gas prices increased by 60.74% during the quarter. Cotton prices were up 24.62% and Coffee prices increased by 21.44%. Oil prices had a big jump during September as Crude Oil prices rose 9.53% but these prices were up only 2.12% for the quarter. The metals saw a negative quarter. Gold was off 0.82%, Copper off 4.63%, Platinum was down 10.30% and Silver saw a 15.83% decline.

After seeing 7 consecutive monthly gains for the S&P 500, volatility picked up in September and the S&P 500 lost 4.65%. This volatility stemmed from the possibility of a large default of a property developer in China, the simultaneous rise of interest rates and energy prices, the risk of higher inflation and concerns around supply-chain disruptions.

One could be forgiven for thinking that the Chinese government has been on a crusade to bring negative headlines to the market over the last year. It all began last November when the government suspended the large initial public offering (IPO) of Ant Group. More recently the government has been going after technology companies as part of their anti-monopoly legislation. Alibaba was fined $2.8 billion and Didi, China's largest ride sharing company, was forced to stop user registrations just days after going public in the U.S. In late September, China continued its crackdown on cryptocurrency, announcing all cryptocurrency activity was illegal which pushed many cryptocurrency asset prices lower—Bitcoin lost more than 5% and Ethereum lost more than 8% on the news. Not completely government related, but in the middle of September one of China's largest property developers, Evergrande, announced that they may default on its debt. The company has $300 billion in liabilities. There does not seem to be an appetite from the Chinese government to intervene as authorities have told local officials to prepare for the company's demise. Investors are concerned of the ripple effect of such a large company going bankrupt.

As detailed in the opening of this commentary, the five largest stocks in the S&P 500 have provided the market leadership since March, while many other stocks traded lower. The increase in interest rates provided the catalyst for these stocks and other growth stocks to sell-off in September. Growth stocks and stocks that are trading at high valuations tend to do better when interest rates are low because of the dependence on and expectation of future growth. Higher energy costs were also a headwind for markets, as they can have act as tax on consumers and on some businesses. If consumers are spending more money at the pump filling up their cars or if heating bills are higher than there is less money that can be put into other more dynamic sectors of the economy. Some businesses are also directly impacted by higher energy prices.

The Federal Reserve met in September and there were a few highlights to pass along. The Fed stated that sectors most adversely affected by the pandemic improved in recent months but the rise in COVID-19 cases has slowed their recovery. This statement was acknowledging the impact that the Delta variant was having on the economy. The Fed also said that inflation was elevated, largely reflecting transitory factors. Lastly, the Fed said if progress in the economy continues broadly as expected the Committee judges that a moderation in the pace of asset purchases may soon be warranted. The Fed is setting the stage to begin reducing asset purchases as early as November of this year, depending on economic conditions. Half of the committee members are expecting a rate hike in 2022 which is an increase from the June dot-plot release.

There continues to be shortages, both goods and labor, throughout the economy. Much of the worker shortage was being blamed on the enhanced unemployment benefits which expired in September.

The September jobs report that came out in early October was a disappointment—while the unemployment rate came down to 4.8%, the labor force participation rate actually declined from August. So, why is there a continued shortage? One reason is that Americans are still flush with cash from the previous stimulus and do not need to work yet. Bank of America CEO Brain Moynihan stated on a recent conference call that before the pandemic, checking accounts that ran an average balance of $1,500 now have balances of around $6,000 to $7,000. It will take time for the excess cash to work through the system, and maybe then it will bring Americans back to the workforce. There remain semiconductor shortages which are used in all kinds of products these days. The semis shortage is a prime contributor to the automobile shortage and spike in used car prices. There are supply issues across the economy being caused by the labor shortage, supply chain issues, congestion at ports and in some cases weather related delays.

Name	**3rd Quarter (%)**	**YTD (09/30/2021) (%)**
DJ Industrial Average TR USD	-1.46	12.12
S&P 500 TR USD	0.58	15.92
S&P MidCap 400 TR	-1.76	15.52
S&P SmallCap 600 TR USD	-2.84	20.05
NASDAQ Composite TR USD	-0.23	12.66
MSCI EAFE NR USD	-0.45	8.35
Bloomberg US Agg Bond TR USD	0.05	-1.55
Wilshire US REIT TR USD	1.64	24.79
IA SBBI US 30 Day TBill TR USD	0.01	0.03

A Forecast in Brief

Like most quarters, there is no shortage of items to keep an eye on in the fourth quarter.

The first item to cover is a positive note on the fight against COVID-19. While the global pandemic has disrupted businesses and families for the better part of 18 months, it appears once again like good news is on the way. The outbreak of the Delta variant caused cases to surge starting in May up until what looks like a peak in September, with numbers now beginning to recede. Progress towards immunity is also improving with some organizations estimating that over 80% of the US population has now either been infected with the disease, vaccinated or both. This does not mean that the pandemic is over. Children under 12 remain vulnerable for now although vaccines may be approved for them during the fourth quarter. We also know that there is still the risk of another mutation that is resistant to the vaccine but currently things are looking better.

Congress is playing games again. The debt ceiling needs to be raised, but Republicans are putting up a fight to stop this from happening, If the debt ceiling is not raised in October, the government will not be able to make interest payments resulting in a default on its debt. Deficits are a problem and spending is part of the problem; both Republicans and Democrats do it when they are in office, but defaulting on our debt is not helpful and could have an impact on the markets. We do not like to bring up this topic because it comes up every couple of years and eventually calmer heads prevail and it gets worked out, but one of these times it might not. At the time of this writing, it appears a short-term deal is increasingly likely.

The fourth quarter is generally a big one for retail companies as holiday shopping kicks into full gear. While the strong balance sheets of consumers are promising, retailers are warning that the supply chain issues mentioned above will impact sales in the fourth quarter. Wages are up, checking account balances are high, but do companies have enough inventory to meet the strong demand? In recent weeks, Bed, Bath & Beyond, Nike and Kohl's all claimed that supply strains are making it harder to keep up with demand. As earnings get underway in October, we expect to see more company executives warn about supply issues.

Analysts have increased earnings per share estimates for the third quarter by 2.9% which, assuming this holds true, will be the fifth straight quarter that S&P 500 companies issued positive EPS guidance compared to negative guidance. On the surface these numbers are encouraging; however, there are two relevant details to the number that are not as positive. For the third quarter, there has been an increase in companies expected to report negative numbers and a decrease in companies expected to report positive numbers compared to the previous quarter. The other concerning trend is that EPS estimates during September declined by 0.9% which is the largest monthly decrease in the quarterly EPS estimates since June 2020. These earnings numbers and estimates are provided by FactSet.

The emergence of the Delta variant and the supply chain issues caused economic growth estimates to be revised lower for the third quarter, but economic growth is expected to accelerate in the fourth quarter and into 2022 as the reopening continues and inventories are rebuilt. There remains a labor imbalance with more job openings than willing job applicants. We are unsure of the exact reason for the labor supply but some of the reasons could be the enhanced unemployment benefit, lower immigration, childcare issues, and fears around the pandemic. The labor shortage is expected to persist for the next several months and even years.

The Fed's policy meeting in November could provide some clarity on the tapering of monthly asset purchases. While any tapering would be considered tightening, the Fed policy will remain accommodative for the next several months and maybe years. If the economy continues to expand, we could see a rate hike at the end of 2022. The Fed's big risk is having to raise rates to fight inflation while not having a strong enough economy to support higher rates. If the shortages in the labor and goods eases in the next several months, inflation should retreat but we expect inflation to stay above recent low averages for some time.

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