OCTOBER 2021

Investment Review and Outlook

KEY TAKEAWAYS

- Emerging COVID-19 variants have disrupted the progress of the economic recovery, but the economy's overall health has strengthened.
- Inflationary expectations, potential tax rate increases, and political gridlock fuel uncertainty. Periods of volatility in both equity and fixed income markets should be expected, as we recently saw in September when the S&P 500 dropped nearly 5% and bonds also declined.
- The Federal Reserve has numerous tools with which to quell inflation, starting with a tapering of its bond purchases and, if needed later, the onset of a gradual increase in interest rates.

Total Returns & Values As Of 9/30/21

	QTD Return	YTD Return	Price/ Value
Dow Jones Industrial Average	-1.5%	12.1%	33,844
S&P 500 Index	0.6	15.9	4,308
Russell 2000 Index	-4.4	12.4	2,204
MSCI EAFE Index	-0.4	8.8	2,281
MSCI EM (Emerging Markets)	-8.0	-1.0	1,253
Bloomberg US Aggregate	0.1	-1.6	106
Bloomberg Municipal Bond	-0.3	0.8	114
Gold (NYM $/ozt) Continuous	-0.8	-7.3	$1,757.00
Crude Oil WTI (NYM $/bbl) Continuous	2.1	54.6	$75.03

Source: FactSet

THE ECONOMY

The Strength Of The US Economy

Despite the fact that growth slowed below expectations at the end of the quarter due to the Delta variant and supply chain bottlenecks, we believe growth will reaccelerate in the fourth quarter. The silver lining is that some of this economic activity will be pushed into 2022, resulting in stronger growth next year than originally expected. Overall, we believe we are still in the early-to-mid stages of an economic recovery that will last for a number of years. This solid fundamental backdrop should be good for stocks.

However, the threat of the Delta variant is having a near-term impact, resulting in select industries operating in an environment that remains challenging. For example, consumer spending on travel remains relatively anemic, and companies in the hospitality and restaurant industries may experience weaker top-line results. The GDP estimate of 3.7% for the period is meaningfully lower than the stellar 6.7% growth rate achieved in Q2. Supply chain issues continue to plague businesses and the American consumer and have forestalled near-term growth.

As these issues dissipate, we expect to see a rebuilding of inventories which will help various sectors of the economy meet any pickup in demand. It is good news that a vast majority of businesses have reopened, the vaccines appear to work, more people will be vaccinated, and a productivity boom is now occurring, which bodes well for future growth.

Uncertainty Hampers Progress

In Q3, economic uncertainty surfaced once again, fueled by a variety of factors, including:

- The political dialogue regarding potential tax rates, spending policies, and the level of US national debt.
- The emergence of the Delta variant, among others.
- Questions pertaining to employment levels, labor shortages, and whether company workforces will return to in-office work or continue to work remotely.

The question also remains as to whether once we have fully emerged from the pandemic, we will resume the way we lived before, or whether there are long-term, more consequential, shifts at play.

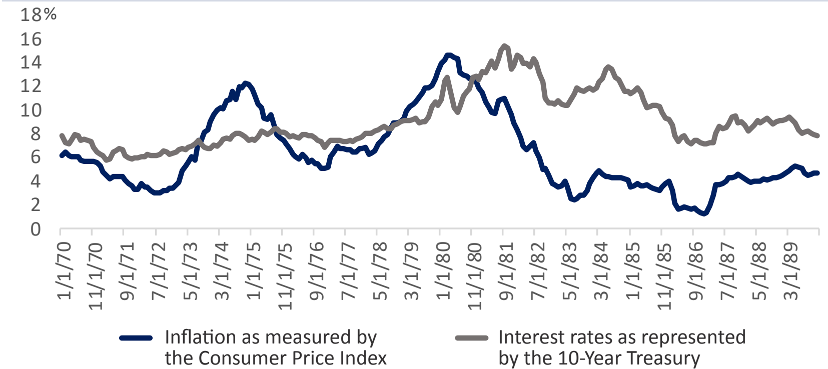
The Inflation Equation

Short-term inflationary pressures continue to affect the economy. However, when we take a closer look at the Consumer Price Index (CPI), we still expect that some price increases in select areas will be transitory. For example, the unprecedented increase in used car pricing likely will revert to more normal levels post-pandemic, once supply chains normalize and parts become available. Shipping costs also remain elevated, which has a trickle-down effect on the final cost of goods, an impact that may be felt for some time. Housing demand remains robust, led by historically-low mortgage rates combined with rising wages, and prices reflect that.

The Fed's Expansive Toolbox

If inflationary pressures persist in this low interest rate environment, the Fed has ample bandwidth to raise interest rates, gradually, as needed. The current economic scenario is in stark contrast to the levels of inflation and interest rates experienced in the 1970s and 1980s, when the Fed implemented a much higher interest rate policy in order to quell inflationary pressures, and the 10-year US Treasury yield reached a high of 15.32%.

Historical Perspective On Higher Inflation and Interest Rates (1970s-1980s)



Source: Federal Reserve Bank of St. Louis

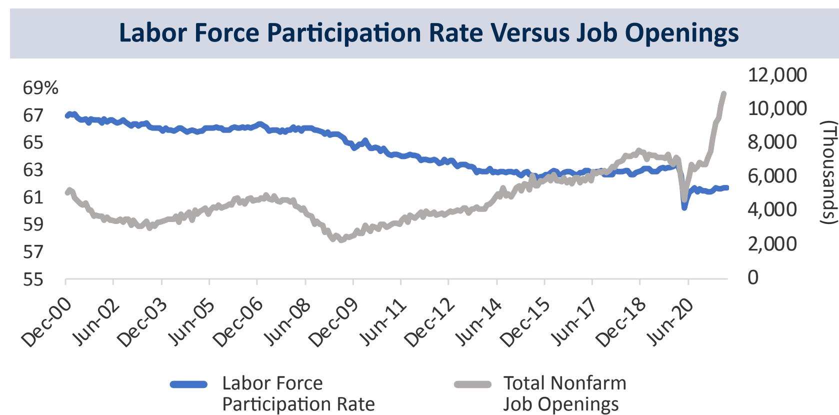
Today, the Fed has a more comprehensive toolbox with which to manage inflation, a tapering of bond purchases being the first step before any interest rate increases would have to be implemented. We have confidence that the Fed can, and will, respond appropriately to any inflationary pressures that may persist. Yet rate increases, however gradual, have the potential to negatively impact most asset classes, including public and private equity, real estate, and bonds, that have been supported by a low rate environment.

The Great Resignation Of 2021

Wage growth can have an impact on persistent inflation pressure as well as the profitability of companies, so it is an area that bears watching. Many businesses still struggle to rebuild their workforces and find qualified candidates to fill jobs at all levels, resulting in rising wages, particularly on the low end and in service sectors. As children return to school and pandemic-related unemployment programs end, childcare concerns and the tradeoff between unemployment benefits and lower-level wages will become less of a factor. Ultimately, we expect lower-end wage rates to level out, but above pre-pandemic levels.

Another labor-related dynamic to consider is the Great Resignation of 2021. The pandemic led many people to rethink when, where, and how they want to work, while also accelerating retirement transitions for many workers. According to the US Department of Labor, from April to June 2021, 11.5 million workers resigned. Recent studies indicate that this trend is not yet over. A recent Gallup poll found that 48% of employees are actively searching for new opportunities.

The implications of this unexpected trend will depend, in a large part, on whether it is fleeting or if there is a longer-term structural shift happening, since labor is one of the most critical parts of the supply chain for goods and services. Potentially higher wages will reduce profitability, productivity will be affected by the time needed to train new employees, and scarcity of workers will impact the number of hours a business even can remain open. Offsetting this is the fact that many businesses have adapted to being less labor-dependent as technological solutions have advanced.



Source: Federal Reserve Bank of St. Louis

THE EQUITY MARKET

Off To A Robust Start

Optimism resulting from the speed and breadth of the ongoing economic recovery set the tone for equities at the beginning of the third quarter until the Delta variant became more prevalent. Despite this, the return of the S&P 500 was positive for the period.

In terms of quarterly sector performance, financials was the strongest performing sector, followed by utilities and communications services. Overall, sector performance was mixed, depending on whether the focus was reopening, as it was early in the quarter, or defensiveness, when rhetoric around inflationary pressures and rate increases grabbed headlines. As a return to the 2020 COVID-19 playbook, while the Delta variant loomed, a number of the technology and work-from-home stocks started to re-engage investors.

Conversely, returns of the consumer discretionary and consumer staples sectors lagged, as did energy stocks, once it appeared that the economic reopening might be hitting a roadblock. Overall, the equity market seemed to oscillate between the drive to return to “normal” and the uncertainty surrounding the ability to do so as COVID-19 variants emerged.

A Word About Financials

Financial Services is an economically-sensitive sector. Currently we are in the early-to-mid stages of the business cycle which should bode well for the sector, as the economy rebounds and demand for credit generally increases. Out of 11 S&P 500 sectors, financials was the top-performer this quarter. States that have reopened earlier experienced strengthening economies and favorable loan growth relative to others. We expect this loan growth trend to continue as other states follow suit.

Net interest margin expansion (net interest income generated from credit products, such as loans and mortgages, compared with the interest paid on deposit products, such as savings accounts and CDs) is an ongoing challenge for banks. We do not expect the yield curve, which reflects interest rates paid at different maturities, to steepen meaningfully any time soon. However, as the Paycheck Protection Program (PPP) is phased out and government loans are forgiven, banks will be assured that PPP funds most likely will remain on deposit, providing banks with increased opportunity to invest in securities or make loans as a result. This should provide an upside to margins.

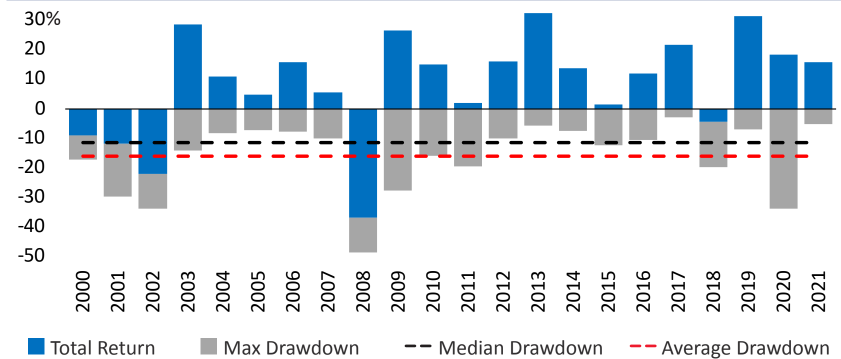
Many financial companies, including banks, insurance, and credit card companies, are reaping the benefits of productivity-enhancing technological investments. The expanded use of machine learning and artificial intelligence (AI) is helpful for operational efficiencies that may counteract potential headwinds such as increased regulations.

From a valuation perspective, as measured by the S&P 500 Financials Index, financial stocks continue to offer compelling opportunities, trading only slightly above their 20-year average valuation, while the entire S&P 500 is trading at a premium of approximately 33% above its long-term average. In addition, the financial sector may serve as a valuable hedge against the technology sector in a portfolio, since higher interest rates, which are beneficial to financial stocks, cause the future cash flows of high-growth tech companies to become less valuable, which may lead to underperformance.

Modest Expectations For Equities

We are in the midst of a secular bull market supported by moderate economic growth, low interest rates, and reasonable wage growth. Consumer confidence has been strong as many consumers have felt the positive wealth effect from home price appreciation.

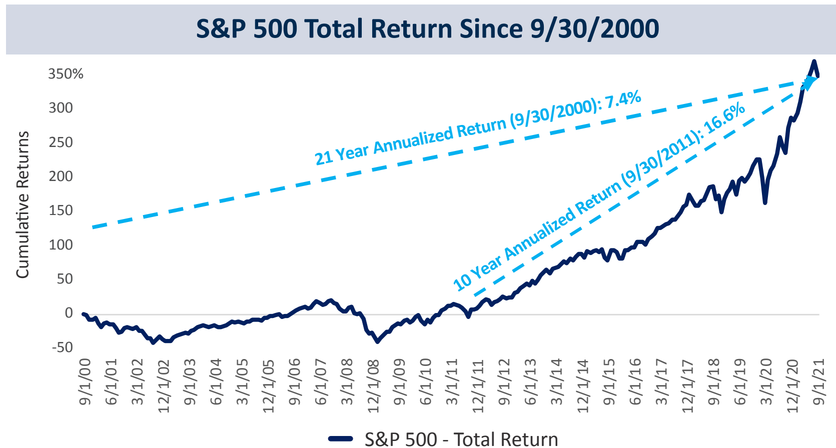
Since the initial pandemic-related correction last spring, investors have enjoyed an extended period without any significant decline in the equity markets. For investors with a long-term time horizon, we believe equities remain the most compelling asset class for growth, but as always, we monitor clients' portfolios for short-term liquidity needs against the potential for a market correction.



Source: FactSet

With respect to market performance over the next few years, our expectation is that returns for equities will be modest as investors navigate the high valuations of recent years. To put this into a historical perspective, the total return from US large-cap equities, as represented by the S&P 500, for the last 10 years has been 16.6% annualized through quarter end, quite a bit higher than its 50-year average of 11%. This is partly due to low interest rates, but also because of a low-valuation starting point that coincided with the downgrade of US government debt in August 2011, resulting in a one day decline in stocks of nearly 6%. However, if one were to measure the period from the beginning of 2000, until September 30, 2021, the return was only 7.4% annualized, well below the long-term average.

This may seem to be a surprisingly modest rate of return given the market's strong performance of late and the exceptional rate of appreciation since the Financial Crisis. However, the starting point of those 20 years was the high-valuations dot-com tech-bubble era with several major market drawdowns experienced along the way, including the Great Recession of 2007 and 2008, and the sharp decline in 2020 from the pandemic.

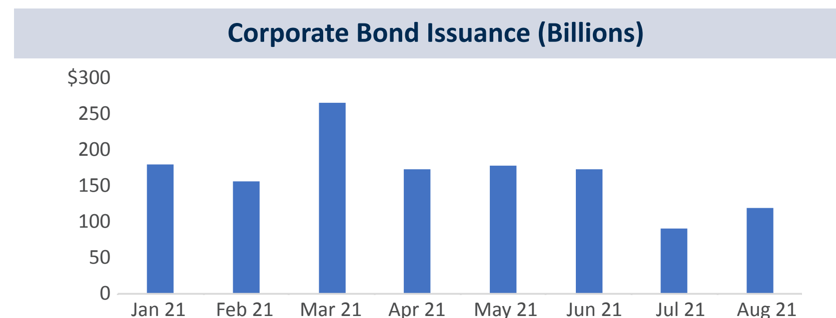


Source: FactSet

THE FIXED INCOME MARKET

A Flight-To-Safety

After beginning the quarter at 1.45%, interest rates on the 10-year US Treasury dipped to 1.17%, in a flight-to-safety demand for bonds due to concerns about the Delta variant. Profit-taking in the waning days of the quarter resulting in the yield at 1.53%, not far from where it started. Correspondingly, corporate yield spreads widened somewhat versus Treasuries during the period. After Labor Day, a surge in corporate bond issuance resulted in increased supply quickly absorbed by robust demand.



Source: Refinitiv

Taper Timing

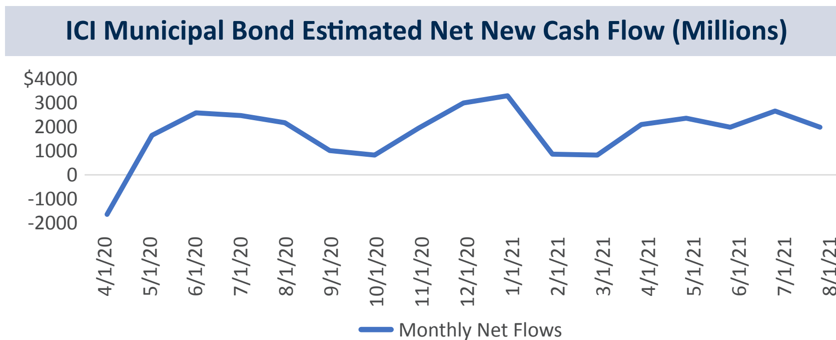
The potential timing of the Fed's tapering of bond purchases is still a predominant focus in the fixed income markets. To reduce market volatility, the Fed has made it a practice to overcommunicate its stance well ahead of taking action. While any impending tapering will have an impact on rates, most likely with upward pressure, the question is whether or not they will go meaningfully higher. In our opinion, the effect should be moderate since rates in the US are still markedly above those in most developed countries. Therefore, any increase in yields should be met with sufficient demand with which to help offset the reversal of the accommodative policy. Any unforeseen significant change in rates would not be well received by financial markets, as the Fed is well aware.

A Ballast For Portfolios

With any measure of inflation outpacing the current low yield on US Treasuries, negative real rates (rates adjusted for inflation) continue to be a concern for investors. Although yields remain low, investment-grade bonds are an integral asset allocation component and serve as a meaningful ballast for portfolios. Overall, fixed income serves as a valuable vehicle with which to moderate portfolio volatility and, secondarily, to function as a source of liquidity when markets become stressed.

The Robust Appetite For Munis

The anticipation surrounding potential tax increases has spurred investors to buy municipal bonds, with significant net inflows into municipal bond funds over the past 27 consecutive weeks. At the same time, municipal bond issuance is still insufficient to satisfy robust investor demand, and bond prices reflect that reality.



Source: Bloomberg

The opportunity for advanced refunding that allows for debt refinancing on a tax-exempt basis is still potentially on the horizon as a component of the Biden Administration's Build Back Better Act. If the administration reverses the 2017 Tax Act decision to prevent municipalities from refinancing debt with tax-free municipal bonds (they are now required to use taxable municipal bonds), there could be robust tax-free refinancing issuance. In most circumstances, an issuer pays a higher interest rate to borrow when issuing taxable bonds than tax-exempt bonds, making tax-free debt for refunding purposes more attractive to issuers as well as more compelling for investors in higher tax brackets.

THE LONG VIEW

Our mission at 1919 Investment Counsel is to help our clients successfully navigate many different economic environments in order for them to achieve their unique goals. With this in mind, we believe keeping a long-term perspective is a key tenet of any effective investment strategy.

Inflationary pressures, COVID-19 variants, and potential tax rate hikes may spur short-term periods of market volatility accompanied by below-average equity returns. Likewise, as interest rates rise in the future, even modestly, bond prices will weaken. These are normal market reactions and should not serve to derail a sound investment plan. Often these market reactions are the same ones that give rise to attractive investment opportunities.

The views expressed are subject to change. Any data cited herein have been obtained from sources believed to be reliable. The accuracy and completeness of data cannot be guaranteed.