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Q3 2021 Review and Outlook

The U.S. economy rebounded sharply in the first six months of 2021, but economic expectations for the second half were revised down during the third quarter. The Delta variant delayed return-to-office plans, thus delaying the office-adjacent economy's recovery. While growth expectations are lower, inflation expectations increased. The balance between economic growth, employment and inflation is likely to keep the Federal Reserve (Fed) in the limelight during Q4 as we await the great taper.

Markets took a breather in Q3 following a strong first half. The S&P 500 Index increased +0.6% and the Nasdaq Composite Index declined -0.2%, bringing their year-to-date returns to +15.9% and 12.7% respectively. Fixed income markets were subdued with the focus remaining on Fed guidance. In Q3, the Bloomberg U.S. Aggregate Bond Index was basically flat with a +0.1% return, which brought its year-to-date decline to -1.6%.

It was a challenging quarter for global equity markets. Similar to the first half, U.S. equity markets remained in the lead, followed by international developed markets. Emerging markets (EM) lagged due to weakness in Chinese markets. Developed markets (MSCI World ex U.S. Net TR USD Index) declined -3.0% and emerging markets (MSCI Emerging Markets Net TR USD Index) declined -8.1%, bringing their year-to-date returns to +5.9% and -1.2%, respectively.

Fast Growth, But Slower Than Initially Expected

The global economic recovery hit some speed bumps in Q3. The Delta variant delayed some economic activity from Q3 into Q4 and 2022, while supply chain bottlenecks and higher prices dampened real growth. The Fed's median real economic growth expectations for 2021 were revised down from 7.0% in June to 5.9% in September, while their growth forecast for 2022 increased from 3.3% to 3.8%. Higher and more persistent inflation factored into the lower real GDP growth forecasts for 2021. The Fed's 2021 expectations for Core PCE inflation increased from 3.0% in June to 3.7% in September.[1]

The U.S. wasn't the only region where 2021 real economic growth was slower than expected. In September, Fitch downgraded their global GDP growth to 6.0% from 6.3% in June. Factors that contributed to the downgrade were reduced expectations for U.S. real GDP growth, the slowdown in the Chinese property sector, and reduced economic growth expectations in Australia and several Asian economies due to new Delta-driven restrictions.[2]

We expect the adverse economic impact of the virus to diminish as global vaccination rates increase in 2022, helping global growth and reducing supply chain bottlenecks. The impact will have positive spillover effects for U.S. economic growth. However, we believe that less supportive factors are likely to be more prominent for the rest of 2021 and into early next year.

- The U.S. is past its peak fiscal stimulus. Stimulus boosted consumer spending and durable goods consumption, putting more money in consumers' hands. The scale of the stimulus is likely to create an unfavorable comparison period for the coming year.

- Monetary policy is likely to become less supportive over the next 12 months. The Fed is expected to announce its tapering plans in November. Also, the dot plot is starting to indicate the potential for a 2022 interest rate hike, though 2023 remains more likely.[3]
- Slower GDP growth in China is expected as their property sector cools. This slowdown is likely to weigh on commodity prices. Depending on how the Chinese government resolves the China Evergrande debt crisis, China may be a more significant drag on global growth next year.

Despite lower growth expectations, the economic recovery is expected to remain strong for the rest of 2021 and into 2022.

Supply Chain Bottlenecks and the Risk of More Persistent Inflation

Global supply chains bottlenecks remain an issue and are expected to persist into mid-2022, with semiconductor shortages likely to continue into 2023. The Baltic Dry Index, a reflection of shipping costs, is currently at its highest level since mid-2008.[4]

Fast-rising gas, oil, and electricity prices are headwinds for global real economic growth. Across several major economies, the post-pandemic recovery has coincided with low energy inventory levels going into winter. Securing supply for the winter is pushing energy prices higher. Crude oil prices are at their highest levels since 2018 while natural gas prices haven't seen these levels since early 2014 and thermal coal prices are off the charts.

- China is rationing electricity due to a coal shortage. Approximately 40% of China's industrial activity is expected to have been impacted by this shortage.[5]
- Europe is facing higher electricity costs driven by the convergence of several factors ranging from low natural gas stockpiles to reduced output from their green energy facilities combined with nuclear plants being offline for maintenance.
- A lack of truck drivers to distribute fuel from refineries to retailers has resulted in a fuel shortage at gas pumps in the UK.

These are all factors that could contribute to higher costs for producers while reducing the consumers' ability to spend. Officials expect energy price increases to continue into early 2022 before slowing down next spring.

Uncertainty Surrounding Infrastructure: Yet the Country Needs an Upgrade to Stay Competitive

The Senate passed a bipartisan bill to authorize $550 billion in new spending on hard infrastructure including roads, bridges, and tunnels. Now it's with the House, where prospects of the bill's passage are murky amid moderate and progressive demands on the Democratic side combining the bipartisan bill with the go it alone budget reconciliation bill.

As of this publication, the fate of both bills are unknown and likely won't be resolved until the end of October, if at all. The package is linked to the Biden administration's ambitious original $3.5 trillion reconciliation package for social initiatives, which includes spending for child and elderly healthcare and climate change. At this point, we believe that if the infrastructure bills are passed and enacted, they will be much smaller in scale, though a path to improvement in the nation's

infrastructure will be a step forward. Also, any step towards combatting climate change on the Federal level will be a net positive.

Debt Problems in an Interconnected Financial System

At the start of Q4, two debt issues have the potential to drive market volatility: the U.S. debt ceiling and Chinese property developer, China Evergrande. While different in scale and complexity, both situations could send ripple effects across global financial markets. On the bright side, politicians have the ability to resolve both situations.

Markets know the U.S. debt ceiling will be raised—the alternative is a self-imposed Global Financial Armageddon. Congress averted a partial government shutdown by passing a nine-week stopgap funding bill, so perhaps that bodes well for a deal sooner rather than later. The deadline is about October 18th, depending on how creative the Treasury can be. In the meantime, the debt ceiling will remain an overhang and potential source of market volatility over the next two weeks.

China Evergrande is the most indebted property developer in the world with $305 billion debt, about 2% of China's GDP. A default could send shock waves through the Chinese property development market and global capital markets.[6] Property accounts for roughly 25% of the Chinese economy, so slower growth in the property sector will weigh on Chinese GDP growth expectations, which brings major deflationary risks.

But similar to the U.S. debt ceiling, it's unlikely the situation gets that far. The Chinese government letting China Evergrande fail would avoid moral hazard and be more in line with the type of genuine economic growth China wants. However, social stability and improved prosperity are important to the Chinese Communist Party, which makes it unlikely that they let China Evergrande default.

Large Caps Takes the Lead as Market Breadth Declines in Q3

When Q3 began, 92.6% of the names in the S&P 500 Index traded above their 200-day moving average. But by the end of the quarter, only 64.6% did. The story is more telling further down the market cap spectrum. The Russell 2000 Index ended Q3 with less than half of its constituents trading above their 200-day moving average, down from 78.7% at the end of Q2.[7] The summer of 2021 was a key focal point for the market during the reopening rotation. As we move into the final stretch of the year, markets are less united on a single idea surrounding the economic trajectory. The result is reduced market depth with a few large companies propping up the market amid increased uncertainty.

Reduced economic growth expectations drove a divergence in performance by size in Q3. Large caps held their ground with the Russell 1000 Index rising +0.2%, while small caps retreated with the Russell 2000 Index declining -4.4%. The performance difference propelled large caps into the lead year-to-date with a +15.2% return versus the Russell 2000 Index's +12.4%.

With a total return of +1.2%, the Russell 1000 Growth Index was the only size and style market segment with a positive return in Q3. Large caps remained solidly in the lead with the Russell 1000 Value Index declining -0.8% while the Russell 2000 Value and Growth Indexes declined -3.0% and -5.7%, respectively.

It was a challenging quarter for the Russell 2000 Value Index, but given its strength in Q1, it remains the top-performing market segment year-to-date with a 22.9% total return. The Russell 1000 Value and Growth Indexes followed with +16.1% and +14.3% returns, respectively. Small cap growth lagged with the Russell 2000 Growth Index only rising +2.8% year-to-date.

Large Sector Divergence Driven by Fed Shift

Seven of the 11 S&P 500 GICS Sectors had positive returns in Q3, but returns were generally subdued. Financials (+2.7%), Utilities (1.8%), Communication Services (1.6%), Health Care (+1.4%) and Information Technology (+1.3%) were the top-performing sectors, while Industrials (-4.2%), Materials (-3.5%) and Energy (-1.7%) were the weakest.

Two distinct trends defined Q3: declining Treasury yields and declining economic growth expectations for most of the quarter, followed by a spike in Treasury yields during the final week.

- Long duration and growth-focused assets had a respite during most of Q3, as 10-year Treasury yields declined from 1.47% to 1.30% as of September 22nd.[8] During this period, the top-performing GICS Sectors were Real Estate, Information Technology, Health Care and Utilities, while the weakest sectors were the cyclical, reflation-focused sectors. Among those sectors, Energy, Industrials and Materials were the weakest.

- Then, following the Fed meeting on September 22, 10-year Treasury yields increased from 1.30% to end the quarter at 1.49%. Updated Fed language indicated that economic growth remains solid while inflation is elevated. This meeting completely changed the course of yield expectations and sector performances, with signals that the Fed may start tapering their asset purchases at the November meeting.

- Higher Treasury yields and improved economic expectations supported a large increase in the typical reflation trade sectors: Energy, Financials, Industrials and Materials. While Industrials, Materials and Energy remained the weakest sectors for the quarter overall, Financials' performance since September 22 made it the top-performing sector in Q3.

- Valuation concerns returned with the increase in yields, which detracted from bond proxy and tech-heavy sectors. Real Estate, Information Technology and Utilities declined sharply as yields increased.

Yields, Valuation, and a Focus on Quality

We believe economic growth expectations, valuations and quality are likely to be key areas in Q4 and into 2022. Where possible, we are targeting quality value and profitable growth while being cautious with our approach to deep value and aggressive growth.

This earnings season, markets will pay close attention to margins and whether companies have been able to pass on higher production costs. The producer price index (PPI) increased 8.3% year-over-year (Y/Y) in August while the consumer price index (CPI) rose 5.3% Y/Y.[9] This gap, the largest between these two inflation gauges in more than 40 years, indicates that corporate margins may come under pressure.[10] Higher global shipping costs combined with higher wages are major factors to monitor.

Should enough companies be able to pass on their higher input costs, consumer inflation could rise faster than expected, potentially bringing forward less accommodative Fed policy.

Expectations for higher interest rates are a concern across the market, but particularly for high growth market segments. The yield environment has been a major factor in the recent valuation environment. Expectations for high future earnings are now discounted at a higher discount rate.

Higher Yields Dampen Fixed Income

Fed talk dominated market sentiment during Q3. September's shift in tapering and interest rate expectations weighed on fixed income markets. The Bloomberg U.S. Aggregate Bond Index was basically flat for the quarter. Prior to September's sharp spike in Treasury yields, long duration Treasuries were strong. But they gave up their advances to end the quarter reasonably flat, with long duration Treasuries only marginally outpacing shorter maturities.

Year-to-date, fixed income remained a challenging area. Treasury yields ended the quarter at 1.49%, up from below 1% at the start of the year. The Bloomberg U.S. Aggregate Bond Index declined to -1.6% YTD.

Easy Gains are now in the Rear-View Mirror, Smarter Gains Are the Focus

With the economy largely open, there is less anticipation and focus on a single idea. So, as we transition away from the reopening economy to the mid-cycle recovery, reduced economic growth expectations shift the focus from deep value towards quality value. Moving into the cooler months, focus is likely to remain on economic engagement and discretionary spending on services. Additionally, sustaining margins is likely to become increasingly important with inflation pressures expected to persist into mid-2022.

Expectations for economic growth are lower, but they remain robust, and improvements in the economy are likely to be accompanied by higher yields. The most recent dot plot raises the potential for a 2022 interest rate hike, but given the Fed's current dovish posture, 2023 remains more likely for the first increase. While we expect this rising rate cycle to be reasonably slow, an increase in the discount rate increases the focus on valuations. As a result, inflation and yields could remain headwinds for U.S. equities while also shaping the segments of the market that are likely to do well into 2022.

Footnotes:

1. Federal Open Market Committee, Summary of Economic Projections, 9/22/2021
2. FitchRating, Global Economic Outlook - September 2021: Speed Limits, 9/2021
3. Federal Open Market Committee, Summary of Economic Projections, 9/22/2021
4. Bloomberg data as of 9/30/2021
5. Reuters, Explainer: Global Energy Shortage or a Coincidence of Regional Crises?, 10/1/2021
6. Carnegie Endowment for International Peace, What Does Evergrande Meltdown Mean for China, 9/20/2021
7. Bloomberg data as of 9/30/2021
8. Bloomberg data as of 9/30/2021
9. Trading economic data as of 9/30/2021
10. Morgan Stanley, Could Rising Costs Squeeze Corporate Profits?, 9/28/2021

Definitions

Baltic Dry Index: This index is issued by the London-based Baltic Exchange and is reported globally as a proxy for the price of moving major raw materials by sea. The index includes three key shipping sizes across 23 different global shipping routes carrying coal, iron ore, grains, and other commodities.

Bloomberg U.S. Aggregate Bond Index: The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-through), ABS and CMBS (agency and non-agency).

Core PCE inflation: Core inflation is measured by both the CPI and the Core Personal Consumption Expenditures Index (PCE) which represents the price of goods and services purchased by consumers in the U.S.

Global Industry Classification Standard (GICS): This is a standardized classification system to sort business entities by sector and industry group. It consists of 11 sectors, 24 industry groups, 68 industries and 157 sub-industries.

MSCI World ex USA Net Total Return Index: The index captures large and mid-cap representation across Developed Markets countries –excluding the United States. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Emerging Markets Net Total Return Index: The index captures large and mid-cap representation across emerging market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

NASDAQ Composite Index: The NASDAQ Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange.

Producer Price Index: The index measures the change in the price of goods as they leave their place of production.

Russell 1000 Total Return Index: Consists of the largest 1000 companies in the Russell 3000 Index. This index represents the universe of large capitalization stocks from which most active money managers typically select.

Russell 2000 Total Return Index: Consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization.

Russell 1000 Growth Total Return Index: The index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Total Return Index: The index measures the performance of those Russell 1000 companies with lowest price-to-book ratios and lowest forecasted growth values.

Russell 2000 Growth Total Return Index: The index measures the performance of those Russell 2000 companies with highest price-to-book ratios and highest forecasted growth values.

Russell 2000 Value Total Return Index: The index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.

Treasury Yield: The market interest rate on debt issued by the U.S. government.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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