ECONOMIC & INVESTMENT PERSPECTIVES

SEPTEMBER: ECONOMIC & MARKET SEA CHANGE?

Figure 1: 9/30/2021 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	QTR	YTD	1YR	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	-0.9%	0.0%	-1.7%	-1.0%	-3.1%	1.4%
Investment Grade Corp Bonds	LQD	-1.5%	-0.5%	-2.2%	1.1%	-4.0%	4.0%
U.S. Treasury Bonds	GOVT	-1.1%	0.0%	-2.0%	-3.3%	-4.2%	1.8%
20+ Year Treasury Bonds	TLT	-2.9%	0.4%	-7.5%	-10.3%	-11.9%	8.4%
Muni Bonds	MUB	-0.7%	-0.4%	0.3%	2.1%	-1.6%	1.1%
High Yield	HYG	-0.4%	0.3%	3.0%	8.9%	-0.8%	5.1%
Non-US Corp Bonds	IBND	-2.8%	-2.6%	-6.6%	-0.4%	-8.2%	0.2%
Emerging Markets Bond LC	EMLC	-3.5%	-3.3%	-7.0%	1.9%	-10.6%	0.3%
Global Equity							
ACWI Global Equity	ACWI	-4.2%	-1.3%	10.9%	26.9%	-5.2%	29.2%
United States	VTI	-4.5%	0.0%	15.2%	32.2%	-5.4%	34.6%
International Developed	EFA	-3.3%	-1.1%	8.4%	25.4%	-5.2%	27.9%
Emerging Markets	EEM	-3.9%	-8.6%	-2.1%	16.0%	-13.6%	15.1%
Global Equity by Region							
United States	VTI	-4.5%	0.0%	15.2%	32.2%	-5.4%	34.6%
Europe	IEUR	-5.5%	-2.1%	10.9%	28.5%	-6.7%	33.4%
Asia ex-Japan	AAXJ	-4.3%	-10.1%	-4.9%	11.3%	-17.1%	10.5%
China	MCHI	-4.6%	-18.1%	-16.4%	-8.1%	-30.8%	3.0%
Japan	BBJP	2.5%	4.0%	4.9%	20.4%	-5.1%	21.6%
Latin America	ILF	-10.3%	-15.8%	-8.5%	28.8%	-18.4%	28.2%
US Equity							
US S&P 500	IVV	-4.7%	0.6%	15.9%	30.1%	-5.5%	33.1%
NASDAQ 100 QQQ	QQQ	-5.7%	1.1%	14.5%	29.5%	-6.5%	34.1%
US Large Growth	IWF	-5.6%	1.1%	14.1%	27.1%	-6.5%	32.0%
US Large Value	IWD	-3.5%	-0.8%	15.9%	34.8%	-4.6%	36.4%
US Eqwt S&P 500	RSP	-3.8%	-0.2%	18.8%	40.6%	-4.9%	41.4%
US Mid Cap	IJH	-4.0%	-1.7%	15.5%	43.7%	-5.3%	42.9%
US Small Cap	VTWO	-2.8%	-4.3%	12.4%	47.7%	-6.6%	46.9%

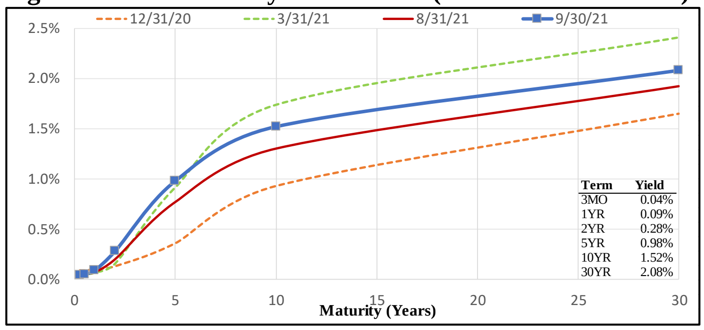
Stocks and bonds fell in September amid rising interest rates, uncertain monetary and fiscal policy, and lingering health and economic concerns due to the virus and lagging vaccination rates. Performance highlights for the month and third quarter (Q3) are below; economic/market cross-currents are discussed on page 2.

- Bonds: The U.S. Aggregate index (AGG) fell 0.9% (0.0% Q3) as interest rates rose across maturities. Long-term Treasuries (TLT) fell 2.9% (+0.4% Q3); corporate bonds (LQD) lost 1.5% (-0.5% Q3), and high yield fell 0.4% (+0.3% Q3). A strong dollar hurt non-U.S. bonds (IBND) which lost 2.8% (-2.6% Q3); emerging market debt (EMLC) lost 3.5% (-3.3% Q3).
- Global equity (ACWI): -4.2% for the month (-1.3% Q3).
- U.S. Equity: The broad market (VTI) fell 4.5% in September (+0.0% Q3). The S&P 500 (IVV) was down 4.7% (+0.6% Q3); small stocks (VTWO) were down 2.8% for the month but under-performed for the quarter (-4.3% Q3). Growth stocks under-performed in September (IWF -5.6%, QQQ -5.7%) as rising interest rates sparked a revaluation of the tech and consumer stocks that have led for most of the year. All sectors logged negative returns during the month except energy (XLE), which rose 9.0% as oil prices rose to $75 per barrel.
- Non-U.S. Equity: Developed markets (EFA) fell 3.3% (-1.1% Q3), with Europe (IEUR) losing 5.5% (-2.1% Q3), but Japan (BBJP) rose 2.5% (+4.0% Q3). Emerging markets were considerably weaker, with Brazil (EWZ) losing 11.7% (-20.7% Q3) and China (MCHI) down 4.6% (-18.1% Q3).

Interest Rates and the Economy

After moving steadily lower since March, interest rates rose measurably in September. Figure 2 graphs the U.S. yield curve, which plots yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Short-term yields remain near zero indicating that despite higher inflation readings recently, bond investors do not believe that the Federal Reserve (Fed) will increase policy rates anytime soon. Longer term maturities rose in the wake of the Fed announcement that they could begin to reduce monthly bond purchases incrementally in late 2021 ("taper"). The benchmark U.S. 10-year bond yield rose from 1.30% to 1.52% during the month.

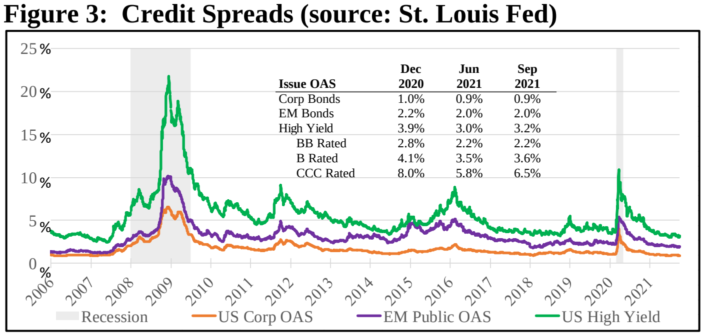
Figure 2: U.S. Treasury Yield Curve (source: St. Louis Fed)



For bonds other than Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads narrowed slightly this month on average and remain considerably below 2020 year-end levels.

- Investment grade corporate bond spreads were stable at +0.9% versus +0.9% in June and +1.0% at 2020 year-end.
- High yield (non-investment grade) spreads widened to +3.2% during Q3 but are well below year-end spreads of +3.9%. The riskiest bonds (rated CCC & below) yield +6.5% over Treasuries, down from 6.6% last month but up from 5.8% in June.
- Emerging market bond spreads were stable at +2.0% this quarter but have narrowed from +2.2% at 2020 year-end.

Figure 3: Credit Spreads (source: St. Louis Fed)



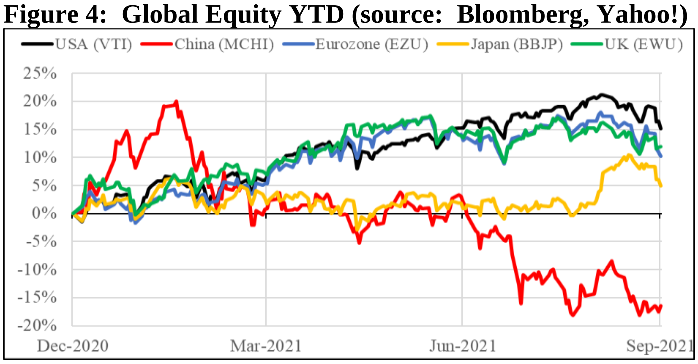
Economic & Market Sea Change?

The US and global stock markets posted their first negative month since January and now rest just over 5% below all-time highs set early in September. Given the extraordinary rise since late March, 2020, the pullback is minor, even healthy so far, but the economy and markets are facing multiple headwinds:

- Virus: Stubbornly high cases, hospitalizations and deaths due to the delta variant and vaccine hesitancy threaten growth.
- Employment: Disappointing August jobs data released in early September warn of slowing economic recovery in the U.S.
- Fed: When will they taper? When will they raise rates?
- Congressional gridlock: Worries over government shutdown, debt ceiling, and infrastructure spending dominate headlines.
- China: Increasing regulation and debt concerns roil markets.

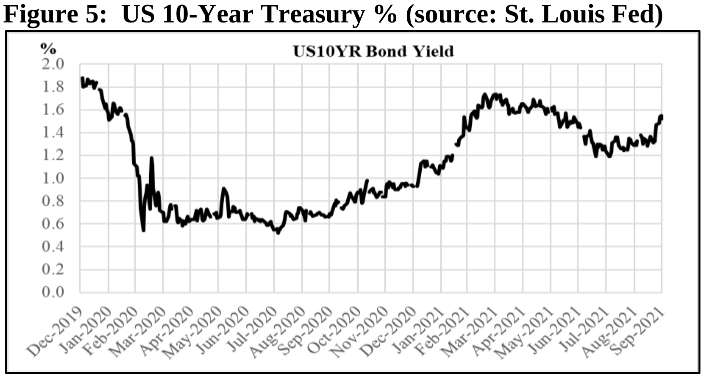
Figure 4 below graphs the YTD equity performance of the five largest global economies. China was the first to falter after peaking in February; Chinese stocks began to decline amid a steady drumbeat of new government regulation aimed at the largest tech, e-commerce and education services firms. More recently, the threat of a major default by Evergrande, a Chinese real estate developer and Asia's largest junk bond issuer, accelerated the selling pressure. Markets have begun to stabilize with the growing consensus that it is in China's best interest to promote open markets and that the debt crisis will be contained.

Figure 4: Global Equity YTD (source: Bloomberg, Yahoo!)



The U.S. market peaked in early September but began to struggle under the on-going threat posed by the delta variant of the virus. A disappointing August employment report (+220,000 jobs, far lower than expectations of +748,000) underscored the sluggishness of the economic recovery. Since March, 2020, the stock market recovery has been fueled by massive monetary and fiscal support, but the recent rise in interest rates indicate that we are nearing an inflection point. Figure 5 plots the path of the yield on the US 10-year Treasury bond through the pandemic era.

Figure 5: US 10-Year Treasury % (source: St. Louis Fed)

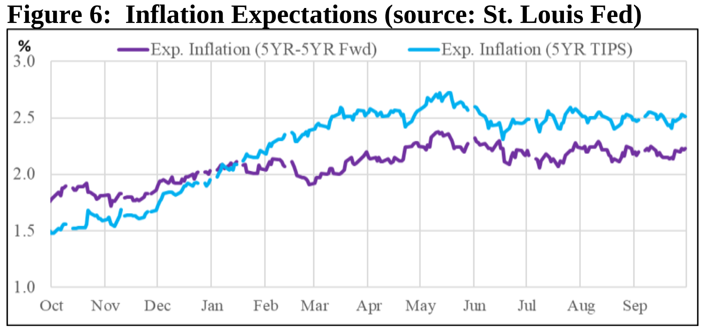


Interest rates have spiked in the wake of the Fed announcement that they could begin to taper (reduce/eliminate) their $120 billion monthly bond purchases as early as November. Furthermore, half of the Federal Open Market Committee (FOMC) members now forecast at least one Fed Funds rate hike in 2022; median FOMC estimates forecast short-term rates (near zero now) rising to 1% by the end of 2023, 1.75% by the end of 2024, and 2.5% thereafter. Rising interest rates did not concern the markets in late 2020 through early 2021 as investors focused on a rapidly improving health and economic outlook, but tighter monetary conditions in a sluggish economy threaten to derail true recovery. Eventually, the Fed will have no choice but to tighten monetary conditions, given their narrow and specific dual mandate:

- Promote full employment: Unemployment has declined to 5.2%. While this is well above pre-pandemic levels of 3.5%, we expect the Fed will begin to increase borrowing rates as unemployment declines toward approximately 4%.
- Maintain price stability: The Fed targets a 2% inflation rate as measured by their core Personal Consumption Expenditures (PCE) metric. While the core PCE (as well as the more familiar CPI) have come in well above 2% in recent months, the Fed continues to believe that elevated inflation is "transitory", caused by the "base effect" (depressed prices a year ago in the depths of the pandemic slowdown) and temporary supply chain disruptions (semiconductors, manufacturing, shipping, etc.). If elevated inflation persists, the Fed will be forced to raise rates.

So far, the markets agree with the Fed's assessment of transitory inflation. Figure 6 illustrates the bond market's embedded inflation expectations, which have been relatively stable around 2.5% in the near term (5YR TIPS breakeven – blue line), declining to 2.2% in the longer term (5YR-5YR Forward – purple line).

Figure 6: Inflation Expectations (source: St. Louis Fed)



Bottom Line

The markets appear to be struggling with the pending transition from a recovery fueled by central bank intervention (low interest rates and massive liquidity injections) to true, self-sustaining economic recovery. Our inability to take the steps necessary to combat the on-going threat of the virus (vaccines, masking, etc.) is threatening that recovery precisely at the time that the Fed is contemplating reducing their support by tapering asset purchases and, eventually, raising interest rates. As yields have begun to rise, investors are reassessing the lofty valuations of market leading stocks and sectors (growth stocks, tech, e-commerce, etc.), a rotation that will likely continue if rates rise further. Though it is difficult to believe that the Fed will withdraw support if the economy falters, markets will likely be volatile as employment, inflation and interest rates seek self-sustaining equilibrium, underscoring the value of a diversified investment portfolio.

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