ECONOMIC & INVESTMENT PERSPECTIVES

OCTOBER: WORRISOME US GDP GROWTH & INFLATION

Figure 1: 10/31/2021 Returns (source: Bloomberg)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	0.0%	-1.7%	-0.4%	-3.2%	1.3%
Investment Grade Corp Bonds	LQD	0.5%	-1.7%	2.2%	-3.6%	4.4%
U.S. Treasury Bonds	GOVT	-0.1%	-2.1%	-2.3%	-4.8%	1.6%
20+ Year Treasury Bonds	TLT	2.5%	-5.3%	-4.9%	-8.9%	10.9%
Muni Bonds	MUB	0.0%	0.3%	2.6%	-1.8%	0.8%
High Yield	HYG	-0.3%	2.6%	8.2%	-1.4%	4.3%
Non-US Corp Bonds	IBND	-0.5%	-7.0%	-0.9%	-8.7%	0.6%
Emerging Markets Bond LC	EMLC	-1.4%	-8.3%	0.5%	-12.2%	0.1%
Global Equity						
ACWI Global Equity	ACWI	5.4%	16.9%	36.8%	-0.5%	34.4%
United States	VTI	6.7%	22.9%	43.8%	-0.1%	41.7%
International Developed	EFA	3.2%	11.8%	34.2%	-2.2%	30.3%
Emerging Markets	EEM	1.1%	-1.0%	15.6%	-12.6%	13.4%
Global Equity by Region						
United States	VTI	6.7%	22.9%	43.8%	-0.1%	41.7%
Europe	IEUR	5.0%	16.5%	42.3%	-2.0%	38.0%
Asia ex-Japan	AAXJ	1.6%	-3.4%	11.0%	-15.7%	9.2%
China	MCHI	2.5%	-14.3%	-10.0%	-29.0%	6.6%
Japan	BBJP	-2.6%	2.2%	19.0%	-7.6%	16.8%
Latin America	ILF	-5.5%	-13.5%	21.7%	-22.9%	19.3%
US Equity						
US S&P 500	IVV	7.0%	24.0%	42.8%	-0.1%	40.4%
NASDAQ 100 QQQ	QQQ	7.9%	23.5%	44.1%	0.0%	44.6%
US Large Growth	IWF	8.7%	24.1%	43.0%	0.0%	43.0%
US Large Value	IWD	5.1%	21.9%	43.4%	-1.0%	40.2%
US Eqwt S&P 500	RSP	5.3%	25.1%	48.9%	-1.0%	45.7%
US Mid Cap	IJH	5.9%	22.3%	48.8%	-0.9%	45.9%
US Small Cap	VTWO	4.3%	17.2%	50.6%	-2.6%	48.5%

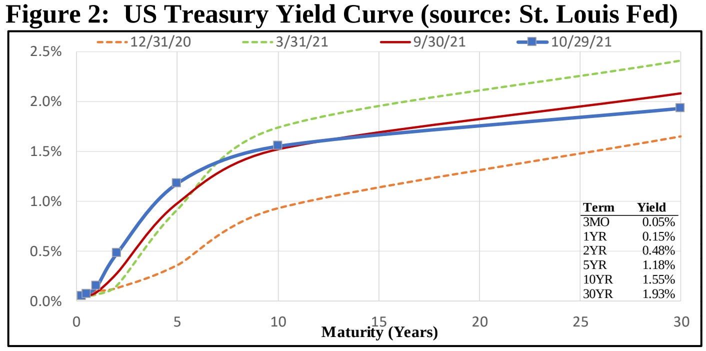
After declining roughly 5% in September through early October amid rising inflation and virus concerns, US and global equity markets recovered to all-time highs, logging strongly positive returns for the month. Performance highlights for October and 2021 year-to-date (YTD) are summarized below.

- Bonds: The US Aggregate index (AGG) was volatile but ended the month flat (-1.7% YTD). Long-term Treasuries (TLT) rose 2.5% (-5.3% YTD), and corporate bonds (LQD) gained 0.5% (-1.7% YTD). Emerging market debt (EMLC) has lagged materially, down 1.4% this month (-8.3% YTD).
- Global equity (ACWI): +5.4% in October (+16.9% YTD).
- US Equity: The broad market (VTI) rose 6.7% this month (+22.9% YTD), led higher by large growth and commodity-oriented stocks. The S&P 500 gained 7.0% (+24.0% YTD), out-performing small caps (VTWO) which rose 4.3% (+17.2% YTD). Growth (IWF +8.7%) out-performed value (IWD +5.1%) and now leads YTD. Sector leaders included Consumer Discretionary (led by a 44% gain in TSLA!), Basic Materials and Energy stocks; all sectors logged gains in October.
- Non-US Equity: Developed markets (EFA) gained 3.2% (+11.8% YTD), led higher by European stocks (IEUR), while Japanese stocks (BBJP) fell marginally. Emerging markets (EEM) were up 1.1% (-1.0% YTD) with strength in commodity-oriented economies (Indonesia, Russia) while Brazil continues to fall amid persistent political and inflation concerns.

Interest Rates and the Economy

Short-term interest rates continued to rise from March lows amid rising inflation concerns, while long-term rates fell this month with slowing economic growth expectations. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remain near zero, but one- to five-year yields rose with the increasing likelihood of Fed rate hikes in the next few years. The US 10-year bond yield rose as high as 1.68% but ended the month at 1.55%. Weak Q3 GDP growth (page 2) validated the growth concerns.

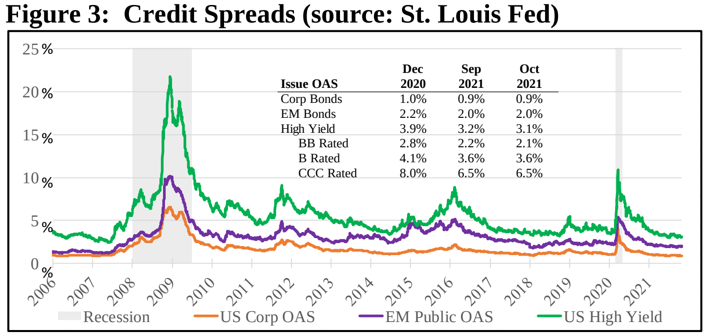
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US 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 were stable in October and remain at or near historic lows, despite rising yields.

- Investment grade corporate bond spreads were stable last month at 0.9% versus 1.0% at the 2020 year-end.
- High yield (non-investment grade) spreads narrowed to +3.1% and are well below year-end spreads of +3.9%. The riskiest bonds (rated CCC & below) yield +6.5% over Treasuries, stable last month but below year-end levels of +8.0%.
- Emerging market bond spreads were stable at +2.0% this month but are slightly tighter than at year-end. The stability of these spreads in a rising interest rate environment means that non-U.S. yields have risen along with those in the U.S.

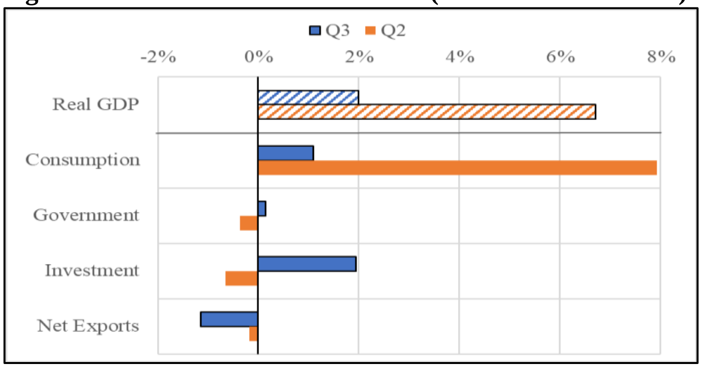
Figure 3: Credit Spreads (source: St. Louis Fed)



Growth & Inflation

The U.S. Bureau of Economic Analysis (BEA) reported that real GDP grew at an annualized pace of 2.0% in the third quarter (Q3), significantly below the annualized growth rates of over 6% in the first and second quarters. (Note: Real GDP stands for Gross Domestic Product, the value of all final goods and services produced in the U.S., adjusted for inflation.) The resurgence of the virus over the summer plus the end of stimulus and extended unemployment benefits dramatically impacted consumer behavior as illustrated in Figure 4, which compares the real growth contributions of the four primary GDP sub-components in Q2 and Q3.

Figure 4: Real Growth Contribution (source: St. Louis Fed)



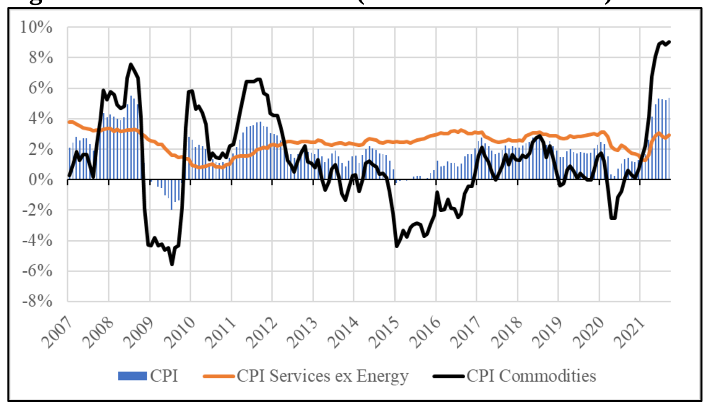
We previously presented concerns that Q2 growth (orange bars above) was artificially buoyed by consumer spending of government stimulus and increased unemployment benefits. As those payments lapsed and the pandemic raged anew, the pace of economic recovery diminished. While growth remained positive in Q3 (blue bars), an analysis of the sources of growth is instructive.

- **Personal Consumption:** 69% of the U.S. economy is powered by the aggregate expenditures of individual consumers. After being the only driver of growth in Q2, consumption contributed just 1.1% to the real GDP growth rate of 2.0% in Q3.
- **Government expenditures:** 18% of GDP is driven by direct consumption of goods and services by federal, state and local governments. After detracting from growth in Q2, government consumption had a slightly positive contribution in Q3.
- **Private Investment:** 18% of the economic output comes from the expenditures and investment activity of businesses, including construction, equipment, manufacturing and inventories. A build in inventories was the primary driver of growth in Q3.
- **Net Exports:** The net value of U.S. exports minus imports (trade deficit) is a drag on our economy, currently -4% of GDP. A record trade deficit increased that drag in Q3.

Economic growth is expected to continue with a diminishing virus threat over time. The Fed expects real growth of 3.8% in 2022, moderating toward a long-run rate of 2.0% by 2024.

The primary concern facing markets and investors is inflation. It is worth noting that nominal GDP growth (not adjusted for inflation) in Q3 was actually +7.8%; with real GDP growth of 2.0%, the remaining 5.8% was due to inflation, not real growth. The Fed believes that this elevated inflation is transitory, caused by spiking oil prices, supply chain disruptions due to the staggered restart of the global economy, and the base effect (higher current prices compared to depressed prices and activity last year). The latest Consumer Price Index (CPI) inflation reading came in at +5.4% for September versus a year ago; core CPI (excluding more volatile food and energy prices) was +4.0%. Figure 5 breaks CPI down into two major sub-components: commodities (raw materials: oil, gas, materials, agriculture, etc.) and non-energy services (housing, medical, transportation excluding gas, education, etc.). It is clear that the current inflation surge is driven by rising commodity prices (primarily oil and gas), while the cost of services (which comprises more than half of the CPI calculation) has remained much more stable (+3%).

Figure 5: Inflation Year/Year (source: St. Louis Fed)

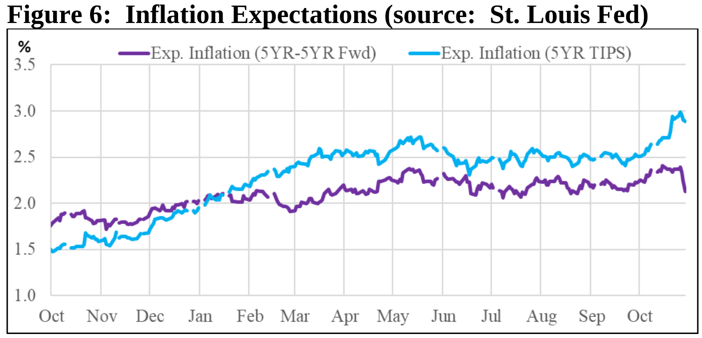


Just because current inflation is commodity-based, that does not mean it is not real. Commodities are used for many things: energy, construction, food, cars, appliances, etc. The fact that services inflation has not spiked supports the notion that elevated inflation is likely transitory, driven by supply chain issues (transportation, workforce, etc.) and not by money printing or wage inflation. The energy markets agree, projecting oil prices to fall back below $60 per barrel over the next five years (from $83 today), but experts know that prices can rise further in the short run.

Bottom Line

The flattening yield curve suggests a moderation of economic growth forecasts (lower long-term yields) and rising near-term inflation concerns (rising short-term yields), reflecting expectations of multiple Fed interest rate hikes in the coming years. We agree with the Fed (and the bond markets) that elevated inflation is likely to be transitory. As illustrated in Figure 6, the TIPS market (Treasury Inflation Protected Securities) implies inflation expectations of just under 3% per annum on average for the next five years (blue line) and much closer to the Fed's 2% target over the longer term (purple line). However, inflation remains a significant investment risk. Markets are likely to remain volatile as economic activity, inflation and interest rates seek self-sustaining equilibrium, underscoring the value of a diversified portfolio that over-weights natural inflation hedges (equity, emerging markets, commodities) and under-weights long-duration bonds.

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



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