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ASSET MANAGEMENT

2021 – 3rd Quarter Review & Outlook

Economic and Investment Review

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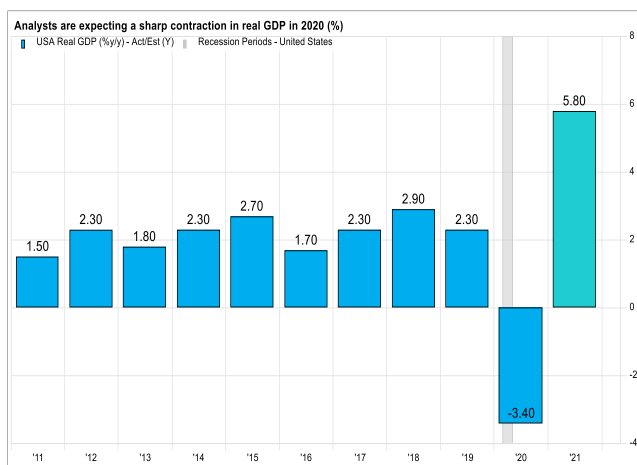
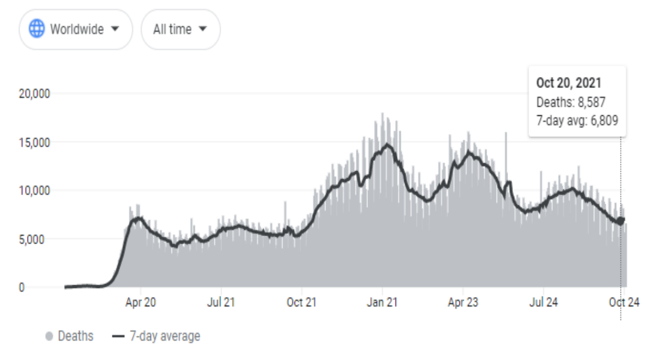
Economic Growth: Revised Q2 2021 real GDP grew at a 6.7% quarter-over-quarter seasonally adjusted annual rate. The decline in inventories was a bit of a drag on growth during the quarter; however, inventories will likely add to economic growth in the coming quarters as businesses restock. The U.S. economy grew by 2.0% in Q3. Actual growth was significantly below the previous estimate of 3.5% due to the semiconductor shortage, and the impact on vehicle production and slower growth in consumer services due to the Delta variant. Estimates for Q3 growth were as high as 7.1% in July. GDP growth is expected to improve to 5.5% in Q4. GDP growth for the full year, 2021, is expected to come in at 5.8%. The consensus estimate was as high as 6.5% just three months ago.



Source: FactSet

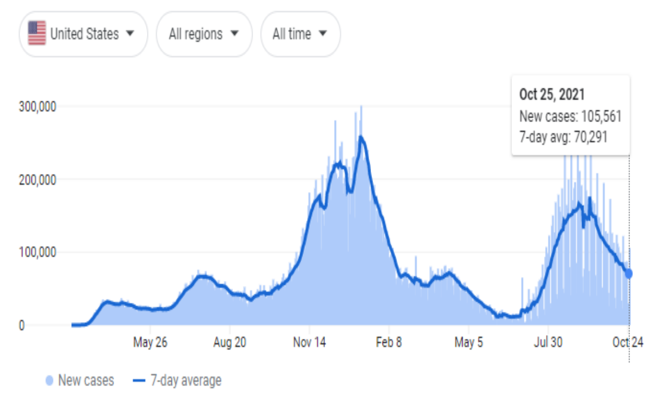
Domestic economic growth is expected to normalize over the coming years to 4.1% in 2022 and 2.5% in 2023. Developed international economies are expected to largely grow in line with the U.S. economy. Emerging market economies are expected to grow at 1.0-2.5% faster rates than developed market economies over the coming years.

The coronavirus continues to take about 6,800 lives each day globally.

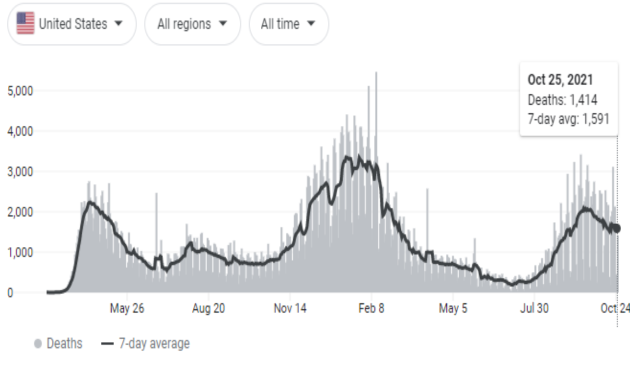


Source: New York Times

Cases and deaths in the U.S. appear to be trending down but many areas of the economy continue to be negatively impacted by the virus.

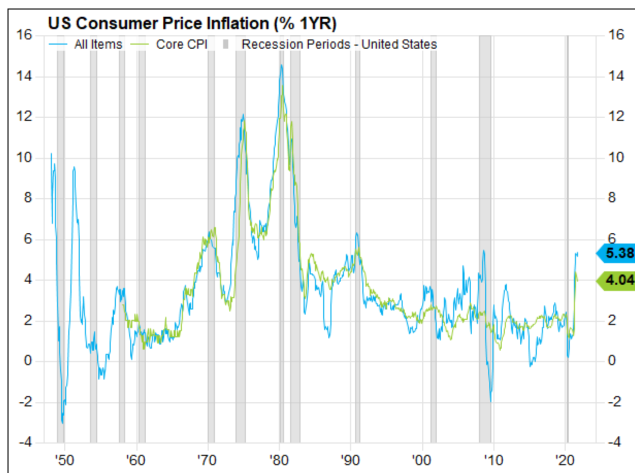


Source: New York Times



Source: New York Times

Significant supply chain issues are being reported in most major economies. The lack of parts and materials has created bottlenecks in manufacturing and the tight labor market has been a difficult challenge for both manufacturing and services. Demand for goods and services continues to rebound while at the same time the supply is constrained. Inflation has surged in the last few months due to limitations on supply of goods and services. The consensus forecast for CPI has moved up to 4.3% for all items and 3.4% for core CPI for 2021. CPI spiked up to 5.38% in September.



Source: FactSet

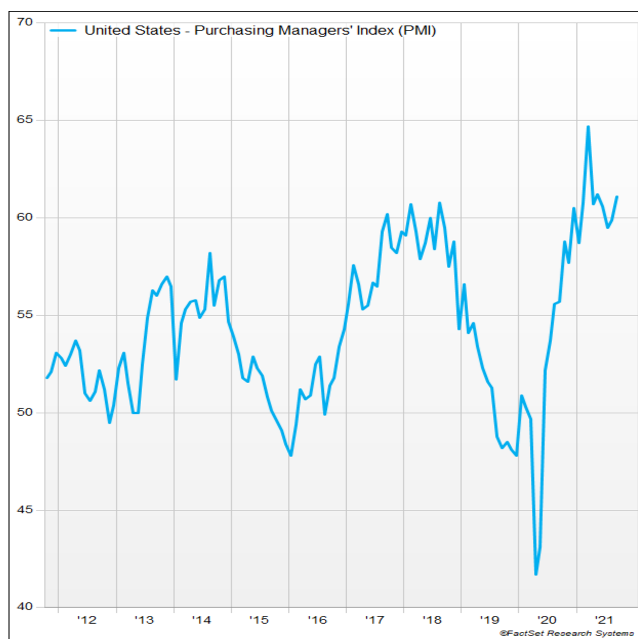
Fed Chairman Jerome Powell and other Fed governors have pushed back on the idea that the recent surge in prices is a precursor to permanently higher inflation. They make the case that pandemic related shutdowns and reopening of the economy have led to temporary price increases. They expect inflation pressures to decline as supply chain issues are sorted out. The Fed also thinks that imbalances in spending on goods as opposed to services has led to inflation. They expect that as spending on services picks up the imbalances will decline and inflation will moderate.

The Fed has announced their intention of reducing, or tapering, asset purchases. The plan is to reduce purchases by $15 billion each month until next June. The asset purchases were used as an economic stimulus tool and liquidity provider. Termination of asset purchases will likely take place prior to any rate increases. Chairman Powell stated that it would be premature to raise rates "now with the effect and intent of slowing job growth when there's good reason to expect supply constraints to diminish." Consensus estimates still do not point to any rate increases in 2022 but the forecast is for an increase of 0.75% in 2023. If the current inflationary pressures persist well into 2022 the timeline of rate increases may have to be reconsidered.

The employment picture has continued to improve as evidenced by the unemployment rate declining from 5.2% in August to 4.8% in September. The consensus estimate for unemployment drops further to 4.1% by the end of 2022. Employers continue to struggle to find qualified workers as many remain out of the labor force. The U.S. labor force participation rate was 63.3% in February 2020 but stands at 61.6% currently. There are many reasons for the reduced participation rate. Many baby boomers have decided that it is time to retire. Research from the St. Louis Fed indicates that more than 3 million Americans retired early. Finding adequate child day-care has been a challenge as many of those employed in the industry prior to the pandemic have chosen to not return. Many others have reconsidered their work/life balance and changed jobs or have become self-employed.

Industrial production has been on the rebound over the past seven months but the rate of increase has steadily been trending down. The areas of greatest strength in the September report were Oil and Gas Well Drilling (up 69.7% y/y), Defense and Space Equipment (up 17.9% y/y), and Communications Equipment (up 15.5% y/y). The area of greatest weakness was Motor Vehicles & Parts.

The ISM (Institute for Supply Management) Manufacturing and Services indices both indicated continued expansion at 61.1 and 61.9 respectively. (Any reading over 50.0 indicates expansion and any reading under 50.0 indicates contraction.)



Retail & Food Services were up 13.9% y/y in September. Gasoline Stations lead the increase at 38.2%, followed by Food Service at 29.5% and Clothing at 22.4%.

Economic and market headwinds have focused on the impacts from COVID and higher levels of inflation. Other headwinds include tax increases and energy costs.

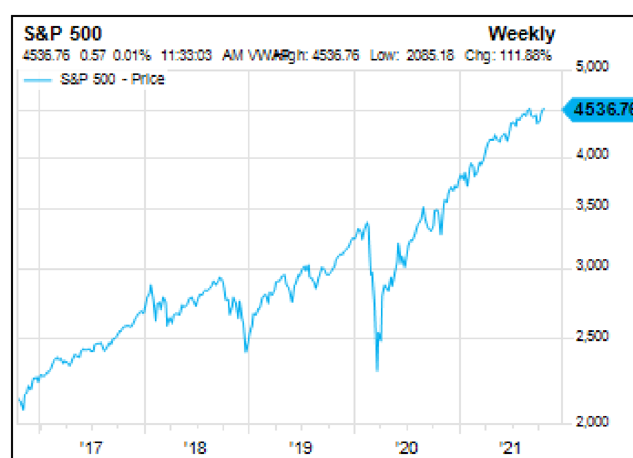
The Democrats' tax plan to pay for their reduced social/environmental reconciliation package of about $1.75 trillion includes:

- 15% corporate minimum tax
- Stock buyback tax
- Stronger International Tax Rules
- Millionaires surtax on incomes above $10 million
- A billionaire tax on unrealized gains
- Expanded Medicare tax on wealthy
- Expanded audits on those making more than $400,000 a year.

Energy prices have surged following a sharp pandemic caused correction in early 2020. The Wall Street Journal (10.10.21) states that "the higher prices are being driven by rising demand and tight supplies." Demand from consumers for goods and services has increased, leading to greater energy usage in production and logistics. Oil supplies are tight because oil-exporting countries have been increasing production in measured steps instead of moving to full capacity production.

Equity Markets

The S&P 500 closed at 4307 on September 30, up 0.58% in Q3 and up 15.92% YTD. The index has continued to move higher since the end of the quarter.



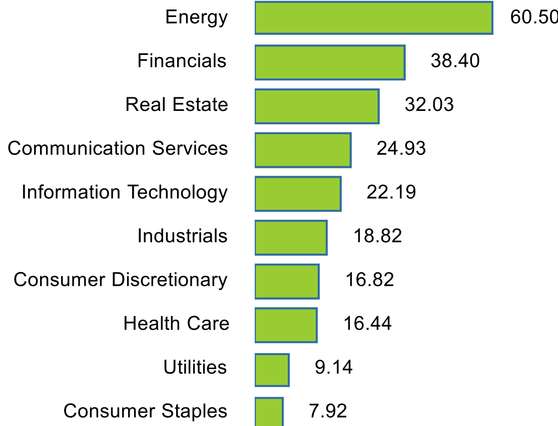
Source: FactSet

Growth stocks outpaced value stocks in Q3 and YTD but lagged value stocks for 1 year. Growth stocks continue to outperform for longer periods.

2021 Q3 Returns				
EQUITY	**Q3 2021**	**YTD 9.30.21**	**1 Year 9.30.21**	**3 Years Annualized**
S&P 500	0.58	15.92	30.00	15.99
S&P 500 Value	-0.85	15.31	32.02	10.69
S&P 500 Growth	1.87	16.44	28.86	20.23
Dow Jones Ind Avg	-1.46	12.12	24.15	11.00
S&P Mid Cap 400	-1.76	15.52	37.08	11.08
S&P Small Cap 600	-2.84	20.05	57.64	9.44
MSCI EAFE	-0.45	8.35	25.73	7.62
MSCI Emerging Mkts	-8.09	-1.25	18.20	8.58

Source: FactSet

YTD sector performance continues to be led by the energy sector followed by financials and real estate.



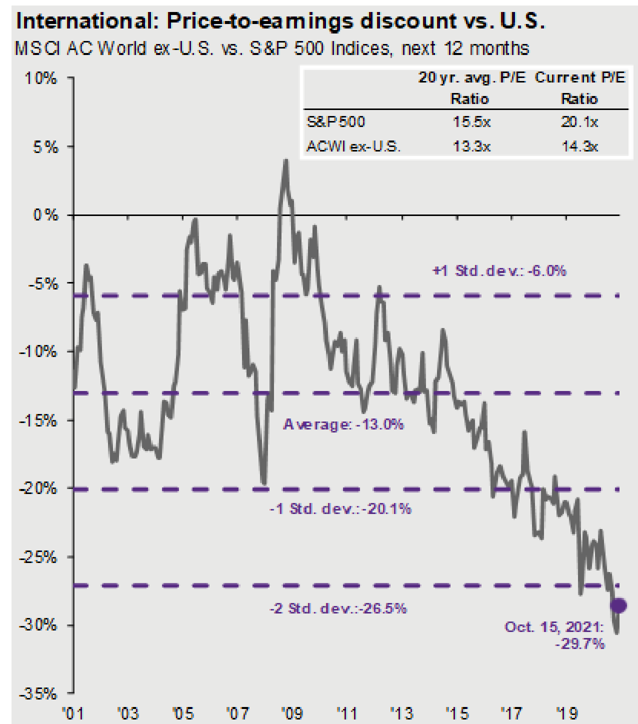
Source: FactSet

Mid Cap and Small Cap stocks took a breather during the quarter but continued to be strong performers YTD and for 1 year.

Developed international markets (MSCI EAFE) and emerging markets (MSCI EEM) continued to underperform the U.S. equity markets. Developed markets were down -0.45% in the quarter but were up 8.35% YTD. The performance gap was narrower for 1 year as developed markets were up 25.73%.

International equities look attractive on a relative valuation basis. The international price-to-earnings discount is at its greatest level in more than twenty years. The 20-year average P/E ratio (12 months forward) for the S&P 500 is 15.5x compared with 13.3x for the ACWI ex-U.S. The current P/E is 20.1x for the S&P 500 compared with 14.3x for the international index.

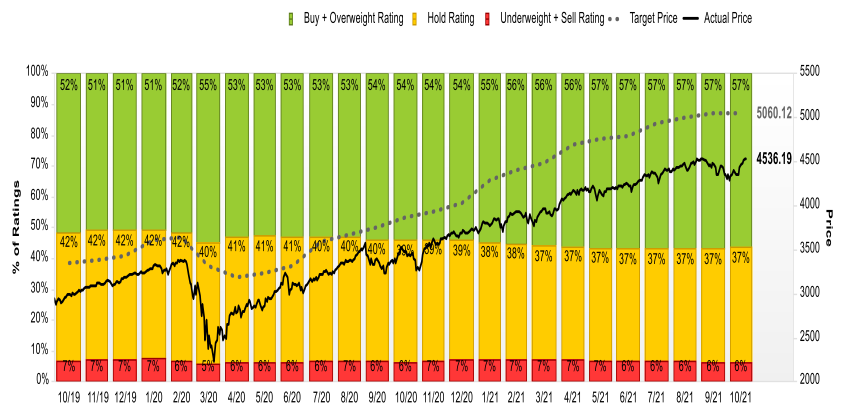
International stocks have historically traded at a discount to the U.S. in part due to economic sector weights. Growth sectors, Technology and Communication Services (Alphabet, Facebook, Netflix) sectors have a greater weight in the U.S. and command higher P/E multiples.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of October 15, 2021.

Our current 12 month forecast for the S&P 500 is 4,700, indicating an upside of only about 3% from the current level of 4,550. The forecast is based on consensus EPS numbers of 199.83 for 2021, 218.32 for 2022 and 237.56 for 2023. The EPS numbers imply growth of 44.8% in 2021, 9.3% in 2022 and 8.8% in 2023. The price earnings multiples being used in the forecast indicate a slow adjustment toward the long-term average.

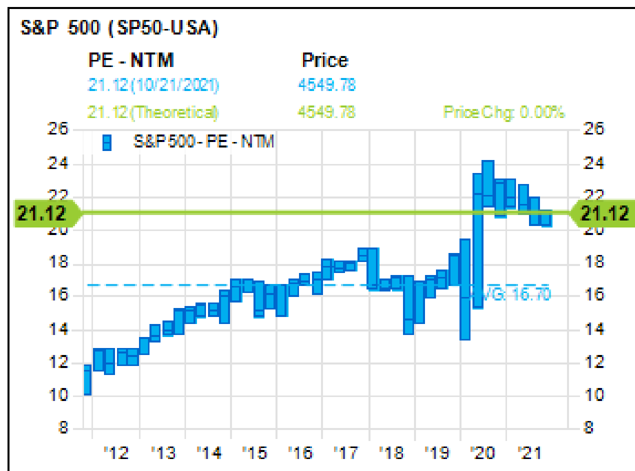
The consensus target price is currently 5,060, pointing to an upside of 11%. The consensus target price indicates a P/E multiple of 20.8x the 2022 EPS estimate and 19.2x the 2023 EPS estimate.



Source: FactSet

The Goldman Sachs forecast is 4,850 for 12 months and the Raymond James forecast is 4,950 for year-end 2021.

Higher than average PE multiples continue to be supported by historically low interest rates and extraordinarily strong earnings growth. When interest rates begin to adjust up and/or earnings growth begins to trend down, PE multiples should trend toward long term averages. The 10-year average PE for the S&P 500 NTM (next twelve months) is 16.7x.

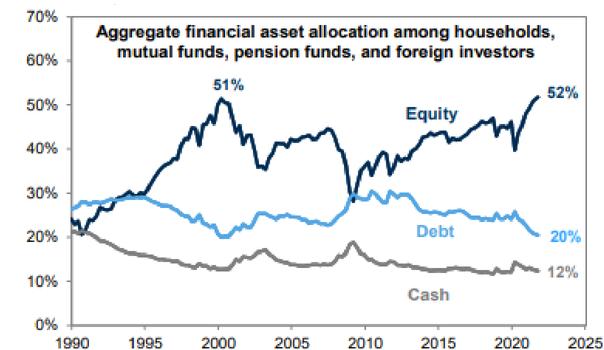


Source: FactSet

Explanations for why price earnings multiples may stay at elevated levels include:

- asset allocation evolution
- cash levels, and
- expected stock buyback levels

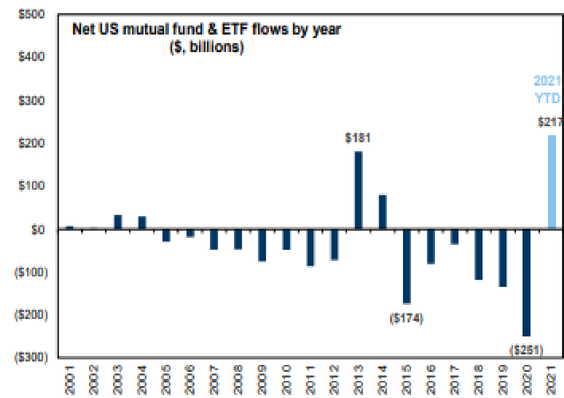
Investor allocation to equity assets is at an all-time high of 52%. The previous high was set during the internet/tech bubble in 2000.



Source: Federal Reserve Board, EPFR, Goldman Sachs Global Investment Research

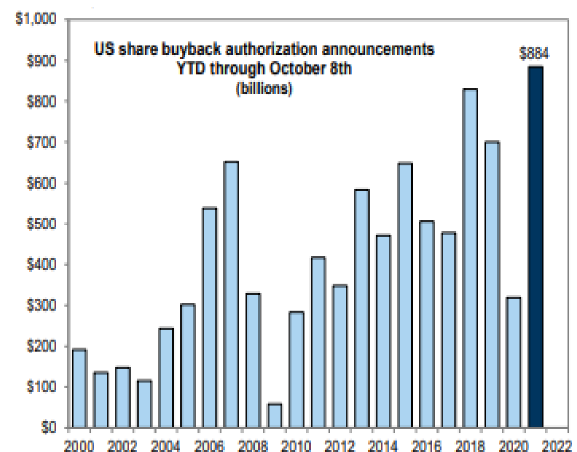
Goldman Sachs expects that the allocation to equities will move even higher in 2022. The basis for their expectation includes:

- TINA or There Is No Alternative. Yields on fixed income remain low and relatively unattractive. Low yields combined with an upward trend in interest rates limits the attraction to fixed income.
- U.S. cash assets are at record levels. Households, mutual funds, pension funds and foreign investors hold $19 trillion of U.S. cash assets. It is anticipated that at least some of cash assets will be invested in equities. Flows of cash into mutual funds and ETFs are at significantly elevated levels.



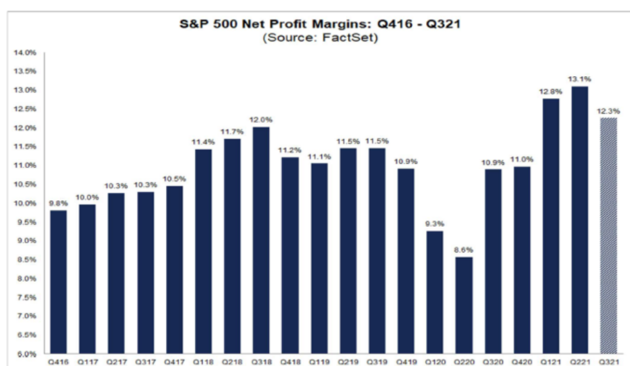
Source: EPFR, Goldman Sachs Global Investment

Corporate stock buyback programs are bouncing back from a low level of authorizations in 2020 to a record level in 2021. Goldman Sachs forecasts that corporations will be the largest source of net equity demand through year-end 2021 and in 2022.



Source: Goldman Sachs Global Markets Division, Goldman Sachs Global Investment Research

One of the factors that could contribute to lower earnings growth is margin compression. Higher wages and input costs will place pressure on margins. FactSet reports that the blended net profit margin for the S&P 500 for Q3 is 12.3%. (The blended net profit margin combines actual result for companies that have reported and estimated results for companies that have yet to report) The margin was above the year-ago net profit margin and the 5-year average net profit margin of 10.9% but slightly below the previous quarter's record high net profit margin of 13.1%.

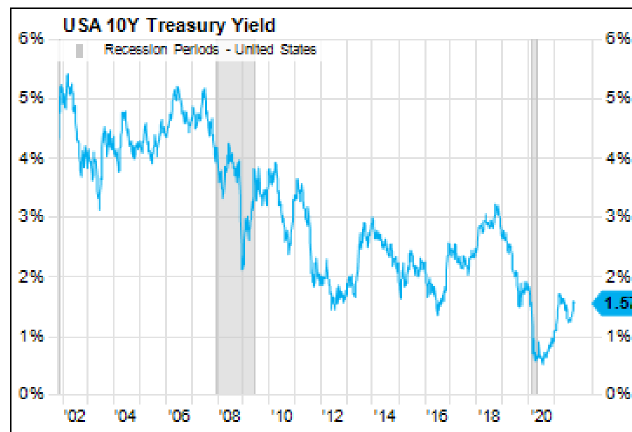


Source: FactSet

FactSet also reports that a higher percentage of S&P 500 companies are beating EPS estimates for the third quarter than average, and that they are beating the estimates by a wider margin than average. These above-average growth rates are due to a combination of higher earnings for 2021 and an easier comparison to weaker earnings in 2020 due to the negative impact of COVID-19.

Fixed Income Markets

After a decades long decline in yield and a commensurate increase in price, fixed income investments appear to have reversed course. Interest rates have risen from low points a year ago to slightly higher levels now. The 10-year U.S. Treasury yield increased from 0.70% in October 2020 to 1.57% today.



Source: FactSet

Bond prices and yields are reacting to renewed inflation concerns and the Fed's announced intention to taper bond purchases.

Investment grade bonds (Barclays U.S. Aggregate Index) were relatively flat in Q3 but remained negative YTD and for 1 year. Additional increases in rates since the end of the quarter have pushed returns further to the negative.

2021 Q3 Returns				
FIXED INCOME	Q3 2021	YTD 9.30.21	1 Year 9.30.21	3 Years Annualized
B B US Agg Bond	0.05	-1.55	-0.90	5.36
S&P National Muni	-0.36	0.75	2.62	4.88
B B High Yield	0.74	3.79	9.97	6.47

Source: FactSet

We continue to expect interest rates to trend upward. In order to reduce the negative impact, we recommend modestly shortening duration (reducing the sensitivity to changes in interest rates) of bond portfolios and bond funds held. Also, the use of TIPS (treasury inflation protected securities) and floating rate funds for a portion of a fixed income allocation may help to offset some of the downside pressure while still producing income.

Municipal bonds, as represented by the S&P Municipal Index, were down -0.36% for the quarter and up 0.75% YTD and 2.62% for one year through September 30. As the Biden administration and the Democrat controlled congress work to increase tax rates, municipal bonds will be more in the spotlight.

There has been a consistent inflow of funds to municipal bond during much of the year. Credit quality of municipal bonds remains strong and proved to be resilient through the pandemic.

High yield bonds, as represented by the Bloomberg Barclays High Yield Index, returned 0.74% in Q3, 3.79% YTD and 9.97% for one year ending September 30. High yield bond spreads have tightened to historically low levels as investors reach for yield in a low interest rate environment. High yield bond returns will likely be more confined to income production than any further tightening in credit spreads.

Disclosures

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