INVESTMENT STRATEGY UPDATE

MARKET REPORT
QUARTER 4 • 2021

MARKETS FACE UNCERTAINTY

The advance in global equity prices fizzled in the third quarter of 2021. Although most stock indices remain positive year-to-date, they were generally flat or negative for the quarter. In the US, the S&P 500 managed a +0.6% increase for the quarter, while the Dow Jones Industrial average was down -1.5%. Abroad, the MSCI EAFE was down -0.5% while the MSCI Emerging Markets Index dropped by -8.1% leaving the emerging markets index also in the red year-to-date at -1.3%.

A multitude of factors weighed on stocks including the impacts of another surge of the Delta variant, continued disruption of the global supply chain, concerns over inflation, and political gridlock in Washington. Within the US, tensions over the $3.5 trillion spending package and raising the debt ceiling added to concerns. Pressure was mounting for Congress to increase the borrowing limit or potentially face significant long-term economic consequences.

Overseas, the potential collapse of the Chinese property company, Evergrande, spooked markets. Stocks were pushed lower by fear that Evergrande may default on its $300 billion of outstanding debt, sending shock waves through the financial system similar to the 2008 financial crisis. In addition, the Chinese government has been implanting new regulations in many areas, including education, gaming, and technology companies, which could limit corporate profitability in the future.

Overall, the US bond market was flat for the quarter, with the yield on the 10-year US Treasury beginning and ending the quarter at 1.5%. With inflation persistent at around 5% in the US, the Federal Reserve indicated that it will reduce its monetary support and raise rates sooner than previously anticipated. In addition to supply chain issues, a tight labor market, with more job openings than unemployed workers, is causing wages to rise at an annualized rate of 4.9%, a level not seen in the US since the 1980s. While price increases due to supply chain disruptions may recede, the increase in wages likely will not and the cost will continue to be passed on to consumers.

Index	*2021 (through 9/30)*
S&P 500	+15.9
DJIA	+12.1
EAFE (Int'l)	+8.4
BC Ttl Bond	-1.6

Dow Jones Relative Risk Benchmarks	
Conservative	+.5
Moderate	+6.4
Aggressive	+12.8

DEBT CEILING DEBUNKED

The debt ceiling is the credit limit of the US government. When tax revenues are not enough to pay for its spending commitments, the US government borrows money by issuing bonds to make up the difference. The "debt ceiling" as currently defined was instituted in 1939 – setting a guideline for the total amount of debt the government can carry. Increasing the debt ceiling would not change the amount of spending the US government has already committed to, but would allow the government to continue to pay its existing bills.

The US has reached the debt ceiling multiple times before now, and has either suspended or raised the borrowing limit. There have been instances where the government has shut down as a result, but the US has never missed a debt payment as of September 2021. In 2011, another instance where the debt ceiling needed to be raised, the US came close but did not technically default on its debt, and its credit rating was still downgraded by S&P from AAA to AA+.

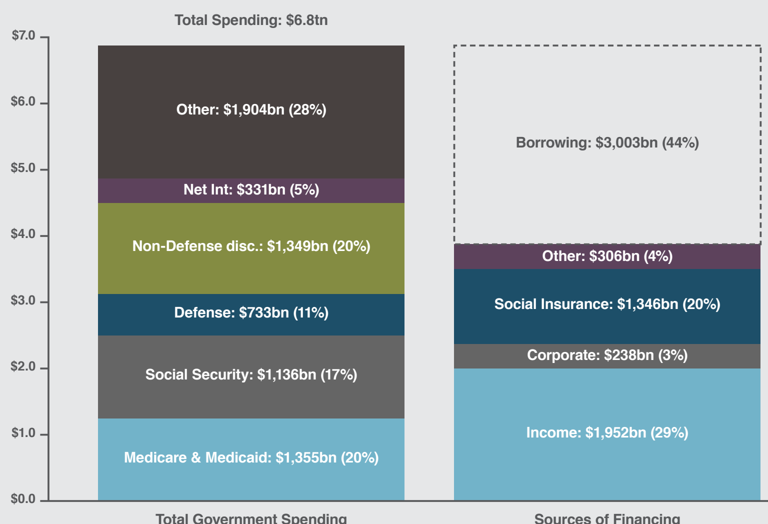
The debt ceiling was last suspended in August 2019 in the wake of the 2017 tax cuts, but that suspension expired at the end of July 2021. At that time, the US Treasury began paying bills through emergency measures, but was expected to run out of those options by October 18. With pressure mounting, on October 7, Congress voted to raise the debt ceiling by $480 billion which is expected to provide funding until early December 2021. Further action will need to be taken before then to again avoid a government shutdown and potential debt default. Until a longer term resolution is reached, the uncertainty surrounding the debt ceiling will likely create volatility in equity and debt markets.

See graph on reverse side ▶

The 2021 Federal Budget

CBO Baseline forecast, USD trillions

SOURCE:
JP Morgan, Guide to Markets, Sept 30, 2021



OUR VIEW

FIXED INCOME — Yields on most investment grade US bonds are currently lower than inflation, and it appears very likely that interest rates will move higher over the next year. We continue to recommend slightly lower traditional fixed income exposure overall, and a combination of bonds and alternative strategies to maintain an adequate level of risk management. We expect active fixed income and alternative strategies to help manage overall portfolio volatility and equity risk with less interest rate risk.

US EQUITIES — Corporate earnings have risen faster than equity prices, causing the valuation of us stocks to come down slightly from earlier this year. Despite concerns over the impacts of the delta variant and supply chain issues, S&P 500 companies are still expected to post record earnings growth and profit margins for the year. We continue to favor value over growth at this point in the economic cycle, and believe that while some stocks appear expensive, selectivity and active management will be more important going forward to identify opportunities.

INTERNATIONAL EQUITIES — Foreign stocks remain cheaper than US stocks, with the MSCI All Country World ex-US index's price to earnings valuation currently -28% lower than that of the S&P 500. (JP Morgan, Sept 2021) Projections for earnings growth in both developed and emerging markets are even higher than for the US, coupled with more exposure to favored cyclical sectors in foreign markets. We remain convicted that foreign stocks are an area of opportunity looking forward, and are in favor of using active managers to help navigate the uneven recovery and geopolitical considerations in these markets.

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