AndCo's Monthly Market Update

September 2021

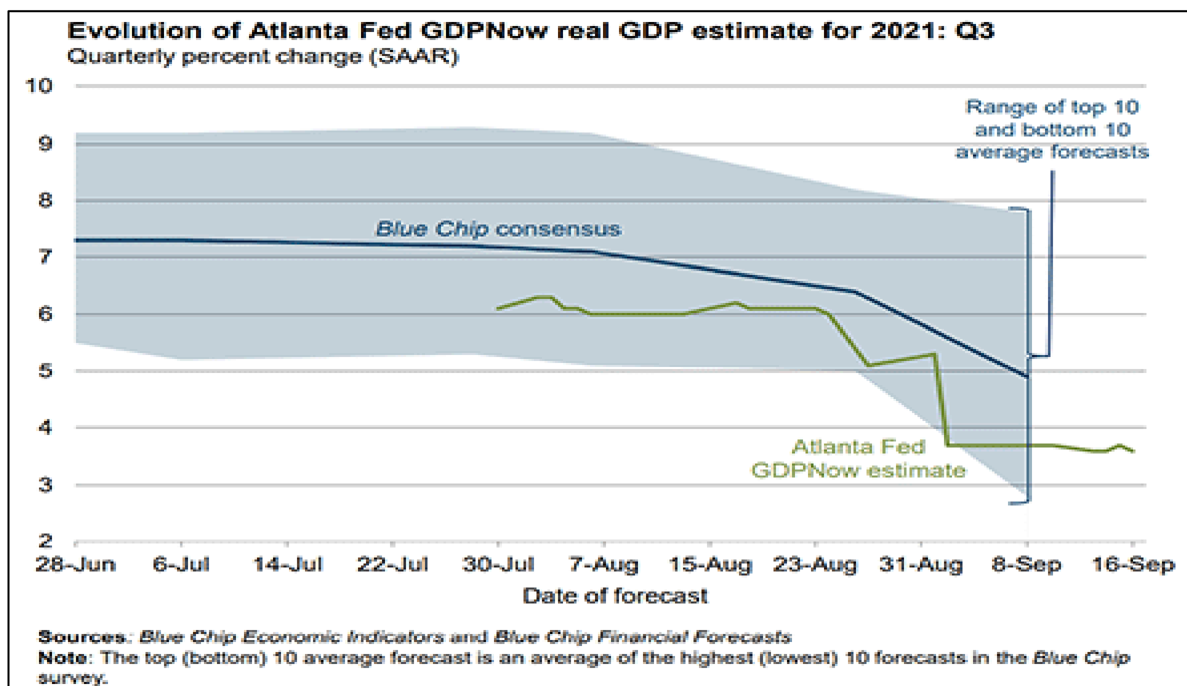
THE ECONOMY

Since the onset of the pandemic last year and the subsequent rebound, the US economy has experienced solid gains as markets have healed. While the economic growth and the resumption of normalcy has been welcomed, we have previously highlighted several concerns that we think are important to consider when thinking about where we go from here. Specifically, the response from the Federal Reserve Bank (the Fed) and the potential implications on leaving monetary policy too loose for too long have been a factor that we have discussed extensively given the implications related to the potential for inflation to rise above expectations. Equally as important, we have kept a watchful eye on the pace of economic growth in light of the fact that it is widely forecasted that US economic growth would eventually fall back towards the long-term trend. For guidance, we were particularly interested in what the Fed would say about the economy and its growth potential moving forward at its annual Jackson Hole Economic Policy Symposium.

Taking a step back, from our perspective we have maintained that the Fed has been behind the curve in both tapering its bond purchasing program as well as raising interest rates. The significant rise in US inflation can primarily be attributed to the massive amounts of liquidity currently in the system. Fortunately, the Fed was handed a gift recently when the CPI report showed the US inflation rose less than expected in August, up 0.3% compared to expectations of 0.5%.[1] Despite the positive news for the month, the year-over-year picture remains challenged with CPI having increased at an annualized rate of 5.3%, dwarfing the long-term Fed target of roughly 2.0%.[2] Also, the pace of hiring slowed during the month with non-farm payrolls rising by only 235 thousand new jobs compared to expectations of more than 700 thousand new jobs.[3] Taken collectively, these statistics may have provided the Fed with the wiggle room needed to message that it would continue its easy monetary policy by not raising interest rates. That said, there was one change in the meeting minutes that caused a stir in the markets. Specifically, the Fed announced that it would begin to consider both the timing and size of the reduction in bond purchases sometime before the end of 2021.[4] Presently, the Fed is purchasing roughly $120 billion in US Treasury and mortgage-backed securities every month. While the size and timing of the taper most likely will not have any material impact on the market, the shift in policy most

likely starts the clock ticking on when the first rate increase will happen. To be fair, this change in policy will most likely be predicated on the continued growth of the economy which is why the Atlanta Fed GDP Now model is so interesting.

In looking at the chart below from the Atlanta Fed, we can see that both the Blue Chip consensus and the Fed model show the US economy slowing markedly in the third quarter. It is likely that the Fed is counting on the economy slowing towards its long-term average in order to help moderate the continued rise in inflation. If true, the slowing of the economy could provide the Fed with additional time to observe how other parts of the economy react before it begins to adjust its policy. That said, no one wants to see the economy slow dramatically when there remains so many people receiving government transfer payments and the end of the eviction moratorium is looming.

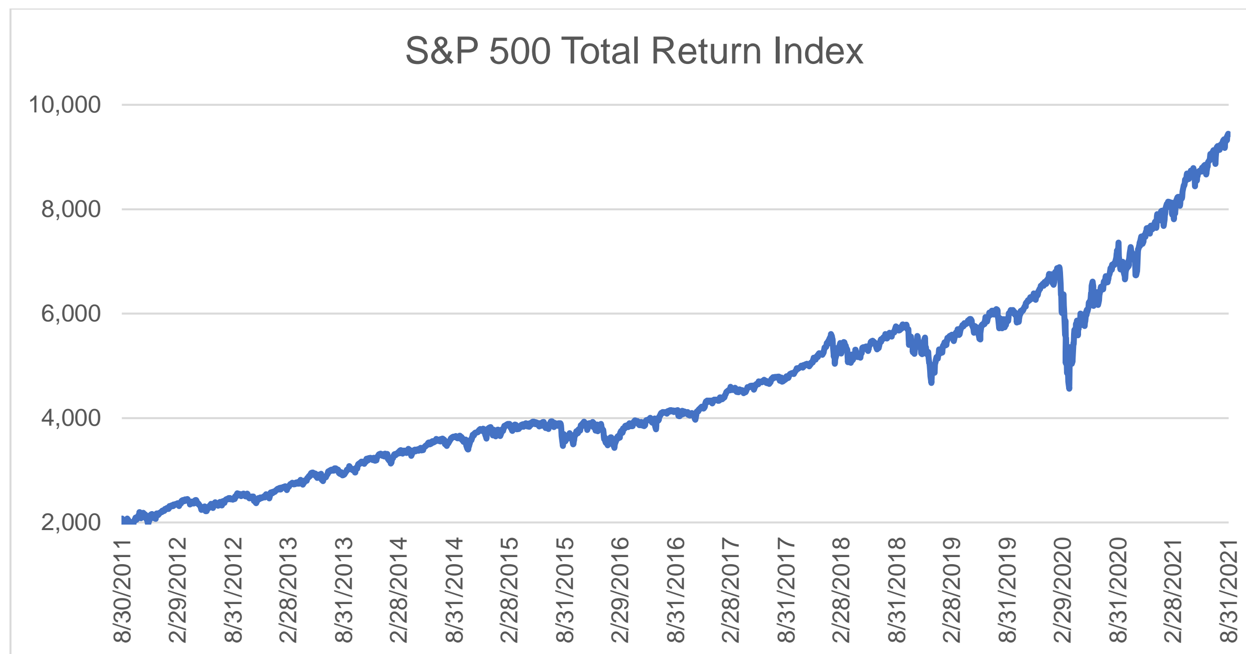


Looking at other economic statistics we follow, there remains a fair degree of ambiguity in the numbers. August retail sales solidly beat expectations by rising 0.7% versus expectations of a decline of -0.7%.[5] Given the recent rise in inflation expectations, we would surmise that some of these sales can be attributed to consumers who are looking to purchase goods before prices increase again. While the increase in sales was a nice surprise, this “pulling forward” of sales could lead to disappointing future results if they remain persistent for too long. Looking at both the Institute of Supply Management manufacturing and services measurements, each rose during the month, albeit at less robust levels from previous months. These indicators are commonly seen as predictors of future economic growth. While positive, we are watching for signs of further weakness which could signal an economic slowdown. Finally, we track consumer confidence closely given the importance of the consumer to the US economy. For the month, the University of Michigan Index showed only a slight gain while the Conference Board of Consumer

Confidence showed a steep decline. Again, we recognize that it is difficult to draw too many conclusions from these statistics given their volatility. However, we do use these to create a mosaic in which to identify a trend or theme in the economy and presently it would appear that we are entering into a period of slower growth here in the US. Given that, we think it is prudent to evaluate portfolios from a total risk perspective and determine if there are opportunities to de-risk the portfolio and lower the expectations for future returns.

EQUITIES

It may sound like a broken record, but equity returns in August were broadly higher characterized by the S&P 500 Total Return Index which climbed 3.0% during the month.[6] Returns were strong across all market capitalizations and styles with large cap growth stocks leading the way higher. For the month, the Russell 1000 Growth Index rose an impressive 3.74% followed by the Russell Mid-Cap Growth Index which increased by 3.23%.[7] Some of the continued strength in equity markets can be attributed to the robust growth in US corporate earnings. According to FactSet, overall profits for the S&P 500 grew by 90% in the second quarter compared to one year ago and represents the highest growth rate year-over-year since 2009.[8] Obviously, there is a basing affect to be considered with this statistic given the onset of the pandemic beginning in the second quarter of last year. However, industry analysts are forecasting EPS growth of roughly 3.8% in the third quarter which represents the fourth largest increase since 2009.[9] While there remains much to be concerned about related to such things as the persistence of COVID-19 infections, it would appear that US stocks may have the ability to grow into those lofty PE multiples, which could quell concerns about the currently elevated stock valuations.

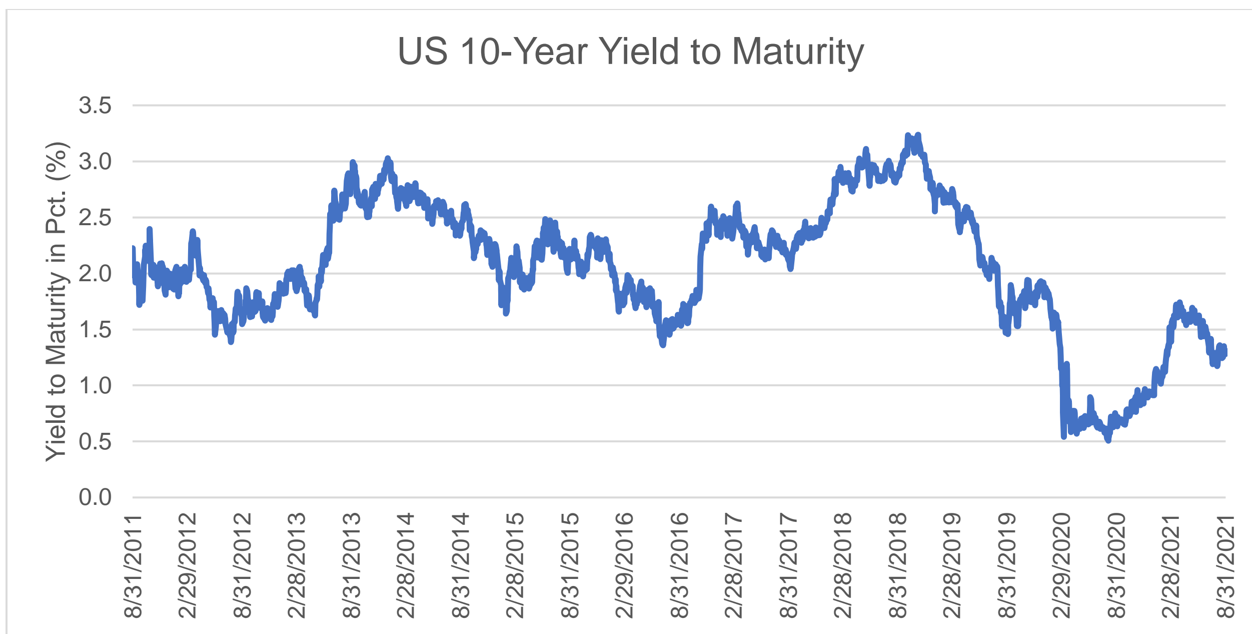


Source: Bloomberg as of August 31st, 2021

With US stocks up a blistering 21.58% year-to-date, we thought it would be an interesting exercise to see how markets have reacted previously to strong back-to-back annual returns.[10] Assuming the market does not contract the remainder of the year, the S&P 500 Index has "experienced two consecutive years of annual double-digit returns 19 times since the inception of the available data in 1958."[11] Given that we are not necessarily in unchartered territory with this year's strong returns, it is a worthwhile endeavor to look backward in order to see the way forward. Following the last year of those 19 periods, the S&P 500 Index was positive roughly half the time, while averaging gains of 3.6%.[11] So, why is this important? While not out of the range of possibility, there is a strong likelihood that the market could experience some sort of mean reversion whereby we could experience lower returns for a period of time. While we continue to believe that over the long-term investors should continue to experience solid returns in equities, for those investors who have the ability to, and where appropriate, they should consider whether rebalancing back to their policy statements makes sense given how far markets have come in recent years.

FIXED INCOME

Fixed income markets faced modest headwinds in August as US interest rates moved higher in anticipation of the Fed's eventual tapering of its bonds purchase program. For the month, the US 10-Year Treasury bond rose 0.08% to close at 1.32%.[12] As a result, most markets showed modest declines during the period with the Bloomberg US Aggregate Bond Index declining by -0.19%.[13] High yield bonds were the exception with the Bloomberg US High Yield Bond Index delivering 0.51% for the month due primarily to the category's higher coupon rate and shorter duration profile.[14] Credit spreads for both investment grade and high yield credits were only moderately wider during the month.[15] Finally, concerns associated with continued rising inflation moderated somewhat during the month which relieved some of the pressure on the bond market.



Source: Bloomberg, August 31st, 2021

APPENDIX

1. Bloomberg, September 2021
2. Bloomberg, September 2021
3. Bloomberg, September 2021
4. https://www.cnbc.com/2021/08/27/powell-sees-taper-by-the-end-of-the-year-but-says-theres-much-ground-to-cover-before-rate-hikes.html
5. Bloomberg, September 2021
6. Morningstar, August 2021
7. Morningstar, August 2021

8. https://www.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_090321A.pdf
9. https://insight.factset.com/fourth-largest-increase-in-eps-estimates-for-sp-500-companies-since-2009-for-q3
10. Morningstar, August 2021
11. https://www.datatrekresearch.com/double-digit-returns-for-the-sp-500-in-2021/
12. Morningstar, August 2021
13. Morningstar, August 2021
14. Morningstar, August 2021
15. Bloomberg, August 2021

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