

AndCo's Monthly Market Update

November 2021

THE ECONOMY

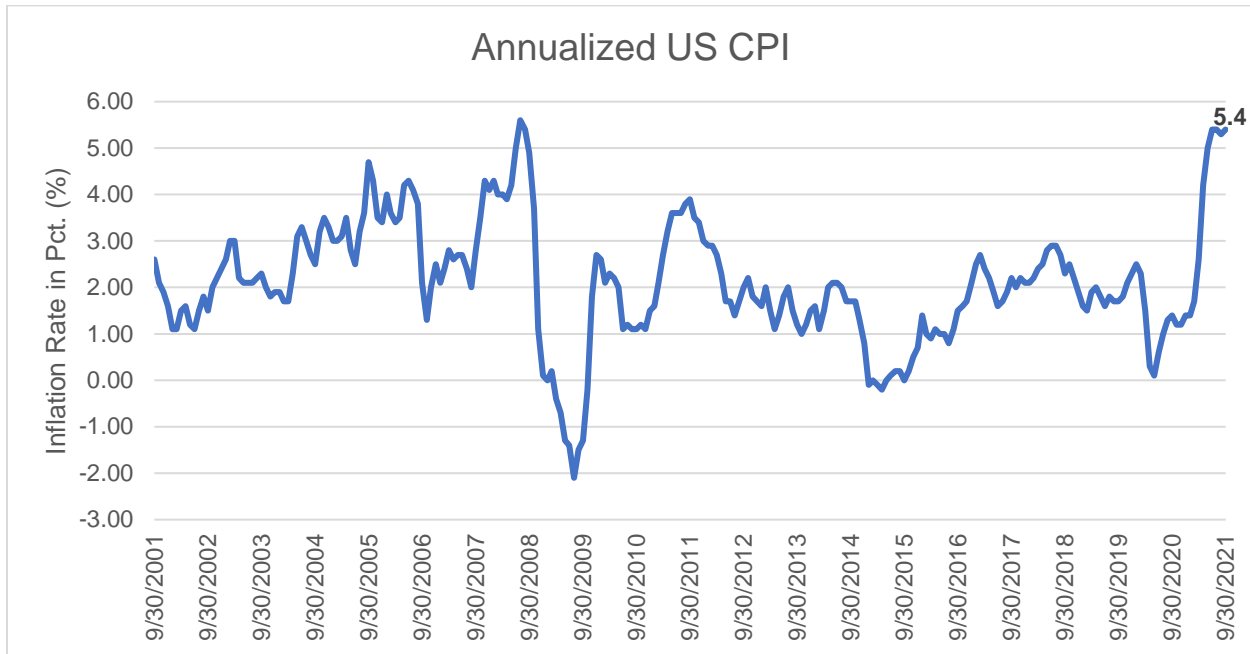
*"Inflation is like sin; every government denounces it and every government practices it." –
Frederick Leith-Ross*

For the better part of one year, the narrative spun by the Federal Reserve Bank (the Fed) was that while inflation is rising, expectations are that the sudden spike would be “transitory”, and that over the long-term inflation would settle back to its long-term trend of roughly 2%. However, as inflation continues to exceed expectations, there are signs that narrative is being challenged. The annual rate of inflation in the US rose to 5.4% in September, up from 5.3% in August.¹ This latest reading is the highest level of annual inflation in roughly 13 years.² Importantly, the food and housing components of the measurement account for nearly half of the total increase for the period.³ Inflation disproportionately affects those with lower incomes given that things such as housing and food take up a greater proportion of their overall income. Recently, Fed Chairman Jerome Powell took a modest step back and suggested that the term “transitory” may be misleading and that it, “merely means that the surge in inflation won’t become permanent.”⁴ While we will have to wait to see if Powell’s clarification of what transitory means to the Fed comes to fruition, in the near-term, consumers are likely to continue to feel its pressures as inflation remains above-trend.

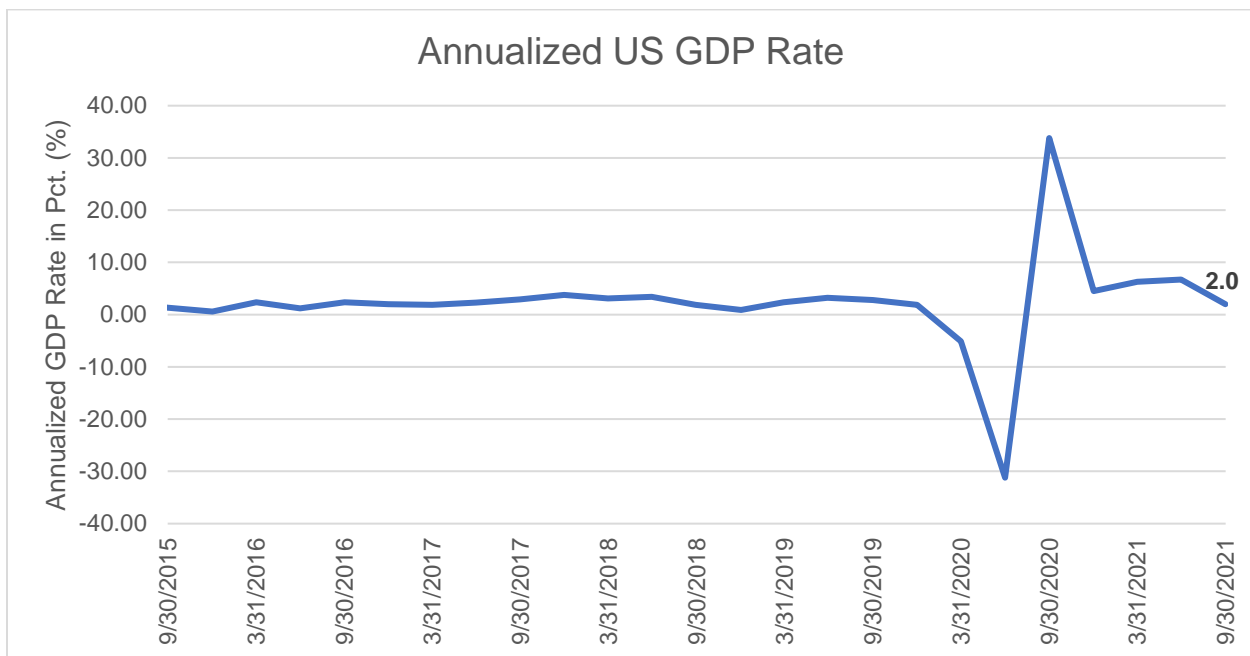
As expected, the Fed recently announced that it would begin the process of normalizing monetary policy by tapering its bond purchases by \$15 billion monthly.⁵ Prior to the action, the Fed was purchasing roughly \$120 billion in US Treasury and mortgage-back bonds monthly. Importantly, Powell reiterated that the decision to begin the process of raising interest rates would be data-driven and dependent on economic conditions.⁶ To that point, from an overall perspective, the economy continues to show signs of improvement, albeit at a materially slower pace. The first measure of GDP for the 3rd quarter showed a dramatic slowing from the previous quarter. For the period, it is estimated that the US economy grew at 2.0%, down from 6.7% in the 2nd quarter.⁷ While a slowdown was broadly expected given the length of the recovery and



the expected ending of certain stimulus programs, the velocity of the change as come as a bit of a surprise.



Source: Bloomberg as of October 31st, 2021

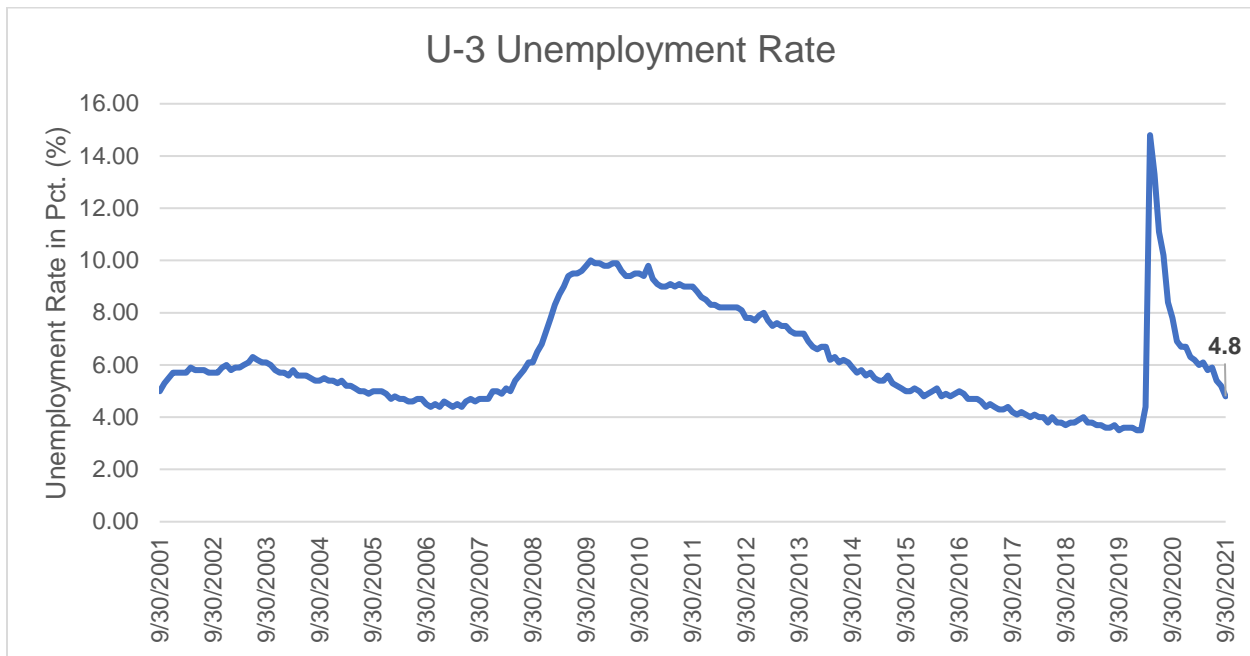


Source: Bloomberg as of October 31st, 2021

Despite the slowdown, there are signs that the segments of the economy are continuing to heal. As evidence, labor markets continued to improve with the US unemployment rate falling to 4.8%, down from 5.2% in September.⁸ There was concern related to the ending of the pandemic unemployment assistance programs and the potential for a spike in the unemployment rate. It is



reasonable to assume that the recent wage growth and the continued opening of the economy likely lured some of those seeking work back into the labor market. The slight drop in the labor participation rate suggests that some people may simply have left the workforce altogether.⁹ Moving forward, we are watching to see what, if any, affects are created by the continued shortage of labor and proposals related to vaccine mandates.



Source: Bloomberg as of October 31st, 2021

Many concerns have been raised about the recent challenges felt within the global supply chain and the potential for negative impacts to economic growth resulting from a prolonged period of disruption. As goods have become scarce, prices have risen accordingly which has the potential to create a negative inflationary feedback loop within the economy. We have already seen signs of this in such datapoints as the ISM Prices Paid Index which measures the costs associated with raw material inputs. The index rose to 85.7 in October, up from 81.2 in September.¹⁰ Other sectors of the economy, such as housing, also are showing signs of coming under pressure resulting from the lack of available materials with the annualized rate of US housing starts falling to roughly 1.55 million in September, down from the 1.62 million reported in August.¹¹ Importantly, the lack of available goods and services could also be impacting consumer sentiment. For October, the University of Michigan Sentiment Index fell to 71.7, down from 72.8 in September, and now stands far below the recent high of 88.3 back in April.¹² Given the reliance of the US economy on consumer spending, our concern is centered on the potential for further deteriorating consumer sentiment which could result in the delaying of purchases of such things as autos, homes, and consumer durables. Should inflation continue to rise, and the cost of items like food, clothing, and gasoline increase, consumers will have less discretionary income to spend, resulting in a further slowdown of the economy.



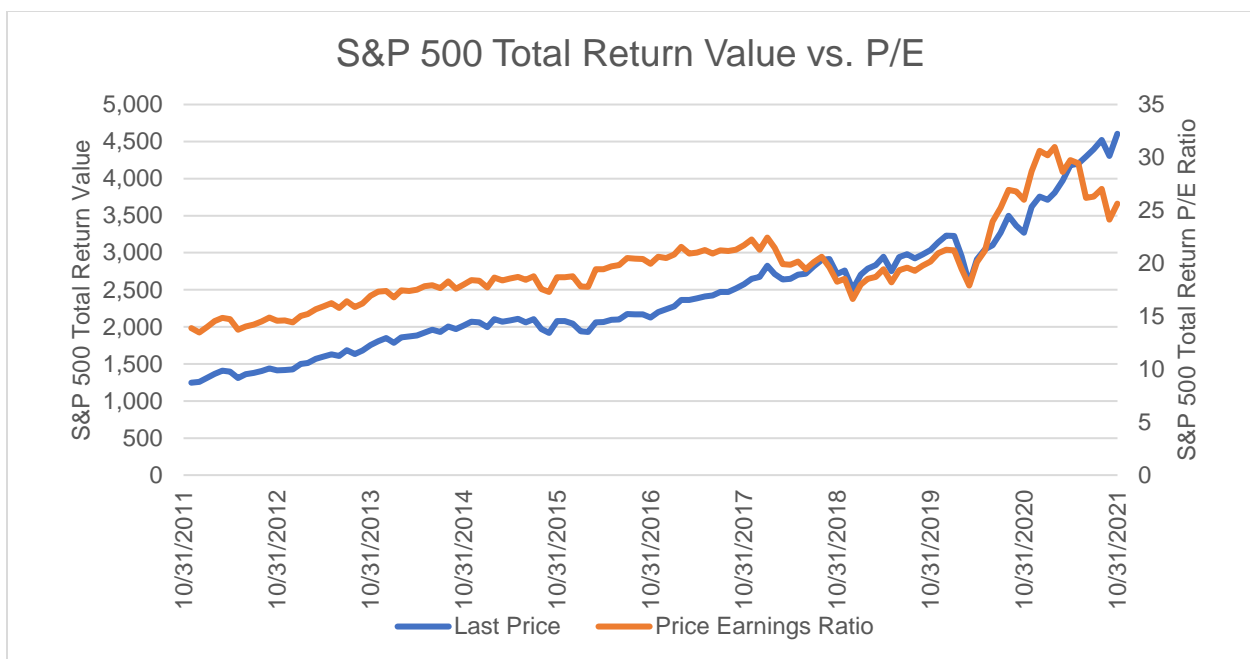
In summary, while our thesis about the continued growth trend for the US economy remains intact, we acknowledge that near-term future growth is likely to remain challenged. Future demand for goods and services will likely be dependent on wage growth keeping pace with inflation. Headwinds to our near-term outlook include the Fed's monetary policy, which will slowly become less accommodative, and continued disruptions in the global supply chain.

EQUITIES

Equity market returns were broadly higher across all market capitalizations, styles and geographies during October, led by the performance of US large cap stocks. For the month, the S&P 500 Index climbed by roughly 7.0% and closed the month at an all-time high.¹³ Growth stocks broadly outperformed value stocks during the period led by large cap technology companies.¹⁴ The dispersion between value and growth was at its widest in large caps. As evidence, the Russell 1000 Growth Index which returned 8.7% compared to 5.1% for the Russell 1000 Value Index.¹⁵ While there is no consensus to the catalyst behind the solid performance in stocks, there is some speculation that should corporate earnings growth begin to deteriorate, Fed may delay its decision to begin hiking rates sometime next year.

From a valuation perspective, stocks remain overvalued relative to their long-term averages.¹⁶ The trailing 12-month price / earnings (P/E) ratio of the S&P 500 Index was roughly 25.0x while the forward 12-month P/E was roughly 21.1 at the end of October.¹⁷ However, as the chart below illustrates, valuations have moderated in recent months despite the continued runup on stock prices. Digging deeper into the numbers we see that more companies within the S&P 500 Index are outperforming expectations than in previous quarters and the margin of outperformance is wider than the historical average.^{18&19} As a result of rising earnings, the PE ratio of the index has declined from recent highs suggesting that stocks are less overvalued. As of the end of the month, nearly 56% of the companies in the index have reported financial results for the 3rd quarter. Of these, more than 80% have reported earnings above market estimates.²⁰ If the trend in earnings outperformance continues, the 3rd quarter would rank as the 4th highest quarter of positive earnings surprises since 2008.²¹ Surprisingly, when we look at which sectors are providing the best earnings performance, it is not the technology sector. Companies in the real estate sector have actually led the relative outperformance of earnings expectations by approximately 93%.²² Six of the eleven sectors within the index are outperforming earnings estimates by more than 80%.²³ What comes as somewhat of a surprise is despite the significant increase in energy prices, only 56% of energy companies have beat earnings expectations through October.²⁴

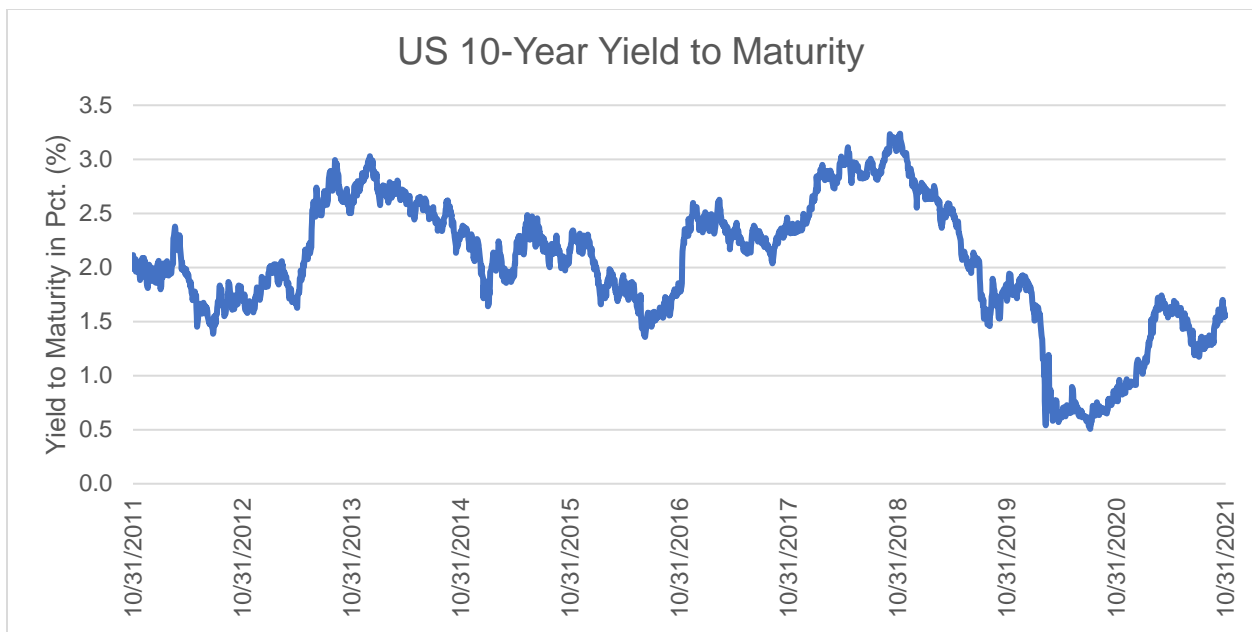
So, what does this all mean? Despite all of the economic headwinds related to the pandemic, a shortage of labor, supply chain disruptions, a potential shift in Fed policy, and turmoil in Washington, DC, corporate America appears to be healthy and the outlook for future growth remains bright.



Source: Bloomberg as of October 31st, 2021

FIXED INCOME

The recent trend lower in fixed income markets continued in October as US interest rates rose slightly during the month. The US 10-Year Treasury bond yield finished the month at 1.55%, up slightly from 1.49% in September.²⁵ The combination of the Fed’s recent statements concerning the tapering of its bond purchase program, combined with higher-than-expected inflation, were likely catalysts for the move higher in rates. While the upward movement in rates for shorter maturities was largely anticipated, the longer-end of the yield curve actually moved lower as evidenced by the 0.11% decline in the US 30-Year Treasury bond.²⁶ A move lower in long-term rates has historically been associated with a slowing economy in anticipation of the Fed moving to an easier monetary policy stance, which is contrary to the current prospect of rising rates. For the month, the Bloomberg US Aggregate Bond Index was essentially flat, returning -0.03%.²⁷



Source: Bloomberg, September 30th, 2021

Returns across corporate credit markets were mixed for the month. Higher quality investment grade corporate bonds outperformed lower quality high yield corporate bonds for the period. Corporate credit spreads were also mixed with investment grade spreads widening by 0.02%, while high yield spreads declined by -0.02%.²⁸ For the period, investment grade corporate bonds rose 0.25% while high yield bonds fell by -0.17%.²⁹



APPENDIX

1. <https://www.bls.gov/news.release/cpi.nr0.htm>
2. Bloomberg, October 2021
3. <https://www.bls.gov/news.release/cpi.nr0.htm>
4. <https://www.marketwatch.com/story/fed-still-thinks-surging-u-s-inflation-wont-last-but-its-now-hedging-its-bets-11635970123>
5. <https://www.cnbc.com/2021/11/03/fed-will-start-tapering-bond-purchases-four-experts-weigh-in.html>
6. <https://www.cnbc.com/2021/11/03/follow-the-feds-market-moving-decision-on-interest-rates-and-bond-buying-here.html>
7. Bloomberg, October 2021
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13. Morningstar, October 2021
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18. <https://insight.factset.com/sp-500-earnings-season-update-october-29-2021>
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24. <https://insight.factset.com/sp-500-earnings-season-update-october-29-2021>
25. Bloomberg, October 2021
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27. Morningstar, October 2021
28. Bloomberg, October 2021
29. <https://d6000000jk8beag--c.documentforce.com/servlet/servlet.EmailAttachmentDownload?q=YMwjpBpgY2uSbQay%2FyyY5OYvEP2A0rRcsk4KFhtBlaiqC2ofK3Ku6PN5pph34yFuJwfrBNGFO5ZfosfN8it3MA%3D%3D>



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