INVESTMENT MANAGEMENT

Third Quarter 2021

ECONOMIC & MARKET OUTLOOK

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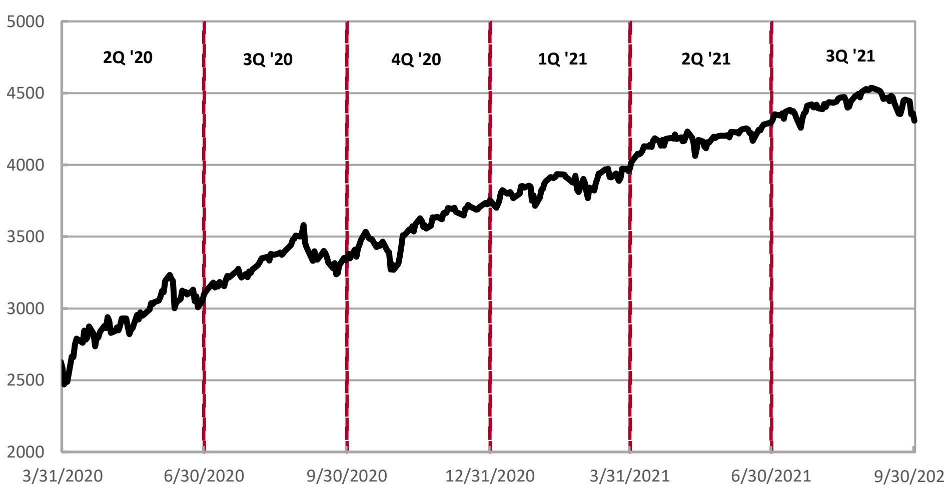
The only constant is…wait for it…Change

The one thing you can always count on when managing investment portfolios is change. Just look at what has happened so far this year in the financial markets. With the vaccine-driven economic reopening in the first quarter, long-term interest rates nearly doubled to 1.7% alongside rallies in commodities, small caps, and the value equity style. Given the Delta outbreak over the summer months, investors have all but given up on cyclicals and the reopening stocks in favor of more defensive growth equities and long high quality bonds. COVID trends continue to influence short-term economic data and have contributed to the volatile market swings, but we are expecting the broader trend for the eventually complete reopening to continue despite the volatile bumps in the road. It's one of the reasons behind our investment management approach to maintain broadly diversified portfolios invested across all the major asset classes: cash, fixed income, equities, and alternatives, with further allocations into sub-asset classes, styles, and market capitalizations. It's not unusual to see investment returns up over 30% on these broadly diversified portfolios over the past 18 months given the massive fiscal and monetary responses to COVID-19. Investment portfolio gains stalled out in the past quarter with returns in the S&P 500 Index up 0.6%, while the Bloomberg Barclays Aggregate Index was relatively flat with a 0.1% return. It's easier to make money in the markets when uncertainty is high and valuations are low, especially while the Federal Reserve is buying everything in sight and Congress is sending out trillion dollar checks. But that is no longer the case today.



Cash isn't king; Stocks continue to surge, but fiscal policy shifts still loom

The investment landscape today is a more challenging one for investors. Returns on cash are pinned at 0% for the foreseeable future, bond yields are below inflation rates, and U.S. stocks are trading at the highest valuation levels in decades. From here, we are also about to encounter shifts in fiscal and monetary policies. The COVID-relief

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stimulus checks have ended, and the moratorium on housing evictions has expired along with the extra $300 per week unemployment benefits. The clock is also ticking on the ability of the Democratic–controlled Congress to pass an increase in the $28 trillion debt ceiling before a devastating default occurs. Compounding the debt ceiling situation, the Democrats have proposed $3.5 trillion in new spending that would be partially offset with approximately $2 trillion in higher corporate and personal taxes. While far from a done deal, the latest proposals include a 26.5% corporate tax rate (up from 20%), capital gains and dividends taxed at 25%, and increasing the tax rate on the highest rung of personal income back up to 39.6%. Regardless of the increased revenue for federal coffers, the additional taxes would be a headwind for next year's income and earnings while any positive impact from increased spending likely won't be felt for three to five years. While the Fed has expressed that short term rate hikes are a long way off, we expect them to ease off the gas pedal starting later this year. Fed Chairman Powell and the majority of the FOMC are in favor of slowing down the $120 billion per month in quantitative easing bond purchases.

Expect a slowdown in QE but no interest rate hikes until unemployment falls

Assuming COVID is contained, we now expect the Fed to formally announce a quantitative easing (QE) taper in November that decreases monthly bond purchases gradually towards zero by the third quarter of 2022. Being careful to avoid the market sell-off that occurred during the 2013 Taper Tantrum, the Fed will likely continue to emphasize excess capacity in the labor markets, and the timing of tapering isn't connected to timing of a Fed funds rate lift off. In support of the financial markets during the taper, the Fed's balance sheet is expected to continue to expand by nearly $500 billion if able to gradually end purchases over the next year. And, don't forget the Fed is maintaining its zero interest rate policy until further progress is made on the employment situation.

Markets will rely on consumer spending and an ease in inflation

With a neutral to negative impulse shift from fiscal and monetary policy, it's going to be up to U.S. consumers to increase spending and inflation subsiding to support the markets going forward. Our base case expectations are for U.S. economic growth to remain above trend over the next few quarters as we complete the economic reopening, primarily in the service sector of the economy. Inflation likely will remain high, but should start to subside over the course of next year. On the consumer spending front, we have previously highlighted record household net worth levels from low debt levels, high savings, and record asset prices. The outlook for continued improvement in the job market is bright given the surplus of job openings relative to the number of workers employed. As the unemployment rate trends down with stronger economic growth, increases in personal incomes will take up the slack lost from the prior year's fiscal stimulus. Inflation trends that prove transitory are also key to our outlook for the risk markets. The negative impact from the Delta-variant was more severe than we expected, and has contributed to persistent shortages and transportation bottlenecks, all of which are adding to the upward inflation pressure. Through August, the year-over-year percent change in the Consumer Price Index (CPI) is 5.3%. The stimulus-induced surge in demand for durable goods contributed nearly 1% to overall inflation. Keep in mind, until we had the vaccine-driven reopening fueled by one-time stimulus checks, overall price trends for durable goods had been in a deflationary environment for the previous 25 years. The expiration of emergency unemployment benefits and COVID cases that appear to be peaking again should alleviate some of the corresponding wage pressure, primarily at the lower end of the wage scale.

Key Points

- The Delta variant of COVID-19 resulted in a resurgence of cases across the United States. Cases and hospitalizations continue to weigh on consumer sentiment.
- U.S. consumer balance sheets are strong and, despite a decline in confidence, the hand-off from the goods recovery to the service economy is likely in the near term.
- As the economy has reopened, supply chain disruptions and demand shocks resulted in significant inflation. This transitory inflation is lasting longer than previously thought.
- The Federal Reserve remains accommodative but is expected to announce plans to reduce 'quantitative easing'. Another massive spending bill is making its way through Congress.
- Equity valuations remain high by historical standards, but the outlook for equities remains attractive relative to other asset classes.

Q3 Performance	
S&P 500	0.6%
Russell 2000	-4.4%
Barclays Aggregate Bond	0.1%
MSCI EAFE	-0.5%
MSCI Emerging Markets	-8.1%

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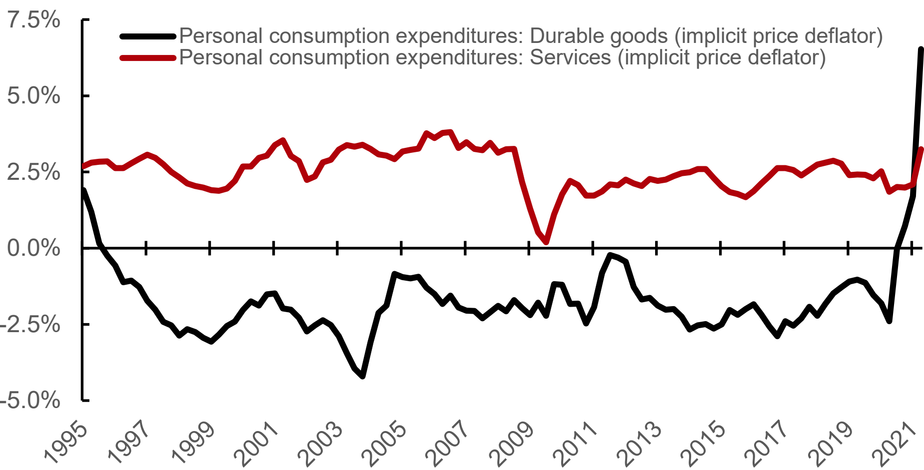
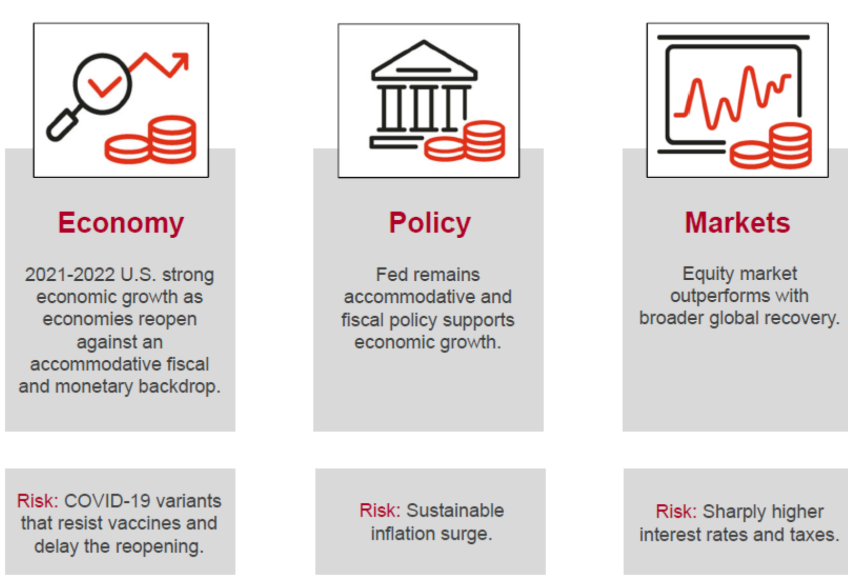


Finally, rents — which make up approximately 40% of core CPI — have bottomed, and are likely to trend higher over the next year. While we are expecting some give back in the prices of durable goods as the temporary bottleneck in supply chains ease, those shifts will be partially offset by a rise in overall rents given the housing shortage.

Here is our base case outlook summary:



Stay diversified!

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Disclosures

Chart data source: Bloomberg

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