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QUARTERLY MARKET UPDATE

WEALTH MANAGEMENT by BerganKDV

OCTOBER 2021

MARKET LANDSCAPE

Name	YTD 2021 Return (%)
Barclays US Aggregate Bond	-1.6
Barclays US Credit	-1.3
S&P 500 TR USD	15.9
Barclays US Corporate High Yield	4.5
MSCI Emerging Markets	-1.2
MSCI EAFE	8.3
Russell 2000 TR USD	12.4

Data Source: Morningstar Direct

Market Backdrop

The Standard and Poor's (S&P) 500 has risen 15.9% year-to-date (YTD) in 2021, including the decline of risk assets during the third quarter, or during September more specifically. This pullback should not be too surprising, as September is seasonally the worst-performing month, generating negative average returns over the last ten years. September 2021 was also the S&P 500's worst-performing month since the height of the pandemic in March 2020.

Market volatility was fueled by deteriorating sentiment from the emergence of the Delta Covid variant, which somewhat restrained economic activity. While cases seem to be peaking, they could remain an issue as fall progresses.

Inflation and supply chain disruptions are also on investors' radars. These matters should moderate over the long term, but renewed disruptions from Covid globally threaten to delay normalization further into next year. And of course, the fear of financial contagion emerging from China's Evergrande (and broader real estate) crisis weighed on markets over the last number of weeks.

Despite the pullback related to Covid, inflation, and China, overall conditions still seem supportive of corporate and market fundamentals. Vaccines still appear highly effective in reducing hospitalizations, so a return to stringent lockdowns in the US is unlikely. The service sector recovery may decelerate but remains growth positive.

Labor markets are strong; unemployment sits at 5.2%, with an average addition of approximately 600,000 jobs per month over the past year. Labor supply is a challenge, but the end of supplemental unemployment benefits in September should provide partial remedy.

Consumption trends resulting from gains in personal income and increases in household net worth remain healthy. Over the past year, consumers have saved an extra $2 trillion compared to pre-covid tendencies, and consumption growth should be strong even as fiscal support fades.

Real Gross Domestic Product (GDP) growth will get a further boost from rising business investment, as inventories are replenished, and firms increase capital expenditures in response to stable demand outlooks. Consensus expectations for US GDP growth in 2021 register nearly 5.5 percent. 2022 estimates are currently in the 4 percent range.

Sector Returns

S&P 500 Sectors	YTD 2021 Return (%)
Information Technology	15.3
Consumer Discretionary	10.3
Communication Services	21.6
Health Care	13.5
S&P 500	15.9
Consumer Staples	4.7
Materials	10.5
Real Estate	24.4
Utilities	4.2
Industrials	11.5
Financials	29.1
Energy	43.2

Data Source: Morningstar Direct

Government Stimulus

In addition to the aforementioned factors impacting investor sentiment, the current and prospective actions of the United States Federal Reserve (Fed) and Congress are also under scrutiny.

The Fed has signaled its plans to begin the reduction of its bond purchases which have provided significant amounts of market liquidity over the past 18 months. At its latest meeting, the Federal Open Market Committee (FOMC) indicated that while not yet initiated, intentions exist to conclude the latest Quantitative Easing (QE) program and eventually start raising interest rates,

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perhaps within a year.

As monetary policy becomes less accommodative, fiscal policy may become so as well. Federal government spending has aided corporate profits and economic growth during the past year and a half. With keen interest, investors are tracking developments of the $3.5 trillion spending plan Democrats in the US Congress are negotiating to pass. Emerging signs indicate that the bill's passage is not guaranteed. Correspondingly, share prices of certain businesses which would benefit from continued federal spending have reacted negatively.

However, even if accommodation is somewhat tempered, both monetary and fiscal policy will remain relatively supportive. Expectations exist that reductions in Fed bond purchases will initiate in early 2022 and endure throughout the year. However, actual interest rate increases are not expected before 2023. The Fed is eager to pursue its dual mandate and emphasize the goal of maximum employment. This will require a historically tight labor market, dictating a continuing patient approach from the Fed.

A near-term risk is the debt ceiling, with the US Treasury set to run out of cash in October. Investors are also increasingly focused on this issue, a sometimes-routine budgeting exercise that has become increasingly politicized. This type of situation creates the potential for market volatility.

Regardless of the form and fate of the current proposed spending package and debt ceiling controversy, there will probably still be additional spending on infrastructure, education, and childcare initiated next year.

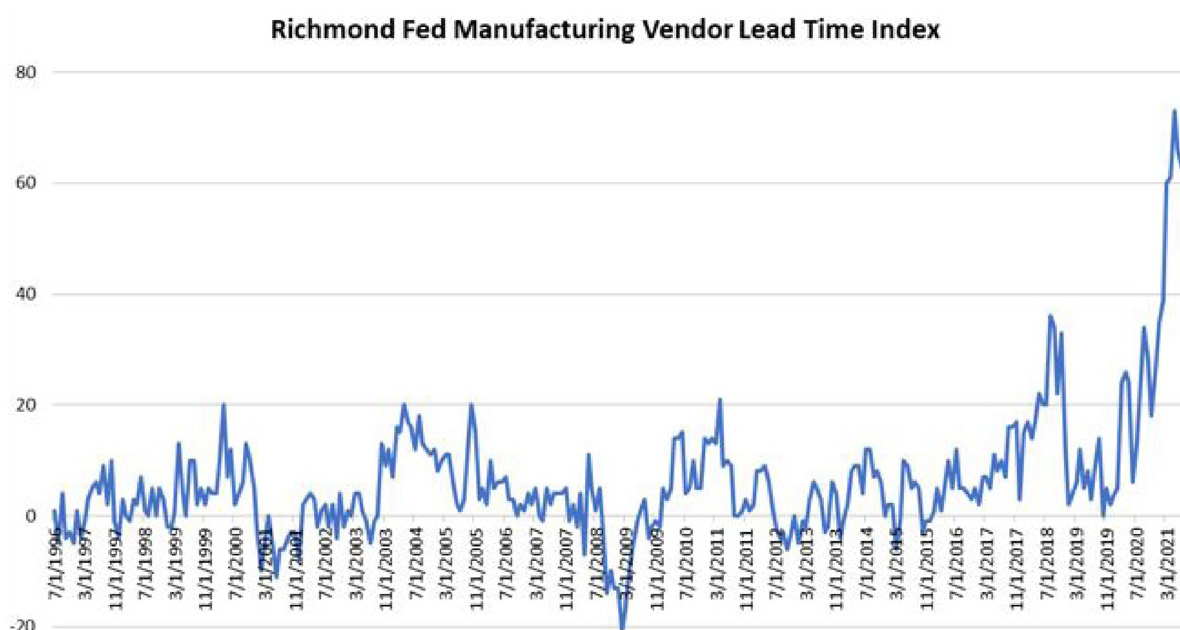
Supply Chains

Increasing in importance and visibility are the mounting ramifications of supply chain imbalances across the global economic landscape. These supply chain disorders create risks beyond inflation and its supposed transitory nature. Just as meaningful are the disruptions in manufacturing and production output that are impacting corporate sales, possibly reducing profits and economic growth more than originally anticipated.

With third-quarter earnings season of 2021 now underway, references to inflation and supply chain pressures on company conference calls have been common. The inability of companies to source parts, people, and materials has been a major hurdle and significant contributor to slowing growth momentum.

Some firms are signaling a curtailment of production due to a lack of semiconductors and electronic components. These actions also inhibit the labor market's recovery. This dynamic can be observed in several industries, most notably the auto industry, where a semiconductor shortage is forcing a slowdown in output.

Chart 1 - Vendor Sourcing Delays



Source: Federal Reserve Bank of Richmond via YCharts

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While some see this issue as mainly attributable to pent-up demand and temporary, there is no question it is putting upward pressure on pricing and potentially downward pressure on margins.

Relief for the global supply chain disruptions is not imminent. If demand pressures remain elevated, COVID outbreaks continue to pressure points of transport, and other connections in the supply chain face interruption, this negative issue will continue. The tangible impacts have not yet been accurately quantified, but they will certainly remain an area of interest as the year progresses.

China

During the latter portion of this last quarter, there was much conjecture surrounding China's Evergrande issue and property market woes instigating a shift in investor sentiment. While there has been no concrete resolution to China's property market issues, and there remains significant uncertainty, these problems have not spread globally.

Historically, Chinese growth has been driven by investment in infrastructure, including residential and commercial property markets, with real estate markets accounting for nearly 30% of the country's GDP. Banks have financed many of these projects at the direction of the government, who saw these investments as crucial to the development of jobs and economic growth. As such, many lenders viewed companies such as Evergrande and others as having an implicit backing. If a company couldn't pay its debts, the government would ensure creditors get repaid.

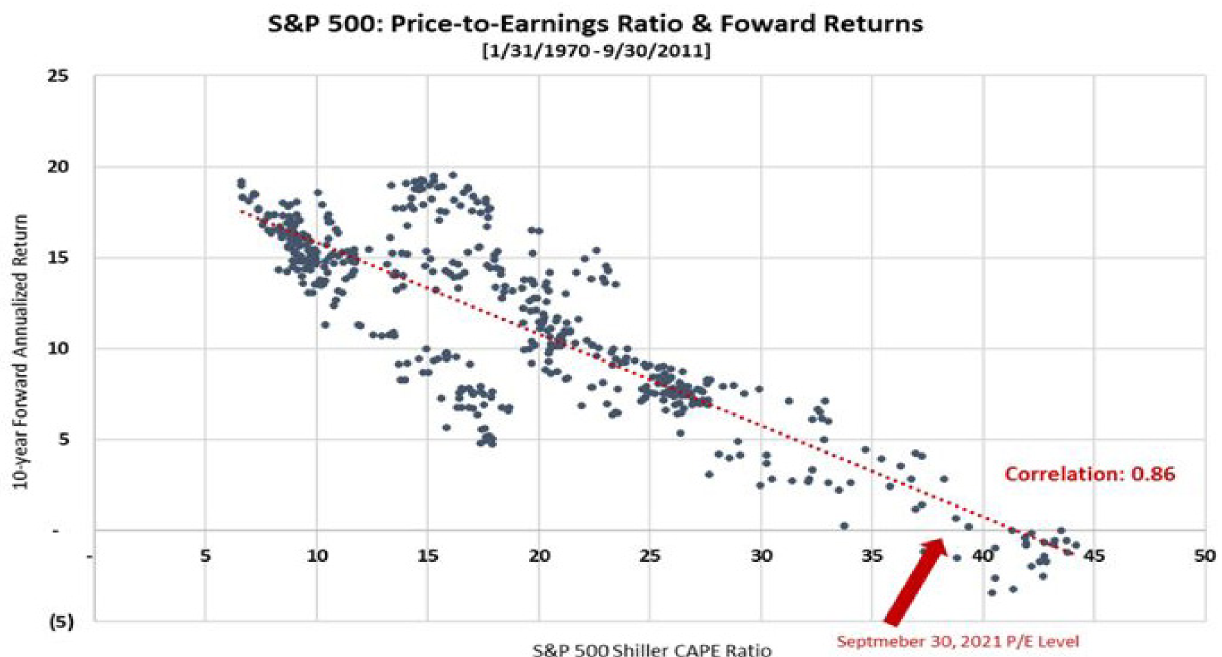
This dynamic is changing. With cash flow waning, solvency of many companies is in question, credit markets are largely closing off access to these firms, and the response of the Chinese government relating to ongoing support remains in question.

The uncertainty that investors have faced this recently regarding Evergrande is not unique, as the Chinese government has pursued other actions consistent with the consolidation of control.

Shares of Chinese technology firms, including Tencent and Alibaba, have been hurt as authorities have issued a multitude of regulations ranging from corporate governance issues to data privacy. These actions, along with crackdowns on information flows and decentralized finance technologies, have been theorized as moves against entities and protocols viewed as emerging threats to government rule.

The coordinated regulatory efforts from the authorities cannot be seen as supportive of growth. It also seems the Chinese government doesn't appear to have the appetite for endless

Chart 2 - Price to Earnings and Forward Returns



Source: Robert Shiller via YCharts & Morningstar

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monetary stimulus. The combination of these realities could result in the removal or diminished augmentation of the Chinese economy to global growth.

Corporate Earnings and Valuation

Analysts are projecting strong earnings and revenue growth for the third quarter. According to FactSet, S&P 500 companies are expected to report earnings growth of 27.6% and revenue growth of 14.9%.

Those projections are impressive. There have been only two other instances since the third quarter of 2010 (the previous two quarters) when earnings growth has been stronger and only one other instance since 2008 (last quarter) when revenue growth has been stronger.

Additionally, these estimates have been increasing. At the end of the second quarter, they stood at 24.2% and 12.6%, respectively. That's well above the five-year average growth rates of 7.1% and 3.9%.

The strong growth outlook is a byproduct of easier comparisons, but also the result of strong demand. Ten of the eleven economic sectors are expected to report year-over-year earnings growth. The one exception is the Utilities sector. The Energy, Materials, and Industrials sectors are anticipated to report the strongest growth of all sectors, though, which speaks to the strength of the cyclical recovery.

These expectations lay out an optimistic future. In essence, we could soon witness some of the strongest earnings growth in over a decade. While this is positive, the market is already wondering what may lie beyond.

There may be apprehension that we have reached peak earnings and a deceleration in growth in the coming quarter is inevitable. Earnings comparison difficulty will increase, as will the profit margin pressure in the face of supply chain constraints, higher prices for capital inputs, and labor costs.

Consumer demand is of primary interest. If companies can mitigate higher prices by passing them on to a willing customer base, markets will more easily tolerate the current higher valuations. So, if the market has faith in current and future levels of demand, fully valued markets should fare well. If it deems otherwise, price multiple compressions could follow.

Valuations are not typically the cause of significant market movements, as stocks can deviate from fair value for extended periods of time. But over the long term, the expected returns in equities are muted when viewed through a period of historically elevated levels.

That is not to write those returns will be negative in real terms or perception. It is simply to point out that investors may need to calibrate their expectations to the prospect of reduced return expectations (as compared to the last decade) over the next number of years, which would be more in line with historical averages.

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