Insights: October 2021

Market Overview and Performance

Without question, 2021 has thus far delivered strong returns for risk asset investors beyond what many including ourselves would have expected. To a large extent, the impetus behind the impressive moves higher can be simplified down to the basic fact that the global economy has re-opened from a virtual standstill in 2020. To initiate that re-opening process, central banks have injected vast amounts of liquidity into the financial system. While successful at inflating risk assets, other segments of the market have suffered. Most significantly, the fixed income market looks to experience negative returns for the first time since 2013 as liquidity is forced to seek out higher yielding assets. And while equity returns in the U.S. have climbed higher consistently since March of 2020, the most recent quarter ending in September revealed that concerns about the longevity of the recovery are still very much in place. Goldman Sachs just this month highlighted the following list of client anxieties from their recent conversations: rising inflation, Fed raising rates too soon, labor shortages, China's slowing growth impacting global growth, virus variants as winter approaches, spike in commodity prices, supply chain bottlenecks, US debt limit, lack of progress on a stimulative infrastructure bill, and of course, potentially higher corporate and personal tax rates. These are not trivial apprehensions - there is some validity to the potential unsettling impact from each of these dynamics. However, in our view, there are also some structural positive influences currently in place which should serve as tailwind for risk assts over the near term. These include strong equity seasonality, record equity flows, record equity buybacks, record high profit margins, seemingly no new corporate tax increases, and a Fed tapering process that will still be injecting hundreds of billions of dollars into the system via assets purchases through at least June of 2022 as of now. With those elements in place, there is good reason to believe that further gains lie ahead.
As always, thank you for reading our latest Insights.

	Quarter to Date September 30	***Year to Date September 30***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.58	15.92
Russell 2000 Index	**-4.36**	12.41
MSCI EAFE Index	-0.45	8.35
MSCI Emerging Markets Index	**-8.09**	**-1.25**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.05	**-1.55**
Barclay's U.S. Aggregate Credit Index	**-0.18**	**-2.66**
Barclay's U.S. Aggregate Corporate High Yield Index	0.89	**4.53**
Barclay's Municipal Bond Index	-0.27	0.79
Macro Measures		
Gold	-0.82	**-7.29**
Crude Oil	**3.11**	**54.64**
CBOE Volatility Index	**46.18**	1.71
USD Dollar Index	1.94	4.78

Current Theme – Risk Assets Consolidated During the Third Quarter as Concerns Over Rising Inflation and an Increase in Fed Fund Rates Lead to a Decline in Sentiment Toward Global Growth

For the First Time Since Early 2020, Evidence of Slowing Global Economic Growth Appeared While Inflation Measures Continued to Rise

After a relentless move higher since March of 2020, U.S. equities peaked in early September before declining roughly -5% to end the third quarter essentially exactly where they were on June 30th. For investors, this should not have been unexpected and in fact, is a good result given that these months are traditionally the most volatile of the calendar year.

S&P 500 Ended September Quarter at Same Level as June

Source: Refinitiv

The S&P 500 has not experienced a drawdown of greater than -5% thus far in 2021 which is an anomaly since the S&P 500 has historically averaged a decline of at least -10% during most years. This dynamic is clearly widely recognized, and as such, many strategists were anticipating a late summer swoon for stocks. While this did not happen at the index level, the table below from Liz Ann Sonders at Charles Schwab highlights the fact that the returns of individual stocks have experienced a very different path throughout the year.

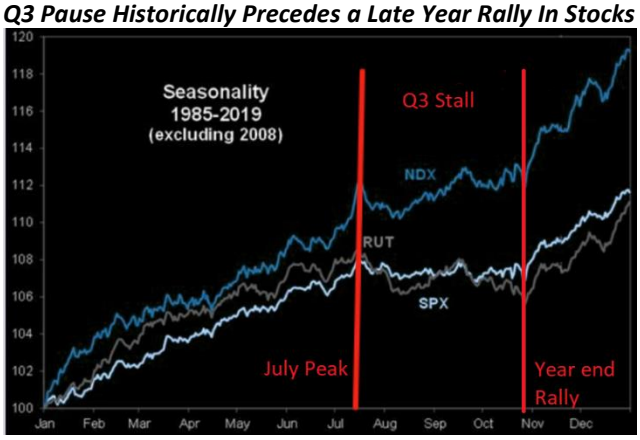
Index Decline of -5% Masks Underlying Stock Declines

Index	% of members with at least -10% drawdown from YTD high	Average member drawdown from YTD high
S&P 500	91%	-18%
NASDAQ	90%	-38%
Russell 2000	98%	-34%

Source: Charles Schwab; Bloomberg; as 10/13/2021

While the Index has remained buoyant, the table shows that among the constituents of the S&P 500, the NASDAQ and the Russell 2000 Index of small cap stocks, over 90% of the companies have experienced a drawdown of at least -10% at some point during the year. In fact, the average stock drawdown from all-time highs during the year has varied from -18% in the S&P 500 to -38% in the technology-oriented NASDAQ.

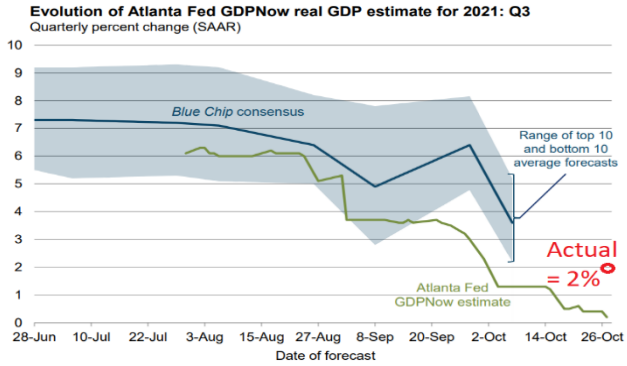
Q3 Pause Historically Precedes a Late Year Rally In Stocks



Source: Goldman Sachs Global Investment Research; The Market Ear

For active managers, this is an ideal environment since it provides very good opportunities to invest in companies with temporarily depressed valuations while others are still waiting around for a larger decline at the Index level. Importantly, the chart above illustrates that over past 35 years, a late summer consolidation period is typically followed by a strong late year rally, particularly for technology.

Est. Third Quarter GDP Fell Sharply – Actual Was Worse

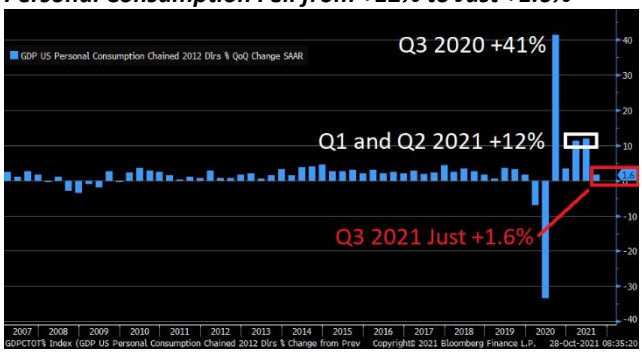


Source: Federal Reserve Bank of Atlanta

It's also important to understand the recent volatility was not driven by elevated market valuations or overbought conditions, it was due to the fact that growth actually slowed in the third quarter. As seen

above, estimates for Q3 GDP growth from economic forecasters fell from over 6% in early October to about 3.5% by the end of the month. The Atlanta Federal Reserve publishes their exhaustive survey of numerous economic indicators and estimated that growth could in fact be below 1%. The number came in at 2%.

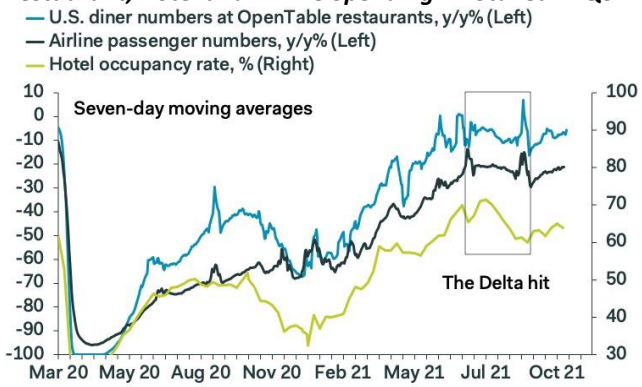
Personal Consumption Fell from +12% to Just +1.6%



Source: Bloomberg

This was a disappointing result, however its fairly clear to see what was driving the slowdown, and fortunately, it will likely be a temporary phenomenon. As one can see in the chart above, consumer spending which accounts for roughly 70% of US GDP growth collapsed from about +12 growth in the first two quarters of this year to just +1.6% in Q3.

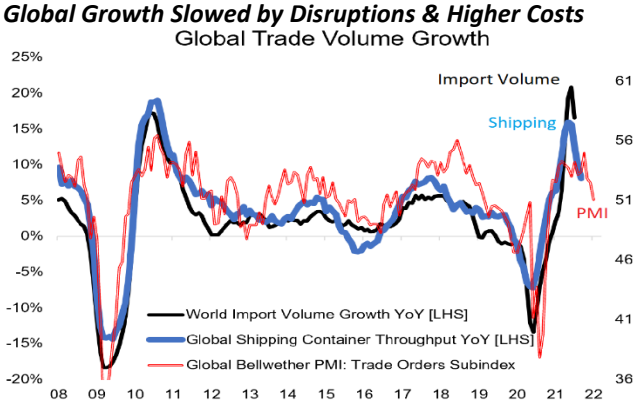
Restaurant, Hotel and Airline Spending All Stalled in Q3



Source: Pantheon Macroeconomics

As seen above, the late summer surge in the Delta variant of COVID negatively impacted consumer spending in the "re-opening" areas of leisure spending like restaurants, hotels and airlines. The chart of that spending already appears to be recovering and with a decline in cases, there is no reason to believe that those sectors will not continue on their recovery trajectory. What is more concerning is the slowdown we have seen in global growth measures, highlighted below through global import volumes, shipping container throughput and PMIs, which captures spending trends of supply chain managers. There are a lot of factors at play here including supply chain disruptions, shipping costs, raw material shortages and energy costs, but the danger is that trade falls into a negative feedback loop. If goods are scarce, companies order more, prices go up, orders decline, goods end up in a glut and growth slows. This is a concern among many for later in 2022.

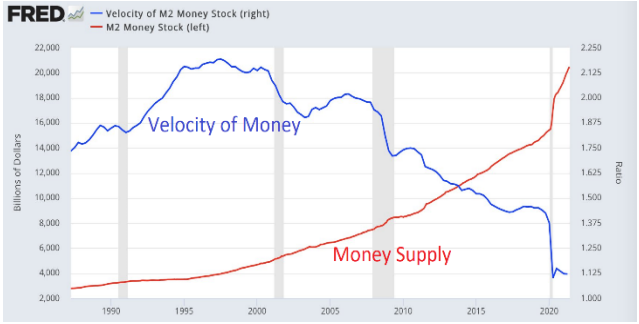
Global Growth Slowed by Disruptions & Higher Costs



Source: TopDownCharts; Datastream; CPB; RWI/ISL

Central banks are very intent on not letting growth slow however and the US supply of money (red line below) has expanded significantly since early 2020. Yet, the money has no "velocity" (blue line) meaning it's not being spent or injected into the economy via business or personal loans from banks for example.

Money Supply Has Exploded But Not Being Circulated

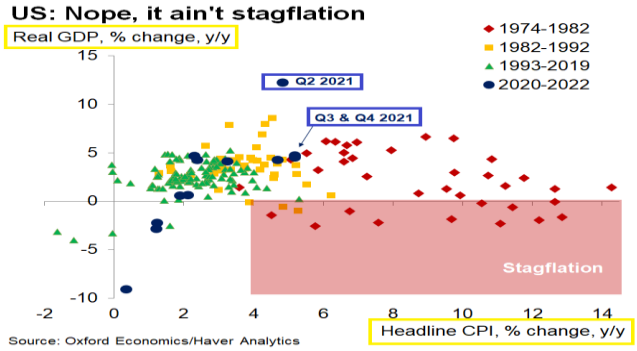


Source: Federal Reserve Economic Data

The chart above also has some worried that the U.S. could be heading toward an environment where inflation increases due to the large money supply while simultaneously, growth slows due to the influences mentioned above. Fortunately, there is little evidence

for this as one can see in the chart below. U.S. economic growth is still robust, estimated at about 5.5% for 2021 and about +4% for 2022 and even if inflation were too actually reach 5%, conditions would be nothing like the stagflation era of the 1970's.

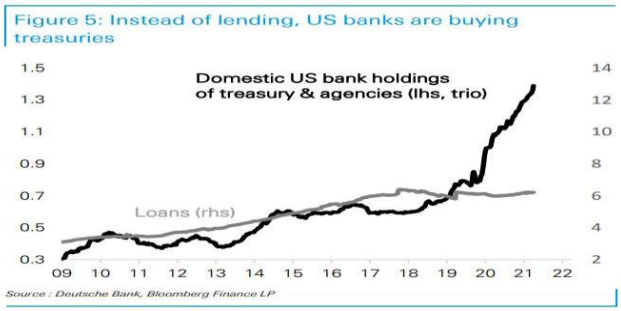
US is No Where Close to Stagflation-Like Conditions



Source: Oxford Economics / Haver Analytics

So where is all the fiscal stimulus going then? As the chart below suggests, banks have to a large degree just simply plowed their excess cash into buying treasuries.

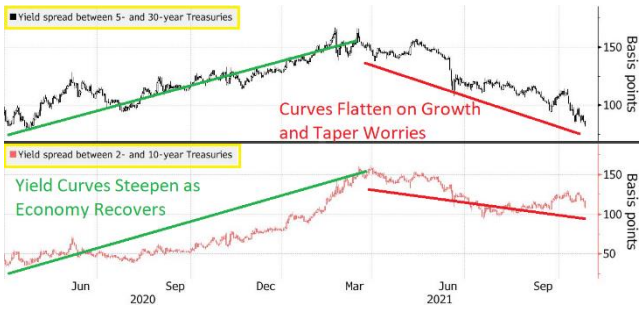
Banks Are Buying Treasuries Instead of Lending Loans



Source: Deutsche Bank; Bloomberg

That constant "bid" for treasuries has helped keep yields in check even as inflation expectations move higher. As shown below, yield curves rose

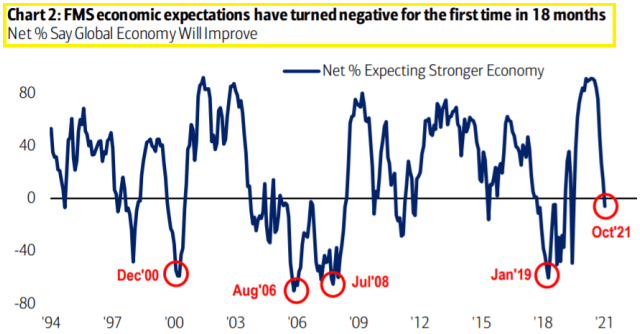
Yield Curves are Flattening on Future Rate Hikes



Source: Bloomberg

from 2020 into early 2021 on improving growth prospects. However, now those curves are flattening as short rates rise in anticipation of Fed rate increases and investors view a weakening growth environment perhaps developing on the horizon.

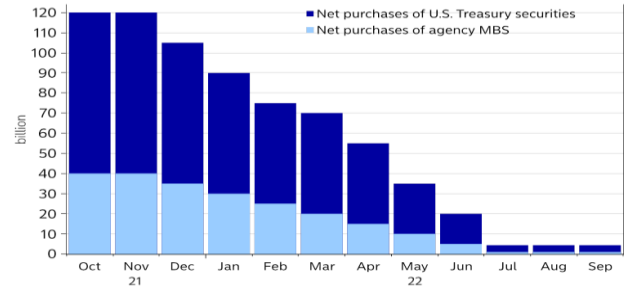
Fund Managers Turned Negative on Growth Outlook



Source: Bank of America Global Fund Manager Survey

In fact, as illustrated above, the percentage of global fund managers expecting stronger economic grow has now turned negative for the first time since March 2020. Additionally, the Fed tapering process in which they begin to reduce their assets purchases, is widely expected to commence in December.

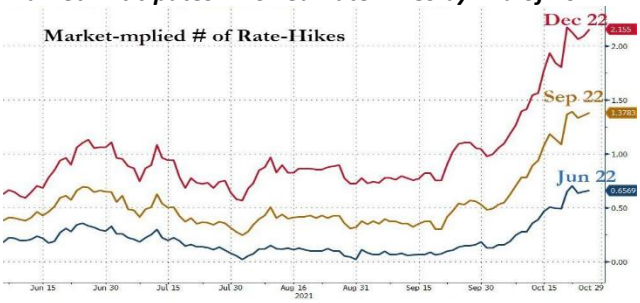
Fed Tapering is Expected to Start in December 2021



Source: New York Fed, MAcrobond, Nordea

Further, at least two fed fund rate hikes are being priced into markets over the next twelve months.

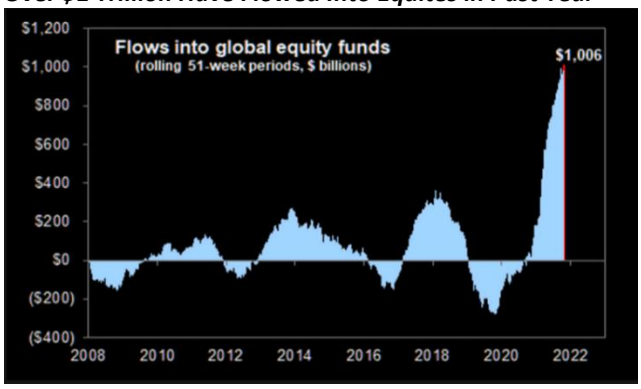
Market Anticipates Two Fed Rate Hikes by End of 2022



Source: Bloomberg; Zero Hedge

Looking at these factors – slowing growth, a flattening yield curve, the Fed tapering asset purchases and rising interest rates – it would be fairly easy to create a pessimistic narrative. However, there are several structural dynamics in place that create a very constructive benchmark for equities in particular over the next few months. First, as we stated earlier, historically, the S&P 500 has performed very well during November and December over the past 35 years.

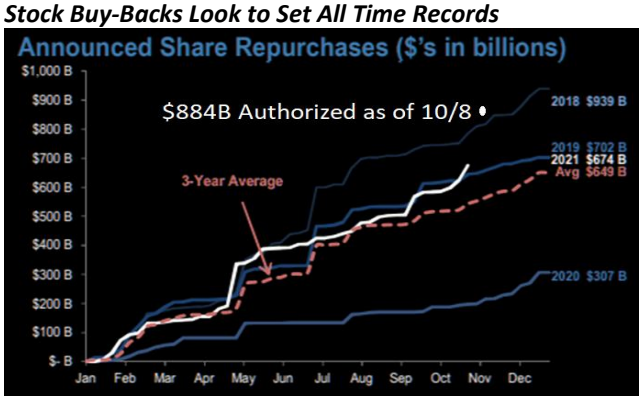
Over $1 Trillion Have Flowed Into Equites in Past Year



Source: Goldman Sachs Global Investment Research

Second, as seen above, a massive trillion dollars have flowed into equities over the past year, dwarfing the previous record of $250 billion. With real yields remaining negative (the yield on treasuries minus the inflation rate), more capital should continue to flow into equities. Third, authorized stock buyback programs are already near a record at $884 billion. According to Goldman Sachs, October represents a quiet period for executing these programs followed by November and December which account for the best 60-day window for stock repurchases during a typical calendar year.

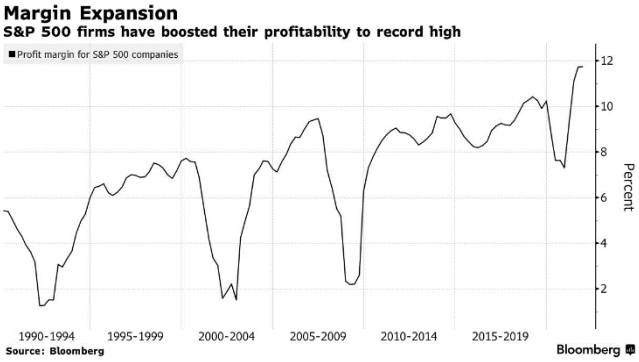
Stock Buy-Backs Look to Set All Time Records



Source: Factset

Fourth, profit margins remain exceptionally high. This ties into the inflation discussion as well. If companies were struggling with wage cost pressures, higher input costs or lack of demand, they would not be able to report record profitability. Instead, margins continue to expand with the latest quarterly estimate from Factset coming in at 12.3%

S&P 500 Net Profit Margins Are at All Time Highs



Source: Bloomberg

And fifth, earnings are incredibly strong. Experience has taught us to always remained disciplined in the belief that prices follow earnings for stocks and this year has been no exception. Full year earnings growth is expected to be +40% with growth this quarter tracking at 33%. Additionally, about 85% of companies have beat earnings estimates, 75% have beat revenue estimates and 65% have beat both, well ahead of historically averages. As a result, full year earnings estimates for the S&P 500 continue to climb. As of late October, earnings are projected to be $202.50 in 2021 and $220.50 for 2022. Importantly, that level of earnings power keeps valuation measures in check with Price/Earning ratio falling form 27 times on 2020 to less than 21 times forward earnings today.

S&P 500 Earnings Continue to Grow; Now +40% in 2021

Source: Factset; Cam Hui

Going Forward

As we highlighted in our opening comments, there is a long list of concerns at present that could very well have a negative influence on markets as we look toward the end of the year. However, as we concluded, there are many structural dynamics in place that we believe strengthen the case for further gains in risk assets, and U.S. equities in particular, over the next few months. The softness in growth experienced during the third quarter can generally be explained by temporary factors, however, it is clear that investors are concerned about the impact of the Fed tapering and the potential interest rate increases on the horizon. The inflationary pressures that some interpret as permanent will in our view be relieved by a resolution of supply chain disruptions sometime in the middle of next year. As we noted however, a larger worry in our mind is an actual deflationary scenario brought on by a negative feedback loop on global growth, trade, and slowing demand. For example, if companies decide to over-order goods for 2022 to "get ahead" of supply disruptions, a scenario could arise where consumer demand declines from the current elevated levels and we wind up with a glut of goods in the back half of 2022. More problematic but less probable, would be a scenario where the yield curve continues to flatten and in fact inverts in conjunction with a Fed policy error of rising rates too quickly, resulting in a recession at some point during 2022. We don't believe that will happen, however 2022 could end up as a year with several challenges that were not present in 2021.

As the U.S. equity market peaked in early September, we choose to lock in some of profits in certain areas before heading into the historically volatile weeks that were to come. Securing those profits has proved beneficial as we continue to find opportunities in quality companies which we view as trading at discounts to their long-term value, namely in the financial, industrial and consumer sectors. As of the end of October, we have largely put most of our cash levels to work. Notably, we never reduced our exposure to the large capitalized technology and communication names which were out of favor during the recovery trade enthusiasm, but have since proved their earning power and sustainability of their business models. We believe these names will continue to lead the market higher throughout the end of this year. In recent weeks, we added to several strong cash generative businesses across industry groups that we believe are well positioned for the balance of the year.

Small and mid-cap stocks have delivered outsized returns since the election last November, but have now been eclipsed by the large cap segment. These companies are more levered to the US economy and benefit from the re-opening dynamics. In general, these companies do best when the rate of improvement is highest, not necessarily when the expansion as a whole takes hold. We therefore reduced some exposure to these market cap segments.

We continue to believe that compelling opportunities exist within non-US exposure. Our dedicated Japan exposure in particular has been additive however, other areas have proved more challenging. Although Europe has vastly improved its vaccine roll-out as a whole, allowing for the re-opening of several major economies, stock performance has yet to reflect those changes. We believe this might be a strong area of opportunity in 2022. Emerging markets continue to be challenged by the COVID environment.

Within fixed income, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value. Fixed income allocations have been very challenging for investors thus far this year with declines experienced for the first time in decades. While the prospect for returns remains muted in treasuries for example, we do believe that allocations to other areas can offer better results and diversification benefits.

Our measured allocation to gold has continued to serve as a non-correlated asset despite the recent declines. Broader commodity exposure has proven to be beneficial this year.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.