Shearwater Creek Investment Matters

3rd Quarter 2021 Market Update

Another Weak September…

<u>3rd Quarter 2021 Review:</u>
September has been historically weak for stocks and 2021 was no different. Following seven months of gains, the S&P 500 declined -4.8% in September as investors grew more concerned about inflation, tighter monetary policy by central banks, a looming U.S. debt ceiling and weaker than expected economic data. Despite these concerns, the S&P 500 managed to post a sixth consecutive quarterly gain of 0.2%, the smallest since the Covid-19 pandemic began. Meanwhile, the Nasdaq Composite and Dow Jones Industrial Average fell -5.3% and -4.3% respectively in September.

Interest rates rose as the 10yr U.S. Treasury note yield hit 1.49%. Rates moved higher after Federal Reserve officials announced on September 22 that they might consider tapering monthly purchases of Treasuries and mortgage-backed securities as soon as November and continue thru mid-2022. The Bank of England also announced the possibility of a rate increase before year-end to combat mounting price pressures.

A new wave in Delta variant cases that began early in June appeared to cool growth expectations. New cases peaked in mid-September however and experts predict further declines due to both acquired immunity through infection and vaccination. Stock indexes reached record highs in August, following news that employers added 943,000 jobs in July, well above consensus estimates; however, payroll growth fell sharply in August with only 235,000 jobs added, below estimates of 725,000 new jobs.

Lingering effects from the pandemic have also contributed to a spike in inflation as persistent supply chain problems have led to soaring shipping costs and raised prices for both inputs and finished goods. June producer prices rose 7.3%, the largest increase since the series began in 2010. In addition, the release of pent-up demand for travel, recreation and other services has pushed prices higher as well.

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Worries that corporate profit growth is peaking may have also contributed to late 3rd Quarter weakness. According to FactSet, overall profits for the S&P 500 rose nearly 90% in 2nd Quarter versus the year before, the best showing in over a decade. Looking forward, many analysts expect coming year-over-year comparisons to be much more difficult especially with rising wage and input costs.

Finally, reduced fiscal stimulus hopes likely also contributed to market weakness in September. On August 10th, the U.S. Senate passed a roughly $1 trillion bipartisan infrastructure initiative aimed at rebuilding traditional transportation infrastructure. Separately, Senate Democrats approved a $3.5 trillion budget resolution to address the Biden administration's priorities on improving access to education and increased support for families with children. Both bills stalled in the House of Representatives however as Democrats debated whether to tie together the passage of the two spending packages.

Overseas, growing concerns of inflation caused a sharp reversal in September and erased most of Q3 2021 gains. The European Central Bank (ECB) said it planned to move to a "moderately lower pace" of emergency bond purchases later this year. The ECB also raised its forecast for inflation to 3.2% in Q4 2021 and then sees a gradual slowing to 1.5% in 2023.

Chinese stocks slumped in Q3 2021 as Beijing announced a regulatory offensive against major technology companies. The MSCI China Index of U.S.-listed stocks fell roughly -18% while its local currency-denominated index declined -4.0%. Following speculation about a potential bankruptcy of cash-strapped conglomerate China Evergrande, China's central bank announced a significant liquidity injection to "ensure a healthy property market" and protect homebuyers rights.

Japanese stocks rose +2.3% in Q3 2021 following the resignation of Prime Minister Yoshihide Suga. His successor, former Foreign Minister Fumio Kishida has called for a sizable stimulus package to offset impacts from the Covid-19 pandemic. In addition, the Bank of Japan is expected to maintain an accommodative stance in order to achieve its 2% price stability target as soon as possible.

4th Quarter 2021 Outlook:

Despite the spread of the Delta variant and increased political uncertainty around the world, we maintain a cautiously optimistic outlook looking forward. The Delta variant likely has delayed rather than derailed a global recovery and might make growth over the next few quarters more robust than they might have been otherwise.

With that said, challenges still loom on the horizon, most notably how equity and bond valuations react to potential new fiscal initiatives and tighter monetary policies. Past Fed tapering efforts have often, but not always, triggered corrections. Central bank actions will have to be carefully communicated and any rise in rates will hopefully be balanced with signs of continued growth and moderating inflation.

The outlook in Washington on new infrastructure spending initiatives and an increase in the federal debt limit remains as clouded as ever. Passage of a physical infrastructure and social spending bills should add to the current recovery, but at a cost of even further elevated debt levels and higher tax burden.

The flood of liquidity has clearly led to speculation in certain markets, however it’s hard to generalize about where these pockets lie and how to avoid them. While some say that growth stocks’ valuations are high relative to historical levels, interest rates are still extremely low and earnings growth rates for many new companies are high. Similarly, it’s difficult to make blanket statements about the relative appeal of growth versus value, developed versus emerging markets or U.S. versus foreign equities. For us, the key going forward is maintaining a diversified portfolio and staying focused on fundamentals.

The good news is hopefully investors have not yet enjoyed all the benefits of the recovery as many companies have yet to see their business return to pre-pandemic levels.

Here’s a performance recap of major market indexes for Q3 2021:

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Equity Indexes:	Q3 2021	2021 YTD
S&P 500	0.58%	15.91%
Dow Jones Industrial Average	-1.46%	12.12%
Nasdaq Composite (Principal Return)	-0.22%	12.54%
Russell Midcap	-0.93%	15.17%
Russell 2000	-4.36%	12.41%
MSCI All Country World	-0.95%	11.49%
MSCI Europe	-1.46%	10.64%
MSCI Emerging Markets	-7.97%	-0.99%
Bond Indexes:		
Bloomberg Barclays U.S. Aggregate	0.05%	-1.55%
Credit Suisse High Yield	0.91%	4.83%

Note: Returns are for the periods ended September 30, 2021. The returns include dividends and interest income based on data supplied by third-party provider RIMES and compiled by T. Rowe Price, except for the Nasdaq Composite Index, whose return is principal only.
Sources: Standard & Poor's, LSE Group, Bloomberg Barclays, MSCI, Credit Suisse, Dow Jones, and J.P. Morgan (see Additional Disclosures).

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Sources: [1]Thomson Reuters. Past performance is no guarantee of future results. Yields may be lower or higher than quoted above. Yields fluctuate as market conditions change. An index is unmanaged and not available for direct investment. The indices are presented to provide you with an understanding of their historic long-term performance and are not presented to illustrate the performance of any security. Large Cap = S&P 500 Index (The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole.), Mid-cap = Russell Midcap Index (The Russell Midcap Index measures performance of the 800 smallest companies (31% of total capitalization) in the Russell 1000 Index, with weighted average mark et capitalization of approximately $6.7 billion, median capitalization of $3.6 billion, and market capitalization of the largest company $13.7 billion.), Small-cap = Russell 2000 Index (The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.), DM Ex-U.S. = MSCI EAFE Index (The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.), Emerging Markets = MSCI EM Index (The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets.), Bloomberg Barclays U.S. Aggregate Bond Index (The Bloomberg Barclays US Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type.), ICE U.S. Treasury 20+ Year Bond (The ICE U.S. Treasury 20+ Year Bond Index measures the performance of Treasury securities and is selected by a Market Value process.), Markit iBoxx USD Liquid High-Yield Bond Index (Consists of liquid USD high yield bonds, selected to provide a balanced representation of the broad USD high yield corporate bond universe. The index is used as a basis for tradable products, including ETFs.)

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