# *2021 FALL INVESTMENT OUTLOOK*

Fueled by ongoing fiscal and monetary stimulus, the economic expansion entered its seventeenth month in September, extending its recovery since the shortest U.S. recession on record ended in April 2020. The good economic times should continue throughout the fall months. A favorable backdrop, which includes an improving employment situation, a solid housing market and generous government support programs, has put consumers in an excellent financial position. Furthermore, corporate America's prospects look solid with a strong profit rebound underway and expected to continue into next year. Meanwhile, the Federal Reserve continues to provide unprecedented support despite the robust economic fundamentals. On the fiscal front, Congress continues to debate the specifics of the next spending bill with the final price tag predicted to be in the trillions of dollars which will further bolster near term economic growth.

The news is not all positive, however. The COVID-19 pandemic has made a comeback as fall approaches as cases and hospitalizations have increased in recent weeks. On the fiscal front, even if the federal government passes additional stimulus measures, the amount of government spending will fall relative to what was given out over the past eighteen months. Moreover, any spending bill that gets through Congress will be paired with new tax measures that will act as a headwind to growth. Additionally, the Federal Reserve has guided investors to expect a paring back of monetary stimulus measures in the months ahead. While the federal funds rate is expected to remain near zero at least into 2022, the Fed has indicated that it will begin to taper its purchases of Treasury and mortgage backed securities later this year.

On balance, bullish sentiment continues to rule the day as investors remain focused on the positives in the outlook. The broad based stock market as measured by the S&P 500 has returned 17.1% year-to-date as noted below, continuing the gains experienced since the pandemic hit in early 2020. The market has nearly doubled since March of last year due to the many positives highlighted. The recovery in equity prices has been robust and without the volatility normally associated with the stock market. So far in 2021, the S&P 500 has not experienced a 5% decline, while this bull market has only experienced three 5% or greater pullbacks, all of which occurred last year. In contrast, in the twelve post-WWII bull markets, stocks have averaged nearly six 5% drawdowns and two 10-20% corrections. While the prevailing mood among investors continues to be one filled with optimism, it is possible that greater volatility may return to the capital markets in the coming months.

***Equity Markets – 9/21/21***

| | Index Price Level | 2021 YTD Total Return |
|---|---|---|
| Dow 30 Industrials | 33,920 | +12.4% |
| S&P 500 | 4,354 | +17.1% |
| NASDAQ Composite | 14,746 | +15.0% |
| MSCI All Country World Index ex-USA | 344 | +7.6% |


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## *Outlook*

Economic growth is expected to remain at above average rates in the near to intermediate term. As noted above, this is in large part due to the generous government support programs that have been enacted since the pandemic hit last year. Consensus forecasts call for the U.S. economy to grow at a 5% rate in the remaining two quarters of the year which would result in full year 2021 growth of 5.9%. Estimates for 2022 currently call for a further 4.2% advance in economic activity. Interestingly, annual growth estimates for the balance of the decade have settled back into the 2-2.5% range indicating that today's massive deficit spending will likely have no lasting impact on the nation's ability to grow over the long term. The government debt will remain, however. According to Congressional Budget Office data, the U.S. federal debt held by the public equaled 100% of GDP at the end of 2020. With a federal deficit likely exceeding $3 trillion this year, that figure is expected to move higher. This is consistent with the notion that growth will slow in the years ahead as many notable studies have shown that high debt levels are associated with below average rates of economic activity. Slower economic growth, in turn, makes it more difficult to be able to pay off the high debt burden levels over time.

For now, however, politicians and monetary policymakers remain largely unconcerned with the longer term consequences of this seemingly unending borrowing binge. Federal Reserve officials have grown their balance sheet to a current size of $8.4 trillion, double where it was before the pandemic hit and up about ten times versus where it stood before the 2008 housing crisis. As a result, the Fed now holds approximately one-third of all publicly held federal debt and an even greater percentage of all federally insured mortgages. This was done in an effort to coax the recovery along and get back to full employment. Despite the strongest economic recovery in the post-WWII era, the Fed continues to pursue extremely accommodative monetary policies with near zero interest rates and ongoing $120 billion monthly purchases of government and mortgage backed bonds. While it is likely that the Fed may indicate a pending tapering of those bond purchases at its September meeting, low rates are expected to continue well into next year.

Some Fed members have voiced concerns that their policies are distorting normal market signals which has led to inflated prices for certain assets. For instance, Dallas Fed President Robert Kaplan has said he believes the low rate environment engineered by the Fed has contributed to rising home prices. The latest Case-Shiller home price index report, which showed that home prices rose by 19% year over year in August, is evidence of this. Meanwhile, rents were nearly 10% higher last month as well. Neither of these facts were reflected in the official government inflation data which showed that shelter costs advanced at an annual rate of only 2.8% last month.

Fed policy has likely inflated asset prices in many other sectors of the economy besides housing as easy access to cheap money over long periods of time has historically led to financial market excesses and a misallocation of capital. Ultimately, this will result in heightened volatility and may act as a headwind to productivity growth. The Fed is keenly aware of this risk and is likely considering any impact its decisions may have on the broad capital markets. After the so called taper tantrum when ten year Treasury yields spiked by over 100 basis points in 2013, Federal Reserve officials do not want to disappoint capital market investors with any unwelcome surprises. This is increasingly difficult to do at a time when they are deploying far more tools than they have in years past. Policy mistakes or the miscommunication of policy intentions are a larger risk today than at any time in recent memory. This is an important concern to keep in mind in a world where high asset prices are underpinned by the expectation of never ending monetary accommodation.

Despite the current political bickering in Washington, it is expected that a tax and spending package will be passed sometime later this fall. One recent positive related to the bill that is likely to emerge from Congress is that, based on the trial balloons that have been released recently, it appears that future tax hikes will not be as onerous as initially proposed. This additional stimulus will enhance an already strong economy and support the ongoing recovery. At least in the short term, this extra spending will also exacerbate the supply-demand imbalances that exist today which are contributing to above average inflation. Shortages relative to demand for automobiles, housing, food, energy and workers to name a few newsworthy categories have led to rising prices. Importantly, consumers still anticipate that these rising costs will be temporary, so expectations of future inflation remain in check. This is significant since, in past cycles, upward wage-price spirals have led to more problematic inflation which had to be addressed with higher interest rates. Such an outcome would not be well received by investors today. At the same time, it is worth remembering that, in the year before the pandemic, market expectations called for inflation over the ensuing five years to average about 1.5%. Current estimates are now up to 2.5%, indicating that markets are often wrong and sentiment can change quickly.

The average American consumer remains in excellent shape with excess savings and jobs plentiful. It is estimated that some $2.5 trillion has been stockpiled and is available to be spent. At the same time, while total employment in this country is still down over 5.3 million people versus pre-pandemic levels, the number of employees on U.S. payrolls has grown by over 17 million since April 2020. The current unemployment rate fell to a post-pandemic low of 5.2% in August, a rate below the long term average. There are nearly 11 million available jobs in this country at present and companies are reporting that one of their main challenges is hiring qualified people to fill those positions. In many industries, this has led to workers having more bargaining power than they have had in decades leading to solid wage gains for many employees. Low immigration rates, weak population growth, rising retirement rates and generous government support programs are among the main reasons given for the dearth of available workers.

The ingenuity of corporate America is on full display as companies continue to meet the various challenges noted as they post a strong profit recovery from last year's depressed levels. According to Bloomberg, the third and fourth quarter of this year should see 25% and 21% corporate profit growth, respectively. Aggregate earnings per share for S&P 500 companies are projected to grow over 40% for the full year which would result in a new record high level by year end 2021. A further advance of 9% is projected for 2022. Record stock buybacks are predicted for this year which will assist in meeting these targets.

Analysts are as bullish as they have been in nearly two decades with the percentage of Wall Street ratings that are 'buy' or 'overweight' at their highest level since 2002. This is occurring at the same time that market valuations exceed the long term trend and earnings expectations are well above historical averages based on a Bank of America/Bloomberg study conducted earlier this summer. Such bullishness makes the market vulnerable to any deterioration in the underlying results of corporate America or to a change of sentiment. This latter point was on display in mid-September when the S&P 500 fell by 1.7% on the news that Chinese property developer Evergrande was in financial distress. Clearly, that news alone was not sufficient fundamental information to justify U.S. shares falling as they did; however, overall market sentiment turned more negative as investors built in expectations of a more broadly slowing Chinese economy.

While companies are making progress on the earnings front, some headwinds persist. Recent calls with many company management teams indicate that raw materials inflation, rising logistical expenses and higher wages are all increasing the cost of doing business. To the extent that these increased expenditures cannot be passed along in the form of higher prices, this will pressure profit margins in the coming quarters. Corporate debt levels remain elevated, too, though the servicing cost of that debt remains very manageable currently due to the low interest rate environment. This is one reason why

stock market investors remain keenly focused on what happens in the bond market. Finally, as noted previously, overall stock market valuations remain well above their long term average. The current price-to-earnings ratio of 20.3x is some 33% above the 20-year historical average of 15.3x This will likely constrain overall stock market gains in the coming years relative to recent history.

### *Investment Conclusions*

While the current backdrop for investors remains constructive, intermediate term capital market returns are likely to fall short of historical averages as gains are likely to be constrained by today's high starting valuations caused in part due to unprecedented government stimulus which is now winding down. Nevertheless, as we balance the competing desires to protect and grow our clients' capital, we continue to commit long term investment funds while remaining mindful of the risks in the present environment. Well diversified portfolios are still expected to provide market participants with acceptable inflation adjusted returns that should allow their capital to grow over the long term, assuming reasonable ongoing withdrawal rates.

As fundamental analysts, we endeavor to identify attractively priced long term investment opportunities while considering all the appropriate risks. On the equity side of portfolios, we study companies' cash flow generating capabilities and buy shares of firms that we believe are trading at a discount to what we determine is their fair value over the long term. While fixed income returns continue to be held back by the low interest rate environment engineered by Federal Reserve policies and low global yields, bonds still represent an important component of a long term investment plan. High quality, short to intermediate term fixed income ladders act as a stabilizing force in client portfolios while providing modest income, known cash flows and a source of funds to invest in the stock market during periods of opportunity.

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