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Investment Insights Quarterly

From The Desk of Bill Hornbarger, Chief Investment Officer October 2021

Rounding the Turn and Headed Towards Year End

Despite the weakness in September, the S&P 500 ended the third quarter with small gains. Our thoughts as we head into Q4 follow.

The Economy

The impacts of the delta variant and the fading impact of the stimulus checks are starting to show up in the economic data. U.S. GDP estimates have been revised lower in recent weeks and the latest Q3 GDP estimate from the Atlanta Fed sits at 1.3% down from 6.1% at the end of July. Most of the downward revisions are due to lower expectations for consumers spending and the housing market, which isn't as strong as it was last year and this spring. Consumer confidence has declined in recent months, which may result in a decline in household consumption, one of the largest drivers of GDP growth. Consumer spending accounts for approximately 70% of GDP. Consensus from economists is still 3-4% GDP growth in Q3 when it is reported.

Labor shortages have held the economy back resulting in the highest wage gains in more than a decade. Wages grew at 4.6% in the September employment report, which is still below the current rate of inflation. The JOLTS data (Job Openings and Labor Turnover Survey) indicates that there remains plenty of room for job growth to accelerate in the months ahead.

Inflation, by any measure, remains elevated. In the latest readings (September) CPI and core CPI were up 5.4% and 4% respectively, and similar patterns have been seen in other inflation measures. The Fed continues to express the view that these pressures are transitory, likely as the result of supply chain disruptions from the Covid-19 pandemic lockdowns and restrictions. Recently, some

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Fed officials have expressed concern about inflation, saying it could last longer "than they currently assumed."

Strong consumer balance sheets, the prospects of stronger job gains, easy financial conditions, a positive outlook for business investment as inventories are rebuilt and supply chain issues recede argue that despite the recent softer patch, the economy should continue to grow at trend or slightly above. At the September meeting, the Fed projected 2022 GDP growth of 3.8%, up from 3.3% in July.

Monetary Policy

The Fed has been patient in their approach to changing monetary policy. In the wake of last year's forced recession, the Fed continued quantitative easing (monthly bond purchases), targeted programs, and lowered rates to zero, where they have remained to date. At the latest Federal Open Market Committee meeting, the Fed indicated that it could begin tapering as soon as mid-November. The tapering process could see a monthly reduction of $10 billion in Treasuries and $5 billion in mortgage-backed securities. The dot plot and futures markets indicate that the first Fed rate increase isn't expected until spring/summer of 2022.

Earnings

Based on data from FactSet, S&P 500 earnings grew a remarkable 91% YoY in Q2, well ahead of expectations. For Q3, earnings are predicted to increase 27.9% with revenue growth of 14.8%. For the full year of 2021, corporate earnings are expected to grow 42.6% with revenues growing 14.9%. In 2022, earnings growth is forecast to decelerate down to 9.4% with revenue growth of 6.6%

Potential Market Ramifications

Fixed Income

Fed tapering, the prospects of change in the target Fed funds rate, and elevated inflation all argue for an upward bias to intermediate- and long-term benchmark Treasury yields. The benchmark 10-year ended Q3 at 1.31%, and the high for the year was 1.74%. Shorter maturities will remain captive to Fed policy. It is important to remember that while U.S. yields remain low relative to what many investors remember, they remain high relative to most other developed countries, arguing that flows will remain positive and potentially mitigate any increase. With the prospects for the economy to grow at/above trend next year, credit trends should remain positive and defaults low. While credit spreads remain tight, the economic environment appears supportive.

Equities

Equities, in our opinion, continue to offer the best risk and reward prospects relative to cash and fixed income based on the low interest rate environment and accommodative central bank monetary policy (see chart 1). Equity risk premiums remain at/above historical levels while core fixed income yields remain below inflation. It is also worth mentioning that cash on the sidelines (as measured by money market funds) remains high (see chart 2), providing more potential "fuel" to be invested in equities. Our preference continues to be U.S. equities over non-U.S. equities, and we have a more cautious view on non-U.S. developed and emerging markets. The economic and earnings backdrop looks more favorable in the U.S. We continue to recommend elements of growth and value across the market cap spectrum because of increased sharp rotations and the challenges associated with market timing. Given the rosier outlook for the U.S., we believe demand for U.S. assets like the dollar will continue to be strong. Any further USD strength will be a headwind for non-U.S. assets.

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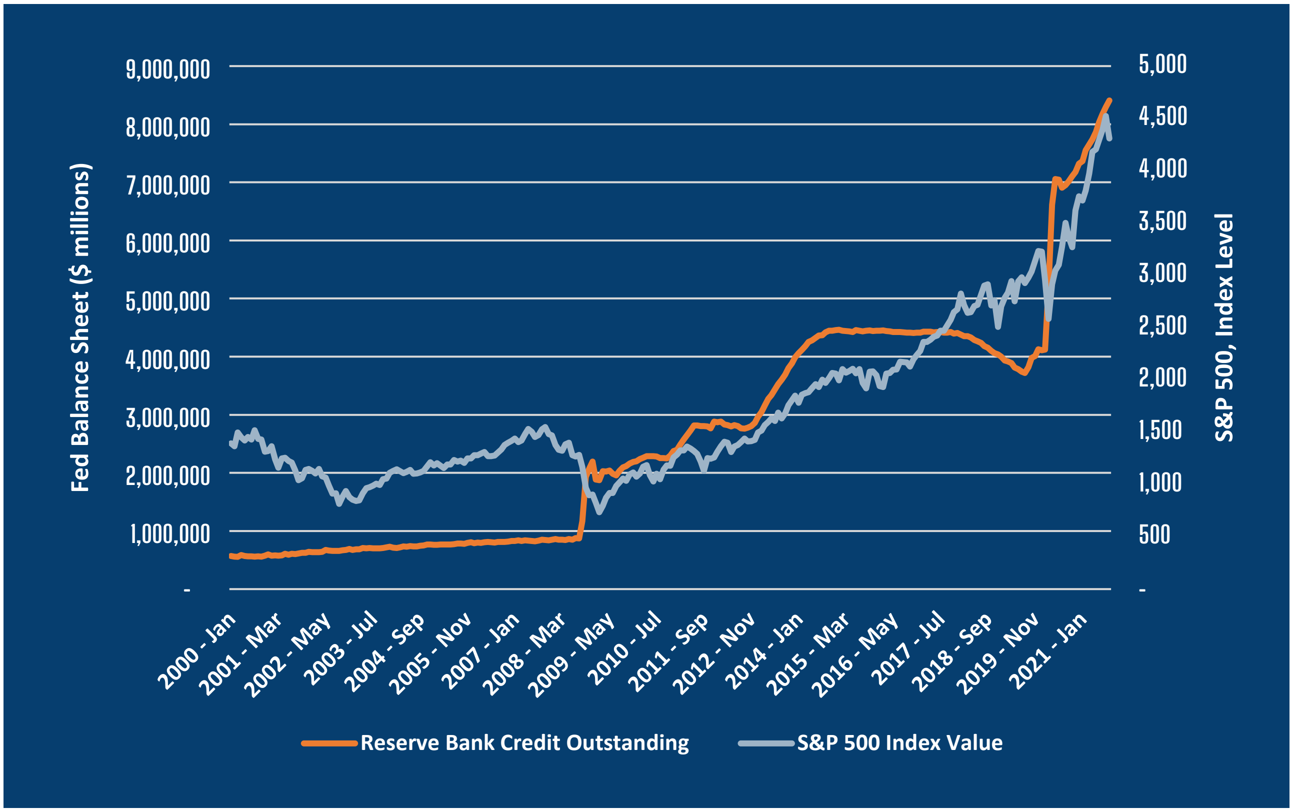
Chart 1: Fed Balance Sheet vs. S&P 500
2000 to present

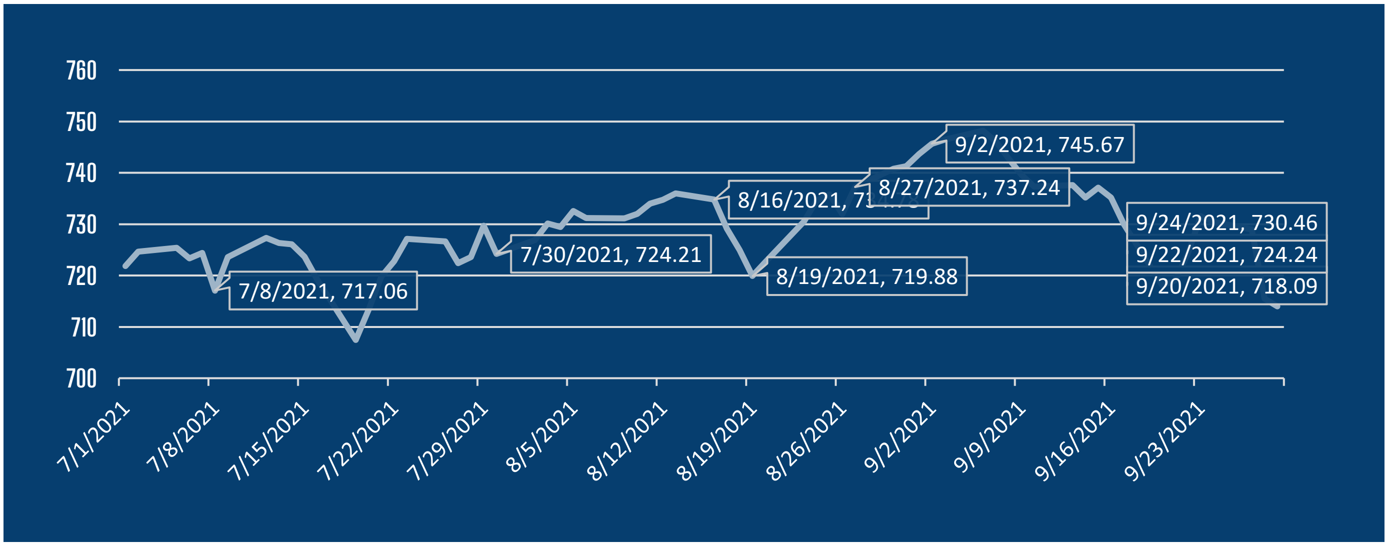


Source: Haver Analytics

Key Q3 Dates

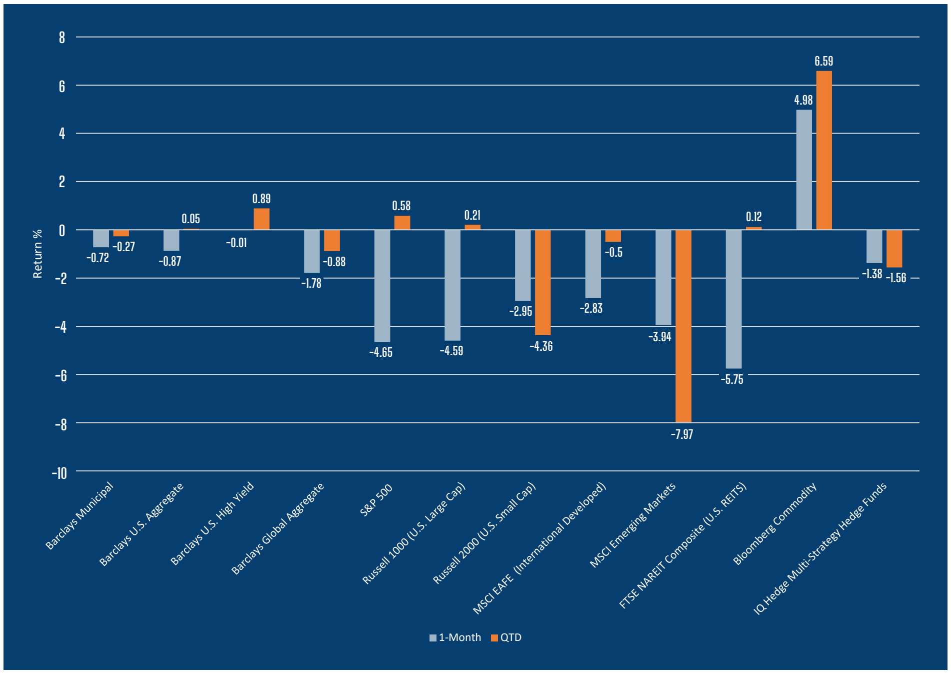
- July – Delta variant becomes more widespread
- July 8 – Bloomberg reports Evergrande is facing a liquidity crunch
- August 16 – The Dow Jones Industrial Average closes at a record high of 35,625
- August 19 – After soaring early in the year, lumber crashes to $454
- August 27 – Fed Chairman Jerome Powell speaks at the Jackson Hole symposium and has a fairly dovish tone to his comments
- September 2 – The S&P 500 closes at a record high of 4,537
- September 20 – The S&P 500 has a four-day losing streak, including a 75 point down day on September 20
- September 22 – Fed Chairman Jerome Powell lays out a possible timeline for tapering at his press conference following the FOMC meeting
- September 24 - China's Central Bank declares all crypto activities illegal and promises to crack down on the market

Chart 2: Global Stock Market
MSCI ACWI in USD



Source: Bloomberg

Asset Class Returns Q3 2021



Source: Conway

Fixed Income

- The 10-year Treasury yield jumped by nearly 25 basis points in September and that was negative for core fixed income and municipal bonds.
- Credit weathered the rate turbulence well in September as higher yields offset wider spreads.
- Bonds outside the U.S. were particularly weak in September, hit by the double whammy of higher rates and the stronger U.S. dollar.

Equities

- U.S. equities ended September on a particularly sour note with steep losses in the tech-heavy Nasdaq.
- Large caps trailed small caps last month and growth stocks underperformed value stocks across the entire market cap spectrum.
- Non-U.S. developed equities outperformed U.S. equities in September, led by strength in Japan. Unlike what occurred in the U.S., small caps lagged large caps, but the trend of value beating growth was consistent.
- Emerging Market equities fell nearly four percent last month, driven mostly by weakness in China and Latin America.
- U.S. dollar strength was a major headwind for non-U.S. assets during September.

Alternatives

- The 29.1% gain in commodities represents the largest annual gain in the last 42 years.
- Supply shortages are causing commodity prices to surge higher and there aren't any short-term fixes on the horizon.
- The forces of rising demand and higher rents are providing strong underlying support for real estate valuations. REIT yields look relatively attractive for investors seeking income.

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The Fed pared back its outlook for 2021 at the September meeting:

Real GDP	2021	2022	2023
June 2021 projections	7%	3.3%	2.4%
September 2021 projections	5.9%	3.8%	2.5%

Inflation (Personal Consumption Expenditures)	2021	2022	2023
June 2021 projections	3.4%	2.1%	2.2%
September 2021 projections	4.2%	2.2%	2.2%

Fiscal and Monetary Policy Highlights

- The Fed met twice in Q3 and left rates unchanged at both meetings.
- The Fed's statement indicated that "indicators of economic activity and employment have continued to strengthen. The sectors most adversely affected by the pandemic have shown improvement but have not fully recovered."
- The Fed "dot plot" released on September 22 now places the odds of a rate increase in 2022 at even.
- The Fed indicated that if the economic recovery continues on track, the Fed will soon begin a "gradual tapering process that concludes around the middle of next year."
- Inflation continued to trend higher during Q3 with CPI posting a 5.4% YoY increase in July. The Fed has been consistent that any inflation surge will be transitory in nature, caused by supply chain disruptions, pent up demand, and easy comparisons to the depressed prices in 2020.
- The Bipartisan Infrastructure Bill was scheduled for a house vote on September 27. Disagreements on this and the proposed $3.5 trillion reconciliation package left Congress in limbo, wondering when, how, and if these measures will be passed and no vote on the scheduled date.

Source: Bloomberg

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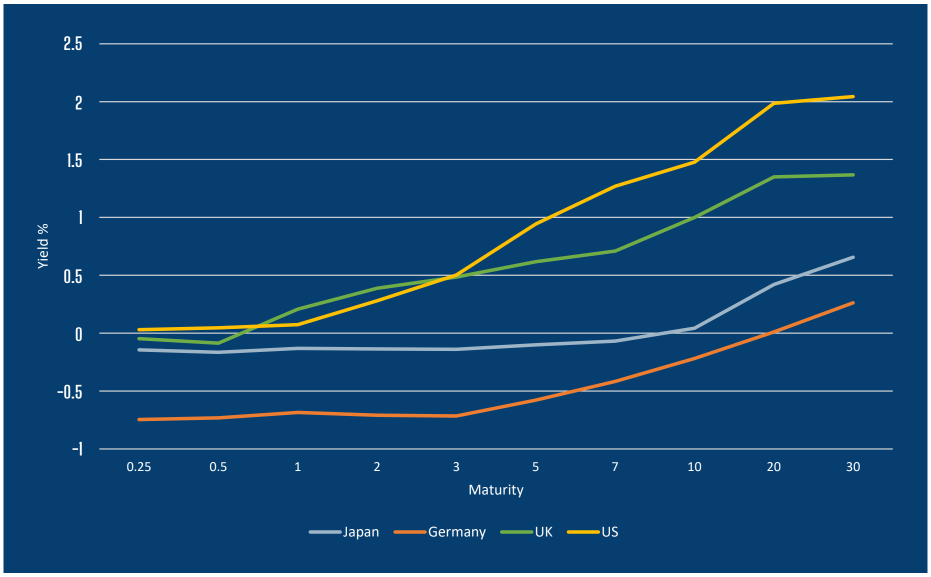
Government Bond Curves

U.S. Treasury yields remain high relative to other developed countries. Approximately $13.4 trillion of global debt continues to trade with negative yields at the end of Q3. That amount increased to as much as $16.9 trillion during the quarter.

Government Bond Curves



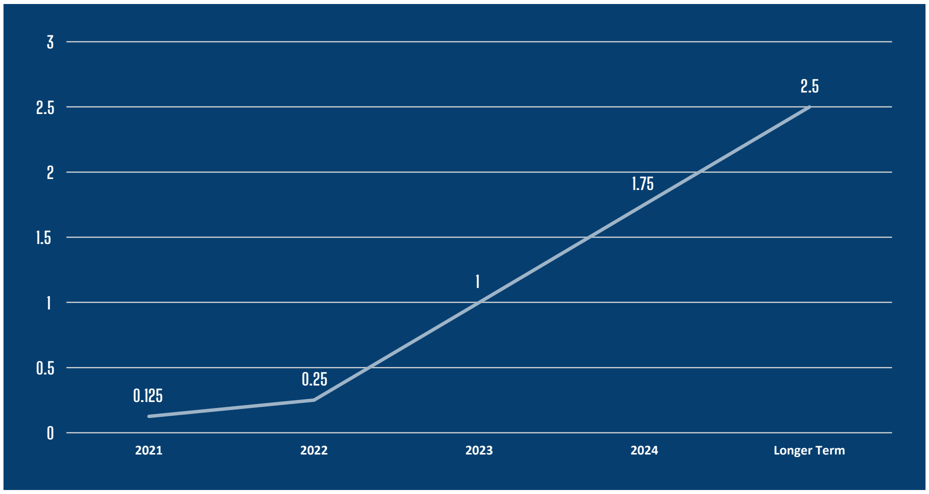
Source: Bloomberg

Monetary Policy Expectations

As economic activity has increased and inflation expectations have risen, the outlook for monetary policy has evolved. The Fed has communicated it will begin tapering this year with the intent of finishing by mid-2022. The median Fed forecast is for the first rate increase in 2022.

Median of FOMC Dots Data Projection

Year End Targets as of Q3 2021



Source: Bloomberg

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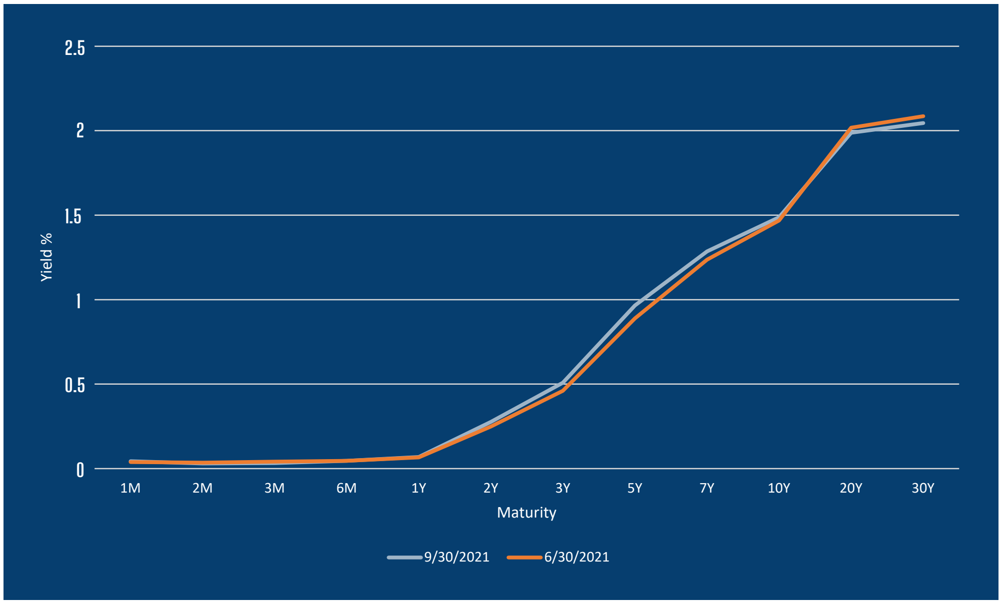
U.S. Treasury Curve

U.S. Treasury yields barely budged quarter-over-quarter. The benchmark 10-year note carved out a 31-basis point range with 2-year notes range less than half of that. The Treasury market remains focused on the Fed and when it will begin tapering.

Treasury Yield Curve

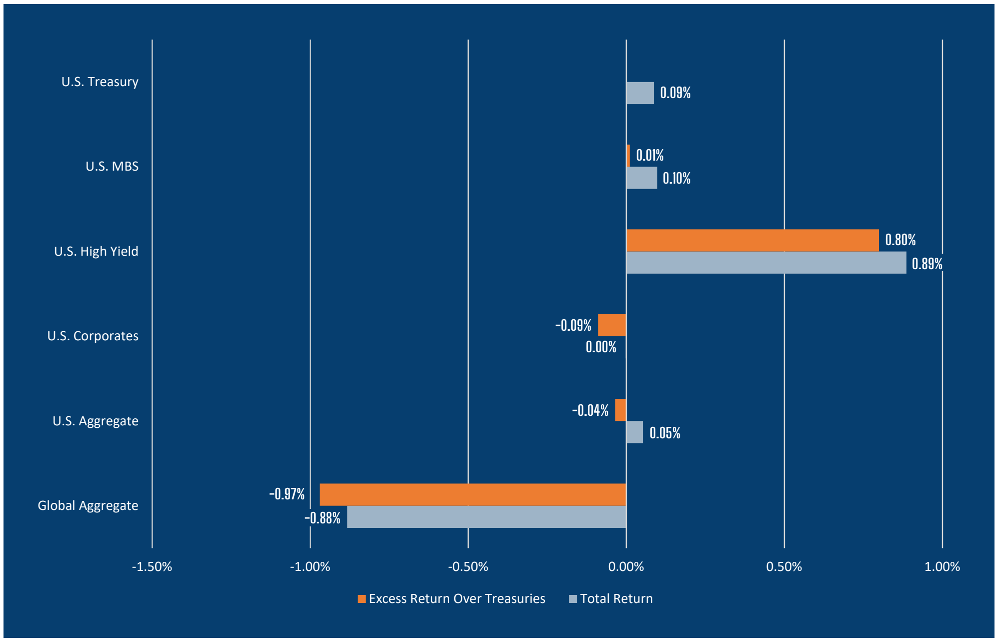


Source: Bloomberg

Fixed Income Performance (Q3)

There was little dispersion in bond returns during Q3. Low and relatively stable yields were the major drivers. High yield outperformed based on the higher carry and slightly stronger equity markets.

Bond Returns



Source: Bloomberg

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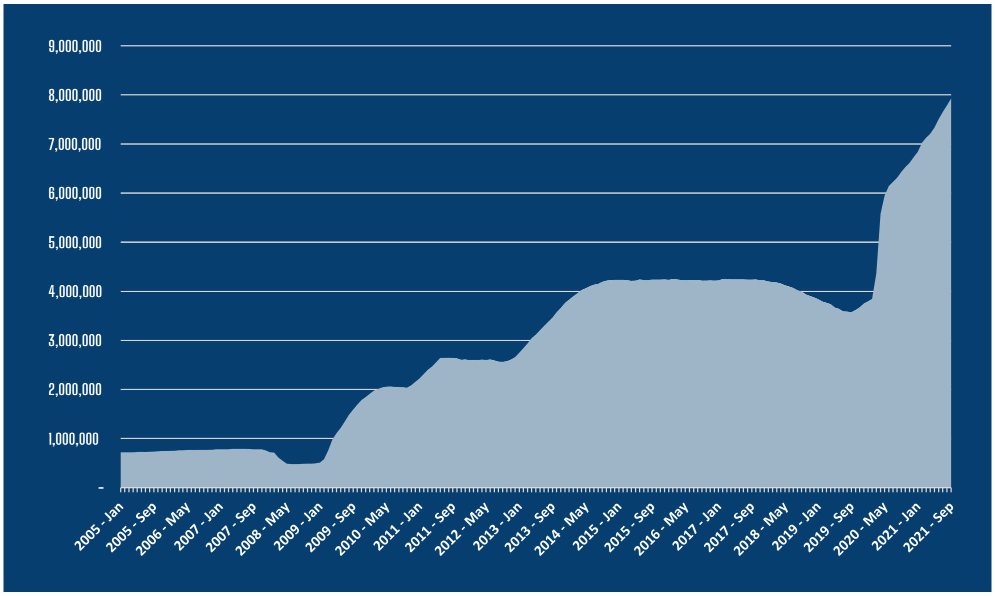
Quantitative Easing

The Fed's balance sheet (treasury and mortgage-backed securities held outright) reached record levels at the end of Q3. The Fed has been a large buyer and talk of tapering could lead to market volatility.

Reserve Bank Credit Outstanding: Securities Held Outright
EOP $ Millions



Source: Bloomberg

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Equity – Value vs. Growth

Growth stocks continued to outperform value until late in the quarter. As the Fed more openly discussed tapering and bond yields rose, value outperformed noticeably late in the Q3.

Large Cap Value/Large Cap Growth - Q3 2021

Russell 1000 Value/Russell 1000 Growth

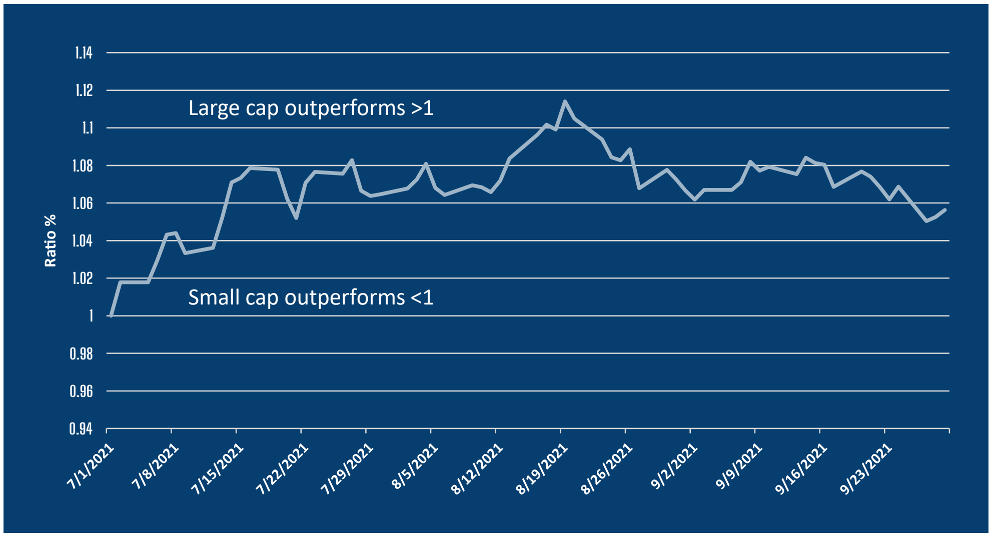
Source: Bloomberg

Equity – Large vs. Small

Large cap outperformed small cap early in the quarter. As bond yields increased and the market rotated towards value and the NASDAQ came under pressure, small cap traded better on a relative basis.

Large Cap/Small Cap – Q3 2021

S&P 500/Russell 2000



Source: Bloomberg

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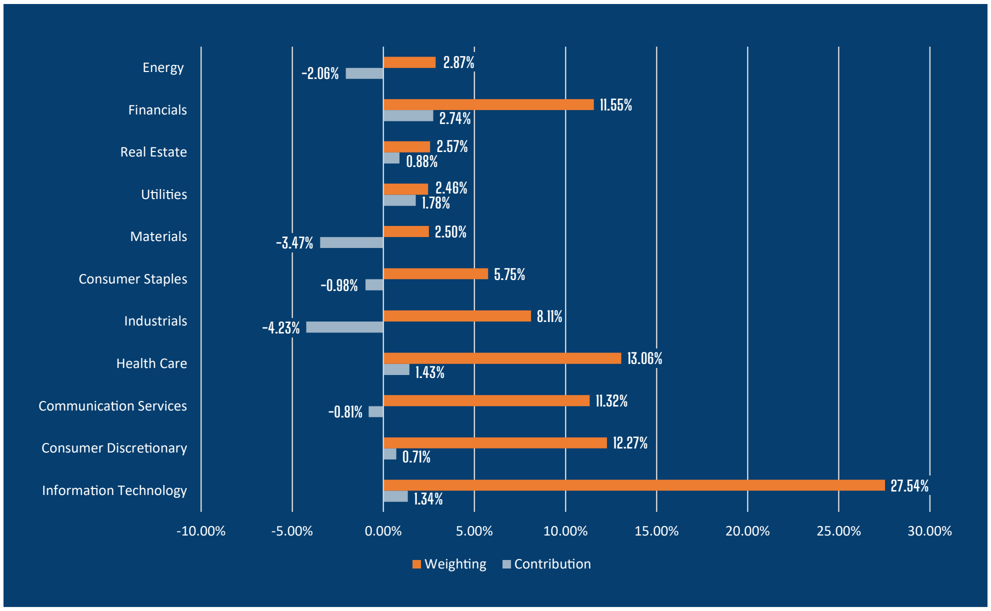
U.S. Equities – Return by Sector

The S&P 500 was up 0.55% during Q3. Financials was the top-performing sector among large and small-caps in Q3. Energy was the leader among mid-caps. The contribution of cross-sector effects to total S&P 500 dispersion rose above average in September, indicating greater relative rewards for sector allocation decisions.

Contribution to Return - S&P 500 by Sector
Q3 2021



Source: S&P, Bloomberg

Country Total Returns (%) – 10 Largest Economies

Returns for Q3 were mixed with the United States generally turning in the best performance. In international markets, eastern Europe and Latin America outperformed Asia and Japan continued to struggle, down 1.64% during Q3.

Country Total Returns

Source: Bloomberg

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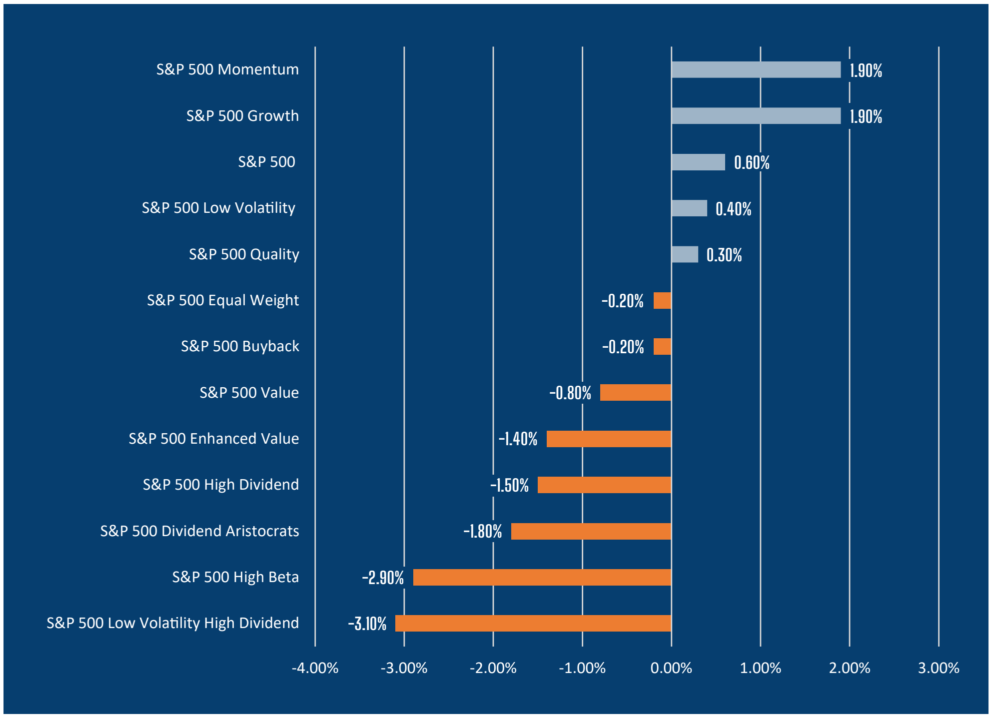
U.S. Equity Factors – Total Return Q3

The momentum and growth factors remained the best performers during Q3 as the market rotated away from the reopening trade that had been in place in previous quarters. Dividend factors struggled as bond yields increased and the Fed openly discussed tapering.

Q3 Total Return by Factor



Source: S&P

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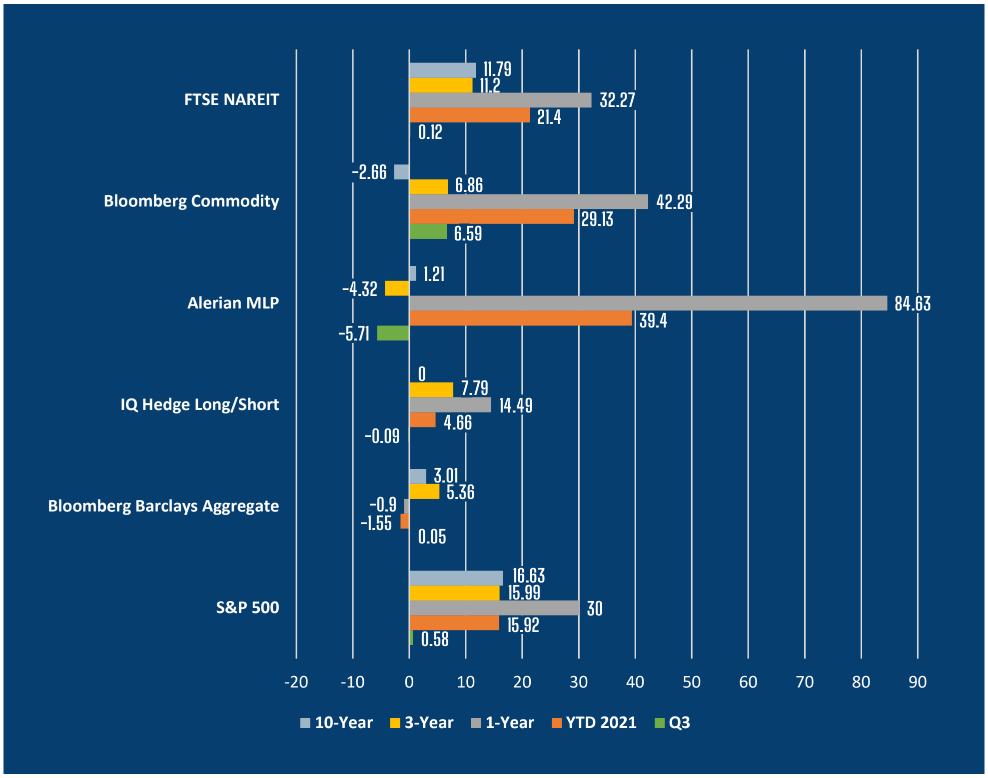
Alternative Returns

While longer term performance remains uninspiring relative to equities, many alternative asset classes and strategies have provided strong recent performance, particularly relative to core fixed income.

Periodic Returns

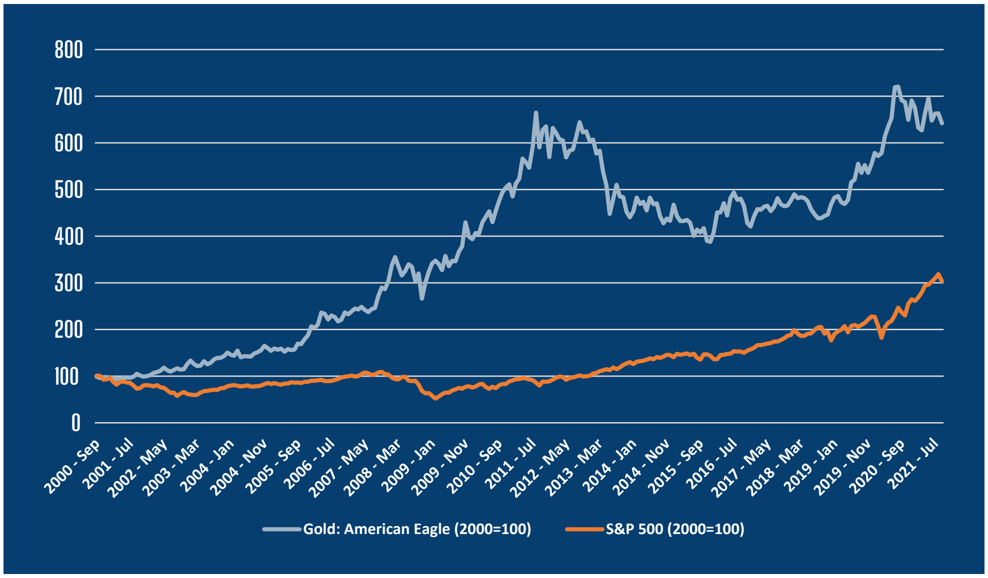


Source: Bloomberg

Gold

Gold vs. Stocks

American Eagle vs. S&P 500
Year 2000=100



Source: Haver

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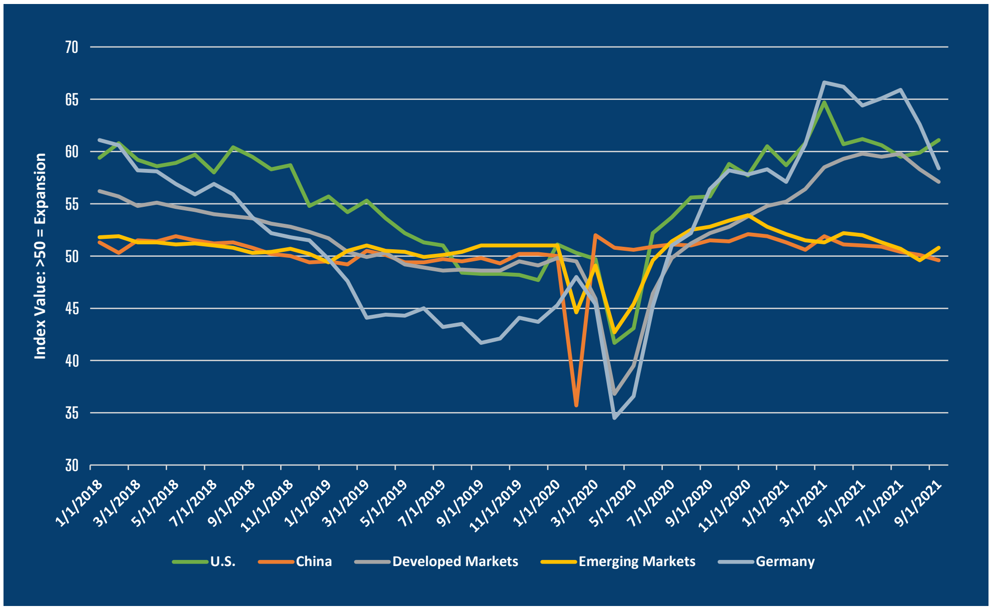
PMI Composites

The Purchasing Managers Index (PMI) is a survey-based measure of the prevailing direction of trends in the manufacturing sector. Readings >50 equal expansion and <50 contraction. Manufacturing has softened (albeit from strong levels) during Q3 and China dipped below 50 in the most recent reading.

Global Manufacturing Surveys

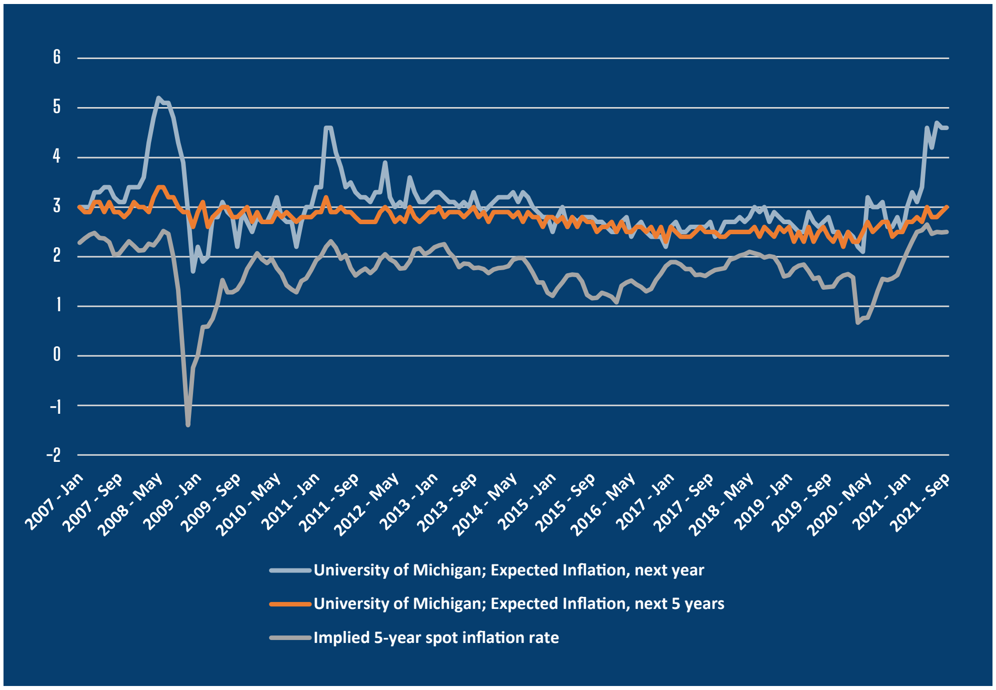


Source: Bloomberg, Haver

Inflation Expectations

Recent increases in inflation measures have led to higher inflation expectations, particularly in the shorter term. This is reflected in both survey-based as well as market-based data. Inflation expectations remain below current inflation readings.

Market- and Survey-Based Inflation Expecations (%)



Source: Haver

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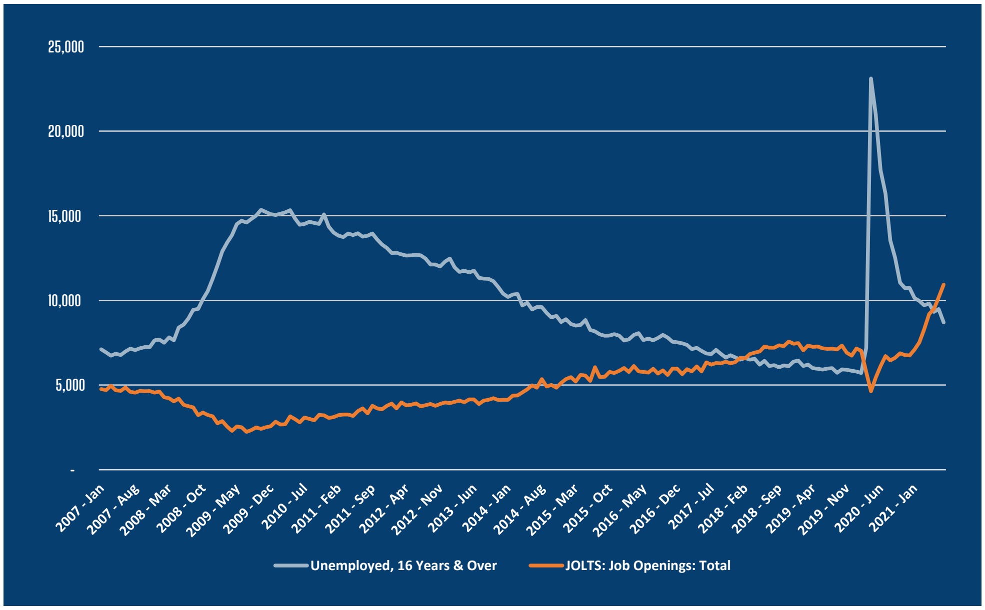
Employment

According to the data, for one of the few times in history, there are currently more jobs available than unemployed people to fill them. Private industry (by %) has more openings than governments, with professional and business services and leisure and hospitality facing the highest shortages of workers.

Job Openings vs. Unemployed

Seasonally Adjusted (thousands)



Source: Bloomberg

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September 30, 2021	MTD	QTD	YTD	1 Year	3 Year	5 Year	10 Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.00%	0.01%	0.03%	0.05%	1.11%	1.09%	0.58%
Barclays Municipal	-0.72%	-0.27%	0.79%	2.63%	5.06%	3.26%	3.87%
BBgBarc US Govt/Credit Intermediate	-0.08%	0.09%	0.09%	0.30%	2.87%	1.89%	1.47%
Barclays U.S. Aggregate	-0.87%	0.05%	-1.55%	-0.90%	5.36%	2.94%	3.01%
Barclays U.S. High Yield	-0.01%	0.89%	4.53%	11.28%	6.91%	6.52%	7.42%
S&P/LSTA Leveraged Loan	0.64%	1.11%	4.42%	8.40%	4.14%	4.58%	4.91%
Barclays Global Aggregate	-1.78%	-0.88%	-4.06%	-0.91%	4.24%	1.99%	1.86%
JPM GBI EM Global Diversified	-3.43%	-3.10%	-6.38%	2.63%	3.66%	2.06%	1.05%
U.S. Equity Indices							
DJ Industrial Average	-4.20%	-1.46%	12.12%	24.15%	11.00%	15.68%	14.72%
S&P 500	-4.65%	0.58%	15.92%	30.00%	15.99%	16.90%	16.63%
NASDAQ Composite (Price)	-5.31%	-0.38%	12.11%	29.38%	21.55%	22.16%	19.59%
Russell 1000	-4.59%	0.21%	15.19%	30.96%	16.43%	17.11%	16.76%
Russell 1000 Growth	-5.60%	1.16%	14.30%	27.32%	22.00%	22.84%	19.68%
Russell 1000 Value	-3.48%	-0.78%	16.14%	35.01%	10.07%	10.94%	13.51%
Russell Mid Cap	-4.12%	-0.93%	15.17%	38.11%	14.22%	14.39%	15.52%
Russell 2500	-3.15%	-2.68%	13.83%	45.03%	12.47%	14.25%	15.27%
Russell 2000	-2.95%	-4.36%	12.41%	47.68%	10.54%	13.45%	14.63%
Russell 2000 Growth	-3.83%	-5.65%	2.82%	33.27%	11.70%	15.34%	15.74%
Russell 2000 Value	-2.00%	-2.98%	22.92%	63.92%	8.58%	11.03%	13.22%
Non-U.S. Equity Indices							
MSCI World	-4.11%	0.09%	13.43%	29.39%	13.72%	14.34%	13.30%
MSCI ACWI	-4.09%	-0.95%	11.49%	27.98%	13.14%	13.77%	12.50%
MSCI ACWI Ex-U.S.	-3.14%	-2.88%	6.29%	24.45%	8.52%	9.45%	7.97%
MSCI EAFE	-2.83%	-0.35%	8.79%	26.29%	8.13%	9.33%	8.60%
MSCI EAFE Growth	-3.87%	0.10%	7.18%	21.25%	12.30%	11.81%	10.46%
MSCI EAFE Value	-1.70%	-0.81%	10.21%	31.43%	3.65%	6.58%	6.58%
MSCI Europe	-4.71%	-1.46%	10.64%	27.97%	8.44%	9.49%	8.79%
MSCI Japan	2.88%	4.70%	6.22%	22.46%	7.93%	9.74%	8.68%
MSCI AC Asia	-1.64%	-4.47%	0.00%	17.40%	8.76%	10.08%	8.73%
MSCI EAFE Small Cap	-3.53%	0.96%	10.35%	29.46%	9.45%	10.79%	11.12%
MSCI ACWI Ex-U.S. Small Cap	-3.00%	0.09%	12.57%	33.54%	10.76%	10.69%	9.84%
MSCI Emerging Markets	-3.94%	-7.97%	-0.99%	18.58%	8.96%	9.62%	6.46%
MSCI EM Asia	-4.11%	-9.47%	-3.92%	14.27%	10.35%	11.09%	8.87%
MSCI China	-5.01%	-18.13%	-16.58%	-7.24%	6.09%	9.28%	8.90%
MSCI EM Eastern Europe	3.91%	8.58%	28.25%	56.80%	12.99%	15.02%	6.26%
MSCI EM Latin America	-10.32%	-13.21%	-5.38%	27.66%	-1.04%	2.19%	-0.78%
MSCI EM Small Cap	-1.95%	-2.00%	17.56%	43.79%	13.53%	10.14%	7.55%
MSCI Frontier Markets	1.20%	3.48%	19.20%	32.58%	11.12%	9.84%	7.42%
Hedge Fund Indices							
IQ Hedge Long/Short	-3.07%	-0.09%	4.66%	14.49%	7.79%	6.84%	--
IQ Hedge Multi-Strategy	-1.38%	-1.56%	0.02%	5.34%	3.70%	3.47%	3.73%
Real Assets Indices							
FTSE NAREIT Composite	-5.75%	0.12%	21.40%	32.27%	11.20%	8.31%	11.79%
Alerian MLP	3.02%	-5.71%	39.40%	84.63%	-4.32%	-2.42%	1.21%
Bloomberg Commodity	4.98%	6.59%	29.13%	42.29%	6.86%	4.54%	-2.66%
S&P Global Infrastructure	-1.28%	1.49%	6.97%	23.04%	6.69%	5.95%	7.85%
Other							
Oil Price Brent Crude	7.58%	4.51%	51.58%	91.75%	-1.72%	9.86%	-2.71%
CBOE Market Volitility (VIX)	39.35%	42.51%	-0.84%	-14.45%	23.01%	11.16%	-6.24%

Source: Morningstar

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Equity investments refer to buying stocks of U.S. companies as well as companies outside of the U.S. The market capitalization of U.S. companies is used to group large, medium (mid) and small companies. The investment return to the owner of stock (shareholder) is in the form of dividends and/or capital appreciation. Shareholders share in both the upside potential and the downside risk. Dividends are not guaranteed and are subject to change or elimination.

There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions. Distributions from REIT investments are taxed at the owner's tax bracket.

The return of principal for bond funds and funds with significant underlying bond holdings is not guaranteed. Fund shares are subject to the same interest rate, inflation and credit risks associated with the underlying bond holdings. Lower rated bonds are subject to greater fluctuations in value and risk of loss of income and principal than higher rated bonds. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value in your investment.

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