Third Quarter 2021 Economic and Market Outlook

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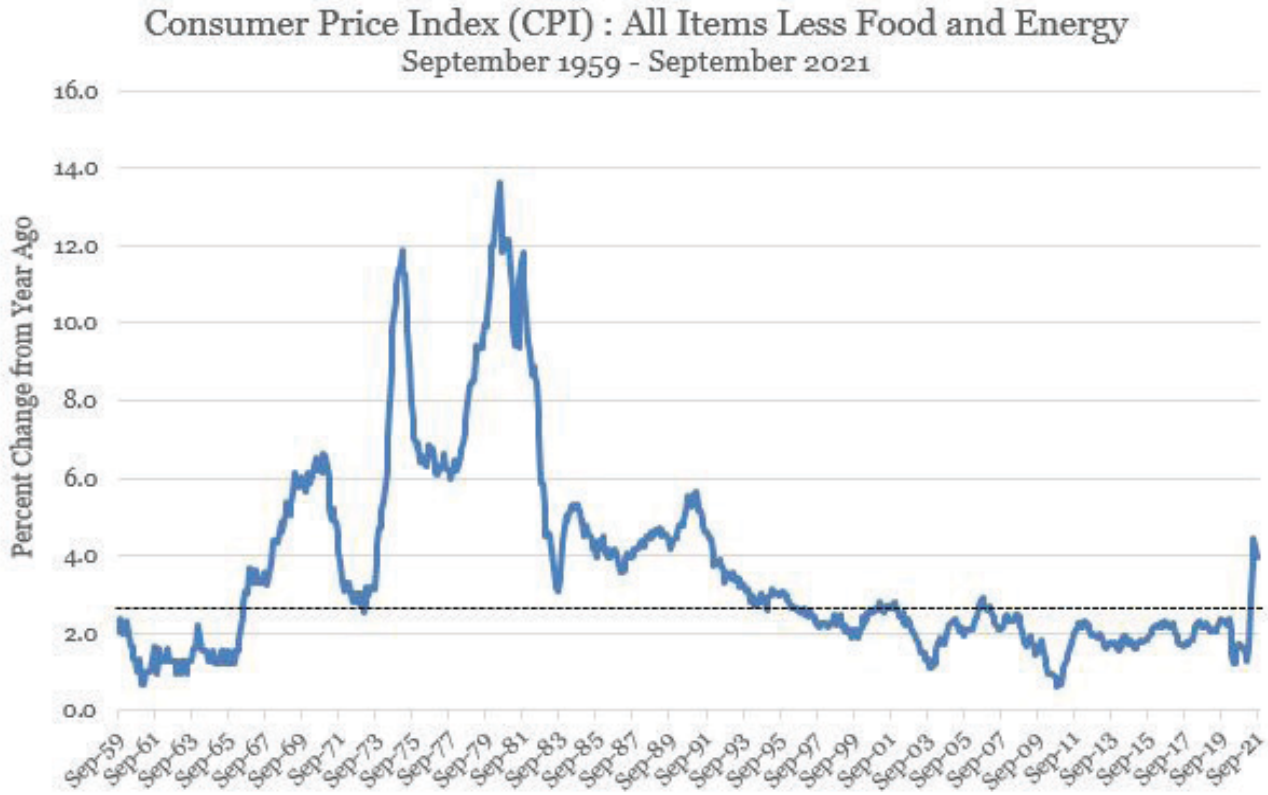
The Delta Variant of COVID-19 caused a delay in the global economic recovery over the summer, reducing air travel, limiting restaurants reopening plans and dampening consumer confidence. The delay also led to slowing job growth and manufacturing activity in the U.S. and abroad. At the same time, increased demand for goods and services as more of the world has opened up has put pressure on global supply chains that have not been able to keep pace.

The shortage of skilled labor in global ports and in the transportation industry, as well as COVID-19 related restrictions on workers, have exacerbated the pricing pressures on everything from appliances to furniture to semi-conductors and everyday consumer goods. This inflationary spike resulted in a reading of 4.0% for the Consumer Price Index (All Items Less Food and Energy) in September, which was much higher than the historical 2.0%-2.5% range in which index has been in since the early 1990s.

While most of the recent increase in the consumer price index is COVID-related, the potential for more sustained increases in prices remains. We expect that the CPI index will moderate once some of the global supply chain bottlenecks have been addressed, however, it may settle at a level higher than the Federal Reserve would prefer (i.e. above 2.5%). If this were to occur, we would expect the Fed to start raising their benchmark policy rate as early as mid-2022 in an effort to stave off further inflation. The link between the market's inflation expectations and tighter monetary policy (i.e. rising interest rates) will be a critical driver of market returns over the coming years.

Exhibit 1: COVID-19 Related Spike in Inflation Likely to Moderate



Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average [CPILFESL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPILFESL, October 13, 2021.

Will Higher Inflation Lead to Stagflation?

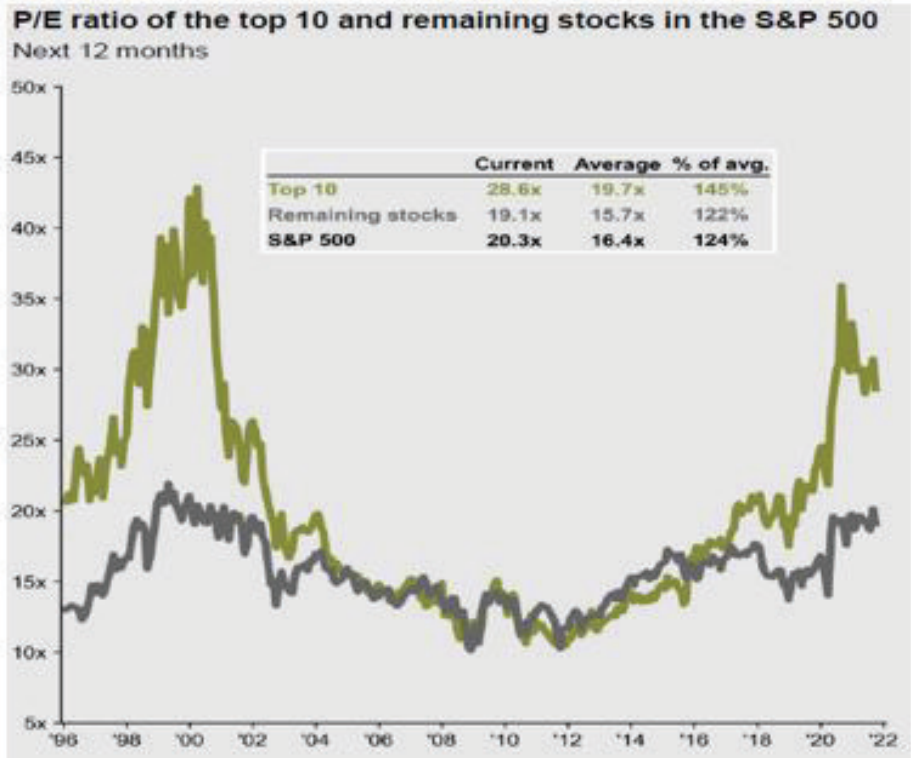
While the economic recovery continues, global growth likely peaked in the second quarter of 2021. The International Monetary Fund (IMF) recently downgraded its expectation for world GDP growth in its most recent report, citing health concerns, supply disruptions and price pressures as major headwinds. They estimate that the global economy will now grow 5.9% in 2021 and 4.9% in 2022. Growth expectations for the U.S. have also been revised down slightly, but remain 6.0% for 2021 and 5.2% for 2022.

Historically, periods of slowing economic growth and rising inflation combine to create stagflation. However, we do not see this as the case today since growth is slowing from a very high level and while short-term inflation expectations are higher, long-term inflation expectations remain in check. In addition, we expect that the U.S. unemployment rate will continue to fall as we move into next year. Finally, we expect that the Infrastructure and the Social Policy and Climate Bills that are being negotiated in Congress will pass in some form. While this fiscal policy may put further upward pressure on prices, they are also expected to fuel economic growth in the U.S. as well.

U.S. Equity Markets Looking For Direction

While U.S. bond markets are beginning to price in expected Federal Reserve tapering and higher interest rates next year, the equity market is looking for direction. The third quarter introduced a number of cross currents including slowing growth, inflation, higher bond yields, potential tax policy changes and the unpredictable course of the pandemic. Even after the modest sell off in stocks in recent weeks, U.S. markets remain near record highs and valuations remain well above historical averages as illustrated in **Exhibit 2**.

Exhibit 2: U.S. Markets Are Trading at High Multiples Relative to History

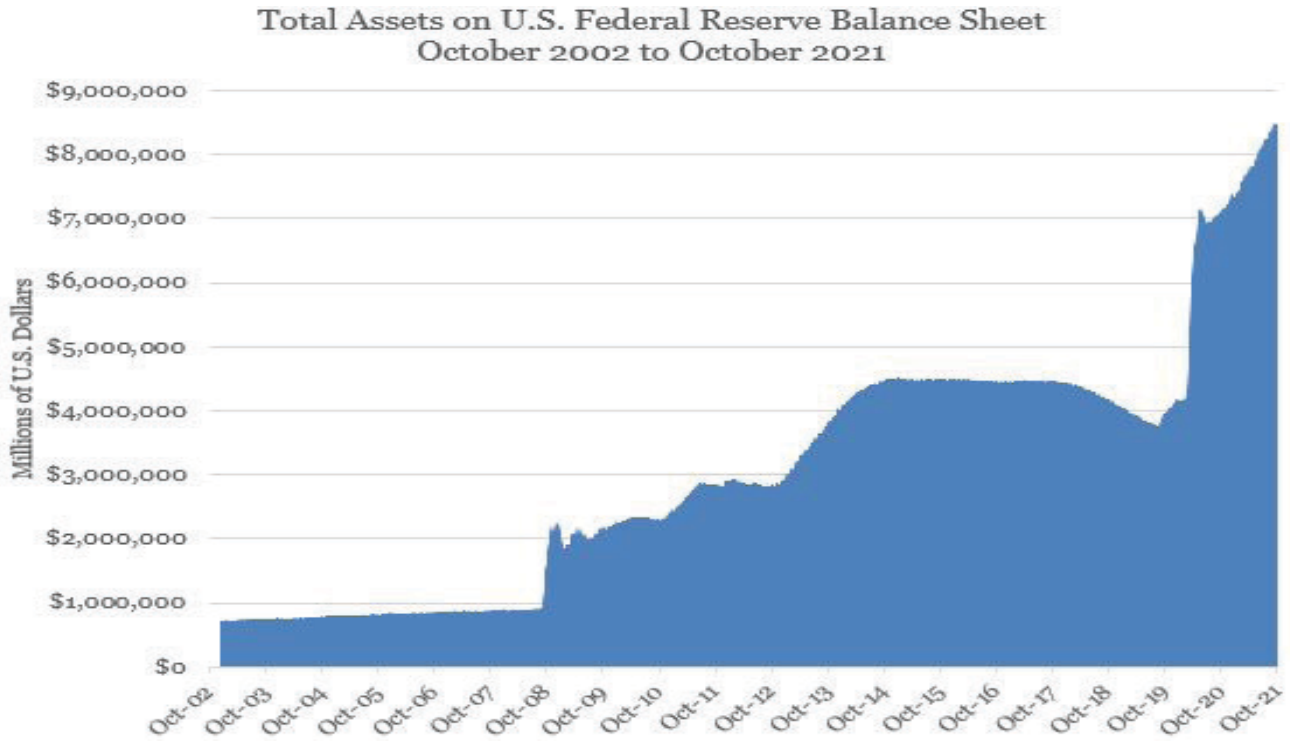


Source: JP Morgan Guide to the Markets (September 30, 2021). The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each month. The weight of each of these companies is revised monthly. As of 9/30/21, the top 10 companies in the index were AAPL (6.1%), MSFT (5.8*), AMZN (3.9%), FB (2.2%), GOOGL (2.2%), GOOG (2.1%), TSLA (1.7%), BRK.B (1.4%), NVDA ()1.4%), JPM (1.3%) and JNJ (1.2%).

The largest ten stocks in the index are the even more overvalued relative to their history on this measure and their stock prices tend to be more sensitive to the level of bond yields. Many of these large companies (Microsoft, Amazon, and Google) continue to generate strong revenue and earnings growth. However, in an environment where economic growth accelerates, bond yields rise and inflation picks up, their valuation support becomes harder to justify. We saw evidence of this during the last few weeks of the quarter as growth stocks led market declines when bond yields increased.

The Federal Reserve has indicated that they plan to start tapering their bond purchases in the coming months. This suggests that they expect inflation to remain at or above their target level of 2.5% and that they see the U.S. employment situation improving to a point where further support is unnecessary. This will be a negative for bond markets in the U.S., but this does not mean that the Federal Reserve is tightening their monetary policy. Balance sheet assets in the form of Treasury and mortgage bonds increased significantly following the 2008/2009 Credit Crisis and again with the onset of the COVID-19 Pandemic. Now with the Fed's balance sheet reserves in excess of $8.0 trillion, there is sufficient liquidity in the system at this stage of the market cycle.

Exhibit 3: U.S. Federal Reserve Tapering to Begin in late 2021



Source: Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WALCL, October 17, 2021.

Because of the large reserves on the balance sheet and the likely continued global recovery, we do not anticipate that bond markets will react as poorly as they did during the so called, "Taper Tantrum of 2013." At that time, investors saw the act of slowing bond purchases designed to provide liquidity to the financial system as monetary tightening. This is not the case today since the Fed has clearly stated that they do not expect to raise their policy rate until the middle of 2022 at the earliest. However, this may be the beginning of the end of ultra-accommodative monetary policy in the U.S. and we are already seeing evidence of this in the form of modestly higher bond yields and mortgage rates.

Non-U.S. Markets Provide Opportunity for Return

International stock markets tend to be more cyclical in their make-up, with industrials, financials and consumer staples making up a larger percentage of the market than technology. As a result, rising bond yields will not have as much of a negative impact as they might in the U.S. In fact, the cyclical nature of their economies make international markets more attractive in a period of economic recovery, which is what we expect for 2022. As COVID-19 restrictions ease around the world, international tourism is expected to rebound, providing much needed business to restaurants, hotels and airlines. In addition, international stock markets are trading at much lower valuation multiples than the U.S. and provide more potential upside at this point in the cycle.

However, emerging markets have been weak this year and China's economy is slowing more than many forecasted. In addition to the challenges that COVID-19 related lockdowns have had on manufacturing in China, policy makers there have been cracking down on technology, education and property companies in an effort to take more control over the impact they have on the population as part of President's Xi's "common prosperity" campaign.

Research from the Bank Credit Analyst highlights the need for China to encourage more consumer spending as a percentage of GDP to meet their annual 6.0% GDP growth target. While the actions taken by the Chinese government earlier this year came as a shock to global investors, it is likely that they will encourage growth again by cutting bank reserves (similar to the Federal Reserve's quantitative easing programs) and increasing local government bond issuance, which provides scope for additional spending across the various regions in China. Going forward, investing in China requires a careful analysis of the many opportunities that still exist in a growing economy, as well as the associated country-specific risks.

Our Outlook

We remain cautiously optimistic for the growth outlook in 2022. Bond markets are signaling continued recovery and pent-up consumer spending is accelerating. While we expect the COVID-19 related spike in inflation to moderate as supply chains return to normal, the era of record low bond yields and ultra-accommodative monetary policy may be over for now. U.S. corporate earnings remain near record highs as do market valuations, particularly in market leading consumer technology names.

As the world continues to recover from the COVID-19 Pandemic, the normal patterns of life are likely to return. However, there will likely be long-lasting effects that remain a part of our lives going forward. The use of technology for business communication is likely here to stay, allowing businesses to improve productivity and limit costs. While the global risks of higher rates, higher inflation, and high valuations may prove to be a headwind for both U.S. bond and stock markets going forward, we expect the benefits of diversification, by style and by geography, will become more apparent.

