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THE LONG BULL MARKET CONTINUES . . .

Stocks continued their post-pandemic climb during the last quarter, with the Standard and Poor's 500 Index hitting a new all-time high on September 2. This was the sixth quarter in a row of positive total returns for the Index, and, astonishingly, the path upward has been very close to a one-way street. Not only has the S&P 500 Index doubled in record time, but it barely sustained even a five percent pullback during the advance. In the past, there may have been longer stretches of time without a market correction, but it is unusual to go more than 400 days without one. Investors have responded to the upward trend by pouring more than $400 billion into equity exchange-traded funds during the first nine months of 2021. This is $100 billion above the *annual* record set in 2017. Everybody loves a Bull Market.

. . .BY THE SKIN OF ITS TEETH

This picture of a strong stock market may be somewhat misleading, however, since the gains this quarter were by only the slimmest of margins; the S&P 500 Index only managed to squeak out a 0.23% price increase. The quarter started well, with the Index showing a 5.5% total return through the end of August, but September lived up to its reputation as being unfriendly to stocks. September's decline broke a seven-month streak of consecutive positive months for the S&P 500 Index and it was the worst performing month for the S&P 500 Index since March 2020. Overall, investors may have added to their equity holdings, but at least a portion of them seemed to have one foot out the door, ready to leave at the slightest provocation. Underneath the long-term trend, many technical indicators deteriorated, suggesting that the market was under some stress. Six months ago, over 85% of listed U.S. stocks were trading above their combined 50-day, 150-day and 200-day moving averages, but by the middle of September that ratio had dropped to only 45%. The Advance/Decline ratio for New York Stock Exchange listed companies peaked last June and that indicator has been locked in a narrow range ever since. One of the oldest technical tools, the Dow Theory, flashed a warning when the Dow Industrials and the Dow Transports were each down more than 10% from their recent highs. None of these indicators are necessarily outright bearish, but there were reasons behind the rise in investor skittishness.

First, the Fed's forecast of a "transitory" rise in inflation turned out to be overly optimistic. Interest rates jumped as bond investors anticipated that monetary policies might have to tighten ahead of schedule. Second, the continued squabbling in Congress raised some nagging doubts whether the Federal debt limit would be raised in time to prevent a potential U.S. default. Third, supply chain problems, which were supposed to be temporary, seemed to be getting worse, as shortages and delays in one area caused logistical nightmares further down the line. Anyone who has tried to prepare a favorite holiday dish, only to be thwarted by a missing ingredient, can readily understand how lacking one crucial item can ruin everything. As it became clear that righting the supply system may take well into next year, investors were understandably disappointed. Fourth, the path toward post-pandemic economic normalization took a detour when Delta variant cases rose sharply in July and August. COVID hesitancy may have been behind a sharp decline in hiring, with disappointing job reports in August and September. Fifth, as if domestic issues weren't enough, there were rumblings that troubles in China's debt-strapped real estate sector could cascade into an international debt crisis. Also in China, there was an acute energy shortage. A strong pandemic rebound increased electricity demand just when Chinese government was reducing supply. A diplomatic dispute caused the ruling Communist Party to drastically cut purchases of Australian coal, which also seemed to dovetail with the Chinese government's plan to reduce coal usage. There was internal pressure to meet announced climate targets and also a desire to reduce air pollution ahead of the Winter Olympics. Demand has been higher than expected, however, and the consequence has been rolling blackouts and electricity rationing across the country. The resulting factory shutdowns in China delayed shipments to companies all across Asia and added another layer of disruption to an already tangled supply system.

BRACING FOR OCTOBER, BUT REMAINING OPTIMISTIC

Historically, September has been one of the worst performing months for stocks, but October won the prize for the greatest volatility. Not only has it seen the most gains or losses of greater than 1%, four of the five largest single-day moves in the history of the stock exchange occurred in the month of October. Only the most pie-eyed optimist would dare to ignore October's erratic past. If stocks do continue to rise, the rally, going forward, may feel different from what we've experienced so far. Globally, monetary policies are diverting courses. The flood of liquidity from the world's major central banks has been one of the major forces driving the markets over the past eighteen months: as monetary authorities were primarily concerned with saving the stability of the financial system, with few worries about inflation. This policy worked in spades, but the recoveries in the world's three largest economies, the U.S., the Eurozone and China, have progressed at vastly different speeds. China, having retained somewhat tighter monetary conditions than others during the downturn, now finds itself leaning toward easing because of some of the problems we discussed earlier. The European Central Bank announced a move to modestly reduce quantitative easing, but the ECB still seems more concerned about maintaining financial stability, with less focus on inflation. Meanwhile, here in the U.S., Jerome Powell has made it clear that the Fed will begin winding down its monthly asset purchases as a precursor to eventually raising interest rates.

Divergent monetary policies make investment analysis more challenging, as the interplay between interest rates and foreign exchange rates can impact each region's relative economic performance. U.S. investors will be impacted the most by tighter Fed policies, but the dollars role as the reserve currency will influence markets around the world. Investors generally don't like change, but especially when the existing policies have benefitted them so much. Bullishness may not be as widely prevalent in the next phase of the recovery.

INFLATION WATCH

With less liquidity available to power the market higher, equity investors' focus should shift to examining the fundamentals more closely, especially inflation. Stocks have been reacting strongly to relatively small changes in interest rates and inflation as investors grapple whether next year's blend of growth and inflation will be beneficial or harmful. Looking back at the experiences of the 1970s, many are under the impression that rising inflation has always been a huge negative for the stock market. A closer examination of the record shows that the relationship between inflation and the stock market is more complex. Historically, moderately rising inflation coupled with above-average real economic growth actually has been a positive combination for stocks. When profits are high and demand for credit rises, it is fairly normal for interest rates and stock prices to march higher together. In a strong economy, many companies can offset rising costs by the strength of their pricing power or simply from seeing better volumes. It is when higher inflation is coupled with low GDP growth, that margins tend to suffer. When that happens, stocks face a one-two punch of seeing sagging profits and falling Price/Earnings ratios. This is what investors remember from the stagflation in the 1970s. From 1978 to 1982, real GDP only grew at a compounded annual rate of 0.8%, as rising inflation almost completely offset average nominal GDP growth of 10% per year. Profit margins were squeezed by rising costs and profit margins were cut by about a third in that five-year period. Stocks had gone essentially nowhere for a decade and *Business Week* ran its infamous "Death of Equities" cover in 1979. This is not the environment we find ourselves in now; the analogy to the 1970s seems weak to us. Yes, inflation is higher, but GDP growth has been even better.

REASONS FOR OPTIMISM

Even though the Consumer Price Index was up over 5% year-over-year in July and August, the Bureau of Labor Statistics estimated that second-quarter real GDP grew at an impressive annual rate of 6.6% in the second quarter of 2021, slightly above the 6.5% rate in the first quarter. Wall Street estimates anticipate a reduction in the third quarter pace of real GDP growth, but all signs point to an above-average number. Profit margins may be near all-time highs, but Wall Street analysts are forecasting that almost every industry group will show even higher margins in 2022. Forward earnings expectations are more than twenty percent above pre-pandemic levels. Notably, these numbers are being recorded while the economy is still feeling the impact of the pandemic and growth is likely to improve when this wave of the Delta variant finally burns itself out. Despite the drag from COVID, consumer spending on goods has been running over 15% ahead of pre-pandemic amounts, while services spending has finally returned to 2019 levels.

Consumer finances are in the best shape they have been in years, with jobs plentiful and wages on the rise. While companies have struggled with supply-chain headaches, few orders have been cancelled and business backlogs have grown. This should lead to an extended re-stocking period and keep factories humming, even if consumer demand were to slacken a bit. The most recent survey of purchasing managers from the Institute of Supply Management signaled that robust growth should continue.

Seasonally, the final three months of the calendar have been the best quarter for stocks, possibly because of the boost from Holiday spending. There may also be a bounce-back effect, since the third quarter is often the worst performing three-month period during the year. We have also seen a shift in sentiment indicators, which tend to be good contrary indicators. The ratio of Bulls to Bears in one survey dropped to levels not seen since May 2020. Even if the pandemic is hanging on, the world is still in a much better place than it was back then.

BUT DON'T THROW CAUTION TO THE WIND

While we continue to have a fairly positive outlook on the overall market, there are aspects to the pandemic period that do seem strange. An odd mixture of caution and unbridled speculation has been occurring simultaneously within the financial markets. While one group of investors is nervously watching inflation rates and worrying about next quarter's earnings, another group has been trading "meme" stocks in highly concentrated portfolios and/or throwing money into the options market in a frantic effort to get rich quickly. These are investments carried along by "good stories" that excite the imagination, driven more by intuitive guesses than fundamental analysis. Many of these aggressive investors are relatively new to the financial markets and have yet to experience a real bear market. Those who entered their first trades last year have probably done extremely well so far and their stories of success have enticed others to imitate their strategies. Fear of missing out is a powerful inducement to try something new. As the popularity of these strategies has grown, individual investors are probably wielding more power in the markets than any time other than the dot.com bubble. Unfortunately, the worst thing about rampant speculation is that it draws in the most investors just when the strategy carries the most risk. When the Internet Bubble collapsed, it impacted the entire market. While the market value of most meme stocks are relatively small, there is a risk that a normal correction in the stock market could trigger a panic in inexperienced traders that ripples into the broader investment community.

EARNINGS THIS QUARTER WILL BE KEY

While many companies are well positioned to deal with rising costs and the supply-chain squeeze, not all firms will be so lucky. We fully expect the number of negative earnings surprises and downward revisions in corporate earnings and sales guidance to increase due to supply chain disruptions. The investment community appears to be braced for this, but if the impact is more widely distributed than anticipated, stock prices could experience a selloff. The past two quarters have been astoundingly good, with results topping estimates by 27% in the first quarter and 17% in the second, far exceeding the typical 3% to 4%.

There have already been several companies that have lowered their guidance because of higher labor expenses and rising freight costs. Investors could be disappointed if the ratio of positive to negative earnings surprises reverts to a more normal level. That being said, a great deal rides on this earnings season.

FIXED INCOME LOOKING AHEAD

One of the strangest aspects to the financial markets this year was the extended decline in interest rates from March through July, while the inflation data was surprising to the upside. During that four-month period, the trailing twelve-month rate of inflation more than doubled from 2.6% to 5.4%, but the yield on 10-year U.S. Treasuries fell from 1.75% to 1.15%. With a divergence of such magnitude, something had to give, either inflation rates falling or yields rising. As it turned out, 10-year Treasury yields turned around and moved back up to 1.55%. Any further increase is unlikely to move in a straight line, however. Similar to our expectation of greater volatility in the stock market, we anticipate that interest rate volatility will also be high in the fourth quarter. Uncertainty tied to supply chains, the labor markets, COVID-19 and additional fiscal stimulus will give bond investors plenty to mull over.

We noted the seasonality present in stock trading earlier, but it is worth noting that historically, there are also patterns in the Treasury market. The summer months tend to be good for bond prices, but the autumn and winter months tilt the other way. Over the past twenty years, interest rates have risen, and bond prices declined, into the fourth quarter over seventy percent of the time. Corporate bonds seem likely to follow the same path as Treasuries. Credit spreads are among the lowest levels in the past quarter century, as investors priced in better economic fundamentals and strengthened corporate balance sheets. Looking at the new-issuance calendar, about $300 billion in corporate bonds are on tap to be sold during the next three months. With the Fed likely to taper their bond market purchases, this added supply will probably put some added weight on bond prices.

SUMMARY

We see the financial markets moving into a new phase, as volatility increases for both stock and bond prices. Despite rising inflationary pressures, we believe economic growth will remain strong enough to allow many large corporations to absorb the added input costs, but not all. Similarly, supply chain pressures are likely to increase the number of negative earnings surprises for the next few quarters. Central bankers will strive to move carefully, which should provide some stability and help moderate the increased level of volatility.

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