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## KEY POINTS

- Global stock markets broadly finished the third quarter in negative territory while bond markets finished flat. Although rates may rise modestly, monetary policy should continue to support risk assets, and corporate earnings growth is likely to continue coming in better than expected. As such, we expect stock prices and bond yields to move higher.
- U.S. economic activity decelerated in the third quarter, while many other major regions abroad maintained their economic growth momentum. The economic recovery from the pandemic is likely to reaccelerate as the virus's toll eases. Current market expectations over the next few years is for inflation to average around 2.6% per year.
- From a financial market risk perspective, the most important topic that needs to be addressed in Washington D.C. is the U.S. debt ceiling. We talk about why the debt limit is important, what could occur if the threat of default grew, and what investors should do in the meantime.
- We believe stock allocations should have a more global orientation and be geared to cyclical sectors, which stand to benefit most from above-trend economic growth. Additionally, we outline ways that investors should position portfolios for a potential above-trend inflationary environment over the next few years.

## MARKET REVIEW

### A SEPTEMBER SELL-OFF DAMPENED THIRD-QUARTER RETURNS FOR GLOBAL STOCKS

The global stock market[1] rose to an all-time high in early September on generally upbeat corporate earnings results and forward guidance amid an improving economic backdrop. However, markets became jittery throughout September. Concerns around the Chinese property market, Federal Reserve (Fed) monetary policy, Congressional budget impasse, and signs of a slowing economic recovery all put downward pressure on stocks, which broadly finished the third quarter in negative territory. (See **Figure 1**.)

### BOND RETURNS WERE FLAT AMID A LATE-QUARTER SURGE IN RATES

Global bond markets finished almost flat in the third quarter as late-quarter bond price declines offset interest payments earned by investors throughout the period. Bond prices declined because interest rates (which move in the opposite direction of bond prices) rose sharply in September. Rates moved up in reaction to the September Federal Reserve meeting, which provided greater clarity on the Fed's expected plans to taper (reduce) bond purchases later this year and eventually increase short-term rates next year.

### STOCK & BOND MARKET RETURNS

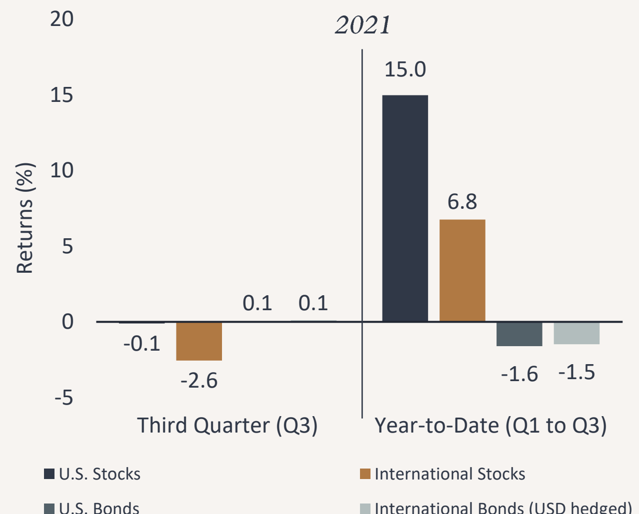


FIGURE 1. Stock markets in aggregate declined in the third quarter as volatility rose in September. U.S. stocks outperformed (fell less than) international markets in the third quarter, buoyed by large-cap growth stocks.

Meanwhile, bond markets worldwide finished the third quarter in positive territory despite a sharp rise in interest rates in September. U.S. and international bonds performed in line with each other in the third quarter.

SOURCE: MORNINGSTAR, RUSSELL, MSCI, BLOOMBERG. DATA AS OF 09/30/2021. SEE ENDNOTE 2 FOR ADDITIONAL DISCLOSURES.

## MARKET OUTLOOK

### DESPITE INCREASED VOLATILITY, STOCKS LIKELY TO MOVE HIGHER INTO 2022

Stock market volatility is set to increase but shouldn't reach extreme levels throughout the rest of the year. Said differently, investor worries about inflation, the Delta variant, Washington D.C. politics, and rising rates, are likely to result in bigger stock market swings and potentially raise correction risk (a decline of 10% or more from peak). However, absent renewed recessionary factors, we do not expect a bear market (a decline of 20% or more) anytime soon.

Moreover, while the Fed is preparing to take its foot off the monetary accelerator, their policy will remain accommodative for quite some time. As such, central bank policy should continue to support risk assets, and together with better-than-expected corporate earnings growth supported by a robust macroeconomic backdrop, we expect stocks to move higher into 2022.

### INTEREST RATES ARE SET TO RISE, BUT AT A MODEST PACE, AND WILL STILL REMAIN RELATIVELY LOW

We expect longer-term interest rates to slowly grind higher into next year as Delta variant concerns subside, reopening continues, and economic growth reaccelerates.

Although the Fed's recent guidance has seemingly been more hawkish (i.e., willing to allow interest rates to rise to keep inflation under control), if recent monetary tightening history is any guide, the Fed will likely move more slowly than its current individual member assessments suggest.[3] Additionally, the "neutral" rate (the Fed's longer-term target interest rate that supports the economy at full employment and maximum output while keeping inflation constant) is likely to end up in the 2%-to-3% range, which is considered relatively low by historical standards.

Rising interest rates will put some downward pressure on bonds in the short term. But in the likely scenario of modest rate increases over a long period, bond markets are not going to be meaningfully disrupted, and bond investors will not suffer through permanent or severe capital losses. The breadth and depth of demand for bonds, particularly high-quality bonds, remain strong. As such, bond returns over the long term are likely to be positive. Eventually, bonds returns should gradually increase due to the higher income (yield) that bonds will offer investors as interest rates rise.

## ECONOMIC REVEW

### U.S. ECONOMY SLOWED IN THE THIRD QUARTER

After a strong second quarter when most U.S. economic data rebounded to their pre-pandemic levels, economic activity decelerated in the third quarter. The spread of the Delta variant, supply chain constraints, and higher inflation caused consumers to slow (or delay) their spending on meals out, hotels, airline tickets, and cars. The Covid-19 surge also complicated office and school reopening. The good news according to many economists was that the economic drag from the Delta variant was less severe than previous virus surges. Additionally, there were initial signs that some of the spending areas that experienced material slowdown over the summer started to recover in late September as Covid-19 cases declined. (See **Figure 2**.)

### THE ECONOMIC RECOVERY ABROAD CONTINUED

In contrast to the U.S., many other major regions abroad maintained their economic growth momentum. Throughout the third quarter, vaccination rates picked up meaningfully across Europe, Asia, and South America. As a result, the Delta variant surge was relatively more subdued abroad. European economic activity broadly continued to exceed expectations. Meanwhile, in China, geopolitical factors and a new cycle of domestic regulation impacting the technology and real estate sectors resulted in a slowdown in some economic activity including industrial production and retail sales.

U.S. AIR TRAVEL STARTED TO REBOUND IN LATE SEPTEMBER AS COVID-19 CASES DECLINED

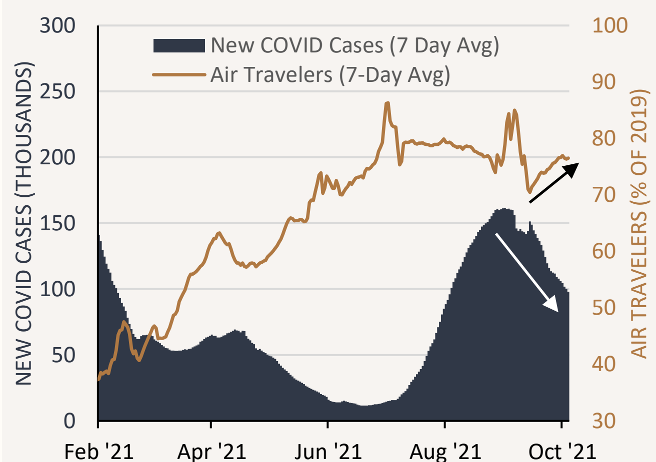


FIGURE 2. U.S. Covid-19 cases started to decline in early September and are likely to continue falling, according to projections from the Centers for Disease Control and Prevention. Air travel has shown initial signs of recovery since hitting a recent trough in mid-September, according to Transportation Security Administration figures comparing 2021 passenger traffic with 2019.

SOURCE: CDC, TSA. DATA AS OF OCTOBER 5, 2021.

# ECONOMIC OUTLOOK

## ECONOMIC GROWTH IS LIKELY TO REACCELERATE

Although the Delta variant tempered economic growth this summer, the recovery from the pandemic is likely to reaccelerate as the virus's toll eases. Backups at ports and overseas manufacturing disruptions are expected to gradually reduce over the next several months. Labor shortages stand to improve as well, helping businesses meet demand. Most importantly, however, is that consumers broadly are in excellent shape and should continue to spend on goods, and now, more services. Excess savings and lower debt compared to pre-crisis levels, together with continued job growth and wage gains, point to solid consumer spending growth well into 2022.

## INFLATION PRESSURE EASING IS LIKELY TO TAKE LONGER THAN INITIALLY EXPECTED

Main risks to the economy include Covid-19 variants holding back recovery progress, and inflation pressures forcing the Federal Reserve (and other central banks) to tighten monetary policy faster than the economy can handle. Although recent inflationary pressures and the news surrounding it have been alarming, the reality is that most of it can be explained by the economic challenges we are facing due to the pandemic. While many pandemic-driven price pressures are easing, others are likely to take longer than initially expected.

## SOME EARLY SIGNS THAT PRICE INFLATION MAY HAVE PEAKED

Prices for lumber, used cars, auto rentals, and lodging away from home, which all shot up earlier in the year due to supply and demand imbalances, eased in August and September, according to the Federal Reserve Bank's Consumer Price Index data.[4] However, despite these early signs that some inflation may have peaked, other drivers of price pressures such as transportation delays, semiconductor shortages, and rising energy prices may last longer than previously thought. Nonetheless, these supply chain issues will likely resolve themselves over the next 6-to-12 months as the world continues to move forward from the pandemic.

## WAGE GROWTH IS NOT WIDESPREAD

Despite elevated unemployment, wage growth has accelerated as demand for workers has outstripped supply. However, the Fed does not yet see evidence of broad-based wage increases that might lead to excessive inflation.

The reality is that wages have risen mostly for the lowest-paid workers. According to the Atlanta Federal Reserve's Wage Tracker through September, the lowest-income quartile has outpaced wage growth for the top 75% of earners by the widest margin since the late 1990s.[5] Low-wage roles, including jobs in the hospitality industry, restaurants, bars, and other establishments, have benefited most from reopening.

But as the labor supply rises over the next several months, some of this wage pressure will likely be mitigated. Enduring, broad-based wage increases will ultimately depend on how much slack remains in the labor market, which is currently nowhere near full capacity.

## FUTURE INFLATION EXPECTATIONS HAVE SETTLED WELL BELOW CURRENT INFLATION READINGS

Future *expectations* for inflation is another important component of inflation itself. One way that inflation expectations can be gauged is by what *investors* are expecting over the next few years via the financial bond markets. (See **Figure 3**.) Current market expectation over the next few years is for inflation to average around 2.6% per year, which is about in line with the Federal Reserve's longer-term inflation target of "over 2% average" inflation over multiple years.

Thus, the Fed would consider this amount of inflation to be a healthy level, versus current Consumer Price Index readings of over 5%, and certainly not a 1970's inflation level that would necessitate material increases in interest rates and ultimately cause a recession.

THE BOND MARKET'S FUTURE INFLATION EXPECATIONS ARE NOT NEARLY AS HIGH AS CURRENT HEADLINE CONSUMER PRICE INDEX (CPI) INFLATION READINGS

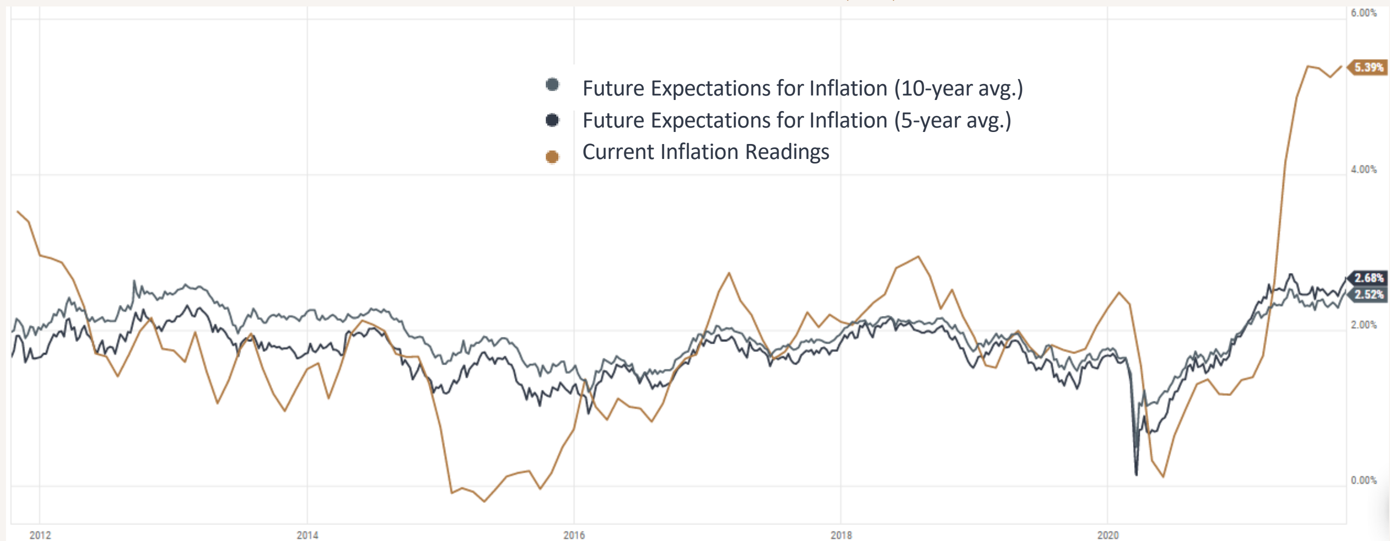


FIGURE 3. Current inflations readings, such as the headline U.S. Core Consumer Price Index (CPI) is drawing a lot of attention these days, most recently citing over 5% inflation. The U.S. CPI looks *backward* and measures the year-over-year average change in the prices paid by consumers for a basket of goods and services. However, future inflation expectations, as measured by bond market breakeven rates, are *forward* looking, and are currently indicating that inflation should average around 2.6% over the next several years.

SOURCE: FEDERAL RESERVE, BUREAU OF LABOR STATISTICS, YCHARTS. FUTURE EXPECTATIONS FOR INFLATION MEASURED BY THE 5-YEAR AND 10-YEAR TIPS/TREASURY BREAKEVEN RATE SPREADS, AS OF 10/13/21. CURRENT INFLATION READINGS MEASURED BY THE CONSUMER PRICE INDEX (CPI), AS OF 09/30/21.

## ON THE MINDS OF INVESTORS

### WHAT SHOULD YOU KNOW ABOUT THE U.S. DEBT CEILING DILEMMA?

There is no shortage of news coming out of Washington D.C. these days, but arguably the most important topic from a financial market risk perspective is the U.S. debt ceiling. New legislation for infrastructure spending and tax increases would likely have relatively marginal effects on the stock and bond markets. However, the aggregate impact of failing to deal with the debt ceiling quickly could be staggering and long-lasting.

### WHY THE DEBT CEILING IS IMPORTANT

The debt ceiling is a self-imposed limit on the amount of national debt that the U.S. Treasury can incur. The debt limit doesn't authorize new spending but allows the U.S. Treasury to raise money to pay for expenses the government has previously approved. If Congress doesn't agree on terms to raise the U.S. debt ceiling and the Treasury ran out of alternative funds, the U.S. government would effectively default. That is, the government would no longer be able to pay all its bills, including interest owed on U.S. treasury bonds, federal employee salaries, Social Security, and Medicare.

### WHAT COULD OCCUR IF THE THREAT OF DEFAULT GREW

According to Treasury Secretary Janet Yellen, the Treasury was set to run out of funds on October 18th, but Congress temporarily extended the debt ceiling until early December. Debt ceiling increases have occurred dozens of times over the last century. However, episodes in 2011 and 2013 were more contentious, leading a major rating agency to downgrade U.S. debt in 2011.

If the threat of a default grew and a downgrade to U.S. debt were to happen again, the interest that the government would need to pay on Treasury bonds would increase and bring forward the urgency to raise taxes. Likewise, interest costs would increase for consumers and businesses. Global investor faith in U.S. Treasury securities and the U.S. dollar could be shaken, leading to less demand for U.S. issued securities. Stock markets would experience heightened volatility as higher discount rates for future cash flows would lower equity valuations.

### WHAT WILL LIKELY HAPPEN

Given the potentially severe market (and economic) consequences, we believe that compromise will be found again in Washington. Such developments occurring while economic recovery from the COVID-19 pandemic is still ongoing make the potential scenario more critical to avoid. Elected officials in Congress are aware of the possible consequences, and in the end, no one will want to be responsible for this type of unprecedented event.

Although the likelihood of a U.S. default is remote, failure to address the challenge could shake global financial markets even before the U.S. Treasury has exhausted its available measures to pay its bills. As such, we are likely in for a period of heightened uncertainty leading up to December; however, in the end, we don't believe that a default will happen.

### WHAT INVESTORS SHOULD DO

We strongly believe that the best course of action for investors is to avoid the temptation to "time the market" around an event like this. History has proven that through market-moving events, including debt ceiling negotiations, that the most successful investors are the ones who stick to their investment plan with a diversified portfolio of growth and defensive assets; that employ a disciplined approach to take advantage of elevated market volatility; and most importantly, keep focus and perspective on their long-term goals and objectives.

## PORTFOLIO MANAGEMENT

### POSITIONING FOR ABOVE-TREND GLOBAL GROWTH

The global economy is expected to grow at an above-trend pace for the remainder of 2021 and 2022. According to the International Monetary Funds' latest outlook, the global economy is expected to grow 6% for the entire year in 2021, and nearly 4.5% in 2022, versus recent historical trend growth of around 3.5%.[6]

As such, we believe stock allocations should have a more global orientation and be geared to cyclical sectors which stand to benefit most from above-trend economic growth. Additionally, now that we are behind the initial sharp economic and stock market rebound from early 2020,  we believe that now is a particularly opportune time to strategically tilt portfolios toward companies with higher profitability and that trade at reasonable valuations.

### POSITIONING FOR ABOVE-TREND INFLATION

As noted earlier, inflation is currently expected to be around 2.6% over the next few years. As such, cash held in short-maturity CDs, money market funds, and savings accounts will effectively lose money (on an inflation-adjusted basis) because they are currently yielding so little. Moreover, despite current valuations in other asset classes like stocks, bonds, and real estate, we firmly believe that investors should not keep a substantial portion of their portfolio in cash for long periods.

For stock allocations, we think portfolios should include diversified allocations to sectors like real estate, infrastructure, energy, and utilities. These sectors tend to do particularly well in an above-trend inflationary environment because of their ability to pass on price increases to consumers and businesses.

For bond allocations, we think portfolios should be overweight in diversified allocations to credit sectors (i.e., non-government bonds), mid-grade bonds (i.e., A and BBB rated), and a limited amount of non-investment-grade bonds. Because of the higher yields they offer investors, these sectors tend to help mitigate interest rate risk resulting from unexpected inflation.

Over the summer, we started implementing the themes outlined above to align client portfolios with our outlook. As always, if you have any questions, please reach out to your advisory team.

# SOURCES & ENDNOTES

[1] Global stock market represented by the MSCI ACWI USA IMI Index peaked on September 6th 2021.

[2] U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Bloomberg Aggregate Bond Index. International bond returns are represented by the Bloomberg Global Aggregate Ex USA Hedged Index.

[3] Federal Reserve Summary of Economic Projections: https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20210922.pdf

[4] Federal Reserve Economic Data: https://fred.stlouisfed.org/series/CPIAUCSL

[5] Federal Reserve Bank of Atlanta: https://www.atlantafed.org/chcs/wage-growth-tracker

[6] International Monetary Fund: www.imf.org/external/datamapper/NGDP_RPCH@WEO/WEOWORLD

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## IMPORTANT DISCLOSURE INFORMATION

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