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Market Newsletter
September 30, 2021

EXECUTIVE SUMMARY

- Stocks had mixed performance in the third quarter of 2021. US stocks of large companies rose marginally but stocks of smaller companies and foreign stocks fell.

- The US economy has hit a speed bump because of uncertainty from Covid, fiscal policy, debt ceiling negotiations, supply chain bottlenecks, inflation fears, monetary policy, and labor market abnormality.

- Consumer and corporate fundamentals are solid and should support a recovery.

- US corporate earnings growth could clock in at over 30% for the third consecutive quarter.

- S&P 500 valuation (Price divided by earnings expected over the next 12 months), is currently 20.5, which is higher than the 25-year average of 16.8 but below its recent high of 22.

- Investors should neither take too much risk nor be overly conservative when markets are strong and making all-time highs. All-time highs are not necessarily followed by a bear market. On the other hand, when bear markets arrive, they lead to deep declines in stock performance that last for a significant time. To achieve long term success reliably, they should create well diversified, robust portfolios in line with their objectives and stay invested for the long term.

Table 1: Market indices

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	0.58%	15.92%	30.01%	15.99%	16.90%
S&P Mid Cap 400	-1.76%	15.52%	43.68%	11.08%	12.97%
S&P Small Cap 600	-2.84%	20.05%	57.64%	9.44%	13.57%
MSCI Emerging Markets	-7.97%	-0.99%	18.58%	8.96%	9.62%
MSCI EAFE	-0.35%	8.79%	26.29%	8.13%	9.33%
Investment Grade Credit (C0A0)	-0.06%	-1.12%	1.84%	7.43%	4.63%
Non-Investment Grade Credit (H0A0)	0.94%	4.67%	11.46%	6.63%	6.35%
Bloomberg Commodity Index Total Return	6.59%	29.13%	42.29%	6.86%	4.54%
Dollar Index (DXY)	1.95%	4.78%	0.36%	-0.32%	-0.26%
Vanguard Total Bond Market Index (VBMFX)	0.09%	-1.66%	-1.03%	5.30%	2.83%
10 Yr Rate	1.53% 09/30/2021	0.92% 12/31/2020	0.68% 09/30/2020	3.06% 09/30/2018	1.61% 09/30/2016

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 10/08/2021			
	Latest Release	Recent Trend	Notes
Non Farm Employment	194,000	Positive	The latest jobs report was disappointing and missed consensus by a wide margin, hurt by the delta variant of Covid 19. However, employment has been crawling out of the hole created by the pandemic. Unemployment rate fell to 4.8%- but the drop was because fewer people are looking for a job. There are structural imbalances in the jobs market because of the pandemic that need to be addressed.
Weekly Claims for Unemployment Insurance	326,000	Positive	In line with an improving employment situation, number of claims is hovering near post-pandemic lows but is higher than the pre-pandemic level around 250K.
ISM Manufacturing Index (over 50 indicates growth)	61.1	Positive	Manufacturing activity grew for the 16th consecutive month. Supply chain issues continue to affect manufacturing. Supplier deliveries and employment gauges climbed, while production weakened and new orders were unchanged.

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ISM Non Manufacturing Index (Over 50 indicates growth)	61.9	Positive	Services sector grew for the 16th consecutive month as well. Labor shortages and supply chain issues affected the sector. 17 services industries (out of 18) grew in the most recent period.
Consumer Prices (Month over month change)	0.3%	Negative	A reopening economy, supply chain bottlenecks and rising gas prices have contributed to an elevated level of consumer inflation. For the last 1year, inflation has been 5.3%. Excluding food and energy, core inflation was 0.1% for the month and 4% for the year.
Producer Prices (Month over month change)	0.7%	Negative	Producer price inflation is at an elevated level as prices for meats, residential natural gas, industrial chemicals, processed young chickens, motor vehicles, and steel mill products increased significantly. For the year the index is up 8.3%. Core inflation (Ex Food and Energy) is up 6.7% for the year.
Retail Sales (Month over month change)	0.7%	Positive	After a drop in July, retail sales grew at a healthy pace in August helped by back to school sales. Core retail sales (ex gas and auto sales) was up 2%. This figure lived up to its reputation of being volatile.
Consumer Confidence (Conference Board)	109.3	Negative	Consumer confidence slipped for the third consecutive month affected by the spread of the delta variant. However, the index is at a historically high level reflecting an improving economy.
Durable Goods Orders (Month over month change)	1.8%	Positive	Orders increased despite labor and parts shortages as well as higher material costs. The index has increased in 15 of the last 16 months. Core capital goods increased 0.5%- this is a good sign that companies are investing for future growth.
Industrial Production (Month over month change)	0.4%	Positive	Industrial production has reached pre-pandemic level despite supply constraints and hurricane related shutdowns.
Capacity Utilization	76.4	Positive	Capacity utilization continues to increase with a growing economy, but is still 3.2% below its long term average.
Housing Starts	1.615 Million	Positive	Housing starts were up 3.9% from the previous month helped by multifamily construction activity. Builders continue to struggle with limited availability of land, labor and materials, but starts is higher than before the pandemic.

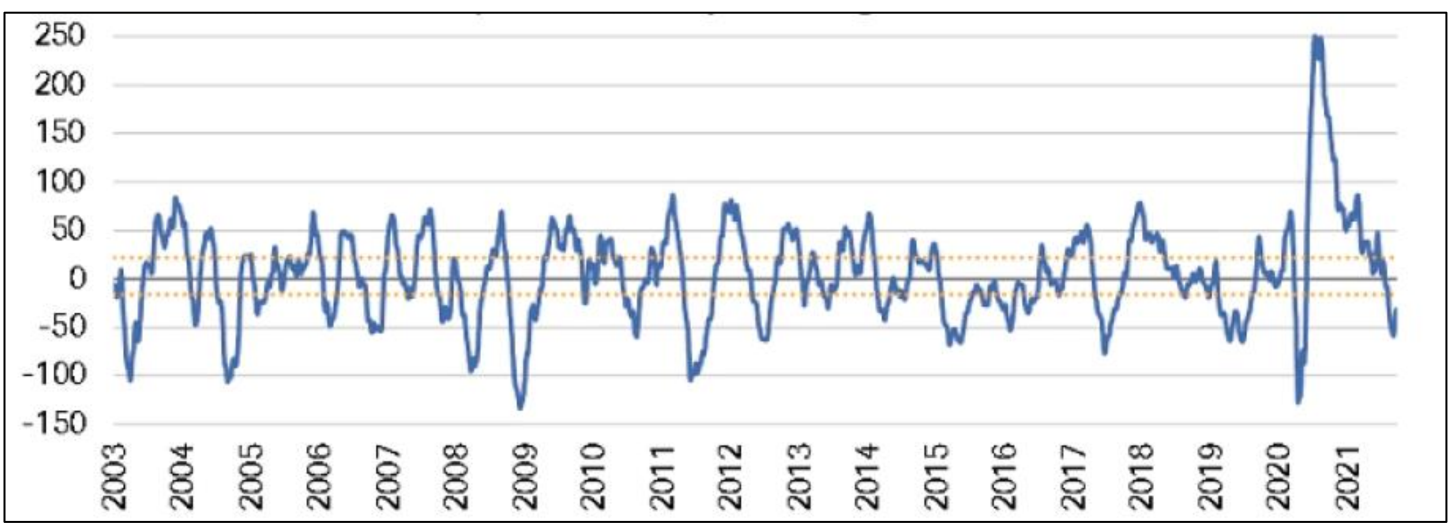
	Latest Release	Recent Trend	Notes
Home Prices (Case-Shiller 20 city Index- Month over Month)	1.48%	Positive	Home prices are up a whopping 19.95% year to dat across the 20 cities in this index. Housing activity continues to be healthy.
GDP (Real, Annualized)	6.7%	Positive	Second quarter GDP rose by 6.7% following a 6.4% increase in the first quarter. For the third quarter, economists have been cutting estimates as the delta variant continues to disrupt economic activity. The economy is still expected to grow at a healthy pace in 2021.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org

Stocks started strong in the first two months of the third quarter only to give back their gains in September. Large US stocks barely managed to eke out a gain, but smaller stocks and foreign stocks ended the quarter with a loss. Non-investment grade bonds (Bond of companies with poor credit quality) rose while investment-grade bonds fell as interest rates rose during the quarter. Commodities finished strong as supply chain bottlenecks led to a demand-supply imbalance.

The US economy has had a good year so far but has hit a speedbump because the delta variant of Covid 19 has curtailed economic activities in some parts of the country. The consensus estimate for US economic growth for 2021 has dropped from a high of 6.6% to about 6.1%, although a substantial part of the reduction has been moved ahead to 2022. There are a host of factors other than Covid that have contributed to the uncertainty in the economy and the markets- fiscal policy, debt ceiling negotiations (Now temporarily alleviated), supply chain bottlenecks and inflation fears, monetary policy uncertainty and labor market abnormality. As seen in Figure 1, the Citigroup Economic Surprise Index (Which measures how various economic indicators are coming in relative to expectations) has dropped sharply.

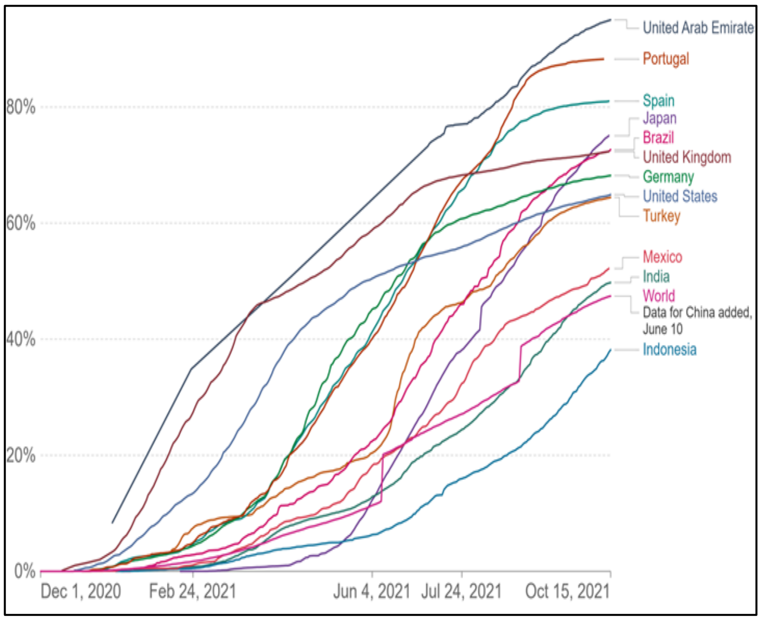
Fig 1: US Citi Economic Surprise Index



Source: Charles Schwab, Citigroup.

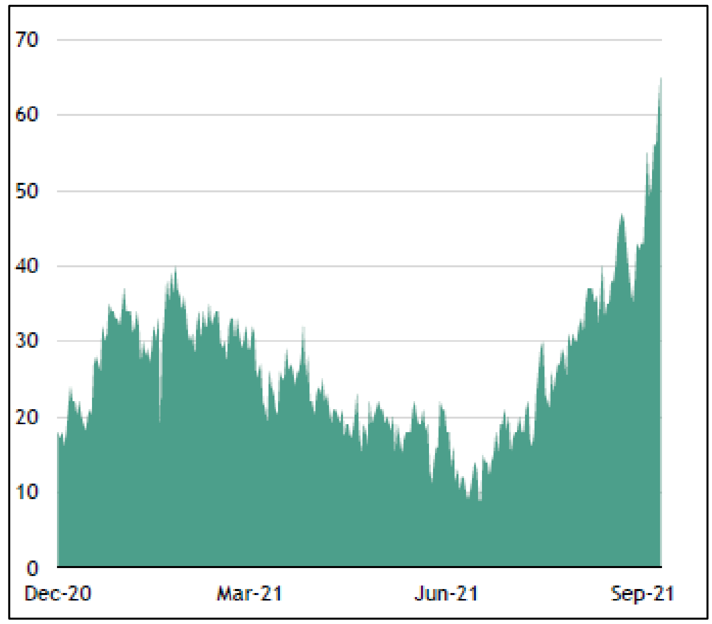
Vaccination rates in the US and several countries around the world have been progressing well as seen in Fig 2 and this should help moderate infections, despite the delta variant. In the US, 60% of the population is fully vaccinated and another 30% has immunity through infection- at these levels the disease should soon become seasonal with fewer casualties. Alleviation of health-related fears and resumption of schools should ease the instability in the jobs markets as workers, especially those with childcare responsibilities, resume work. Currently, there are a record 10.9 million job openings versus 8.3 million unemployed people as per the Job Opening Labor Turnover Survey (JOLTS). The most recent employment report showed that nonfarm payroll increased by only by 194,000- far fewer than expected. However, the average jobs growth over the last three months is a healthy 550,000.

Fig 2: Share of population- at least one dose of Covid vaccine



Source: Our World in Data

Fig 3: Container Ships Waiting at LA and Long Beach



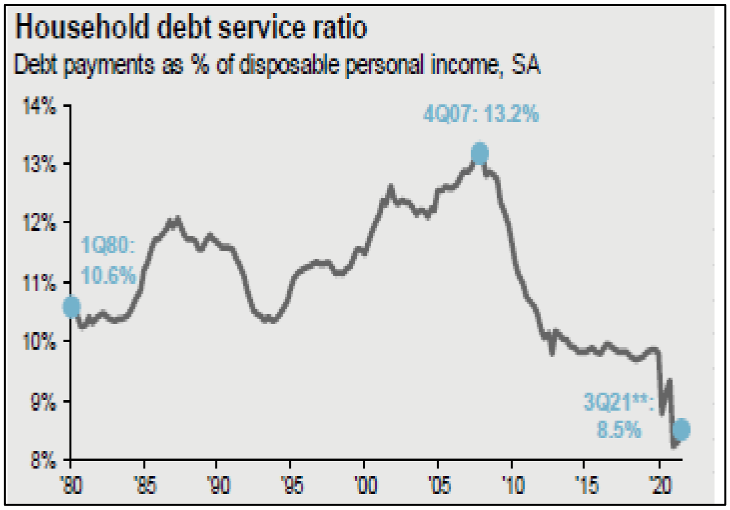
Source: Blackstone Investment Strategy

Countries around the world are easing lockdowns and restrictions at different rates and that, along with a sudden surge in demand is causing supply chain and transportation bottlenecks (Fig 3). The resolution of this situation depends on the trajectory of Covid infections but should resolve itself sometime in 2022. This should also ease the pressure on inflation which has spiked up significantly recently. Some of the cyclical components of inflation such as used car prices are already easing. A significant portion of the costs for companies is labor cost, which should moderate as workers return to work over the next few quarters.

There are two important spending bills that are making their way through Congress: The $1 trillion bipartisan infrastructure package and the $3.5 trillion reconciliation bill. Both bills have passed the Senate in their initial iteration. The infrastructure bill has bipartisan support and is likely to eventually pass without changes, but the reconciliation bill has hit turbulence because centrist and progressive Democrats are unable to come to an agreement. It is likely to eventually pass but in a smaller form, possibly of the order of $2 trillion.

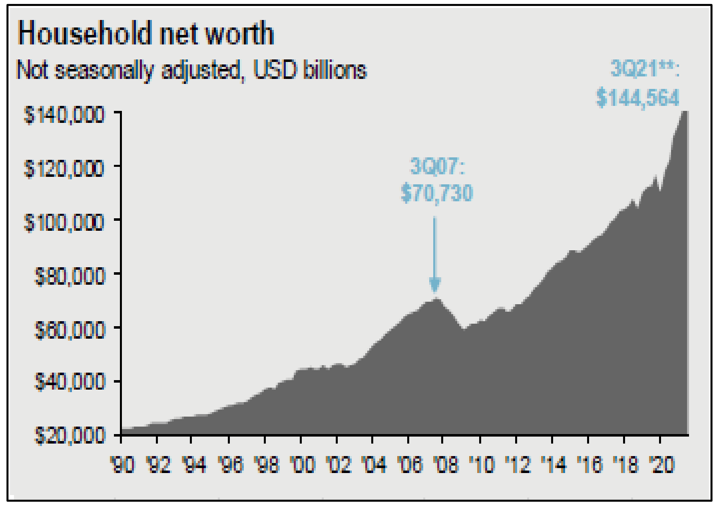
Despite the uncertainties and recent setbacks, consumers and corporate fundamentals are solid, and should support a strong recovery. Low interest rates and high (albeit falling) savings rate have led to one of the lowest rates of consumer debt service payments in over 40 years as seen in Fig 4. The consumer balance sheet is very healthy with a record level of net worth owing to strong equity and housing markets as seen in Fig 5. Corporate fundamentals continue to strengthen with strong revenue growth and profitability.

Fig 4: Consumer debt service ratio continues to improve.



Source: JP Morgan

Fig 5: Consumer net-worth continues to rise.



Source: JP Morgan

According to Factset, corporate earnings growth for the third quarter is expected to be 27.6% for companies in the S&P 500. Considering the 5-year average of improvement in earnings growth because of positive surprises, growth could clock in at over 30% for the third consecutive quarter. S&P 500 valuation (Price divided by earnings expected over the next 12 months), is currently 20.5, which is higher than the 25-year average of 16.8 but below its recent high of 22.

In countries outside the United States, there were similar uncertainties pertaining to covid and inflationary pressures, but the most significant news was from China. The Chinese Government continued its crack down on several companies in education, gaming, and mortgage lending, to curtail their torrid growth. Previously, some large internet-based companies like Didi were targeted. These measures were ostensibly carried out as a measure to rebalance the economy and 'level the playing field' among the Chinese consumers. Concurrently. China's second largest property developer missed interest payment and was on the verge of bankruptcy- quickly dubbed as a 'Lehman moment' for China. China also has one of the strictest lockdowns in place limiting mobility. Together, these factors have contributed to a reset in the economy with sharply lower retail sales and negative manufacturing sentiment. As a result, emerging market stocks were volatile during the quarter.

Investing for the long term to improve the odds of success

We have had a long bull market* since the financial crisis of 2008-2009 briefly interrupted by the short and swift bear market in March 2020 when Covid first hit. During this period, every time the market fell, it snapped back within a short period of time. Even the vicious 'covid bear market' last year, lasted for less than 2 months. Encouraged by this market performance, investors are taking inappropriate risks and have begun questioning the need for diversification and defensive portfolios. Investors should bear in mind that historically, bear markets have often been deep and long. Table 1 below shows the bear markets since 1950, along with its duration and the magnitude of the losses. As seen, the average bear market saw peak to trough performance of -35% and it took almost a year for the market to find the trough (And longer for it to recover to previous highs). A high risk, concentrated portfolio would do much worse. While nobody can predict the next bear market, it pays to be prepared for it, because it is not a question of 'if' but 'when'. It is important to create portfolios that can survive bear markets and thrive between them.

On the other hand, the more nervous investors are anxious as stock markets continue to make all-time highs. (There have been 54 all-time highs in the S&P 500 so far this year). They believe that all-time highs will necessarily and immediately be followed by a market crash. However, in the 94 years till 2020, the S&P 500 has been at all-time highs 30% of the time as per calculations by Dimensional Fund Advisors. On average, purchasing stocks after those all-time highs have produced similar returns as purchasing stocks after steep declines based on subsequent 1, 2 and 3 year returns as seen in Table 2.

Table 1: Bear markets in S&P 500since 1950

Period	Losses	Days between peak and trough
1957	-20.70%	99
1961	-28%	196
1966	-22.20%	240
1973-74	-48.20%	630
1980-1982	-27.10%	622
1987	-33.50%	101
2000-2002	-49.10%	929
2007-2009	-56.80%	517
2020	-33.90%	33
Average	-35.50%	374

Source: Yahoo Finance, S&P

Table 2: S&P 500 returns after market highs and after steep declines

	Average S&P 500 annualized returns		
	1 year later	3 year later	5 year later
After a new high	13.90%	10.50%	9.90%
After a 20% decline	11.60%	9.90%	9.60%

Source: Dimensional Fund Advisors, S&P

*A bear market starts, and a bull market ends when markets have dropped by at least 20%. A bull market is when the markets have risen by at least 20% from the previous trough.

Putting the above two discussions together, neither should investors take too much risk, nor should they worry about the next market crash when markets are strong. They can increase the odds of long-term success by creating a well-diversified portfolio in line with their risk profile and objectives. Investing appropriately, means creating a portfolio that can survive a bear market should one arrive and thrive during bull markets.