Marietta Wealth

Third Quarter 2021 Review & Outlook

"To expect the unexpected shows a thoroughly modern intellect." – Oscar Wilde

Review

After enjoying a long stretch of monthly gains in the stock market since February this year, September kept to its historical trend as a bad month for stocks by wrapping up the quarter with a 4.8% decline. According to CFRA research, since 1945 only two months have produced an average negative return for stocks - February and September. The average monthly decline in September is 0.56% over that 76-year time frame, with the index dropping 55% of the time. And it doesn't seem to matter if the market is moving along swimmingly prior to September. According to Sam Stovall of CFRA, "Following the 14 years that new S&P 500 highs were set in both July and August, the S&P 500 declined an average 0.74% and rose only 43% of the time." Beyond the large cap stocks that make up the S&P 500, the trend also holds true for small cap stocks with September proving to be the worst month for the Russell 2000 index.

For the full quarter, the S&P 500 managed a small gain of 0.23% which resulted in its sixth straight quarter of gains. However, the Dow Jones Industrial Average and NASDAQ both posted quarterly negative returns of 1.91% and 0.38%, respectively. The best performing sectors during the third quarter were Financials, Communication Services, Technology, and Healthcare; all posting quarterly returns over 1%. The worst performing sectors were Industrials, Materials, and Energy. Despite the weak ending to the quarter, the S&P 500 is still up over 15% for the year, well on pace for a strong year.

During the first six months of the year market participants were enthusiastic about investing in economically sensitive companies such as banks, manufacturers, and airlines with the expectation of a reopening economy. Meanwhile, investors were not as excited about the "stay-at-home" technology companies when it looked like the economy would boom with the Covid-19 vaccines widely available. However, during the third quarter, the re-opening trade reversed course, and technology shares did well in July and August before retreating in September.

The bond market did not fluctuate much for most of the third quarter until the latter part of September. Interest rates on the 10-year U.S. Treasury note rose to over 1.50% at the end of September after the Federal Reserve indicated it was ready to begin reversing many of the easy money programs it started because of the pandemic. The Fed signaled it would begin reducing bond buying as soon as November and possibly begin raising interest rates next year. The expectation for interest rate increases by the Federal Reserve and higher inflation in the future led some investors to sell bonds pushing rates higher at the end of September.

Outlook

Investors are confronted with a myriad of issues that could disrupt the market. These issues include inflation, supply chain bottlenecks, Federal Reserve monetary policy, budget and debt ceiling negotiations in Congress, and the potential for higher taxes for individuals and corporations.

Inflation has moved up considerably during 2021. The year-over-year consumer price index (CPI) reading for September came in at 5.3%. CPI is a measure of the increase in prices of consumer goods. For comparison, the annual increase in CPI was running at only 1.4% back in January of this year. Meaning, at the beginning of 2021, prices were only 1.4% higher than they were before the pandemic hit. Pre-pandemic prices had been increasing in the range of 1.5%-2.5% per year, which is an appropriate range considering the Federal Reserve's long-term inflation target goal of 2% price increase per year.

A key cause of current inflation is the supply chain bottlenecks around the world. Major ports on the east coast and west coast are not operating at full capacity, which has resulted in fully loaded container ships waiting off the coast until they can dock and be unloaded. The main reason is there are not enough dock workers to unload the ships and not enough trucks to transport the goods away from the ports. To make matters worse, the port constraints coincide with companies stocking up ahead of the holiday shopping season. Griff Lynch, the executive director of the Georgia Ports Authority, was recently quoted in a Wall Street Journal article saying, "Business is booming and e-commerce is booming. We have seen this transition from just-in-time in supply chains to just-in-case, and that is significantly changing our environment. Because of all this extra freight being imported, it's creating a backlog from the ship side to the dock side to warehouses and across the whole supply chain."

Despite the sharp increase in the costs of materials and labor for many corporations, businesses generally have been able to report strong profits this year. In fact, since the second quarter of 2020, earnings for S&P 500 companies on average have beaten analysts estimates by double-digit percentages. Looking forward, analysts expect earnings to increase 29% above the prior year level for companies in the S&P 500, according to Refinitiv. However, businesses are keenly aware of the limitation in how much labor and raw materials costs can be passed on to consumers through higher prices. According to FactSet, approximately 45% of the companies in the S&P 500 referenced inflation on their second quarter earnings calls, which is the highest since FactSet began tracking the data in 2010.

The Federal Reserve has held a consistent position in recent months that inflation should be transitory. However, recently Fed Chairman Jerome Powell acknowledged inflation pressures have become frustrating. Powell was recently quoted saying, "It's also frustrating to see the bottlenecks and supply chain problems not getting better — in fact at the margins apparently getting a little bit worse. We see that continuing into next year probably, and holding up inflation longer than we had thought."

Since the pandemic began, the Federal Reserve has been purchasing $120 billion in monthly bond offerings, made up of treasuries and agency mortgage-backed securities, to stimulate economic growth to achieve its goal of full employment and 2% average annual inflation. At the

September Fed meeting, Jerome Powell indicated the Fed would begin reducing the monthly bond purchases as early as November. In addition, the Fed signaled an increase in interest rates could occur in late 2022. The longer above average inflation persists, the more likely the Fed will need to act sooner on reducing bond purchases and increasing rates. Therefore, investors are closely monitoring the Feds language with concern that a premature increase in rates could cause a negative reaction in the stock market as experienced in 2013 when bond purchases were tapered and in late 2018 when interest rates were increased.

Congress is currently negotiating two proposed spending bills – a $3.5 trillion budget reconciliation package and a $1.2 trillion infrastructure bill. In addition, the recently extended temporary debt ceiling increase will need to be further extended come early December. As part of the budget reconciliation package, to offset the new spending, several different tax increases have been proposed including the following:

- Corporate tax increase from 21% to 26.5%
- Individual top tax rate increase from 37% to 39.6%
- Long-term capital gains tax increase from 20% to 25%

No one can say with certainty, but it's a high probability the debt ceiling issue will be resolved by December. It is still too early to predict if one or both spending packages pass, but the popular belief is a slightly lower spending package of $2-2.5 trillion has the potential to be signed into law. The immediate impact should not be inflationary since much of the spending is phased in over years, but the impact of potentially higher taxes going forward would likely be a headwind for the stock market. According to Goldman Sachs research, an increase in corporate tax rates from 21% to 25% would cause a 5% reduction to S&P 500 company earnings in 2022.

We will continue to monitor all these issues since they will impact the economy and stock market for the rest of this year and in 2022. One nice impact of inflation is that Social Security recipients will receive a 5.9% increase in their benefits in 2022, which is the largest annual increase in almost 40 years. Considering the concerns faced by the market, it is important to remember that market declines happen, and happen for many different reasons. The prudent stance for investors is to maintain an appropriate allocation to stocks consistent with a sound long-term financial plan. It is important to be reminded of the old market adage, "It's time, not timing, that makes money in the market." Investors who achieve substantial gains usually do so by remaining invested in a diversified portfolio for many decades.

Company Information

We are regularly posting investment and financial planning related articles to the "News" portion of our website that we trust you will find relevant and interesting. Please visit www.mariettawealth.com at your convenience. We also welcome you to follow us on our company Facebook and LinkedIn pages. If you would like to monitor your accounts online, please contact Ryann Laurin at rlauren@mariettawealth.com to have your investment portal established.

Please let us know if anything has changed in your financial situation.

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