MARKETS IN FOCUS

GEMMER
ASSET MANAGEMENT LLC
LOCAL PARTNER
GLOBAL INVESTING

THIRD QUARTER 2021 OCTOBER 14, 2021

Market Benchmarks

Market Indices	3rd Qtr	Ytd	3-Yr An
S&P 500 Index	+0.5%	+15.8%	+15.8%
Russell 2000	-4.3%	+12.3%	+10.4%
Global Equities	-1.3%	+11.3%	+12.7%
Int'l Index (EAFE)	-1.1%	+8.4%	+7.5%
Emerging Mkts	-7.0%	+1.2%	+9.4%

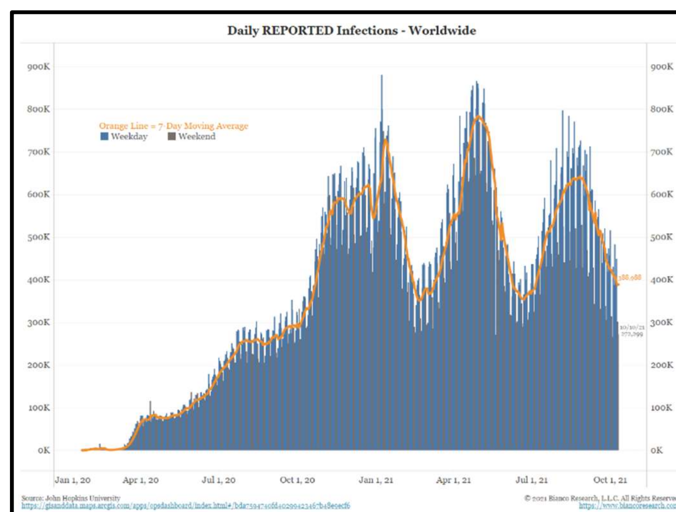
Other Indicators	9/30/21	6/30/21	12/31/20
Fed Funds Rate	0%-0.25%	0%-0.25%	0%-0.25%
2-Year Treasury	0.28%	0.26%	0.12%
10-Year Treasury	1.53%	1.44%	0.92%
S&P 500 P/E Ratio*	20.3	21.5	22.3
Crude Oil	$75.12	$73.47	$48.45
Core Inflation	3.6%	3.4%	1.4%

**Forward 12-month operating earnings per S&P*

Quarter-In-Review – The markets took a breather in the third quarter with most asset classes closing in the red. Large-cap growth stocks and the energy sector stand out as the two winners, but small-cap U.S. equities were down -4.3% while international developed lost -1.1%. The big loser on the equity side during the quarter were emerging market stocks. Their -7.0% loss was driven in part by a roughly -18% decline in Chinese equities. However, a strong dollar hurt other emerging markets as well.

The fixed income markets went through something of a whipsaw. Despite all the talk about supply chain problems and inflation, the yield on the 10-year Treasury dipped to 1.18% in early August and government bond prices rallied. As we explore in more detail below, several factors conspired to weigh on global growth expectations and push yields down. However, this quickly reversed in August and yields moved higher in September. For the quarter intermediate-term government bonds were basically flat while high quality corporate debt lost -0.5%. For the year the two benchmarks are down -3.4% and -2.2% respectively. Only low quality high-yield corporate bonds have proved resilient this year with a +3.0% in 2021.

Another Growth Scare – Temporary or Something More Ominous? – What was behind the stumble in the equity markets during the third quarter? It's always hard to lay blame, but there were three main concerns that probably caused the markets indigestion. First is the Delta strain of COVID. Coming into 2021 the consensus trade was that this year would be the year of normalization. Many investors were betting on a recovery in global growth, a return of travel, and an easing of lockdowns. While this seemed to be the case in the first half of the year, the world saw another surge in cases in late July and early August (chart to the right). This hammered home the point that COVID isn't done with us yet and new restrictions were implemented in some parts of the world. From a global growth perspective, the most important move was the continuation of China's 'zero tolerance' policy regarding infections.

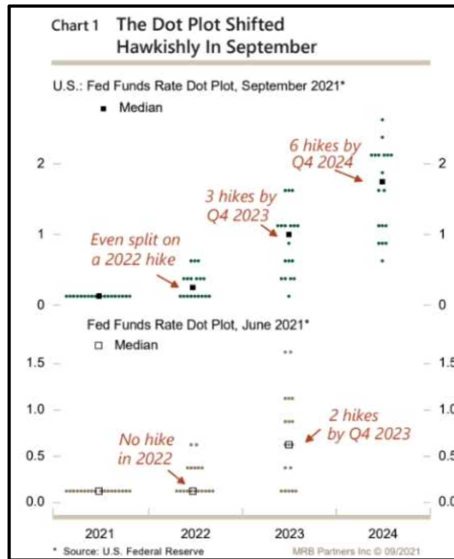


Staying in China, the second reason global markets struggled were policy actions taken there to reign in both the technology and real estate sectors. The government first clamped down hard on some of their internet and on-line education companies, hammering their stocks. The Chinese authorities have made a conscious decision that firms like Tencent, Alibaba, and Meituan do little to foster productivity growth, as anyone who has spent time on Facebook can attest!! Once they were done with tech, the authorities turned on real estate, pushing a major real estate developer to the brink of bankruptcy in the third quarter. More on that below, but needless to say, Chinese growth took a hit during the quarter and this bled over into the rest of the world.

The third headwind for the markets has been growing uncertainty about the direction of both monetary and fiscal policy. On the monetary front, the Federal Reserve started to openly talk about their exit strategy from 2020's emergency policy measures. And on the fiscal side, President Biden's fiscal spending initiatives ran into a roadblock at the same time Congress became consumed (again) by a debate on the debt ceiling.

These three factors (COVID, China, and policy uncertainty) were enough reason for the markets to correct during the quarter. And this was especially true because expectations were very much positioned for a surge in global growth earlier in the year. And

while the main indexes indicate only a modest correction during the quarter, under the surface there has been far more turmoil. At the beginning of October more than 90% of S&P 500 and NASDAQ stocks are down more than 10% from their highs with an average correction of -17% for S&P stocks and -38% for NASDAQ names.



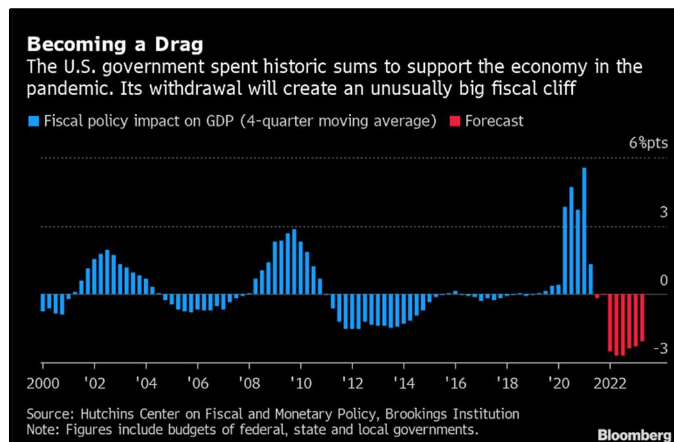
How to Look at China – It's human nature to look at current events through the lens of the last crisis. In the same way the generals in the 1930's prepared for a repeat of WWI, investors are looking at the Evergrande news in China through the lens of the U.S. real estate crisis. But we would argue this misses a key point. While the U.S. crisis was market driven, the China situation is policy driven. The U.S. didn't choose to pop the real estate bubble. Prices overshot fundamentals by a significant margin, and once the market and real estate sentiment turned, a negative spiral set in whereby falling prices fed through to a highly leveraged financial system which then fed back into even lower prices. The authorities were slow to realize they had a problem, and once they did, were slow to react.

The difference with Evergrande is that the authorities are choosing this time to deflate their real estate sector. The timing isn't random. In 2020 China implemented a 'three red lines' initiative to control leverage in the real estate sector. The current Evergrande situation is simply an extension of this policy. The authorities are allowing Evergrande's problems to develop to send a signal to the rest of the sector to reign in leverage and speculative building. We shouldn't forget China's financial system is essentially state owned. If they are told to lend to a firm, they lend. Conversely, if they are told to limit lending, that happens as well.

How will the situation play out? No one can be sure of course, but we suspect we see something along the following lines:

- Stockholders are wiped out and bond holders are forced into a debt-for-equity swap. Investors will suffer some pain, but the banks don't take a loss.

- Suppliers are paid. China can't afford to wipe out the thousands of small businesses that feed into Evergrande. This will prevent a systemic crisis.



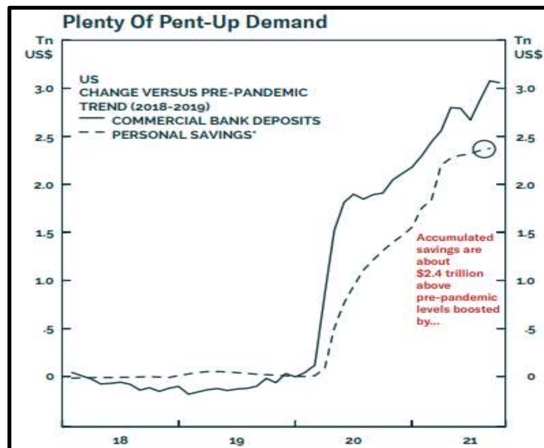
- Critically, individuals who put down deposits are made whole. China still doesn't have a well-developed savings system for consumers. Many families buy condos as a way of saving for a rainy day. Social cohesion is critical in China so consumers will not suffer from the Evergrande situation.

What does it mean for the global markets? We suspect the situation blows over in the months to come. Investors in the bonds are exposed, but we have no holdings in that area. Furthermore, we should see further policy easing in the near future which should support both Chinese and global growth at the margin.

A Trickier Policy Backdrop – Last quarter we noted that we had probably reached peak stimulus in many countries. After three months we feel more confident in this view. We are already starting to see some small countries raise interest rates, with New Zealand and Poland the most recent examples. Both the Fed and the European Central Bank are prepping the market for a reduction in asset purchases in 2022, and the next step will be rate hikes, at least in the U.S. At the September meeting the Fed communicated that they are split on raising rates late next year after thinking they would do nothing back in June. As you can see above, the Fed also went from projecting two hikes in 2023 to three hikes, and now think they will hike six times by then end of 2024. The tailwind from monetary policy is ending.

The fiscal outlook is as murky as it has been in a couple years. President Biden's infrastructure and social spending proposals appear to be locked in Congressional purgatory. And this is being made all the worse by the debt ceiling sideshow. Now whether you view this as a good thing or a bad thing probably depends on which op-eds you tend to read, but as you can see below, over the next few months fiscal policy will be a drag on growth as spending falls below last year's bloated levels. But we doubt this is a long-lasting phenomenon. We think President Biden ultimately can pass another fiscal package before Congress ceases to function altogether ahead of the approaching mid-terms.

The Case For Growth – We have laid out the case for why growth (and the markets) softened in the third quarter, but we wouldn't extrapolate this trend. We think a decent case can be made for solid growth in 2022. Consider the following:

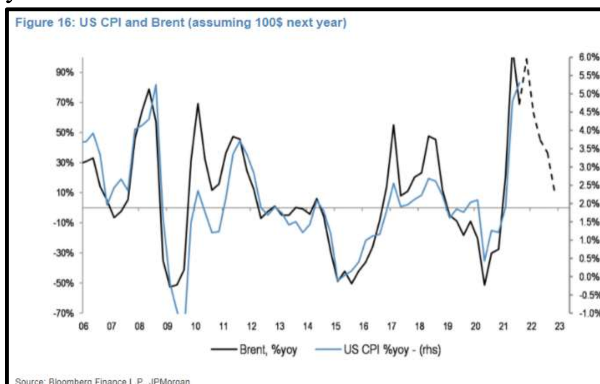


The Consumer is Stronger Than Ever. The chart to the right captures this idea. Since COVID started U.S. consumers have accumulated almost $2.5tn of excess savings. And this is just on the income side of things. Consumer net worth has soared as both the stock and real estate markets have hit new highs. Consumer debt levels have been pared back, and the odds of a consumer driven recession over the next year are awfully slim.

It's worth pointing out that this cycle is setting up very differently from the cycle after the financial crisis in 2008 and 2009. Coming out of the real estate bust, U.S. consumers continued to deleverage, or pay down debt, even after the crisis passed. But today debt levels are already relatively low, so much of this excess savings is likely to be spent over time.

Corporate Investment Should Accelerate. It isn't much of a stretch to say that every corporate consultant is telling their clients to move away from 'just in time' inventory management and to make their supply chains more robust. The U.S. government is actually mandating this for suppliers of essential products like computer chips. This 'onshoring' trend will entail a massive investment in domestic supply chains. If the 2009 to 2019 period was characterized by share buybacks, the coming years will be characterized by capex spending, at least in key industries.

High Energy Prices Will Accelerate the Energy Transition. Coal, natural gas, crude oil, and other key commodity prices have been soaring the last few weeks. A confluence of events is triggering the runup in prices, but one thing is clear, the transition from fossil fuels to cleaner sources of energy is reaching a tipping point. On some estimates the U.S. might spend upwards of $130tn to transition away from fossil fuels by 2030. And even if we miss the 'net-zero' target and spend half as much, the amount of money going toward the energy transition will dwarf anything we've seen before.



Most Voters Like Proactive Fiscal Policy. This is another way of saying that most voters like deficits (dare I say free money!!). The current debate about President Biden's spending proposal isn't a yes or no debate, it's about how much. $1.5tn or $3.5tn? As with consumer spending, this is where the coming cycle is likely to be very different from the 2009 to 2016 period. Back then austerity was the name of the game. It seems quaint in retrospect that the sum total of government support during the financial crisis was roughly $800bn in the form of the American Recovery and Reinvestment Act of 2009. Even before the crisis had passed the Tea Party had formed and there was relatively broad public support for cutting government spending. This was doubly true in Europe where Greece, Spain, Portugal, and Italy were crushed by balanced budget mandates. This simply won't happen this cycle. Every downturn in the economy is likely to be greeted with more fiscal spending because, for the time being, it is a vote winner.

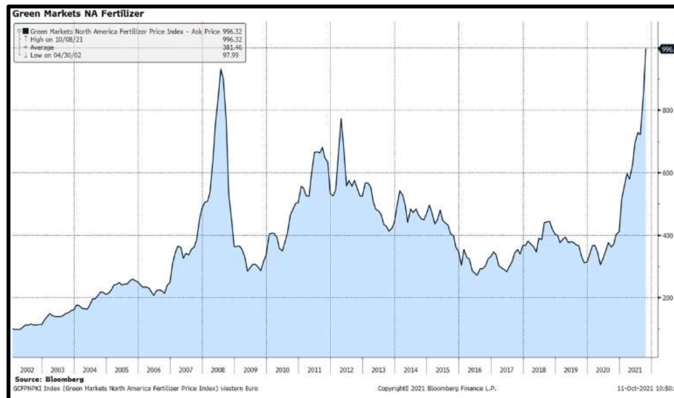
Delta Has Crested. Take this one with a grain of salt seeing as we have zero medical training, but it seems as if we have seen the peak in the Delta wave. Vaccine rollout continues at a decent pace, booster shots are working their way through the population, and vaccines for younger age groups will probably be approved soon. And just as critically, it seems as if we are learning to live with COVID while still allowing the economy to function.

Inflation – Conflicting Signals – The debate about inflation is getting contentious in part because no one under 60 has lived through much of it. Ever since 1982 we've basically been in a deflationary period where the rate of change has come down. Japan and parts of Europe have actually seen falling prices.

Without question inflation has been on the rise. The latest report shows core inflation (excluding food and energy) running at +3.6%, well above the 2% threshold. And given our natural inclination to extrapolate trends, the consensus view is that inflation should only get worse. However, we should remember that inflation is measured year-over-year. As we move into 2022 the so-called base effects will become challenging for materially higher inflation. As you can see from the chart below, J.P. Morgan estimates that inflation will drift down towards +2.5% by late next year even if oil prices remain at or above today's levels. So over the short-term inflation should moderate.

However, the longer-term view on inflation is getting less constructive. There are a few reasons for this:

1) On-Going Labor Shortages. Talk to most small business owners and their number one concern is finding qualified employees. There was some thought this situation might improve after the enhanced unemployment claims expired, but early signs are mixed.

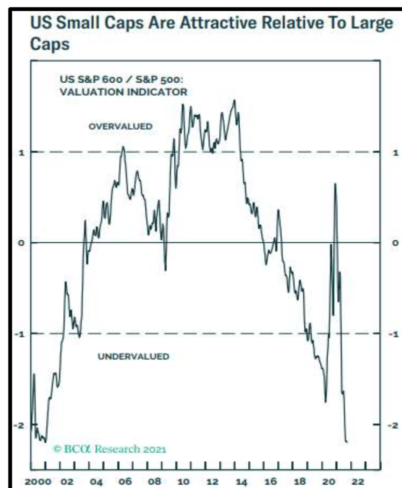


2) Rising Energy Costs. Coal, natural gas, uranium, and crude oil prices have been on a tear the last few weeks. While the drivers of the price moves are varied, it is becoming apparent that years of underinvestment in productive capacity is proving to be a problem in a world of rebounding demand.

3) Rising Food Prices. This is related to rising energy costs to some extent. For example, natural gas is a key input into fertilize production and gas prices are up. As you can see above, fertilizer prices have skyrocketed. Additionally, China is struggling with a shortage of phosphate (an input into fertilizer) and has banned its export until the middle of next year. The U.S. doesn't buy much from China, but the country represents about 30% of world trade.

All of these issues are manageable and do not spell the onset of 1970's style inflation, but they do argue that inflation over the coming years is likely to run hotter than it has since 2009. Rather than inflation in the 1.5% to 2% range think 2.5% to 3.5%. Could inflation overshoot? That is a clear risk and something we must stay attuned to.

What Does it Mean for the Markets? – There are clearly a lot of moving pieces in today's global economy. The first critical question is whether global growth continues in 2022 or not? A recession would be very bearish for stocks and bullish for bonds. We think the odds of a recession in the next year are low, say 10% to 15%. We've detailed some of the reasons earlier, but one indicator that isn't even flashing yellow yet is the yield curve. Typically, the spread between the 10-year Treasury yield and the 2-year goes flat or even negative before a recession sets in. That is definitely not the case today.



So, if we see growth in 2022 what type of growth will we see? Sluggish growth in the developed world that isn't inflationary or something a bit hotter? On this question we think the past isn't a prologue. The decade from 2009 to 2019 was marked by slow growth, low inflation, falling interest rates, and rising price-earnings ratios for the growth darlings (Google, Apple, Netflix, etc.). The next few years could differ markedly. As we have detailed above, we think both growth and inflation could run on the hotter side meaning the path of least resistance for interest rates is modestly higher. This means traditional bonds are likely to generate only modest returns until yields increase. Stocks can perform well in this environment, but we think higher inflation/higher rates is supportive of a rotation in market performance away from the winners of the last decade towards those sectors that benefit from 'reflation.' This would include traditional value stocks such as financials and energy as well as small-cap stocks. As you can see from the chart below, small-cap equities are as cheap as they have been relative to large-caps since 2000.

Looking Ahead – All too often our tendency when talking about markets is black or white. Is the outlook good or bad? Should I be invested or not? But most of the time these are the wrong questions. Where are the tailwinds and opportunities? Which areas face a headwind? How should a portfolio be tilted to benefit from such a view while at the same time managing the risk? We think this is where we are today. We suspect the growth and inflation dynamics over the next few years are likely to differ from the recent past and we are positioning our portfolios accordingly.

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Charles Blankley, CFA

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