Outlook for September 2021

Key Market Drivers

The onset and spread this summer of the delta variant of Covid-19 will slow, but not stop, the U.S. economic expansion. Given some anecdotal evidence of greater spending caution in the hardest hit regions of the country, strong consumer balance sheets and the need for businesses to increase production to match demand will allow an effective transition from government-supported growth to an economy where growth is largely driven by the private sector.

Infection rates in Europe and Japan appear to be peaking which should allow the somewhat aborted economic reopening process to resume in many of these countries. Supply chain bottlenecks continue to impair industrial production, but they are expected to abate as we approach the end of the year with only limited permanent scarring from higher input costs.

The regulatory crackdown in China will have a much longer lasting impact on the domestic and global economy than the effect of Covid-19. The government ostensibly is looking to prevent unfair competition and redistribute wealth with their "Common Prosperity" initiatives. This greater imposition of government authority on the economy should slow longer term GDP growth from the current 6% level to 3-4% by 2023.

Our Perspective

Equity Markets

- U.S. equity markets appear unstoppable on the back of strong corporate earnings growth and continued low interest rates which have allowed valuation multiples to be maintained at historically high levels. Tougher year-over-year comparisons in third and fourth quarter earnings reports, and the expected increase in yields, may cause heightened volatility through year-end.
- The increase in infection rates from the delta variant has been a relative performance head wind for U.S. small and midcap equities as they tend to have greater exposure to the more cyclical sectors of the market. An expected peak in the spread may lead to some performance catch-up against large caps.
- Developed international equities are also typically more exposed to cyclical sectors such as Industrials, Consumer Discretionary, and Financial Services, so a resumption of economic recoveries as the delta wave peaks could help relative performance compared to U.S. equities.
- Recent Chinese political and regulatory moves have cast somewhat of a pall on emerging market equities which had already been restrained this year by lower vaccination rates and slower economic reopening. A delayed, but tangible recovery in the economies should help this sector participate more fully in the global bull market.

Bond Markets

- Continued above trend economic growth through year-end with some stubbornly persistent inflation should cause U.S. treasury bond yields to drift higher in the coming months. Effective messaging from the Fed as to the timing and magnitude of a decreased rate of bond purchases should prevent a 2013-style taper tantrum where yields spike disruptively higher.
- As municipal bonds are historically expensive compared to like maturity treasuries, the expected increase in treasury rates can lead to underperformance within the tax-exempt municipal markets.
- The yields on below investment-grade U.S. bonds have declined to the extent that they appear to be overvalued at current spread levels to U.S. treasuries. Emerging market debt is a better high-yielding alternative as the less-developed economies finally begin to recover from the effects of the pandemic.

Outlook for September 2021

Our Perspective (Continued)

Monetary Policies/ Currencies

- The uncertain timing and impact of the recent Covid-19 wave decreases the urgency for the Fed to begin the monetary tightening process as the central bank continues to view the current inflation increase as largely temporary. This month's FOMC meeting should produce greater detail around the timing and magnitude of asset purchase tapering which is expected to begin in November and be completed by the second quarter of 2022. No fed funds rate increases should occur until late next year or early 2023.
- With less fiscal support, a slower economic recovery, and lower inflation, the central banks of Europe and Japan are not as close to beginning a tightening cycle and should continue to purchase assets at current rates well into next year with no rate increases on the horizon.
- The Chinese central bank appears to have the difficult task of trying to partially offset any slowdown caused by the more restrictive government regulatory stance while also looking to prevent the formation of inflationary excesses in certain sectors of the economy. These somewhat conflicting goals should lead to a bias towards an easier monetary policy at least through the end of this year.
- Rising fiscal deficits in the U.S. should serve to counteract the positive impact of stronger economic growth and nearer term monetary tightening to keep the trade-weighted dollar in a trading range although any break of that range will likely be to the upside.

Commodities

- With demand showing signs of slowing somewhat as global economic growth passes its peak, the expected supply increases coming from OPEC+ Russia and the U.S. shale producers will prevent oil prices from rising much higher from current levels.
- If inflation is indeed transitory and near its peak, and the Fed proceeds with beginning the process of removing excess monetary ease, gold prices should remain range bound over the coming months.

What This Means for Investors

While investors continue to confront the implications of a persistent pandemic, prospective tax increases, supply chain constraints, and greater regulation in China, above trend earnings growth with continued historic monetary accommodation has proven a much more powerful motivation in driving equity prices higher. Markets will monitor the beginning and ultimate path of monetary tightening, but the current environment remains favorable for risk assets.

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