Third Quarter 2021 Review and Year-End Outlook

Third-Quarter Recap

Global equities had sloppy, uneven performance in the quarter as several restraining factors developed over the summer. To be fair, with the incredibly strong performance coming off the March 2020 pandemic-induced lows, we were probably due for some stock flattening, if not a 5% pullback or outright 10% correction in prices.

When the numbers are reported at the end of October, the U.S. economy, which registered over 6% annualized growth in both the first and second quarters of the year, is expected to have slowed in 3Q to roughly 2-3%. The primary culprit for the slowdown to what are still reasonably strong growth rates was the spread of the highly contagious delta variant of Covid-19 and the impact it had on both restraining consumer spending on services and prolonging global supply chain dysfunction. An example of how supply shortages are impacting the slowdown is currently taking place in the auto industry where Toyota recently announced a 40% reduction in production. The company cited the inability to procure enough semiconductor chips needed to manufacture the increasingly sophisticated cars.

Inflationary Concerns

The concept of "stagflation," a term coined in the 1970s to describe an economy with high inflation rates and little to no economic growth, has resurrected this year, even though it is difficult to characterize the current growth environment as stagnant. Inflation is the greater long-term risk to the markets as price increases in certain sectors have been surprisingly persistent with strong aggregate demand and constrained production due to supply chain and virus issues. Price surges were particularly acute in the energy sector as the OPEC+Russia cartel showed surprising production discipline and a rather severe Atlantic hurricane season shut down Gulf Coast production a few times in the U.S.

The lumber price undulation experienced this year is an example of the economic response to commodity price spikes. Lumber prices surged earlier this year as the industry could not hire enough loggers to meet the demand from home builders. The increase in prices naturally elicited more labor supply to take advantage of sharply higher wages being offered by producers. At the same time, the end buyer demand softened as new homes became somewhat less affordable. The combined effect rather quickly moved lumber prices down to a market clearing level where supply met demand. This natural behavioral reaction may next take place in the automotive industry as it is poised to ramp up production in anticipation of some loosening in semiconductor chip supply.

Regime Change at the Central Banks

In addition to the profit impact that higher input prices can have if manufacturers cannot fully pass along the increase to consumers, higher inflation rates usually provoke some reaction from the various global monetary authorities that are all subject to certain price stability mandates. The U.S. Federal Reserve consistently characterizes this year's inflation as transitory. Moreover, it says the inflation is a function of base effects from very low Covid-induced prices of last year and what they believe to be temporary supply chain issues that should dissipate over the coming months. Other central banks in the demographically challenged developed market countries are suppressing the urge to tighten into this inflationary environment unless, and until, the price increases become truly persistent.

We are likely moving into a new monetary policy regime where the central banks view deflation as riskier than inflation and more difficult to eradicate. They are likely willing to tolerate more inflation before acting to initiate tightening programs.

With inflation currently rising faster in the U.S. than in most other developed market economies, the Fed will be the first global central bank to begin removing the extraordinary purchase of short to intermediate maturity government bonds. The Fed has been very careful in its messaging to avoid market disruption, but as indicated in its quarter end meeting, the "tapering" process should begin in December.

However, there will be no Fed funds rate increases until late next year or early 2023 as employment has yet to fully recover. An additional perceived central bank mandate around ensuring greater income equality could further bias the Fed towards protracted ease which would keep rates low and bode well for further appreciation of risk assets.

Tighter Fiscal Policy

Fiscal policy concerns and dissonance within the Democratic Party contributed to September market skittishness. While dominating the headlines at the end of the quarter, debt ceiling debates and government shutdowns have historically been viewed by markets as political sideshows with minimal long-term impact. But fiscal policy will be less supportive of the economy as the government passes the baton of consumer support to the private sector with taxes increased for both individuals and corporations. Senators Manchin and Sinema have become leaders of the moderate faction of the Democrats and their influence on the political process should lead to a notable tamping down of the magnitude and scope of spending increases including the tax increases needed to finance the spending.

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China Growth Slowdown

Political developments in China helped drive outright declines in many Asian and emerging equity markets in the quarter. The Communist government announced a Common Prosperity initiative to promote greater participation in the growth of wealth and to rein in excesses that have developed in certain sectors of the economy. These excesses were overtly demonstrated in the property sector where Evergrande, the second largest real estate developer in the country, could not fully pay end of quarter interest payments. The global surge in energy prices will likely have an inordinate impact on a Chinese economy that still relies heavily on manufacturing for GDP growth.

These recent developments, in addition to the already established demographic headwinds and ongoing trade conflicts with the U.S., will further slow longer term economic growth to the 3-4% annualized range from the previously forecast 5%. Expect pressure on the Peoples Bank of China to offset this growth slowdown with more aggressive monetary ease through the remainder of this year into 2023.

Outlook for Fixed Income and Equities

Given the above trend economic growth the U.S. experienced in the third quarter, and little risk of recession on the horizon, it was somewhat perplexing that bond yields declined in July before moving back up for the rest of the summer. Meaningful foreign buying of what are effectively higher-yielding securities provided some support. Any remaining bond bears who would be prone to short treasury securities may be hibernating until the Fed leaves the intermediate maturity area of the market. Looking ahead, bond yields should continue to increase towards 1.75% on the 10-year treasury by year end and the treasury yield curve should continue to steepen. Continued careful messaging by the Fed and a gradual implementation of the tapering process should prevent any disruptive spike in yields.

Also of note in the fixed income markets was the stability of credit spreads in both the investment grade and high yield areas of the corporate bond market. While credit continues to be historically expensive from a portfolio construction perspective, these narrow spreads confirm both the strength of the economy and the low likelihood of any increase in debt defaults.

In assessing the global equity markets, it appears the U.S. large cap sector, as reflected by the S&P 500 index, is vulnerable to a correction given the strong year to date performance on top of last year's impressive returns. Investors should be aware that the average stock in this index has already corrected over 10% and the small and midcap sectors have underperformed large cap year to date. With the current infection rate decline from the delta variant of Covid-19 and the anticipation of greater certainty around both fiscal and monetary policy, we may again see increased breadth of participation in the U.S. equity market. This is likely to be reflected in a "re-recovery" trade which favors the classic cyclical sectors of Financials, Energy, and Industrials over the less cyclical sectors such as Technology and Communication Services that have outperformed year to date. Any recovery in the cyclical sectors should also help the performance of the more manufacturing-oriented European and Japanese markets.

Earnings growth will slow somewhat due to tougher year-over-year comparisons and input cost pressures. However, earnings per share is expected to be up on average 25-30% for both the third and fourth quarters. This kind of earnings backdrop, with only slightly higher interest rates, remain a favorable environment for equity price appreciation.

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What This Means for Investors

Low inventories, the need for supply to catch up with demand, strong jobs and wage growth, and very healthy corporate and consumer balance sheets all provide a favorable economic backdrop and imply a low probability of recession going into 2022.

Persistent, more permanent inflation in commodity prices, particularly energy, could hamper growth. However, it appears inflation is peaking and pandemic-related effects such as port congestion will begin to be rectified. Wage pressure may take much longer to dissipate. Continued productivity enhancing technology investments by corporations will be key to maintaining profit margins, preventing the development of a truly inflationary cycle, and growing real wealth in the economy.

For more market insights, contact a Cerity Partners advisor or visit the thought leadership section of ceritypartners.com.

Index Performance Data

	3Q 2021	YTD	1-Year	3-Year Annualized
Equity Index Returns				
Dow Jones	-1.46%	12.12%	24.05%	10.94%
S&P 500	0.58%	15.92%	29.87%	15.91%
Russell 2500	-2.68%	13.83%	44.82%	12.40%
MSCI ACWI	-1.05%	11.12%	27.32%	12.51%
MSCI EAFE	-0.45%	8.35%	25.62%	7.58%
MSCI Emerging Markets	-8.09%	-1.25%	18.13%	8.54%
Other Index Returns				
MSCI U.S. REIT	0.98%	23.00%	37.00%	10.04%
Bloomberg Commodity Index	6.59%	29.13%	42.10%	6.83%

	3Q 2021	YTD	1-Year	3-Year Annualized
Fixed Income Returns				
Barclays Aggregate Bond Index	0.05%	-1.55%	-0.89%	5.33%
Barclays 1-10 Year Municipal Bond	-0.01%	0.35%	1.33%	3.91%
Merrill Lynch High Yield Master II	0.94%	4.67%	11.41%	6.59%
Citi World Government Bond Index	-0.01%	-2.38%	-2.11%	4.47%
JPM Emerging Markets Bond Index Global	-0.70%	-1.36%	4.34%	5.62%
Barclays TIPS	1.75%	3.51%	5.17%	7.41%
Citi U.S. 3-Month T-Bill	0.01%	0.04%	0.06%	1.14%

Source: FactSet, Morningstar Direct
**Citi World Government Bond Index is the hedged index

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Third Quarter Market Summary

								Annualized		
		4Q20	**1Q21**	**2Q21**	**3Q21**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
U.S. Equity Benchmarks	**Price**									
Dow Jones Industrial	33,844	10.73	8.29	5.08	(1.46)	12.12	24.05	10.94	15.63	14.67
NASDAQ Index Composite	14,504	15.63	2.95	9.68	(0.23)	12.66	30.13	22.54	23.29	20.85
S&P 500	4,307	12.15	6.17	8.55	0.58	15.92	29.87	15.91	16.84	16.57
Russell 1000 (Large Cap)	2,446	13.69	5.91	8.54	0.21	15.19	30.83	16.34	17.06	16.70
Russell 1000 Growth	2,417	11.39	0.94	11.93	1.16	14.30	27.20	21.88	22.76	19.60
Russell 1000 Value	1,551	16.25	11.26	5.21	(0.78)	16.14	34.86	10.02	10.90	13.46
Russell Mid Cap	3,129	19.91	8.14	7.50	(0.93)	15.17	37.94	14.14	14.34	15.47
Russell Mid Cap Growth	1,808	19.02	(0.57)	11.07	(0.76)	9.60	30.32	19.04	19.20	17.48
Russell Mid Cap Value	2,615	20.43	13.05	5.66	(1.01)	18.24	42.21	10.22	10.56	13.88
Russell 2000 (Small Cap)	2,204	31.37	12.70	4.29	(4.36)	12.41	47.46	10.48	13.41	14.58
Russell 2000 Growth	1,492	29.61	4.88	3.92	(5.65)	2.82	33.12	11.63	15.29	15.68
Russell 2000 Value	2,397	33.36	21.17	4.56	(2.98)	22.92	63.61	8.54	10.99	13.17
S&P GICS Sectors	**Weight**									
Consumer Discretionary	12.3%	8.04	3.11	6.95	0.01	10.28	19.15	16.27	19.00	19.54
Consumer Staples	5.9%	6.35	1.15	3.83	(0.31)	4.69	11.34	11.93	8.55	11.93
Energy Sector	2.9%	27.77	30.85	11.30	(1.66)	43.22	82.99	(6.80)	(1.57)	2.12
Financials	11.3%	23.22	15.99	8.36	2.74	29.14	59.13	13.38	16.64	17.00
Health Care	13.0%	8.03	3.18	8.40	1.43	13.45	22.56	12.39	14.18	17.06
Industrials	8.5%	15.68	11.41	4.48	(4.23)	11.48	28.96	9.83	12.50	15.00
Information Technology	27.4%	11.81	1.97	11.56	1.34	15.29	28.90	27.26	28.42	23.14
Materials	2.6%	14.47	9.08	4.97	(3.51)	10.49	26.48	13.37	12.95	12.83
Communication Services	11.1%	13.82	8.08	10.72	1.60	21.59	38.39	20.08	12.54	12.42
Utilities	2.5%	6.54	2.80	(0.41)	1.78	4.20	11.01	10.27	9.11	10.59
Real Estate	2.6%	4.94	9.02	13.09	0.88	24.38	30.53	14.72	10.22	12.96

		4Q20	1Q21	2Q21	3Q21	YTD	1-Year	Annualized 3-Year	5-Year	10-Year
Global Equity Benchmarks	**Price**									
MSCI ACWI	3,006	14.68	4.57	7.39	(1.05)	11.12	27.32	12.51	13.15	11.86
MSCI AC World x-USA	341	17.01	3.49	5.48	(2.99)	5.90	23.81	7.98	8.91	7.45
MSCI EAFE	2,281	16.05	3.48	5.17	(0.45)	8.35	25.62	7.58	8.78	8.07
MSCI EAFE Growth	2,208	13.09	(0.57)	7.42	0.07	6.88	20.79	11.84	11.37	10.02
MSCI EAFE Value	2,828	19.20	7.44	3.01	(0.97)	9.61	30.53	3.03	5.94	5.95
MSCI Emerging Markets	1,253	19.70	2.29	5.05	(8.09)	(1.25)	18.13	8.54	9.20	6.06
MSCI BRIC	360	15.26	(0.10)	5.40	(11.28)	(6.57)	7.65	8.48	9.74	6.04
MSCI Japan	4,015	15.26	1.57	(0.28)	4.56	5.90	21.97	7.50	9.33	8.32
Interest Rates	**Yield**									
3m Treasury Bill	0.04	0.02	0.01	0.01	0.01	0.04	0.07	1.18	1.16	0.63
U.S. LIBOR 3m	0.15	0.06	0.05	0.04	0.03	0.12	0.18	1.28	1.41	0.90
U.S. Treasury 3m	0.45	0.05	0.06	0.09	0.01	0.03	0.05	1.02	1.09	0.59
U.S. Treasury 10yr	1.48	0.21	0.32	0.39	0.33	1.05	1.26	1.60	1.96	2.04
U.S. Treasury 30yr	2.05	0.40	0.51	0.56	0.48	1.56	1.96	2.16	2.47	2.75
Fixed Income	**Price**									
Citi 3-month T-bill	660	0.02	0.02	0.01	0.01	0.04	0.06	1.14	1.12	0.60
BC U.S. Gov't & Related 5-7	105	0.80	(2.65)	1.44	(0.00)	(1.25)	(0.46)	5.74	3.40	3.28
BC Municipal Bond 1-10 Year	113	0.98	(0.26)	0.62	(0.01)	0.35	1.33	3.91	2.50	2.72
BC TIPS	114	1.62	(1.47)	3.25	1.75	3.51	5.17	7.41	4.32	3.11
BC Aggregate	106	0.67	(3.37)	1.83	0.05	(1.55)	(0.89)	5.33	2.93	3.00
ML High Yield Master II	106	6.48	0.90	2.77	0.94	4.67	11.41	6.59	6.33	7.27
Citi World Gov't Bond Index	955	0.26	(3.08)	0.74	(0.01)	(2.38)	(2.11)	4.47	2.57	3.43
JPMorgan EMBI Global	917	5.49	(4.74)	3.93	(0.70)	(1.36)	4.34	5.62	3.87	5.78

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								Annualized		
		4Q20	**1Q21**	**2Q21**	**3Q21**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Real Estate	**Price**									
MSCI U.S. REIT	1,365	11.52	8.76	12.00	0.01	23.00	37.00	10.04	6.82	11.18
FTSE EPRA/NAREIT Europe	1,917	16.96	(4.32)	10.95	(2.01)	4.02	21.57	5.39	5.95	8.72
Commodities										
Bloomberg Commodity Index	100	10.19	6.92	13.30	6.59	29.13	42.10	6.83	4.52	(2.65)
Energy	35	2.21	17.32	23.23	20.99	74.93	78.40	(5.95)	0.68	(8.89)
Agriculturals	57	21.36	6.81	12.77	(1.03)	19.20	44.46	12.19	1.87	(2.30)
Livestock	22	2.45	10.44	(1.46)	(2.01)	6.64	9.21	(8.18)	(0.61)	(4.75)
Softs	45	14.26	(1.49)	18.68	16.54	36.25	55.41	13.70	(2.97)	(5.97)
Industrial Metals	159	14.25	7.49	9.41	2.05	20.01	36.94	10.84	10.52	1.15
Precious Metals	210	2.41	(9.26)	3.93	(4.56)	(10.00)	(7.80)	12.15	3.77	(1.14)
Currencies	**Price**									
ICE Dollar Index	94	(4.21)	3.66	(0.85)	1.94	4.73	0.37	(0.32)	(0.26)	1.84
Euro / U.S. Dollar	1	4.34	(3.94)	0.90	(2.27)	(5.28)	(1.16)	(0.07)	0.62	(1.45)
Pound / U.S. Dollar	1	5.74	0.93	0.13	(2.40)	(1.36)	4.28	1.11	0.75	(1.43)
U.S. Dollar / Yen	111	(2.17)	7.03	0.44	0.53	8.07	5.71	(0.59)	1.95	3.75

Source: Factset, Morningstar Direct, iShares website