3Q 2021
Market Commentary

Where is the stock market headed now—back to the recovery trend or in the recent shelter-in-place countertrend? We have defined the "recovery trend" as representing the shift in favor towards value stocks that began in the spring of 2020. Until then the long-running trend in growth stocks, further exacerbated by the pandemic's shutdown, drew all of the market's attention to the shelter-in-place stocks. Yet, it appeared to us that a new trend in favor of stocks that would benefit from the reopening of the economy had begun, benefited by cheap valuations and surprisingly high price inflation in the intervening period. Furthermore, the low interest rate period that supported the high valuations of the growth stock segment of the market also seemed to have exhausted itself. Yet, after a significant recovery of return in the likes of depressed consumer discretionary, energy, industrials and materials stocks, the emergence of the Delta variant halted this trend in May.

Cyclically-sensitive stocks took a breather starting in June along with the countertrend rally back to the old leaders in the stock market. Federal Reserve Board Chairman Powell's comments in September, however, acknowledged both that price inflation would not be so transitory after all and that the taper in the Fed's huge purchases of Treasury securities would likely begin in 2021, effectively ended this countertrend rally. The broad market quickly declined, yields rose, and the three-month countertrend rally of passive indexes and growth stocks began to underperform value benchmarks once again.

Here is the picture of total returns through September 30th by index:

	September	3rd Quarter	YTD
NASDAQ	-5.3%	-0.3%	12.7%
S&P 500	-4.7%	0.6%	15.9%
Russell 1000 Value	-3.5%	-0.8%	16.1%
30-Yr T-Bond	-3.3%	0.6%	-8.4%

(*Source: FactSet and Bloomberg*)

As the Delta variant surged over the summer, even as vaccination rates continued to rise, many economic indicators weakened a bit. This is not difficult to understand as, even without another devastating shutdown, consumer confidence eroded and folks avoided group settings again—like going out to restaurants. Yet as the current wave of cases appears to have peaked, economic growth indicators may again reaccelerate. And with the JOLTS indicator (Job Openings and Labor Turnover Survey) at nearly 11 million job openings, an all-time record, jobs are waiting for those willing to work. Now that schools are reopening and pandemic unemployment benefit payments have ended, monthly employment gains should reaccelerate.

As a result, the economic boom underway could still create real GDP growth near 6% in 2021 and in the 3-4% range in 2022, but it is coming with high-sustained price inflation. While August's 0.3% gain in the Urban CPI was initially celebrated as a sign that price inflation would indeed be transitory (compared to June's 0.9% CPI gain), if we just stay at 0.3% for the four remaining months of 2021, the annual rate for the year would be an astonishing 5.7%! At 0.4% per month, the year could reach 6.2%.

The combination of 6% GDP growth and 5-6% price inflation adds up to an 11-12% revenue growth rate for the U.S. economy, not bad for the top line of corporate America. This could moderate to 7-8% in 2022, but the recovery in jobs, pent up demand, low inventories, extraordinary government deficit spending, and rising prices should drive revenues and earnings of all sorts of companies that have economically cyclical characteristics.

Unfortunately, economic booms do not necessarily result in sustained stock market booms. In such an environment, there is no possible justification for the Federal Reserve Board to suppress interest rates to sustain a 10-year Treasury bond yield at only 1.5%, where it sits today. Even if price inflation were to settle back down to 3%, the real return on the 10-year T-bond is still negative 1.5%. This is awful. The best one can hope for in owning nominal Treasury bonds is downside protection should the economy fall back into recession. Such defensive characteristics, however, were not on display in September. If rates are allowed to rise as the Fed starts tapering (reducing) its current $120 billion of monthly bond purchases, it will not be good for bonds, high P/E growth stocks, or interest-sensitive stocks.

We believe that value stocks and TIPS (Treasury Inflation Protection Securities) in general will offer better downside protection and greater upside return in the current market environment. Since the Par Value of all TIPS accretes each month with the change in the CPI (lagged), year-to-date, the high CPI gain has added roughly 4.5% to the return of TIPS relative to Treasuries. In the 3rd quarter, for example, 10-year TIPS gained 2.2% compared to 0.1% for 10-year Treasuries.

The combination of the COVID 19 economic shutdown in 2020, which temporarily shut down manufacturing and slashed inventories, and the Delta wave this summer, have continued to hamper the recovery in supply chains while at the same time government spending has stimulated demand. The negative effect (meaning higher) on prices and on costs is likely to be long lasting, and not resolved by early 2022. The delay in the return of supply to meet the market's demand probably lengthens the boom, but only companies that sustain profit margins by raising prices as fast as their costs are increasing will be at the top of the earnings growth and performance charts. While the overall stock market valuations could easily decline as inflation remains high and interest rates rise, following a long drought, now appears to be the right time for diversifying away from last decade's winners and investing in value stocks.

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