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October 2021 Market Review

Market Recap

After falling in September, the S&P 500 Index rebounded in October to notch its best month of the year and finish at an all-time high. The S&P 500 gained 7.0% and the Russell 2000 Index (smaller-company stocks) returned 4.3%. The market was buoyed by strong third quarter earnings. Companies have been beating on both the top and bottom lines. Individual companies that have disappointed, however, have been punished.

October Benchmark Returns

	MTD	QTD	YTD
EQUITY BENCHMARKS			
S&P 500 Index	7.0%	7.0%	24.0%
Russell 1000 Index	6.9%	6.9%	23.2%
Russell 1000 Value Index	5.1%	5.1%	22.0%
Russell 1000 Growth Index	8.7%	8.7%	24.2%
Russell 2000 Index	4.3%	4.3%	17.2%
MSCI U.S. IMI Real Estate Index	7.1%	7.1%	30.9%
MSCI ACWI Index	5.1%	5.1%	16.8%
MSCI EAFE Index	2.5%	2.5%	11.0%
MSCI Emerging Markets Index	1.0%	1.0%	-0.3%
FIXED-INCOME BENCHMARKS			
Bloomberg U.S. Aggregate Bond Index	0.0%	0.0%	-1.6%
Bloomberg Municipal 1-15 Year Index	-0.3%	-0.3%	0.2%
Bloomberg U.S. Treasury TIPS Index	1.1%	1.1%	4.7%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	-0.2%	-0.2%	4.4%
S&P/LSTA Leveraged Loan Index	0.3%	0.3%	4.7%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	0.90	0.90	4.51
Bloomberg Commodity Index	2.6%	2.6%	32.5%
SG Trend Index	2.99	2.99	13.81
3-Month LIBOR	0.0%	0.0%	0.1%
U.S. Dollar (DXY Index)	-0.1%	-0.1%	4.6%

Source: Morningstar Direct.

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Of greater interest for investors was the surge in inflation pressures during the summer and into the fall. After years of waiting for inflation, the wait is over. Prices across asset and goods markets are surging. Whether this is a temporary phenom caused by lockdowns, production glitches and logistical delays or whether it is a more deeply embedded, structural inflation is the key question of the day. Central banks are in the former camp, although we have been interested to the see their certainty about the transitory nature of the spike in prices give way to language that is best described as "hedging." If higher inflation is more durable, the bond market has substantial adjustments to make as it is difficult to square 1.5% ten- year Treasury yields with 5%+ CPI readings.

The confusion was evident for bond investors as the ten- year Treasury had a particularly volatile quarter and ending nearly where it began. The unexpected plunge in rates to 1.2% in the summer was reversed by the end of September. The swings in rates didn't seem to dent the overall stock market, but beneath the surface we saw some swings between value and cyclical stocks (which should benefit from higher inflation) and growth names. After seven consecutive up months, investors were reminded that stocks could go down in September, but this move was quickly reversed in October

The other notable development this quarter was the ongoing weakness in emerging markets. China is the dominant factor in emerging markets and the Chinese Communist Party seems be re-evaluating its relationship with privately held, capitalist business. Without much pattern, China is regulating or taxing entire sectors out of business. For instance, the flourishing for profit education industry (think of tutoring and test preparation) was decreed to be counter to "common prosperity" and overnight made to be not for profit. Suffice to stay, the wipeout of equity value for investors was complete. Since no amount of analysis can bake these sorts of shifts in policy into an asset price, investors are increasingly wondering if China is a place that you can invest at all. That is quite a change from the fawning and bragging that Western investors have been guilty of in recent years.

Key Market Drivers

As noted above, inflation has become the key consideration for investors. If you believe that higher prices are temporary effects of Covid, then you are likely to invest very bullishly. Given the ongoing monetary and fiscal stimulus, even the tapering of Fed bond purchases announced the first week of November will mean that money printing will continue to the benefit of asset markets. Damn those inflation torpedoes and full speed ahead!

Alternatively, if you worry that inflation is becoming entrenched, that will eventually force interest rates higher and should put downward pressure on asset prices from bonds (directly) to stocks (indirectly through discounting future cash flows at higher rates) to houses (lower affordability with higher rates). In this instance, investing more defensively makes sense. We are in the latter camp but humbly confess to having resided there for a very long time. While there are many forecasters and economists that both sides can point to for support in the debate, and many charts that can be printed to emphasize a point, we wanted to point out two slightly out of the mainstream observations that suggest to us that higher inflation isn't a short- term occurrence.

The first involves shipping. Logistics, or getting what you need to where you need it when you want it, is often overlooked. But the last eighteen months has highlighted how important the flow of

goods or resources are. From the humble toilet paper shortages of the lockdown, to winter time power shortages, to the dearth of semiconductors needed for manufacturing many goods (most notably cars), business and consumers the world over have been shocked to learn that we can't take manufacturing and delivery for granted. Interestingly, despite Covid lockdowns ending all over the world, the problems seem to be getting worse, not better.

One cause of that is global shipping. As the world outsourced most manufacturing to the Far East, the capacity to deliver those manufactured goods grew as well. Shipping was a low glamour, very low margin business. When the lockdowns occurred, shipping companies that had come to control much of the global industry moved quickly to slash capacity to survive. That extended to cutting orders for new ships. When the global recovery began, shippers and ports were not prepared. As successive Covid waves have complicated a return to normal, the industry simply hasn't been able to adjust. The result has been a five-to-six-fold increase in the cost of shipping goods from China to the US. Even when goods arrive, they often are stuck in port or on the ground. A thorough and interesting report from Rabo Bank, entitled "In Deep Ship", note that at the present time 10% of the world's global container capacity is waiting to be unloaded.

If this wasn't enough, the festering fears about China and a desire to onshore production suggests that these issues aren't going to be quickly, inexpensively or easily resolved. For example, we simply don't enough port capacity to unload all of the world's ultra large container ships that are, in some cases, larger than aircraft carriers. Rome wasn't built in a day and the port of Los Angeles and Long Beach won't be modified in a day either. Expect that issue, and the resulting upward pressure on prices, to continue.

The second topic worth discussion is the labor shortage. As you have undoubtedly noted, everyone is hiring. You are hard pressed to go anywhere that you don't see signs that tend toward pleading for new workers. The most recent statistics show that there are approximately 3,000,000 more jobs than unemployed people. Where have they gone? What is the cause of this and what might fix it?

As always, the answer defies a simple and quick explanation. Clearly, Covid and health issues have contributed. Some people are afraid of the risk of being exposed to Covid and don't want to return to work. Others are struggling with the yet ill- defined symptoms of long Covid. Still others found not working to their liking. For a subset of this group, finances may allow them not to return to work. For another subset, the enormous policy support in the form of high and extended unemployment benefits (which recently ended) along with the new child care credit have made it financially viable if not attractive to stay out of the work force. Whatever the cause, we are stuck with a very low 61% labor force participation rate.

This low rate of participation is forcing employers to bid up wages. We have always had faith in the markets and this adjustment isn't a surprise to us. It has essentially eliminated the minimum wage as a discussion topic since competition is so fierce for many hourly and lower wage jobs that signing and retention bonuses are creating effective hourly rates of more than $20 in many places. Business have responded to these higher costs by raising prices and, for the most part, these price increases are being accepted. That doesn't seem transitory to us.

Economists and policy makers are furrowing their brows and wondering what we can do to fix this

shortage. However, we wonder if the wrong question is being asked. Instead of their being too few workers, could there be too many businesses? For any business to succeed, it requires a combination of the factors of production: land, labor, capital and intellectual property (know how). If any of those isn't present, or isn't available at an affordable price, the business will fail. However, since the great financial crisis much of the body politic has worked tirelessly to ensure that no one ever fails. The result in the public markets has been that nearly 20% of all listed companies are zombies. That non-technical term describes a company that fails to generate sufficient cash flow to service its debt. How can a company be in that spot and not fail? The answer is an abundant amount of low cost, easy to secure financing. Make no mistake, there has been plenty of cash available for a business that "hopes" tomorrow will be better.

The numbers for non-publicly traded zombies aren't as readily discernible, but our sense is that there are plenty of these entities. How many pizza joints, or coffee shops, or burger restaurants do we need? Perhaps a culling of the business herd would allow employees to land on their feet in healthier businesses? We won't know unless and until policy makers allow markets to adjust without constant interference. We aren't holding our breath for that day, however.

Whatever the cause of the labor market challenges, we would again argue that they point toward higher and more persistent inflation.

How does this impact portfolio positioning?

As noted in last quarter's comments, central bank support for markets is, we believe the driver of asset market returns. If the Fed is true to its word, and begins to taper bond purchases, we think that will be negative for risk assets. The economy might well perform better without this interference, but the economy and the markets aren't the same thing. If the Fed blinks and doesn't taper, it will be due to signs of a weakening economy. This would suggest to us that with valuations remain stretched, the risk reward tradeoff isn't compelling. And so, we diversify and move cautiously.

As we noted last quarter:

That is the thrust of the investor's dilemma today. There are myriad other issues to consider and be concerned about. Is Covid vanquished? What will happen with tax and spending policy? Can we run unchecked deficits for as far as the eye can see without consequence? How will the world deal with aggressions of China? What impact does division and social unrest in the US have on the economy and markets?

We wish we could answer these questions. We certainly have our opinions, but those can't drive portfolio construction. Our focus remains on constructing and maintaining well diversified portfolios that we believe can withstand periodic bouts of market volatility. Anticipating tax issues, liquidity needs and the impact of inflation on longer term financial plans remains a critical part of our process.

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