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Clear Direction in a Complex World

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Quarterly Insights – October 2021

The S&P 500 hit new all-time highs again in the third quarter as investors looked past a resurgence of COVID-19 cases in the U.S. and instead focused on the positive combination of a resilient economic recovery, ongoing historic support from the Federal Reserve, and strong corporate earnings. Market volatility did notably pick up during the final few weeks of September, however, reminding investors that the transition to a post-pandemic "new normal" isn't always going to be smooth.

Stocks moved steadily higher to start the third quarter as the U.S. economy continued to return to pre-pandemic levels of activity while corporate earnings remained solid. To that point, second quarter earnings results, which were released in mid-to-late July, were stronger than expected and broadly did not show signs of the margin compression that some analysts feared might hurt corporate profitability. Additionally, at the July FOMC meeting, Fed Chair Powell reiterated that, despite economic progress, it was not yet time for the Fed to begin to reduce Quantitative Easing (QE), thereby ensuring the economy and markets would continue to enjoy full Fed support until late 2021. Those factors helped investors look past an increase in COVID-19 cases as the S&P 500 hit a new all-time high in late July.

That positive momentum for markets continued in August, powered by similar factors: Positive corporate commentary, solid economic activity, and continued supportive Fed rhetoric. Those forces again combined to help markets look past a further increase in COVID-19 cases. Unlike during the COVID-19 waves of 2020 and early 2021, government authorities did not re-impose economic restrictions or lockdowns in response to rising case counts. Instead, most policy responses centered on mask mandates, and as such, the economic headwinds from rising COVID-19 cases were mild compared to previous episodes. Meanwhile, politics once again became a focus of the markets in August. The Senate passed a $3.5 trillion budget reconciliation bill that would be the framework for potential changes to tax rates, entitlements, and climate policy. But what passed in August merely set the stage for the looming policy battle once Congress returned from the summer recess. Given that, stocks were able to look past future policy risks and climb steadily higher throughout the month with the S&P 500 ending August essentially at all-time highs.

The market tone changed in September, however, as many of the positive factors that supported stocks earlier in the quarter began to fade. First, corporate commentary turned more cautious last month. Profit warnings that cited supply chain constraints and margin compression came from multiple industries, and that caused investors to become more concerned about the outlook for corporate earnings. Then, economic data from August showed that the rise in COVID-19 cases had weighed slightly on the economic recovery. Finally, after investors ignored the looming policy battle in August, politics once again became an influence on markets as new details on a $3.5 trillion spending and tax plan that included increases to the corporate tax, personal income tax, capital gains tax, and inheritance tax. Those factors weighed on markets initially in September, but the volatility was compounded by the news that the second-largest property developer in China, Evergrande, was likely going to default on debt payments. Fear of potential financial market contagion hit stocks in late September and the S&P 500 suffered its first 5% pullback in nearly a year. Markets remained volatile into the end of the quarter as the Federal Reserve confirmed market expectations that it will begin to reduce Quantitative Easing before year-end, while Washington approached the looming deadline of a government shutdown with no extension in sight, although that was avoided in the last few days of the quarter. The S&P 500 finished September with moderate losses although the index still logged a positive return for the third quarter.

In sum, the market remained resilient in the third quarter, but the final few weeks of September served as a reminder to investors that markets will face the resolution of numerous macroeconomic unknowns in the fourth quarter, and while fundamentals remain decidedly positive, an increase in market volatility should be expected.

Third Quarter Performance Review

The last few days of the third quarter had a substantial impact on quarterly index returns. For the majority of the third quarter, the NASDAQ had solidly outperformed both the S&P 500 and the Dow Jones Industrial Average as investors continued a trend from the second quarter by moving to less economically sensitive large-cap tech shares. However, during the last week of the quarter, as global bond yields rose, there was heavy selling in tech shares as investors rotated into other market sectors. The NASDAQ still slightly outperformed the S&P 500 while the Dow Jones Industrial Average produced a negative return for the third quarter thanks to the late September sell-off.

By market capitalization, large-cap stocks outperformed small-cap stocks in the third quarter. In fact, small-cap stocks had a negative return for the quarter as rising COVID-19 cases, mixed economic data, and the prospects of eventually higher interest rates caused investors to favor large-cap stocks as the outlook for future economic growth became less certain.

From an investment-style standpoint, growth outperformed value in the third quarter, thanks to tech sector gains, although the amount of that outperformance shrunk considerably during the final week of the quarter as tech shares declined.

On a sector level, performance was more mixed than the previous two quarters as six of the 11 S&P 500 sectors realized positive returns in the third quarter, with financials leading the way higher. For much of the third quarter, the tech sector outperformed, but as bond yields rose in late September, financial stocks rallied on the prospect of higher interest rates and overtook tech as the best performing sector in the quarter. Healthcare also performed well, bolstered by strength in pharmaceutical stocks following more COVID-19 vaccine mandates and booster shot approvals.

Sector laggards included the industrials and the materials sectors, both of which finished with negative returns for the third quarter. Uncertainty surrounding the strength of the ongoing economic recovery in the face of higher COVID cases pressured industrials initially in the third quarter, as did a lack of passage of the $1 trillion bipartisan infrastructure bill. Meanwhile, the materials sector declined late in the third quarter on Chinese economic growth concerns following the Evergrande debt drama. Broadly speaking, cyclical sectors, those most sensitive to changes in economic growth, lagged more defensive sectors in the third quarter due to the uncertainty of the economic recovery in the face of the COVID wave in July and August.

US Equity Indexes	Q3 Return	YTD
S&P 500	0.58%	15.92%
DJ Industrial Average	-1.46%	12.12%
NASDAQ 100	1.09%	14.58%
S&P Midcap 400	-1.85%	15.21%
Russell 2000	-4.36%	12.41%

Source: YCharts

Internationally, foreign markets declined in the third quarter. Emerging markets dropped sharply, initially on concerns that rising COVID-19 cases would derail the global recovery, but late in the quarter, emerging markets fell even further on Chinese growth worries that stemmed from the Evergrande debt issues. Foreign developed markets, meanwhile, declined modestly during the final few weeks of the quarter on general global growth concerns combined with potentially higher global interest rates.

International Equity Indexes	Q3 Return	YTD
MSCI EAFE TR USD (Foreign Developed)	-0.35%	8.79%
MSCI EM TR USD (Emerging Markets)	-7.97%	-0.99%
MSCI ACWI Ex USA TR USD (Foreign Dev & EM)	-2.88%	6.29%

Source: YCharts

Commodities posted strong gains for the fourth quarter in a row and again outperformed the S&P 500 over the past three months. Major commodity indices were led higher by a late-quarter rally in oil prices as members of “OPEC+” maintained a historically high compliance rate to self-imposed production targets while easing COVID-19 cases around the globe in September bolstered the demand outlook for refined petroleum products. Additionally, there was no progress on nuclear negotiations between the U.S. and Iran, and sanctions remained in place preventing Iran from selling oil on the global market. Meanwhile, gold posted a small loss in the third quarter as a firming dollar and rising interest rates helped offset still stubbornly elevated inflation metrics.

Commodity Indexes	Q3 Return	YTD
S&P GSCI (Broad-Based Commodities)	5.22%	38.27%
WTI Crude Oil	1.21%	55.18%
Gold Price	-0.39%	-7.73%

Source: YCharts/Koyfin.com/Marketwatch.com

Switching to fixed income markets, most bond classes were little changed in the third quarter. The majority of bond indices were solidly higher through mid-September as investors rotated to safety following the rise in COVID-19 cases in July and August. But in late September, the Federal Reserve confirmed tapering of Quantitative Easing will begin this year. That, combined with still-high inflation statistics, weighed on fixed income markets during the final few days of the third quarter which erased most of the quarter-to-date returns for many bond indices.

Looking deeper into the bond markets, longer-duration bonds and shorter duration bonds had very similar returns in the third quarter. For most of the quarter, longer-term bonds outperformed shorter-term bonds on the growing expectation that the Fed would begin to taper QE late in 2021, and that interest rates would start to rise in late 2022. But the late-September rise in global bond yields resulted in a moderate drop in longer-dated bonds, which erased the earlier outperformance over short-duration bonds.

In the corporate debt markets, higher-yielding, lower-quality bonds outperformed investment-grade bonds thanks to a late September drop in investment-grade following the rise in global bond yields, as investors rotated out of lower-yielding, yet higher-credit quality corporate debt as global yields rose.

US Bond Indexes	Q3 Return	YTD
BBgBarc US Agg Bond	0.05%	-1.55%
BBgBarc US T-Bill 1-3 Mon	0.01%	0.03%
ICE US T-Bond 7-10 Year	-0.21%	3.50%
BBgBarc US MBS (Mortgage-backed)	0.10%	-0.67%
BBgBarc Municipal	-0.27%	0.79%
BBgBarc US Corporate Invest Grade	0.00%	-1.27%
BBgBarc US Corporate High Yield	0.89%	4.53%

Source: YCharts

Fourth Quarter Market Outlook

Market performance in the third quarter reflected continued improvement in the macroeconomic outlook as a society, the economy, and risk assets showed resilience in the face of another wave of COVID-19, while corporate earnings were better than expected. However, that resilient performance should not be taken as a signal that risks no longer remain. In fact, the next three months will bring important clarity on several unknowns including future Federal Reserve policy, taxes, the pandemic, inflation and interest rates.

The Federal Reserve has communicated that it will begin to taper Quantitative Easing in the fourth quarter, but markets do not yet know when exactly the Fed will start to scale back those asset purchases or the pace at which they will be reduced. If the Fed starts to taper QE sooner than expected, or the pace of reductions is faster than the market has currently priced in, it will cause additional volatility.

Meanwhile, in the third quarter investors were reminded that politics can be a powerful influence on markets, and over the next several weeks we will learn whether the debt ceiling is extended and if there will be any significant tax increases. If policies from Washington are viewed as negative for corporate earnings or consumer spending by passing large tax increases, there may be a rise in market volatility. If the debt ceiling is not raised in a timely manner there may be significate market volatility.

Regarding the still ongoing pandemic, COVID-19 remains a risk for the economy and the markets. Positively, effective vaccines have allowed policymakers to avoid re-implementing economic lockdowns that could hurt corporate earnings and the economy. But the risk remains that a new

COVID-19 variant renders the vaccines less effective and that would put the economic recovery in jeopardy.

Finally, inflation remains elevated and at multi-decade highs, and that combined with continued supply chain disruptions is starting to impact corporate margins and profitability. If an increasing number of companies warn about future profitability due to these factors during the upcoming third-quarter earnings season, it will negatively impact markets.

Yet while risks remain, as they always do, macroeconomic fundamentals are still decidedly positive and it is important to remember that a well-executed and diversified, long-term financial plan can overcome bouts of even intense volatility such as we've seen over the last two years.

At Zick Whitted Taub Investment Strategies, we understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this still-challenging investment environment. Successful investing is a marathon, not a sprint, and even temporary bouts of volatility like we experienced during the height of the pandemic are unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it's critical for you to stay invested, remain patient, and stick to the plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

The economic and medical progress achieved so far in 2021 notwithstanding, we remain vigilant towards risks to portfolios and the economy, and we thank you for your ongoing confidence and trust. We wish you and your family good health and happiness. Rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

Allen

Allen Zick, CFP®	Brad Whitted, CPFA	Alex Taub, CRPC®
Financial Advisor	Financial Advisor	Financial Advisor

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The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. The Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stock of companies maintained and reviewed by the editors of the Wall Street Journal. The NASDAQ-100 (^NDX) is a stock market index made up of 103 equity securities issued by 100 of the largest non-financial companies listed on the NASDAQ. It is a modified capitalization-weighted index. ... It is based on exchange, and it is not an index of U.S.-based companies. The S&P MidCap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, measures the performance of mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index. The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

The MSCI EAFE (Europe, Australasia, and Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the United States & Canada. The EAFE consists of the country indices of 22 developed nations. The MSCI Emerging Markets is designed to measure equity market performance in 25 emerging market indices. The index's three largest industries are materials, energy, and banks. The MSCI ACWI (All Country World Index) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of June 2007 the MSCI ACWI consisted of 48 country indices comprising 23 developed and 25 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indices included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. S&P GSCI Gold is an index tracking changes in the spot price for gold bullion. S&P GSCI Crude Oil is an index tracking changes in the spot price for crude oil.