Third Quarter 2021

Fig. 1 – S&P 500

Fig. 2 – U.S. 10-Year Treasury Yield

Market Recap

Market volatility returned for the quarter with equity market performance starting strong in July and August but turning negative in September. Performance in the third quarter was slightly positive with the large cap S&P 500 index +0.6% (**Figure 1**) and still solidly positive year-to-date (+15.9%). Growth stocks (+1.3%) outperformed value stocks (-0.9%) for the quarter and financials (+2.7%) led all sectors. Mid cap and small cap US stocks both came in negative for the quarter with the S&P Mid Cap 400 index down 1.9% and the Russell 2000 Small Cap index down 4.4%. International markets also produced negative returns for the quarter with foreign developed markets -0.4% and the emerging markets -8.0%. Notably, emerging markets were challenged by continued uncertainty stemming from Chinese government intervention.

Underlying company fundamentals continue to look strong. S&P 500 earnings grew 95.0% in the second quarter and are expected to increase 26.1% for the third quarter. Aggregate earnings for the S&P 500 came in at $473.4 billion topping Q1 for another all-time high. Most sectors are expected to see improved earnings relative to the third quarter last year with the finance and technology sectors expected to see the highest percentage increases. Auto sector earnings are forecast to decline due to Covid-related supply chain issues.

Economic Perspective

Second quarter gross domestic product increased at an annual rate of 6.7%, building on the first quarter's 6.4% rate. The economies in all 50 states grew. Services, including hospitality, food, information and technical, were among the leading contributors. Retail sales fell, as consumers shifted spending from goods to experiences. This trend appeared to slow in the third quarter, when concerns about the Covid-19 delta variant led to travel cancellations. However, purchasing manager surveys for both manufacturing and services remained strong, signaling continued growth. Supply chain problems in many industries have led to intermittent shortages in some products and persistent inflation.

The delta variant has disrupted, but not derailed economic growth. As cases rose in the U.S. and abroad in late July and August, economic activity, especially travel, moderated somewhat. In some countries, such as Vietnam, factories closed temporarily, adding to supply chain woes. Hospitals in some states have struggled with increased patient loads from new Covid cases, mostly among the unvaccinated. The vaccination rollout has continued, steadily, and may be blunting the impact of the delta variant. As of October 3rd, about 78% of U.S. adults have had at least one shot, and 67% are fully vaccinated. About 700,000 people are receiving shots every day, and the vaccines are expected to soon be approved for children 5 and older. New cases have dropped 42% in the U.S. since the end of August and 24% worldwide, and reports suggest that factories overseas are reopening.

Employers added to payrolls in July and August, although August's result of 235,000 jobs added was well below consensus and may have hinted at weakness for September. Initial unemployment claims rose slightly in the past 3 weeks, as some industries struggled with the delta variant. The unemployment rate continued to decline, reaching 5.2% in August. At the same time, many jobs are still looking for workers. The Job Openings and Labor Turnover Survey (JOLTS) reached 10.9

Index returns taken from Morningstar.com

million openings in July, another all-time high. Labor shortages are increasing costs in many industries, squeezing company profit margins and adding to inflation pressures.

Interest rates started to rise again in August. Although Covid cases were rising in some states, case growth appeared to slow, raising hopes of economy strengthening. In addition, inflation was more persistent in the quarter than expected, leading bond buyers to demand higher yields. Oil prices in particular have risen, driven by limited supply (**see Figure 3 – Brent Crude**). These factors have led investors to expect the Federal Reserve to begin tightening monetary policy soon. The Fed in turn has hinted that they may begin to reduce their bond purchases, which have helped keep interest rates near record lows. This dreaded tapering has weighed on investor sentiment, contributing to declines in growth stocks including technology.

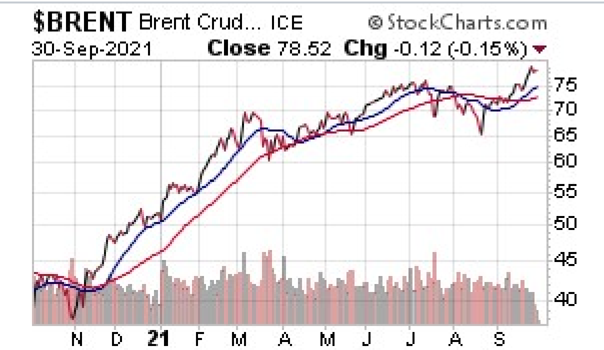

Fig. 3 – Brent Crude Oil Futures

Fig. 4 – Energy Select SPDR Sector Fund

Looking Ahead
The declines of the last month have some investors on edge. It's reasonable to wonder (or worry) how much stocks may fall. Interest rate increases and inflation tend to reduce asset prices, including both stocks and bonds. If the Fed reduces and eventually eliminates bond purchases, and someday raises interest rates, there will be some pressure on stocks, especially the growth leaders of the past decade. Investors may find opportunity in traditional value stocks such as financials and energy (**see Figure 4 – Energy Sector**), which tend to perform better when interest rates are rising. However, we caution against major shifts in portfolios. Timing interest rate changes is notoriously difficult, as is timing the market.

On an exciting note, we are happy to announce that we have signed a lease for our new office space at 360 N. Main Street in Royal Oak. The space is in the process of being prepared for us, and we are hopeful that we will be able to move in by the end of the year. Of course, this is subject to change due to delays in the construction process. We will certainly keep you updated.

We hope that you are well and look forward to speaking with you soon.

Best regards,

Kenneth M. Bernard, CFA