October 2021 – A Market Seeking Answers

"When an investor focuses on short-term investments, he or she is observing the variability of the portfolio, not the returns – in short, being fooled by randomness."
- Nassim Taleb

Performance

After an impressive first half of the year, the S&P 500 had an incremental 0.58% gain during the third quarter. The market's performance for the year now stands at +15.92%. Of the sectors, Financials (+2.74%) and Utilities (+1.78%) led while Materials (-3.51%) and Industrials (-4.23%) were negative. For the year, Energy (+43.22%) and Financials (+29.14%) stood out while Staples (+4.69%) and Utilities (+4.2%) lagged.

Doom and Gloom

Avid business news viewers may have noticed that predicting disaster is something of a pastime among many market commentators. With a recent spike in volatility, investors are wondering what is causing the market's choppiness. Historically, September and October are the most volatile months. In fact, the volatility index (VIX), which is a gauge of stock option prices, spiked midmonth from 16 to 29 and then settled back down to 22. With the economy recovering and growing from the pandemic lows, what is now stressing the market? Markets do not like uncertainty, and we believe the following unanswered questions have been stoking volatility:

1) ***What are the implications for inflation and monetary policy***? We believe that before the end of the current year, the Fed will initiate a tapering of its bond buying program which began at the start of the pandemic in March 2020. The bigger challenge for central banks is determining the right amount to taper. Markets have benefitted from very large monetary stimulus since the beginning of the pandemic. During this time, the Fed grew its balance sheet to almost $8 trillion.

   Based on the statements coming out of the Federal Reserve (FED), any increase in short-term interest rates will most likely come in the latter part of 2022. However, this will depend on how inflation fares, or more importantly flares, as many of you might have noticed when shopping for groceries or a car. Investors are uncertain about what is going to happen with inflation and what actions the Fed will be taking in the future.

   In August, inflation hit 5.4%, the highest level in 13 years and surpassed the Fed's target of 2%. This has raised concerns among investors that the Fed may have to step in to fight inflation aggressively and in doing so back off from its highly accommodative stance. Currently, the bond market seems to agree with the Fed that the current inflation will be transitory in nature.

2) ***When will supply chain bottlenecks be resolved***? Since the introduction of vaccines, economic demand has roared back, but supply chains have not kept up. Rising shipping and freight costs have added significantly to inflation pressures. The shipping industry is reporting that costs increased six-fold to ship a container from Asia to western US ports. The bottleneck has also spilled over to the semiconductor industry which is reporting serious shortages, which affects everything from your phones and computers to cars and even home appliances. While eventually the supply chain issues will be resolved as the supply and demand equilibrium returns, the easing of these shortages is difficult to predict.

In addition, President Biden should soon be re-appointing Fed Chairman, Jay Powell, or appointing someone else. If he chooses to not re-appoint him and appoint someone else, there could be an adverse reaction from the markets.

3) ***When will labor markets normalize?*** Labor is a critical component of any economy and its impact on inflation. According to the Bureau of Labor Statistics (BLS), wages account for 50% to 55% of the cost of goods sold. Its impact is more widely felt in service industries such as hospitality, airlines and restaurants. According to BLS, as of July there were 10.9 million unfilled positions versus 8.3 million unemployed workers. This gap indicates inefficiencies wherein the labor market is taking longer to match individuals to jobs than in the past. Other factors such as childcare costs, health fears, extraordinary unemployment benefits (which ended in September) and early retirement among workers 55-64 have contributed to worker shortages, resulting in higher wages and inflation.

4) ***What level of fiscal stimulus will Congress pass?*** Currently there are two pieces of legislation – a $3.5 trillion budget reconciliation bill which has less support in its current form and the $1.5 trillion bipartisan infrastructure package. It is unlikely that the bipartisan infrastructure bill will change, but Democrats are toying with the idea of reducing the reconciliation bill and making changes amenable to both sides of the aisle. It is uncertain what the outcome would be for the reconciliation bill. Another uncertainty that has cropped up is the raising of the debt ceiling. At this time an agreement was reached to extend the debt ceiling until December. The debt ceiling has been raised approximately 80 times in the last 40 years and has the potential to create havoc if a long-term solution is not reached.

5) ***How much longer will the U.S. be allowed to increase spending and not have a plan for fiscal responsibility?*** In the past decade our governmental outflows have greatly exceeded our inflows causing material deficits. As noted above the Senate has passed the Infrastructure Bill and the Administration is trying to use a reconciliation process which significantly increases spending and raises taxes. Higher taxes should decrease earnings and affect savings rates. Neither of which is good for the stock market.

There are reasons to stay positive despite the concerns listed and the market being historically pricey. Currently we have a recovering economy because of pent up demand and low interest rates. The economy has undergone a sea change with the “digitalization of everything”, and the pandemic has accelerated that process. If we adhere to the long-term plan the issues listed above could be transitory. We can then focus on investment opportunities. It is time to remain vigilant while not panicking. We are not dismissive of these concerns; the road ahead is murky in the short-term, but trying to time markets and interest rates is futile. Therefore, having a diversified portfolio across various investment classes usually proves to be a wise choice.

As always, please let us know if you have any questions, comments, or suggestions. We are thankful for your support.