Third Quarter Market Review and Comment
October 2021

Updated Market Performance

Returns	3rd Quarter 2021	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**0.58**	**30.00%**	**15.99%**	**16.90%**	**16.63%**
DJIA	**-1.46%**	**24.15%**	**11.00%**	**15.68%**	**14.72%**

Performance: July added gains right where June left off posting a return of 2.38 %. We continued to add gains in August returning 3.04%. After setting an all-time high in early September (4,536.95 September 2, 2021). September decided to live up to its tradition (averaging a decline of 0.99% with it being negative for the month 53.8% of the time). The month ended down -4.65% ending the quarter with a total return of 0.58%.

After the 2nd quarter posted a gain of 8.55%, the 3rd quarter squeaked out a positive return rising 0.58%. The Dow Jones Industrial Average (DJIA) underperformed the SP500, posting -1.46% loss over the same period. For the previous twelve months the SP500 has returned 30.00%, handily outpacing the DJIA which returned 24.15% over the same period. The annualized three-year returns are well above average (around 10%) with the SP500 one-year returns posting 15.99% and the DJIA one-year returns increasing 11.00%. Over the last five years the annualized returns are running well above historical norms (around 10%), with the SP500 returning 16.90% and the DJIA posting 15.68%. The ten-year annualized numbers are also running above long-term averages (around 10.00%); the S&P500 posted 16.63% versus the DJIA which turned in 14.72%.

Breaking down the returns for the Q3 2021, we note that there were six outperforming sectors and five underperformers. **The best sectors were Financials (2.29%), Communication Services (1.40%) and Information Technology (1.13%)**. **The underperformers during the quarter were Industrials (-4.55%), Materials (-3.94%) and Energy (-2.82%).** The best sectors over the last twelve months were Energy (74.02%), Financials (56.04%) and Communication Services (37.12%). Following behind, were Utilities (7.53%), Consumer Staples (8.41%) and Consumer Discretionary (18.38%).

Economy: Growth in the economy has started to decelerate. We are seeing signs of inflation but currently they look to be transitory. If they are not, then the Fed will need to tighten monetary policy sooner than anticipated to prevent runaway inflation. Once the economy is fully operational, spending slows, and the fed begins to tighten monetary policy, the economy will go back to below average growth (Historical growth is ~3.00%). We do not currently see recession risks on the horizon. Normally when the federal reserve begins to tighten monetary policy and raise short term rates, they usually end up thwarting growth and causing the economy to go into recession. Currently, it looks like the Fed does not have plans to raise short term rates for the foreseeable future.

The advanced estimate of 3rd quarter Gross Domestic Product (GDP) is 2.0% according to the report released at the end of October by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 3rd quarter decreased 4.7% from the 2nd quarter 2021 third estimate of 6.7%. GDP for 2020 came in at -3.5% compared to 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently the Atlanta Fed GDPNow estimate (Forecast of U.S. GDP Growth) has forecasted 2021 Q4 GDP growth at 6.6%. By comparison, China says

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their GDP increased at 4.9% in the 3rd quarter of 2021. Decreasing from 2nd quarter 2021 increase of 7.9%. China's 2020 GDP was 2.3%, 6.1% in 2019, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were 13.80% and 2.2% respectively in the 2nd quarter 2021. For 2020, GDP fell -6.1% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 3rd QTR 2021 are 3.60% for the EU and 3.7% for the Euro Area.

Unemployment is continuing to trend down and is now below historical norms (~5.77%). According to the Bureau of Labor Statistics, September unemployment decreased to 4.8% from 5.2% in August. Unemployment for 2020 came in at 8.11% and was 3.67% in 2019. The number of unemployed fell by 710,000 in September to 7.7 million. Although both measures are much lower than their April 2020 highs, they remain above their pre-pandemic levels in February 2020 of 3.5% and 5.7 million, respectively. The labor force participation rate was 61.6% in September; little changed from August and 1.7% lower than in February 2020.

Inflation increased 5.40% in September continuing its above average trend. After averaging 4.87% in the 2nd quarter 2021, inflation as measured by the Consumer Price Index (CPI) increased to an average of 5.37% for the 3rd quarter 2021. The average rate of inflation for 2020 was 1.23% and was subdued by historical standards (~2.31% over last 30 years). The energy index rose 24.8% over the last 12 months, and the food index increased 4.6%.

Consumption is an important driver of the economy as it represented 69% of 3rd quarter 2021 nominal GDP. The U.S. Census Bureau announced in October that retail sales for September 2021 were up 0.7% from August and were up 13.9% above September 2020. Gasoline stations were up 38.2% from September 2020, while the food and beverage industry was up 29.5%.

Manufacturing economy grew in October. Economic activity in the **manufacturing sector** expanded for the month of October, with the overall economy notched its 17th consecutive month of growth. The Purchasing Managers Index (PMI®) registered 60.8; a decrease of 0.3 from September's reading of 61.1. The Manufacturing PMI® continued to indicate strong sector expansion and U.S. economic growth in October. All five subindices that directly factor into the Manufacturing PMI® were in growth territory. The six biggest manufacturing industries expanded, in the following order: Food, Beverage, and Tobacco Products, Computer & Electronic Products, Chemical Products, Fabricated Metal Products, Petroleum & Coal Products, and Transportation Equipment. The New Orders and Production indexes remained at strong levels. The Supplier Deliveries Index continued to reflect suppliers' difficulties in maintaining delivery rates, due to persistent direct-labor and transportation challenges. Nine of the 10 subindices were positive for the period; a reading of 'too low' for the Customers' Inventories Index is considered a positive for future production. A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. The overall economy grew for the 17th consecutive month, according to the nation's supply executives in the latest Manufacturing ISM® *Report on Business*®. Based on historical relationships between PMI and GDP, a PMI of 60.8 corresponds to a 5.0% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices remained high in August. According to the S&P Case-Shiller Home Price Indices home prices remained the same in August with the S&P CoreLogic Case-Shiller National Home Price Index rising 19.8% over the last 12 months. Phoenix, San Diego, and Tampa had the largest year over year increases with 33.3% for Phoenix followed by 26.2% for San Diego and 25.9% for Tampa. According to the National Association of Realtors, the year over year change in existing home sales was 3.0% in September for Single family homes between $250,000-$500,000 and housing supply continued to remain tight in September with 2.4 months of supply.

Markets: The markets are hitting all-time highs. At this time, the market is being driven by the hope of more fiscal spending, dovish monetary policy, inflation, interest rates, and some actual fundamentals.

Covid-19 Virus: The market reacted fast and furious as it priced in a worst-case scenario. We have since rebounded and hit another all-time high on August 27, 2021 on the SP500 (We hit another one October 29, 2021 4,605.38). The SP500 posted 33 new closing highs in 2020. As we continue to work to get on the other side of the virus and the economy returns to normal capacity, equity markets should benefit from ultra-low interest rates and the tail wind of all the economic stimulus we have and will receive. The old acronym TINA (There is no alternative) will come back to fashion.

- **Earnings growth for the SP500 is expected to increase 33.6% for the 3^{rd} quarter 2021. If the actual increase for the quarter is 33.6%, it will mark the third highest year-over-year earnings growth rate reported by the index since 2010.** According to FACTSET, of the SP500 companies that have reported earnings as of October 29^{th} (approximately 283), 82% reported earnings above the mean estimate, and 75% have reported sales above the mean estimate. Looking at future quarters, analysts project double-digit earnings growth for the 4^{th} qtr. and the full year of 2021.
- **While valuations remain stretched, we believe we can sustain these levels with the economic recovery, easy money policy, and improving corporate profitability.** ***Earnings growth will be above average for the next couple quarters due to higher earnings and from weaker earnings in 2020 due to the negative impact of COVID-19 on numerous industries (the bar is set low).*** The current 12-month forward Price not see a lot of room for valuations to move higher without growth. Lower interest rates allow for higher multiples, so we could maintain these higher levels of P/E's until interest rates return to meaningful levels.
- **Short Term Interest Rates remain near zero, but they will soon start to taper their bond buying programs and might have to raise interest rates sooner than anticipated if inflation increases to fast.** The Federal Reserve dropped short term rates 1.50% in March of 2020 and launched multiple quantitative easing programs. Rates have since been left unchanged at a range between 0.0-.25%. The Fed continues to closely monitor developments and is prepared to adequately adjust plans. The Fed has said that it expects to keep its benchmark short-term interest rate near zero through at least late 2022 or early 2023. The 10-year treasury started the year yielding .93%, ended the 1^{st} quarter at 1.74%, ended the 2^{nd} quarter at 1.45% and ended the 4^{th} quarter at 1.56%.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by runaway inflation, the Fed beginning to tighten monetary policy, large tax increases on corporations, and the uncertainty presented by the Covid-19 virus variants. We think the SP500 will end the year between 4,500 and 4,700. At this juncture, we venture a guess that stocks will end somewhere between 22% and 24% for the year.

For the next six to twelve months, the Federal Funds rate should remain at its current range of 0%-0.25%. **The 10-year Treasury which is currently priced at ~1.55% should remain in a range between 1.40%-1.60% through the end of the 4^{th} quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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