Independence Asset Advisors

MarketMatters

INDEPENDENCE ASSET ADVISORS'S QUARTERLY GLOBAL MARKET JOURNAL SEPTEMBER 30, 2021

Quarterly Market Overview & Key Themes

- New COVID-19 cases skyrocketed from a daily average of 12,000 to more than 150,000.
- The Fed turned hawkish, suggesting a reduction in bond buying and a 2022 rate hike.
- Inflation remained elevated amid surging consumer demand and supply shortages.
- The U.S. recovered 17.0 million of the 22.4 million jobs lost between February/April 2020.
- Real GDP recovered to the output levels from the fourth quarter of 2019 (pre-pandemic).
- Global equities declined 1.1% over the quarter, including September when the index fell 4.1%.
- Equity valuations improved modestly, but most equity categories remained expensive.
- Fixed income yields remained very low, with spreads at the bottom of their 15-year ranges.

Monthly Snapshot
September 2021

September has historically proven to be the weakest month for global equity returns and this September was no exception.

During the month, the broad U.S. equity market declined 4.5%; its worst result since March 2020. Foreign equities fared marginally better, declining a combined 3.2%.

While returns were broadly negative, no individual global equity market experienced a correction, represented by a 10% decline from a peak. For some perspective, the S&P 500 Index has produced an overall average annual return of 10.4% over the past 42 years, with the largest annual intra-year declines averaging 14.1%.

As global equity markets took a break after rallying 46% between April 2020 and August 2021, valuations improved to a more reasonable 18.5[1], which was 2.7 below the 10-year high, but still 7.6 above the low.

Growth stocks, which had largely driven the rally, remained extremely expensive relative to value stocks, at 28.6 versus 15.8, respectively.

In fixed income markets, yields remained very low, with spreads-to-worst across the primary sectors at or close to their 15-year lows. U.S. corporate high yield bond spreads, for example, were at 332 basis points, compared to the 502 basis point 15-year median and the 2,200 basis point high. U.S. municipals, investment grade corporates, mortgage backed securities and asset backed securities sectors were all reflecting spreads at the bottom of their 15-year ranges at the end of September.

In terms of pricing, all sectors, aside from floating rate loans, traded at a steep premium to par through month-end.

COVID-19

The domestic rate of new confirmed cases plummeted in the spring as the U.S. rolled out its vaccination program. The daily average of new cases dropped as low as 12,000 in late June, but skyrocketed to more than 150,000 by the end of September, as Americans enjoyed a broad relaxation of social distancing guidelines at the same time the Delta variant took hold. Fortunately, the rate of confirmed new cases and fatalities appears to have peaked, with 85% of citizens estimated to have at least some immunity.

Rates

The Fed turned slightly hawkish at its September meeting, acknowledging that the Delta variant had slowed economic progress, but that the labor market recovery had been robust and inflation could remain elevated throughout the remainder of this economic expansion. As such, the Fed downwardly adjusted its economic projection for 2021 from 7% to 5.9%, and increased its inflation projection. The Committee closed the meeting by signaling that the tapering of bond purchases could "soon be warranted" and that interest rates could begin to rise by the end of 2022, with three additional rate hikes in both 2023 and 2024.

Unemployment & Wages

The U.S. labor market had recovered 77% of the jobs lost as a result of the pandemic by the end of the third quarter. However, the recovery remained incomplete with the unemployment rate at 5.2%, compared to 3.5% prior to the pandemic. Meanwhile, wage growth continued to increase, reaching an annualized rate not seen since the 1980s by quarter-end. With wages up, the labor market slack appeared to be a result of labor supply, which remained sluggish due to enhanced unemployment benefits, higher child care costs and continued pandemic fears.

Inflation

Inflation remained elevated throughout the quarter, as pent-up consumer demand for goods once again collided with supply shortages, sending prices ever higher. The year-over-year CPI gain was 5.2%, or 4.0% excluding food and energy. The PCE deflator, the Fed's preferred measure of inflation, was up more than 4%, well above the long-term target of 2%.

Earnings

S&P 500 operating earnings declined amid the deep economic recession, but had more than recovered through quarter-end, and are expected to hit a new all-time high in 2021.

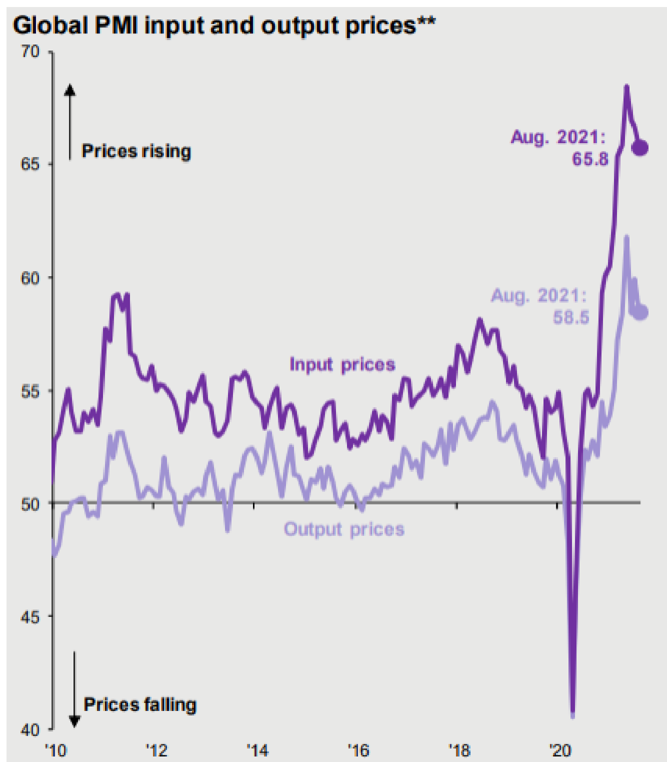
[1] NTM P/E is the market price per share divided by expected earnings per share of the next 12 months.

Sources: JP Morgan, Eaton Vance, federalreserve.gov

We use each issue of *MarketMatters* to explore in greater detail a specific topic that captured the interest of the investing community during the previous quarter. In this issue, we discuss the global supply chain - how it has been impacted as a result of the pandemic and how the issues may be resolved in the future.

A supply chain can be defined simply as the entire process of making and selling a commercial good, including the sourcing and supply of materials, the manufacturing process, as well as the distribution and sale. Before the pandemic disrupted the global supply of goods, the supply chain was operating efficiently, and companies had fully adjusted to the "Amazon Effect," which saw orders processed instantaneously and deliveries completed as quickly as same day. With the global economy operating at full employment, online retailers and their procurement staff were able to fulfil more blanket orders at a faster rate, and orders from foreign countries, like China, were able to deliver on smaller orders with rapid turnaround times.

As the COVID-19 pandemic unfurled, the demand for foreign goods surged in the West amid work-from-home trends and increased home improvement spending. With orders surging and unemployment rising, the decline in workers required to maintain and operate supply chains resulted in slower delivery times, which contributed to a rapid rise in prices. As the cost of goods increased, so did concerns that higher inflation would result in the Fed's abandonment of accommodative monetary policy. This rattled markets and sent global equity indexes lower for the first time since March 2020.



Source: 2021 Q3 JP Morgan *Guide to the Markets*

By the end of the third quarter, there were still not enough workers to smooth out labor issues, delivery times remained slow and prices remained high. The good news was that many of the places where goods are produced (including semiconductors, a particularly critical component to the supply chain) had begun to see COVID-19 infections and death rates decline.

As the pandemic begins to ebb and workforces rebound, it is more likely that the supply chain disruptions will abate and prices will come down. Most analysts agree that the recovery in the global supply chain will align with the continuation of the synchronized global economic recovery.

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Key Insights:

- COVID-19 will remain the critical factor in the speed and strength of the global economic expansion.
- The travel and entertainment industries could benefit the most from increased vaccinations or natural immunity.
- Global supply chain disruptions are expected to gradually fade as vaccinations increase and workflow resumes.
- Inflation is expected to subside, although here in the U.S. it is expected to remain above 2% for some time.
- Interest rates are not expected to increase in 2021, but we could see a liftoff by the end of 2022.
- More likely, the Fed will begin to taper its bond buying program, thereby pushing less cash into the economy.
- The labor market is expected to strengthen further as wage growth compensates for unemployment benefits.
- Global equities are expensive, but the outlook is positive, supported by record high earnings growth forecasts.
- Fixed income yields are expected to remain low, and any rise in interest rates could result in negative total returns.

"*While the pandemic isn't over yet, many parts of the economy have adapted to operate in a pandemic environment. We hope the pandemic will fade as we move into 2022 but, whether it does or not, it should have much less of an impact on the economy than it has over the last two years*." – Dr. David Kelly, JP Morgan

COVID-19

There is no more important factor when considering the outlook for the global economy than COVID-19. The pace and scope of vaccinations will directly contribute to improvements in the labor market, which should diffuse supply chain disruptions and normalize the transitorily high inflation rate. Recent data suggests the spread of COVID-19 decelerated meaningfully last month, which is a positive development after the late-summer surge.

Rates

The Fed is not expected to raise interest rates in 2021, nor is it expected to taper its accommodative bond purchasing program in the very near term. By continuing to make borrowing easy and pump cash into the system, the Fed is giving the U.S. economy the strongest chance to reaccelerate through the rest of the year and into 2022.

Looking ahead, the American economy is expected to continue its rebound from the pandemic recession, supported by ample stimulus, plus strong equity market gains and home prices, and consumers eager to spend.

Earnings & Valuations

The severity of the economic recession was expressed by the sharp decline in S&P 500 operating income in 2020. Since then, however, earnings have recovered to the point where guidance suggests they could hit a new all-time high in 2021. This has been accomplished, despite the stiff pandemic headwind, by the evolution of businesses that have been able to improve productivity, reduce costs and grow revenues in a more virtual environment.

However, as we look ahead, the positive earnings forecast is muted by an expected economic slowdown, wage growth, higher interest rates and likely some form of corporate tax hike. With earnings growth appearing constrained in the quarters ahead, valuations become more important.

U.S. stocks were trading at 21 times forward earnings at quarter-end, which was high compared to the long-term average. Looking ahead, valuations could become pressured by the aforementioned earnings growth hindrances, and perhaps a fairer consideration when evaluating equities going forward is to use profits.

Key Concern

Interest Rates

With yields for nearly every fixed income sector at or near historic lows, there will be very little protection against interest rate risk when the Fed eventually tightens.

While there is no expectation that the Fed will raise interest rates in 2021, there is a good chance it will in 2022, and it is important for investors to begin evaluating if a rotation out of higher duration bonds is appropriate.

To demonstrate the potential impact of higher interest rates at current spreads, we considered the 10-Year U.S. Treasury and Investment Grade Corporate Bonds. Should interest rates rise 1%, these fixed income sectors would suffer negative price returns of 8.9% and 8.7%, respectively, with total return reduced incrementally to 7.4% and 6.6% with the offset of current yields.

Duration is key to minimizing negative total returns. Investors looking for some shelter should consider lower duration strategies or introduce investments with minimal duration risk, including floating rate loans or convertible bonds.

Sources: IAA Proprietary

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Global Market Investment Returns — September 30, 2021

		Sept 2021	YTD	1-Year	3-Years	5-Years	10-Years
U.S. Large Cap Equities	S&P 500	-4.65%	15.92%	30.00%	15.99%	16.90%	16.63%
U.S. Small Cap Equities	Russell 2000	-2.95%	12.41%	47.68%	10.54%	13.45%	14.63%
Energy Infrastructure Equities	Alerian U.S. Midstream Energy	5.23%	44.15%	86.20%	1.14%	1.30%	-
U.S. Real Estate Equities	Dow Jones U.S. Select REIT	-5.52%	24.48%	40.56%	8.32%	5.68%	10.53%
Global Equities	MSCI All Country World Index	-4.13%	11.12%	27.44%	12.58%	13.20%	11.90%
International Developed Equities	MSCI EAFE	-2.90%	8.35%	25.73%	7.62%	8.81%	8.10%
Emerging Market Equities	MSCI Emerging Markets	-3.97%	-1.25%	18.20%	8.58%	9.23%	6.09%
U.S. Taxable Fixed Income	Bloomberg U.S. Aggregate	-0.87%	-1.55%	-0.90%	5.36%	2.94%	3.01%
U.S. Tax-Exempt Fixed Income	Bloomberg Municipal Aggregate	-0.72%	0.79%	2.63%	5.06%	3.26%	3.87%
High Yield Fixed Income	Bloomberg U.S. Corporate High Yield	-0.01%	4.53%	11.28%	6.91%	6.52%	7.42%
Floating Rate Loans	S&P/LSTA Leveraged Loan	0.64%	4.41%	8.39%	4.14%	4.58%	4.91%
International Fixed Income	Bloomberg Global Aggregate Ex-U.S.	-2.45%	-5.94%	-1.15%	3.17%	1.10%	0.90%

- September has historically served as the poorest month for global stock market returns, and September 2021 was no exception.
- Global equities declined 4.1%, led by U.S. equities that shed 4.7%; this was the worst monthly result since March 2020.
- Despite the negative returns, there was no meaningful step-up in volatility (U.S.), with the VIX Index average remaining well below the 20 volatility cap.
- Taking a look at the monthly equity dashboard, value stocks outperformed growth stocks by 2.5% in September, led by Energy that gained 14.8%.
    - Value stocks continued to offer more favorable relative pricing compared to growth stocks, with Forward P/Es at 16.0 and 28.9, respectively.
- Outside of the U.S., international developed and emerging markets equities held up relatively well, a result of increased small businesses reopening.
- Emerging Markets equities declined less than U.S. equities in September, but headwinds mounted during the month:
    - Increased demand for Chinese goods, coupled with an under-supportive infrastructure system, prompted broad energy usage restrictions.
    - Evergrande, a key Chinese real estate developer, missed two interest payments on U.S. dollar bonds, and carries $300 billion owed liabilities.
- Switching to bond markets, investment grade bond returns were negative, while yield spreads-to-worst remained at or near the 15-year lows.
- High yield bonds performed admirably considering the sector's 0.73 correlation to the S&P 500 Index; floating rate loans outperformed.
- International fixed income declined in September amid a 1.7% strengthening of the U.S. dollar.

Sources: eVestment Analytics, JP Morgan *Guide to the Markets*, Macrotrends, New York Times

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