POST OAK PRIVATE WEALTH ADVISORS

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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Quarterly Market & Economic Commentary

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Stocks entered the summer riding a wave of positive momentum; COVID-19 cases were largely improving in many parts of the country, businesses were re-opening and people were mobile, travelling and dining out and going shopping. Economic data supported the optimism among stock investors; 2nd Quarter GDP growth was strong and the employment markets were adding millions of jobs each month.

But the tide turned and became choppy as the 3rd Quarter progressed. Volatility reared its head in September as the S&P 500 Index suffered its worst monthly performance since the outbreak of the pandemic. Following its last all-time high on September 2nd, the benchmark stock index was down at least 5% at one point during the month, the biggest drop since March 2020. Things were worse for the Nasdaq Composite Index; after sliding 5.3% in September, the tech-heavy index declined in Q3. At least the S&P 500 managed a 0.6% total return for the three-month period, a gain but only just.

Volatility returned in September as the S&P 500 suffered its worst monthly performance since the outbreak of the pandemic.

There has always been a degree of seasonality in the stock market, and the September-October period is generally among the most volatile from a historical perspective. Still, concern is growing among investors about rising interest rates, the threat of inflation and legislative uncertainty. That means volatility is likely to persist for the near term.

The Fed shortens the horizon

At the end of Q2, markets were waiting on the Federal Reserve for signals on when they would begin to back away from the accommodative monetary policies (i.e., bond-buying programs and near-zero interest rates) that were put in place in March last year to ease the economic repercussions of the pandemic. Earlier this year, whispers of ending the Fed's massive asset purchase programs (or "tapering", as it's called in the financial world) created a "mini-tantrum" in the markets, pushing up rates on the benchmark 10-year U.S. Treasury note to 1.75% in March. But the central bank made it clear that increases in the Fed funds target rate weren't imminent. The earliest markets could expect a rate hike from the Fed was the end of 2022. So long-term interest rates slipped from their year-to-date peak, with the 10-year rate falling to 1.2% by August.

Central bank guidance shifted this past quarter following the Federal Open Market Committee's September meeting. In the post-meeting announcement, the Fed gave its most direct guidance to date on tapering asset purchases, which is now expected to start before the end of this year, mostly likely in November. That would mean the central bank would wrap up bond-buying intervention sometime in mid-2022. After that, the next step in reducing monetary policy accommodation would be rate hikes. That timeline keeps moving forward; now, many Fed officials think rate increases will come in late 2022, sooner than the end of next year as previously estimated.

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What's behind the shift in the Federal Reserve's stance on monetary policy? It's a mix of good news and bad news. On the positive side, sustained growth in the U.S. economy this year means less help from the Fed is needed to prop things up. Future growth in Gross Domestic Product (GDP) is expected to moderate from the rapid pace of the last two quarters, when GDP growth exceeded 6.0% annualized. As of September 12, the Atlanta Fed's GDPNow forecast estimates an annual growth rate of 3.7% for the 3rd Quarter. That's still considered a robust pace of growth, but almost half the rate the U.S. produced in the first two quarters of this year.

On the negative side is inflation. "Transitory" has been the word closely linked with inflation, ever since the Fed used it to explain their reasoning for not raising rates from rock-bottom levels. Inflation has been running hot since June, when the headline Consumer Price Index posted a 5.4% annual growth rate. Prices have cooled some since then, especially with the core CPI rate excluding food and energy prices; headline CPI was 5.3% year-over-year in August, while the core rate was reported at 4.0% from a year earlier. Over the summer, more investors seemed to buy into the Fed's idea of transitory inflation. Easing concerns over rising prices helped stoke the stock market rally, with the S&P 500 Index notching a gain of 5.5% through July and August.

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Will inflation turn "sticky"?

But the Fed's recent shift in thinking contributed to the change in mood among investors. Has the central bank altered its view on transitory inflation? Are higher prices sticking around longer than previously believed? That could help to explain the Fed's move to shorten the timeline on tapering and rate hikes. Supply chain constraints, shipping bottlenecks and labor shortages have persisted in Q3. Not that these problems would be resolved quickly, but they certainly haven't eased in recent months. There's a sense in the economy that rising prices will only get worse in the near term and not better, thanks in part to these lingering issues.

Some of the worst cases of inflation have let up this past quarter. Used cars prices, for example, fell 1.5% in the August CPI report. Lumber prices too have plummeted after peaking earlier in Spring. For markets that were hit hard by pandemic shutdowns such as travel and hospitality, price spikes from earlier in the year have eased considerably. Some of these declines reflect a return to normality as pandemic restrictions have eased, but other businesses experienced drops in demand as the Delta coronavirus virus dampened activity. Airfares, for one, fell more than 9% in August.

Producer prices are also on the rise, but for businesses input costs don't appear to be moderating. That could prove to be further bad news for consumers if higher production costs are passed down to retail buyers. The Producer Price Index (PPI) for August increased 8.3% on a year-over-year basis, the biggest jump in over 10 years. Higher costs for warehousing and transportation rose 2.8% during the month, contributing significantly to the increase in PPI. Many manufacturers are struggling to secure raw materials or components for production, which is affecting other producers downstream or retailers who are increasingly running on thin inventory levels.

The supply chain squeeze

Supply chain constraints could soon become a big problem for the economy as a whole and exacerbate inflation pressures. Recent news headlines about product shortages have focused on automakers and semiconductors, but material and component shortages are stretching into nearly all sectors, from construction equipment to medical supplies to bourbon distillers. Some of the

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shortages are due to scaled-back production at the outset of the pandemic and higher demand when the economy snapped back. Many producers, especially in Asian markets, are dealing with lockdowns and shortages of laborers as the Delta variant spreads in these countries. Vietnam is one recent example, as large-scale shutdowns throughout the country have halted production of apparel and footwear.

There's no root cause to the shortage problem. Rather, it's occurring all along the supply chain in ways that impact all businesses, from transportation bottlenecks to lack of available workers. Shipping has been a notable concern this year. In last quarter's report, I touched on the incredible jump in shipping container prices. Over the last three months, costs have exploded; the spot price to ship a 40-foot container from China to the U.S. west coast rose from almost $9,000 at the beginning of July to over $20,000 by mid-September. Some of this increase may be seasonal in advance of holiday shopping, but these rates are around five-times higher than they were last year, according to the Freightos Baltic Index. Soaring costs for ocean shipping are affecting all products shipped on water, which is practically everything in today's interconnected and interdependent world.

With ongoing shipping bottlenecks and, especially for imported goods, high container prices, it will be interesting to see what the upcoming holiday season will look like. Some sellers may have planned ahead for potential problems; imports of toys ballooned over the first seven months of the year, up 50% over the same period last year. At the Port of Los Angeles—the primary hub for American imports arriving from Asia—volume is up 30% year to date compared with 2020. Still, there are 60 container vessels sitting in the bay, waiting to offload in L.A.

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Those containers have to travel over the road as well, along with other goods. Trucking is proving to be another bottleneck for producers and retailers to contend with. A lack of drivers is a perennial issue that all trucking firms face, dating prior to COVID, but the pandemic has made the driver shortage worse. Pay is rising, as it is in many occupations, but turnover is high as it's traditionally been. Add rising fuel prices and it becomes clear to see how un-transitory inflation could become. Supply chain constraints are naturally inflationary. The fear is once prices begin to rise across the board, they're not likely to come down.

Labor shortages and rising wages are separate but critical concerns, especially when you consider that wage inflation doesn't tend to reverse. Over the summer, labor shortages remained persistent in many sectors of the economy, with a record number of unfilled job openings (10.9 million) reported at the end of July. It's not that the economy isn't creating jobs; June and July were the best months so far in 2021 for employment growth, with over 2 million jobs added to non-farm payrolls in both months combined. But August was disappointing with just 235,000 newly added jobs, the lowest number in seven months. On the brighter side, wages grew 4.3% during the month compared with the same month one year ago. Lower-income workers enjoyed the bulk of the recent wage gains. However, rising wages can be a double-edged sword when consumer inflation eats up more of workers' take-home pay.

Earnings power equities

Higher prices and supply chain constraints have given firms and investors plenty of reasons to fret, but fortunately these issues haven't showed up in corporate earnings. Q2 earnings growth for S&P 500 firms was really good, with 87% of companies exceeding analyst EPS estimates according to Factset. Current forecasts for Q3 earnings are following this positive trend, even as

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many CEOs and CFOs discuss the impacts that rising inflation and supply chain concerns have had on operations during analyst calls.

From a sector standpoint, earnings were strong across a number of industries. Firms in the financial and health care sectors by and large produced the largest positive earnings surprises for 2nd Quarter. These sectors outpaced the broad market in Q3 and were among the top performers, with utilities and communications also posting quarterly gains. Supply chain concerns took a toll on industrial and materials stocks, the worst performing sectors in the 3rd Quarter. Energy stocks were also lower in Q3, but had rallied in September as oil prices recovered after a summer stumble to close above $75 per barrel.

S&P 500 sector	Q3 2021 return	S&P 500 sector	Q3 2021 return
Financials	2.7%	Consumer Discretionary	0.0%
Utilities	1.8%	Consumer Staples	-0.3%
Communications	1.6%	Energy	-1.7%
Health Care	1.4%	Materials	-3.5%
Technology	1.3%	Industrials	-4.2%
Real Estate	0.9%		

Tax law toss-up

If all that wasn't enough to induce headaches for the market, investors were also confronted with the specter of tax increases, or at least the Democrats' proposal to roll back the tax cuts that were passed during the Trump administration. Raising the corporate tax rate to 26.5% from 21% would certainly impact company earnings. Individual tax rates for high earners would also go up, to as high as 39.6%. Most critical to investors are the proposed changes to capital gains taxes; long-term gains and dividends would be taxed at 25% instead of the current 20%. My fear about higher capital gains taxes is that it would induce lots of selling among stock investors and contribute to a significant drop in current equity index levels.

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But it's also important for individual investors to remember these proposed tax provisions are all up for grabs. The different elements of this tax increase proposal could change. The whole package may not even pass the House or the Senate. There may not be an appetite for higher taxes even among Democrats as the country continues to deal with COVID. Right now, all I see is plenty of discussion and plenty of concern. I have no sense of the likelihood of this tax proposal becoming law. It does bear watching, and we will remain vigilant in how any tax changes may impact our clients' portfolios.

Scaling the wall of worry

Even in relatively good times, investors seem to find some cause for anxiety. But as we head into the final quarter of 2021, markets may climb higher on the "wall of worry". The initial shock of the COVID-19 outbreak will recede further into the past, but many of the current concerns are likely to compound as we look forward. The tapering of Federal Reserve asset purchase programs means a large buyer will exit the market. The demand created by the Fed was artificial, even as it was important to sustaining financial markets at a critical time. Interest rates are likely to continue to rise as the end of monetary policy accommodation draws near. Economic growth won't look as strong as it did in recent quarters, when GDP numbers were measured against a depressed base.

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Markets will also have to contend with more uncertainty as we look for clues on the direction that inflation takes and signs of easing in supply chains and labor markets. Changes to tax policy has the potential to severely disrupt the stock market, but that outcome is too unknowable as of this writing to take any defensive action. One constant that may prove helpful in the tax debate to come is political partisanship; we know we can count on Washington D.C. to wrangle over nearly everything, and that by itself could stifle any tax law changes or at least water down the current provisions.

As worry builds, markets are likely to remain volatile in the short term, with the potential for more volatility as these unknowns become known. The persistence of volatility underscores the importance of having protection for your portfolio, no matter the market or economic climate. But taking a long-term view, the U.S. economy remains vibrant and strong. We believe well-run companies have the ability to prosper and succeed through this time of transition, and that markets will continue to offer opportunities for investors to seek returns that help them realize their financial goals.

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