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Q3 Market Commentary

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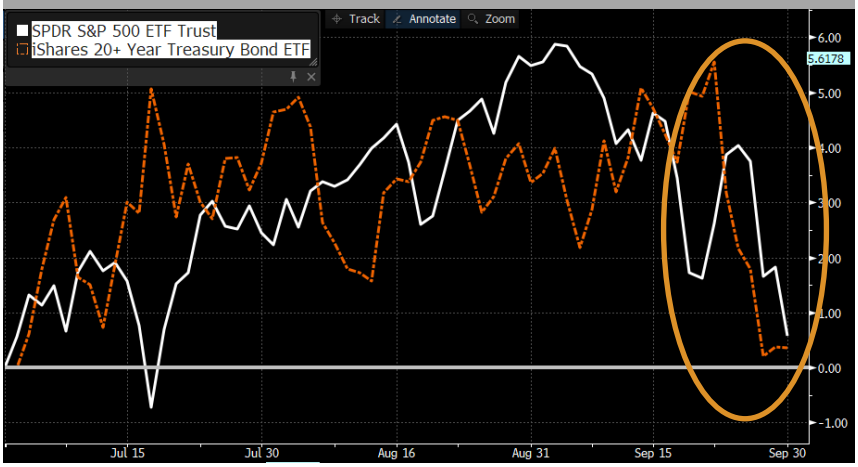
Q3 2021 — Fed Watch Drives Mixed Results

The third quarter began with bad news, as the new Delta variant spread quickly around the world, threatening a new round of lock-downs and the global growth recovery. Soon thereafter the Chinese economy, now comparable to the US in size and global importance, began to slow as authorities there attempted to deflate ongoing debt and real estate bubbles. Paradoxically, this bad news for growth was good news for markets as expectations the Fed would keep rates "lower-for-longer" created a surge in stock and bond prices through July and August, led especially by tech stocks. Meanwhile, throughout Q3 inflation continued to rise at the fastest pace in decades, as Covid induced supply chain disruptions proved persistent--even as global economies reopened.

By September, Delta variant concerns relaxed but market fears grew that inflation might compel the Fed to reconsider tightening policy again. This caused bonds to fall and triggered a modest decline in stocks and commodities, especially in tech stocks and precious metals. By quarter's end, the net result was that most asset classes ended the quarter largely flat or with minor losses, with precious metals and Chinese/emerging markets performing worst.

Looking forward, we see strong economic growth conditions continuing together with inflation pressures. We expect market action to continue to be driven by expectations about future Fed policy, and whether or not inflation will compel the Fed to accelerate its current policy tightening plans in order to combat it.

Stocks & Bonds Fell Together Over Fed Tightening Fears



Source: Bloomberg

Five Things You Should Know About Q3

1. Covid Delta Variant Triggers Growth Concerns

In July, global growth concerns resurfaced as the Covid Delta variant spread rapidly around the world, threatening the pace of the global economic recovery,

2. China Growth Slows

The Chinese economy demonstrably slowed in Q3, adding to global growth fears and causing emerging stocks to underperform.

3. Fed Tightening Fears Fade

As growth concerns related to the Delta variant and China set in, expectations for a Fed tightening/tapering subsided, prompting a surge in bond and stock prices, particularly tech stocks.

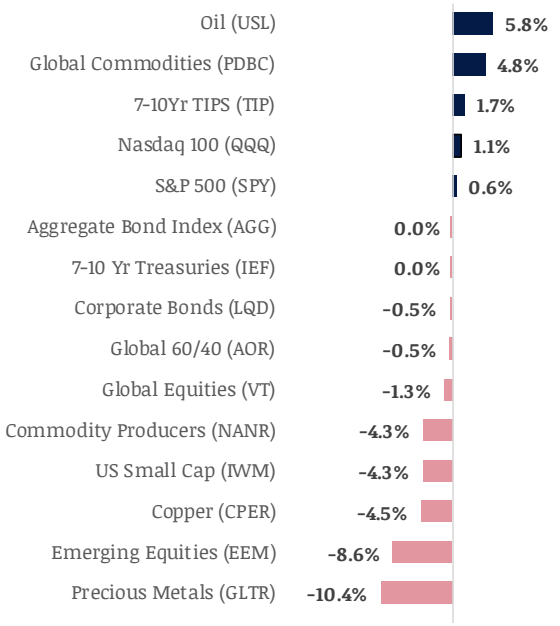
4. Inflation Continued to Climb

Inflation in the US continued rising throughout Q3, creating doubts that "temporary" Covid induced price spikes might normalize any time soon.

5. Delta Fears Fade and Fed Tightening Fears Resume

By September, Delta variant market fears largely subsided. This triggered renewed concerns about potential Fed tightening/tapering. In response, bonds fell along with equities (lead by tech stocks), reversing prior gains to end relatively flat.

Asset Class ETF Total Returns: Q3 2021



Market Outlook

Inflation & Liquidity Risk

Inflation pressures today are a combination of temporary and structural effects—separating and quantifying both is challenging. What does seem clear is that transitory pressures now appear sticky (perhaps into late 2022), creating an increasingly tricky environment for policy makers, with inflation likely to be well above stated Fed targets for longer.

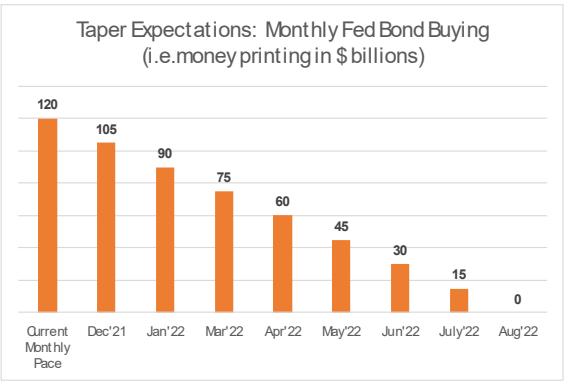
The longer inflation persists, no matter the cause, the more inflation expectations seep into the consciousness of consumers and workers. Corporations are becoming more willing to pass along price increases. While consumers may accept them they are also likely to demand higher wages to offset them (or not return to work until they get them). The combined effect is positive for demand but keeps a lid on supply growth, which can add sustainable upward pressure to prices. This is how inflation can spiral to become self-reinforcing and over time a much more difficult problem to solve.

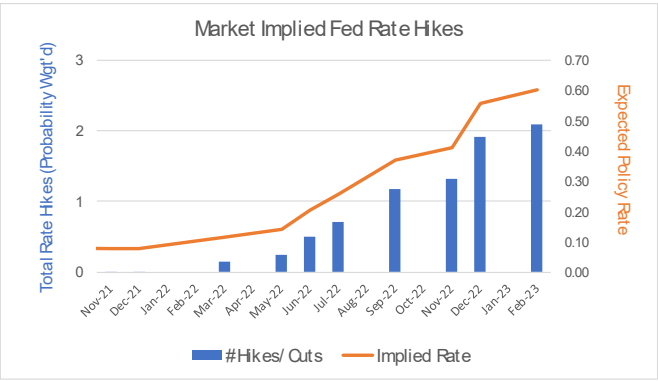
While central banks have plenty of ammunition to fight inflation via rate hikes, the political will in the current environment is weak. The path of least resistance from a policy perspective is to slow-roll any inflation fighting moves until absolutely necessary, since stomping out inflation also carries with it the risk of inadvertently snuffing out the economic recovery at a time when interest rates are already zero.

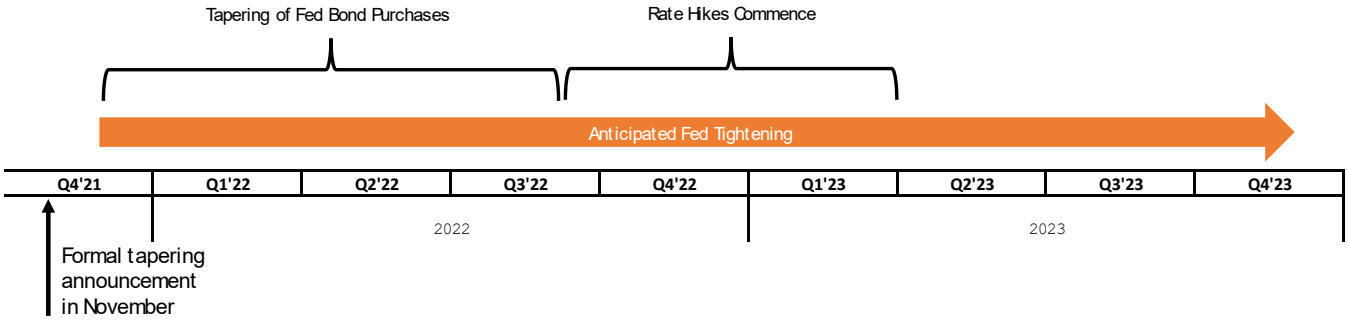
While any comparison of today's inflation pressures to the 1970s may seem like hyperbole, there are plenty of similarities. Then (as now) the big decision policy makers faced was the will to fight inflation in a period of weakening growth. In that era, it was an oil shock that sent inflation skyrocketing—while also causing the economy to slow sharply. By comparison, today we have the inflationary effects of Covid radiating from supply chain disruptions and labor shortages at a time when economic activity is in the process normalizing and still considered fragile. We wouldn't want to be Jay Powell.

To the extent inflation pressures are a result of supply chain disruptions, tightening policy (e.g. raising rates) would have a marginal impact on these prices. Meanwhile the trajectory of growth, which is strong right now, continues to increase the pressures on secular inflation. The dilemma for the Fed is how to slow growth enough to tamp down secular inflation, while waiting for transitory inflation pressures to burn themselves out. This is why the Fed has clearly signaled its

Expected Fed Monetary Tightening







Source: Bloomberg

intention to formally announce a tapering in its bond buying program (i.e. slowing the pace of money printing) at its November meeting.

The Risk of Tighter Monetary Policy

Tapering bond purchases usually means less liquidity and higher bond yields, since the Fed has been buying most of the Treasuries issued since Covid began. US stocks have benefited from a host of extraordinary government measures, but low bond yields and massive liquidity probably lead the list. Any tightening would convert these tailwinds into headwinds. We continue to see a liquidity-induced market correction as the greatest risk confronting all asset classes—especially US equities (led by tech stocks). US stocks (and particularly tech stocks) are probably the most liquidity and rate sensitive asset class in the world today. They have benefited the most from the flood of USDs that have been printed, as everyone from institutions to stay-at-home traders have piled into the US market. As we discussed in the prior section, Q3 market action was substantially driven by waning and waxing fears about the pace of Fed tightening. We expect more of the same in Q4 and beyond.

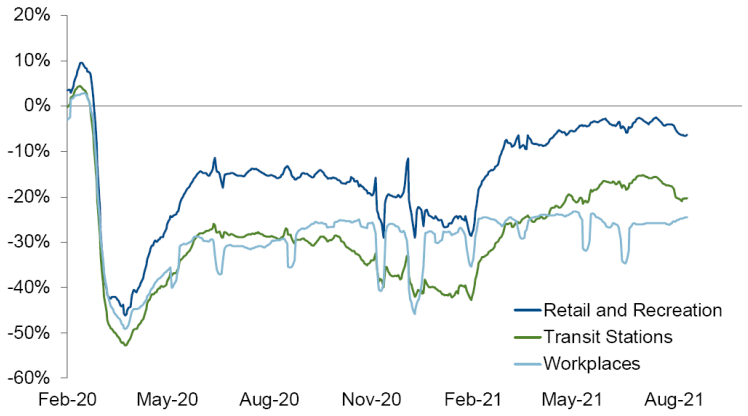
The liquidity situation is changing. The flood of money being pumped by the US and other central banks is now subsiding. While there is still a large liquidity pool from this prior flooding supporting markets, the effect is fading. *Putting it all together, the biggest market risk we see is that inflation pressures will continue to rise, potentially forcing an even faster withdrawal of liquidity conditions by the Fed.* While withdrawing liquidity would have a slow-moving impact on actual economic conditions, the response from markets will likely be fast and furious.

Our Positioning

We continue to believe purposeful diversification is the best way to deal with this collection of risks. Specifically, this means maintaining a mixed balance of inflation-seeking exposures (like commodities and inflation-linked bonds) to complement equities. Our second risk management response has been to modestly reduce overall portfolio risk during this period of uncertainty. While a liquidity-driven sell off could be frightening, we expect any serious market event to swiftly be met with fresh rounds of stimulus (as has been the Fed's playbook since 2009) creating a new slate of investment opportunities.

Economic Activity Has Not Yet Normalized

Google Mobility vs. January 2020 Median, 7 day moving avg

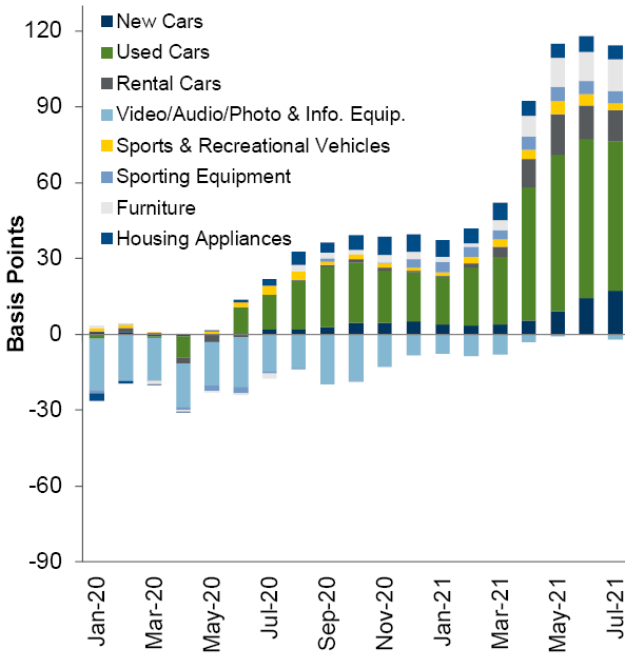


Source: Goldman Sachs, Google

Transitory Inflation Pressures

Contribution to Year-over-Year Core PCE Inflation

From Supply–Constrained Categories



Source: Goldman Sachs

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