CHANCELLOR
WEALTH MANAGEMENT®

QUARTER MARKET REVIEW

Q3 2021

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- Navigating the Latter Stages of the Pandemic
- Disruptions to Supply Chain and Labor Markets
- Inflation: Transitory or Sticky?
- Federal Reserve Policy Update
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- Equity Valuations and Outlook

S&P 500 CHART FOR 3RD QUARTER 2021

Source: Big Charts/Marketwatch as of 10/05/21

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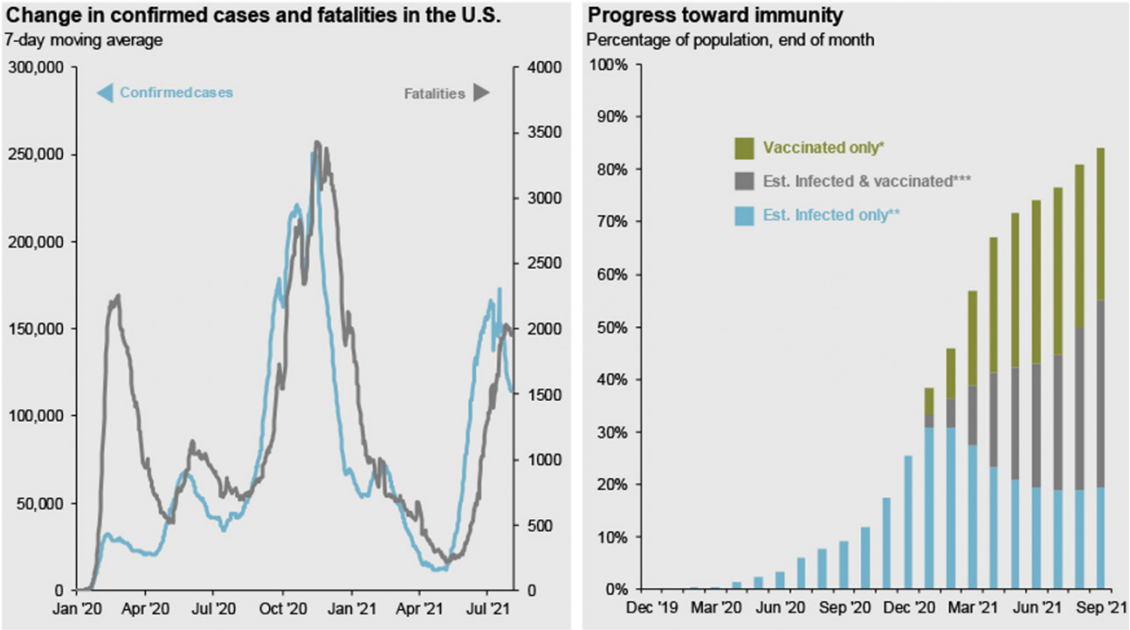
RECAP SUMMARY

The 3rd Quarter of 2021 saw a pause in the upward momentum in equity prices that have been recovering since mid 2020. Over this quarter, the S&P 500 increased less than 1%, while small cap stocks declined 3.14% and mid cap stocks had a marginal loss of 0.8%. International equity also slowed, as the MSCI/EAFE index showed a 1.1% loss for the quarter.

Selected Indices	12/31/20	6/30/31	9/30/21	3Q $ Change	3Q % Change	YTD $ Change	YTD % Change
S&P 500 (Large Capitalization)	3,756.07	4,297.50	4,307.54	10.04	0.23	551.47	14.68
S&P 400 (Mid-Level Capitalization)	2,306.62	2,696.12	2,691.26	-4.86	-0.18	384.64	16.68
S&P 600 (Small Capitalization)	1,118.93	1,374.84	1,331.69	-43.15	-3.14	212.76	19.01
Dow Jones Industrials (Large Capitalization	30,606.48	34,502.51	33,843.92	-658.59	-1.91	3237.44	10.58
Nasdaq	12,888.30	14,503.95	14,448.58	-55.37	-0.38	1560.28	12.11
5-year Treasury Note Yield(percent)	0.36	0.87	1.00	0.13	14.60	0.64	176.94
10-year Treasury Note Yield (percent)	0.92	1.44	1.53	0.09	6.18	0.61	66.20
MSCI/EAFE (International Equities)	72.96	78.88	78.01	-0.87	-1.10	5.05	6.92

There were several headwinds to the economy and markets during the quarter including a frustrating rise in the Delta variant of COVID-19 in late summer. This led to prolonged shutdowns in some areas of the world economy and has also resulted in supply challenges for the labor markets as well as the delivery of goods. As we will discuss in the report, the Federal Reserve policy remains supportive of markets, but they are also grappling with what appears to be a temporary uptick to inflation in the economy. Government bond yields have increased slightly during the quarter, with the 10-year treasury rising to 1.53% from 1.44% at the beginning of the quarter. The 5-year treasury note also rose to 1.00% from .87%.

NAVIGATING THE LATTER STAGES OF THE PANDEMIC



Source: Centers for Disease Control and Prevention, Johns Hopkins CSSE, Our World in Data, J.P. Morgan Asset Management.

As the above chart indicates from the CDC, the 7-day moving average of confirmed cases inside the U.S. peaked in late 2020 and was on a rapid decline. It appeared at that point that the end of the pandemic was in sight. However, in late

spring and early summer, the Delta variant of the virus began to rapidly spread and increased the rates of infection to levels first seen in the rise of the 2020 pandemic. Thankfully, the chart also indicates that the progress towards immunity is closing in on 85% in the U.S. due to the rates of infections and vaccinations. While mutations of viruses can be very unpredictable, the CEOs from Moderna and AstraZeneca have both said publicly that they believe the pandemic will likely end sometime in 2022.

In an interesting development in September, the FDA did not approve the proposed Pfizer "booster" vaccine for use in the general population, but rather for only individuals deemed to be high-risk. While such approvals and decisions are very complicated, it likely indicates that the existing vaccines are being effective along with the increased natural herd immunity in resolving the pandemic. These are certainly positive developments for the economy and markets looking forward into 2022.

DISRUPTIONS TO SUPPLY CHAIN AND LABOR MARKETS

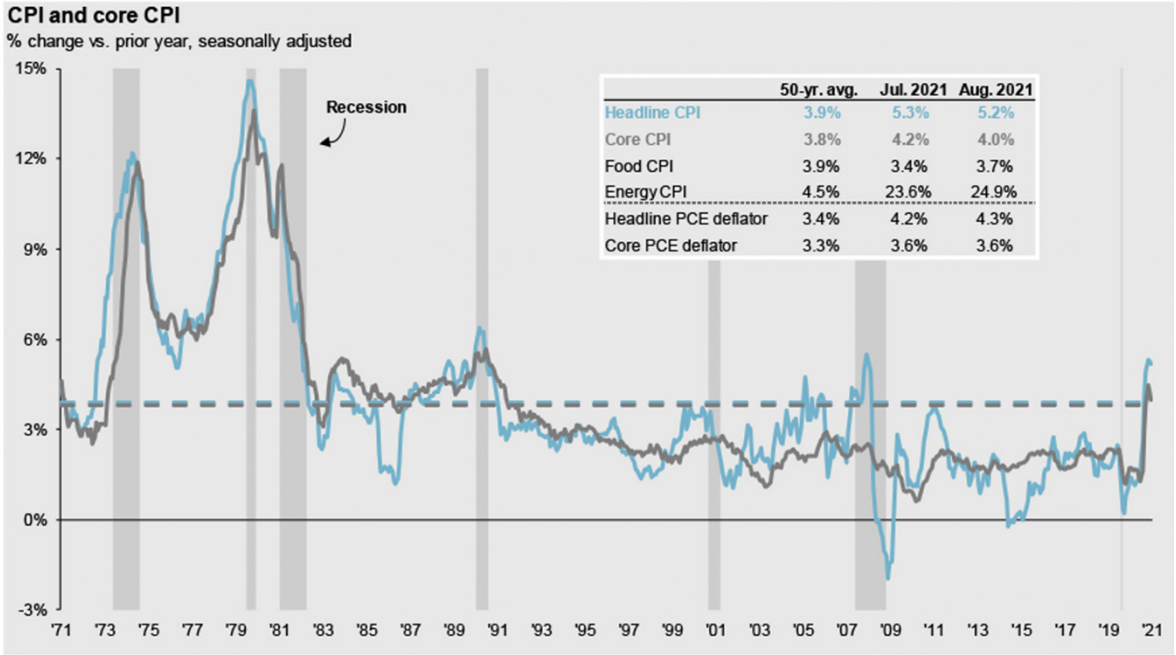
The most recent surge in the Delta variant further exacerbated an already strained supply chain throughout the world. Disruptions related to COVID-19 have particularly impacted incoming trade from Asia into the ports in the U.S. Three of the largest ports in the U.S., all located in California (Port of Los Angeles, Port of Long Beach, and Port of Oakland), are all currently experiencing a bottleneck in unloading the regular flow of entering cargo ships. These combined ports account for over 50% of the imports for the U.S. and have caused shortages across the country for a wide range of inventories. At the Port of Los Angeles as of the end of the quarter, there were 30 ships anchored at sea waiting to unload cargo. Each ship accounts for an estimated $100 million in goods and currently have a 10.9 day delay before being unloaded. Backlogs have begun to improve, albeit with higher transportation costs, to move the cargo. Shortages in items such as semi-conductors have been significant and have driven up the costs for many products including automobiles. Thankfully, these bottlenecks are expected to resolve over the coming months and should resume some normalcy in 2022.

Source: Bureau of Labor Statistics

After shedding an estimated 19 million jobs because of the COVID-19 shutdowns, the labor market has been in recovery ever since, and has replaced roughly 77% of the jobs that it had lost to return to the current level of 5.2% unemployment. Also, in the 3rd Quarter several of the temporary Federal unemployment assistance programs expired which has incentivized many to return to the workforce. However, the economy has slowed its pace of lowering unemployment, as there appears to be a continued mismatch of job openings with job applicants.

It may take some time for the economy to return to its pre-pandemic employment levels of 3.5%, as there are still 11 million job openings still in the United States ready to be filled. The "slack" in the labor markets has caused wages to increase on a year over year basis to 4.9%, which has not been seen since the 1980's. We expect this to continue to resolve as labor participation returns to more normalized levels.

INFLATION: TRANSITORY OR STICKY?



	50-yr. avg.	Jul. 2021	Aug. 2021
Headline CPI	3.9%	5.3%	5.2%
Core CPI	3.8%	4.2%	4.0%
Food CPI	3.9%	3.4%	3.7%
Energy CPI	4.5%	23.6%	24.9%
Headline PCE deflator	3.4%	4.2%	4.3%
Core PCE deflator	3.3%	3.6%	3.6%

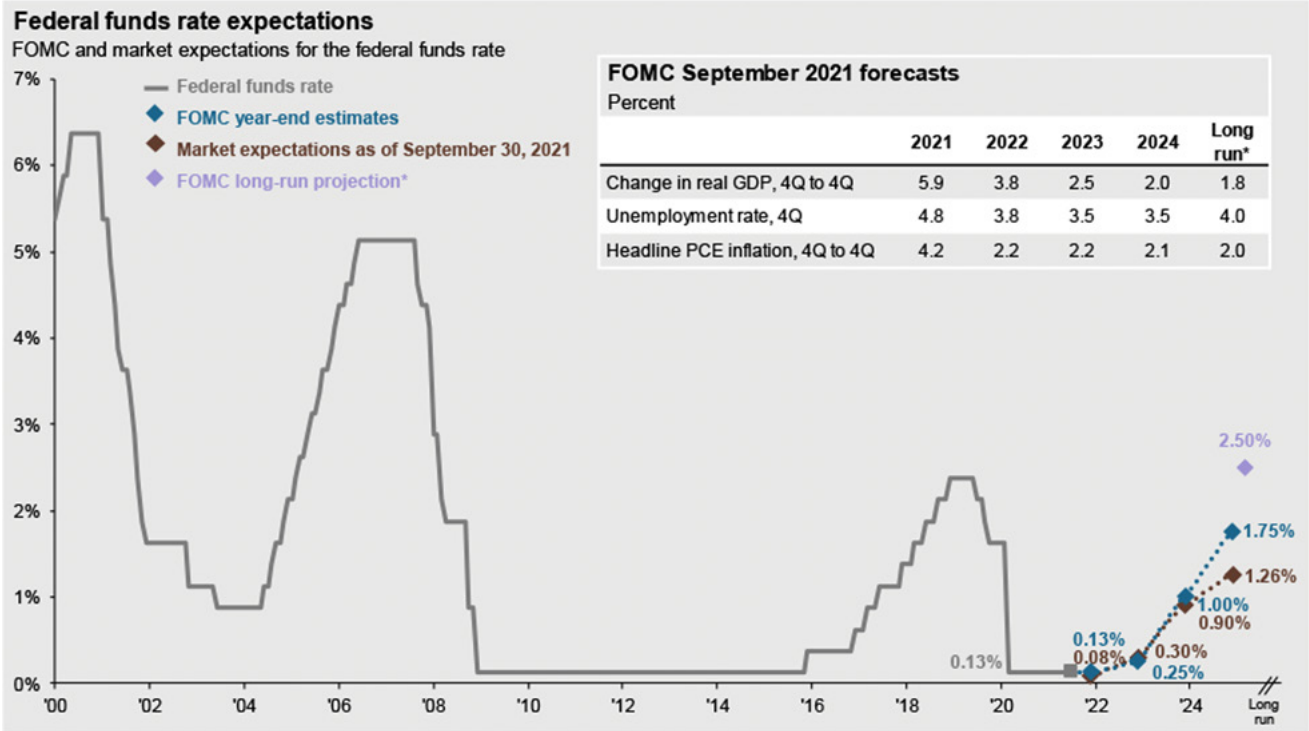
Source: BLS, FactSet, J.P. Morgan Asset Management.

The result of the pickup in demand post pandemic, the supply bottlenecks caused by the COVID-19 shutdowns, and the related labor shortage have all caused inflation to rise over the past several months. This rise should not come to a great surprise and would be expected as the economy recovers to normalcy from a global pandemic. In economics, prices are observed to rise whenever supply is short, and demand is high. Looking at the above chart, we see how the U.S. has enjoyed relatively low rates of inflation for the past decade. The last time we saw inflation above 5% annually was during the period of 2007-08 when the economy was booming as a result of an overheated housing market. In August of 2021, the Bureau of Labor reported headline inflation (CPI) at 5.2% annual rate. This is well above the stated goal of the Federal Reserve to maintain 2%.

The real question is whether this spike in inflation will be "transitory" or "sticky" as described by the Federal Reserve Chairman Powell in recent speeches. The Fed believes that once the supply chain bottlenecks resolve themselves, inflation will return to the baseline estimates of +/- 2% within the next year or so. It isn't necessarily a cause for concern, according to the Fed, that inflation is higher for the short term if it returns to a lower level within the intermediate term.

FEDERAL RESERVE POLICY UPDATE

In their most recent statement dated September 21, 2021, the Federal Reserve released the following, "The path of the economy continues to depend on the course of the virus. Progress on vaccinations will likely continue to reduce the effects of the public health crisis on the economy but risks to the economic outlook remain." In addition, they indicate they remain committed to assist the overall economy by helping to keep inflation low (a 2% long term target) and full employment (typically considered to be 4% or lower). Currently the Fed is purchasing $120 billion bonds per month, broken up between $80 billion in Treasuries and $40 billion in mortgage-backed securities (MBS). Both of these programs help to keep the rates lower for government bonds as well as help sustain the housing market with low mortgage rates. The Fed has also indicated they intend to keep the overnight discount rate between the target range of zero to .25%, which is essentially the lowest rate possible to keep short term interest rates low.



FOMC September 2021 forecasts
Percent

	2021	2022	2023	2024	Long run*
Change in real GDP, 4Q to 4Q	5.9	3.8	2.5	2.0	1.8
Unemployment rate, 4Q	4.8	3.8	3.5	3.5	4.0
Headline PCE inflation, 4Q to 4Q	4.2	2.2	2.2	2.1	2.0

Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.

In terms of looking forward, based on their most recent language the Fed has indicated it might "taper" some of its bond purchases towards the end of the 4th Quarter or early in 2022, but will likely not raise rates until 2023 or beyond.

GOVERNMENT POLICY UPDATE

Since the Pandemic began, the policy decisions of the U.S. government have had significant involvement relating to health, restrictions, as well as spending measures. The CBO indicates that spending increased dramatically from $4.1 Trillion in 2019 to $6.1 Trillion in 2020 and $6.3 Trillion in 2021.

According to the CBO August 2021 report, "Programs and policies implemented in response to the coronavirus pandemic—notably, refundable tax credits (particularly the recovery rebates), expanded unemployment compensation, and the Small Business Administration's Paycheck Protection Program—substantially boosted spending, both this year and last year."

Budget Totals, October–August

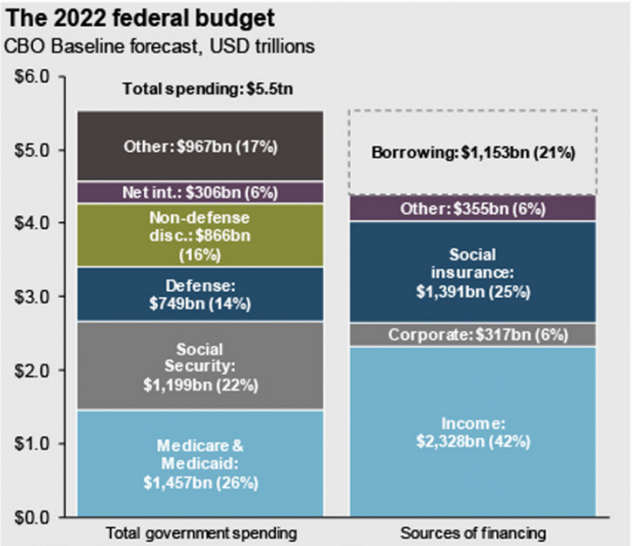
Billions of Dollars

	Actual, FY 2019	Actual, FY 2020	Preliminary, FY 2021	Estimated Change From 2020 to 2021: Billions of Dollars	Estimated Change From 2020 to 2021: Percent
Receipts	3,088	3,047	3,586	539	18
Outlays	4,155	6,054	6,299	245	4
Deficit (−)	−1,067	−3,007	−2,713	295	−10

Data sources: Congressional Budget Office; Department of the Treasury. Based on the *Monthly Treasury Statements* for July 2021 and September 2020 and the *Daily Treasury Statements* for August 2021.

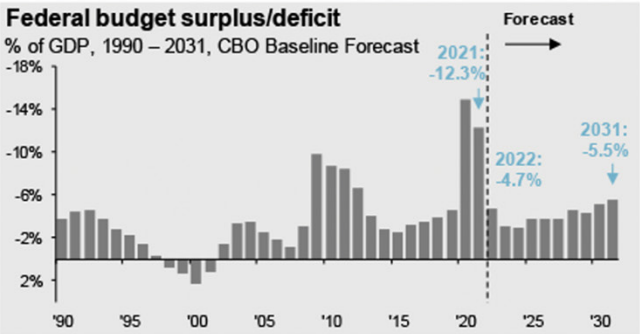
The above table from the CBO indicates that deficit spending nearly tripled from 2019 as a result of the response to the pandemic. The table below describes their baseline federal budget for 2022 which is currently estimated to be reduced to $5.5 Trillion and a lower deficit of $1.1 Trillion due to a higher tax base and potential tax increases. The current administration is currently discussing the details of the proposed increase to taxes, but no legislation has been passed. We do expect to see some increase to taxes, which we believe has already been mostly priced in to current market valuations.

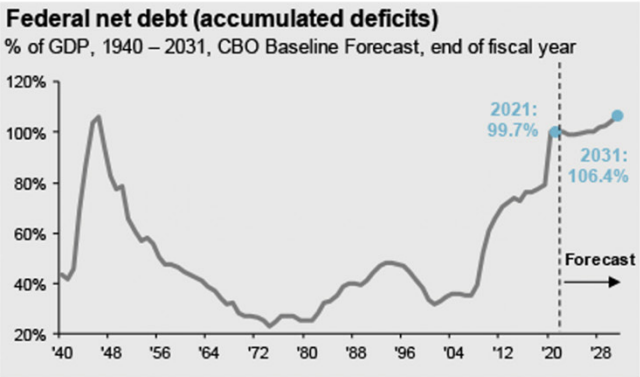
It is interesting that the CBO has a slightly higher estimate for inflation in the next few years (higher than the Fed), but it is still within the +/- 2% range. They also estimate that the 10-year treasury rate will continue to increase to 1.9% next year, from the current level of 1.5%.



CBO's Baseline economic assumptions

	2022	'23-'24	'25-'26	'27-'31
Real GDP growth	6.1%	1.6%	1.3%	1.6%
10-year Treasury	1.9%	2.1%	2.6%	3.2%
Headline inflation (CPI)	2.7%	2.3%	2.4%	2.4%
Unemployment	4.1%	3.8%	4.2%	4.4%

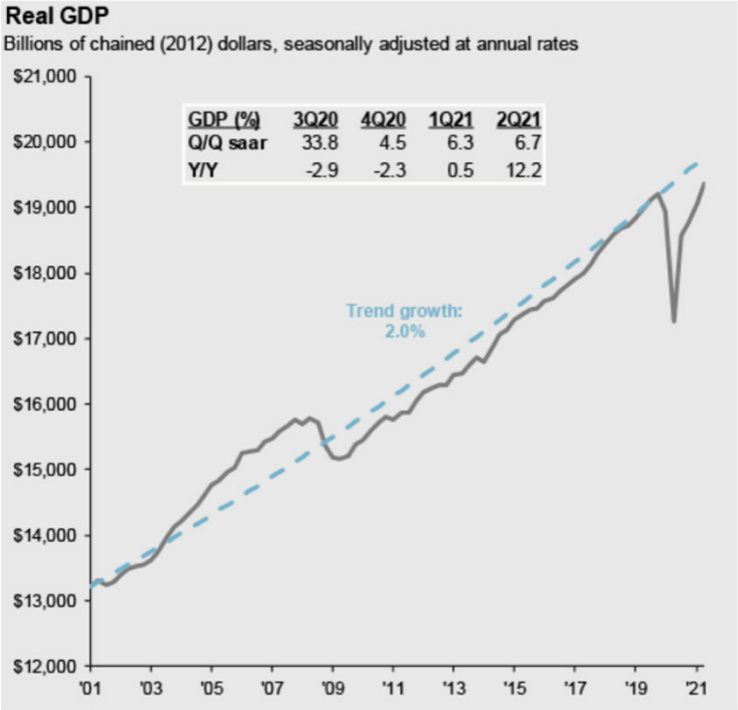


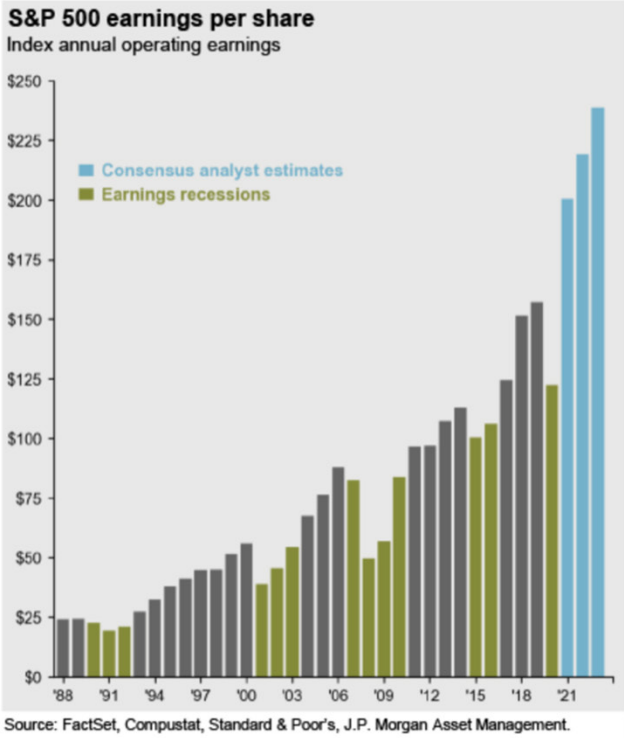


Source: CBO, J.P. Morgan Asset Management; (Top and bottom right) BEA, Treasury Department.

EQUITY VALUATIONS AND OUTLOOK

We have discussed many of the macroeconomic factors currently facing the global and U.S. Economy. GDP growth has recovered from the pandemic, to where it is starting to resume the longer-term trend line of 2%. The S&P 500 earnings per share growth estimates for next three years are expected to continue to reach new all-time highs, as the economy shifts into lower but steady growth in a post pandemic environment. While the forward P/E ratio for the S&P 500 is 20.3x, still above the 15-year average of 16.7x, the ratio has come down significantly over the past year as earnings have had time to catch up to the prices. We expect, all things being equal, that continued expansion of corporate earnings could continue to bring the P/E ratio to more normalized levels.





Despite the headwinds of the potential of "sticky" inflation, eventual modest increase to interest rates, potential higher individual and corporate tax rates, the case for the long-term growth for equities continues to be strong. Although they are certainly not infallible, the Federal Reserve has presented their conviction that some of these headwinds will subside in the intermediate term, especially as we move through the latter stages of the pandemic. However, the growth we have enjoyed over the past two years in equity prices has been greater than what we should expect when looking at longer term averages for planning purposes. We should be prepared for short term volatility, and we continue to recommend periodic rebalancing of a diversified portfolio of equity funds (including some exposure to international) along with bonds funds in an appropriate mix, depending on the time horizon and risk tolerance of each individual client.