

Review & Outlook

THIRD QUARTER 2021



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Review and Outlook

The S&P 500 index increased 5% through July and August, then fell in September, ending the quarter essentially flat. The dominant story for the overall market continues to be interest rates, especially the 10-year Treasury rate, and the price response of the largest listed companies, in particular, Apple, Microsoft, and Alphabet (Google). In general, when interest rates fall, these stocks increase in value, and their dominance pushes the overall market up.

Alternately, when interest rates rise, these stocks decrease in value. This is in part because current valuation is based on estimates of future income, and that future income stream is more heavily discounted when interest rates increase.

From March 31st to August 5th, interest rates for the 10-year Treasury fell from a high of 1.72% to a low of 1.2%. This decline was due to a combination of renewed domestic and international COVID restrictions in response to the Delta variant, and ongoing supply chain disruptions, including a lack of computer chips. From August 5th to September 22nd, the 10-year Treasury's interest rate started to creep back up, but made a pronounced move higher in the last 10 days of the quarter, rising from about 1.3% to 1.55%.

While the stock market has been turbulent, we do not think stocks fell because the economic outlook is deteriorating. Forecasters are still calling for relatively strong growth well into 2022, and the stock market is not wrestling with worries of economic weakness. The major concerns center around inflation and supply chain challenges, and the impacts on sales and margins over the next few quarters. There is also increased anxiety about whether or not Congress will raise the debt ceiling, which has to be done.

The bond market is also struggling a bit. There are concerns about inflation, and how quickly the Federal Reserve might slow its bond purchases, which was part of its effort to support the economy during the COVID recession. If investors anticipate higher inflation, they will pay less for bonds, increasing rates and yields. And if they think the Fed is going to taper its bond purchasing soon, they may equate that with a decline in the demand for bonds, and as a result expect higher yields in the future. There are many reasons to

expect interest rates to rise, and higher interest rates could put downward pressure on stock prices. That downward pressure would be felt most acutely by stocks with high prices relative to current and expected future income.

We expect upward pressure on interest rates to continue in the coming quarters, and that a relatively strong economy with interest rates slowly moving upwards will be the dominant background for the financial markets. Volatility will persist, tied to uncertainty around the yet to be passed infrastructure bill, and whether we will see a "Build Back Better" program with human infrastructure.

Our view is in line with the National Association for Business Economics (NABE), Blue Chip forecasters, the Congressional Budget Office, and many more groups are calling for slow, but still relatively strong, economic growth in late 2021 and into early 2022. Growth should be relatively strong because of the amount of stimulus provided in recent quarters. But forecasts have dropped a bit because of the persistence of COVID and on-going supply chain disruptions.

NABE and Blue-Chip forecasts expect interest rates to be slightly higher by the end of the year than where they are now, and for rates to continue to rise slowly in 2022.

Index Performance Data
Total Return as of 9/30/2021

Indices ¹	Q3 2021	Trailing 12 Months
CRSP U.S. Total Stock Market Index	-0.06%	32.11%
MSCI Global ex-U.S. Total Stock Market Index	-3.65%	20.48%
Bloomberg Barclays U.S. Aggregate Bond Index	0.05%	-0.90%

The U.S. stocks and bonds we hold in our clients' portfolios reflect the broader market, with a slight emphasis on smaller companies with reasonable price relative to earnings. We have positioned our portfolios for a world where interest rates continue to move up slowly, but the economy remains sound.

We continue to hold a lower-than-typical allocation to foreign stocks. What we do hold in foreign developed and emerging markets has performed well relative to benchmarks. Within emerging markets, we have reduced our exposure to China, with an eye towards real estate debt and other issues, and are exploring suitable alternatives in Global/Non-U.S. sectors.

We also continue to hold very short-term, high-quality bonds. When interest rates fall, riskier bets in fixed income (high yield or junk bonds) look good, but the fixed income securities we hold do better when interest rates are on the rise.

While we are not without concerns, we remain invested close to target allocations, with only a small amount of cash. We expect some short-term volatility, but feel owning equities provides some protection against inflation risks, and is likely a stronger long-term position for real returns (i.e., returns adjusted for inflation) than fixed income or cash.

Lastly, we hope you find the benchmarks we provide to be helpful. The S&P 500 index has increasingly become a gauge for a handful of companies (like Apple, Amazon, and Microsoft) rather than a barometer for a broad group of large companies. And in the Russell 2000 index, one of the largest small cap stocks in terms of valuation is now AMC. Thematic bets in recent quarters have been significant and have really impacted benchmarks. We do not hold stocks like AMC or GameStop because the fundamentals do not look good. Those stocks can do spectacularly well when social media focuses on them, and a few have done so well that they have affected key benchmarks. Rather than chase the temporary winners, we take a more thoughtful and patient approach.

In Focus

It seems like everyone is talking about inflation. Maybe you've talked with friends about the increased cost of housing, cars, or food. It is a core area of focus for the Federal Reserve, and very important to

ourselves, as Investment Advisors. Stock prices and the value of bonds are affected by interest rates, which are directly linked to inflation and expectations for inflation in the future. Part of the inflation story is ongoing constraints in supply chains, like overcrowded, backed up ports, but is largely viewed as transient, not permanent, in nature. For example, West Coast ports have experienced an unprecedented amount of congestion.

The Northwest Seaport Alliance CEO estimated in August there were 6,000 containers at the Port of Seattle, with crews working overtime to get them loaded onto trucks and trains. There are more ships waiting to be unloaded, with so many in Elliot Bay near Seattle that we have even had two Seattle-bound ships anchored in Bellingham Bay. And as of September 14th, there were a record 56 container ships anchored off the coast of California, waiting to unload at the Port of Los Angeles/Long Beach.² Consumer demand for retail increased significantly in the first half of 2021, and many of the goods sent in response now arrive on larger ships with more containers. Some of the ships have arrived too close together, their loading stacking up following COVID closures and power outages at some ports in China. At the same time, worker shortages and logistical constraints at U.S. ports make it harder to move the offloaded containers. The cost of moving goods has increased dramatically, and some of that increased cost has been passed on to consumers.

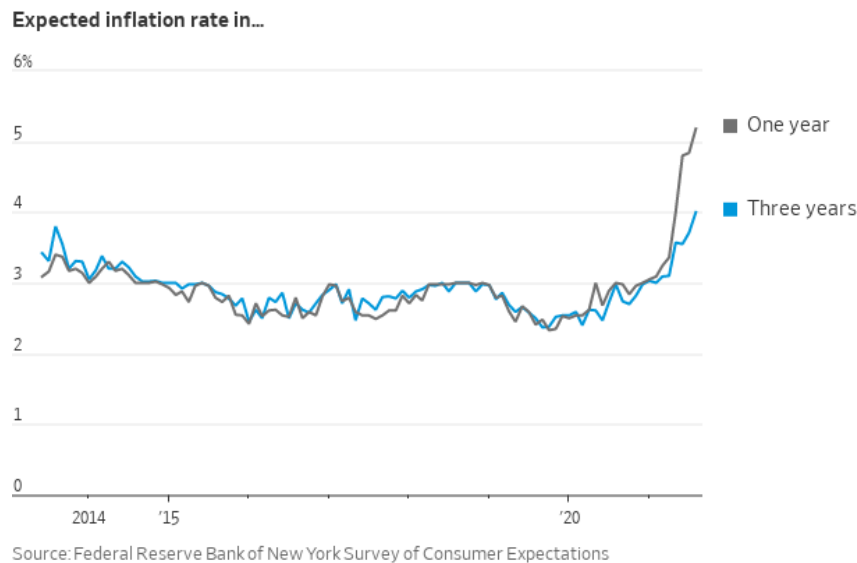
The big debate is whether we view any supply chain related inflation as temporary, and therefore not cause for concern, or something more persistent that deserves immediate policy action. Investors are concerned that the Federal Reserve Bank may curtail asset purchases resulting in a significant rise in interest rates.

With respect to the ports, we are confident that the backlog of containers and waiting ships will be processed and the congestion will work itself out over the coming months. Some of the reasons for congestion are clearly short term in nature. Terminal 5 in Seattle has been under construction and will reopen this winter. Shipping companies will make adjustments, and we hope to see more people in the shipping industry working again soon.

Nevertheless, expectations of future inflation matter. If investors think lumber prices are going to remain high or move even higher, they will act one way. If they think lumber prices are only temporarily high, and should come back down in the not-too-distant future, they will act another way. Expectations can drive inflation, and right now, expectations of higher inflation are rising. A recent survey from the Federal Reserve Bank of New York shows consumers are expecting current inflation rates to persist for at least a year, and to remain elevated for several years. Forecasters have also been steadily increasing their outlook for inflation in recent months. At the same time, we've seen prices for lumber and used cars decline, so inflation could be temporary.

The Federal Reserve has been favoring this view. They look at different

metrics, and know the importance of managing expectations. If successful, they do not have to act. They can keep interest rates low, to help support the economy and job growth for a longer period of time. If they are wrong, however, and inflation turns out to be persistent, they'll have to increase interest rates to fight inflation, possibly triggering an economic slowdown. They are trying to engineer a 'soft landing' where they reduce the monetary stimulus at just the right time and pace, avoiding both excessive inflation and an economic downturn. At the moment, the Blue-Chip Consensus forecast, and forecasts from groups like the Congressional Budget Office, all call for much more muted inflation by 2022. They view today's inflation as temporary. A recent article in Bloomberg also described today's inflation as a stimulus-led outlier that will pass.³



Source: Federal Reserve Bank of New York Survey of Consumer Expectations

We agree with this assessment to a degree. We think inflation will be a bit more of a problem than the Fed anticipates. Supply chain struggles are not clearing as quickly as we thought when we wrote our last Review and Outlook. In addition, the labor market continues to baffle most analysts. While these struggles point to more stubborn inflation, as economic activity slows in the second half of the year, we should see fewer inflationary pressures.

Having said that, we may see a kind of difficult to measure

invisible inflation, by receiving less for the same price. For example, food companies might reduce the size of packaged portions, or hotels might continue on with not cleaning rooms daily.

In the end, we think inflation over the next year

will be higher than what is in many forecasts. We also expect to see news reports sensationalizing the worries, while the Fed continues to manage expectations.

The chart above shows how expected inflation expectations have increased remarkably in the past months. However, what the chart does not show is that actual inflation has consistently turned out to be much lower than expected inflation over the past decade. Actual core inflation has consistently measured below 2% during this time. We anticipate that inflation expectations will overshoot, again. At some point we will find ourselves back in a sub-2% inflationary environment. While we don't predict a date, we feel confident that longer term inflation will not be a serious problem, and are making investment decisions accordingly.

1. Index price and performance data is provided by Black Diamond Wealth Platform, an SS&C Advent product.

2. <https://news.yahoo.com/record-breaking-44-container-ships-145905612.html>

3. <https://www.bloomberg.com/news/articles/2021-09-13/u-s-inflation-is-starting-to-look-like-a-stimulus-led-outlier?sref=lxvJQkZu>