From the Curb

Letter to Clients
Quarter Ending September 30, 2021

The S&P 500 hit new all-time highs again in the third quarter as investors looked past a resurgence of COVID-19 cases in the U.S. Instead, investors focused on the positive combination of a resilient economic recovery, ongoing historic support from the Federal Reserve, and strong corporate earnings. Market volatility did notably pick up during the final few weeks of September, reminding investors that the transition to a post-pandemic “new normal” isn’t always going to be smooth.

Positive momentum ruled in July and August, powered by: upbeat corporate forecasts, solid economic activity, and continued supportive Fed rhetoric. However, the market tone changed in September, as many of the positive elements that supported stocks earlier in the quarter began to fade. First, corporate commentary turned more cautious. Profit warnings that cited supply chain constraints and margin compression came from multiple industries, which caused investors to become more concerned about the outlook for corporate earnings. Then, economic data from August showed that the rise in COVID-19 cases had weighed slightly on the economic recovery. Finally, after investors ignored the looming policy battle in August, politics began to weigh on markets as Democrats unveiled new details on a $3.5 trillion spending and tax plan. Included in the package, were increases to corporate and personal income taxes, and changes to capital gains and inheritance taxes.

Adding to volatility came the news that the second-largest property developer in China, Evergrande, was likely going to default on debt payments. Fear of potential financial market contagion hit stocks in late September and the S&P 500 suffered its first 5% pullback in nearly a year. Markets remained volatile into the end of the quarter, while Washington approached the looming deadline of a government shutdown. The S&P 500 finished the month with moderate losses, although the index still logged a positive return for the third quarter.

That resilient performance should not be taken as a signal that risks no longer remain. The next three months will bring important clarity on several unknowns, including future Federal Reserve policy, taxes, corporate health and inflation.

The Federal Reserve has communicated that it will begin to taper Quantitative Easing (QE) in the fourth quarter, but markets do not yet know when exactly the Fed will start to scale back those asset purchases or the pace at which they will be reduced. We anticipate additional volatility if the Fed starts to taper sooner than expected or, if the pace of reductions, is faster than the market has currently anticipated.

Politics can be a powerful influence on markets, and over the next several weeks we will learn whether the debt ceiling is permanently extended and if there will be any significant tax increases. If policies from Washington are viewed as negative for corporate earnings or consumer spending, we could likely see a rise in market volatility.

Finally, inflation remains elevated at multi-decade highs and that, combined with continued supply chain disruptions, could begin to impact corporate margins and profitability. If an

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increasing number of companies warn about future profitability due to these factors during the upcoming earnings season, we could see a revaluation of market prices.

While risks remain, macroeconomic factors and company fundamentals are still decidedly positive. That said, it is quite normal for equity markets to correct 5% to 10%. While no one likes seeing lower prices, we believe market pullbacks are a healthy process in preventing asset bubbles from growing unchecked.

We understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this still-challenging investment environment. Therefore, it’s critical for you to stay invested, remain patient, and stick to your plan.