Signals of potential lower growth ahead

U.S. consumer confidence dropped in September for a third straight month, suggesting concerns over the delta variant and higher prices continue to dampen sentiment. The confidence index unexpectedly fell to 109.3 versus estimates of 115.0. Escalating home prices are also weighing on consumer optimism, which surged 19.7% in July. It's the biggest jump for the S&P/Case-Shiller Home Price Index in over thirty years. The Producer Price Index (PPI) showed inflation at 8.3% year-over-year for August. Persistent supply chain disruptions continue to squeeze production costs higher, which are being passed along to the consumer. Oil prices have been rapidly rising, putting additional pressure on the economy. Crude ended the month at $75.03 a barrel, a level not seen since October 2018. The demand for oil from the developing energy crisis in Europe and China is outpacing supply. Analysts from Goldman Sachs said oil prices could hit $90 this year and Bank of America has chatted up $100 a barrel over the winter as the pandemic retreats and more countries open their borders to travel. That said, longer term deflationary forces are still present as summarized by Hoisington Investment Management:

> "The current economic growth and inflation rates of 2021 will be the highest for a very long time to come. The main obstacle to a return to sustained growth in the standard of living, extreme over-indebtedness, was dramatically worsened by the multiple rounds of fiscal stimulus which has caused the temporary improvement in economic growth and inflation in the second quarter. No pathway out of this trap exists as long as the overreliance on debt remains the only tool of monetary and fiscal policy. The situation is no different in Japan and Europe. Thus, while long Treasury yields can increase over the short run, the fundamentals are too weak for yields to stay elevated. More debt does not cure a subpar economy mired in a debt trap. Given the above, our view is that the trend in long-term Treasury yields remains downward."

Fixed Income

In the bond market, the third quarter began with a rally as the prospect of a slower recovery pushed the yield on the 10-year U.S. Treasury note to its lowest level since February. Comments from Powell that the Fed could start scaling back its bond buying in November triggered a surge higher in Treasury yields. The markets are hoping it won't be a repeat of 2013, the year of the taper tantrum. Ben Bernanke triggered a surge in yields when he said the Fed could reduce the asset purchases it had orchestrated in response to the 2007-2009 financial crisis. It was also the last time bonds posted a negative yearly return when the Aggregate lost 2%. With the exception of high yield bonds and Treasury Inflation Protected Securities, most bond sectors are on track for a negative year.

Equities

It was a round trip for U.S. stock investors in the third quarter of 2021, with the broad market posting 19 new highs before falling back to end up where it had been three months earlier. Still, major stock markets around the globe are still up strongly over the past year. Investors entered 2021 with high hopes that the worst of the pandemic was behind us. Equity markets surged during the first half of the year, with strong outperformance across value and small-cap categories. However, the delta variant this summer sent many investors back to their 2020 playbook. As such, large-cap and growth categories surged in July and August as investors rotated out of small-cap and value categories. The market retreated in September as the combination of broad market overvaluation and acknowledgement that the Fed will begin to taper its asset purchase program this fall took its toll on stocks. According to Barron's, during the third quarter, S&P 500 earnings estimates rose just 2.9%, less than half the increase of the past two quarters. And broken down monthly, they rose 3.8% over July and August, and then fell 0.9% in September. That's not a big drop, but it's the biggest since June 2020, before vaccinations began turning things around. That raises the question of whether inflation and shortages will sap growth around the same time that easy comparisons with hard-hit Covid quarters are ending. As things stand now, earnings are expected to rise 28% in the third quarter, and 22% in the fourth, before suddenly slowing to 6% and 4% growth in the first two quarters of next year.

Asset Allocation

Going forward, the inflation theme is rapidly gaining traction, casting doubt in the Fed's assurances that it is transitory. Powell conceded that inflation could last longer than expected before moderating. Although this might suggest more upside for higher yields, there are just too many short-term uncertainties. High covid cases, the debt crisis in China's real-estate sector, a budget showdown in Washington, lower consumer sentiment, and overblown stock valuations could spur a flight to safety. Morgan Stanley analysts for example, said their optimistic view is a 10% downturn in the S&P 500. Their worst-case, and more likely scenario is a plunge of more than 20%. In addition, the future expectations of monetary policy could shift as Senator Elizabeth Warren said she wouldn't support Jerome Powell for a second term, and two Federal reserve leaders announced their early retirement. This all makes for greater volatility.

Our portfolio strategy continues to emphasize a balanced asset allocation with fixed income providing stability and liquidity for future investment opportunities.

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Monroe Vos has over $6.5 billion under advisement for 100 clients. Recent rankings are as follows:

- The 3rd largest independent registered investment advisor ("RIA") in Texas
- The 8th largest independent RIA in the Southeast
- The 60th largest independent RIA in the United States

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