Q3 MARKET INSIGHTS

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Fall 2021

For most of the past year and a half, equity market returns have been on an upward trajectory following the steep decline caused by the COVID-19 pandemic in March 2020. This trend continued into the third quarter of 2021 before leveling off as the rise in the Delta variant, the Evergrande real estate debt failure in China, political gamesmanship in Washington D.C., and global supply chain challenges continued to weigh on the markets. Here in the U.S., the S&P 500® Index closed at an all-time high of 4,536.9 on September 2nd, before fading into quarter end. Despite this weakness, the S&P® 500 finished the quarter with a positive return of 0.58% and is currently up 15.91% year-to-date (YTD). Internationally, foreign markets declined in the third quarter. Emerging markets dropped sharply, initially based on fears that rising COVID-19 cases would derail the global recovery, but late in the quarter, emerging markets fell even further over the possible impact Evergrande would have on the Chinese economy. Meanwhile, foreign developed markets declined modestly during the final few weeks of the quarter due to general global growth concerns. During this time, emerging markets, represented by the MSCI Emerging Markets Index, posted a return of negative 8.03% (-1.16% YTD), while foreign developed markets, as represented by the MSCI EAFE Index, were down 0.33% (+8.84% YTD). Switching to fixed income markets, most bond classes were little changed in the third quarter. Bonds were solidly higher through mid-September as investors rotated to safety following the rise in COVID-19 cases in July and August. But in late September, the Federal Reserve (the "Fed") confirmed that tapering of Quantitative Easing ("QE") will likely begin later this year. That, combined with higher than expected inflation statistics, weighed on fixed income markets during the final few days of the third quarter and erased most of the quarter-to-date returns for many bond indices. As a result, the Bloomberg Barclays U.S. Aggregate Bond Index, the leading benchmark for bonds, returned 0.05% for the third quarter (-1.55% YTD).

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Once again, September lived up to its reputation as a month of subpar investment returns and heightened volatility. News headlines regarding the Delta variant, tensions in Washington D.C., Fed tapering of QE, supply chain issues, and the debt default of Chinese property developer Evergrande weighed on investor sentiment. Despite these headlines, we believe the outlook for equities continues to be positive as the underlying fundamentals remain unchanged. As we have highlighted many times in previous letters, secular tailwinds from excess liquidity created by easy monetary and fiscal conditions will likely remain in place for an extended period. Moreover, equity markets are not only being supported by liquidity, but also by a scarcity of compelling asset allocation alternatives. From a relative value standpoint, low interest rates continue to make stocks look attractive. However, this does not mean markets will go up in a straight line. September served as a reminder that uncertainties created by specific headlines can lead to an increase in volatility, and until there are resolutions, we believe the volatility will likely continue. That being said, let's take a closer look at some of the issues that are concerning investors today.

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DELTA VARIANT

The Delta variant of COVID-19 initially caused investor anxiety as it became the predominant variant in the U.S. Initial data suggested that the variant was more contagious and possibly more virulent than earlier forms of SARS-CoV-2 (the virus that causes COVID-19). Unlike the COVID-19 waves of 2020 and early 2021, government authorities did not re-impose economic restrictions or lockdowns in response to rising case counts. Instead, most policy responses centered around mask mandates, and as such, the economic headwinds from rising COVID-19 cases were mild compared to previous episodes. Recent data suggests that infections appear to be trending downward. While there is always a risk of additional variants, the current case trends, combined with continued uptake of vaccinations, should allow policymakers to avoid re-implementing economic lockdowns that could hurt corporate earnings and the economy.

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TAPERING OF QE

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At the end of the third quarter, the Federal Reserve communicated that tapering of its QE program "may soon be warranted." Expectations are that the tapering will begin sometime during the fourth quarter (with most pundits anticipating November), but markets do not yet know exactly when the Fed will start to scale back those asset purchases or the pace at which they will be reduced. If the Fed starts to taper QE sooner than expected, or the pace of reductions is faster than the market has currently priced in, it will probably cause additional volatility. While this may sound troublesome for equities, as they rely on monetary support in the current environment, there is a big difference between tapering quantitative easing and outright quantitative tightening. Tapering is not the same as raising interest rates. Tapering is a reduction in the number of bonds the Fed purchases every month. While the number of bonds they purchase each month may be decreasing, the Fed is still providing additional liquidity to markets. Even once the taper is complete, we believe that monetary conditions will remain benign as we don't expect any immediate interest rate hikes from the Fed.

EVERGRANDE

The real estate market in China has been booming over the past several decades as the Communist Party has forbidden most of its people from accessing the global financial markets. Real estate was an asset most Chinese citizens were able to buy that felt safe and reliable. In fact, owning property in China denotes a higher status in society. Continued investment by the Chinese people has led to ever-increasing price and resulted in many areas being overbuilt. In addition, the rising prices have created an environment plagued by mal-investment as investors chase returns without spending discipline. As of the end of July 2021, about 70% of household wealth in China is tied up in real estate (vs. 24% in the U.S.). Given the large levels of speculation, the Communist Party instituted new regulations in August of last year to curb risk-taking and reduce leverage in the property sector. This was done under the policy called "common prosperity" in an effort by Chinese President Xi to crack down on wealth inequality (President Xi was even quoted as saying "homes are for living in, and not speculating"). Evergrande is China's second-largest property developer. Over the years, Evergrande has grown deeply indebted to fund its expanding empire of property developments as well as its forays into

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electric vehicles, wealth-management products, a soccer club, and bottled water. The privately-owned developer is now financially stricken resulting from its years of aggressive borrowing, set against the government's regulations to tighten up leverage in the real estate sector. The company has $90 billion in debt outstanding as well as $313 billion in unpaid bills, with only $13 billion in cash. At the end of September, the company defaulted on interest payments on some of its debt. This caused the S&P® 500 and many emerging equity markets to fall at the end of the quarter as investors worried that the contagion from the default and an ensuing slowdown in the Chinese economy would spread to other markets. There are likely some underlying risks related to these defaults, although it is impossible to know who ultimately has exposure to this debt. However, in the U.S., we feel the risk is very small. Banks in the U.S. have very little exposure to Chinese real estate (there may be some hedge funds that do, but no large banks). In addition, S&P® 500 revenues from greater China, which includes Hong Kong and Taiwan, accounted for only 2% of revenues in 2019. Therefore, we would not expect any impact from an economic slowdown in China to be significant.

LEGISLATIVE DRAMA IN WASHINGTON D.C.

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It's probably fair to say that Washington D.C. has been a mess for quite some time, however, wrangling between Democrats and Republicans over a multitrillion-dollar legislative agenda, while simultaneously attempting to avoid an ugly battle over the U.S. debt ceiling and a potential government shutdown will probably continue to add to market volatility in the coming months. If the federal debt limit is not raised or suspended, the government could lose its legal authority to borrow money and perhaps fall into technical default for the first time. As we write this letter, the Senate has agreed to extend the government's borrowing authority into December, temporarily averting a default. Again, while this may lead to increased bouts of volatility, previous U.S. government shutdowns have not meaningfully impacted equity returns. Goldman Sachs recently released a research report where they examined the previous 14 times that the U.S. government has shut down since 1980. During those previous instances, the S&P® 500 generated median returns of -0.1% on the dates of budget authority expiration, +0.1% during the shutdown periods, and +0.3% on the dates of resolution (see table on following page). One notable exception was the recent federal shutdown in December of 2018 when the S&P 500 fell 2.1% on the spending authority expiration date. However, this decline was likely driven by investor concerns about the Fed tightening (if you recall, Fed Chairman Powell said the Fed was "on autopilot" for removing liquidity, and markets fell considerably that month).

As you can see from the table on the following page, historical returns show no consistent impact to the S&P® 500 from government shutdowns or the recent debt-ceiling showdowns.

The key thing to recognize is that the underlying macro environment has been the catalyst for long-term equity market performance. While we believe that the current fundamentals are supportive for equities, this does not mean that we think the stock market is going to go up every day, every week, or even every month. It won't. Nor does it exclude the possibility of a correction in equities at some point. If anything, these headlines, along with September's market action, remind us that we should continue to expect increased volatility going forward.

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S&P 500 Returns Around Government Shutdowns

14 Episodes Since 1980

	Max drawdown in week before shutdown	Return on date of budget authority expiration	Return from expiration to date before resolution	Day of resolution	Week after resolution
Max	-0.4%	2.5%	9.3%	2.5%	7.4%
Median	-2.0%	-0.1%	0.1%	0.3%	0.5%
Average	-2.2%	0.0%	0.7%	0.3%	0.8%
Min	-7.1%	-2.1%	-2.5%	-2.7%	-2.4%

Source: Goldman Sachs Global Investment Research

TAXES AND THE BUILD BACK BETTER ACT

Taxes are top of mind for many individuals as Congress works to pass a $500 billion infrastructure bill as well as a proposed $3.5 trillion budget resolution (called the "Build Back Better Act") focused on health care, education, family support, and climate change initiatives. To pay for these ambitious programs, a series of tax hikes are on the table, including increases in individual, capital gains, and corporate tax rates. In addition, there is discussion of rolling back the estate and gift tax exemptions to 2010 levels. The process of developing tax policy is multifaceted, with many moving pieces. It's important to remember that the items are still in their formative stages, with many of the proposals subject to critical debate and revisions that occur during the legislative process. Individuals and investors who are worried about drastically higher taxes or runaway spending should take comfort knowing that the outcome will be shaped by the centrist Democrats in the Senate. The more progressive wing of the Democratic party wants to see the higher end of the proposed tax increases and spending programs passed. Given the slim Democratic majority in both chambers, it is likely that the initially proposed tax and spending increases will be scaled back. So, while we don't expect any extreme increases in taxes (or adverse outcomes in the financial markets), we should all expect to be paying more taxes next year. We should get a clearer picture regarding taxation methods and magnitude as the 2022 budget deliberations occur throughout the fall.

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IN CLOSING

Our approach remains consistent regardless of short-term market cycles, and we continue to believe that long-term investors can be rewarded by ignoring the short-term market-moving headlines and instead focus on the fundamentals. Since we cannot predict when these temporary cycles will start or end, we believe there is no good time to try to "time the market". The best way to achieve your long-term investment goals is to create an investment plan to fit your needs and risk tolerance and establish an asset allocation that will allow you to endure bouts of volatility.

We thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate the financial markets.

Happy Fall!

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