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INVESTMENT MANAGEMENT

Third Quarter 2021 Commentary

Dear Clients,

Please find enclosed your September 30, 2021 Investment Reports.

A September slump led to a pause in the global stock bull market. For the third quarter, U.S. large cap stocks were near flat at 0.5% while developed international stocks were down 1.2%, and emerging market stocks declined 6.6%. For the year to date, the FTSE All World Index, a global stock index, is still up a healthy 11.5%.

The culprit behind emerging market stocks' poor recent showing is China, with Chinese stocks comprising roughly 35% of the emerging markets stock index. The MSCI China Index was off 18.2% in the third quarter, weighed down by regulatory interventions in the Chinese technology sector and a struggling property development sector.

Meanwhile, within the broad U.S. market, smaller-company stocks dropped 2.6%, and growth stocks beat value stocks for the second straight quarter. The financials sector was the top performer, but the energy, industrials, and materials sectors (all cyclically sensitive) were in the red. These style and sector performances reflect a somewhat more risk-averse investor mindset, consistent with the COVID-19-related economic growth slowdown during the quarter. In the bond markets, the benchmark 10-year Treasury yield ended the quarter just a bit above where it began, at 1.53%. But it was a roller-coaster ride, with the yield falling below 1.2% in early August, and then climbing back up in the last two weeks of September. For the quarter, the core bond index return was essentially flat, up 0.1%

The spread of the highly contagious Delta variant during the summer led to an unfortunate upsurge in daily new cases, hospitalizations, and deaths. However, on the positive side, this fourth wave appears to have peaked globally and is subsiding. Given the ongoing rollout of effective vaccinations-with more than 6 billion total shots given—and rising natural immunity, along with social/behavioral adjustments, we believe the most likely scenario is for the virus's impact on global economic activity to continue to diminish over time.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	0.5	29.0	17.8
US Mid Cap Stocks	0.0	36.1	14.6
US Small Cap Stocks	-2.6	44.0	14.0
Developed International Stocks	-1.2	27.3	9.7
Emerging Market Stocks	-6.6	18.9	9.5
US Bonds	0.1	-0.9	2.9
Global Bonds	-1.6	-1.2	1.1
US REITs	0.7	35.8	5.6

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
US Mid Cap Stocks: CRSP US Mid Cap TR USD
US Small Cap Stocks: CRSP US Small Cap TR USD
Emerging Market Stocks: FTSE Emerging TR USD
Developed International Stocks: FTSE Developed Ex US TR USD
US Bonds: Barclays US Aggregate Bond TR USD
Global Bonds: Barclays Global Aggregate Ex USD TR USD
US REITs: MSCI US REIT NR USD

On the fiscal policy front, the quarter witnessed Washington gridlock, political posturing, and party infighting. It remains to be seen what type of infrastructure spending and tax-hike legislation emerges from Congress in the weeks ahead. We were not surprised with the last minute resolution to the federal debt ceiling standoff, though the reprieve only lasts until December. We do not believe it is in either party's best interest to engineer a Treasury default, but the markets understandably become anxious each time politicians play so close to a proverbial third rail.

On the monetary policy front, The Federal Open Market Committee (FOMC) produced their quarterly economic and interest rate projections. These revealed a modestly hawkish shift compared to last quarter's meeting. Nine of the eight-

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een FOMC participants now expect to start raising interest rates by the end of 2022, compared to just seven at the June meeting. The median FOMC member also expects an additional three federal funds rate hikes in 2023 and three more in 2024. This would bring the target fed funds rate to 1.75% by the end of 2024. However, it's important to remember that the FOMC rate projections—the "dot plots"—have never been an accurate forecast of the Fed's actual interest rate moves several years out. As we've often said, no one, not even the Fed itself, knows what the Fed will actually do two or three years from now.

The FOMC's updated forecasts for growth and inflation reflect the evolving economic consensus. The Fed has lowered its median GDP growth forecast for 2021 to 5.9%, from 7.0% in June, a function of the Delta-driven growth slowdown during the summer and ongoing production shortages and supply-chain bottlenecks (e.g., semiconductor and shipping container shortages). Although global and U.S. economic growth rates slowed in the third quarter, they are still solidly above trend, and the near-term (6– to 12-month) risk of recession remains low, absent the always-present possibility of an exogenous shock (e.g., geopolitical conflict, etc.). Meanwhile, along with reducing its 2021 growth forecast, the FOMC raised its median core inflation forecast for this year pointing to ongoing supply-side disruptions (e.g., new car prices continue to rise). Since June, the inflation data have continued to give mixed messages. The "transitory vs. sustained high inflation" debate remains unresolved.

For example, while key measures of wage inflation remain within a normal historical range, they *have* increased over the past few months. The same is true for some key measures of inflation expectations. Shelter prices (measured by the government as rent and "owner's equivalent rent") account for roughly 40% of core CPI and are now on the upswing as a result of the sharp, sustained rise in national home prices, which have surged a record 19% in the past twelve months.

On the other hand, August's CPI inflation numbers came in below consensus expectations. Month-over month core CPI rose just 0.1%. And the majority of recent inflation increases still look to be driven primarily by pandemic-related supply and demand shocks that should continue to normalize over the next year, assuming the pandemic comes further under control. We also give some credence to Powell's (and other Fed governors') statements that the Fed will act to tighten monetary policy if core inflation stays elevated and/or medium- to longer-term inflation expectations become unanchored.

If incoming inflation data (e.g., wages, core inflation metrics, and inflation expectations) strongly support the "non-transitory high inflation" argument, and if history is any indication, the market and the Fed are likely to respond by pushing interest rates higher. If the level of Fed tightening was to exceed investor expectations it would likely hurt investor sentiment and impact valuation multiples, particularly for the long-duration high-growth stocks that have been the primary beneficiary of the recent period of exceptionally low yields and low inflation.

Some analysts are quick to point out that the U.S. stock market has not experienced a 10% correction in more than a year. It should be noted however that the stock market has had periods in the past where it has gone several years without a 10% correction. Additionally, investors should keep in mind that for the past decade, the S&P 500 has gained well above its long term historical average. Absent significant U.S. stock valuation expansion (higher price-to-earnings multiples), higher than average U.S. stock market annualized returns may be more difficult to come by at this point. In contrast, international stocks have had a less notable decade of performance, and appear better positioned going forward from a long term valuation standpoint.

Markets will always have periods of increased volatility like the type we observed as the third quarter came to a close. As always, the best defense against unexpected stock market movements is a sound, fundamentally grounded investment process that will weather the short term ups and downs that inevitably occur in market cycles. Maintaining a long term perspective is crucial to successfully capturing market returns.

Thank you for your continued confidence and trust.

Timothy S. Healey
Chief Investment Officer

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Chief Operating Officer

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