

EQUITY MARKET UPDATE

As of 9/30/21 | Volume 10, Issue 9 | FFTAM.com

Stocks' winning streak ended in September. Rising interest rates after the Fed meeting was the biggest culprit. Politics also played a major role. The US Congress continued to debate the two massive spending measures proposed by President Biden, while Speaker Pelosi and Senate Majority Leader Schumer have yet to garner the needed votes to raise the debt ceiling. In China, President Xi continued his regulatory crackdown on various industries, and energy shortages in a major manufacturing region will likely cause further supply chain disruption. Economic data softened in September but remained firmly in expansionary territory. Inflation readings, meanwhile, are running hotter than Fed estimates. Daily new infections from the Delta variant appear to be falling, which should result in further reacceleration in economic activity.

Tech Sell-Off Leads US Stocks Lower

The S&P 500 fell 4.76% in September. The index was powered by a rally in energy stocks and banks. Higher interest rates led to a sell-off in tech stocks, along with utilities, real estate, and materials. Year-to-date, the S&P 500 is still up 14.68%; however, the index is little changed since June.

The Dow Jones Industrial Average declined by 4.29% last month. A lower allocation to technology helped performance versus the S&P 500. Year-to-date, the Dow is up 10.58%. Less technology, along with poor performance from Boeing, Visa, Honeywell, and Disney have hurt returns.

The NASDAQ was the worst performer among the major indexes losing 5.31%. After being the market darling throughout the summer due to the spread of the Delta variant, big tech stocks sold off as the Fed announced plans for tapering monthly asset purchases, and new daily COVID infections improved. Large declines in Facebook, Apple, Microsoft, Amazon, Alphabet, NVIDIA, and PayPal accounted for the bulk of the loss. The NASDAQ still trails the S&P 500 in 2021 with a total return of 12.11%.

Mid-to-small sized companies were not spared during the late month sell-off, although they did outperform their large cap peers. The S&P 400 Mid-Cap Index fell 4.09%, while the S&P 600 Small-Cap Index decreased 2.56%. Both indexes were aided by an overallocation to banks. Thus far in 2021, mid and small-sized companies have rallied 14.48% and 19.01%, respectively. The small-cap index return continues to benefit from meme stocks, like AMC Entertainment and GameStop, as retail investors chase ideas being spread on the social media platform Reddit.

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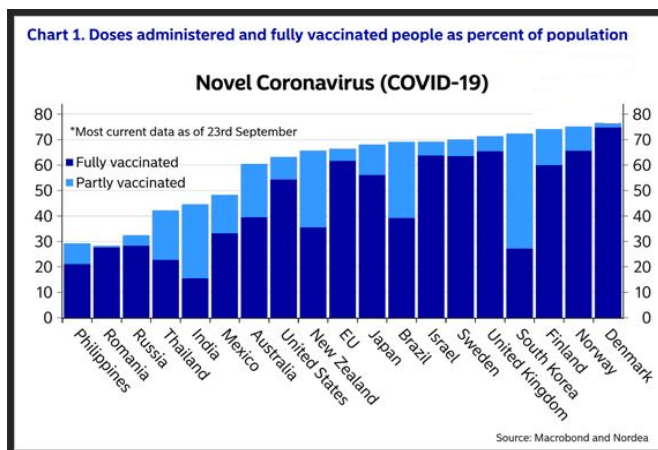
International & Emerging Market Stocks Fall & Trail US Indexes YTD

The Eurozone reopening continued although economic data was slightly less than the previous month. The IHS Markit European PMI Index was 56.2. This is a strong result, although it was less than the previous month's 60.2, the highest level since 2000. A retracement was seen in manufacturing (58.6) and services (56.4); however, both readings are signaling strong expansion. Difficulty in getting parts was a large detractor as supply chains are strained worldwide. Also, a lack of truck drivers and power outages in the UK due to poorly performing wind farms caused 50% to 90% of retail gas stations to run out of fuel throughout the country. Eurozone inflation was 3%, much hotter than ECB targets. The European economy is gaining steam as over 70% of eligible EU citizens are fully vaccinated against COVID-19. Conditions also improved in Japan as the government removed all COVID related restrictions, and Fumio Kishida was named the new Prime Minister. The MSCI EAFE Index decreased 3.19%. Year-to-date, the index is up 6.23%.

The MSCI Emerging Markets Index fell 4.25% in September as Chinese economic activity slowed once again. An increase in Delta variant cases led to weak service and factory data. Retail sales rose just 2.5% year-over-year, well below the 7% consensus forecast. Auto sales were the biggest drag, falling 7.4% in the past year, as semiconductor shortages persist. Fixed asset investment and industrial production numbers were also less than expected. In Hong Kong, real estate values fell as property developers faced renewed pressure from President Xi to control prices, and China's largest property developer Evergrande spent most of the month restructuring debt to avoid default. Energy shortages occurred in the Guangdong region that is home to many major factories. Several companies have reported production cuts to conserve power; therefore, global supply chains are likely to suffer further challenges. Year-to-date, emerging markets are the only major index in the red with a loss of 2.96%.

Global Vaccinations Increase, FDA Approves Boosters, & Merck Develops Anti-Viral Pills

The Delta variant of COVID-19 that originated in India and spread worldwide showed signs of abatement in September. Daily new infections have begun to decline in the United States, Western Europe, and Japan. The number of people fully vaccinated continues to increase worldwide. The lowest levels of protection are in the emerging markets where access and storage of the vaccine remain a challenge. The FDA joined Israel and Europe by approving a booster shot of the Pfizer vaccine for individuals who are more than eight months removed from their second shot. In the United States, senior citizens, patients with autoimmune disorders, and folks who work in highly populated environments are eligible for the booster. In mid-October, the FDA will evaluate data submitted from Moderna and Johnson & Johnson on their booster shots. Pfizer also submitted their clinical trial results for giving a one-third dose of vaccine to children ages 5-11. The FDA will meet regarding the child vaccine in late-October. Finally, the biggest news on the pandemic came from Merck. They announced the development of anti-viral pills for COVID-19 that act like Tamiflu for flu patients. The medication can be given to patients who are within 5 days of developing symptoms. Clinical trials showed the risk of hospitalization fell by more than 50% and the likelihood of death was reduced by over 95%. If approved by the FDA, Merck plans to deliver 1.7 million doses to the United States by year-end, and they will significantly ramp-up production in 2022. The combination of vaccines, anti-viral pills, and antibody cocktails could transform COVID-19 from a pandemic to an endemic, similar to the seasonal flu. This would greatly improve economic activity by allowing people to return to their normal lives and settings.



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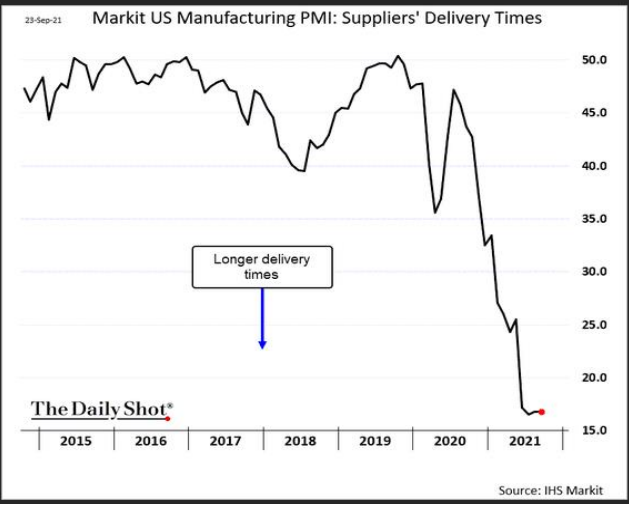
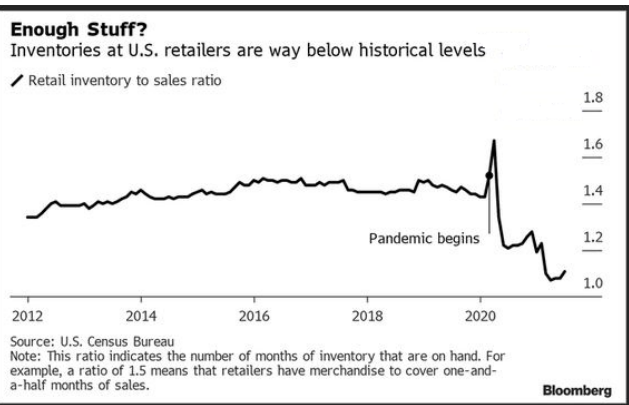
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US Economy Slows but Remains Healthy, While Fed Nears Taper

Economic data showed further improvement in September; however, the pace of growth continued to slow. Non-farm payrolls increased by only 235,000 jobs. This was a significant slowdown from the levels seen during the summer despite the end of enhanced unemployment benefits nationwide. As I have written for the past several months, there are numerous reasons for the drop. First, the spike in Delta variant cases caused hotels, restaurants, and retailers to slowdown hiring plans. Labor force participation continues to improve among prime aged workers (25-54 years old); however, the number of people over the age of 55 that are electing to retire is far above historical trend. Finally, there are mismatches in jobs available and the skill sets of unemployed citizens. All of these factors are contributing to worker shortages and higher wages. The problem is most acute among lower skilled jobs and manual labor such as fast-food restaurants, hotel cleaning staffs, warehouses, truck drivers, and construction.

Both US Manufacturing and Service PMIs declined slightly, although both remain firmly in expansion territory. Supply chain issues remain problematic as order backlogs and delivery times are stretched. Consumers' ability to spend is high, but inventories for many products are at low levels with the most critical shortages occurring in automobiles. This is pushing up prices at both the producer and consumer levels.

Hotter than expected inflation readings has placed outsized attention on the Fed. The FOMC left monetary policy unchanged during its September meeting; however, Federal Reserve Chair Jerome Powell said they would likely start scaling back monthly bond purchases in November and end the program altogether by mid-2022. The dot plots, which show the views on future interest rates from 18 Fed officials, pointed to earlier and more rapid tightening than previously communicated. The first interest rate hike is now projected for the end of 2022. During the press conference, Mr. Powell continued to reiterate that inflation is transitory as the economy reopens; however, he admitted that many of the inflation readings have remained persistently high for longer than initially thought. This why the Fed accelerated their forecast for future rate hikes. In the eight days after the Fed meeting, interest rates increased with the 10-year US Treasury rising to 1.51% from 1.32%, which sparked the sell-off in the stock market.



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Market PE Remains Elevated Entering Earnings Season

Currently, the S&P 500 trades at 21.28x 2021 EPS estimates. This is far better than the 25.82x trailing earnings reading, and it shows how rapidly corporate profitability has improved. This puts heightened attention on the upcoming earnings season. According to FactSet, 3rd quarter earnings are expected to grow 27.6% on a year-over-year basis. This a strong forecast, but it is a major deceleration from the 2nd quarter's growth of 90.1%. This is a signal that we have passed the easiest year-over-year comparisons. There will also be close attention paid to comments about product availability and cost inflation. In September, Nike and FedEx reported supply chain issues and employee shortages, which resulted in downward pressure on their stocks.

Even if earnings forecasts come to fruition, stock valuations remain pricey. If you fast forward to the 2022 and 2023 profit forecasts, the index trades at 19.43x and 17.74x, respectively. This is an improvement from last month, but all these valuations are well above the historical median of 16.69x. They also do not consider President Biden's proposed tax increases.

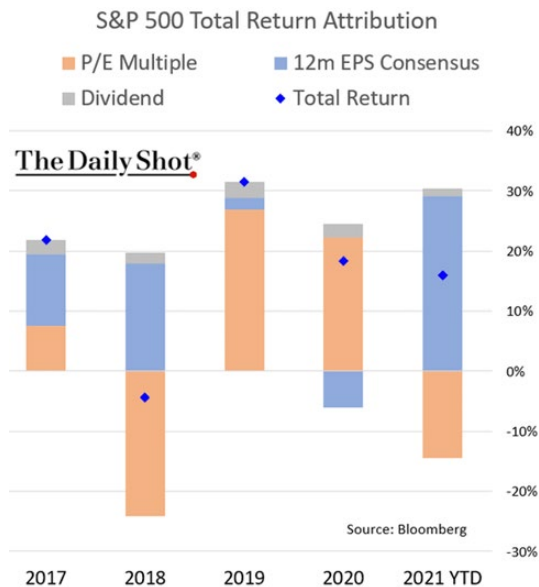
The above average valuations can be justified by low interest rates and the enormous amount of liquidity in the system. However, the Fed and other global central banks have announced reductions in their asset purchase plans as the global economy reopens and inflation readings remain elevated. This makes stocks ripe for increased volatility, especially among the higher valuation growth names. Last month's sell-off let some of the air out of the balloon, but the market is still vulnerable to further consolidation or pullbacks in the next few months.

Our Outlook & Strategy

The stock market has operated under two very different climates thus far in 2021. For the first five months, investors' willingness to take risk was high, and they preferred the most economically sensitive stocks. That trend reversed itself during the summer months as the Delta variant spread across the globe and consumers spent their stimulus checks. This led to a rotation towards quality, which aided our portfolios.

As autumn progresses, many questions need to be answered. First, is the recent deceleration in economic activity purely a function of the Delta variant, or have consumers spent all their stimulus funds? Is the Fed's tapering of asset purchases a good or bad thing for stocks? Will Congress pass President Biden's massive spending proposals that increases taxes, and what effect does that have on future earnings? Is inflation really transitory, or has the pandemic exposed weaknesses in global supply chains that will lead to longer term price pressures? The answer to those questions will have a significant impact on both the direction of the overall market and the stocks that serve as leaders.

Even though global central banks are starting the process of scaling back stimulus, they have vowed to go slow and proceed with caution. This leaves vast amounts of liquidity in the system that must find a home. Interest rates rose last month, but bonds still trade at negative real yields (the rate on a bond minus the inflation rate) and credit spreads are tight. Therefore, the bond market is providing little competition to stocks, which is supporting the higher valuations.



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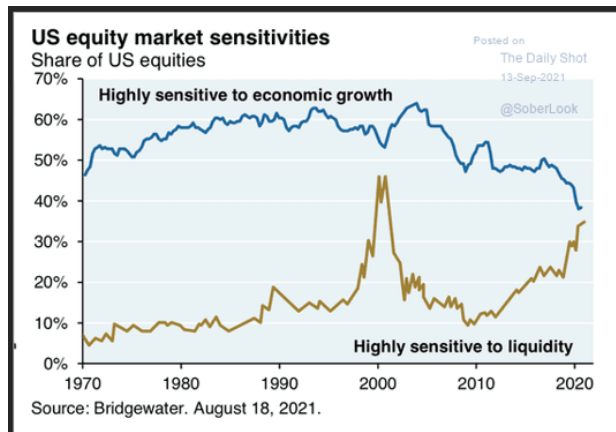
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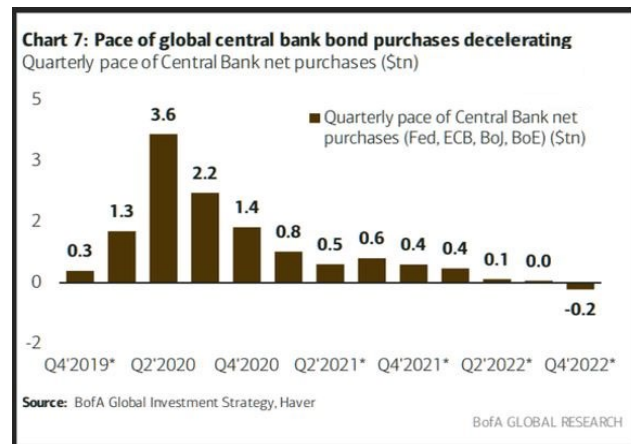
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I have said many times that the yield on the 10-year US Treasury has become the most important price indicator in the world. The correlation between bonds and stocks is high; therefore, providing less diversification benefits than the past. The excess liquidity is inflating all assets to levels that have historically indicated below average forward one-year and five-year returns. A recent chart from Bridgewater showed the stock market is becoming almost as sensitive to liquidity levels as economic growth. This means volatility will likely remain high. It also makes inflation readings very important to watch. The future path of interest rates and the speed in which they change will determine whether growth (led by technology) or value (led by financials and energy) will serve as market leadership.



The effects of COVID-19 have created a new “normal” for investors to consider. We have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, doctor visits, etc. We have also adapted to a non-centralized workforce. We have seen from the past two administrations that the United States wants to encourage domestic manufacturing of semiconductors, medical equipment, and other items deemed to be of national security importance. Finally, the rush to develop a vaccine has brought many new healthcare related technologies to the marketplace. When considering all these items collectively, the Fed is likely correct that total inflation will prove to be transitory as productivity rises from these technological innovations; however, a misallocation of workers and skillsets increases the likelihood that certain pockets of the economy will see above average inflation for many years.



As we evaluate our roster of holdings across our equity styles, we remain highly selective about which companies to own. We are constantly searching for companies that will benefit from long-term secular trends that can produce top-line revenue growth and sustainable cash flows. This naturally leads to overweight positions in technology and healthcare. These stocks are negatively impacted when interest rates rise, so we have been boosting our holdings in energy and financials to offset this risk should inflation readings remain hot for longer than expected.

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