MoneyMatters
Market Update

Q4
2021

Navigating Uncharted Waters

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It has been nearly two years since the pandemic began, and finally there are indications that a global recovery is on the horizon. As vaccine distribution continues to expand, the US and the world overall are adapting to a new semblance of normalcy.

Significant headwinds, however, continue to batter the speed of recovery. Markets have been volatile, and the S&P 500 Index fell 4.8% in September, the worst month since March 2020 (Source: *Financial Times*). The bond market experienced its eighth worst start ever during the first nine months of the year, creating challenges in balancing risk and return for prudent investors. (Source: *Morningstar*)

It is our view that we are now formally in an inflationary period with no realistic end over the near term. The economy is continuing to be plagued by increasing food and gas prices along with deepening port delays and supply shortages—all contributing to the inflation we are witnessing. Further complicating matters is the multi-trillion-dollar spending package currently in limbo in Congress—with unknown impacts on the American public, our day-to-day lives, or the economy should it pass.

The US is working to fully reopen, but navigating the uncharted waters of vaccine mandates on citizens, an unprecedented labor shortage, continuing government stimulus efforts beyond unemployment benefits, and resurfacing fears of a winter surge of the Covid Delta variant certainly add to the vortex of instability throughout the country.

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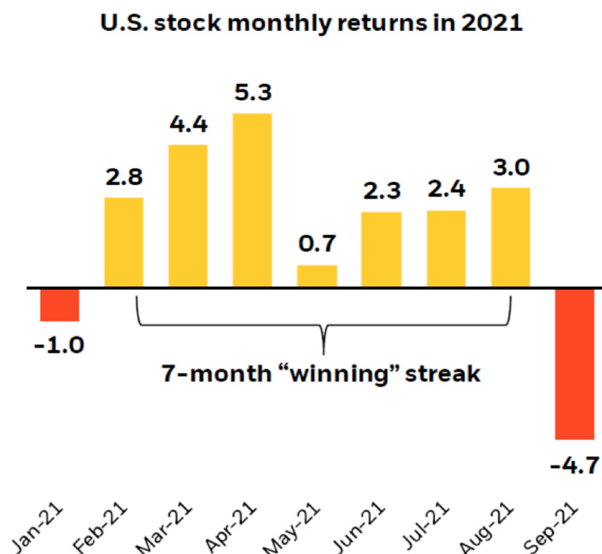
Market Recap

Stock Market

September is historically the worst month of the year for stocks. The S&P 500 Index ended the month down 4.8%, its first monthly drop since January and the largest since March 2020. (Source: *Financial Times*) After climbing steadily for much of the year, the stock market became rattled by the spread of the more contagious Delta variant of the coronavirus, a sudden surge in long-term bond yields, and word that the Federal Reserve may start to roll back its support for the economy via a reduction of its bond buying program.

September Snaps 7-Month "winning" Streak for Stocks

U.S. stock monthly returns in 2021



Other recent winning streaks for stocks
Since 1990

Ending Month	Length of streak (months)	1 year later
Jan-18	15	-2.3%
Sep-95	10	20.3%
Jun-96	8	34.7%
Jan-07	8	-2.3%
Apr-11	8	4.8%
May-91	7	9.9%
Mar-93	7	1.5%
Sep-09	7	10.2%
May-13	7	20.5%
Sep-16	7	18.6%
Aug-21	7	?
Apr-98	6	21.8%
Aug-03	6	11.5%
Apr-06	6	15.2%
Sep-18	6	4.3%
Jan-99	5	10.4%
Feb-04	5	7.0%
Dec-04	5	4.9%
Jun-14	5	7.4%
Aug-20	5	31.2%
Average	7	12.1%

Morningstar as of 9/30/21. U.S. stocks are represented by the S&P 500 TR Index from 3/4/57 to 9/30/21 and the IA SBBI U. S. Lrg Stock TR USD Index from 1/1/50 to 3/4/57, unmanaged indexes that are generally considered representative of the U.S. stock market during each given time period. Past performance does not guarantee or indicate future results . Index performance is for illustrative purposes only. You cannot invest directly in the index.
Source: BlackRock

All major equity sectors ended September in negative territory, as demonstrated by the overall Russell 1000 index, which was down 5.6%; the Russell 1000 large-cap value index was down 3.48%, and the Russell 2000 small-cap value index was down 2.95% on the month. International stocks were down by 3.97%.
(Source: *Morningstar*)

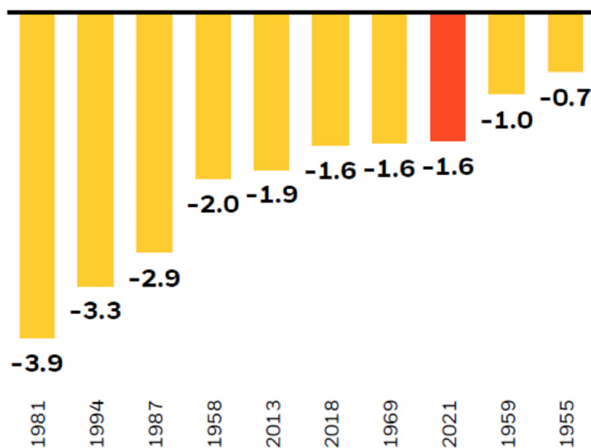
Interest Rates and the Bond Market

The bond market experienced the eighth worst performance ever for the first nine months of the year (ending September), and 2021 could end up being one of the worst years on record. Nearly all fixed income categories were in the negative for September, with the Bloomberg Aggregate Bond Index (which tracks the general US bond market) down by 0.87% for the month. (Source: *Blackrock*)

8th Worst Start of a Year Ever for Bonds

For the worst starts, the next 3 months on average saw bond returns bounce back

Top 10 worst starts of the year for bonds
(Since 1926, total return for first nine months of calendar year)



Returns after each "worst start"
(Since 1926, total return for given time periods)

Year	First 9 months	Next 3 months
1981	-3.9	10.6
1994	-3.3	0.4
1987	-2.9	5.8
1958	-2.0	0.7
2013	-1.9	-0.1
2018	-1.6	1.6
1969	-1.6	0.9
2021	-1.6	?
1959	-1.0	0.6
1955	-0.7	0.1
Avg	*-2.1*	*2.3*

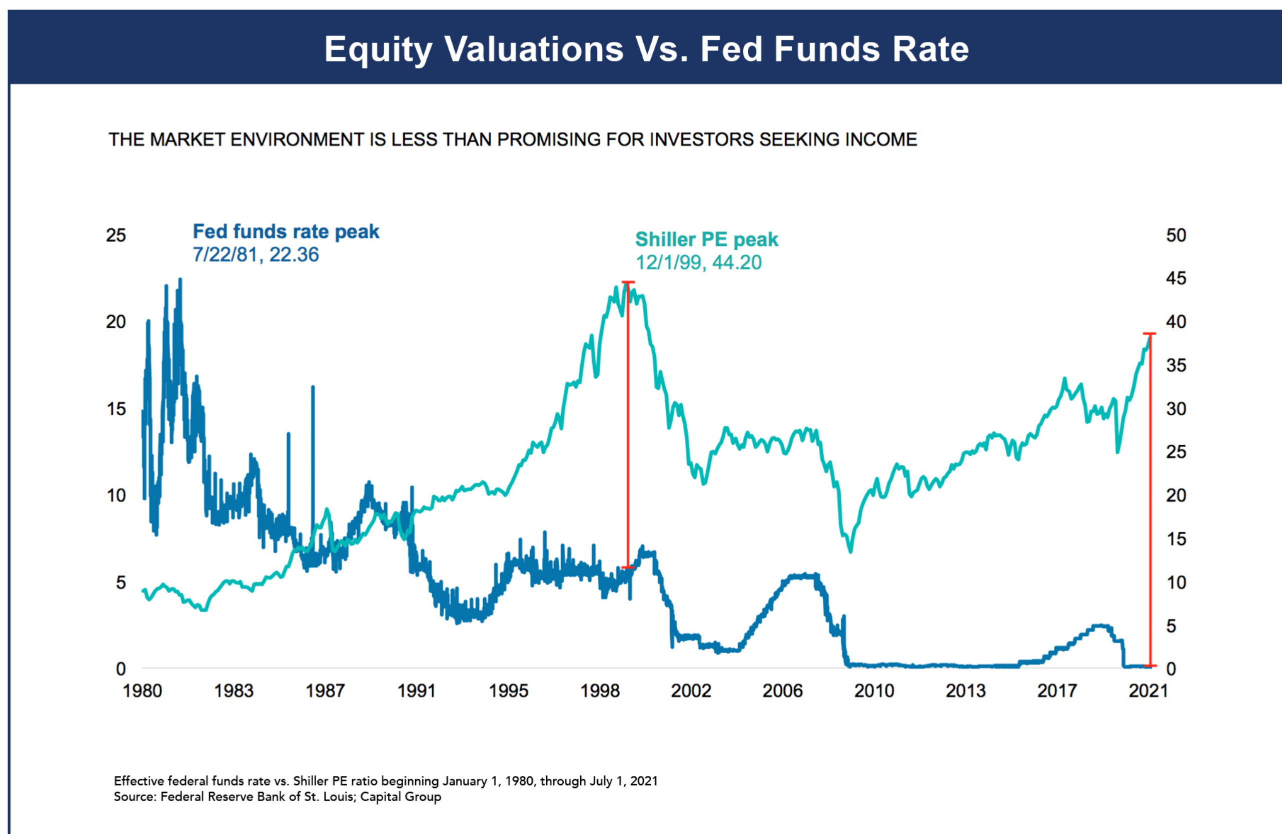
Morningstar as of 9/30/21. U.S. bonds represented by the IA SBBI US Gov IT Index from 1/1/26 to 1/3/89 and the BbgBarc U.S. Agg Bond TR Index from 1/3/89 to 9/30/21. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.
Source: BlackRock

According to analysts, the current low yields on the Bloomberg Aggregate Bond Index imply a high probability of zero or negative returns through the end of 2021, with a 50% probability that nominal returns for the index will be between -0.9% and +0.9% through year-end. (Source: *Blackrock*)

Quantitative Easing and Falling Interest Rates

The decline in interest rates has been dramatic over the last 10 years. The chart below shows the Shiller P/E ratio, which measures equity stock prices relative to earnings per share versus the federal funds rate (money market rate), which refers to the target interest rate set by the Federal Open Market Committee (FOMC).

We are experiencing the byproduct of the Fed's near-zero interest rate policy and the largest spread in the last forty years between the Fed Funds rate and equity valuations. (Source: *Capital Group*). We believe that this policy has led to asset bubbles in many asset classes including domestic, large company tech stocks, real estate, and cryptocurrency.



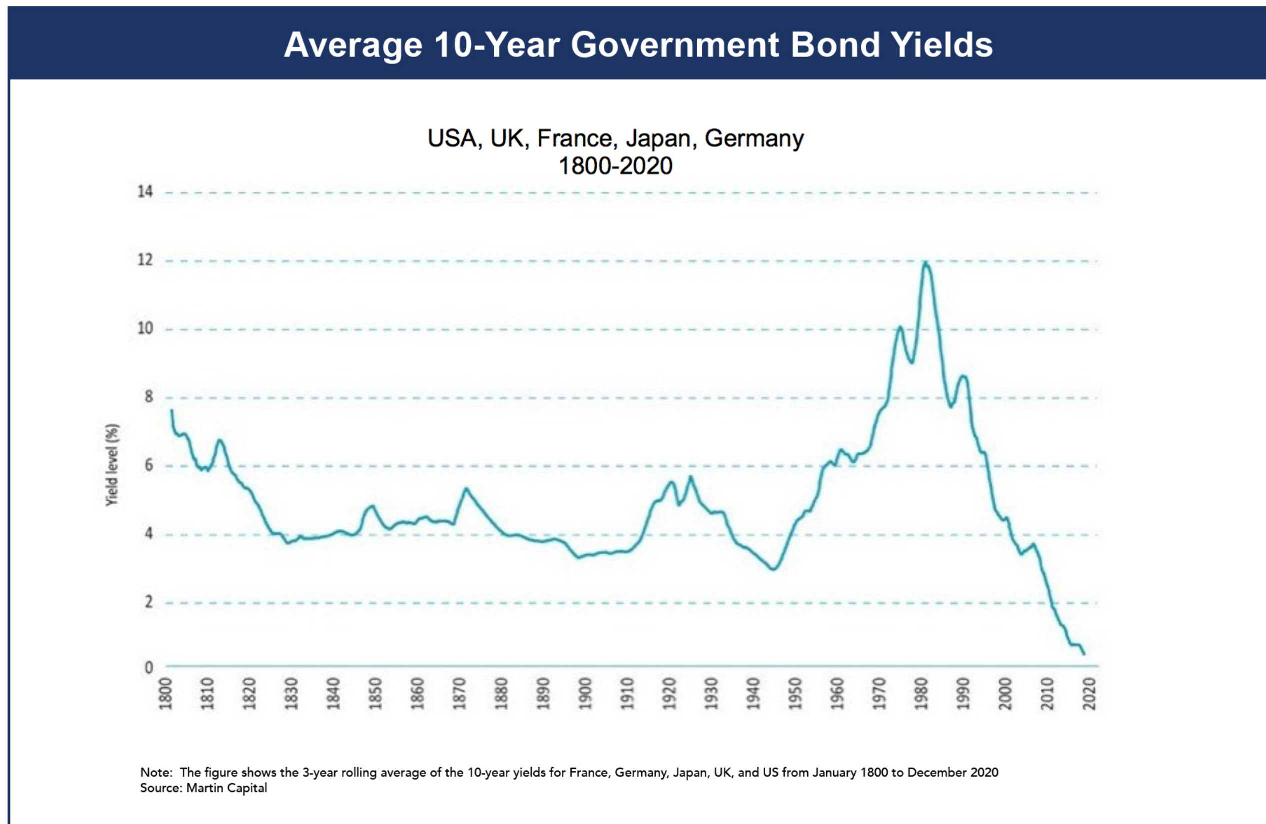
Effective federal funds rate vs. Shiller PE ratio beginning January 1, 1980, through July 1, 2021
Source: Federal Reserve Bank of St. Louis; Capital Group

In response to the pandemic, the Federal Reserve announced on March 15, 2020, the purchase of $700 billion in government bonds and mortgage-backed securities from domestic financial institutions—a policy known as quantitative easing (QE). Then, on June 10, 2020, it extended the program by $120 billion per month until further notice. (Source: *Federal Reserve Bank of New York*)

This type of easing has occurred only once before in American history, during the 2008 market crash. The aim is to increase the country's money supply to encourage lending and spur economic activity by keeping short-term interest rates low (usually targeted at 2%). In contrast, long-term interest rates are affected by demand for 10- and 30-year US Treasury notes.

The Risks of Quantitative Easing

While QE was implemented to help mitigate an economic depression, the average 10-year government bond yields are currently about 1.627% as compared to the unusual spike to 12% to fight hyperinflation in the early 1980s. (Source: *ROBECO; Baltussen, Martens, Penninga—June 2021*)



Average 10-Year Government Bond Yields

Note: The figure shows the 3-year rolling average of the 10-year yields for France, Germany, Japan, UK, and US from January 1800 to December 2020
Source: Martin Capital

Investors are attracted to government bonds because they have been a very safe investment historically. However, the Federal Reserve's low interest rate policy has created a challenge for investors.

For example, a responsible senior citizen who holds $300,000 in bank certificates of deposit (CDs) that until recently had been yielding approximately 4% can no longer live comfortably from the income, as a one-year CD currently pays 25bps or ¼ of 1%. As a result, investors are considering moving away from the traditional 60/40 stocks-to-bonds portfolio allocation and opting instead to take on more risk by increasing their allocation to more volatile assets in hopes of increasing returns.

As long-term investors, we believe that we should welcome higher interest rates as they will provide greater interest income over time but must deal with near-term pressure on bond values until things settle out.

The Fed has begun scaling back on bond purchases and may potentially raise interest rates in mid to late 2022.

International Stocks

International equities were down 8.09% for the third quarter (Source: *Morningstar*), so we'd like to address the recent headline risk on China.

In July 2021, China's equity market suffered one of its worst monthly declines in a decade amid internal, escalating regulatory pressures. The steep fall has raised concerns about the outlook for and risks of investing in Chinese equities. (Source: *Capital Group*)

In short, these regulations may affect various industries in China's economy, including:

- **Housing**
- **Private tutoring**
- **Consumer finance**
- **Online gaming**
- **Mobile apps**
- **Restrictions on M&A activities of technology firms**

In some areas, such as cybersecurity and digital commerce, current rule-making and stricter enforcement parallels the efforts by policymakers in the US and Europe to regulate the digital economy and protect consumers.

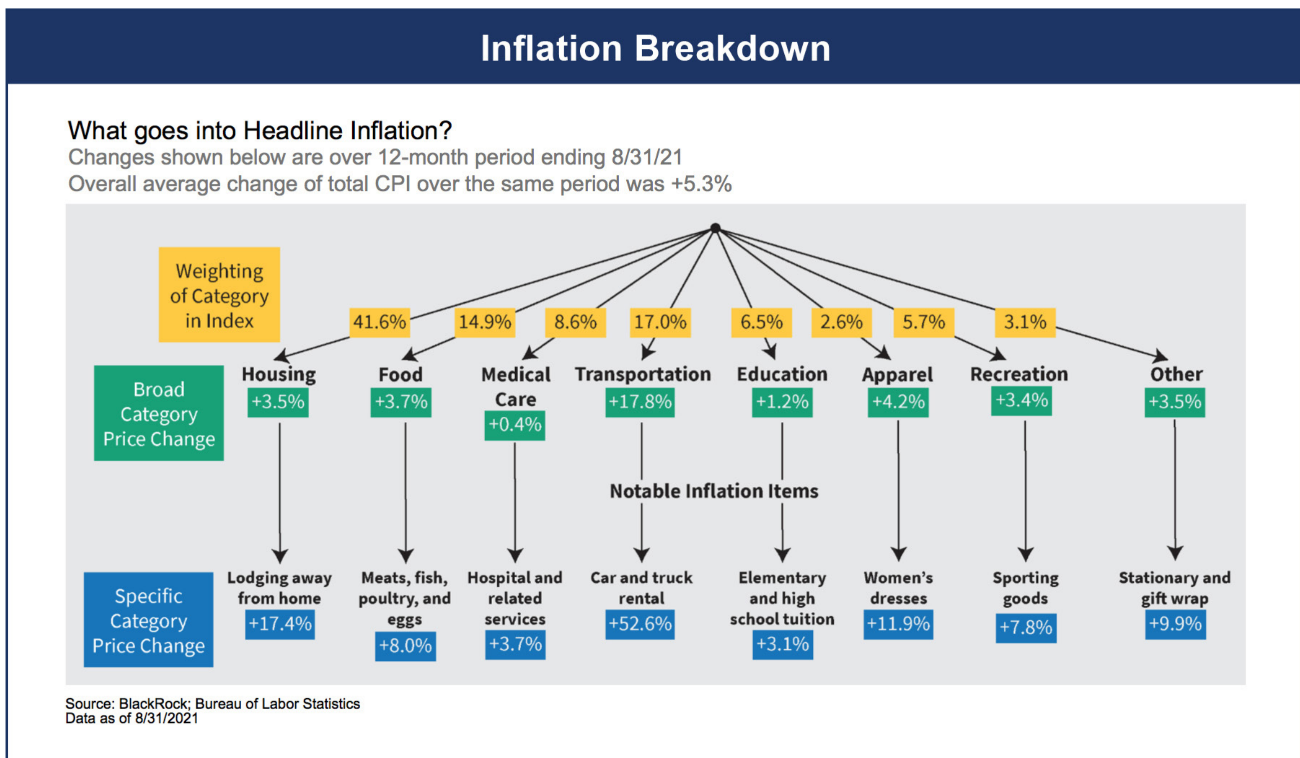
Regulations can cause a loss of profitability, increase the cost of conducting business, and lower business valuations inside China's economy—something the Chinese Communist Party (CCP) would like to avoid given its main goal of building and strengthening the capabilities of its domestic economy. Roehl & Yi does not believe this market turbulence will have a meaningful ripple effect in the US markets.

The Economy

Inflation

The US is in an inflationary period which we believe is likely to persist.

The Consumer Price Index (CPI) has increased to 5.4% in the last 12 months and 6.5% on an annual basis so far in 2021. This is the largest year-over-year increase in 13 years. (Source: *Department of Labor*)



Roehl & Yi believes we are experiencing what is known as a bottleneck recession. Many products and services that are needed to operate the US economy are in short supply and this may begin to impact demand activity.

Evidence of a Bottleneck Recession

- ***Paint Manufacturing***: The paint industry is experiencing broad shortages in supplies, including paint, paint buckets, and plastic handles for paint brushes.

  Sherwin-Williams' CEO John G. Morikis recently said, *"In addition to the significant supply challenges, raw material pricing remains highly elevated, and we are increasing our full-year raw material inflation outlook to be up a high-teens percentage compared to last year. We continue to combat these elevated costs with pricing actions across all of our businesses."*

- ***Auto Industry***: Dealerships are grappling with limited supply and frustrated consumers.

  For example, one dealership in Michigan sold eight out of 10 Chevrolet Silverados before they even arrived on the lot. The remaining two sold only a few hours later (Source: *Financial Times*). Inventory levels have dropped from a 90-day supply to two days or fewer. Ownership even sold a fleet of “loaner” vehicles which had previously been used by customers while their vehicles were being repaired.

  The semiconductor shortage that has disrupted the global car manufacturing industry is touching every participant in the chain of supplying, building, selling, and disposing of cars and trucks in the US, a country with 276 million registered vehicles. Even junkyards are struggling to replenish inventory. (Source: *Financial Times*)

- ***Port Challenges***: US shipping operations continue to be log-jammed due to a lack of labor (for shipping lines, port workers, truckers, warehouse operators, railways, retailers, etc.) and lack of agreement on timeframes for operations.

  Tens of thousands of containers remain trapped within the ports of Los Angeles and Long Beach, California, whose waters transport more than 25% of all US imports. Current operations stand at 60-70% of their capacity. (Source: *Wall Street Journal*)

For context, the US reopened at a greater rate of speed than many other countries, including Asia, Germany, and Australia.

The Energy Crisis

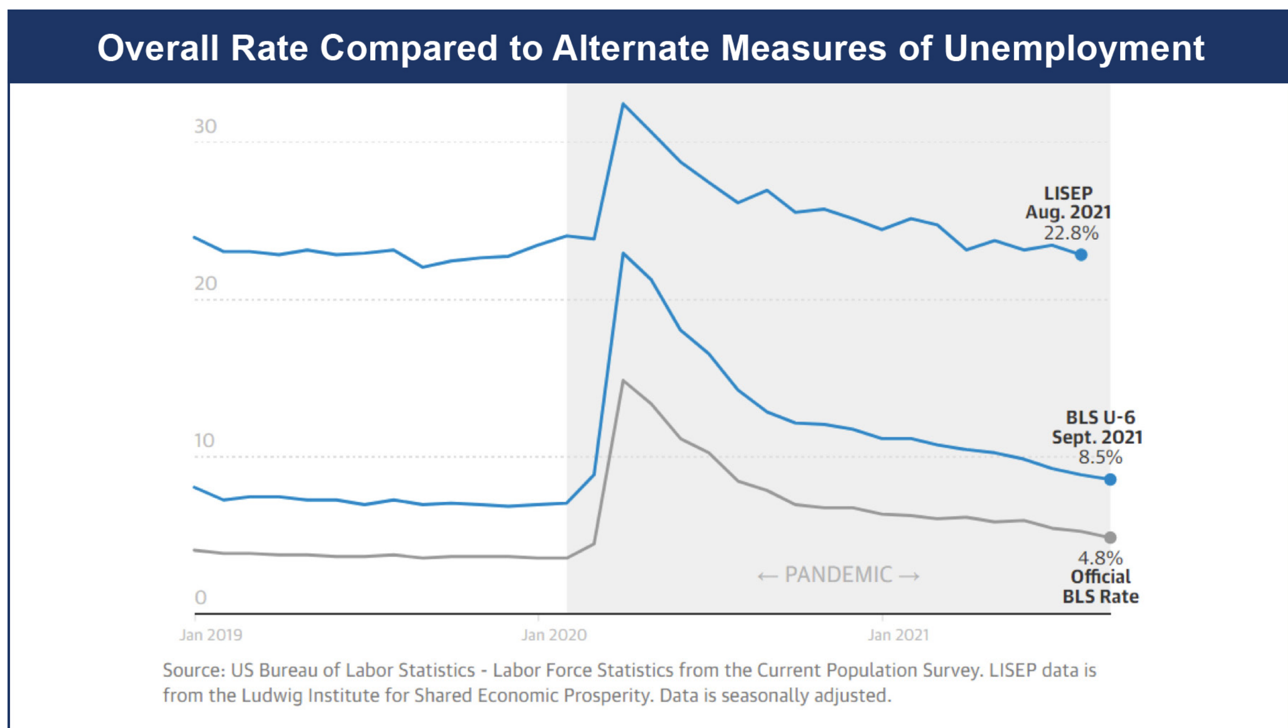
Energy prices are high and are expected to remain so through the winter. Between the COVID-19 pandemic, restrictions on new oil and gas leases by the federal government, the shutdown of key pipeline initiatives, and hurricanes in the southeast shutting down refineries, crude oil prices have risen to their highest level in seven years, $80 a barrel (Source: *Wall Street Journal*). Global energy shortages are also occurring in Asia and Europe, in particular, where wind power is not bearing fruit due to a lack of wind. (Source: *Wall Street Journal*)

Roehl & Yi expects that the higher demand in the coming months will likely result in further inflation and interest-rate increases.

Unemployment

September added 194,000 jobs (down from 366,000 in August), and the official unemployment rate fell to 4.8%, the lowest since its climb to 14.7% when the pandemic began. (Source: *Bureau of Labor Statistics*)

These figures, however, tell only a partial story. The headline unemployment rate measures the proportion of the American civilian labor force (anyone over the age of 16) who do not have jobs and are still actively looking for work. It does not include the millions of people who are not looking for work or who have left the labor market. In fact, research suggests that the real unemployment rate is closer to 22%.
(Source: *Ludwig Institute for Shared Economic Prosperity*)



Source: US Bureau of Labor Statistics - Labor Force Statistics from the Current Population Survey. LISEP data is from the Ludwig Institute for Shared Economic Prosperity. Data is seasonally adjusted.

Increasing Wages

The recent increase in wages compared to the last five to seven years is a positive change, although it has been precipitated by the labor shortage. This leaves employers grappling with increased costs that will likely be passed to consumers, which may prove difficult to reverse given the period of inflation we are experiencing.

Consider these two scenarios:

- A credit union in the southwestern US is now paying new cashiers $20/hour, an increase of 33% from previous wages. (Source: *Security Service Federal Credit Union*)
- Bank of America placed a full-page advertisement in *The Wall Street Journal* offering a starting rate of $21/hour.

Roehl & Yi believes these wage increases may become permanent.

Tax Policy

Given the contentious tax policy legislation currently making the rounds in Congress, we wanted to outline some key tax considerations. The Biden administration has proposed about $4 trillion of new federal spending over 10 years, partially funded by higher taxes for individuals and businesses, through bills that include everything from increases in capital gains and corporate income taxes to new individual and business tax credits.

American Jobs Plan (AJP) Highlights*:

- Raise the federal statutory corporate tax rate from 21% to 28%.
- Impose a 15% minimum tax on worldwide pretax corporate book income for firms with more than $2 billion in net income.
- Raise the top marginal income tax rate from 37% to 39.6%.
- Tax long-term capital gains as ordinary income for taxpayers with adjusted gross income above $1 million, resulting in a top marginal rate of 43.4%.
- Extend the enhanced Child Tax Credit (CTC) in the American Rescue Plan Act (ARPA) through 2025. This tax credit provides $3,600 for children under age six and $3,000 for children aged six to 17, phasing out at a 5% rate beginning at $112,500 for head-of-household filers and $150,000 for joint filers.
- Increase Internal Revenue Service (IRS) funding by $72.5 billion over a decade and make other IRS reporting and compliance changes to increase tax collection activities.

**Partial list only.*

(Source: *Taxfoundation.org*)

We will follow these developments closely.

Final Thoughts

We expect a continuing recovery in the coming months. We also believe the US economy is strong, and while there are major headwinds, both known and unknown, there are positive signs that demand will continue, and recovery will follow.

What Should You Do as An Investor?

Consider these three suggestions:

- As year-end approaches, talk to Roehl & Yi about tax planning and consider charitable giving or seeking alternative investment strategies.
- Be prudent in your approach to stock investing and stay within your tolerance for risk.
- Remember that moderately rising interest rates over time are positive for the bond market, so exercise patience.

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Roehl & Yi has made a commitment to delivering more value through enhanced client engagement, new educational videos, resource-filled emails, and more.

As always, we are grateful for your continued trust in Roehl & Yi, and we ask that your first phone call be to us if you have any questions or concerns about your investments. May you and your family experience happiness and good health.

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