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Investment Commentary

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The overall stock market has climbed steadily this year and is currently up about 16.5%. For the month of September, the market was down 4.0% and there could be more downside in the near term. There are concerns 3rd quarter corporate profits will disappoint due to supply chain problems. While there is plenty of demand, supply isn't keeping up.

The economy continues to grow and could reach pre-pandemic growth trends by the 1st quarter of 2022. Despite various concerns in the near term, global economic growth in 2022 is likely to be extremely robust with rising stock markets.

Supply Chain Issues and Inflation

Supply chain problems have had an adverse effect on corporate profits, manufacturing production and inflation. It will likely be next year before supply chains are back to normal. But efforts are being made to alleviate some of the current backlog by large retailers, port operators, labor unions and truckers' associations. The ports of Los Angeles and Long Beach, which handle 40% of container traffic in the U.S. are now working 24/7 to clear the backlog.

There is pressure on the Biden Administration to lift the tariffs imposed on China by the Trump Administration. This will alleviate supply chain stress on U.S. companies. Long term fixes are required to resolve these issues but tariff removal will provide immediate relief.

Supply chain issues along with increased labor and commodity costs have resulted in a spike in inflation. Financial markets have not responded adversely to this spike and appear to have built in a more subdued rate next year. Inflation should trend down next year to a more normal 2.5% to 3.0%.

The increase in oil prices is primarily due to supply chain constraints and the price of gasoline will likely remain elevated through the winter months into next spring. But prices will eventually move back down as problems with supply chains are resolved.

Interest Rates

The Federal Reserve Bank has indicated it will end its bond buying program as soon as mid-November or mid-December. Intermediate and long-term rates will drift higher but not significantly enough to derail the economic recovery. The 10-year U.S. Treasury Note currently yields 1.52% and could drift as high as 2.00% to 2.25% over the next several months.

Depending on the strength in the economy and job market growth in coming months, the Fed has indicated it could begin raising short term rates as soon as late next year. Some projections indicate the Fed will increase rates only up to 1.0% by 2024.

In this environment there is more "interest rate" risk as opposed to "credit quality" risk. Higher rated investment grade bonds will experience more downside as interest rates move up than bonds rated a bit lower on the credit quality scale. The current economic environment favors short term maturities over long and intermediate term and also favors multi-sector bond funds and floating rate funds over investment grade bond funds.

While interest rates will eventually move up, they will continue to be low, possibly for the next 10 years or even longer.

The U.S. Stock Market

While the performance of the overall stock market suggests a relatively tame market, there has been considerable churning underneath the surface. While the S&P 500 index has not yet seen a 5% correction this year, nearly 90% of its members have corrected at least 10% at some point. This is often referred to as a "rolling correction".

With some of the economic uncertainties we are seeing there are sharp swings in industry sectors. And while the value style performed well earlier this year the growth style has performed better in recent months. At this juncture the investment returns year to date are about the same with the growth style only slightly higher.

Large cap stock indices continue to be held up by a handful of stocks (Apple, Microsoft, Alphabet (Google), Facebook and Tesla (a recent report indicates Elon Musk has now overtaken Jeff Bezos as the world's richest man). These stocks are overvalued and won't continue to move up as dramatically going forward. But it is difficult to know when other sectors of the market will begin to outperform. A catalyst for placing downward pressure on growth stocks is higher interest rates.

International Stock Markets
Looking back more than 50 years, we are currently in the longest period of domestic stock outperformance over international stocks ever. Eventually the international stock markets will outperform but there is no way of knowing when. The longer this period of U.S. outperformance lasts, the closer we get to an international stock turnaround.

The Chinese stock market is down about 12% this year due to heavy handed regulation of many of its largest, most valuable and most prestigious companies. And Chinese property giant Evergrande Group, the world's most indebted property developer and one of the most highly leveraged companies in the country, is struggling to meet its debt obligations and could default.

Residential Real Estate
The boom in residential real estate appears to have peaked and home prices are moderating. But demand is still robust and should continue into 2022. Prices will continue to moderate and the housing market is likely to return to "normal" in the latter half of 2022.

Legislative Agenda
Legislation has been passed to temporarily raise the debt ceiling until December 3rd and avoid a government shutdown. The standoff between the two political parties can rattle markets but ultimately, Congress has never failed to raise the debt ceiling before the country went into default. Failure to do so would be disastrous.

Washington policy developments do not appear to be a serious threat to broad markets in the near-to-medium term. A direct connection between policy and broader market direction is rare. An individual sector can be affected by policy but the outcome for broader markets is not necessarily in line with what conventional wisdom expects.

The current infrastructure legislation is likely a mixed bag for markets. Markets tend to respond positively to stimulus but higher taxes could be a headwind. Ultimately, business is the primary driver of economic recovery and history shows what happens in Washington is usually not enough of a catalyst to reverse market momentum.

Overall Perspective
The stock market typically experiences a "correction" of 5% or more two or three times a year. So far this year the market has not gone down 5%. It would not be

surprising to see a correction in the near term. But as long as interest rates remain low and the economy continues to grow, the market will have an upward bias.

The bond market is not likely to provide much in the way of investment returns anytime soon. And it will probably be at least couple of years before we see even a small increase in savings account and money market rates.