

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Big Picture

On the Fridge

TIPS

US treasury inflation protected securities returned 1.8% in the quarter amidst wide spread inflation fears. TIPS now lead all other fixed income classes besides High-Yield year-to-date.

Financials

Led primarily by the big banks (JPM +5.8%, MS +6.9%, BAC +3.5% WFC +2.9%), the financials sector rose 2.7% in the quarter, enough to beat all other sectors and continue a great year as the sector is now up 29.1% through the first 9 months of the year.

In the Dog House

Industrials

The industrials sector fell -4.2%. Fedex and UPS led the retreat losing -26% and -12%, respectively. The rising cost of energy and inflation generally hurt the sector as investors fear the effects on industry margins.

Emerging Markets

Alibaba (-36%) and Tencent (-21%) alone accounted for over 35% of the -8% retreat in emerging markets in the third quarter. This leaves emerging markets down -1% year-to-date and continues a decade of disappointing returns for the highest risk class of equities.

The spread of the Delta variant was the headline for the summer of 2021. New cases, hospitalizations, and deaths surged as the variant proved virulent even among the vaccinated (although vaccinations appear highly effective at reducing severe cases). Despite widespread availability, vaccination rates seem to have plateaued as an unfortunately high percentage of adults remain wary of the vaccine. With that said, JP Morgan estimates that between natural immunity due to prior infection and vaccines, nearly 85% of the US population has some COVID-19 immunity.

After the coronavirus itself, inflation was a key concern throughout the third quarter. Inflation remains widely misunderstood and most discussions regarding the concept are far too oversimplistic to be valuable. There are monetary and fiscal purists that site deficit spending and the money supply as the key drivers of inflation, and while the academic logic may be sound, we just finished a decade of deficits and ballooning money supply with hardly any inflation to speak of.

Beyond the monetary and fiscal theories on inflation, the third quarter featured many discussions on labor's role in inflation. Despite the wrapping up of many of the extra unemployment and stimulus benefits doled out during the pandemic we are still seeing employers that are unable to attract employees. Workers have been stubborn about returning to work and as the economy continues to open back up, employers have been racing to raise wages to attract a workforce to deliver their goods and services.

Looking Ahead

Stocks are expensive. The S&P 500 ended the quarter with a 20.3x forward P/E, just above the 19.2x at the pre-COVID peak. That puts the forward P/E 1.06 standard deviations above the 25yr average of 16.78x and that time period includes the lofty valuations hit during the peak of the dot-com bubble. However, valuations are always relative. With bond yields still very low, the EY Spread or earnings yield minus BBB yield, is currently 1.56% compared to a 25yr average of just 0.13%, in this context, stocks remain cheap relative to bonds, and I would argue that above average valuations can be sustained.

Additionally, and perhaps counter-intuitively history shows us that value stocks are one of the single best ways for long-term investors to grow and protect purchasing power during periods of high inflation. While secular growth companies are always attractive, the current market provides savvy stock-pickers the chance to find attractive stocks at more reasonable valuations.

Links and Articles

4 Reasons to Invest Internationally

Diamond Hill makes a case for a global portfolio despite recent underperformance

Productivity Will Battle Inflation

Ed Yardeni makes the case for booming productivity in "the roaring '20s."

The Best Advantage in Life?

Nick Maggiulli argues the best way to help your children might be to get rich yourself

Tall Tales and True Causes

GMO's James Montier and Philip Pilkington's excellent whitepaper on inflation

Performance

TIPS returned 1.8% as inflation fears led the market narrative in the third quarter. That's good for first place among the asset classes we track. US equities were second best returning 0.4% in the quarter and 15.3% year-to-date. International investments suffered as emerging market stocks fell -8%, international bonds lost -1.6%, and developed market equities fell -0.6%. While the US ranks 18th globally in terms of COVID-19 vaccination rate, only 2.5% of people in low-income countries have received at least one dose of the vaccine. This leaves emerging and frontier economies at risk for continued breakouts.

	Benchmark Index	2021 Q3	YTD	LTM	3yr	5yr	10yr
Cash	Bloomberg US Treasury Bill 1-3 M TR USD	0.0%	0.0%	0.1%	0.0%	1.1%	0.6%
Fixed Income	Bloomberg Global Aggregate TR USD	-0.9%	-4.1%	-0.9%	4.2%	2.0%	1.9%
Fixed Income Blend	Bloomberg Global Aggregate TR USD	-0.9%	-4.1%	-0.9%	4.2%	2.0%	1.9%
Government	Bloomberg US Government TR USD	0.1%	-2.4%	-3.2%	4.9%	2.3%	2.2%
Inflation Protected	Bloomberg US Treasury US TIPS TR USD	1.8%	3.5%	5.2%	7.4%	4.3%	3.1%
Municipal	Bloomberg Municipal TR USD	-0.3%	0.8%	2.6%	5.1%	3.3%	3.9%
Floating Rate	Bloomberg US Trsy Floating Rate TR USD	0.0%	0.1%	0.1%	1.2%	1.2%	0.0%
Corporate	Bloomberg US Corp Bond TR USD	0.0%	-1.3%	1.7%	7.4%	4.6%	4.9%
High Yield	Bloomberg US Corporate High Yield TR USD	0.9%	4.5%	11.3%	6.9%	6.5%	7.4%
International Bond	Bloomberg Gbl Agg Ex USD TR USD	-1.6%	-5.9%	-1.2%	3.2%	1.1%	0.9%
Equity	MSCI ACWI GR USD	-1.0%	11.5%	28.0%	13.1%	13.8%	12.5%
Equity Blend	MSCI ACWI GR USD	-1.0%	11.5%	28.0%	13.1%	13.8%	12.5%
US Equity	MSCI USA GR USD	0.4%	15.3%	30.5%	16.7%	17.3%	16.8%
Developed Markets	MSCI World ex USA GR USD	-0.6%	9.7%	27.1%	8.4%	9.4%	8.4%
Emerging/Frontier	MSCI EM GR USD	-8.0%	-1.0%	18.6%	9.0%	9.6%	6.5%
Alternatives	Wilshire Liquid Alternative TR USD	-0.4%	4.1%	8.7%	3.3%	2.9%	2.5%
Alternatives Blend	Wilshire Liquid Alternative TR USD	-0.4%	4.1%	8.7%	3.3%	2.9%	2.5%

Sector	2021 Q3	6mo	YTD	1yr	3yr	5yr	10yr
Information Technology	1.3%	13.1%	15.3%	28.9%	27.3%	28.4%	23.1%
Financials	2.7%	11.3%	29.1%	59.2%	13.4%	16.6%	17.0%
Health Care	1.4%	10.0%	13.5%	22.6%	12.4%	14.2%	17.1%
Consumer Discretionary	0.0%	7.0%	10.3%	19.2%	16.3%	19.0%	19.5%
Consumer Staples	-0.3%	3.5%	4.7%	11.4%	11.9%	8.6%	11.9%
Industrials	-4.2%	0.1%	11.5%	29.0%	9.8%	12.5%	15.0%
Energy	-1.7%	9.5%	43.2%	83.1%	-6.8%	-1.6%	2.1%
Utilities	1.8%	1.4%	4.2%	11.0%	10.3%	9.1%	10.6%
Materials	-3.5%	1.3%	10.5%	26.5%	13.4%	12.9%	12.8%
Communication Services	1.6%	12.5%	21.6%	38.4%	20.1%	12.5%	12.4%
Real Estate	0.9%	14.1%	24.4%	30.6%	14.7%	10.2%	13.0%

Source: Morningstar; The 1,3,5, and 10 year performance is annualized.

The financial sector led the quarter returning 2.7%, well above utilities in second place with a 1.8% return. Year-to-date this places the financial sector in second (behind energy up +43.2%) by a wide margin, up 29% while the next best, real estate is up 24.4%. The industrials and materials sectors fared the worst losing -4.2% and -3.5%, respectively. The industrial and materials sectors were another victim of inflation fears. They may be especially vulnerable to rising commodity prices, as many of the direct inputs to their products and services are raw materials.

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Asset Class	Benchmark	Description
Cash	Bloomberg US Treasury Bill 1-3 M TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	Bloomberg Global Aggregate TR USD	The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	Bloomberg US Government TR USD	The Bloomberg US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Inflation Protected	Bloomberg US Treasury US TIPS TR USD	The Bloomberg US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.
Municipal	Bloomberg Municipal TR USD	The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.
Floating Rate	Bloomberg US Trsy Floating Rate TR USD	The Bloomberg US Treasury Floating Rate Index measures the performance of floating rate bonds issued by the US Treasury.
Corporate Bonds	Bloomberg US Corp Bond TR USD	The Bloomberg US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	Bloomberg US Corporate High Yield TR USD	The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.
International Bonds	Bloomberg Gbl Agg Ex USD TR USD	The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.