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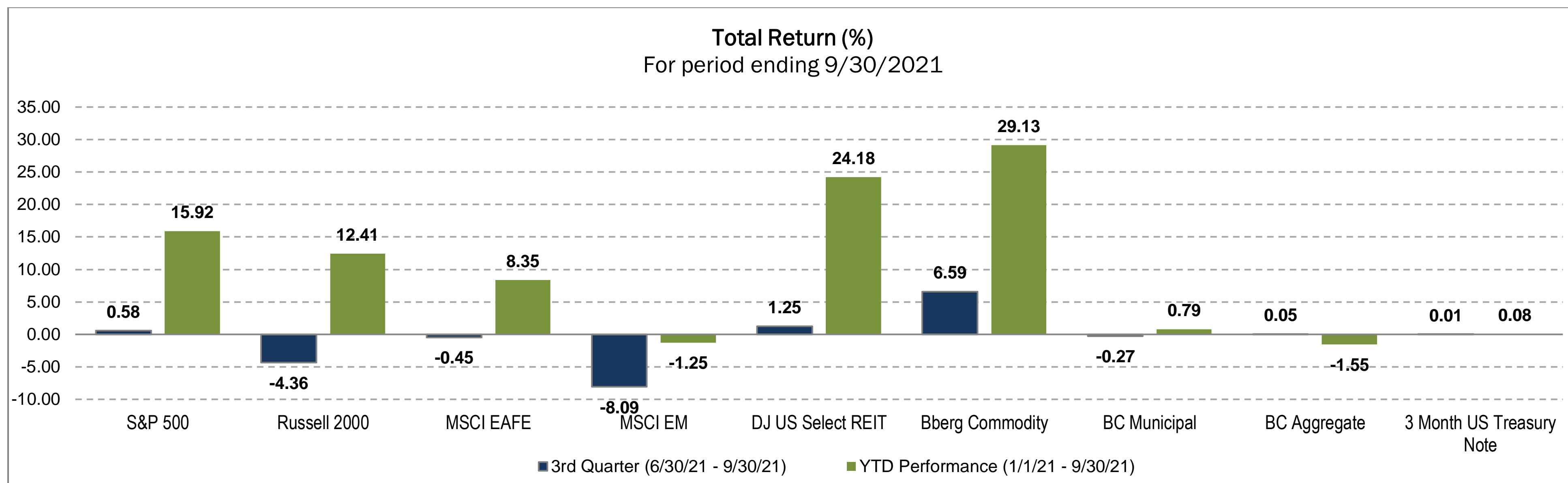
Wealth Management

Some More Normal With a Side of Inflation

Schneider Downs Wealth Management Advisors, LP
Q3 2021 Market Commentary

Big Thinking. Personal Focus.



Our second quarter letter was titled "Revenge of the Normal," appropriately describing market conditions that had transitioned from the COVID wall of worry to future growth expectations in a post-COVID world. While the third quarter saw some overhang concerns about the Delta variant of the Coronavirus, there were no discussions on moving back to the lockdown status that permeated throughout the national dialogue a year ago. Instead, market participants and investors continued to wrestle with the nature of inflation (transitory versus longer lasting), the level of fiscal and monetary support from legislatures and central banks[1], trajectory of interest rates, and geopolitical and financial volatility percolating in China. In the United States, we have yet another debt ceiling battle that could roil markets. Additionally, we are facing the prospect of a new tax bill and an infrastructure spending bill with a yet-to-be-determined price tag (with an estimated floor of One TRILLION dollars). If the second quarter was revenge of the normal, the third quarter could most aptly be described as "some more normal with a side of inflation."

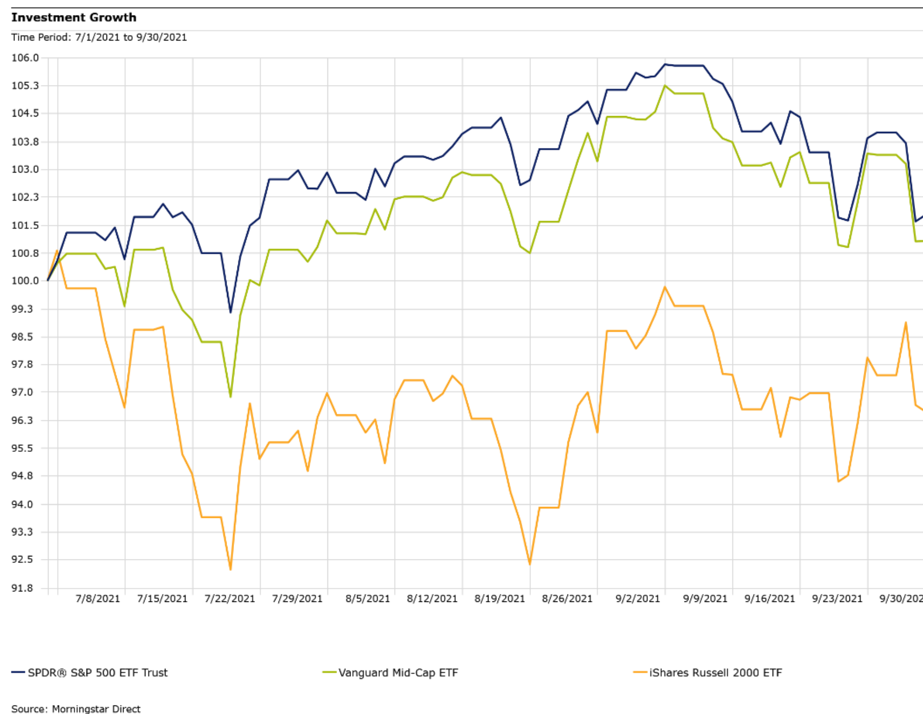
Saber rattling coming from the Chinese Communist Party (CCP) happens every few years. Looking through the short-term noise, there remains significant opportunity in China but in areas away from information technology/internet companies and toward companies that are more aligned with the CCP's "balanced growth" agenda. While in the U.S., Democrats and Republicans alike have become increasingly comfortable "playing chicken" with the debt ceiling with their colleagues and the capital markets. In other words, it was just another September/third quarter for the U.S. and China. The one marked difference in this quarter is inflation, which is running higher and longer than most anticipated.[2] Inflation (duration and breadth) is the fulcrum at which the short- to intermediate-term trajectory of interest rates, monetary and fiscal support, and risk assets (e.g., stocks) rests. Supply chains in almost every category and sector are challenged, as suppliers and producers grapple with the aftereffects of unprecedented fiscal and monetary stimulus that seems to have pulled five years' worth of durable goods orders forward[3]. As we move into year-end, we received what we

[1] Fiscal support is in the purview of legislatures (e.g. U.S. Congress) and monetary support is the purview of central banks (e.g. U.S. Federal Reserve and European Central Bank)
[2] https://apnews.com/article/business-economy-prices-inflation-jerome-powell-7c8ef4f026df7d2903b2683b8936d5e8#:~:text=WASHINGTON%20(AP)%20%E2%80%94%20Federal%20Reserve,more%20long%2Dlasting%20than%20expected.
[3] https://www.wsj.com/articles/u-s-durable-goods-orders-rise-sharply-despite-continued-supply-constraints-11632747393

have come to expect from markets (September wouldn't be complete without volatility) and from our politicians. However, the trajectory of inflation is likely to have the last word on capital market returns in 2021. Buckle up, for it is likely to be an interesting and eventful fourth quarter.

Core fixed income is a topic we have expounded on for quite some time. We continue to believe that most investors need to have an allocation to high-quality fixed income that will serve as the ballast of their portfolio. Having a strong ballast to the portfolio will help navigate tempestuous markets into calmer seas. If you prefer Top Gun references, it is akin to Maverick steadfastly refusing to leave his wingman, even when the incredulous Merlin (played by a game Tim Robbins) bellows "what" at the idea of not evading the MIG fighter jet on their tail. However, we are not blind to the realities of what a decade of 0% interest rates have done to the core fixed income market. Over the past 24 months, we have steadily increased our allocation to real assets (infrastructure, farmland, timberland, and high-quality commercial real estate) that have more performance levers to pull on. Real assets have the ability to benefit from inflation, both from the upward revaluation of the underlying asset, AS WELL AS the ability to pass on the increased cost of inflation. In addition, real assets offer significantly better yields than core bonds, adding another lever to pull on for our portfolios. Core fixed income has modest yields, high interest rate sensitivity, and a negative reaction to inflation; for these reasons, we are underweighting the asset class. We are not abandoning our wingman, just repositioning to better defend them.

It was a volatile three months for U.S. equities and a far more interesting quarter than the modestly-positive returns of U.S. large cap (+0.6%[4]) and mid-cap equities (+0.01%[5]) would seem to suggest. Sandwiched in between two negative months (July and September), U.S. large and mid-cap companies raced out to intra-quarter highs of +5.7% and +5.3%, respectively, only to see those returns wilt away in the last days of the quarter. As the chart to the right shows, there was a significant divergence in the quarter between U.S. small-cap companies (yellow line) and their medium (green line) and large cap (blue line) cousins that is noteworthy. While large and medium companies rebounded to new all-time highs intra-quarter, small-cap companies struggled to gain their footing. As we have noted in prior letters, U.S. small-cap companies are the most exposed to the U.S. economy and were negatively impacted by the economic summer malaise caused by the Delta variant of the Coronavirus. The slowdown in economic growth, combined with the impacts of rising input costs (labor being chief among them), caused investors to reevaluate the valuations across market capitalizations. If one is to believe that the market is a forward-looking instrument, a belief we hold at SDWMA, then the present value of the future cash flows is worth less in an inflationary environment. Until late September, the market had largely shrugged off the prospect of stickier and longer-lasting inflation. The general dismissal of persistent inflation led to the aforementioned run in August and early September. However, the continued



[4] SPDR S&P 500 ETF returned +0.56% for the quarter. Returns generated by Morningstar Direct.
[5] Vanguard Mid Cap ETF returned +0.01% for the quarter. Returns generated by Morningstar Direct.

rise of energy prices, supply chain bottlenecks, and increased compensation costs for labor were too much to ignore, leading to the selloff in risk assets to end the quarter.

International stocks were not immune to the volatility observed in U.S. stock markets in the third quarter. International developed and emerging markets experienced difficult quarters, but for different reasons. International developed stocks had a similar trajectory to U.S. large and medium sized companies in the quarter, rising and selling off in more or less than same fashion. Eurozone inflation rose to the highest levels in a decade,[6] increasing speculation that accommodative fiscal and monetary measures would come to a close sooner than expected. Due to economic growth looking challenged in the Eurozone, we maintain our allocation tilt toward more growth-oriented strategies. Valuations look more compelling on a relative basis versus U.S. stocks and tilting toward strategies that have both secular and cyclical characteristics put our portfolios in the best position to succeed. Emerging market stocks sold off primarily due to China clamping down on internet/e-commerce, gaming, and online education companies. These regulations caused significant deterioration in the market capitalization of the previous market darling Alibaba, TENCENT, Weibo, JD.com, and Didi among others.[7] These measures were meant to curb the immense power and wealth accumulated over a short period of time by the executives and founders and reassert power and control by the CCP. The CCP has announced a transition to a more "sustainable growth" initiative, which will be accretive to more domestic-oriented companies and will likely mean more volatility and uncertainty for the Alibabas of the world. The recent actions by the CCP are the reason we believe in active management in emerging markets, as we believe that volatility creates opportunity. Looking through the short-term noise and taking an intermediate to longer term view, emerging markets offer the best growth prospects of any equity market. China, while not growing at levels they did in the early aughts, will still have a much higher growth rate than the western world. The difference will be in how you invest in China, which means aligning more with the CCP's vision of sustainable growth.[8]

With the ending of the third quarter, we thought it prudent to think back to a year ago at this time. News from Moderna, Pfizer, and Johnson and Johnson looked promising, yet unproven. Fast forward a year and we now have three effective vaccines that significantly minimize the worst outcomes of COVID-19. Economies are reopening, not perfectly, but the threat of another Great Depression has been staved off. To get to this point hasn't been easy - it has been emotionally and physically taxing for you and your families. As we look to the fourth quarter, we expect there to be more, not less, volatility, and our team is prepared to guide you and your portfolios through that volatility. However, we would be remiss if we didn't also point out that this year most of us will be able to see our friends, families, and loved ones around the holidays. It is easy to focus on the negative; we as humans are almost conditioned to do so – but there are so many things to celebrate as we wind down 2021. Thank you for your continued trust in our team; we believe we have truly extraordinary clients and are incredibly grateful for the opportunity to work with you all. Please continue to be safe and healthy, and as always, we are here to help you in any matter that you have, big or small, heading into year-end.

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[6] https://www.ft.com/content/2af45b20-ef7b-4506-a29f-b4938edbe5c6
[7] https://www.bloomberg.com/news/articles/2021-10-05/china-tech-stock-gauge-hits-lowest-on-rising-yields-crackdown
[8] https://active.williamblair.com/global-equity/ken-mcatamney/long-view-on-china/?et_rid=00360000028He7MAAS&et_sid=895990&utm_source=MC_2&utm_medium=Email&utm_campaign=ASG%20-%20Active%20Thinking%2020210909&utm_content=https%3a%2f%2factive.williamblair.com%2fglobal-equity%2fken-mcatamney%2flong-view-on-china%2f&id_mc=61141403