Market Review and Outlook—October 11, 2021

COVID-19 Surges, But Must Share Headlines with the Fed and Congress—During the 3rd quarter, daily new COVID-19 cases leapt from 18,000 to 125,000. While we began the quarter with close to 70% of US adults at least partially vaccinated, the Delta variant ferociously attacked the large number of unvaccinated, including children, and also racked up sizeable breakthrough numbers. This led to a sharp rise in COVID deaths, and overwhelmed many hospital systems. This dashed hopes for a fall emergence from COVID. Nonetheless, most US schools have opened this fall with no more than moderate difficulties.

Recently, there have been several negative economic developments. Job growth has come in lower than expected three months ago, and, not surprisingly, wage growth has accelerated, as businesses are having a terrible time finding employees. Wage growth has teamed up with sharp price increases for many manufactured goods, most of which is tied to serious raw material supply chain hurdles to bring the highest one-year level of inflation in 20 years. This has led the Fed to announce plans to taper its stimulus starting later this year, and it expects to begin raising overnight rates starting in 2023, if not in late 2022.

Four top challenges facing Congress are the budget (and potential government shutdown), raising the debt ceiling to authorize the Treasury to pay the spending Congress has already approved, passing the bipartisan ‘hard infrastructure’ bill, and passing the larger ‘soft infrastructure’ bill. Of this long to-do list, very little has been accomplished; only the first challenge has been addressed, and only by kicking the can down the road two months.

With that backdrop, and uncertainty on many fronts increasing, it isn’t too surprising to see red ink in the three-month column, below. There is a rosy scenario possible, with these Congressional open items resolved, one way or another, by December. The anticipation of Fed stimulus tapering is scarier than the actual tapering will be, once it is underway. Finally, the Delta surge peak appears to have passed, and the rising proportion of those with at least some protection, the imminent availability of vaccines to youth, and the continued development of effective treatments implies that Delta could be the last bad surge for the US.

As we have noted throughout this pandemic, performance figures that begin during the depth of a crisis are not very illuminating or meaningful. The data in the right three columns is thus more enlightening, showing very good trailing results, as investors with moderate (60% stock) portfolios earning attractive results, over 9% annualized. While the past has been far from smooth, over time the sharp ups and downs tend to fade. This is fundamental to Mallard’s long-term focus for our clients’ retirement portfolios.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.88%	+0.86%	+0.44%
Intermediate Core Bond	-0.01%	-0.27%	+5.29%	+2.92%	+3.05%
Intermediate Muni Bond	-0.33%	+3.07%	+4.49%	+2.72%	+3.25%
Multisector Bond	+0.30%	+6.52%	+4.94%	+4.15%	+4.70%
Large-Cap Stock	-0.18%	+29.94%	+14.34%	+15.28%	+15.12%
Small-Cap Stock	-2.23%	+51.11%	+9.47%	+11.96%	+13.70%
Foreign Large-Cap Stock	-1.90%	+23.96%	+7.55%	+8.33%	+8.07%
Health	-2.11%	+20.86%	+11.46%	+13.75%	+16.95%
Real Estate	+0.65%	+34.73%	+10.86%	+7.27%	+10.97%
Technology	-2.74%	+33.74%	+24.25%	+24.82%	+20.90%
Moderate Allocation (60% stocks)	-0.71%	+20.04%	+9.65%	+9.52%	+9.52%

The data in this table comes from Morningstar and is as of September 30, 2021.

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Very Uncertain Forecast—So much has happened in the past eighteen months, and so much uncertainty has come and gone, it is a bit surprising that there is still so much uncertainty remaining. In some cases, the outcome is uncertain, and in others the timing is. Regardless, this makes it harder to make investment decisions.

Pandemic—It is clear that the worst of the pandemic, and hopefully the worst of the Delta surge, is behind us. We have tests, vaccines, treatments, and a very high proportion of the population with at least some protection against infection. The US had been leading in vaccination rates through June, but now trails over forty countries. Our stubborn level of vaccine hesitancy has delayed an expected post-COVID economic bounce. Not only has it been delayed, but the economic bounce seems likely to unfold in stages, across the country over several months, perhaps based on both vaccination rates, population density, and weather patterns.

The pandemic has indirectly caused problems with the global supply chain, and employers' ability to fill positions. Both of these factors have caused the slowing of economic growth, but both factors are likely to diminish in the next few quarters, delaying rather than preventing growth. These factors have also contributed to the high current rate of inflation, but this, too, is expected to return to a more normal level in a few quarters.

The American Rescue Plan, signed into law in March, is providing substantial fiscal stimulus to the US economy, and this should continue to provide a good tailwind. The two infrastructure bills, in whatever form ultimately passed, should provide further stimulus for years to come. The expectations for these two bills have fallen in recent weeks, leaving it likely that the final result will be better than feared. While there are fears of a government default (debt ceiling bill) and shutdown (budget bill), both seem **very** unlikely. Furthermore, the fears are great enough that, again, the final result of each is likely to be better than feared. Note one fear is that the final bill will involve an increase to the tax rate for very high income individuals and for corporations; if included and passed, such a corporate tax rate increase would reduce future corporate earnings.

Thus the most likely outcome for the US in the coming months is for us to 'muddle along.' The expected economic strength we ultimately see should be far weaker than what we saw in the past year, but that strength was climbing out of a very deep pandemic-created hole. We are no longer in the sub-basement.

This raises the issue of valuations. Both stock and bond prices are not in the sub-basement, they are on the second floor, if not the attic. There are no great bargains that appear to us at this time. The table on page 1 shows all of the strong 3-, 5-, and 10-year returns, and thus some of our future returns have already been provided to us. There are relative values apparent to us. Let's explore stocks first, and then bonds.

Sequencing—Typically markets move first, then the economy, and then profits. We saw that on the way down, and expect to see it play out in the recovery. The global stock markets recovered in just a few months. The US economy (just) now exceeds its pre-COVID level, and S&P 500 earnings are expected to exceed their pre-COVID peak level by year-end. This has an important impact on stock and bond valuations.

Stocks—As of last week, PE level, the price investors would pay for a dollar of US stock earnings, fell 10% year-to-date, and yet US stocks have risen 17% year-to-date. How is this possible? US stock earnings have risen 27% year-to-date. Thus earnings strength can overwhelm high valuations. If the expected post-COVID boosted economic activity is strong enough, stocks can 'earnings grow into their current prices' without harming investors. Purchasing managers are expecting strong growth, both in the US and in most major foreign markets. Increasingly, foreign stocks have higher yields and less expensive prices, however this has continued for years, and we don't currently see a clear catalyst to reverse leadership between US stocks and foreign ones.

Bonds—We believe that the quality bond gravy train has reached the end of the tracks. Interest rates have fallen from 15.8% to 1.6% in the past forty years. This has provided quite a tailwind which is simply no longer available. We expect that this will substantially limit future returns from quality bonds, and reinforces our preference of opportunity bonds. These are bonds that are credit-sensitive, which typically provide good returns during times when the economy is strong, as is expected for several quarters.

There is a lot of uncertainty now, however by strategically allocating risk, preparing for some of your assumptions being wrong, you can strive to put odds in your favor, and chart a course through uncertain waters.