Third-Quarter 2021
American Portfolios Quarterly Market Commentary
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AFTER SEVEN MONTHS of a seemingly relentless climb in prices, the equity markets slumped in September. The S&P 500 pulled back nearly 5%, slumping into month-end, while the Nasdaq was down more than 5%. This was the worst month of U.S. equity performance since March 2020. For the quarter, both indices were basically flat while U.S. small cap contracted 4% and emerging markets dropped 8%. U.S. bonds were flat while global bonds were down roughly 1%. As such, no matter the allocation, returns were flat to down in the third quarter of 2021.

THE CURRENT ECONOMIC PICTURE

The economy is in the final stages of its reopening phase. Most businesses are operational. Emergency unemployment insurance has been cut, so millions of people are now returning to work. Supply shortages remain from computer chips to a broad range of consumer products. Even shipping availability is tight, which exacerbates product shortages for goods and industries dependent on foreign suppliers. This has created a supply-driven (or lack thereof) rise in prices. This is a distinction worth noting and will be discussed below when we delve deeper into inflation. It is markedly different than demand-driven inflation. The lack of distinction between the drivers of inflation is one of the key reasons why we believe so many people are wrong on the future of inflation. But again, more on this later.

Shifting gears to consumer spending, we are beginning to notice troubling trends in the consumer space, which give us cause for concern. Some may be temporary as the aforementioned supply issues are worked out. Other trends are likely less transitory and signal choppy economic waters ahead, quite possibly with terrible timing--a huge increase in inventory is coming and the Federal Reserve (the Fed) is looking to withdraw stimulus from the markets.

The U.S. economy has not generated any real consumer spending growth between April and August. Auto sales declined five months in a row for the first time since the Great Financial Crisis. This is one area that could see renewed strength once the computer chip issue is resolved; however, that’s a mighty big ticket item, so perhaps not.

Our hope is that with an increase in supply from the ramp-up of production, as well as an improvement in shipping and container availability, prices will come down—spurring consumers to rethink purchasing activity they perhaps put off because of higher prices or lack of product availability. But there is no doubt in our minds that many consumers have overspent, pulled forward significant consumer purchases and will not be enticed by a return to pricing normalization.

Consumer sentiment aligns with a pullback in spending. The University of Michigan consumer sentiment index was at 72.8 at the end of September, a significant decline from 81.2 in July and 85.5 in June. The large household goods buying intentions subindex fell to the lowest level since April 2020 (and was down three months in a row). Home-buying plans are down to the lowest level since August 1982 (likely due to skyrocketing prices) and auto-buying plans are down to their lowest levels since November 1974 (which we hope will rebound as the supply of computer chips rebounds.)

This begs the key question: how much of the pullback in consumer spending intentions is a result of supply shortages/product availability/temporarily higher prices and how much is due to tapped-out consumers? We won't know the answer until the economy works through the supply shortages.
All we know is that the broad durable goods sector saw volume expenditures decline 1.3% in August after a 4.3% plunge in July, which was the fifth straight decline. Service sector spending increased by 0.3%, up six months in a row, and is growing at a +10.7% annual rate. Overall, this means real consumer spending was flat for the past four months. Consumer spending makes up 70% of the U.S. economy, so this lackluster activity is concerning, especially when construction activity and business spending/capex is contracting as well.

This slowing is evident when looking at the Atlanta Fed GDPNow forecast, which offers a running estimate of current quarter GDP based on available data. For the third quarter of 2021, the forecast stood north of 6% at the end of July, but has deteriorated to 1.3% the first week of October. As we are now in the fourth quarter, this forecast will continue to update as September economic data is released.

With the equity markets only 5% from its peak, valuations at historical highs and U.S. Treasury rates factoring in a hawkish Fed, we think the financial markets will be quite interesting heading into year end.

GOVERNMENT STIMULUS: DOWNSIZED EXPECTATIONS AND DEBT CEILING

Given the immense influence the government has had on the economy through massive spending initiatives and regulations, no discussion about the economy is complete without taking a closer look at the bills on the Hill in D.C. The combined $4.5 trillion (yes, trillion) bipartisan infrastructure (BIF) and build back better (BBB) bills are being hotly contested and negotiated. We do not see any path where the combined spending totals $4.5 trillion. However, before year's end, we see it as a very strong possibility that $2.5 to $3 trillion is passed. While the president claims that the $3.5 trillion BBB bill will cost zero dollars, we call it fuzzy math and are concerned about the tax and debt implications of such a bloated spending package. We will have a better sense of the size and likelihood of passage of these bills by the end of October (BIF) and the Thanksgiving recess (BBB).

Regardless of the spending initiatives set out by either bill, the debt ceiling needs to be dealt with. Investors do not expect a default by the U.S. government, and we agree, but it could be met with some volatility. The S&P 500 pulled back 17% during the debt ceiling fiasco of 2013 when S&P downgraded U.S. debt. The interesting piece this time around is that Democrats can raise the debt ceiling via the reconciliation process. They'd like Republicans to agree to it, but we see that as unlikely. This will create significant consequences, in our view, come the 2022 mid-terms. Acting through reconciliation without

Republican support to raise the debt ceiling, and other significant spending initiatives, Democrats own these decisions. This strengthens the support for our prediction that Republicans will retake control of the House, and perhaps also the Senate.

INFLATION

There continues to be no topic more frequently discussed in the financial markets than inflation and the Fed's likely response. In May, we saw the largest jump in inflation since 2008 as the CPI increased again, spiking to 5% over the past year. Similar rates continued throughout the summer. Many investors focused on the government stimulus, the oversized budget figures and the infrastructure package as drivers of potential runaway inflation, but we do not believe that any of these are the real drivers behind the numbers we've been seeing on the inflation front. Instead, the rise in inflation is coming from the combination of the economic shutdown, inventory reductions, out-of-whack pricing comparisons and temporary supply/demand imbalances as the economy reopens.

We continue to believe that current inflationary forces will be short-lived and is more noise than long-term news, even if the Fed is moving away from its transitory view. In fact, we take comfort in being on a different page from the Fed as its track record in making predictions about the strength of the economy, inflation and interest rate targets is flat-out terrible.

A deeper dive into the components of the CPI illustrates our view. A global chip shortage—another result of the economic shutdown—has driven used car prices up 30% because new car production has been constrained by the shortage of this key component. This is an example of a supply shock that will work itself out as production comes back online; this is hardly a long-term driver of higher prices, but it continues to manifest itself in the inflation data.

Energy prices were up 42% in August, year over year, highlighting not only supply constraints as the economy reopens, but the ridiculous nature of comparing any pricing data to a period when 70% of the economy was shut down. Energy prices were down 17%, year over year, last August. The pricing fluctuations are well within a normal range.

Airline prices were up 7% in August, but that is compared to a period when prices were down 23%. Is that inflation or the result of wacky comparisons of prices in an industry group that was virtually nonexistent a year ago? The same can be said for car and truck rentals, which were up 53% in August. In order for current inflation rates to continue as the 5+% pace, oil prices would have to break $100. Car and truck rentals would have to increase another 50%. Is this possible? Theoretically, yes. But highly improbable, in our view. Prices are filling gaps from the economic shutdown. They are not breaking out higher because of any other reason. As supply comes back online, we wonder if prices will even hold at existing levels, let alone continue increasing at the current breakneck pace.

As such, we believe that the spike in inflation is transitory and has likely peaked. The breakeven on five-year TIPS has dropped from 2.72 in mid-May to 2.59 during the first week of October, range bound

between 2.4% and 2.6% since June. We expect this will continue to drop and that all the hyperinflation rhetoric will fade.

But not without a potential policy mistake by the Fed…

FED TAPERING AND EXPECTATIONS

The Fed took a more hawkish tone recently, which triggered a sizable move in both the equity and fixed income markets. We expect this to be short lived, but not without consequences first. The Fed has been talking about tapering and rate increases for quite some time. However, the Fed recently surprised market participants with the timing of such. The Fed indicated tapering would start in November and that it targeted mid-2022 to complete its taper, which means an aggressive reduction of bond purchases over a short window. This is about a quarter earlier than the market had expected and also likely increased the probability of a rate hike in the second half of 2022, at least as the current economic data stands.

This is where the probability of a policy mistake grows. We have already outlined a slowing economy that could persist. The ISM Suppliers Deliveries Index averaged 74 during the past six months (greater than 50 indicates slower deliveries), the highest level since 1974. As this eases, inventory will rise and the inflation that many are so worried about will ease, just as the Fed begins to taper/tighten.
The problem is this: the Fed can print trillions of dollars and the federal government can borrow and spend trillions of dollars, but neither have the ability to fix supply chains or reduce shipping constraints. Therefore, it appears likely that the problem is misdiagnosed. It is one that will seemingly solve itself without the help of the Fed (one could argue this for most of the areas where the Fed meddles), but the market and the economy will receive a dose of medicine regardless.

MEANWHILE, RISKS ARE MOUNTING IN ASIA

A conversation about the current state of the financial markets would not be complete without a discussion about China's economy and the Evergrande debt fiasco. Regardless of what happens with the bankruptcy of China's largest property developer, Evergrande, China's economy is facing significant pressure. The first country to emerge from the COVID-19-induced recession might be the first one to return to a recession. The spillover effect in the local Asian markets and trade partners could be significant, as well.

Manufacturing PMI in China contracted in September for the first time since the COVID-19 outbreak. An interesting dichotomy has emerged. The production and new order indexes of high-energy-intensive industries fell below 45.0, likely due to the production cuts caused by energy constraints, while the production and new order indexes of high-tech manufacturing were above 54.0, suggesting continued expansion in that area.

Overall, new orders dipped to 49.3, with new export orders down to a 15-month low at 46.2. Imports pulled back even more, down 1.6 to 46.8. The purchasing price index rose by 2.2 to 63.5. The concerns we have for the U.S. economy are similar and exacerbated for China. A rapid contraction, coupled with

more debt than the U.S. and the Evergrande fiasco as a potential negative catalyst, the world's second largest economy could be heading toward recession.

DEBT DEFAULTS IN CHINA

Numerous construction developers in China have recently defaulted in China, including its two largest: Evergrande and Country Garden (Fantasia Holdings). Real estate development is significantly more important to China's economy than it is in the U.S., which could mean a significant hampering of growth. As far as Evergrande and Fantasia are concerned, it is our opinion that the damage will not be confined to these players. It will spread quickly to its counterparties, including other developers and banks, perhaps impacting local emerging market economies. However, we expect the impact on U.S. markets to be minimal at the current time, but to push Evergrande from our sights completely would be foolish. We've seen lesser events have significant market events, so we are following the situation closely.

Over the past few years, we've continually expressed a lack of confidence in China's debt-fuel economy, and ours as well. Many analysts have suggested that up to half of China's investment over the past decade lacks merit. While jobs and demand for cement, steel, copper and oil were created, the finished products were often underutilized or not utilized at all. While China's communist government claims to play the long game, this strategy—which wasn't about investment at all, but about providing jobs and a rising standard of living to citizens so that the government could remain in power—is a short cut that created false and unsustainable prosperity.

China's structural problems are clear and Evergrande is a consequence of those problems. China's debt no longer produces growth. Debt payments for many businesses in China are growing and becoming harder and harder to service. With a slowing economy, this issue will only exacerbate. There are two ways to get rid of debt: 1) deflation, which results in write-offs, bankruptcies and unemployment; and 2) inflation, which results in the loss of purchasing power. Large amounts of collateral damage in either area would cause social unrest and unleash revolutionary potential in the communist country. So, we expect the government to contain the situation as best as it can; however, if the situation deteriorates, the damage could be significant. China accounts for nearly 20% of global GDP and consumes half of the world's basic materials.

The Evergrande real estate debt fiasco in China may not impact the U.S., but it does highlight China's massive debt problem that will have global ramifications, and it could have lasting effects on the emerging market economies in Asia. Not to mention, the Chinese economy is showing significant signs of slowing as of late. Perhaps a debt-fueled economy does have limits. In the meantime, the slowing economy could auger well for inflation if a pullback in demand weighs on commodity prices.
We will continue to monitor the fallout in China and the potential impact on global economic conditions over the next few months.

PUTTING IT ALL TOGETHER

Given that inflation has likely hit its peak for this cycle and economic growth is set to fade in the fourth quarter of 2021 and into 2022 following the removal of government unemployment support and recent pullback in consumer spending, we are cautious on the equity markets for the rest of this year. Slowing growth, high valuations, Fed tapering, government largesse in the U.S., and a potential debt crisis and recession in China are a bad combination. We simply do not see favorable reward opportunities for purchasing equities at current levels.

As we look forward through 2022, we foresee a roller-coaster ride of economic activity fueled by ebbs and flows of government stimulus and spending. We are not overly concerned about mutating COVID-19 variants at this point, so the economy should continue to normalize, at least from a supply standpoint, meaning easing inflation.

As such, we continue to believe that one's investment focus should become increasingly thematic and more selective than in the past because the equity markets, and financial assets in general, have become extended. Broader asset prices don't reflect the mid- to long-term economic outlook because the financial markets have been boosted by unprecedented fiscal and monetary policy stimulus, requiring nimbler and more focused asset allocation down to the industry and stock levels. While valuation is not a reliable timing tool, current levels suggest limited long-term gain potential based on history.

We also look to fade inflation, considering how much bad news is factored in for bonds: massive inflation chatter, huge recent increases in commodity prices and Fed tapering, to name a few. Long-duration bonds continue to look attractive here for capital appreciation potential, especially considering that the current trend of slowing growth does not appear to be discounted in prices.

We'll see how this all plays out in the coming months. We will continue to examine the CPI components as they are released, as well as follow the Fed's comments coming out of each meeting, looking for changes on the margin relative to its sky-high growth projections and tapering plans. We expect slowing growth and waning inflation to cause the Fed to balk and pull back the reins on its tapering plans, which should be positive for long bonds. And if not, it will be even better for the asset class should the Fed taper aggressively into a slowing economy. In either case, we think long bonds will outperform equities in the near future.

Opportunities in China and the emerging markets are developing and could become interesting into year end, but we suggest it is a bit too early to take outsized positions there.

QUESTIONS AND COMMENTS

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