Making Sense of Finance

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Third Quarter 2021 Review

STOCK MARKET

The S&P 500 index hit multiple record highs in the last quarter. The quarter began as if it would be smooth sailing, continuing the easy gains from the first half of the year. That seemed to be the case until we entered the month of September. Although posting a slight gain of 0.23% for the third quarter, the S&P 500 declined almost 5% in September amidst increasing volatility, its worst monthly performance since March 2020. Supply chain constraints, both here and abroad, were a common complaint among companies that reported earnings last month. The duration of these conditions and how they may affect corporate profitability across the board has contributed to investors' anxiety. Other major indexes were negative last quarter. There was a small loss of 0.38% for the Nasdaq accompanied by heavy selling in technology shares, and a loss of 1.91% for the Dow Jones Industrial Average. Although last month's market dip was noteworthy, all major stock indexes still had double digit percentage gains year to date. As mentioned in our previous newsletter, although the indexes show handsome gains there is an ongoing sector rotation as 71% of S&P 500 stocks have seen a correction of at least 10%, with 29% having a pullback of at least 20%.

Most stock sectors had positive performances in the third quarter. Financial stocks had the largest increase, aided by the rise in interest rates last quarter and all year, which bolsters their profitability. Utility, healthcare and technology stocks also gained last quarter although closing out the quarter much lower than their highs reached during the summer. Though energy stocks seem to be on fire right now, this sector had negative returns last quarter even after they led all sectors in the month of September. Material (commodity related) and industrial stocks were the worst performing groups last quarter; however, they have bounced back more recently.

Foreign developed market stocks continue to lag their US counterparts. The MSCI EAFE Index (measured in US dollars) lost 1% in the third quarter and continues to trail the S&P 500 on a year-to-date basis. Japanese stocks performed better than most, with their economy getting

Making Sense of Finance

Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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back on track with increasing vaccination rates. Europe, like the US, is experiencing higher inflation rates with ongoing supply chain problems and labor shortages. Emerging markets declined sharpy last quarter. Chinese stocks saw a significant sell off. Rolling power outages and increased government regulatory enforcements in China influenced investor sentiment in a negative way. The rise in the U.S. dollar also had a detrimental effect when measuring performance of foreign markets in U.S. dollar terms.

BOND MARKET

After experiencing a volatile quarter, bond prices ended September virtually flat versus the end of the previous quarter. The Barclays US Aggregate Bond Index total return was marginally positive in the third quarter. The yield on the 10-year Treasury rose ever so slightly to end last quarter at 1.52% (bond prices decline when yields increase), not too much difference than its 1.45% yield at the end of June. In the interim, however, the 10-year yield declined to as low as 1.19% in early August before spiking higher amidst rising inflationary fears. Foreign investors in Treasuries have supported their prices. Foreign holdings of bonds are higher than pre-pandemic levels. The Federal Reserve also confirmed that it will begin to reduce quantitative easing by year end, which in turn caused rates to increase. The Fed indicated it will “taper” its asset purchases, not end the purchases completely yet, as to wean bond investors off the tremendous amount of monetary stimulus provided since the beginning of the pandemic. Bond investors are aware that the current amount of Fed asset purchases and accommodative interest rate policy cannot last forever. If the easing is gradual, markets (both bond and stock) should adjust. Hikes in the Fed Fund rate are not anticipated until at least mid-2022. However globally, many central banks have increased their interest rates, led by emerging markets such as Brazil and Russia, due to inflationary pressures. In general, inflation will have more of a negative effect on bond prices than on equity prices because of the erosion of the value of fixed payments of bonds.

Although bond prices in the aggregate were unchanged for the quarter, global bonds were the worst performers followed by municipal bonds. High yielding lower quality bonds increased in price and had the best total return in the third quarter.

OUTLOOK

We expect Covid-related problems to continue for the foreseeable future. Inflation will continue to be a headwind, but not worrisome unless there are large and unexpected rises. Fear mongering by news outlets should continue to cause short-term volatility, but the silver lining is that corporate America is kept on its toes and can resolve these problems. We don’t see any of the challenges in the economy to be unsolvable. In the second quarter, interest rates rose marginally, and we think higher rates are actually better for U.S. companies over the longer term. “Free money” (borrowed money at historically low interest rates), as we call it, can lead to market bubbles and marginal companies eating up valuable resources. For now, it’s been a good way for the Fed to keep the economy stable.

Further down the road, we see the economic divide between the haves and the have-nots growing. This is a trend we noticed since the Financial Crisis in 2008. Globalization and a greater reliance on technology are the two primary factors, in our opinion, and this does not look like it will subside anytime soon. This may be positive for stocks in the future as equity valuations are spurred on by profits, not employee counts. By our count, 8/10 of the largest companies by market capitalization (market value) are technology based; however, only two of those companies are ranked in the top 10 for companies with the highest sales, illustrating how higher profit margins are weighed heavier than the size of the organization.

This poses a problem for other asset classes too. Currently, we still do not see much value in bonds except as a place holder and as a tool to decrease volatility. Our opinion on real estate, also remains tepid. While the pendulum will likely swing back closer to pre-covid levels, the pandemic has proven to many companies that remote work is more efficient and cheaper than having multiple or expensive corporate offices. For sure, commercial office footprints have generally declined during the past 18 months.

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