HIGHTOWER
Westchester

Market Commentary Q3 2021

Three down, one to go…. It's hard to believe we are already entering the final stretch of the year given how far we have come since the lows of spring 2020! As difficult as it is to look past concerns surrounding the likes of the delta variant, inflation, and supply chain issues, we see the S&P 500 is up a strong 16% this year.[1] The third quarter turned out to be a relatively choppy period, being a largely headline-driven few months. Despite the volatility along the way, the S&P 500 and 10-year Treasury yields ended the quarter little changed, with the S&P 500 only up 0.6%, NASDAQ down 0.2%, and the DOW down 0.6%.[1]

Corporate earnings results remained solid throughout the summer. Overall earnings results were stronger than most analysts expected and as a result did not bleed into corporate profitability. Furthermore, Federal Reserve ("Fed") Chair Powell noted at the July Federal Open Market Committee meeting, that despite the economic progress, it was not yet time for the Fed to begin to reduce Quantitative Easing ("QE"), which turned out to be a tailwind for markets.

That positive momentum continued into August, powered by what seems like ever-supportive Fed speak, and solid economic activity. Yet, as mentioned above, politics came to the forefront once again with discussions of infrastructure and budget reconciliation bills that would be the framework for potential changes to tax rates, entitlements, and climate policy. Given all that, market participants were able to look past any future policy risks and move the S&P 500 towards all-time highs.

Then September rolled around, and the market took a turn. Many of the encouraging news and market dynamics that supported stocks earlier in the quarter began to fade. COVID cases spiked and clearly weighed on the recovery, while supply chain issues started to cause investors to worry about profits across multiple industries and its impact on earnings. Then the volatility was compounded by the news that the second-largest property developer in China, Evergrande, could have issues paying its debts. We got some clarification around the reduction of QE before year-end, but it was not enough to move us into the green. All of this caused our first meaningful pullback in the market this year to the tune of 5%![1]

From a market capitalization perspective, we saw large-caps outperformed small-caps in the quarter. The rise of uncertainty at the end of the quarter pushed investors away from small-cap stocks in favor of their larger counterparts.

From a style perspective, growth, which has been made a significant comeback from the beginning of the year, outperformed value in the third quarter. This was largely due to gains in the technology sector ("tech"), although the amount of that outperformance shrunk significantly during the final week. We continue to watch the dispersion between growth and value as the economy ebbs and flows and the prospect of future rate increases loom.

The tech sector has been under the microscope for some time now, and rightfully so. The average tech stock is down double digits and off its 52-week high.[1] With that said, the technology sector has the lowest net debt of any sector out there. With record debt issuance in both the investment grade and high yield markets over the last year plus, rising rates could materially hinder companies' ability to grow as interest payments increase when debt maturities roll. Yet, from a net debt perspective, tech has consistently had the lowest net debt over time which means the more established companies with strong cash flows could handle higher rates better.

As we dig a bit deeper into the sector levels, performance was more mixed than the first half of the year as about half of the S&P 500 sectors realized positive returns in the quarter. Financial stocks rallied as bond yields rose late in the quarter and the prospects of higher interest rates pushed them to be the best performing sector. Healthcare has been an interesting sector the last 18 months primarily due to COVID-19. We are witnessing more vaccine mandates and booster shot approvals which have benefited the sector overall.

Sector laggards included the industrials and the materials sectors. Similar issues plagued the two sectors, COVID, Evergrande and the lack of passage of the $1 trillion bipartisan infrastructure bill.

US Equity Indexes	Q3 Return	YTD
S&P 500	0.58%	15.92%
DJ Industrial Average	-1.46%	12.12%
NASDAQ 100	1.09%	14.58%
S&P MidCap 400	-1.85%	15.21%
Russell 2000	-4.36%	12.41%

Source: YCharts

Looking abroad, we saw international markets decline in the quarter. Developed international markets declined modestly during the final few weeks of the quarter on general global growth concerns combined with potentially higher global interest rates.

Emerging markets dropped sharply, initially on concerns of rising COVID-19 cases, but later in the quarter, emerging markets fell even further on Chinese growth worries that stemmed from the Evergrande debt issues. Regulatory actions in China were the initial trigger for market weakness. These were compounded by the re-imposition of some Covid-19 restrictions and supply chain disruption in August, worries about possible systemic financial system risks

stemming from the potential collapse of Evergrande, and power shortages.

International Equity Indexes	Q3 Return	YTD
MSCI EAFE TR USD (Foreign Developed)	-0.35%	8.79%
MSCI EM TR USD (Emerging Markets)	-7.97%	-0.99%
MSCI ACWI Ex USA TR USD (Foreign Dev & EM)	-2.88%	6.29%

Source: YCharts

Commodities posted strong gains to continue their streak of four quarters in a row. They have even outperformed the S&P 500 over the past three months.[1] As many know, the price of oil is significantly impacted by the members of OPEC and that continues today. They seem content with their current production levels based on where the price of oil has gone. The year 2020 saw the largest ever global drop in energy and oil demand, but 2021 has witnessed a significant rebound as vaccines were rolled out, lockdowns were eased, mobility increased, economies opened further, and fiscal and infrastructure packages were implemented.[1] U.S. prices are up significantly this year and up almost a dollar at the pump.[1] The spike is weighing on drivers' wallets and boosting inflation concerns because higher oil/gas prices mean pricier goods for consumers. President Biden asked OPEC to crank up production to keep economic recovery on track. But as of this writing, OPEC's powerhouses rejected the request and said they'd make only gradual production increases to help prop up prices. This is something the markets are watching closely as higher oil prices don't only affect consumers, they can also up supply-chain costs and shape policy priorities.

Meanwhile, gold posted a small loss in the third quarter as a firming dollar and rising interest rates helped offset still stubbornly elevated inflation metrics.

Switching gears to the fixed income markets, like equities, most bond classes saw little movement in the quarter. Initially, we witnessed a flight to quality following a jump in COVID cases in the summer. The news of QE tapering, and rising inflation weighed on fixed income markets as the quarter ended. In the corporate debt markets, higher-yielding, lower-quality bonds outperformed investment-grade bonds.

Looking at municipal bonds ("munis"), we witnessed a move higher in yields with AAA munis up almost half a percent on the year. Demand for munis has remained strong as can be seen by 30 consecutive weeks of flows into muni bonds funds.[1] Year-to-date new issuance through September totaled approximately $346 billion, down just 2.4% vs the same period last year.[1] This muni market supply and demand

dynamic is likely one of the reasons municipal-to-Treasury ratios have remained in their current range, and that is not likely to change over the course of the fourth quarter.

US Bond Indexes	Q3 Return	YTD
BBgBarc US Agg Bond	0.05%	-1.55%
BBgBarc US T-Bill 1-3 Mon	0.01%	0.03%
ICE US T-Bond 7-10 Year	-0.21%	3.50%
BBgBarc US MBS (Mortgage-backed)	0.10%	-0.67%
BBgBarc Municipal	-0.27%	0.79%
BBgBarc US Corporate Invest Grade	0.00%	-1.27%
BBgBarc US Corporate High Yield	0.89%	4.53%

Source: YCharts

Market performance in the third quarter reflected much of what transpired in the short-term with better-than-expected corporate earnings and a resilience to another wave of COVID. However, that resilient performance should not be taken as gospel with the risks that remain. We should have more clarity on several important questions such as future Fed policy, taxes, the pandemic, and inflation as we approach year-end.

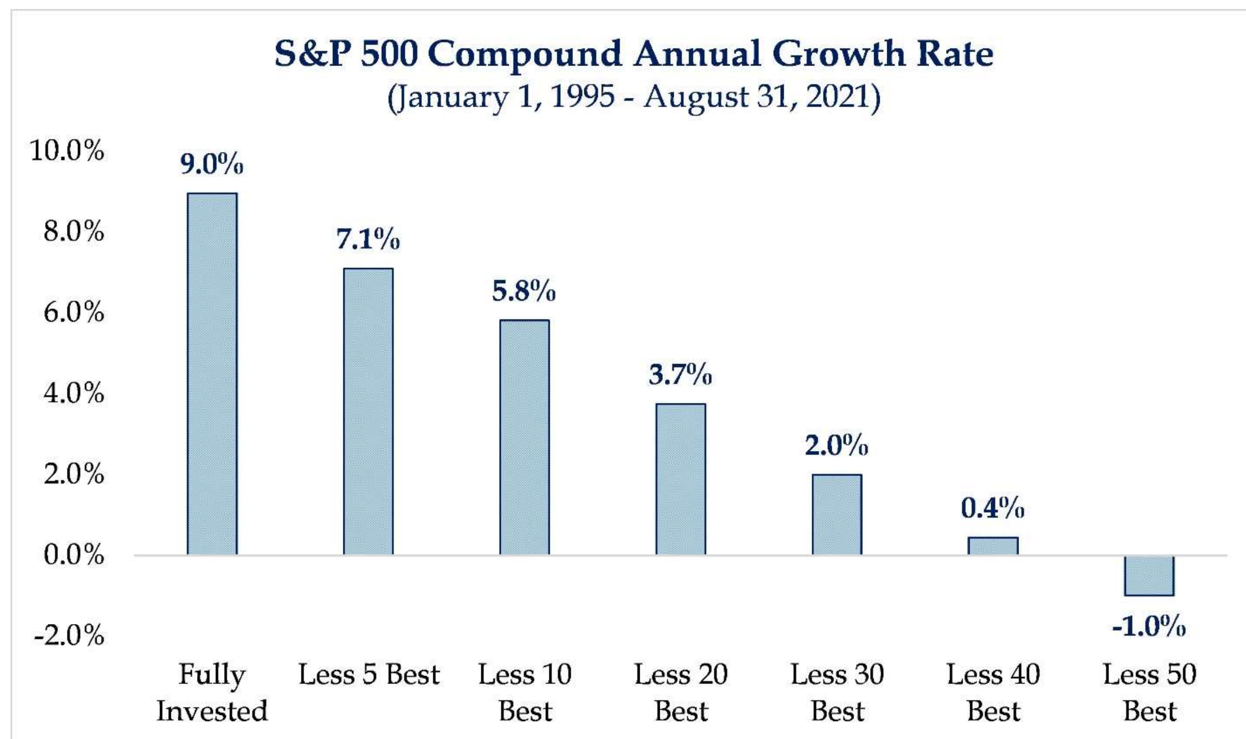
The Federal Reserve has communicated that it will begin to taper QE at some point in the fourth quarter or early next year. This is based on several factors such as employment, COVID and the like. All of which could either delay or change the size of the taper. Policy action as serious as this is bound to cause some level of volatility if they deviate from their plan.

Finally, inflation remains elevated and at multi-decade highs. The talk of this inflation being transitory seems less and less likely as they keep moving the goalpost further down the line. When you combined that with continued supply chain disruptions, market participants need to be mindful of the risks that remain.

Yet as bearish as some of these issues sound, fundamentals, be it money supply, low rates, etc., are still decidedly bullish and it is important to remember that a well-executed and diversified, long-term plan can weather periodic bouts of volatility. We understand the risks facing both the markets and the economy now, and we are committed to helping you navigate this investment environment much like we have in the past.

With the aforementioned volatility in mind, it is important to remember the lesson of market timing. While it can be easy to whipsaw oneself in and out of the market with news headlines, it can be rewarding over the long run to hold steady and maintain an allocation to equities. As you'll see below, missing the five best days

would lead to an annualized return of 7.1% from January 1995 to August 2021, while staying fully invested would lead to an annualized return of 9.0%.



Source – Strategas Securities, LLC

We often ask our investment managers the question, “What keeps you up at night?” The risks outlined above certainly bear monitoring, and there’s always the chance for a policy misstep or an exogenous black swan event (e.g. COVID-19). Fortunately, we’re able to sleep well, knowing that our process prioritizes risk mitigation and protecting our clients’ capital when it matters most. The macro landscape is often overwhelming and complicated. This quarter is a reminder that the consensus outlook often turns out to be wrong or things don’t always go according to plan. We don’t overreact to the macro and remain focused only on the things we can control.

As always, we appreciate and value the trust you have placed in us.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] Strategas Securities, LLC

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