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MARKET COMMENTARY

October 1, 2021

The World Health Organization declared COVID a Global Pandemic on March 11, 2020. The S&P 500 would bottom 12 days later after falling 34% in roughly a month. Congress and the Federal Reserve reacted quickly and without restraint, unleashing a fiscal and monetary response so large we're still searching for sufficient adjectives. In back-to-back quarters, US GDP experienced both its steepest contraction and largest expansion in history delivering a super charged economy, growing well above trend. Since bottoming 18 months ago, the index has returned 100% inclusive of dividends. In short, it's been a wild ride.

The second quarter was one for the record books. Because the economy was lapping a shutdown, it wasn't a question of would results improve but by how much. This heady combination of reopening enthusiasm, excess savings and results that were almost certain to be good, caused investors to storm the equity markets, which returned 8.55% from March to June as measured by the S&P 500 Index. Companies did not disappoint, putting up 89% average earnings growth, the highest since the fourth quarter of 2009.

After a quarter where everything seemingly went right, the third quarter had its share of pluses and minuses. At the end of June, COVID seemed well-contained but case counts have since entered a fourth wave. While vaccines still offer excellent protection against severe illness, a more contagious strain and waning vaccine efficacy has complicated reopening decisions. Trade frictions abound, from excessive shipping costs, commodity price spikes and natural disasters all resulting in significant supply chain disruption. Almost 50 companies have warned that higher costs, (either raw materials, wage pressures or both), will hamper earnings growth in the third quarter. In basketball terms, if improvement in the second quarter was a lay-up, the third quarter is more like a well-guarded jumper from 15 feet.

Someday we look forward to writing a *Market Commentary* without discussing the Federal Reserve but given the size and scope of its COVID response, today is not that day. While the Fed is almost always a variable to consider when pricing assets, it's worth asking how much stimulus an economy growing 6% really needs (*spoiler alert*: we think it's less). Two of the more obvious signs its policies may be too accommodative are inflation and asset bubbles, which, as any recent homebuyer can tell you, seem to be occurring. Historically, taking away the punchbowl has resulted in grumpy partygoers, no matter how well telegraphed. While it's logical to think that an economy strong enough to withstand tightening monetary policy should be a good thing, inflections are seldom smooth and often reveal those that borrowed too aggressively. As Warren Buffett is fond of saying, it's only when the tide goes out that you discover who has been skinny dipping.

Put it all together and you've got decelerating growth, tightening monetary policy, historically elevated multiples and a pandemic that refuses to go away. After a 100% return in 18 months, it shouldn't come as a surprise that we suggest tempering your expectations. Inflation seems stubbornly persistent and while growth is still positive, it's much less so. Taken as a whole, there are more than a few lights flashing yellow, suggesting caution may be warranted.

While wet blankets rarely make great gifts and all investing involves risk and uncertainty, there are a number of reasons to be optimistic about the future beyond the next six to twelve months. In an investment landscape with more capital than uses, we're gravitating towards high quality companies with strong secular growth, conservative balance sheets and long reinvestment runways. Many great businesses have a way of deepening their moat in both good times and bad. In a world awash with debt and central banks repressing returns for the foreseeable future, we expect growing businesses with high returns will remain a good home for your capital. While their multiples may not be as low as they once were, they still seem like the best game in town and provide a fair shot at a decent return in a return-starved world.

We thank you for your business and as always, should you have any questions, please don't hesitate to reach out to your relationship manager.

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