Third Quarter Summary

The S&P 500 squeaked out another positive return for the quarter rising 0.6%, although it ended on a down note by falling 4.7% in September. The September loss was the first since January and has investors a bit unnerved as the market faces a number of short-term risks as it enters the earnings reporting season. Perhaps the most prominent of these risks is the looming extension of the federal government debt ceiling. The U.S. government has never defaulted on its U.S. Treasury bond obligations in its roughly 245 years of existence, but it has gone to the wire on several occasions resulting in investor angst. Treasury Secretary Janet Yellen said a default would be “catastrophic” and send the U.S. economy into another recession. We view a U.S. Treasury default as a low probability, but extremely high impact event, so are watching the situation closely.

Speaking of defaults, perhaps the biggest catalyst for the market’s September drawdown was the slow motion train wreck occurring with Evergrande Group, one of the largest property developers in China and the world. Real estate, and its related ecosystem, is at the heart of the Chinese economy, so the controlled restructuring of Evergrande poses the risk of a collapse and contagion beyond the Chinese real estate sector. Also adding to the September fireworks was the Federal Reserve’s announcement that a tapering of its longstanding bond buying program of $120 billion a month is at hand. Assuming the federal debt ceiling is extended, we believe the taper is likely to begin in November, but all bets are off in the case of a U.S. Treasury default. The taper talk has sent the yield on the benchmark 10 Year U.S. Treasury Note from roughly 1.25% to 1.50% in short order. The impact on the rise in long-term interest rates has not only been felt by holders of fixed income securities, but also for owners of many growth stocks. Growth stocks are expected to receive much of their earnings in the future and are more susceptible to rising rates. To wit, the Russell 1000 Growth Index fell 5.6% in September, relative to the 3.5% drop for their Russell 1000 Value Index brethren.

Adding to the risk bonfire is the ongoing supply chain bottlenecks experienced by many firms. These bottlenecks range from companies being unable to get their hands on production inputs, to COVID related lockdowns, to products sitting offshore on massive container ships with no one available to unload them. First, the shortages were confined to computer chips, but now shortages are springing up in areas as far flung as Nike’s sneaker factories in Vietnam. Fortunately, in most of these cases demand is delayed rather than destroyed completely, although the short-term effect is rising prices and dissatisfied customers.

Market Outlook

Assuming the federal debt ceiling is increased, as it always has in the past, we expect interest rates to gradually trend upward and the supply chain problems to slowly disappear, allowing for synchronized global growth to resume in earnest. In order for the economy to start to resemble what it looked like nearly two years ago, further progress on beating the COVID-19 pandemic must occur. There is good news to report on this front ranging from continued increase in global vaccinations, to a pill from Merck that limits the damage from the virus in most instances, to the impending launch of vaccinations for those at the age of 5 and above.

To touch upon some additional risks not covered earlier in our note, we start with inflation, with recent readings of the Consumer Price Index (CPI) coming in at 5%+. There is increasing doubt that the Fed’s longstanding trope of “transitory” inflation will, in fact, not come to pass. “Sticky” inflation may result in spiraling wage inflation creating a double whammy with the surge in most commodity prices this year. It raises the specter of the s word – stagflation – that is usually anathema to financial assets. At Beacon, we are not yet in the stagflation camp, but have it on our collective radar screens.

It seems like we have been saying this for months, but Congress continues to work on an infrastructure package. Our current thinking is that the traditional infrastructure package (e.g., bridges, roads, tunnels, sewers, broadband, etc.) will go through largely as planned, but that the “human services” infrastructure program may have to be slimmed down in order to receive congressional approval. An approved infrastructure package is likely to boost short-term

GDP but also raises the possibility of higher taxes in order to pay for it. Geopolitical risk is ever present, with China-U.S. relations leading the list due to the enormous size of their respective economies. Beijing leaders have been cracking down on prominent Chinese firms, such as Alibaba and Tencent, in part to advance their "common prosperity" philosophy. It is not out of the question that Beijing will next target global firms doing business in China, negatively impacting profitability. China's show of force with naval and air power over the South China Sea and Taiwan adds another dimension to geopolitical risk. Traditional hotspots in Russia, Iran, Afghanistan, and North Korea always have the potential to move from the back pages of the news to the front pages in a heartbeat.

The recent pullback in U.S. equities is normal, if not to be expected. We still favor equities over fixed income for the long-term. Prior to the current market decline, the biggest year to date drop for the S&P 500 was a paltry 4%. This figure compares to an average intra-year decline of roughly 14% over the past 40 years and median decline of 8%. Yet, 75% of the time over this time frame, investors in the S&P 500 have finished the year in positive territory. The lesson? During times of market distress, it usually makes sense to act like Rip Van Winkle. Relax, don't focus on the stress of the short-term market turmoil, and wake up refreshed to discover great long-term performance.

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