Fourth Quarter 2021 Investment Outlook

Dead Man Walking?

"The test for beginning our (QE) taper is that we've achieved substantial further progress toward our goals of inflation and maximum employment and for inflation we appear to have achieved more than significant progress, substantial further progress. So that part of the test is achieved, in my view and in the view of many others (on the FOMC). Many on the Committee feel that the substantial further progress test for employment has been met. Others feel that it's close, but they want to see a little more progress."

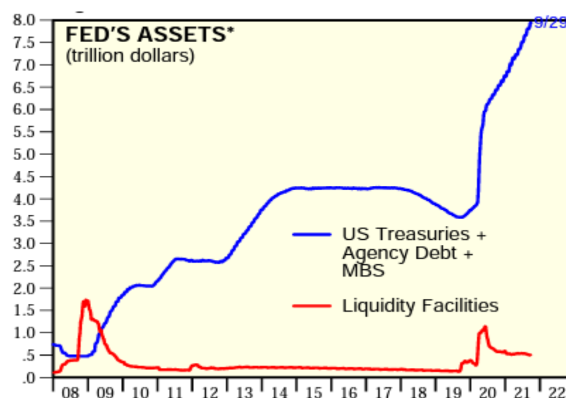
– Federal Reserve Chair Jerome Powell

"Your record gives me grave concerns. Over and over, you have acted to make our banking system less safe, and that makes you a dangerous man to head up the Fed, and it's why I will oppose your renomination."

– Senator Elizabeth Warren

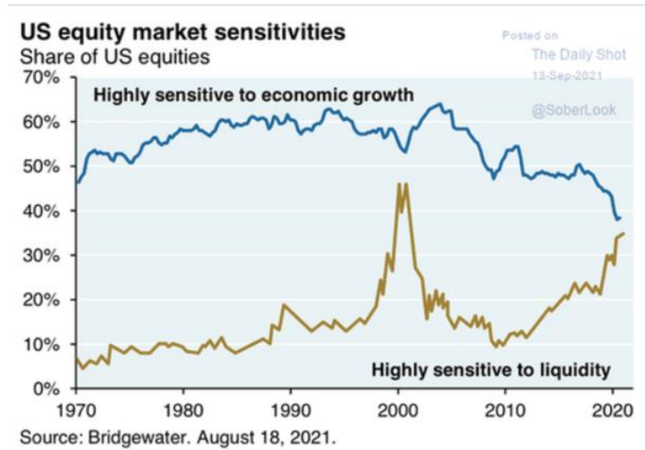
More than anything, financial markets hate uncertainty, and there is more uncertainty as we finish out 2021. The biggest uncertainties center around changes to Federal Reserve ("Fed") monetary policies and the status of Chairman Jerome Powell. In March 2020, when the C-19 pandemic hit and U.S. economic activity plunged, the Fed acted quickly and announced it was cutting interest rates to 0% and employing Quantitative Easing (QE) via buying $120 billion per month of Treasury and mortgage-backed bonds. Separately, the Fed also purchased $750 billion of corporate bonds. Almost instantly, the massive plunge in financial markets was reversed. Risk assets have been on strong upward trajectory since then, helped by the ongoing U.S. economic recovery, C-19 vaccination developments, and strong corporate earnings. The corporate bond buying program recently ended but the QE and zero interest rate policies have continued. At the press conference following the Fed's September meeting, Chair Powell indicated that the majority of the FOMC members were leaning towards a start of tapering its monthly QE related bond buying before the end of the year with plans to fully end QE by mid-2022.

Investors have been debating when QE tapering would start and more clarity was provided last month by Chair Powell on this important matter. As shown in the chart below, the Fed has injected approximately $4.5 trillion of liquidity into the U.S. financial system since March 2020 when the C-19 pandemic started and the Fed's balance sheet now sits at a mind boggling $8 trillion of assets.

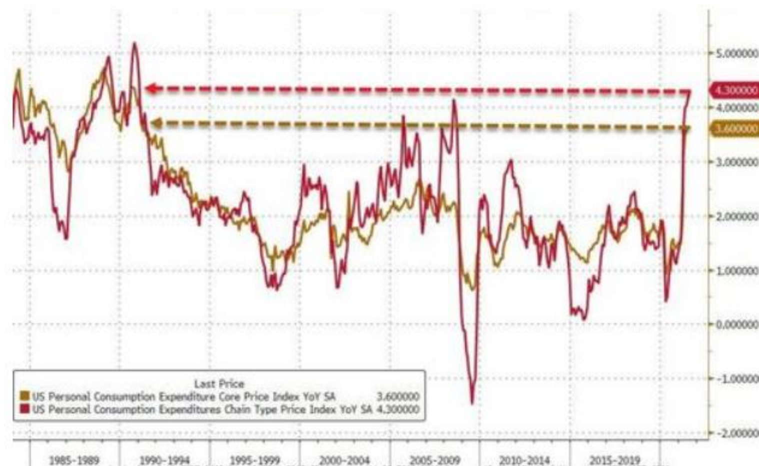


Source: Yardeni Research

This unprecedented level of liquidity support has been an important factor in driving financial assets higher over the past 18 months (in reality, since 2009) so the reversal of monetary policy support has important implications for financial markets going forward. In fact, ever since the Fed started to aggressively use Quantitative Easing as a major economic policy tool starting in 2009, the sensitivity of U.S. equities to liquidity changes has increased dramatically, as shown in the next chart below. Therefore, a withdrawal of liquidity support by the Fed on the margin is a negative for stock valuations, as evidenced by the negative performance of both U.S. stocks and bonds since Chair Powell's comments post the Fed September meeting.



Monetary policy tightening is normal during this stage of the economic cycle when GDP growth is strong and inflation levels are elevated, yet the Fed says interest rate hikes are still not on the table. Chair Powell's view for most of 2021 was that elevated levels of inflation were transitory, but that view is increasingly being questioned as monthly inflation data remains well above the Fed's 2% annual target. The next chart shows the year-over-year change in Core PCE inflation data going back to the early 1980's and the rapid increase in inflation that has occurred over the past year. The latest Core PCE reading was above 4% compared to the Fed's 2% target. The Fed forecasts Core PCE to decline back down to 2.2% in 2022 but it remains to be seen if such a reversal lower will happen when energy prices are rising, labor shortages are driving wages higher, and global supply chains are stressed.



Source: Bloomberg

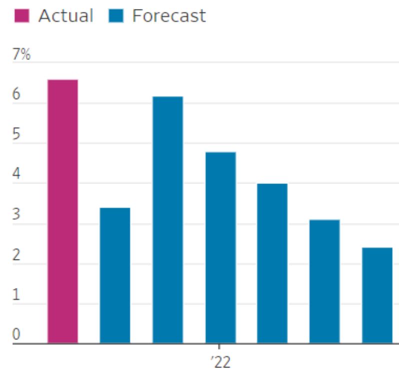
More recently, several FOMC members including Chair Powell have talked more about persistent inflation. If inflation readings remain elevated into 2022, the Fed could be forced to act sooner and pull forward interest rate hikes, which the market currently does not expect to occur until late 2022 or early 2023. Increasing interest rates are another way to reduce liquidity in the financial system and are also a headwind to stock valuations.

The September jobs report released on October 8th showed job gains of 194,000 compared to consensus estimates of 500,000 and year over year wage growth came in at 4.6%. Although the September jobs data was below consensus expectations, July and August job were revised higher by a combined 169,000 and the jobs and wage data should be good enough for the Fed to announce the start of QE in either November or December. The Fed's next FOMC meeting occurs in early November.

Another uncertainty relates to the status of Chair Powell's job security. His four year term as Fed Chair ends in February 2022. The President nominates the Federal Reserve Chair and the Senate confirms the nomination. Until recently, the market put at a high probability on President Biden renominating Chair Powell until Senator Elizabeth Warren stated in a not so nice and very public way that she will not support Powell's renomination. The market considered the renomination of Powell a high probability until Warren used her Congressional bully pulpit to make a strong statement against Powell's renomination. It probably doesn't help Powell that he was nominated by a Republican president, is a Republican, and there are other Federal Reserve Board members President Biden might find as acceptable alternatives to Powell if he believes he needs to appease the Progressive (or is it Regressive?) wing of his own party to gain political capital to pass other parts of his agenda. Whatever the case, a change in the Fed Chair could be a negative event because as far as investors are concerned, the devil you know is preferable to the devil you don't.

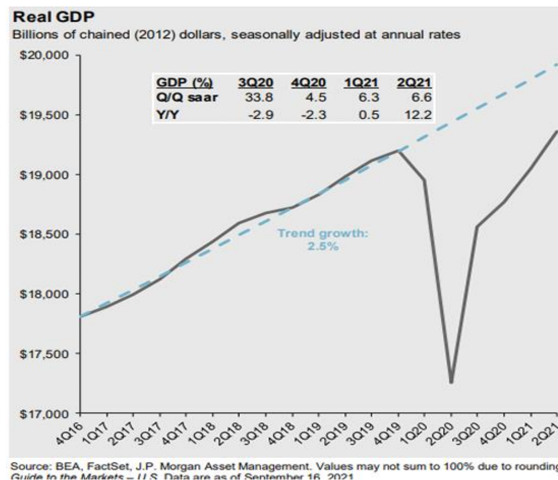
It is a particularly crucial point in time as it relates to how the Fed is going to unwind its ultra-accommodative monetary policies that have been instrumental in driving financial assets higher since last March. Financial markets have become quite comfortable with Powell as Fed Chair and his public comments, known as Fed Speak, is a unique skill that requires the Fed Chair to be ambiguous and try to avoid answering any question directly. If Chair Powell becomes Dead Man Walking, there almost certainly will be a period of market indigestion as investors size up and get comfortable with a new Fed Chair. In light of President Biden's low approval ratings and a large number of challenging issues his Administration is currently dealing with, it would be a negative surprise to financial markets if Powell is not renominated as Fed Chair.

More uncertainty relates to the recent slowdown in U.S. economic growth forecasts. The next chart shows the Wall Street consensus forecasts for quarterly U.S. real GDP growth out to the end of 2022. The red bar was the actual real GDP growth for the quarter ending June 30, 2021. The next blue bar is the forecast for September real GDP growth, which is now at just over 3%, down from over 6% back in July. The third quarter 2021 estimate has been significantly reduced since June as the C-19 Delta variant has had a negative impact on economic activity, combined with global supply chain issues, labor shortages, and inflation related demand destruction. Wall Street consensus expects U.S. real GDP growth to rebound back to 6% in the fourth quarter. However, that is a significant rebound from the current third quarter estimate and may be too optimistic, especially if the C-19 Delta variant remains an issue. The U.S. Bureau of Economic Analysis will announce its first estimate of third quarter real GDP growth in late October.



Source: Wall Street Journal

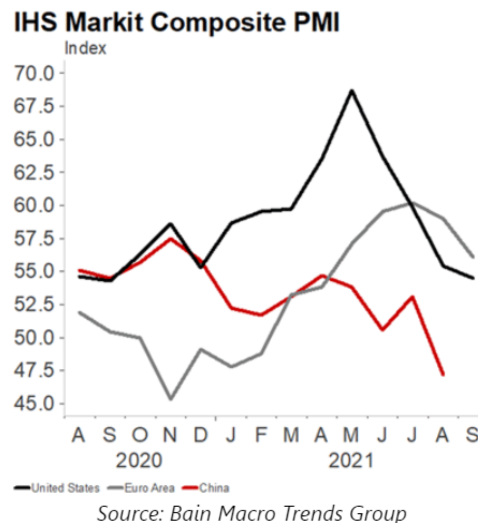
The next chart provides a snapshot of U.S. real GDP growth from the end of 2016 through 6/30/21. The grey line is the actual results of the U.S. economy with the large plunge due to the negative impact of the C-19 pandemic, followed by the rapid V-shaped recovery off of the bottom. The dashed line shows what the path of the U.S. economy most likely would have been without the pandemic and assuming trend growth of 2.5%. Even though the U.S. economy generated very strong real GDP growth over the past year, it is still below the trend line. Even with the reduced third quarter real GDP estimates, the U.S. economy should get back to its pre-C-19 2.5% growth trend line at some point in 2022 or two years after the C-19 pandemic hit.



U.S. GDP growth is important but it's not the only thing that matters. China's GDP growth is also very important since China is currently 17% of world GDP compared to 25% for the U.S. (per World Bank estimates) and China also has a higher economic growth rate profile than the U.S. These two economies are the main drivers of global GDP growth so if either the U.S. or China sneezes, the rest of the world catches a cold. The chart at the top of this page shows that quarterly U.S. economic growth is forecast to remain strong into 2022 due to abnormally high levels of monetary and fiscal stimulus. In contrast, China

is now dealing with a number of issues that are negatively impacting its economic growth outlook. The IMF forecasts China real GDP growth to slow from 8.0% in 2021 to 5.6% in 2022 and the risk is to the downside.

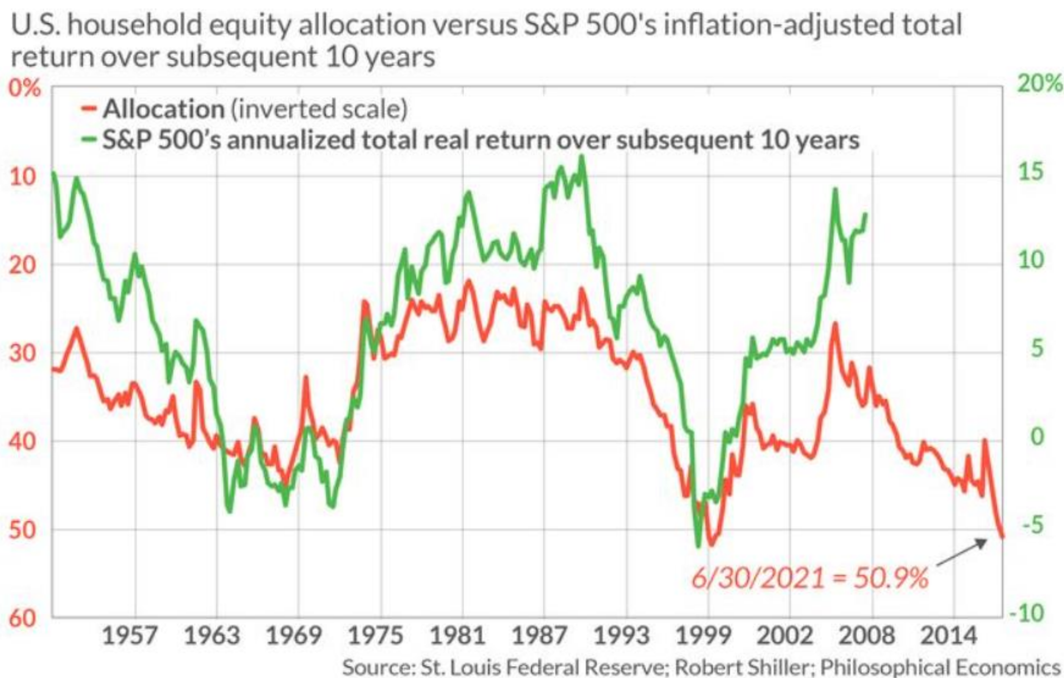
China recently implemented major social and regulatory policy changes called Common Prosperity that created major upheaval for some of its biggest growth companies and industries and roiled global investors. It is also dealing with the debt default of its second largest real estate development company called (not so) Evergrande and several other property development companies are in difficult financial straits. According to Goldman Sachs, property development and related sectors are 29% of China's GDP growth compared to the U.S. at only 6.2% and that segment of China's economy is dealing with excessive debt and overbuilding. Most of that debt is held onshore in China as opposed to held by foreign investors so this debt default situation is unlikely to create a global financial contagion effect like the U.S. housing bubble and bust did in 2008. That being said, when a major component of global GDP growth experiences difficulties, there are bound to be negative knock-on effects. The U.S. trade war is also still a factor. Since taking office, the Biden Administration has kept the Trump Administration Chinese tariffs in place and relations remain contentious. China also implements draconian shutdowns whenever it has any C-19 breakouts since it has less effective C-19 vaccines than the West. In one instance, a major port was entirely shutdown due to one person having C-19. The slowdown in China growth is evident in its manufacturing PMI Index, with the most recent reading now below 50, which indicates its manufacturing sector is in contraction rather than expansion. Below is a chart comparing the PMI readings of the U.S., Europe, and China with China showing the weakest readings.



Source: Bain Macro Trends Group

After a period of ultra-accommodative central bank policy support and strong financial market returns, an increasing number of macro related risk factors in both the U.S. and China are now in play and will keep markets on edge until the clouds of uncertainty lift.

Let's next turn to the U.S. stock market. After a tremendous run higher for stocks since the March 2020 low, investors are all-in on U.S. stocks. The next chart below shows the equity allocation of U.S. households going back to the 1950's. As is often the case, during periods of strong stock returns like we have experienced over the past 18 months, retail investors tend to chase returns higher and become complacent. The red line in the chart below shows the U.S. equity household allocation to stocks was 51% (left hand scale, inverted) as of 6/30/21. The last time U.S. households had this level of exposure to U.S. stocks was at the tech bubble peak of 1999, which was also after a period of stock returns being well above the long-term average. The green line is the rolling 10-year annualized returns for the S&P 500 Index on a lagged basis, which the chart shows inversely aligns with household equity allocations over longer periods of time. Let's use the tech bubble of 1999 as an example. At that time, the household equity allocation hit the same level it is at today, around 50%. After that 50% equity allocation peak was reached in 1999, the green line shows the S&P 500 Index generated a -5% annualized return (right scale) in the subsequent 10 years. If this inverse relationship continues to hold true in the future, the rolling 10-year annualized S&P 500 Index returns will start to decline over the next 10-year window and generate very low or possibly even negative annualized returns 10 years from now.

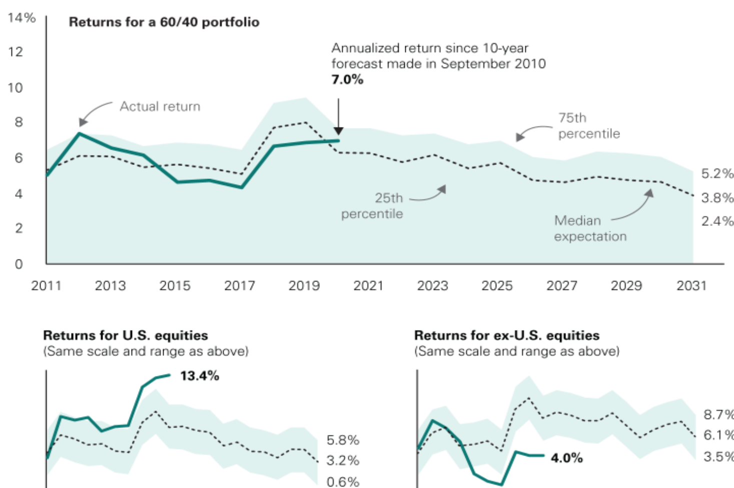


Keep in mind a very important fact. The Fed's unprecedented monetary policy stimulus combined with the unprecedented fiscal stimulus that were unleashed in response to the C-19 pandemic have dramatically juiced financial asset returns to a significant degree. In addition, monetary policy accommodation of various degrees by global central banks have been going on now for 13 years, providing a strong tailwind to financial asset returns. For the 10 years ending 9/30/21, the average U.S. balanced mutual fund with a 60% weight in stocks and 40% weight in bonds generated just under 10% annualized returns while the S&P 500 Index generated 16.5% annualized returns. In both cases, these return profiles are substantially above the long-term averages. If the historical inverse relationship in the chart above holds true, it means the next 10-year window for portfolio returns will most likely be much lower than the past 10 years.

What most investors really care about is what does all of this mean for the future and specifically for returns one can potentially earn from investment portfolios. The chart below from Vanguard provides some clue. The top chart shows a balanced portfolio of 60% stocks / 40% bonds. Vanguard updates its 10-year return projections for a 60/40 balanced portfolio each quarter. Vanguard went back and looked at their historical return forecasts for a 60/40 balanced portfolio and then compared it to what the actual return was 10-years later. The dashed line represents Vanguard's median return forecast and the green (solid) line was the actual returns for a 60/40 balanced portfolio. The solid line and dashed line will not always be exact since actual returns will differ from forecasts but the actual 10 year annualized return from 2011 through 2020 was pretty close to Vanguard's median return forecast from 10 years prior.

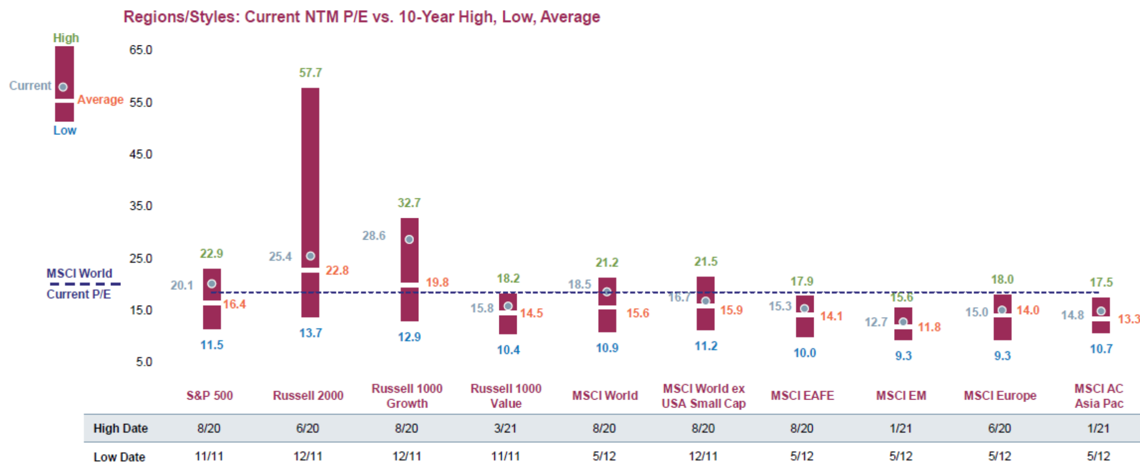
While Vanguard's forecasts for balanced portfolio returns were pretty tight to actual returns, its return forecasts for U.S. and non-U.S. stock returns were pretty far off the mark (so were everyone else's). The bottom left chart shows U.S. stocks and the actual results of 13.4% annualized returns was substantially higher than Vanguard's median return forecasts and was also well above the 75th percentile return forecast. In contrast, non-U.S. stock returns at 4.0% annualized were significantly lower than Vanguard's median return expectations and well below the 25th percentile return forecast. Both of these return outcomes suggest that the past 10-years were a highly unusual period of global stock returns.

The major takeaways from this data are twofold. First, investors should expect balanced portfolios to deliver much lower returns over the next 10 years than in the past 10 years. Vanguard currently forecasts a standard 60/40 U.S. balanced portfolio will generate a 3.8% annualized return over the next 10 years out to 2031 compared to a 7.0% annualized return over the past 10 years. Second, expect future U.S. stocks returns to revert lower towards the median return expectation over time and potentially generate low single-digit annualized returns over the next 10-year window. Non-U.S. stock returns should revert higher towards the median return forecast and produce higher returns than U.S. stocks over the next 10-year window. Today, Vanguard forecasts U.S. stocks to produce a 10-year median annualized return of 3.2% (bottom left) and non-U.S. stocks to generate a median return of 6.1% (bottom right). U.S. stock return outcomes could be dramatically different than what must investors have come to expect over the past decade, especially if U.S. monetary policy becomes less accommodative.



Source: Vanguard Group

The next chart below is a valuation comparison for major global equity asset classes. On the far left are U.S. equity benchmarks including the S&P 500 Index (large caps) and Russell 2000 Index (small caps). Both benchmarks have forward price/earnings (PE) multiples (blue dots) that trade above their 10-year average (orange figure) and also trade at a sizable premium to non-U.S. stocks. The PE premium of U.S. stocks is due to growth stocks as represented by the Russell 1000 Growth Index, which trade at nearly a 29X forward PE multiple. By comparison, U.S. value stocks as represented by the Russell 1000 Value Index trade only at a 14.5X forward PE multiple. Tech stocks now represent 27% of the S&P 500 Index and their high sensitivity to low interest rates explains why U.S. stock valuations are currently well above the trailing 10-year PE average and why U.S stocks substantially outperformed non-U.S. stocks over the past decade. By comparison, the majority of non-U.S. equity asset classes on the right side of the chart trade much closer to their 10-year average PE multiples. Non-U.S. stock markets have lower weights to tech stocks and a 50% weight to cyclical stocks (vs. 30% in U.S.), which generally have lower PE multiples. The last decade of ultra-accommodative monetary policy and low absolute levels of interest rates has had a major influence on stock valuations today being well above long-term averages across all global equity asset classes. Relatively speaking, U.S. stocks are more overvalued today and therefore have greater probability of producing lower returns than non-U.S. stocks over the next decade.

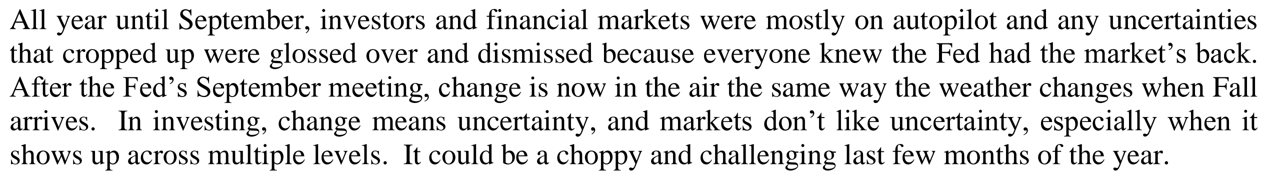


	S&P 500	Russell 2000	Russell 1000 Growth	Russell 1000 Value	MSCI World	MSCI World ex USA Small Cap	MSCI EAFE	MSCI EM	MSCI Europe	MSCI AC Asia Pac
High Date	8/20	6/20	8/20	3/21	8/20	8/20	8/20	1/21	6/20	1/21
Low Date	11/11	12/11	12/11	11/11	5/12	12/11	5/12	5/12	5/12	5/12

Source: FactSet as of 9/30/21. NTM P/E is market price per share divided by expected earnings per share over the next twelve months.
Data provided is for informational use only. See end of report for important additional information.

Summary

The majority of investors have experienced strong returns from their investment portfolios over the past 10-years but let's be real. Monetary and fiscal policies have played a heavy hand in driving financial market returns well above long-term averages over the past 10 years and especially over the past 18 months. Today, we are on the cusp of an important change in Federal Reserve monetary policy that will start to remove some liquidity support via the start of QE tapering. In addition, if inflation remains persistent and not transitory, it could force the Fed's hand in pulling forward interest rate increases too. The job security of Fed Chair Powell has recently become more uncertain. If Powell becomes Dead Man Walking, financial markets will face additional uncertainty with a new Fed Chair. All of this uncertainty related to Fed policy and Chair Powell's job status is occurring at the same time Chinese economic growth is going through a notable slowdown and the U.S. is also experiencing near-term growth headwinds.



All year until September, investors and financial markets were mostly on autopilot and any uncertainties that cropped up were glossed over and dismissed because everyone knew the Fed had the market's back. After the Fed's September meeting, change is now in the air the same way the weather changes when Fall arrives. In investing, change means uncertainty, and markets don't like uncertainty, especially when it shows up across multiple levels. It could be a choppy and challenging last few months of the year.

Mark J. Majka, CFA
Chief Investment Officer

October 13, 2021

IMPORTANT DISCLAIMER:

This report and all content on mjminvtadvisors.com is presented for educational and/or entertainment purposes only. Under no circumstances should it be mistaken for professional investment advice, nor is it intended to be taken as such. The commentary and other contents simply reflect the opinion of the author alone on the current and future status of the markets and various economies. It is subject to error and change without notice. The presence of a link to a website does not indicate approval or endorsement of that web site or any services, products, or opinions that may be offered by them. Neither the information nor any opinion expressed constitutes a solicitation to buy or sell any securities or investments. Do NOT ever purchase any security or investment without doing your own and sufficient research. None of the parties adding to or affecting the content of mjminvtadvisors.com in any way shall have any liability for any loss sustained by anyone who has relied on the information contained herein. Neither mjminvtadvisors.com nor any of its principals or contributors are under any obligation to update or keep current the information contained herein. The principals and related parties of mjminvtadvisors.com may at times have positions in the securities or investments referred to and may make purchases or sales of these securities and investments. The analysis contained is based on both technical and fundamental research. Although the information contained is derived from sources that are believed to be reliable, they cannot be guaranteed.

FAIR USE NOTICE: mjminvtadvisors.com and reports downloaded from the site contain copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available in our efforts to advance understanding of issues of economic and social significance. We believe this constitutes a 'fair use' of any such copyrighted material as provided for in section 107 of the U.S. Copyright Law. In accordance with Title 17 U.S.C. Section 107, the material on the site and in reports downloaded from the site is distributed without profit. If you wish to use copyrighted material from this site for purposes of your own that go beyond 'fair use', you must obtain permission from the copyright owner.