INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

THIRD QUARTER 2021: OFF PEAK, BUT NOT OFF TRACK?

If you'd take it easy, trust awhile
Don't look blue, don't look back
You'll pull through in just awhile
'Cause you're on the right track.
–Stephen Schwartz

Recently, the Metro-North system, operator of the suburban commuter trains in New York City's northern suburbs, announced additional train service to its three lines. The increase will bring service levels to 82% of its pre-pandemic schedule. But where are the riders? Metro-North's ridership is off more than 50% from 2019 levels. In an inducement to get reluctant passengers to heed the "all aboard" call, the rail operator plans to continue to offer all riders reduced "off peak" fares, even during rush hour commutes.

It's hard to say whether the lack of recovery in ridership for Metro-North is a reflection of a durable reduction of working in city center/downtown locations, or a deferral of return-to-office pre-pandemic commuting resulting from the infection spike in the COVID Delta variant.

What is clear is that the Delta variant has, hopefully only temporarily, derailed the reopening-the-economy narrative that began a year ago and propelled the market substantially higher since recession lows in the spring of 2020. Concerns about economic growth, labor market participation, and inflation all stem wholly or largely from lingering or ongoing effects of the pandemic.

MARKETS STALL

Engine, engine number nine.
Going down Chicago line,
If the train goes off the track,
Do you want your money back?
–nursery rhyme

For the first two months of the third quarter, equity markets chugged along, continuing the steady appreciation of the past year. And then came September, and along with it, worries about inflation, the Delta variant, political infighting, rising energy prices, and Chinese developer Evergrande's $310 billion debt problem, among others. For the month, the S&P 500 fell nearly 5%.

That said, markets haven't fallen far from recent peak levels. Thus far in 2021, the S&P 500 has notched 54 record high closes, en route to a 16% gain in the first nine months of the year. And it has been among the calmest, not to say most complacent, markets we've witnessed. We have not had so much as a 5% pullback since last November—the seventh-longest stretch in market history.

For the third quarter as a whole, most markets were flat, with very modest single digit gains or losses. The outliers were commodities on the plus side, mostly on tighter oil supplies, and emerging markets to the downside, on general risk aversion and Chinese market interventions.

Asset Class	Index	3rd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	0.6%	15.9%
US Small Cap Stocks	Russell 2000	-2.7%	13.8%
International Developed Markets Stocks	MSCI EAFE	-0.5%	8.4%
Emerging Markets Stocks	MSCI EM	-8.1%	-1.3%
Real Estate Securities	MSCI US Real Estate	1.0%	23.0%
Commodities	Bloomberg Commodities Futures	6.6%	29.1%
Bonds	Bloomberg Barclays US Aggregate	0.1%	-1.6%
Cash	FTSE 3-month UST Bill	0.01%	0.03%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

For the year to date, US markets have been robust, notching double digit gains. Overseas markets have lagged, held back by initially slower progress on vaccinations.

The stand-out asset classes have been real estate, rebounding after a soft 2020, and commodities. These are both reflation stories. Bond prices have declined modestly as interest rates have risen, and cash continues to generate no return.

HAS INFLATION LEFT THE STATION?

Even if you're on the right track, you'll get run over if you just sit there.
–Will Rogers

Nobel prize-winning economist Milton Friedman declared that inflation is caused by too much money chasing too few goods. As inflation readings heated up this spring, we are mindful that the Fed and Congress have flooded the economy with money, in response to the pandemic-driven recession. This record policy accommodation remains largely in place—which is to say, arguably, there's too much money.

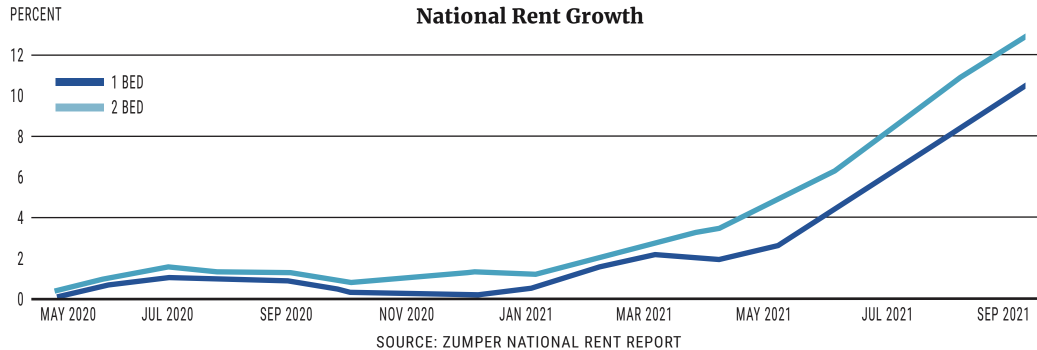
At the same time, with widespread availability of vaccines, the American economy has been 're-opening,' unleashing a strong consumer spending impulse driven by pent-up demand.

For a variety of reasons, producers have been challenged to meet elevated demand. In many instances, businesses lack the work force needed to increase production. Many diverse industries are also experiencing difficulties obtaining sufficient raw materials or inputs. Supply chains have been stretched to the breaking point.

There are also transportation bottlenecks that are preventing goods from getting to consumers. Ports are severely backlogged, due to labor shortages. The ports of Los Angeles and Long Beach recently had a record 66 ships anchored offshore, waiting to unload their cargoes. Ports in Seattle and Savannah, among others, are also struggling with congestion. Trucking companies, too, report delays in moving goods to warehouses and retailers, as they deal with a shortage of drivers.

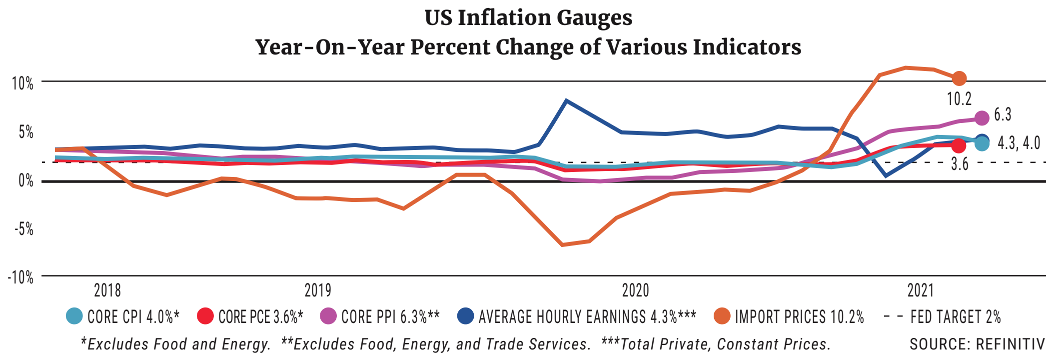
These supply chain and transportation challenges have numerous knock-on effects. A paucity of computer chips has forced Detroit to cut back on automobile manufacturing, despite robust end demand. Costco announced recently that it will limit customer purchases of toilet paper, bottled water, and cleaning supplies. Consumers looking to buy home appliances and furniture face long delivery delays.

Inflation is also apparent in other areas of the economy. Housing prices are up 19.7% from a year ago, according to the most recent (July) report from S&P CoreLogic Case-Shiller. Home price appreciation is now spilling into the apartment market, where rents are up more than 10% since the pandemic lows.



SOURCE: ZUMPER NATIONAL RENT REPORT

More broadly, the Fed's preferred inflation gauge, the Bureau of Economic Affairs' Personal Consumption Expenditures ("PCE"), is up 3.6% year over year. Other measures are running even hotter, with the Consumer Price Index ("CPI") up 4.0%. Producer prices, which sometimes predict the direction of consumer prices, are up 6.3%.



*Excludes Food and Energy. **Excludes Food, Energy, and Trade Services. ***Total Private, Constant Prices. SOURCE: REFINITIV

These inflation gauges exceed by a wide measure the Fed's average 2% inflation target.

The Fed has repeatedly opined that inflation readings are transitory, reflecting depressed year-ago price levels (so-called base effects). One example: prices for travel related services like airline tickets and hotel rooms have soared in comparison with depressed levels last year. And energy prices are up a whopping 25%, but not included in the core CPI measure because of their volatility.

The jury remains out as to whether prices will go off the rails. The largest item in the CPI goods and services basket is shelter, and it is possible that statisticians' measure of housing costs—owner's equivalent rent—has not yet caught up with home price appreciation. There has also been a recent pick-up in wage inflation, with average hourly earnings up 4.3% in the past year. The most recent JOLTS report from the Bureau of Labor Statistics indicated that there are an unprecedented 10.9 million unfilled jobs in the US—with such a large labor shortage, it's little surprise that wages are rising. It remains to be seen if productivity improves sufficiently to offset higher labor costs.

And even if the Fed is ultimately correct about inflation being 'transitory,' transitory could prove longer than it expects. It is hard to estimate when supply chains will normalize, when bottlenecks will ease, and when—or even if—sidelined workers will rejoin the labor force.

THE ECONOMY: SMOOTH RIDE, OR FRICTION ON THE TRACKS

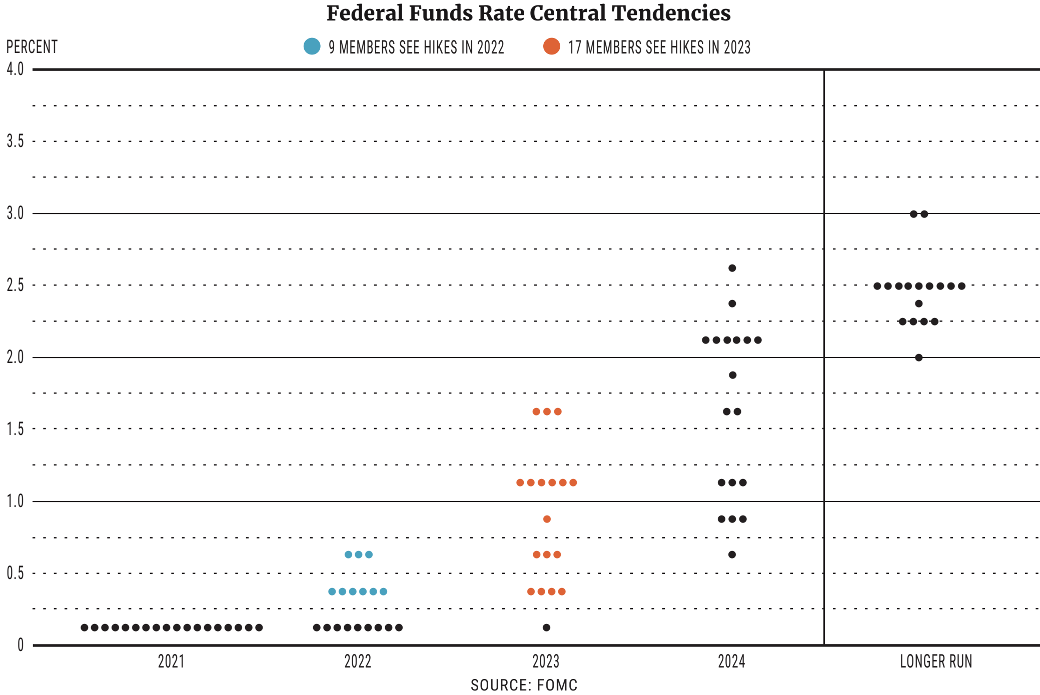
A maximum friction coefficient (μ) of 0.2 with a Kalker's reduction factor of 15% is needed in the case of trains with a heavy axle load to avoid crack formations.
–Saad Ahmed Khan

The focus on inflation is not misplaced. Physicists have figured out how to safely decelerate a train moving down a track. But economists lack a clear formulaic answer as to how to safely slow down inflation that's running too fast.

The Fed has a mandate to maintain price stability, and if it proves too complacent—that is to say, it commits a policy error and allows prices to rise too far for too long—it will be forced to remove accommodation more rapidly than markets anticipate.

At its September meeting, the Federal Open Market Committee ("FOMC") moved closer to tapering the Fed's monthly purchases of $120 billion of Treasury and mortgage-backed bonds—its first move to reduce its extraordinary response to the pandemic.

Federal Funds Rate Central Tendencies



SOURCE: FOMC

The FOMC also revised its closely watched 'dot plot.' Half of the committee members are now forecasting one or two rate increases as early as next year, and all but one see rate increases in 2023. This is a somewhat accelerated pace from prior forecasts, and presumably reflects some recognition by the members of the inflation threat playing through the economy.

If inflation proves to be more durable than the Fed's modeling, interest rates will rise more rapidly and to higher-than-expected levels. This will dampen demand, particularly for big-ticket goods that are often financed. Housing, which has been one of the locomotives of the economic recovery, might bear the biggest brunt from rising rates, as low mortgage costs have propelled home buying and home price appreciation. But automobiles, appliances, and a host of other goods and services could well experience downturns in consumer demand.

WILL MARGIN PRESSURE DERAIL STOCKS?

Those who gawk at train derailments are not so different from those who conduct autopsies; both want, at some level, to know what has happened, and, by extension, what will happen.
–Christopher Buehlman

Trains may derail for a number of reasons: a collision with another object, an operational error (such as excessive speed through a curve), the mechanical failure of tracks (such as broken rails), or the mechanical failure of the wheels…among other causes.

Higher inflation could well collide with higher stock prices. Or an operational error by policymakers could cause the stock market to derail—a significant and unanticipated rise in rates, as a response to higher inflation would, at a minimum, be a formula for bond and stock market volatility.

Persistent inflation is likely to adversely affect profit margins, particularly for businesses that will find it difficult to pass along higher costs. And there is some evidence that higher costs are already impacting corporate profits. We'll begin to see third quarter profit results in a couple of weeks, but early reports are not encouraging. Here are a few examples:

- **FedEx missed earnings estimates** due to "a constrained labor market," and is raising shipping rates by 5.9%, the most in at least a decade, for its new fiscal year. (Translation: we can't find enough drivers.) It has also added a fuel surcharge to recuperate higher gasoline costs.

- **General Mills cited higher prices** for raw ingredients and a shortage of truck drivers as it raises prices across nearly all its grocery categories around the world. It now expects input cost inflation between 7% and 8% in its fiscal 2022. The company's profits fell year over year.

- **Campbell Soup reported a gross margin decline** from 35.4% to 31.3% in its fourth quarter due to "higher cost inflation and other supply chain costs." The company expects core inflation of high single digits for the coming year. The price of steel, used in packaging for its soups, was cited as a specific challenge.

- **Nike produced solid results** for its recently announced fiscal first quarter, but noted higher product costs primarily due to increased freight costs. (Shipping rates have risen dramatically, and importers in many cases are turning to more expensive air freight in order to obtain inventory on a timely basis.) Citing factory issues in Vietnam, the company lowered its sales forecast for the new fiscal year from low double-digit to mid-single-digit growth.

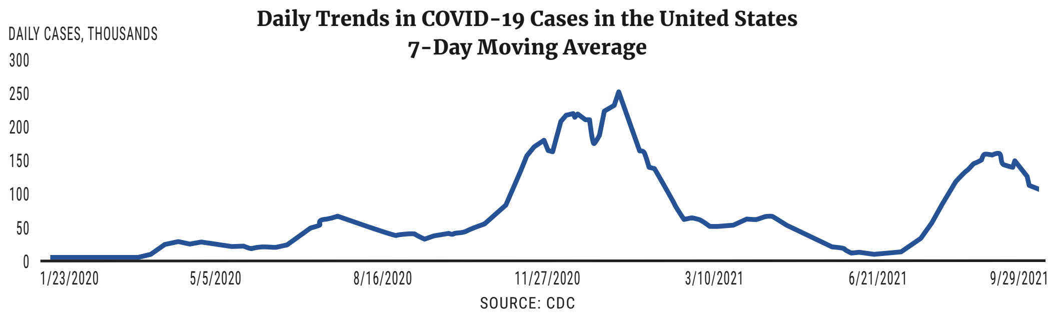
Stocks are trading at an expensive 21 times next year's expected earnings. According to FactSet, S&P 500 earnings are expected to climb 9.3% next year. Market experience tells us that expensive stocks that disappoint lofty earnings expectations are in for a fall.

THE JOURNEY AND THE DESTINATION: AVOIDING TRAIN WRECKS

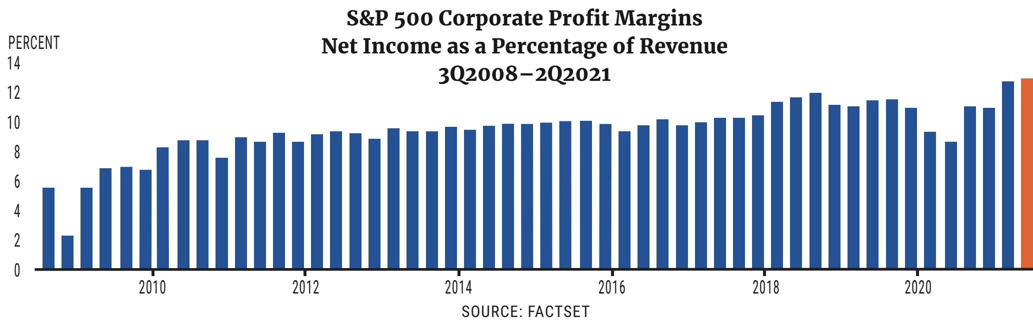
If your train's on the wrong track every station you come to is the wrong station.
–Bernard Malamud

Will the economic expansion remain on the right track? A reasonable case can be made for anticipating continued GDP growth, at a decelerating pace. The economy remains in a solid recovery mode, following last year's pandemic lockdowns. And, at this juncture, the policy backdrop remains favorable. As noted, the Fed is only beginning to contemplate removing excess accommodation, and a long way from actually tightening. Liquidity remains ample.

It appears that COVID infections from the Delta variant have peaked. Almost 65% of all Americans have received at least one vaccination dose. Antivirals are proving highly effective for patients who are infected. Employers are setting policies to address pandemic issues. Looking ahead, COVID may well prove to be waning as an economic issue.

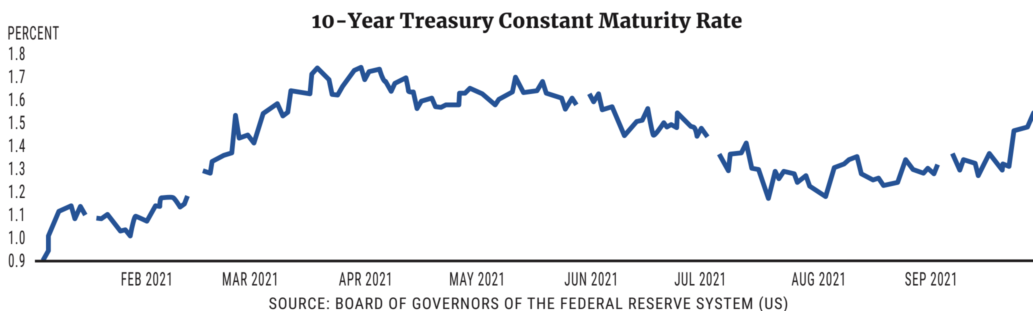


From an equity market perspective, some caution may be warranted in the near term. Equities may be challenged to make sizable further advances until it becomes clear that inflation forces are abating. Companies may well continue to notch respectable revenue gains, but margin contraction could pressure bottom lines.



Corporate profit margins reached record high levels in the second quarter, on strong revenue growth. Higher raw materials and input costs, transportation, wages, and corporate tax rates could drive a reversion to mean gross and net profit margins. There may also be widely variant results from company to company, both across and within industries, depending on their ability to pass along higher costs.

Fixed income markets have been roiled this year by alternating concerns of coronavirus spread on the one hand, and by fears of accelerating inflation on the other. Yields have spiked, plummeted, and risen again. That said, high investor demand for fixed income instruments has kept yields at historically low absolute levels.



In this environment, it seems prudent to capture and keep some of the excess gains stocks have provided this year, rebalancing portfolios. With decelerating profit growth and higher cost pressures—and a 16% gain—US equities are not as attractive today as they were at the start of the year. We note that only small cap value stocks are priced in line with their 20-year average. Looking internationally, developed markets—heavily weighted in cyclical stocks and earlier in the business cycle—may be poised to out-perform.

In the fixed income arena, we are wary that inflation pressures may force the Fed to bring forward future interest rate increases. That has us considering keeping duration comparatively short. In addition, spreads remain historically tight, even if they have widened modestly more recently. Put differently, investors are not well compensated for taking incremental credit risk.

Of course, we always have to allow for the unexpected. Last month, an Amtrak train derailed near Joplin, Montana, killing 3 and injuring more than 50.

Investigators have not yet determined the cause(s) of the derailment.

Such literal train wrecks remind us to do all the sensible things possible to avoid terrible accidents: engineering analysis, ongoing maintenance, inspections, metal stress tests, employee training, weather awareness.

And so it is, managing portfolios to safely reach destinations. The basic tools of portfolio construction—time horizon, risk tolerance, asset allocation, diversification, rebalancing—need to be employed to assure a smoother ride. So, climb on board an off peak Metro North train to see a re-opened Broadway show. Look for a revival of *Pippin*, where you'll hear that "There's no trick to staying sensible/Despite each cul-de-sac/'Cause each step's indispensable/When you're on the right track."

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