First Midwest | WEALTH MANAGEMENT

Third Quarter 2021

Market Outlook

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Economic Outlook

Ongoing Recovery at a Slower Pace. The Federal Reserve lowered its forecast for U.S. growth in 2021 from 7.0% to 5.9% with estimated growth of 3.8% for 2022. The Fed also bumped up its inflation forecast to 4.2%, from 3.4%, before moderating to 2.2% in 2022. Job growth continued at a solid pace in the third quarter, although it slowed a bit second quarter due to industries impacted by the delta variant. Inflation remains in the headlines, with CPI reported at an annual change above 5% for 3 months in a row. The Fed continues to label the elevated levels as "transitory" – due to temporary pandemic reasons. We expect the recovery to continue. The job market continues to heal, boosting consumer spending. Overseas, the recovery has been mixed. China, the world's second largest economy, has slowed. Increased regulations have impacted the gambling/gaming, real estate, tech, and education industries. China was also impacted by some COVID-related lockdowns. Europe's growth was boosted by higher vaccination rates and a strengthening reopening. Overall, growth estimates for the world GDP are for 5.9% for 2021 and 4.5% for 2022, before moderating to 3.4% in 2023.

Key Economic Indicators

	2021	2020	2019
GDP[1] U.S. Growth Rate	Q2/21: 6.7%; Q3/21: 5.6%E 2021: 5.9%Est 2022:4.1%E	-3.5%	2.2%
Unemployment Rate	Sept: 4.8%	6.7%	3.6%
Payroll Additions[2]	Sept: 194,000 YTD: 5,050,000	-9,416,000	2,054,000
Consumer Price Index	Aug: YoY: 5.3%	1.2%	1.8%
Employment Cost Index	Q2/21 YoY: 2.9%	2.5%	2.7%

Source:
[1] Bureau of Economic Analysis, Next GDP Release: Oct 29, 2021. GDP Estimates from Bloomberg.
[2] Bureau of Labor Statistics, Next Jobs Release: November 6, 2021.

Tailwinds to Recovery:

- **Global Vaccines Boost Re-Openings.** By October, most developed nations (for example, the U.S., EU, Canada, and Japan) were at or above 60% of the population vaccinated. Emerging-market countries have made strides as well. Supply is expected to be adequate, although some emerging markets are struggling from lack of infrastructure.
- **Job Openings Remain Near Records.** Reports continue to point to ongoing job growth, with openings and business hiring intentions near record highs. Hirings in COVID-impacted industries like hospitality and leisure have lagged, but are expected to improve. Some businesses, especially small businesses, continue to express frustration with applicants' skills not matching existing positions. Further job gains should lead to further consumer spending. The number of employed are still nearly 4M less than pre-pandemic levels.
- **Strong Business Confidence.** Measures of Business Confidence remain at or near record highs. The ISM surveys, CEO, CFO, and NFIB Small Business Surveys all point to ongoing growth ahead. Many surveys also point to ongoing hiring intentions, business investment and Cap-Ex spending.
- **A Second Infrastructure Week?** During the summer, the Senate passed a bi-partisan infrastructure bill for roads, ports, grids and broadband, among other things. It would boost GDP a bit over the coming years, as the capital outlays take place. However, Congress is still debating a second plan on childcare, healthcare and college funding. This has yet to come to fruition and final details remain to be resolved.
- **Central Banks To Keep Rates Low.** Central Banks are expected to remove some of the pandemic-emergency responses, specifically bond purchase programs, in the coming months. To support the recovery, interest rates are expected to remain low.

Headwinds to Recovery:

- **Transitory Inflation Becomes More Sticky.** Inflation levels have been elevated for a number of reasons, including year-over-year comparisons, recovery in commodity prices, housing prices, and tight supply chain issues. The Fed has labeled this current condition as "transitory," with the expectation that conditions will normalize in 2022 (forecast 2.2%). We continue to watch the data. In most measures of inflation, there is a small number of goods driving the number higher, such as energy and transportation expenses. The last CPI report was 5.3%, although the median price increase of the items in the index was a more moderate 2.3%. If these higher inflation figures persist, it could ultimately force global Central Banks to turn less accommodative. Higher inflation may be impacting Consumer Confidence – it has diverged from Business Confidence in recent months.
- **Supply Shortages.** A contributor to higher inflation has been persistent supply chain shortages in a number of industries. Semiconductors have impacted a number of sectors, including autos. Ports on both coasts remain jammed, while there are also a lack of trucks and truck drivers. Moving the cargo around the country is now complicated. Food has been impacted by draughts and wildfires across the globe. Europe experienced a fuel shortage. It has been difficult for businesses to ship goods to their customers.
- **Fed Taper.** While the Fed is unlikely to raise rates until 2023, they appear on track to reduce some stimulus, via fewer bond purchases. Currently, the Fed is purchasing $150B of bonds per month. The Fed is expected to taper these large purchases by approximately $15B per month beginning around the new year.
- **Massive Global Debt.** As governments responded to the pandemic, massive government debt has accrued. It currently stands at $300T (or 350% of GDP), and increased by $40T since the pandemic hit. At the height of the housing bubble, global debt was at $170T or 280% of GDP. With rates low, the debt service is "manageable," but may become more burdensome if rates move higher.
- **Geo-Politics, Elections, and Unknowns.** Geopolitics are always a short-term concern for consumers and businesses. China has adjusted to a number of increased regulations. Recent elections in Germany, Japan, and Canada could impact fiscal policy down the road. In the U.S., there could be potential political squabbles on Fed appointments, the debt ceiling, and the second infrastructure plan.

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Stocks

Major U.S. Stock Indexes Have Plateaued. We just had a historic 18-month stock market, which doubled. Is this a good enough reason to signal a market peak to investors and market watchers? On a valuation basis alone, we would suggest no to a market peak. The current forward 12-month P/E ratio for the S&P 500 is 20.5 and not egregious when compared to history. The 20.5 P/E multiple is above the 5-year average 18.3 and above the 10-year average 16.4, but below the forward P/E ratio of 21.4 at the start of the second quarter, according to FactSet.

The S&P 500 is likely to report earnings growth of more than 30% for the third straight quarter. If we look back two quarters, analysts were estimating earnings for the S&P 500 companies to increase 24% in Q1 and 63% in Q2. The actual earnings growth rate for Q1 was 52%, a 100% increase to the upside. The actual earnings growth for Q2 was 91%, a 50% increase to the upside. The market is currently focused on the rate of growth in earnings – we have seen a material slowdown in earnings revisions.

Will the earnings growth slowdown be offset into 2022 and beyond? For 2022, analysts are projecting an earnings growth rate of 9.7% for S&P 500 companies. If we look back one quarter, analysts were projecting earnings growth of 11% and so it appears the slowdown in company fundamentals is being driven by more permanent and less transitory factors. The top reasons for an earnings slowdown appear to be supply chain disruptions, labor shortages, transportation costs, and raw material and commodity costs. We see evidence of this in the transcripts of the S&P 500 company calls.

S&P 500 Operating Earnings Growth

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Year
2019	-0.3%	-0.4%	-2.1%	0.9%	0.1%
2020	-15.0%	-31.6%	-5.7%	4.0%	-11.2%
2021	52.5%	90.9%	27.6%E	21.8%E	42.8%E
2022					9.7%E

Source: FactSet

The Trend of Earnings Growth. Historically low corporate borrowing interest rates, improving COVID trends, and the strength of demand from an overall macro imbalance put stocks as a top ranked asset class for the next 12 months. The level of volatility for stocks will be driven by how much and how long these temporary cost pressures persist. The Fed and ECB haven't budged in terms of suggesting inflation is still temporary for companies and consumers and continue to lament that the cycle has been elongated due to the longer recovery in the pandemic and supply chains.

If inflation isn't temporary, the fall out effects and impact to the equity markets could be sizable. The U.S. stock market capitalization is now around 200% of GDP. In 2020, U.S. corporations piled on almost $1T in debt. Corporate debt as a percentage of GDP sits at all-time highs. Economic downturns have historically been when corporations reduce debt, so the aberration we saw last year may eventually have larger ramifications for the general debt levels of corporate America.

The markets could experience a domino effect from interest rates repricing as a result of higher levels of persistent inflation, stronger non-temporary headwinds to earnings growth, lower future values of earnings, and lower stock valuations. Consensus now expects inflation to normalize and the labor market to heal in 2022 to levels mandated by the Fed. At the very least, we expect volatility to increase as we wait for clarity, given the extreme views of market watchers.

Major Stock Index Performance

	3rd Quarter Returns	Year to Date Returns	2020 Returns	2019 Returns
S&P 500	0.59%	15.93%	18.4%	31.5%
Russell 2000 Index	-4.36%	12.41%	19.9%	25.5%
NASDAQ Composite	-0.55%	12.11%	43.6%	35.2%
International Developed Index	-0.35%	8.30%	8.27%	22.0%
Emerging Markets Index	-8.10%	-1.20%	18.7%	18.4%

Source: Bloomberg

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Bonds and Interest Rates

Interest Rate Outlook – Rates Drifting Higher. The 10-year Treasury started off the quarter at 1.45% on June 30th and finished the quarter at 1.52% on September 30. On the surface, it seems uneventful, but the closing low yield was 1.19% on July 19, as the delta variant spread across the US.

Yields stayed relatively stable throughout the quarter, until the Fed Statement on September 22. The 10-Year Treasury jumped 0.09% on September 23 and an additional 0.14% over the course of the next 5 trading days, to end at 1.55% on September 29. In the FOMC meeting minutes, released on September 22, the Fed changed his inflation assessment from "has risen" to "is elevated," reflecting that it's been elevated since before the last inflation assessment in June. The Fed still blames this on transitory factors, but acknowledged the supply chain bottlenecks and labor challenges have persisted longer than anticipated, as the delta variant lingered. Furthermore, the "dot plots" indicated there could be a rate hike as soon as the Q4 2022, sooner than the previous anticipation of 2023. The chairman also addressed the tapering of its $120 billion per month bond/MBS purchases. His comment: "If progress continues broadly as expected, the committee judges that a moderation in the pace of asset purchases may soon be warranted." This indicated the taper timeline will be announced at the November 3 meeting. He reiterated that just because they may be winding down asset purchases, that doesn't mean they were close to raising rates. He also reminded the market that "dot plots" are not policy, but merely forecasts not to read too much into.

The market narrative that the spike in yields is driven by concerns about higher inflation, U.S. policy rates and congressional bickering may be missing the mark. It may be as simple as an overdue correction of the disconnect between low yield levels and the economic restart. Given the backdrop of the strong consumer demand, robust jobs numbers achieved in May, June, and July and higher than normal growth, the market should expect higher rates moving forward. The recent rise in yields has not negated the fact that real yields are still negative and will remain that way for some time.

Bonds: Focus on Shorter Duration and Credit Quality. Intermediate and longer-term interest rates moved significantly higher during the last two weeks of the quarter. We could see those rates continue to move higher as the delta variant is brought under control, with children between 5-12 getting vaccinated. The economy continues to see robust demand from the reopening, and jobs numbers continue to be strong. Reinvestments should focus on the 4- to 5-year maturities. We continue to recommend an overweight to corporate debt for accounts that allow those mandates.

Recent Treasury Yields

	09/30/21 Yields	3rd Quarter Returns	12/31/20 Yields	12/31/19 Yields
3 Month T-Bill	0.03%	0.01%	0.06%	1.54%
2 Year Treasury	0.28%	0.09%	0.12%	1.57%
10 Year Treasury	1.49%	-0.31%	0.91%	1.92%
2-10 Year Spread	+1.21		+0.80	+0.35
BB Int Gov/Credit		0.02%		

Source: Bloomberg

Past performance is no guarantee of future results. This commentary has been prepared for informational purposes and may include some forward-looking views which reflect current expectations and opinions which reflect our judgment and are subject to change. Market conditions may change due to further uncertainty, market volatility and/or economic disruptions caused by the COVID-19 global pandemic

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