OXFORD | HARRIMAN & COMPANY

Third Quarter 2021 Commentary

An Oxford Harriman & Company Market Commentary

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Now Is Not the Time for Complacency & Greed

As we are writing this quarter's commentary, equity markets are down approximately 5% from the all-time highs set during the third quarter. This decline is the worst since the first quarter of 2020 at the onset of the pandemic. In our opinion, investors have become accustomed to steadily increasing returns and we are concerned complacency is prevalent. Additionally, many client conversations about investment allocation include the desire to get more aggressive to try and earn higher returns. We believe now is not the time for complacency and greed.

Delta Variant Signals the Pandemic's Continued Impact

The highly transmissible delta variant grabbed headlines during the third quarter. During July, the number of daily new confirmed Covid-19 cases started to unexpectedly spike as the delta variant spread. Covid case counts remained elevated during August before the growth rate of new cases gradually trended lower during September. The delta-driven fourth Covid wave in the U.S. occurred as the pace of vaccinations slowed and the percentage of fully vaccinated individuals fell below many foreign countries.

The official response to the fourth Covid wave differed considerably from prior Covid waves. Instead of returning to the strict lockdowns used early in the pandemic, public officials emphasized vaccinations and masking. While the change in approach blunted the delta variant's economic impact, the economic recovery still encountered separate labor market and supply chain disruptions during the third quarter. Those disruptions, which remain, caused both Wall Street economists and the Federal Reserve to lower their GDP growth estimates for the remainder of 2021.

Job Growth Slows Despite Record High Openings

The U.S. Labor Department reported the labor market added 235,000 jobs during August, significantly missing economists' 720,000 consensus estimate. It was a sharp deceleration from the approximately 1 million jobs added during both June and July. The labor market slowdown coincided with the delta variant's spread and companies' decision to pause hiring amid an uncertain outlook. As an example, the Leisure & Hospitality industry, which led the labor market recovery this year, was flat during August. It was a sudden, steep drop-off for an industry that added hundreds of thousands of jobs per month from February 2021 through July 2021.

The slowdown in job growth does not appear to be labor demand related. A separate batch of Labor Department data showed the number of U.S. job openings set a record high for the sixth consecutive month during August. There are now 10.9 million jobs for 8.4 million unemployed individuals, or approximately 5 open jobs for every 4 unemployed individuals. We attribute the labor market mismatch to a combination of Covid fears, enhanced unemployment benefits, childcare issues, and career changes. It is increasingly clear this is not a normal labor market recovery.

Supply Chain Disruptions Pressure Growth

Supply chain disruptions continue to act as a constraint on manufacturing activity. The disruptions are caused by a combination of parts and labor shortages, as well as gridlock at ports, warehouses, and railroads. Companies report it is difficult to source the materials they need to produce goods, which in turn is leading to depleted inventories and further intensifying supply chain issues.

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The friction created by supply chain disruptions is turning up in economic data. As an example, August manufacturing surveys conducted by regional Federal Reserve bank branches were weaker than economists' forecasts. The weak data highlights the difficulties manufacturers face as they work to restart production. While recent data is weaker compared to earlier this year, it is important to point out manufacturing growth remains positive. For example, the Federal Reserve reported industrial production expanded month-over-month during August despite Hurricane Ida closing refineries and plants along the Gulf Coast and lower automobile production. The economy's resiliency is impressive when considering the delta variant and other economic disruptions.

Inflation Pressures Remain Elevated

The Federal Reserve believes inflation pressures are transitory (i.e., temporary), implying inflation will settle back to levels from the 2010s. However, some investors believe inflation pressures will persist for an extended period, which implies the inflation rate will return to the levels experienced in the 2000s.

Inflation pressures remained elevated during the third quarter as the economy battled labor shortages and supply chain disruptions. The Personal Consumption Expenditures (PCE) Price Index, which measures the prices individuals pay for goods and services, rose 4.3% year-over-year during August 2021. While this reading was the highest since January 1991, more recent month-over-month data indicates the growth rate of inflation is easing as the economy gradually reopens and inflationary pressures fade. The PCE price index rose 0.4% month-over-month during August compared to increases of 0.5-0.6% during each of March, April, May, and June 2021.

With inflation spiking this year, the question moving forward is, "Where does the inflation rate settle during the 2020s"? The Federal Reserve believes inflation pressures are transitory (i.e., temporary), implying inflation will settle back to levels from the 2010s. However, some investors believe inflation pressures will persist for an extended period, which implies the inflation rate will return to the levels experienced in the 2000s. It is still too early to tell, but the answer will have profound investment implications.

Equity Markets Trade Sideways During Third Quarter

The performance divergence between large cap and small cap stock is likely due to fears of an economic slowdown, as small cap stocks are often considered more economically sensitive.

Quarterly performance trends highlight how the delta variant, labor market shortage, supply chain disruptions, and inflationary pressures impacted third quarter equity performance. The S&P 500 advanced 0.6% during the third quarter, while the Russell 2000 Index of small cap stocks declined 4.3%. The Russell Growth Index returned +1.1% compared to the Russell 1000 Value Index's -0.8% return. The performance divergence between large cap and small cap stock is likely due to fears of an economic slowdown, as small cap stocks are often considered more economically sensitive.

International equity markets also exhibited performance dispersions during the third quarter. The MSCI EAFE Index of developed market stocks declined 1.1%, while the MSCI Emerging Market Index declined 8.6%. Chinese equities were a big contributing factor to emerging markets' 7.5% underperformance after Chinese officials advanced a regulatory agenda aimed at the technology, education, ride-hailing, and gaming industries.

Lower vaccination rates also weighed on emerging countries as the delta variant spread. In contrast, most developed countries saw their vaccination rates increase during the quarter, which most likely limited the delta variant's impact.

Bond Markets Track Evolving Investor Sentiment

While interest rates across the Treasury yield curve ended the third quarter mostly in line with where they started, their path during the quarter shows how the delta variant and headwinds mentioned above impacted yields.

Fears of an economic growth slowdown also impacted credit markets during the third quarter. While interest rates across the Treasury yield curve ended the third quarter mostly in line with where they started, their path during the quarter shows how the delta variant and headwinds mentioned above impacted yields. As growth fears took hold at the start of the quarter, investors purchased bonds and pushed the yield on the 10-year U.S. Treasury from 1.45% at the start of July to 1.22% on July 30th. The 10-year Treasury yield bottomed in early August, traded sideways through mid-September, and then surged higher in late September as inflation expectations picked back up and Covid trends improved.

Interest rate moves during the quarter impacted bond market performance. Investment grade corporate bonds, which tend to be longer maturity and therefore more sensitive to interest rate moves, outperformed high yield corporate bonds during July as interest rates declined due to economic growth fears.

As interest rates stabilized and reversed higher in late September, high yield bonds outperformed due to their shorter duration (i.e., lower sensitivity to interest rate moves). The third quarter ended with high yield bonds generating a +0.3% total return, slightly outperforming investment grade's -0.4% total return.

The Federal Reserve continues to play a key role in the bond market as it works through when to start tightening monetary policy. Investors expect the Fed to start reducing its monthly bond purchases sometime during the fourth quarter. At the same time, investors expect the Fed to keep interest rates low through most of 2022. Continued uncertainty regarding the Federal Reserve's policy decisions could keep financial markets volatile in the months ahead.

Fourth Quarter 2021 Outlook

From a performance perspective, strong returns in one year do not necessarily indicate markets will sell off the next year. However, strong returns may suggest the market has already priced in a robust recovery. In the months ahead, the equity market may become more reliant on earnings growth rather than increasing valuation multiples to power further gains.

From a performance perspective, strong returns in one year do not necessarily indicate markets will sell off the next year. However, strong returns may suggest the market has already priced in a robust recovery. In the months ahead, the equity market may become more reliant on earnings growth rather than increasing valuation multiples to power further gains. The encouraging news is corporate profit margins held up well during the pandemic and demand appears to remain strong. Investors will be paying close attention during the third quarter earnings season to understand how the labor shortage, supply chain disruptions, and inflationary pressures are impacting businesses.

As we conclude this commentary, we wanted to provide a list of some of the more significant items we are monitoring:

- Covid-19 progression
- Inflationary pressures
- Upward trending energy prices & the potential for an all-out energy crisis in parts of the world
- Softening manufacturing data
- US Retail sales and consumer confidence
- Unemployment trends
- The Federal Reserve's balance sheet and tapering actions
- Continued supply chain stress and chip shortages
- Negative earnings surprises and/or reduced guidance
- US political infighting and the looming debt ceiling debate

We know from history that there are two times when investors must be disciplined: when the markets are up and when the markets are down (in other words, always.) The best way to deal with uncertainty is to not overreact to it. That's why as we conclude 2021, we are going to remain disciplined and not allow emotions to impact our long-term strategy.

We recognize the importance of the relationship we share, and thank you for your continued trust in us. If you ever have questions or concerns, please let us know. We will always be here for you.

Sincerely,

Dennis P. Barba, Jr.
President & Managing Partner

Michael Finkelstein
Managing Partner