LIFESTYLE ASSET MANAGEMENT
LSAM

Market Commentary

September 2021

Equity and Bond Market Update

(as of August 31, 2021)

Index	YTD	1-Year
Dow Jones Industrial Average TR	+17.0%	+26.8%
S&P 500 Total Return Index	+21.6%	+31.2%
Russell 2000 Total Return Index	+15.8%	+47.1%
MSCI EAFE Index (net)	+11.6%	+26.2%
MSCI Emerging Markets Index (net)	+2.8%	+21.1%
Barclays US Aggregate Bond TR	-0.7%	-0.1%

Recent Economic Indicators

	Statistic	Data as of
Unemployment Rate	5.4%	Jul 2021
Gross Domestic Product (GDP)	+6.6%	Q2 2021
Consumer Price Index (CPI)	+0.5%	Jul 2021
Consumer Confidence (1985=100)	113.8	Aug 2021
30-year fixed mortgage rate	3.03%	9/1/2021
Housing Starts (single family)	1,111,000	Jul 2021
10-Year Treasury Yield	1.29%	8/30/2021

After a slight pullback in mid-August, equity markets continued their post-COVID recession recovery with all major indices closing in the black for the month of August. Year-to-date, large-cap U.S. stocks are still in the lead advancing over +21% so far in 2021, with small-cap U.S. stocks slightly trailing large-caps, at almost +16% this year. Foreign stocks have struggled by comparison to domestic stocks, especially in broad emerging markets up just shy of +3% so far this year, and foreign developed country EAFE stocks up just over +11%. The bond market, in aggregate, is still in negative territory at -0.7% for 2021, but has made up quite a bit of ground since bottoming out in March this year at around -3.6%.

In this commentary, I'd like to briefly touch on and give some thoughts on some of the more macro topics and trends we are seeing:

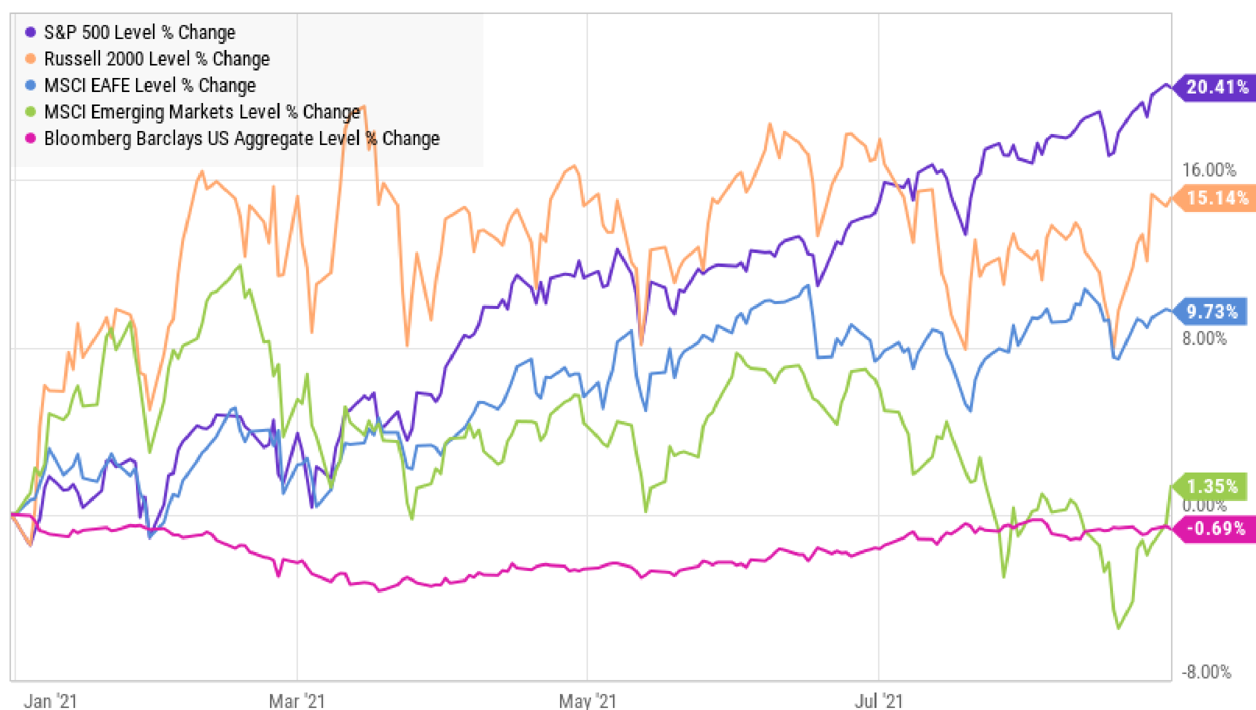
Corporate earnings – corporate earnings are noticeably strong over the last year since the Q1-2020 COVID lockdowns. The U.S. economy has shown strong resilience in the post-pandemic era. Obviously, the first and second quarter of last year were low points in corporate earnings growth due to COVID lockdowns, but since then, the year-over-year quarterly results have recovered and exceeded any historical previous quarterly growth, especially the first and second quarters of 2021. To put this into perspective, over the last three years since the beginning of third quarter of 2018 when S&P 500 constituent earnings hit their highest point at that time of $41.38, earnings have grown at an +8% annualized growth rate to the most recently closed second quarter of this year at $52.11 (with 97% of companies reporting). Prior to Q3-2018, the ten-year annualized growth of these earnings was +9.2%, so we are very close to that recent historical average even as we went through the pandemic and associated economic lockdowns.

In the most recently closed second quarter of this year, over 86% of S&P 500 companies that have reported so far (97% of the total) have beat their analyst earnings estimates, and less than 11% missed their estimate numbers. Prior to the second quarter and since 2013, these numbers have averaged around 71% beating and 21% missing analyst estimates. So, along with strong expected earnings growth from the analyst community, corporations are surprising to the upside at a much higher rate, another positive.

As we've touched on before, corporate earnings drive stock market values. There are a few more topics we will cover in the rest of this report that all effect corporate earnings, so changes in them will drive the growth or suppression of earnings in the future. Accordingly, the final result of earnings that are posted, and the anticipation of growth in the future based on the perceptions of the following topics, justify the current level of the equity markets, as well as the rate of advancement or weakening of future market values.

Federal Reserve and interest rates – recent comments from Fed Chair Jerome Powell have re-ignited risk assets like the stock market over the last week. At this point it does look like the Fed is holding its view that short-term interest will be held at bay until at the earliest the beginning of 2023. In the meantime, however, the Fed will at some point begin tapering its monthly bond purchases which have also provided an anchor to bond yields. Currently, the Fed buys around $120 billion of treasury securities ($80 billion) and mortgage-backed securities (MBS) ($40 billion) per month. Obviously, this floods the economy with more liquidity. At some point, whether that be before the end of this year or no later than the beginning of 2022, they will start pulling back on these purchases. Many forecast that this tapering will be by $10 billion per month for a year until the total comes to $0. This is widely accepted as what will happen in the coming months.

Major Market Indices Price Return (YTD through August 31, 2021)



The question now is whether the U.S. economy will be in a state, after that one year of tapering, where the Fed will begin raising short-term rates immediately, or will there be a gap, or delay, in when that will happen. All-in-all, we can safely assume at this time that there will be no rate movements, all other things remaining equal, until early 2023.

Inflation – There has been a lot of discussion and worry about inflation over the last few months. While the inflation growth numbers are alarming, both the Consumer Price Index (CPI) as well as Personal Consumption Expenditures (PCE), are growing from levels that were depressed due to government-sanctioned economic shutdowns and the associated recession. These higher numbers in the short-term can be described as "transitory", or temporary, due to this factor. Time will tell in the coming six to twelve months if these numbers stick or if they revert back to more normal levels. If you were to take the "dip" out of both the CPI and PCE we experienced in the first half of 2020, and simply continued on the mean level using the same inflation rates we have experienced over the last ten or so years, we would be right back where we currently are. The point is that inflation feels much worse now than it would have been sans-COVID, but prices would still be relatively the same.

Taxes – Tax rates are most likely going to go up. Given the current make up of the federal government, especially the Congress, however, it is not likely that rate hikes will be too excessive. Don't get me wrong…any tax hike at this point is NOT a good idea in any shape or form. But the severity of proposed hikes and the most likely outcome are probably lower than most people expect. Top regular individual rates will probably end up at the pre-Trump 39.6%. Keep in mind that this would still be one the lowest marginal rates we have seen since the early 1930's, and lower than 75% of the last 88 years. Corporate taxes will probably end up in the mid-twenty percent range, and capital gains and dividend tax rates also in the mid twenty percent range. Also, the step-up basis for inherited investment holdings is most likely safe for now.

Overall, tax hikes are probably a sure thing at this time. Any sharp stock market adjustments due to the coming passage of new tax law, however, should probably not be expected. Most investors are expecting changes, so it is most likely already priced into stock market values.

Stock market highs – There is always concern when the stock market continually hits new highs. But then again, if it didn't, then it wouldn't be such a great place to invest your money for the long-term. We have heard about the market continually hitting new highs for some time now. It is true that large-cap indices like the S&P 500 have hit highs recently, but not all equity indices can say the same. Small-caps, represented by the Russell 200 index, hit their all-time highs back in March this year and have traded in about a 10% range since then.

Currently, this index is about 3% below it's high. The MSCI EAFE index, which represents developed countries such as Japan, United Kingdom, France, Switzerland and Germany (about 70% of the index), actually hit its all-time high back in October 2007 before the financial crisis, and has never fully recovered. Currently, the EAFE index is trading within 1% of that all-time high from almost 14 years ago. The MSCI Emerging Markets Index, which represents countries such as China, Taiwan, South Korea, India and Brazil (almost 80% of the index), also recently hit it's all-time high earlier this year in February. Currently, this index is trading about 9% below this high from earlier this year, mainly due to the poor performance of the Chinese market which is down -8% in 2021.

The point is that you may continue to hear that the stock market is continually making new highs, but that is referring only to large-cap U.S. equities. This year, being invested only in these large-cap stocks has worked, but that would have dictated a non-diversified portfolio. Additionally, there are other risky asset classes that have performed even better than large-cap stocks this year, namely commodities and real estate. Last year, small-caps and emerging markets were the highest performers. Over the last 15 years, large-cap stocks were the best performer only one of those years, in 2019.

As we have discussed before, with preferable market performance over the last year, it is a good time to assess your financial condition and associated views on risk. Think about how you felt in March and April last year when the market fell, and weigh in the fact that we can look back and see that the market recovered very quickly. These feelings are laid out in our Risk Tolerance Questionnaire through a series of short-term and long-term outlook questions. If you haven't updated this form in at least two years, we highly recommend reaching out to your advisor to do so at this time.

Always keep in mind that fear, panic, and optimism are not investment strategies, but rather emotions that drive short-term markets.

Please contact Lifestyle Asset Management, Inc. at (281) 612-2035 or by email at **pjackson@lsaminc.com** should you have any questions or comments.

Sources:

S&P Dow Jones Indices website (us.spindices.com)
MSCI Barra website (http://www.mscibarra.com)
The Conference Board (www.conference-board.org)
Bureau of Economic Analysis (www.bea.gov)
JP Morgan Guide to the Markets
FTSE Russell (www.ftserussell.com)
Bankrate.com (www.bankrate.com)
Bureau of Labor Statistics (www.bls.gov)
United States Census Bureau website (www.census.gov)

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