The Cobblestone Advisor

Investment Brief

October 2021

COBBLESTONE CAPITAL ADVISORS

Recalibrating Expectations: Growth, Inflation, and Policy

Global equities lost steam in early September, steadily pulling back from their all-time highs and closing the quarter delivering mixed performance. US large caps managed to eke out a small gain (+0.6%), while other segments including US small cap (-4.4%), international developed (-0.4%), and emerging markets (-8.1%) experienced negative returns for the period.

Looking under the hood of the performance-challenged quarter shows some interesting dynamics at play. On September 2nd, the S&P 500 had closed at a record high—its 54th one of the year—and the index appeared on track to deliver another strong quarter of high single-digit returns. From there, however, investor uncertainty surrounding the sustainability of the economic recovery came to a boil, driving the prices of risk assets lower and culminating in the S&P 500's first 5% selloff since the pandemic-induced shock to the market drove it 34% lower 18 months prior.

Driven in part by concerns over the Delta variant, its impact on economic activity, and the risk of contagion stemming from weakness in China's property sector, investors looking for cover from the selloff in risk assets were largely unable to find it. Even in bond markets, all major bond categories sold off in sympathy with risk assets throughout September, leading to essentially flat broad bond market returns for the quarter (+0.1%).

It is probably safe to say that market action in September and the uptick in market volatility likely unnerved some investors. Indeed, concurrent with the drawdown, investor sentiment fell from elevated levels, a sign that suggests we are starting to see some skepticism creep back into markets. Nonetheless, it is important to consider recent market weakness in a broader context, and acknowledge the recent developments that suggest an outlook of cautious optimism may be warranted.

First, a -5% move in equities is a minor pullback from a historical perspective considering the average intra-year decline in the S&P 500 since 1980 is -14.3%. Additionally, this marked the first 5% selloff in 226 trading days, which is more than twice as long as it has typically taken to cross that threshold going back to 1929 (a 5% selloff occurs every 95 days on average).

Many of the catalysts that drove investors to reposition away from risk assets are also abating. COVID-19 case counts—the rise of which called into question the sustainability of the economic recovery—have started to show signs of improvement, with the trend in new infection rates and hospitalizations continuing to improve in recent weeks. Furthermore, Chi-

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Total Return (%), Ending 9/30/2021				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	0.58	15.92	30.01	15.99	16.90	16.63
Russell 2000 (Small-Cap Stocks)	-4.36	12.41	47.68	10.54	13.45	14.63
MSCI EAFE (International Stocks)	-0.45	8.35	25.73	7.62	8.81	8.10
MSCI EM (Emerging Markets)	-8.09	-1.25	18.20	8.58	9.23	6.09
Bloomberg Barclays US Aggregate Bond Index	0.05	-1.55	-0.90	5.36	2.94	3.01
Dow Jones US Select REIT	1.25	24.48	40.56	8.29	5.66	10.52
Consumer Price Index (% Chg over Period; One-Month Lag)	1.62	5.03	5.25	2.76	2.58	1.90

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na's property market challenges do not appear to pose a systemic risk to offshore markets, and Beijing appears ready to provide the necessary backstops in the event that it needs to step in to mitigate financial contagion.

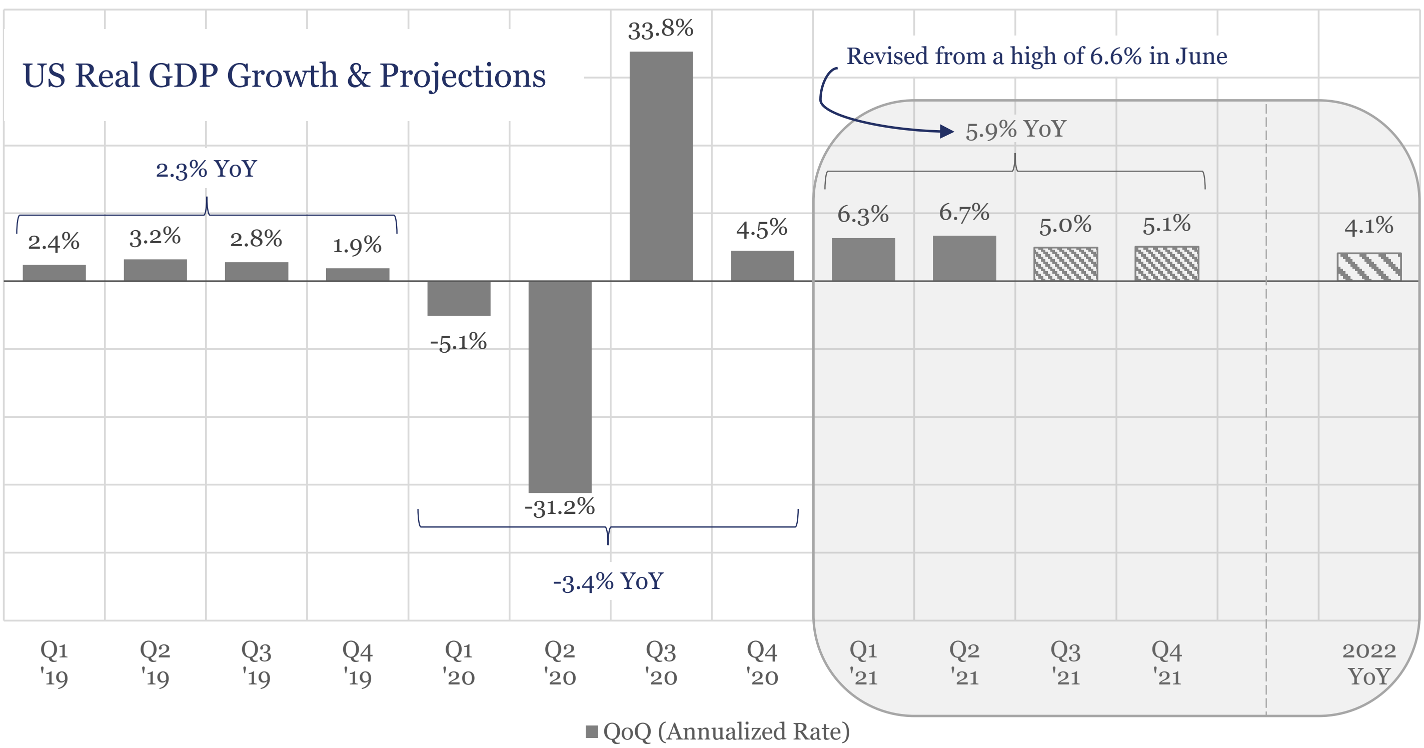
Developments on the macro front tell a similar story: that apparently bad news may not actually end up being so bad after all. To be sure, there has been a softening in broad measures of economic data. Manufacturing growth has slowed, activity in the services sector has waned, and projections for US growth have been revised downward modestly for the remainder of this year and next. Despite all this, the fact remains that a slowdown in economic activity is a materially different phenomenon than a contraction in economic activity, especially when slowing from extraordinarily elevated levels.

Case in point: softer Purchasing Managers' Indexes for both manufacturing and services in recent months indicate slowing but still robust levels of activity, while consensus economic forecasts continue to indicate strong growth for the remainder of 2021 with above-trend growth also expected in 2022 (see below chart).

Contrary to just a few months ago—when bond yields were declining—long bond rates have also started moving higher, suggesting that bond markets are now corroborating the narrative of still strong growth ahead and what that implies for inflation and policy. The upward trend in yields was further exacerbated following September's Federal Reserve meeting, during which policymakers expressed incrementally more concern about rising inflation.

The move higher in yields appears to signal that investors are recalibrating their expectations regarding the inflation, growth, and policy backdrop that is anticipated in the quarters ahead. This is not especially surprising given how low yields had fallen relative to the fair value implied by the Federal Reserve's forecasts for the future path of interest rates. Taking all of this into consideration, it is plausible to believe that yields could continue to move higher from here.

Nevertheless, considering the environment of still-strong economic growth, healthy levels of company profitability, and strong earnings growth, we believe the current backdrop provides a favorable environment for investors, and reiterate our belief that an outlook of cautious optimism is warranted.



Source: US Bureau of Economic Analysis, Bloomberg. Consensus (median) economic forecasts are as of October 4, 2021.