Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

SEPTEMBER 30, 2021

Equity Market Summary

U.S. Equity Markets	3Q'21	1 Year
S&P 500	0.6%	30.0%
Russell 1000 Growth	1.2%	27.3%
Russell 1000 Value	-0.8%	35.0%
Russell 2000	-4.4%	47.7%
Russell 2000 Growth	-5.7%	33.3%
Russell 2000 Value	-3.0%	63.9%

Top/Bottom Sectors	3Q'21	1 Year
Financials	2.8%	59.3%
Utilities	1.8%	11.1%
Comm. Svcs.	1.6%	38.6%
Energy	-1.6%	83.2%
Materials	-3.5%	26.3%
Industrials	-4.3%	29.1%

Non-US Equity Markets (in USD)	3Q'21	1 Year
MSCI AC World Ex U.S.	-3.0%	23.9%
MSCI EAFE (Developed)	-0.5%	25.7%
MSCI Emerging Markets	-8.1%	18.2%
MSCI China	-18.1%	-6.8%
MSCI United Kingdom	-0.1%	31.2%
MSCI Brazil	-19.8%	22.4%

Non-US Regions (in USD)	3Q'21	1 Year
Developed Americas	-2.2%	35.0%
Developed Asia	1.7%	23.3%
Developed Europe	-1.2%	28.0%
Emerging Americas	-12.9%	28.4%
Emerging Asia	-9.3%	14.7%
Emerging EMEA	4.1%	41.3%

Market Review:

September is historically a difficult month for equity markets and this year it held true to form when compared to the rest of the year. Concerns du jour included a Delta Covid spike, slowing U.S. growth, stronger for longer inflation, previews of Fed tapering, potential contagion from an Evergrande default, and slowing Chinese growth to name a few. Lurking below the surface is the valuation debate that has raged throughout the year. Despite these inflated multiples and a rougher September, the market continues to march upward with no more than a 5% intraday correction. There is still liquidity on the sidelines that is anxious to buy the dip and earnings expectations continue to rise. Large cap stocks barely managed to hold onto a positive result during the quarter with the S&P 500 returning 0.6%. Their small cap brethren were not as resilient with the Russell 2000 slipping -4.4%. Growth stocks outpaced value peers but with more volatility. Overall, volatility has returned to pre-Covid levels and return dispersion is near historic lows. With plentiful cash on the sidelines many investors are bemoaning the lack of a meaningful pullback in the market. But digging a bit deeper they may find some opportunities. While the S&P 500 closed -5.1% off its high the average company in the index ended -13.1% lower that its peak. This dynamic is even more pronounced in small companies where the Russell 2000 finished –6.6% from its 12-month high while the average company -27.6% from its summit.

Optimistic projections of herculean global economic growth have trended downward toward more mortal levels. The combination of a Delta Covid mutation and supply chain bottlenecks have acted like a dam holding back the gush of liquidity into the economy. Yet growth has been inhibited, but not derailed. At the beginning of the third quarter many economists were projecting U.S. real GDP growth for the third quarter to be north of 7%, now most estimates are south of 5%. Some are closer to the Atlanta Fed model that uses real time data indicating actual growth may be closer to the long-term average of 3%, still respectable growth. Economic reports earlier in the year were pervasively ahead of expectations and the outlook for the rest of the year grew to be quite optimistic. Those hurdles became more difficult to achieve, however given some of the constraints businesses experienced and a resurgence of a new Covid strain. The Citi Economic Surprise Index (CESI) turned negative in August and drifted down to the bottom decile of historic readings. It bottomed in mid-September and is now rising as economic reports have had an easier time meeting or exceeding expectations. Manufacturers both large and small report strong demand but tight inputs are increasingly making it difficult to meet demand. Growth remains strong for the services sector but the tight labor market, materials shortages, inflation and logistics issues continue to cause capacity constraints. Nevertheless, a rebound in the fourth quarter is still in the cards.

Market Outlook:

The valuation debate will not go away any time soon but valuation has never been a good short-term indicator of market direction. Current price/earnings (P/E) levels are clearly elevated. Liquidity and low interest rates are enablers of these high valuations. But P/E's have been lofty all year and stock prices have steadily risen despite ongoing angst. That can be partially attributed to earnings estimates rising faster than the market during the year, so P/E's have eased a bit at the margin from peak levels. However, in September earnings estimate movement flattened at the same time as the

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Fed started signaling a move toward tapering bond purchases and interest rates rose sharply in the final days. We believe the current economic constraints will begin to loosen a bit allowing for the rise in earnings expectations to resume. But tapering may act as an offsetting force on equity markets. As the quarter ended, interest rates began to rise as the market started to take Fed tapering more seriously. Arguably, further bond purchases are not likely to solve many of the issues holding back economic growth and employment, so it is logical for them to ease the use of that tool. They have done a much better job of telegraphing this than the last time but that does not eliminate the possibility of some form of a taper tantrum and market volatility is possible. It would not be surprising to get the much anticipated "market correction" in the near future. But with so much unfulfilled global demand the global economy looks to have a long runway that should feed earnings growth for some time as supply works to catch-up. Earnings in 2021 are anticipated to increase by 46% over 2020, with an additional 9% tacked on in 2022. So far companies have handily exceed expectations during reporting season so these growth estimates might prove conservative. Much will depend on the shape of the global economy as the current pandemic wave dissipates and bottlenecks begin to resolve. Central bank rhetoric has turned a bit more hawkish but monetary policy plans look like it will take years before they would be considered tight. Inflation has been bloated but the main recent drivers are more transitory in nature (see below), albeit probably stronger for longer than the Fed hoped. Earnings may have to grow into stock prices in order to eventually resolve the valuation conundrum.

Some Inflation Insights:

An examination of what has been driving higher inflation in the past year helps to alleviate a bit of anxiety about future price increases. The hot spots over the last twelve months have been gasoline, car prices, electric/gas services, plus meat/poultry/fish/eggs. Those four items contributed 3.4% to the total 5.3% CPI increase during that period. Without them the CPI would be quite tame. The Reserve Bank of Dallas publishes a Trimmed Mean Personal Consumption Expenditures (PCE) metric which eliminates the most volatile inputs - that currently yields a 2.02% result. Lest we be accused of cherry -picking let's examine some of these components. The biggest driver this year has been gasoline prices that are up 43% and contributed 1.6%, or almost a third of the total CPI change. Similarly, natural gas service prices are up 21% and it has even flowed through to electric prices, up 5%. Headlines are currently filled with fuel shortages and predictions of gloom. But fuel prices have historically been difficult to predict and quite volatile. Remember that for continued inflation from this source these price rises would have to repeat, which is not likely. The next largest input is used car prices that are up 32% year-over-year and contributed 1.1% to the total. The only other time appreciation of this magnitude occurred was in the 1970's when overall inflation was well into the double digits. The median used car annual increase for the life of the series is 1.7% and prices dropped in the last month so this cycle may have run its course. Grocery shoppers can certainly attest to the 8% jump in prices at the meat counter. But having grown up on the farm the author can certainly attest to the cyclicality of crop and animal product prices. The propensity is always to maximize production, especially when selling prices have risen. Sustained price increases are thus extremely rare in the absence of crop failures. The drivers of inflation in the coming period are unlikely to be these four inputs. The cost of shelter in the CPI calculation has been tame in the past year but is poised to be the next hot spot as rents begin to ramp up and owners' equivalent rent starts to reflect increases in ownership costs. These could also prove to be a cyclical bounce rather than a sustained trend. So the issue of transitory versus persistent inflation is still an evolving discussion.

We would be remiss if we did not acknowledge the role that supply chain issues are playing in price increases in the world. The record backlog at the ports of Los Angeles and Long Beach are the most visible examples of some of the bottlenecks. Chinese ports are equally clogged. Stretches of interstate are packed with eighteen wheelers and a shortage of truck drivers is a big issue. Even if ports were to work 24/7 the supply of trucks and warehouses to receive goods can't handle the volume. Labor shortages are impacting production and services across the board. Throw in some electricity blackouts, natural disaster disruptions, or pandemic shutdowns and backups are exacerbated. Semiconductor production can't keep up with demand. . Thankfully, businesses are getting creative in adapting to these issues. Sourcing is becoming more geographically diverse. New-build container ship orders have accelerated. Global transportation infrastructure capital expenditures are projected to rise by 15% this year. Containers are finding their way onto intermodal trains instead of trucks. New supplier plants are being built closer to customers. But adaptation takes time and some of these issues will be around for a while. The transitory nature of these issues means that while resolution may take a bit longer they will eventually work out.

Those of us that were in the investment business during the Volcker inflation-fighting years will recall the concepts of "cost push" versus "demand pull" inflation. At present we have a bit of both: businesses are raising prices to offset increases in input costs and increased consumer demand in the face of shortages of product is pulling prices higher. Are either of these conditions transitory? Many input costs have risen sharply as the global economy ramped up and supply chains are suffering unprecedented stress. But the adage that "the best cure for high prices is high prices" is beginning to work

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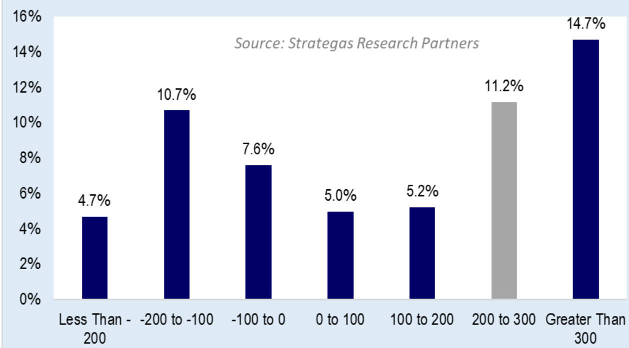
in some instances like lumber, copper, and iron ore as the supply and demand mismatch abates. Lumber prices spiked to 400% of the pre-covid average but have since corrected -68%. Copper is -10% off its high and iron ore is -50% lower than the May peak. The question remains as to whether some of the more persistent bottlenecks driving higher prices will remain. Suppliers are in the process of adding capacity but capital expenditures take time. Excess liquidity in the system coupled with consumer confidence in the face of supply disruptions is impacting the demand side of the inflation equation. Lately, confidence has taken a hit but that has not really flowed through into less spending. Yet consumer caution was even more evident in recent surveys, which could lead to a pause in spending. A pause might allow supply chains to catch-up a bit. However, cash in consumers' bank accounts is still high and household leverage has not been this low since the early 1980's. The current inflation calculus has many moving parts. The transitory argument is that those mismatches will equalize before an inflationary psychology like the late 1970's and early 1980's becomes entrenched. Stronger for longer inflation is increasingly likely but U.S. business has proven adept at adjusting to changing conditions. The transit lounge may be further from the gate than anticipated but we think we will get there eventually.

Some Valuation Thoughts:

Some blame investor exuberance and liquidity for today's high valuations. But investor surveys are actually signaling a quite bearish attitude toward stock prices. Liquidity coupled with few attractive investment choices is a more logical argument at present. By extension low interest rates appear to be the primary driver of current elevated valuations. The equity risk premium, which measures the expected return of stocks versus interest rates, is a reflection of that condition. It is currently in the top quartile (most attractive) of readings going back to 1960 due to very low interest rates. Historically this has been associated with plentiful forward returns. The current reading in the mid-200's places it in the second highest tranche in Exhibit #1 at right. The historical average return for the S&P 500 in the following 12-months is in the double digits. However, the dispersion of returns in that tranche is quite wide. That should not be a surprise given that forward market returns depend on a multitude of inputs. Further multiple expansion does not seem likely so the base conditions for achievement of this type of return probably would be continued modest interest rates and earnings growth. Both are possible but not a forgone conclusion.

Exhibit #1: Average Forward 12 Month Return by ERP Tranche (1960 - Current, Quarterly)



Does Economic Momentum equal Stock Momentum:

The U.S. Citi Economic Surprise Index (CESI) turned negative in August indicating that economic reports were falling short of expectations. It bottomed on September 14th at -61.7 and has begun to work higher. Historically, the period after the CESI bottoms is a good time to own stocks. Since inception in 2003 the series has troughed below -55 twelve times (the lowest 10 percentile). After those bottoms S&P 500 returns have only been negative twice in the following six months and once in the next twelve months. The median returns for six and twelve months have been 10.4% and 16.6%. The logic behind this experience would be that more positive economic momentum as reflected in better than expected reports would be a catalyst for higher stock prices. Of course, there are always risks that history does not repeat. The economic news could turn negative again or investors could be spooked by any of the risks prevalent today.

Exhibit #2: S&P 500 Returns after U.S. CESI Bottoms in the Lowest 10%

	6-month	12-month
Count	12	12
Median	10.4%	16.6%
High	26.4%	48.9%
Low	-1.1%	-1.7%
% Positive	83%	92%