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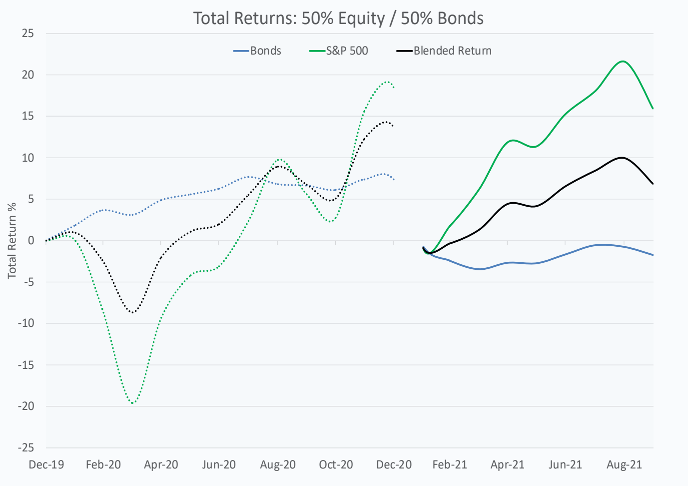
WHERE WE STAND – Q3 2021

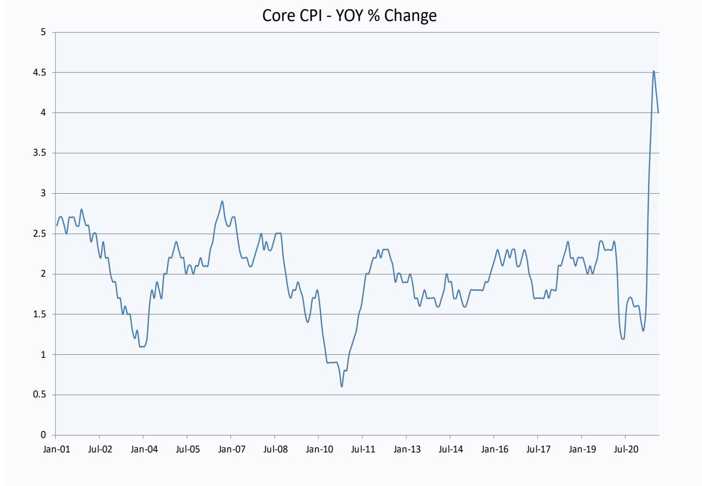
The S&P 500 Total Return Index was up 0.5% (including dividends) in Q3 2021. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was down 0.2% for the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be 6.9% (black line). Data for 2020 is shown, broken lines, to the left.



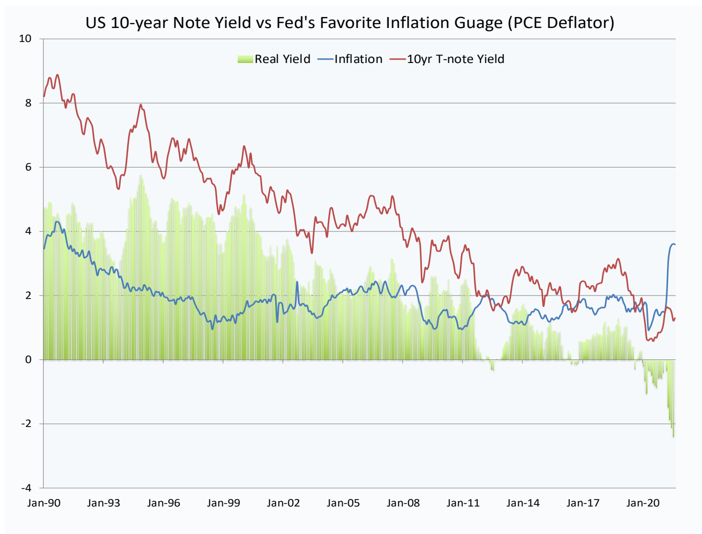
Overview

The S&P 500 price index ended the 3rd quarter unchanged. The fundamental backdrop of extremely easy monetary policy and very aggressive fiscal spending provided an ongoing supportive backdrop to financial asset values in general. However, a subtle change in the narrative regarding inflation and economic growth weighed on investor sentiment in September, causing all gains for the quarter to be reversed.

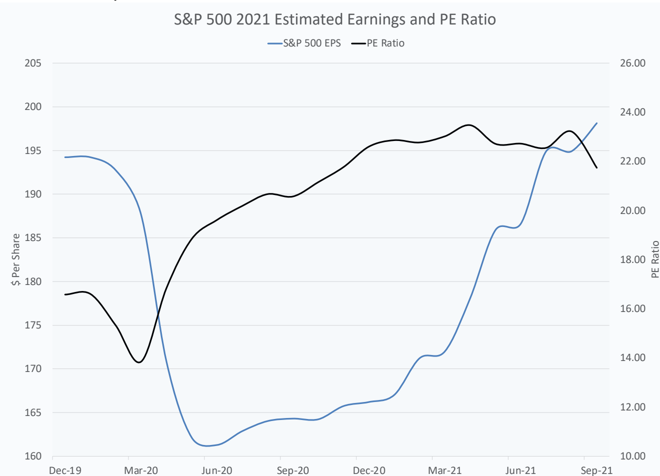
In particular, the 'inflation is transitory' stance of the Federal Reserve is being tested by ongoing reports of building price pressures in the US economy. See the next chart.



As a result, even though the yield on the 10-year US T-note rose in reaction to this changing narrative, it still trades at the deepest negative real yield since the 1970s when inflation was building in the US economy. See chart below for data from the 1990s.

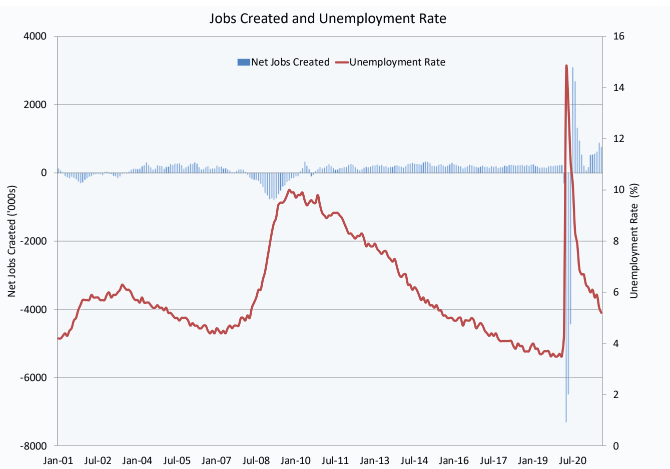


It is true to say, that since the intense economic growth scare caused by the onset of the pandemic, actual S&P 500 earnings have since surpassed the adjusted 'Wall Street' expectation of March to June 2020.



The blue line in the chart above shows how earnings expectations for 2021 for the S&P 500 collapsed from ~$195 per share in February 2020 (which equated to a PE ratio of around 17x earnings - black line) to around $162 by June 2020. And how those expectations have since risen back to the $195 to $200 level. In the process though, animal spirits have taken hold and there has been a large increase in the price investors are prepared to pay for those same earnings: from 17x PE to around 22x PE or 30% more.

As everyone knows, the Federal Reserve, via its zero percent base rate policy, and $1.4 trillion (annual rate) purchase of government debt (thereby enabling the US Treasury to finance its deficit spending), have achieved an environment of extremely easy money in the US economy. As mentioned in the past, the Fed has a dual mandate: achieve 'full' employment and, second, achieve price stability. For now, the Fed justifies its extremely easy monetary policy by arguing that the employment mandate (red line in the next chart) has not



quite been met. And as mentioned above, the Jerome Powell led Fed posits that the 'miss' on their inflation mandate can take a back seat because this time the inflation we are seeing is transitory.

Usually, the bond market reflects a collective market judgement on the Fed's policy stance and has, historically, been effective in signaling that the Fed may be 'behind the curve' when it comes to its views on inflation. What happens is longer term interest rates begin to rise more than short term rates and the yield curve steepens. This prompts the Fed to respond by raising short term rates and in so doing prevents an inordinate rise in longer-term rates. This ensures less volatility in the economic cycle and prevents a boom-bust environment. However, by buying the massive amounts of treasuries (on and off since 2009, and with renewed intensity in the last two years), the Fed is drastically muting the signaling ability of the bond market.

In September, however, the Fed finally acknowledged that it would begin to 'taper' its bond buying in the next month or so, acknowledging that it must pay some heed to the inflation pressures building in the economy. This dented investor confidence during the month and caused the 5% pullback we saw in the broader equity market. Investors are questioning the deeply negative yield on US treasury notes, and hence the bond market's extreme overvaluation, if inflation proves not to be transitory. Since the very low yield on long term interest rates is the de facto justification for the high PE ratio investors are willing to pay for US equities, these concerns are existential for investors.

Where We Stand

Our investment allocation in our discretionary portfolios remains somewhat defensive in deference to how mature the investment cycle is; the overall high valuation of financial assets; and the uncertainty regarding the sanity of current global fiscal and monetary policy.

As can be expected from value investors such as ourselves, the beta of our portfolios is lower than that of the overall market, meaning that although our returns will be positive in a bullish environment, they will lag those of the overall market. Likewise, as was the case in the earlier part of last year, we will avoid any large drawdowns during market declines, and in fact be in an ideal position to allocate our cash to value propositions that arise.

We believe that patience is appropriate this late in the investment cycle. That there is a fundamental warp in asset valuations caused by the combination of excessive monetary stimulation by the Fed; reckless deficit spending by the US government; and over-exuberant and untested investor sentiment.

For now, we are navigating the path between maximizing returns and preserving capital, somewhat more towards the latter. This means having a higher cash-equivalent allocation than we would normally have. And for those riskier assets that we are invested in, making sure that they are all fair value propositions; have adequate cash flow; pay dividends; are of shorter duration; and are well positioned to never face the prospect of unrecoverable loss.