

Investment Commentary

SEPTEMBER 2021

U.S. stocks led the way in August and helped propel global indices higher. Despite worries about an uptick in delta variant cases, stocks in the U.S. rallied amid continued Fed support, generally positive economic data and upbeat earnings results. Foreign stocks had solid performance, led by the emerging markets. Core bonds were down slightly for the month as interest rates rose modestly.

- All economic sectors, with the exception of energy, had positive returns for the month. The S&P 500 gained over 3%, its seventh consecutive monthly gain.
- The S&P 500 closed at a record high 12 times in the month, more than any other August in history.
- Despite the upbeat market, consumer confidence fell to a six-month low, reflecting concerns about the delta variant’s potential impact on the economy.
- In general, foreign stocks performed well as corporate profits growth exceeded expectation and economic data was generally positive. China was an exception as factory activity slowed in August and Chinese stocks lagged.
- U.S. Treasury yields rose modestly in August and core bonds were down slightly but outperformed global bonds. With yields at current low levels, the general trend is likely to be for a continued rise in yields through year-end.

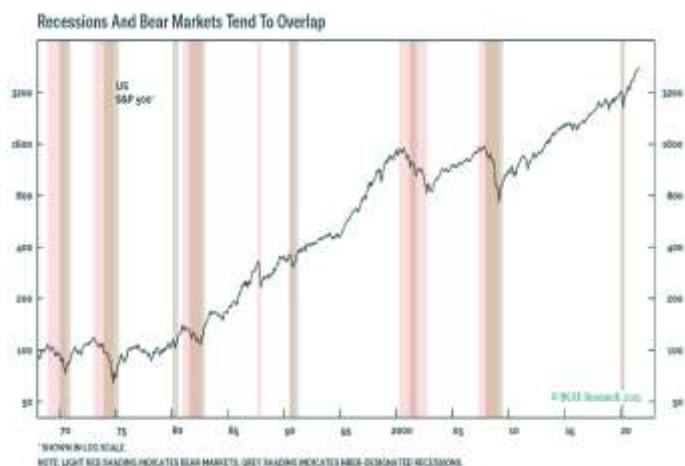
Returns (%)	1 MO	3 MO	YTD	1 YR
S&P 500	3.04	7.95	21.58	31.17
Russell 2000	2.24	0.45	15.83	47.08
MSCI EAFE	1.77	1.42	11.96	26.65
MSCI Emerging Markets	2.62	-4.12	2.84	21.12
Bloomberg Barclays U.S. Aggregate Bond	-0.19	1.63	-0.69	-0.08
Bloomberg Barclays Global Aggregate Bond	-0.42	0.02	-2.33	0.52

Data as of 8/31/2021, Performance in USD. Source: FactSet.

This month we take a look at whether the current stock market rally is in the late innings; updates on the outlook for small vs. large cap; whether valuations matter and some key risks we are watching.

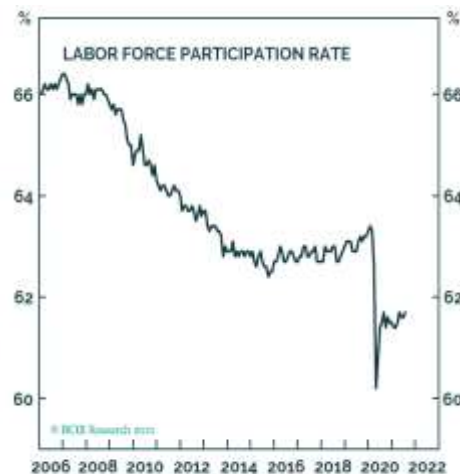
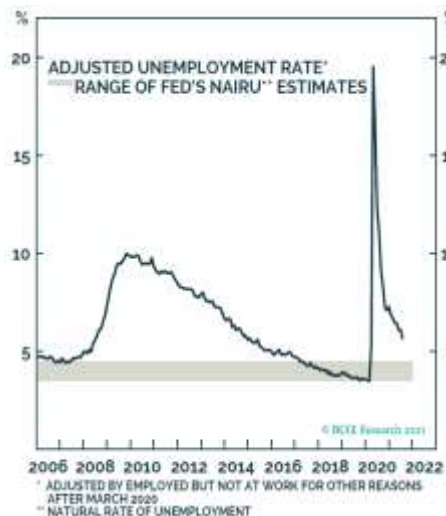
Are We in The Late Innings?

The general trend for stocks over time is higher, a result of long-term growth in the economy and profits. It is normal to see corrections (stocks down 5-10%) along the way, however, bear markets (stocks down more than 20%) usually don't happen unless there is a recession on the horizon. Therefore, the best asset allocation decision investors can make is to maintain a positive outlook on stocks unless there is a good reason to think a recession is around the corner. The chart to the left, from BCA Research, illustrates the close relationship between recessions and major stock selloffs. The shaded areas highlight recessionary periods.



At present we do not see a recession on the horizon. Rather, the current economic cycle seems to be in the mid to possibly later stages, where global growth is weakening but still solidly above trend. Historically, stocks have generated positive returns during this phase, although returns tend to be modest compared to earlier in the cycle. In general, stocks perform best coming out of recessions; that is when the economy is weak but rapidly improving and perform worst when the economy is entering a recession. In sum, we maintain a positive outlook on stocks but are watching closely for signs that we are approaching the "later innings" of this cycle. One signal that has been fairly consistent the past 25 years is when the economy reaches "maximum employment." In its simplest terms, maximum employment is the point where everyone that wants a job has one and is estimated to be close to when unemployment reaches 3.5%. Every recession and stock bear market the past 25 years (the early 2000's tech bubble, the 2007 financial crisis, and the 2020 covid crash) happened close to maximum employment. It's counter intuitive but the stock performs worse when unemployment is low, because the Fed is more likely to tighten monetary policy. The next move is likely to be towards higher unemployment, and stock valuations are usually high at this point. In the current cycle, we are still well above maximum employment, partially because the economy is still recovering and a sharp drop in labor force participation. See chart to left.

ADJUSTED UNEMPLOYMENT RATE*
RANGE OF FED'S NAIRU** ESTIMATES



LABOR FORCE PARTICIPATION RATE

The research team at BCA estimates that based on the current growth of the economy and the improving labor force participation, we won't reach the maximum rate of employment until sometime in the fourth quarter of 2022. We'll be watching closely, and view this as a reasonable place to potentially get more cautious as we approach those levels.

Time to Think Small?

The relative performance of small-cap stocks compared to large-cap stocks has been on a roller-coaster ride the past year. From September of last year to mid-March, small-cap stocks have outperformed large-cap by nearly 33%. Since then, small-caps have lagged their larger counterparts by a wide margin, and given up their performance advantage. The brightside for small-cap stocks is this underperformance has left valuations at relatively attractive levels (compared to large-cap), that we haven't seen since the early-2000's technology bubble. The chart on the right, from the Leuthold Group, illustrates the relative valuation of small-cap compared to large cap stocks, and shows they are trading at a significant relative valuation discount compared to the past 25 years. Even though small-caps have been lagging since March, we think the valuation discount, strong earnings, potentially higher interest rates, and weaker dollar all bode well for the relative performance of small-caps looking forward.

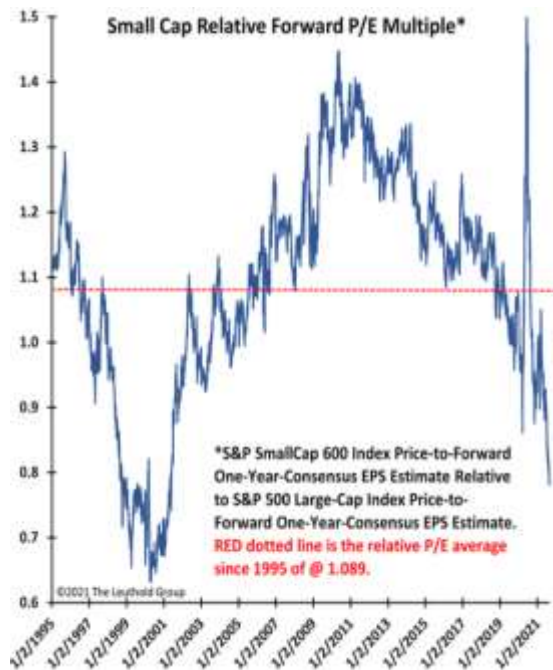


EXHIBIT 7: PERCENT OF U.S. STOCKS TRADING OVER 10x PRICE/SALES



Data from 1/1980-6/2021 | Source: GMO, Compustat

Does Valuation Matter?

The quick answer is that in the short-term, no, but in the long-term it definitely has an impact on performance. The research team at GMO recently did an in-depth study of the performance drivers for growth and value stocks. The study covered many areas, below we specifically highlight some of their findings on valuation. Exhibit 7, left, illustrates the percentage of the U.S. stock market trading at a valuation multiple of over 10x sales (a very high level). Currently about 25% of the stock market trades above the 10x sales multiple, the only time there was a higher percentage of overpriced stocks was during the tech bubble. Clear evidence of mania like behavior in the market today.

Why it matters is because the long-term performance of stocks trading at these levels has been poor. Exhibit 8 shows the long-term real returns to a portfolio of stocks trading at 10x sales or more compared to the overall stock market. The 10x sales portfolio of stocks underperformed by over 4% per year since 1980! The

underperforming portfolio reduced a 30x real gain over the 41 years for the S&P 500 to less than 4x, basically generating returns comparable to bonds. According to GMO, value stocks are currently trading at a 40% discount to their historical average relationship with growth stocks. The last time value stocks showed this big of a discount was in 2000, right before value went on an extended run of outperformance. See exhibit 9 below.

The takeaway is the valuation disconnect between value and growth is at historically extremes today. We don’t know when and how quickly the trend will reverse, but we do believe longer-term investors should tilt portfolios towards value. There’s a good chance you’ll look back in 5 years and ask, ‘what were growth investors thinking!’

EXHIBIT 9: VALUE IS EXTREMELY CHEAP



As of 7/31/21 | Source: GMO

Composite Valuation Measure is composed of price/sales, price/gross profit, price/book, and price/economic book. Value and growth groups are both sliced over 12 months.

If you have any questions on this commentary or would like to discuss your investment strategy, please give us a call.

Best regards,



Steve Giacobbe, CFA, CFP®

EXHIBIT 8: PERFORMANCE OF STOCKS TRADING OVER 10x P/S VS. INDEXES



Data as of 6/30/2021 | Source: GMO, Compustat, Standard & Poor’s

The over 10x P/S portfolio is a market capitalization weighted portfolio of all stocks trading above 10x trailing 12-month sales, rebalanced monthly.

Risks We Are Watching

Since this commentary is running long, we’re just going to highlight some of the risks we are watching. We will elaborate in future commentaries. Here’s the list:

- The emergence of vaccine resistant Covid variants
- A Goods Recession: the pandemic reallocated spending from services to goods. Will that reverse?
- Higher real bond yields or a Fed mistake
- The impact of higher U.S. corporate tax rates
- A weaker Chinese economy and ongoing regulatory crackdowns