Graves Light Lenhart
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Graves Light Lenhart October ‘21 Market Commentary

Markets Turn Up Heat On Policymakers

Market Overview:

Markets quickly recovered during the month of October, with limited hangover effects following a sluggish end to the third quarter (September-end) during which the S&P 500 experienced its first 5% pullback in eleven months, ending its 13th longest streak on record without a correction of this magnitude. The recent bounce back occurred despite both supply-chain delays and persistent inflationary concerns unabating. To this extent, Consumer Pricing Index (CPI) data released at the beginning of the month largely dismissed the argument for “transitory” inflation, an oft-used categorization posited by central bankers. Market participants have become overly familiar with the deluge of inflation metrics provided to “explain away” why any given reading should be short-lived. However, recent readings – which are now well past the one-year mark of temporarily depressed prices due to stringent lockdowns – are proving otherwise. To illustrate, we highlight the “Stepford core inflation rate”, which the Bureau of Labor Statistics started to publish earlier this year. It excludes a laundry list of items that many consumers generally want to buy, including food, energy, shelter and used cars and trucks. Excluding all of those things from the CPI basket (which is highly unrealistic and somewhat comical) still produced a year-on-year inflation rate above 3%, which is barely down from its recent peak while still at a level not previously seen in 28 years. This highly stripped-down version of inflation compares to a recent headline rate of +5.4% year-on-year. As a result, markets adjusted to reflect acceptance that the current wave of inflation is more than a blip.

We highlighted in our recent quarterly missive (4Q21 Newsletter) our subscription to the view that we are not in for a repeat of the hyperinflationary analog of the late 1970s and early 1980s. Nonetheless, recently published data points to price pressures being more persistent and less transitory than central banks across the globe previously believed. A corollary of this change in rhetoric was brought to the fore in recent weeks, as both the Bank of Canada and the Bank of England surprised investors with sharply hawkish statements of intent to tighten monetary policy. In essence, other central banks have catalyzed a shift in expectations for Federal Reserve policy in the US to move towards tightening more quickly than previously expected. Not long ago, the assumption was that the Fed would do nothing all of next year. By the end of October, markets quickly shifted to not only pricing in a possible rate hike as early as March, 2022, but also for a total of 2-3 rate rises by January, 2023.

Asset Performance:

Domestic equities broadly resumed their ascent during the month of October, with the S&P 500 producing its fastest monthly increase this year at +7.0% (inclusive of income and price). While 3rd quarter real US GDP markedly slowed to an annualized rate of +2.0% (versus +6.7% for 2Q21), the tone out of corporate America has been more optimistic. Through month-end, 3rd quarter earnings were largely beating consensus estimates by a decent margin. Evercore ISI, a leading economics firm, recently highlighted through its proprietary surveys that pricing power for US corporates has surged to record highs by very wide margins. While inflationary concerns remain front and center, at present most companies feel confident they can pass along cost increases, which in essence, protects margins. Additionally, the Atlanta Fed's GDPNow estimate for the 4th quarter moved significantly higher compared to the 3rd quarter trend, underlining the improved economic outlook going into year-end.

Key US Index Returns	YTD '21	October '21
S&P 500	+24.0%	+7.0%
Nasdaq	+20.9%	+7.3%
Dow Jones Industrial Average	+18.8%	+5.9%

Relevant Fixed Income Yields	YE 2020	October '21
US 10-Year Treasury Note	0.92%	1.55%
Investment Grade Corp. (C0A0)	1.8%	2.2%
High Yield Corp. (H0A0)	4.2%	4.2%

Source: Factset as of 11/01/21

For the fixed income market, what was most notable during the month was the rapid adjustment in the short-end of the US Treasury curve. As the possible timing of the Federal Reserve's first interest rate rise came into narrow focus, the policy-sensitive US 2-year rate increased to 0.49% at month-end. Since the dramatic market declines induced by the pandemic last March, this short-term benchmark rate has largely been in the 0-0.25% range. In this context, fixed income instruments with lower interest rate sensitivity (as measured by duration) would have been penalized. As illustrated by the Bloomberg US Government Credit/Float Adjusted Index, returns for the month of October declined 0.51%. While the decline isn't ostensibly outsized, this marks the 4th worst monthly performance over the last 10 years for this low duration benchmark.

Closing Thoughts:

As recently posited, the transition of interest rates from a friend to possible foe has indeed been tethered to the spillover effects from recent inflationary pressures. What's more, markets will need to learn how to operate without the unprecedented liquidity tidal wave unleashed since the precipice of the pandemic. As markets steel for the post-"QE infinity" regime, we emphasize the importance to act on what we can control, which is ultimately linked to the price we pay for any given asset, while remaining focused on long-term portfolio positioning for our clients.

Warm regards,

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