QUARTERLY MARKET REVIEW

THIRD QUARTER 2021

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OCTOBER 25, 2021

Dear Investors,

Eighteen months into the rapid economic recovery off pandemic-related lows, the US economy continued to improve over the third quarter, albeit at a moderating pace. Spring this year started on an optimistic note with regards to the containment of the Covid pandemic, and hence the positive outlook for the economy and the markets. Investors expected a sharp rebound in the economy to begin in the second quarter, which could lead to real GDP growth of as much as 7 percent or more for the year.[1] However, as the Delta variant gained momentum around mid-year in the U.S. and throughout the world, expectations for earnings and real GDP growth were lowered as supply chains continued to be disrupted and the expected easing of labor shortages proved elusive. Initially, lowered growth expectations occurred in a benign interest rate environment. However, this began to change as supply problems and pressure on wages allowed for a rise in prices, leading to a brisk increase in the 10-year Treasury yield to 1.52% at the end of the third quarter from a low of 1.19% in early August. More to come on this topic.[2]

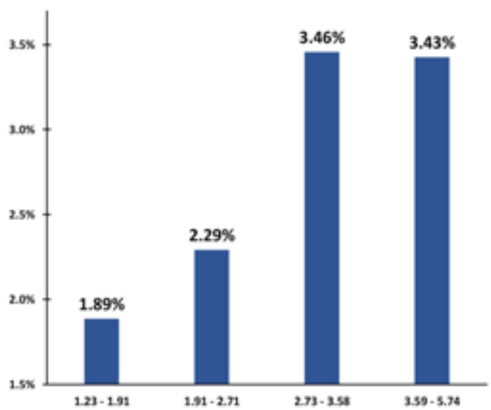
Following a palpable rotation from growth to value in the first quarter of this year on optimistic expectations of the "reopening trade", the third quarter was more akin to 2Q, during which we saw investor sentiment vacillate between growth and value. The primary drivers of this fluctuation in conviction were inflation and interest rate expectations. During the quarter, the spread of the Delta variant prompted a slowdown in hiring and consumer spending, as mentioned above. As we have now seen 3Q earnings from a significant population of the market, the vast majority of companies continue to post remarkably strong results.

The second quarter produced the 5th straight quarterly gain since the dramatic sell-off of 1Q 2020, although results for this past quarter were more mixed. The Dow Jones Industrial Average finished the quarter down -1.46%, while the tech and financial heavy S&P 500 finished up 0.58%. Overall, larger market capitalized companies, as measured by the Russell 1000, continued to outperform this year as the index was up 0.21% for the quarter. This compares to the Russell 2000, an index of smaller market capitalized companies, which posted a -4.36% return for Q3. As we have been trading off between growth and value this year, the net result for large caps has been relatively balanced performance year to date. The story has been very different for the smaller market capitalized companies. Among small caps, value again outperformed in the 3rd quarter, bringing the year to date spread between the two subsectors to over 20%, with the Russell 2000 Value up 22.92% through the quarter, while the Russell 2000 Growth was only up 2.82%. This disparity was likely part reversion to the mean, as growth has outperformed value for the last several years, although it was primarily driven by inflation and interest rates.[3]

We began our April letter highlighting the fundamental drivers of the markets since Covid, including: the success of the vaccination rollout, tremendous government stimulus, infrastructure spending, GDP growth, low unemployment, high corporate profits, pent up demand, and low interest rates. At this writing, seven of those eight drivers remain, the exception being interest rates. Aside from geopolitical events, including domestic tax policy, interest rates remain the focal concern of market pundits. This has been evidenced by the dispersion in performance between small cap growth and value highlighted above, and will likely continue to be a major factor of market performance, at least for the intermediate future. The harder question is how much inflation is the right amount to promote growth, and what does that mean for interest rates.

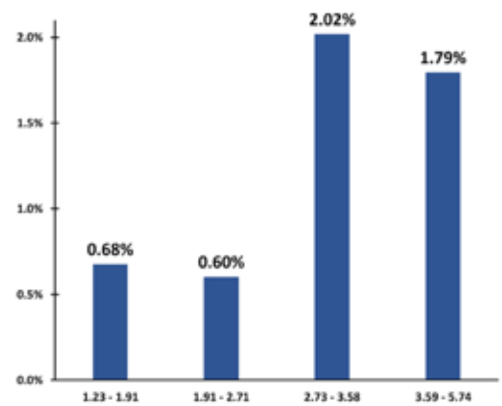
The reason why the Fed's target for inflation is not zero is because inflation can be a sign of healthy economic expansion. Indeed, in our free market economy, price increases are a signal to direct more resources to the production of particular goods and services. The trick is finding that level which is healthy, while staying below a level which may encourage central bankers to raise rates in order to prevent an overheating. As seen in the charts below, inflation expectations of 2.73-3.58% have historically produced the most productive economic environments (measuring back to 1982).[4] Although the markets are very wary of inflation at the moment, and those who remember back to the 70's know why they should be, we are currently still below what some would consider healthy for continued economic expansion.

Average Annualized One-Quarter-Forward Growth In Real GDP By Future 10-Yr Consensus U.S. Inflation Expectation Quartiles 1982-2021



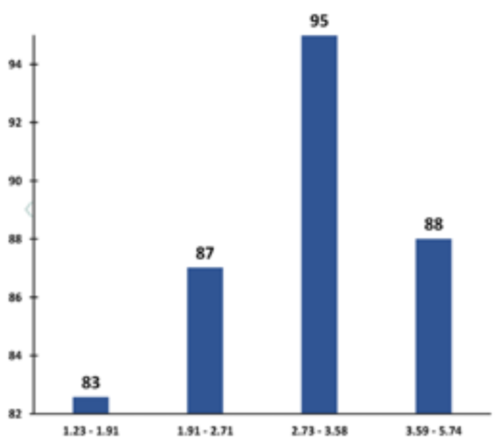
10-Year Consensus CPI Inflation Expectation Quartile Ranges
(1982 to Date)

Average Annualized One-Quarter-Forward Growth in Non-Farm Payroll Employment By 10-Yr Consensus Future U.S. Inflation Expectation Quartiles 1982-2021



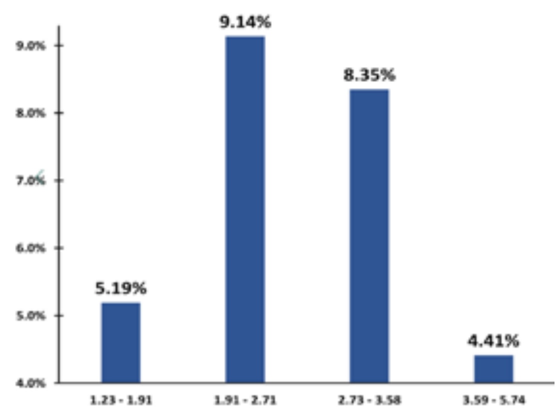
10-Year Consensus CPI Inflation Expectation Quartile Ranges
(1982 to Date)

Average Level of Univ. of Michigan Consumer Sentiment Index By 10-Year Consensus Future U.S. Inflation Expectation Quartiles 1982-2021



10-Year Consensus CPI Inflation Expectation Quartile Ranges
(1982 to Date)

Average Annualized One-Quarter-Forward Growth in S&P 500 EPS By 10-Yr Consensus Future U.S. Inflation Expectation Quartiles 1982-2021



10-Year Consensus CPI Inflation Expectation Quartile Ranges
(1982 to Date)

Source: Paulsen, James. The Leuthold Group. "Should Hotter Inflation Be FEARED Or EMBRACED?". October 15, 2021.
All Charts ©2021 The Leuthold Group

As many will recall, Milton Friedman famously said: "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."[5] What most don't recall is that Friedman also commented extensively on the fact that there are often long and variable lags between changes in monetary policy and changes in the economy. This variable lag, particularly when trying to account for the economic anomalies brought on by Covid, is why we are in such a tricky place, and hence the constant fluctuation in conviction we've seen the last two quarters.

We have now seen interest rates move off their lows, twice in fact (as seen below), and the question is: will we be able to remain in this range, which could be very healthy for the economy, or may the Fed eventually have to raise rates in order to combat inflation, causing multiple compression and major headwinds for growth assets such as equities?

Source: Factset. GOVT YIELD - 10 YR

Notwithstanding the preceding, real GDP growth in 2022 is likely to be above trend, perhaps as high as 6 percent, which should benefit earnings.[6] However, valuations will probably be lower given interest rates are unlikely to pull back as inflation could persist at a higher rate than in recent years and the Fed is expected to be less accommodating (which they should be at this point). In sum, equity markets may show a moderate increase over the next several quarters, with interest rates having an upward bias, although it is our expectation these returns will be muted and choppy. These expectations continue to be dependent on a gradual easing of the Covid pandemic, a resolution of Federal budget issues and an unchanged geopolitical background. Now is the perfect time to maintain balance in one's portfolio, as opposed to making bets before we have more clarity on how the dance between inflation, interest rates, and the Federal Reserve may evolve.

As always, we appreciate the trust you place with the entire SIG team.

Warm regards,

Chris — **CHRISTOPHER SARGENT**, Principal

Ricardo — **RICARDO ROSENBERG**, Principal

Brian — **BRIAN McGREGOR**, Principal

Important Considerations:

The views and opinions expressed are for informational purposes only as of the date of writing and may change at any time based on market or other conditions and may not come to pass. This material is not intended to be relied upon as investment advice or recommendations to buy or sell securities. The information provided is taken from sources we believe to be reliable but it has not been independently verified. Past performance is not a guarantee of future results. All investments involve risk, including the loss of principal.

[1] *O'Rourke, Mike. The Closing Print. "Kicking Can to Taper Time". October 6, 2021. P.1.*

[2] *U.S. Department of the Treasury. "Daily Treasury Yield Curve Rates". https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2021.*

[3] *Source: Orion Advisor Solutions.*

[4] *Paulsen, James. The Leuthold Group. "Should Hotter Inflation Be FEARED Or EMBRACED?". October 15, 2021. https://advisors.leutholdgroup.com/research/paulsen/2021/10/15/should-hotter-inflation-be-feared-or-embraced.23234.*

[5] *Williams, John C. FRBSF Economic Letter. "Monetary Policy, Money, and Inflation". July 2, 2012. P.1.*

[6] *J.P. Morgan Asset Management. "Guide to the Markets: U.S. 4Q 2021". P. 22.*