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Resilient Markets Fade into Quarter End

Market Commentary – Q4 2021

The S&P 500 hit new all-time highs again in the third quarter as investors looked past a resurgence of COVID-19 cases in the U.S. Instead, the focus was on the positive combination of a resilient economic recovery, ongoing support from the Federal Reserve, and strong corporate earnings. Market volatility did pick up during the final few weeks of September, however, reminding investors that the transition to a post-pandemic "new normal" isn't always going to be smooth as the market struggles to find its way forward.

The market tone changed in September even though many of the positive factors that supported stocks earlier in the quarter began to fade. First, corporate commentary turned more cautious last month. Profit warnings that cited supply chain constraints and margin compression came from multiple industries, and that caused investors to become more concerned about the outlook for corporate earnings. Then, economic data from August showed that the rise in COVID-19 cases had weighed slightly on the economic recovery. Finally, after investors ignored the looming policy battle in August, politics once again became an influence on markets as Democrats unveiled new details on a $3.5 trillion spending and tax plan that included increases to the corporate tax, personal income taxes for high earners, and changes to capital gains and inheritance taxes.

The volatility was compounded by the news that the second-largest property developer in China, Evergrande, was likely going to default on debt payments. Fear of potential financial market contagion hit stocks in late September and the S&P 500 suffered its first 5% pullback in nearly a year. Markets remained volatile into the end of the quarter as the Federal Reserve confirmed market expectations that it will begin to reduce Quantitative Easing before year-end, while Washington approached the looming deadline of a government shutdown with no extension in sight- although that was avoided in the last few days of the quarter. The S&P 500 finished September with moderate losses although the index still logged a positive return for the third quarter.

In sum, the market remained resilient in the third quarter, but the final few weeks of September served as a reminder to investors that markets will face the resolution of numerous macroeconomic unknowns in the fourth quarter, and while fundamentals remain decidedly positive, an increase in market volatility should be expected.

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Third Quarter Performance Review

The last few days of the third quarter had a substantial impact on quarterly index returns. For the majority of the third quarter, the Nasdaq had solidly outperformed both the S&P 500 and the Dow Jones Industrial Average as investors continued a trend from the second quarter by moving to less economically sensitive large-cap tech shares. However, during the last week of the quarter, as global bond yields rose, there was heavy selling in tech shares as investors rotated into other market sectors. The Nasdaq still slightly outperformed the S&P 500, while the Dow Jones Industrial Average produced a negative return for the third quarter thanks to the late September sell-off.

By market capitalization, large-cap stocks outperformed small-cap stocks in the third quarter. In fact, small-cap stocks had a negative return for the quarter as rising COVID-19 cases, mixed economic data, and the prospects of eventually higher interest rates caused investors to favor large-cap stocks as the outlook for future economic growth became less certain. From an investment-style standpoint, growth outperformed value in the third quarter, thanks to tech sector gains, although the amount of that outperformance shrank considerably during the final week of the quarter as tech shares declined.

US Equity Indexes	Q3 Return	YTD
S&P 500	0.58%	15.92%
DJ Industrial Average	-1.46%	12.12%
NASDAQ 100	1.09%	14.58%
S&P MidCap 400	-1.85%	15.21%
Russell 2000	-4.36%	12.41%

Source: YCharts

Internationally, foreign markets declined in the third quarter. Emerging markets dropped sharply, initially over concerns that rising COVID-19 cases would derail the global recovery, but late in the quarter, Chinese growth worries stemming from the Evergrande debt issues caused them to fall even further. Foreign developed markets, meanwhile, declined modestly during the final few weeks of the quarter on general global growth concerns combined with potentially higher global interest rates.

International Equity Indexes	Q3 Return	YTD
MSCI EAFE TR USD (Foreign Developed)	-0.35%	8.79%
MSCI EM TR USD (Emerging Markets)	-7.97%	-0.99%
MSCI ACWI Ex USA TR USD (Foreign Dev & EM)	-2.88%	6.29%

Source: YCharts

Fourth Quarter Market Outlook

The next three months will bring important clarity on several unknowns including future Federal Reserve policy, taxes, the pandemic, and inflation. The Federal Reserve has communicated that it will begin to taper Quantitative Easing in the fourth quarter, but markets do not yet know when exactly the Fed will start to scale back those asset purchases or the pace at which they will be reduced. If the Fed starts to taper QE sooner than expected, or the pace of reductions is faster than the market has currently priced in, it will cause additional volatility.

Meanwhile, in the third quarter investors were reminded that politics can be a powerful influence on markets, and over the next several weeks we will learn whether the debt ceiling is extended and if there will be any significant tax increases. If policies from Washington are viewed as negative for corporate earnings or consumer spending, they could cause a rise in market volatility as well.

Regarding the still ongoing pandemic, COVID-19 remains a risk for the economy and the markets. Positively, effective vaccines have allowed policymakers to avoid re-implementing economic lockdowns that could hurt corporate earnings and the economy. But the risk remains that a new COVID-19 variant renders the vaccines less effective and that could put the economic recovery in jeopardy.

Finally, inflation remains elevated and at multi-decade highs, and that combined with continued supply chain disruptions is starting to impact corporate margins and profitability. If an increasing number of companies warn about future profitability due to these factors during the upcoming third-quarter earnings season, it will negatively impact markets.

Yet while risks remain, as they always do, macroeconomic fundamentals are still decidedly positive and it is important to remember that a well-executed and diversified portfolio strategy can overcome bouts of even intense volatility. Markets will sell off on a combination of the impact factors noted above; however, as long as the easy money policy of the Federal Reserve remains, the periods of volatility will be short-term in nature.

At Capital Investment Services, we understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this still-challenging investment environment. Successful investing is a marathon not a sprint. Therefore, it’s critical for you to stay invested, remain patient, and stick to your risk-based investment strategy. I thank you for your ongoing confidence and trust. Rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

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Managing Partner, Capital Investment Services
Founder, investingsimply
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