The Fairlead Quarterly

Third Quarter of 2021

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Quarterly Overview

The first two months of the third quarter were quite strong but when September arrived it brought a downtrend that wiped out most of the gains accumulated in July and August. The S&P 500, for example, was up over 15% for the year at the end of June, was up another 5% by the end of August, but lost -4.65% in September to end the quarter up a mere 0.58%. Similarly, bonds posted a very modest gain for the quarter with the S&P US Aggregate Bond Index up 0.12%, but that's after falling 0.79% in September due to the 10 year Treasury yield which trended higher. Supply chain issues continue to plague recovering economies with record numbers of container ships waiting offshore from Long Beach to London, England. Inflation also remains a concern as the Office of Management and Budget has revised upwards its consumer price increase expectations for the fourth quarter to 4.8% - note that in May they were forecasting 2%. In addition to the real concerns of inflation and interest rates there is also politically driven uncertainty in the markets over tax legislation, infrastructure spending and the extension of the debt limit all of which weighed on the markets at the close of the quarter.

The Russell 1000 (Large Cap Stocks) ended the quarter up 0.21%, with the Russell 1000 Growth Index up 1.16%, and the Russell 1000 Value down -0.78%. In spite of a tepid Q3 the Russell 1000 was still up 15.19% YTD.

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The smaller capitalization indexes were all negative for the quarter. The Russell Midcap Index, lost -0.93% for the quarter with growth down -0.76% and value down -1.01%. The Russell 2000 (Small Cap), Index was down -4.36% with growth down -5.65% and value down -2.98%.

It is worth noting that year to date all domestic capitalization classes (Large, Mid and Small) have seen value outperform growth. The performance spread in the Russell 1000 was only1.84%, the Russell Midcap was a more pronounced 8.64% but the spread in the Russell 2000 was particularly large with value up 22.92% YTD and growth up only 2.82% YTD - a 20.10% differential.

MSCI EAFE (Developed Overseas Markets) was down -0.45% and Foreign Emerging Markets (MSCI Emerging Markets Index), were down -3.97% for the quarter negatively impacted by China's government intervention in the economy.

The Bloomberg-Barclays US Aggregate Bond Index was up 0.05% but is still down -1.46% year to date. High Yield Bonds (Junk- lower quality bonds - S&P U.S. High Yield Corporate Bond Index) were up 0.92%.

The Real Estate Investment Trust Index (FTSE NAREIT ALL Index), was up 0.2%, and is still up 21.4% YTD. Utilities (DJ US Utility Index), were up a 0.75% for the quarter but are only up 3.55% YTD. The Alerian MLP Index (Energy – Master Limited Partnership) lost -5.7% but is up 39.4% YTD after losing -28.7% in 2020.

The Backdrop

Oil & Commodities: Average crude oil prices (WTI Crude) ended last quarter at $73.52, bounced around and went as low as $62.25 in August, but rallied into September closing the month at $75.22.

Commodities (Dow Jones Commodity Index) were up 3.08% for the quarter and are up 27.09% YTD. Gold, which ended the second quarter at $1763.15 closed the third quarter at $1742.80 for a loss of -1.15%. (FRED - London PM).

The Fed, The Treasury and Global Central Bankers: During its September meeting the Federal Open Market Committee (FOMC) indicated it is accelerating the time line for beginning to "taper" the Quantitative Easing (QE) bond buying program that has the Fed buying $80 billion of treasuries and $40 billion of mortgaged back securities each month. The initial decrease in bond purchases may come as soon as their next meeting on November 2-3. While no decision has been made as to the timing and reduction of purchases most agreed that a gradual process "that concludes around the middle of next year is likely to be appropriate."

In June the Fed had expected to raise rates by 2023, but now half of the 18 officials expect to raise rates by the end of 2022. These moves have interesting implications for interest and the economy. With the Fed absent as a buyer of bonds (post taper) what interest rates will the remaining buyers require to entice them to make purchases? Presumably higher rates. If the Fed raises the Fed Funds target what cooling effect will that have on the economy? That rate which is considered the "risk free" rate underpins every other rate in the economy (prime rate, mortgage rates, etc, etc)

Trade, Tax & Fiscal Policy: Just at the quarter's end the Senate passed a $1 trillion infrastructure bill with a vote of 69 to 30 - surprisingly bipartisan in today's political environment. But getting through the house could prove more difficult if the Democrats stick to their position that the bill would not get a vote in the house until the second part of the bill, a "human infrastructure/social policy" bill of $3.5 trillion, is passed by the Senate. The politics surrounding the passage of these two bills is very tricky and it should be noted that any funds will be spread out over a period of years.

The Biden Tax Plan which is the revenue generation scheme to offset the proposed spending has been scaled back to appeal to more moderate Democrats. Salient points include increased taxes on individuals earning over $400,000 per year from 37% to 39.6%, and an increased corporate tax rate on corporations earning over $5 million from 21% to 26.5%. There will undoubtedly be more changes before the final legislation is crafted.

U.S. and Overseas Economic Activity:

Europe: In the second quarter of 2021 (most current data) the Euro Area GDP was up by 2.2% after falling -0.3% and -0.6% in the first quarter of 2021 and the fourth quarter 2020. This rebound was helped by an acceleration in Covid-19 vaccinations and a reopening of the various economies. Year over year the economy expanded at a record rate of 14.3% due to the low base year provided by the pandemic.

U.S.: Second quarter (most current data, Third Estimate) GDP increased by 6.7% after 6.4% and 4.3% in the previous two quarters.

China: China's economy grew by 7.9% in the second quarter compared to a year ago. Since the pandemic the first quarter of 2020 was the only quarter that experienced contraction as compared with the same quarter of the previous year.

Inflation: The Consumer Price Index for All Urban Consumers (CPI-U) increased, 0.3% in August, 0.5% in July, and over the last 12 months the all items index increased 5.3%. The index for all items less food and energy was up 0.1%, its smallest increase since February 2021. Is inflation transitory or persistent? Schwab recently suggested that "Persistently going from one source of transitory inflation to the next may keep inflation elevated for longer than markets currently anticipate."

Unemployment: In July the US unemployment rate fell to 5.4% as employment surged adding 943,000 jobs. Unemployment fell further in August to 5.2% but only 235,000 jobs were added and fell further still to 4.8% in September in spite of adding a disappointing 194,000 jobs - economists had been predicting close to 500,000.

Housing: Case/Shiller data (published with a two month lag - July 2021) reported record high price gains in July. The National Home Price NSA Index reported a 19.7% annual gain, up from 18.7% the previous month. The 10 City Composite was up 19.1% and the 20 City Composite was up 19.9% year over year. Phoenix, Seattle and San Diego have lead price appreciation for the last several quarters.

"July 2021 is the fourth consecutive month in which the growth rate of housing prices set a record… We have previously suggested that the strength of the U.S. housing market is being driven in part by a reaction to the COVID pandemic, as potential buyers move from urban apartments to suburban homes. July's data is consistent with this hypothesis." (S&P Dow Jones Press Release)

Going Forward

The market paused to take a breath this past quarter and periods of consolidation are generally considered healthy. While we would all love to see our portfolios do nothing but reach ever higher values - that's not realistic. Warren Buffet is credited with saying that "the future is never certain and uncertainty is the friend of the long term investor". Though there is plenty of uncertainty out there surrounding government plans and programs, tax plans, inflation, and the enduring impact of the pandemic, uncertainty is typically accompanied by a fearful market that provides reasonable stock valuations. Unfortunately, the future course of the market is never obvious and certainly not in today's pandemic driven environment. It is very important that investors acknowledge that precipitous market drops on the order of 40-50% are possible, but weigh that against the long term need to make their invested capital productive - because in today's low interest rate environment, coupled with high inflation it is necessary to take risk to see capital grow, if only to maintain purchasing power.

As always I am available to discuss the markets, the economy, your portfolio and your concerns.

JOHN VREELAND

SUMMARY OF INDEX RETURNS

Global Markets Year to Date					
INDEX	3rd Quarter 2021	Calendar Year 2020	Calendar Year 2019	Calendar Year 2018	INDEX DESCRIPTION
Russell 1000	0.21%	20.96%	31.43%	-4.78%	*US Large-cap Stocks*
Russell 1000 - Growth	1.16%	38.49%	36.39%	-1.51%	
Russell 1000 - Value	-0.78%	2.8%	26.54%	-8.27%	
Dow Jones Industrials - Total Return	-1.46%	9.72%	25.34%	-3.48%	
S&P 500 - Total Return	0.58%	18.40%	31.49%	-4.38%	
NASDAQ Composite	-0.38%	43.64%	35.23%	-3.88%	
Russell Mid-Cap	-0.93%	17.10%	30.54%	-9.06%	*US Mid-cap Stocks*
Russell Mid-Cap - Growth	-0.76%	35.59%	35.47%	-4.75%	
Russell Mid-Cap - Value	-1.01%	4.96%	27.06%	-12.29%	
Russell 2000	-4.36%	19.96%	25.52%	-11.01%	*US Small-cap Stocks*
Russell 2000 - Growth	-5.65%	34.63%	28.48%	-9.31%	
Russell 2000 - Value	-2.98%	4.63%	22.39%	-12.86%	
MSCI EAFE (USD-Net)	-0.45%	7.82%	22.01%	-13.79%	*Developed Overseas (US$)*
MSCI World ex USA (USD-Net)	-0.66%	7.59%	22.49%	-14.09%	*World ex USA (US$)*
MSCI Emerging Markets (USD-Net)	-3.97%	18.31%	18.42%	-14.57%	*Emerging Mkts (US$)*
Consumer Price Index - US (CPI-U)	5.3%*	1.4%	2.1%	1.91%	*Measure of Inflation*
S&P US High Yield Corporate Index	0.92%	6.78%	14.47%	-2.17%	*High Yield (Junk) Bonds*
Bloomberg-Barc US Aggregate Bond Index	0.05%	7.51%	8.72%	0.01%	*General US Bond Index (AGG)*
FTSE NAREIT All Equity REITs	0.2%	-5.1%	28.7%	-4.0%	*Real Estate Investment Trusts*
Dow Jones US Utility Average Tot Ret	0.75%	1.55%	24.94%	4.37%	*Utility Index*
Alerian MLP Index	-5.7%	-28.7	6.6%	-11.90%	*Master Limited Partnerships*
Dow Jones Commodity Index	3.08%	-2.98	10.12%	-8.91%	*Basket of Commodities*
Gold - London PM	-1.15%	24.61%	18.07%	-0.93	*London Spot Price*

*Inflation is All Items Unadjusted over the previous 12 mos. through August 2021