MANAGED ASSET PORTFOLIOS

MAP VIEWS

MAP QUARTERLY COMMENTARY | OCTOBER 2021

September marked the worst performing month for stocks since the pandemic-induced swoon in March 2020. Last month's market decline ended a seven-consecutive month winning streak for the S&P 500. Historically, September has proven to be the worst month for stocks over the past 10 and 20 years. September 2021 was no different as markets grappled with concerns over the financial fallout from the problems with the Chinese property development firm Evergrande, and debates as to when the Federal Reserve will begin to taper their bond buying program, while simultaneously dealing with the impacts of COVID-19 and the supply chain issues stemming from it.

During the quarter, Inflation rates remained at elevated levels, but the rate of increase lessened as the quarter progressed. The slowdown in inflation's rate of change weighed on some of the names we hold as inflationary hedges which began in late Q2, such as Mosaic, Bunge, and Freeport McMoran. However, in the past few weeks, these names have strengthened as some extrapolate additional shortages in commodities, such as natural gas, that have begun to impact regions in the U.K. and Europe, and will ultimately reach the U.S. The inflation hedges these names provide our portfolios are not the only impetus for our positioning. Rather, there are several structural issues around the food supply, demand for low carbon emissions, and a disconnect in energy supplies versus demand that drive our positioning for the longer term.

As communicated in the past, we believe inflationary pressures will be more than transitory (contrary to the Fed's stated beliefs). While we do not anticipate that double-digit inflation is in the cards, we believe an inflation rate in the 5% range will be with us for the foreseeable future. Commodity prices go up and down, but wages do not. Fast food companies paying $8 to $9 per hour a couple of years ago are now having to offer $15 per hour or more to attract workers. As much as companies may be disinclined to pass these additional wage costs to their customers, these efforts will be short-lived, and we expect these increases in costs will be passed along to consumers. Worker shortages, transportation challenges and other supply chain issues appear to be with us for the foreseeable future, putting further upward pressure on prices. From an investment standpoint, we remain comfortable with the stocks we placed in our portfolios to serve as an inflationary hedge.

Rising prices have been particularly problematic for the bond market, where yields on ten-year treasuries increased from 1.24% in mid-August to over 1.5% in early October. The upward pressure on interest rates weighed on high-dividend stocks, including names in our portfolios such as the French telecommunications company, Orange. With a dividend yield in excess of 6% and the stock trading at inexpensive valuations, we continue to like this company. One of the reasons we believe that our investment in Orange will benefit our clients is because the company is pursuing multiple opportunities to create value for its shareholders, including the spin-off of its business in Africa and/or of its successful Orange Bank. The company generates substantial cash flow from operations and maintains one of the best balance sheets in the communications services industry, and while it may lag in raging bull markets, we feel it warrants holding.

Value and growth stocks are another area of the market being impacted by the increase in interest rates. When rates decline, growth names tend to benefit from a tailwind. As rates rise, the rotation shifts, creating a tailwind for value and a headwind for growth. Price action during the past few months illustrates this point. Interest rates weakened during the latter part of the second quarter and the first two months of the third quarter before rising in September and into the first week of October. Growth outperformed value from May through August, after trailing value since November's elections. Once interest rates began to move higher, the rotation kicked in again in September in favor of value.

Within our Global Balanced portfolio, we continue to maintain a 30% allocation to bonds (the lowest permitted by the strategy's guidelines). The rationale remains the same as it did when we first made this allocation decision; buying bonds with fixed coupons in a period of rising prices for goods and services is risky for bond investors. To counteract some of this risk, we began to purchase Treasury Inflation-Protected Securities (TIPS) earlier in the year. These securities are backed by the U.S. government and will pay higher interest if the Consumer Price Index (CPI) rises. Additionally, we continue to keep our duration short, with a weighted average maturity (WAM) of approximately two years. The Fed is currently purchasing $120 billion of bonds (Treasuries and mortgages) every month to inject additional liquidity into the system and keep interest rates low. Many are calling for the Fed to begin tapering as inflationary pressures build. If the Fed starts to taper, this too may put upward pressure on interest rates and higher valuation stocks. Recall in 2018 when the Fed last attempted to reduce the size of its balance sheet, stocks fell nearly 20%, closely matching the percentage value of the balance sheet shrinkage. Stocks with the loftiest valuations were hit particularly hard.

On the political front, Congress has spent the past two weeks going back and forth over the debt ceiling and while they agreed to a short-term increase, the issue is likely to weigh on markets in December. However, we view this as nothing more than a game of "political chicken." Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit. This occurrence took place 49 times under Republican administrations and 29 times under Democratic administrations. It seems the only party that is ever concerned about the deficit is the party that is not in control. Realistically, the stakes are too high to let the government default on its financial obligations.

As debt levels continue to escalate, we believe it may have increased ramifications for the financial markets. Currently, U.S. government debt relative to GDP is on par with the peak of World War II and forecasted to grow. In an upcoming thought piece due out later this quarter, we will take a deeper dive into these mounting debts and their impact on the economy and investments.

As another year is coming to a close, we want to thank you for allowing us the opportunity to serve as your investment adviser. We diligently seek out the best risk-adjusted returns over complete market cycles for our clients every day. Stay safe and stay healthy!

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