



Market Review
Third Quarter 2021

The third quarter was a long, slow grind that left investors in a much less settled place.

During the period, the S&P 500 index managed a slight gain of 0.6%, but the result felt fortunate with the Large Cap index down -4.7% in September. The decline in Small Cap stocks was more persistent and the Russell 2000 index ended lower by -4.4%. After Value outperformed in Q1, and Growth recouped in Q2, the market vacillated back and forth between the two for most of the past three months. The pace of sector rotation got faster and faster. Emerging Market equities were the biggest loser, hurt by a Chinese regulatory crackdown coupled with highly-publicized financial strain at Evergrande Group, the country's second largest property developer.

Going into July, the market was focused on the unexpected decline in the 10-Year U.S. Treasury Bond Yield, which seemed inconsistent with the reopening economy and surging inflation. Unfortunately, the trend made more sense as the Delta variant spread, quashing the prevailing sentiment that a return to normal was imminent.

Amazingly, as infections surged and the outlook for the country turned more dire, stocks largely continued their ascent in July and August. But the gains felt tenuous. The list of concerns and shocks also continued to grow.

In July, Chinese authorities introduced legislation increasing oversight of the Internet, gaming, and education industries, worrying investors. In August, the U.S. bungled its withdrawal from Afghanistan with the Taliban promptly seizing control. The prospects for fiscal stimulus worsened amid inter-party wrangling on the price tag for the human infrastructure bill. The straw that broke the market's back, however, was the report that China's second largest property developer was struggling to make loan payments, which sparked concerns about systemic risk. The property sector accounts for over 20% of that country's GDP.

Through everything, the global component shortage and supply chain constraints persisted, further clouding the outlook for corporate earnings amid so much change.

Over time, the combination of these developments gave rise to the bearish notion of "Peak Everything." The simple explanation is that economic indicators, corporate earnings (and revisions), valuation multiples, and fiscal and monetary policy support appear to have reached a natural limit and have nowhere to go but down. By quarter-end, the concern about "what comes next" appears to have superseded investors' long held bias to "buy the dip" ... at least for the time being.

Despite the increased volatility, the Federal Reserve has remained resolute that a reduction in asset purchases is appropriate and should begin soon. This feels like a bit of a departure from the past. For most of the bull market, policy authorities have been reluctant to act when markets waived.

At this point, the challenge for investors is trying to discern if the change in tenor in the markets is short-lived sentiment, or the beginnings of a broader, valuation-based correction. Although our instinct is that it is the former, we have long been concerned that there is not enough focus on profitability, which has made valuations excessive and subjective. While down from the peak, loss-making companies account for over 30% of the Russell 2000 Growth benchmark and the index is trading at a 35x forward P/E. In our experience, the problem with subjective valuations is that it is hard to know where stocks should trade when the market momentum swings the other way.

As a parting surprise, in late-September the benchmark U.S. Treasury bond yield increased sharply and suddenly. So, the market has come full circle. Clearly, the most likely explanation is that the change in trend reflects the inevitability of Fed tapering. Our, hope, however is that it also signals better control of the spread of the Delta variant, and better future economic prospects accordingly.



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Sources: FactSet, Jefferies, The Business Insider

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The 10 Year Treasury Rate is the yield received for investing in a U.S. government issued treasury security that has a maturity of 10 years.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

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Index Definition Sources: FTSE Russell

Mutual fund investing involves risk including the possible loss of principal. There are specific risks inherent in small cap investing, such as greater share volatility as compared to other funds that invest in stocks of companies with larger and potentially more stable market capitalizations. Products of technology and biotech companies may be subject to severe competition and rapid obsolescence.

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