



Investment Newsletter

Third Quarter 2021

Despite strong positive returns in July and August, the S&P 500 Index declined -4.65% in September – the worst monthly performance since March 2020 – resulting in a modest total return of +0.48% for the quarter. International equities posted negative performance during the quarter, with the MSCI All-Country World ex-U.S. Index returning -2.99%. On a one-year basis, the S&P 500 Index has gained +29.30% and the MSCI All-Country World ex-U.S. Index +23.81%.

Three key events surfaced nearly simultaneously in September to cause the sell-off in equity markets: 1) increased systemic risk tied to the potential bankruptcy of China's Evergrande Group – the most indebted real estate company in the world with \$300 billion in liabilities and \$88 billion in debt; 2) a quick rise in the 10-Year Treasury yield caused in part by the Federal Reserve's announcement that it could soon begin tapering its asset purchases of Treasuries and agency mortgage-backed securities – and raise interest rates sooner than expected (mid-2022); and 3) a stalemate in Congress over raising the U.S debt limit by the Treasury's deadline of October 18. While the U.S. debt limit issue is expected to be resolved within the next few weeks, the other two issues will play out over time and could cause continued volatility for financial markets in the short term.

The fixed income markets were also volatile during the quarter, with the 10-Year U.S. Treasury yield trading in a wide range of 1.17% to 1.53%. Yields ended the quarter on an upward trend as investors focused on the following concerns: the Federal Reserve tightening monetary conditions; rising inflation driven by upward wage pressure; potentially worsening federal budget deficits tied to higher spending; and Congress wrangling over raising the debt ceiling.

The Bloomberg-Barclays Intermediate Government/Credit Index increased +0.24% for the quarter, and the Bloomberg-Barclays (1-5 year) Municipal Bond Index increased +0.11%. Despite rising Treasury yields, municipal bonds continued to perform well, reflecting strong investor demand for tax-free investments.

Because of the increasing concern over rising inflation, we conducted a special analysis this quarter to answer the question, How do equities perform during periods of inflation? We took the annual percentage change (no dividends included) of the Wilshire 5000 Index – which includes all the stocks listed in the U.S. regardless of market capitalization – going back 49 years to 1971 (the Index's inception year), and compared it to each year where inflation was +3.00% or higher (20 of 49 years), as measured by the Personal Consumption Expenditures (PCE) Index – the Federal Reserve's preferred gauge of inflation.

Here are the key findings and the data:

1. Equities beat inflation in 12 of the 20 years (60% of the years), and did so by +67.14 percentage points cumulatively over those 20 years.
2. The biggest declines for equities came over the 1973-1974 period in the aftermath of President Nixon decoupling the U.S. Dollar from gold (a one-time event), the U.S. Dollar devaluation under the Smithsonian Agreement, and the subsequent collapse of the Bretton Woods global monetary system.

Performance of Wilshire 5000 Index During Years in Which the Personal
Consumption Expenditures (PCE) Index Was +3.00% or Greater
1971-2020

Year	PCE Index (Inflation)	Wilshire 5000 (Equities)	Equities Minus Inflation
1971	4.25	14.33	10.09
1972	3.41	14.86	11.45
1973	5.38	-20.96	-26.35
1974	10.41	-31.49	-41.90
1975	8.34	32.83	24.49
1976	5.49	21.68	16.20
1977	6.50	-6.98	-13.48
1978	6.96	3.96	-2.99
1979	8.88	19.28	10.40
1980	10.77	27.61	16.84
1981	8.96	-8.43	-17.39
1982	5.55	12.86	7.30
1983	4.25	18.74	14.49
1984	3.78	-1.25	-5.03
1985	3.49	27.18	23.70
1987	3.08	-0.73	-3.82
1988	3.91	13.29	9.38
1989	4.37	24.89	20.52
1990	4.39	-9.31	-13.70
1991	3.34	30.30	26.96
		TOTAL:	67.14

As for how bonds would fare in an inflationary environment, the Federal Reserve's Quantitative Easing (QE) policy that began in 2008 has kept bond yields abnormally low, at levels last seen in the 1940s. As such, even a small rise in interest rates would likely result in negative total return performance for most bonds. Therefore, our investment strategy for client bond portfolios remains capital preservation by maintaining short maturities. Should the Federal Reserve allow bond yields to rise in response to higher inflation, that would provide a welcome reinvestment opportunity for clients to capture additional yield.

With corporate earnings growth decelerating, equity market valuations elevated, fiscal and monetary stimulus waning, labor markets and supply chains constrained, and China now confronting its over-indebted property sector, clients should expect potentially higher inflation and equity market volatility in the short term.

Despite that, new COVID-19 infections in the U.S. and globally are now on the decline, COVID-19 medical innovation continues apace with Merck's promising new antiviral pill, and FactSet's consensus projected 2022 outlook for real GDP growth (+4%) and S&P 500 Index earnings growth (+9%) looks respectable. Moreover, we remain confident our investment strategy can successfully navigate an increasingly challenging environment.

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