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Growing Market Risks Weigh on Investors

- U.S. equities have enjoyed a strong 2021 with the S&P 500 more than doubling from its 2020 lows.
- Growing evidence of troubling market risks have emerged.
- Expect market volatility to rise as these risks and high valuations weigh on investors.

Throughout most of 2021, U.S. equities have climbed the proverbial “wall of worry,” ignoring increasing risks and instead fixating on strong economic and earnings news, propelling the S&P 500 to 49 record closing highs since the start of the year. The combination of U.S. GDP now above pre-pandemic levels and an impressive second-quarter earnings season that saw corporate profits jump over 90% from year-ago levels have helped the S&P 500 double its price level off of 2020 pandemic-lows and return over 17% this year. However, after hitting an impressive streak that saw this index close at a record-high for five consecutive sessions, U.S. equities have succumbed to investor worries. The S&P 500 has experienced a two-day sell-off that has seen the index drop nearly 2%, its worst two-day performance in almost a month, while the small-cap Russell 2000 has fallen for five straight sessions. As we have noted in numerous commentaries, we see three primary risks facing investors, and this past week saw clear evidence that financial markets are finally beginning to take notice.

We continue to feel that the risks to the markets are peak economic growth, rising inflation and a slowing Chinese economy. As the economy progresses through the current recovery, expect to see slowing rates of change in economic data as the easy year-over-year comparisons roll off. While this is a normal transition in any recovery, given the extremes of this cycle, comparisons may deteriorate more swiftly than anticipated. Evidence of this slowing rate of change came earlier this week as we saw retail sales and housing starts for the month of July and the August Empire State Manufacturing Survey all significantly miss expectations. These reports came on top of an extremely weak preliminary August Consumer Sentiment report late last week that fell to the lowest levels since 2011 and growing concerns that the recent rise in Delta variant COVID-19 cases could again disrupt the U.S. economy.

We also remain concerned that inflation may be less transitory than the Fed suggests, forcing central bank officials to raise interest rates faster than markets anticipate. Evidence of this concern came in Wednesday’s release of the July FOMC minutes that showed most Fed governors feel the central bank should consider tapering its asset purchases in the coming months, a possible first step toward raising interest rates. Prior to this report, investors had hoped that the Fed might hold off tapering until next year. Lastly, we worry that the Chinese economy, which was one of the first to exit the pandemic-led recession last year, is starting to slow and, as the world’s second-largest economy, could add to investor angst. Case in point, late last week we saw July retail sales and industrial output reports in China miss expectations.

Regardless of these growing market risks, a stock market correction is possible. Keep in mind that we have not seen a 5% pullback in the S&P 500 since October of last year. As we have noted in the past, [August tends to be a weak month for US equities](#) and [valuations](#) in both stock and bond markets suggest little margin for error in economic data and market expectations. Market fears are compounded by weakening market breadth that suggests a less healthy stock market.

With market risks rising, we continue to anticipate more volatility in the near term. Any disruption to current expectations could be a headwind for stocks, and stock market valuations priced to perfection could amplify this volatility. We may see a stock market correction at some point this year, but we still don’t expect a big sell-off as we saw in early 2020. We maintain that diversification is the key in this market. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

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Glossary

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The S&P MidCap 400 provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

The S&P SmallCap 600 seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.