QUARTERLY MARKET OUTLOOK

CETERA® INVESTMENT MANAGEMENT

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2021 FOURTH QUARTER OUTLOOK

A Watched Pot Never Boils

At-A-Glance

The global economy appears to have hit peak growth and the rate of growth is starting to slow. The pace in U.S. is already slowing from high levels as the next phase of the expansion takes hold.

The Fed has one eye on inflation and another eye on Congress, trying to weigh its next move which will likely be bond tapering in December and raising rates by the end of next year.

Many equity investors are looking at the growing risks and waiting for a correction that seems overdue, yet volatility remains at low levels.

Bond investors seem relatively complacent with the risks, and bond yields and spreads remain near all-time lows.

Risks are growing in both equity and bond markets and we do expect volatility to rise at some point. Predicting when is difficult, so having a balanced portfolio is more important.

We continue to recommend diversifying across and within asset classes, along with a focus on long-term objectives and not getting caught up in day-to-day fluctuations and noise.

Overview

Watching financial markets recently, you might be reminded of when you were a child watching a pot of water boil at your grandma's house. "A watched pot never boils," your grandma may have told you. If you were a stubborn child, you will know that the water did eventually boil, but it seemed to take forever.

With high valuations, peak economic and earnings growth, fading stimulus, supply disruptions and looming Delta variant fears, many investors are watching for a correction, defined as a 10% fall in stocks. Corrections are normal—they happen roughly every eight months on average going back to 1928. Legendary investor Peter Lynch once said, "More people lost money waiting for corrections and anticipating corrections than in the actual correction." Sticking to long-term risk and return objectives is still prudent.

The economy appears to be slowing from peak growth in the second quarter and the size of the overall economy has surpassed pre-pandemic levels. With the headwinds mentioned above, growth will slow from currently unsustainable levels. The Fed is looking at tapering its bond purchases and eventually raising rates. Inflation is currently high but expected to moderate. The question is, at what level inflation will stabilize? We expect it will likely settle somewhere above pre-pandemic levels, but lower than where it is today.

Before the Fed starts to decrease stimulus, officials may want to make sure the economy is on sound footing. The problem is that short-term inflation ticked up again due to temporary supply side constraints caused by the Delta variant. Fed prognosticators can't get an accurate temperature reading on inflation and don't want to overreact, as tightening financial conditions too fast may cause a slowdown, potentially hurting the economy and labor markets.

In stocks, investors are looking at the same data and trying to gauge what the Fed will do. See our Fed Monitor as we try to gauge the Fed too. Stocks remain expensive relative to their projected future earnings. Additionally, the S&P 500's largest drawdown in 2021 was only 4.23% (as of this writing) and it occurred in March. Meanwhile, volatility remains relatively low in the face of all these risks. So naturally, many investors are waiting for the pot to boil (a stock market correction), but of course that takes time.

Bond investors are probably even more worried about what the Fed will do but seem to have faith that tapering and rate increases will come in a slow and dovish fashion. Inflation is retreating, which gives the Fed some room to take a wait-and-see approach to raising rates.

We reiterate our recommendation to diversify across asset classes, sectors and countries, while adhering to long-term risk and return objectives. We remain cautiously optimistic, but risks are increasing and therefore we are more balanced in our outlook. Your financial professional can help you stay on track and keep focused on your long-term plans. So, let’s leave that pot to boil and step away to take a deeper dive into the economy and the markets.

Global Economy

The global economy has hit peak growth following the massive amounts of stimulus pumped into economies around the world. Global output is forecast to grow 6% in 2021 and the growth rate may drop below 5% in 2022. Meanwhile, gross domestic product (GDP) growth has already begun to slow. The U.S. saw an annual GDP growth rate of 6.3% in the first quarter and 6.6% in the second quarter. The Atlanta Federal Reserve publishes a model forecasting what GDP will be in the third quarter. The model started the third quarter over 6% and has fallen to under 4% amid renewed disruption of global supply chains and Hurricane Ida. While growth is slowing, the decline is from high growth rates which were not sustainable. Growth rates were propelled by stimulus and lower starting points caused by the contraction in 2020. Going forward, economic growth will be more modest but sustainable, because the economy has grown past pre-pandemic levels. In the second quarter, the size of the U.S. economy grew to nearly $23 trillion, well above the 2019 GDP level, which was just over $21.5 trillion.

Going forward, some of the tailwinds that propelled the economy will become headwinds. Fiscal stimulus will be harder and harder to pass with a split Senate, strong economic growth, elections in 2022 and World War II levels of debt-to-GDP. The political will to pass more stimulus will likely wane. The Fed is looking to reverse course and tighten financial conditions if inflation and employment targets are reached. The Fed insists tapering is not tightening, but it might be more of a game of semantics. By definition, tapering involves tightening financial conditions, but to be fair, they are tightening from extremely loose conditions. As we head into the next phase of the expansion, the Fed will be very influential, and equity and bond investors will be looking for clues into the Fed’s next moves. The Fed has a dual mandate to keep inflation, or prices, in check and at the same time keep employment at full capacity. So, let’s look at what the Fed is looking at for insights into what it may do next.

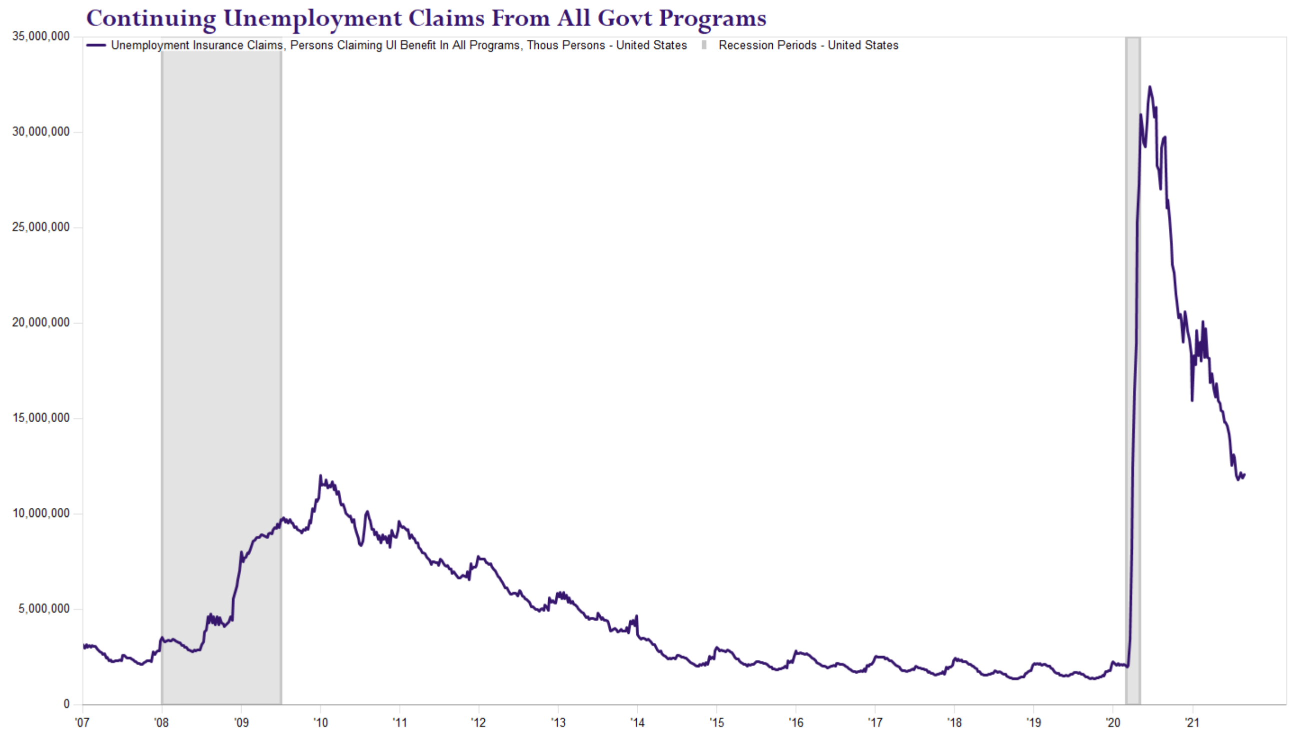
Last quarter, we spoke a lot about inflation and if it would be temporary or more long-lasting. And since then, we have had more data to analyze and digest. Categories that influenced the sharp rise in the consumer price index (CPI) are abating. Below are the August drops in prices for categories that experienced a lot of inflation because of the economic reopening:

Airline Tickets	-9.1%
Rental Cars	-8.5%
Hotels	-2.9%
Used Cars	-1.5%

These declines were expected since these categories had short-term pressures driving up prices that were not sustainable. However, the question as to whether inflation is temporary or long-lasting is still up for debate. Most would agree we were not going to see runaway inflation, but instead elevated inflation followed by more sustainable inflation. The question is where inflation will settle after the temporary pressures diminish. Eventually global supply chains will normalize, and industries will catch up to demand. When the dust settles, will inflation be higher or lower than when the pandemic started? To answer this question, we need to look at the labor market.

Lasting inflation usually comes from the labor market as employers compete for employees and drive up wages. While labor has not had as much bargaining power as it has in past decades due to globalization and automation, the pandemic is changing that. Many employees are leaving the labor force, and some are reluctant to return for various reasons. Some older workers are choosing to retire, while others are hesitant to return because of virus concerns. Additionally, with some schools still requiring at-home learning, many parents are forced to remain home with their children. Finally, some workers are simply opting to stay home because it pays more to do so, as extra unemployment benefits in some states offer more money than working. All these factors are keeping people out of the workforce. **Figure 1** shows that despite a large improvement, continuing unemployment claims are still around the highest level seen since the Great Financial Crisis.

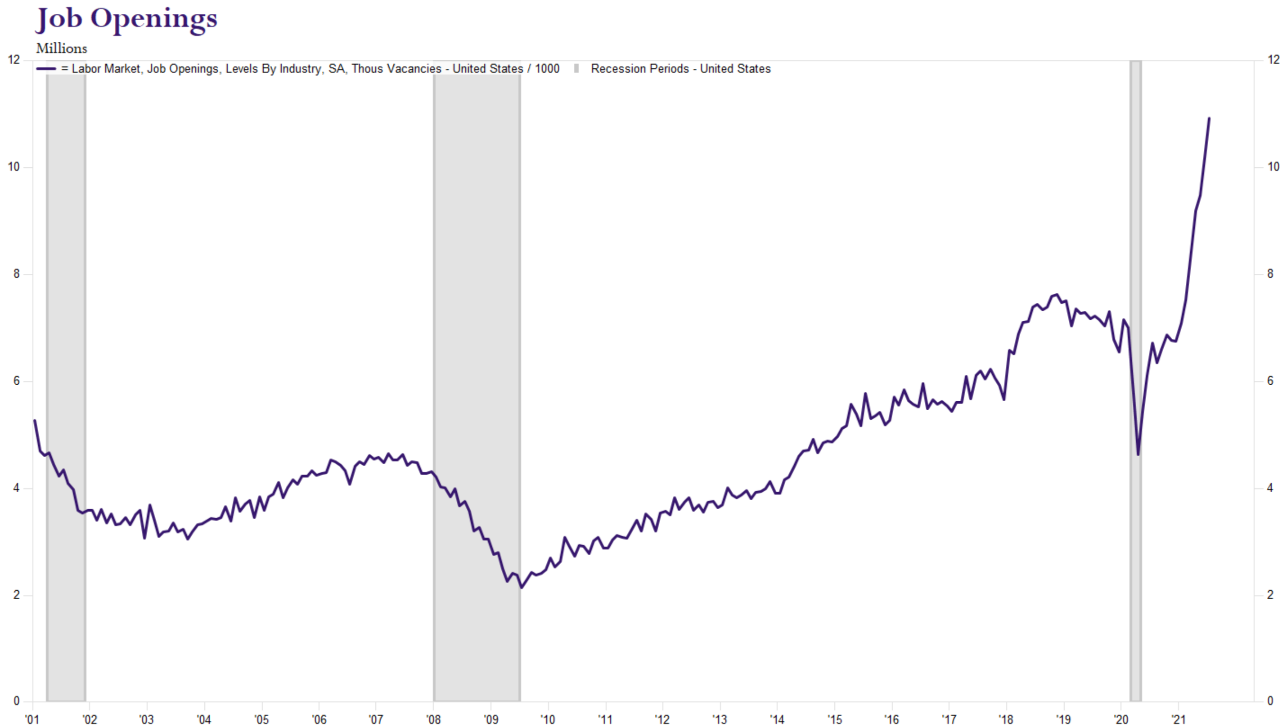
Figure 1: Continuing Unemployment Claims



Source: Cetera Investment Management, FactSet, U.S. Department of Labor. Data as of 8/30/2021.

At the same time unemployment claims are elevated, so are job openings. **Figure 2** shows that job openings are well above pre-pandemic levels with nearly 11 million job openings. There are now more than 2.5 million more job openings than unemployed individuals seeking employment. This is forcing employers to compete for candidates and this competition ultimately causes them to pay more to fill positions. Higher wages cause companies to have higher expenses, which ultimately get passed back to the consumer as higher prices. These higher prices are what we refer to as inflation and this type of inflation can persist for longer periods.

Figure 2: Job Openings



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 7/31/2021.

So, what does the Fed think about all this? The Fed is watching these developments closely but must be careful. It doesn't want to tighten conditions if inflation is temporary and the labor market has yet to fully recover. The Fed seems to be waiting to see where inflation settles after supply chain disruptions subside and the labor force normalizes a little more. Unfortunately for the Fed, the Delta variant is causing renewed supply chain disruptions which continue to distort their inflation views. As of now, it seems the Fed will probably start to taper bond purchases before year-end. The central bank has been buying long-dated bonds to keep longer maturity yields down. This stimulates the economy by helping to keep mortgage rates low and borrowing cost low, so people can buy more cars and businesses can finance new projects. We expect the Fed will gradually reduce the amount of bonds it is buying and let yields rise modestly. Other countries have even lower yields, so some of the demand for these bonds may be taken up by foreign countries as well, softening the blow of the Fed tapering.

The next step for the Fed would be to raise short-term interest rates, which it must do with great caution. And the Federal Reserve is probably watching Congress, as there are proposals to increase regulations and taxes, and to pass even more stimulus. While future stimulus should be modest, so should tax increases. Either way, the Fed probably wants to have a better idea of the impact of Congressional actions before it acts. Economists are speculating the Fed will raise rates by the end of 2022 and investors seem to agree. The CME Group estimates the probability of a rate hike using Fed Fund Futures as a gauge. Currently, their CME Fed Watch Tool shows a 12.5% probability of a rate hike by June of 2022 but roughly a 67% chance of at least a 0.25% increase by the end of 2022. This would give the Fed another year to gauge inflation and give the labor market more time to recover.

A notable item outside the United States is the slowing of Asia's growth, including China's economy. China's central bank is ahead of the Fed in withdrawing support and has started to do so already, although it recently was forced to ease up again. China's leaders are also focused on long-term ideological goals and are willing to sacrifice shorter-term growth to achieve these goals. Since the virus hit China first, the Chinese are ahead of the world in their economic recovery. Europe, on the other hand, is a little more behind. The eurozone has experienced less economic growth than the U.S. and U.K., and as Delta variant infections seem to be subsiding in Europe, that should put them back on track for growth in 2022. The eurozone saw deeper economic declines in 2020, but less of a rebound in 2021. Growth could be higher in 2022 as Europe catches up.

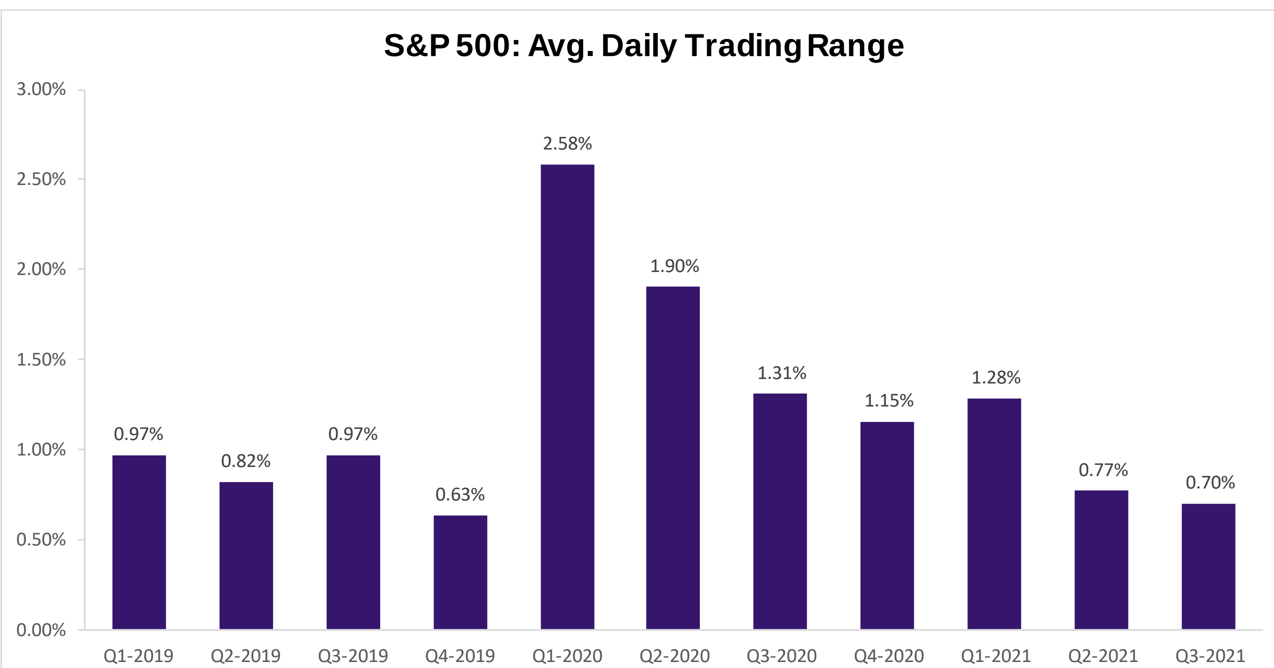
Equity Markets

Stock investors have pushed equity indexes to new highs in 2021. With all the risks we discussed in the economic section this may seem counterintuitive, but corporate earnings have surpassed pre-pandemic levels and fiscal stimulus combined with low borrowing costs have been a boon for many large corporations. However, with stimulus fading, earnings growth is slowing. Investor optimism has been warranted, but should investors start to curb their enthusiasm?

Combined with higher inflation (wages and materials), earnings will be dampened even further. As mentioned earlier there are also proposals in Congress to increase regulations and corporate taxes and the Fed will start tightening financial conditions sooner or later. Stock prices seem largely unaffected by these developments that will ultimately take a bite out of future earnings.

Volatility has been relatively low. Prior to mid-September, the S&P 500 hadn't seen a drawdown of more than 5% this year. If we look at the average daily trading range in **Figure 3**, we can see that the S&P 500 has been in a tight trading range this year, considering the average daily trading range since 1990 is 1.26%. This is just one way to look at volatility, but if we were to look at other metrics, we would see similar results.

Figure 3: S&P 500: Average Daily Trading Range



Source: Cetera Investment Management, Yahoo Finance, Standard & Poor's. Data as of 9/10/2021.

Increasing risks combined with high valuations should eventually cause higher volatility. We have been predicting more volatility in the second half of this year, but it has yet to arrive. When it does arrive, diversification within asset classes like bonds should help, but additionally being diversified within equities with lower valuations owning value stocks, mid cap stocks, small cap stocks and even international stocks, should also help. These asset classes naturally have lower valuations but are also trading closer to their historical valuations or even significantly lower, in the case of small cap stocks.

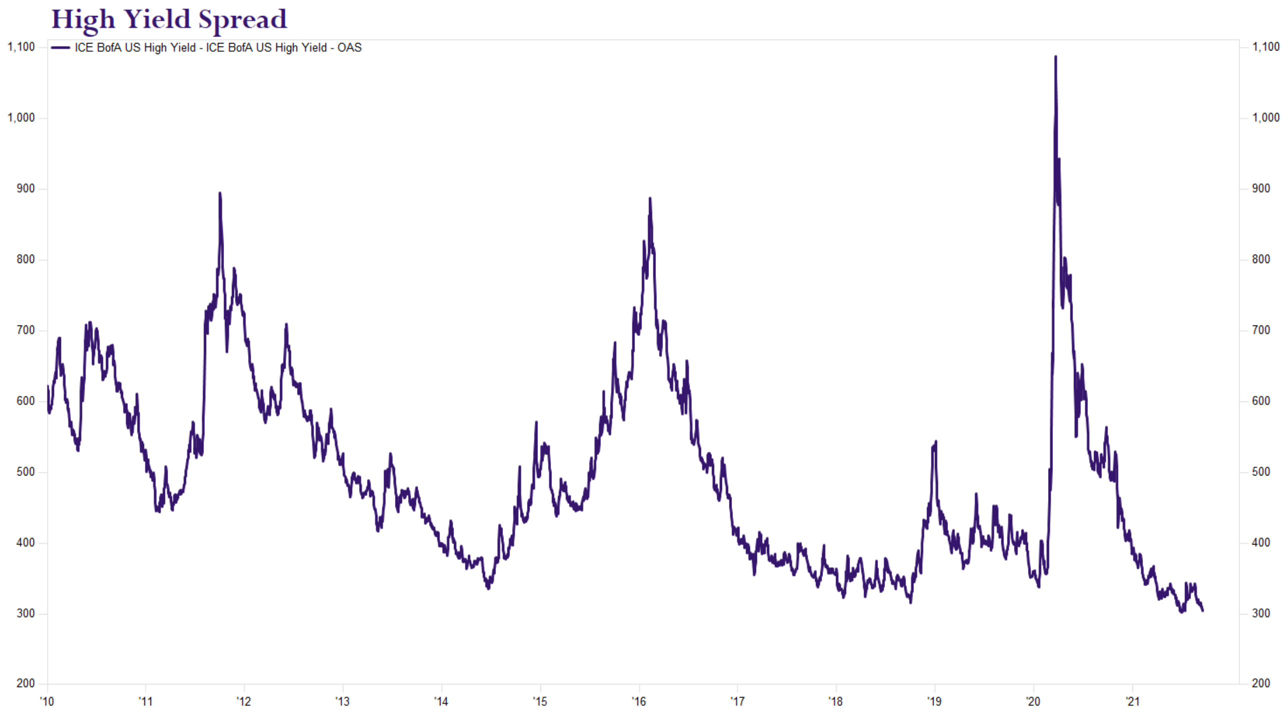
International stocks provide diversification from some of the high-flying, technology-oriented stocks that dominate large cap indexes in the U.S. Additionally, international developed economies are earlier in their recovery stage, which could benefit foreign equities. The dollar was up slightly this quarter, but longer-term it could eventually weaken against other currencies, which would create profits for U.S. investors investing abroad. International valuations are still elevated relative to their historical averages but are less stretched than U.S. large cap equities. The U.S. has outperformed for many years, so now may be a good time to consider rebalancing international exposure to long-term targets.

Fixed Income

Another possible reason stocks may seem resilient in the face of increasing risks is that bonds don't offer much of an alternative. The benchmark 10-year U.S. Treasury yield has been fairly stable this quarter under 1.4%. That's not a lot of return for bonds that have nearly a 10-year duration, or interest-rate sensitivity. With a 10-year duration, a 1% move up in yield would cause just under a 10% drop in the price. That seems like a lot of risk for a little bit of return. Pensions and endowments that have longer-term objectives can deal with this type of price volatility. After all, if yields do go up, they can invest more in higher-yielding bonds. Retirees, however, typically don't have the same the time horizon and may not be able to afford this type of drawdown. That's why we recommend being underweight duration, or having a larger focus toward bonds with shorter maturities. If interest rates rise, the price drop would be less and the yield differential between longer maturity and shorter maturity bonds isn't as substantial with yields being so compressed. The yield on the 5-year Treasury bond is around 0.8%.

One way to gain additional yield is by shifting away from government bonds and adding credit risk by investing in corporate bonds. Corporate bonds, however, are unfortunately not the silver bullet to getting the yields we were accustomed to prior to the pandemic. The current yield on corporate investment grade bonds is around 2%, while the yield on below-investment-grade bonds (junk bonds) is close to 4%, which are at or near all-time lows. Volatility in equity markets could cause volatility in credit markets, but these tight spreads could be justified with corporations having the ability to refinance their debt at low rates and the possibility to raise prices because of modest inflation. These factors are good for corporate bonds, but spreads are tight, as you can see in **Figure 4**.

Figure 4: High Yield Spread



Source: Cetera Investment Management, FactSet, BofA. Data as of 9/17/2021.

Like price-to-earnings ratios (P/E) and other valuation metrics in equities, this spread over treasuries is a valuation metric for bonds. It is the additional yield over risk-free government bonds that an investor receives for taking on the additional risk of default or credit rating downgrade within corporate bonds. Tight spreads could mean more volatility down the road, but it also just means the value for taking on the additional credit risk is low. Like durations, when credit spreads widen, bond prices fall. In times like this, owning a diversified mix of bonds is important, just like equities. Finding the right mix could depend on the investor, but we recommend not focusing on a single sector. Keeping some exposure to government, investment-grade corporate or high-yield corporate bonds is important.

Our recommendation is for below-benchmark duration, but still having some duration to offset equity volatility. Corporate bonds offer more yield with extra risk, but the reward for taking this extra risk is small, yet possibly justified. For these reasons, we like broad diversification within bonds with not too much exposure to any one asset class.

The Bottom Line

There are quite a lot of market participants "watching a boiling pot." The Fed is watching inflation and the labor market closely, while keeping an eye on Congress to gauge what it might do next. Equity investors are watching what the Fed will do next, while monitoring mounting risks. Many have been expecting a stock market correction, but everyone is still waiting. Bond investors are watching all of this but seem relatively complacent. Bond yields and credit spreads remain very low as bond investors seem to trust the Fed will navigate the next phase of the recovery smoothly.

Like these market participants, we are also watching and analyzing what the Fed will do next and keeping an eye on the growing risks in the economy and markets. But don't forget—stock market corrections are normal and happen on average about every eight months. We don't have a crystal ball of when this will happen next, but risks are growing. As such, we favor staying invested and diversified in all asset classes. We cannot predict when a correction will occur, but we also do not anticipate it to be as severe as we experienced in March of 2020.

Most importantly, investors can lose more money waiting for a correction than being harmed by the correction itself. It is always best to be prudent and focus on long-term goals and objectives. While we often focus on the risks, there is a lot to be optimistic about in the markets. Increased savings rates, low yields, and possibilities of more stimulus are positives. While earnings and economic growth are slowing, they are slowing from large percentages and corporate earnings are expected to be strong. If you are waiting for a pot to boil, it's quite possible you will be waiting longer than you expect.

As always, count on your financial professional to help you stay on track and keep your sights on your long-term goals.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

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 ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch) and an investment grade rated country of risk. Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.