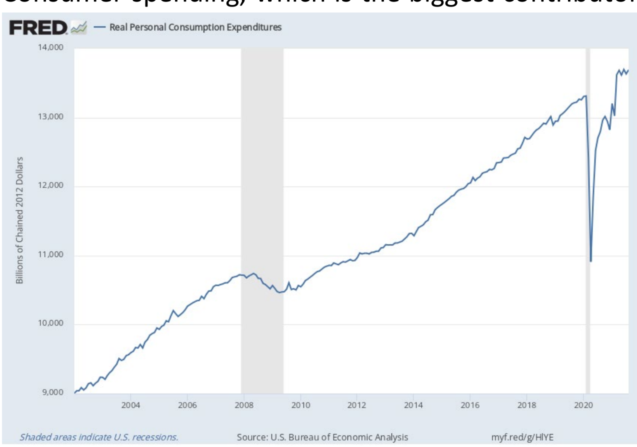
Capital Markets Review and Outlook

By: Cyril M. Theccanat, Chief Investment Officer

September 2021

Economy and Outlook

While the total death toll in the United States from the Covid-19 pandemic crossed the sobering 700,000 level in September with the reported fatalities worldwide nearing 5 million, significant progress continues to be made in controlling the disease. The vaccination pace has accelerated with over 6.1 billion doses administered globally. Over one-third (35%) of the world's population is fully vaccinated and close to half (47%) have received at least one dose. In the United States, 75% of the population over the age of 12 has received at least one vaccine dose. Infections are occurring primarily in the unvaccinated population which is shrinking as more measures such as vaccination mandates are implemented. There are also encouraging signs that cases of the fast-spreading Delta variant are levelling off and likely to begin declining. Consumer spending, which is the biggest contributor to growth in the U.S. economy, remains firm as shown in the chart on the left with real personal consumption expenditures above pre-pandemic levels. Households are bolstered by high savings rates, the significant number of job openings and rising wages. After its most recent meeting towards the end of September, the Federal Reserve signaled that it might begin dialing back its extraordinary stimulative monetary policy later this year if the economy continues to improve. There may be concerns at the central bank that the rise in inflation thus far may be transitory for longer than desired. Meanwhile, the prospective for greater fiscal stimulus continues unabated with the almost $1 trillion infrastructure and $3+ trillion climate and social change spending bills that are being debated in Congress. The risks facing the financial markets are that the ocean of liquidity may lead to a renormalization of interest rates at a faster pace than anticipated by the Federal Reserve resulting in a sharp increase in volatility and risk-aversion.



Equity Markets

After seven consecutive months of gains, equity markets pulled back as interest rates rose sharply in September. The broad domestic equity market represented by the Russell 3000 index slumped -4.5% for the month trimming its gains for the first three quarters of the year to +15%. September marked a reversal in performance by capitalization with Large Cap (-4.6%) losing more ground than Mid Cap (-4.1%) and Small Cap (-2.9%). From a Style perspective, after the three consecutive months of Growth outperforming Value, there was a sharp reversal in September, with Value outperforming Growth across all capitalizations ranging from +110 bp in Mid Cap to +210 bp in Large Cap. In Small Cap, Value's outperformance over Growth has now ballooned to over 20 percentage points for the year. In terms of sector performance, the broad sell-off in the equity markets hit both Cyclicals and Defensives. The only sector with a positive return was Energy (+9.4%) as energy prices shot higher in September with crude oil (WTI) closing the month above $75 a barrel, its highest level in three years. Financials was the next best sector (-1.8%) as investors anticipated the positive benefits to banks' net interest margins from the steepening in the Treasury yield curve. Conversely, other interest rate sensitive sectors such as Utilities and Real Estate were hit hard by the rise in yields, each losing -6.2% for the month. International equity markets also slumped in September as concerns grew about the rise in interest rates and inflation, and the market turmoil in China stemming from fears about major company defaults and increased regulatory oversight. The MSCI Developed Markets equity index declined -2.9%. Losses were limited by the +2.8% gain in Japan which rebounded from its sharp underperformance in the first half of the year on hopes for more fiscal stimulus and a further reopening of the economy. Germany (-5.6%) and France (-4.3%) were among the big losers in the developed markets. Canada (-2.6%) benefited from the sharp increase in energy prices. The MSCI Emerging Markets index lost -4% dragged down by China (-5%), Korea (-6.6%) and Brazil (-13%). Only India managed to eke out a small gain of +0.6%. Year-to-date, the Developed Markets index with a gain of +8.3% is significantly ahead of the -1.2% decline for the Emerging Markets index.

Fixed Income Markets

Interest rates rose sharply in September on signs that the Federal Reserve is getting closer to reducing its monetary accommodation policy. The belly of the Treasury yield curve bore the brunt of the yield increase with 5-year and 10-year maturities rising by +21 and +22 bp respectively to 0.98% and 1.52%. The two-year Treasury rose +8 bp to 0.28%, while the 30-year Treasury bond climbed +16 bp to end the month back above 2% at 2.1%. The Treasury yield curve steepened for the second consecutive month with the 2-year/30-year Treasury yield spread widening by 8 bp to +180 bp; the curve closed the month 28 bp steeper since the beginning of the year. Despite the declines in the equity markets, the corporate bond sector rallied in September. The investment grade credit sector's option-adjusted spread (OAS) tightened by 2 bp to +80 bp resulting in +20 bp of outperformance over duration-matched Treasuries. Compared to a year ago, the OAS is almost 50 bp tighter. In excess returns terms, both the quality curve and the credit curve flattened for the month with the BBB-rated sector outperforming the Single-A sector by +7 bp, while the long maturity sector outperformed the short/intermediate sectors by an average of +14 bp. With the rise in energy prices, the best performing sectors were energy-related: Oil Field Services (+100 bp) and refining (+98 bp); underperformers included Sovereigns (-95 bp) and Gaming (-84 bp). Although the credit index

OAS tightened in September, this was more than offset by the rise in Treasury yields. As a result, the investment grade credit sector lost -1.1% for the month and is now down -1.3% for the year. Performance in the high yield sector mirrored its investment grade counterpart and generated excess returns of +53 bp despite the slight 1 bp widening in OAS. Like the investment grade sector, lower quality high yield bonds outperformed in September with the Caa and Single-B rated sectors outperforming the higher rated Ba sector by +73 bp and +32 bp respectively in total return terms. Not surprisingly, Oil Field Services (+282 bp) was the best performing high yield sector, while Health Insurance (-74 bp) and Metals and Mining (-68 bp) were among the laggards. For the month, the High Yield sector's return was flat (0%) as its coupon yield was offset by the price decline due to higher Treasury yields. Year-to-date, the index had a total return of +4.5%. Government yields in international developed markets also rose sharply in September as investors pondered the implications of a potential reversal later this year of the Federal Reserve's easy money policy. In some developed markets, the rise in longer maturity yields eclipsed the corresponding increase in the United States: 10-year government bond yields in the United Kingdom shot up 40 bp in September. Additionally, the U.S. dollar strengthened across the board with the dollar index (DXY) rising +1.8% for the month. As a result, the FTSE non-US World Government Bond Index (WGBI) lost -2.9% in August underperforming the U.S. government bond index which declined -1.1%. Year-to-date, the underperformance of the international government bond index (-7.9%) versus the U.S. government bond market (-2.4%) has widened.

		Returns as of 9/30/21 (In %)					
		Month	Q3	YTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	-4.5	-0.1	15.0	31.9	16.0	16.9
Russell 1000®	US Large Cap Equity	-4.6	0.2	15.2	31.0	16.4	17.1
Russell 1000® Growth	US Large Cap Growth	-5.6	1.2	14.3	27.3	22.0	22.8
Russell 1000® Value	US Large Cap Value	-3.5	-0.8	16.1	35.0	10.1	10.9
Russell Midcap®	US Mid Cap Equity	-4.1	-0.9	15.2	38.1	14.2	14.4
Russell Midcap® Growth	US Mid Cap Growth	-4.8	-0.8	9.6	30.5	19.1	19.3
Russell Midcap® Value	US Mid Cap Value	-3.7	-1.0	18.2	42.4	10.3	10.6
Russell 2000®	US Small Cap Equity	-2.9	-4.4	12.4	47.7	10.5	13.5
Russell 2000® Growth	US Small Cap Growth	-3.8	-5.7	2.8	33.3	11.7	15.3
Russell 2000® Value	US Small Cap Value	-2.0	-3.0	22.9	63.9	8.6	11.0
MSCI ACWI ex-US	Global Equity ex-US	-3.2	-3.0	5.9	23.9	8.0	8.9
MSCI EAFE	Global Developed Mkts Equity	-2.9	-0.4	8.3	25.7	7.6	8.8
MSCI EM	Emerging Mkts Equity	-4.0	-8.1	-1.2	18.2	8.6	9.2
Bloomberg/Barclays US Agg	US Core Fixed Income	-0.9	0.1	-1.6	-0.9	5.4	2.9
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	-0.5	0.0	-0.8	-0.4	4.4	2.5
Bloomberg/Barclays US Credit	US Corporate Bonds	-1.1	0.0	-1.3	1.4	7.1	4.4
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	-0.4	0.1	-0.7	-0.4	3.9	2.2
Bloomberg/Barclays US Corp HY	US High Yield	0.0	0.9	4.5	11.3	6.9	6.5
FTSE Non-US WGBI	Global Fixed Income ex-US	-2.9	-2.0	-7.9	-3.4	2.9	0.8

3333 Piedmont Road NE Suite 755 • Atlanta, GA 30305 • 404-883-2500 • consequentcm.com