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QUARTERLY REPORT SEPTEMBER 30, 2021

2021 3rd Quarter Review

Economic Commentary

The US economy has remained resilient through the summer as consumer demand helped boost confidence of businesses in both the manufacturing and service industries. The final real GDP figure for the 2nd quarter came in at a robust 6.7%, which on its face, seems like the US economy is cruising. However, the continued rebound is faced with a labor shortage, with many businesses unable to find qualified candidates, despite an increase in incentives and job openings. Rising prices have begun to worry consumers according to August and September surveys by the University of Michigan and the Conference Board. Persistent inflation readings have pushed prices for goods and services higher than the pre-pandemic levels, while the latest Personal Consumption Expenditures (PCE) price index (an inflation measure) recorded a 6.5% year-on-year increase for the 2nd quarter, according to the Bureau of Economic Analysis. Supply chain problems for raw materials and goods shipments have led to delays and have also contributed to those rising prices, but these things are likely to be and are considered transitory by monetary policy makers at the Federal Reserve. The Fed has signaled that it is likely to begin tapering the pandemic-related $120B per month of bond purchases by the end of this year, by stating that it will likely be at no new purchases by mid-2022.

Overall, conditions are likely to continue to be easy monetarily until the Fed begins increasing the federal funds rate, which the latest Fed dot plot forecast targets 2023. The Fed has insisted that it will not commence lift-off of the near lower bound of interest rates until the economy approaches something close to full employment. The other half of the Fed's dual mandate, inflation, could make the Fed increase rates quicker than forecasted, and threaten to derail the economic rebound. The major X-factor here is the effect the continuing pandemic will have if cases begin to rise again.

As of now, the main thrusts of fiscal support (which increases deficit spending by the US Govt) have expired leaving the economy and consumers to fend for themselves. Political support has shifted to headwind despite a nearly unified control of congress as a couple senators dig their heels in to oppose the broad $3.5T spending bill presented as *infrastructure.* The details of the bill seem unimportant to those trying to pass it, as the bottom-line dollar amount seems the most important thing while the public is still desensitized to the trillions thrown about during the heart of the pandemic.

Real GDP growth estimates for the 3rd quarter have faded alongside the erosion of consumer confidence and prospects for additional monetary and fiscal stimulus, with the Atlanta Fed's GDPNow estimate falling to just 3.2% growth from above 6.0% in August.

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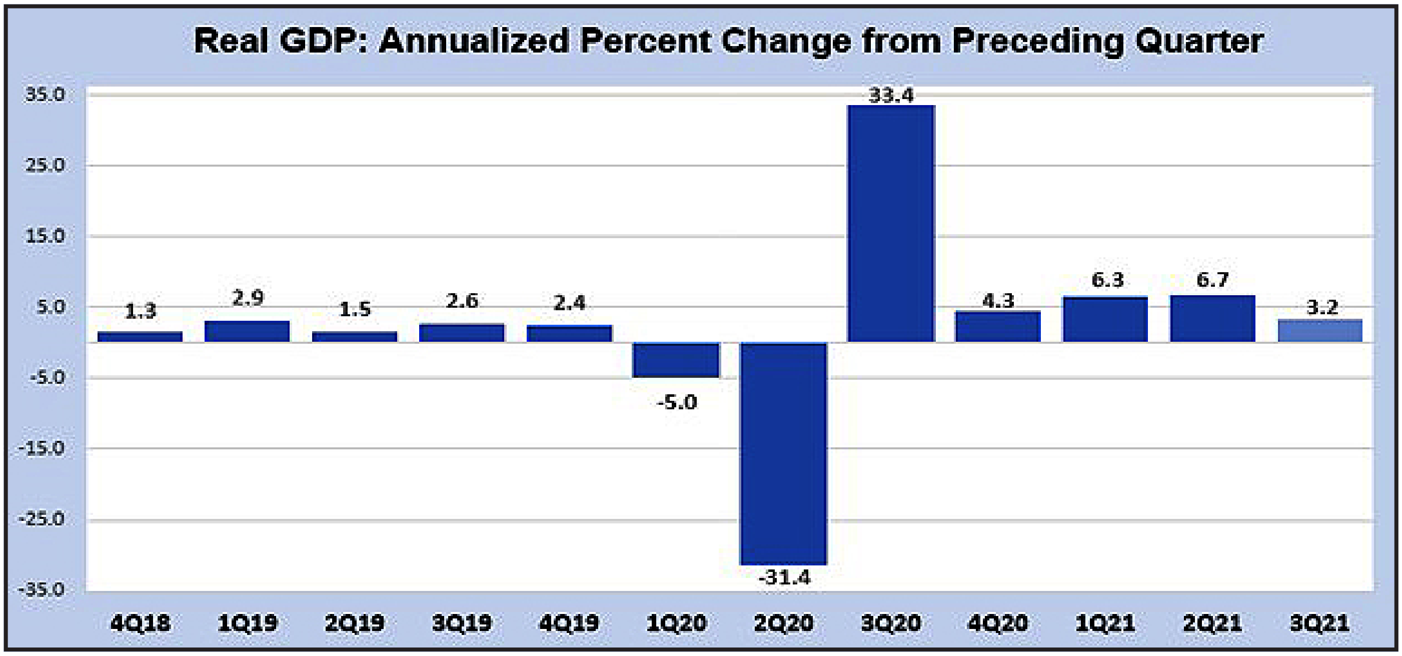

Chart created by Hanlon with data provided by Atlanta Fed GDPNow.

Market Commentary

Broad US equity markets faded from all-time highs in September, as interest rates started to jump again in anticipation of less accommodative policies and a stronger US dollar. Technical indicators started to work against indices struggling to break out after muted price responses to blockbuster earnings results from many large cap corporations signaled that the usually forward-looking markets anticipated the potential for peaking earnings and stock prices expectations for the immediate future. Small and mid-cap US equities were also signaling the end to broader strength by not participating in the July-Aug equity large cap price appreciation and have basically gone sideways since March. Growth names went back to outperforming value during the 3rd quarter, despite the late pull-back for growth narrowing the gap. For the 3rd quarter the S&P 500 had a return of 1.5%, the technology-heavy Nasdaq Composite and the Dow Jones Industrial Average ended with more-modest quarterly returns of 0.5% and 0.2%, respectively. The price-to-earnings (PE) multiple on S&P 500 stocks has retreated to 20x with the recent decline in stock prices, i.e., stocks are less expensive than they were a month ago for instance.

Small-cap US equities were the underperforming US asset class during the quarter. While the Russell 1000 Mid-Cap Index remained roughly flat, the Russell 2000 Small-Cap Index finished the 3rd quarter -3.5% lower. Underperformance from the industrials sector in the small-cap space canceled relative strength from the small-cap indices' overweight to the financial sector. Financials finished the quarter relatively well due to rising interest rates which may help improve profit margins for financial companies going forward.

International equities underperformed US equities during the quarter, though the modest decline from broad developed international markets was dwarfed by the roughly -10% decline by the iShares MSCI Emerging Markets ETF (EEM), which was responding to slowing growth in China. The weakness in China was exacerbated by China cracking down on some of its largest companies in the technology sector. A missed debt payment by a large Chinese bank and property developer called Evergrande, with $300B in debt obligations, helped cause a broader anxiety about the health of the global economy.

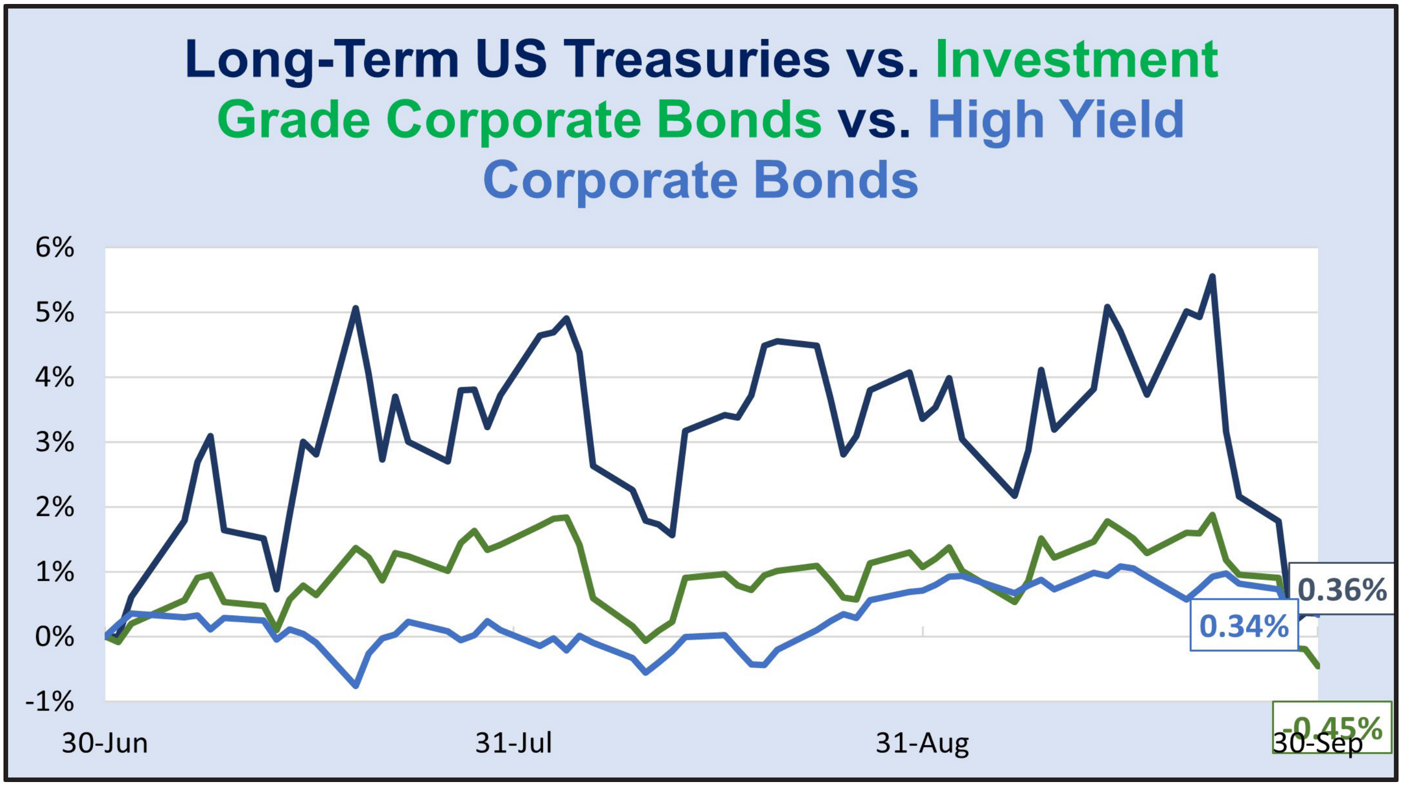

Chart created by Hanlon with data provided by Investors FastTrack. Data as of 9/30/2021. Long-Term US Treasuries is represented by the iShares 20+ Year Treasury ETF (TLT), IC Corporate Bonds by iShares Investment Grade Bond Corp Bond ETF (LQD), and HY Corporate Bonds by iShares iBoxx US High Yield Corporate Bond ETF (HYG).

US interest rates had been falling since March, though now they have been back on the rise since early August. The yield on the US 10-Year Treasury Note has spiked since the most recent Fed meeting announcement in mid-September, which indicated some tapering of the monetary support and the dot plot of expectations showing a slightly quicker-than-anticipated timeline for interest rate hikes. The iShares 20+ Year Treasury ETF (TLT) still managed a slight gain on the quarter despite rates being higher than when the quarter began. The speed and severity of this most recent interest rate increase was notable due to the negative effect it had on equity markets, and high valuation multiple technology stocks. The effect on corporate bonds was more mixed, with investment grade corporate bonds underperforming versus the return on high yield bonds, whose historically tight interest rate spreads still provided enough buffer for a positive return during the quarter. The uncertainty surrounding Chinese company Evergrande has yet to significantly affect the perception of riskier borrowers in the US, as default rates remain near historic lows.

Many commodities have remained hot as manufacturers seek raw materials that have proven to be in demand and hard to acquire in some instances. Energy prices have spiked recently despite concerns about a slowdown in China, where in-fact, there has been a shortage of resources to be able to power large manufacturing centers. Hurricane Ida has taken its toll, here in North America, shutting down already tightened production in the Gulf of Mexico while the US administration pleads with OPEC+ members to further increase production output even more than was added by a removal of self-induced production quotas earlier in the year. Natural gas prices have also increased due to the limiting of previously abundant American production and anticipation of a colder winter. The front-month contract for natural gas is nearing $6/MMBtu after beginning the quarter sub-$4. This helped companies in the energy sector buck the broader equity weakness late in September, making up for underperformance during most of the 3rd quarter. Prices for other raw materials such as iron ore and lumber have fallen precipitously during the quarter, however, mirroring the credit challenges and slowdown in the pace of property development in China.

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Closing Remarks

Optimism for future returns has started to wane due to a variety of factors including political uncertainty, a reduction in monetary support, fiscal support ending, high inflation impacting consumer confidence, and economic cracks in China. History has suggested that these things work themselves out, though markets may remain volatile in the interim. The low interest rate environment has pushed many out on the risk spectrum to seek higher income, which has created a musical chairs situation where significant drawdowns can happen quickly if confidence were to erode.

Ample liquidity has so far allowed market participants to feel secure that backstops are in place, helping traders feel confident about “buying the dip”, but the psychology can change quickly and expected return premiums may be inadequate for current levels of assumed risk. Investors need to be sure that their current allocations are appropriate for both their time horizon and risk appetite, so please contact your financial representative if you have any concerns or if your situation has changed.

At Hanlon, we will continue to focus on avoiding pitfalls where we can, persevering on our mission to manage your portfolio(s) with a disciplined and emotionless investment approach. As always, we will be guided by our principles of Passion, Integrity, Vision, and Care.

Thank you for the opportunity to be of service and we hope that everyone stays healthy and positive in these trying times.

Sincerely,

Sean Hanlon, CFP®
CEO and Co-Chief Investment Officer

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