Summary

Economic data for the week included no action by the Federal Reserve regarding interest rates (although they gave strong signals about upcoming tapering). Otherwise, existing home sales fell, new home sales and housing starts rose, while jobless claims were mixed.

U.S. equity markets rebounded from a volatile start to the week to gains, while foreign equities ended mixed. Bonds lost ground across the board as investors interpreted a somewhat optimistic Fed into higher interest rates. Commodities rose across the board, led by a sharp supply-driven rise in the price of crude oil.

Economic Notes

(0) The **FOMC decision** on Wed. to keep policy steady was far overshadowed by the blatant hint that tapering of bond-buying 'may soon be warranted,' due to their tests being 'all but met'—in their words. (The press conference afterward provided more clarity, in that tapering could come as soon as the early Nov. meeting, and could end by mid-2022.) It was noted, though, that recent economic results have been slowed by the Covid delta variant, and some expected recovery activity pushed out by a few quarters. Most importantly, the 'dot plots', which are current FOMC member estimates as to future policy, showed potentially a half-dozen rate hikes over the next few years. While this might seem jarring at first glance, a half-dozen ticks higher at 0.25% per meeting only equates to 1.5% in total interest rate change. A nominal cash rate moving from 0.0% to 1.5% is significant in comparative terms, but remains quite low, and accommodative, when looked at from a long-term real rate basis. The long-term expectation for a nominal rate fed funds rate of 2.5% remained unchanged—which implies 2% long-term inflation targeting being met, plus a more historically-normal 0.5% real yield.

During the Q&A, there were points of surprising detail and clarity about the process, perhaps more than we've been used to. For example, Chair Powell noted that merely 'decent' employment reports in the coming months would be enough to feel comfortable with starting the taper (although they're no doubt reviewing a variety of labor data points). However, it was reiterated that the bar for moving from tapering to actually raising interest rates is quite a bit higher.

(-) **Existing home sales** in August declined by -2.0% to a seasonally-adjusted annualized rate of 5.880 mil. units, further than the forecasted drop of -1.7%. Single-family units were down -2%, with condos/co-ops slightly worse at -3%. All four national regions saw a drop in sales, with the South faring worst. The median sales price ticked up a tenth of a percent to $356,700, which resulted in a 14.9% year-over-year median price gain, despite the -1.5% decline in sales volumes during the year. The months supply of existing homes was unchanged at 2.6—remaining far below average and pre-Covid levels. The lack of available supply continues to be a primary driver of flattening sales as of late.

(+) **New home sales** for August rose 1.5% to a seasonally-adjusted average annualized rate of 740k units, surpassing expectations calling for a 1.0% increase. This included an upward revision for the prior month also, which tempered August's result by a few percent. Regionally, sales were strongest in the South (up 25k), moderately higher in the West and Northeast, while the Midwest experienced a sharp decrease for the month. The months' supply of new homes ticked up a tenth to 6.1, based on a rise in inventories.

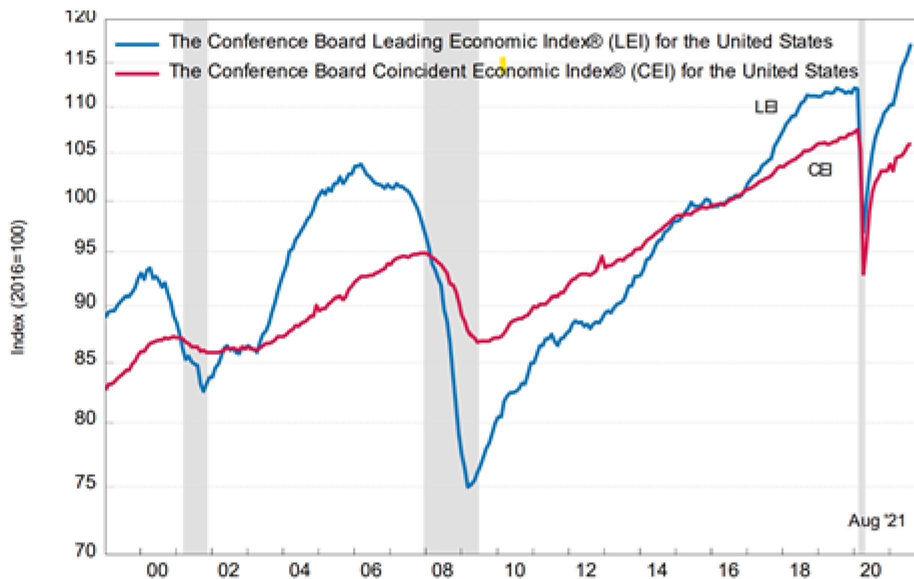
(+) **Housing starts** for August rose by 3.9% to a seasonally-adjusted annualized rate of 1.615 mil. units, beating expectations calling for a 1.0% increase, and including an upward revision for July. The headline figure was driven by a 21% rise in multi-family starts, a more volatile and lumpy group than single-family, which fell by -3%. Regionally, the Northeast saw extreme gains of nearly 170% (no doubt weather-based), followed by moderate gains in the Midwest and South, while starts in the West fell by over -20%. Overall, starts are up 17% from last year, led by a 50+% increase in multi-family units. **Building permits** rose by 6.0% to 1.728 mil.

annualized units, far surpassing the -1.8% decline expected, with a 16% gain in multi-family outweighing a 1% rise in single-family. Every region saw permit gains, led by the Northeast, up almost 20%. The more recent dynamic remains interesting, with what looks to be some further interest (and capital) moving toward apartments, and a bit away from single-family, in keeping with stronger urban rents. Real estate operators, though, tend to be a reactionary bunch, which can sometimes be at odds with intermediate-term construction cycles. With labor scarce, larger multi-family units may be seen as a better leveraged use of available resources.

(+) The **NAHB housing market index** rose by 1 point to 76 in September, bucking expectations calling for a decline of a point. By component, current sales rose a point, prospective buyer traffic rose 2 points, while future expected sales came in unchanged. Regionally, the Midwest and South saw gains in sentiment, while the Northeast and West experienced substantial declines.

(+) The Conference Board's **Index of Leading Economic Indicators** for August increased by 0.9%, which represented an accelerated rate of growth from both June and July, and continuing the steady upward trend of the past year. Of the ten indicators, eight showed gains in the month, led by jobless claims, new ISM orders, and building permits; consumer expectations for business conditions remained the sole negative factor. Over the past six months, the leading indicator rose at a robust annualized rate of 13.1%, which far surpassed the 6.9% annualized rate of the prior six months, ending in Feb. 2021.

The coincident index rose by 0.2%, while the lagging economic index gained 0.1% for the month. Based on this data, recent strength was noted by the Board as having significantly reduced the chances of a recession in the near-term, which is among the most helpful uses of the leading indicator metric, as the individual component data is already known.



Source: The Conference Board. Shaded areas indicate recessions, as defined by the NBER.

(-) **Initial jobless claims** for the Sep. 18 ending week rose by 16k to 351k, which surpassed the median forecast of 320k. **Continuing claims** for the Sep. 11 week also rose, by 131k, to 2.845 mil., above the 2.600 mil. level expected. The initial claims figure was driven almost exclusively by CA, which reflected claims status changes from federal insurance (which has ended) to other state programs. Looking at the trend of the last 12 months, claims have steadily fallen from nearly 1 mil./week to a steadier pace of 300-500k/week over the past six months, although still elevated relative to history.

Question of the Week

What is there to worry about? (Fall edition)

Markets have pulled back over the past few weeks, with more volatility in both directions last week, based on a variety of converging concerns (not listed in any order of severity).

Peak growth. Following the historic economic pullback in 2020, the depths of which had not been seen since the Great Depression, the subsequent recovery in economic and corporate earnings growth has equally fast and dramatic. But it has to level off sometime, at least to a more normal trajectory, and that seems to be starting now. This year's growth rate remains higher than average, and is expected to remain so into next year, but not at the same extreme rate from last year's trough.

This is not only happening in the U.S., but also in other regions, such as China—which was seen as having an early handle on Covid, limiting the economic destruction, and speeding up the recovery time. In business cycles, an early start can also come with an early ending, and it appears that Chinese growth has begun to decelerate. As China remains a significant growth engine for global growth, this slowing has been viewed especially negatively, especially when coupled with U.S.-China political tensions. An unwinding of debt-fueled and speculative excesses, such as with the property developer Evergrande, have also caused sentiment to weaken. The risk of spillover from that firm's problems to other companies, sectors, or worse, globally doesn't appear to be high (unlike a feared 2008-like 'Lehman moment' from sub-prime mortgages), but a pullback in speculative capital can be a sign of a change in investor mood. There could be other Evergrandes in the Chinese economy, requiring government attention and resources to resolve. That said, absolute growth in developed nations remains positive, which is a cornerstone for equity earnings growth—the important driver of long-term returns.

'Minsky moment.' This term was named after economist Hyman Minsky, who described the conditions of rising financial instability needed for such a moment to eventually happen. It refers to the end of some business cycles first fueled by normal improving fundamentals, but in the final stages by excessive speculation—usually fueled by leverage. Abstract chaos theorists have tried to model sandpiles or mountain avalanches in the physical world, in attempts to draw parallels with financial volatility episodes. What does the grain of sand look like that finally causes the avalanche (real or financial)? Timing of events has been concluded as largely random or unpredictable, but instability from 'steeper inclines' raises their probability. Compared to some prior cycles, the valuation of financial assets is currently richer in some areas than others, but doesn't seem to point to a broader economic bubble generally. Those types of bubbles can end tragically when there are no speculators left willing or able to buy assets. Whether sentiment is that buoyant today is debatable, with very large and persistent money market mutual fund balances. Additionally, intervention in asset markets by global central banks has created distortions that make normal assessment of risk more difficult, due to the perception that they'll come to the 'rescue' as needed. However, several so-called 'micro-bubbles' have been identified, in such areas as cryptocurrency, meme stocks, SPACs, etc., but this is different than every asset class being affected equally.

Fed taper/interest rates. Speaking of the Fed, markets are worried about this accommodative monetary policy stretch coming to an end. Historically, sharply rising interest rates have been a catalyst for poor market performance, and even a recession trigger. So the fear isn't baseless. The Fed is no doubt aware of this, so by action and communication, has moved very slowly when changing policy in recent years. Far before raising rates, the 'tapering' off of treasury and agency mortgage bond buying is the first step, with the Fed noting this process will end in mid-2022. Through deliberate communications and news leaks, the Fed carefully 'primes' market expectations well in advance to avoid surprises. A remaining question is how will markets react to the eventual decision to raise rates? Then again, that could be a year away or more, with at least a few economists arguing low rates in general may not be going away anytime soon. That assumption is due to the pre-pandemic

demographic influences of slower labor force and weak productivity growth, which have kept economic growth contained as a result. This also points to lesser chances of an overheating that would normally justify higher rates.

Inflation. This would be the reason to move away from easy monetary policy, if any. Classic economics dictates that higher inflation should be met with higher interest rates. This was seen in the extreme during Fed Chair Paul Volcker's policies of the late 1970s/early 1980s. The shock caused damage initially, in the form of back-to-back recessions, but the result settled the inflationary heartbeat down to stable ever since. However, the unique events of Covid created production and transportation disruptions we haven't seen in decades, generating price increases from supply and labor shortages. A mainstream economic view continues to point to these inflationary forces as 'transitory', and likely to abate over the next few quarters. Others are less convinced, believing trillions of government stimulus dollars stand poised to flood the economy with cash, set to drive up prices for a more sustained period. Time will tell, as inflation is a sneaky dynamic with apparent effects only over time. It may not seem like it, but over the last 20 years, headline CPI has averaged just over 2%; but over the past century, that number has been closer to 3%, so the baseline for what is 'normal' can shift over time.

Congressional infrastructure/tax plan. This isn't new, but the draft congressional plan offers mixed potential for investors. On the positive side, large amounts of government fiscal stimulus will find their way into the economy—to businesses fulfilling the needed projects, to worker pay, and thus to business and consumer spending elsewhere. It may not be as obvious to financial markets, as many infrastructure projects are local, and are implemented via regional construction companies, etc., but larger materials companies and other selected members of the S&P may directly benefit. On the negative side, higher planned corporate tax rates would have a negative impact on earnings, although the anticipated tax rates discussed are lower than the worst-case scenarios first proposed. Some independent studies show that, regardless, the plan may not generate the GDP gains hoped vs. taxes collected.

Government spending. There are deeper, long-term concerns about the high level of U.S. spending that we'll just touch on here, due to those being a debate all their own. Spending has ramped up over the last decade regardless of political party, so it seems to be an endemic issue. Worry has grown over the high debt/GDP ratio, and what appears to some as at least a partial adoption of Modern Monetary Theory (MMT)—which states that a country of our stature can print unlimited money to fund anything it needs. A look at history would show how extreme money printing policies have led to multiple downfalls. This problem is likely more long-term than short-term, but that's not to downplay the issue. The near-term respite is likely based on two important factors: (1) the U.S. dollar's ongoing status as the world's 'reserve currency', which gives it much more leeway than if it didn't have that status; and (2) other developed nations are printing and spending large amounts as well. The latter has put a damper on the expected dollar-weakening effects that would normally occur from such a policy. The impacts of currency value erosion and inflation of this type can also be slow and creeping, as opposed to immediate.

Government debt ceiling debate. The raising of the U.S. government debt limit used to be a routine Congressional matter, required on a regular basis due to annual budget deficits and impact of inflation. However, since about a decade or so ago, this vote has been used as a political tool. In 2011, threats to vote down the agreement, and final punting of an agreement to the 11th hour caused S&P to downgrade the credit rating of U.S. debt from its long-time pristine AAA level to AA+ (where it remains today). While outright or 'technical' default wasn't considered a high-probability outcome, the threats were seen as a needless and dangerous exercise. While this may have caused subsequent Congresses to be scared straight, this looks to be a potential issue again this fall as some have vowed to withhold support. The mystery is enhanced by the fact that no one claims to know exactly when the Treasury will run out of money, but it appears to be sometime in October. Last resort strategies include shuffling funds to pay bond interest first, moving different debt issues around on the Treasury balance sheet, as well as the final steps of ceasing government payments like social security, and another government shutdown. Markets don't seem to realistically think the debt limit won't be

approved, but last-minute theatrics raise the chances for a mishap, and so can bring market volatility. Since 1960, the debt limit has been increased 78 times, so the chances of it not being approved now, given the absurd alternative, seem slim but not zero in today's contentious political environment.

Covid (ongoing/delta variant). The case charts for Covid generally show a strong initial peak in 2020, as the world became aware of the problem and implemented widespread shutdowns. However, the recent second peak, from delta variant cases, has been higher than the first, although mortality rates have fallen due to vaccination effects. While the economically unpopular business shutdowns appear to be behind us, activities in a variety of sectors, including travel, leisure, and office work, have yet to return to pre-Covid levels. The uncertain timeline on the end of the pandemic has kept pressure intact, despite help from government stimulus money. Fears of a new variant (even eventually a vaccine-resistant strain) 'out there' remain, which raises the possibility of economic disruption down the road again.

Seasonality. As we've mentioned plenty of times before, autumn has historically been a volatile time for markets. It defies most rational explanations, but higher trading volumes in a return to 'normal' business (at least compared to lower summertime volumes), the looking ahead to next year's earnings picture, Congressional activity, and elections, are all possible causes. September has been the stock market's worst-performing month over the past century (the only month with a net negative return), while the Sept.-Oct. period has been known for a variety of rapid stock market meltdowns. Of course, this is not always the case. On the positive side, Nov.-Dec. market returns have historically been among the best of the year, in the always-hoped-for 'Santa Claus Rally'. These have been oddly persistent, but of course, never guaranteed.

Market Notes

Period ending 9/24/2021	1 Week (%)	YTD (%)
DJIA	0.62	15.28
S&P 500	0.52	19.87
NASDAQ	0.03	17.32
Russell 2000	0.51	14.59
MSCI-EAFE	-0.30	11.01
MSCI-EM	-1.02	-0.35
BBgBarc U.S. Aggregate	-0.40	-1.16

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2020	0.09	0.13	0.36	0.93	1.65
9/17/2021	0.04	0.23	0.88	1.37	1.91
9/24/2021	0.03	0.29	0.97	1.47	1.99

U.S. stocks started the week poorly, down over -2.5% upon news of Chinese debt contagion (property developer Evergrande) and the upcoming fight over the U.S. debt ceiling. However, the vote by the House for temporary suspension of the ceiling until year-end 2022, and agreement to fund the government until early Dec. appeared to help matters, although Senate approval remains the wildcard. Generally, easing worries over the Evergrande response in China, and a Fed that remained confident about the economy appeared to boost spirits through the remainder of the week.

By sector, energy was the outperformer, up 4%, followed by moderate gains in financials, technology, and industrials. The defensive sectors of health care, consumer staples, and utilities lagged, with negative returns for the week. Real estate also fell over a percent, in keeping with higher interest rates.

Foreign stocks were mixed, as strength in Europe and the U.K. was offset by a sharp decline in Japan and the emerging market group. Although returns were generally mixed by country in a tight band, the broader index was pulled down by China, with sentiment no doubt impacted negatively by the Evergrande incident. A restructuring plan and banking system injection seemed to calm conditions down, to some degree.

U.S. bonds suffered last week, with long-term treasury rates rising by over 10bp, as investors digested the Fed's somewhat hawkish comments mid-week. Immediately following the Fed meeting on Wed., interest rates were little changed in response, and the treasury curve actually flattened slightly, before later higher rates. Another compounding effect was the central bank of Norway deciding to raise rates (from zero to 0.25%—the first developed nation to do so), as well as discussion about the matter at the Bank of England, resulting in an end to their QE. Corporate bonds declined a bit less, while floating rate bank loans experienced positive returns.

Foreign bonds generally fell to a greater degree, with the negative headwind of a stronger dollar—particularly in emerging markets, driven by negative China news. The Chinese real estate developer Evergrande's potential default on more than $300 bil. rattled global markets. It's a classic tale of too much leverage, although the risk has plagued the Chinese real estate development sector for quite a while. Other than in some EM high yield debt market indexes, exposure to that segment appears contained in many asset allocation portfolios.

Commodities saw gains broadly last week, despite the usual headwind of a stronger dollar. Energy and agriculture outperformed lesser increases in industrial metals and precious metals. In addition to further price increases for natural gas, the price of crude oil rose 3% to just below $74/barrel. This was due to tighter supply concerns from stronger demand (in fact the lowest oil stocks in three years), as well as still-reduced production from hurricane-affected Gulf of Mexico facilities.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, National Association of Realtors, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, Tax Foundation, The Conference Board, Thomson Reuters, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.