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TRANSCRIPT: Q3 2021 Market Update

This is a transcript of a video created on October 14, 2021. Visit our YouTube Channel to view this video at https://youtu.be/-esNIarBnL4 or our website at www.levelFA.com

Steven Elwell: Hi everyone, this is Steve Elwell, chief investment officer of Level Financial Advisors, and this is your third quarter market update. The stock market took a little bit of a breather in the third quarter here. It actually started the quarter off fairly nicely, as you look at June and... Excuse me, July and August, and halfway through September, but then gave up most of the gains that were made by the end of September, as the stock market started to become a little spooked about some delays in Congress about passing some of the bills that are on the table, the spending bill, the infrastructure bill, raising the debt ceiling, some of the things that Congress was negotiating, stock market became a little impatient on, so stocks finished down, slightly down, both in the U.S. and internationally.

Emerging markets had a little bit of a worse quarter. There were some unique things happening there as a large real estate company that is potentially teetering on default, and some in China were concerned that that might be a Lehman Brothers-type moment, although it appears that there are... Things have calmed down a little bit on that front, as that company particularly starts to figure out how they're going to pay back the massive amount of debt that they owe.

There also were some regulatory crackdowns in China on tech companies around anti-monopoly laws, and data security laws, and consumer protection laws, and that sort of spooked part of the Chinese market particularly in the third quarter. So it was a little bit of a rough quarter for emerging market stocks, although they have started to bounce back. And the bond market was relatively flat for the third quarter as well.

If we take a bigger-picture view, if we sort of widen the lens a little bit, over the last year, last 12 months, the U.S. stock market has gained almost 32%, so for stocks to take a little bit of a breather is not only not surprising, but probably expected. As all of you know, stocks don't go straight up all the time, and investing would be easy if that was the case.

In fact, in any given 12-month calendar year, there's usually one or two, or sometimes multiple declines throughout the year of 5% to 10%, that would be considered totally normal. And as you know, every now and then, every couple years, there's a decline that's bigger than that for various reasons, but the last 12 months, by any measure, both in the U.S., internationally, global real estate, emerging markets, either way, the last 12 months have been fantastic.

The bond market has pulled back a bit, although remember the bond market had a fantastic 2020, as a result of all the fear and volatility that came from the shutdowns and quarantines and lockdowns and pandemic control measures that were implemented throughout the economy, so it's not surprising to see bonds have a rough 12 months, knowing that the... If you go back for the first nine months of 2020, they had a fantastic run during that period.

If we get a little deeper on the bond side, this past quarter, particularly in the Treasury inflation-protected bond corner of the market, which as a reminder, are U.S. government bonds that values automatically adjust upward as inflation goes up, and as you might guess, when inflation runs hot, those bonds do pretty well, and they continue to lead the way, they had a great quarter, up 1.75% last quarter. High-yield corporate bonds had a good quarter as well, as corporate earnings have been fantastic, and those two categories are really leading the bond market for the year, up approximately three and a half percent for the TIPS bonds, and four and a half percent for high-yield corporate bonds.

U.S. long government bonds, so long U.S. Treasury bonds, have had a pretty rough year for the same reason that I mentioned before, as the economy has recovered and corporate profits have recovered, and volatility has calmed down, then those that are seeking the protection of U.S. government bonds and long... Particularly long U.S. government bonds, like 20 and 30-year bonds, have seen prices come back down to Earth, and they're down about 7% for the year.

So, the bond market also has been taking a close look at what the Federal Reserve is saying. It appears at this moment that they're starting to position themselves to taper their bond-buying measures, which as a reminder, throughout the pandemic, to help support the liquidity of the bond market and the economy as a whole, the Federal Reserve and Treasury went into the bond market and was purchasing bonds, all sorts of different types of bonds, and they don't always do that, and they don't also always do that in the level of magnitude that they're doing now. And so at some point, they determine that the economy's healthy enough where they start to take the foot off the pedal, and they reduce the bond-buying.

Now, they have to be careful, because of course as you can imagine, they are a very large entity, and if they went from buying bonds to all a sudden not buying bonds, that would be quite disruptive, so they have to be very measured and thoughtful about how they start to reduce that program. Fortunately, they have experience doing this, they did it, if you remember right, after the Great Recession. Back in 2012 and 2013, that was the hot topic of the day, was tapering, specifically they called it in the news media, "The taper tantrum," whether this was going to cause volatility in the stock market. And if you take a quick look at how things looked in 2013, the evidence was quite obvious that there was not any huge effect on the stock market as they started to implement the tapering of that bond-buying program.

So we remain confident that they'll be able to execute the same strategy this time, and in fact, if they find themselves starting to affect the stock market in some way, or if they think they are, in some negative way, then I also would probably anticipate that they might just slow down the tapering of their bond-buying in recognition of that. They're trying to do no harm here, as they pull back some of the stimulus that they've been implementing through 2020.

So, time will tell, we'll see whether they start tapering in November, but that is what the current belief is for most observers, and based on the language that they're using, is that it appears they're going to start doing that. Once they start doing that, the longer-term picture in late 2022 and early 2023 is that they may actually start to slowly raise interest rates. They typically do that at a quarter percent per quarter, so kind of a slow move, but that is all dependent on all the economic data we're going to get between now and then, as the... And potentially any change in the Board of Governors that directs the Federal Reserve, so we'll see between now and then what plays out, but that's currently at the moment what the market believes the Federal Reserve is going to do in the bond market, and so it should be interesting to watch, as it always is.

On the stock side of the equation, we showed this same J.P. Morgan chart last year, last quarter, excuse me, and one of the things that we were highlighting was that right now it feels like, because course it's true, that stock prices have set multiple all-time highs this year, as the stock market has moved up and up and up, and many people are sort of scratching their head and saying, "How is that possible? This can't continue, this isn't sustainable," despite of course a 100-year history of the stock market setting new and higher prices.

What's actually happening, and we tried to highlight this last quarter, but I want to further emphasize it, because it's to a greater degree this quarter, that earnings growth, profit growth for the S&P 500 specifically, which is the most common measure of the U.S. stock market, has been fantastic this year. The third quarter was another quarter of great earnings, above average earnings. So earnings growth year-to-date on the upper-left side of this chart that you're looking at, when we showed you this chart three months ago, it was around 19%, and now it's up to 26% year-to-date. That is obviously a fantastic year.

Also, you may notice there's another description there, a number there called "Multiple growth," which as we explained in last quarter's video, is effectively the price people are willing to pay for earnings, the same level of earnings. And so actually the price people are paying for earnings has gone down, but the earnings growth has gone up by so much more that the S&P 500 has continued to go up and set new all-time highs. So it's almost counter-intuitive, but the bottom line is corporate profits have been so good this year and have grown so much this year, that people are actually paying a lower price to get more profit, and that, as you say it out loud, if you say it slowly, sounds great on both fronts.

And so that really flies in the face of the argument of, "This is unsustainable, this doesn't make sense. How is it possible that the S&P 500's at all-time highs?" And we touched on this a bit before, but I'll reiterate the sort of same sentiment, is that corporate payrolls still have not recovered from where they were before the pandemic, and we see that, I'm going to get into that a little bit more in a slide here in a second, but corporate earnings and profits and revenues have definitely recovered. And so of course, if you're selling as much stuff as you were before the pandemic, but your cost to produce those goods and services are lower, your profit margins of course must be bigger, and that holds true, that's what's happening right now.

Now, at some point, corporations struggle to continue that pace of growth without hiring more people, and that's kind of the moment we're finding ourselves in now, as we look at this additional chart that really shows in three different ways the same thing. A record number of job openings, there are more job openings than people looking for jobs. The consumer confidence as it relates to the job market, which has sharply moved upward. And the NFIB Small Business Jobs Report, saying the percentage of firms with one or more jobs open that are unable to fill the job, seasonally-adjusted, because of course the seasons do matter for a lot of companies, is at its highest level in decades. Actually, for that chart, ever.

And so this is one way of... Well, three ways of showing the same thing that all of us see when we simply drive around our neighborhoods and our favorite business districts, we see hiring signs all over the place, and that's because there are a lot of job openings, and companies, as it turns out, after a certain amount of time, if they want to continue to grow at the pace that they have been growing, they're going to have to hire more people.

There isn't a chart that I have here that shows the other side of that, but that also is helping on the wage pressure side, the wage growth side, which for workers, of course, is fantastic news if they're getting paid more money to do similar jobs to what they would've been doing before the pandemic, that that wage growth allows them to of course, in an economic sense, have more free cash flow to buy more things. And so that is good news on the job market side if you're someone looking for a job, and difficult news if you are a business trying to hire to facilitate continued growth here, growth that for many has been better than expected in 2021, despite Delta variants of COVID and COVID cases kind of roaring back in certain spots over the summer.

And so we'll ultimately see how that plays out over the next three and six months, whether those jobs get filled and workers come back, or if companies' growth stagnates as a result of just simply not having enough people. I mean, even this morning, I see stories about Southwest Airlines canceling flights, 1,000 flights, because they don't have the people to manage the flights, the pilots, the attendants, the ground workers that they need, and so of course if you don't have people to run the plane, you're not going to fly the plane.

And so from that picture standpoint, the economic picture looks good, we will see what happens in the job markets, we will see what happens with the Federal Reserve starting to taper their bond-buying and how that might affect the markets, and it still remains to be seen exactly what's going to happen with the infrastructure bill and the spending bill that the elected officials in Congress continue to negotiate, but have yet finalized a deal and have yet to pass, and is yet for the president to sign, and so we will see what type of reaction the markets get if ultimately that ends up getting done, which one would expect it to be a positive development for the stock market, but of course, it hasn't happened yet, so we don't know exactly how that will play out.

One thing that I will add as I sort of wrap up the recap here is for many of the client portfolios, it's pretty intuitive that this excellent run in the stock market has led to our portfolios for the most part being slightly overweight in stocks, and so if we haven't rebalanced already, it's likely that rebalancing is on the way. As a reminder, we always set a risk level when we first start working with clients as to what we want to maintain, so something that would be typical would be 60% stocks and 40% bonds, and if that 60% target for the actual portfolio starts to creep up to 63%, 64%, 65% stocks, as a risk control strategy, we will want to trim some of those stocks so we get back down to our target level of 60%, and we use the proceeds that we get when we sell some of those stock funds to turn right around and buy some of the safer things like bonds, various types of bonds, and that effectively does two things.

It, like I said, limits the risk in the portfolio, because if you never did that, over time the portfolio would become 70% stock, 80% stock, 90% stock, because over the long run, stocks tend to do better than bonds, so it's a risk control measure, but also it's a measure to lock in some of the profits that we have made on the stock side of the portfolio, which for those who are concerned that the stock market's level of growth is unsustainable, or a downturn, even if temporary, may be coming, then that rebalancing should be something that gives you comfort, because we're taking some of the stocks off the table by trimming some of those profits, so that's something that...

We're at the point where most client portfolios, if they haven't had it done this year already, will likely have it coming up here soon. We try to do that, of course, in the most tax-efficient way that we can. But that's something that we'll continue to monitor, and for those that need it, take action and have conversations about how to do that in the smartest way.

And then beyond that, as one, two additional reminders that we mentioned in the quarterly letter, is if you haven't taken your required distribution yet for 2021, we will be in contact soon about deciding what you'd like to do with that and getting that done before the year is over, because as a reminder, the penalty for not taking that by December 31st is very substantial, 50% of whatever dollar amount you were supposed to take out, so if you were supposed to take out $10,000 and you don't, that would be a $5,000 penalty, and that is a pretty steep cost, so we obviously want to avoid that.

And then also, this is the time of the year where for the clients that it makes sense, we take a deep dive to see if we recommend any conversions of money from an IRA to a Roth IRA, and if you're someone who fits for that, we will be reaching out and doing the analysis to determine whether that's an appropriate strategy for you not, and how much we recommend doing if it is, and then we can talk through that. So with that, that will be the end of the third quarter market recap, I'm Steve Elwell for Level Financial Advisors, and we'll talk to you next quarter.