CONWAY• JARVIS LLC
Investment Outlook

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Time For Investors To Adjust Their Market Expectations?

We saw a change in the tone of the market emerge in recent months. Despite seeing a number of new records for the major indexes this summer, the third quarter closed very quietly for stocks with returns that can only be described as "flat". Thus ends a string of impressive quarterly returns, tracing back to Q2 of last year, that reflected the vigorous recovery of the economy. While that recovery continues, there are some challenges of which investors should take note. Some of these hurdles are predictable and inevitable with any expansion. Others are not so easily explained and could put a wrinkle in what has been a stable, upward trajectory for the economy and the stock market this year.

The Fed's Response to Inflation

Given the severity of the pandemic and the disruption imparted on day-to-day life and commerce, deflation was our biggest worry in 2020. In 2021, it should come as no surprise that it's now inflation. The Fed responded admirably to the pandemic with all the tools at its disposal. The goal was to avert a deflationary collapse of the Global Economy. Mission accomplished. The byproduct of that effort are the inevitable inflationary pressures that we're seeing today. Thankfully, that's more easily cured than the pandemic-related threat posed by the lockdown of the economy. But, is it in this case? Unfortunately, in this instance the traditional cure, credit tightening, may not resolve the challenges overhanging this recovery.

While a surge in pent-up demand for goods and services could have been predicted after the reopening, the pervasive disruption of the global supply chain was not anticipated. A surge of inflation due to *continuing* supply constraints is an anomaly and the solution to that problem sits outside the traditional scope of the Fed's mission. Chairman Powell has been clear and direct in shaping expectations regarding the strategy employed by the Board in steering the recovery. Little mystery surrounds future monetary policy. The intent to reduce bond purchases (QE) has been advertised in advance and is very likely to begin early next month. Normalizing (raising) key interest rates would naturally follow, but is unlikely until late next year or beyond. Powell has made it clear this is not the time to dampen demand by raising rates precipitously. That will do nothing to alleviate supply constraints and could threaten a slowing of the economy and a return of stagflation.

We view the inflation some experts fear as a temporary surge and a sign that the economy can be taken off life support. We view the Fed as responding appropriately while awaiting the enactment of the next chapter of fiscal policy that will hopefully complement the planned reduction of monetary support. From our perspective as longer-term investors, the Board has been prudent and measured in crafting monetary policy during a period fraught with fiscal policy volatility and pandemic-driven event risk. We view speculation regarding Powell's reappointment as unwarranted and self-serving to journalists and politicos who traffic such clickbait. That, and the uncertainty over the enactment of fiscal policy is reason enough for investors to hit the Pause button on the stock market until we begin to see the outcome of the upcoming earnings season. It's expected that we may see some good results from the recent quarter but future guidance will likely reflect the uncertainty of what's been discussed here.

Other Reasons to Adjust Expectations

The Employment Conundrum: 11 million job openings, 8 million unemployed. Why the mismatch and how to resolve it? The most recent data showed a *decline* of the unemployment rate to 4.8%. That would normally be greeted as good news by investors. However, when taken in the context of the current mismatch, it points to thousands of workers leaving the labor force. That has yet to be sufficiently explained. Many investors see this as a possible detour for the recovery and have become wary.

Fiscal Policy Uncertainty: Nothing unusual here, just the normal state of affairs while the Centrist/Extremist divide continues on both sides of the aisle in Washington. We're optimistic that we'll eventually have an outcome somewhere in between the respective positions staked out earlier in the year. Those make headlines and sell advertising but rarely make it to the finish line in their original form. While traders will no doubt transact on the noise, it's too soon for most investors to predict the final iteration of some wide-ranging US tax proposals and their effect on the markets. A good example is the 15% Global Minimum Corporate tax announced last week. It was the product of a negotiated compromise between what were initially extreme positions. The end-product didn't move the needle for the markets. We're anticipating a similar compromise for the domestic tax proposals currently in play.

The Uncertainty of Adapting to COVID: The challenge posed by the virus itself is compounded by the varied policy responses and uneven enforcement of mandates. Combined, they are almost certain to distort the Recovery going forward. It's generally believed that Delta is the first of what is likely to be a series of mutations that could detour or delay a return to normalcy for the economy.

While we acknowledge that these uncertainties might alter market expectations in the present environment, we're not reducing exposure to equities. This is not the stuff of bear markets. We could see a moderate drawdown in the indexes morph into a mid-cycle correction if we don't attain some level of certainty that restores investor confidence. The economy is still grinding through its expansion. The earnings season that kicks off this week will shed some light on its trajectory. The fourth quarter should provide substantial clarity regarding investor expectations for next year and beyond. We can't wait.

Update on our list of Risks to Recovery and Economic Expansion

COVID-19: Surge of Delta Variant has disrupted the reopening but has peaked according to sources. Remains **Benign**

The Fed: Inflation narrative ramps up pressure from some for a dramatic response from the Board. They're holding fast to their stated strategy. Possible replacement of Powell poses a risk increase to **Moderate**

Trade War: Global Minimum Tax points to cooperation with Developed economies. China's economy weakens on central policy missteps. Remains **Benign**

Global Economy: US still leads the post-COVID recovery. Canada, Europe, though behind, are keeping pace with their central banks in sync. Emerging Markets trail while playing catchup with their vaccination rates and a slowing China. Risk remains **Moderate**

Policy Formation: Monetary policy clearly stated and on track. Still awaiting final budget and fiscal policy enactment. Centrists/Extremists Divide persists. Risk remains **Moderate**

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