

FROM THE DESK OF DARRELL L. CRONK

State of the Markets

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Risks to fade, follow, or fear

“Successful investing is about managing risk, not avoiding it.” – Benjamin Graham.

Over the past few weeks, numerous investors have asked us about various market risks and the possibility of a near-term correction — a fair question given that the S&P 500 Index bottomed on March 23, 2020, at a closing price of 2,237 and has essentially doubled since. In fact, based upon index closing levels, we have to go back to last October to find the most recent 5% correction. This is statistically unusual — going back to 1928, each calendar year has generated three to four such corrections.

It is often said that bull markets climb a wall of worry, and today, there are many bricks stacked in that wall. So here for your consideration is our Top 10 list and our assessment of which risks to fade, follow closely, or fear.

1. **Inflation:** It has to be first on the list. There is little question that the target for “transitory” is being elongated at least into next year. Underlying rates of core inflation remain near multi-decade highs — supply bottlenecks have boosted goods pricing, while the rapid normalization of the services sector has lifted prices from depressed levels. Going forward, inflation surprises and central bank policy are likely to be more important for the trajectory of interest rates and equity valuations than growth surprises. **Follow.**

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2. **Delta Variant:** This one's complicated. From a health perspective, the Delta variant has spread fast and is a quickly growing concern. However, at least at this time, we believe the economic consequences are likely to be contained given progress on vaccinations across major economies. The lesson from other countries where the Delta variant spiked —India and the UK, for example —is that the wave decline was as quick and steep as its surge. Additionally we see little appetite by governments, especially in countries where vaccination rates are well advanced, to reverse previous lockdown restrictions at this point. **Fade economically, but follow from a health standpoint.**
3. **Debt ceiling:** Once again, we are dancing on the debt ceiling as we have reached the \$28.5 trillion cap. The U.S. Treasury is invoking extraordinary measures this month, buying Congress another two to three months to address the debt ceiling cap. It has been 10 years ago this month since the debt ceiling standoff in 2011 triggered a downgrade of the U.S. credit rating. We do not see that happening again. Because a debt ceiling resolution was not attached to the fiscal year 2022 budget — which would have been the easy button —this unfolding drama may create white-knuckle policy moments in September. **Follow trending toward Fear.**
4. **Everything peaking:** There have been lots of headlines about peak gross domestic product (GDP) growth, peak earnings growth, peak margins, peak fiscal spending, and peak liquidity. Three important points here. One is that even though we may be putting in high-water marks, we believe many of these will remain at multi-decade high levels for some time to come. Second point — all of this is already known and priced in by the market. This is not new news. Third, the historic collapse in inventories is unprecedented outside of a recession and in our view will serve to elongate the early-cycle recovery and fuel a bigger boost to growth than most expect. All is well that grows well. **Fade.**
5. **Fed tapering:** Risks of an early taper of Federal Reserve (Fed) bond buying have risen given July's strong payroll report, a new record-high services ISM report, and increasingly hawkish speak from two Fed governors. Let's be clear, with the U.S. experiencing the fastest nominal GDP growth since the 1950s and what looks to be the best ever S&P 500 earnings beats on record, we agree that it is time to begin removing emergency monetary policy. The taper itself is less consequential — given universal acceptance that it will happen — but the timing creates a repricing of the path of the federal funds rate that does matter to markets. The FOMC (Federal Open Market Committee) has been clear that it will be transparent on the timing and give markets plenty of advanced notice. **Follow.**
6. **Tax increases:** The Biden administration has proposed the largest and most sweeping tax-increase proposal since 1968. Markets believe, and we concur, that tax increases are coming. The only question is how much and exactly where. The proposed stimulus already in flight will require the U.S. Senate to use the budget reconciliation process. Our base case is that top-tier individual income tax rates revert back to pre-2017 levels, corporate income taxes get reset to 25% or 26% (from a 21% effective level), and capital gains rates land in the upper 20% range after intense negotiations. Anything higher than these levels would be market negative, in our view. **Fear.**
7. **Equity valuation and rotation:** It is fair to say that valuations are not cheap, but multiples actually retreated as earnings growth outpaced price appreciation over the past several quarters. Most Wall Street analysts have been too slow to adjust their earnings numbers higher and are finally catching up to where we have been for some time on forward-looking estimates. Beyond the new all-time highs in most equity indexes being set almost daily, the real story of 2021 has been the intense style rotation beneath the surface. The shift toward cyclicals, then to growth, and then to bond proxies and back again has left many managers scrambling to keep up. We believe positioning should remain tilted toward

cyclicals as early-cycle dynamics continue to reign supreme into the back half of 2021. Our guidance: Remain overweight risk assets in this environment. **Fade.**

8. **China slowdown and crackdown:** China's credit slowdown was a big drag on second-quarter growth, but it looks to be dissipating. It was one of the big reasons for Emerging Market Equities' underperformance during the middle of this year, and a regulatory crackdown only exasperated this even more. Little spillover into global markets kept this impact localized to China equity, debt, and currency markets. Following a sizable correction in prices and investors demanding a higher risk premium to hold these securities, the risk/reward ratio looks to be turning more positive from here. Perhaps more important to watch on this front for capital markets is a recent geopolitical turn by China toward a more aggressive stance on Hong Kong, Taiwan, and the U.S. **Follow.**
9. **Complacency:** This is always a concern, but difficult to effectively measure and time. Complacency can cut both ways —too complacent on emerging risks but also too sanguine on future outlooks. In our view, the latter seems more concerning. For example, it is true that direct fiscal support is set to fade next year, but capital markets may be underestimating the magnitude and persistence of the demand shock created by back-to-back years of extraordinary liquidity and stimulus. For now, we remain comfortably numb, with our fingers tightly on the pulse of the rapid pace of recovery and on the lookout for any sustainable signs of a change. **Follow.**
10. **Commodity exposure:** Commodities have been one of the best performing risk assets of this year, besting equities by decent margins. Yet, investors largely remain underexposed following a decade-long bear market. The upcycle that began late last year has structural momentum supported by post-pandemic supply/demand imbalances, inflation-hedging tailwinds, and energy transition policies reducing fossil energy capacity faster than demand can convert over to renewables. Investors should sit up and take notice. We think this broader trend has miles yet to travel. **Follow.**

In a nutshell, we are optimistic about the second half of 2021 and 2022. However, we need to be clear-eyed about the risks that exist — and especially how material they are, or may become, for capital markets. Wise investors realize that investment risk often hides where it is least likely to be found. While these risks are in a constant state of flux and change, we trust this piece will help you better assess which bricks in the wall of worry may fade, which have the potential to create fear, and which we're following closely for more clues. Invest well.

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