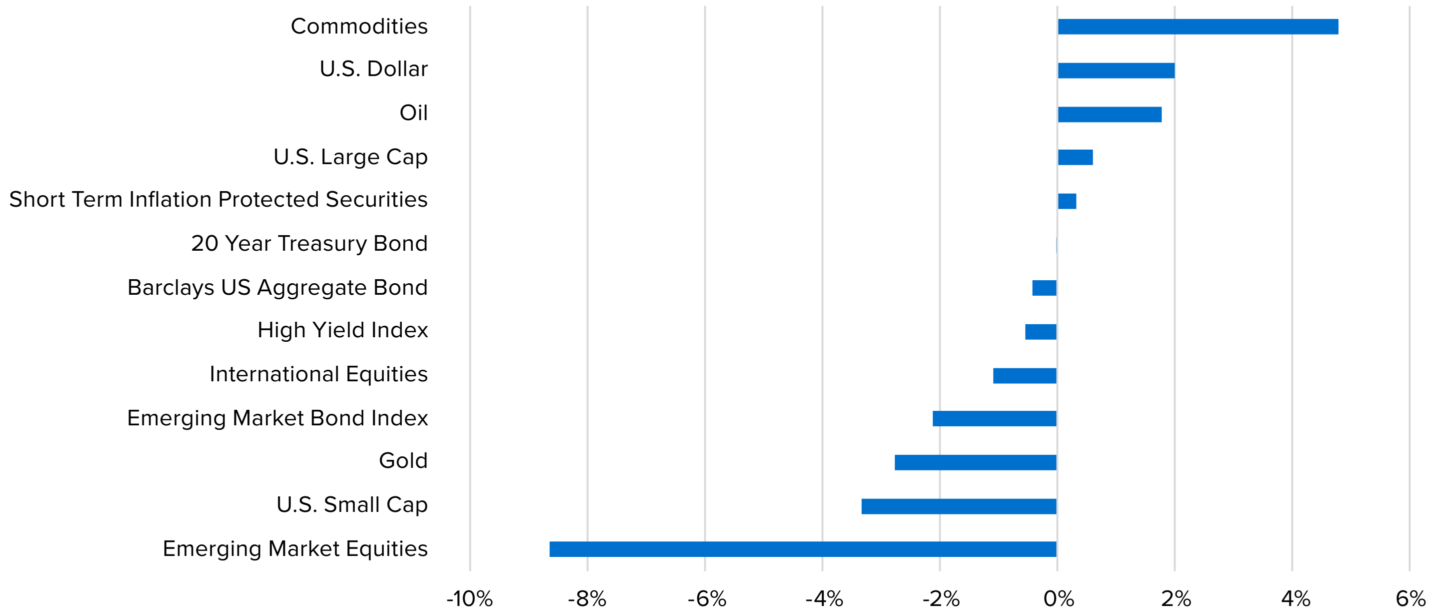
GLOBAL COMMENTARY
THIRD QUARTER 2021

ANCHOR CAPITAL ADVISORS LLC

Overview

Many asset classes pulled back in September reflecting a pause after the massive run since last November.[1] In the U.S., only large cap growth and the S&P 500 was positive for the quarter while all other indices were down.[2] Outside the U.S., Europe and the Emerging Markets were negative.[3] That was primarily driven by China being down, reflecting the slower growth and regulatory reforms being implemented.[4] Fixed income ended down for the quarter as interest rates rose after the Fed meeting.[5] Commodities were a mixed bag with aluminum climbing and lumber falling.[6] Overall, most economies are seeing an economic recovery post COVID-19.

Third Quarter 2021 Returns

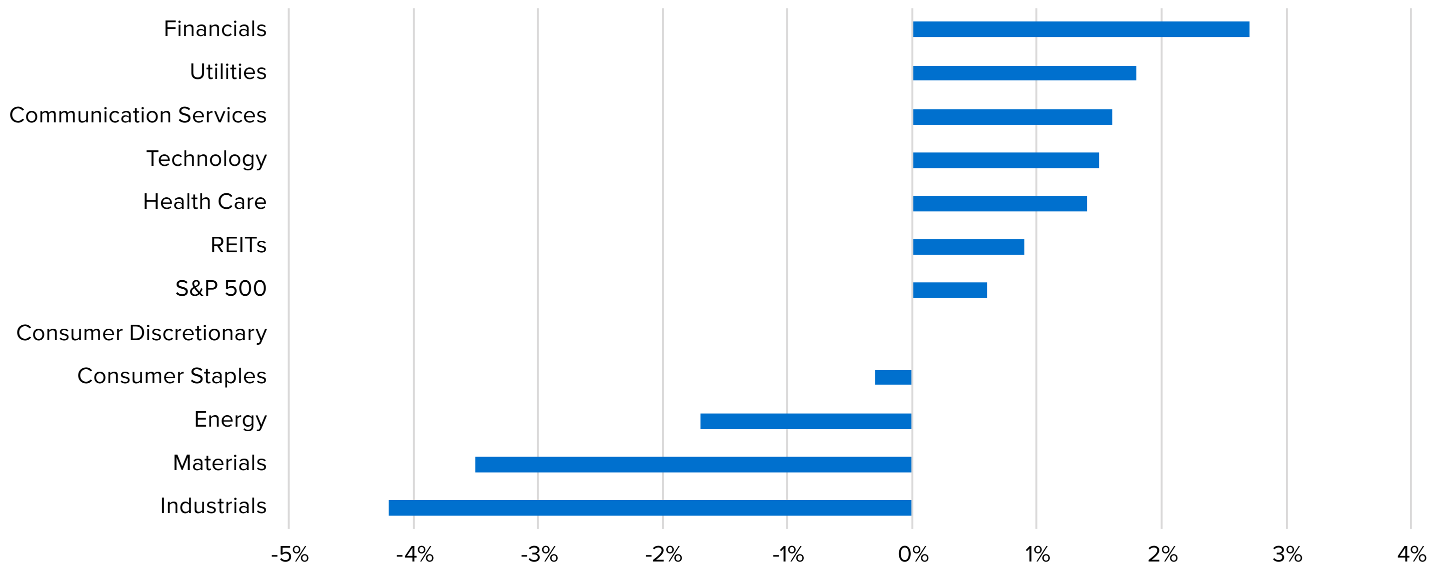


Source: FactSet financial data and analytics

U.S. Equity Markets

The U.S. equity markets continue to lead the way with the S&P 500 +0.6% for the quarter. Mid cap stocks were down 1.3%[7] and small cap stocks were down -3.3%.[8] We also saw growth outperforming value in the large cap space, which reversed late in the quarter.[9] Small cap and value stocks were strong in the beginning of the year but fell slightly behind, resulting in technology and communication services sectors outperforming while materials and industrials lagged.[10]

Third Quarter 2021 S&P 500 GICS Sector Returns



Source: FactSet financial data and analytics

Governments around the world continue to provide liquidity and there is the potential for additional spending. A significant and obvious example is if, and to what extent, the Biden infrastructure, healthcare, education and climate bills are passed. This could provide up to $4 trillion of additional money to be spent on various projects. On an individual level, households seem to be redeploying cash back into the markets as we have seen records inflows into U.S. equities during the year.[11]

Investors have struggled with various factors, including the rise in infections and hospitalizations from the COVID-19 Delta variant. Concern exists that the rise in COVID-19 cases may slow economic growth or cause another economic shutdown. In addition, many businesses are facing higher than expected costs and constrained inventory along with higher than expected demand. Companies with pricing power pass along price increases to offset inflationary fears. We expect that some companies without pricing power will experience margin pressure as we move into year-end.

By some measures, market valuations are higher than historical averages. The next 12-month price-to-earnings ratio is at 21x, which is higher than the 16x we have seen historically.[12] Some believe the current low interest rate environment is contributing to higher than normal valuations. As others point to the economic recovery and earnings growth as the valuation driver. During a typical recovery, there is multiple compressions caused by accelerated earnings growth. We expect to see this same pattern as the recovery continues to take hold.

Fixed Income, Interest Rates, and the Fed

The U.S. fixed income markets have been relatively quiet over the quarter. The 10-year Treasury bond yield started the quarter at 1.45% and ended at 1.5%, with some gyrations in between.[13] In addition, the credit spreads for most corporate and high yield bonds remain tight. As a result, there is very little opportunity in fixed income right now. The benchmarks were down slightly due to interest rates rising at quarter end. At the September Federal Reserve meeting, the Fed, which is trying to balance inflation levels and employment, said that it expects to pare back the $120 billion per month bond buying program (quantitative easing), most likely towards year-end.[14] The Fed also said it expects that it will start raising interest rates towards the end of 2022.[15] Economists are expecting one rate increase in September or October 2022.[16] Due to this announcement, rates on the shorter end have moved a bit higher. With the economy continuing to improve, and more color from the Fed, the 10-year Treasury Yield should increase, putting pressure on bond performance.

Europe

Europe is seeing many of the same reopening trends as the U.S. with economic activity improving across the continent. The S&P Global has revised its GDP forecast for the European Union from 4.4% to 5.1% for 2021.[17] Europe has been more successful in managing COVID-19, with 65% of the population vaccinated.[18] In addition, the government has continued with its accommodative monetary policy between bond buying at low interest rates.[19] The European Union Commission (ECB) is not expecting to change that stance before 2023.[20] Parts of the economy are being constrained by the supply chain and low inventories, which is also translating into slightly higher inflation.[21] Most economic indicators are showing improvement and returning to 2019 levels.[22]

China

China continues to report a strong economy, but is facing a number of pressures that can affect growth. Over the summer, China's President Xi instituted a regulatory crackdown on a number of industries in an effort to reduce inequality, redistribute wealth, and reduce the country's total debt levels.[23] The regulatory crackdown affected internet platforms, fintech, video games, off-campus tutoring, crypto miners, ride hailing, data privacy, food delivery, and e-cigarettes.[24] The debt crackdown in particular has affected the property market and investors are worried about the potential bond default of China's largest property developer, Evergrande, which has $300 billion of debt and is currently late on its interest payment.[25] China's property market and related industries are one fourth of China's GDP.[26] We have done a lot of work internally to understand the impact of the regulatory reforms and how that might affect U.S. investors.

Oil/Commodities

The commodity sector performance has been dispersed during the quarter. At the beginning of the year, all commodity costs were climbing higher due to the global growth, but we saw that pull back a bit. Oil prices ended the quarter at $75/barrel, but during the quarter prices dropped to as low as $62/barrel.[27] Other parts of the commodity sector, like aluminum and steel, continued to climb in price, while copper and steel pulled back.[28] We expect that materials and commodities will be in demand with the global growth.

Gold

Gold is thought of as a store of value and a safe haven asset. With the recovery well on its way, gold has pulled back this year, down 2.8% for the quarter and down 9.1% year-to-date.[29]

Bitcoin

Bitcoin and the other cryptocurrencies have been volatile. At one point, Bitcoin was over $60,000, but dropped to $33,000 by the end of June. By the end of September, the price increased over 25% to $43,000. The cryptocurrency and blockchain area is getting a lot of attention from big investors and governments. Some governments like China are blocking cryptocurrency activity, while others like Guatemala are embracing it as a national currency. Infrastructure and financial support seem to be available for execution, like with Coinbase, which went public this year. Additionally a number of firms are seeking approval for Bitcoin ETFs. The industry has become quite large and there are elements of blockchain that will help reduce friction and transaction costs. One example may include removing a lot of the foreign currency costs and roadblocks involved with moving money globally. It is an interesting space and it is moving from purely speculative to more mainstream.

Housing

Many people have asked if we are in a housing bubble as we have heard stories of houses being sold well above asking price. We are certainly in a period of demand exceeding supply, coupled with low interest rates. Over the last year, people moved out of cities to the suburbs, plus you had the Millennial generation finally buying their first homes. As a result, we are short approximately four million homes, especially starter homes.[30] In 1982, 40% of new home construction was considered starter homes, in 2019 only 7% of new construction is considered starter homes.[31] Many builders cite higher land prices and other input costs that are preventing them from building starter homes and causing them to focus on higher-end homes.[32] Many cities and towns are trying to zone or incorporate more affordable housing options.[33] Until the supply side catches up with demand, we will continue to see a crunch for housing.

Conclusion

We are seeing the markets in recovery mode and transitioning to more mid cycle. After the initial rebound, coupled with an upswing in inflationary pressures and interest rates, the markets are trying to sort through the winners and losers and determining who can manage the higher costs. This bodes well for more value parts of the market like financials, energy, and materials, but is more impactful for the technology and consumer discretionary sectors. Remaining diversified across regions and asset classes allows us to take advantage of the recovery and protect with non-correlated assets.

1. FactSet Data & Analytics, Charting
2. Ibid.
3. Ibid.
4. Ibid.
5. Ibid.
6. Ibid.
7. Ibid.
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9. Ibid.
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23. https://www.cnbc.com/2021/09/27/nomura-cuts-china-gdp-forecast-as-power-crunch-drags-down-growth.html
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26. Ibid.
27. FactSet Data & Analytics, Charting
28. Ibid.
29. Ibid.
30. https://www.npr.org/2021/09/04/1033585422/the-housing-shortage-is-significant-its-acute-for-small-entry-level-homes
31. Ibid.
32. Ibid.
33. Ibid.

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