Wellington Shields

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Quarterly Market Strategy Report

Welcome a Fourth Quarter Bump

The post-Covid recovery period has been a profitable time for investors. By the end of the third quarter of 2021, the S&P 500 was the best performing index with a gain of nearly 15% year-to-date, followed by the Russell 2000 with a gain of 14%, the Nasdaq Composite index was up 12% and the DJIA had a gain of 10.5%. But from the pandemic March 2020 low, the biggest winner was the Russell 2000 with a gain of 120% versus the S&P 500's gain of 92%. This means that equity performance has been broadly-based and small capitalization stocks have actively participated in the 20-month bull market. This is good news.

WEAKENING UNDERPINNINGS

At the risk of oversimplifying, we believe the 2020-2021 bull market has been supported by two important factors: 1.) a strong rebound in earnings growth and 2.) extremely easy monetary policy. But as we enter the last quarter of 2021 both of these bedrocks are less certain. Whereas consensus earnings forecasts for 2021 and for 2022 moved steadily higher for eighteen months, this began to change in mid-September. Consensus earnings forecasts are starting to edge lower and though estimates still reflect a positive earnings growth rate for 2021 and 2022, these growth rates are falling. This is noteworthy. Steadily rising earnings forecasts have provided a reliable incentive to buy stocks and good fundamental support in the event of any negative news shock. But today, with estimates drifting lower, downside support is less definable and reliable. This change is subtle, but it could result in less demand for stocks and could make speculators more cautious in the final quarter of the year. In short, the equity market could become more volatile in the final months of the year.

Inflation is a core problem for companies. In its third quarter earnings report PepsiCo (PEP - $155.74*) indicated that higher transportation and raw material costs will be passed on to consumers in the form of price hikes this year and again next year. Higher inflation hurts profit margins, particularly if companies cannot pass on these costs. And when companies do pass on higher costs to consumers it can hurt household consumption

SUMMARY

The equity market is overdue for a pullback, and this could provide an excellent opportunity for investors to adjust their portfolios for the longer term. Energy and financial stocks are best positioned to counter the negative impact of higher inflation in the fourth quarter.

Market indices have more than doubled since the March 2020 low without any intervening correction of 10% or more. This is well in excess of the average historical gain of 54% prior to a 10% correction.

Inflation is a core problem for companies, and it will be a significant challenge for the Fed.

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and lower GDP. Inflation is apt to make earnings growth less predictable in the quarters ahead.

Inflation is also a challenge for the Fed. With CPI and PPI rising well in excess of 5% for three months in a row, inflation can no longer be viewed as transitory. It is a problem. Therefore, the Fed could be forced to change its policy of extreme quantitative easing and low interest rates before the end of the year. The September employment report was weaker than the consensus expected, and this could ease some of the pressure on the Federal Open Market Committee, but all in all, the Fed is in a complex situation. Financial news headlines will continue to focus on monetary policy as a threat to investors, but history shows that monetary policy does not have a negative impact on stock prices until it raises interest rates three times in a row. That is unlikely to occur until 2023.

A GAME OF HOT POTATO

Despite the vote to raise the debt ceiling by $480 billion, the debt ceiling will remain a major financial topic in the weeks ahead. Do not forget that the US government has been shut down several times in the recent past due to a debt ceiling crisis, most notably in 1995 (one 5 day shutdown and one 21 day shutdown), in 2011 (when Treasury Secretary Timothy Geithner utilized "extraordinary measures" such as the sale of assets from the Civil Service Retirement and Disability Fund and the G Fund of the Thrift Savings Plan to acquire funds) and in 2013 (which stretched on for months and also included “extraordinary measures” to pay obligations). Typically, the first step in a government shutdown is the closure of national parks and the layoff of nonessential personnel to save cash flow for obligations such as social security payments and payments on debt. The Treasury has demonstrated a variety of creative ways to survive during a debt ceiling crisis and there has been unverified chatter of the Treasury minting a billion-dollar gold coin to raise capital if the debt ceiling is not raised in the months ahead. The debt ceiling debate can be a useful dialogue in terms of curbing fiscal spending, and it has been a political game of hot potato many times in the past. Nevertheless, while economists can list 23 times that the government has been shut down due to the debt ceiling, the US government has never defaulted on its debt. We do not believe it will any time soon.

CLIMBING A WALL OF WORRY

But if bull markets like to climb a wall of worry, there will be many international concerns to think about in the fourth quarter. China’s energy shortage and the OPEC+ group deciding not to increase the output of oil, has put pressure on energy prices and this lifted WTI crude oil as high as $79 a barrel recently. Higher crude prices will put even more pressure on global inflation. China’s twin energy and Evergrande property crises could trigger slower growth around the world. In the UK, a combination of the pandemic and the county’s departure from the European Union are

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resulting in a shortage of tanker drivers to transport fuel across the country. In Germany, a lack of clarity about the composition of the next government following Merkel's departure, is creating a predicament for the European Union. Without a clear government in Germany a range of decisions from economic policy to defense are being delayed in the EU. In the background, many countries in East Asia and the Pacific continue to face major setbacks in their recovery from the coronavirus. In short, there is no shortage of worries in the globe.

THE FOURTH QUARTER

Looking ahead to the last few months of the year we believe there are many areas of the market that will do well despite a rise in inflation and a shift in Fed policy. One of these is energy which is likely to have positive earnings growth in the fourth quarter given the rise in crude oil prices. The second is financial stocks. Banks in particular are insulated from the rise in inflation and will be beneficiaries of a rise in long-term interest rates. As inflation rises, PE multiples come under pressure and this explains why many technology stocks, where PE multiples are the highest, have come under pressure recently. However, to the extent that earnings growth will justify a high PE multiple, any sell-off in technology issues should be considered a buying opportunity. Overall, companies with below average PE multiples and above average dividend yields are always good holdings when markets become volatile.

The market indices have more than doubled since the March 2020 low without experiencing any intervening correction of 10% or more. This is well in excess of the average historical gain of 54% prior to a 10% correction. In other words, the equity market is overdue for a normal pullback, and investors should use this as a good opportunity to adjust portfolios for the longer term.

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