Investment Tally & Perspective

MAJOR ASSET CLASS RETURNS	3rd Qtr. 2021	1-Year	3-Year	5-Year
Equities				
S&P 500	0.6%	30.0%	16.0%	16.9%
MSCI EAFE	-0.4%	25.7%	7.6%	8.8%
MSCI Emerging Markets	-8.1%	18.2%	8.6%	9.2%
Fixed Income				
Barclays Capital US Aggregate	0.1%	-0.9%	5.4%	2.9%
Barclays Capital US Corp. Inv. Grade	0.0%	1.7%	7.5%	4.6%
Barclays Capital Emerging Market	-0.6%	3.3%	5.9%	4.1%
Other Assets				
MSCI US Reit Index	1.0%	37.2%	10.1%	6.8%
S&P GSCI	5.2%	58.3%	-1.5%	3.6%
ICE WTI Crude Oil	2.1%	86.5%	0.8%	9.2%
Comex Gold	-0.8%	-6.9%	13.7%	5.8%

Source: Capital IQ — All returns greater than one year are annualized

Market Activity - Despite a placid start to the quarter, equities and other risky assets experienced heightened volatility as the third quarter closed. The media's list of culprits includes partisan wrangling over the debt ceiling, intra-party fighting creating uncertainty for Democratic priorities, changes in Fed policy, supply chains and inflation denting near-term profits, and the ongoing collapse of Evergrande, an overleveraged Chinese property developer. Many of these issues are still impacting the market with volatility continuing into the fourth quarter.

Economic Activity– The U.S. economy grew at a slower pace compared to the brisk level witnessed in the second quarter. The Citigroup Economic Surprise Index (measures actual economic data against expectations) has turned decidedly negative, after being positive since the late spring of 2020. The Atlanta Fed's economic forecast model, GDPNow, predicts the economy is likely to register 2.3% growth in Q3, down from prior expectations of more than 6%.

The downdraft in expectations has been mainly driven by revisions in personal consumption expenditures (PCE) and fixed investment. After expecting more than 3% growth in PCE in July, Q3 now appears to have grown closer to 1.4%. The negative revisions to third quarter consumption are mainly attributed to the latest COVID-19 wave impeding the economic recovery. Meanwhile, goods consumption is falling back to trend levels after spending was targeted on these categories during the early stages of the pandemic. Supply chain issues have also dented demand, most notably in the automobile industry. For auto production, IHS estimates that supply chain issues have cost the industry 7 million vehicles during the first 9 months and underlying issues will not be resolved until the second quarter of 2023.

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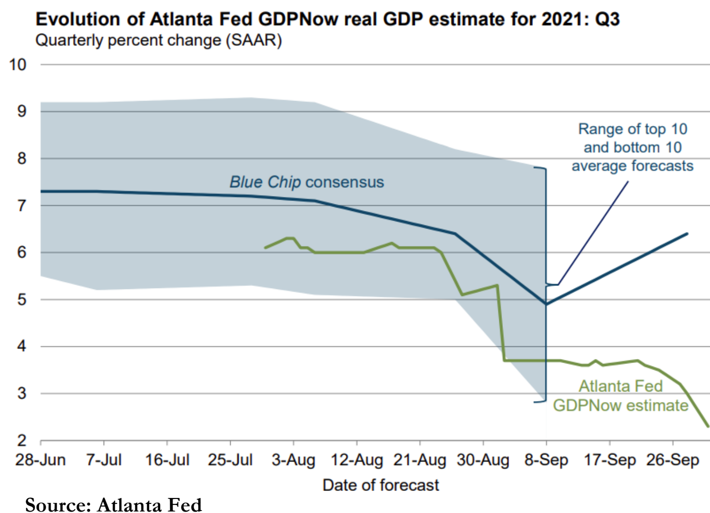


Source: Atlanta Fed

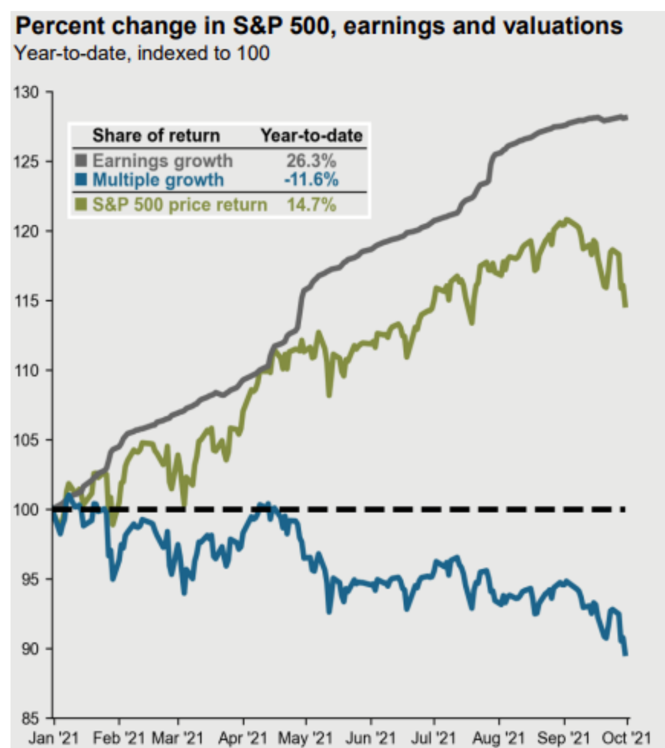
Lastly, supply bottlenecks are also delaying the much-needed inventory restocking, which is pushing growth into future quarters.

Globally, China has become a key area of focus. After being the only major economy to grow in 2020, the Chinese economy is slowing significantly (per Goldman Sachs, third quarter GDP was likely flat to the prior quarter). COVID restrictions weighed on this in August, while Evergrande and power availability have impacted growth recently. Whether this slowdown is temporary, or a key inflection point warrants close attention given China's high contribution to global growth and its impact as a major exporter.

Monetary Policy – The Federal Reserve announced that tapering their asset purchases will begin in November, or possibly December of this year. With bond purchases ending by the middle of next year, the probability of the Fed raising interest rates in 2022 has increased. Globally, central banks are making a hawkish shift, as announced rate hikes vastly outnumber rate cuts in 2021. While monetary policy is getting less accommodative (a lighter push on the gas pedal) it may be several years before policies become restrictive (hitting the brakes).

Valuation and Sentiment - The Price to Earnings (P/E) multiple is a widely used valuation rule of thumb. Though it has several variations, the P/E measures the price (P) of a security or index to the level of expected earnings (E) in the upcoming year. Estimated earnings, expected growth rates, and discount rates all impact what is the "correct" multiple to pay for an index or security. The S&P 500 P/E multiple today is approximately 19.6x (times) 2022 estimated earnings, a level well above historical norms. This level has been justified by comparing it to the paltry yield on bonds. However, as can be seen to the right, despite the price of the S&P 500 rising, the valuation multiple has actually come down due to the strength in earnings.

As we prepare for third quarter earnings releases, we estimate brisk earnings growth of 28% in Q3. As year-end approaches, the magnitude of future earnings growth is expected to moderate, with the extent of moderation largely determining whether stocks are fairly valued, under-valued, or overvalued.



Source: J.P. Morgan

Investment Outlook and Strategy

Economic Considerations - COVID and the economic shutdown wreaked havoc with supply chains and the lives of workers, resulting in inventory shortages across industries. Many employers desperately seek qualified workers while, at the same time, millions of unemployed are seeking jobs. This mismatch is due to people leaving the workforce supported by generous government benefits, and their need for child-care and adult care (aging Baby Boomers). The shortage of inventories and workers is pressuring prices higher, raising concerns that the result will be rates of inflation that exceed Fed expectations, forcing the Fed to tighten monetary policy sooner than expected (unlikely until end of 2022).

The D.C. budget and debt ceiling battles provide ample fodder for the daily media, yet the real impact on the economy from this political posturing is modest. These issues will ultimately be settled without our country defaulting on its obligations. More important are the cash-laden balance sheets of consumers and businesses, which are primed for spending, and which will result in corporate profits growing at above average rates.

With this as background, investors are well advised to view the recent 5% decline in the stock market from the proper perspective. From the market low in the Great Recession (2009) to today, stock prices multiplied with the S&P 500 Stock Index (SPX) rising over 650%. More recent returns for periods ending September 30, 2021, are as follows: Year to Date +15.92%; 1 Year +30.00%; 2 Years +49.70%.

What about interest and inflation rates rising? We would welcome higher interest rates, as would most retired individuals, endowment funds, pension plans, and the financial industry. Consider our current status compared to four decades ago. On October 2, 1981, interest rates peaked as the yield on the 10-Year U.S. Treasury bond reached 15.66%. In the prior year (1980) inflation peaked at 13.55% (Consumer Price Index). In contrast, we see inflation moving well above desired levels (2.0% to 2.5%) in the near term, yet double digit rates are unlikely in the next decade. We hold the same view for interest rates with expectations for the 10-Year U.S. Treasury bond yield, which has increased from 1.3% to over 1.5% recently, perhaps reaching 2.0% to 2.5% in the next year or two, and higher over the next decade. Main factors for taming inflation and interest rates are technological developments. Technology produces higher rates of productivity and cost efficiencies that offset inflationary pressures, as well as opening new areas of economic expansion. Also, the global glut of savings and capital that seeks rates of return serve as a huge reservoir of funds that will suppress rate increases.

Investment Implications and Strategy - During the 40-year decline in interest rates, assets such as stocks, bonds, and real estate benefited from valuation metrics which priced assets at higher levels. With interest rates near zero, if rates move higher then stock prices are expected to receive lower valuation multiples. The offset to lower multiples will come if rates rise with an expanding economy, and with corporate profits rising commensurately, resulting in higher equity valuations.

We view the recent decline as a normal and healthy pullback following months and years of rising stock prices. In addition, we anticipate stocks remaining the asset of choice with returns exceeding bonds and cash in the months ahead.

The Effects of the Pandemic and the Current Status of

Long Term Care Insurance (LTCI)

Since the pandemic began in 2020, interest in estate planning has risen as well as a greater interest in Long-Term Care Insurance (LTCI), according to insurance industry reports. LTCI is an insurance product that helps pay for the costs associated with long-term care, such as a chronic medical condition, disability, or a disorder such as Alzheimer's. This care is not covered by health insurance, including Medicare and Medicaid. The increased interest in LTCI since the pandemic began may be attributed to people seeing that the need may arise suddenly, and much earlier than anticipated.

During the pandemic, many people had the unfortunate experience of losing a loved one in a nursing home or other long-term care facility. While it is well known that LTCI covers individuals in nursing homes, it also covers home care expenses, something the industry is now stressing to applicants and policyholders. According to The Covid Tracking Project, 34% of Covid related deaths were individuals in these assisted care facilities. In addition to the number of deaths, many facilities were on lockdown for extended periods of time, forcing family members to go weeks or months without in-person contact, and many are now facing staffing shortages.

Before the pandemic began, the number of insurers offering LTCI had decreased significantly from 2004 to 2020. The reason being – wide mispricing errors by the insurance industry. The industry suffered great losses as the premiums charged and the investment income received was much less than the amount of claims paid.
Even now, with a renewed interest in LTCI, it is more difficult than ever to obtain LTCI as insurers are turning down more applications. Some carriers are now requiring in person medical exams, when a questionnaire and review of medical records were all that was previously required. Others are lengthening their pre-existing condition list and lowering the age limit for issuing policies. Some carriers may deny coverage if the state you live in has a high Covid-19 rate, or it may force the insureds coverage to be delayed.

The difficulty in receiving a LTCI policy has consequently increased the interest in hybrid policies that link LTCI to an annuity or life insurance. These have less stringent underwriting requirements, and they resolve the "use it or lose it" issue, as holders will receive a payout either through the death benefit, annuity income, or LTCI claim. The negative to these policies is that they typically require up-front payment of premiums, which can be expensive. Because of this, many opt to self-insure.

Please view Lincoln Capital as a resource if you have any questions about estate planning or LTCI, and, as always, please contact us if we may be of assistance in any financial manner.

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