Clarity for the Present ♦ Vision for the Future

Dear Valued Client:

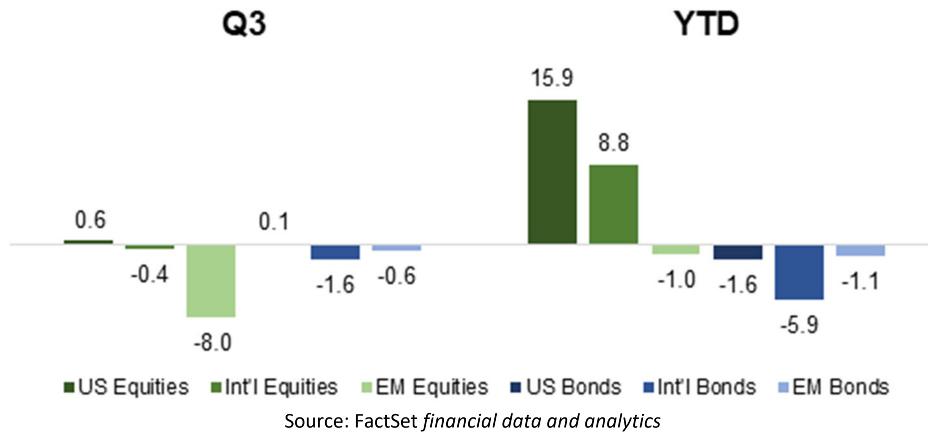
Fall is in the air here in New England and stocks have done what they historically have done more often than not this time of year- Fall! Well, put into context, a tough September was not enough to ruin what has so far been another positive year for most asset classes. The wall of worry is building daily highlighted by another debt ceiling battle in polarized Washington, inflation looking to be more than a bit temporary, and a Fed ready to tap the brakes. Add to that concerns about China's corporate governance and a troubled real estate market, oil spikes, tax hikes on the way, and supply chain issues and we have a wall that the American Ninja Warriors would find challenging.

Fortunately, there is some positive news out there as well. Covid cases from the Delta variant are falling as are deaths from the virus. The economy remains healthy, and spending has picked up dramatically. Corporate and household balance sheets are in solid shape with household savings having increased $2.5 Trillion (10% of GDP!) since last March. Josh Feuerman, Senior Global Strategist at JP Morgan, shared with us on a recent call that corporate cash as a percentage of current asset is at 35% and that this cash is expected to be deployed in part to fund stock buybacks and dividend payments that could be supportive of the markets in the coming months. Service sector and manufacturing sector readings are still in expansionary territory as the unemployment rate heads back to pre-pandemic levels.

Today's macroenvironment is quite different than the one we have been in for the last 4 decades. Inflation is meaningfully impacting us for the first time thanks to supply constraints and increased demand from fiscal and monetary stimulus. While this in fact may be temporary until supply chains catch up, there is certainly a palpable impact on consumer sentiment as seen in the most recent readings last month. As noted in our last letter, the cost of higher wages will be challenging to reverse. Coupled with higher taxes and slowing growth, the impact on corporate margins should be negative suggesting a reset of expectations already happening in estimates and the cooling stock market. Fortunately, employment is improving, and the economy continues to benefit from further reopening.

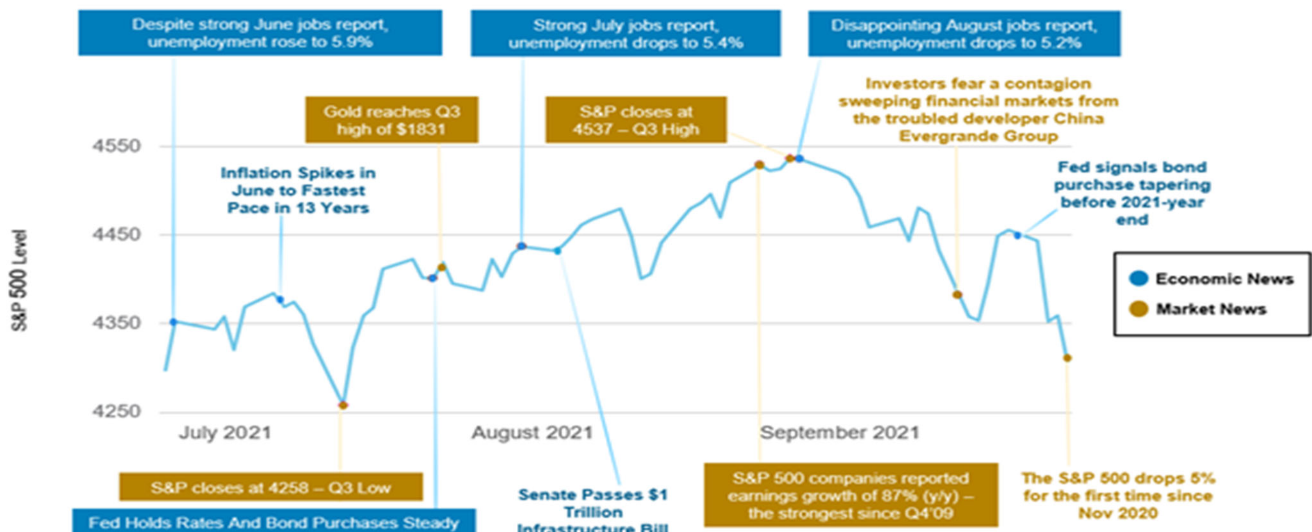
Like a box of chocolates, we do not know what we are going to get this coming quarter or beyond. The underlying gyrations jockeying for leadership between re-opening stocks and one time "growth" leaders has been dizzying the last 6 months. As such, we believe that staying well diversified is the best course of action currently.

Third Quarter Market Review



Source: FactSet *financial data and analytics*

- **US equities eked out a 0.6% gain for the third quarter driven by a select handful of large technology companies. Despite the pause, it maintains a strong lead of 15.9% for the year.** After setting new records in the summer, US equities finally took a breather and saw a correction of -5.0% for the first time since November 2020. The selloff was caused by fears of a contagion from potential default of Chinese real estate developer Evergrande, rising inflation pressures, uncertainties about the US government's debt ceiling and potential for government shutdown.



Source: FactSet, CNBC, Newsweek, NY Times, JPMorgan, IG.com, US News, Barron's

- **International markets once again trailed US equity markets for both the quarter and the year**. Emerging markets sold off sharply and fell 8.0% for the quarter and are now negative -1.0% for the year. The selloff was led by fears of regulatory crackdowns in China in the name of promoting "common prosperity" and the potential default of highly levered property developer Evergrande. Developed international equity markets, on the other hand, were mixed in Q3. For example, Japan outperformed the US, as it made rapid gains in its vaccination rate, while broad European markets performed in line with the US in their local currencies but had negative US dollar returns.

- **Within the US sector, performance was varied with results ranging from 2.7% for Financials to -4.2% for Industrials.** Industrials, Materials, and Energy, some of the most economically cyclical US sectors, underperformed as economic growth slowed and supply chain constraints continued to limit some production. Sectors with a mix of cyclical and secular growth tailwinds generally outperformed, including Information Technology, Financials, and Health Care sectors.
- **Concerns of the COVID Delta variant slowing economic growth caused economically sensitive value stocks to once again underperform growth stocks.** It also was the second straight quarter in which large caps outperformed small caps. Large growth outperformed small value by nearly 6.0% during the quarter. However, small value still maintains the lead for the year up 25.3%.

- **In US fixed income markets, 10-year Treasury rates declined early in the quarter, as concerns escalated over the Delta variant's potential economic impact. However, interest rates retraced earlier declines in the back half of the quarter as the Federal Reserve signaled it is ready to taper bond purchases.** US bonds were flat and gained 0.1% during the quarter but were unable to reverse the losses from prior quarter and remains negative (-1.6%) for the year. High-yield bonds gained 0.9% for the quarter and 4.5% for the year and continue to outpace government and corporate bonds.
- **Commodities surged 6.6% in the second quarter and remains up 29.1% for the year driven by inflation concerns and supply chain disruptions.** US REITs were flat for the quarter, but still maintain a healthy return of 21.6% for the year.

Outlook

The kick the can down the road game in Washington has set up a Game of Thrones like battle in December but temporarily cooled the immediate pressure on Congress. Until then, we will be focused on earnings, the historic driver of market returns, over time. According to NASDAQ, Q3 earnings for the S&P 500 Index are expected to show growth of 26% from the same period last year on 13.7% higher revenues. Rising cost pressures amid supply-chain disruptions and labor/material shortages are key factors that will influence forward guidance. Q3 estimate revisions trend remains positive but not as strong as we have seen, and Q2 GDP is already expected to be in just the 2% range.

On the campaign trail in 2016, Donald Trump famously invoked the name of China in his speeches to the point where tik tokers drew millions of views with their montages. Well, China is one of our hot spots to watch as they have cracked down on private companies, find themselves amid a bursting property bubble and hit to growth,

and they continue to saber rattle with Taiwan and allies (read: United States). China may have flat growth for the first time in years. China leaders will need to try and clean up the leverage in their economy and reevaluate the relationship between the almighty government and the private sector. The country has also adopted a zero-tolerance approach to COVID-19, resulting in a strict response function from policymakers for even a single case detected in some cities, further weighing on activity. Finally, nationwide energy shortages continue to bedevil the country and create an additional headwind to growth.

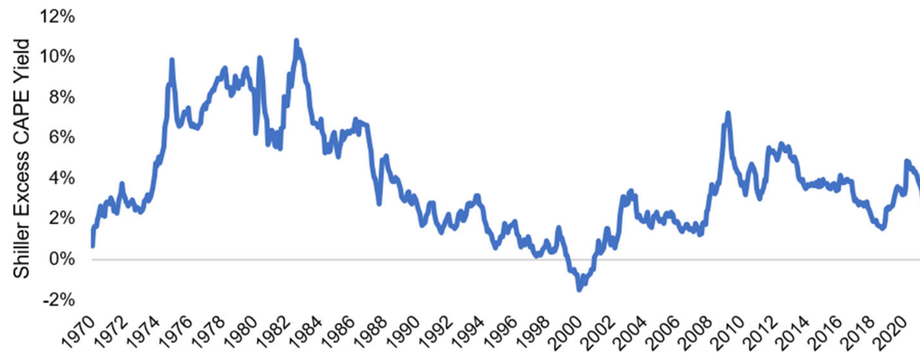
The US is facing decelerating growth, tax hikes, and less accommodative monetary policy on the way. Shortages of labor and materials are hindering growth and those factors are likely to remain well into the new year. China and the US combined make up roughly 31% of global GDP. The International Monetary Fund forecasts global growth will expand 6% this year and 4.9% in 2022 (IMF World Economic Outlook Update, July 2021). As such, as these countries go, so goes a big part of the growth equation.

Recent history has shown us that the world's governments and central banks have a propensity to act together to avert financial crises. They have gone "all-in". It is fair to question how this can continue as we borrow from the future. For now, we believe that the backstop powers will remain in place for the near future. We believe that the pause in economic growth and commensurate market pullback may have reset expectations lower and could set up for continued albeit moderated growth ahead.

The market will be eyeing corporate earnings near term and debt ceiling/infrastructure dealings post-earnings. The spike in energy prices and transport issues will continue to be a headwind for the economy. It seems likely that the $3.5 trillion bill advocated for by President Biden will be scaled down. A smaller package means a reduced amount of revenue (taxes) would be needed to offset proposed spending. The uncertainty surrounding the tax package does make planning more challenging.

Markets are trading at elevated valuations relative to history. Small value stocks currently look the most attractive from a valuation standpoint, but most equity asset classes still look attractive when looked at in relationship to fixed income. Davin Gibbins, CFA, CAIA®, Deputy Chief Investment Officer at AssetMark, Inc., noted the following in his recent commentary, focused on "how concerns loom about the absolute valuation of some portions of the equity market, such as growth/technology stocks, and how this might affect broad market indices.

He notes "Take the S&P 500, for example. The chart below shows that, while nowhere near its historic buying opportunity lows of the early 1980s, when compared to bonds, large cap stocks may still have some gas in the tank. That is, the earnings yield on the S&P 500 (as defined by Robert Shiller's Cyclically Adjusted Price-to-Earnings yield) is still attractive relative to that of the U.S. Ten Year Treasury. Indeed, today's 3.2% differential compares quite favorably to its 2007 peak of 1.2% and remarkable -1.5% in March 2000!



Shiller Excess CAPE Yield
Source: Robert Shiller, "Irrational Exuberance"

In addition, the global equity landscape is not just U.S. large cap growth and technology stocks, which should tend to do well in the middle part of the cycle. Many pockets have lagged this year and, in some instances, for many years. Cyclical stocks such as financials and industrials, would stand to benefit in the latter stages of the economic cycle should a "soft landing" scenario materialize. Not to forget that outside of the US, many indices and regions, such as developed international markets, are more cyclical in nature and on their own recovery roads which are still in their early stages."

Gibbin's comments point to the relative attractiveness of equities versus bonds without necessarily suggesting that we can time markets or avoid downturns that come along the way during an investment horizon. We anticipate continued volatility for the remainder of the year keeping the markets in a compressed range. We have positioned portfolios fairly equally between growth and value styles without major favoritism to large or small company stocks. Recently, we have begun to introduce structured notes[1] to you as we look for alternative exposures to hedge risk or provide yield in a yield starved environment. We will be discussing these notes and other thoughts during our calls with you this quarter.

Our headwinds/tailwinds summary is below.

Headwinds

- Inflation in a decelerating economy
- Supply chain issues hampering economic growth
- Equity and Fixed Income valuations are high on an historical basis
- Elevated corporate and government debt levels offset in part by healthier consumer balance sheets.
- Government stimulus sill on the way but winding down.
- Covid still lingering and disrupting.
- Higher tax rates expected in coming year(s)

Tailwinds

- More fiscal support on the way at some point
- Corporate buybacks likely to be supportive
- Accommodative monetary policy
- Healthy consumer and corporate balance sheets
- Vaccines are working and enabling the economy to reopen

PRW News

We are thrilled to announce that after serving as a Trustee for 16 years, Rick Renwick has been appointed an Emeriti Trustee at Babson college.

Bill Payne spoke at a national conference this quarter attended by 200 wealth management firms held in Dallas, TX on the subject: "Working Collaboratively to Serve Your Clients Well".

PRW's own Director of Advanced Planning Ted Dziuba was recently named the 2021 Most Valuable Player of the Boston Men's Senior Baseball League (MSBL). Ted set a new league record with 44 Runs Batted In across a 21-game campaign that also saw him lead the league in Batting Average and Home Runs.
https://www.bostonmabl.com/accolades/awards/msbl/2021/?fbclid=IwAR3ffHa0M2vXnpkymROCC3t3_WIH0aNdaZKaMSn8we39VxaZiL2ZdgdyRas

Elliot Herman is quoted in the Reuters article: **Global ETFs draw record inflows in first half of 2021** by Gaurav Dogra, Patturaja Murugaboopathy
Global ETFs draw record inflows in first half of 2021 | Reuters

PRW's Estate and Wealth Management Counsel, Janice Forgays, who serves on the National Tax Committee of FINSECA, a financial services advocacy organization, has been following the Democrat's Reconciliation Bill closely. In light of the possible upcoming House Vote, she provides both content and context. Janice put together a great piece which was recently emailed. She will continue to keep you abreast of updates as they materialize. Please reach out with any questions!

We look forward to connecting with you in the coming weeks as we look at planning ideas for year-end. Thank you.

William A. Payne   Richard A. Renwick   Elliot B. Herman

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Footnote:
(1) With structured notes, protection of principal is subject to the creditworthiness of the issuer. Structured notes holders may lose up to 100% of their investment upon the bankruptcy of the issuer, even if the value of the reference asset is favorable. Creditworthiness of the issuer may change at any time during the term of the note. Generally, structured products are not listed on an exchange, do not trade, and are not liquid. The price is provided by the issuer, or an affiliate of the issuer. In addition, broker-dealers affiliated with the issuers often make a market in structured products, but may not be able to offer liquidity, or the price may be substantially less than the original payment. Investors should be willing and able to hold their structured product investment until maturity.
Structured products are complex products that involve investment and other substantial risks compared to traditional investments and may not be appropriate for all investors. Investors should consider the investment objectives, risks, charges and expenses of the structured product carefully before investing. The prospectus contain this and other important information about the product. Clients should read the prospectus carefully before investing.

Asset classes are represented by the following indexes:

US Equities	**S&P 500** – is an unmanaged index that is generally considered representative of the US equity market, consisting of 500 leading companies in leading industries of the US economy (typically large cap companies) representing approximately 75% of the investable US equity market.
International Equities	**MSCI EAFE** – is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of countries considered to represent developed markets, excluding the U.S. and Canada.
Emerging Markets Equities	**MSCI Emerging Markets** – is a free float-adjusted, market capitalization index that is designed to measure the equity market performance of countries considered to represent emerging markets.
US Bonds	**Barclays US Aggregate —** measures the market of USD-denominated, investment grade, fixed-rate taxable bond market of SEC-registered securities, including bonds from the Treasury, government-related, corporate, mortgage-backed securities (agency fixed-rate and hybrid ARM passthroughs), ABS and CMBS sectors. US Agency Hybrid Adjustable-Rate Mortgage (ARM) securities were added to the US Aggregate Index on April 1, 2007.
International Bonds	**Bloomberg Barclays Global Aggregate ex USD** - is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classification.
Emerging Markets Bonds	**Bloomberg Barclays Emerging Markets USD Aggregate** - is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classification.
Small Caps	**S&P 600 -** measures the performance of 600 small-sized companies in the U.S. Constituents generally have a market-cap between $400 million and $1.8 billion and meet criteria to ensure they are liquid and financially viable.
Energy	**S&P 500 Energy Sector** -measures the performance of companies in an array of diversified financial service firms, insurance, banks, capital markets, consumer finance and thrift companies.
Real Estate	**S&P 500 Sector Real Estate -** measures the performance of companies from the following industries: real estate management & development and REITS, excluding mortgage REITS.
Technology	**S&P 500 Technology Sector** - measures the performance of companies that product, generate, transmit or distribute electricity, water or natural gas, and also includes power producers & energy traders and companies that engage in generation and distribution of electricity using renewable sources.
Utilities	**S&P 500 Sector Utilities** - measures the performance of companies that product, generate, transmit or distribute electricity, water or natural gas, and also includes power producers & energy traders and companies that engage in generation and distribution of electricity using renewable sources.
EM Latin America	MSCI Emerging Markets Latin America - measures the performance of USD-denominated, investment-grade, fixed-rate taxable bond market of SEC-registered securities. The index includes Treasury bonds, Government-related Corporate, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS sectors.
China	**MSCI China -** measures the performance of small-cap equities in developed market countries around the world, excluding the U.S. and Canada. The index covers approximately 14% of the market cap in each country.
Long term Treasuries	**Bloomberg Barclays US Treasury Long** - measures the performance of US Treasury and US Agency markets. The index includes USD-denominated fixed-rate, nominal US Treasuries and US agency debentures (securities issued by the US government-owned or sponsored entities), and explicitly guaranteed by the US government.
High-Yield Bonds	**Bloomberg Barclays US Corporate High Yield** - measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.
Leveraged Loans	**S&P/LSTA Leveraged Loans** - measures the performance of investment-grade fixed-rate mortgage-backed pass-through securities of GNMA, FNMA and FHLMC.
Commodities	**Bloomberg Commodity. -** dynamically rebalances exposure to maintain a 10% volatility target and represents portfolios consisting of the S&P 500 index and a cash component accruing interest. Uses S&P 500 methodology and overlays algorithms to control the index risk at specific volatility targets.
Precious Metals	**Bloomberg Precious Metals -** measures the price of gold futures contracts, reflecting the return of underlying commodity futures price movements quoted in USD.
US REITs	**FTSE NAREIT All Equity REIT -** measures the price of physical commodities futures contracts traded on US exchanges, except aluminum, nickel and zinc, which trade on the London Metal Exchange. Weightings are determined by rules designed to insure diversified commodity exposure.

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