# ACCESS FINANCIAL SERVICES, INC.

## Quarterly Review and Outlook

**October 10, 2021**

**Third Quarter, 2021**

**Table 1: Benchmark Returns as of September 30, 2021**

| INDEX | 3 Mo. | 6 Mo. | 12 Mo. |
|---|---|---|---|
| ***US STOCKS*** | | | |
| S&P 500 Index (large-cap stocks) | 0.58 | 9.18 | 30.00 |
| Dow Jones Select Dividend Index | (0.77) | 2.53 | 46.15 |
| Russell 2000 Index (small-cap stocks) | (4.36) | (0.25) | 47.68 |
| ***FOREIGN STOCKS*** | | | |
| MSCI EAFE Net Total Return Index (US$) | (0.45) | 4.70 | 25.73 |
| S&P Europe 350 Index Net TR Index (US$) | (1.44) | 5.84 | 27.69 |
| MSCI Japan Net Total Return Index (US$) | 4.56 | 4.27 | 22.07 |
| MSCI Emerging Markets Net TR Index (US$) | (8.09) | (3.45) | 18.20 |
| ***COMMODITIES & CURRENCIES*** | | | |
| US Dollar | 1.94 | 1.07 | 0.37 |
| Euro | (2.34) | (1.28) | (1.20) |
| Gold | (0.74) | 2.88 | (6.83) |
| Oil (West Texas Intermediate) | 2.12 | 26.83 | 86.55 |
| MVIS CryptoCompare Bitcoin | 26.08 | (26.05) | 307.83 |
| ***BONDS*** | | | |
| BBgBarc US Aggregate Bond (inv. grade) | 0.05 | 1.88 | (0.90) |
| BBgBarc US Treasury 20+ Year | 0.10 | 7.31 | (10.66) |
| BBgBarc US Treas. Inflation Protected Secs. | 1.75 | 5.06 | 5.19 |
| BbgBarc Municipal Bond | (0.27) | 1.15 | 2.63 |
| BBgBarc US Corporate TR (corporate bonds) | (0.03) | 3.30 | 1.45 |
| BBgBarc US Corp. High Yield Bond | 0.89 | 3.65 | 11.28 |
| S&P International Sov Ex-US Bond US$ | (2.10) | (1.55) | (3.49) |

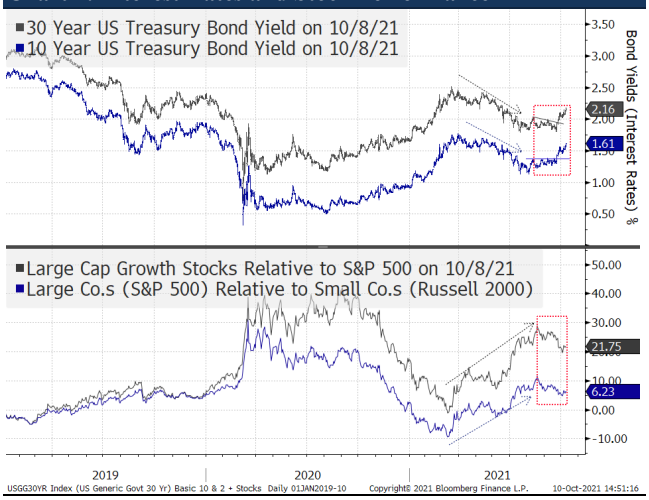
*BBgBarc: Bloomberg Barclays; Source: Bloomberg and Morningstar*

September 30 marked the last day of what was the weakest, but still positive, quarter for the S&P 500 Index over the last twelve months. The Index of US large company stocks rose 0.58% during the third quarter compared with 8.55% in 2Q, 6.17% in 1Q and 12.14% in 4Q 2020.

Will it be positive in four out of four quarters this year? That's happened five times in the last 10 years: 2013, 2014, 2016, 2017 and 2019. The third quarter has generally been the worst for stocks while the fourth has been the best. This year, a number of headwinds including challenging earnings comparisons, elevated valuations, political discord, inflation, rising interest rates, and instability in China could counteract that seasonality. Although the economic expansion is intact, such a backdrop is fueling fears of a mix of weaker growth and higher inflation to come, threatening to complicate emerging efforts by central banks to dial back stimulus without rattling financial markets.

While the first two months of the third quarter saw a continuation of the general market trends that prevailed in the second quarter – declining longer term interest rates and the outperformance of technology related large capitalization stocks – the tide turned in September as interest rates broke to the upside during the month (Chart 1).

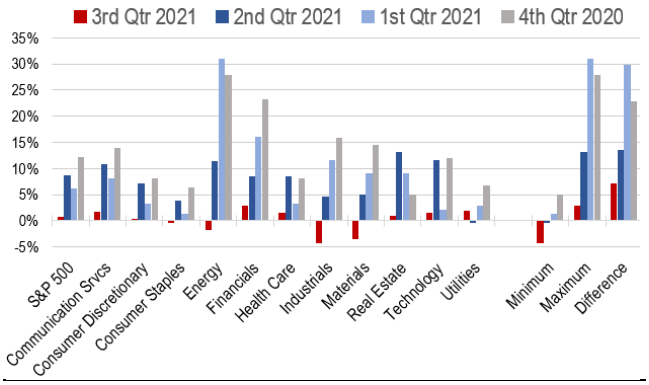
**Chart 1: Interest Rates and Stock Performance**




*Source: Access Financial Services using Bloomberg Software & Data*

The variation in sector returns within the US stock market narrowed again in the third quarter to a range of -4.22% (industrials) to +2.74% (financials) for a difference of 6.96% versus 13.50% in the second quarter and 29.69% in the first quarter (Chart 2).

**Chart 2: US Stock Market Returns by Sector**

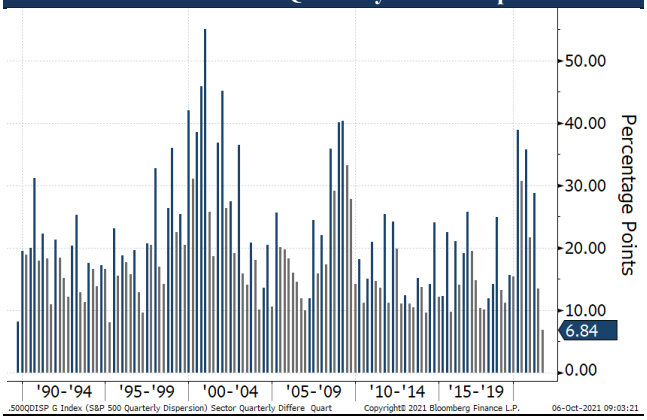



*Source: Access Financial Services using Bloomberg Data*

The gap of 6.96% between first and last place was the narrowest for any quarter since the sector indices were first calculated in 1989 (Chart 3). The prior record low was 8.14%, set in 1989's third quarter.

Stock market returns have generally drifted lower over the last four quarters as shown in Table 2 with September posting the first monthly loss (-4.65%) since last year's two month -6.32% return in August and September.

**Chart 3: US Stock Market Quarterly Sector Dispersion**




*Source: Access Financial Services using Bloomberg Software & Data*

**Table 2: S&P 500 Sector Returns**

| SECTORS | Sept. 2021 | 3rd Qtr 2021 | 2nd Qtr 2021 | 1st Qtr 2021 | 4th Qtr 2020 | Twelve Months |
|---|---|---|---|---|---|---|
| S&P 500 | -4.65% | 0.58% | 8.55% | 6.17% | 12.14% | 29.98% |
| Communication Srvcs | -6.58% | 1.60% | 10.72% | 8.08% | 13.82% | 38.39% |
| Consumer Discretionary | -2.56% | 0.01% | 6.95% | 3.11% | 8.04% | 19.15% |
| Consumer Staples | -4.14% | -0.31% | 3.83% | 1.15% | 6.35% | 11.34% |
| Energy | 9.37% | -1.72% | 11.29% | 30.84% | 27.76% | 82.83% |
| Financials | -1.85% | 2.74% | 8.36% | 15.90% | 23.19% | 58.97% |
| Health Care | -5.55% | 1.43% | 8.40% | 3.18% | 8.03% | 22.56% |
| Industrials | -6.15% | -4.22% | 4.48% | 11.41% | 15.67% | 28.95% |
| Materials | -7.21% | -3.51% | 4.97% | 9.08% | 14.47% | 26.48% |
| Real Estate | -6.23% | 0.88% | 13.09% | 9.02% | 4.94% | 30.52% |
| Technology | -5.78% | 1.34% | 11.56% | 1.97% | 11.81% | 28.90% |
| Utilities | -6.18% | 1.78% | -0.41% | 2.84% | 6.58% | 11.06% |
| | | | | | | |
| Minimum | -7.21% | -4.22% | -0.41% | 1.15% | 4.94% | 11.06% |
| Maximum | 9.37% | 2.74% | 13.09% | 30.84% | 27.76% | 82.83% |
| Difference | 16.58% | 6.96% | 13.50% | 29.69% | 22.82% | 71.77% |

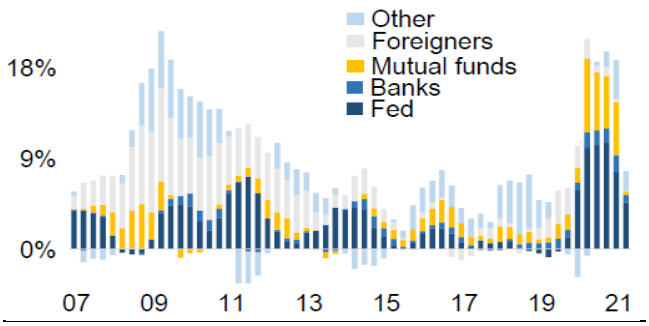
*Source: Access Financial Services using Bloomberg Data*

A disappointing earnings season compared with the last two could also keep a lid on stock prices into the end of the year. First quarter earnings for S&P 500 companies grew 15.8% from the previous quarter and 53.5% year-over-year. Second quarter earnings increased by 10.6% versus the first quarter and 102% year-over-year. Third quarter results, which are starting to roll in now, are expected to show a slowdown in growth with only a 1% increase sequentially and a 37.5% increase year-over-year.

Following the Federal Open Market Committee (FOMC) meeting on September 22, Fed chair Jay Powell confirmed the central bank will soon dial back its pandemic-era quantitative easing (QE) program[1]. The Fed plans to eliminate all bond purchases by this time next year.

This tapering of QE has important consequences for investors. As shown in Chart 4, QE has made up the vast majority of US Treasury security purchases since early 2020, making the central bank by far the largest owner of US Treasuries at almost 40% of all marketable debt outstanding. As tapering unfolds, bond prices should weaken unless US investors and foreign governments absorb the resulting excess supply.

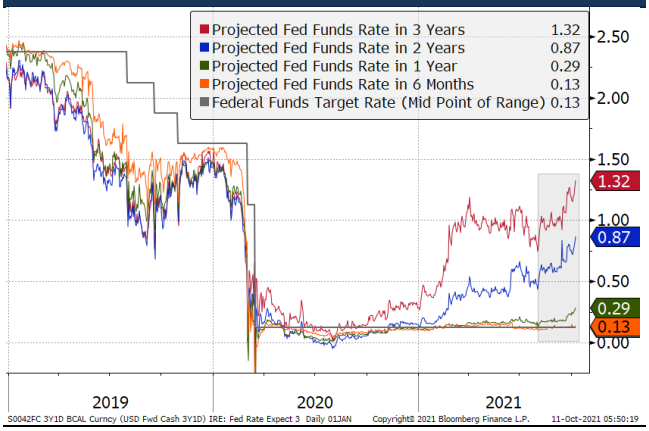
**Chart 4: Change in Public Debt Ownership (Year/Year)**




*Source: Numera Analytics*

While tapering will only begin later this year, bond yields (longer term interest rates) have been rising ahead of the policy shift. In addition, market implied probabilities of how fast the Fed will hike short term interest rates have increased despite the Fed explicitly mentioning that they will leave policy rates unchanged (Chart 5).

**Chart 5: Interest Rate Swap Market Implied Future Fed Funds Rate**




*Source: Access Financial Services using Bloomberg Software & Data*

Given the Fed's dual mandate of price stability and full employment, the future path of monetary policy depends on both inflation and employment, and the weight assigned by FOMC members to each factor.

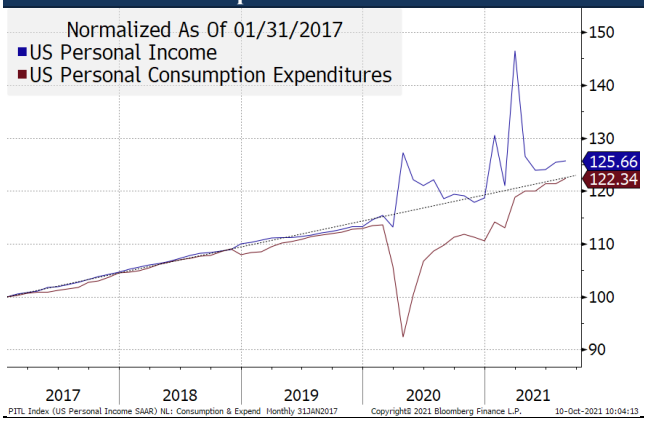
Fed officials expect above average inflation to continue in the near term, but ultimately still perceive the current inflation shock as a transitory phenomenon. They anticipate headline personal consumption expenditure inflation (PCE – the Fed's preferred measure of inflation) of 4.2% this year and of 2.2% in 2022 and 2023. Official FOMC projections are, however, arguably more of a signaling device (to anchor market expectations) than an unbiased view of the future. PCE inflation of around 3%

[1] Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase money supply. Quantitative easing is considered when short-term interest rates are at or approaching zero, and does not involve the printing of new banknotes. (Source: Bloomberg)

next year seems more realistic, with inflationary pressures more in line with the Fed's projection in 2023.

The prospect of high and persistent inflation increases the likelihood of Fed tightening which is generally not great for financial assets. An important distinction in today's environment is that the current burst of inflation in developed economies is – at least at this point – due to a supply shock resulting from supply chain disruptions, high logistics costs and labor shortages as opposed to a demand shock. If it was demand driven inflation, aggregate demand would be surging, but it is not.

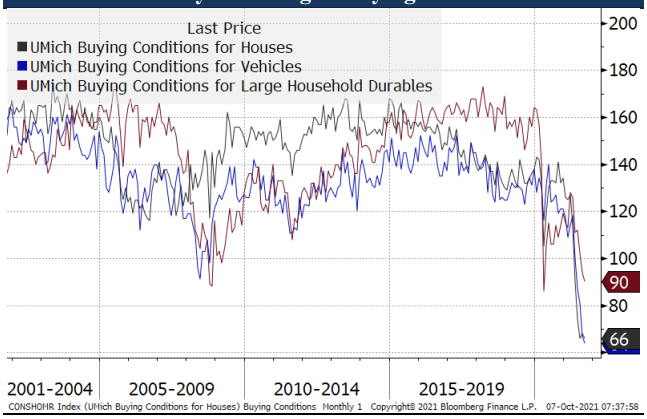
**Chart 6: Income & Expenditures at Pre-Pandemic Trend**




*Source: Access Financial Services using Bloomberg Software & Data*

For example, both consumer spending and income lie on their pre-pandemic trend (Chart 6). Furthermore, consumers are complaining that high prices for household durables, homes, and vehicles have caused "the poorest buying conditions in decades" according to the University of Michigan's latest consumer sentiment survey (Chart 7). If a positive demand shock was due to rising incomes relative to prices, consumers would not be feeling this way. But because they are, there is the real risk of demand destruction.

**Chart 7: University of Michigan Buying Conditions**

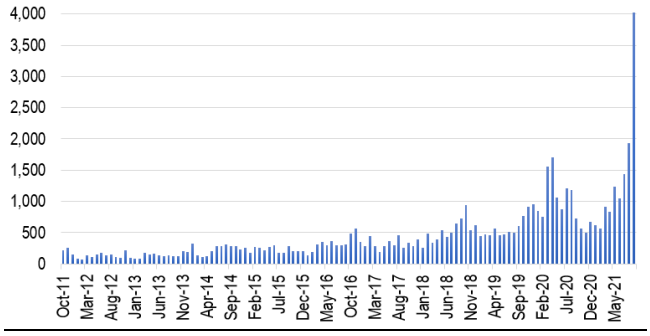



*Source: Access Financial Services using Bloomberg Software & Data*

Even so, there's a growing drumbeat of speculation that the current state of the world (stimulus fueled-demand meets bottleneck-restricted supply) is going to result in the sort of low-growth, high-inflation (stagflation) outcomes that characterized the 1970s.

Anecdotally, in September there were more than 4,000 stories on the Bloomberg Terminal mentioning the word "stagflation." That's more than twice as many as in August, which itself was a record high going back to 2012 (Chart 8).

**Chart 8: Bloomberg Story Count – "Stagflation"**

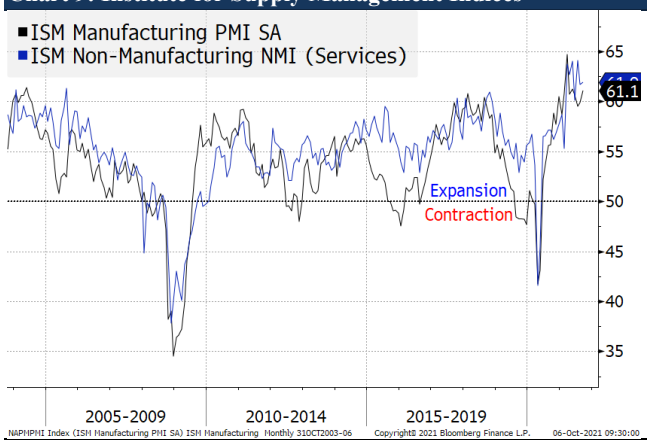



*Source: Access Financial Services using Bloomberg Data*

Officials and a variety of firms across industries – including technology, semiconductor companies, builders and manufacturers – are grappling with rising costs and fresh Covid impacts. Corporate earnings are suffering from supply chain problems that are more serious than previously anticipated. That could increasingly pressure stocks, while raising further warnings about inflation.

While growth as measured by the Institute for Supply Management (ISM) indices remains strong (Chart 9), the most important part of the ISM reports is what survey respondents are saying.

**Chart 9: Institute for Supply Management Indices**




*Source: Access Financial Services using Bloomberg Software & Data*

Here is what procurement professionals are reporting:

"Constraints on logistics from a cost and availability standpoint continue to be an issue." [Construction]

"Both domestic and international logistics are increasing lead times about six weeks for ocean freight and two

weeks for domestic freight." [Management of Companies & Support Services]

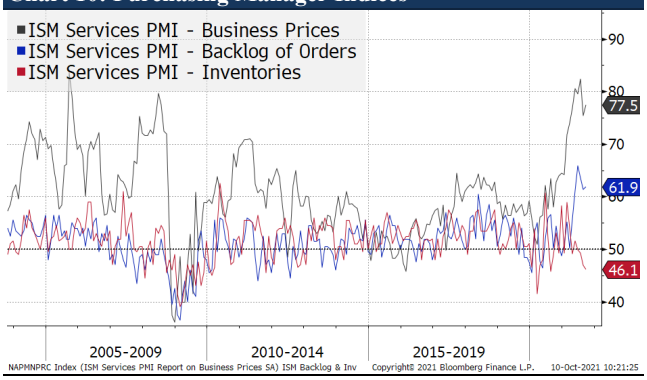
"Inventories shrinking due to global shipping logistics being a seller's/provider's market." [Professional, Scientific & Technical Services]

Lead times "still remain lengthy relative to pre-pandemic levels. We continue to see rising costs for both supply and service inputs." [Public Administration]

"We continue to deal with extended delivery lead times and high costs. Stress on the supply chain beginning to be reflected in the quality of products offered and delivered. Current buying strategy is to wait — except with equipment, as (price) increases are expected." [Utilities]

These comments are confirmed by the components of the September Services ISM Report On Business with prices and backlogs printing high numbers and inventories contracting (Chart 10).

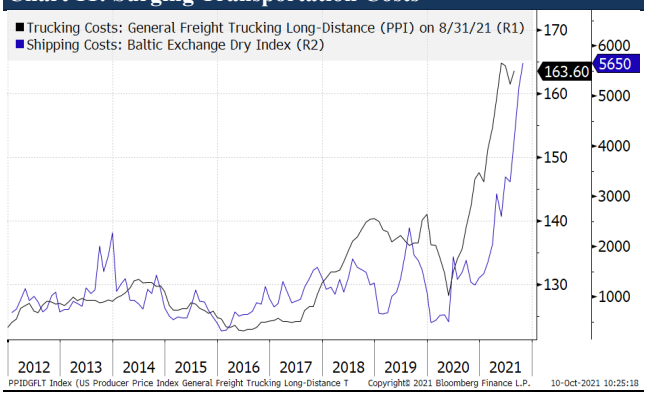
**Chart 10: Purchasing Manager Indices**




*Source: Access Financial Services using Bloomberg Software & Data*

Transportation costs continue their ascent (Chart 11). The average delay of cargo ships traveling between the Far East and North America is 12 days – compare that to 1 day in January 2020. The ISM Supplier Performance index increased from 69.5 in August to 73.4 indicating that supply bottlenecks are not easing. It will take time for supply chains to normalize, with most industry participants expecting the situation to improve only in 2022.

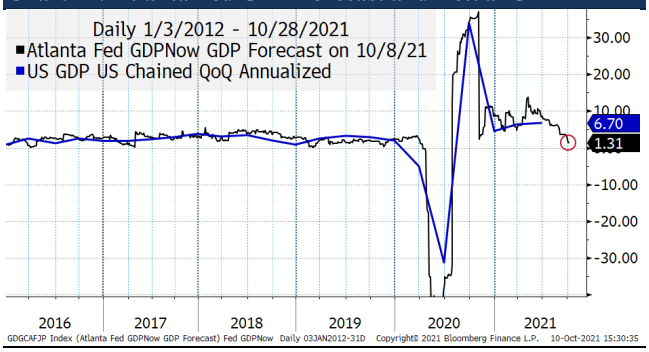
**Chart 11: Surging Transportation Costs**




*Source: Access Financial Services using Bloomberg Software & Data*

Add to this the projected third quarter GDP of 1.3% according to the Atlanta Fed's GDPNow forecast (Chart 12) and it is easy to see why fears of a stagflationary outcome are rising.

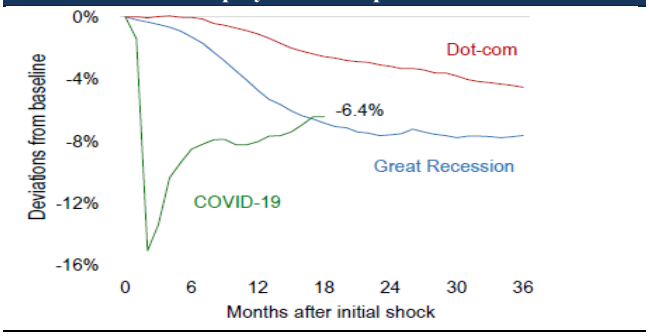
**Chart 12: Atlanta Fed GDP Forecast and Actual GDP**




*Source: Access Financial Services using Bloomberg Software & Data*

Meanwhile, employment remains far below its pre-pandemic trend (Chart 13) with the US adding fewer jobs than forecast for a second month in September (194,000 actual vs. 473,730 to 500,000 expected according to Bloomberg). While we expect job creation to remain elevated in 2022, secular changes such as firm restructuring and persistent declines in labor force participation will probably result in a lengthy employment recovery.

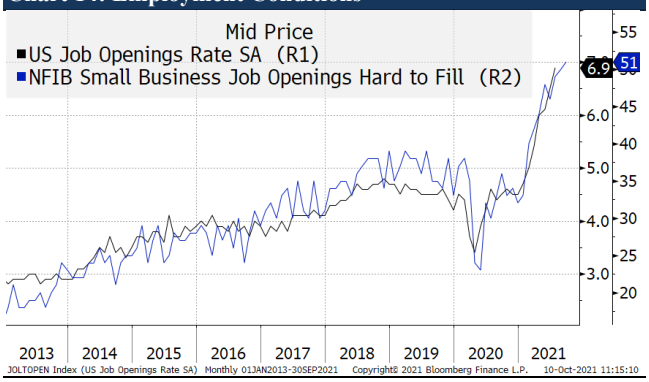
**Chart 13: Actual Employment Compared to Pre-Shock Path**




*Source: Numera Analytics*

On the positive side, jobs are still plentiful with small businesses reporting record levels of job openings hard to fill (Chart 14).

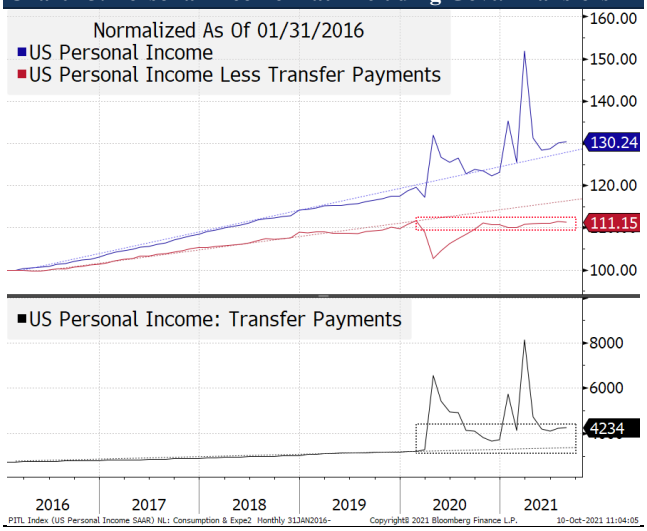
**Chart 14: Employment Conditions**




*Source: Access Financial Services using Bloomberg Software & Data*

All of this has put Americans in a worse mood. Consumer confidence survey readings continue on a downward path. The combination of higher prices for everyday goods, the loss of purchasing power, the discontinuation of supplementary unemployment benefits and paychecks weigh on consumer sentiment. While personal income is in line with its pre-pandemic trend, personal income less government transfer payments has been flat since 2020 (Chart 15 – red line)

**Chart 15: Personal Income Flat Excluding Govt. Transfers**




*Source: Access Financial Services using Bloomberg Software & Data*

Arguably, the reopening of the economy has advanced and we are moving toward a new normal for business, work and consumption. A big question remains as to what growth levels we will settle into and sub 2% is not good when the US economy is still millions of jobs short of pre-pandemic levels especially now that the government transfer boost has faded and we are moving from a world in which central banks promise to keep policy rates lower for longer to one in which inflation may be transitory for longer, as supply-chain disruptions continue.

While the Fed is willing to accept higher rates of inflation for a period of time before actually tightening monetary policy, in recent testimony before Congress, both Fed Chair Powell and Treasury Secretary Yellen admitted surprise at how long supply chain bottlenecks have gone on. If inflation remains persistent, the Fed will have to move to increase short term interest rates as higher rates help contain inflation by curbing private spending.

Getting this inflation diagnosis right is important because responding to supply shock generated inflation with tighter monetary policy is dangerous. Higher prices that result from a supply shock eventually lead to demand destruction and supply gluts which serve to reverse the supply driven inflation. Therefore, it is risky for central banks to respond with tighter policy, including the signaling of tighter policy that leads to higher bond yields. Higher interest rates will, with a lag, choke demand just as the supply bottlenecks ease and let loose a flood of supply resulting in a deflationary shock for the economy, stock market, and commodities.

If inflation stems from cost-push factors, tightening could trigger a downturn without reigning in price growth (like in the 1970s). In this context, it is unlikely that the Fed will adopt a hawkish stance over the coming year. This framework matches Fed actions in 2014, when the central bank ended its QE program and raised rates once but delayed multiple rate hikes for almost two years.

In addition, the Fed's shift towards 'average' inflation targeting reduces the value placed on near term price stability. This is because inflation has fallen short of the Fed's 2% target for the better part of a decade, so an average target signals a greater tolerance for above trend inflation. By extension, the policy shift gives a prominent role to job market conditions and, as noted above, employment levels remain far from their pre-pandemic path.

All of these factors are potential headwinds for financial assets. 'Transitory (inflation) for longer' is a threat to long duration assets like long maturity bonds, technology related stocks and high yield bonds. A rising rate environment is also a threat to government and investment-grade bonds. For the balanced portfolio, this can also be the kind of toxic environment where bonds don't offset losses in stocks. Rather stocks fall because bond prices are falling.

Ultimately, there are two ways out. Either inflation fades and bond yields and discount rates remain low as a result, or inflation persists so much that a combination of higher rates and lower consumption threaten the economy, bringing longer term interest rates down and giving some relief to the bond side of the portfolio. Clearly, the former scenario is better than the latter. And that's why 'transitory for longer' is a growing threat.

Companies are citing surprisingly grim supply chain obstacles and soaring costs so often it's starting to feel almost routine. Signs point to a third quarter earnings season hurt by supply chain problems that are deeper and longer lasting than earlier expectations. That could pressure stocks across a variety of industries, while adding fuel to the debate about how transitory inflation may be.

While the majority of S&P 500 companies will report earnings results for Q3 2021 over the next few weeks, about 4% of the companies in the Index (21 companies) have already reported earnings results for the third quarter (through October 7). Supply chain disruptions and costs have been cited by the highest number companies in the Index to date as a factor that either had a negative impact on earnings or revenues in the third quarter, or are expected to have a negative impact on earnings or revenues in future quarters. Of these 21 companies, 15 (or 71%) have discussed a negative impact from this factor. After supply chain disruptions, labor shortages and costs (14),

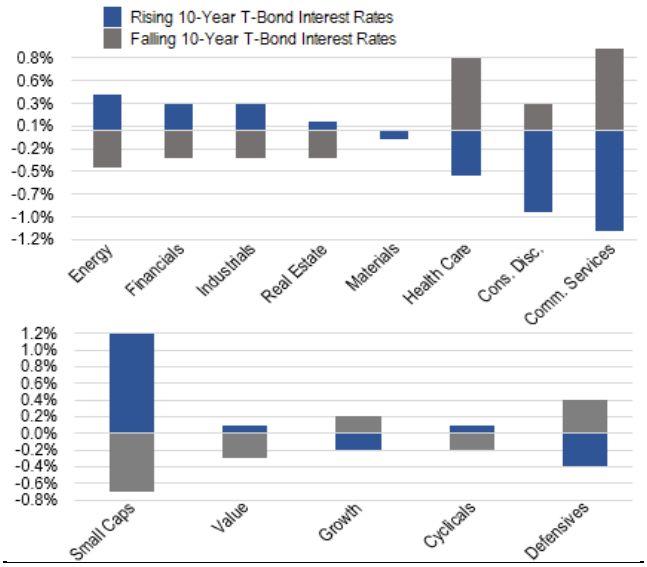
COVID costs and impacts (11), and transportation and freight costs (11) have been discussed by the highest number of S&P 500 companies.

Adding it all up, profit margins have likely peaked and will head lower over the coming quarters. Slower earnings growth usually translates to weaker stock market returns. The risk to the technology heavy S&P 500 is particularly high given its high valuation.

The bond market's initial reaction to QE tapering is reminiscent of the 'taper tantrum' episode of 2013. In May of that year, then Fed chair Ben Bernanke suggested the Fed could eventually end its QE program without offering a concrete timeline. Ten year Treasury bond yields doubled over the next six months, from 1.5% ahead of Bernanke's comments to 3% by year end sending bond prices tumbling.

While bond yields may not double this time around, they have moved up meaningfully over the last few weeks. Changing interest rate regimes have historically had implications for sector returns and style investments. Specifically, rising long term bond yields and elevated inflation risk have tended to favor value stocks and small cap stocks versus growth and technology related stocks (Charts 16 and 17). As we have highlighted in the past, growth stocks are more sensitive to changes in long term yields compared to value and small cap stocks.

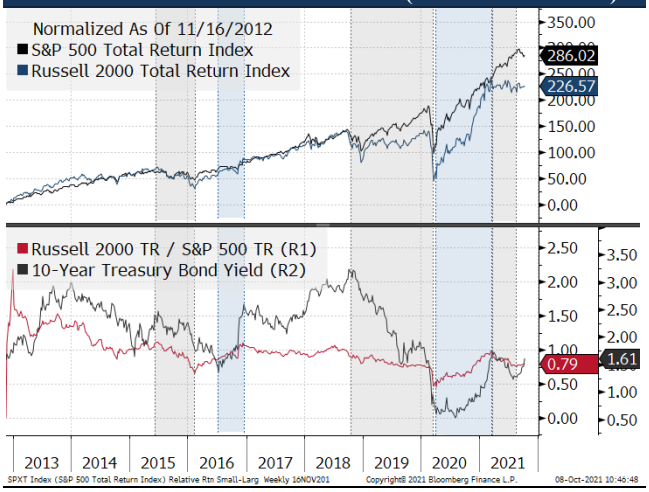
**Chart 16: Median Relative Three Month Returns by Interest Rate Regime (1995 – 2021)**




*Source: Access Financial Services using Data from BCA Research*

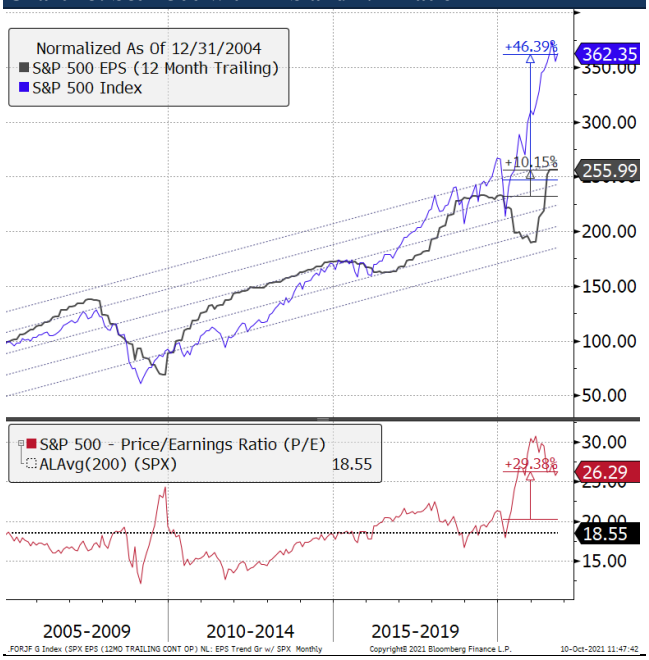
The pre-pandemic month-end S&P 500 earnings per share (EPS) was $151.63 on February 28, 2020. Month-end EPS bottomed on December 31 at $123.85. Today, the figure is $166.98. So, EPS are 10% higher today that they were before the pandemic. In contrast, the S&P 500 has advanced 46% since February 28, 2020. This has driven the price/earnings (P/E) ratio (currently 26.3) up 29% during this period (Chart 18). The average P/E ratio for the S&P 500 since 2005 is 18.6.

**Chart 17: Large (S&P 500) & Small Cap (Russell 2000) Performance Relative to Interest rates (10-Yr. Treas. Bond)**




*Source: Access Financial Services using Bloomberg Software & Data*

**Chart 18: S&P 500 with EPS and P/E Ratio**



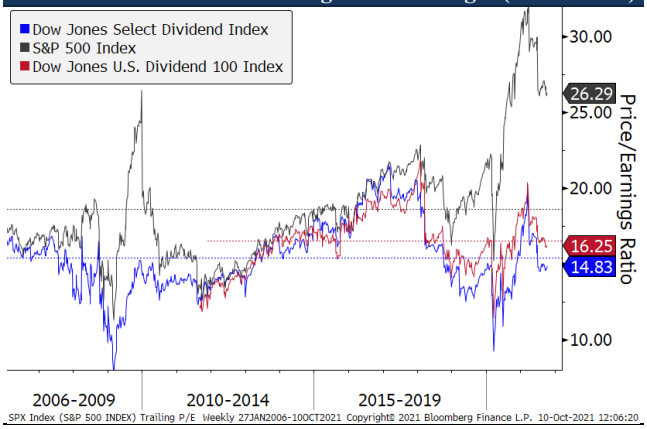

*Source: Access Financial Services using Bloomberg Software & Data*

In contrast, indices that measure the performance of stocks that pay high dividends are trading at P/E multiples slightly below their long term averages (Chart 19).

Since recovering to its post-covid highs in August 2020, and prior to its September decline, the technology (and related sectors) heavy S&P 500 has advanced steadily with very little in the way of pullbacks (Chart 20). However, the S&P 500 has now registered a closing drawdown of 5% from its all-time high for the first time in nearly a year; that is the seventh longest gap between such dips since 1928. Of the six longer gaps, four saw the stock market higher a month after it registered the 5% drawdown, with an average gain of 1.62%. However, it also took an average of

209 trading days to reclaim a fresh market peak, with the shortest amount of time coming in 1996 – 44 trading days (Table 3).

**Chart 19: P/E Ratios with Long Term Averages (dotted lines)**




*Source: Access Financial Services using Bloomberg Software & Data*

**Chart 20: S&P 500 Since Pandemic Selloff**


*Source: Access Financial Services using Bloomberg Software & Data*

**Table 3: Market Behavior Around 5% Dips**

| | Days Between 5% Dips | 1 Month Forward Return | Days Until New Peak |
|---|---|---|---|
| 02/05/18 | 396 | 2.94% | 141 |
| 06/09/65 | 372 | 0.79% | 77 |
| 07/15/96 | 357 | 4.83% | 44 |
| 03/29/94 | 341 | -0.35% | 223 |
| 09/09/59 | 241 | -0.84% | 350 |
| 01/10/62 | 238 | 2.35% | 416 |
| Average | 324 | 1.62% | 209 |
| 09/30/21 | 220 | ? | ? |

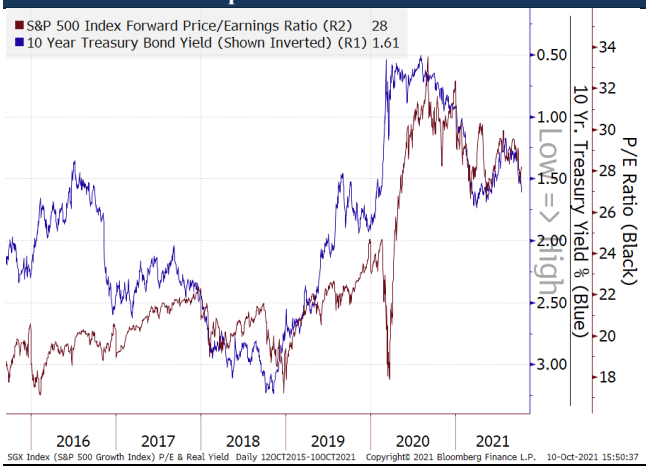
*Source: Bloomberg*

While that is no guarantee that this dip is swiftly reversed, it does offer some suggestion that when a long period of clinging towards all-time highs finally ends, there usually seems to be a good reason. At this point, the bit of inflation, the growth headwinds from bottlenecks, and a belated withdrawal of monetary accommodation could all combine to provide just such a reason.

Stock market valuations are stretched. They are also closely linked to long term bond yields (Chart 21). The takeaway is that there is little room for interest rates to rise before pulling down many areas of the stock market.

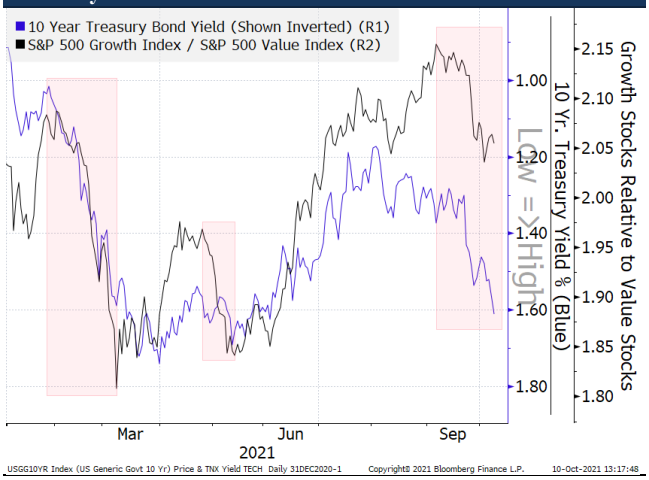
Since February, the performance of large cap growth stocks relative to large cap value stocks in particular has closely tracked the ten year Treasury bond yield. On the three occasions that yields have risen, growth stocks have underperformed relative to value stocks (Chart 22).

**Chart 21: Relationship Between Valuations and Bond Yields**




*Source: Access Financial Services using Bloomberg Software & Data*

**Chart 22: Growth vs. Value Stock Performance with 10-Year Treasury Bond Yield**



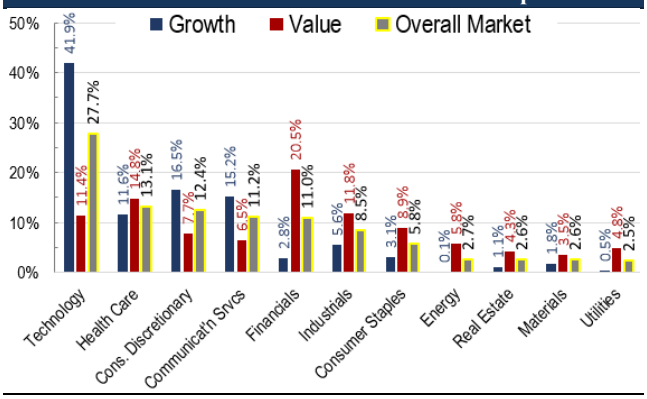

*Source: Access Financial Services using Bloomberg Software & Data*

Put simply, changes in bond yields are driving overall stock market and sector performance via their impact on valuations. Since growth sectors have much higher valuations than value sectors, the result is that growth stocks are lagging the rest of the market when bond yields are rising.

Of course, stock prices are also premised on earnings. So, given enough time, rising earnings can make valuations less extended, adding more wiggle room for bonds to sell off. The trouble is that a change in earnings happens much more gradually than can a change in valuation – a 10 percent rise in earnings can take a year, whereas a 10 percent fall in valuation can happen in a week.

For the next few months at least, changes in bond yields are likely to be the dominant driver of the most extended areas of the stock market and, by extension, the overall market itself. This is especially true for the growth heavy S&P 500 (Chart 23) which, since March, has been tracking the changes in bond yields very closely.

**Chart 23: S&P 500 Growth Vs. Value Sector Composition**




*As of June 12, 2021*
*Source: Access Financial Services using BlackRock Data*

There has been a tight feedback loop from bond yields (interest rates) to stocks and then back to interest rates. Rising bond yields pressure stocks resulting in a drop in bond yields as money flows out of the stock market and into the bond market. The key question is, what is the upper limit to bond yields before stock market damage causes interest rates to stabilize?

Given the tight feedback loop, interest rates as measured by the ten year Treasury bond yield probably need to rise to around 1.8% from their current level of 1.6% for the stock market to correct enough to limit any further ascent in bond yields and reverse course.

At this point, we don't think a stock market correction will progress into a drawn out bear market and believe we will add to our clients' stock market exposure if rising interest rates rise driving valuations low enough to make the market attractive.

In the meantime, we expect stocks with lower valuations and stronger dividend yields to continue their recent outperformance relative to the overall stock market as higher rates put pressure on rate-sensitive sectors and styles, such as Growth, Technology, Communication Services, and Real Estate.

*Brant Kairies*
*952-885-2732*