Boston Trust Walden
Principled Investing.

Investment Commentary

September 30, 2021

Financial Markets

Total Returns through September 30, 2021		
US Stocks	**3rd Quarter**	**Year-to-Date**
Standard & Poor's 500	0.6%	15.9%
Russell 2000®	-4.4%	12.4%
International Stocks		
MSCI World Ex-US	-0.7%	9.2%
MSCI Emerging Markets	-8.1%	-1.2%
US Fixed Income		
Bloomberg Gov't/Credit	0.0%	-1.9%
90-Day Treasury Bill	0.0%	0.0%

Stocks entered the quarter with double digit year-to-date gains and rallied further during July and August. In September, however, markets faltered; the S&P 500 Index declined 4.7% to end the quarter with a gain of 0.6%. Small capitalization and international stocks followed a similar path but fared slightly worse, ending the period in negative territory.

The price of the 10-year Treasury bond also varied considerably during the quarter, only to end near where it began. Yields were in a downward trajectory for much of the period as investors sought safety in the face of spiking COVID-19 infections and potential disruption to the economic recovery; in early August, the US Treasury 10-year yield fell to 1.17%. However, in subsequent weeks yields reversed course. Investors reacted to comments from the Federal Reserve that suggested it may begin tightening monetary policy sooner than expected, as well as to possible effects of Washington political skirmishes surrounding the debt ceiling and government funding. The yield on the 10-year Treasury ended the quarter at 1.49%.

Investment Perspectives

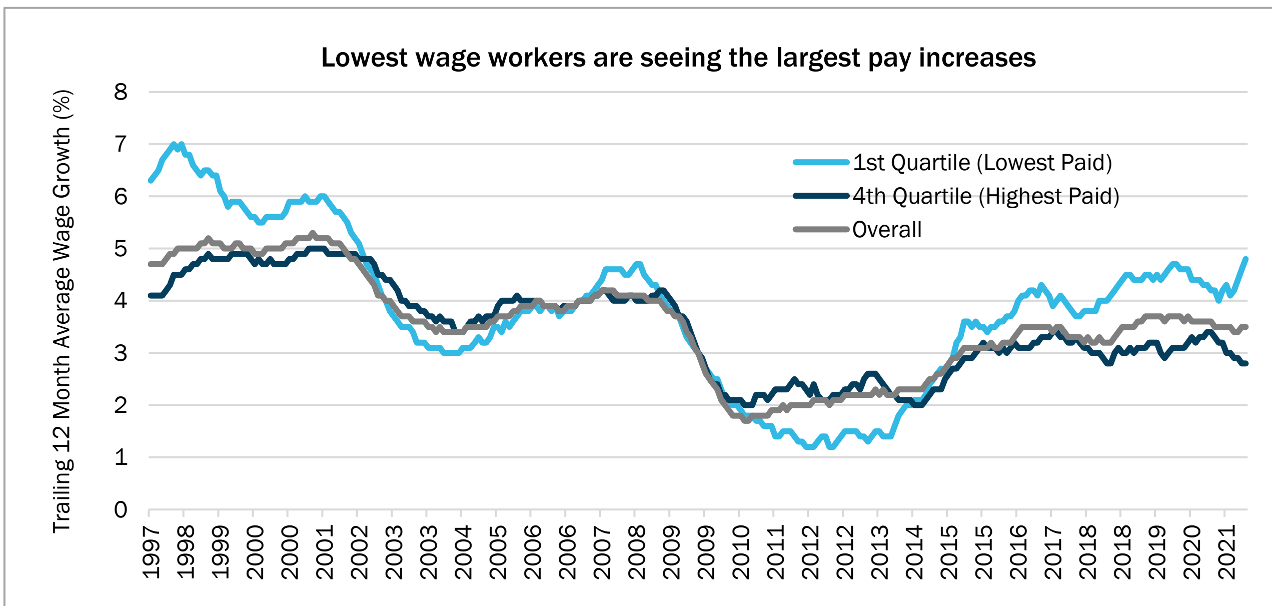
The volatility in financial markets in the final weeks of the quarter reflected increasing economic risks. The most prominent concern was the hypervirulent Delta variant of the COVID-19 virus, yet consumer spending was resilient, employers remained in hiring mode, and economic activity continued to expand. That said, the persistent increases to estimates of corporate profits and US GDP growth — which had driven the market higher for the past year — have slowed. While growth in the back half of the year is likely to be shy of economists' original GDP projections, 2021 remains on track to be the strongest in nearly four decades.

On the employment front, job gains have been uneven, but considerable. As of the August report, the unemployment rate dropped to 5.2% from 8.4% a year earlier and 14.8% at the height of the pandemic. Leisure & Hospitality, the hardest hit sector during the downturn, added 2.1 million jobs between February and July this year, accounting for half of overall job creation during the period. However, as employers confronted a resurgence in COVID-19 cases, job growth in the sector flattened in August. In aggregate, there were still job gains across the economy, albeit at a slower pace. Including August's slowdown, job growth has averaged an impressive 586,000 per month in 2021. This compares quite favorably to 173,000 monthly average job growth in 2011 after the previous recession. If the labor market was to sustain its year-to-date pace, employment would

return to pre-pandemic levels by June 2022 — just over two years after the official end to the recession. It took five years following the Financial Crisis for employment to return to pre-recession levels. Granted, the exogenous shock nature of last year's recession stands in stark contrast to the systemic excesses that marked that of the previous recession, but so too, does the recovery.

Rising Wages

Despite the healthy hiring pace, a record number of job openings suggests many employers are finding it difficult to attract workers willing and able to fill vacancies. As such, it's unsurprising that wages are moving meaningfully higher. The economic impacts of the pandemic were felt disproportionately across the workforce, with many lower paid service workers, including those in Leisure & Hospitality, bearing the brunt. Many of those workers are now experiencing a reversal of fortunes as wage gains for the lowest paid quartile of workers are far outpacing the rest of the workforce. This segment's earnings increases have averaged 4.8% over the last 12 months vs. 2.8% for the highest paid quartile, and 3.5% overall. As the chart below shows, this outsized growth at the lower end of the pay scale is not new, but the rate of increase is now the highest it has been relative to the aggregate workforce in over twenty years.



Source: Federal Reserve Bank of Atlanta
The data are 12 month moving averages of monthly median wage growth for each average wage quartile through August 2021. Wage computed on an hourly basis.

Strength at the lower end of the pay scale bodes well for the longevity of the economic recovery, as those workers are more likely to spend, rather than save, their newfound increase in funds. Though a rise in spending boosts economic activity, it can also have negative consequences — notably inflation.

Inflation and the Fed

Persistent inflation remains a risk to financial markets. Yet, inflationary readings are not as high as earlier this year, as some pockets of pricing pressure have begun to abate. In fact, August's Core CPI reading (excluding volatile food and energy prices) was up only 0.1% month-over-month — the smallest increase since February. Pandemic-induced bottlenecks, including the labor market dynamics described above, are still affecting supply

chains, and consequently, prices. Official statistics on rents, which comprise a significant portion of household expenditures, have shown only a small uptick in housing inflation thus far. However, many investors worry the combination of rising home prices, renewed demand for rental units as people return to jobs in cities, and an end to eviction moratoriums put in place during the pandemic will result in higher housing inflation.

The Federal Reserve acknowledges inflation is running above its long-term target, but has maintained its stance that the pressures are transitory. What constitutes "transitory," however, is a significant question among Fed watchers, economists, and investors alike. The Fed cites an economy that restarted almost as abruptly as it halted, and counsels it will take time for the bottlenecks to work through the system. Should higher inflation readings persist and require sooner-than-expected Fed intervention in the form of higher interest rates (and, in turn, borrowing costs), the economic recovery could be disrupted.

For financial markets, quickly rising interest rates would be disruptive as well. Ever-lower rates over the last few decades have supported the enduring rise in value of many assets, most prominently stocks, bonds, and real estate. Further, the current historically low rates are a primary pillar upon which today's above-average stock valuations are based, despite the backdrop of an unprecedented global pandemic. An abrupt increase in rates could cause a sell-off among stocks, along with many other asset classes.

Uncertainty in Washington

While investors are contending with uncertainty regarding future Fed policy, there are also many policy questions emanating from Capitol Hill. The Senate's passing of the Infrastructure Investment and Jobs Act in August marked a rare episode of productive bipartisanship, but things have deteriorated since. In the final days of the third quarter, congressional Republicans refused en masse to vote for both funding the federal government as well as raising the debt ceiling (a requirement for the Treasury to issue bonds and pay for debts already incurred). Though the former was resolved with only hours to spare before the Federal government was to shut down on September 30th, the latter remains largely outstanding given that Congress has passed a measure that only provides the Treasury with enough authorization to last until December. The increased, though still remote, possibility of default by the US government is disconcerting for investors and the global financial system; rising US Treasury bond yields at the tail end of the quarter were likely tied, in part, to this risk.

Also important for markets, and another area of uncertainty for investors, is the Build Back Better Act—a bill that encompasses several of the Democratic Party's domestic priorities. The prospective law seeks to make permanent various tax credits for lower paid Americans by increasing taxes on the nation's most wealthy individuals as well as on corporations. The bill also incentivizes investment in clean energy and other environmental and social programs. It is indisputable that higher corporate taxes, in the short-term, would take a bite out of corporate earnings. In the longer term though, if the spending components of the bill work to achieve higher, more sustainable economic growth, they could end up enhancing corporate earnings streams. Given the primacy of corporate profits in driving long-term stock returns, we are paying close attention to both the tax and spending aspects of a prospective final bill.

Outlook

The economy and financial markets are facing a plethora of crosscurrents. Though lower than previous expectations, economic growth appears likely to continue at a solid clip during the remainder of this year and into next. Despite the growth, uncertainty abounds. In the US, the list includes the path of the virus, inflation, and both monetary and fiscal policies. But potential issues abroad are evident, too. Chief among them relate to China, including the fate of Evergrande. Investors are assessing the impact of this giant, heavily indebted real

estate company on the Chinese economy and global financial system. The episode is also of interest for indications of how the Chinese government might evolve how it manages the private sector and its economy in the future.

On balance, and within the context of client-specific guidelines, we continue to favor stocks. Encouraging trends that bolster prospects for continued economic growth and corporate profits support this view, but so too does the dearth of other options that offer more attractive risk-return characteristics. We remain focused on investing in companies with sustainable business models and strong financial underpinnings. Given the risk posed by inflationary pressures and/or the prospect of rising interest rates, we are especially attuned to companies that have pricing power and can offset rising costs to maintain profitability, as well as those that would not face undue harm should borrowing costs increase. And as always, we are disciplined with respect to valuation — avoiding investment in those companies whose share prices imply unreasonable growth expectations.

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