



Heating Up

October 2021

- The S&P 500 Index had its best month of the year in October, rising 7% and bouncing back from September's 4.7% loss, its worst month since March 2020.
- Investors remain focused on how unprecedented levels of monetary support could be driving inflation.
- Markets are also watching other outstanding policy decisions and legislative actions in the US, which could significantly impact levels of policy support, interest rates, and market prices.
- Elevated energy prices could produce a new form of market vigilante—the energy vigilantes—who could force policymakers' hands to address this emerging issue.

Markets

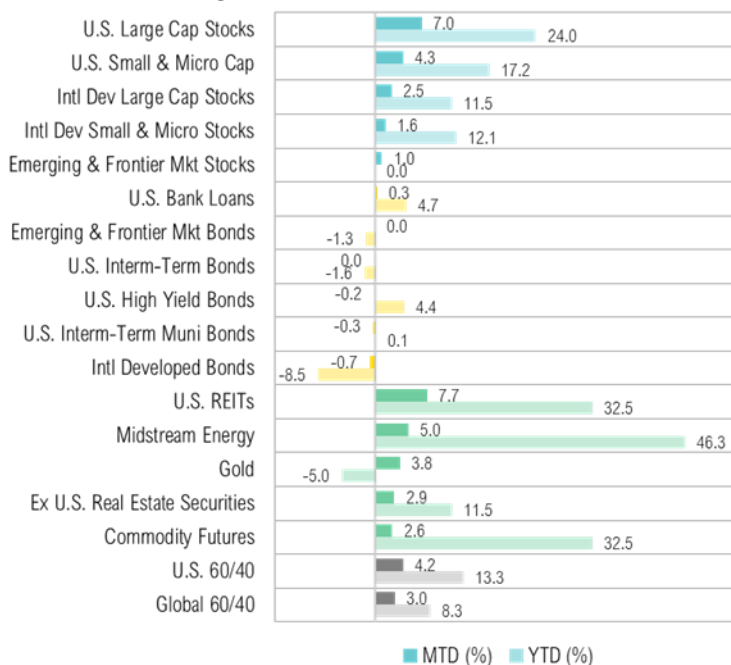
The S&P 500 Index had its best month of the year in October, rising 7% and bouncing back significantly from September's 4.7% loss, its worst month since March 2020. The large cap index ended October at an all-time high, adding to an impressive run of 59 new daily closing highs in 2021, the third-highest annual total since the Great Depression.¹ While valuations are unquestionably high,² the recent rally has been supported by higher-than-expected earnings and profitability. As of the end of the month, the blended third-quarter earnings growth rate for the S&P 500 is 39.1% on a year-over-year basis, the third-highest growth rate since 2010³. Further, operating margins are 13.3%, substantially higher than the 8.1% average since 1993.¹ Equity markets also responded favorably to a dovish interpretation of the Federal Reserve's mid-October interest rate decision, as well as decreasing COVID-19 cases and hospitalizations in the United States.⁴

Despite the good news, investors remain fixated on the government's unprecedented monetary policy support. The S&P 500 was up just 1% month-to-date through October 12. On October 13, the Fed announced that it would continue with the status quo of purchasing \$120 billion Treasury and mortgage-backed securities per month. However, it hinted that at the November meeting, if the decision were made to begin slowing purchases, the tapering cycle could be completed around mid-2022.⁵ (As suggested, the Fed did indeed decide in early November to start tapering asset purchases in late November.)⁶

International developed market and emerging market stocks lagged behind U.S. equities despite posting absolute returns of 2.5% and 1.0%, respectively. As a result, emerging market stocks have bounced back to flat for 2021.

Equity markets responded favorably to a dovish interpretation of the Federal Reserve's mid-October interest rate decision and decreasing COVID-19 cases in the United States, but remain fixated on the government's unprecedented monetary policy support.

October 2021 Key Market Total Returns



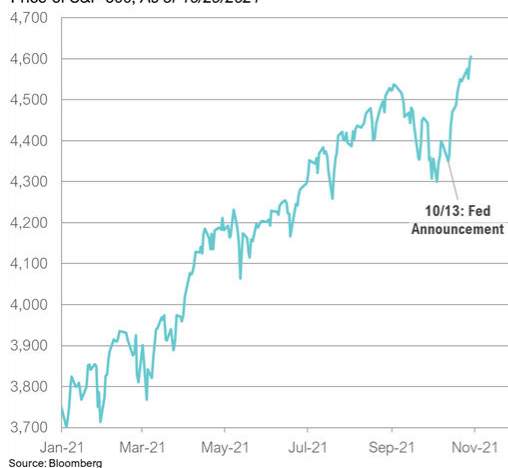
Source: Bloomberg

Multi-decade high inflation pushed interest rates higher throughout the month, resulting in poor performance for longer duration bonds and strong returns for real assets.

Within fixed income markets, longer duration bonds underperformed as interest rates rose due to inflation concerns. Five-year market-implied inflation, as proxied by the yield spread between Treasuries and Treasury Inflation-Protected Securities (TIPS), finished October at a multi-decade high of 2.9%. Real assets, often viewed as a hedge against the declining purchasing power inflation causes, posted impressive gains. U.S. REITs led the way, up 7.7% for the month. The price of crude oil jumped higher by over 20%, reaching \$85/barrel for the first time since 2014. The demand for energy continues to climb; total world petroleum consumption was estimated to be 98.9 million barrels per day in the third quarter, a post-pandemic high.⁷

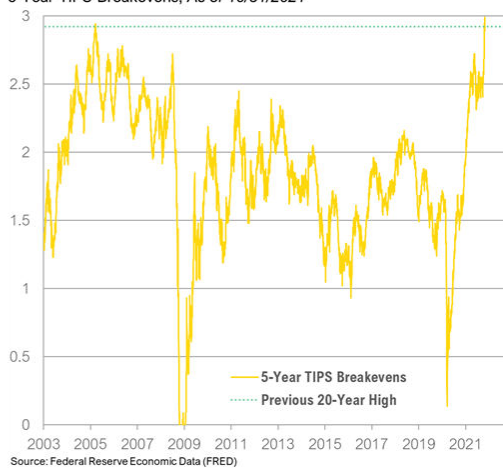
Markets Rally Following Fed Tapering Announcement

Price of S&P 500, As of 10/29/2021



Inflation Expectations Breakout Higher

5-Year TIPS Breakevens, As of 10/31/2021



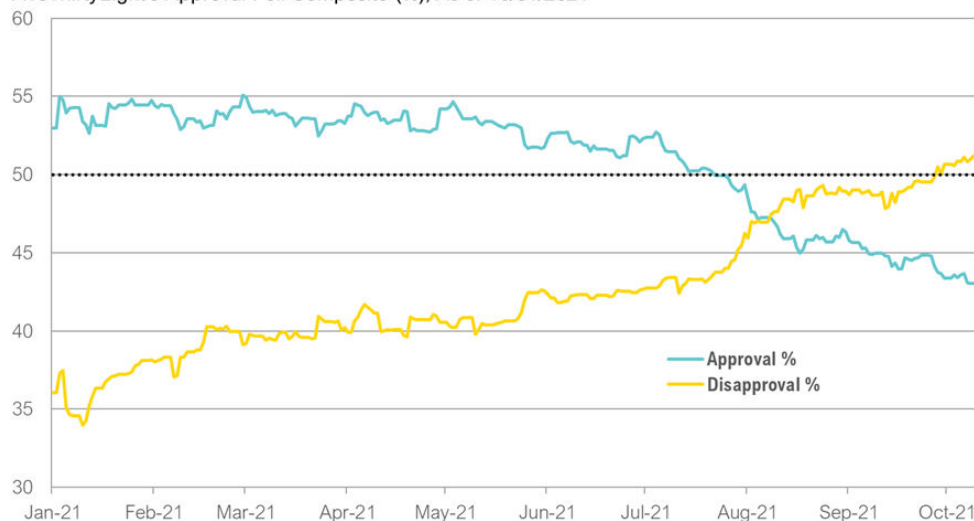
Biden's Approval Slide

As with his two predecessors, U.S. President Joe Biden's net approval rating has declined since his inauguration, dropping steadily from +17% at the start of his presidency to -8.2%

by the end of October.⁸ This represents the second-worst net approval rating by any president 285 days into their first term since World War II.⁸ Some blame the delta variant COVID-19 surge, while others point to delays surrounding key agenda items, like the bipartisan infrastructure bill and a multi-trillion-dollar social spending package focused on health care, education, and climate change policies.⁹

Biden's Approval Rating Slide

FiveThirtyEight's Approval Poll Composite (%), As of 10/31/2021



Source: FiveThirtyEight

U.S. President Joe Biden's net approval rating has declined since his inauguration. Some attribute the slide to the delta variant COVID-19 surge and delays surrounding key agenda items such as the "Build Back Better" legislation featuring the \$1 trillion infrastructure bill and multi-trillion social spending package.

Biden and his cabinet have their work cut out for them if they hope to turn public perception around. One big ticket item, the aforementioned \$1 trillion bipartisan infrastructure bill, was nearing a conclusion at the end of October (and finally passed and signed into law in early November).¹⁰

As the clock wound down on the U.S. defaulting on its debt, the House voted to increase the debt ceiling by \$480 billion, an amount expected to allow the U.S. to pay its bills through December 3.

As Congress debates how to pay for this legislation, the United States government once again finds itself up against its debt limit.¹¹ The prior extension of the limit to \$28.4 trillion, agreed upon in 2019, was reached at the end of July, which means the Treasury can no longer issue additional debt to fund obligations until a new limit is set.¹¹ Since then, the Treasury used its cash surplus to fund its day-to-day operations, but this was scheduled to run out by the end of October.¹¹ As the clock wound down, the House voted to increase the debt ceiling by \$480 billion, an amount expected to allow the U.S. to pay its bills through December 3.¹² Since then, the debt debate has mostly taken a backseat to the "Build Back Better" legislation. At the end of the month, Janet Yellen brought the debate to the forefront once again by saying Democratic Congressional leaders could push through the debt ceiling bill on their own via the reconciliation process:

*"Should it be done on a bipartisan basis? Absolutely. Now if [the Republicans] are not going to cooperate, I don't want to play chicken and end up not raising the debt ceiling. I think that's the worst possible outcome. If Democrats have to do it themselves [through reconciliation], that's better than defaulting on the debt to teach the Republicans a lesson."*¹³

Bond markets in particular will remain attentive to how Congress will deal with the federal debt ceiling and how this issue will affect Treasury issuance (supply) for the coming quarters. From an economic and market perspective, interest rates must remain contained.

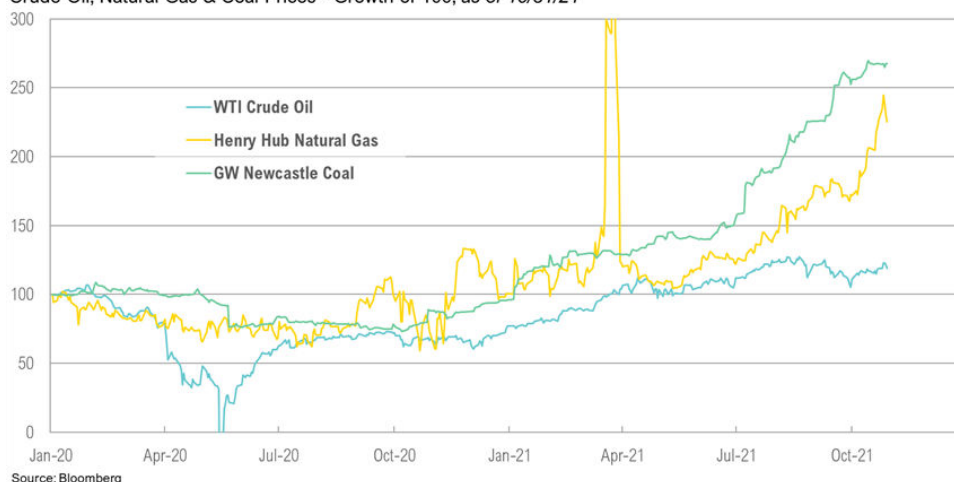
Heading into the winter months in the northern hemisphere, natural gas prices are particularly concerning outside the U.S. as spot prices have more than quadrupled and hit record levels in Europe and Asia.

Energy Price Spike

Energy prices shot higher in October. Crude oil, natural gas, and coal prices increased 13%, 30% and 6%, respectively. Year-to-date increases have been even more surprising—crude oil is up 54%, natural gas up 125%, and coal up 178%. Heading into the winter months in the northern hemisphere, natural gas prices are particularly concerning outside the U.S., as spot prices have more than quadrupled and hit record levels in Europe and Asia.¹⁴ The price of natural gas typically reflects seasonal and localized factors, but we could be experiencing the beginning of an unprecedented global price shock.¹⁴

Energy Prices Spiking

Crude Oil, Natural Gas & Coal Prices - Growth of 100, as of 10/31/21



Despite higher prices, demand for natural gas remains strong. This year, 36% of electricity generation is expected to come from natural gas—only a small dip from last year's 39%.¹⁵ Coal will likely benefit the most from this 3% decline. It is projected to generate 18% more electricity this year than in 2020, hitting its highest level since 2001.¹⁵ Its price is also soaring. However, constraints on coal supply and low coal reserves are limiting consumption, compared to previous periods of natural gas price increases.¹⁵ Oil also seems unlikely to provide an alternative heating and power source due to high prices and the October announcement from OPEC+ that its production targets will remain unchanged.¹⁶ The International Monetary Fund (IMF), which promotes global economic growth and financial stability, has warned that global growth may soon be impacted if energy prices remain elevated.¹⁴

Due to labor shortages, maintenance backlogs, longer lead times for new projects, and investors' lackluster interest in fossil fuels, companies were slow to increase supply when demand suddenly jumped, and as a result, energy prices shot upward.

This macro environment stands in stark contrast to conditions 18 months ago when May 2020 WTI oil futures contracts plummeted to -\$37.63/barrel due to a massive supply glut following global lockdowns.¹⁷ As a result, energy producers cut production and slashed their investments. However, consumption rebounded faster than anticipated, led by the industrial sector. Yet due to labor shortages, maintenance backlogs, longer lead times for new projects, and investors' lackluster interest in fossil fuels, companies were slow to increase supply when demand suddenly jumped, and as a result, energy prices shot upward. At the end of October, natural gas production in the U.S. still remains below pre-crisis levels.¹⁴

With winter rapidly approaching and markets struggling to correct themselves, a bipartisan group of senators from New England sent a letter on October 28 to the White

House urging “targeted actions” to provide relief “given the current state of energy markets.”¹⁸ The letter goes on to suggest “releasing inventory from the Strategic Petroleum Reserve and the Northeast Home Heating Oil Reserve and limiting natural gas exports to lessen the effect of potential residential energy price increases.”¹⁸ It’s worth noting that both the IMF and the U.S. Energy Information Administration expect prices to normalize by sometime next year, but both agencies predict volatile conditions in the near term.^{14,15}

Looking Forward

Across the globe, communities continue to recover from the effects of the COVID-19 pandemic and lockdowns, but challenges persist. Although record levels of stimulus were initially welcome and likely necessary, continued stimulus – exacerbated by a multitude of supply issues – is leading to overheating in some sectors, most notably in energy.

As we explained in our September commentary, we expect market participants—and bond vigilantes—to start paying more attention to price shifts in the energy complex. At the end of October, a barrel of WTI crude oil traded for a little over \$83, a price not exceeded since 2014. Similarly, the national average gas price is now well over \$3 per gallon, a seven-year high.¹⁹ Finally, natural gas prices are at 13-year highs. If bond vigilantes stay quiet, unsustainable policy accommodation can likely continue. If they do not, investors should expect elevated volatility—at least relative to what has been an extraordinarily good year for asset prices. Another scenario is that the economic pain of higher energy prices could become so acute that a new breed of vigilantes may emerge—the energy vigilantes—who could force policymakers’ hands.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

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Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/L STA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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