MARKET COMMENTARY

# Under the Surface

August 2021

- The U.S. stock market rallied for the seventh consecutive month in August, adding to an unusually impressive – and relatively calm – year thus far for risky assets.
- A string of regulatory crackdowns out of China resulted in a bear market in Chinese stocks with no clear end in sight.
- At its annual Jackson Hole Symposium, the Fed's primary message was one of patience. We believe their bias still leans to providing more support rather than less.
- Strength in major U.S. indexes belied a growing list of global cross-currents that could upend today's calmness, including a massive increase in expected Treasury issuance and a potential reduction in the pace of Fed bond buying.

## Markets

The S&P 500 Index rallied yet again in August, its seventh consecutive monthly gain. On the last day of the month, the index registered a new record high of 4,523, its 53rd record high of the year. Indeed, with an eight-month gain of 21.6%, the S&P is on the way to one of its best years in the last half century. This impressive streak has been coupled with minimal volatility: the largest drawdown so far this year was just -4%.[1] (The 50-year average is -14%.)[1] Foreign large cap stocks have also performed well, rising 12% for the year. U.S. high yield corporate bonds, which are 4.5% higher for the year, also benefited from the increased appetite for risk. High yield spreads closed the month at just 288 basis points, near a record low. Indeed, across every major credit category, spreads are either at or near their all-time lows. On the other hand, safe haven investments have suffered. U.S. intermediate-term bonds, intermediate-term municipal bonds, and gold all declined in August, albeit less than 1%.

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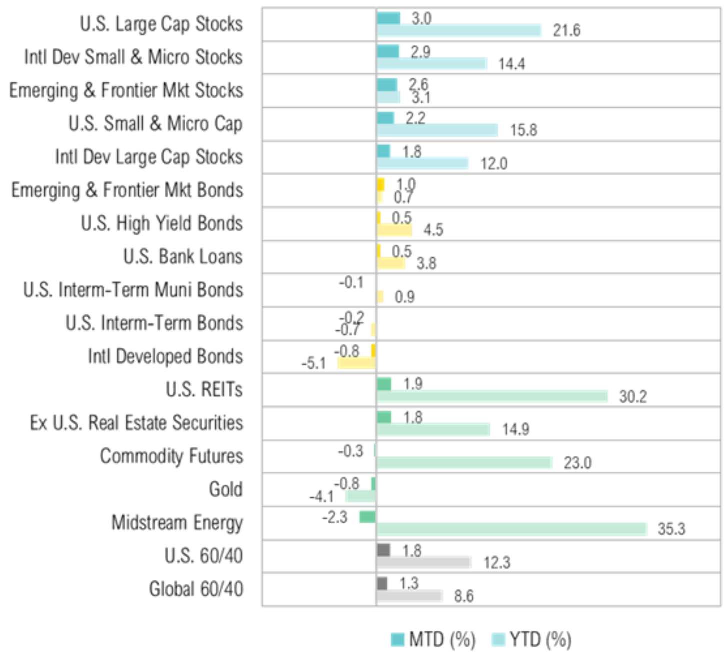
**The Best Start to a Bull Market Since at Least 1949**

S&P 500 Index Growth of 100: Current vs. Historical Bull Markets, *As of 8/31/2021*


Source: Bloomberg

Looking at the stock market's gains since the pandemic lows, the current bull market sits comfortably at the top of the list of most remarkable in the post-War era.[2] But with the sizable gains comes rising risks. An almost eerie calm – along with substantially higher valuations of all assets – hides pressures building under the surface.

**August 2021 Key Market Total Returns**




Source: Bloomberg

These gains were not without reason. The economy and labor market have improved, corporate earnings have grown, and the vaccine rollout has been robust.[3] But more notable than all of these factors is the massive amount of fiscal spending, largely funded by the Federal Reserve's continued bond buying. As such, investors are on the lookout for signs the support may be reduced. For instance, after months of exceptional labor market gains, a good, but weaker-than-expected, round of August payrolls (released on September 3) softened expectations for any tapering of Fed bond buying.[4]

***At the Federal Reserve's Jackson Hole Economic Symposium, Fed Chairman Jerome Powell suggested the Fed may taper bond purchases later this year, while simultaneously emphasizing that the labor market was far from healed, implying substantial further support would be needed.***

## Jackson Hole

On August 27, 2021, Fed Chairman Jerome Powell shared his keynote comments at the Federal Reserve's virtual Jackson Hole Economic Symposium.[5] In a speech reminiscent of the Greenspan era, Powell spoke a lot without saying much at all. His comments included enough hawkish language to suggest the Fed was paying attention to growing inflation pressures, but he also indicated that the recent jump in inflation was transitory.

> *"The spike in inflation is so far largely the product of a relatively narrow group of goods and services that have been directly affected by the pandemic and the reopening of the economy… **we expect the inflation effects of these increases to be transitory.**"* [5]

Powell also suggested the Fed may taper bond purchases later this year, while simultaneously emphasizing that the labor market was far from healed, implying substantial further support would be needed.

> *"[I]f the economy evolved broadly as anticipated, **it could be appropriate to start reducing the pace of asset purchases this year."*** [5]

*"The unemployment rate has declined to 5.4 percent, a post-pandemic low,* ***but is still much too high****, and the reported rate understates the amount of labor market slack. Long-term unemployment remains elevated, and the recovery in labor force participation has lagged well behind the rest of the labor market, as it has in past recoveries."* [5]

Finally, Powell appeared to solidify the Fed's relatively dovish bias as he laid out the risks of removing monetary support too soon.

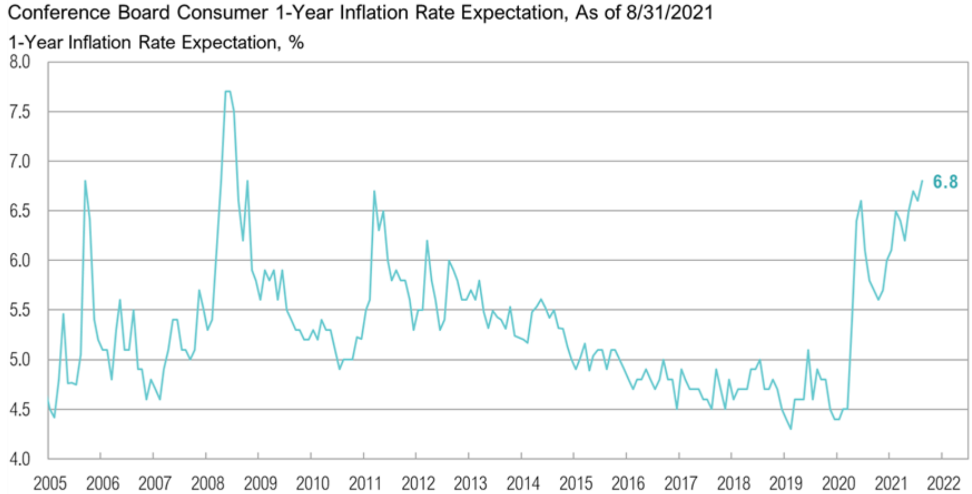
*"Indeed, responding [reducing support]* ***may do more harm than good****, particularly in an era where policy rates are much closer to the effective lower bound even in good times. The main influence of monetary policy on inflation can come after a lag of a year or more. If a central bank tightens policy in response to factors that turn out to be temporary, the main policy effects are likely to arrive after the need has passed. The ill-timed policy move unnecessarily slows hiring and other economic activity and pushes inflation lower than desired. Today, with substantial slack remaining in the labor market and the pandemic continuing, such a mistake could be particularly harmful. We know that extended periods of unemployment can mean lasting harm to workers and to the productive capacity of the economy."* [5]

***The Federal Reserve may be confident that inflation is transitory, but consumers are more skeptical. A Conference Board survey of consumer confidence for August showed that consumer inflation expectations over the next 12 months had increased to 6.8%, a 10-year high.***

The U.S. dollar declined by almost half a percent on Powell's comments, confirming his dovish stance and suggesting the market had expected more clarity on when support would be withdrawn. Regardless of what was said, the Fed continued, at pace, with their bond buying program. For the four weeks ending August 25, the Fed purchased an additional $111 billion worth of bonds, bringing their balance sheet to well over $8.3 trillion.[6] And while the Fed may be confident that inflation is transitory, consumers are more skeptical. A Conference Board survey of consumer confidence for August showed that consumer inflation expectations over the next 12 months had increased to 6.8%, a 10-year high.[7]

**Rising Consumer Inflation Expectations**

Conference Board Consumer 1-Year Inflation Rate Expectation, As of 8/31/2021




Source: Bloomberg

## Chinese Regulatory Crackdown

While U.S. and developed countries' equity markets have been remarkably stable in 2021, Chinese markets sold off 32% from February 17th to August 20th amid the latest round of regulatory reform by the Chinese Communist Party (CCP). The crackdown began with the

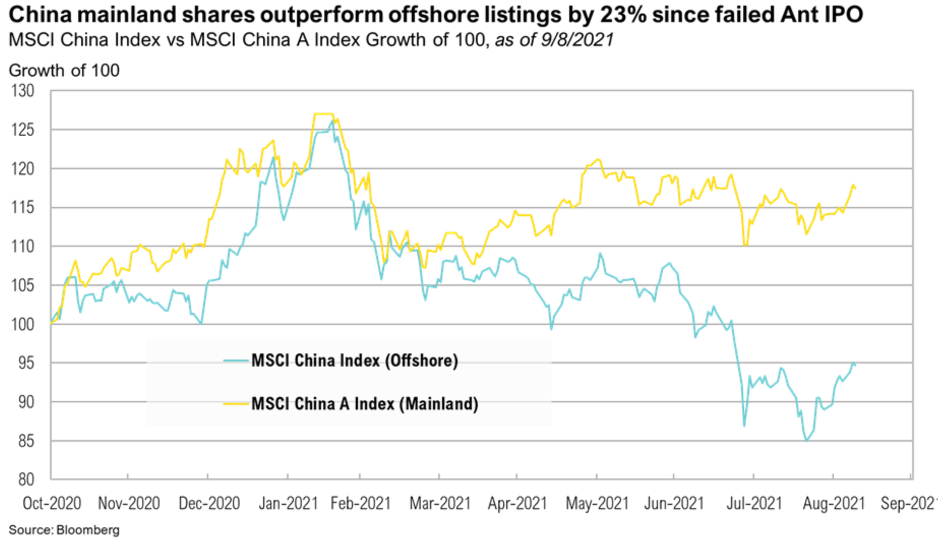
***Historically, the Chinese Communist Party has used regulation to push companies to serve the CCP's economic, social, and national-security concerns. Most recently, the CCP has announced measures such as banning for-profit enterprises in the education sector, restricting gaming activity for kids and suppressing alcohol consumption.***

cancellation of Chinese financial giant Ant Group's IPO, scheduled to take place in November 2020.[8] Valued at over $300 billion, the company was expected to overtake oil giant Saudi Aramco as the world's largest initial public listing.[9] However, after Ant Group founder and Alibaba CEO Jack Ma apparently disparaged Chinese banking regulations,[8] the CCP introduced more stringent lending laws, which hurt Ant's lending and credit business and therefore threatened nearly 40% of the company's revenue.[9] Ant subsequently decided to postpone its listing amid what would have been a much lower valuation for a substantially altered business. In addition, the CCP launched an anti-trust investigation into e-commerce giant Alibaba, resulting in a record $2.8 billion fine, a direct retaliation by the CCP against Ma.[10] In an even stranger turn of events, the normally charismatic Jack Ma disappeared from the public eye without much explanation. Some even speculated the Chinese government had taken him hostage, until he reappeared three months later.[11]

This isn't the first time the Chinese government has increased corporate regulations. Historically, it has done so to push companies to serve the CCP's economic, social, and national-security concerns.[10] Since Ant's failed IPO, the CCP has announced and implemented several new regulatory measures, including:

- Banning for-profit enterprises in the education sector, disrupting the $100 billion dollar tutoring industry[12]
- Restricting gamers under the age of 18 from playing on weekdays and limiting usage to just three hours on the weekends to curb addiction and improve kids' mental health[13]
- Suppressing post-work alcohol consumption in response to sexual assault allegations[14]
- Attempting to put an end to "idol culture" by restricting the ranking of celebrities by popularity and removing content from specific actors and musicians from online social media and video platforms[15]

Setting aside these policies' attempts at social engineering, they represented new and unexpected rules, costs, and uncertainty for markets, wiping out over $1 trillion in market value in just a few months, and there is fear that more regulation is coming.[16] Chinese tech companies have been popular investments in international portfolios over the last decade, despite a Chinese law that forbids them to list on foreign exchanges.[17] To circumnavigate the law, these firms set up structures called Variable Interest Entities (VIEs), offshore shell companies that enable mainland Chinese firms to list in overseas markets and attract international capital. Some analysts speculate that the CCP will crackdown on this activity, cutting off international investment and triggering massive capital outflows, which would permanently impair the value of these firms.[18] As a result, Chinese companies that are organized as VIEs have been hit the hardest. Among these firms are Tencent and Alibaba, down 38% and 47% from their respective highs.




## Looking Forward

Record-high equity prices reflect fundamental improvement in the economy and earnings backdrop. That said, part of this improvement has unquestionably been driven by massive amounts of stimulus pumped into the economy and markets. Investors are right, therefore, to focus on the Fed and when it might withdraw support. Recent comments from Fed Chairman Powell suggest the Fed currently favors more, rather than less, support.

But there is an additional element of the policy backdrop that also needs to be watched. The U.S. Treasury ended August with an operating cash balance of just $356 billion, down from almost $1.8 trillion at the start of the year.[19] At the beginning of August, the Treasury expected to need to issue almost $1.4 trillion of debt in the back half of the year.[20] This assumption was based on known expenditures and a presumed increase in the debt limit, which is yet to occur.[20] As it stands, Treasury estimates it will run out of operating cash around the middle of October 2021.[21] Assuming that Congress is able to find a way to raise the debt ceiling, this could lead to a dramatic increase in debt issuance, which has the potential to put upwards pressure on bond yields.

## 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


1. Drawdown data is based on monthly total returns sourced from Bloomberg.
2. Bloomberg, SpringTide calculations based on daily closing price index values.
3. Factset: https://www.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_090321A.pdf
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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/LSTA 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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