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CLIENT COMMUNICATION

Madison Commentary Report - September 30, 2021

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EQUITY MARKETS EDGED HIGHER IN THE THIRD QUARTER

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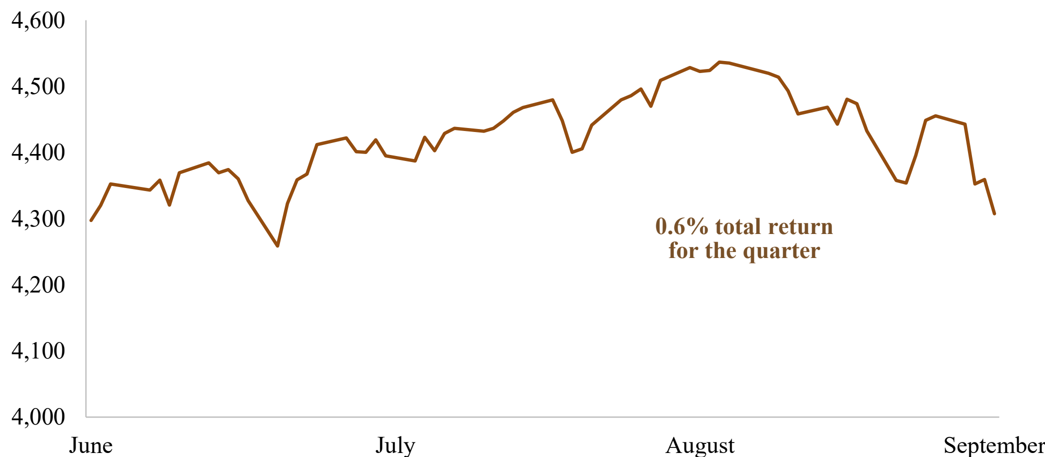
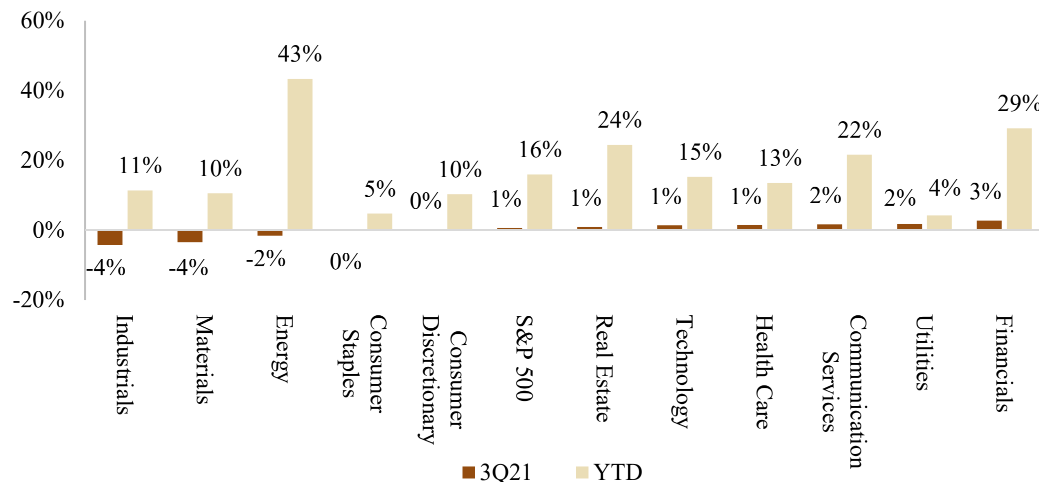


Quarter Highlights

- With the Delta variant and increased volatility, the S&P 500 closed just higher in the third quarter, up 0.6% bringing the full year to +15.9%.
- The Federal Reserve (Fed) has begun to message its path for removing stimulus. We expect the Fed to announce a reduction in bond purchases at the November meeting. The latest Fed meeting suggested possible interest rate hikes as early as the second half of 2022.
- The Delta variant, supply chain issues, policy changes in China and disagreement in Washington have resulted in increased volatility and as a result, we could see slower GDP growth in the third quarter and more volatility in the markets.



Sector Snapshot

- Performance was more mixed during the third quarter with the cyclical sectors of Energy, Industrials and Materials experiencing negative returns. Financials, Utilities, and Communication Services were the strongest sectors with modest positive returns.
- We believe that we have reached the mid-point of the current economic cycle and should continue to see quality and stable growth perform better while we expect the cyclical sectors to see more volatility dependent on earnings growth.
- On a year-to-date basis, Energy and Financials remain the top performers with Real Estate and Communication Services also posting very strong performance. Consumer Staples and Utilities, both defensive sectors, are the weakest performers but still positive for the year.

Source: FactSet, Bloomberg

EQUITY MARKETS EDGED HIGHER IN THE THIRD QUARTER

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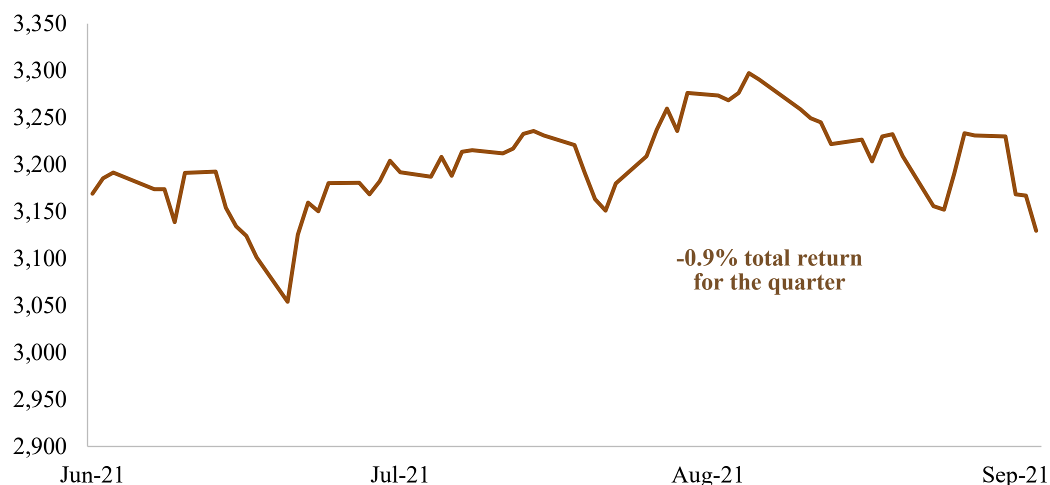
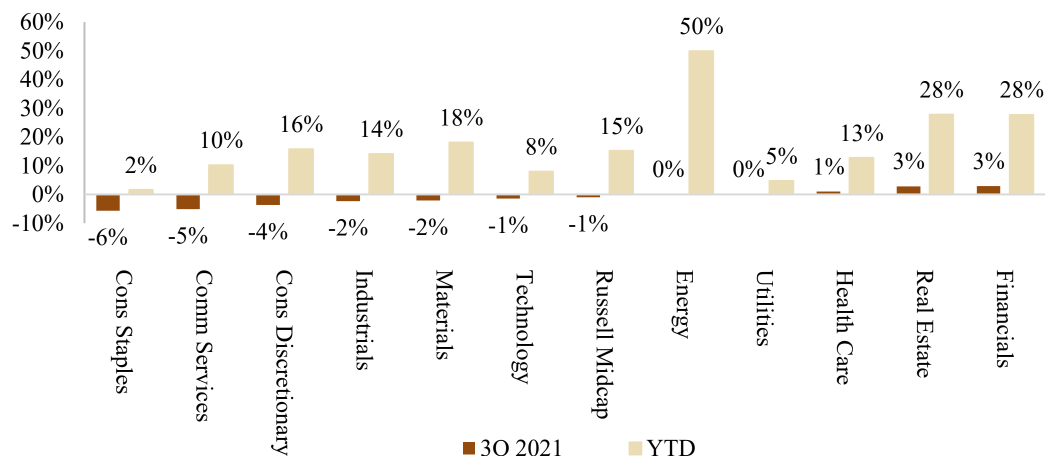


Quarter Highlights

- With the Delta variant and increased volatility, the Russell Midcap closed down -0.9% bringing the full year to +15.2%.
- The Federal Reserve (Fed) has begun to message its path for removing stimulus. We expect the Fed to announce a reduction in bond purchases at the November meeting. The latest Fed meeting suggested possible interest rate hikes as early as the second half of 2022.
- The Delta variant, supply chain issues, policy changes in China and disagreement in Washington have resulted in increased volatility and as a result, we could see slower GDP growth in the third quarter and more volatility in the markets.



Sector Snapshot

- Performance was more mixed during the third quarter with the cyclical sectors of Materials, Industrials and Consumer Discretionary experiencing negative returns. Financials, Real Estate, and Health Care were the strongest sectors with modest positive returns.
- We believe that we have reached the mid-point of the current economic cycle and should continue to see quality and stable growth perform better while we expect the cyclical sectors to see more volatility dependent on earnings growth.
- On a year-to-date basis, Energy, Financials, and Real Estate remain the top performers with Materials and Consumer Discretionary posting strong performance. Consumer Staples and Utilities, both defensive sectors, are the weakest performers but still positive for the year.

Source: FactSet, Bloomberg

THIRD QUARTER - VOLATILITY RETURNS WITH MUTED RETURNS

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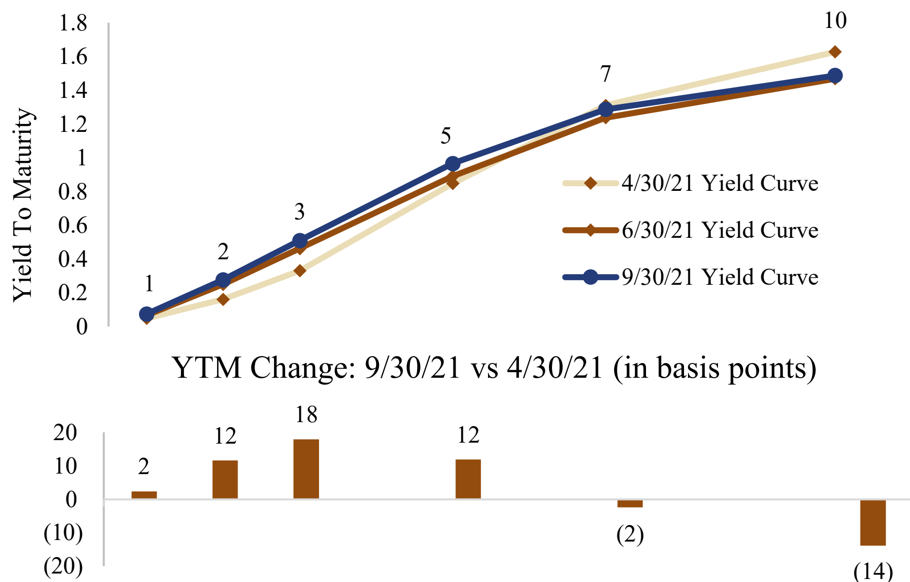
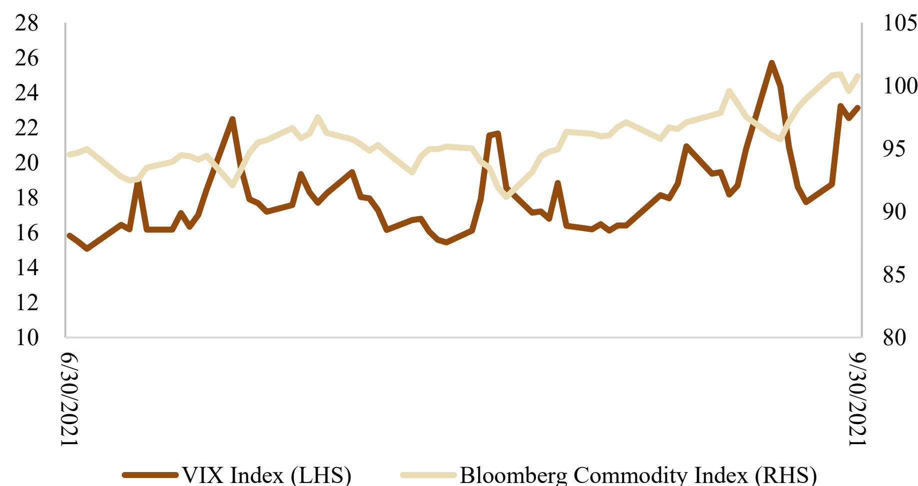
Note: Returns in USD

- Equity market returns were varied during the third quarter across geography, size and style. Small cap stocks underperformed with a -4.4% return during the quarter. Cyclicals also had a challenging quarter with negative returns. Growth led the market during the quarter while Value experienced negative returns. On a year-to-date basis, total returns remain strong with the S&P 500 up 15.9%, Midcap up 15.2% and Small cap up 12.4%.
- International and emerging market returns continued to trail US equity returns as many economies continue to vaccinate their populations and work to reopen their economies. Emerging markets were down -8.0% in the quarter and are now down -1.2% year to date. International developed markets were also down modestly during the quarter but year-to-date returns remain solid, up 8.3%.
- (Bottom Left) Bond markets continue to be volatile this year. During the third quarter, 10-year Treasury yields dropped to a low of 1.18% but then moved higher by the end of the quarter. The 10-year Treasury yields now stand at 1.48%, only modestly higher than at the end of the second quarter. With the Fed announcing it will soon begin to taper bond purchases, short term rates have continued to move higher since the end of April.
- (Bottom Right) Commodity prices and volatility moved higher during the quarter. Higher commodity prices will likely impact consumer spending and corporate margins. This may result in lower earnings for the third and fourth quarter.





Sources: Bloomberg, FactSet

GROWTH EXPECTATIONS COOLING, INFLATIONARY CONCERNS RISING, IS STAGFLATION ON THE HORIZON?

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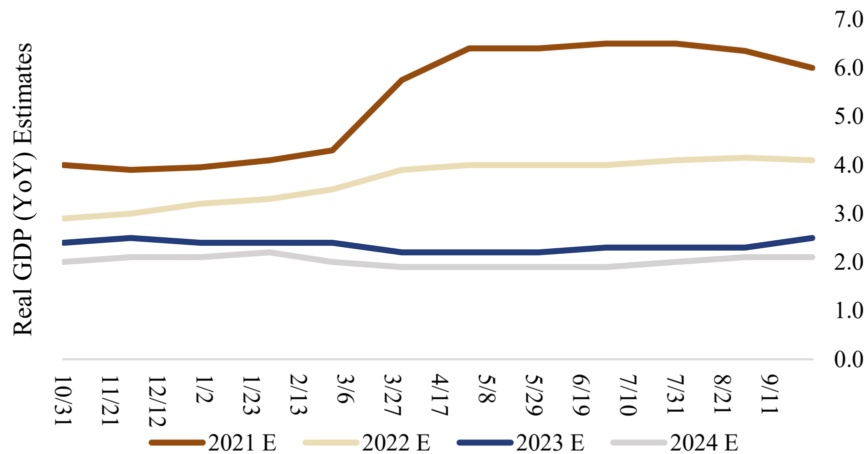

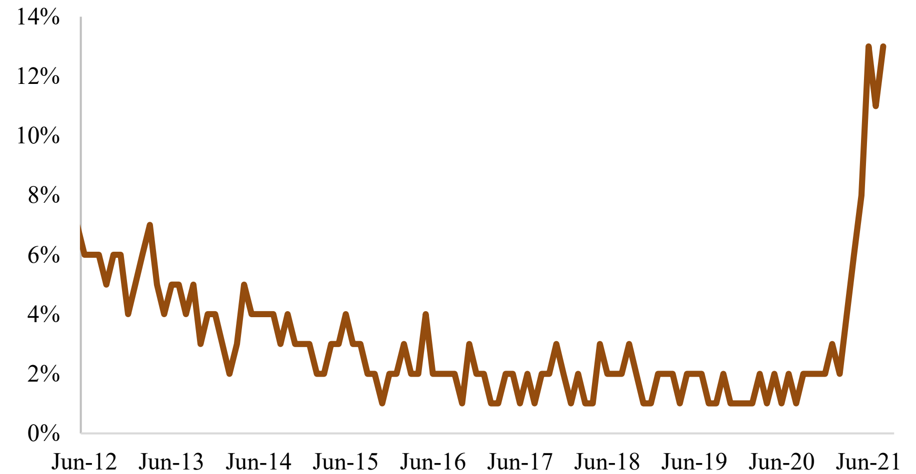

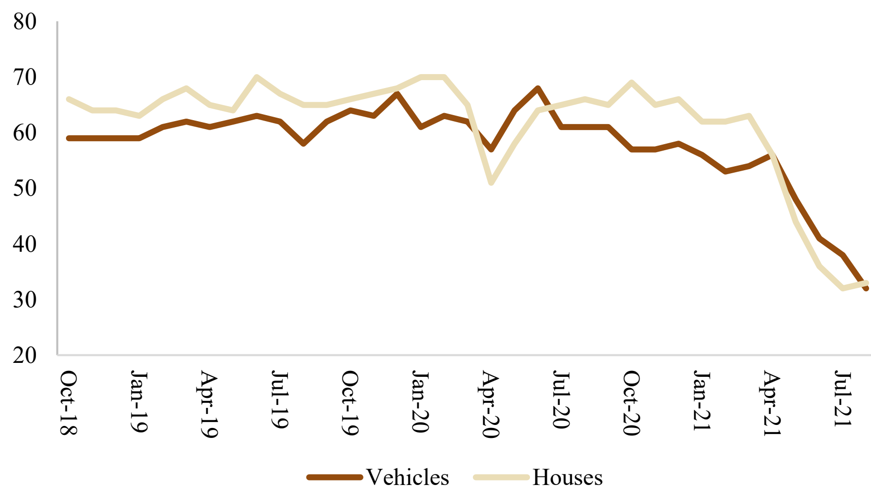

- (Top Left) GDP growth estimates for 2021 increased earlier this year as additional fiscal stimulus was passed and the economy continued to reopen. Recent GDP growth estimates have started to drift lower as infrastructure spending negotiations have stalled and the odds of the Biden agenda passing are diminished. The Delta variant circulating and increased supply chain issues across industries may also impact economic growth.
- (Bottom Left) As prices have continued to accelerate this year, consumers are pulling back as recent survey results increasingly indicate that consumers who believe now is a "good time to buy" large items such as a home or vehicle have declined.
- (Top Right) As costs have continued to move higher, an increasing share of small businesses have indicated that inflation is a top concern, registering at the highest rate in the past decade.

Sources: Factset

BEIJING'S CAMPAIGN FOR "COMMON PROSPERITY"

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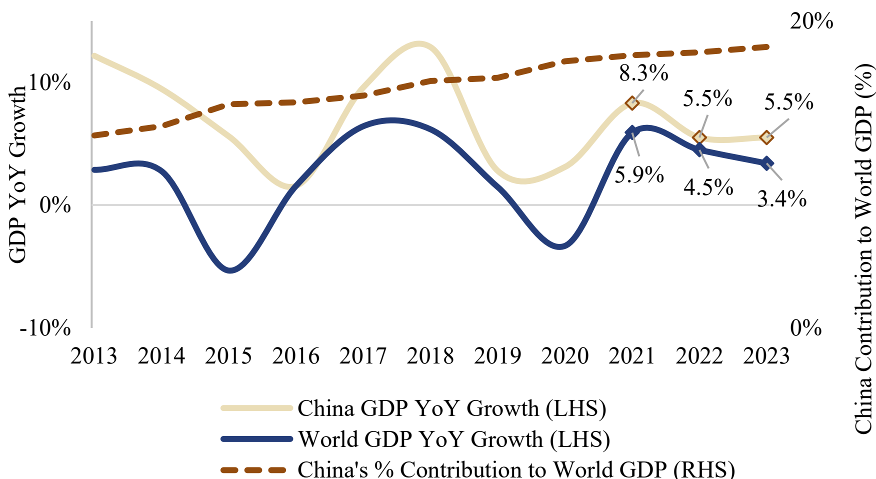

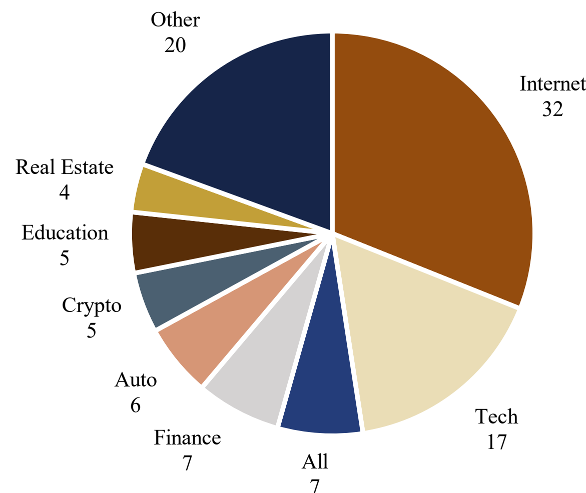

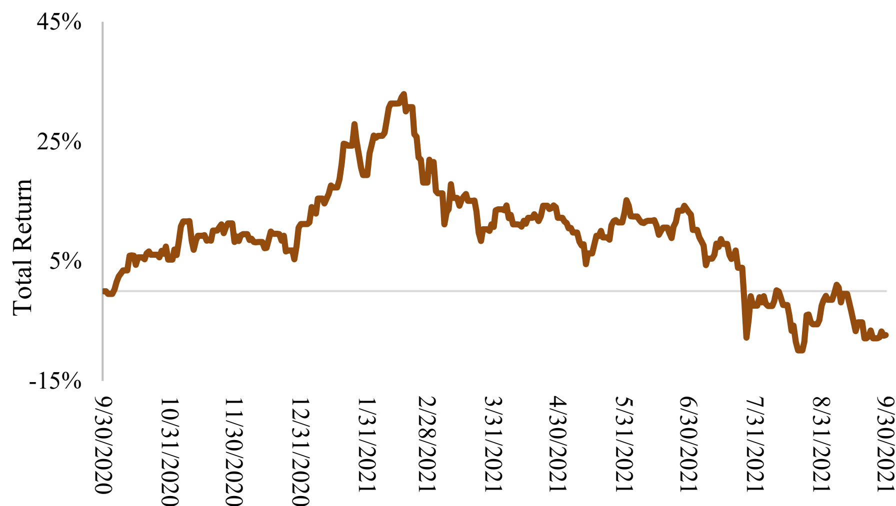

- (Top Left) Various actions by the Chinese government have impacted growth dynamics for both China and the global economy. China GDP growth is expected to be in the 4% to 6% range going forward compared to historical levels of 7% to 10%. Slower growth in China will likely cause a headwind for global growth as it accounts for a high-teens percentage of global GDP.
- (Top Right) In pursuit of achieving "common prosperity", Beijing has continued and accelerated its regulatory campaign against the private sector by implementing over 100 regulations in the past year, with more than 75% of them coming in the 3rd quarter alone. The increased regulatory scrutiny has been broad-based, creating a burden shared by roughly 20 industries. While the large cap technology companies were among the first to be targeted, more damaging regulatory impacts can be seen within education and real estate industries.
- (Bottom Left) Over the past year the Chinese equity markets had seen an impressive rebound from the start of the fourth quarter of 2020 until February of 2021, however, the pursuit of "common prosperity" has created headwinds for the Chinese equity markets resulting in weaker relative performance this year.

Source: Cornerstone Macro, Morningstar Direct

SUPPLY CHAINS ARE NOT RUNNING SMOOTHLY, WILL IT CREATE HIGHER INFLATION?

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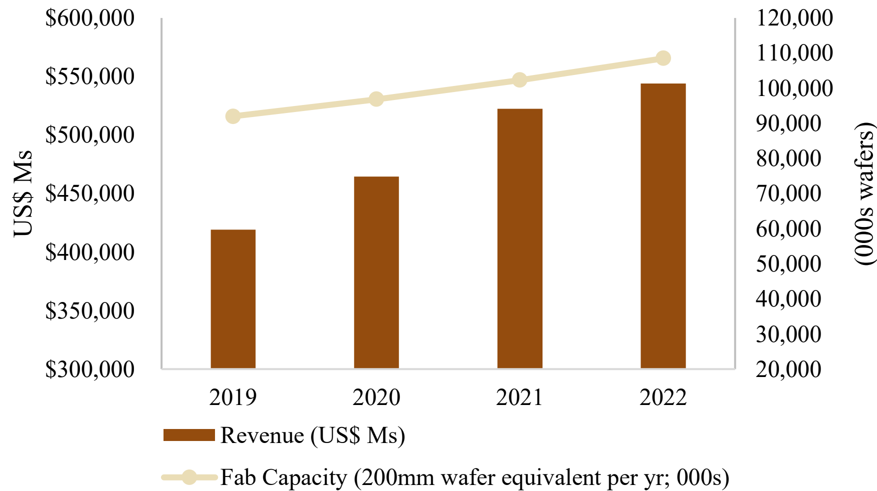

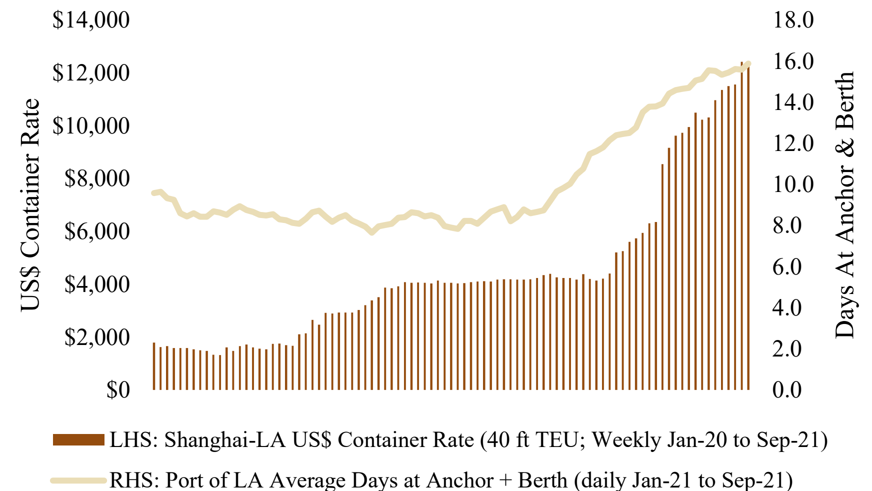

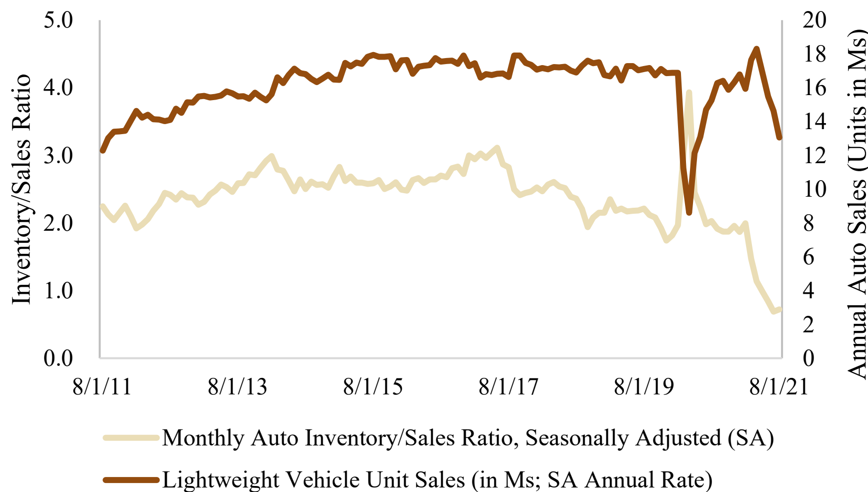

- (Top Left) Demand for semiconductors has grown faster than wafer fabrication capacity with demand growth in the low double digits while capacity has increased by approximately 5%. The stay at home shift during Covid has driven higher consumer electronics demand which along with inventory builds by PC makers led to tight chip supplies. On the supply side, tepid capacity growth combined with weather disruptions in Texas caused several semiconductor plants to close. Additionally, a large fire at a major provider of auto chips earlier this year further disrupted supply.
- (Bottom Left) At the start of 2021, auto sales were expected to reach 18.5 million units for the year but that estimate has fallen 30% to 13 million units due to chip shortages. Auto makers have reduced shifts and closed plants. General Motors is temporarily shutting down eight of its fourteen North American plants because of the chip shortage. The Inventory-to-Sales ratio is at less than 1.0, a decades low which is driving much higher prices for new and used cars.
- (Top Right) The Ports of Los Angeles (LA) and Long Beach (LB) account for 40% of U.S. imports and 30% of exports. Duration of anchored and berthed ships has doubled to 16 days due to Covid related restrictions and labor shortages with the two ports operating at 60% to 70% of capacity. Container rates have increased dramatically causing additional supply uncertainties with inflationary forces expected to last longer.

Source: Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, Port of LA, Drewry World Container Index, Bloomberg, SEMI, Madison Investments

EARNINGS ESTIMATES HAVE CONTINUED TO RISE BUT WE MAY SEE SOFTNESS IN THIRD QUARTER

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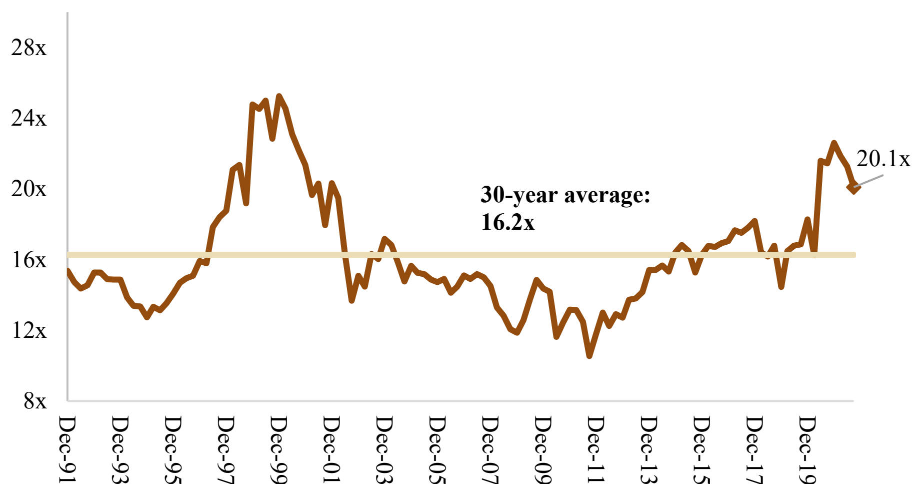
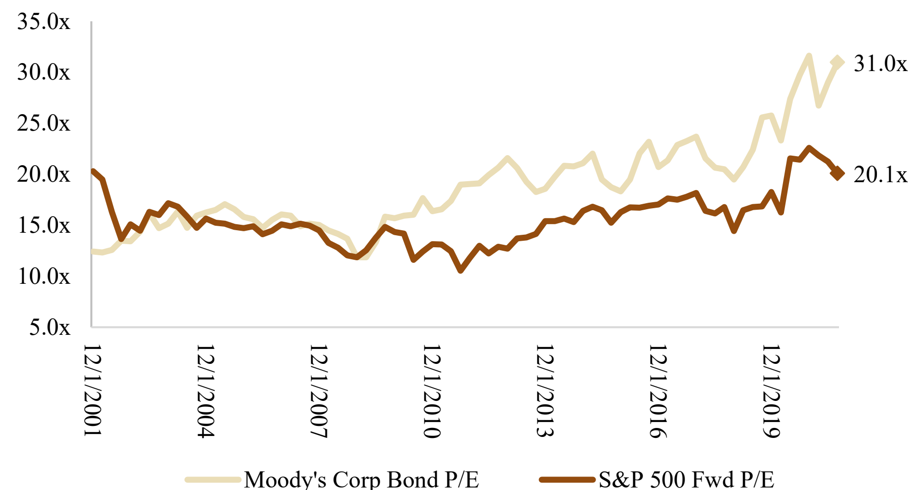


- (Top Left) However, we have seen more volatility this quarter as a result of the Delta variant, supply chain issues as well as the political uncertainties in Washington and as a result, we could see estimates drift lower. Equity valuations remain above historical averages but with historically low interest rates and strong earnings growth, a higher price-to-earnings ratio is warranted. The Fed has stated that it may soon begin to reduce its bond purchases with an announcement forthcoming in November. This may cause additional volatility.
- (Bottom Left) We have started to use 2022 estimates for equity market valuation and although we do expect equity markets to continue to be supported by the strong recovery and liquidity in the financial markets, we do not expect a strong move into year-end.
- (Bottom Right) With low interest rates and negative real yields, equities remain more attractive than bonds. Earlier this year, the yield curve began to flatten with the yields on longer dated maturities moving lower driving bond prices higher. Meanwhile, earnings estimates have moved higher driving a bigger divergence in the valuation of bonds versus equities.

S&P 500 Level Implied by Price to Earnings Combinations

		Price/Earnings Multiple				
		14x	16x	18x	20x	22x
	$ 250	3,500	4,000	4,500	5,000	5,500
	$ 240	3,360	3,840	4,320	4,800	5,280
	$ 230	3,220	3,680	4,140	4,600	5,060
S&P 500	$ 220	3,080	3,520	3,960	4,400	4,840
Earnings	$ 210	2,940	3,360	3,780	4,200	4,620
per Share	$ 200	2,800	3,200	3,600	4,000	4,400
	$ 190	2,660	3,040	3,420	3,800	4,180

S&P 500 Top Down Estimates		
	Mean	Growth
2019A	$ 163.13	
2020A	$ 140.46	-14%
2021E	$ 200.59	43%
2022E	$ 219.17	9%
2023E	$ 238.66	8%



Source: FactSet, Bloomberg

MACROECONOMIC SCORECARD: SEPTEMBER 30, 2021

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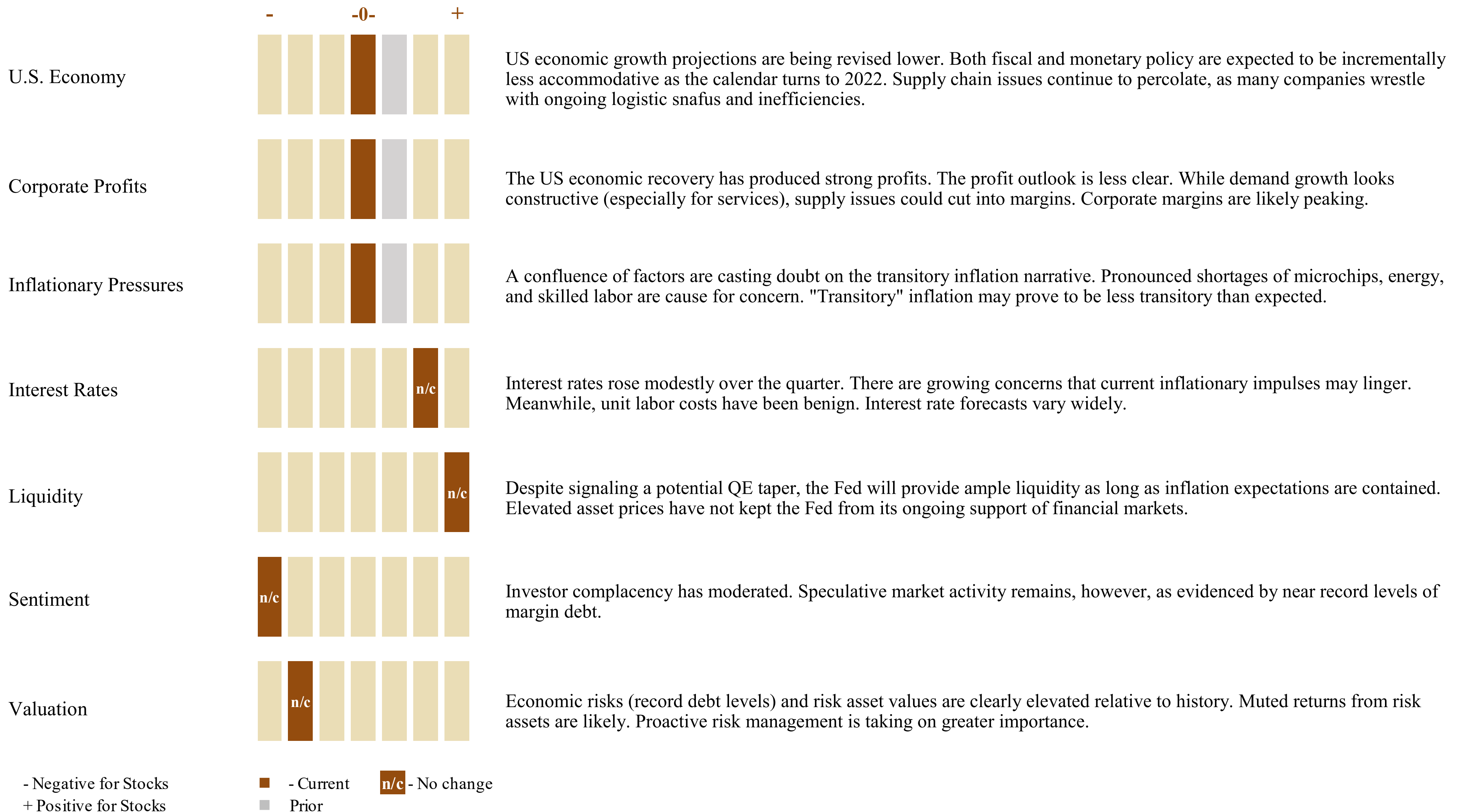
After a strong rebound, US economic growth is now slowing. Global supply chains are being challenged by a number of factors including shortages of microchips, higher energy prices and labor shortages. Logistic delays are now lengthening and broadening out, slowing economic growth and creating unwelcome pressures on corporate profit margins.



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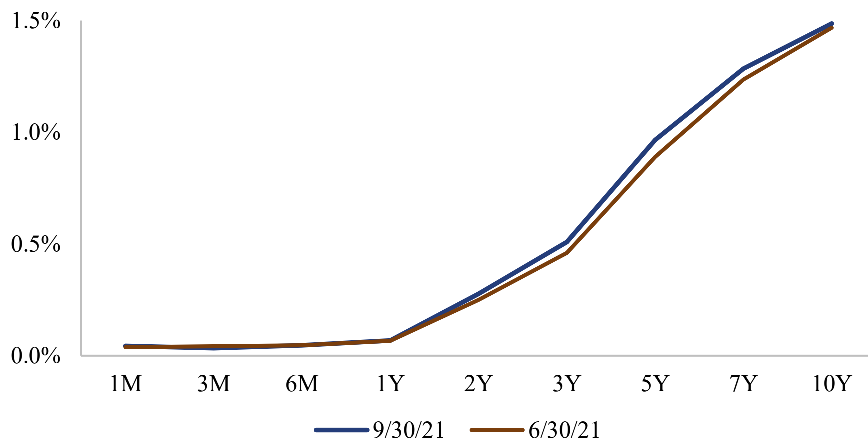
NEWS INFLUENCING MARKETS

Potentially Positive for Bond Returns

+ The transition from public to private support could prove difficult, especially with respect to labor markets and persistent supply bottlenecks, and the Fed could decide to maintain low interest rates.
+ The Delta variant or emergence of another troublesome COVID-19 strain could hamper a return to more normal economic conditions, and slow reopening efforts.
+ Valuations for riskier assets could adjust downward should rates rise due to the intertwined nature of markets. A desire for market stability could delay the Fed's march towards tighter monetary policy.

Potentially Negative for Bond Returns

– A forthcoming reduction in the amount of Treasuries purchased by the Fed will significantly reduce demand and yields are apt to rise before attracting sufficient investors to fill the void.
– Inflation could remain elevated for much longer than anticipated, thereby causing the Fed to accelerate policy changes and/or investors to command additional compensation for the risk taken.
– An increase in fiscal spending without a commensurate increase in tax receipts might necessitate incremental Treasury issuance, possibly pushing rates higher as government debt swells.



Source: Madison, Bloomberg

Fixed Income Scorecard

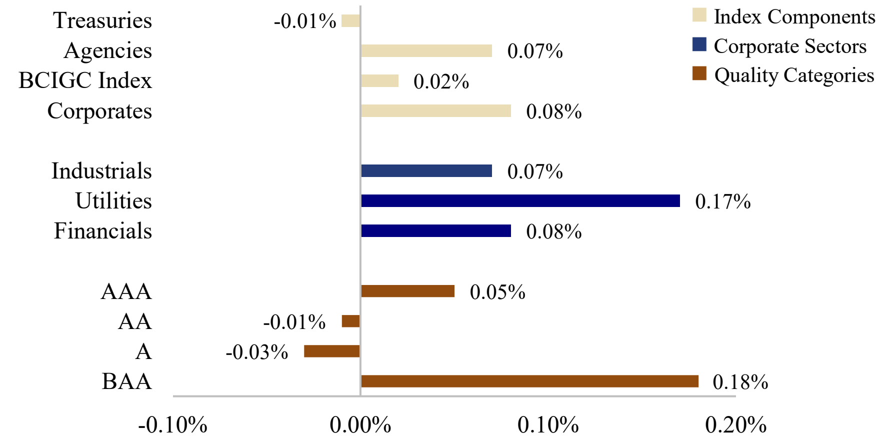
Potential Influence on Bond Returns

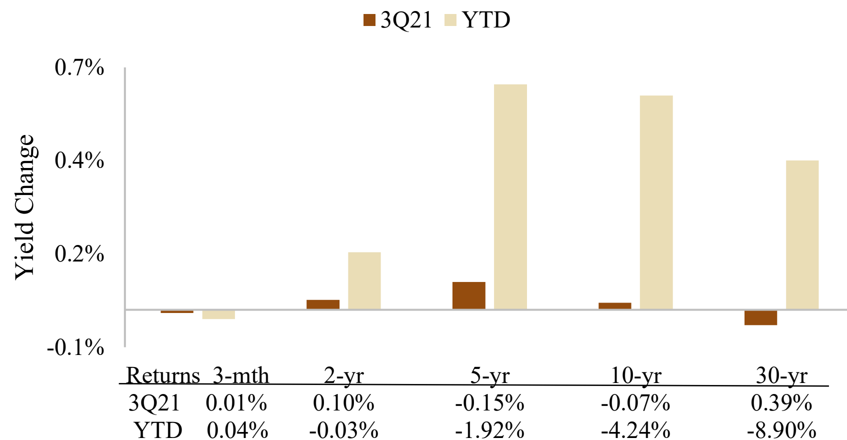
	-			-0-			+
U.S. Macroeconomics							
Economic Growth			n/c				
Employment			n/c				
Inflationary Pressures			n/c				
U.S. Policy							
Monetary (Fed)			n/c				
Fiscal (Congress)			n/c				
Regulatory / Tax			n/c				
Global							
Foreign Macroeconomics				Current	Prior		
Geopolitical tensions				n/c			
Central Bank Policies				n/c			
U.S. Corporates							
Credit Fundamentals			n/c				
Risk Premiums		Current	Prior				
Liquidity				n/c			
U.S. Treasury Market							
Interest Rates			n/c				
Sentiment			n/c				

- Negative for Bonds
+ Positive for Bonds

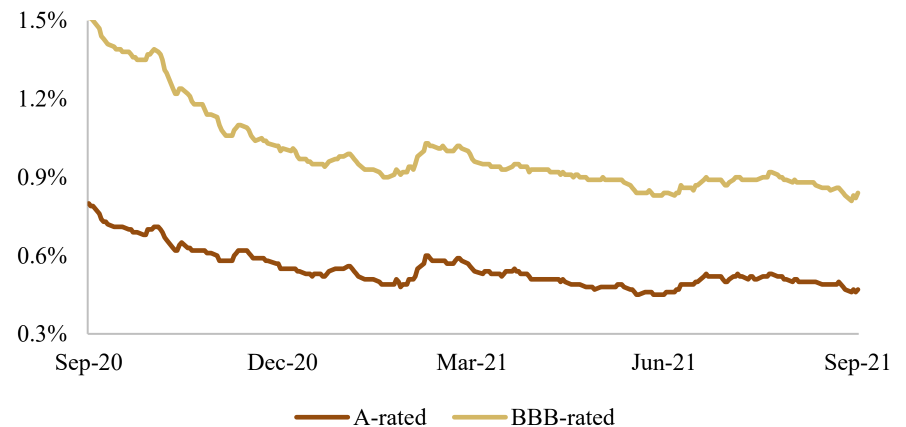
■ - Current
■ - Prior
n/c - No change

Asset Class	Market Sector	3Q21	YTD
Money Market	3-month Tbill	0.0%	0.0%
Fixed Income	TIPS (1-10 year)	1.7%	4.1%
	US High Yield	0.9%	4.5%
	US Aggregate (1-30 yr)	0.1%	-1.6%
	Intermediate Gov/Credit	0.0%	-0.9%
	Municipal Bonds (1-30 yr)	-0.3%	0.8%
	EM Aggregate	-0.5%	-1.1%
Equities	S&P 500 Index	0.6%	15.9%
	Russell 3000 Index	-0.1%	15.0%
Int'l Equities	MSCI Europe, Asia, Far East	-0.3%	8.8%
	MSCI Emerging Markets	-8.0%	-1.2%
Commodities	Crude Oil (Brent)	8.1%	60.9%
	Commodities	6.6%	29.1%
	Gold	-1.0%	-7.9%





Returns	3-mth	2-yr	5-yr	10-yr	30-yr
3Q21	0.01%	0.10%	-0.15%	-0.07%	0.39%
YTD	0.04%	-0.03%	-1.92%	-4.24%	-8.90%



Source: Madison, Bloomberg

U.S. ECONOMIC GROWTH IS FORECAST TO EXCEED PRIOR TREND

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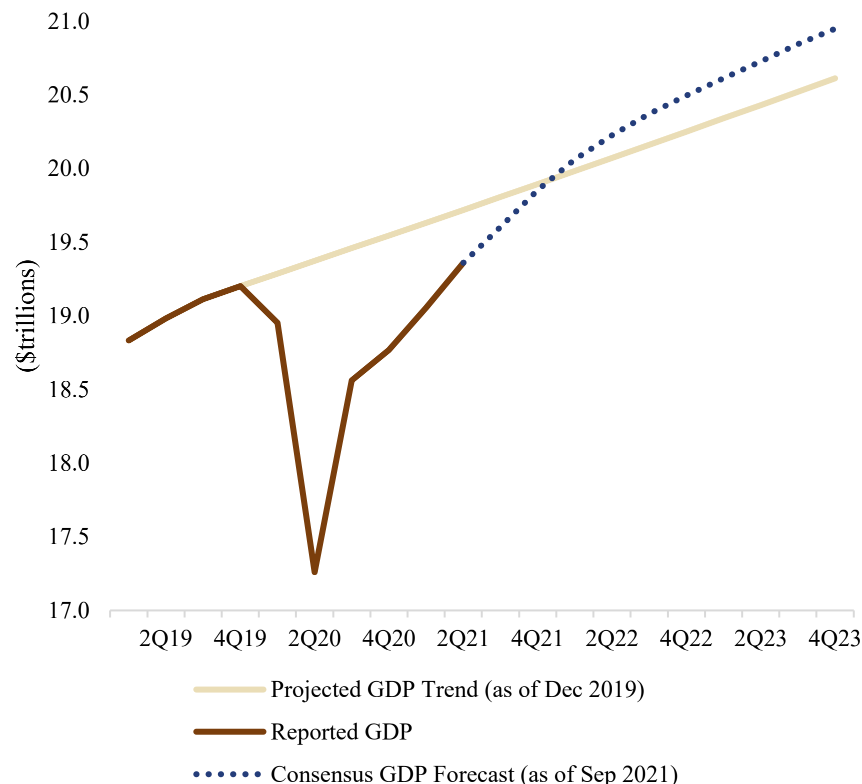

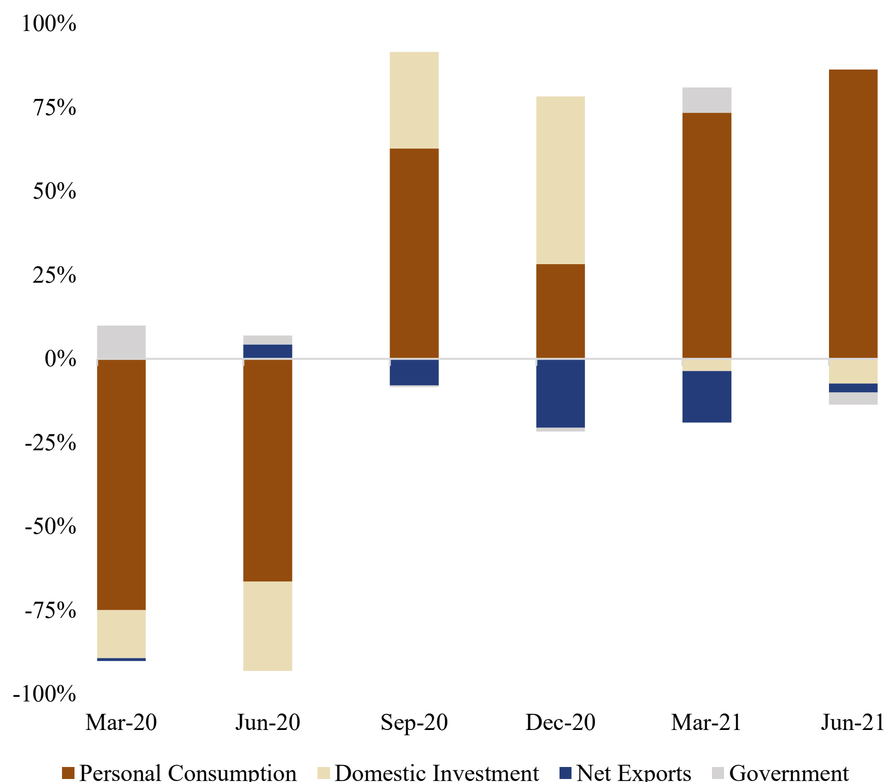

- Currently, economists estimate GDP will grow just under 3% on an annualized basis during the next three years. In comparison, the three year rolling growth trend in December 2019 was under 2%.
- Assuming GDP is not stymied by prolonged supply chain issues or the Delta variant, the current trajectory of U.S. economic growth should eclipse pre-pandemic projections in the coming quarters.

- Consumers have accounted for the vast majority of the contribution towards GDP growth during the past two quarters; the result of purchasing both goods and services.
- Growth contributions from the other three main GDP categories fell during the second quarter with drops in residential investment, net exports, and government expenditures.
- The growth outlook remains positive as consumer demand remains strong and business are apt to replenish depleted inventories.

Source: Bloomberg, Bureau of Labor Statistics

EMPLOYMENT CONTINUES TO IMPROVE ALTHOUGH WAGES HAVE FALLEN BELOW CORE INFLATION

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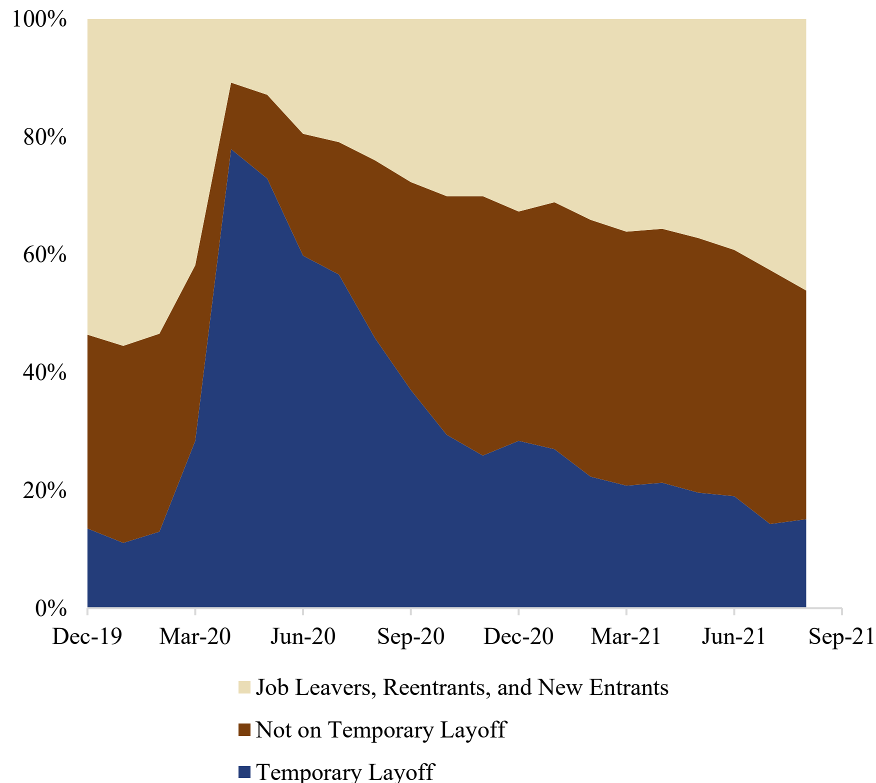
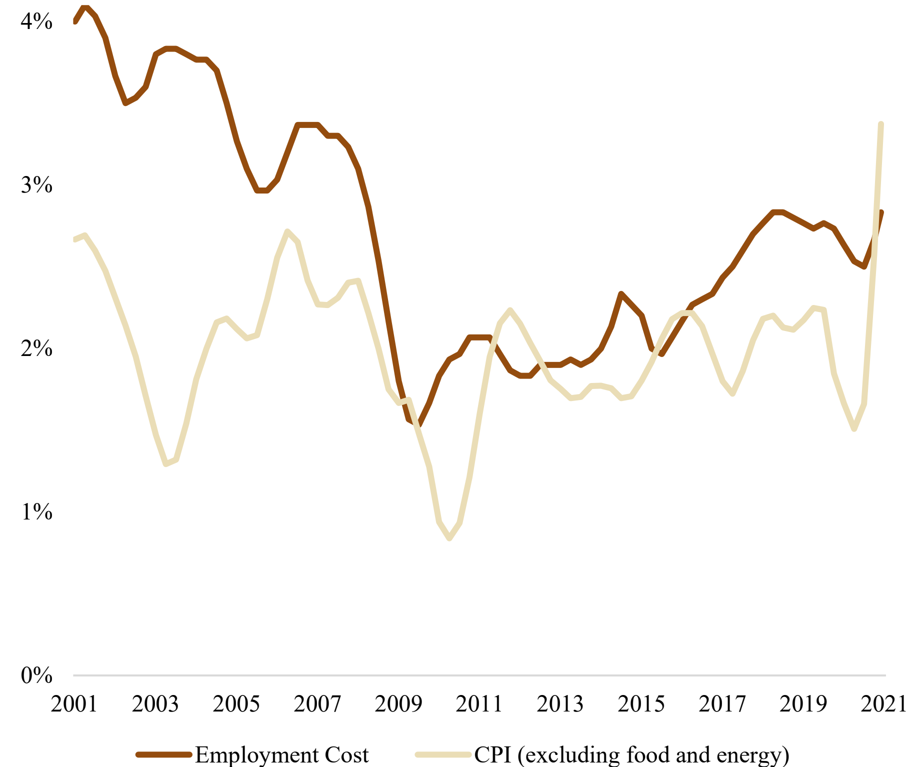


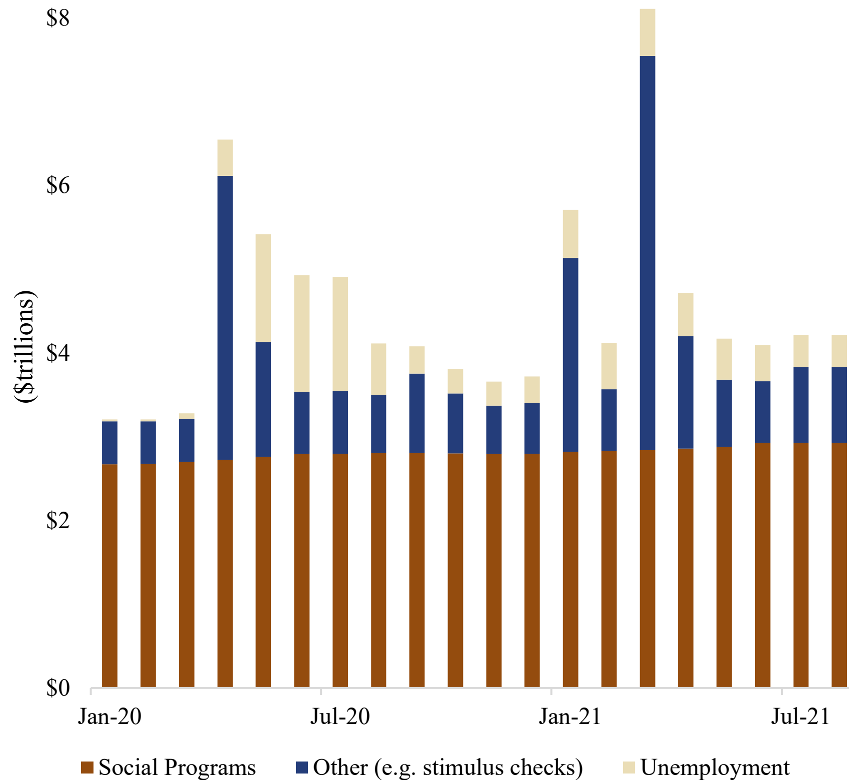


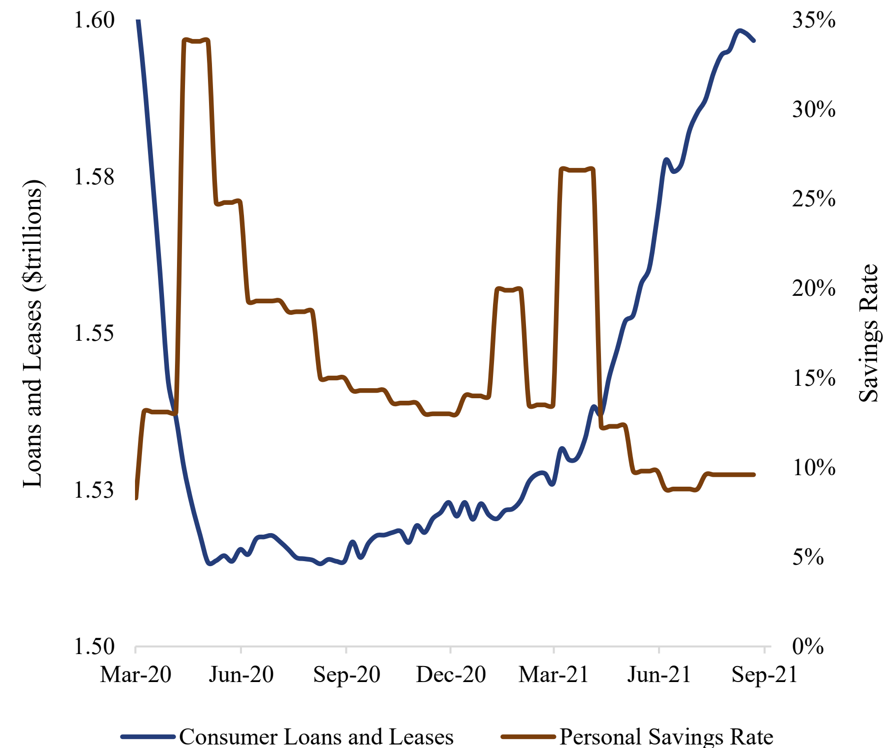
- Employment gains during the past year have been a leading catalyst for accelerated GDP growth.
- Most workers temporarily laid off after the pandemic hit the U.S. have been rehired; a sign of economic reopening. Many of today's unemployed lost their jobs due to business closure or workforce reduction while others have either reentered the workforce or willingly left their jobs.
- Employers are citing "a skills gap" for the abundance of job openings left unfilled; a troublesome reality for many displaced workers.

- Current employment costs are reported to be rising just under 3% annually, a level below the current rate of core inflation.
- Historically, the rate of inflation has exceeded the percent increase in wages and benefits only for brief periods.
- Though it's premature to conclude the magnitude of change for inflation or wages/benefits, both factors could affect future economic growth.

Source: Bloomberg, Bureau of Labor Statistics

CONSUMPTION IS EXPECTED TO CONTINUE DESPITE DIMINISHING FEDERAL STIMULUS





- Federal government payments from various stimulus programs and relief packages provided since April 2020 are nearing an end.
- We expect a limited impact on economic growth since many of the recipients either found jobs or did not rely on these funds to support spending habits.

- Savings as a percentage of disposable income rose significantly during periods when the government made one-time stimulus payments. Bank balances indicate much of this amount remains available for upcoming consumption.
- In addition to savings, we anticipate consumers will borrow funds to augment spending patterns as evidenced by the recent surge in bank loans and leases.

Source: Bloomberg, Federal Reserve

SMALL BUSINESSES MAY PROVIDE IMPORTANT CLUES ABOUT ECONOMIC PROSPECTS

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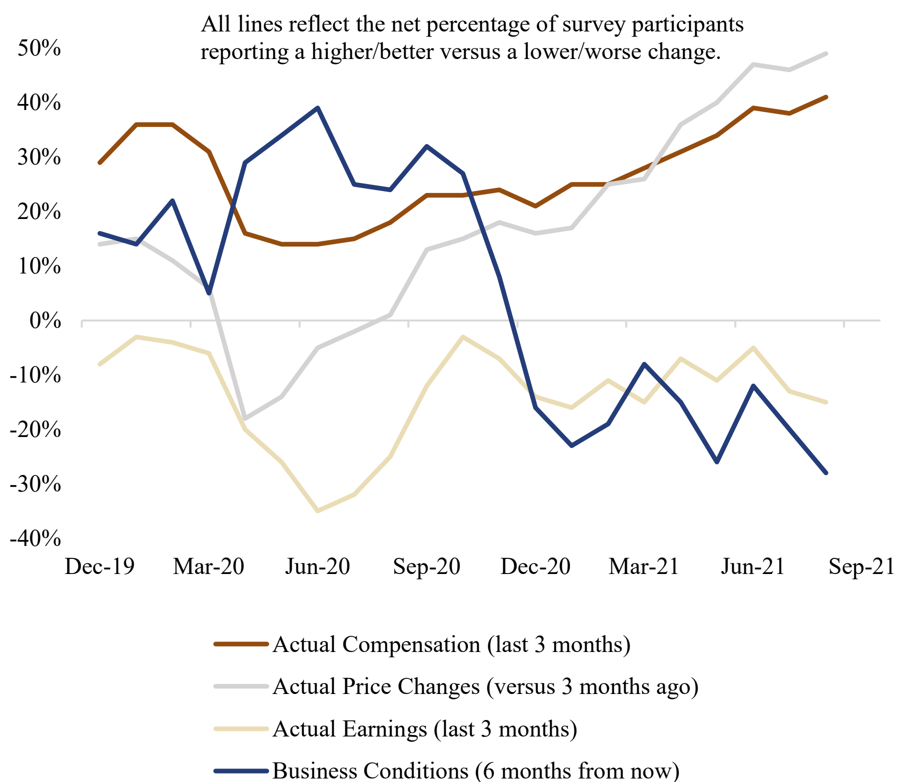

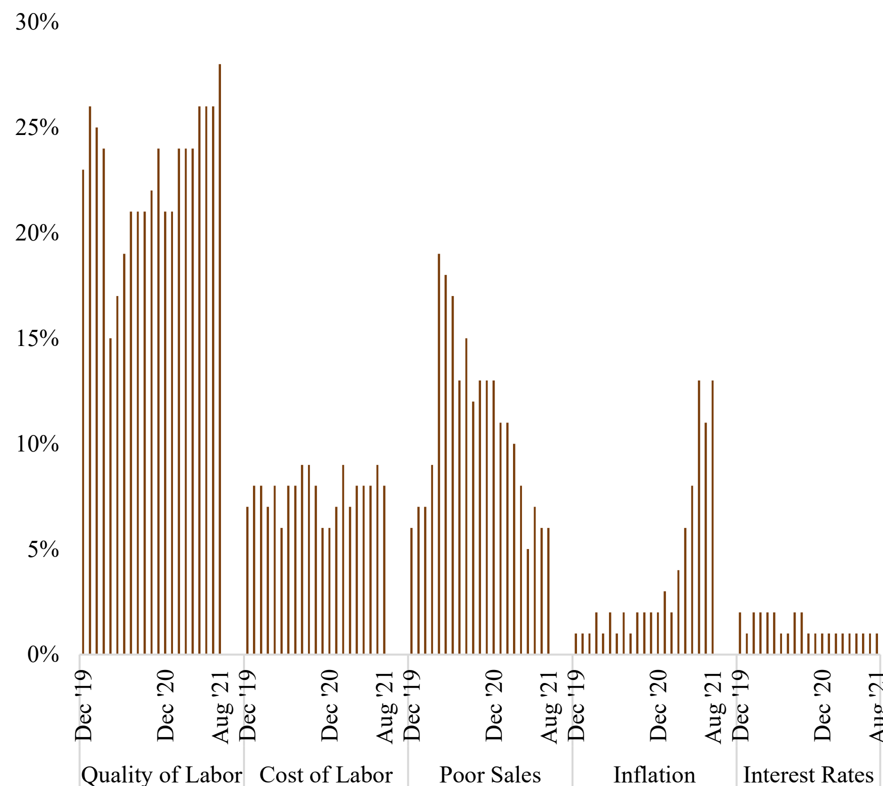

- In August, the National Federation of Independent Business (NFIB) reported companies are experiencing rising costs and are struggling to grow earnings.
- This may be problematic for economic growth given small businesses account for nearly two-thirds of new jobs and over 40% of GDP.
- Most concerning is survey participants on average expect business conditions to deteriorate during the next six months.

- In terms of specific concerns, the NFIB respondents indicated quality of labor (e.g. skills gap) as their number one problem. Despite hard to fill job openings, concern about labor costs remains similar to pre-pandemic levels.
- Inflation worries have risen steadily during the past six months, likely due to cost increases. Thus far, wage inflation has not been seen as a problem.
- At this point poor sales are less of concern than a year ago while rising interest rates have not been a concern. However, many companies indicated they did not have current borrowing needs.

Source: Bloomberg, National Federation of Independent Business, Small Business Association,

THE FED IS PREPARING TO REDUCE PURCHASES AS LONG-TERM YIELDS FLUCTUATE FOR MANY REASONS

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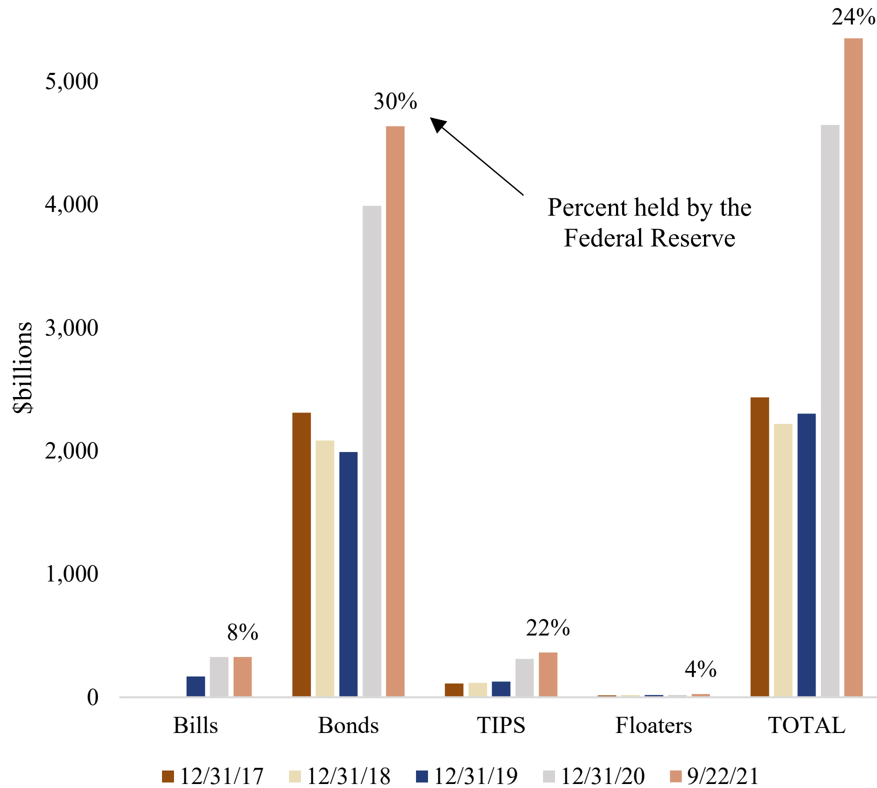

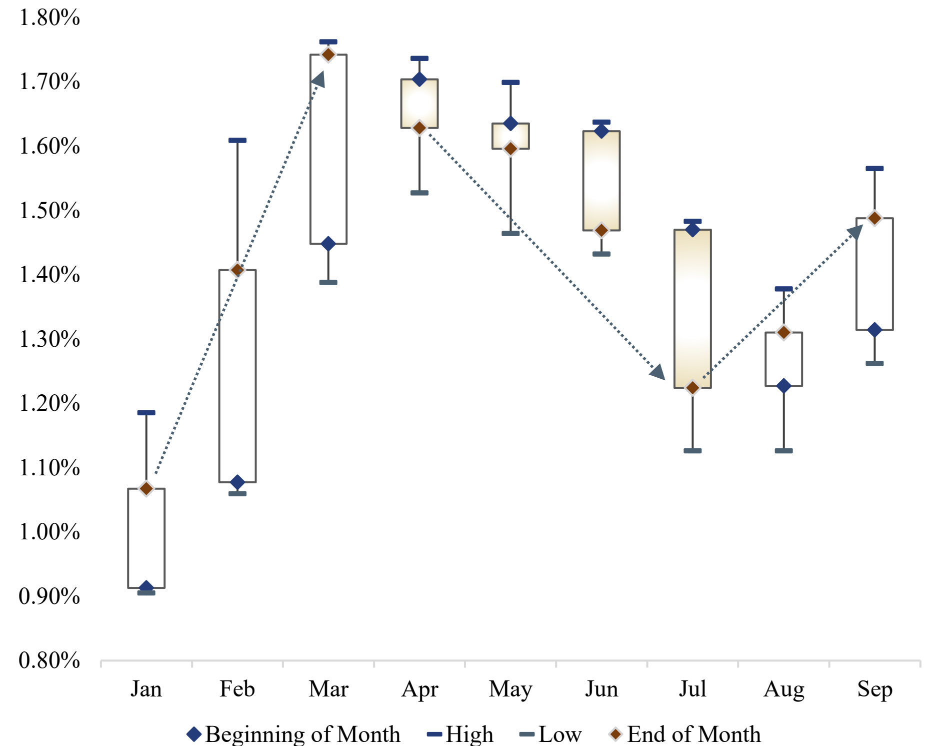

- We expect the Fed will announce a timeline for tapering asset purchases before year-end. Currently, the Fed purchases an incremental $80 billion in Treasuries and another $40 billion in mortgage-backed securities each month.
- The Fed holds about 24% of the outstanding marketable Treasury securities, a level the central bank will likely maintain for the foreseeable future.
- Post tapering, the Fed is likely to purchase Treasuries and mortgages to replace maturities, leaving other market participants to absorb the $120 billion plus new Treasury issuance.

- During the first nine months of 2021, the 10-year Treasury yield has ranged from 0.91% to 1.74%, fluctuating in response to economic outlooks, inflation reports, global trade, talk of Fed tapering, and the recent political stalemate.
- While we believe rates will drift higher, it’s unlikely 10-year yields will exceed 2% anytime soon given U.S. rates remain globally competitive as well as pent up demand for yield from pension funds and insurance companies.
- We intend to lengthen maturities once Treasury valuations adjust to levels indicative of existing financial and monetary realities.

Source: Bloomberg

A FOCUS ON BREAKEVEN YIELDS AND IN-THE-MONEY CORPORATE BOND MAKE-WHOLE CALLS

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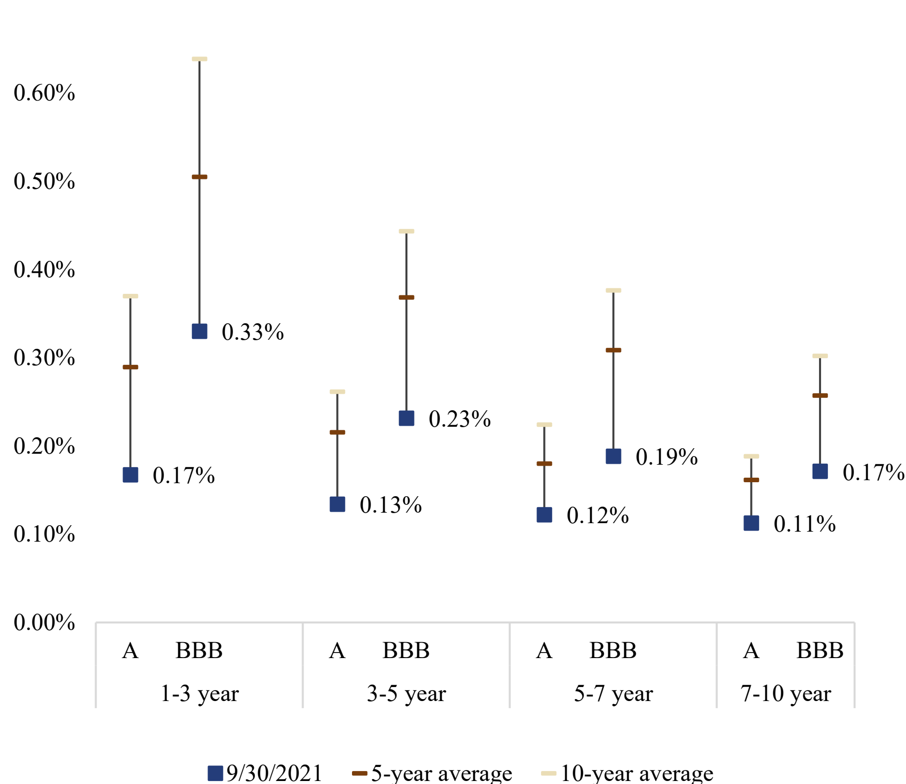

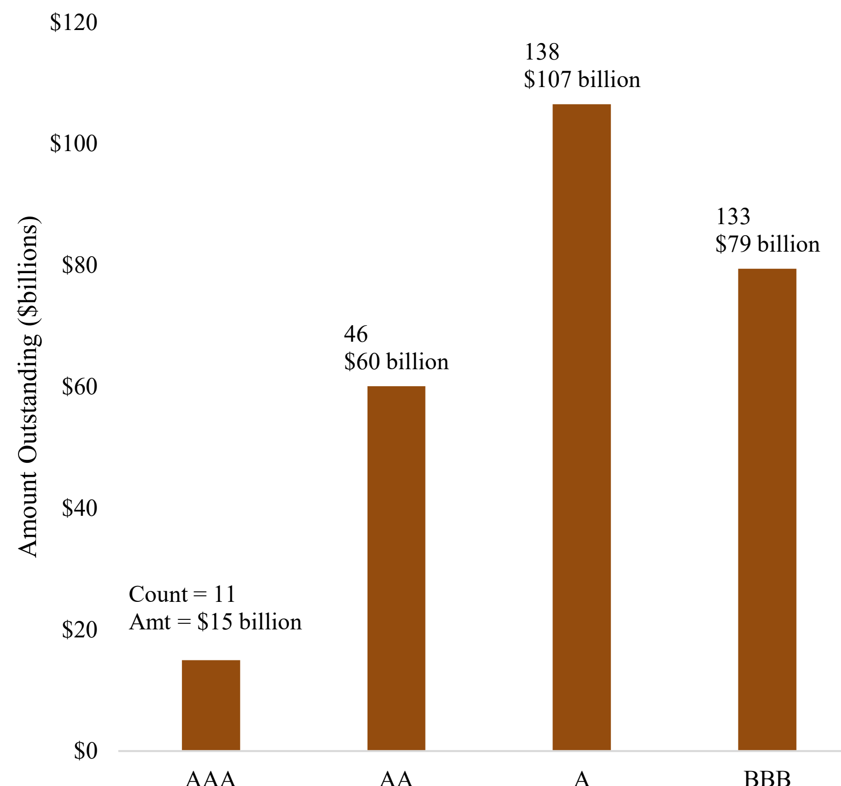

- Corporate bond valuations appear fully valued when compared against five and ten year averages, as measured by breakeven spreads versus Treasuries.
- Although the 1-3 year maturity segment indicates the highest yield per unit of risk, we have limited purchases in this portion of the yield curve because short-term Treasuries yield less than 0.25% on average.
- Currently, we view the 3-5 year maturity segment as providing the best risk/reward opportunity given our anticipation for interest rates (and potentially credit spreads) to move higher.

- In addition to concern about the credit fundamentals of some issuers, we urge investors to review the callability of bond issues given a number of callable bonds trade at a price above their make-whole call price.
- The combination of low interest rates and narrow risk premiums has caused a number of callable bonds to trade through their make-whole call spread.
- Assuming interest rates remain low, purchasing such a bond at a price above par could result in a loss if the bond was called prior to maturity.

Source: Bloomberg, ICE Bond Indices

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The Bloomberg Intermediate Govt/Credit Bond Unmanaged index that tracks the performance of intermediate term US government and corporate bonds.

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The Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

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