SERVANT

Market Commentary

Bond Vigilantes

3Q, 2021

Summary

- Markets delivered bland returns during the third quarter—a welcome development considering the stellar returns achieved earlier in the year.
- It has been nearly 18 months since COVID-19 hit the U.S., and even with two-thirds of American adults fully vaccinated, the recovery is disjointed and will remain so for the foreseeable future.
- Supply chain issues are beginning to severely affect economic growth and inflation.
- Given the uncertain backdrop, policymakers are unwilling to pull back on historic levels of accommodation, and bond vigilantes could begin to stir.

Overview

Markets delivered bland returns during the third quarter—a welcome development considering the stellar returns achieved earlier in the year. U.S. stocks, as proxied by the S&P 500, gained 0.6% while U.S. bonds, proxied by the Bloomberg U.S. Aggregate Bond Index, were nearly flat at 0.1%. Commodities were the top-performing asset class, up 7% in the quarter leaving the Bloomberg Commodity Index up 29% for the year. Most of the commodity gains were generated by the energy complex, which was up 21% in the quarter and 17% in September alone. Energy is up 75% for the year, U.S. stocks are higher by 16% and U.S. bonds are down 2%.

It has been nearly 18 months since COVID-19 hit the U.S., and even with two-thirds of American adults fully vaccinated, the recovery is disjointed and will remain so for the foreseeable future.[1] The virus forced many companies and people to make dramatic changes, and as time goes on, it appears that some of the changes may be more structural than temporary.

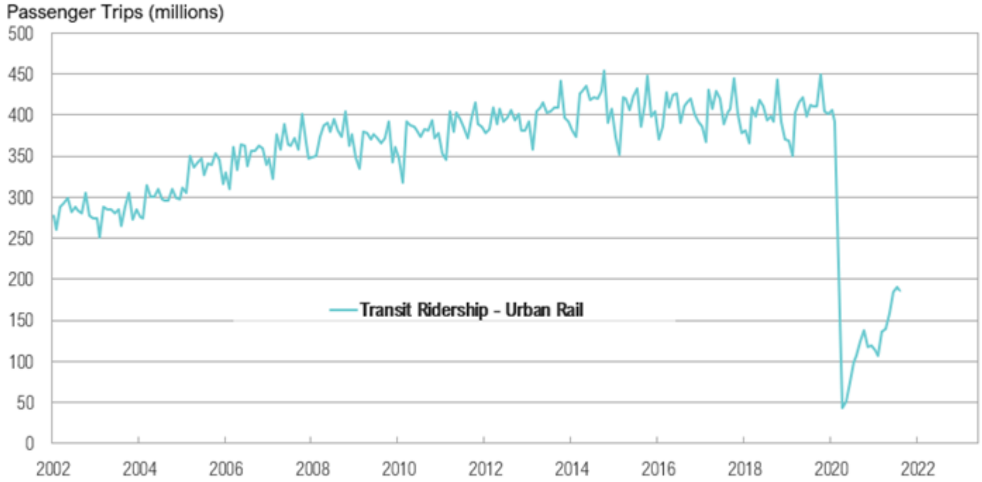
There remains a shortfall of nearly 5 million jobs relative to pre-pandemic levels, yet the recent Job Openings and Labor Turnover Survey report showed that current job openings continued to move parabolically higher to a record level of 11 million, nearly 2.5 million more than the pre-pandemic high.

In the labor market, there remains a shortfall of nearly 5 million jobs relative to pre-pandemic levels, yet the recent Job Openings and Labor Turnover Survey report showed that current job openings continued to move parabolically higher to a record level of 11 million, nearly 2.5 million more than the pre-pandemic high.[2,3] As evidence of the economy's extreme situation, the quit rate, a measure of the number of workers voluntarily leaving their jobs, remained at record levels.[4] In terms of travel, TSA checkpoint metrics remained below pre-pandemic levels. Relative to 2019, traveler throughput in the last week of September was down 23%, with more notable weakness during the week, suggesting suppressed business travel.[5] Further, the Bureau of Transportation Statistics showed that urban rail transit ridership, although recovered from last year's economic shutdowns, had not yet reached 50% of pre-pandemic levels.[6] This speaks to both the durable trend of working from home as well as the meaningful migration patterns away from densely populated cities.

__The enormous re-orientation of business and consumer activity has created tremendous hurdles for economic growth, especially in supply chains.__

Urban Public Transit Slow to Recover

Transit Ridership - Urban Rail Monthly Trips, *as of 8/31/21*



Source: U.S. Department of Transportation

Cause-and-effect relationships are difficult to decipher, especially when factoring in a lingering pandemic, but the enormous re-orientation of business and consumer activity has created tremendous hurdles for economic growth, especially in supply chains. With fiscal stimulus effects wearing off, the Atlanta Federal Reserve's GDPNow is now forecasting third-quarter GDP growth of 1.3%, substantially lower than the second-quarter GDP growth rate of 6.7%.[7,8]

__There has been a record backup in containerships at major U.S. ports, further exacerbated by labor shortages in trucking and warehousing. The issues at ports go a long way in explaining why there are some bare shelves in stores and suggest that the severe inflation levels seen in some parts of the economy will persist in coming months.__

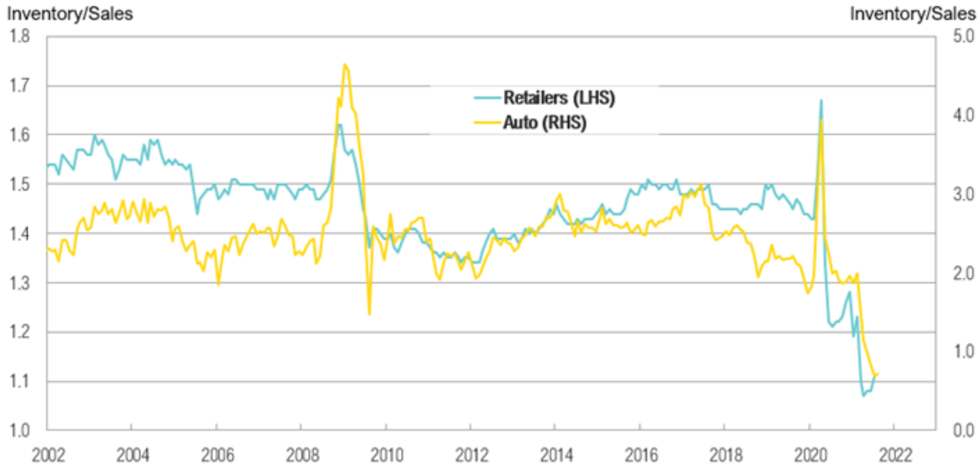
In another example of pandemic disequilibrium, there has been a record backup in containerships at major U.S. ports, further exacerbated by labor shortages in trucking and warehousing. Around 90% of all traded goods are carried by container ships, making ocean freight the main mode of transportation for global trade.[9] Last year, the adjacent Los Angeles and Long Beach ports handled the equivalent of 8.8 million loaded import containers—more than double the 3.9 million loaded boxes that arrived at the nation's next busiest port complex at New York and New Jersey.[10] To keep up with the large inbound container volumes this year, the Port of Long Beach started 24-hour operations four days per week. The Port of Los Angeles, however, held off on a 24-hour operating policy because, according to executive director Gene Seroka, 30% of trucking appointment slots on average every day go unused despite record container volumes. He says the port can extend operating hours only if trucking, warehousing and other industries also move toward 24-hour operations.[11] The issues at ports go a long way in explaining why there are some bare shelves in stores as well as astonishing declines in the inventory-to-sales ratio of many U.S. retailers.[12] It also suggests that the severe inflation levels seen in some parts of the economy will persist in coming months.

The automotive industry has been dealing with its own supply chain issues due to a semiconductor chip shortage, which is expected to cost the global auto industry more than $200 billion in 2021.[13] The situation, it seems, has only gotten worse throughout the year. According to consulting firm AlixPartners, expectations were for a $100 billion hit earlier in 2021.[13] In the U.S., automakers announced sales of 13 million vehicles for August.[14] Outside of the pandemic, this was the lowest monthly sales since September

2011. The inventory-to-sales ratio for automakers highlights the same hurdles faced by retailers.[15]

Retail and Auto Inventory/Sales at Record Lows

Auto & Retailer Monthly Inventory to Sales Estimate, Seasonally Adjusted, *as of 7/31/21*



Source: U.S. Beureau of Economic Analysis

Bond Vigilantes

Given this uncertain economic backdrop, policymakers are unwilling to withdraw a meaningful level of accommodation. This inaction could spur a certain class of fixed income investor, referred to as "the bond vigilantes," to stir. When these investors deem monetary and fiscal policies as inflationary, they sell bonds, and yields rise in turn. Viewed over the long term, bond vigilantes are a positive force to maintain fiscal and financial stability; however, in the short term, they can create a skittish bond market and interest rate volatility, which can wreak havoc on financial asset returns. The interest rates of bonds reflect the marginal costs of a crucial source of funding for governments (Treasuries), businesses (corporate bonds), and even consumers (mortgage rates). The economic significance of large moves in interest rates cannot be overstated. However, so far, the bond vigilantes have not shown up. The 10-year U.S. Treasury yield was relatively unchanged during the quarter. The quarter started with a yield of 1.45% and subsequently declined to 1.19% on a closing basis in early August. Since then, the yield rose to end the quarter at 1.52%.[16] This is remarkable given the backdrop of massive fiscal spending and elevated inflation. Since COVID-19, the amount of fiscal debt has jumped to 125% of gross domestic product while at the same time the Congressional Budget Office estimates deficits will now average well over $1 trillion annually through 2031.[17,18] This translates to net treasury debt issuance of more than $4 trillion last year and an estimated $2.1 trillion for this year.[20] Perhaps even more astonishing, the last time the Consumer Price Index was up more than 5% on a year-over-year basis, as it has been for the last two months, was in September 2008.[21] Back then, the 10-year U.S. Treasury yield was in the mid-to-high 3% range—more than double what it is today.[17]

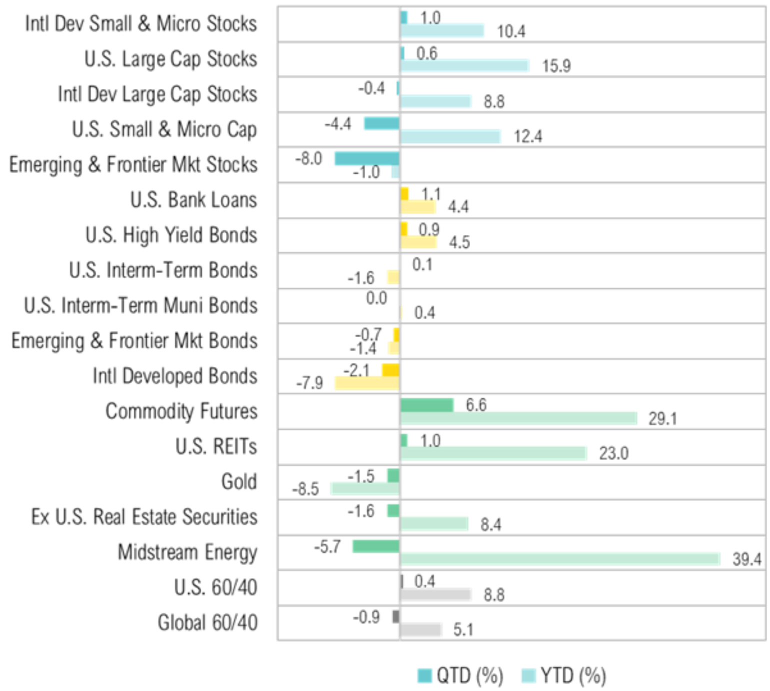
Given the uncertain economic backdrop, policymakers are unwilling to withdraw a meaningful level of accommodation. This inaction could spur a certain class of fixed income investor, referred to as "the bond vigilantes," to stir.

Markets

In the U.S., larger companies outperformed smaller companies. In terms of investing style, equity returns showed no consistent differentiation between value and growth during the quarter. The Russell 1000 Growth Index, a proxy for large growth companies, gained 1% during the quarter, leaving it up 14% for the year. The Russell 1000 Value Index lost 1% in the quarter and is now up 16% so far in 2021. Within smaller companies, value slightly outperformed growth during the quarter. The Russell 2000 Value Index lost 3% in the quarter and is now up 23% for the year. The Russell 2000 Growth Index was lower by 6% for the quarter, leaving it up 3% for the year. From a sector perspective, materials and industrials were each down 4%. The strongest performing sectors were ones that are sensitive to interest rates, including financials, which were up 3%, and utilities, which were up 2%. Stocks outside of the U.S. trailed their U.S. counterparts during the quarter and so far in 2021. The MSCI EAFE Index was lower by 0.4% in the quarter and is up 9% for the year in U.S. dollar terms. In local currency terms, developed market equities were up 1% in the quarter and up 15% for the year. Emerging markets in U.S. dollar terms also lost 8% for the quarter, wiping out gains achieved earlier in the year. China was down 18% during the quarter as it dealt with Evergrande, one of its largest property developers, now facing default. It is also confronting energy supply issues that have caused power grids to ration energy to factories, thus curbing production.[22] China is now down 17% for the year. Emerging markets local currency returns have nearly matched U.S. dollar returns on a quarter and year-to-date basis.

Municipal bonds, as measured by the Bloomberg Barclays Municipal 1-10 Year Bond Index, performed in-line with investment-grade taxable bonds during the quarter—they were both flat and ended up 0.4% for the year. The Bloomberg Barclays High Yield Index posted a gain 0.9% and is now up 4.5% for the year. Although fixed income securities are affected by many factors, it is noteworthy that municipal bonds, which have outperformed like-duration treasuries, have experienced a decline in debt issuance (-4%) so far this year. After issuing a record $2.3 trillion last year, corporations have issued just $1.3 trillion, a decline of 41% on a year-over-year basis.[23]

September 2021 Key Market Total Returns



Source: Bloomberg

Looking Forward

Energy is another sector that plays a key role in economic growth and inflation and that has been impacted by supply chain issues. As of the end of the quarter, a barrel of WTI Crude Oil was trading at a little over $75, a price we have not exceeded since 2014. Similarly, the national average gas price is at just over $3 per gallon, a seven-year high.[24] Finally, natural gas prices are at 13-year highs. Given these price levels, we expect market participants—and the bond vigilantes—will begin to pay more attention to future price moves in the energy complex.

We remain keenly interested in 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. The Treasury has been unable to move forward with the majority of its scheduled second-half debt issuance, roughly $1 trillion, due to the debt ceiling.[20] That said, we do not have concerns that the federal government will fail to pay its bills—the debt ceiling has been raised twenty-nine times since 1990.[25] 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.

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. CDC COVID Data Tracker
2. Johns Hopkins: https://coronavirus.jhu.edu/data/cumulative-cases
3. FRED: https://fred.stlouisfed.org/series/PAYEMS
4. FRED: https://fred.stlouisfed.org/series/JTSJOL
5. FRED: https://fred.stlouisfed.org/series/JTSQUR
6. TSA: https://www.tsa.gov/coronavirus/passenger-throughput
7. BTS: https://data.bts.gov/Research-and-Statistics/Transit-Ridership-Urban-Rail/rw9i-mdin
8. Atlanta Fed: https://www.atlantafed.org/cqer/research/gdpnow
9. BEA: https://www.bea.gov/data/gdp/gross-domestic-product
10. OECD: https://www.oecd.org/ocean/topics/ocean-shipping/
11. WSJ: https://www.wsj.com/articles/why-container-ships-cant-sail-around-the-california-ports-bottleneck-11632216603?mod=article_inline
12. WSJ: https://www.wsj.com/articles/port-of-los-angeles-stops-short-of-24-hour-operations-unlike-long-beach-11632506723?mod=hp_minor_pos14)
13. FRED: https://fred.stlouisfed.org/series/RETAILIRSA
14. CNBC: https://www.cnbc.com/2021/09/23/chip-shortage-expected-to-cost-auto-industry-210-billion-in-2021.html
15. FRED: https://fred.stlouisfed.org/series/TOTALSA
16. FRED: https://fred.stlouisfed.org/series/AISRSA
17. FRED: https://fred.stlouisfed.org/series/DGS10
18. FRED: https://fred.stlouisfed.org/series/GFDEGDQ188S
19. CBO: https://www.cbo.gov/system/files/2021-02/56970-Outlook.pdf
20. U.S. Department of the Treasury: https://home.treasury.gov/system/files/136/Sources-and-Uses-July-2021.pdf
21. FRED: https://fred.stlouisfed.org/series/CPIAUCSL
22. Bloomberg: https://www.bloomberg.com/news/storythreads/2021-09-28/global-energy-shortage-why-is-everyone-talking-about-a-power-crunch?
23. SIFMA: https://www.sifma.org/resources/research/us-fixed-income-securities-statistics/us-fixed-income-securities-statistics-sifma/
24. EIA: https://www.eia.gov/petroleum/gasdiesel/
25. Wikipedia: https://en.wikipedia.org/wiki/History_of_the_United_States_debt_ceiling

Asset Class Definitions

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. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-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.

Disclaimer and Terms of Use

DISCLAIMER

Past performance is no guarantee of future performance. Any opinions expressed are current only as of the time made and are subject to change without notice. This report may include estimates, projections or other forward-looking statements, however, due to numerous factors, actual events may differ substantially from those presented. The graphs and tables making up this report have been based on unaudited, third-party data and performance information provided to us by one or more commercial databases. Additionally, please be aware that past performance is not a guide to the future performance of any manager or strategy, and that the performance results and historical information provided displayed herein may have been adversely or favorably impacted by events and economic conditions that will not prevail in the future. Therefore, it should not be inferred that these results are indicative of the future performance of any strategy, index, fund, manager or group of managers. While we believe this information to be reliable, we bear no responsibility whatsoever for any errors or omissions. Index benchmarks contained in this report are provided so that performance can be compared with the performance of well-known and widely recognized indices. Index results assume the re-investment of all dividends and interest. Moreover, the information provided is not intended to be, and should not be construed as, investment, legal or tax advice. Nothing contained herein should be construed as a recommendation or advice to purchase or sell any security, investment, or portfolio allocation. This presentation is not meant as a general guide to investing, or as a source of any specific investment recommendations, and makes no implied or express recommendations concerning the manner in which any client's accounts should or would be handled, as appropriate investment decisions depend upon the client's specific investment objectives.