VWG WEALTH MANAGEMENT
A Hightower Company

VWG Wealth Management 3rd Quarter Review

Executive Summary

- Beyond the continuing global battle to contain COVID-19 outbreaks, the list of significant economic and macro concerns grew during the quarter. These included persistent global inflation, spiking energy prices, proposed increased U.S. individual and corporate taxes, expectations of Federal Reserve tapering, the possibility of a U.S. government shutdown, and slowing growth in China.
- Despite these threats and uncertainties, asset markets were fairly resilient during the 3rd quarter. Large U.S. and international stock indices finished close to even.
- It became more widely accepted that some of the labor tightness, disruptions in supply chains, and inflation currently experienced will not quickly dissipate. After surprisingly falling, and then rising throughout the quarter, the 10-year U.S. Treasury finished yielding 1.49%.
- The U.S. economy remains firm, and monetary conditions continue to be extremely easy. Numerous industries and companies are engaged in remarkable explosions of change and technological innovation. Against this backdrop, long-term investors should be optimistic.

- We recommend that investors hold diversified, moderately balanced portfolios. For certain clients, some trimming and rebalancing may be appropriate, with holdings of cash and liquid short-term bonds marginally increased. Increased tax rates for 2022, if enacted, must be considered when reviewing and tactically adjusting portfolios moving into year-end.

Review of the Markets

We hope everyone enjoyed their summer months. Hopefully these were highlighted by some time to relax, and opportunities to spend time with family and friends. Observing from a wider lens, broad equity and bond markets, as well as many commodities, showed little price change from the end of the 2nd quarter to the end of the 3rd. Beneath this calmness, many short-term movements and gyrations occurred. These were buffeted by an increasing number of macro concerns. These included:

- Persistence in U.S. and global inflation.
- Continuing global manufacturing and supply chain issues, persistently tight labor markets.
- Escalating natural gas prices, and the resurgence of higher crude oil prices after a mid-summer lull.
- Market uncertainty about the timing of the Federal Reserve moving to reducing their enormous stimulus and liquidity programs (enacted in response to the pandemic crisis). This was marked by a swift 20 basis point rise in the 10-year U.S. Treasury bill yield at the end of the quarter.
- Congressional wrangling over a proposed massive economic spending plan, that could include significant personal, corporate, and capital gains tax rate increases, major changes to estate tax and rules treatments, IRA reforms, and many others.

- The inability of U.S. Congress to agree on raising the statutory limit on U.S. borrowing (debt ceiling). This threatens a government shutdown, and potential pressure on the U.S. credit rating.
- Continuing severe regional and specific country COVID-19 delta variant outbreaks. Vague and inconsistent government, business and school rules and mandates issued in the attempt of slowing its spread.
- Aggressive Chinese regulatory crackdowns on credit excesses, consumer technology and housing, raising the odds of softening China's economy (and thus dampening global economic growth).

Despite these fears and potential headwinds, the U.S. large cap benchmark S&P 500 Index was steady, nudging higher 0.6% for the quarter. It has gained 15.9% for the year. Underneath the surface of this stable index, the average stock fell, and market breadth contracted. Bespoke Investment Group noted that the percentage of S&P 500 stocks trading above their 50-day moving average fell to 31.5%, down from over 70% in August. Reflecting this action, smaller U.S. stocks underperformed larger stocks in the 3rd quarter, with the benchmark Russell 2000 Index down 4.3%. It is up 12.2% this year.

Large international stocks lagged U.S. stocks during the quarter. The MSCI EAFE Index, a benchmark for stocks of companies domiciled in developed economies, fell 1.1%. It has returned 8.4% for the year. The MSCI Emerging Markets Index fell 8.6%, due to its 31% weighting in Chinese stocks. China enacted a series of interventions, crackdowns, and regulatory measures under the theme of "Common Prosperity." This roiled capital markets, with some noteworthy investors and institutions pondering the future "investability" of China. The MSCI Emerging Markets Index has now lost 2.0% this year.

U.S. manufacturing, housing, and consumer demand remained firm. Persistently tight labor markets, supply chain disruptions and shortages, and rising energy prices kept the spotlight on inflation and the "transitory vs. secular" debate. This was countered by fears of the COVID-19 delta variant and its potential negative effect on economic activity. Reflecting this push-pull battle, the yield of the 10-year U.S. Treasury bill began the quarter yielding

1.48%, dropped to 1.17% on August 4, and then jumped back to 1.49% at quarter's end. The Barclays Aggregate Bond Index has lost 1.7% this year. The 2-year U.S. Treasury note ended the quarter yielding 0.30%, its highest since the pandemic crisis ensued.

In a sign of investor confidence in the economy and in the health of corporate balance sheets, high yield bonds stayed stable. The Barclays High Yield Very Liquid Bond Index edged 0.5% higher in the quarter and has gained 3.3% this year. Municipal bonds also were steady, supported by the threat of tax increases. The S&P National Municipal Bond Index has returned 0.3% this year.

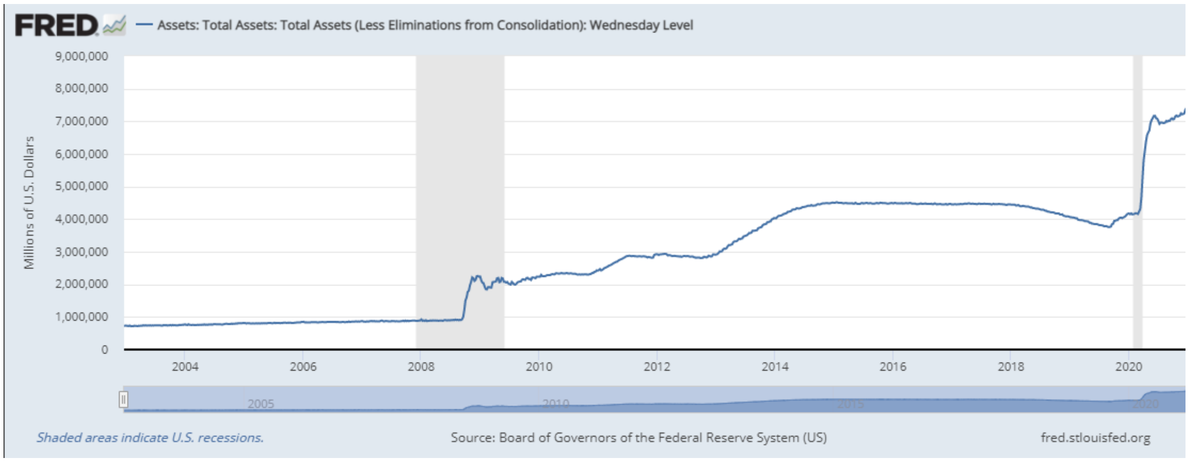
Serious attention was focused on natural gas in the 3rd quarter. Prices shot to levels seen only briefly in 2014. Year-to-date the NYMEX Natural Gas continuous futures contract has risen a whopping 132%! This has pushed several United Kingdom utilities to a crisis point, threatening their ongoing viability as they are unable to pass this magnitude of increases on to consumers. Contributors to rising prices included the recovering global economy, marginal switching to "the fuel of choice for clean energy transmission," and hottest U.S. summer on record according to NOAA. Crude oil also garnered attention, as demand continued to exceed expectations, and inventories tightened. For the quarter the NYMEX West Texas Intermediate crude oil contract gained 2.1%.

When will Tapering Begin, and How will Markets React?

We expect to see increasing attention to monetary policy over the coming months. The Treasury Department's federal debt limit must be increased, and the legislative process of doing so will be messy. The Federal Reserve is expected to begin Tapering, and markets will be keenly attuned to its magnitude and effects.

Tapering refers to the winding down of certain expansionary activities by a central bank. The specific tapering now being discussed relates to the Fed's large-scale asset purchases, commonly known as quantitative easing (QE). In response to COVID-19, the Federal Reserve began buying assets to inject liquidity into the financial markets. From March 2020 through June 2020, the Fed's balance sheet swelled from approximately $4 trillion to over $7 trillion dollars. Beginning in June of 2020 the Fed also began buying $80 billion of Treasury securities and $40 billion of mortgage-back securities each month. Today the balance sheet is near $8.5 trillion. Paling in magnitude, the Fed increased its balance sheet from $1 trillion to $3 trillion over five years in response to the financial crisis of 2008/09.

The Fed uses QE in the attempt to stimulate the economy by reducing long-term interest rates to incentivize capital spending. According to the Fed, "These asset purchases help foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses." Evidence suggests that there is a positive correlation between QE and a rising stock market. Some of the largest stock market gains in the U.S have come under QE regimes. It is not clear how the stock market and the prices of other assets will respond when the "punchbowl" begins to be removed.



The remarkable twenty-year expansion of the Federal Reserve's asset portfolio

Federal Reserve Bank of St. Louis Economic Research

The Federal Reserve has two stated goals, promote maximum employment and price stability (inflation of 2% over the long run). Once the Fed believes those goals have been met, they will begin to gradually reduce the pace of assets purchases. Although simple in theory, central bank tapering is a daunting task. If the taper is made too early or the pace too swift, economic recovery could be hindered. Some economists surmise that QE could be suppressing long-term rates by 1.5-2.0%. If long-term rates were to rise quickly, consumer and business spending could slow abruptly. Waiting too long to taper poses its own set of problems. An over-stimulated economy could overheat, causing excesses in inflation or even damaging asset bubbles.

The Fed must also consider how the capital markets will react. According to the Economist, *"Mr. Powell (Chairmen of the Federal Reserve) is trying to pull it (tapering) off by giving markets plenty of warning, in hope of avoiding a repeat of the "taper tantrum" that spooked markets in 2013."* During the 2013 taper tantrum bonds sold off sharply (yields rose), the U.S. dollar soared, equity volatility spiked, and emerging markets saw significant capital outflows. Asset prices are currently trading near historical highs, reflecting the assumption that long-term rates will stay low for several years. Too fast of a reversal in that view could result in a swift downward resetting of asset prices.

It is important to note that tapering does not refer to a contraction of the Fed's balance sheet, only a reduction in the pace of its expansion. The current consensus view is that tapering will begin in November, with the Fed reducing their assets purchases by $15 billion a month, ultimately eliminating them completely in nine to twelve months. Theoretically, this should lead to long-term interest rates rising from their historically low levels. After tapering is complete, the Fed is likely to reduce the size of its balance sheet by letting maturing securities "roll off", as it did in October 2017. At some point the Fed could begin to gradually lift short-term rates, from its current 0.0-0.25%. A growing number of Federal Reserve officials expect the first interest rate hike to occur in 2022.

It is widely accepted that the Federal Reserve's staggering and unprecedented actions in response to COVID-19 helped support and stabilize the economy. Economic growth, employment growth and asset prices all recovered quickly. It now faces the more difficult task of slowing, and then reversing, this aggressive stimulation without upending all the positive results they achieved.

Portfolio Strategy and Asset Positioning

Reflecting closely on the past twenty-one months we have all experienced - emotionally, financially, and for many, physically - is an exhausting and disorienting exercise. We are deeply fortunate to have trusting clients that have allowed us to stay the course, rely on a strong backbone of financial planning, and maintain a long-term investment focus. It is truly a great honor to serve you. Although we believe that our investment behavior has proven sound, and many of our clients have profited over this period, we cannot take the entire credit for the results. The outcomes from the virus, the pandemic, and the calamity that ensued could have been much different.

The COVID-19 crisis has not concluded. The virus will likely never be fully contained. We don't know its future course or possible mutations. As outlined earlier in this letter, the pandemic is just one in a list of major concerns that could have significant impact on asset prices and portfolios going forward. And there are potential risks currently not in view. Charles Wheelan famously stated that *"the greatest risks are never the ones you can see and measure, but the ones you can't see and therefore can never measure."*

Therefore, our best defense is to attempt to properly diversify client portfolios. Diversification is the remedy for the fact that we don't know the future, and we can't assume that we'll enjoy the same results of the past. As many assets have enjoyed impressive gains during the pandemic, it is now time to review and consider various tactics to trim, reallocate, or rebalance portfolios over the next few months. The coming year could be more difficult and more volatile. Continuing strong corporate profit growth in certain industries may become difficult. An appropriate allocation to cash and quality, liquid short-term bonds is required for almost all investors.   The real possibility of higher income, capital gain and estate taxes effective in 2022 further emphasizes the need for review and contemplation of specific actions tailored to the household's finances and future planning. As Morgan Housel writes in his excellent "The Psychology of Money:"

"Getting money requires taking risks, being optimistic, and putting yourself out there. But keeping money requires the opposite of taking risk. It requires humility and fear (that it can also be lost.) It requires frugality and an acceptance that at least some of what you've made is attributable to luck, so past success can't be relied upon to repeat indefinitely."

This does not mean that we are shifting to a defensive stance. The U.S. economy remains strong, pockets of pent-up future demand still exist, and monetary policy is extremely easy. VWG believes that the potential for long-term appreciation currently outweighs short-term risks. Balance is called for, and this includes allocating capital that can opportunistically be deployed in the future. Our world is quickly changing in mind-blowing directions. Many amazing opportunities, both seen and unseen, are being presented for hard-working companies and entrepreneurs trying to make a difference. These hold great promise for their investors. We continue to search for these, and we look forward to sharing them with you once they are identified and proper due diligence has been performed.

As always, we maintain our vigilance for both risks and opportunities. VWG will communicate to you if our views change. Please reach out to us with your questions and your engaging dialogue. Let us know if anything significant in your financial situation has or is expected to change. We'll look forward to talking.

Regards,

VWG Wealth Management

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Who we are

** Index Data and Charts Sourced from FactSet Research, Morningstar, Blackrock Investment Management, Goldman Sachs Asset Management, Strategas Research Partners.*

Please reach out to us if you have any questions or comments.

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