Balancing the Scales

As we close the books on the third quarter of 2021, we continue to face a challenging path forward given the mixed signals we are currently seeing. There are a multitude of positive and negative economic, political, and societal factors influencing global markets. In this edition of Market Insights, we attempt to determine which way the scales are tilted for the remainder of 2021 and beyond.

Market Recap Q3

Markets mostly flatlined in the third quarter, as U.S. Large Cap Growth stocks were the top equity performer with a paltry 1.2% gain. Bond returns were muted, while absolute return investments were modestly positive.

Asset Class Returns

Asset Class	Benchmark	Q3 July-September 2021	YTD	2020
U.S. Large Cap	S&P 500	0.6	15.9	18.4
U.S. Large Cap Value	Russell 1000 Value	-0.8	16.1	2.8
U.S. Large Cap Growth	Russell 1000 Growth	1.2	14.3	38.5
U.S. Small Cap	Russell 2000	-4.4	12.4	20.0
International Developed	MSCI EAFE	-0.4	8.3	7.8
Emerging Markets	MSCI EM	-8.1	-1.2	18.3
U.S. Investment Grade	Barclays U.S. Aggregate Bond	0.1	-1.6	7.5
U.S. Inflation-Indexed	Barclays U.S. TIPS	1.8	3.5	11.00
U.S. High Yield	BBgBarc U.S. Corp High Yield	0.9	4.5	7.1
EM U.S. $ Debt	JPM EMBI Global	-0.7	-1.4	5.3
Absolute Return	HFRX Global Hedge Fund	2.3	6.1	6.8

Source: Morningstar

The global pandemic continues to create headwinds for global economic growth. Companies are faced with supply chain issues and are dealing with a rocky return to the office. Chinese authorities have spooked investors by taking a heavy-handed approach in corporate regulations. The Evergrande real estate debt situation further raised concerns about China. China represents over 30% of the MSCI Emerging Market index, which declined 8.1% for the quarter.

U.S. Sector Review

In the United States, the financial sector was the top performer this quarter as the 10-year Treasury yield advanced to 1.47%. On the year, energy continues to be the top performer (+43.2%), with financials and real estate a distant second and third at 29.0% and 24.4% respectively.

Sector Returns: Q3 and 2021

Index	Q3 July-September 2021	YTD	2020
S&P 500 Sec/Information Technology	1.3	15.3	43.9
S&P 500 Sec/Real Estate	0.9	24.4	-2.2
S&P 500 Sec/Industrials	-4.2	11.5	11.1
S&P 500 Sec/Energy	-1.7	43.2	-33.7
S&P 500 Sec/Cons Disc	0.0	10.3	33.3
S&P 500 Sec/Commun Services	1.6	21.6	23.6
S&P 500 Sec/Cons Staples	-0.3	4.7	10.8
S&P 500 Sec/Utilities	1.8	4.2	0.5
S&P 500 Sec/Materials	-3.5	10.5	20.7
S&P 500 Sec/Financials	2.7	29.1	-1.7
S&P 500 Sec/Health Care	1.4	13.5	13.5

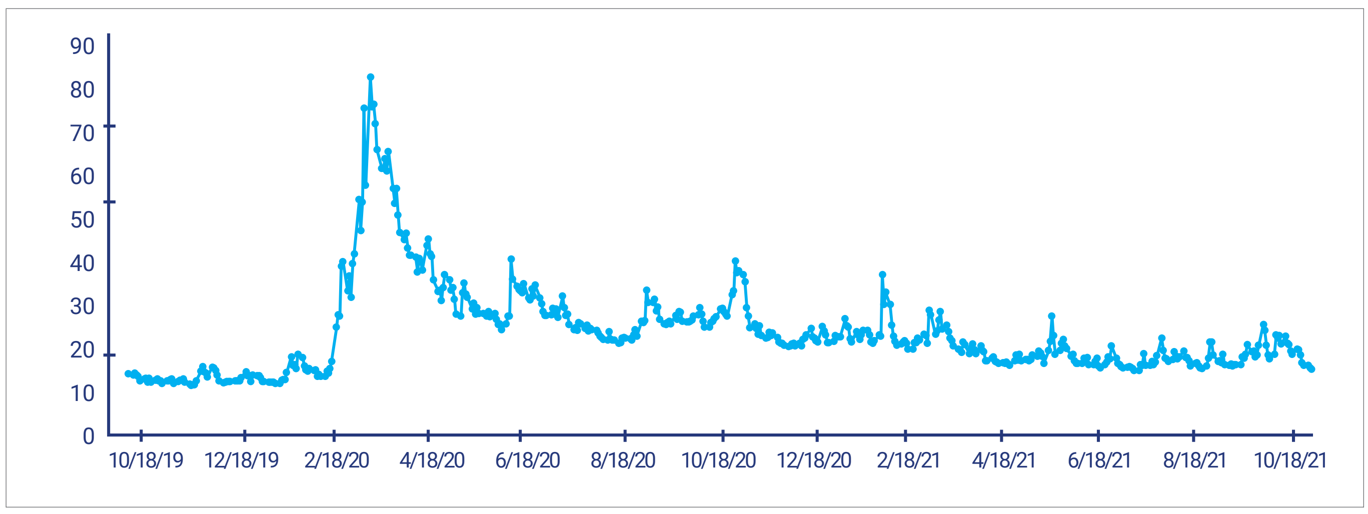
Source: Morningstar

Optimistic Despite Headwinds

Despite these headwinds, we are optimistic about the future. Many of the issues facing the global economy will be temporary. Consumer balance sheets remain strong, and we believe consumer demand is only delayed. Above-trend growth will likely continue in 2022 and beyond. The recent inflation spike will dissipate as supply chain issues correct and the economy normalizes.

Low volatility in the stock market since late 2020 (see VIX chart below) is rather surprising, given what we have been through. As volatility has increased here in October, we remind investors that this is a more normal aspect of a healthy market. Some of the biggest up days in the market occur after corrections.

CBOE Volatility Index - Prices



Source: FactSet

Positives and Negatives

- ⊕ Economic reopening ahead/pent-up demand/ job recovery continues
- ⊕ Fed policy remains accommodative
- ⊕ Washington gridlock
- ⊕ Consumer strength

- ⊖ Inflation
- ⊖ Delta/potential for future variants knocking economy off course
- ⊖ Higher interest rates
- ⊖ China regulation
- ⊖ Debt ceiling "brinksmanship"

As portfolio managers, it is extremely important for us to recognize and consider the risks as well as the opportunities in front of us at all times. Markets provide a constant tipping of scales between bullish (positive) and bearish (negative) factors.

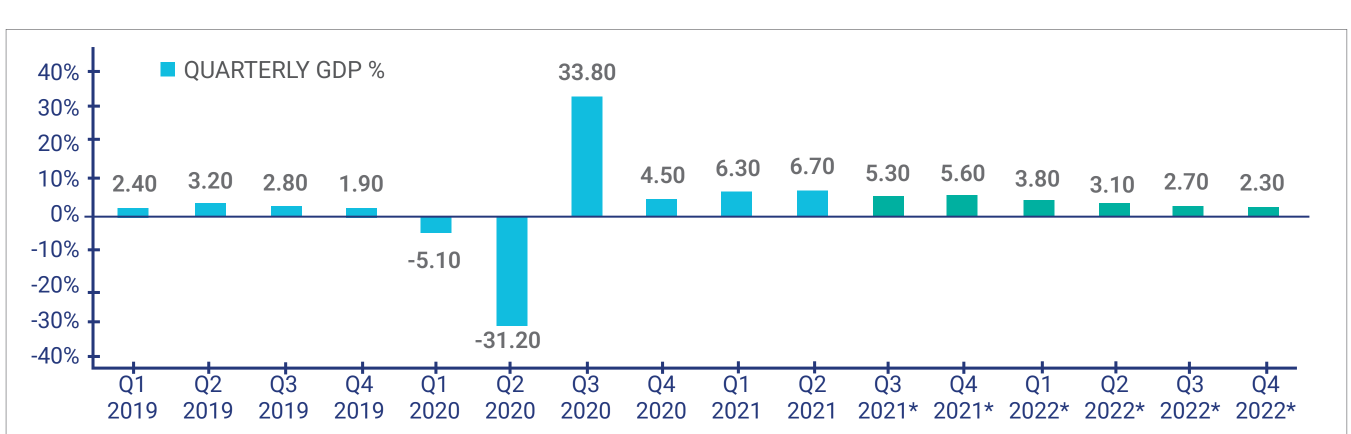
Stocks have had a great run in the last 18 months, with the S&P 500 up an amazing 97.3% from the pandemic-era low on 3/23/20 (source: FactSet). But investing is about the future, not the past. What are the risks and opportunities we see in markets today? Which matter the most for our clients' portfolios?

We've written before about the "wall of worry" the stock market climbs as it moves higher over the long term. It's true that the "wall" is looking fairly tall today.

Delta variant creating concerns

The delta variant (as well as potential future variants) is undoubtedly weighing on sentiment and is certainly a reason for concern. Delta has had a substantial impact on the U.S. economy in the 3rd quarter. The Federal Reserve admitted this in its post-meeting statement on 9/23, reducing their full-year 2021 GDP estimate to 5.9% (from 7% previously). That's a fairly large reduction in its GDP forecast, but some perspective is necessary. Even at the Fed's reduced estimate of 5.9% for full-year 2021 GDP, that would still be the best full-year GDP in the U.S. since 1984 (source: WorldBank.org). Perhaps equally important, the Fed increased its 2022 GDP prediction to 3.8%, well above the long-term pre-pandemic trend.

U.S. Real GDP Growth



Source: FactSet
*Estimated

Demand + Cash = Untapped Momentum

We believe there is still tremendous economic momentum under the surface. Plenty of demand is yet to be unleashed, with many people still not back at work and uncomfortable dining indoors or riding on airplanes/public transportation. An August study by building security company Kastle Systems indicated that only **23% of NYC Metro workers** were back at office desks. (Source: Bloomberg). Households and corporations are in good financial shape, with cash at the ready, as we continue to inch toward normalcy.

Fed telegraphing taper

Another factor often cited as a current risk for markets is the Fed's tapering plan. Will the Fed be able to wean the market off all the excess cash without igniting another "Taper Tantrum" à la 2013? The Fed is highly likely to start to reduce its bond purchases soon, with an announcement anticipated at the next meeting on November 3. The Fed has telegraphed this "taper" to markets extremely well, as seen in the steepening of the yield curve. Markets reacted poorly in 2013 because that "taper" was seen as coming out of nowhere. It is important to remember that "tapering" does not mean rates will immediately be raised. It simply means that bond purchases will be reduced. Even with the "taper" imminent, all indications are for the first Fed hike of interest rates to come in late 2022/early 2023. That leaves risk assets a long runway to enjoy low interest rates.

Investment Themes Review

The themes we identified going into 2021 included the following:

• **Innovation Across Sectors** – Embracing technology
• **Cyclical Recovery** – Cyclical and value are not synonyms
• **Fixed Income and Alternative Strategies** – Dual options for downside protection

As 2021 has unfolded our themes have largely been on point and have positively influenced our tactical portfolio decisions. Webster Private Bank client portfolios have benefited as a result.

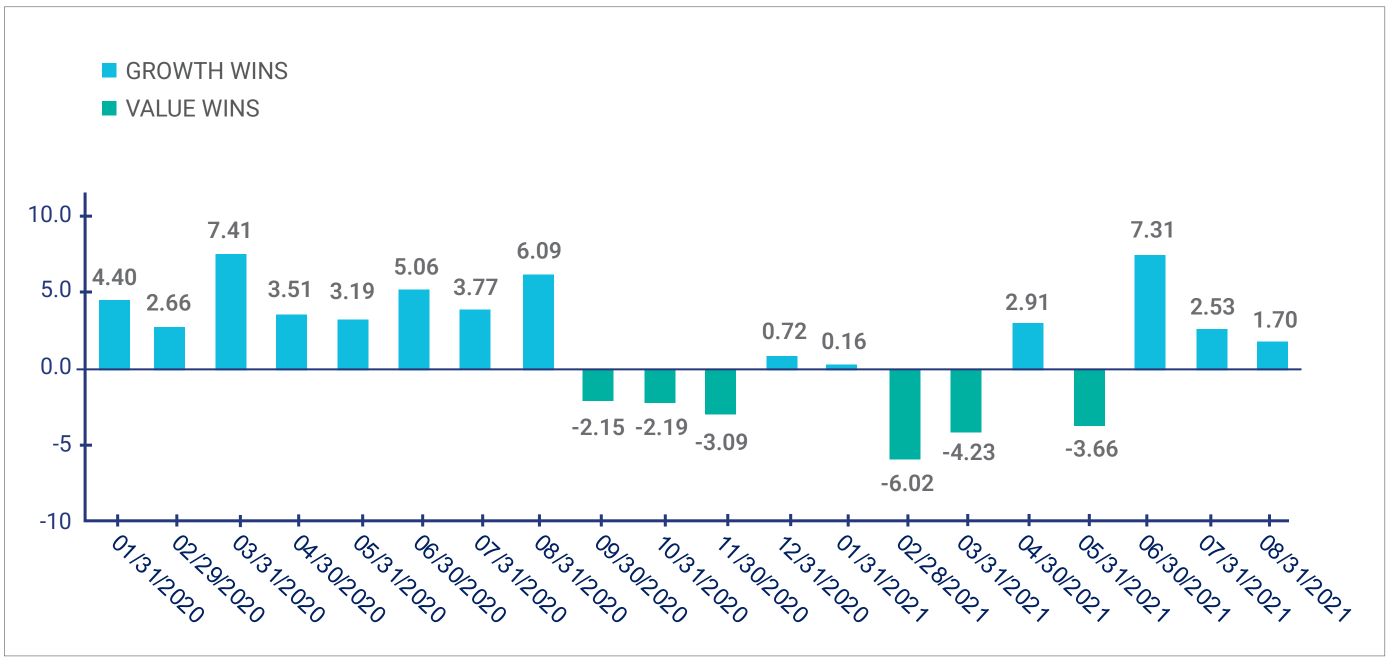
Embracing technology continues to pay off

We have seen firms that continue to embrace technology make up significant ground since the early spring of 2021. This shift has coincided with the unfortunate slowing of uptake in COVID-19 vaccines and a surge in infections due to the highly contagious delta variant. This unexpected twist to the pandemic has solidified our view that companies that embrace new and emerging technologies will continue to outperform markets over the long term.

Managing for cyclical recovery

Even with the delta variant slowing the economy's reopening, we continue to believe that a cyclical recovery will continue to develop over the longer term. As a result, we are continuing to research and add to best-of-breed companies and fund managers found in more cyclically oriented parts of the market. The value stocks that took the lead in the fourth quarter of 2020 have yielded ground to cyclically oriented growth stocks as 2021 has progressed.

Growth & Value Stocks



Source: FactSet
Russell 1000 Growth/Russell 1000 Value Total Returns.

Downside protection with alternative strategies

For balanced portfolios we invest considerable effort in providing downside protection, historically through fixed-income investments. However, given the low-interest-rate environment and the current upward trend of interest rates (bond prices fall as interest rates rise) we continue to feel complementing bond holdings with alternative strategies is warranted. In 2021 interest rate increases have resulted in a negative aggregate bond return of -1.2%. The trend is likely to continue as the Federal Reserve begins to embark on its plan to normalize interest rates before year end with plans to reduce its bond purchasing program.

Scales tilting positive ... at least for now

With our themes continuing to be realized as the year unfolds, we continue to favor U.S. equities over international and emerging market stocks, an underweight to bonds, and an overweight to alternatives. These views and positioning have been proven largely beneficial thus far in 2021. As we look forward, we believe the scales are decidedly tilting in a positive direction, at least for the next 12 months. The crystal ball gets murkier as we move beyond that time frame.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times, and we appreciate the trust you have placed in us.

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