Retire sooner? Retire later?

Or just retire from worrying about it.

Bangor Wealth Management

Key Takeaways

- Firmly in expansion, the U.S. economy has faced supply challenges in the third quarter.
- Stubborn price inflation may force the Federal Reserve to tighten policy sooner than previously estimated.
- For stock investors, September erased most of the previous two months' advances and ended an unusually long period of uninterrupted advances.
- The trend of positive earnings revisions may have peaked in the second quarter.
- Bonds also had a challenging quarter, and like stocks, gave up gains in September to end the quarter little changed.

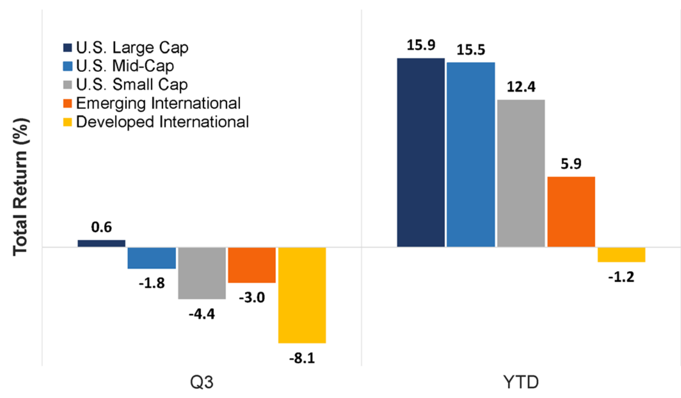
The Cure for High Prices

While still firmly in expansion, the U.S. economy faced some challenges in the third quarter. Some of these challenges resulted from the reopening in the second quarter and the new Delta variant of COVID-19. With more returning to normal activities, we soon saw a spike in COVID-19 cases. This resurgence contributed to labor shortages and production shutdowns that in turn created supply chain issues for many businesses and consumers. As a result, we have seen prices on all manner of goods increase as demand outstrips supply. This includes food, used cars, steel, and the semiconductors used in new cars and other electronics. The Federal Reserve has acknowledged that the rise in prices due to these supply challenges may be stickier than they had anticipated. The Consumer Price Index has been running at over 5% since May, some of the highest inflation seen since the 1990s. This presents a conundrum for the Fed. Given their mandate to maintain price stability, potentially higher inflation would normally push them to tighten monetary policy. But with the labor markets still well off their pre-pandemic highs, they also don't want to risk prematurely squashing an economic recovery. If prices remain elevated, the Fed may be forced to act sooner than expected. That possibility has weighed on market sentiment.

All Good Things Must Come to an End

After shrugging off practically every negative headline during the summer, the S&P 500 index peaked early in September and has yet to regain its high point. The S&P 500 had gone 211 trading days without a 5% decline, up until September month end, when it closed 5.1% down from its recent closing high. Other equity asset classes also struggled. U.S. small-cap and mid-cap, emerging markets and developed international all posted weaker results for the quarter (Fig. 1). However, on a year to date basis, equity returns still look robust, with returns made in the first half of the year carrying the weight.

Fig 1. U.S. and international stock markets experienced material declines in Q3 as the concerns grew over Covid-19 variants and peak economic growth



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

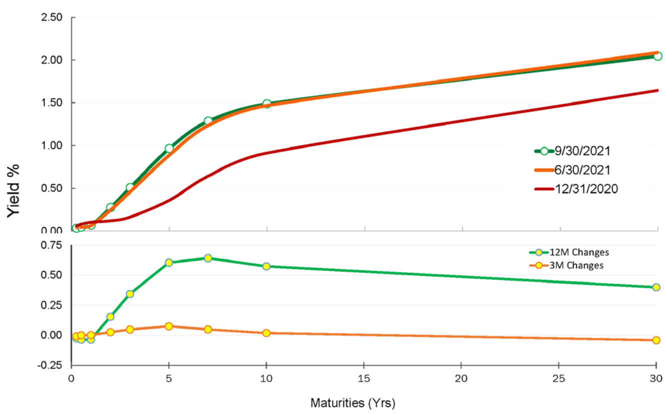
Reversion on Revisions?

Last quarter we discussed how unusually strong earnings revisions for U.S. stocks had been a factor in the current rally – better than expected earnings translated into higher stock prices for many companies. The first and second quarters of 2021 saw S&P 500 earnings revised up 6.5% and 7.2% respectively, according to Factset. This trend has continued into the third quarter, albeit at a more moderate pace of 2.9%, and in a departure from previous quarters, saw a decline in the month of September of 0.9%. While one month does not make a trend, this decline may mark a turning point for what has been an unusually strong period of positive revisions.

A Round Trip on Bond Prices

Fixed income had a similarly negative reaction to the Fed's September minutes, with rates rising across the entire curve. But this sell-off in the bond market came on the heels of a summer rally, which for the full quarter ended right back at June 30 levels with very little change in return for most bond investors (Fig. 2).

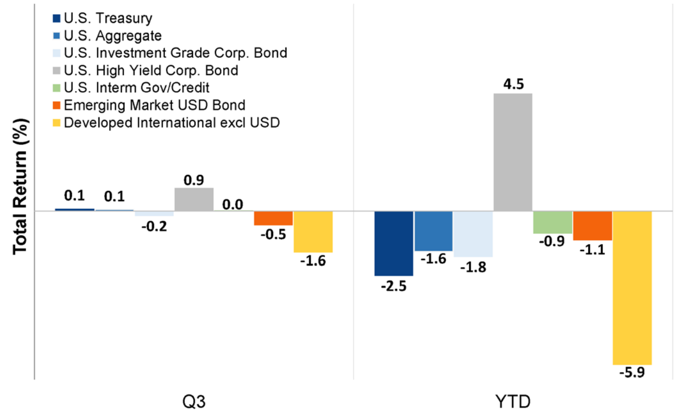
Fig 2. The U.S.Treasury market experienced a dramatic sell-off since the Fed September meeting, but the curve barely changed from Q2



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

It continues to be a challenging year for fixed income investors, as already low levels of interest rates combined with price weakness have led to negative returns for all but high yield investors (Fig. 3).

Fig 3. Rising inflation expectations and hawkish monetary policy drift have dented all fixed income markets except high yield



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

What's Next?

With only a few months left in 2021, we are maintaining our emphasis on stocks over bonds for clients who own both. While it is likely we will see more bumps in the road as we navigate the ongoing pandemic, the very low level of interest rates makes bonds unlikely to deliver significant total returns. While bonds remain an important portfolio component to control volatility, equities, especially in the longer term, are more likely to be the driver of growth for portfolios. Even if the Fed does start to tighten financial conditions, they will move at a deliberate pace, recognizing the need to keep markets calm and the expansion on track.

If you have questions regarding your portfolio or would like to schedule a review, please reach out to your Relationship Manager. We look forward to hearing from you!

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