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The market as measured by the S&P 500 was roughly flat during the third quarter. However, when examining the period in more detail, the performance was anything but boring. Market sentiment picked up where it left off in the second quarter – optimistic, with a continued upward trajectory. As the calendar hit September, the market began to turn and ended up marking its first negative month since January. It seemed as if this was almost by design, lending credence to the well-known rhetoric of September being the worst month of the year for stocks. From our perspective, the shift in investor sentiment is much more telling than the date on the calendar. Currently, the market and investor sentiment can be described as indecisive.

In general, being indecisive is viewed as a weak character trait. Ancient Greeks, Jewish philosophers, past presidents, and modern business gurus all agree that it is better to make a decision, even a wrong one, than no decision at all. Deciding is the only way to move forward in life. Otherwise, you could end up becoming stuck in a perpetual loop of paralysis by analysis, doubt, and anxiety. As such, the longer it takes to make a decision, the harder it becomes to do, and the more erratic the process will be.

Since the beginning of the year, the market virtually went straight up with January being the only down month during the period. Investors had no issues making up their minds and were fully convicted in their positions. Through August, the market achieved over 50 record closes, the IPO market had been on a tear (only to be outdone by the dotcom bubble), merger and acquisition activity hit an unprecedented level (surpassing the last record in 2007), and private company valuations hit record highs. The high levels of conviction led to a blind optimism that would stop at nothing to achieve the goal of investing bliss. Everything seemed to be going right. The economy was reopening and growing, and monetary policy was very accommodative.

Towards the end of the third quarter investors began having trouble digesting and acting upon the conflicting data points that were presented to the market. These included the ongoing developments of the Delta variant, the shift in monetary policy by the Fed, inflation expectations, increased geopolitical tensions, and the seemingly unsolvable domestic political divide. Of these, the one with the most outsized influence was the Fed's monetary policy in response to economic activity and inflation expectations. Earlier in the year, there were very few questions on how the Fed would act due to its clear and consistent messaging of maintaining a very accommodative economic environment. Investors took this in stride and did not focus as much on the other variables. So long as the Fed would continue with its easy policy, the party would go on, despite everything else that was happening around the world. However, as the quarter progressed, the Fed started to change its tune. Doubts about the transitory nature of inflation ensued, forcing the Fed to slowly reverse its stance on monetary policy. In tandem with the Fed's announcement, investors were forced to consider and decide on how to handle the other data points that were previously in the background. The market began whipsawing between optimism and pessimism as it tried to decide on how to proceed. In other words, this indecision has led to the reintroduction of a vital market participant - volatility. So long as the market continues to be indecisive and investor psychology remains weak, volatility will persist, and the likelihood of continued weakness will endure.

Outlook

As we enter the fourth quarter, the economy continues to grow, although not at the unabated level it did coming out of the pandemic. Companies are generally in a strong financial position and should be able to continue investing in and growing their businesses. There is significant slack in the labor market and major retailers are introducing significant hiring initiatives to manage what is expected to be a robust holiday season. Consumers are still expected to continue to fuel the economy as spending on goods and services should continue to rise throughout the holiday season.

Some of the risks we see on the horizon are the increased availability of easy consumer credit and the supply chain bottlenecks, specifically in shipping and trucking, that are plaguing everything. Due to the low interest rates and high levels of liquidity, competition for lending has been fierce. Banks have had a very hard time growing their lending volumes in a meaningful way (if you're not convinced, just check your mailbox). This has forced them to reduce their underwriting standards to boost their loan volumes and profitability. We are also beginning to see the proliferation of alternative lending solutions such as Buy Now Pay Later (BNPL), payday advances, and home equity cash outs, among others. Although this is not an immediate concern, this is something that we are watching very closely. Anything that would lead to a decrease in consumption, whether it be a decrease in credit availability or the increase of defaults, would be a major hit to the economy.

The more immediate concerns are the supply chain bottlenecks brought on by the lack of transportation capacity. The transportation sector is the lifeblood of the economy. Like oxygen, it is seldom thought about when plentiful, but when it is absent or disrupted, it is the only thing that matters. For years, the transportation sector has been optimized to support a Just-In-Time inventory environment. As the names implies, inventories would be received just as they were needed to reduce the investment required to hold unsold inventory. This worked wonders for years, boosting productivity and profitability, leading to the unbelievable increase in market values since it started in the 1970s. However, due to the disruptions from the pandemic, Just-In-Time has turned into Just-Send-Anything. There is currently a severe shortage of truck drivers to transport goods and the logjams at major shipping ports are causing significant shipping delays that are rippling through the global economy. This has been one of the main culprits of inflation and if it is not resolved in a quick and orderly fashion, it is unlikely that inflation will abate anytime soon. Moreover, considering it is difficult to buy something off an empty shelf, a lack of supply due to the transportation issues could potentially lead to decreased consumption and a slowdown in the economy. Longer term, a move by companies to hold higher levels of inventory to avoid shortages could lead to lower profitability and potentially stock market valuations.

Warm Regards,

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