Happy October! Summer has flown past and at least here in Vermont the leaves are changing colors and falling from trees, the air is crisp and cool, and evening darkness is coming earlier and earlier. Summer 2021 felt more celebratory than ever as COVID restrictions lifted, the economy re-opened, and we were all able to travel and dine out with family and friends. The onset of fall has brought not only a shift in the weather but also in the positive economic and market outlook. COVID cases are once again on the rise due to the Delta variant. Jobless claims are ticking higher as extended unemployment benefits have ended but yet there are more jobs available than workers seeking them. Washington is engaging in seemingly endless political negotiations. On the positive side, as of yesterday, a looming government shutdown has been averted. Or, should I say yet another looming government shutdown?!

Can all the chaos in D.C. halt the bull market or is this just another bout of Washington-fueled volatility?

The gridlock in Washington is so tiresome it seems like a broken record. Initiatives face bi-partisan support yet as they work their way through the legislative process get stuck on the same scratch in the record and we go back to the beginning.

There are four key issues facing Washington and they all seem to have come to a head this week: an infrastructure bill; a second economic package focusing on climate change, health care, and social programs; a bill to avert another government shutdown by temporarily funding government operations for a couple of months; and legislation to suspend the debt ceiling and avoid a catastrophic default by the United States. At the final moment yesterday, September 30, Congress resolved to keep the government open until December 3. Of course, the extension was only temporary and just like a broken record, at the end of the album we will start again and soon hit the same scratch. This temporary extension of funding just kicks the can down the road. Lawmakers still must figure out how to pass the 12 appropriations bills that fund all federal agencies and programs for the remainder of the fiscal year.

The infrastructure bill – a key tenet of the Biden Administration – continues to meander its way through Congress. The legislation would commit $1.2 trillion towards roads, bridges, waterways, airports, the electrical grid, and other projects. Some progressives in the House want to partner the bill with the larger budget reconciliation package and in typical Washington fashion this is causing extensive negotiation and little action. Speaker Pelosi is calling for a vote on infrastructure today so perhaps the issue will be resolved by the time you read this article.

The remaining two issues are far more complicated. The proposed $3.5 trillion spending package faces up to $2 trillion in cuts on both sides of the aisle but on different issues. Democrats are championing health care, climate change, immigration, tax code changes, and a myriad of other initiatives. A $1.5 trillion package will fall far short of Democrat initiatives, but a $3.5 trillion package may not even reach a vote. We will watch this unfold for weeks, or even months, to come.

The debt ceiling issue is perhaps the longest-played broken record. There are different players each time but the story is the same as we continue to run a debt-fueled economy. Treasury Secretary Janet Yellen announced earlier this week that she expects the Treasury to run out of cash to pay its bills on October 18. Though bipartisan support for a debt ceiling increase has been a long-standing precedent, Republicans are placing the responsibility on Democrats as they control the House, the Senate, and the White House.

What Does All This Mean for Investors?

The political posturing in Washington is nothing new and for all the pending issues, except the debt ceiling, we will likely continue to see volatility but no systemic market shifts. The debt ceiling is the one critical issue that is a bit different this time, even though it feels like the same broken record. The October 18 deadline when the Treasury will run out of cash and thus cause the U.S. to default is very serious issue. Though the debt ceiling has been raised approximately 80 times since 1960, historically when the debt ceiling has reached the catastrophe level it is now nearing, the market has reacted very negatively. 2011 and 2013 were the most recent market corrections driven by debt ceiling crises. Randy Frederick, Schwab's Managing Director of Trading and Derivatives, stated yesterday that if the unthinkable happens and U.S. Treasuries go into default, the impact to U.S. credit and the economy would be severe and we would likely enter a bear market. That said, the U.S. has never defaulted on its debt. While we want to be cautious about risks in the market, we need not panic that a bear market is coming: instead, we should prepare for both upside and downside potential.

This preparation means employing the same strategies as always – well-diversified portfolios, a measured response to market action, and not getting too aggressive in search of excess returns that could end up only increasing risk. CenterPoint is always in pursuit of this balanced approach and though the circumstances are ever changing, our management of your portfolio continues to be thoughtful and measured in response to these market shifts.

Rising Prices – Here to Stay?

I would be remiss if I did not address one of the biggest headlines today: inflation. Whether at the gas pump, in the grocery store, labor, or buying a new appliance or car, there is no debate that inflation is upon us. Only time will tell, however, if it is transitory or systemic. Price increases have been driven by increased demand as consumers are enthusiastic to consume goods and services, travel, and re-engage in the economy. Continued breaks in the supply chain have led to extremely low inventories in both manufacturing components and finished products. This in turn has caused very low supply in response to that higher demand. Labor shortages have caused delivery issues such that the goods that are produced cannot get to consumers, further reducing supply and driving demand. Finally, we must remember that inflation is measured year-over-year so when comparing the shuttered economy of 2020 to the enthusiastic summer re-opening of 2021, it is no surprise that we are seeing year-over-year inflation. These inflationary triggers indicate transitory inflation but when combined with the easy money policies of the last 12 years, inflation may be a longer-term factor after all.

Persistent low interest rates and increased inflation means that real rates are negative. Nominal rates should likely be higher given surrounding market conditions but continued Fed stimulus is holding rates down. The Fed has just announced that it intends to begin tapering its $120 billion per month bond purchases in November and will continue winding down until the end of 2022 when it can begin to actually raise rates to counter inflation as appropriate. The U.S. dollar has stayed low but likely will increase as the Fed starts to taper its asset purchases. International growth will likely outpace U.S. growth and that will, in turn, drive the dollar lower again.

Wages are increasing across the market as the economy re-opens and workers are incentivized to return to work. This wage reset, however, is only happening for blue collar workers as most white-collar workers were able to continue working from home throughout the pandemic. In addition, the labor force participation rate for age 55+ is very low as many are not re-employing but instead choosing early retirement due to COVID risks. The most recent JOLTS (Job Openings and Labor Turnover Survey) report showed 10.9M job openings. The unemployment report showed 8.4M filings which indicates that there are more job openings than people looking for work. Extended pandemic unemployment benefits ended September 6 so the coming weeks of labor market data will be important in forecasting the trends.

Despite the contradictions in the labor market, the consumer remains resilient with an elevated savings rate (due to pandemic limited spending and stimulus income), and rising income. Though direct stimulus payments have ended, consumer debt and mortgage delinquencies remail low. The housing market continues to surge due to still-low interest rates and low housing inventory.

China – An Opportunity or a Risk?

Though we could fill pages analyzing international markets and the various opportunities, in pursuit of maintaining our readers' interest, we will summarize developed international markets as looking highly favorable and emerging economies as long-term opportunities for exponential growth. China, on the other hand, requires a bit more ink in this market outlook.

The Chinese government's regulatory actions have certainly rattled investor sentiment toward Chinese assets in recent months. The impact on the global market has been negative as regulations are implemented. The stated objective of Chinese policymakers to better align Chinese companies and industries with the government's goals of prosperity, sustainability, and stability and has been in the works for a long time. These regulatory actions are designed to celebrate the 100-year anniversary of the Communist Party and present President Xi's strength as a leader in anticipation of next year's Party Congress. President Xi hopes to overcome term limits and perhaps even continue in power for life.

The most recent Chinese headline which led to a quick market drop that was soon erased was driven by Evergrande, China's largest real estate development company. Evergrande was unable to meet its debt obligations and under new Chinese regulations was not allowed to simply borrow more money. Evergrande's debt crisis caused financial distress to spread faster and more forcefully than Beijing's financial regulators expected, putting pressure on them to move quickly to stop the contagion. Such action to rescue Evergrande's creditors in turn undermines the government's new fight against bad debt. As China continues to pursue increased regulation, we should be mindful that Evergrande may be the first of many casualties in the fight against bad debt.

What Are We Doing Now?

In summary, politics, the labor market, a frothy U.S. stock market, inflation, and Chinese regulatory risks is probably enough to make your head spin. There are days when the headlines come in so fast that it is enough to make mine spin, I assure you. The key, however, is to remember that headlines are designed to catch your eye and the reality is often deep down. We at CenterPoint do not react to headlines alone but read between the lines, incorporate reason, listen to the opinions of others (many others), and formulate measured opinions about how to respond to the market today. We are taking a more defensive approach as we see the risks ahead of us but also know that the opportunities are great. As we move into the last quarter of the year we will take profits where appropriate to mitigate risk and lock in returns. We will harvest outsized gains against losses to minimize the tax impact in your taxable accounts. We will also be rebalancing portfolios to ensure that we are well positioned for the next market shift. As always, we appreciate your confidence in us and encourage you to reach out with any questions or concerns.

Warmly,

Priscilla N. Gilbert, CFP®