IRONWOOD
Investment Counsel, LLC

Ironwood Investment Counsel, LLC constructs and manages customized investment and wealth management programs designed to meet our clients' unique goals and objectives. Our distinctive process maximizes performance through return enhancement, risk reduction, tax efficiency, and cost containment.

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Third Quarter 2021 Market Commentary

Despite a myriad of developing economic issues in the final month, major market results were generally mixed in the third quarter. Inflation concerns, slowing job growth, and supply chain disruptions were just a few of the items that characterized the economic and financial markets backdrop. The S&P 500 index advanced 0.6% in the quarter, after selling off nearly -5% in September. Across larger, domestic businesses, growth companies outperformed value companies as the Russell 1000 Growth returned 1.2% in the quarter versus the Russell 1000 Value which posted a -0.8% decline. Smaller capitalization businesses, measured by the Russell 2000 index, declined by -4.4%.

International equities declined modestly by -0.4%, whereas emerging markets produced much lower returns of -8.1% in the third quarter. Both emerging markets and international fixed income and equities were negatively affected by China, whose index declined by -18.2% for the quarter. Chinese regulators surprised market participants in July with a more restrictive regulatory framework against their major technology companies. Concurrently, the highly levered Chinese construction company, Evergrande, sold off significantly during the quarter as concerns about China's debt driven growth model collided with a slowing economy.

Fixed income returns were muted during a volatile quarter for interest rates. A multi-month rally that began in the second quarter brought the 10-year Treasury yield to its lowest level since early 2021. This rally quickly reversed in the days following the Federal Reserve's guidance that it will likely begin to reduce its asset purchases of $120 billion per month beginning in November of this year. As a result, the benchmark 10-year Treasury settled slightly above where it resided at the beginning of the quarter at 1.5%. Both the Bloomberg U.S. 1-5 Year Corporate index and longer duration Bloomberg US Intermediate index were essentially flat. Fixed income instruments with lower credit quality fared better with the Bloomberg High Yield and Barclays Leveraged Loan indices advancing 0.9% and 1.1%, respectively.

Inflation concerns continue to dominate business headlines and consumers' pocketbooks as we draw closer to year end. This begs the question, what time period does "transitory inflation" encompass? Does transitory inflation mean 3-6 months or 3-6 years? While no one (not even the Federal Reserve) knows the answer to such questions, inflation pressures persisted throughout the quarter after rising to a 29 year high in June. The reasons behind this persistent inflation are multi-faceted. Consumer spending has roared back in 2021, but supply chains have been slow to return to normal. Scenes of growing backlogs at shipping ports perfectly highlight the supply/demand imbalance currently facing the US economy. As Nobel Prize winning economist Milton Friedman famously said, "inflation is caused by too much money chasing too few goods."

While there are reasons to believe that these inflationary pressures will subside next year as COVID related shocks recede, persistently higher costs could continue to challenge businesses. Even Dollar Tree regrettably announced recently that it will no longer limit prices to $1.00, but will raise many items to $1.25 or $1.50. Dollar-Fifty Tree anyone? Ultimately, continued inflationary strains could reduce corporate earnings growth if costs rise faster than revenues, which could eventually affect equity prices.

Intertwined with these underlying cost pressures, businesses have also been faced with a puzzling labor market. Despite robust job growth in July of 943,000 jobs, iM Global Partners indicated "that employment is still 5 million jobs below pre-pandemic levels". As the quarter progressed, only 366,000 jobs were added in August, and September saw even fewer new jobs with a disappointing 194,000 gain. With job growth slowing, and employers in desperate need of workers, the question of, "Where are the workers?" seems appropriate to ask. There is no shortage of explanations for the lack of labor participation, including enhanced unemployment benefits, worries over the spread of the Delta variant, early retirement of baby boomers, and two income households reverting to one income due to childcare issues. Our concern resides with the ultimate outcome of continually rising wages (or lack thereof), how such a result would affect corporate earnings and the equity and debt of the companies we invest in on behalf of our clients.

Questions about peak corporate earnings growth continue to be expressed by market pundits and investors. For 2021, however, earnings have consistently outperformed expectations which has continued to propel equities and other risky asset classes into October. According to FactSet, overall profits for the S&P 500 rose nearly 90% in the second quarter versus the year before. This rise in earnings was the most significant year over year gain in nearly ten years. Even with the fading impact of stimulus, corporate profit growth may continue into 2022 for two primary reasons. First, U.S. economic output, in real terms, has now surpassed pre-pandemic levels with continued strong demand for goods and services. And second, forward equity valuations (a measure of the price of a company relative to future earnings) have actually improved this year with such strong revenue growth. Of course, the "fly in the ointment" could be any one or all of these nagging economics issues gaining traction, including, higher inflation, mounting wage pressure, and/or further snarled supply chains.

With so many economic unknowns, we continue to favor high quality investments. More specifically, our approach is to focus on cash flow centric investments to achieve our client's objectives. We strive to utilize well diversified portfolios that can prove successful in a variety of economic environments. We believe our commitment to quality serves our clients well.

As we approach the end of 2021, we want you to know how much we value the confidence you place in us, and appreciate the opportunity to be of service. Please let us know if you have any questions, or would like to meet to discuss your portfolio in greater detail.

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