HORAN Capital Advisors

Quarterly Investor Letter

FALL 2021

"What the human being is best at doing is interpreting all new information so that their prior conclusions remain intact."
- Warren Buffett

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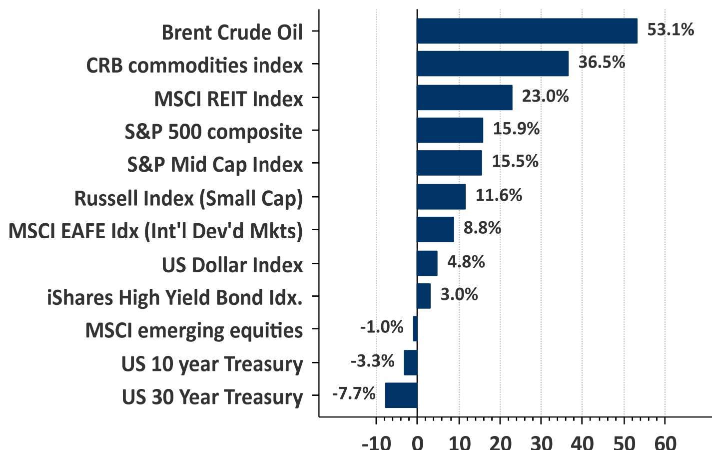
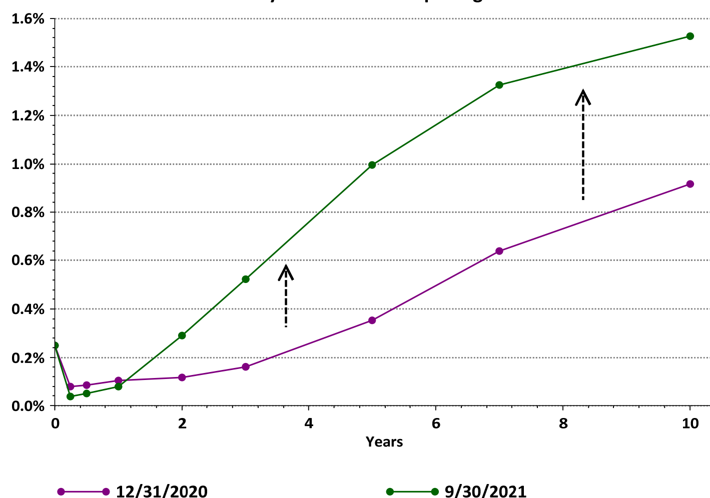
Another Positive Quarter

The S&P 500 Index managed to generate a small 0.58% gain in the third quarter. This is the sixth consecutive positive quarter for the S&P 500 beginning with the second quarter of 2020. Since the end of the 2008/2009 financial crisis, there have been two time periods where the S&P 500 Index finished higher for nine consecutive quarters. Not sure nine green quarters is in the cards during this current bull market run, but six straight positive quarters is impressive and is reflective of the upward bias currently in place for the market. On a year-to-date basis through September 30, 2021 the U.S. equity market returns outperformed both the developed and emerging market indexes. In the U.S., large company stocks (S&P 500 Index) returned 15.9%, compared to 15.5% for the S&P Mid Cap 400 Index and 11.6% for the Russell 2000 Small Cap Index.



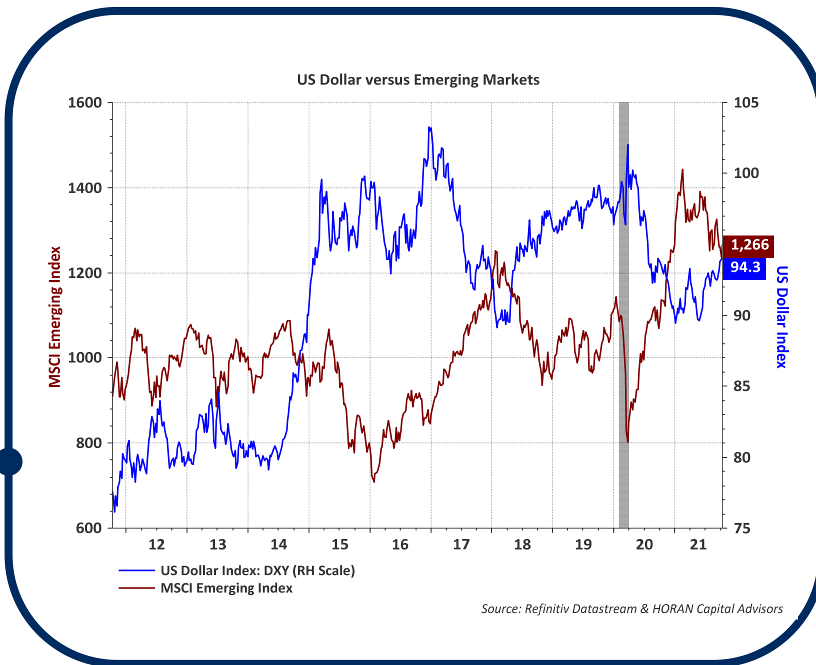
From a sector perspective, energy has been the standout this year, up 43.2%. The reopening of the economy and higher economic activity is driving increased oil demand. Additionally, domestic oil production of 11.1 million barrels per day is down from the pre-pandemic peak of 13.1 MB/day. The increased demand and lower production are contributing to a drawdown in oil inventory, thus leading to higher prices and improved profitability for companies in the oil sector. Oil inventory, excluding the Strategic Petroleum Reserve, stands at 418.5 million barrels versus June 2020 inventory of 540 million barrels, i.e., oil inventory down over 20%.

The next closest sector in return is the financial sector, up 29.1%. Stronger economic activity through the third quarter has led to a steepening in the Treasury yield curve as seen in the chart to the right.



Banks/lenders generally borrow with short term deposits and lend money at a spread over a longer interest rate. With long term rates higher than short term rates, this has led to improved profitability for banks as loan demand remains strong.

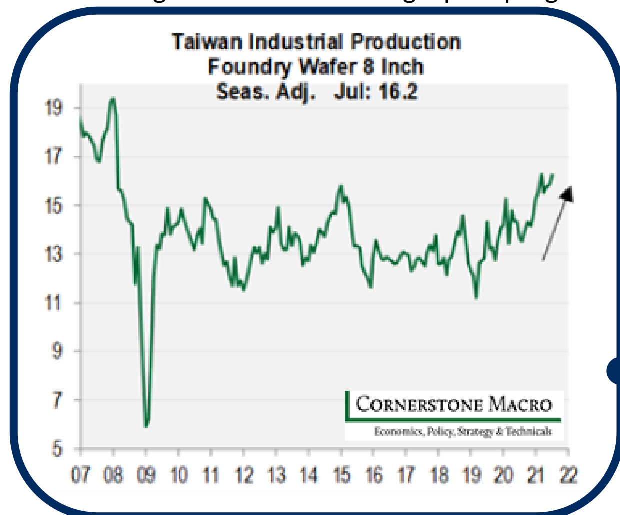
The move higher in interest rates has led to increased strength in the U.S. Dollar which has implications for various intermarket relationships. One such relationship is that a rising dollar puts pressure on emerging markets assets. The chart to the right illustrates this inverse relationship.



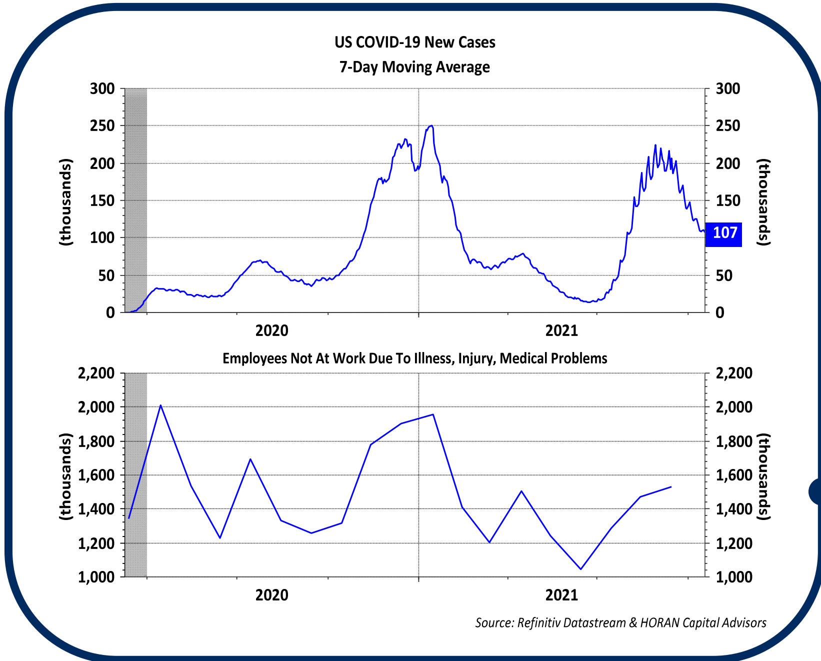
The primary reasons for this intermarket reaction are two-fold. First, many emerging market countries borrow in US Dollars. When those dollars become more expensive via a rising US Dollar, their debt loads become more burdensome making it more expensive to service their liabilities. Second, as local emerging currencies weaken, capital tends to flow out of these economies, further tightening financial conditions. Emerging markets assets have significantly lagged the rest of the developed world as rates have risen, the dollar has strengthened and China has exerted more control over its large companies.

Jobs and the Supply Chain

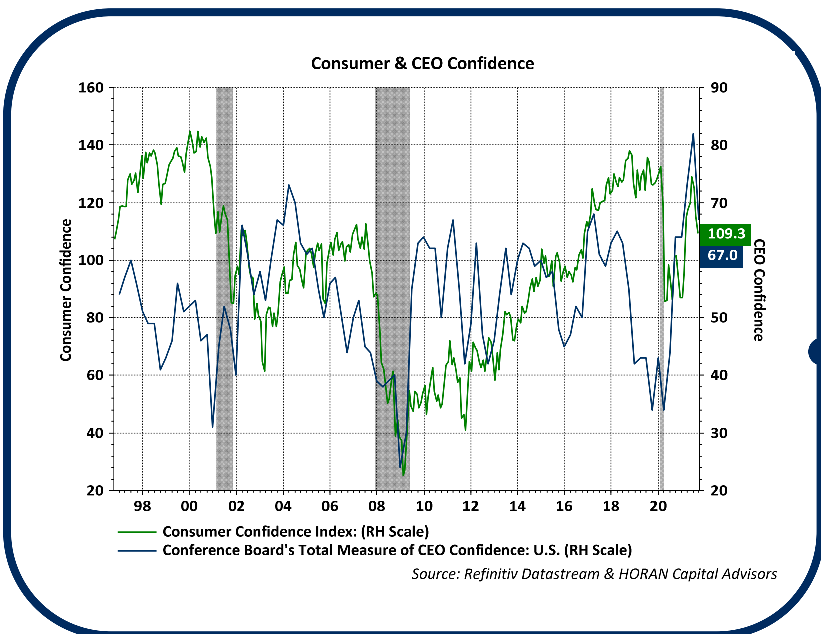
In our *Investor Letter* last quarter, we commented on inflation and the clogged supply chain. Since then, annual inflation has receded slightly, and breakeven inflation data remains stable. The congested supply chain continues to be an issue and is leading to price spikes and/or product shortages in some goods categories. A recent report by *The Guardian* noted "The bottleneck this week [September 23] at America's busiest port complex is the result of a shortage of trucks and drivers to pick up goods, coupled with an overwhelming demand for imported consumer products." Despite the bottleneck, the Long Beach and Los Angeles ports are unloading record amounts of cargo. To help address this issue, the Port of Long Beach is now testing a pilot program to allow cargo pickup by trucks everyday around the clock.



New automobile production has been impacted by a global shortage in microchips critical to automobile manufacturing. The tight supply in this area seems to be easing as well as noted in an October 8 article in *Automotive News*: "General Motors said it expects to reopen the remaining three North American assembly plants that have been idled because of the global microchip shortage by Nov. 1." Additionally, the research firm Cornerstone Macro highlighted in a research report the rebound in semiconductor chip orders and manufacturing. The chart to the left shows chip wafer production is at its highest level in the last 12 years.



A part of the shortage issue is related to companies' inability to fill open positions. There is some belief the extra pandemic unemployment insurance (PUI) was reducing the need for individuals to seek employment. Since the PUI benefits expired September 6, the total number of individuals receiving unemployment benefits, including the PUI category, has declined from 11.2 million to 3.6 million. In comparison, companies are reporting they have open positions totaling 10.4 million. There is also evidence the increase in COVID-19 cases has impacted the employment picture. The chart to the left shows the relationship between new COVID cases (top chart) and employees missing work due to illness, injury, or medical problems (bottom). As real-time cases have declined, the lagging data showing employees missing work should ease job issues further.

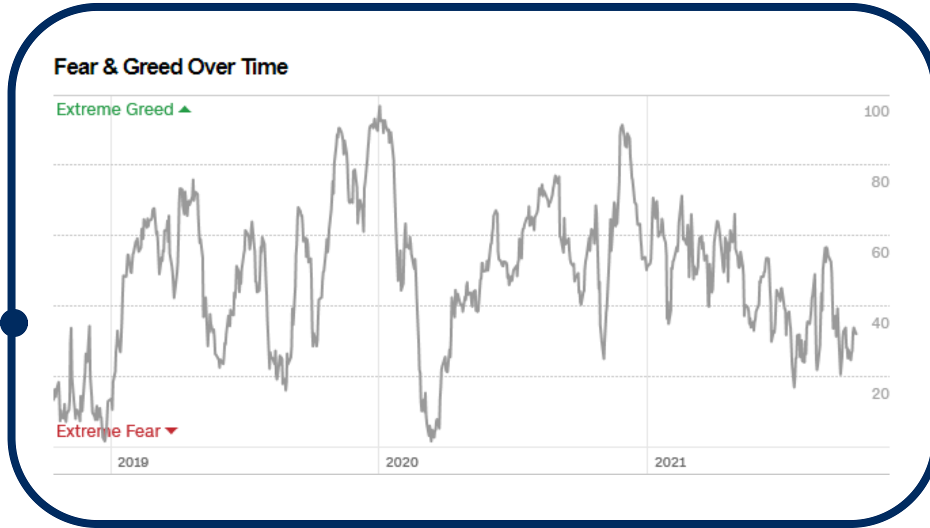


Confidence

Related to the employment level is the confidence expressed by consumers. Consumers account for 70% of economic activity and their financial position and sentiment can be important factors in driving future economic activity. At the end of September, The Conference Board (TCB) reported the Consumer Confidence Index declined for the third consecutive month to 109.3, down from its recent peak of 128.9 for June. The consumer responses noted less optimism about short-term business conditions and the labor market; responses also indicated consumers were less positive about their short-term financial prospects.

CEO Confidence also experienced a decline in the third quarter. The Conference Board's report showed a decline of 15 points to 67%, down from its all-time high of 82%. Labor issues are a large part of CEO's reduced confidence as well. Businesses appear eager to invest and expand but are hampered by labor shortages—55% of firms surveyed cited issues with recruiting.

Looking at equity market sentiment, investors are feeling uneasy about the current market situation as well. One publicly available sentiment gauge is the CNN Fear and Greed Index. This index tracks several factors and places them into a composite score to give insight into the mood of the market. The gauge to the right indicates investors are more fearful than confident. At extremes, equity market sentiment tends to be a contrarian indicator. Importantly, investors are not overly "greedy" now. Overly greedy readings tend to mark short-term market tops.



Expectations for Q4 and the Year Ahead

The balance of 2021 will round out a year of extremes. Hot inflation readings, manufacturing backlogs, shipping delays, labor shortages, automobile production constraints, etc., have touched everyone's lives in one way or another. On the positive side of extremes, earnings growth has been robust and is forecasted to continue. The current estimate is for S&P 500 companies to grow fourth quarter earnings 22.2% year-over-year. This would indicate full year 2021 earnings growth of 46%. Coming off a strong year, we would expect many of these extreme readings to subside. The current outlook is for earnings to grow about 10% in 2022. There are signs of relief at the ports as well as the potential for labor force participation to increase. There seems to be no playbook for the current economic environment. This is a prudent reminder of the importance for diversification and risk management in portfolios.

Thank you for your continued confidence and support in HORAN Capital Advisors. We are always available to answer your questions and discuss our outlook further. Please be sure to visit us for company news, reports and our blog at https://horanassoc.com/insights/market-commentary-blog.

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