



A Message from the TOPS® Portfolio Management Team

3rd Quarter 2021 Market Commentary

“Slowing Momentum and Risks of Policy Changes Caused Volatility During Q3”

Year-to-date 2021 stock market returns remain well above average. Despite losing ground in September, the S&P 500 eked out a small gain in Q3, marking its sixth consecutive positive quarter. However, many other major stock indexes saw their winning streaks snapped. The Delta COVID variant resulted in a resurgence of COVID cases around the world, with many downline effects on the economy. This impacted supply chains and workers, causing shortages of both goods and services, so the ongoing economic recovery slowed markedly. In addition, concerns about rising inflation and a likely Federal Reserve shift away from easy-money policies caused bond yields to rise modestly.

As a result, the TOPS portfolios earned a wide range of year-to-date returns (+3.4% to +12.1%). The more aggressive TOPS portfolios (higher equity allocations) were aided by the continued resurgence of diversified market leadership for the year-to-date, although large cap growth returned to its leadership position in Q2-Q3. We continue to note all TOPS portfolio returns for the trailing three-year, five-year and ten-year timeframes remain well into positive territory, with the more aggressive portfolios recording double-digit returns over those timeframes.

After discussing Q3 and year-to-date 2021 financial market results, we will address three topics that are important to TOPS portfolio returns and strategies:

- Inflation: Are higher inflation rates “transitory” or “enduring”?
- The Fed: Impact of tapering Bond purchases and raising interest rates
- Valuation: is the stock market dangerously overvalued?

Third Quarter and Year-To-Date Markets Review

Volatility returned to stock markets in Q3, and the S&P 500 finally suffered its first 5% pullback since 2020 at the end of September. Nonetheless, trailing twelve-month (TTM) returns are remarkable. The TTM return for the large cap S&P 500 is +30.0%. That is a tremendous return, except in comparison to the gains from S&P SmallCap +57.6% and MidCap +43.7%.

For Q3, the only stock indexes with positive returns were S&P 500 Growth +1.9%, S&P 500 +0.6% and MSCI US Investable Market Real Estate +0.5%. The other “diversifiers” posted negative returns ranging from -0.4% for the MSCI EAFE (developed international) to -8.1% for MSCI Emerging Markets. The S&P Midcap was -1.8%, S&P Smallcap was -2.8%, and S&P GSSI Natural Resources was -2.5%.

As noted above, year-to-date (YTD) stock index returns are still above average. Of course, we were gratified to see our largest allocation – the S&P 500 – record a strong +15.9% return. S&P GSSI Natural Resources +29.4% was the best performer YTD. Strong results were also achieved by S&P Smallcap +20.1%, MSCI World Real Estate +16.2% and S&P Midcap +15.5%. The laggards were MSCI EAFE (developed international) +8.3% and MSCI Emerging Markets -1.2%.

Bond yields rose toward the end of Q3 and finished modestly higher, as the 10-year US Treasury yield rose from 1.45% to 1.52% during Q3. Total returns were slightly positive for Q3, as the Barclays US Aggregate Bond returned +0.1% and

the Barclays US TIPS returned +1.8%. High Yield corporate bonds had positive returns, while Investment Grade Corporates and Emerging Markets bonds saw negative returns.

The 10-year US Treasury Bond yield rose from 0.93% at yearend to 1.52% in September. Barclay's US TIPS recorded a solidly positive return of +3.5% YTD versus the broader Barclay's US Aggregate at -1.6%. US High Yield achieved positive returns while developed international and emerging markets were negative. The TOPS strategy of maintaining below-market durations helped portfolio returns.

Inflation: Are higher inflation rates "transitory" or "persistent"?

Central bankers who believed the current surge in inflation would wind up being a short-term phenomenon aren't sure how long transitory pressures will persist. Investment Strategists who predicted another quarter of strong economic growth were forced to cut estimates because of supply-chain bottlenecks and falling consumer and business confidence amidst the resurgence of COVID due to the Delta variant. In August, the Atlanta Fed's GDPNow forecast for Q3 2021 was for 6.3% growth, but it fell to +2.3% by early October.

If economic activity does slow even as COVID caseloads once again decline, it could allow inflation to fall, but the CPI seems unlikely to return to the Fed's target range of 2% until sometime in 2022 at best.

One leading indicator of non-transitory inflation may be the following: 224 of the S&P 500 companies mentioned inflation on their second quarter earnings calls, according to FactSet. That is the highest number since FactSet began tracking the data in 2010 and may be a signal that inflation is more widespread and persistent than the Fed hopes.

And Chairman Powell himself has recently stated that "Central banks cannot count on inflation being transitory." He conceded that inflation has been less transitory and more persistent than he expected and he is no longer talking about the temporary "base effect" on inflation. Instead, it appears he is blaming the problem on supply bottlenecks. This is not totally unreasonable, but will price increases be reversed when (if?) supply chain issues are resolved?

Labor costs are also clearly rising, and likely must rise further to lure workers back into the job market. In the past, persistent inflation outbreaks have been fueled by rising incomes in a scenario known as a "wage/price spiral". Higher incomes allow greater spending (higher demand for goods and services) and limited supplies of goods and services are thus priced at higher levels. Economists, strategists, the Fed and the TOPS portfolio team will all be watching for signs that this is beginning to take place.

The Fed: Impact of tapering Bond purchases and increasing interest rates

In September, the Fed signaled that "tapering", a reduction in bond purchases, will begin sooner than previously expected. A tapering announcement in November is seen as very likely and most economists expect a gradual taper of \$10-15 billion from the current \$120B monthly pace. The Fed is justifiably concerned about inflation and their "dot plots" (FOMC member forecasts) now indicate rate increases may begin sometime in 2022, rather than in 2023 or even 2024. The long-overdue process of reducing monetary stimulus is about to begin.

Tapering bond purchases is not the same as aggressively reducing the Fed's bloated balance sheet. They will likely only allow it to shrink gradually as bonds mature. The next step for the Fed if inflation stays high and real interest rates become more negative is that the Fed will have to start applying the brakes by raising interest rates. The Fed will surely prefer to signal a slow pace of rate increases, so if persistent inflation forces them to increase rates higher and faster, the markets may be surprised and react negatively.

At this time, it seems likely that shorter term yields will stay lower than they would have in past periods as central bank policies remain accommodative, while longer term yields may gradually rise if inflation proves to be non-transitory. We will continue to monitor this closely.

Valuation: Is the Stock Market dangerously overvalued?

Valuations are above historic averages. The S&P 500 has been trading around 21 to 22 times forward earnings since Spring 2021, compared to a long-term average closer to 16.5x and an average of 18.5x over the past five years. There are several factors that support these higher valuations: no signs of recession, solid earnings growth, very low interest rates, and the ongoing unprecedented monetary and fiscal stimulus.

Obviously, a lot of stimulus funds flowed into investments of all types, including stocks. The COVID economic shutdown caused a dramatic 35% plunge in the S&P 500 large-company stock index during February-March 2020. The reversal was equally astounding, as new highs were reached within five months. Since then, the S&P has steadily moved higher, as there have been over 50 daily closes at new all-time highs so far this year. The stock market rally benefitted from a strong recovery in actual (and forecasted) earnings as well as an expansion in the price/earnings ratio.

The latter factor has many observers worried, but we note that high valuations rarely cause Bear Markets. High valuations may impact longer term expected returns, but that is a subject for another Commentary. With regard to earnings, the growth rate peaked in Q2 2021, but consensus expectations are still rising. These positive revisions to estimates are a plus for the stock market outlook. Given the continuation of extremely low interest rates, the current 20.5x price/earnings ratio does not look outlandish.

TOPS Portfolio Strategies

The combination of fiscal and monetary stimulus, along with the desire of businesses and consumers to return to normal spending patterns suggests the US economy will grow throughout 2021, albeit at a somewhat slower pace. The TOPS portfolio team will continue to monitor and assess the importance of potential Federal Reserve policy shifts and President Biden's infrastructure initiatives, as well as the constant flow of economic and financial market data as we strategically implement our philosophy of maintaining broadly diversified portfolios.

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