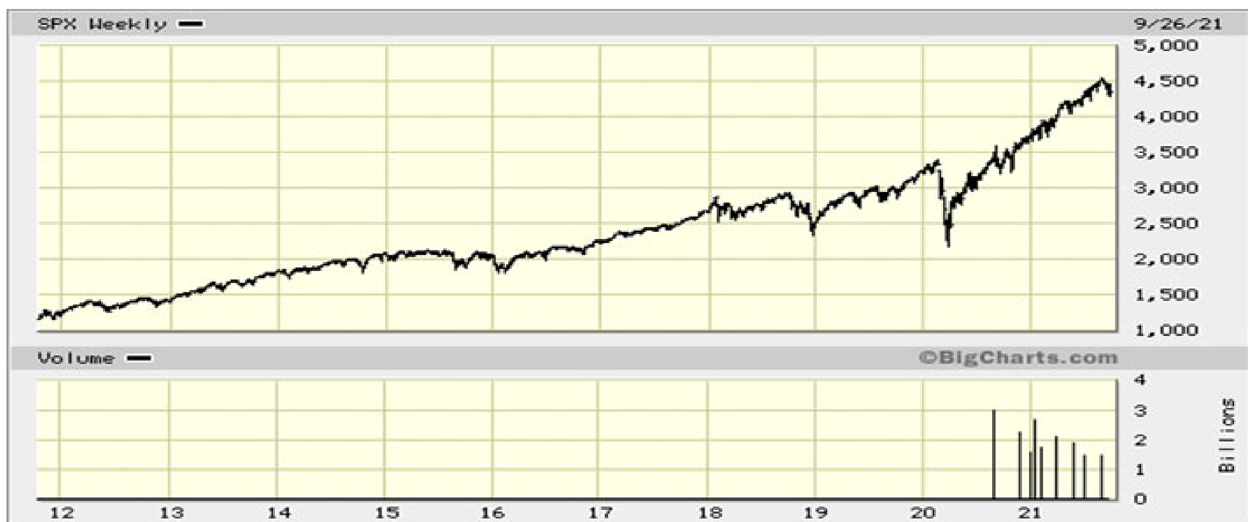
THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – SEPTEMBER 2021

U.S. Markets and Economy

Time for a well-deserved rest. U.S. stocks finally had a 5% correction in September, which was the first down month this year. For the month, the S&P 500 was down 4.8%, with similar losses for the blue-chip Dow Industrials and the tech-heavy NASDAQ Composite. Small stocks, as measured by the Russell 2000, also declined. This S&P 500 graph, however, provides the long-term perspective that is a hallmark of successful investing. Even the short collapse in 2020 is dwarfed by the stunning long-term rise in stock prices.



Although the long-term graph does not show it, September has often been a weak month for stocks. But this year there were plenty of reasons for short-term traders to create a short-term selloff, which happens periodically in every bull market. This selloff had multiple key drivers: monetary policy, COVID-19, inflation, and fiscal follies.

Although the Federal Open Market Committee (FOMC) has been preparing Wall Street for a taper of its quantitative easing (QE4 by our reckoning), Wall Street still prefers maximal easy money to just very easy money. The September meeting of the FOMC, and public statements

made by its members, now suggest that QE4 could end by the middle of 2022. Sometime after that (the Fed is hazy on this), short-term interest rates could begin to rise from zero. This should not come as a surprise, as the Fed cannot keep both feet on the monetary accelerator forever. In fact, the Fed ended its QE *and* began raising short-term rates in the years after the credit collapse of 2007–2009. The graph above clearly shows that easing off the monetary gas did not stop the long-term bull market. With short- and long-term interest rates still well below zero in real terms (after subtracting inflation), monetary policy is likely to be supportive of stocks for many months.

What did stop the long 2009–2020 bull market was the arrival of COVID-19. Unfortunately, the virus continues to mutate, and the Delta version has created havoc in many parts of the world. U.S. vaccinations (and, in many states, indoor masking rules) appear to have ended our own spike of infections, but the Delta variant put the brakes on U.S. economic growth and corporate profit growth for the July–September quarter. Spikes elsewhere (such as Vietnam) may continue to create supply bottlenecks that will both put a damper on growth and lead to unwelcome increases in prices over the next six months.

This increase in inflation, combined with a slowdown in economic growth, does put the Fed in a bind. In the 1970s, this was called stagflation: economic stagnation or outright recession combined with high inflation, which in those years reached about 12%. The Fed's monetary tools cannot solve both these problems at the same time. The good news is that much of the rise in inflation (now at about 4%, based on the Fed's favorite measure) could dissipate as supply bottlenecks are ironed out. Even though stocks rallied sharply on the first day of October, this memory of the 1970s could keep a lid on traders' enthusiasm for stocks. Bond traders have lifted the 10-year Treasury rate to about 1.5%, which is also viewed as a negative for stocks even though this is still a below-zero real yield when subtracting inflation. The bond market certainly believes that the current blip in inflation is temporary and that the Fed's policies are sensible and should keep interest rates low for years.

It's hard to say the same about Congress and fiscal policy. The nation barely avoided another government shutdown, and it's still facing the possibility of default if the so-called debt limit is not increased. What is truly bizarre is that the federal government's borrowing needs are based on spending and taxation *already approved* by Congress: even if Biden's plans for infrastructure and social spending are defeated, we will still run into the debt limit in October. A default of any kind would be hazardous to our economic and financial health, so we have to assume that Congress will do the right thing.

World Markets and Economy

Europe is still suffering economic malaise, with the Brexited British facing a difficult winter of discontent: shortages of milk, meat, petrol, and natural gas are hobbling the economy and driving up inflation. Although British stocks fell only moderately in September, the FTSE 100 index is only up 9% for the year—no higher than it was at the start of 2017, nearly five years ago. Overall, European stocks, as measured by the STOXX Europe 600 index, fell modestly in September, but the economic outlook has darkened. Bank of America analysts suggest that energy shortages and supply bottlenecks could plague all of Europe for months. Germany, the manufacturing locomotive of Europe, is facing slower growth for these reasons: some analysts expect 2021 GDP growth to average only 2.5%, with inflation spiking as high as 5%. Germany's DAX index fell almost 5% for the month.

The Chinese economy, which recovered first from COVID-19, now faces a real-estate crisis as a large firm, Evergrande, teeters on the edge of bankruptcy with $300 billion in debt. Although the financial shock waves should mostly remain in China, a slowing growth rate for the world's second-largest economy could reduce China's demand for imports from other countries. Although Chinese stocks, as measured by the Shenzhen CSI 300, were flat in September, the index is down almost 7% for the year.

Outlook

Even though economic growth may slow down in the coming months, corporate profits will continue to rise, and monetary policy will keep interest rates low. This environment means that U.S. stocks can resume their bull run. The major risks are that the worldwide spread of COVID-19 slows growth outside the U.S., with supply bottlenecks contributing to more inflation and even slower growth here. Another wild card in October is fiscal folly surrounding the debt limit. Short-term traders could therefore make stocks quite volatile in October, but long-term investors can take comfort in the chart above: the best asset to hold in the long term is still common stock.

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