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Bull Market to Continue: Corrections, Inflation, & China

Investment Outlook
Fall 2021

Third Quarter Review. Fourth Quarter Outlook

The Long-Term Bull Market

Expect the long-term bull market that started in 2009 to continue. Corrections are normal and inevitable. The S&P 500 went over 215 days without a 5% or more correction. This is longer than average, so it is not surprising we saw one right before quarter-end.

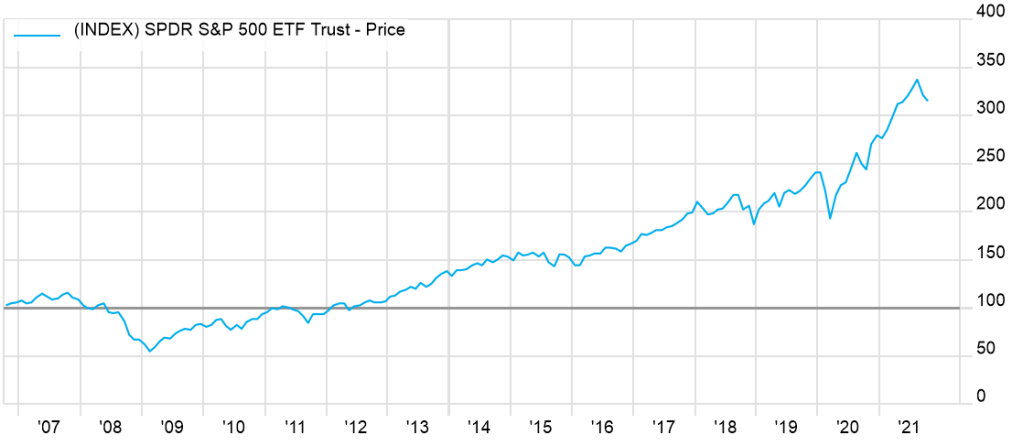
Although it has been longer than average without a correction, the long-term bull market that started in 2009 has not been longer than average. The last two long-term bull markets lasted 24 and 18 years.

Even within long-term bull markets, short-term bear markets can occur. Last year we saw this clearly. COVID-19 caused the quickest 30% or more drop in the S&P 500 ever. However, governments and central banks around the world stepped in to bolster the economy. Stocks rebounded sharply as can be seen in the chart of the S&P 500 to the right.

Besides the short-term bear market caused by COVID-19, the long-term bull market that started in 2009 has been defined by governments and central banks fighting deflation with low interest rates. Low interest rates incentivize borrowing and spending. This was a good environment for stock returns as interest rates stayed low while real GPD expanded at a relatively consistent pace (~2.3%/year from 2009-2020).

SPDR S&P 500 ETF Trust (SPY-USA)

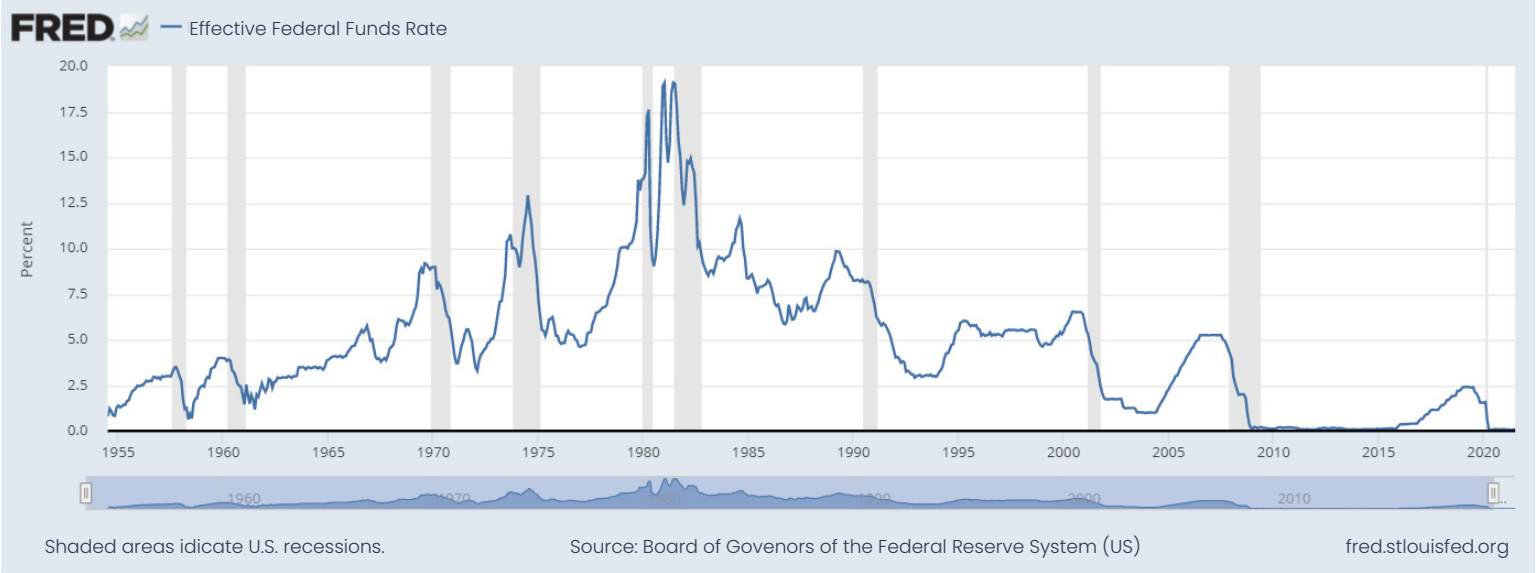
High: 338.04 Low: 55.35 Last: 315.44



Source: Factset: Argent Wealth Management, LLC © 2021

Percent GPA During Secular Bull Markets		
Dates	Nominal DJIA	Real DJIA
1900-03-31 to 1906-01-19	8.0	6.5
1921-08-24 to 1929-09-03	24.9	26.1
1942-04-28 to 1966-02-09	10.5	7.3
1982-08-12 to 2000-01-14	16.8	13.2
2009-03-09 to 2021-09-28	14.1	11.8
Percent GPA During Secular Bear Markets		
Dates	Nominal DJIA	Real DJIA
1906-01-19 to 1921-08-24	-1.1	-5.4
1929-09-03 to 1942-04-28	-10.6	-10.1
1966-02-09 to 1982-08-12	-1.5	-7.9
2000-01-14 to 2009-03-09	.6.2	-8.4

Source: Ned Davis Research



The economy is now reliant on low interest rates. For example, the affordability of a house is aided by near record low mortgage rates. It is higher interest rates, caused by sustained inflation above the 3-4% range, that will eventually end the long-term bull market.

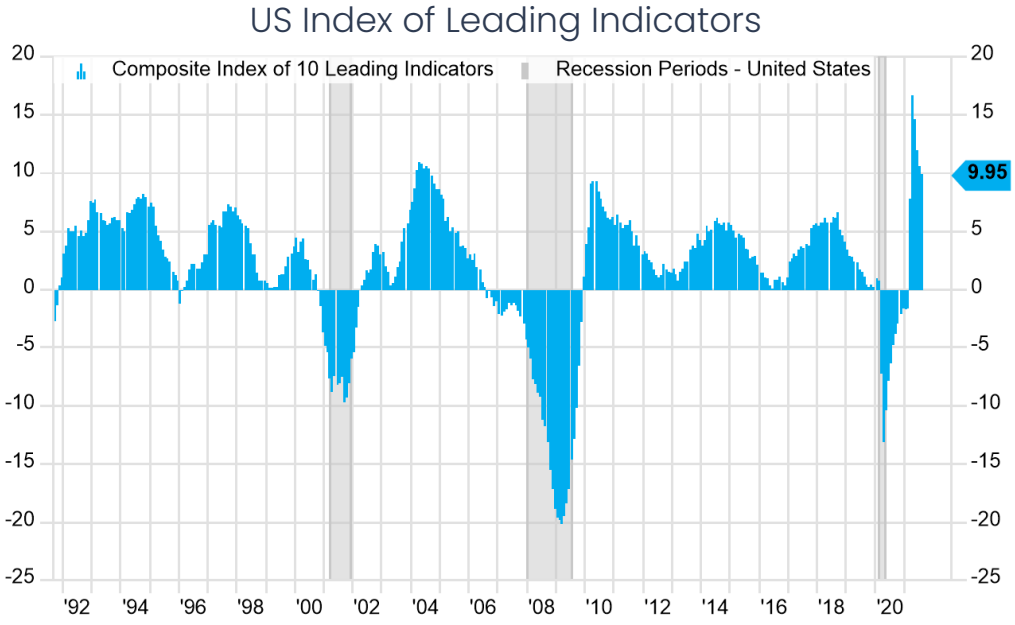
When should we expect this? No one knows for certain. Historically, bull markets persist in the U.S. until the Federal Funds Rate (FFR) reaches the 4% range. At this point, the Federal Reserve induces a recession to slow an overheating economy. Currently the FFR is at 0%, and, according to FactSet, as of September 29th, the bond market is pricing in an 83.8% chance that FFR will be 0% in June 2022. Those expectations can change based on the inflation outlook.

Inflation

Supply Chains

The latest CPI (Consumer Price Index) reading indicated that prices rose 5.3% year-over-year. This was due to a mix of supply chain pressures and increased demand for goods. If inflation were to continue at this pace, the Fed would be forced to raise rates to combat prices that are increasing too fast.

COVID-19 wreaked havoc on supply chains which are global in nature. Most products source parts or commodities from multiple countries around the world. When these countries enact, at various times, restrictions on companies' ability to produce (due to COVID-19) it causes bottlenecks. Moreover, most manufacturers and producers underestimated the amount and speed of demand that would come from customers for products after the quick hitting COVID-19 induced global recession.

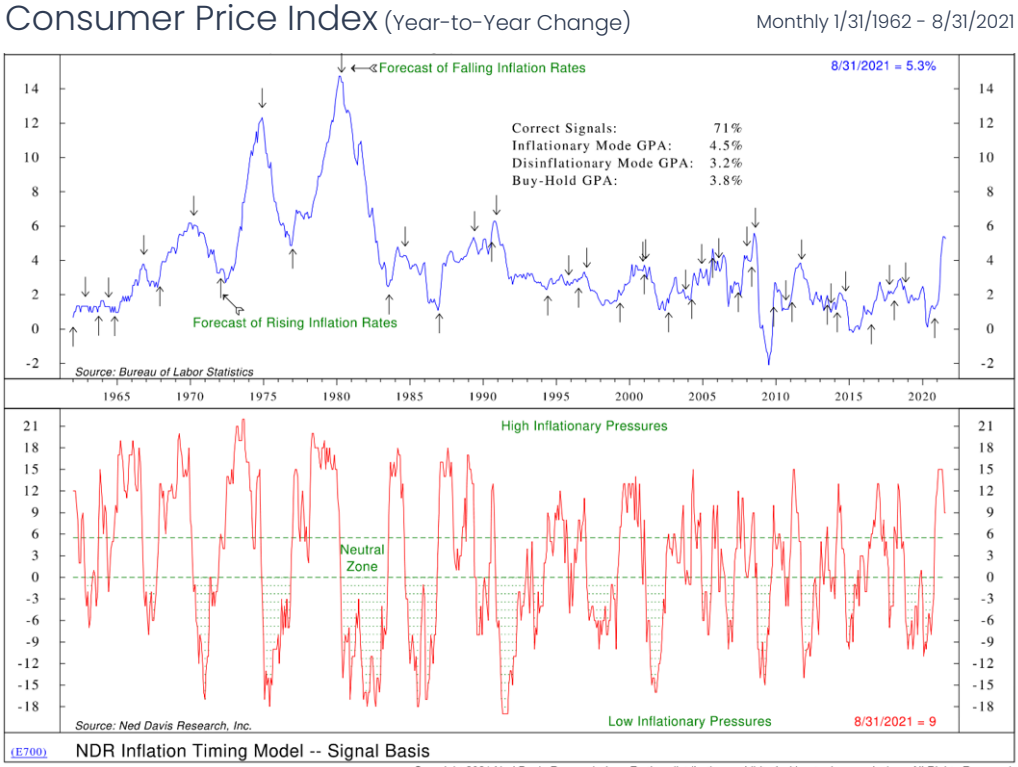


Source: Factset: Argent Wealth Management, LLC © 2021

The combination of bottlenecks and unexpected demand is causing many to worry about inflation. The economy would be a lot worse off, however, if demand languished and supply was plentiful. Companies grew earnings over 80% in the U.S. in Q2, and real GDP was up over 6%. Leading economic indicators are at record high readings. Recession odds are near 0%. This backdrop remains favorable for stocks.

Without supply chain bottlenecks, the economy would have grown faster with less inflation. Over time, supply chain bottlenecks will be resolved and supply will catch up with demand. Expect this

to be a volatile process. Argent's team is watching indicators to see when these supply pressures will peak, and they already may have according to NDR's inflation timing model. This model consists of 22 indicators that primarily measure various rates of change of commodity prices, consumer prices, producer prices, and industrial production. If we hit peak pressure, expect supply chain pressures to ease over the next six months.



Labor

In August, the Bureau of Labor Statistics reported that 161.5 million U.S. Citizens were in the labor force; this is the base used to calculate the unemployment rate. We estimate there are ~10 million people who were in the workforce pre-COVID-19 who have not returned to work. 10 million is a significant number of workers, especially in this context. The shortage may be more temporary than most predict.

For the above reasons, it is unlikely inflation will derail the market over the next two to three years. However, as discussed in the previously quarterly, the COVID-19 pandemic induced a record amount of fiscal stimulus. Unlike temporary supply and labor shortages, too much stimulus can cause aggregate demand and real GDP to increase faster than expected. This can lead to more persistent inflation, along with a faster growing economy, over the next three to five years. The beginning of an environment with too much demand and faster than expected real GDP growth is favorable for stocks. It is when the Fed is forced to raise the FFR towards 3-4% to combat the overheating economy that investors will want to move more away from stocks and into bonds.

Technology vs. Stimulus

If stimulus is the push for inflation down the road, technology might be the pull that keeps it in check. A computer bought five years ago likely has much less power than a new computer, but the price has not changed much.

We might now be living in the golden age of technological development. The speed of innovation is astounding, and the internet and corresponding technological revolution might be in the third or fourth inning. Widespread use of high-speed internet started only about 20-25 years ago.

Use of big machine learning, renewable energy technology, artificial intelligence, driverless technology, automated manufacturing, cloud computing, 5G data speeds, robotics, virtual reality, the metaverse, gene editing, and payment processing (to name a few) are societal trends that will continue to advance our standard of living and help our economy grow.

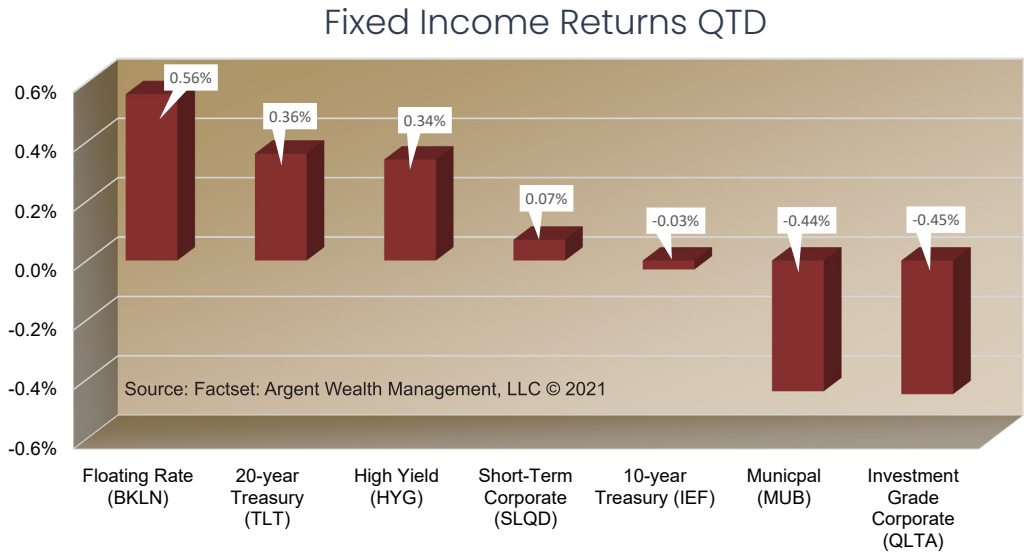
Argent's stock strategies, and asset allocation strategies are investing in companies and industries that benefit from these societal trends. U.S. industry and universities are at the heart of this innovation. For this reason, we believe the U.S. will remain a global superpower indefinitely. **Americans should be optimistic long term!**

China

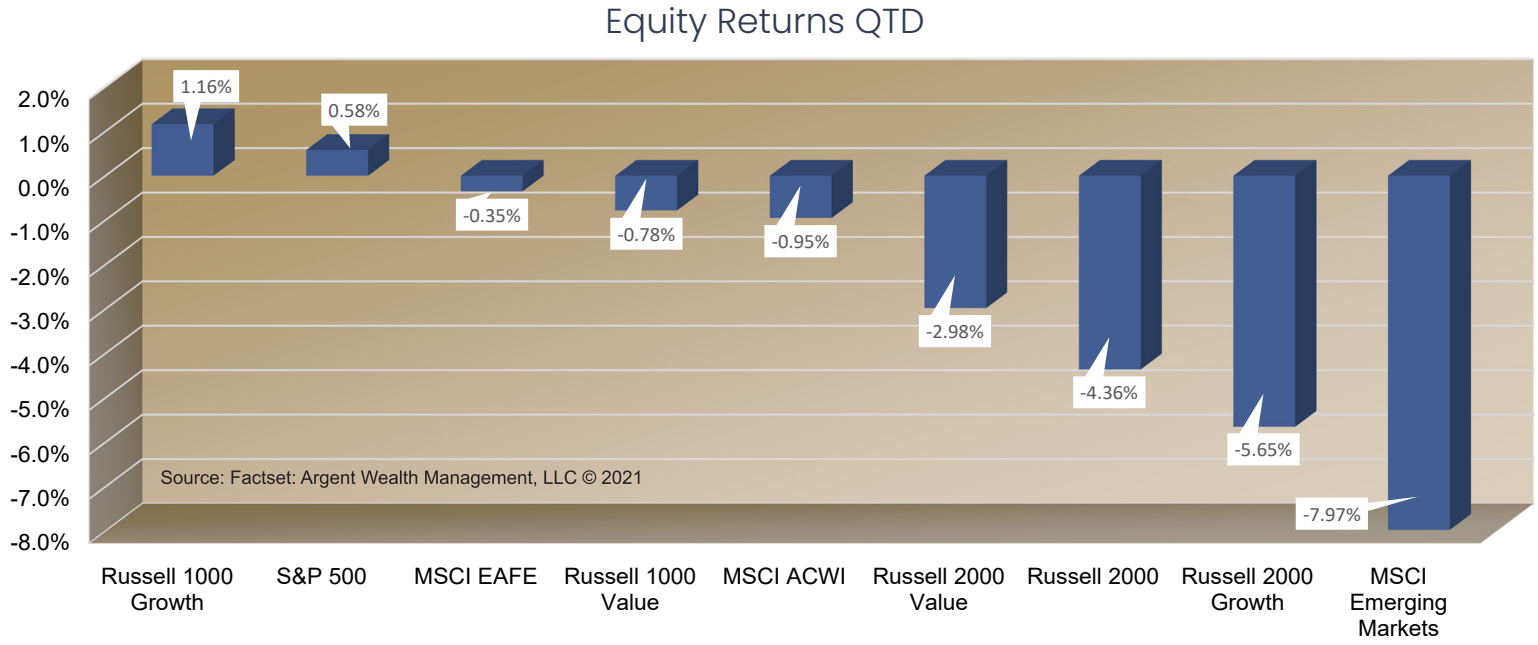
According to Ned Davis Research, from 1975 to 1995 the share of wealth owned by the top 1% of the population was steady at ~16%. From 1995 to today that number has steadily grown to 30%. This rise has correlated with the growth of capitalism and a slow progression towards freer markets. The head of the CCP (Chinese Communist Party) President Xi recently announced a "common prosperity" campaign. Essentially this will lead to more state control over private corporations and more regulations with the goal to ease wealth inequality. More regulation and state control over corporations is a reversal from what has helped China grow over the last thirty years. Economic growth and innovation do not jibe with regulation and communism. China must decide whether it wants to become more democratic and continue to innovate and grow economically at a rate commensurate with history, or become more communist, less free, and stunt potential growth. **Beware of investments in China.**

Returns for the Quarter

The negative returns from Emerging Market Stocks in the quarter reflect the new policies the CCP are adopting. Large growth outpaced value as concerns over the Delta variant and a COVID-19 resurgence dominated headlines for most of the quarter. Growth indices tend to hold more technology stocks that benefit more from remote work and less travel than other industries. Small cap stocks underperformed as investors migrated towards less volatile large cap stocks.



High yield bonds outperformed investment grade bonds as investors generally migrated towards riskier assets for most of the quarter. In addition, interest rates rose. Investment grade and government bonds have more sensitivity to rising interest rates than high yield bonds. As interest rates rise, bonds lose value. Interest rates remain low globally. Stock continues to look attractive relative to bonds.



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