QUARTERLY MARKET REVIEW

THIRD QUARTER 2021

First Business Bank.

EXECUTIVE SUMMARY

The U.S. economy continues to grow despite significant challenges. Quite likely the rate of growth has peaked, and we will see slower, but still solid and positive U.S. economic growth in 2021 and beyond. The primary reasons for slowing growth are supply shortages and bottlenecks, the Delta variant, labor shortages, and surging prices that are near decade highs. In the face of these challenges, the resilience of the economy is impressive. The job market has lost some steam, but payrolls continue to expand and jobless claims recently registered new pandemic lows. Industrial production remains strong despite the obstacles and the additional headwinds from Hurricane Ida in the Gulf Coast. After strong growth of 6.7% in the second quarter it appears that we will see something in the range of 3 to 3.5% for the third quarter. Although a sizable decline from the first half of the year, it is a highly respectable number and would still rank in the top 10 of the strongest quarter-over-quarter annualized growth rates. While many economists are lowering forecasted growth projections for 2021, they are increasing the forecasted strength in 2022.

Equity markets stumbled in September as signs of slowing growth and a host of others concerns weighed on investors. For the S&P 500, September was negative at -4.65% but the quarter's return was slightly positive at 0.58%%. Year-to-date returns for the large cap market are strong at 15.92%. Developed international markets turned slightly negative for both the quarter and the year to date. The aggregate bond market posted a flat return for the quarter and is -1.55% year to date as rates have trended higher since January. The Federal Reserve signaled that they will likely commence tapering monthly bond purchases prior to year-end.

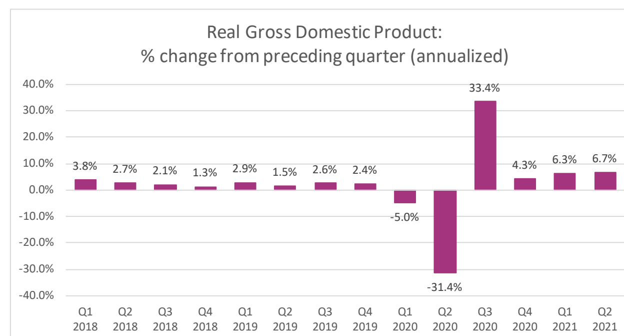
ECONOMIC RECOVERY SLOWS

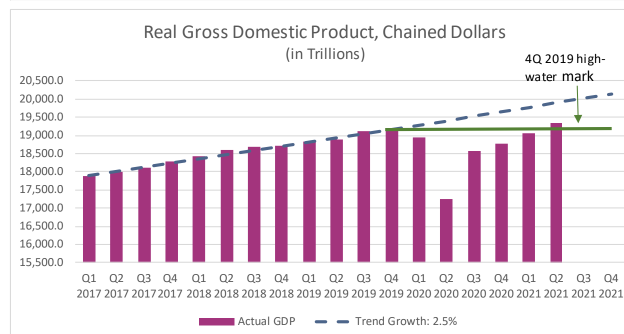
The economy grew in the second quarter at a pace just slightly better than in the first quarter. This result was disappointing, given that the consensus outlook for growth in the 8 – 9% range, but it was not all bad news. Personal expenditures continued strong at +11.8% and account for 69% of all economic activity. This is the second-best performance since 1952, topped only by the huge rebound in the third quarter of 2020.

The economy has surpassed its pre-pandemic level but remains roughly 2.4% smaller than if the pandemic never occurred. Had the pace of growth continued through the second half of the year, we would have been very close to "back on track" but, as growth has slowed, that goal will remain elusive.

We will get our first official look at third quarter GDP growth in late October, but current estimates reflect expectations that several factors, including the emergence of the Delta variant of COVID, labor mismatches, supply shortages, and bottlenecks, have limited and slowed economic activity. Although these headwinds have detracted from the pace of growth, the trajectory remains positive and what gets trimmed in 2021 will be added to 2022 and 2023. Estimates for third quarter growth have declined and stabilized in the 3.0 to 3.5% range. Although a sizable decline from the first half of the year, something in that range is a highly respectable growth number and would rank in the top 10 of the strongest quarter-over-quarter annualized growth rates. At the most recent meeting, the Federal Open Market Committee (FOMC) decreased their 2021 growth projection from 7% to 5.9%. While many economists are lowering forecasted growth projections for 2021, they are increasing the forecasted strength in 2022. Global economic growth is expected to be 6% for 2021 and 4.9% for 2022, according to the International Monetary Fund (IMF). If realized, this would be the fastest growth in at least a generation, possibly two or three, since 1973 was the last time growth was 6% or higher.

COVID continues to bedevil the supply chain — the main conversation topic as we close out the quarter. As an example, Ningbo-Zhoushan Port in China, the third-largest container port and a big gateway for Chinese exports, was shut down for a few weeks in August due to a single COVID-19 case. A disruption of this magnitude causes a cascading effect down the supply chain with delays and congestion elsewhere that will impact retailers both large and small. The backlog has stretched across the Pacific Ocean to the ports of Los Angeles and Long Beach, which together handle about a third of all containers coming into the U.S. Many large retailers in the United States are taking the drastic step of chartering their own ships rather than pay freight rates that have roughly quadrupled since the start of the year. One potential upside is that some production may move from overseas back to the U.S. due to delivery delays, but that switch does not get flipped overnight.





Manufacturing slowed into the back half of this quarter, reflecting the challenges to the supply chain and ongoing materials and labor shortages. The most recent reading points to the slowest growth in factory activity in five months after posting record activity in July. Delivery times lengthened substantially as transportation challenges and shortages led to one of the greatest deteriorations in vendor performance on record. Optimism is high among manufacturers as hopes of easing shortages and increasing staffing in the coming months will allow them to take advantage of strong demand conditions.

Manufacturing and services businesses hit a speed bump as U.S. industrial production fell in August partly due to Hurricane Ida's severe impact in the Gulf region. IHS Markit said its Purchasing Managers index (PMI), a measure of U.S. business activity, fell to 54.5 in September from 55.4 in August. That was the lowest level in a year, as activity at services businesses reached a 14-month low. A level above 50 points to an increase in activity, while a level below 50 indicates a contraction. A measure of optimism at U.S. services businesses reached a three-month high, IHS Markit said, as purchasing managers anticipated a pickup in demand

and an easing of the pandemic. While overall business activity at U.S. manufacturers slowed slightly this month amid supply-chain issues, new orders and hiring increased. Businesses are investing heavily in equipment, software, and R&D, which has the potential to boost productivity rates in future years.

The high-frequency indicators for in-person services suggest that activity levelled out in August and weakened a little in early September. Last month's retail sales report also revealed that spending on food services was broadly flat, but overall spending rebounded strongly, as households refocused their expenditures online and in favor of goods consumption. New Child Tax Credit payments will offset the impact of expired enhanced federal unemployment benefits on September disposable incomes and contribute to recovery in private incomes.

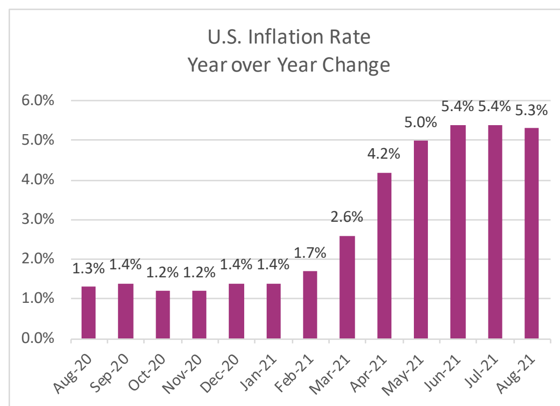
QUICK NOTES

- Durable goods orders surged 1.8% in August following a 0.5% increase in July and easily beating the forecast number of 0.7%. The lion's share of the increase was in orders for nondefense aircraft and parts.
- IHS Markit U.S. Manufacturing Purchasing Managers Index (PMI) fell to 60.7 in September, reflecting growth that is slower but still well in expansion territory.
- IHS Markit U.S. Services PMI dropped in September to 54.4 amid less-robust demand and higher cost pressures, down significantly after setting an all-time high of 70.4 in May.
- U.S. consumer confidence fell to a seven-month low in September as the rise in COVID-19 cases deepened concerns about the economy's near-term prospects, reinforcing expectations for a slowdown in growth.

INFLATION REMAINS ELEVATED

The rate of inflation abated somewhat in August with the Consumer Price Index for All Urban Consumers (CPI-U) increasing 0.3% after rising 0.5% in July. The indexes for gasoline, household furnishings and operations, food, and shelter all rose in August and were the primary contributors to the increase. The energy index increased 2.0%, mainly due to a 2.8 % increase in the gasoline index. The core index — less food and energy - rose only 0.1 % in August, its smallest increase since February 2021. Along with the indexes for household operations and shelter, the indexes for new vehicles, recreation, and medical care also rose in August. The indexes for airline fares, used cars and trucks, and motor vehicle insurance all declined over the month.

Over the last 12 months, the "all items" index increased 5.3% before seasonal adjustment. The energy index rose 25.0% over the last 12 months, and the food index increased 3.7%. Oil has been a volatile commodity historically and this has continued to be the case during the pandemic. WTI crude hit a low of $11.57 on April 21, 2020 but has rebounded higher to sit at $75 at quarter's end. The energy component comprises 7.2% of the consumer price index. The core inflation rate (less food and energy) rose 4.0% over the last 12 months. The Personal Consumption Expenditures Price Index (PCE) was up 3.6% year over year in July. This gauge is preferred by the Federal Reserve because it is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.



Inflation isn't something we have had to fret about in the last few decades. The average annual increase in inflation for the last ten years has been less than 2.5%, and sometimes significantly so that the conversation has more often been about the lack of pricing power and potential for deflation. As our economy reemerges from the short but sharp pandemic recession, rising demand and shortages have driven inflation at the hottest pace in 30 years. Typically, rising inflation would be countered by the Federal Reserve raising interest rates to cool demand. However, the Federal Reserve is walking a very fine line to both keep the economic recovery on track and control inflation. There are any number of headwinds that could knock the U.S. recovery off course, including a deadlock over the debt ceiling, risks that COVID may further hamper growth, and slow jobs growth. These risks potentially postpone the tapering of bond purchases (discussed below) and further delay any interest rate increases into 2024 or later. Meanwhile, continued supply chain issues and high demand could push prices higher.

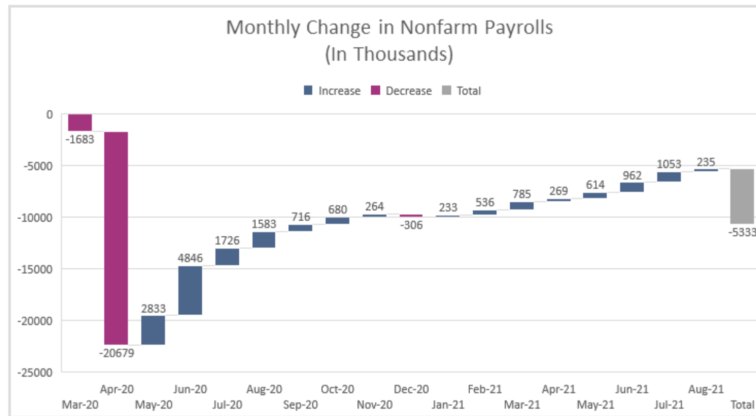
The statement following the September FOMC meeting reflected that the Committee is close to announcing a tapering of the bond purchases that have been in place since the early days of the pandemic. The likely scenario is that a tapering process would commence later this year and would conclude by mid-2022. As a refresher, the Federal Reserve began buying $80 billion in U.S. Treasury and $40 billion of agency mortgage-backed securities monthly back in March 2020 to keep interest rates low and support the economy and the markets. "Tapering" refers to the process of slowing the pace of these purchases over time to zero and is a precursor to raising rates. The FOMC cited continued economic improvement in recent months, especially in some of the hardest hit sectors, but also noted that supply constraints and a recent rise in COVID-19 cases has constrained activity. Demand for labor is high but job growth has slowed, particularly in sectors most sensitive to the pandemic, including leisure and hospitality. Despite the recent rise in inflationary pressures, the FOMC feels that the long-term inflation expectations "appear broadly consistent with the longer-run inflationary goal of 2%." That said, recent comments have acknowledged that inflationary pressures have not eased as quickly as predicted and may persist for longer than forecast.

As we write this third quarter update, there is a standoff in Washington over a variety of issues including the debt ceiling, infrastructure spending, and the proposed $3.5 trillion healthcare, education, and climate spending package. It appears that at the 11th hour, a deal has been reached over stopgap legislation to avoid a government shutdown and provide funds into early December, kicking the can down the road, so to speak. There is plenty of talk about a bond default but there is little chance of that happening. Nonetheless, a failure to raise the debt ceiling would have repercussions and implications, including a potential downgrade of the United States' AAA credit rating. To avert this debt ceiling crisis, something will need to be put in place before the deadline which, is estimated to be October 18. As a reminder, raising the debt limit does not authorize new spending. It allows the government to finance legal obligations already committed. This is not a new issue. In fact, since 1960 Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit. It now appears that the bipartisan $1 trillion dollar infrastructure plan will now be considered separately from the larger $3.5 trillion dollar spending plan. Negotiations are fluid at this time.

EMPLOYMENT UPDATE

A disappointing 235,000 gain in non-farm payrolls in August means that employment is still more than 5.3 million below its February 2020 peak and nearly 9 million below where it would likely be without a pandemic. The lethargy in employment in the leisure & hospitality sector in August indicates that rising fears over the Delta variant were a key drag on hiring. That weakness reflects supply as well as demand, however, with the labor force rising by only 190,000 and the participation rate still well below its level early last year, even for prime-aged workers. Worsening labor shortages highlight that conditions are much tighter than the 5.2% headline unemployment rate implies. Wage growth in the leisure and hospitality sector, where shortages have been most acute, has gone vertical. Survey evidence on firms' compensation plans suggests wage growth more generally will remain unusually rapid over the coming quarters as competition for the available workforce remains fierce.

Consensus estimates are that the September job growth numbers will be stronger.



Labor economists have been puzzled over why businesses are having so much trouble hiring workers given that there are still almost 9 million unemployed Americans seeking work as of August's month end. Several factors appear to be at play, but the desire for flexibility seems to be at the forefront. According to the job site Glassdoor, job searches for remote work are up 460% in the two years through June 2021. But some jobs — like those in restaurants, hotels, and retail — of course, can't be done remotely. In July, 46% of employees in management, business, and financial operations occupations were teleworking because of the pandemic; by contrast, that was true of just 5% of service jobs, according to the U.S. Bureau of Labor Statistics.

The U.S. consumer is proving resilient in the face of the Delta variant. Recent data reflects an increase in spending as sales at the nation's retailers rose 0.7% in August, rebounding from a drop of 1.8% in July. Retail sales have increased 15.1% over August a year ago. With many schools, college campuses, and offices reopening, shoppers stocked up on groceries and merchandise at big-box stores. Those purchases — along with higher spending on furniture and hardware — offset another big decline in car sales, which have suffered from a global computer chip shortage that has crimped supply. A flat-lining in spending on food and drink services, and a reduction in travel, implies that the Delta wave has persuaded some consumers to avoid once again crowded spaces. This is reflected in the U.S. consumer confidence data, which fell to a seven-month low in September.

When Americans regain confidence, they are flush with cash to spend. The Federal Reserve recently reported that the net worth of U.S. households was $142 trillion in Q2 2021, up from $110 trillion pre-pandemic. Personal income rose 2.7% year over year as increased compensation levels offset a decline in stimulus payments and unemployment benefits. Personal savings is still elevated at 9.6%; consumers have $17 trillion in cash and cash equivalents on household balance sheets as of June. Household debt levels have trended higher but are well below the peak levels seen prior to the Great Recession.

HOUSING MARKET

Home prices have continued to grow at a record pace. According to the S&P CoreLogic Case-Shiller Home Price Index, home prices increased 19.9% from a year ago in July, another record high in the 30+ year history of the index. Fall may bring some softening as the National Association of Home Builders (NAHB) measure of homebuilder confidence dropped back in August as soaring house prices and higher mortgage rates dampened new home demand. The prospective buyers' balance dropped to its lowest since the height of the pandemic in July 2020. That said, demand and confidence is still elevated compared to its pre-COVID level. While single-family housing has cooled, multifamily construction is heating up. A strong bounce back in rental demand and rising rents has spurred a boom in multifamily construction. After dropping a bit over the summer months, multifamily housing starts rose in August by over 20%.

ELSEWHERE IN THE WORLD

The eurozone experienced a more pronounced slowdown in September as supply-chain issues and worries over the Delta variant led to slower growth. Gauges of business activity in the 19-nation eurozone recorded sharply slower growth in September in both manufacturing and services. The slowdown began in August after activity in July hit a 21-year high when widening vaccination campaigns allowed public health restrictions to be rolled back and economies to rev up. IHS Markit said its index of eurozone activity fell to a five-month low of 56.1 in September from 59 in August, a fall that was steeper than predicted.Factories worldwide have been plagued by higher shipping costs, rising energy prices, and component shortages as the global economy struggles to meet surging demand. Differences in vaccination levels between advanced and emerging economies are contributing to the squeeze, economists say, because some economies are under tighter restrictions than others. Despite the soft patch, the surveys signaled faster growth in Europe that was typical prior to the pandemic, suggesting that a solid recovery is developing.

China's services sector suffered an unexpectedly severe blow in August as a wave of COVID-19 infections sparked new lockdowns. China's official nonmanufacturing purchasing managers index, which tracks activity in the construction and services sectors, plunged to 47.5 in August, from 53.3 the prior month. This marks the first time that the gauge has fallen below the 50-mark, separating expansion from contraction since February 2020. Some of the weakest global PMI data comes countries with the strictest lockdown protocols, such as Vietnam and New Zealand.

The European political landscape is set to change as Germany's Socialist Party, SPD, narrowly won the election and defeated the Merkel's conservative alliance of the Christian Democratic Union and Christian Social Union, which has dominated German politics for decades. Germany is a founding member of the EU and Chancellor Merkel has often helped to lead the EU's response to any variety of political, financial, and humanitarian crises.

KEY RATES

	12/31/2020	06/30/2021	09/30/2021
2-yr U.S. Treasury	0.12%	0.26%	0.29%
10-yr U.S. Treasury	0.92%	1.47%	1.50%
30-yr Fixed Mortgage Rate	2.91%	3.15%	3.21%
Fed Funds Target Rate (upper)	0.25%	0.25%	0.25%
U.S. Dollar Index	89.92	92.40	94.24
Crude Oil	$48.41	$73.71	$75.01
Gold	$1,903	$1,776	$1,757
Unemployment Rate	6.7%	6.0%	(Aug) 5.2%

Source: *The Wall Street Journal*

MARKET COMMENTARY

The S&P 500 posted a modest return of 0.58% for the quarter, bringing the year-to-date total return to +15.92%. There was very little volatility in the quarter with only nine trading days that were +/- 1%, five that were negative. After trading since October 2020 without a pullback of 5% from a market peak, this occurred in September as markets experienced elevated concern about the slowing rate of growth, the rise in Delta cases, the Evergrande real estate failure in China, and the high potential for political gamesmanship in Washington. September has historically tended to be the weakest month of the year. That is again the case as September's decline of -4.65% was the first negative monthly return since January's -1.11% decline and the worst month since March 2020. The markets' relative resilience in the face of negative September seasonality is a positive sign of decent tailwinds for the equity markets.

Year-to-date sector performance favors value sectors, like energy, and financials that underperformed in 2020. Performance overall was more subdued with financials and communication services leading the pack at 2.8% and 1.2%, respectively. Materials and industrials

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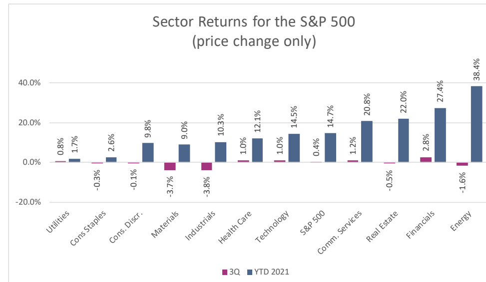
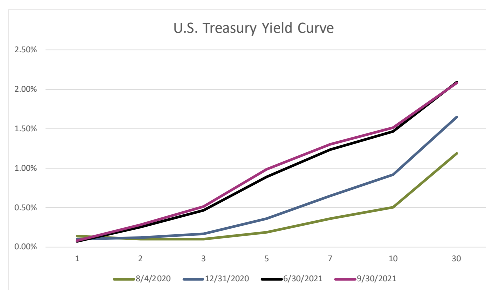
lost ground in the quarter as signs of slower growth impacted those sectors. Looking exclusively at the period since the announcement of a vaccine on November 9, 2020, the best performing category by size is small cap. The top style is value and the best sectors are energy, retail REITs, and banks. The U.S. and Europe are about the same.

Earnings growth has continued strong throughout 2021 with the S&P 500 earnings per share estimated to rise this year by 65% after declining by -22% in 2020. As analysts are fine-tuning their estimates for 2022 — the bias continues to be for continued earnings growth next year. The strong earnings growth is reflected in equity prices, so risks that pose a threat to continued strong growth in earnings can unnerve the markets.





Small-cap stocks have lost some steam and posted a decline of -4.36% for the quarter. Returns are still strong year to date at 12.4% but are well off the highs set early in the year when the index was up as much as 19.6%.

Growth stocks outpaced value for the quarter but value has the edge for the year to date by 1.5%. This margin of outperformance is wider in the mid and small cap space where value stocks are strongly outperforming growth.

Developed international markets posted a modest decline of -0.45% for the quarter and 8.35% year to date. The local currency return is slightly higher but has been eroded by a stronger U.S. dollar. The outlook for Developed International may be improving as the MSCI EAFE index has historically produced above-average returns when global growth was above 4%. Emerging markets fell by -8.09% in the quarter, posting the first quarterly loss since the start of the pandemic as Beijing's crackdown on businesses, worries about a likely default at Evergrande, slowing growth, and rising inflation weighed on investors' risk appetite. Year-to-date returns turned slightly negative in the quarter after a promising start to the year.

Bond yields ended the quarter not far from where we were at the end of June, but that understates the level of volatility that we saw during the quarter. As an example, the 10-year Treasury note started the quarter at 1.47% and closed as low as 1.17% in early August only to close the quarter back up at the 1.50% level. The shorter end saw some movement, too, as the 2-year traded as low as 0.17% and as high as 0.33%. The quarterly return of the Aggregate bond index was flat at 0.05% for the quarter and is negative at -1.55% for the year to date as rates have increased across the yield curve. Bond yields are likely to grind slightly higher as expectations for growth and inflation remain elevated.

PORTFOLIO AND OUTLOOK

Despite higher volatility in September, our portfolios have continued to benefit from an overweight to risk assets as appreciation has carried our exposure back to the higher end of the allowable range. Through August, our trailing one-year performance is ahead of the peer group benchmark across the board for all risk categories.

Equity valuations have continued to improve as earnings estimates have been boosted. Although still above the 25-year average of 16.8%, the current forward price earnings ratio (P/E) for the S&P 500 of 20.5% is just above +1 standard deviation from the average. The dividend yield of 1.4% remains attractive relative to bond yields. We continue to view equities as the more attractive asset class compared to fixed income. Accordingly, we will continue to allow our portfolios' equity levels to remain at the higher end of the allowable range.

Our entire Private Wealth team is closely monitoring proposed changes to income and estate taxes that would impact our clients. At this time, the negotiations remain ongoing but there are a few changes that seem to have support. Estate and gift tax exemption limits are likely to fall to $6 million per person starting in 2022. It appears that proposals to change the tax basis carry forward do not have adequate support for passage. On the positive side, the exemption limit of $10,000 for state and local tax (SALT) likely will be raised and possibly fully reinstated. Other changes that have been proposed would increase the top marginal tax rate for joint filers with income exceeding $450,000 to 39.6%. A top federal rate of 25% has been proposed for all long-term capital gains for individuals making more than $400,000. When combined with the 3.8% net investment income tax, the top rate becomes 28.8%. The preferential tax treatment on dividends was not included in the proposed changes put forward by the House in September, but that was likely an oversight. Corporate taxes would increase under this proposal to 26.5%. The good news for equity investors is that previous capital gains increases have not negatively impacted stock market returns, at least in the near term. The average return in the six months following capital gains tax increases in 1975, 1986, and 2012 (Medicare tax) were 17.9%.

With many moving parts in play, you may be wondering how changing tax and estate laws might impact you and your family. If you haven't recently reviewed your financial plan or you want to more fully understand your financial picture, please connect with our Private Wealth team. We can help you verify and achieve your financial goals while gaining back peace of mind.

Index Returns	3Q 2021	2021 YTD
S&P 500 Index	0.58%	15.92%
Russell 2000	-4.36%	12.41%
MSCI EAFE Index	-0.45%	8.35%
MSCI Emerging Markets Index	-8.09%	-1.25%
Bloomberg Barclays U.S. Aggregate Bond	0.05%	-1.55%
Bloomberg Barclays U.S. Treasury 1-3 Year	0.07%	-0.03%
Bloomberg Barclays U.S. Treasury 5-7 Year	-0.11%	-2.31%
Bloomberg Barclays Municipal Index	-0.27%	0.79%

Source: Morningstar Direct

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