Dear Turtle Creek Client,

Investment markets posted volatile and ultimately flat results through the third quarter as an increasing number of headwinds emerged for an already-slowing global economy. Wide-spread raw material shortages, supply-chain snarls, labor shortages, spiraling commodity prices, congressional dysfunction, and a suddenly more hawkish Federal Reserve Bank all combined to cast doubt on the ongoing growth of the economy and corporate profits. The broadly accepted view that recent inflationary and supply-side challenges were simply "transitory" faded throughout the quarter and corporate managers and economists now see lingering challenges through 2022 and potentially beyond.

Despite this growing uncertainty, the overall economy continues to exhibit strength and we do expect the current economic disarray to dissipate and a more normal economic cycle to take hold at some point. Considering this and the still dismal outlook for fixed income and cash returns, we have not changed our view that risk assets such as domestic and international equities will drive portfolio returns for the foreseeable future. We do caution that market volatility will likely remain elevated until the laws of supply and demand assert themselves and recent imbalances are rectified. Patient investors willing to look through near-term uncertainty will likely be rewarded for staying the course.

Source: Bloomberg

<u>Third Quarter Stock Market Performance</u>

U.S. stocks reversed sharply in the final month of the quarter, eliminating gains for the period and undoing the trends that had driven equity returns through July and August. In the third quarter, the S&P 500 had advanced 5.5% through the end of August, led by growth-oriented and interest-rate sensitive stocks in the Utilities, Real Estate, Technology, and Communications sectors. Cyclical sectors such Industrials and Materials trailed overall returns and the Energy sector posted a sharp loss of nearly 12% in this stretch.

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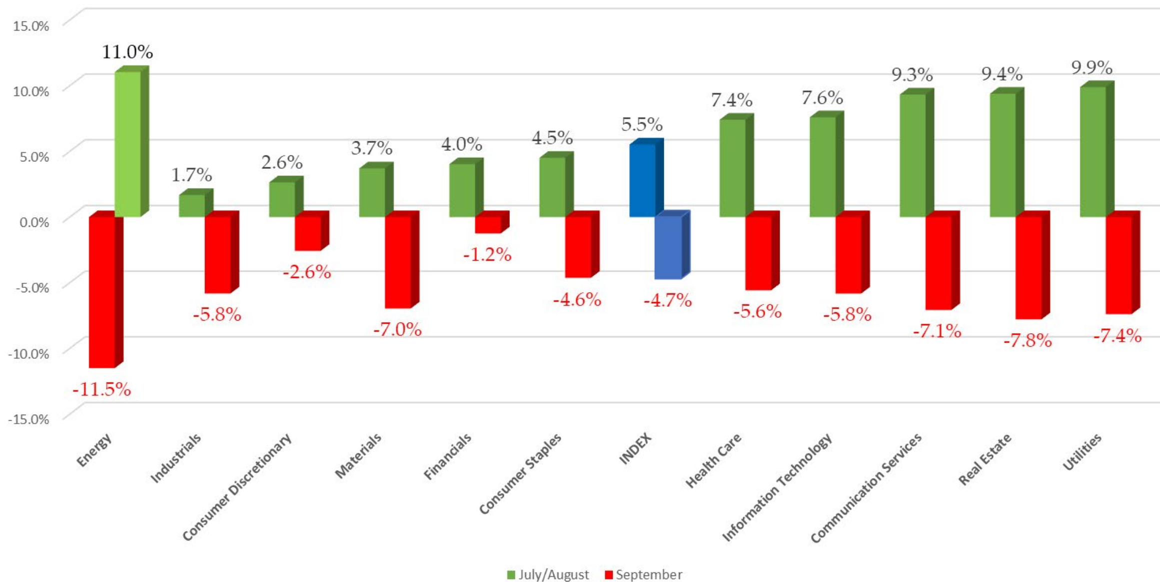
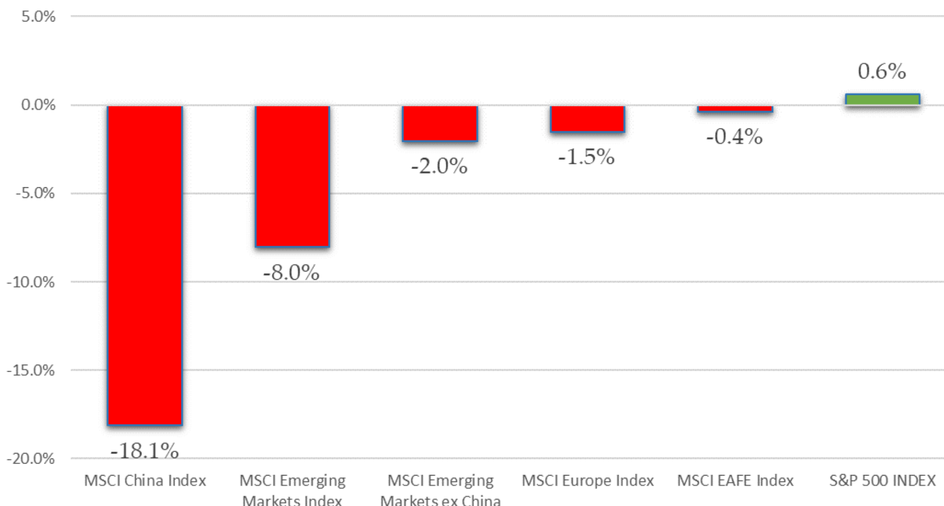
September's trading was a complete reversal of this pattern. Energy was the only sector to post gains in the month, regaining nearly all of its previous losses. Every other sector declined with the aforementioned Utilities, Real Estate, Technology, and Communications sectors posting losses in excess of the overall market.



Source: Bloomberg

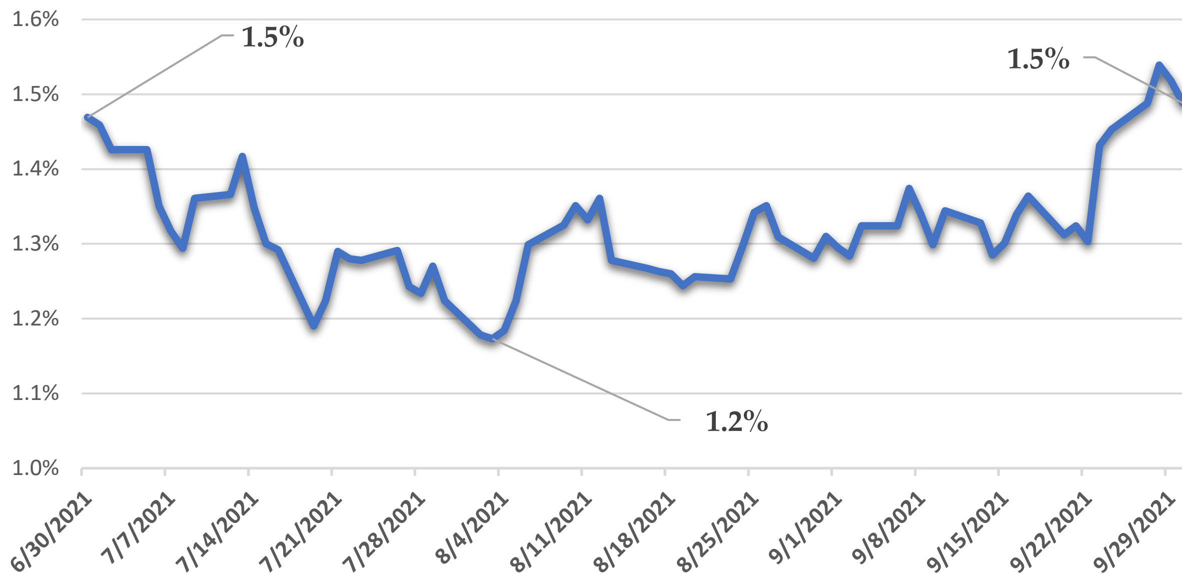
International stocks once again underperformed their domestic counterparts. Chinese equities accounted for nearly all the variance, dragging down overall emerging markets returns in the process. The Chinese government spooked investors by announcing, in the name of "common prosperity", a broad array of financially damaging regulatory measures targeting its leading multi-national companies. Looming insolvency in the country's largest real estate developer, China Evergrande, also worried investors who have long viewed China's poorly capitalized banking system and over-indebted borrowers as a source of significant long-term risk.



Source: Bloomberg

Fixed Income

Bonds posted similarly volatile results, as the benchmark 10 Year Treasury yield dipped throughout the quarter only to spike noticeably in the last week of September. While numerous factors influenced this quarter's stock market behavior, bond rates primarily moved due to the September 22nd Federal Reserve meeting in which Fed chair Jay Powell expressed concern over near-term inflationary trends and hinted strongly that crisis-era stimulus measures would be reduced or curtailed in the months ahead. This more hawkish tone surprised bond investors, who had previously relied on Fed assurances that any policy shifts were far in the future and near-term inflationary challenges were transitory and not relevant to Fed thinking.



Source: Bloomberg

Unpacking the Current Inflationary Challenge

Given the extreme impact of inflationary trends on the average American household, it is surprising that leading academics and policymakers have never reached a consensus on its precise definition or root causes. The current best guess regarding inflation marries short-term supply and demand issues with a more important set of long-term inflation expectations on the part of the American consumer. The first is easily quantifiable, but the second requires guesswork ranging from household surveys to financial markets that speculate on inflation trends and interest rates far into the future.

The short-term factors currently pressuring prices reflect highly unusual events that have severely diminished global supply at a time that Americans have built record savings and wealth and can borrow at historically low interest rates.

- COVID lockdowns greatly reduced output in critical manufacturing inputs ranging from semiconductors to commodities.
- These shortages in turn held back producers ranging from automakers to homebuilders from increasing output and meeting heightened demand.
- A lack of skilled job seekers meant service industries could not operate at full capacity.

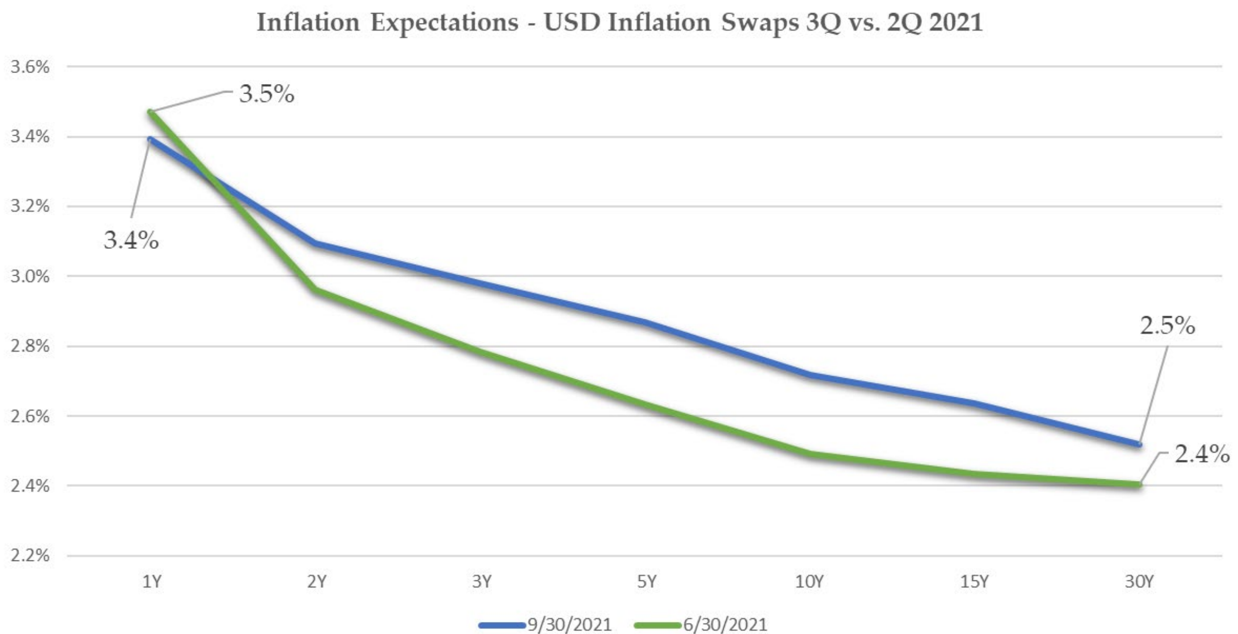
- Acts of God exacerbated these problems. Global shipping was brought to a standstill as the largest cargo ship in the world ran aground in the Suez Canal. Harsh winter weather, fire, and extreme drought ravaged global agricultural suppliers in Latin America.

These events negatively impacted corporate forecasts in the third quarter. Federal Express reduced its outlook for the year, noting it had to pay workers a near 25% wage hike to meet current demand. Nike lowered it sales outlook due to shuttered production facilities and greater than expected delays in getting its product to store shelves. Homebuilders Lennar, D.R. Horton, and Pulte all pre-announced reduced results due to their inability to procure adequate raw materials and finish constructions projects as scheduled.

While these short-term challenges are greater in scale and more complex than initially thought, history does show they are ultimately resolved as supply chains adjust and higher short-term prices stimulate greater production. Lean inventories in most cases have translated to supply gluts down the line, certainly the case with he most recent Energy crunch of 2014 and most other historical examples of supply shortages.

As market pundits bemoaned spiraling prices and equity prices gyrated, longer-term inflation expectations as measured in the bond and futures markets barely budged and remain only slightly elevated compared to recent history. The Treasury Yield Curve still forecasts rock bottom rates for decades and inflation swaps, the purest form of longer-term speculation on future inflation rates, continue to show declining inflation rates over all its forecasted time periods, a clear signal that the worst appears to be behind us.

The larger structural debate regarding inflation also appears unchanged. The global inflation debate until recently focused on the specter of deflation due to aging global populations, technological advancement pressuring wage growth or displacing workers, globalized supply chains reducing costs, and central banks firmly committed to price stability. The current supply/demand mismatch does not fundamentally change these critical longer-term factors that foreshadow downward pressure on prices.



Source: Bloomberg

Investment Strategy

While we cannot predict with any confidence when or how current logistical and supply challenges are resolved, financial markets signal that these are indeed transitory factors that do not represent a sustained threat to longer-term corporate profit growth. As near-term economic demand remains strong and corporate forecasts remains very optimistic, equities should continue to benefit from brisk profit growth over the next several years.

The market pause during the quarter did alleviate somewhat the risks posed by historically premium valuations for equities. The S&P 500 at the beginning of September stood at 27.3x forecast earnings, one of the highest readings on record. It steadily sank down to 21.3x by quarter end, a level still elevated compared to longer-run averages but much more palatable for investors. Other pertinent broad market indicators such as the equity risk premium, dividend, and cash flow yield also improved during the quarter. The near-term outlook for equities continues to balance the headwind of moderating market valuations and the tailwind of strong earnings growth for the next several years. We expect this to translate to respectable, positive stock market returns that will likely not keep pace with historically above-average returns of the last decade.

Your fixed income and cash holdings, by contrast, continue to face a dour outlook. Historically depressed interest rates and the likelihood of rate increases over the next several years imply lower-than-average returns on this portion of your investment allocation.

Considering all the above, we urge investors to look through current stock market gyrations and continue to lean on the risk portion of your investment strategy for both near and longer-term portfolio goals.

As always, we hope to discuss these topics and any other questions or concerns with you soon.

Sincerely,

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA

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