



THIRD QUARTER SUMMARY

2021

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— TRUST —



After a strong start to the third quarter, an equity market slump in September led U.S. stocks to finish relatively flat over the last three months – the weakest quarter for stocks since the start of the pandemic during Q1 2020. Small cap (-4.3%) and international equities (-3%) were down modestly, while bonds also struggled, losing 0.9% in September to finish the quarter flat. This is in stark contrast to the strong performance we have grown accustomed to experiencing over the past year and a half.

Starting in early 2020, the massive amount of government stimulus – both fiscal and monetary – led to a huge equity rally. U.S. stocks are up roughly 90% from the market bottom on March 20, 2020, and much of this strong performance has come from very steadily upward-trending markets.

Any bit of bad news over the past 18 months was rapidly passed over amidst stimulus checks (multiple rounds!), a zero-interest rate policy, quantitative easing programs from central banks across the globe, direct stimulus to businesses (the Paycheck Protection Program), and enhanced unemployment benefits. All of these programs led to an *increase* in personal income, even though economic activity slowed down more rapidly than at any point since the Great Depression.

Strong performance continued into the Spring and Summer of 2021 as a reopening economy took over from governmental support. After a year of being stuck at home, economic activity rebounded dramatically as people began going out and resuming a more normal life. Real gross domestic product (GDP after inflation) increased by 6.7% in the second quarter after rising 6.3% in the first quarter. This has us on track for the strongest calendar year of economic growth since 1984. At the same time, corporate earnings have rebounded in dramatic fashion. After a steep drop in 2020, earnings are now significantly higher than where they were pre-pandemic, rising by more than 30% for three straight quarters. This has helped fuel the strong rally in stock prices.

A FEW BUMPS

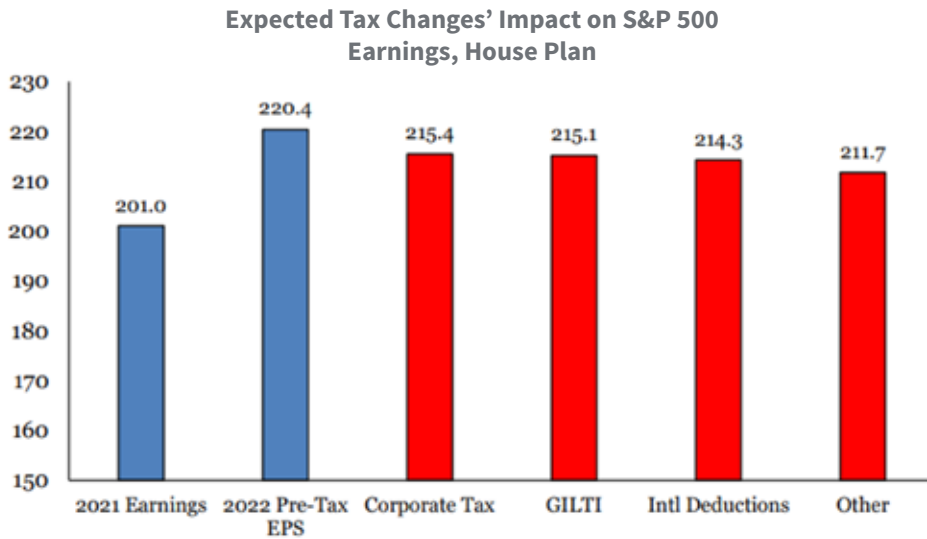
If economic activity is accelerating and corporate earnings are rising rapidly, why the difficult month for markets in September? It boils down to three main issues:

1. The rise of the Delta Variant in the U.S. and its constraint on economic activity.
2. Concerns over the direction of government policy, specifically around tax increases.
3. Worry over slowing growth and the potential for inflation.

While each of these issues is cause for concern, and has clearly hurt equities in recent weeks, we believe the impact of each will either be minimal, transient, or both. Despite the human toll from the Delta Variant, barring another more virulent strain, it appears clear that Covid is nearing the end of its pandemic stage. As the virus becomes endemic – widely circulating within the population, but less likely to cause as deadly an infection due to vaccines and acquired immunity – its ability to impact economic activity should decline. Vaccine availability for children will also likely provide a psychological boost for many, helping lure families back out to restaurants and other businesses. So, while the summer economic rebound has slowed in August and September, we believe it is likely to resume later this year or early in 2022.



On the tax front, an increase in rates will absolutely have a negative impact upon both corporate earnings and take-home pay for those with higher incomes. However, as the size of the potential spending package has come down, the need to increase taxes has declined as well. Thus, what is likely to be enacted are more modest changes: a slight increase in corporate tax rates to 25%, a return of the 39.6% income tax rate for the highest earners, and a possibility of higher capital gains rates for high earners. The higher corporate rate should only have a modest impact on earnings:



Earnings are likely to be reduced by higher corporate tax rates, but the hit should be minimal: ~4% from a combination of higher rates, taxation of foreign affiliates (GILTI), and reduced deductions for foreign income.

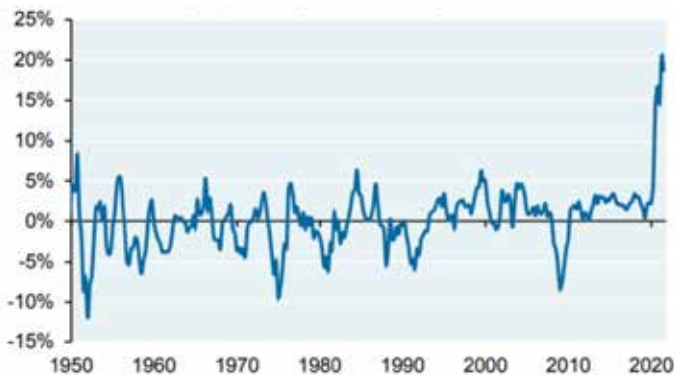
Source: Strategas

Perhaps most importantly, all of these increases have been well telegraphed and are, in all likelihood, lower than what most investors were expecting just a few weeks ago. Thus, we feel that much of the impact from higher tax rates was likely priced into markets during the past couple months.

The area of most concern is around growth and inflation. The Delta Variant slowdown of the past two months has slowed the pace of recovery, but supply chain issues have further constrained growth – it’s hard to buy something if it isn’t in stock. This started with the computer chip shortage (well documented in a recent white paper by our own Bill Spitz), but is continuing with other goods. Demand for goods has skyrocketed over the last year, as we have substituted the usual spending on services and experiences for *stuff*. Unfortunately, this demand for *stuff* coincided with all kinds of production disruptions associated with Covid shutdowns in China and elsewhere. On top of that, many who were furloughed or opted out of the workforce during the past year have been slow to return to work. While the unemployment rate is now back below 5%, labor force participation is still down by several million people, especially amongst parents of young children. So, the *stuff* we can get made is likely to still be sitting on a ship waiting to be unloaded.

A Surge in U.S. Goods Spending

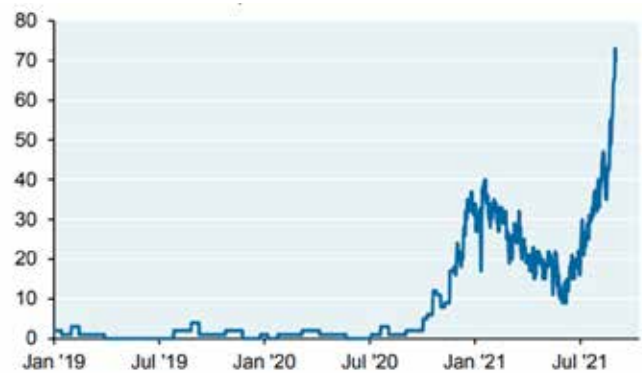
Difference in rolling 5 quarter growth rates, goods - services



Source: BEA, JPMAM. Q2 2021

Anchored Containerships in LA and Long Beach Ports

Number of containerships



Source: Cornerstone Macro. September 20, 2021

A constrained supply chain and surging demand have unsurprisingly led to price increases. The Consumer Price Index (CPI) has risen by a roughly 5% rate over where it was last summer, fueling worries that inflation will stay elevated for some time to come. Inflation levels are currently as high as they have been in a generation, but there are some signs that it will be, in the words of the Federal Reserve, “transient.”

First, on the demand side, as people begin leaving their houses more frequently, their spending should revert back towards the previous balance between goods and services. We may not need as many Peloton bikes if we can go back to the gym. Money could be spent on vacations and other experiences rather than a new deck. This should all help alleviate the need for higher levels of production.

Second, many of the supply chain woes should start to abate as well. It is unlikely that factories will be shut down due to Covid in the future. A return to normal school and child-care schedules will allow some parents



to come back to the work force, helping with labor shortages. Fear over contracting Covid has kept some out of the labor force as well, but this should subside over the next few months. As supply chains function more normally, prices should equilibrate back towards the cost of production. This augurs well for inflation returning to more subdued levels sometime in early/mid 2022.

CONCLUSIONS

Inflation coming under control. Supply chains normalizing. Putting tax uncertainty behind us. Put it all together and it sounds like a recipe for positive equity returns. We believe this to be the case, but it is likely that markets will be bumpy for the next few months. There will likely still be a lot of hand wringing from investors about government policy, inflation, and growth concerns until each is shown to resolve itself. This could take a bit of time.

However, longer term the bias is still towards positive returns for stocks. We remain relatively early in the economic cycle, creating plenty of room for earnings to increase in coming years. Although valuations are somewhat elevated in absolute terms, equities still look attractive compared to other assets. Forward returns for bonds and cash are anemic (Cash is currently yielding near zero, while the 10-year Treasury is at roughly 1.6%), which will push investors towards stocks and other risk assets in order to out-earn inflation. As long as interest rates remain relatively low – and central banks have a lot of incentive to keep them that way – equities should be able to perform well.

Within equities, now is the time to focus on quality and companies that are growing their earnings faster than had been anticipated. This is not a growth- or value-driven market right now. Companies with good pricing power and strong competitive positions should do best in this type of environment.

The remainder of the year is likely to be more challenging. It almost certainly will be bumpier than that to which we have grown accustomed over the past year and a half; however, we believe patience will be rewarded.

A FEW THOUGHTS ON CHINA

Chinese markets have severely underperformed this year, following a flurry of sudden, and often unexpected decrees from the Chinese government. Some of these can be filed under the category of amusing – *American Idol*-style TV talent competitions have been banned – but others have decimated entire industries. In July, Chinese regulators released sweeping new rules effectively banning for-profit tutoring, causing tens of billions in market capitalization losses for companies focused on this area. TAL Education, one of the largest such firms, saw its stock price drop from \$90/share in March to just under \$5/share today.

China's largest technology and e-commerce companies have not been immune to government intervention either. Following some comments chiding the efficiency of Chinese state-owned banks, Jack Ma saw the IPO for his Ant Group halted by regulators. Ma is also the Chairman and Founder of Alibaba, Asia's largest e-commerce firm. It is no coincidence that Alibaba's shares have slid by almost 1/3 from their highs earlier this spring. Additionally, Didi – the *Chinese Uber* – raised several billion dollars in a U.S. IPO against Chinese regulators wishes. Soon thereafter Didi was pulled from several major app stores in China, resulting in significant losses for the firm.

Meanwhile, the government is also choosing not to intervene in what is becoming a crisis in the Chinese real estate sector. Years of rapid development have fueled speculation in Chinese real estate markets, and oversupply, especially in the mid- to high-end condo market, is leading to significant problems for developers. The most notable of these is China Evergrande, which has 1,300 real estate projects in 280 cities across China – and \$300 billion in liabilities to go along with that. To this point, Chinese banking regulators have decided to maintain their regulations around leverage and bank loan supply to both developers and home buyers. As a result, Evergrande is moving towards insolvency, which could prove catastrophic for some of its lenders.

While it would seem that the Chinese government is actively trying to sabotage portions of its own economy, the impetus behind these changes is a desire for “common prosperity.” As a single-party government that is supposedly not following a capitalist economic system, the Chinese Communist Party (CCP) has to focus on keeping its population supportive of the party. For years, their embrace of capitalist principles fueled extremely rapid growth, raising living standards and generally leaving citizens willing to put up with the controls imposed on them by the authoritarian government. However, as China's economy is maturing, growth is necessarily slowing somewhat. Hundreds of billionaires have been created (not to mention at least 5 million millionaires) in a nation where per capita income is just \$17,000/year. This rising inequality, and how visible it has become, has clearly become an area of concern for the government.

Viewed in this light, the actions of Chinese regulators make more sense. The CCP is moving to fight income inequality and the perception that their policies favor the growing class of ultra-rich. Eliminating for-profit tutoring at least appears to help level the playing field for getting into competitive schools and colleges. Clamping down on companies that speak out against the government or tease state-owned enterprises for their inefficiency has been part of their playbook for years and helps reduce future disobedience.

This policy shift will have profound impacts upon investing in China. The risk of government intervention has gone up substantially seemingly overnight, and investors are demanding lower earnings multiples as a result. While some are advocating a move away from investing in Chinese markets, China remains the most populous country on earth, and the second largest economy. It is still growing faster than most of the developed world, and restrictions imposed upon foreign businesses often require investing in Chinese companies in order to get access to that growth. We firmly believe that investing there is still worthwhile – it just needs to be done more carefully going forward. Active management in China will become more important in order to try and either invest alongside the government or in companies that will most directly benefit from their policies. In the future, state-owned entities are more likely to benefit at the expense of the private sector, and some of the more high-flying technology companies are likely to face further regulatory scrutiny.

We firmly believe that investing there is still worthwhile – it just needs to be done more carefully going forward. Active management in China will become more important in order to try and either invest alongside the government or in companies that will most directly benefit from their policies.

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