Third Quarter 2021 Review and Market Outlook

October 2021

MALVERN CAPITAL MANAGEMENT

Third Quarter 2021 Review

We recorded mixed results in the 3rd quarter 2021. The Dow Jones Industrial Average, mid-capitalization stocks and small-capitalization stocks posted negative returns while the S&P 500 and Nasdaq 100 indices posted modest gains. Small-cap stocks as measured by the Russell 2000 Index did the worst domestically in the quarter falling 4.36%, but have performed the best globally over the past 12 months by rising 47.68%.

Developed international stocks as represented by the MSCI EAFE Index were down slightly for the 3rd quarter and emerging markets suffered a rather big loss of 6.76%. A broad basket of commodities were up sharply in the quarter with the Bloomberg Commodity Index rising 6.59% while gold was down and oil was only modestly up. Many of the emerging markets economies are tied closely with a single commodity and their equity markets' performance usually correlates with those respective commodities prices.

As continued follow through from the 2nd quarter 2021, large-cap "growth" stocks out-performed large-cap "value" stocks in the 3rd quarter. The Russell 1000 Growth Index returned 1.16% while the Russell 1000 Value Index returned a negative .78%. Value has still performed better than growth over the past 12-months with the Russell 1000 Value returning 35.01% to the Russell 1000 Growth's 27.32%.

High quality bonds were virtually flat for the quarter while low quality bonds rose by .89%. Positive performance from high yield bonds is generally a sign that the underlying economy is doing well and expected to continue to do well. Yields on U.S. Treasury securities were also fairly stable during the quarter. The 10-Year U.S. Treasury note yield initially fell in the 3rd quarter but began to rise again after the Federal Reserve's Economic Symposium in late August.

Where do we go from here? We believe that the equity markets are setting up a year-end rally in the 4th quarter 2021. Volatility has increased, and may continue in equities, but we see the trend as being upward sloping over the next three months.

Index Performance

Category	Representative Index	3rd Qtr 2021	Year-to-Date	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	-1.46	12.12	24.15	11.00	15.68	14.72
Broad US Large Companies	S&P 500 Index	0.58	15.92	30.00	15.99	16.90	16.63
US Small Cap Companies	Russell 2000 Index	-4.36	12.41	47.68	10.54	13.45	14.63
US Mid Cap Companies	Russell Mid Cap Index	-0.93	15.17	38.11	14.22	14.39	15.52
Largest 100 NASDAQ Companies	NASDAQ 100 Index	1.09	14.58	29.58	25.57	25.93	22.65
Large "Value" Stocks	Russell 1000 Value Index	-0.78	16.14	35.01	10.07	10.94	13.51
Large "Growth" Stocks	Russell 1000 Growth Index	1.16	14.30	27.32	22.00	22.84	19.68
Developed International	MSCI EAFE Index	-0.45	8.35	25.73	7.62	8.81	8.10
Emerging Markets	FTSE All Emerging Markets	-6.76	0.79	18.51	9.36	9.16	6.14
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	0.05	-1.55	-0.90	5.36	2.94	3.01
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	0.89	4.53	11.28	6.91	6.52	7.42
Commodities	Bloomberg Commodity	6.59	29.13	42.29	6.86	4.54	-2.66
Total US Market (all cap stocks)	Russell 3000 Index	-0.10	14.99	31.88	16.00	16.85	16.60
Real Estate Investment Trusts	Wilshire US REIT Index	1.64	24.79	38.04	10.39	6.97	11.30
Cash	US T-Bill 90 Day	0.01	0.03	0.05	1.01	1.08	0.58

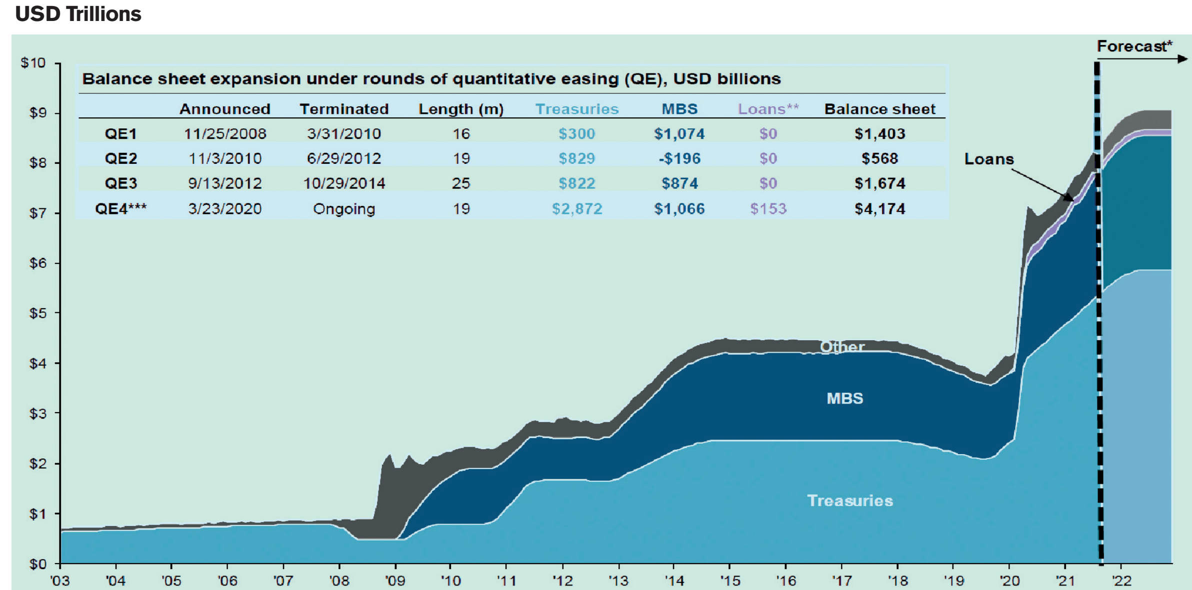
** 3 year, 5 year and 10 year returns are annualized. All periods ending September 30, 2021.*
All returns include the reinvestment of dividends.

Federal Reserve to Begin Bond "Tapering"

Federal Reserve Chairman Jay Powell spoke at the Jackson Hole Economic Symposium on August 27th. The 10-year U.S. Treasury Note yield closed on that day at 1.312%. The 10-year U.S. Treasury Note yield closed the 3rd quarter 2021 at 1.529%, a month later. Although Powell did not formally announce specifics of bond tapering, he did discuss that tapering was on the way soon. Its formal announcement of tapering means that the Fed will tell us when it will start reducing the amount of its monthly purchases of bonds and by how much each month. Although Powell has hinted that tapering will likely end by the middle of 2022, the Fed has not yet stated when tapering will start or how much of a reduction in purchases will be made each month once it does begin.

It is currently purchasing $120 billion of U.S. Treasuries and mortgage-backed securities per month which is effectively increasing liquidity in the financial markets each month. The result is that these purchases have been driving down interest rates, such as the yield on the 10-year U.S. Treasury note. We are not suggesting that the Fed's bond purchasing program, or quantitative easing, is the only reason interest rates have fallen, however. When the Fed actually starts to reduce its purchases, yields should rise further (and bond prices will fall as they move inversely to interest rates). We believe that yields will keep climbing perhaps to the 2% level on the 10-year U.S. Treasury note. Tapering will mean less and less demand each month for these securities (U.S. Treasury and mortgage-backed securities).

The Federal Reserve Balance Sheet



	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4***	3/23/2020	Ongoing	19	$2,872	$1,066	$153	$4,174

Source: FactSet, Federal Reserve, J.P. Morgan Investment Bank, J.P. Morgan Asset Management

If we look back at 2013, the last time the Fed began the tapering of a prior quantitative easing program, upon the announcement that it would begin tapering, the 10-year U.S. Treasury note yield jumped immediately. The Fed announced in May of 2013 that it would begin tapering later that year but it did not actually start tapering until December 2013.

Yields prior to May 2013 were relatively low, and then they spiked after the Fed announced tapering in May 2013. By the time tapering had started in December 2013, bond yields had effectively finished rising (or peaked) and started pulling back after the start of 2014. We expect that we may see something similar this time. A formal announcement of tapering should be made at the Fed's November 2021 Federal Open Market Committee (FOMC) meeting.

$UST10Y 10- Year US Treasury Yield (EOD) INDX

What does all of this mean for client portfolios? More interest rate sensitive (higher duration) bonds should pull back and yields will rise which they have started to do. When interest rates rise, "value" stocks and small cap stocks tend to also rise. Growth stocks tend to decline, especially technology stocks. From a portfolio standpoint we want to hold shorter duration bonds or those bonds that have a shorter time until maturity within our bond allocation.

What if we are wrong? If the Fed does not announce tapering in November, or it does and interest rates do not move, or even go down, there is minimal downside to the bond positions we will be holding. We will be forfeiting a little yield by investing in short duration bonds in an already low interest rate environment. If we are right by investing in short duration bonds, we will protect the bond allocation from potential principal losses. Likewise, value and small-capitalization stocks should still participate in any year-end rally even if interest rates do not rise. Their rise just won't be as profound as if interest rates do rise. Value versus growth and small-capitalization stocks are discussed in more detail below.

Federal Reserve Will Change Interest Rate Policy, Eventually

The FOMC concluded its two-day meeting in September and left the Fed Funds rate unchanged at near zero. In previous meetings this year, as well as through public statements by many of the Fed governors, it has signaled that it will not raise interest rates until 2023. More recently there has even been some hinting toward raising the Fed Funds rate as early as June 2022 by some of the Fed governors.

FOMC members now see core inflation at 3.7% versus previous expectations in June of a 3% core inflation rate. It sees inflation at 2.3% in 2022 and 2.2% in 2023, slightly higher by one-tenth of a percent than it had projected in June. The Fed forecasts Gross Domestic Product (GDP) growth at 5.9% this year which is down from the 7% growth projection it made this past June.

It is of our opinion that if inflation targets remain intact and inflation is in fact "transitory", that the Fed will likely not increase the Fed Funds rate until early 2023. At this time, we are in agreement with the Fed and inflation is temporary.

Look for a Resurgence of Value and Small-capitalization Stocks

We have seen a slight pause in the out-performance of value stocks over growth stocks in recent months. However, as we see interest rates begin to rise as a result of the Federal Reserve's tapering of its bond purchase plan, we believe we will see a re-emergence of value stocks' leadership in the market. Secondarily, we also expect small capitalization stocks to show some out-performance as well.

The 10-year U.S. Treasury note yield was .67% on September 1, 2020 and closed at 1.74% on March 31, 2021. During this same time period (9/1/2020 to 3/31/2021) the Russell 1000 Value Index's total return was 26.16% while the Russell 1000 Growth Index's total return was 7.15%. The Russell 1000 Value Index out-performed the Russell 1000 Growth Index by over 19 percentage points over this time period. After March 31, 2021 yields on the 10-year US Treasury note began to retreat and growth stocks re-established their leadership with the Russell 1000 Growth Index out-performing the Russell 1000 Value Index by over 9.50 percentage points between April 1, 2021 and July 31, 2021. Interest rates began to rise again in the beginning of August.

Likewise, U.S. small-capitalization stocks followed a somewhat similar pattern to large-cap value stocks. Between September 1, 2020 and March 31, 2021, the Russell 2000 Index (U.S. small-cap stocks) out-performed the Russell 1000 Index (U.S. large-cap stocks) by over 27 percentage points. We saw a similar reversal after March 31, 2021 to the reversal of value stocks versus growth stocks with small-cap stocks versus large-cap stocks. Between April 1, 2021 and July 31, 2021 large-cap stocks out-performed small-cap stocks by over 10 percentage points.

A similar out-performance of value stocks and small cap stocks should evolve should our anticipated rise in the 10-Year U.S. Treasury note yield (and other U.S. Treasury securities) materialize.

Fiscal Policy from Washington

In the waning weeks of the 3rd quarter 2021, the Federal government once again faced a shutdown as it needed to increase the debt ceiling to keep the government running. Some of the market jitters in September could probably be traced to the potential shutdown. Although no long-term solution has been achieved yet, lawmakers were able to extend the deadline until December 3rd when once again we will have to address increasing the debt ceiling. We will see how the markets react to the situation in December. The debt ceiling crisis is due to the fact that Congress has an inability to spend within its means.

Speaking of spending money, recently the $1.2 trillion infrastructure bill has passed in the senate with bipartisan support. As of this writing, it now goes to the house for further debate. It includes funding for roads and bridges, airports, ports and waterways, transit and rails and broadband upgrades. It will also create nationwide charging stations for electric vehicles and provide money for additional electric vehicles such as busses. Although congress claims that the bill is paid for, the Congressional Budget Office (CBO) scored the bill and finds that it adds more than $350 billion to the national debt over 10 years. There appears to be a lot of "gimmicks" used to pay for it such as delaying until 2026 a Trump Administration rule to pay for drugs through Medicare and Medicaid and by repurposing funds previously earmarked for pandemic related unemployment benefits that were terminated early by states trying to encourage the unemployed to return to work.

In addition to the infrastructure bill, President Biden also proposed a $3.5 trillion social spending bill which is not gaining bipartisan support, so the Democrats will have to come up with the votes themselves to pass it. They are running into resistance from the progressive caucus who wants to spend more and moderate Senators (Joe Manchin and Kyrsten Sinema) who want to spend less. As of this writing, no compromise has been reached and nothing has been passed into law. Although many of the provisions of the proposed bill are noble on the surface, many of these provisions are labeled "socialist" by the Republican opposition. It currently includes such things as "free" community college, child care and universal pre-K, Medicare expansion, extended child tax credit, cuts in prescription drug prices, paid family and medical leave, funding for climate change as well as many other provisions.

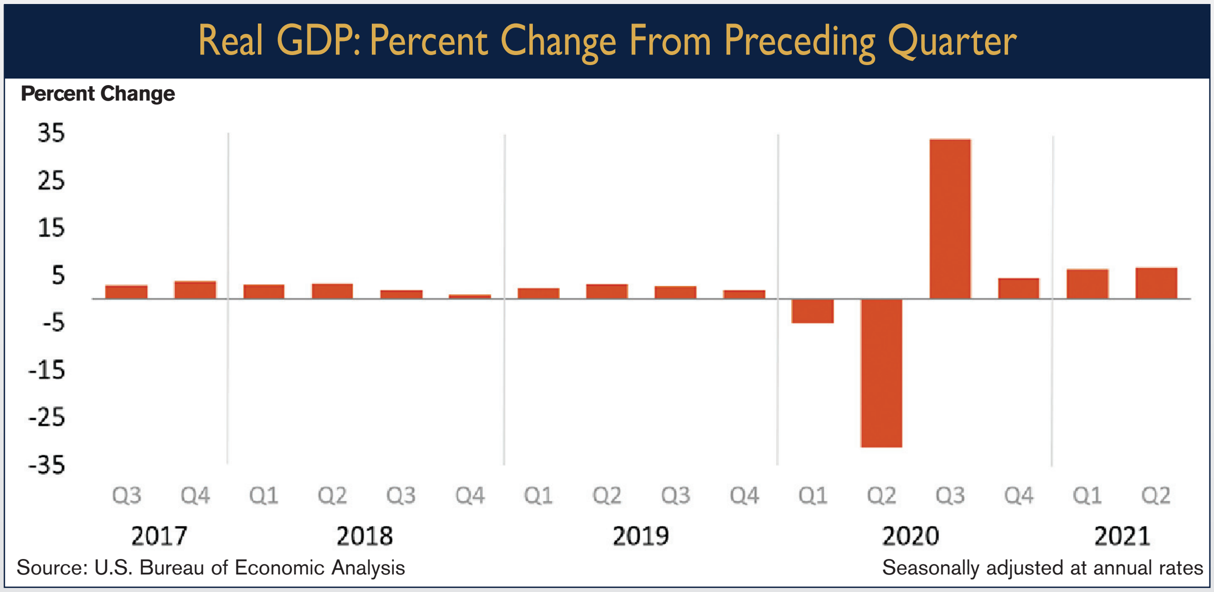
The President claims that the bill is paid for and will cost "zero" dollars. The Administration plans to pay for it by raising the corporate income tax rate to 26% from 21%. Also, it will raise taxes on those earning more than $400,000 per year. It will hire more IRS agents to "go after tax cheats" which the Administration believes will raise $100 billion per year.

During the presidential election campaign in the fall of 2020, there were many tax proposals made by candidate Biden which are no longer likely to come to life, at least not now. These proposals include the following: 1). There will not likely be a top capital gains tax rate of 40%. The top rate will most likely rise to 25% plus the 3.8% Medicare tax rate. 2). A corporate income tax rate originally at 28% will not happen. Rather, we believe a corporate tax rate of 25% is likely, not the aforementioned 26% rate that is currently proposed in the social spending bill. Again, the current corporate income tax rate is 21%. 3). A minimum corporate income tax rate does not have enough support in Congress. 4). A capital gains tax on estates and elimination of the "step up" in basis is left out of any current legislation. 5). There will be no increase in the Social Security tax for wealthy individuals. 6). A wealth tax is not going to happen.

The Economy

Inflation is a major concern for the economy at present. We believe, as the Federal Reserve does, that inflation is "transitory" meaning temporary. One of the reasons that inflation may be temporary is that it has been partly due to supply chain disruptions which will work themselves out as more people return to work. However, of concern in our opinion, is the massive government spending which is anticipated through the proposed infrastructure and social spending bills. More dollars, chasing a fixed amount of goods and services will likely push prices up. We will have to monitor the levels of government spending going forward.

The real Gross Domestic Product (GDP) increased by an annual rate of 6.7% in the 2nd quarter of 2021. The strong pace of growth of real GDP is a result of the continued re-start in the economy following the Covid-19 outbreak globally. Businesses have gradually re-opened and more people have returned to work which have contributed to economic growth.



As such, the unemployment picture has steadily improved despite setbacks in August and September as reflected in the August and September jobs reports. Only 235,000 jobs were created in August and just 194,000 jobs were created in September; both months' jobs creation were well below the consensus expectations. The average monthly job gain is now 561,000 jobs each month so far this year. Although actual jobs created were lower than average, the unemployment rate declined .4% to 4.8% in the month of September. The 4.8% rate is considered very low or near "full" employment, but is still well above the pre-pandemic rate of 3.5% we saw in February 2020.

Corporate Earnings Outlook

In December 2020, analysts at the Standard & Poor's Corporation projected full year operating earnings for 2021 at $164.41 per share. At present those earnings estimates for full year 2021 are at $198.13 per share. Growth in earnings estimates have been a big driver of stock prices this year. Earnings drive stock price. Earnings for the S&P 500 Index for the full year 2020 were $122.37 per share. Should we be able to achieve the full year 2021 earnings of $198.13 per share, this would represent a year-over-year growth in earnings of almost 62%. The estimated earnings for full year 2022 on the S&P 500 Index are $217.31 per share. Standard & Poor's estimates growth in earnings for 2022 to be a more modest 9.7%.

Despite the stock market volatility in the 3rd quarter of 2021, such earnings growth helps to justify the nearly 16% total return year-to-date of the S&P 500 Index through the end of the 3rd quarter. Much of the growth in earnings can be attributed to the re-start in the "Covid" economy largely because of a very accommodative Federal Reserve. As the Federal Reserve begins to lessen its accommodation when it tapers the bond buying program and eventually raises interest rates, will earnings continue to grow as projected?

Increasing Operating Margins

Operating margins, or effectively return on sales, have been increasing steadily since 2008 and especially have increased in the past few quarters. The operating margin tells us how profitable a company is. A high operating margin can justify a higher price-to-earnings (P/E) ratio. Fast growing companies with high P/E ratios will often also have higher than average operating margins. The current operating margin on the S&P 500 Index is 13.55% (end of the 2nd quarter 2021). This level of operating margins can help support the analysts' earnings projections for the Index in the upcoming quarters.

Companies have become more efficient at managing their business operations while the environment for business has improved substantially since the great recession. The higher operating margins also give us an indication of how strong the economy is in order to support greater corporate profits. Undoubtedly the low interest rates are a contributing factor to these margins and we will have to monitor operating margins as interest rates increase, as we expect to see, over the upcoming quarters.

S&P 500 Operating Margins

QTR	2021	2020	2019	2018	2017	2016
Q4		10.39%	10.61%	10.10%	10.27%	9.27%
Q3		10.93%	11.21%	12.13%	10.16%	9.86%
Q2 *	13.55%	8.49%	11.41%	11.55%	10.14%	9.03%
Q1	13.02%	5.86%	11.21%	11.40%	9.84%	8.75%

*Q2 2021 is an estimate
Source: Standard & Poor's Corporation, 9/30/2021

The Market Valuation is Expensive

We track a number of indicators to help guide us in our evaluation of the stock market's valuation. These indicators include the Q Ratio, CAPE Ratio and the Buffett indicator. We will focus here on an evaluation of the P/E ratio to demonstrate where we stand right now. The closing price for the S&P 500 Index on September 30, 2021 was 4,307.54. The Standard & Poor's Corporation's analysts currently estimate the past 12-month earnings per share of $185.88 which gives us a "trailing" P/E ratio of 23.17. The 25-year average trailing P/E ratio is 20.06 so we are currently above the average suggesting that the market is on the expensive side (the average is of the quarter-ending P/E ratios for the past 25-years). The "forward" P/E ratio is 20.44 with a 25-year average "forward" P/E of 16.78 (the average forward P/E ratio is calculated by JP Morgan based on consensus earnings estimates). The forward P/E ratio also suggests a market that is expensive historically.

The market can certainly get more expensive before investors run to other asset classes. The March 2000 quarter ending "trailing" P/E ratio was 27.79. March 2000 was the start of a three-year bear market as technology and dotcom stocks tanked. However, for the quarter-ending March 2008 the trailing P/E ratio was 17.23 prior to the collapse of Lehman Brothers (September, 2008) and the beginning of the "great" recession. The market would not have been considered "over-valued" at that time and sold off because of the housing bubble, not for valuation purposes.

Even though we are over-valued right now, and we saw some selling of equities in the month of September, as mentioned earlier, we believe we are setting up a "year-end" rally that will propel equity prices to new highs. The market has been pricing in the Fed's bond tapering and when it actually happens this fall, it will be a non-event for the equity markets. Despite current valuations, equities are still a good place to be invested given the current level of interest rates and the over-valuation in the bond market.

Conclusion

The 3rd quarter 2021 was fairly flat for the major indices. Growth stocks continued to out-perform value stocks. We believe there is an impending resurgence in value stocks and small-capitalization stocks as yields on U.S. Treasury securities are poised to rise. The rise in yields is good for value and small-capitalization stocks and not so good for growth stocks, especially technology stocks. Equities are expensive by various valuation measures. Despite this over-valuation, we believe we will see a "year-end" rally in the Fourth quarter 2021.

The Federal Reserve will likely begin tapering its bond purchase program in the fall of 2021. It will keep the Fed Funds rate near zero percent at least through the first half of 2022 and perhaps longer. Market oriented rates such as the yields on U.S. Treasury securities have been on the rise since the Fed's August Economic Symposium. Perhaps the rise in yields since the Economic Symposium is a coincidence but we believe the rise in yields may have been caused by the expectation of the tapering of bond purchases.

From Washington, we are seeing some wrangling over the debt ceiling with a temporary measure put in place. There are two bills which include substantial government spending being debated at present (as of the time of this writing nothing has been passed into law). There is obviously no clear mandate from the electorate with a nearly evenly divided congress which may be the reason nothing has been done yet.

On the earnings front, corporate earnings have grown substantially since the post-pandemic slide in the spring of 2020. Operating margins have also improved giving a sign that earnings may continue to improve. Overall, we feel comfortable with where the economy is right now even though inflation has picked up. We think this pickup in inflation is temporary as does the Fed.

All in all, year-to-date the markets have performed well and we see continued advancement of stock prices. As such, we are here to listen, counsel and provide direction to all of our clients and friends.

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