Blue Chip Partners: Quarterly Edge

Q4 2021

Market Outlook

Welcome to the fourth quarter. Football is back, the leaves are changing, and pumpkin spice lattes have found their way into your local coffee shop. As we digest the state of U.S. markets today, we have identified three key themes to watch in the fourth quarter of 2021:

You're Hired!

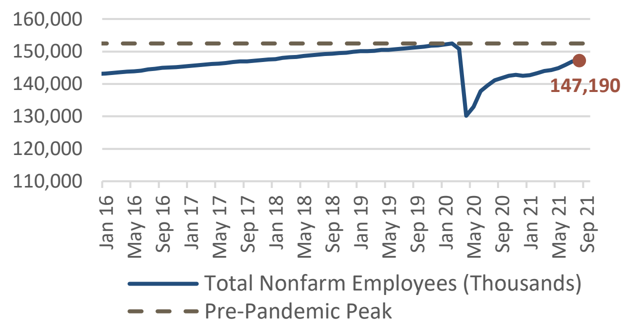
Equities In Charge

The Road Ahead

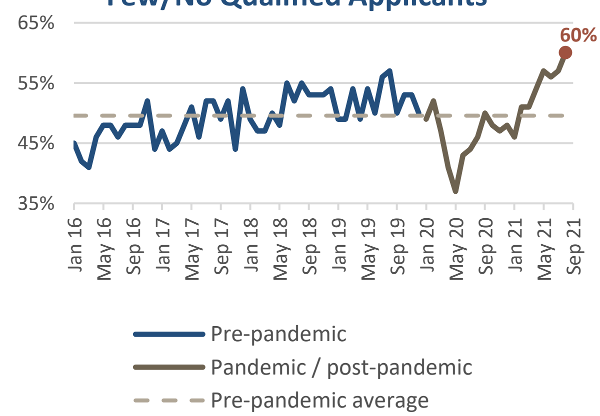
You're hired!

From an economic perspective, the United States has proved resilient. After GDP growth of an annualized 6.5% in the second quarter, the U.S. economy is now larger than it was before the pandemic. Strong household balance sheets have fueled robust consumer spending, a trend we highlighted last quarter and one that we see persisting. There is, however, a formidable chink in the economy's armor; it is nearly impossible to hire individuals. While GDP has recovered, employment as measured by total nonfarm employees still has significant ground to cover. Employers are pulling out all the stops – Walmart increased its minimum wage to $12/hour, Amazon is offering tuition reimbursement programs, and small businesses are offering $1,000 bonuses and free meals – yet the mismatch between labor supply and labor demand is stubbornly persistent. This is especially pertinent for small businesses, the backbone of the U.S. economy. A record number of small businesses have open positions which they are unable to fill, leading to constraints on operating hours and capacity. Perhaps more concerning: forget about a large number of open positions – a record number of small businesses aren't even receiving qualified applicants! With the labor participation rate at 61.7% vs. 63.3% pre-COVID, the dynamics at play are clearly hindering the next leg of this economic restart. As the Delta variant made a noticeable impact on job growth in the back half of the third quarter, some combination of a general fear of the virus and desire for more workplace flexibility is leading individuals to take their time with returning to the workforce. Going forward, there is potential for hourly earnings (up 4.3% y/y as of the end of August) to continue to march higher as the balance of power remains with potential employees. In the immediate-term, we are intently watching to see if the September withdrawal of excess unemployment benefits can successfully lead to the filling of some of the record-high 10.1 million open jobs. Any reduction in that eye-popping number would be helpful in keeping a lid on wage inflation.

Total Nonfarm Employees (Thousands)



Percent Of Firms With Few/No Qualified Applicants



Source (top chart): Federal Reserve Bank of St. Louis. Data shown from 8/31/11 – 8/31/21.
Source (bottom chart): National Federation of Independent Businesses. Data shown from 1/31/16 – 8/31/21. Pre-pandemic average reflects the period from 1/31/16 – 12/31/19.

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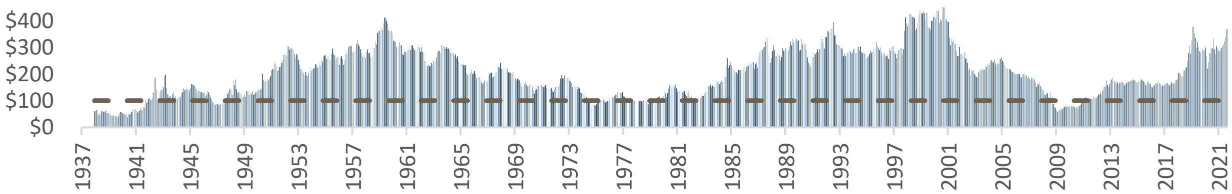
Equities In Charge

At Blue Chip Partners, we are rooted in the belief that given a long-term time horizon, an overweight allocation to equities is prudent. When viewing rolling 10-year equity returns, very few periods in history would have yielded a negative result.

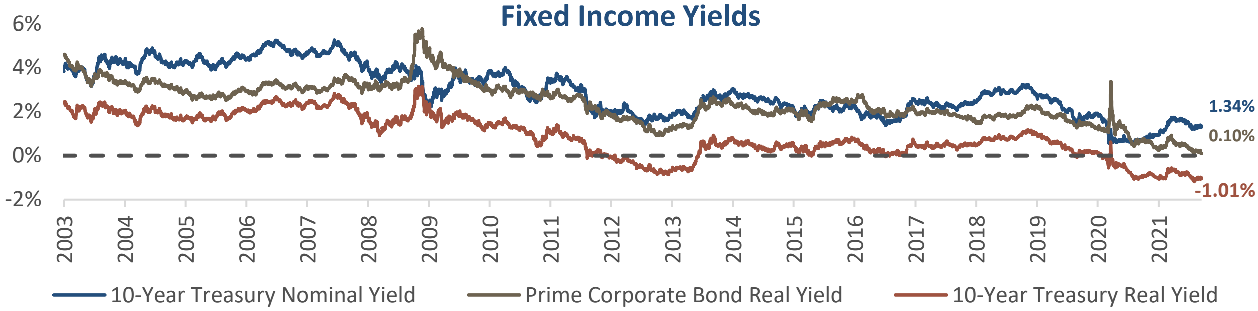
10-Year S&P 500 Index Rolling Returns
Value of $100 invested ten years earlier



Source: Bloomberg. Data shown from 1/1/11 – 9/16/21. Data is shown for the S&P 500 Index Price Return and does not include dividends.

Further, today's environment for traditional interest-bearing securities is rather dull, as investors currently experience negative real yields across a large portion of the fixed income market (real yield = bond yield after expected inflation is considered). Today, investors are essentially paying to participate in "risk-free" treasuries and are earning less than a high yield savings account in prime-rated corporate bonds.

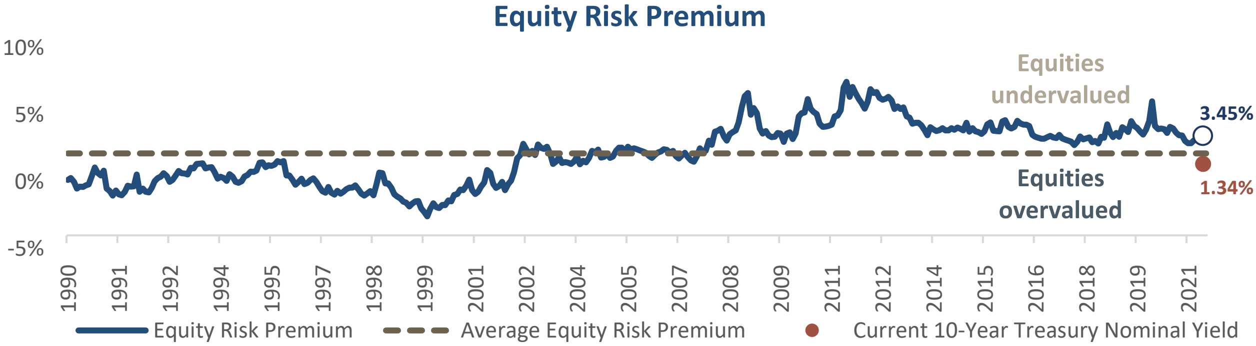
Fixed Income Yields



Source: Federal Reserve Bank of St. Louis. Data shown from 1/1/11 – 9/16/21. Real yields are computed by subtracting 10-year breakeven inflation rates from nominal yields. Prime corporate bond yields utilized to compute real yields are long-dated Moody's Aaa rated bonds.

On the equity side, it appears that investors are set up to be more favorably rewarded relative to the level of risk involved. The Equity Risk Premium (ERP) provides insight into whether or not equity market participants are properly compensated for assuming additional risk in stocks relative to "risk-free" government bonds. The ERP has resided above its long-term average post-2008 financial crisis, and remains elevated today. **This suggests that stocks remain undervalued from the standpoint of risk vs. potential reward.**

Equity Risk Premium



Source: BlackRock Fundamental Equities, with data from Wolfe Research Portfolio Strategy, Compustat, Thomson Reuters, Standard & Poor's, FactSet, and the Federal Reserve Bank of St. Louis. ERP is calculated using the S&P 500 earnings yield and subtracting the 10-Year Treasury Constant Maturity Rate (GS10). Data shown from 1/31/90 – 8/31/21.

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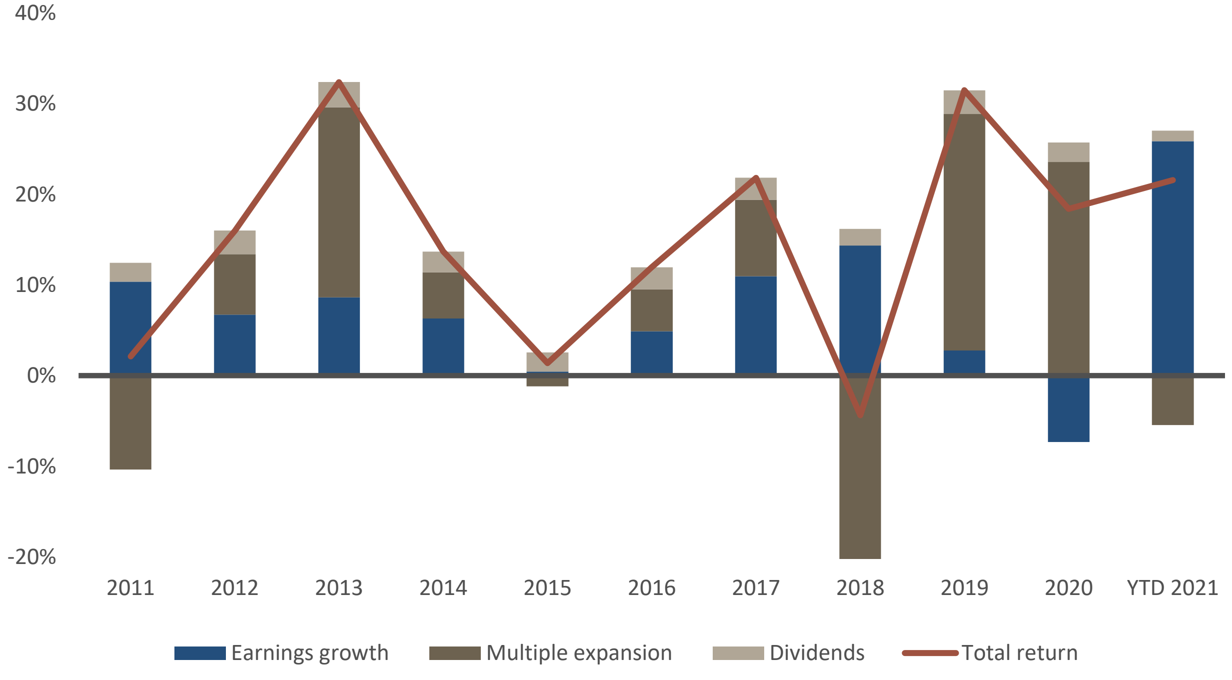
Equities In Charge (continued)

From another valuation angle, the traditional price-to-earnings metric would suggest that if one liked stocks at the beginning of 2021, one should like them even more today. While prices have appreciated year-to-date, earnings growth has accelerated to a greater degree, resulting in more attractive valuations today. U.S. companies are firing on all cylinders in a post-pandemic world. **For the most recent quarter, 87% of S&P 500 companies surpassed estimates for revenue, and the same percentage displayed a greater level of earnings than consensus expectations.** Taken together, even as inflationary pressure has magnified costs of inputs and raw materials, companies are broadly displaying pricing power. By passing increases in input costs down the chain to consumers, companies have been able to maintain (or in many cases, grow) margins, resulting in the **highest year-over-year earnings growth rate for the S&P 500 since Q4 2009.** This is in line with one of our assertions from last quarter – that the consumer, with healthy household finances and significant pent-up demand, will provide the fuel for the next leg higher. In addition to consumer-oriented businesses, our preferred holdings in the information technology space remain positioned to tap into growing streams of sticky recurring revenue. Elsewhere, Blue Chip's recommended holdings in the health care sector are poised to benefit from demographic and societal trends in a post-pandemic world. While the level of earnings growth will undoubtedly ease off record highs in the quarters to come, we believe the strong execution exhibited by U.S. companies in a challenging environment speaks highly of their dynamic nature.

S&P 500 Index Sources Of Return



Source: BlackRock Fundamental Equities with data from FactSet. Earnings growth is based on the 12-month change in 12-month forward earnings estimates. Data shown from 1/1/11 – 8/31/21.

Despite potential modest headwinds from an uptick in corporate taxes and the relaxing of easy monetary policy, we are constructive on the operating environment for U.S. businesses. Given strong momentum in the U.S., we continue to recommend letting equity allocations run, even if it means drifting modestly away from target weights in client portfolios.

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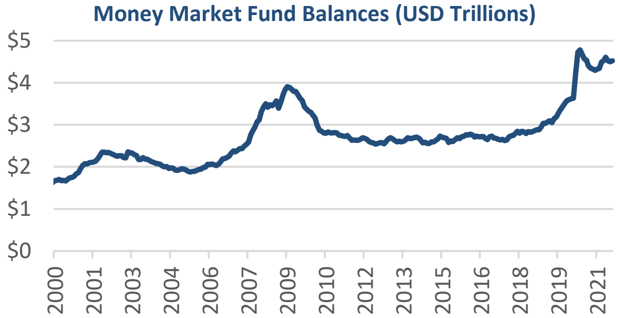
The Road Ahead

While our outlook for the economy and financial markets is constructive, you may recall that our Q3 Quarterly Edge pointed out the tendency for the second year of a secular bull market to pose bumps in the road. We have digested elements from the last quarter that should be reassuring to investors, but as with any market environment, risks appear on the horizon as well. A summary of potential catalysts, positive and negative, are outlined below.

Bullish Observations

Cash on the sidelines: While everything from semiconductors and personal electronics to washing machines and couches are in short supply, the same cannot be said for cash. The level of liquidity on both personal and corporate balance sheets has never been higher, which provide a base for an optimistic equity market outlook.

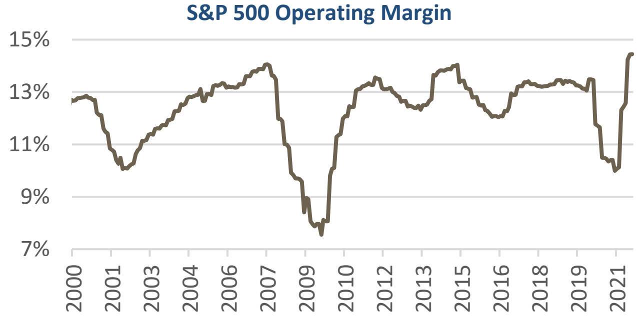
Money Market Fund Balances (USD Trillions)



Potential Risks

Margin degradation: Earnings have been the primary driver of returns in 2021. However, supply chain challenges have persisted, and if wage pressures accelerate due to continued labor shortages, less resilient businesses will be exposed. Margin degradation is not our base case, but it highlights the need for selectivity.

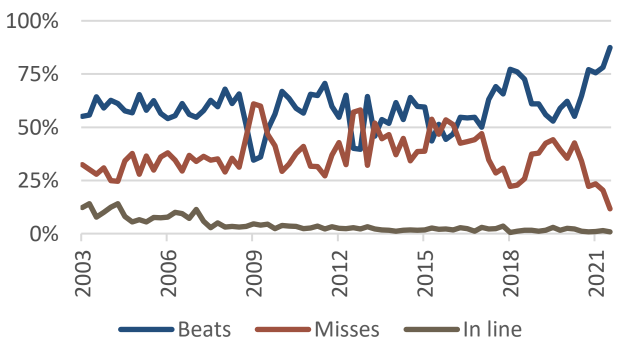
S&P 500 Operating Margin



Sources: Bloomberg MMFA Index (left chart), S&P 500 Index (right chart) with data from Bloomberg. Data shown from 1/1/00 – 8/31/21.

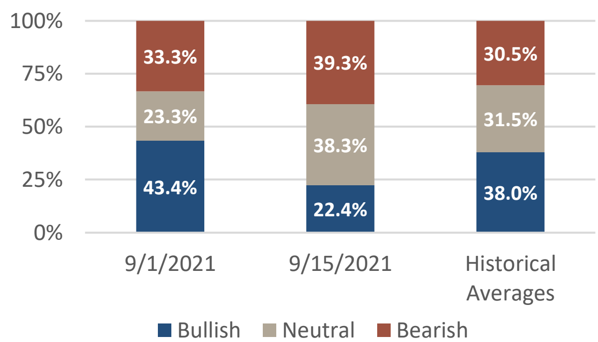
U.S. businesses have proven themselves: It is encouraging to see that a record number of firms are posting financial results that are above consensus expectations. Businesses have weathered the challenging environment that arose post-pandemic, and we believe there are ample examples of companies who are poised to continue to execute well.

% of Companies Beating Revenue Estimates



Policy push: With a smattering of potential policy actions on the horizon, markets may be susceptible to headline risk in the coming quarter. Infrastructure negotiations, Fed tapering and reappointments, and the debt ceiling all will garner attention from investors, although President Biden's fiscal policy may be the most impactful. Tax hikes would certainly impact corporate bottom lines, and it remains to be seen if investor sentiment will be affected.

Individual Investor Sentiment



Sources: BlackRock Fundamental Equities, FactSet (left chart). Data shown 2/28/03 – 8/31/21. AAII Investor Sentiment Survey (right chart)

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Your Bottom Line

The U.S. economy has proved resilient after the bumps in the road presented by the COVID-19 pandemic. Data points to continued growth through the end of the year, albeit with lower intensity than has been seen through the first three quarters of 2021. The employment picture remains the laggard, as a stubbornly low participation rate could lead to continued upward pressure on wages. Small businesses are feeling the pain given the lack of available labor, a trend that we hope to see moderate over the next six months as virus fears moderate and excess unemployment benefits are withdrawn.

While the fixed income market poses unique challenges via ultra-low interest rates and deteriorated purchasing power, equities appear ripe for investment today. Earnings growth at the company level has outpaced price appreciation, which has led to multiple contraction and thus more attractive valuations on a price-to-earnings basis. Further, the Equity Risk Premium, which sheds light on the attractiveness of stocks relative to government bonds, remains well above the historical average. This indicates that investors are more than fairly compensated for the assumption of additional risk in equities relative to fixed income.

The road ahead finds financial markets at an interesting juncture. We find optimism in a tremendous amount of corporate and individual cash on the sidelines as well as a record number of companies posting financial results that exceed already lofty expectations. On the contrary, potential risks on the horizon solidify the need for selectivity in markets. There is potential for companies to experience margin pressure amid rising labor costs and supply chain challenges, and a host of high-profile political items may lead to wavering investor sentiment.

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