Fourth Quarter 2021 — Economic and Capital Markets Commentary

Supply Chain Blues

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"The amateurs discuss tactics. The professionals discuss logistics." – Napoleon Bonaparte

Building on gains from the first half of the 2021, U.S. stocks continued to move higher through the summer before stalling in September. This pause, in what had been a meteoric rise since March of 2020, in large part reflected concerns about the COVID-19 Delta variant, which continued to snarl global supply chains, causing investors to reevaluate their expectations for inflation and global growth.

Below, we discuss why companies and the average consumer continue to experience higher prices and delayed delivery, and what, if anything, this might mean for corporate earnings going forward.

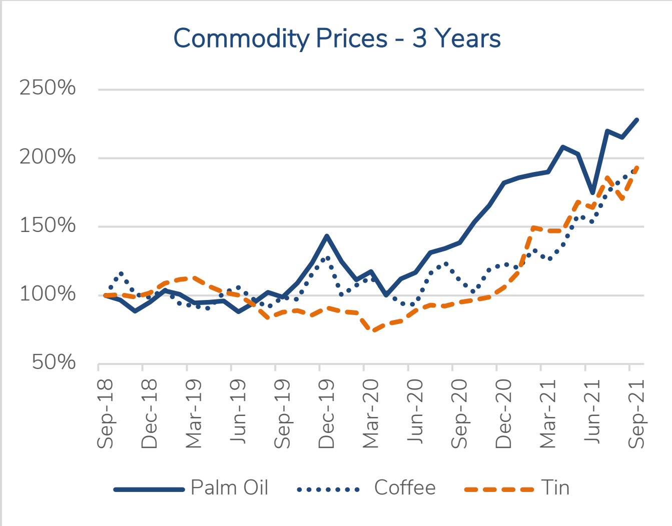
Production Interruptions

In the first quarter of 2021, as the U.S. economy reopened and consumer demand for goods and services far outpaced the available supply, Asian manufacturers, who supply most of the world's goods, started to increase production. But the vaccine rollout in Asia lagged that of the rest of the world, creating the perfect opportunity for the highly contagious Delta variant (now the dominant COVID strain worldwide) to cause greater disruption in these countries.

To combat Delta, Asian governments re-implemented stringent lockdowns, throttling production just as demand soared. In other words, while the West was reopening and demanding goods at a record pace, the factories in the East were still experiencing intermittent 2020-style lockdowns, exacerbating the imbalance between production and consumption. One result was a dramatic increase in the price of raw materials and other inputs. For example:

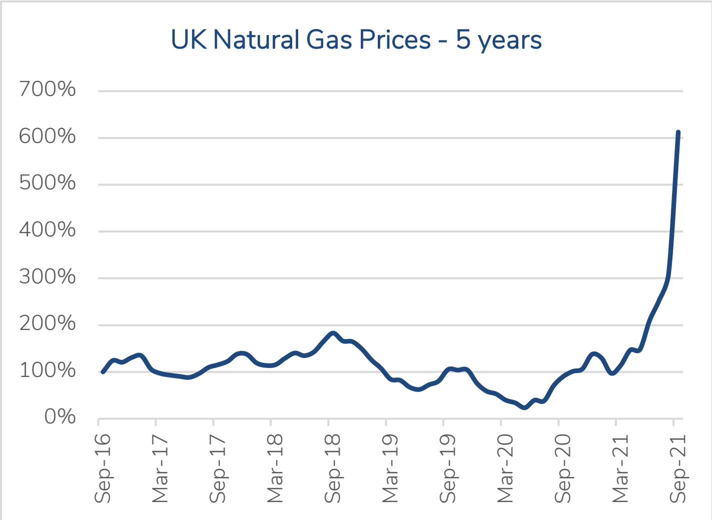
- Lockdowns in Malaysia prevented laborers from harvesting palm oil, an ingredient for a multitude of consumer products. The price of palm oil rose 70% above its long-term average.

- Elsewhere in Malaysia, the production of tin was impacted. One of the world's largest producers of the metal had to sporadically halt operations, leading to nearly a 30% decrease in exports. Tin is used in various industrial and commercial applications, including electronic circuit boards.
- Lockdowns in Vietnam resulted in delays in harvesting coffee beans. This, coupled with poor weather in Brazil, led to the highest coffee bean prices in 7 years.



Source: Bloomberg

Energy Inflation



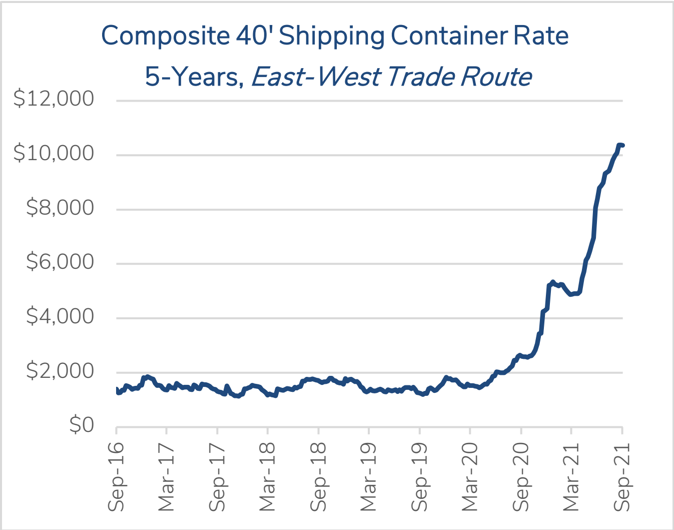
Source: Bloomberg

Production requires energy, and energy costs have also risen as demand has picked up, in some cases not related to COVID at all. In Europe, hot summer temperatures increased the demand for electricity right as North Sea wind energy production decreased drastically. Stockpiles of natural gas were then drawn down, leading to higher natural gas prices heading into the winter months. In addition to costing consumers more to heat their homes as winter approaches, this spike could have a ripple effect. For example, it has already increased fertilizer costs in Europe, which could lead to increased costs for farmers and higher food prices for consumers.

Transportation Disruptions

Producing goods was only part of the supply problem; transporting products to the end customer presented even more of an issue.

Normally, a full 40-foot cargo container from Asia that arrives in Los Angeles is refilled and sent back across the Pacific. When COVID first hit in 2020, however, demand for U.S. products essentially stopped. As a result, empty containers piled up in various ports and rail yards across the U.S.; businesses (rationally) refused to pay to send them back to Asia empty. When U.S. demand for overseas goods returned, there simply weren't enough containers in Asia to get the goods to U.S. markets.



Source: Bloomberg

Changes in the shipping industry over the past five years also exacerbated the problem. Consolidation, which has resulted in fewer shipping companies and a shift to larger ships and fewer trips, meant the industry itself faced a supply / demand imbalance with no easy fix. There were not enough small- and medium-sized ships available to step in and meet demand. The result: skyrocketing shipping costs this year.

Other complications ranged from Delta outbreaks resulting in shutdowns in Chinese ports to labor shortages on the U.S. end of the transit. By September, over 70 container ships sat at anchor off the Southern California coast waiting to offload due to a lack of dock workers and truck drivers. Normally, only one or two would be seen.

The Impact & The Outlook

Higher material, energy, and transportation prices have a direct impact on the operations and profitability of major U.S. and international companies, and several have already warned of significant disruptions:

- A global sportswear company warned it would not have the inventory (from Asia) it anticipated it could sell during the upcoming holiday season.
- A major national retailer began rationing the purchase of select consumer paper products in anticipation of much lower inventory over the coming months.
- A global automaker slashed worldwide vehicle production by 40% due to the ongoing shortage of microchips.

Firms like these are drawing down inventory and searching globally for alternative supplies or shipping options, but eventually they may have to pass added costs onto the consumer. In the interim, they, and many other companies, are warning Wall Street to expect lower profits over the next one to two quarters.

As a result, while we still believe that the inflationary impacts of COVID which started this past spring are short-term in nature, we now feel that due to the Delta variant, it may take more time than initially anticipated for global supply chains to right themselves. We are confident, however, that in a stable world, free markets can adjust and adapt to these supply and demand challenges.

Many companies now recognize that going forward they need to hold more inventory, diversify suppliers and factories, and engage in some strategic onshoring. The benefits of globalization—outsourcing to the lowest bidder—may have peaked due to COVID. This could usher in a trend of returning manufacturing to domestic sites to prevent supply issues in the future. But all of this will take time.

Until then, as we head into the end of 2021, the average consumer may experience higher gas, electricity, and food costs. And with the holidays around the corner, everyone should prepare for higher prices, longer lead times and possible shipping delays of their most requested presents. To repeat, however, the underlying problems are fundamentally temporary, workable solutions exist, and the likelihood of long-term negative impacts appears low.

Note that at the end of this Commentary we have Included our third Investment Insights column. This quarter we discuss ESG Investing, and the opportunities and potential pitfalls.

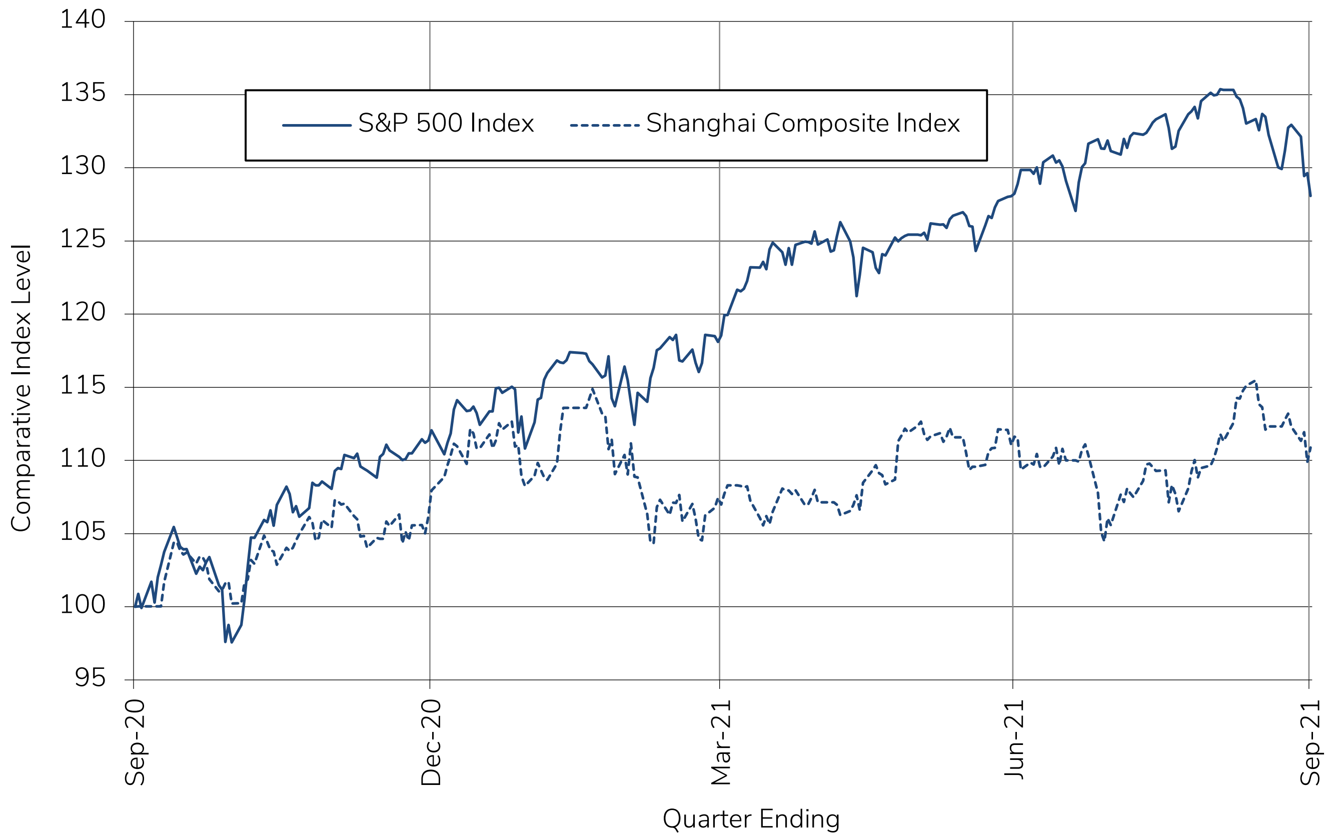
Economic and Capital Markets Data

	September 30, 2021	September 30, 2020	September 30, 2016
S&P 500 Index	4307	3363	2169
Price / Earnings Ratio	25.7	26.1	20.4
Dividend Yield	1.32%	1.79%	2.13%
Federal Funds Rate	0.25%	0.25%	0.50%
10-Year U.S. Treasury Yield	1.49%	0.69%	1.60%
Gold	1755	1886	1316
Oil (Brent)	75	41	49
GDP* (Annualized)	6.7%	33.8%	2.4%
Unemployment**	5.2%	8.8%	5.0%
Inflation** (Annualized)	5.3%	1.4%	1.5%

* GDP Data as of 6/30/2021

** Inflation & Unemployment Data as of 8/31/2021

S&P 500 Index (U.S.) vs Shanghai Composite Index (China)

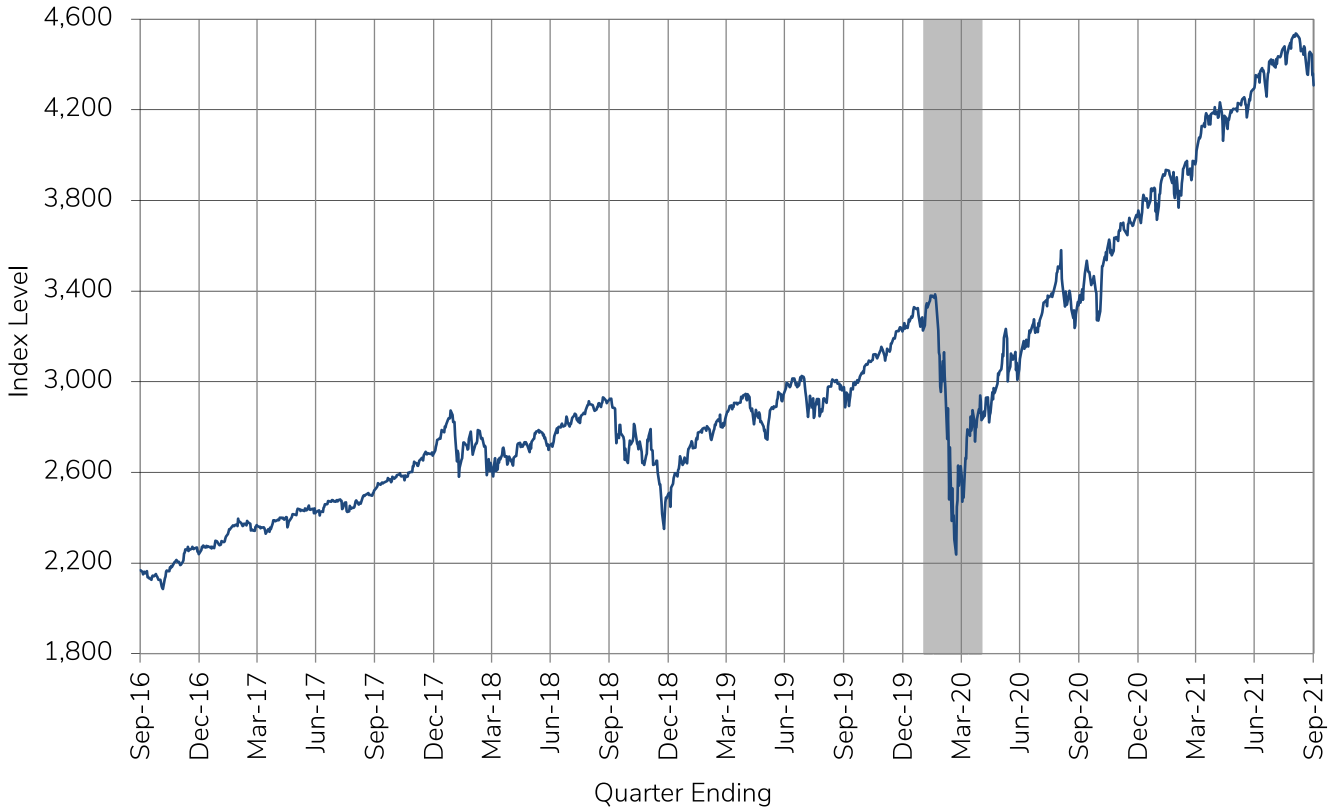


The Chinese real estate market and its potential impact on the global banking system is one situation we are monitoring. In China, real estate is a much larger percent of the economy than it is in the U.S. A major Chinese real estate developer, Evergrande, faces possible bankruptcy. Outside of the impact on China's real estate and banking sectors, such a large bankruptcy could dent global investors' willingness to take risk. (To date, U.S. banks have indicated they have no exposure to Evergrande debt.)

Source: Bloomberg

Standard & Poor's 500 Index

Five Years



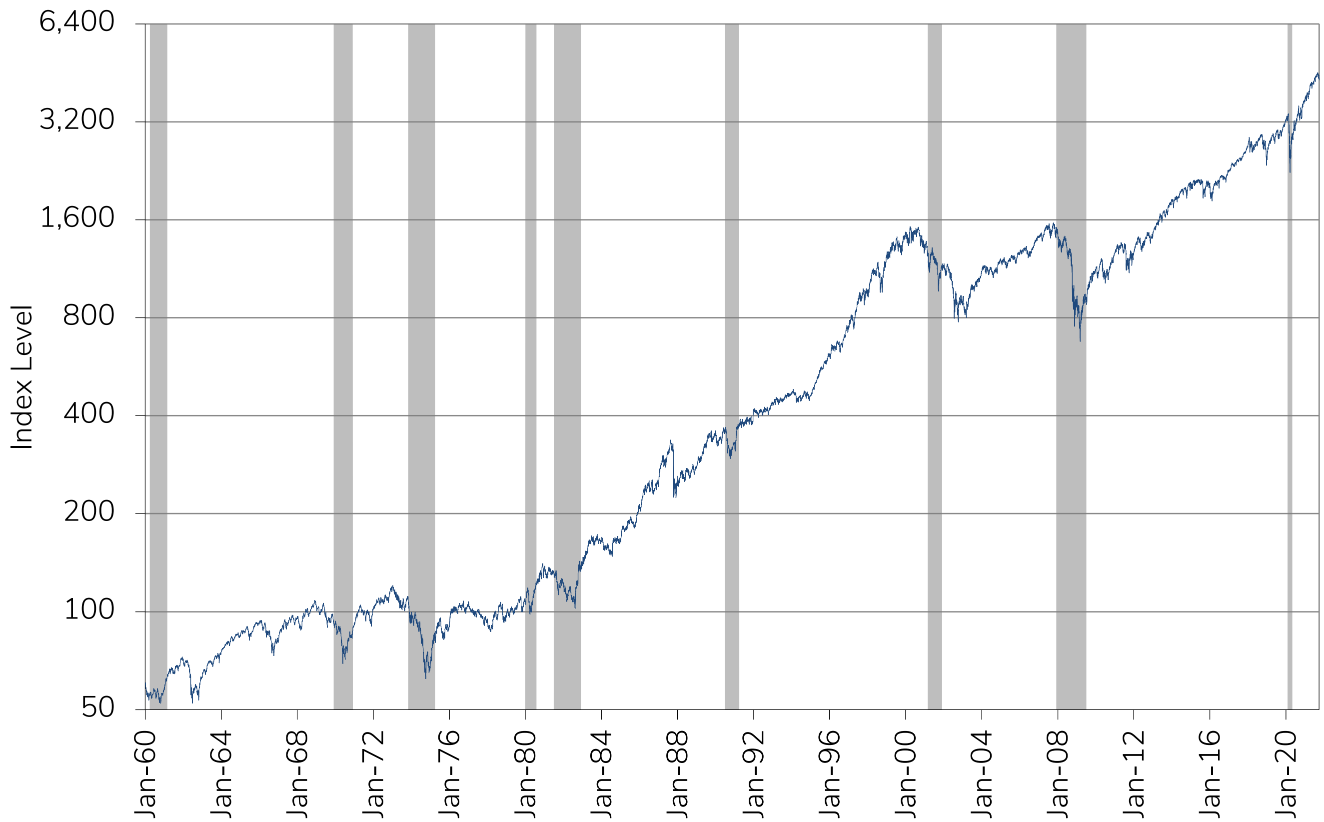
While two quarters of strong earnings have moved stocks higher in 2021, third quarter earnings may reflect an impact from the Delta variant. Note that the recession that began in February of 2020 is now officially the shortest in U.S. history.

= Recession

Source: Bloomberg

Standard & Poor's 500 Index

Since 1960



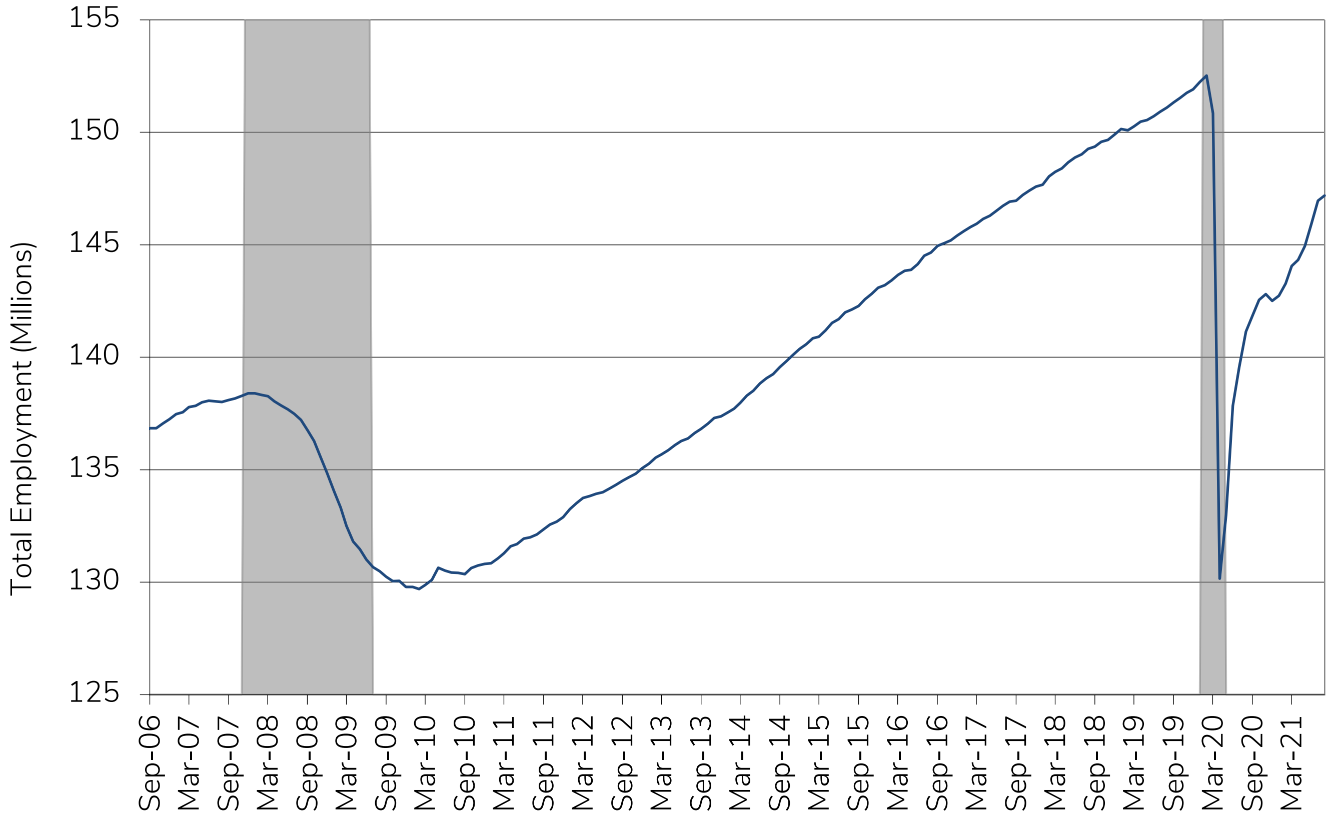
Over the long-term, stocks remain the only liquid asset class with the potential for growth in excess of inflation.

= Recession

Source: Bloomberg

U.S Total Employment

Fifteen Years



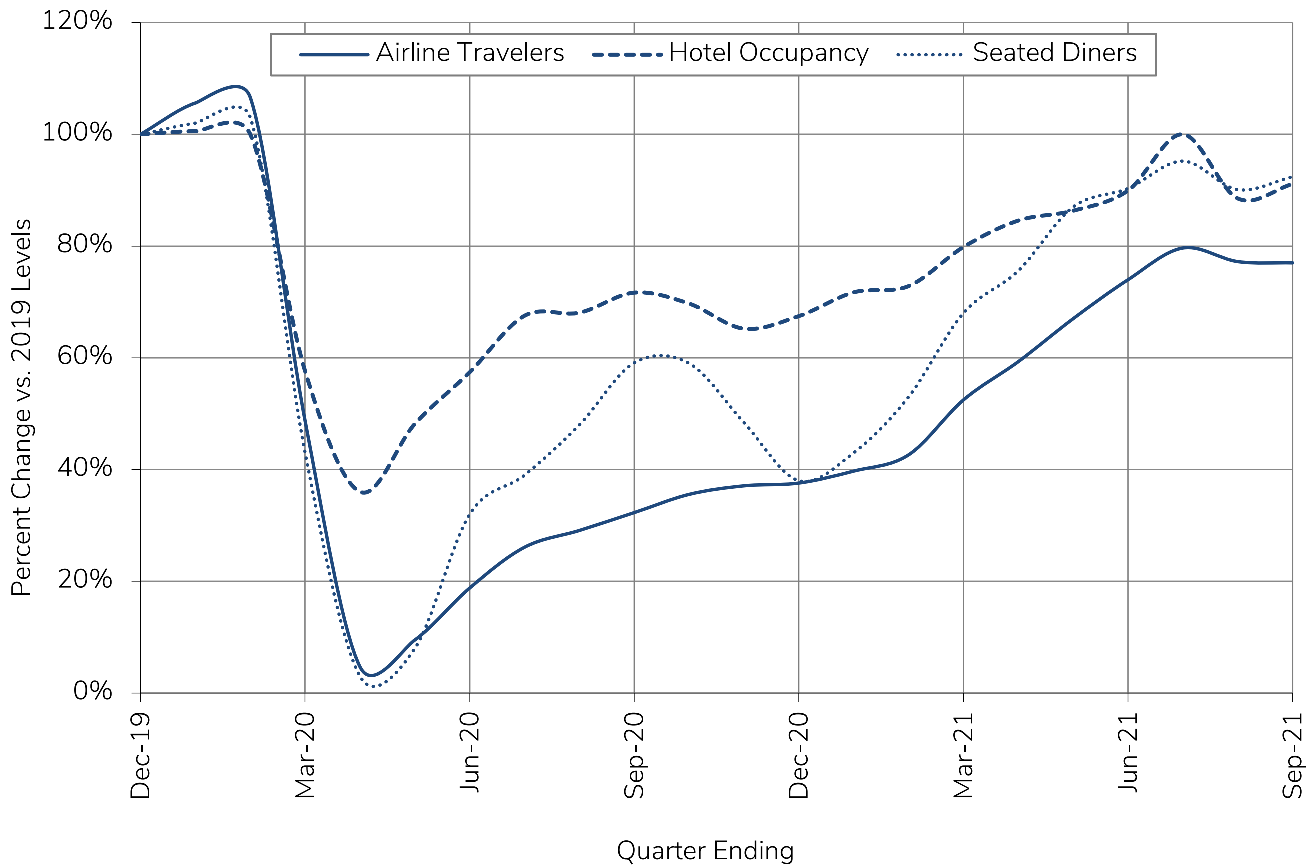
Post-lockdowns, employment continues to recover as demand for goods and services has increased. More work needs to be done, however, to begin to fill the record number of U.S. job openings.

= Recession

Source: Bloomberg; Data as of August, 2021.

Economic Data Points

Twenty-One Months

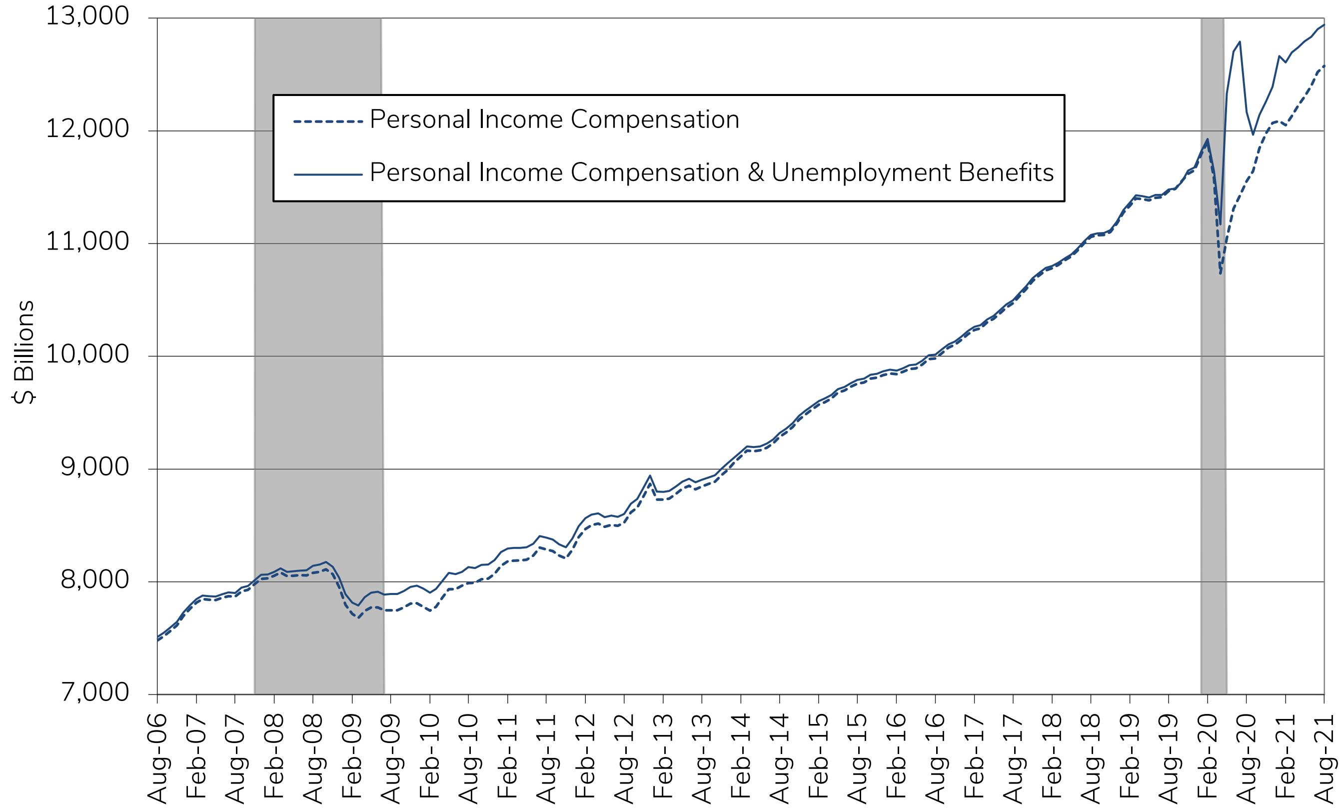


The Delta variant clearly influenced economic activity in the third quarter.

Source: TSA, STR, OpenTable

Total U.S. Monthly Compensation & Unemployment Benefits

Fifteen Years



Steady gains in employment are helping to offset expiring government pandemic assistance benefits.

= Recession

Source: Bloomberg; Data as of August, 2021.

Sustainable Investing:
The ESG Water Can Be Murky

Over the past several years, an increasing number of investors have become interested in aligning their portfolios with their values, seeking investments they view as *sustainable*. Wall Street—always quick to capitalize on a trend—has taken note. The number of sustainable investment funds, often incorporating environmental, social, and governance (ESG) factors in their investment processes, has tripled in just the past five years. By some estimates, roughly a third of every dollar under professional management in the United States today is subject to some sort of sustainable investing criteria or factors.

On the surface, this may seem like a positive development—a wealth of new products for investors to choose from. But as with all things pitched by Wall Street, a healthy dose of skepticism is warranted.

In the Beginning

While the number of sustainable investing funds available today is greater than in the past, the idea itself is not new. Socially Responsible Investing (SRI), a sustainable investing movement similar to ESG, has been around for decades.

SRI's initial focus was rather narrow and tended to concentrate on boycotting certain "sin stocks"—historically companies involved in selling tobacco, liquor, or firearms. But increased attention to climate change in recent years and more vocal calls for social activism have driven new interest in the field. SRI's goals have largely been absorbed into the broader ESG movement, resulting in investment restrictions that reach beyond a few narrow categories.

As Currently Defined

Sustainable or ESG factors are non-financial criteria applied to the analysis of investment options. For example:

- *Environmental factors* such as a company's carbon emissions, impact on climate change, or record on pollution, waste stream management, and recycling.

- *Social factors* including progress when it comes to gender, diversity, and inclusion in the workplace as well as more general concepts such as customer satisfaction and employee engagement.
- *Governance factors* like the diversity of the boardroom, policies on executive compensation, and exposure to legal and regulatory risks.

Unfortunately, there is no definitive list of ESG criteria, and many ESG factors may be connected or overlap.

Murky Waters

The lack of clearly defined ESG criteria and competing interests has opened the door to a proverbial gold rush as Wall Street competes with itself for customer dollars. Investors should proceed cautiously for several reasons:

- ESG funds are generally more expensive than other fund types with similar industry or stock exposure. Passive, or indexed exchange traded funds (ETFs) marketed as ESG carry an average fee that can be significantly higher than popular alternatives. And the fee difference is even higher for actively managed ESG mutual funds.
- Higher fees might be justified if ESG funds delivered better performance, but with the exception of 2020, they have largely failed to do so. (ESG funds tend to overweight technology stocks, which performed better than the broader market last year. While technology stocks have a lower environmental footprint than manufacturers, for example, they still need to make progress on diversity and inclusion.) Interestingly, some research has found that the holdings of many popular ESG funds are nearly identical to those of the S&P 500 index. This implies that these ESG funds are simply expensive indexers.
- Regulation regarding the marketing of sustainable and ESG investment products has not kept pace with the proliferation of products. In the void, many fund companies have seized the opportunity to

rebrand poorly performing legacy funds as ESG with little change to the fund's underlying management or approach (a process called "greenwashing"). And because the definition of ESG varies widely, many so-called ESG funds invest in carbon emitters, gun manufacturers, and junk food companies that manage to satisfy the investment manager's ESG screen. The SEC is aware of these issues and has recently stepped up its regulatory efforts, but this may have little impact on the growth of ESG funds.

This is not to dismiss all sustainable funds out of hand. An ESG fund may in fact be an appropriate option for an investor, but as with all investments, due diligence is key.

What is the Conscience-Driven Investor to Do?

Given the pitfalls, investors interested in ESG investing may be left wondering how to proceed. We believe incorporating sustainable investment principals into portfolios is possible, and it starts by understanding the end goal: the values, beliefs, and objectives an individual investor is targeting. Sustainability means different things to different people, so it's important to be clear about an investor's aims. With this knowledge, a portfolio can be crafted to achieve the given objectives. At Michell Sinkler & Starr, we have the advantage of tailoring our approach to suit our clients, using stocks or—with very careful due diligence—funds that satisfy their goals. It turns out that old-fashioned attention to detail may be the best answer to satisfy newly heightened interest in sustainable investing.