



Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY

October 14, 2021

3 Economic Risks for the Coming Year

The stock market endured a choppy September. The S&P 500 slid for the month, nearly wiping out all of Q3's gains. Many analysts cited the debt ceiling drama and/or economic issues emerging from China as causes for the volatility, but I generally refrain from assigning causes to short-term volatility. The market may be responding to those issues, or there could be other risks and factors in play. Over short time frames, no one truly knows.

Longer-term, however, I do think there are a few budding risks to keep an eye on. So as not to bury the lead, I believe the U.S. economy is in a strong enough position to overcome these headwinds. But we will be watching these three risks closely in the coming months.

Risk #1: Supply Chain Constraints Meet Rising Energy Prices

Strained supply chains continue causing shortages of product components and putting price pressures on raw materials and finished goods. It currently takes about 80 days to transport goods across the Pacific Ocean, which is twice as long as pre-pandemic and is creating

many problems for businesses entering the holiday shopping season. To boot, once cargo ships make it to major U.S. ports, they are often stalled there for days or even weeks. The problem is significant enough that some major U.S. retailers like Walmart, Home Depot, and Costco have resorted to chartering their own cargo ships to move goods – a very costly process.¹

As supply chain issues persist, rising energy prices are serving as a crosswind on businesses, applying cost pressures at seemingly just the wrong time. Crude oil prices are up over 60% this year, natural-gas prices have doubled over the last six months, and coal prices are at record.² For businesses that rely heavily on energy, the cost of production is moving higher.

The combination of supply constraints and rising energy costs are putting the squeeze on corporate profit margins, at least in the short-term. S&P 500 company profit margins are estimated to have fallen from 13.1% in Q2 to 12.1% in Q3.³ The risk here is that rising costs continue to pressure profit margins to the point that companies end up earning less or passing

along higher costs to consumers – or both.

Risk #2: Negative Earnings Revisions

Related to risk #1, the downstream effect is that corporations must respond to cost pressures, supply chain disruptions, and labor/material shortages by revising earnings forecasts lower. This can create uncertainty in the earnings outlook, particularly given the lack of visibility with respect to the duration of inflationary pressures.

According to analysts at Zacks Investment Research, the current earnings picture remains strong, even though the growth pace is expected to decelerate significantly from the first half's breakneck pace. What we don't know at this stage is whether the incremental change in the earnings outlook over the coming weeks, as reflected in earnings estimate revisions, will be positive or negative. This factor will be watched closely as companies start reporting earnings.

Risk #3: Disorderly Management of China's Real Estate Bubble

The downfall of the Chinese property developer, Evergrande, caused a stir in the global markets in September. Issues with China's real estate market have been known for some time. Evergrande racked up more than \$300 billion in liabilities (2% of China's GDP) and has some \$37 billion in outstanding debt due within the next year. They have already missed \$40+ million in dollar bond coupon payments due, and Chinese luxury developer Fantasia Holdings Group also missed a \$206 million bond payment just recently.

For now, it appears increasingly likely that the Chinese government will not be stepping in for a full bailout, instead of allowing international investors to take losses while overseeing an unwinding of the company. This outcome seems to be favored by global markets – it shows that

China is no longer willing to prop-up failing enterprises and is instead allowing a market-based outcome.⁴ In short, an economic 'hard landing' does not appear likely, but new twists and the possibility of a larger credit event are still possible, making this risk worth watching in the coming months.

Bottom Line for Investors

Perceived headwinds have been building in recent weeks, and I think it could result in higher levels of volatility in Q4 and beyond. In my view, however, these risks and perceived headwinds are likely to be fleeting – supply chain constraints should ease in coming months, moderating demand should take pressure off of energy prices, corporations should be able to navigate a few more months of price pressures, and China is not likely to allow a crisis to unravel. I believe any lost growth in the coming months will simply be pushed to 2022, not lost altogether.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

¹ Wall Street Journal. October 10, 2021.
https://www.wsj.com/articles/biggest-u-s-retailers-charter-private-cargo-ships-to-sail-around-port-delays-11633858380?mod=djemRTE_h

² Wall Street Journal. October 11, 2021.
https://www.wsj.com/articles/oil-price-jumps-above-80-and-natural-gas-races-higher-turbocharged-by-supply-shortages-11633943832?mod=hp_lead_pos1

³ Wall Street Journal. October 11, 2021.
https://www.wsj.com/articles/investors-watch-for-rising-costs-in-earnings-this-week-11633858202?mod=djemRTE_h

⁴ Wall Street Journal. October 4, 2021.
<https://www.wsj.com/articles/selling-off-its-property-services-wont-save-evergrande-11633349342>

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- The fall of U.S. unemployment rates
- Higher oil prices
- Risk of China contagion

The U.S. Unemployment Rate Fell, but for the Wrong Reasons

In September, the U.S. economy added a disappointing 194,000 new jobs, which was the smallest gain since December 2020. The job gains fell far short of expectations, as did the economic recovery in Q3. The Delta variant surge put a soft patch in economic activity that showed up clearly in the data. And yet, the unemployment rate in the U.S. fell from 5.2% in August to 4.8% in September. Good news, right? Not exactly. The quirk with U.S. unemployment data is that it measures people actively looking for work – if a person is on the sidelines and not looking for a job, then they are not counted in the official unemployment rate. Thus, the unemployment rate can fall when people leave the labor market, which is what we saw in September. The number of workers who cited the pandemic rose in September for the first time since January and reached 1.6 million. There are other reasons folks leave the labor force – retirement, lack of child care, or in the present moment, refusal to get vaccinated. Whatever the reason, a record number of Americans are quitting their jobs – in August, nearly 3% of the workforce (4.3 million people) left a job, which is the most since data started being collected in 2000. In some cases, workers are leaving for the aforementioned reasons. In

others, workers are leaving jobs because they are confident, they can find work, and perhaps better pay, elsewhere.¹

Oil Prices Continue to Push Higher

Oil prices have crept up to around \$80 a barrel, marking a seven-year high and a 60+% increase in 2021 alone. Natural gas and heating oil prices have also soared, and most readers have likely noticed higher prices at the pump. As ever, prices are set by supply and demand, and the current pressures on price are a result of very strong demand being met by tight supplies. As the global economy comes back online and U.S. consumers lead the charge in economic activity, manufacturers and suppliers are racing to ramp up production to meet demand, which requires energy. While we might reasonably expect energy producers to ramp up production to capitalize on higher prices, doing so takes time and may not provide immediate relief.²



Source: Federal Reserve Bank of St. Louis³

Keeping an Eye on the Risk of China Contagion

China's \$5 trillion real estate market continues to roil – home sales are stalling and crackdowns on easy lending have choked off liquidity to some of the largest property developers. The year-over-year declines in home sales are approaching 20% to 30%, figures that may arise

in the short-term as the market recalibrates. Many Chinese families have wealth tied up in homes and apartments, which can put a dent in finances and spill over into lower consumption and growth. Meanwhile, China's economy is facing another crisis as President Xi Jinping continues to press forward with market reforms that target China's private-sector businesses. Chinese stocks have been battered as the state has moved from private technology companies to the education sector, and now to state-owned banks to examine whether they have forged too strong of ties with private firms. The effort is part of Xi Jinping's move to shift China even further away from Western-style capitalism, which has been very damaging to Chinese shares.⁴

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¹ Wall Street Journal. October 8, 2021. https://www.wsj.com/articles/september-jobs-report-unemployment-rate-2021-11633641477?mod=article_inline

² Wall Street Journal. October 11, 2021. https://www.wsj.com/articles/oil-price-jumps-above-80-and-natural-gas-races-higher-turbocharged-by-supply-shortages-11633943832?mod=djemRTE_h

³ Fred Economic Data. October 5, 2021. <https://fred.stlouisfed.org/series/DCOILWTICO>

⁴ Wall Street Journal. October 12, 2021. https://www.wsj.com/articles/chinese-developers-report-sharp-drops-in-monthly-home-sales-11634037472?mod=djemRTE_h

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*This information is supplemental to GIPS and is based off the composite

**The standard deviation shown here is calculated since inception

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