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The many students who have recently returned to school can only hope for grades like the stock market has posted for most of the year. Over the past several months, the market has successfully shrugged off a number of concerns, including extended valuations, rising inflation, and a slowdown in the economic recovery caused by the Delta variant of Covid-19. The result has been an unusually steady climb higher by the market for most of the year with just a few minor blips along the way. In fact, the S&P 500 has doubled since bottoming in March of 2020 without a single 10% correction during that span. A rise in interest rates represents the latest challenge for stocks and has added some volatility to the market in recent days. The result has been the first 5% pullback in the market since just before the election last year, ending what had been the second-longest stretch without such a decline over the past 25 years and the 8th longest streak since 1930. There has also been some choppiness below the market's surface throughout the year, with bigger fluctuations among various sectors of the market that have come in and out of favor. However, the market as a whole has been pretty resilient, with the S&P 500 remaining just a handful of percentage points off its high.

Of course, it is much easier to fend off threats with a force field around you, which is essentially what the Federal Reserve's ultra-loose monetary policy has been for the market since its implementation in the early days of the pandemic. Fed actions such as slashing short-term interest rates to zero and buying back $120 billion a month of U.S. Treasuries and mortgage-backed securities have suppressed bond yields and encouraged investors to pour money into stocks. However, with the economy having made substantial progress since the rollout of these measures, the Fed is now set to begin gradually reducing (or tapering) its bond buying later this year at a pace that will allow for the end of the purchases by the middle of next year. The conclusion of the bond buying would then set the stage for the Fed to begin raising short-term rates, which it now expects to do in either the second half of 2022 or in 2023. In response to the Fed's tapering plans, the yield on the 10-year U.S. Treasury note has already started to move higher, which appears to have agitated the market a bit recently. However, with rates still at historically low levels, the market is well positioned to absorb the rise in rates as long as the increase is gradual.

Strong corporate earnings growth has also played a role in the market's climb this year. The strength in profits has eased some of the pressure caused by elevated valuations as earnings growth has handily surpassed expectations and easily exceeded even the market's strong gains. As a result, despite the market's rise, the forward P/E multiple of the S&P 500 has actually declined from a high of over 23 in August of 2020 to just over 20 today. However, corporate profit growth is now set to descend from its peak recovery rate to a more normalized level, with S&P 500 earnings growth expected to decelerate from 43% this year (peaking at 91% in the second quarter) to about 9% next year. Achieving those expectations could be made more difficult by various headwinds, including a slowdown in the economic recovery caused by the Delta variant, supply chain disruptions that are increasing costs for businesses and making it difficult for some companies to meet demand, and a winding down of the vast amount of government stimulus that has helped to boost consumption since the start of the pandemic. Another potential headwind for earnings would be a higher federal corporate tax rate next year. Though there is certainly a lot of political wrangling left to endure before a corporate tax hike

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is passed, an increase from today's rate of 21% to somewhere near the compromise figure of 25% that many analysts are expecting would likely cut about 5% off S&P 500 profits next year. While earnings growth should continue to be solid, all of these factors have increased the uncertainty of forecasts.

The market appears to be at a pivot point, with economic and corporate earnings growth about to decelerate from peak recovery levels at the same time the reversal of the pandemic stimulus programs is set to begin. It is certainly a good sign that the economy looks to be on solid enough footing for the monetary and fiscal support to be scaled back. It is also a safe bet that even with the unwinding of the monetary stimulus, the Fed will remain very accommodative by historical standards. Still, the rollback of stimulus should prove to be the biggest challenge the market has faced since the early days of the pandemic. Owning quality companies will be particularly pivotal as we head for a stretch in which the market is likely to be a bit more turbulent than it has been in a while. As such, our focus will be on owning profitable companies with ample free cash flow and strong balance sheets that should serve them and investors well in a more volatile environment.

Sincerely,

Alison

Alison Gamble, President
Gamble Jones Capital Management

P.S. Please note that our suite number has changed to #830

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