HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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We wrote three months ago about the potential for the high flying stock market to feel the force of gravity. That statement seemed unfounded until, wham bam, we hit the month of September and saw a 4.8% decline in the S&P 500. It now seems we are in for a bit of a grind during the period immediately ahead.

Market analysts often talk about the "wall of worry." That is a crowded wall at the moment: anxiety over future monetary policy; the impact of the Delta variant on economic growth; supply chain bottlenecks; the prospect of sustained inflation; problems in the Chinese economy; and Washington's political gridlock over taxing and spending policies and the national debt limit.

At Hudson Advisors, our anxiety is higher on some of these items than on others. On the positive, we think the economy will grow well despite the prolonged pandemic. We think the Federal Reserve will act carefully as it tightens monetary policy. We think Congress will extend the debt limit. That said, we are uncertain when supply bottlenecks will improve and how that situation affects inflation. We are uncertain about the impact of whatever happens with the Biden domestic agenda. We are uncertain about China's shifting regulatory policies over technology and real estate.

We share the viewpoint that the market will bump along in a narrow trading range for the rest of 2021 and into early 2022. We are not concerned about a major retreat. But we do not think the market can accelerate until some of the "worry wall" items are clarified. As always, we will manage in this climate to find the best long-term opportunities for our clients.

MARKET TRENDS

The accompanying chart summarizes stock and bond market trends for the third quarter and year-to-date 2021. Both stock and bond prices increased for most of the quarter, but then saw declines in September.

Equity Market: The equity indexes moved higher in July and August continuing the rebound that started in April 2020. The S&P 500 struck a record level of 4536.95 on September 2. Then the "worries" hit the market – topped by the Delta variant and the Fed's announcement of plans to taper bond purchases. September became the worst month since the pandemic panic of March 2020.

The Dow Jones Industrial Average fell 2.3% for the quarter, but was still ahead 11.12% for the year-to-date. The S&P 500 was ahead 0.58% for the quarter and 15.92% for the year. The Nasdaq Composite was down just 0.23% for the quarter and ahead 12.66 % for the year-to-date. The Russell 2000 index was hit the hardest with a 4.36% decline in the quarter – reducing its year-to-date gain to 12.41%.

Fixed Income Market: Bond prices fluctuated during the quarter. Much of that investor behavior reflects the same concerns about the macro issues evident in the stock market. But some of the recent sell-off may just be investor decisions to take profit. The yield on the 10-year Treasury bond (which moves inversely to prices) had ended 2020 at .931% and reached a post pandemic high of 1.749% on March 31. It then bounced around during the third quarter reaching a low of 1.173% on August 2 before settling at 1.528% on September 30.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Composite Average TR	11.12
S&P 500 Index TR	15.92
Russell 2000 Index TR	12.41
NASDAQ Composite TR	12.66
EAFE Index NR	8.35
Bloomberg Aggregate Bond Treasury TR	-2.50

Source: Morningstar® as of September 30, 2021

THE OUTLOOK

The Economy: The U.S. economic recovery is fully underway although slowed by the Delta variant. The forecast for expansion of GDP in 2021 is now 5.9% according to the Conference Board. Earlier they had forecast growth for the year at over 7%. The recovery is uneven across economic sectors with travel and entertainment effected most negatively by the prolonged effect of Covid 19. Small business is suffering from labor shortages and the disruptions in the supply chain, much of it related to problems in international shipping, are slowing some economic activity. Those disruptions have also pushed inflation above 5%.

Looking ahead, the Conference Board sees GDP growth of 3.8% in 2022 and 3.0% in 2023. This annual growth rate is much healthier than in most of the decade prior to the pandemic. The U.S. consumer is at the center of this positive outlook.

The Market: Because of the core economic strength, corporate earnings are healthy. Most companies in the S&P 500 have exceeded earnings forecast. Many companies will have annual profit growth in excess of 20% for this year compared to 2020. As the economy normalizes in 2022, those earnings are expected to be in the 10% range – which is still a good performance.

Many investors ask if the market is overvalued at the current time. Are stock prices too rich? At present, the forward price/earnings ratio for S&P 500 companies is 22.04. Because of the good corporate earnings, that number is below the high of 23.6 on August 28, 2020. Historically, the P/E ratio has been in the range of 13 to 15. So, yes, stock prices have come down somewhat in the past year, but are still quite rich.

As stated, because of the positive economic and earnings outlook, we do not expect the stock market to see a major pullback. But we do think it will be difficult for the market to move much higher in the months ahead given the rich price of stocks and all the issues causing anxiety. We think the market will be especially nervous about tightening monetary policy by the Federal Reserve. We expect the rest of 2021 to see a flat and sometimes choppy performance.

OUR STRATEGIES

Asset Allocation: Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. We will be assisting some clients to rebalance portfolios where the run-up in equities has thrown off the optimal allocation.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, similar to last quarter, we are looking at these sectors:

HEALTH CARE: This sector has interesting opportunities in biotechnology and in the variety of new treatments being developed for the aging population.

FINANCIALS: Somewhat higher interest rates may benefit the financial sector – and regional banks are appealing

INDUSTRIALS/MATERIALS: President Biden's plans for infrastructure investment, if enacted, should create opportunity for many companies in this sector.

TECHNOLOGY: We are holding but not expanding our allocation to the FANG stocks. We are interested in selective technology companies with emphasis on innovation.

ENERGY: This sector has opportunities worth exploring in traditional oil and gas industries and in the electric companies that will be modernizing their power grids.

Other Assets: Our aversion to long-term bonds remains. We like maturities under two years, floating rate funds and cash and alternative investments such as real estate investment trusts.

Dow Jones U.S. Sectors Total Return
(Percent Change for YTD, Ending September 30, 2021)
Source: Morningstar®

Oil & Gas	**50.97**	**Consumer Services**	**10.27**
Basic Materials	**13.54**	**Telecommunications**	**-2.78**
Industrials	**14.05**	**Utilities**	**6.27**
Consumer Goods	**7.77**	**Financials**	**28.04**
Health Care	**13.55**	**Technology**	**22.88**

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