Forza Investment Advisory, LLC

Strengthening Our Clients' Financial Lives

FROM THE DESK OF BOB CENTRELLA, CFA

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Well the summer has come to an end (and so have the Yankees) with the usual sadness but fall on the East Coast is always beautiful with the foliage. For sports fans we have college and pro football in full swing with hockey right around the corner. And of course baseball in October means World Series (but not for the Yankees). Personally I still have a dog in the fight as I'm also a SF Giants fan ever since I was a Willie Mays fan as a kid. Funny that being an Italian I often got in some arguments as a kid with fellow "pisans" when I would declare that the "Say Hey Kid" was the greatest centerfielder of all. Sorry Joltin Joe Dimaggio, but you were the best Italian ballplayer!

As for the markets, September brought some anxiety and an end to the stock rally which was making new highs through August. Stocks headed lower in September with the S&P 500 declining 4.7% for it's worst month since March 2020 when the pandemic began. October has started very volatile with stocks moving up or down over 1% almost every day and bond yields rising. In the 3rd quarter, the S&P eked out a .58% gain for its 6th consecutive positive quarterly gain. Looking at the chart below, Energy stocks were about the only bright spot in September with Nat Gas jumping almost 32% and Oil up 9.4%. More on that later. For the quarter, most stock indexes fell in the US with large Growth stocks performing the best with a 1.7% gain which reflected the 1.1% gain on the Nasdaq. Digital currencies Bitcoin (+13.6%) and Etherium (+27%) bounced around quite a bit before finishing higher. On the international scene, most countries declined with India +11.3%, Japan +4% and Russia +4.6% showing gains. Bonds finished the month about flat. See below:

Asset Class Performance Sept., Q3, and YTD - Total Return (%)

US Related

ETF	Description	Sept.	Q3	YTD
SPY	S&P 500	-4.66	0.58	15.91
DIA	Dow 30	-4.21	-1.49	12.04
QQQ	Nasdaq 100	-5.68	1.11	14.50
IJH	S&P Midcap 400	-4.01	-1.75	15.49
IJR	S&P Smallcap 600	-2.39	-2.92	19.92
IWB	Russell 1000	-4.60	0.18	15.12
IWM	Russell 2000	-2.88	-4.34	12.29
IWV	Russell 3000	-4.48	-0.10	14.95
IVW	S&P 500 Growth	-5.82	1.77	16.30
IJK	Midcap 400 Growth	-4.20	-2.01	10.05
IJT	Smallcap 600 Growth	-3.52	-1.68	14.47
IVE	S&P 500 Value	-3.30	-0.94	15.21
IJJ	Midcap 400 Value	-3.78	-1.66	20.87
IJS	Smallcap 600 Value	-1.46	-4.04	25.15
DVY	DJ Dividend	-2.63	-0.75	22.36
RSP	S&P 500 Equalweight	-3.79	-0.24	18.78
FXB	British Pound	-2.02	-2.72	-1.76
FXE	Euro	-2.01	-2.56	-5.90
FXY	Yen	-1.22	-0.32	-7.65
GBTC	Bitcoin Trust	-10.38	13.55	5.78
ETHE	Ethereum Trust	-13.62	27.00	83.29
XLY	Cons Disc	-2.14	0.66	12.12
XLP	Cons Stap	-4.13	-1.00	3.92
XLE	Energy	8.97	-2.09	42.03
XLF	Financials	-1.83	2.74	28.94
XLV	Health Care	-5.52	1.43	13.44
XLI	Industrials	-6.08	-4.14	11.54
XLB	Materials	-7.18	-3.46	10.70
XLK	Technology	-5.84	1.31	15.50
XLC	Comm Services	-6.27	-0.89	19.34
XLU	Utilities	-6.09	1.79	4.22

Global

ETF	Description	Sept.	Q3	YTD
EWA	Australia	-4.24	-4.46	5.08
EWZ	Brazil	-11.73	-20.74	-12.00
EWC	Canada	-2.79	-2.60	18.43
ASHR	China	0.58	-5.99	-4.87
EWQ	France	-3.70	-1.61	13.22
EWG	Germany	-5.81	-4.86	5.38
EWH	Hong Kong	-6.95	-10.25	-1.30
PIN	India	0.34	11.26	23.93
EWI	Italy	-3.95	-2.28	8.82
EWJ	Japan	2.70	4.01	4.74
EWW	Mexico	-5.58	0.56	13.14
EWP	Spain	-4.06	-5.10	1.17
RSX	Russia	3.55	4.62	25.55
EWU	UK	-2.30	-1.38	11.97
EFA	EAFE	-3.26	-1.10	8.38
EEM	Emerging Mkts	-3.87	-8.65	-2.07
IOO	Global 100	-4.74	0.21	14.08
BKF	BRIC	-3.54	-11.85	-7.40
CWI	All World ex US	-3.53	-4.07	5.87
DBC	Commodities	5.21	4.83	37.28
DBA	Agric. Commod.	-0.05	2.63	18.46
USO	Oil	9.41	5.37	59.22
UNG	Nat. Gas	31.59	54.13	119.13
GLD	Gold	-3.22	-0.85	-7.93
SLV	Silver	-7.32	-15.28	-16.48
SHY	1-3 Yr Treasuries	-0.10	0.03	-0.11
IEF	7-10 Yr Treasuries	-1.60	-0.03	-3.44
TLT	20+ Yr Treasuries	-2.91	0.36	-7.55
AGG	Aggregate Bond	-0.92	-0.01	-1.67
BND	Total Bond Market	-1.01	-0.05	-1.83
TIP	T.I.P.S.	-0.78	1.71	3.20

Continuing my comments from last quarter I'd like to talk about key takeaway points from last quarter and heading into Q4. As I mentioned above October has been volatile, continuing a trend that started in September. A **wall of worry** has formed, and investors have a lot to digest as we are amid a seasonally weak period for stocks. Historically the last 2 weeks of September and first 2 weeks of October are among the worst 2-week periods for stocks. And it looks like this year is no exception. As of today, the S&P 500 was down just over 5% from its early September high while the Nasdaq 100 reached a low of -7.6% from it's high. Which way it will go from here is up for debate. Here are some of the key issues forming the Wall of Worry and takeaway points.

1. Politicians are playing a game of chicken with the federal Debt Ceiling. The government will run out of room and default on its debt by October 18 if the debt ceiling isn't raised. Repercussions from this would be catastrophic as the credit rating of debt and the dollar's supremacy in the world would be called into question. Headline risk will make for potential market declines and volatility, **but as of today it looks like a deal has been reached to kick the can down the road into December and raise the ceiling**. The biggest issues on the table include the massive $3.5 trillion (+ $1.5 trillion approved) democrat spending bill, a new tax scheme to pay for it, and funding the government which runs out in December. Without getting into a drawn-out discussion, I see little need for such a mortgage of our future with a combined $5 trillion of new spending and taxes. Increasing taxes to pay for social programs is not needed in this capitalist's opinion, especially now as the economy is recovering on its own. Inflation would be a significant risk, which brings me to…
2. Risk of a more permanent rise in inflation. Inflation rates around the world are on the rise fueled by high energy prices, supply chain disruptions, and excess demand due to central bank easy monetary policy and government fiscal giveaways. And it is not just the US. Consumer prices in the EU are rising the fastest in 13 years. Inflation would eat into company profit margins causing lower earnings and weak equity prices. It also would cause higher wages as consumers would demand more money to pay for rising prices. *My take: Although I still think inflation is transitory, the risk is ratcheting up of being more than transitory. Supply-chain disruptions may last a year and any big fiscal spending plans could also up the risk.*
3. Natural gas prices are surging, and oil prices are at levels not seen since 2018. An increase in demand for oil & gas coupled with less supply due to lower production especially here in the US is causing high energy prices which also could hurt profits and consumer pockets. OPEC is balking on producing more as they worry about oversupply and a price drop. Gasoline prices are up $1.00 per gallon from a year ago. Meanwhile we are getting doublespeak from the US as the President is calling for foreign producers to crank up supply while pushing climate change and less fossil fuels here. Oil execs have no incentive to produce more as there is no guarantee that demand will continue if coronavirus cases increase again.
4. Bond yields are on the rise. The yield on the 10-yr UST has risen over the past few weeks to above 1.5% from around 1.3% as the Federal Reserve announced they would begin tapering bond purchases in November and conclude in 2022. The speed of tapering is a question mark as a faster tapering could cause a jump in yields. Also, it is looking more likely the Fed could raise interest rates in late 2022. Historically yields rise when the economy is strengthening. However, this drop in prices and rise in yields may be more due to correcting artificially propped up prices from Fed buying. All else being equal, higher yields can be interpreted as lifting corporate borrowing costs and reducing the value of future earnings. *My view is that somewhat higher*

yields will eventually be digested by investors as a 10-yr yield of even 2% is still relatively low based on history. But the digestion period will cause market volatility in the short term.

5. <u>Covid is still here as are the variants, it remains a risk</u>. Drug companies have produced vaccines and are now coming out with treatments, such as the recent announcement from Merck about its new drug to treat symptoms rather than being a vaccination. As we enter the cold season, we will have to see if covid spikes again as consumers are forced inside more often at restaurants, concerts and other events. *We will need to live with covid in our lifetimes and adjust to new realities.*
6. <u>China property giant Evergrande is at risk of defaulting on over several hundred BILLION of debt and payables</u>. The risk of a contagion has investors worried. There is a big unknown as to what the Chinese government will do. Although exposure is mostly limited to China banks, investors, consumers, suppliers, etc., contagion risk potential is out there. It's a huge amount of money. An amazing stat is that the floor space under construction is equal to 513 empire state buildings. Hope is that the China government takes some responsibility and limits the fallout. Do we trust the Chinese government???
7. <u>Corporate earnings gains peaked last quarter</u>. We are entering the beginning of 3rd quarter earnings season. Earnings are forecasted to grow 27.6% for the S&P 500 in the quarter, an excellent growth rate by all accounts. However, it is well below the 90% increase in Q2 where earnings gains peaked. Q4 is forecasting a 21.5% gain and then slowing to 5% in Q1-22. So, on the margin, earnings are slowing on a quarterly basis and will normalize in 2022. *My take: OK earnings are slowing as we are lapping the covid shutdowns, which is only natural. The key is that they resume growth in 2022 and at what level. As of now analysts are looking for 9.6% growth in 2022 which would be a nice gain and could support further market moves higher.*
8. <u>The economy is slowing, and dollar strength is not helping</u>. As US yields have risen and the economy is growing faster than around the developing world, the dollar has strengthened. A strong dollar is not good for US companies operating overseas as it makes their goods more expensive. Q2 GDP growth came in at 6.7% and estimates are around 5.5% for Q3. Both inflation and shortages could lower Q3 further and the strong dollar could start nipping at profits. Job growth is still key and with many "free money" programs ending in September, hopefully companies can start filling vacancies and supply chain issues can start lessening. The government needs to step back and let the free-market economy be free.
9. <u>International economies are mixed</u>. The rest of the world is seeing similar rising energy costs, covid uncertainty, and supply-chain disruptions leading to shortages. The UK is having fuel and goods shortages while Germany is seeing shortages as well. Germany also has a new government which could be a left-leaning party in charge. China's government is imposing many restrictions on companies and also has the previously mentioned Evergrande problem. Russia appears to be exerting its power over Europe on energy prices, especially gas prices which have gone through the roof. The international house is big and has issues that we need to consider in making investment decisions.

WRAP-UP & OUTLOOK

Although there are more worry items out there, the aforementioned issues are at the top of investor's lists. You might think I am becoming bearish given the number of issues. Not so. At any point in time there is a wall of worry, sometimes higher than others. Given the big runup in stocks since the depths of the pandemic, it is not unusual that we have a higher wall of worry now, and we are also in the middle of a seasonally weak period for stocks. Q3 earnings results and corporate outlooks will be key as usual and could lead us out of the malaise.

Since Midyear, I've been less bullish due to valuations of big stocks. In my last letter I mentioned that I was looking for a pullback late in Q3 but that I thought it would be shallow and a buying opportunity in time. That started in September and is continuing in October with some volatility. Although the overall market has only declined 5-7%, many individual stocks have declined 20% or more from highs. Stock valuations are better and even the S&P 500 is slightly cheaper at 20x forward earnings than it was in the beginning of the year. I'm looking to selectively buy stocks here and be more fully invested into November and year-end. There are finally opportunities out there and there is some debate whether to buy Growth or Cyclical stocks given the potential for rising rates. Bond yields may continue to move higher, and you could see the 10-year UST in a 1.6% to 2.0% range by year-end. So, I continue to favor stocks over bonds, and I still like the barbell approach of owning both Value and Growth stocks. I always say, a stock doesn't know if it's value or growth. That is just a tag that is put on them. Just own good companies and the rest will take care of itself. I would look to own some bonds at higher yields for balanced accounts but for now I prefer convertibles, floating-rate and variable preferred securities along with high yield bonds. I still favor US equities over international but do want some exposure for diversification.

I'd stay away from emerging markets if rates go higher. I also like midcap and small cap stocks into year end, especially those concentrated in the US. So overall, I'm still optimistic for Q4 but it will be a bit bumpy as we get through the wall of worry. I can see nice gains ahead when stocks bottom, and think we are close to a bottoming. Many things can change the outlook, especially a spike in Covid or political shenanigans. But overall, I look for a year-end rally.

Have a great fall and winter. I hope to touch base with you in coming months. As always, feel free to call or email me anytime for discussion.

Bob