First Trust

Quarterly Market Overview

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We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

Equity investors can boost their exposure to economically sensitive and cyclical sectors via small-cap stocks

First things first. Let's acknowledge the fact that history suggests the U.S. stock market could be due for a correction. Since 1950, on average, the S&P 500 Index has sold off by 10% or more a total of 38 times, or about once every 1.84 years (as of October 2020), according to The Motley Fool. In nine of those instances the market declined by more than 20%, which qualifies as a bear market. On average, a bear market occurs about every 7.78 years. A correction is defined as a price decline of 10.00% to 19.99% from the most recent peak in a stock or equity index. Since the last major decline in the S&P 500 Index was a 33.93% price-only plunge from 2/19/20 through 3/23/20, it would not be a shock if the market endured another correction by year-end. The S&P 500 Index closed trading at 4,307.54 on 9/30/21. That was 5.06% below its all-time high set on 9/2/21, according to data from Bloomberg. That is halfway to a correction.

Now let's flip the script and talk about what might inspire investors to take this market higher. We could use a catalyst or two, in our opinion. The most obvious would be to turn the corner on the COVID-19 pandemic and fully reopen the U.S economy, including getting the unemployed back to work. That, in turn, would likely motivate the Federal Reserve ("Fed") to begin tapering its $120 billion ($80 billion in Treasuries and $40 billion in mortgage-backed securities) monthly bond buying program designed to keep bond yields artificially low. While the Fed has already commented that it might begin to taper soon, September's nonfarm payroll was very disappointing to some, coming in at 194,000 jobs, well below the 500,000 consensus estimate from economists polled by Bloomberg. Once the Fed begins to taper, we believe that intermediate and long maturity bond yields could trend higher. That could provide a boost to economically sensitive and cyclical stocks, like Financials, in our opinion.

While it is not a sure thing at this point, a second catalyst for the stock market could be the passage of the bipartisan infrastructure bill and the Build Back Better Act. Ideally, the Democrats would like to pass them one after the other. While the $1.2 trillion infrastructure bill appears to be more palatable, hence the bipartisan label, than the current $3.5 trillion Build Back Better Act, which is likely to be trimmed markedly in order to secure enough votes to pass it, only time will tell. Senator Joe Manchin, who represents a swing vote, has made it known he is in favor of more modest tax hikes to fund it. We concur. The current self-imposed deadline from the Democrats for voting on these bills is 10/31/21.

There could be other catalyst candidates that emerge, such as a weaker U.S. dollar, but the two mentioned above seem front and center in the current climate. With respect to our take on economically sensitive and cyclical sectors, their combined universe includes eight of the 11 sectors that comprise the major equity indices at S&P. The three that do not qualify are Consumer Staples, Health Care and Utilities, which are defensive in nature. Of the remaining eight sectors, the four classified as cyclicals are Consumer Discretionary, Financials, Materials and Real Estate, according to Morningstar. Communication Services, Energy, Industrials and Information Technology are classified as economically sensitive.

Select S&P Equity Index Sector Weightings (9/30/21)
(Mega-Cap, Large-Cap & Small-Cap Exposure To Cyclicals)

Sectors	S&P 100	S&P 500	S&P SmallCap 600
Communication Services	15.5%	11.3%	1.7%
Consumer Discretionary	13.9%	12.4%	13.5%
Consumer Staples	6.5%	5.8%	4.3%
Energy	2.2%	2.7%	5.0%
Financials	9.9%	11.4%	18.6%
Health Care	11.9%	13.3%	12.2%
Industrials	5.0%	8.0%	16.7%
Information Technology	32.1%	27.6%	13.2%
Materials	0.9%	2.5%	5.1%
Real Estate	0.7%	2.6%	8.0%
Utilities	1.4%	2.5%	1.7%

Source: S&P Dow Jones Indices

We have highlighted (blue shading) five of the sectors in the table above to show the disparities between their respective weightings in the S&P 100 Index (Mega-Caps), S&P 500 Index (Large-Caps) and the S&P SmallCap 600 Index. These five sectors are either cyclical or economically sensitive in nature. As we noted earlier, should bond yields rise moving forward, either due to rising inflation, tapering, a boost to the economy from the two bills in Congress or perhaps all of the above, these are some key sectors poised to benefit, in our opinion. Their weightings in the S&P SmallCap 600 Index suggests investors might garner more exposure to these sectors simply by diversifying into the small company space.

The one thing we do know, based on statistics, is that investors are likely underweight small-capitalization (cap) stocks. As recently as July 2021, U.S.-based large-cap mutual fund and exchange-traded fund (ETF) assets totaled $10.16 trillion, compared to $1.13 trillion for their small-cap counterparts, according to data from Morningstar.

While small-cap stocks are inherently more risky than large-caps, they have generated higher returns over a long time horizon. From 1926 through 2020 (95 years), the average annual total return on the Ibbotson® Small Company Stock Index was 11.86%, compared to 10.28% for the S&P 500 Index, according to data from Morningstar/Ibbotson Associates. How about something a little more recent? From 12/30/94 through 9/30/21, which captures the internet revolution and three bear markets, the S&P SmallCap 600 Index posted an average annualized total return of 11.63%, compared to 10.81% for the S&P 500 Index, in line with the averages since 1926, according to data from Bloomberg. Looking ahead, consider putting small-cap stocks on your radar screen, continue to monitor the yield on the 10-Year Treasury Note to see if it trends higher and keep an eye on Congress to see if it can pass the two massive spending bills. And let's reopen this economy.

Sizing up interest rates, bond yields, inflation and the credit markets

While interest rates and bond yields remain at or near their historical lows, inflation spiked from 1.4% on a trailing 12-month basis in January 2021 to 5.4% in September 2021, according to the Consumer Price Index (CPI). The last time the CPI stood at 5.4% was in August 2008, according to Bloomberg. The Fed has stated that it does not intend to hike short-term rates (federal funds target rate) until 2023. As we noted on page one, it has stated that it may begin to taper its monthly bond buying program by year-end. The table to the right shows that the current real rate of return (yield minus inflation rate) on the benchmark 10-year Treasury Note (T-note) was -3.9% at end of September. That is incredibly unattractive. For comparative purposes, for the 50-year period ended 9/30/21, the average real rate of return was 2.2%, according to data from Bloomberg. As indicated in the table, we have not seen a real rate close to that historical average since 2008. The notion that higher inflation will be transitory, or temporary, is losing credibility with each passing month, in our opinion.

The climate is even worse for savers than high-grade bondholders in the U.S. Currently, the average savings account pays 0.06% interest annually, according to Vox. That amounts to $6 of interest for every $10,000 a saver has deposited. Despite the paltry payout, the personal saving rate in 2020 was the highest it has been in the 62 years it has been tracked by the government. It remains elevated today. That signals a risk-off mentality for many, and that presents a potential dilemma moving forward. What happens if higher inflation levels do not abate? The purchasing power of dollars held in savings vehicles will erode.

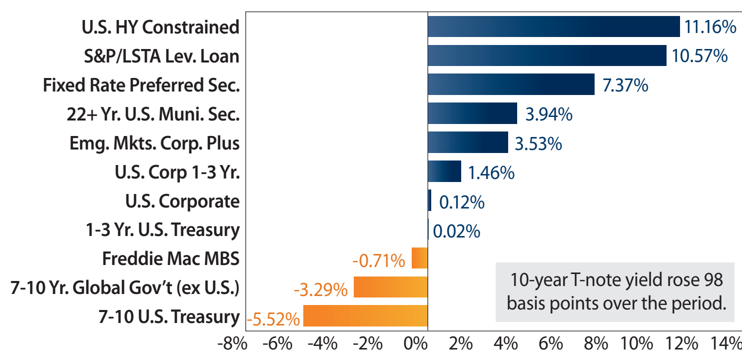
The challenging climate for generating current income in recent years is a byproduct of the Fed's overly accommodating/easy bias towards monetary policy since the end of 2008. The Fed's approach to monetary policy has been a signal to savers and investors to assume more risk (risk-on). The Fed, in its own way, has been disincentivizing savings by keeping short-term rates artificially low. The chart to the right shows how the major bond categories have performed since the yield on the 10-year T-note set its all-time low of 0.51% on 8/4/20. The categories with the highest risk have performed the best.

Historical Real Rates Of Return On 10-Yr. Treasury Note (T-Note)

Year	10-Yr. T-Note (Year-End & 9/30/21)	CPI YoY (Year-End & 9/30/21)	Real Rate (Yield-CPI)
As of 9/30/21	1.5%	5.4%	-3.9%
2020	0.9%	1.4%	-0.5%
2019	1.9%	2.3%	-0.4%
2018	2.7%	1.9%	0.8%
2017	2.4%	2.1%	0.3%
2016	2.5%	2.1%	0.4%
2015	2.3%	0.7%	1.6%
2014	2.2%	0.8%	1.4%
2013	3.0%	1.5%	1.5%
2012	1.8%	1.7%	0.1%
2011	1.9%	3.0%	-1.1%
2010	3.3%	1.5%	1.8%
2009	3.8%	2.7%	1.1%
2008	2.2%	0.1%	2.1%

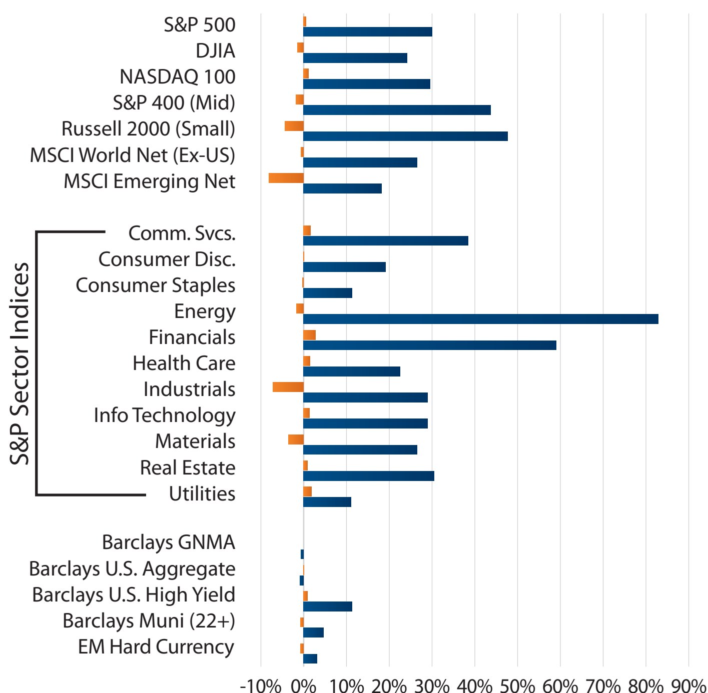
Source: Bloomberg. **Past performance is no guarantee of future results.** *10-Yr. T-Note yields are rounded. CPI rates are measured year-over-year (YoY) and are not seasonally adjusted.*

Bond Index Total Returns (8/4/20-9/30/21)



Source: Bloomberg. **Past performance is no guarantee of future results.** *Index returns reflect the performance of ICE BofA Indices except for the S&P/LSTA Leveraged Loan Index.*

Total returns for Q3 and past 12 months (9/30/21)



Sources: Bloomberg and Barclays. ***Past performance is no guarantee of future results.***

A Look Ahead:

A year-over-year earnings comparison in U.S. dollar terms (per share). The S&P 500 Index dollar figures reflect the 11 major sectors on a weighted-adjusted basis.

Index (Weighting In S&P 500)	**Q4'21E**	Q4'20A	**Q1'22E**	Q1'21A	**2021E**	2020A
Communication Svcs. (11.3%)	**3.06**	2.03	**3.08**	3.10	**12.09**	7.26
Consumer Disc. (12.4%)	**9.86**	8.72	**11.26**	10.29	**40.99**	28.29
Consumer Staples (5.8%)	**8.52**	7.42	**8.57**	7.85	**34.22**	32.05
Energy (2.7%)	**7.51**	-8.53	**7.34**	3.32	**24.23**	-27.58
Financials (11.4%)	**10.31**	14.39	**10.70**	14.80	**50.97**	32.66
Health Care (13.3%)	**21.28**	13.66	**23.32**	18.69	**80.05**	57.93
Industrials (8.0%)	**9.33**	3.02	**9.35**	5.77	**32.59**	13.59
Information Tech. (27.6%)	**27.40**	22.79	**24.54**	21.07	**93.96**	67.79
Materials (2.5%)	**8.27**	5.13	**8.04**	5.84	**31.40**	15.86
Real Estate (2.6%)	**1.36**	1.50	**1.35**	1.49	**6.27**	5.28
Utilities (2.5%)	**3.25**	3.52	**4.56**	4.63	**16.15**	15.60
S&P 500 Index	**50.43**	38.18	**51.15**	47.41	**198.12**	122.37
S&P 400 Index (Mid-Cap)	**39.98**	28.79	**39.31**	32.91	**147.68**	74.17
S&P 600 Index (Small-Cap)	**20.57**	13.11	**19.60**	14.61	**70.08**	-3.99

Source: S&P Dow Jones Indices (9/29/21). Sector weightings as of 9/30/21.
There is no guarantee past trends will continue or projections will be realized.

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