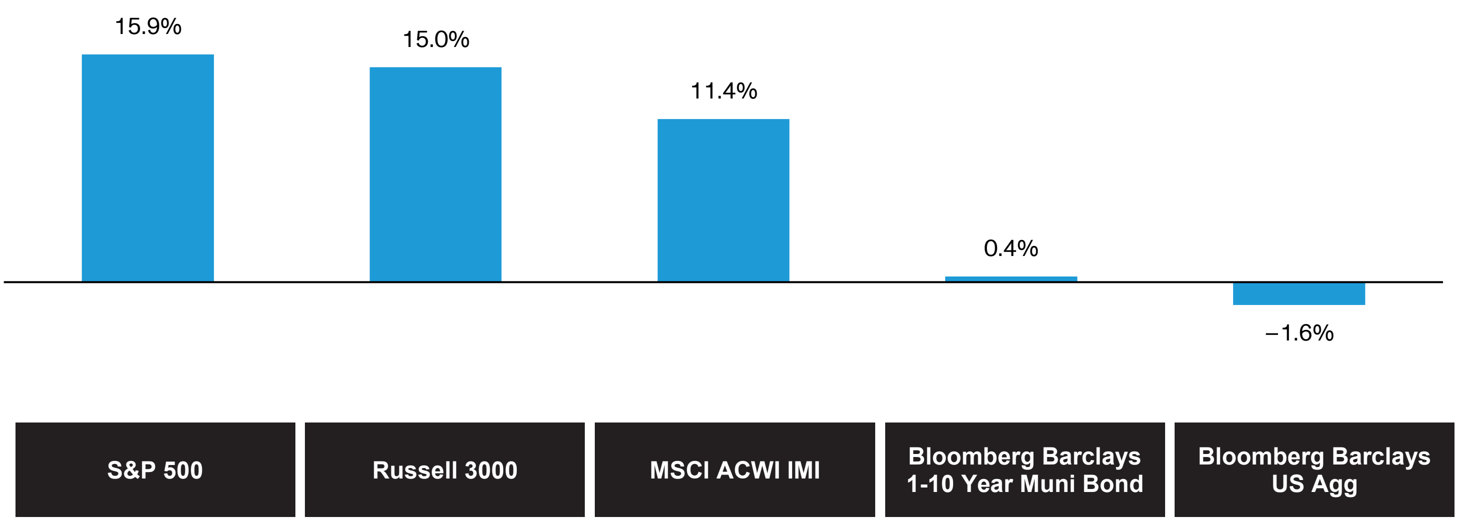
Standing By… But Not on the Sidelines!

The whirlwind of 2021 continues to fly by, with the third quarter now in the books. Overall, post-COVID economic expansion has continued, but with some headwinds. Through September 30, 2021 US large cap stocks returned 15.9%, US stocks across all market caps 15.0%, global stocks 11.4%, municipal bonds 0.4%, and global bonds -1.6% (**Display 1**).

DISPLAY 1: ASSET CLASS RETURNS YTD



Past performance does not guarantee future results. The unmanaged S&P 500 Index comprises 500 large-capitalization US stocks and is a common measure of the performance of the US stock market. The Russell 3000 is a capitalization-weighted index tracking 3,000 US companies of all sizes and seeking to measure the returns of the broad US stock market. The MSCI All-Country World Index (ACWI) is a market-capitalization-weighted index designed to provide a broad measure of equity market performance throughout the world. The Bloomberg Barclays 1-10 Year Municipal Blend Index is a market value-weighted index that covers the short and intermediate components of the Barclays Municipal Bond Index—an unmanaged, market value-weighted index which covers the U.S. investment-grade tax-exempt bond market. The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.
Source: Bloomberg and Bernstein analysis

Throughout the quarter, four key themes played out: the Delta wave, inflation, tapering, and concerning headlines from China, where the unease shifted from too much—to not enough—government intervention. Yet rather than focus on where we've been, we're focused on where we're going. As we look ahead, some of those themes remain in focus, joined by others coming over the horizon:

- We continue to monitor and evaluate the threat from the Delta wave and other variants.
- Inflation data has come in hot over the past few months, although we're seeing early signs of cooling. We can envision a path where those pressures continue easing in the coming quarters. But we also acknowledge a higher-than-normal risk of elevated inflation emerging several years from now—it would behoove inflation-sensitive investors to prepare for that prospect today.
- We're keenly focused on the trajectory of corporate earnings, which have driven the rally to date, but may find it tougher to beat expectations moving forward.
- The Fed's upcoming decision to taper its bond purchases casts our eyes toward interest rates and their impact on portfolios.
- Tax changes may be in the offing and we consider what steps investors may need to take in response.

Monitored During the Quarter		Monitoring by the End of the Quarter
Delta variant	→	Delta declining, but what about Mu?
Inflation…bear with it	→	Inflation…signs of turning point?
Taper…but when?	→	Tapering in November
Chinese government intervention		Interest rates starting to move
		Corporate earnings

COVID STILL A FORCE

We came into the quarter imagining the day when COVID would no longer be part of our market dashboard. Unfortunately, the virus reared its head yet again, with the Delta variant spreading rapidly around the world. While vaccines and acquired immunity allowed us to avoid shutdowns, the wave has still been severe, filling hospitals, upending return-to-office plans across the country, and coloring many people's desire to engage with the economy (and the workplace, see *The Big Picture*). Nonetheless, life has continued to normalize and the growth backdrop has remained strong, despite headwinds and well-publicized supply constraints—some driven by COVID-related shutdowns in Asian manufacturing hubs.

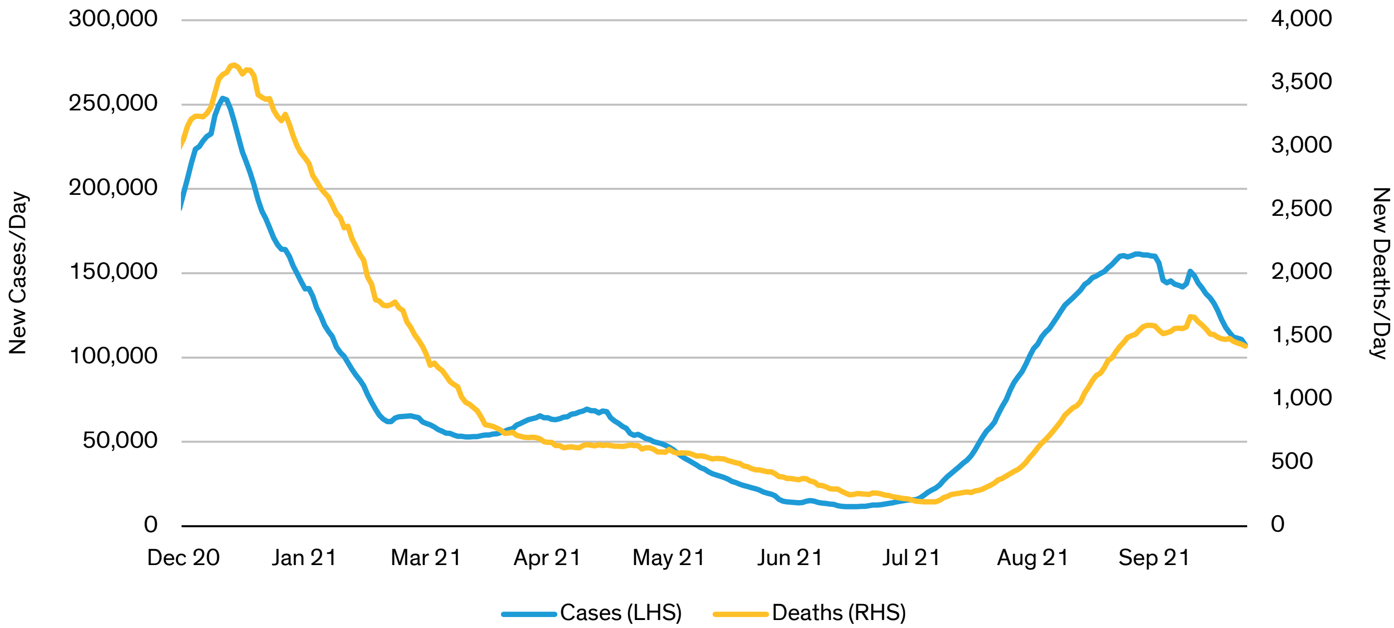
Looking ahead, it appears that the Delta wave recently crested in the US. Yet risks remain—the more that the coronavirus can reproduce, the more opportunity it has to mutate. Our eyes are now on Mu, which the WHO has labeled a "variant of interest." We hope that vaccinations and acquired immunity will dampen the spread and forestall future variants, but the pandemic could continue to create headwinds, especially as the northern hemisphere enters the flu season. Even with potential challenges, our base case looking into 2022 calls for economic growth to remain well above trend. We also hope that the "emergency mindset" of the last 18 months shifts to an acceptance of COVID as an everyday risk, managed with booster shots like other infectious diseases (**Display 2, next page**).

INFLATION PRESSURES IN FOCUS

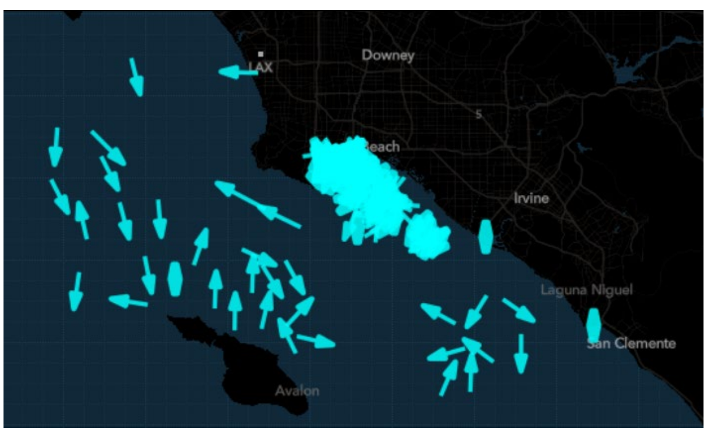
The downside of all the growth we're seeing is a rash of price increases driven by extreme supply constraints. We're focused on three dislocations in particular—semiconductors (computer chips), supply chains, and labor—as well as inflation expectations, the magic fairy dust of inflation. Semiconductors, which are integral to everything from computers to cars, have been in short supply amid the economy's rebound. After initially cancelling orders in the early stages of the pandemic, manufacturers rapidly reordered chips, anticipating a surge in the demand for goods. But supply hasn't been able to catch up, a situation exacerbated by periodic production and shipping shutdowns due to COVID. While we think we've reached peaks in some areas, like PCs, shortages in sectors like autos will likely take longer to work through. Fortunately, we do see early indications that chip supplies are turning the corner.

Viewed more broadly, the global supply chain chaos has been hard to miss. You can see it in the wait times for products ordered online, the record 73 ships waiting to dock the other week in California's ports, or in the more-than-doubling of shipping costs as measured by the Baltic Dry Index. Unfortunately, shipping shocks continue to arise—a single infected worker shut down one-quarter of the capacity at China's second-busiest port for two weeks in August. It will take time to recalibrate the world's containers and ships, and each COVID flareup comes with a cost.

DISPLAY 2: COVID CASES ARE TRENDING DOWN AS DELTA PASSES



Source: CDC and Bernstein analysis



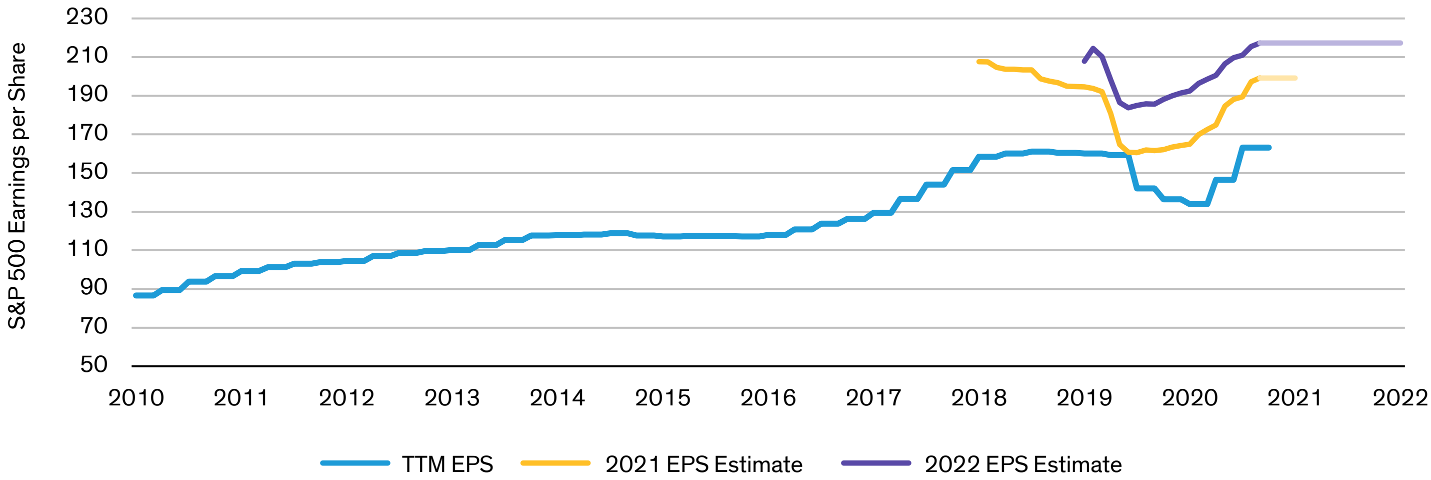
Source: Bloomberg

We also have our eyes on wage pressures and the slow pace at which workers are resuming labor force participation. We believe this stems from a combination of enhanced unemployment benefits, a lack of childcare options, and ongoing health concerns about returning to work. With enhanced benefits ending, children returning to in-person schooling, and the Delta wave peaking, headwinds should ease. But we're keenly interested in how the labor force is changing and how it will look in the future relative to today (see *The Big Picture*).

The outlook for all these drivers is set to improve in the coming quarters. That leads us to believe that this bout of inflation is transitory—while prices have climbed rapidly year over year, we believe it will be much harder for them to rise to the same extent in 2022. Plus, the fact that the market's long-term inflation expectations remain well-anchored near the Fed's 2% target strengthens our conviction that inflation is unlikely to spiral from here.

That said, investors should consider how sensitive they are to inflation. Over the longer term, we believe a path could emerge for inflation to track higher than it has in recent decades. Our Investment Strategy team's research has shown that for those who are sensitive to inflation, adding inflation protection to a portfolio may substantially improve expected performance. Our analysis shows that the best hedge consists of a combination of stocks with pricing power, inflation-linked bonds or inflation swap agreements, as well as real assets like commodity futures and real estate. For investors who can invest in private markets, that exposure can also add value. How do you know if you're inflation-sensitive? Start here, and consider speaking with your financial advisor to explore the matter in depth.

DISPLAY 3: EARNINGS GROWTH HAS UNDERPINNED THE RECOVERY



Source: FactSet and Bernstein analysis

WILL EARNINGS CONTINUE TO BEAT?

The earnings outlook also remains crucial. Most of the post-COVID rally has been driven by rapidly rebounding earnings. The question now is the pace at which those earnings continue to grow and whether there's still room for investors' expectations to rise. 2021 earnings estimates appear to be near a peak. And our bottom-up work suggests further caution about the pace of earnings growth in 2022. Yet, if our forecasts for economic growth and inflation prove correct, there could be further upside to earnings estimates. Against this is the potential for countervailing winds, particularly from a corporate tax hike. Overall, we remain optimistic on the market and believe that there are meaningful opportunities for active managers to outperform the index. We're also heartened that year-to-date in 2021, while less than half of active managers are outperforming US and global equity indices, a large number of our managers are beating their benchmarks across our equities, fixed income, and multi-asset strategies.

One concern for stocks and other assets is the prospect of higher interest rates. The Fed has indicated it will taper its bond purchases from late 2021 into mid-2022. The clock is also ticking on its first rate hike. But we're not worried about tapering. Despite the rocket-like move in yields earlier this year, bonds have digested the news relatively smoothly. We do believe rates will rise from here, but the pace will depend on a host of factors, including recovery and inflation—not just in the US but around the world.

Finally, our Wealth Strategies team is closely monitoring the proceedings in DC as tax law changes work their way through the Hill. While the final outcome of any proposal remains uncertain, it's clear that future tax laws are unlikely to be more favorable than they are today. As we detail here, we believe investors who have postponed implementing lifetime wealth transfer strategies should begin to execute them as soon as possible.

Beata Kirr

Alex Chaloff

Beata Kirr and Alex Chaloff are co-heads of the Investment Strategy team at Bernstein, a group of senior investment professionals who develop our investment advice and are responsible for investment outcomes. The team oversees Bernstein's investment offerings, ensuring that our asset allocation advice, suite of strategies, and development of new investment ideas is continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Both Alex and Beata have spent their Bernstein careers refining our investment platform, listening to clients, and conducting deep research into investment topics that are critical to achieving clients' goals.

The Big Picture *aims to pull back the lens and reflect on some personal big-picture observations.*

Where Did the Workers Go?

Beata: *"The labor force is changing. Much has been written about the challenge of attracting workers over the last year. While employment participation is improving, there were still 5.5 million fewer people employed at the end of August than pre-pandemic. Stimulus checks may have played a role earlier in the recovery, yet even as different states have curtailed them, workers haven't materialized.*

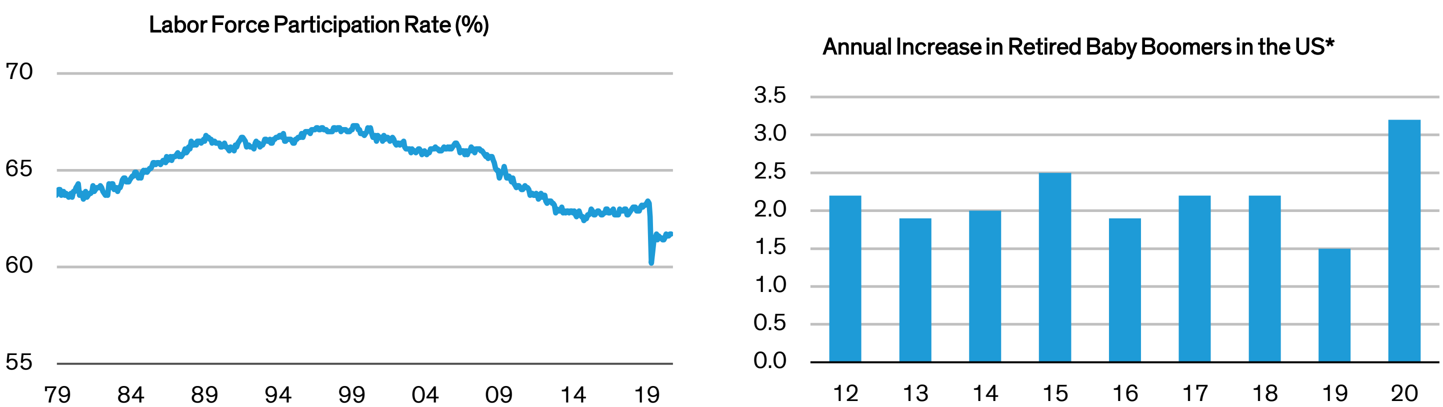
We believe that there are larger forces at work, and I wonder what this will mean for current and future employment trends and our experience as consumers.

If you've travelled recently, you've likely noticed a serious mobility crunch. I waited over an hour for an Uber home in August from a location that normally takes five minutes. You've probably had similar experiences dining at a restaurant, and it's leading to emotional outbursts—on both sides of the counter.

Will the workers eventually come back? Or will secular forces like the one below make us more self-sufficient than ever, while sacrificing more of that human connection? Will "just walk out" digitalization and self-checkouts deepen society's tech addiction and isolation? What summer jobs will remain for teens and young adults to learn soft skills? How much automation is too much? The questions quickly spiral, echoing Alex's from last quarter.

The employment picture is changing rapidly. Time will tell whether wage increases will prove sufficient to lure workers back. My guess is not all of them—and how we manage those consequences will affect society for decades."

DISPLAY 4: LABOR FORCE PARTICIPATION HAS FALLEN FOR DECADES



*Data estimated.

Source: Haver Analytics, Bloomberg, Pew Research Center analysis of IPUMS data, and Bernstein analysis.

Where Have All the Inflation Managers Gone?

Alex: *"Across Wall Street, the current generation of portfolio managers has navigated a pandemic, a global financial crisis, and a dot-com bubble, along with other upheavals. But with few exceptions, nobody managing money today was investing during the last real inflation spike.*

That means everyone is operating from variations of the same historical playbook, looking at what's worked in the past without knowing what it feels like to manage through an inflation spike firsthand. I'm happy to admit I wasn't co-heading investment strategies at Bernstein in the 1970s. But acknowledging that—and working hard to uncover the biases of our peers at other firms—is an important part of what the Bernstein investment strategy team does today.

Does the absence of grizzled veterans create a risk in itself? If the entire asset management industry works off the same theoretical model, that means groupthink like we've never seen before. Going forward, will everyone crowd into the same trades, creating new risks? While we hope never to experience the 1970s again, it remains a threat—and with the odds tilted toward higher inflation over the next decade than in the past decade, we have to write our own playbook, not use the old one. I hope others follow the same strategy."

BER-1901-1021
Bernstein.com