Third Quarter 2021

As I write this just a couple of days before the end of the month/quarter, stock markets have taken what could best be described as a "pause" in September, moving sideways to slightly lower. This is certainly a change from what has felt like a steady rise in stock markets around the world since mid-2020 just after Covid struck. While we continue to have a positive long-term outlook for the markets at this time, we are not surprised by the pause that we have seen over the last month and would not be surprised if we experienced some additional declines in the markets in the weeks/months ahead. Markets have never gone up in a straight line without some volatility along the way. Over the last forty years, stock markets have experienced a decline of at least 5% an average of 4-5 times per year. In 2020, we had twelve such declines but in 2021 have had *zero*.

It is often said that stock markets "climb a wall of worry" and now is no different. Some are worried that the market is simply too high. Others worry about inflation rising to a point of being harmful to the economy. Covid and the Delta variant are certainly a concern for some. Your team at Legacy is mindful of all these factors and is monitoring them closely. Our current view is that companies will continue to grow their earnings as the current Covid threats subside and the economy continues to reopen. Inflation will be higher for a period of time but is likely to come back down to manageable levels. As we expect companies and the economy to continue to do well, we expect the market to rise, albeit at a slower pace than we have seen over the last 12-15 months.

One of the worries in the "wall of worries" the market faces today is the drama unfolding in Washington around the debt ceiling and the government's ability to pay its bills. The discussions around the debt ceiling are making the news regularly and will continue to do so for the next several weeks. In the article below, James Liu from Clearnomics presents a good discussion of how this issue has impacted stock and bond markets in the past. James points out that markets often react in unexpected (even irrational) ways as seen in the bond market's positive performance in the face of a debt rating downgrade in 2011. And yes, the stock market reacted negatively in 2011, but that negative reaction was short lived. James' conclusion, and ours, is that it is best to maintain a long-term perspective on the economy and markets and avoid short-term decision making that could negatively impact your long-term goals.

The following article and charts are from James Liu at Clearnomics.

Partisan drama is once again center stage as the debt ceiling deadline approaches. Although this has become a regular occurrence in Washington, many investors are still understandably nervous. While it's unclear how this will play out over the coming weeks, especially as ongoing debates over $4.5 trillion in new spending proposals continue, the fortunate news is that financial markets are taking these events in stride. History shows that investors who are able to stay focused through periods of political and fiscal uncertainty are better positioned to achieve their financial goals.

Regardless of how the current episode is resolved, this is unlikely to be the last debt ceiling debate. The debt ceiling was intended to be a way for Congress to revisit the size of the national debt periodically. By limiting the ability of the Treasury to borrow new funds, politicians are forced to acknowledge and address the level of the federal deficit by voting to raise it.

However, this also prevents the government from paying its bills. Thus, the real problem is simple: the spending that causes the government to reach the debt limit has already been approved via the budget. This is akin to signing the papers for a new luxury car then requesting an increase to your credit card limit when you receive the bill. For most of us, the decision to buy something can't be separated from whether and how we will pay for it.

It's important for investors to distinguish between their political feelings on government spending and how they manage their portfolios. Given that this is how the system works, what matters to long-term investors is whether a game of fiscal chicken will spill over into financial markets - even if the government does not default on its debt.

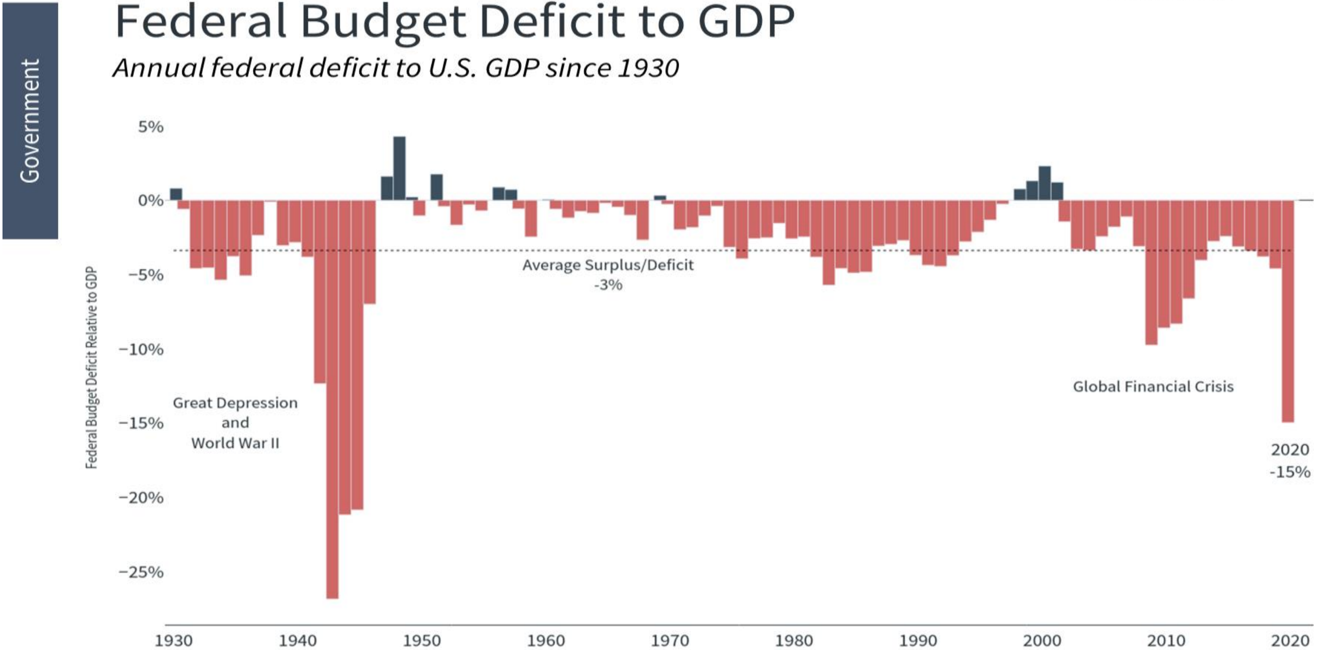
This is what occurred in 2011 when a political standoff around the debt limit led Standard & Poor's, a credit rating agency, to issue a warning and then to subsequently downgrade the U.S. debt. Over this period, the stock market fell into correction territory with the S&P 500 declining 19%. Ironically, the prices of Treasury securities increased during this period. Even though these were the exact securities being downgraded, investors still believed they were the safest in the world at a time of heightened uncertainty. Thus, they helped to balance portfolios even in extraordinary times.

Ten years later, this is still held as the worst-case scenario for problems in Washington affecting markets. As unfortunate as this period of brinksmanship was, markets eventually recovered, as they tend to do. The S&P 500 returned to its all-time high about four months later, despite on-going challenges related to the global financial crisis and eurozone debt crisis. Debt ceiling debates since then have resulted in much less market volatility despite anxiety and headlines.

Thus, while investors can't control what happens in Washington, they can control how they react to headlines as they manage their portfolios. Political events, more often than not, serve only as distractions when managing toward financial goals. Even when they do result in market volatility, stocks have tended to recover quickly. Below are three charts that help provide perspective on current debt ceiling and fiscal challenges.

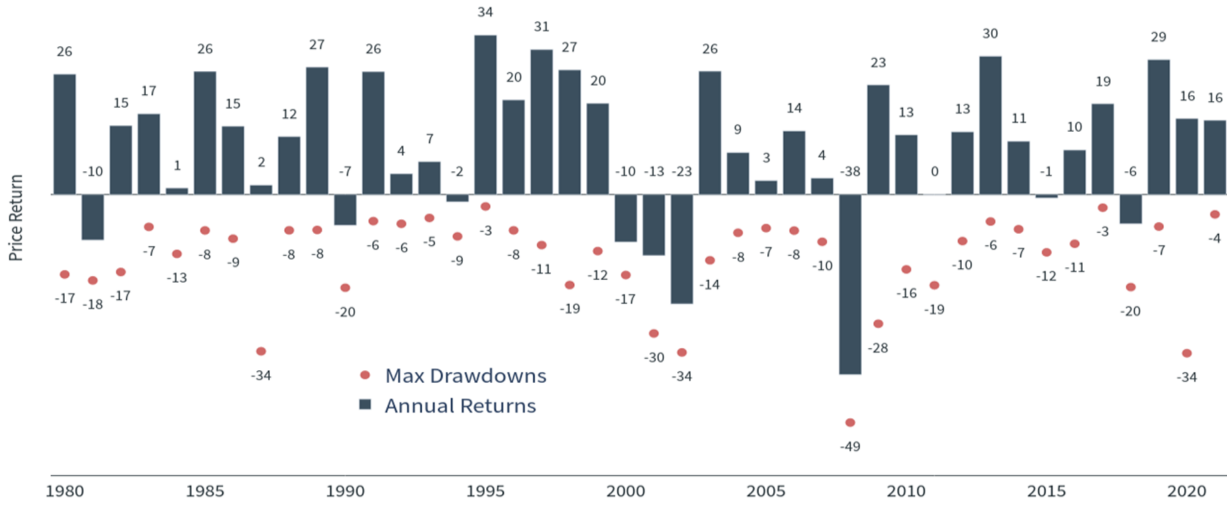
1. The federal debt is approaching the debt ceiling

Federal Budget Deficit to GDP



Congress will need to approve an increase to the debt ceiling soon. This has accelerated in importance due to emergency pandemic spending and increases to the federal budget. Without a raise to borrowing limits, the Treasury will need to enact "extraordinary measures," including a government shutdown, in order to keep paying the bills.

2. Even in 2011, markets recovered quickly



Annual Returns and Pullbacks

This last affected markets in 2011 when the debt ceiling debate resulted in the downgrade of the U.S. debt. This rattled markets and led to a 19% decline in the S&P 500. Although the index was flat for the year, markets recovered within months and generated a strong return the following year.

3. Fixed income fared well during the 2011 debt ceiling crisis

Fixed Income Performance

Market and Economic Chartbook | September 29, 2021

LEGACY WEALTH MANAGEMENT

Fixed Income

Fixed Income Performance

Annual bond sector total returns

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Treasuries 13.7%	High Yield 58.2%	EMD Local 15.4%	TIPS 13.6%	EMD Local 17.5%	High Yield 7.4%	Munis 9.1%	Munis 3.3%	High Yield 17.1%	EMD Local 14.7%	Munis 1.3%	EMD USD 15.0%	TIPS 11.0%	High Yield 4.5%
MBS 8.3%	EMD USD 29.8%	High Yield 15.1%	Munis 10.7%	EMD USD 17.4%	MBS -1.4%	Corp 7.5%	MBS 1.5%	EMD USD 10.2%	EMD USD 10.3%	MBS 1.0%	Corp 14.5%	Corp 9.9%	TIPS 3.4%
Agg 5.2%	EMD Local 21.7%	EMD USD 12.2%	Treasuries 9.8%	High Yield 15.8%	Corp -1.5%	EMD USD 7.4%	EMD USD 1.2%	EMD Local 10.0%	High Yield 7.5%	Treasuries 0.9%	High Yield 14.3%	Treasuries 8.0%	Munis 0.9%
TIPS -2.4%	Corp 18.7%	Corp 9.0%	Corp 8.1%	Corp 9.8%	Agg -2.0%	MBS 6.1%	Treasuries 0.8%	Corp 6.1%	Corp 6.4%	Agg 0.0%	EMD Local 10.1%	Agg 7.5%	MBS -0.8%
Munis -2.5%	Munis 12.9%	Agg 6.5%	Agg 7.8%	TIPS 7.0%	Munis -2.6%	Agg 6.0%	Agg 0.5%	TIPS 4.7%	Munis 5.4%	TIPS -1.3%	Agg 8.7%	High Yield 7.1%	Corp -1.3%
Corp -4.9%	TIPS 11.4%	TIPS 6.3%	EMD USD 7.3%	Munis 6.8%	Treasuries -2.7%	Treasuries 5.1%	Corp -0.7%	Agg 2.6%	Agg 3.5%	High Yield -2.1%	TIPS 8.4%	EMD USD 5.3%	EMD USD -1.4%
EMD Local -5.9%	Agg 5.9%	Treasuries 5.9%	MBS 6.2%	Agg 4.2%	EMD USD -5.3%	TIPS 3.6%	TIPS -1.4%	MBS 1.7%	TIPS 3.0%	Corp -2.5%	Munis 7.5%	Munis 5.2%	Agg -1.7%
EMD USD -12.0%	MBS 5.9%	MBS 5.4%	High Yield 5.0%	MBS 2.6%	EMD Local -8.3%	High Yield 2.5%	High Yield -4.5%	Treasuries 1.0%	MBS 2.5%	EMD USD -4.3%	Treasuries 6.9%	MBS 3.9%	Treasuries -2.6%
High Yield -26.2%	Treasuries -3.6%	Munis 2.4%	EMD Local -2.0%	Treasuries 2.0%	TIPS -8.6%	EMD Local -5.2%	EMD Local -14.3%	Munis 0.2%	Treasuries 2.3%	EMD Local -6.9%	MBS 6.4%	EMD Local 3.5%	EMD Local -6.1%

Latest data point is Sep 28, 2021

Source: Clearnomics, Bloomberg

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Fixed income securities also helped to balance portfolios in 2011, as they often do during times of market stress. This has been true even when interest rates have been low, such as during the COVID-19 pandemic.

The bottom line? Investors ought to remain focused on their financial goals despite daily headlines out of Washington.

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