

October 14, 2021

Dear O'Brien Client,

After five consecutive quarters of gains – the longest such period in over four years – and an 89% rally, global stocks finally paused to catch their breath in 3Q. Concerns over the spread of the COVID Delta variant, a shift toward tightening policy in China and the U.S., peaking global growth rates, and a rapid surge in inflation caused by economies reopening combined to drive global stocks (as measured by ACWI) down roughly one percent. While these concerns are valid, we also believe them to be transitory. As a result, we remain positive on the economic outlook, and therefore the asset market outlook, for the rest of 2021 and into 2022.

Market and Portfolio Performance

After several quarters of impressive gains, markets hit the collective pause button in 3Q, with most major markets showing little net movement despite some intra-quarter volatility. Bonds outperformed stocks, but not by enough to meaningfully change the year-to-date performance gap between the two asset classes.

	3Q 2021	YTD 2021		3Q 2021	YTD 2021
Commodities	6.6%	29.1%	Municipal Bonds	-0.3%	0.8%
High Yield Bonds	0.9%	4.7%	Non-U.S. Developed Market	-0.4%	8.3%
U.S. Large Cap Stocks	0.6%	15.9%	U.S. Mid Cap Stocks	-0.9%	15.2%
Real Estate Stocks	0.2%	21.6%	Gold	-1.0%	-7.9%
Mortgage-Backed Bonds	0.1%	-0.7%	Global Stocks	-1.1%	11.1%
Treasuries	0.1%	-2.5%	Non-U.S. Stocks	-3.0%	5.9%
U.S. Aggregate Bond Index	0.1%	-1.6%	U.S. Small Cap Stocks	-4.4%	12.4%
Investment Grade Bonds	0.0%	-1.3%	Emerging Market Stocks	-8.1%	-1.2%

Past performance is no guarantee of future results. You cannot invest in an index. YTD: Year-to-Date.

Source: Morningstar Direct, O'Brien Wealth Partners, as of 9/30/21.

The return of the equities in portfolios was slightly negative, but outperformed the ACWI benchmark due to the positive relative performance of our continued overweight to U.S. large cap equities and excess returns generated by several active mutual fund managers. International stocks – particularly emerging markets – lagged during the quarter.

Interest rates rallied during the first two months of the quarter and then sold off in September, leaving absolute bond returns roughly flat. Within bonds, credit-sensitive sectors such as high-yield continued to outperform – resulting in modest relative outperformance versus the AGG benchmark.

Your 3Q statements will have additional details for your specific portfolios.

Economic and Market Outlook

As we turn to the economic and market outlook, we begin by considering opportunities and risks over multiple time horizons. More often than not, when there is a difference of opinion about an economy or asset market that difference comes down to the time horizon under consideration.

Our secular views (think next decade) have not changed. Economic growth – on average – will likely be slower because population growth is slowing. When combined with relatively high asset valuations, market returns may be more challenged than in previous decades. Our biggest concern is higher inflation, as the diversification benefits from owning stocks and bonds together tend to diminish when inflation is rising sustainably.

Cyclically, the key theme for 2021 remains the transitioning of COVID from a pandemic to an endemic. The latest data suggest that Delta cases are again peaking globally¹, but it is unlikely that COVID will disappear altogether. New, and sometimes more contagious variants, and the gradual waning of vaccine protection over time suggest an endemic outcome similar to that of influenza may be more likely than total eradication.

Internationally, increased policy tightening in China has dominated headlines and weighed down market performance. “Common Prosperity” is a new effort by China policymakers to promote more sustainable and equitable growth. While this agenda has resulted in unprecedented regulatory tightening that is weighing down near-term growth and market returns, it also could result in a more resilient foundation from which China may be able to capitalize on its relative longer-term growth advantages.

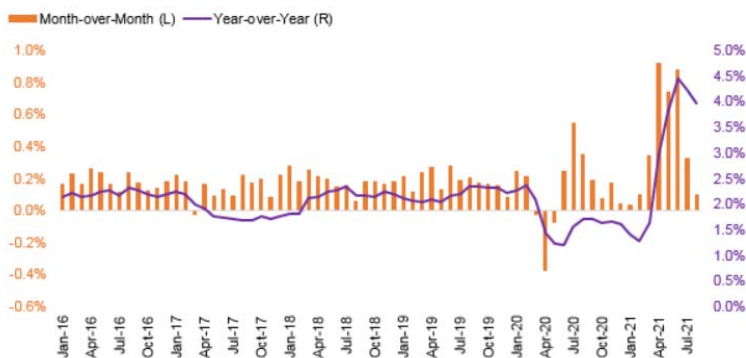
Domestically, COVID appears to be again peaking. The Centers for Disease Control estimates that roughly 65% of the U.S. population is now either fully vaccinated or has recovered from infections. Pfizer is seeking approval to begin vaccinating children between 5-11 years old. Merck is seeking approval for a new pill to treat COVID. Hopefully, all of this means COVID will not be a meaningful driver for the economy in the future.

If COVID fades in importance, then more traditional drivers of growth – such as business demand and labor markets – will once again take center stage. To that extent, backlogs of manufacturing orders and surging job openings persist and bode well for continued economic expansion.

While recent employment data have disappointed, faster hiring could soon return as the largest remaining employment gaps are in the most COVID-impacted sectors. Longer-term labor dynamics will remain tight, however, as aging demographics and early retirements during COVID will continue to pressure labor supply.

U.S. inflation has been strong and driven by COVID-related disruptions – both from the closing of the economy last year and the reopening this year (see table below). More recently, inflation has slowed sharply as these disruptions have started to fade (orange bars below). Annual inflation rates may likely follow if COVID’s importance continues to fade (purple line below).

U.S. Core Consumer Price Index Growth Rates



Core inflation: inflation excluding volatile food and energy prices. Source: Bureau of Labor Statistics, IHS Markit, O'Brien Wealth Partners, as of 8/30/21.

U.S. Core Inflation Drivers Over the Past Year

Fastest Growing Components	% Ch.
Supply Chain Disruptions	
Motor Vehicle Rentals	52.6%
Motor Vehicle Purchases	17.2%
Televisions	13.3%
Laundry Equipment	11.0%
COVID Stay at Home Demand	
Delivery Services	8.9%
Household Services	7.3%
Economy Reopening Demand	
Hotels and Motels	19.6%

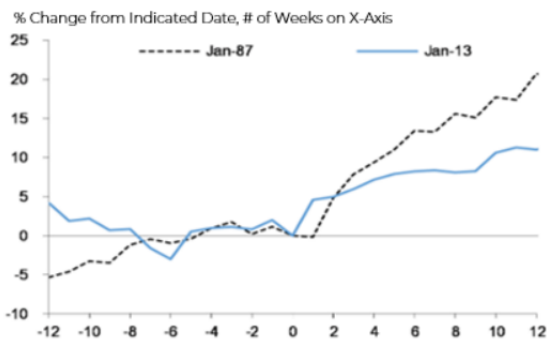
A healing economy and higher inflation both suggest that policy stimulus will diminish. From a monetary standpoint, the Federal Reserve will likely soon begin to taper asset purchases, and may even begin raising interest rates before the end of next year. From a fiscal standpoint, even if infrastructure stimulus is passed this year, fiscal support is poised to decline sharply compared to 2020 levels.

¹ Source: Our World in Data, O'Brien Wealth Partners, as of 9/30/21.

These macro views lead us to the following investment outlook. Secularly, slower economic growth, high valuations, and policy/political risks are likely to persist and challenge average returns. Cyclically, less monetary stimulus likely reduces the magnitude of return potential in markets, but a solid economic backdrop keeps those returns, on average, positive.

One near-term market risk worth monitoring in 4Q is the potential for higher taxes. For what it's worth, previous capital gains tax rate hikes have coincided with modest sell-offs ahead of implementation (left chart below), followed by rallies provided the economy is still continuing to grow. And while corporate tax hikes would be a drag on corporate profits in 2022 (right chart below), if the economy continues to expand, overall profitability would likely still be higher than in 2021.

S&P 500 Performance Around the Previous Two Capital Gains Rate Increases



LEFT: Source: JPMorgan, O'Brien Wealth Partners, as of 10/9/20. RIGHT: Assumes a \$1.5 trillion infrastructure spending package, a 15% minimum book tax rates, an 21% GILTI tax rate and a 28% statutory corporate tax rate. GILTI: Global Intangible Low-Taxed Income. Source: JPMorgan, Bloomberg Finance, L.P., O'Brien Wealth Partners, as of 9/1/21.

Estimated Corporate Tax Hike Impact on 2022 S&P 500 Earnings per Share



Portfolio Activity

Two trades occurred during the quarter: a portfolio rebalance and an increased investment in emerging markets.

Stocks have significantly outperformed bonds since COVID began, leaving most investors overweight the former versus their Investment Policy Statement benchmark targets. As such, we enacted a “happy rebalance,” taking some profits from those high-flying stocks to rebuild fixed income allocations.

Emerging market economies represent a growing share of global population, technology usage, and economic growth. Moreover, the apparent peak of globalization – and economies increasingly operating independently from each other – could lead to greater diversification from investing abroad. Finally, emerging market valuations are significantly cheaper than other markets. All of these dynamics suggest that – while emerging markets underperformed during 3Q – there may be a greater benefit going forward from owning these assets than has been the case over the past decade.

We hope you are all taking care and staying healthy. If you have questions, or would like to talk, please reach out to your Advisor or any member of our investment team.

Your O'Brien Team

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