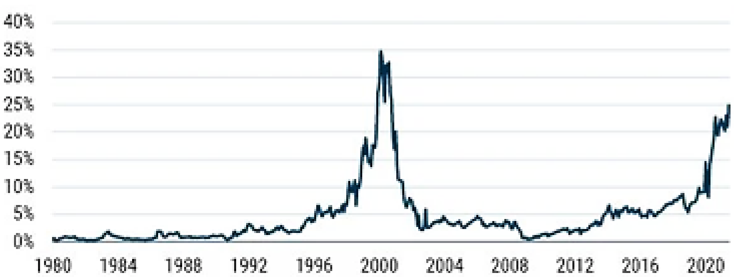
Market Review and Outlook

Global equity returns were mixed during the third quarter, as investors had to navigate a worrisome uptick in Covid-19 Delta variant cases, concerns about rising inflation spurring tighter monetary policy, and anxiety over deteriorating economic conditions in China (tied to regulatory crackdowns and potential fallout from the failure of a large debt-laden property developer). U.S. stocks proved relatively resilient amid this turbulent period, as the S&P 500 extended its market rally to a sixth consecutive quarter of gains by eking out a third-quarter return of +0.6% (+15.9% YTD). In overseas markets, developed international equities (EAFE) closed the quarter down -0.4% (+8.8% YTD) and emerging markets (EM) reported a third-quarter decline of -8.0% (-1.0% YTD).

Despite posting a modest gain for the quarter, the S&P 500 closed the final day of September down more than 5% from its all-time high earlier in the month. This marked the S&P 500's first 5% drop in 227 trading days (i.e., since November 2, 2020), the seventh-longest such streak on record, with the index returning 33.5% during that period. Digging deeper below the surface, however, suggests that not all corners of the equity market have participated in this prolonged rally. Technology stocks—which account for 27% of the S&P 500 Index (more than double the percentage of the next largest sector)—continued to post impressive gains and push the composite index return higher, but a number of companies in more cyclical sectors have retreated considerably in recent months. About 15% of the big cap S&P 500 names are more than 20% below their 52-week highs. An even larger percentage of the S&P midcap (30%) and S&P small cap (43%) indices are down 20% or more from their highs, as these groups are less tech-focused and more susceptible to an economic slowdown.

Nonetheless, the prolonged market rally in equity prices overall has predictably put upward pressure on valuations. The price-to-sales ratio for the S&P 500 Index is now around 3.0x, the highest level on record and more than double the 30-year historical average. Moreover, roughly 25% of the U.S. stock market is trading at a price-to-sales multiple above 10x (as shown below), much higher than any time in history aside from the peak of the internet bubble in 2000.

Percentage of U.S. Stocks Trading Over 10x Price/Sales



Source: GMO LLC, Compustat (Data from 1/1980-6/2021)

Some companies will achieve growth rates that ultimately justify their lofty price-to-sales valuation multiples, but many won't. With such a sizable portion of the market trading at what have historically proven to be unsustainable valuation levels, equity returns are likely to be more modest than what investors have become accustomed to in recent years. That doesn't necessarily mean a significant downturn in equities is looming, as valuation corrections don't always require market pullbacks. History demonstrates, however, that elevated valuations eventually constrain equity returns until underlying fundamentals can catch up.

While stocks look expensive overall, we continue to find pockets of value in the market. With the International Monetary Fund (IMF) predicting global economic growth of 6.0% for 2021 (the highest since 1973) and 4.9% in 2022, the earnings prospects for most companies should continue to expand. Against this backdrop, underperforming stocks with reasonable valuations and strong balance sheets should have plenty of wind in their sails—potentially allowing them to close the valuation gap with more expensive areas of the market that have been the primary drivers of the S&P 500 Index's recent gains.

Heading into the final quarter of the year, we see a number of positive and negative market variables that could drive the trajectory of equities over the coming months. The bullish narrative continues to revolve around accommodative fiscal/monetary conditions, pent-up demand, sustained earnings expansion, and strong capital inflows. With these durable tailwinds, bulls argue the path of least resistance for the market continues to be biased to the upside. Meanwhile, bearish investors are justifiably concerned about proliferation of the Delta variant, vaccine efficacy uncertainty, peak economic/earnings growth forecasts, waning stimulus support, margin headwinds from persistent supply chain constraints and input price pressures, and stretched valuations.

Having carefully assessed each of these considerations, we remain constructive on the outlook for stocks. The much-needed market pullback in September may be a harbinger for increased bouts of volatility through the balance of the year—especially as a divided Congress recklessly proceeds towards a debt-ceiling breach that could force the Treasury Department to default on its loans for the first time. Ultimately though, we expect more rational decision making in Washington to produce a working compromise on the debt ceiling. This will enable investors to turn their attention back to the market's solid economic fundamentals, sustained earnings expansion prospects, and still-favorable interest rate environment that we believe could continue to push equities higher.

Portfolio Transactions

We initiated a position in the Horizon Kinetics Inflation Beneficiaries ETF (INFL) during the third quarter as part of our tactical allocation.

INFL is an exchange-traded fund that owns a basket of equity securities with capital-light business models, such as energy/material royalty trusts and financial/commodity exchanges, whose revenues are expected to increase with inflation (without a corresponding increase in expenses). Opinions vary on the expected magnitude and duration of inflation pressures over the intermediate term, but having some level of protection against inflation risk seems prudent given the unprecedented level of fiscal and monetary support that has been injected into the economy. We believe INFL offers a compelling vehicle to capitalize on this risk versus other inflation protection strategies, as its portfolio isn't reliant on inflation to appreciate in value, but the fund's holdings would theoretically see markedly higher cash flows if the economy does enter a prolonged period of rising inflationary conditions.

We exited our Core Portfolio holdings in Microsoft, Sysco Corp and the Utilities Select Sector SPDR Fund.

Microsoft has long been a company that provides vital computing software and services (e.g. Microsoft Office, Teams, Azure, LinkedIn, etc.) to enhance workplace productivity and collaboration. The accelerated shift toward remote working due to the COVID-19 pandemic has been a boon to Microsoft's revenue and profitability, as organizations and consumers raced to adopt the requisite technology/infrastructure for a seamless transition to the work-from-home setting. With Microsoft shares now trading at valuation multiples that are more than 50% above their respective 10-year averages, coupled with the expectation that earnings growth will slow from the torrid pace of the past few quarters, the company's stock looks close to fully valued in our view. Thus, we decided sell our stake in Microsoft and reallocate the capital into investments where we see greater price appreciation potential.

Sysco is the largest food service distributor in the U.S., distributing over 400,000 food and nonfood products to restaurants (62% of revenue), healthcare facilities, schools, and other locations where individuals consume away from home meals. We purchased Sysco in the second quarter of 2020, when its sales were being dramatically impacted by the drop in restaurant dining at the outset of the pandemic lockdowns. Believing Sysco's drop in revenues would prove temporary, we expected the company to be a prime beneficiary of the economic reopening. That thesis proved correct, as the company took market share in its fragmented industry from smaller competitors and is now reporting sales above pre-pandemic levels. We believe Sysco's success has now been largely reflected in the company's current share price, so we decided to exit our position in the firm.

The Utilities Select Sector SPDR Fund is an ETF that holds a diversified basket of electric utilities, gas utilities, independent power producers and renewable electricity producers. While utility stocks were hammered with the rest of the market at the onset of the COVID outbreak in 2020, stock prices in the sector have rallied back towards their early 2020 peak. With the prospect of rising interest rates as the Fed dials back monetary stimulus, coupled with slowing (albeit still positive) economic growth in the coming quarters, price appreciation across the utility sector from these lofty levels could prove limited. As a result, we sold our holding and plan to reinvest the proceeds in more compelling opportunities.

Fixed Income

After falling early in the quarter, the 10-year Treasury yield rallied to close the third quarter modestly higher at 1.52%. Much of this yield recovery occurred after a Federal Open Market Committee (FOMC) meeting in September, where the Fed indicated that robust economic expansion and signs of rising inflation would likely prompt an end to its bond buying program in the coming months—followed by an increase in short-term interest rates as soon as 2022. Expectations of tighter monetary policy and concerns about inflation pushed investors to sell treasuries, modestly boosting their still unusually low yields.

It's likely that yields will remain anchored at depressed levels for a protracted period given that pension funds, foreign buyers, and other investors continue to be attracted to the safety of U.S. Treasuries and their superior yields relative to even lower (or negative) yielding international bonds. That said, Treasury yields seem excessively low at present levels given the outlook for continued economic growth. Interest rates are therefore seemingly poised to move higher in the coming quarters—putting downward pressure on bond prices and returns. Nonetheless, we still believe modest exposure to fixed income securities provides an important portfolio diversification counterbalance for long-term investors that have sizable equity exposure.

Final Thoughts

Parkside views client communication and education as a critically important aspect of our advisory role. To enhance information sharing, we recently added both a blog and a podcast section to our website. We hope clients find the Parkside-originated content be topical and useful information about finances, investing, and the markets. Please visit www.parksideinv.com to see these and other updates to the site.

It was wonderful visiting with clients who were able to attend the Parkside Shred Day event held outside of our Deerfield office on September 23rd. We look forward to catching up with others in the near future. We are available for you, please call us anytime.

Have a great close to the year!

Parkside Investments, LLC

October 6, 2021

Please contact your Parkside representative at 312/778-7700 if there are any changes to your financial situation or objectives, or if you wish to modify any restrictions on your account.

Parkside Investments, LLC maintains a business continuity plan and periodically reviews the plan for disaster preparedness. In an emergency, news updates will be posted to our website www.parksideinv.com until the critical situation has been resolved. You may also contact us through our individual phone lines and e-mails or by our main phone 312/778-7700 and e-mail address info@parksideinv.com. Your calls and e-mails will automatically forward to other devices away from our offices.

Disclosures: *The information contained in this message is intended to provide general information only and should not be construed as an offer of specifically tailored individualized advice or results. Clients or prospective clients should not assume that their performance will equal or exceed historical market results and/or averages. The securities identified and described do not represent all of the securities purchased, sold, or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. With any investment, there is the possibility of loss as well as gain. Past performance is not indicative of any specific investment or future results.*

Benchmark performance shown for various market indices is shown with interest and dividends reinvested and gross of all fees and expenses. An investor's individual performance would include interest and dividends reinvested, but would be net of all fees and expenses incurred from transactions and management of their portfolio. No one can invest directly in a benchmark.

Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements.