Morris Capital Advisors, LLC

Investment Commentary
September 30, 2021

The Dude's Dilemma

"It's a very complicated case. . . You know, a lotta ins, lotta outs, lotta what-have-yous." That is how "The Dude" described his dilemma in "The Big Lebowski". In reality, however, it wasn't all that complicated. The Dude, a deadbeat ne'er-do-well, was entrusted to deliver a $1 million dollar ransom. Not surprisingly, he didn't make the drop and lost the money. His efforts were now focused on finding a way to get the money back so he could get back to life as he knew it, bowling and drinking with his friends.

The market's dilemma these days is complicated, and just like The Dude, it revolves around money, the Fed's money, a lot of it, and how the Fed is going to get it back. Over the past several years the Fed has been expanding its balance sheet through the outright purchase of government debt, a process known as "quantitative easing." In 2008 the Fed balance sheet was less than $1 trillion. It doubled to $2.2 trillion the next year, and doubled again by 2014. It doubled again over the last two years, and is now more than $8.4 trillion. The Fed needs to return its balance sheet to more normal levels, but that reversal, known as "quantitative tightening", could push interest rates higher and tank the economy, at a time that the economy is already struggling with supply chain issues and inflationary pressures. The Fed's dilemma has generated speculation about "tapering", "dot charts", and "transitory" inflation (a lotta what-have-yous, as per The Dude).

The stock market managed to generate a small positive return during the 3rd Quarter of 2021. Strong earnings lifted stocks early in the quarter, assisted by supportive comments from the Fed indicating a reluctance to tighten policy too fast. That began to change later in the quarter as growth and inflation concerns began to surface. As the quarter progressed, economists began to revise their real GDP (inflation adjusted Gross Domestic Product) expectations for 2021 from 7% down to 5.9%. At the same time, the Fed raised its inflation estimate for 2021 to 4.2%, up from its previous estimate of 3.4%. Both of these inflation measures are well above the Fed's stated long-term inflation target of 2.5%. In addition, the Fed seemed to walk back from its description of inflation being "transitory", raising concerns that we could be heading into "stagflation", a period of slowing growth and persistent inflation.

But, as The Dude said, it's very complicated. In addition to uncertainty about the timing of Fed policy shifts, slowing economic growth and rising inflation, political machinations in Washington add another layer of complexity. The $3.5 trillion budget reconciliation bill, coupled with the $1.5 trillion "infrastructure" bill will substantially increase the deficit, and by extension, dramatically increase pressure on the Fed to expand its balance sheet. Many policy changes included in these bills could constrain business investment and employment growth. The negative impact could begin to surface around the time that the Fed has targeted to reduce its quantitative easing and begin to raise interest rates.

Recent quarterly earnings announcements provided some early indications of an economic slowdown. Revenue and earnings over the past 15 months have been juiced by blank check stimulus spending. At the same time, year-over-year comparisons look overly attractive when compared to lockdown induced spending reductions of 2020. Top line revenue growth will suffer as it becomes more difficult for consumers to maintain their spending levels as stimulus payments end and extended unemployment benefits expire. At the same time, structural issues in the economy will increase operating costs. Supply chain constraints caused production cutbacks in a number of industries, while rising raw material and transportation costs pressure operating margins. These factors may be "transitory", but extended unemployment benefits have reduced work incentives and increased labor costs that will be difficult to reverse.

We expect to encounter higher market volatility in both the stock and bond markets as the economy transitions from the stimulus-induced rebound to a more moderate economic expansion. The Fed will need to proceed cautiously as it tapers its liquidity injections and begins to raise interest rates. Based on the experience of previous Fed policy shifts, the transition may increase uncertainty as the Fed adjusts its policy actions in an attempt to manage market reactions. As investment managers we know that the immediate impact of those policy changes are beyond our control and that our best course of action is to focus on the investment discipline that has guided us successfully through difficult markets in the past. We believe that company fundamentals matter and that an investment strategy built on that belief has the best opportunity for success over the long term. We will continue to search for companies that demonstrate the potential to grow revenue and earnings despite the complexities of recent events. We aim to invest in those companies whose shares are priced attractively relative to those fundamentals. We believe that well diversified investment portfolios based on this philosophy have the best chance to handle "a lotta of the ins and outs" of our very complicated markets.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

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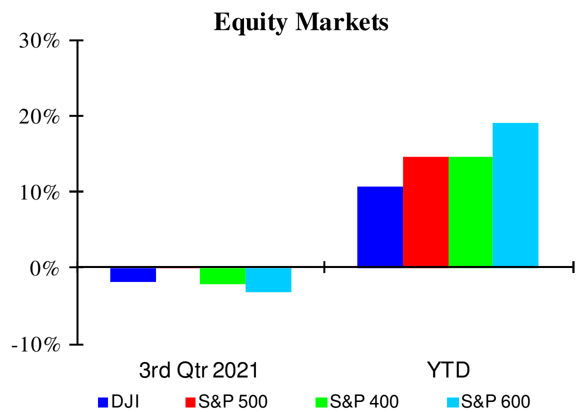
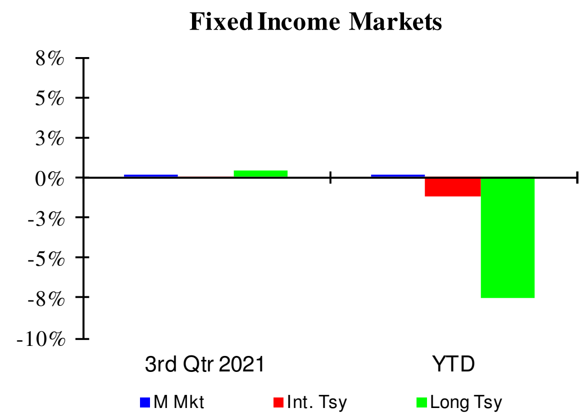
Market Summary
September 30, 2021



Stock market returns were mixed during the 3rd Quarter of 2021 reflecting investor concerns about slowing economic growth, rising inflation, and uncertainty about the timing of Fed policy shifts. The S&P 500 rose slightly, but the return paled in comparison to the previous five consecutive quarters of above average concerns. Among the large-cap indices growth stocks outperformed value stocks led by names in the Information Technology, Financial, and Health Care sectors while economically-sensitive sectors such as Industrials, Materials, and Energy underperformed. Concerns about slowing growth and rising inflation were more apparent in the small-cap space as those indices posted negative returns and value names outperformed growth names.



The bonds markets were little changed in the third quarter as concerns about slowing economic growth counterbalanced concerns about rising inflation. Most bond indices were solidly higher through mid-September as investors sought to reduce risk as stock market returns moderated and economic headwinds surfaced. But late in the quarter the Fed indicated that it would begin to reduce its liquidity injections this year. This news, combined with concerns that rising inflation may not be transitory, weighed on the fixed income markets in the final days of the quarter, erasing most of the quarter-to-date returns. Higher yielding, lower-quality bonds outperformed investment grade bonds as spreads widened and the income component of return became more important.