Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

QUARTERLY NEWSLETTER

2021: THIRD QUARTER **131ST EDITION**

"Inflation is the parent of unemployment and the unseen robber of those who have saved."
~ Margaret Thatcher, Former Prime Minister of the United Kingdom

"Inflation hasn't ruined everything. A dime can still be used as a screwdriver."
~ H. Jackson Brown, Jr., Author

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CAPITAL MARKETS SCOREBOARD

Equities					
Indices	3Q21 Total Return (%)	2021 Total Return (%)	Index Characteristics		
Domestic			NTM P/E	P/B	Div. Yld. (%)
S&P 500	0.6	15.9	20.3	4.5	1.3
DJIA	-1.5	12.1	18.0	4.6	1.8
NASDAQ	-0.2	12.7	29.6	6.4	0.6
Russell 1000 Growth	1.2	14.3	28.6	13.3	0.7
Russell 1000 Value	-0.8	16.1	15.8	2.5	1.9
Russell 2000	-4.4	12.4	25.4	2.6	0.9
International*					
MSCI EAFE	-0.4	8.8	15.3	1.9	2.2
MSCI Emerging Markets	-8.0	-1.0	12.7	2.0	1.8
MSCI United Kingdom	-0.3	12.2	12.0	1.8	3.0
MSCI France	-1.7	12.6	15.6	1.9	2.2
MSCI Germany	-4.2	5.0	13.5	1.7	2.2
MSCI Japan	4.7	6.2	15.5	1.5	1.9

Fixed Income		
Indices**	3Q21 Total Return (%)	2021 Total Return (%)
Domestic		
U.S. Corp - Gov (1-3 Years)	0.1	0.1
U.S. Corp - Gov (3-5 Years)	0.0	-0.6
U.S. Corp - Gov (10+ Years)	-0.1	-4.9
U.S. Treasuries Master	0.0	-2.7
U.S. Corporates Master	-0.1	-1.1
U.S. Municipals Master	-0.4	1.0
U.S. High Yield Master	0.9	4.7
International*		
Developed Markets Sov Bond	-1.1	-5.9

Commodities		
Resource	3Q21 Total Return (%)	2021 Total Return (%)
Precious Metals		
Gold	-0.9	-7.3
Silver	-16.5	-18.7
Industrial Metals		
Copper	-4.8	16.4
Aluminum	13.0	44.1
Energy		
Brent Crude Oil	1.1	51.9
WTI Crude Oil	2.3	55.6
Natural Gas	60.7	131.1

Key Rates				
Rates	9/30/2021	6/30/2021	12/31/2020	9/30/2020
U.S. Target Fed Funds Rate	0.25	0.25	0.25	0.25
2-Year U.S. Treasury	0.28	0.25	0.13	0.13
10-Year U.S. Treasury	1.52	1.45	0.93	0.69
30-Year U.S. Treasury	2.08	2.06	1.65	1.46
10-Year German Bund	-0.19	-0.21	-0.58	-0.53
10-Year Japanese Bond	0.07	0.06	0.02	0.02
30-Year Fixed Mortgage	2.90	2.98	2.68	2.89

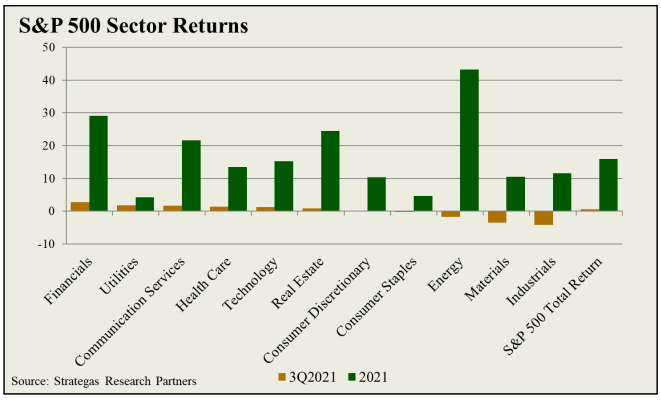
Currencies				
Indices/ Exchange Rates	9/30/2021	6/30/2021	12/31/2020	9/30/2020
ICE U.S. Dollar Index	94.23	92.44	89.94	93.89
USD per EUR	1.16	1.19	1.22	1.17
USD per GBP	1.35	1.38	1.37	1.29
JPY per USD	111.58	110.99	103.25	105.53
CAD per USD	1.27	1.24	1.27	1.34

*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

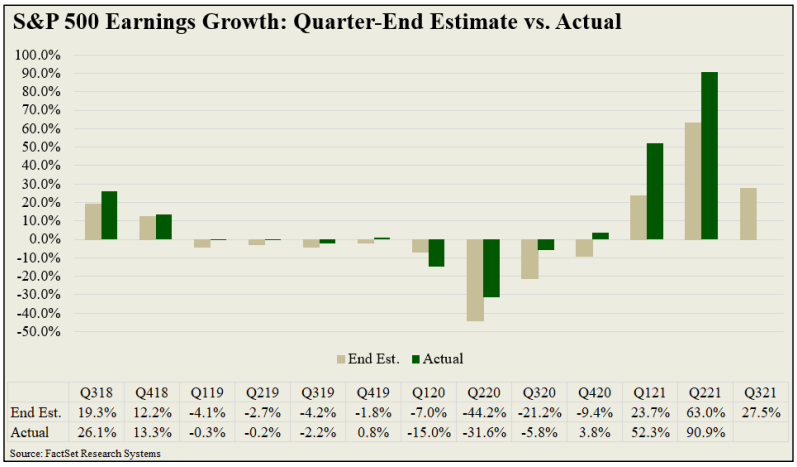
EQUITIES

- The Standard & Poor's (S&P) 500 index posted a total return (price appreciation plus dividends) of 0.6% for the third quarter. The Financials Sector led the way, up 2.7%, while Industrials Sector stocks trailed at -4.2%. For the year, the S&P 500 has returned 15.9%, led by the Energy Sector at 43.2%. All 11 sectors are positive on the year, with the Consumer Staples and Utilities Sectors posting the only single digit returns at 4.7% and 4.2% respectively.



- Smaller company stocks have underperformed large cap stocks, with the Russell 2000 Index returning -4.4% for the quarter and 12.4% year-to-date (YTD). International stocks have also underperformed large cap domestics this year, returning -0.4% for the quarter and 8.8% for the year when denominated in U.S. dollars. Emerging Markets stocks have fared worse at -8.0% for the third quarter and -1.0% for the year in U.S. dollar terms, predominantly due to China's -16.6% YTD return.

- The S&P 500 closed the quarter 5.1% off its September 2 high. While this marked the index's first 5% correction since October 2020, concentration within the index has masked underlying volatility. More than 90% of stocks in the index experienced a 10% correction over the same period. The Communications Services Sector, for example, was 5.2% off its 52-week high in late September, while the average stock in the sector was off 19.4%. Google, which makes up nearly 40% of the sector's market value, has held the sector up while its average constituent has approached bear market (20% decline) territory. Concentration risk closed the quarter near an all-time high, with nearly one-quarter of the S&P 500 concentrated in just five companies versus 16.8% at the height of the Technology Bubble. Of note, Microsoft is the only company included in both concentrated periods.



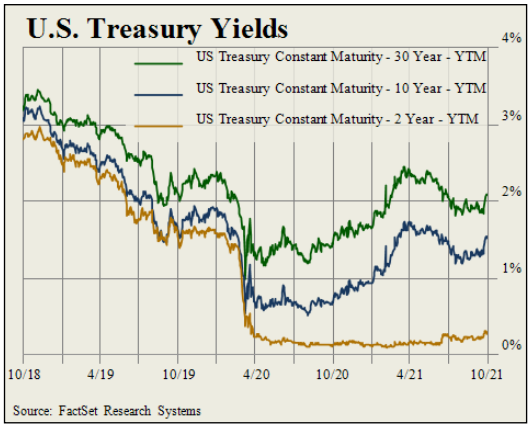
	Q318	Q418	Q119	Q219	Q319	Q419	Q120	Q220	Q320	Q420	Q121	Q221	Q321
End Est.	19.3%	12.2%	-4.1%	-2.7%	-4.2%	-1.8%	-7.0%	-44.2%	-21.2%	-9.4%	23.7%	63.0%	27.5%
Actual	26.1%	13.3%	-0.3%	-0.2%	-2.2%	0.8%	-15.0%	-31.6%	-5.8%	3.8%	52.3%	90.9%	

- S&P 500 companies are expected to post a net profit margin of 12.1% for the third quarter, well above the 5-year average of 10.9% but below the second quarter's 13.1%. Thus far, cost management measures have curtailed margin erosion and allowed companies to drive expectations for a record fifth consecutive quarter of positive earnings per share (EPS) growth. But margins and earnings face persistent pressure from input cost increases and supply chain challenges. Of note, EPS growth estimates were positive for the quarter but negative in September. A potential rollover of margins and earnings will be paramount for investors to monitor in the coming months.

- Lower dividend and earnings yields of growth stocks effectively make them longer-duration assets, which are impacted more by interest rate movements than value stocks and other shorter-duration assets. Growth stocks have largely outperformed their value counterparts for more than a decade as interest rates remained low. This year, however, value stocks have outperformed growth stocks as assumptions of increasing and longer-term inflationary pressures have pervaded financial markets. Rising interest rate environments have similar negative impacts on both fixed income and growth stocks. In this regard, investors should pay particular attention to tightening correlations between the two. Considerable investment in both bonds and growth stocks in a rising interest rate environment provides far less portfolio diversification than generally assumed and exposes investors to significantly more interest rate risk than they likely realize.

FIXED INCOME

- After ending the second quarter at 1.45%, 10-year U.S. Treasury (UST) yields continued their downtrend and fell to as low as 1.19% in July and August. Rates would rally in the latter half of September, however, and the 10-year UST finished the third quarter yielding 1.52%. This point-to-point increase in rates caused interest rate sensitive corporate and government bonds with over ten years until maturity to provide a -0.1% return, reducing their YTD return to -4.9% as measured by BofA-ML indices. Less interest rate sensitive comparable short-term debt with one-to-three years until maturity has protected downside risk, but provided meager 0.1% returns for the quarter and YTD. USTs in aggregate were flat for the quarter, and their YTD return remained at -2.7%.

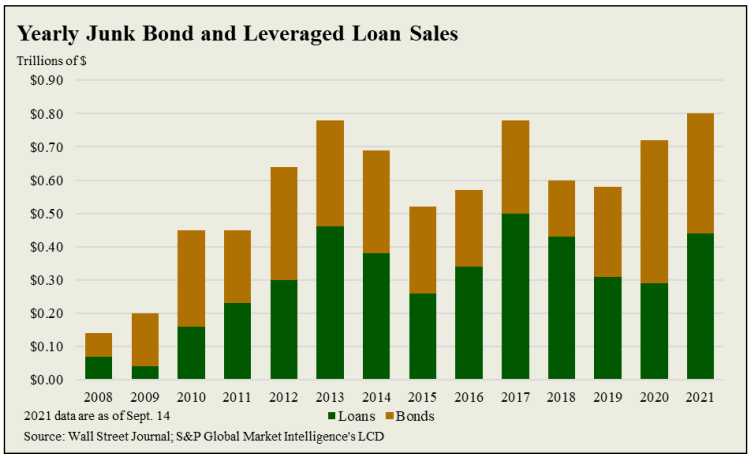


- The Federal Reserve (Fed) has been purchasing $80 billion of USTs and $40 billion of mortgage-backed securities per month since June 2020 in an effort to increase liquidity in the financial system and support the economy. Following Fed Chairman Jerome Powell's comments in September, analysts generally agree "tapering" of the stimulus measures will likely be announced in November and begin in December. Purchases of these securities are expected to be systematically reduced until they are ended in mid-2022 short of any major economic or market disruptions. The tapering of stimulus indicates the first step in tightening of monetary policy and acts as a signal of future increases in interest rates.

- The yield curve, the spectrum of UST yields across varying maturities, has begun to reflect anticipated increases in interest rates. The 2-year UST yield increased from 0.13% at the start of the year to 0.28% at the end of the third quarter. Federal Open Market Committee (FOMC) members have a diverse outlook for the trajectory of short-term rates. Half of the FOMC participants believe the fed funds rate will be held at current levels through 2022, while half believe there will be at least one rate increase. The median forecast jumps to four 0.25% rate increases through 2023, but on an individual basis the participants expect between zero and six increases. Through 2024, the forecast range expands to between two and ten rate increases.

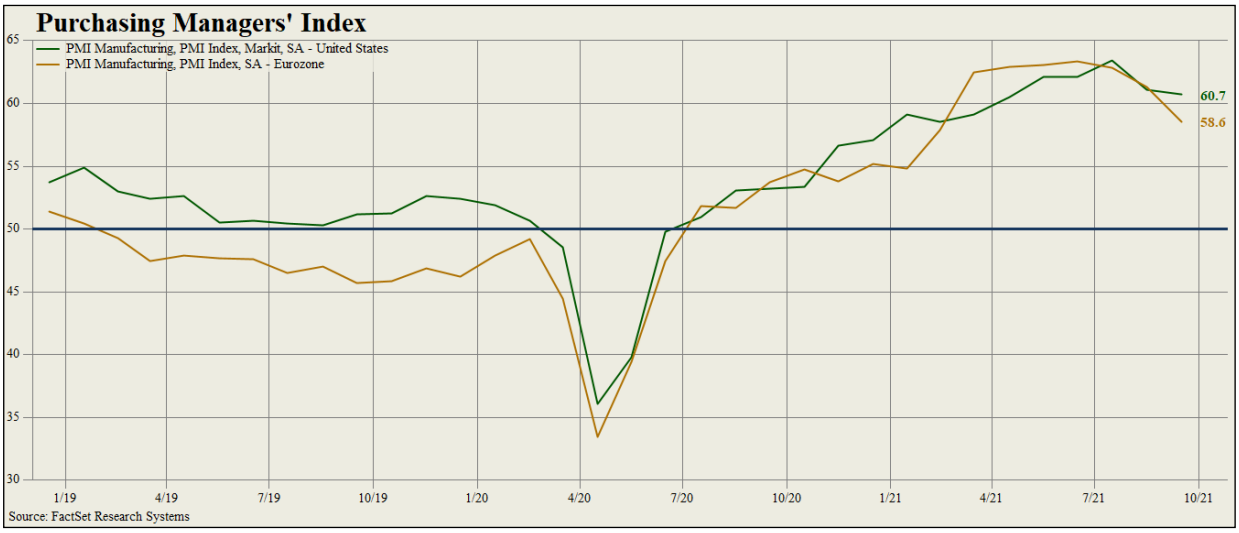
- Although expectations for economic growth were brought down in the third quarter, corporate credit markets largely remained stable, and credit spreads, the yield differential between corporate and government debt, remained contained. Investment grade corporate bonds returned -0.1% in the third quarter, bringing their YTD return to -1.1%. Although high-yield credit spreads displayed marginally more volatility than investment grade credit spreads, higher coupon payments allowed high-yield bonds in aggregate to outperform and return 0.9% for the quarter and 4.7% for the year.

- Tight credit spreads have persisted despite nonfinancial companies still maintaining higher gross leverage (roughly debt divided by operating earnings) than before the pandemic began, according to Bureau of Economic Analysis data. This paints a worse outlook than the reality, however, as record cash and equivalent positions held on corporate balance sheets have caused *net* leverage (debt less cash and short-term investments divided by operating earnings) to fall below pre-pandemic levels. Companies have continued to take advantage of the favorable market conditions and manageable leverage levels, as sales of junk bonds and leveraged loans already set a calendar year record through September 14.

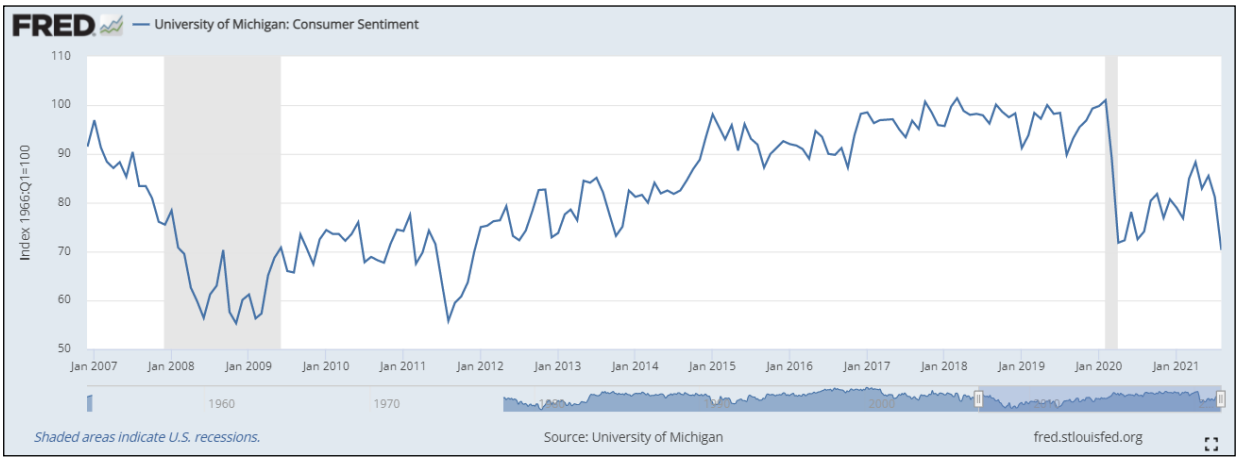


ECONOMICS

- Ongoing supply constraints, COVID concerns, and decelerating growth indicators have prompted many economists to revise their Gross Domestic Product (GDP) growth expectations downward. The Markit Manufacturing Purchasing Managers' Index (PMI) came in at 60.7 in September, down from August's figure of 61.1. While a reading above 50 denotes an expanding manufacturing sector, the drop between months indicates growth is slowing. In the Eurozone, PMI numbers echoed those of the United States with September's numbers coming in at 58.6 vs 61.4 in August. Supply constraints remain the primary driver of the slowdown, as shortages in semiconductors and raw materials persist in global supply chains. COVID served as an additional drag on economic growth for the quarter, as the rise of the Delta variant brought the seven-day average of new cases to an 8-month high in September. The rise in uncertainty has led panelists for the National Association of Business Economics to revise their third quarter annualized real GDP growth expectations to 4.0%, down from the May forecast of 6.2%. This forecast would represent a significant slowdown from the actual second quarter growth rate of 6.6%.

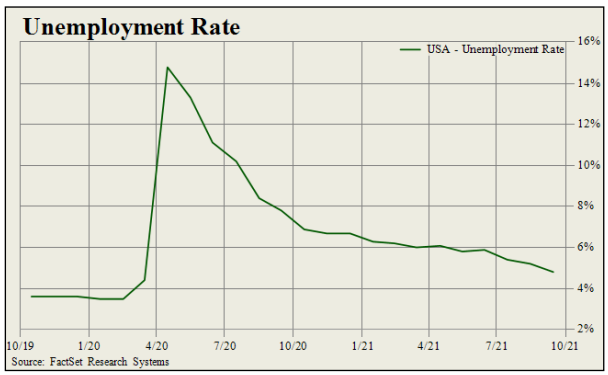


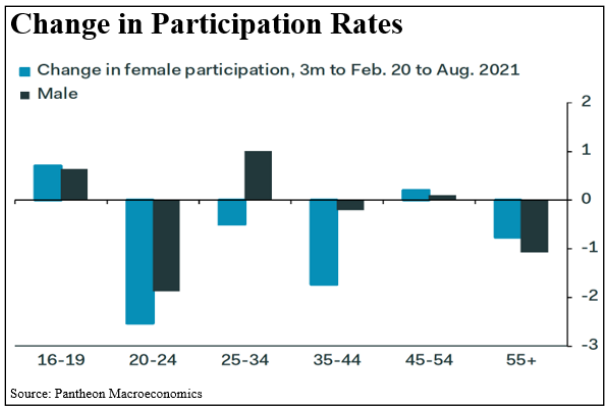
- Consumer expectations took a hit during the quarter, as the University of Michigan's Consumer Sentiment data returned to levels not witnessed since January 2012. The survey is designed to estimate consumers' perception of economic conditions in the near- and long-term. The results are intriguing on the back of U.S. household net worth burgeoning to a record high of $141.7 trillion in the second quarter. Personal Consumption Expenditures (PCE) were flat in July but rebounded up 0.8% in August. Spending on goods was down -2.1% in July while services was up 1.0%. Both were up in August, with services up 0.6% and goods up 1.2%. On an annual basis, spending increased 11.5% from the depressed levels in August 2020. The PCE Index has risen over 10% six months consecutively for the first time since 1984, mirroring the historic inflation numbers coming through recently.



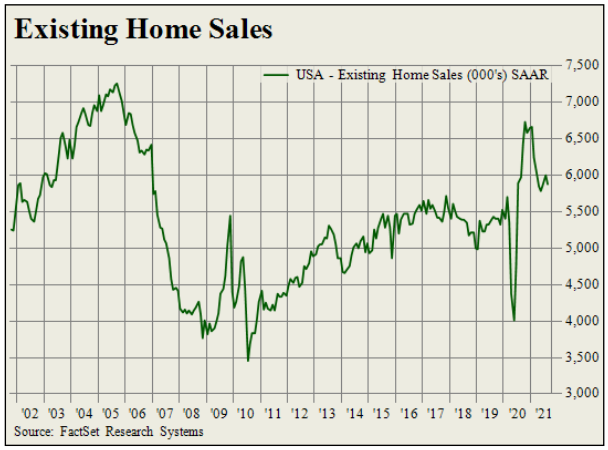
ECONOMICS

- Despite GDP returning to its pre-pandemic trajectory, the labor market continues to struggle. COVID-related federal unemployment benefits were stopped on September 6. Expectations were for this to be a catalyst for Americans to return to work. For the third quarter, payrolls were up 1.6 million helping reduce the unemployment rate to 4.8% from the April 2020 high of 14.8%. On a monthly basis, August nonfarm payrolls disappointed. Only 366,000 payrolls were added, 384,000 off consensus expectations of 750,000. September payrolls also missed, coming in at 194,000 added compared to consensus expectations of 479,000. These represent significant drops from the roughly one million jobs added in both June and July. The muted figures have been attributed to the Delta variant, continued home childcare needs, early retirees, and the unemployed holding out for higher wages. The Labor Force Participation Rate has not rebounded from the pandemic, with a reading hovering at 61.6% in September compared to 63.4% pre-pandemic. The most glaring gap in participation can be seen in the 20-24 age group which have been adversely affected by the reopening struggles of the restaurant and hospitality industries. According to Pantheon Macroeconomics, there is a 9.7 million labor shortfall compared to the pre-pandemic trendline.





- The S&P CoreLogic Case-Shiller Home Price Index returned a year-over-year increase of 19.7% for July 2021, the biggest jump in more than 30 years. Existing home sales remain elevated but fell 1.8% in August following back-to-back increases in June and July. August's reading is 970,000 off the high set in October 2020. First-time home buyers are having an increasingly difficult time in the market with their share of sales falling to 29%; below the five-year average of 32% according to the National Association of Realtors. Potential home buyers are having to turn to renting, where prices are also increasing. The median rent for a one-bedroom apartment is up 10.7% from March 2020, while the rent for two bedrooms is up 13.1% according to the Zumper National Rent Report.

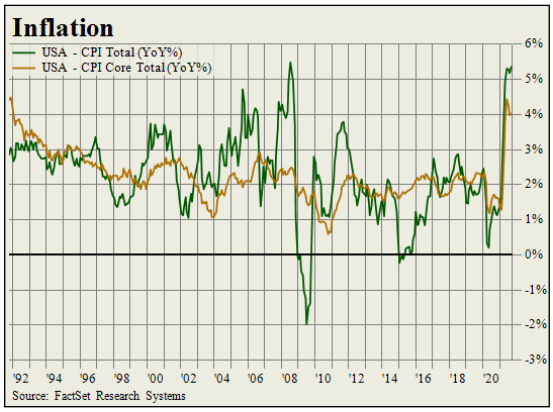


- On the last Monday of the quarter, it was announced that Eric Rosengren and Robert Kaplan, both Fed branch presidents, would be resigning following disclosures about their personal stock trading activity in 2020. Their departures now mean 6 of the 19 seats on the FOMC are to be filled in the upcoming months, potentially including the seat of Fed Chair Jerome Powell. The openings on the FOMC add to the list of policy items that the Biden Administration will have to work through. There continues to be ongoing debate in Congress over the infrastructure bills and tax changes on corporations and wealthy individuals. With limited clarity on the size and scope of the eventual policy decisions, the uncertainty is creating a murky near- and long-term future for investors.

Inflation: Structural or Transitory?

Rising prices have made inflation the most prevalent economic concern expressed in a recent survey from the Pew Research Center. Based on survey results, 63% of Americans are very concerned with rising prices, particularly for food and consumer goods while only 29% expressed concern that Americans would not be able to find jobs.

The Consumer Price Index (CPI) has been running above 5% on a year-over-year (YOY) basis during June (5.4%), July (5.4%), August (5.3%), and September (5.4%). Core CPI, which excludes food and energy, rounded to 4% or higher for the same four months. The Federal Reserve's (Fed) preferred inflation measure, the Personal Consumption Expenditures Price Index (PCEPI), has typically been lower than the CPI, but core PCEPI was still up 3.6% in July and August YOY, the largest increases in 30 years. Over the same time period, goods inflation was up 5.5% while services inflation was up 3.6%. The Producer Price Index was also up 8.6% for the 12 months ending in September, the largest increase since the data series began in 2010. Eurozone prices have also risen at the fastest rate in 13 years.



Home prices are surging in the U.S. and other developed countries. The S&P Core Logic Case-Shiller National Home Price Index was up 19.7% YOY in July, the largest increase since 1987. Homes are considered an investment and not an expense, so home prices are not directly factored into inflation numbers. The CPI and PCEPI compute an implied owners' equivalent rent to indirectly account for ongoing housing costs. This is based upon how much owners would theoretically pay to rent their own home. Owners' equivalent rents are highly correlated with home prices with a lag of 18-24 months, so record home price appreciation in recent months will continue to push up inflation going forward. Also, multi-family property values have increased 13% since 2019 while rental occupancy is at a record 97%, resulting in apartment rental costs rising 10% for the 12 months ending in August. Record low inventories of homes for sale, especially of lower cost homes, and less affordability due to rising prices will continue to fuel future rent increases.

There are two types of inflation: cost-push and demand-pull. Cost-push inflation occurs when raw materials and/or production costs increase and are forwarded on to consumers, while demand-pull inflation occurs when growth in aggregate demand outpaces aggregate supply. Unfortunately, the U.S. is currently experiencing both, fueled by extremely strong recent growth in the U.S. economy. After beginning in February 2020 and ending in April, the two-month recession was the shortest on record. The recovery has been nearly V-shaped with real (inflation-adjusted) annualized growth in Gross Domestic Product (GDP) averaging 6.5% in the first half of 2021 and reaching all-time highs by the second quarter.

The majority of the inflationary pressure has been in the goods market thus far. This reflects the type of economic recovery the U.S. has experienced. With COVID restrictions continuing to hamper travel, a significant portion of the early recovery has been concentrated in the goods market, particularly in durable goods expected to last more than three years. The Commerce Department reported that orders for durable goods hit a record of $263 billion in August, up 1.8% for the month. Demand for durable goods has increased in 15 of the last 16 months. Depleted business and retail inventories have translated into increased demand from manufacturers, but supply chain bottlenecks continue to constrain production.

While supply chain bottlenecks may have originally catalyzed inflation, pressures have broadened out to other sectors of the economy such as transportation, energy, the job market, and, as mentioned above, housing. The increased demand for goods has increased global transportation costs. The cost of shipping a standard 40-foot container from Asia to the U.S. has jumped from under $2,000 in 2019 to $25,000 recently. There is not only a container shortage but also congestion at most ports. Recently, there were 80 container ships waiting weeks to be unloaded at Los Angeles and Long Beach ports. Container traffic from Asia to North America is up 27% in 2021, but some of the shipping capacity which was idled in 2020 has not yet been fully activated. While high-value goods would potentially be able to use air freight, nearly 50% use passenger jets, and those flights have been curtailed internationally. As a result of the supply chain bottlenecks and increased transportation costs, manufacturing costs have been escalating.

Rising energy costs are also contributing to inflation. The August PCEPI showed energy prices up 24.9% in the last year. Oil prices exceeded $75 per barrel both in the U.S. and globally at the end of the third quarter. Goldman Sachs projects U.S. crude prices could reach $90 a barrel by year end. Gasoline prices are already up $1 per gallon in the last year, and $90 oil could increase the price another 20 cents. Prices of oil-based products are also increasing. In addition, U.S. natural gas prices have moved from under $2 per million British Thermal Units in 2020 to over $6 in the first week of October. European natural gas prices rose from under €5 per megawatt-hour in 2020 to well over €100 in October 2021. There is normally a thin buffer between energy supply and demand, and increased demand and curtailed supply have resulted in higher prices. There are a multitude of factors impacting energy supply. Droughts in the U.S., Latin America, and China have reduced the supply of hydropower, wind power has waned in Europe, and Hurricane Ida caused oil production in the Gulf of Mexico to drop by 20%. Additionally, a cold winter in Europe and hot summer in Asia have increased demand for liquified natural gas (LNG). Europe has also been shutting down coal plants while Japan has decreased its output of nuclear energy. This has caused them to pivot to LNG and coal usage, driving coal prices to record highs. As governments set goals for more renewable energy and less fossil fuel usage, investment in fossil fuel exploration and production is impacted. If oil and gas producers scale back investment because of government environmental mandates, higher and more volatile oil and natural gas prices may be around for a while. In August, President Biden called on OPEC to increase its oil production, raising the ire of the North American energy industry. Calls to increase production have largely been ignored, as OPEC insists the current oil deficit will turn into a surplus in 2022 under their current plans.

China, which is by far the largest producer of goods globally, has been experiencing power outages and labor shortages and their energy problems have also created inflationary pressures globally. Coal provides about two-thirds of China's electricity while hydropower provides 20%. Despite setting carbon emission targets, China is still building coal plants as other countries in the developed world are closing theirs. As mentioned, China's hydropower output is down, so coal is the fallback. China stopped importing coal from Australia, its largest supplier, for political reasons in 2020 leading to surging imports from other countries as coal plants try to rebuild inventories before the winter. China has taken the unusual step of shutting manufacturing plants on a rotating basis and cutting plant hours. They recently ordered their state-owned companies to secure energy supplies at all costs. Europe and other Asian countries may face the same problem. China's energy crisis will result in fewer goods being produced and at higher prices in the short-term.

Food prices are also increasing as a result of higher energy prices. Ammonium nitrate, which is one of the most commonly used fertilizers globally, is produced with ammonia derived from natural gas. Gasoline is used to transport food in the supply chain, and food processors and grocery stores use electricity to provide power to equipment and lighting in their physical plants. In an article published online at OurWorldInData.org by Max Roser and Hannah Ritchie, they state, "Studies have suggested the passthrough of price changes in energy and transport inputs to agricultural commodities result in a price increase of approximately 15-20%."

Underlying all these inflationary pressures have been the greatest shocks to the labor markets since the 1930s. In the U.S., there are still 4.7 million fewer workers than in January 2020 according to Bureau of Labor Statistics (BLS) data. The labor force participation rate decreased from 63.4% in January 2020 to 61.7% in August which translates to 4-5 million workers leaving the workforce. People aged 20-24, women aged 35-44, and those 55 and older make up the majority of those who have departed. Also, vaccination mandates have caused workers to quit their jobs.

While the unemployment rate was recently reported at a low 4.8%, there are more than 8 million unemployed, while 10.4 million job openings existed in August. The labor shortage is starting to impact wages. For the 12 months ending in September, average hourly wages were up 4.6%, which after inflation, caused real wages to be negative. September wages, though, increased at a much higher 7.7% annual rate. The labor shortage could very well prove to be a multi-year problem resulting in wage pressures eventually affecting prices of goods and services.

Fed Chair Powell has contended for months that the higher inflation being experienced in the U.S. has been transitory. Treasury Secretary Janet Yellen also affirmed her assessment recently that elevated inflation will prove transitory. But how long is transitory? Fed Chair Powell early on said, "The current inflation spike is really a consequence of supply constraints meeting very strong demand. And that is all associated with the reopening of the economy which is a process that will have a beginning, middle, and end." Apparently, the U.S. is still in the middle stage as Powell recently stated that the higher inflation might last longer than anticipated, certainly into 2022, a posture acknowledged by Yellen. Powell admits they missed the scope and persistence of the supply constraints, so the Fed is keeping a wary eye on inflation. While the Fed still says that inflation will moderate, they have signaled that the tapering of bond purchases may be steeper than anticipated, and the first interest rate hike may be sooner than expected.

Hopefully the Fed is correct about high inflation being transitory. The worst scenario would be for the economy to experience stagflation as in the 1970s when economic growth was slow and inflation was high. Broadly, the stagflation period was from 1966-1982 when inflation averaged 6.8% annualized and real GDP grew at just 2.2% annualized. The 17-year period experienced three recessions, several years of double-digit inflation, and the highest interest rates in U.S. history. One Fed concern is that inflationary expectations become anchored at higher levels and become embedded in wage and price hikes. Expectations can be measured in the bond markets or by consumer surveys. The difference between nominal yields in Treasury bonds and yields on Treasury Inflation-Protected Securities (TIPS) is one market-based measure and indicates inflationary expectations have risen. The New York Fed September Survey of Consumer Expectations showed consumers expect inflation to be 5.3% over the next year, the highest level since the survey started in 2013, but also expect it to decrease to 4.2% three years from now. Thus, consumers believe inflation is transitory but at higher levels, although financial market-based indicators are only anticipating inflation of about 2.5% annually over the next five years. Supply constraints and the Delta variant have lowered U.S. and global economic growth expectations for the second half of 2021. This may be a "silver lining" as lower consumer demand may reduce some of the supply chain bottlenecks and other inflationary pressures. Hopefully, the inflation pressures will be mitigated, and the Fed does not ultimately have to make a difficult choice between combating inflation or stagnant economic growth as was seen in the 1970s.