Financial Markets Perspective

October 2021

The Economic Expansion Continues

Overview

We monitor the economy as the basis for making informed investment decisions. Each economic cycle is similar but with important differences. For example, the recession of 2000-2002 was caused by the perceived crisis surrounding Y2K (the feared failure of our computer systems when the new century began), while the 2008-2009 recession was brought about by the financial meltdown on Wall Street. As we emerge from the pandemic, and the deepest and shortest recession in history lasting just 2 months, the solutions to that crunch are having an important effect on the global economy and financial markets. Some of these decisions may not be fully understood in the early years after the pandemic fades into history. As we reflect on the past nineteen months, some amazing events have occurred - most of them positive - that are changing the direction of how we live. Government interference in our lives has increased, some would say for the better, others would not agree. The knee-jerk government reaction at all levels to the pandemic and then the broad safety net launched to offset the impact of the shutdown was more than the total spending on World War II. Such monetary and fiscal largesse changed the outlook for both businesses and consumers and the results of the government response is evident in the growing level of wealth in America as documented in the following exhibits.

Exhibit #1

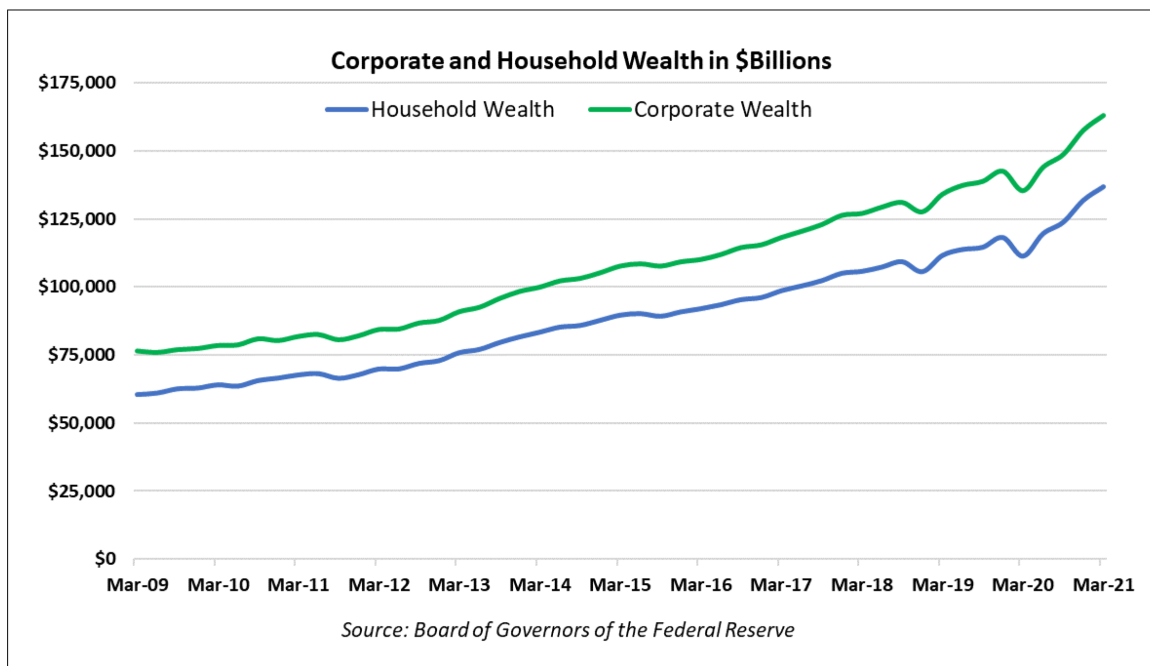
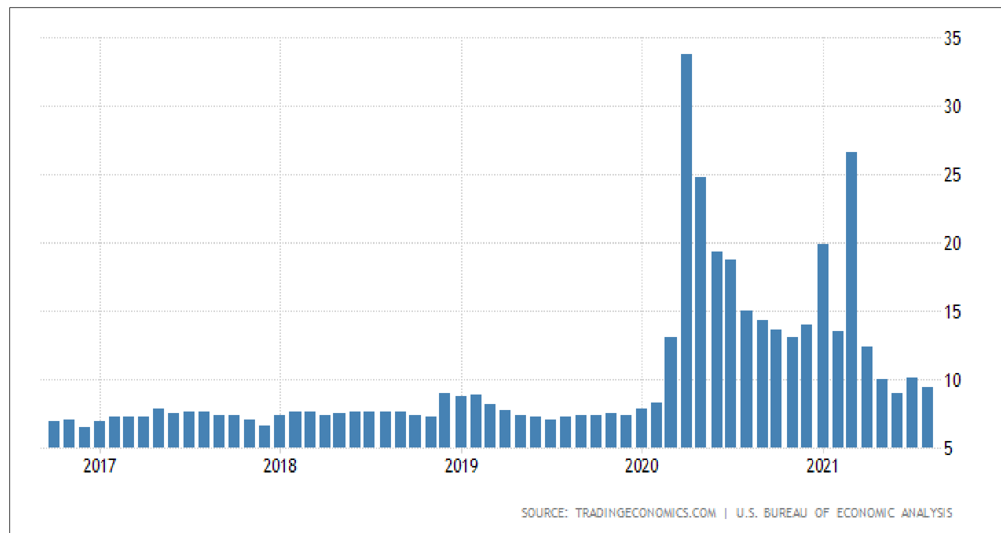


Exhibit #2
Household Savings Rate in the U.S.



The basis for our favorable outlook for equity investments is the historical progress on wealth creation in this country. As the charts above indicate, wealth has grown since the last recession but the surge in savings in the past year provides a reservoir of potential spending that can keep the economy on an upward trend for the foreseeable future. The pending federal government spending programs will further add to the fiscal stimulus that is already at record levels. The border crisis and surge in immigrants from poor countries is adding to the burden of taking care of these people, but many of them are industrious and will begin to fill the gap associated with the labor shortfall and keep the economy growing. The shortage of goods created by the pandemic and Covid-related loss of jobs is pressuring the transmission of goods from producer to consumer, but the private sector is quickly responding to those shortages. The biggest impediment to a smooth expansion is the bottlenecks at ports of entry where thousands of containers loaded with goods are treading water while waiting to reach the port to unload. Observers expect these bottlenecks to continue well into 2022 with attendant inflation as demand outstrips supply.

Speaking of Inflation

Ever since inflation popped above a 5% annual rate in August, the markets have become more volatile as observers fear that the Federal Reserve will begin to push interest rates higher. The traditional rationale is that the Fed is responsible for keeping inflation under control by raising interest rates and, therefore, slowing the economy. The problem in this traditional analysis is that we surely do not need to slow the economy right now.

From our perspective, the “inflation” we see has been brought about by the pent-up demand for goods and services that accumulated during the economic slowdown. To add fuel to the fire, the government’s spending put billions of dollars into consumers’ hands. Couple the continued impact of the delta variant and the lack of available workers and you have the elements of the perfect storm—a surge in inflation.

The question is whether the rise in prices has made us all poorer. Not measured in traditional measures of inflation is the governments' spending to contain the coronavirus. Prices have risen for selected commodities that have suffered due to the pandemic, yet consumers did not have to pay for Covid-related healthcare. Imagine calculating the cost of vaccinations and hospitalizations that were provided essentially for free and then deducting these costs from the traditional measures of inflation. In this circumstance, there would be little to no concern about inflation.

To take this analysis a step further, a big price buster in the inflation surge was the rise in used car prices. Is that surge a measure of broad-based inflation or is it a measure of the rising costs to buyers and a windfall to sellers resulting in a zero impact on the overall economy? We also were quite upset a few months ago when the inflation culprit was money management fees. The calculation infers inflation occurs when the stock market goes up so that management fees go up because they are calculated based on asset values. In this case the investor is better off because the account values have risen and the money manager benefits since compensation is tied to asset values. A win/win situation — but the gurus say that is an increase in inflation!

Another Angle on Interest Rates

Exhibit #3
Long Term Government Bond Yields

Looking at the chart of long-term government bond yields above, the period 1975 to 1982 shows the residual impact of the Arab oil embargo and associated rise in inflation. Attempting to normalize or come up with an "average" yield for these bonds over time to develop an expectation for where future interest rates may be is difficult. What is more difficult to understand is why market pundits characterize the decline in interest rates since the peak in 1982 as a bull market in bonds. For investors, this was not a bull market. As time passed, falling interest rates resulted in lower rates of return. Even for investors who bought those double-digit bonds in the early Eighties, the yield to maturity estimate was too high as interest on those bonds would have been invested at lower interest rates.

Since 2007, the fall in short-term interest rates and related declines in the yield on money market funds has been dramatic. Investors who received money market returns around 5% suddenly found themselves getting virtually nothing. Yields on bank deposits were worse. If one were to look at the other side of monetary policy that depressed interest rates, the biggest loser in this effort were investors and retirees who saw their income collapse. This collapse was government-induced and could be viewed as a massive tax increase on the retired and the middle class who relied on these safe investments to maintain their standards of living. The government was also a major beneficiary of this policy as the cost of financing shrunk with interest rates on short-term government securities falling to near-zero. When inflation is considered, the rate of return on many government bonds falls below zero. For investors seeking a secure income, bonds should be avoided.

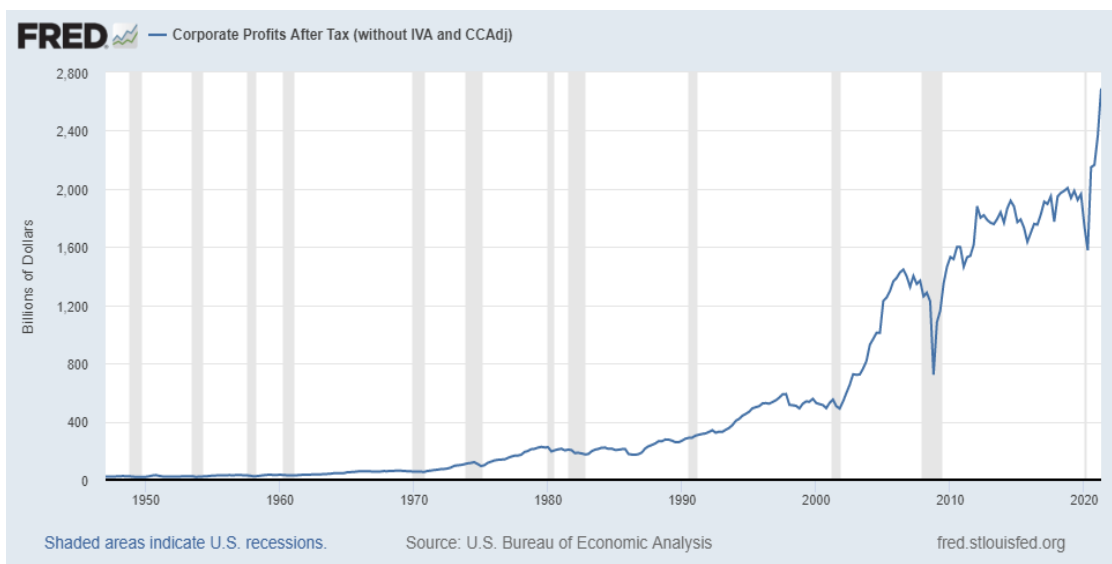
The Outlook for Corporate Profits

There remains a stigma of the pandemic on many U.S. corporations. As the Delta variant has imposed a longer period to a full recovery, those companies that benefit from an open society remain under pressure. The imposed masking and distancing rules forces a natural limitation on many people who fear socializing. When the masks came off in the summer, the number of virus cases skyrocketed. The stock market did not seem to care as the major stock market indices reached record highs in August and into September. While the Covid-susceptible companies prayed for a quick decline in coronavirus cases, other companies continued to benefit from the accelerating economic expansion.

Corporate profits growth is a key component to continued increases in equity markets. After a brief decline in 2020, profits have surged in 2021 and analysts are forecasting another advance in 2022. Companies are buying back stock and increasing dividends, which are factors keeping the stock market in an uptrend. In our internal equity research, there continues to be analysts mostly raising their earnings estimates for 2022 even with all the logjams and major ports keeping pressure on growing business activity.

Exhibit #4

Corporate Profits After Tax



Conclusions

Being optimistic on the economic and equity market outlook is not without some risks. One critical risk is the outcome of the tax debate in Congress and the impact that a major tax increase might have on equity markets. If there is a small tax increase, a booming corporate America can absorb such an increase given the ability to borrow money at near-record low interest rates. However, an increase that taxes wealth rather than income could be a disaster for the stock market. The indirect effect of wealthy entrepreneurs having to sell billions of dollars of stock to pay a wealth tax could have an overwhelming negative effect on stock prices. There is an array of different options for tax increases that we must carefully interpret and make subsequent decisions that affect our portfolios.

Another short-term risk is the potential for a change in expectations about Federal Reserve interest rate policy and the impact on margin debt, which has been running at record levels. Speculators have made money by borrowing at low interest rates and investing in the stock market. If those speculators experience a rise in interest rates, they may decide to find another investment medium. This decision affected stocks in 2018 and pushed the S&P 500 index lower in the fourth quarter by more than 13%.

The risks of Covid continue to decline, America has never been wealthier and the outlook for the economy continues to brighten. After the third quarter market consolidation, the fourth quarter should be a good one for stock investors.

Diane V. Nugent, *President/CEO*
Thomas E. Nugent, *Director of Investments*