Weekly Market Missive

Government Revenues and Equity Markets

May 16, 2022

Equity markets declined last week even though corporate profits continued to surprise on the upside and recent metrics revealed a strong employment picture. Even though the economy continues to grow, various financial surveys indicate that investors consider inflation to be the biggest threat to future growth. Drilling down to the components of the 8.3% inflation rate in April reveals that used car prices surged. How many people buy used cars? The point being that the components of inflation measures are arbitrary and sometimes make no sense, particularly on a month-to-month basis. For example, a couple of years ago, the biggest contributor to inflation was investment advisor compensation. When the stock market goes up, advisor compensation goes up because they get paid on assets under management—as the value of an account goes up, then advisory fees go up. So where does inflation rise in that example? Why aren't stock prices included in that calculation? Monthly rents are included in the inflation calculation so why not stock prices? Postage stamps and cigarettes are too, but the arbiters decided that rising stock prices are not inflationary. So, what is on the other side of an inflationary transaction? For example, consumers pay more for milk, but farmers get more money for their milk. Are we experiencing a wealth transfer from one economic sector (consumers) to another (producers)? Yes, as we have written about many times before.

Speculation seems to be coming out of not only high-flying equities but other real assets. Thankfully, we have seen a meltdown in speculative "assets" such as cryptocurrencies, NFTs and SPACs as novice investors have had their fingers burned. Retail option activity has also been on the decline which tells us that we have almost shaken out the speculation. However, there are some longer-term risks to consider that include a Fed policy that may be increasingly tight (for the first time in 40 years!), bonds that are offering higher yields than in the recent past, overvalued stocks across capitalization levels, elevated oil and natural gas prices and the possibility of a prolonged war in Ukraine that would exacerbate the latter. One bright spot is the strength in the U.S. dollar! Remember that a strong dollar acts as a tempering of inflation as imports become cheaper for Americans.

An important phenomenon affecting financial markets is the fact that the U.S. government showered the economy with $7 trillion in 2020-2021 resulting in record tax revenues that have been a burden on economic growth and the stock market. In April, federal tax collections soared and drove the budget surplus (not a deficit) to a record $308 billion! Overall, government revenues rose 97% to $864 billion. To compound this transfer of wealth from the private to the government sector is that federal outlays fell 16% to $555 billion. This number could continue to decline as spending on the pandemic shrinks which would further harm equity markets. The nearly $3 trillion in tax revenues this fiscal year are also at record levels. This situation at the federal level is just the tip of the iceberg. State and local governments are also experiencing huge tax windfalls from both rising income taxes and ballooning real estate tax collections. Let's see if they give any of it back!!

109 East Bay Street * 1E * Charleston, SC 29401 * 843-342-3044 * www.vcm.us.com