Financial Markets Perspective

April 2022

A Return to Equilibrium?

Introduction

At the end of last year, the economic and financial market outlook appeared bright. The Covid crisis was ebbing after several fits and starts and the variant-forced vacations for workers was coming to an end. Employment was on the rise bringing the unemployment rate down to 3.6% not bad, given the recession of 2020 pushed that rate over 14%. Yet, job openings were still more than 11million at the end of February. The government's 7+ trillion-dollar stimulus package was helping the economy get back on its feet as GDP grew 6.9% in the fourth quarter of 2021.

Unfortunately, doling out that much money caused the normal balance between supply and demand to be knocked off-kilter. Compounding the problem was the negative impact of the virus on normal supply channels. Cargo ships backed up at all U.S. ports due to a lack of qualified machine operators and truck drivers necessary to handle those containers. Backups of 50+ ships occurred at Long Beach in California and, here in Charleston, the backup was 27 ships! Foreign ports experienced similar backups with Shanghai, Singapore and Shenzhen also suffering labor shortages and continued on-and-off Covid-19 restrictions.

Then along came a burst of inflation due to increasing demand and lack of supply. In addition to the surge in demand, the inexorable rise in energy prices, for a variety of reasons, complicated the situation. Putin's invasion of the Ukraine added fuel to the fire and propelled oil and other commodity prices higher. The result was not a transitory inflation situation but a longer-term threat. Financial markets seemed to accept all these uncertainties with stocks rallying across the board in March – even though they were still down for the year. The bond market suffered from higher inflation, rising interest rates and fears of recession. The bond market's pain and suffering has not been this bad since the 1980s!

March was probably a turning point in government policy regarding inflation, the economy and interest rates. The pop in inflation for the month of February to 7.9% scared a lot of economists and market mavens. The Federal Reserve quickly shifted from a policy of wait-and-see to a policy of raising interest rates sooner rather than later. Expectations of many rate increases were on the table with 50 basis point jumps expected during the balance of 2022 with more to follow in 2023. The federal government went from proposing (and failing to pass) another $2 trillion stimulus package to a plan to reduce the budget deficit. The stock market rally in March began on the day the Fed increased the fed funds rate by 25 basis points. This rally could be related to the ongoing events regarding the invasion of the Ukraine and the commitment by NATO members to maintain a strong front against Russian aggression. Also, the failure of the Russians to maintain military superiority revealed the prospect that the war is likely to be over later rather than sooner.

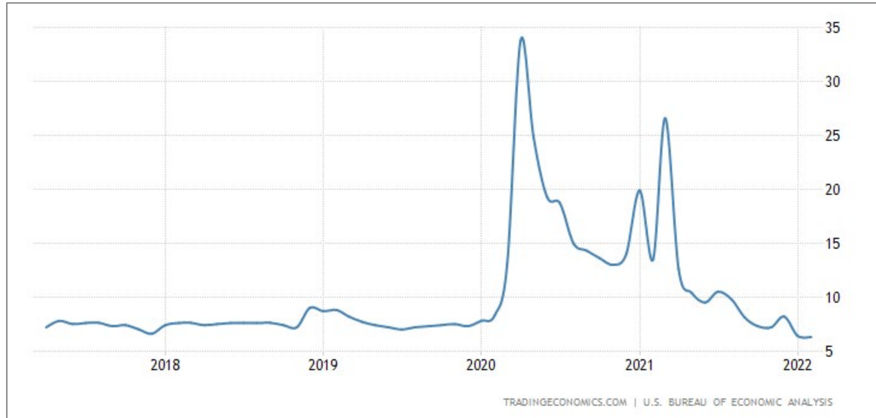
The Administration also announced plans to reduce the budget deficit by increasing the income tax rate on billionaires and proposing a combination of a minimum tax and a tax on unrealized

capital gains. But why raise tax rates? At last measure, the federal government's tax revenues have been surging as all that Covid spending is winding its way through the economy and making a tax stop at every transaction. Similarly, state, and local governments are flush with tax revenues as higher incomes push people into higher tax brackets, rising capital gains increase tax collections and surging real estate prices add more real estate tax to government tax coffers at all levels. Interestingly, several states are proposing reduced tax rates given these surpluses.

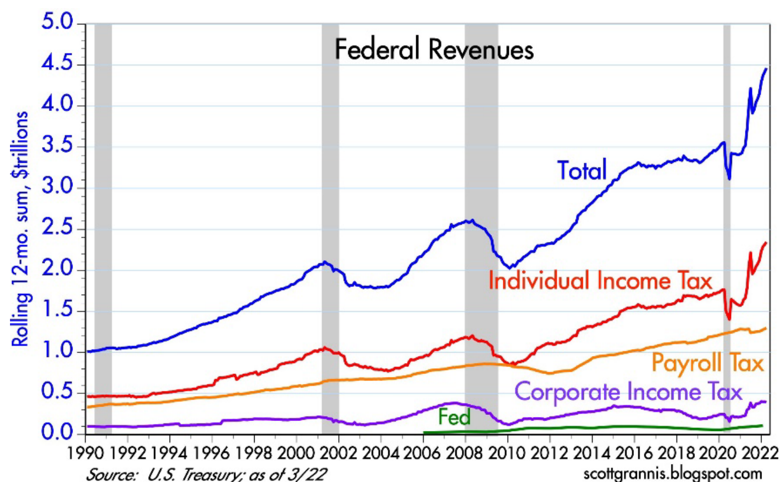
The Effects of Monetary and Fiscal Stimulus

Since the onset of the virus, the government shutdown, and the kneejerk government spending programs to avoid an economic collapse have benefitted financial markets as well as the overall economy. Moreover, the $7 trillion-plus federal government stimulus dropped on the economy is still trickling down and benefitting both businesses and individuals. Never has there been such an increase in money given to the private sector and state and local governments. Initially, the private sector didn't know what to do with that money so they saved it as can be seen in the chart below. Currently, the personal savings rate remains down from a high of 33.8% in April of 2020.

Personal Savings Rate



The growth in the savings rate and subsequent return to semi-normalcy indicates that consumers decided to spend some of the Covid windfall. Remember that consumer spending represents someone else's income that will be taxed at various levels. The chart below reflects the benefits of a spending-oriented consumer who is contributing to federal revenues.



Indian Givers

We have all had a friend who would give us a gift and then take it back – better known as being an "Indian Giver." As we have documented above, the U.S. government falls into this category over the past two years. First, the government doles out over $7 trillion to keep the economy afloat during the pandemic, then reaps the rewards of that spending by receiving rapidly increasing tax revenues. Yet at the same time, inflation picks up and the givers become the takers because monetary policy was not just stabilized but reversed. The Fed could have just stopped buying bonds. After all those fiscal giveaway programs to individuals and businesses, the spending was quickly reversed, and a major tax rate increase is in the works. Keeping taxes unchanged would be neutral if the government slowed spending but that is not in the plan. Another multi-billion-dollar Covid spending bill is on its way. Stay Tuned!

These dramatic changes in policy are having a negative effect on financial markets. Both bonds and stocks suffered through the first quarter of this year with the S&P 500 declining by 4.6% and the 10-year treasury bond falling by 6.9%. The 30-year government bond fell a whopping 11.4%! If these new fiscal and monetary policies are implemented over the next few months, both financial markets and the economy could be under more pressure. If the invasion of the Ukraine continues through the summer, markets are likely to remain volatile; a resolution of the war should be a major positive for the outlook.

The Impact of Rising Interest Rates

Over the past few weeks, changes in interest rates because of the Fed moving forward on its plan to slow the economy and, in turn, lower inflation, are showing up in mortgage rates. Two months ago, a 30-year conventional mortgage was available for under 3%. Today, that same rate has risen to almost 5.4%. The increase in monthly payments is about 80%! Individuals who could buy a home based on their monthly payments are being squeezed out of the housing market and the increase has knocked out more than a few applicants for a mortgage. Ironically, there are many corporations that have been purchasing packages of homes for investment purposes – somewhat of an indicator that the great housing boom of our lifetimes may be coming to an end.

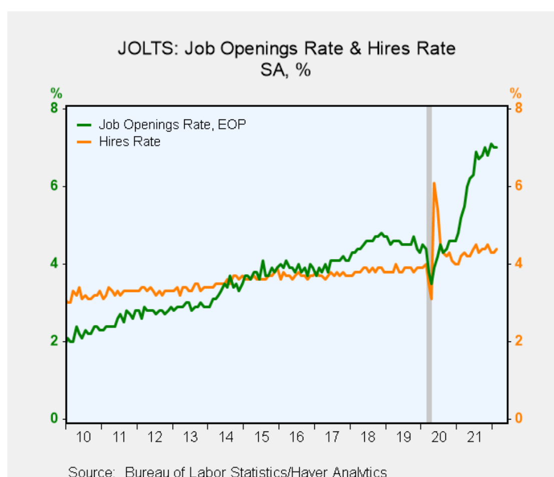
On the other hand, interest rate increases benefit conservative investors and retirement plans where rising rates result in higher income for investors who have kept their portfolios in short-term bonds or bond funds. This increased income allows those investors to spend more on goods and services. If that increase becomes telling, the economy could maintain overall growth in the 2% range for the foreseeable future. Additionally, conservative investors may finally be getting a break. The prospect for an extended period of rising interest rates can improve long-term bond returns as reinvestment rates should be higher. Investors who bought bonds at the low point in terms of coupon should get some relief as their reinvestment rate will be at higher coupons and thus higher income levels. Unfortunately, high levels of inflation will continue to erode the value of bonds despite higher interest rate payouts making bonds an unattractive investment option.

Conclusions

Financial markets ended a long-term bull-market run in the first quarter of 2022. Fears of inflation triggered weakness in almost all financial investments. The exception was commodities that saw double-digit returns as fears of scarcity drove prices higher. The current high-inflation environment was fomented by record government spending and easy monetary policy that

flooded the economy with money. Putin's invasion of the Ukraine added more uncertainty to the duration of high inflation globally.

The outlook for inflation may shift to a more optimistic view when the productive machine begins to meet increased demand. We are seeing that the pandemic is becoming more of an endemic condition as more and more people go back to work. When looking at the labor market we find that the unemployment rate fell to 3.6% in March yet there still exists a huge gap between workers who want to work and jobs that are available as you can see in the chart below. The green line represents the job openings rate, and the orange line denotes the hires rate. The labor force participation rate (not shown) is still below pre-COVID levels but is climbing higher as more people are staying unemployed for a shorter period that explains why continuing unemployment levels are at lows not seen since the late 1960s. Another important statistic is that the quit rate, the rate at which workers are quitting their jobs is at a record high. These are good times for Joe Six-Pack.



Improving corporate profits, record stock repurchase programs and the ability to pass along increases in raw materials prices to consumers should benefit most companies. Such companies remain attractive as long- term investments and history provides us with a record of how well such companies do over longer time periods. For many investors, now is the time to buy these companies' that will work out to be attractive investments in the years to come. When looking back on an annual basis to 2010 earnings forecasts versus actual results, we found that actual results were better than forecast. Looking ahead to 2025, we find that estimates are hitting record highs, so that if history is any guide (and we know that past performance is no guarantee of future results) companies in the S&P 500 will likely come in ahead of estimates and investors should be commensurately rewarded. There will always be downturns along the way but staying invested - even in difficult times - is always recommended.

As our regular readers know, we would rather not have government interference in financial markets, but COVID and associated variants have resulted in record intervention from both fiscal and monetary policy decision makers. American corporations have never been leaner with record low interest rates on their debt and record cash stockpiles. Ditto for the American consumer. "This too shall pass" is a saying that Abraham Lincoln said was applicable in any and every situation one could encounter. The malaise that threatens the economy and financial markets will pass too!!