Economic and Market Newsletter Summer 2021

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INVESTORS REMAIN FOCUSED ON INFLATION

The investment community had been bracing for higher inflation, but no economics degree was required to recognize its arrival. Recent Government reports confirmed that the prices of everything from groceries to semiconductors to used cars were moving higher and at a rapid pace. April's Consumer Prices Index rose 4.2%, which was followed by an even larger 5% increase in May. The three-month annualized rate of change was still more disturbing, rising by almost 8%, the fastest increase in over a decade. Whether one is looking at Consumer Prices, Producer Prices, headline numbers or core, inflation readings were up markedly across the board. So far, the financial markets have taken these increases in stride. A short-term surge in inflation was considered likely, because the year-ago comparisons were during the worst part of the COVID lockdown. Even though economists had baked in a high number, inflation still managed to surpass the consensus forecast. Let us be clear, the rates of inflation that were reported recently are negative for society. Even if inflationary pressures begin to recede soon, consumers will still be burdened by the many prices that have already risen faster than their incomes. That being said, for the investment community, the critical question is how severe price increases ultimately will be and how long the acceleration in inflation is likely to last.

The most important voice in the debate, Federal Reserve Chairman Jerome Powell, still officially sees the current bout of inflation as "transitory." There were some signs, however, that the Fed's confidence may be lessening. Notably, the Open Market Committee increased its 2021 forecast for their preferred inflation measure, the Personal Consumption Expenditure Index (PCE), from 2.2% to 3.0%. That increase may seem small compared to the recent CPI data, but it was the largest revision between meetings that we can recall. In the same announcement, the Fed shifted the likely timing of an interest rate hike forward by a year, to 2023 from 2024. In typical Central Bank language, Chairman Powell also acknowledged that members of the Fed's Open Market Committee were ready to start "talking about" reducing the Fed's aggressive quantitative easing program. The market interpreted these tea leaves as a tilt toward a slightly more hawkish stance.

Opinions vary on how long this spike inflation will last, even within the Federal Reserve. Independent economists' expectations seem to congregate around one of four scenarios on how the inflationary pressures will eventually play out. Each forecast has its scholarly adherents with plenty of facts to support it, so it isn't clear which prediction may prove to be correct. Depending on which forecast is right, vastly different outcomes could occur for the financial markets, so it is worth exploring each in detail.

ECONOMISTS' FOUR FAVORITE FORECASTS

(A) The Federal Reserve turns out to be right: The current upsurge in inflation may have less to do with untamable inflationary forces, but more to do with short-term supply shortages that will eventually cure themselves. Many companies burned by the Great Financial Crisis were unwilling or were unable to secure sufficient capital to expand their businesses. This was particularly true in commodity sectors, where falling prices led to abysmal profitability, plant shutdowns and a lack of new investment. It is often said in cyclical businesses that the cure for low prices are the low prices themselves. Now that demand has recovered, the earlier curtailed investment and reduced capacity has led to shortages, causing prices to rise. This improved pricing power boosts returns and should eventually attract new investment, helping supply to catch up with demand. For example, recently, ocean-going traffic has been hampered due to a shortage of shipping containers. There aren't enough containers overall and many empty ones are stuck in ports where they aren't needed. This single bottleneck has raised shipping costs enough to affect the prices of almost all imported goods. Fortunately, shipping containers are fairly straightforward to produce and eventually logistics systems will make sure they are in the right places. If such supply constraints turn out to be the most significant reasons for recent inflationary pressures, then investors could begin to rest easier in a few quarters after these temporary obstructions are eased.

Productivity could be another force that could help tame inflation, which some economists believe could improve markedly. In response to workplace disruptions during COVID, many employers learned how to do more with less: adapting to a dispersed workforce by altering workflows and job responsibilities. Many firms, particularly very large ones, have invested more in automation and advanced technology to increase efficiency. A recent McKinsey survey showed that 80% of firms plan to increase the digitalization of their operations and 50% plan to accelerate the automation of repetitive tasks. Better efficiencies could offset some of the many cost pressures and help to preserve corporate profit margins.

(B) A slower recovery equals lower inflation: Once the initial economic rebound subsides, another group of economists expect inflation to subside quickly, because the anemic, pre-pandemic trend in GDP will begin to reassert itself. The past two economic recoveries in the U.S. were some of the weakest on record due to demographic factors and globalization. The two largest factors driving GDP growth, increasing population and better productivity have been trending lower. Population growth was already slowing prior to the pandemic and it declined further during COVID.

Productivity gains have also been more challenging to realize. Services industries tend to be more labor intensive and as the service sector became a larger portion of our economy, productivity improvements became harder to achieve. The vast increase in private and public debt in the wake of the Financial Crisis may have impacted economic growth as well. While increased leverage may have initially helped to pull demand forward, the burden of repayment may have slowed the pace of GDP growth in subsequent years. Some economists worry that all of these factors remain in place and seem to have gotten worse over the past year. If they are right, the economic bump from the initial rush to normal after vaccination may turn out to be a flash in the pan, followed by a damp fizz.

(C) The return of boom and bust: The U.S. economy is recovering, but it still hasn't shaken off the effects of the pandemic. Like a prize fighter that has been knocked for a loop, the country may no longer be flat on its back, but it hasn't quite reverted to top form yet either. Even though 14 million jobs have been filled since the April 2020 low, almost a third of the jobs lost in the recession still haven't returned. Once the U.S. gets its bearings again, however, the economy may be ready to rumble. The flood of monetary and fiscal stimulus, here and abroad, are unlike anything ever seen in peacetime. The Federal Reserve has never injected vast quantities of liquidity into the financial system simultaneously with massive fiscal stimulus and with the balance-of-payments deficit that exists today. The so-called Twin Deficits totaled a combined 22.8% of GDP for the twelve months ending in March, far above the previous record of 12.8%. As a result of the flood of money being pumped into the economy, households have saved record amounts during the downturn, possibly setting the stage for an explosion of spending once consumer confidence improves.

Using such an untested playbook increases the chance that officials have made a policy misstep that will lead to a massive economic boom. Inflationary expansions can be great fun at the beginning, but when monetary authorities eventually have to tighten to the point of causing a recession, they become no fun at all.

(D) Back to the 1970s: No investor remembers the 1970s markets with fondness, since stagflation was bad for both stocks and bonds. Yes, inflationary pressures were building in the late 1960s, but it was the two oil crises in the 1970s that were the root cause behind the worst of that decades' economic dislocations. Skyrocketing oil prices acted like massive OPEC taxes, bringing two deep recessions along with inflationary shocks. Countries that had no domestic source of oil had to borrow deeply to prevent landing in a depression, while oil producers borrowed as if oil prices could only go up. This excessive leverage eventually led to a series of international debt crises that caused further economic pain.

Inflationary pressures may be building now, but we don't see a parallel to the seventies' energy crises. The political landscape in the Middle East or Venezuela cannot be considered to be very stable, but events of the magnitude of the 1973 OPEC oil embargo or the downfall of the Shah of Iran fortunately tend to be relatively rare.

While the balance of power in the oil markets has been shifting back toward OPEC recently, both the supply and demand structure of the U.S. energy industry make America less vulnerable to an oil shock today. On the supply side, advanced drilling techniques in the oil patch have helped increase domestic crude production and on the demand side, less of our GDP is directly tied to oil consumption than it was fifty years ago. Increasing use of natural gas and alternative energy sources, along with better conservation efforts have made a real difference. Back in the 70s, oil analysts worried about the imminent peak in world oil production and the inability of producers to meet future demand. Now, there is more discussion of when the peak in oil demand is likely to occur.

LOOKING TO THE BOND MARKET FOR ANSWERS

How to choose among these four forecasts? To help us, we've taken a careful look at the bond market. Bond investors are obsessed with protecting the loss of purchasing power of their capital, so long-term bonds ought to be one of the most sensitive inflation indicators. Given that the most recent headline inflation number was reported at 5%, one might have assumed that bond yields would move sharply higher. That has not been the case. Bond prices have been generally rising as yields have drifted lower. It appears as if the most inflation-sensitive investors in the world are backing the Fed's transitory theory. Perhaps they are. Digging deeper, however, other factors could be behind the move in bond yields that make us less willing to accept that blindly. It shouldn't be a surprise that the bond market reflects the Fed's thinking, when the Fed has become the largest participant in Government bond trading. Over the course of 2020, the U.S. Central Bank accounted for about half of all U.S. Treasury note purchases. This aggressive monetary policy has had secondary influences on the bond market as well. As liquidity has poured into the financial system, bank deposits have grown faster than loan demand. Banks have been buying Treasuries and Agencies as a stopgap measure to put the money to work. If Central Bank distortions are supporting price levels, then the decline in interest rates may not be helpful in judging investors' inflation worries. We cannot ignore the action in the bond market, but it is not enough, by itself, to put us firmly in one camp or the other.

OTHER INDICATORS TO CONSIDER

We turned to other assets that are traditionally viewed as hedges against inflation to see if they confirmed the signal from bond yields. These would include precious metals, industrial commodities, oil, some foreign currencies and the new asset class of digital currencies, like Bitcoin. We've been interested to see that the prices of almost all of these different inflation hedges topped out this year, one after the other. Spot gold prices peaked back in January, followed by platinum and the Australian dollar in February, Bitcoin in April, copper and lumber in May. Energy prices remain the last holdout and are still on an upswing as we write these notes. If investors were convinced that an inflationary boom was imminent, all of these assets should consistently be hitting new highs.

The fact that they are not, gives greater confidence that Chairman Powell may be right and the inflation surge could be transitory. The first step will be to see how quickly if the supply chain disruptions can be resolved, but the impact from the pandemic-related Federal spending may take longer to discern. The size of the various infrastructure programs are still being debated, so the ultimate size of the Federal deficit is still a question mark. We, at Hallmark, will keep a steady eye on the economic indicators and remain vigilant on inflation.

PEAK EARNINGS GROWTH, BUT WHAT A PEAK!

Inflation has been the major topic of discussion in the markets, but earnings growth remains one of the most important determinant stock market results over the intermediate and longer term. Historically, according to data provided by Neuberger Berman, earnings growth correlates to 80% to 90% of stock market returns for holding periods beyond three years. Since Price/Earnings ratios have remained steady (at fairly high levels) for the past year, the bull market in stocks since last spring has been due to the remarkable recovery in corporate profits. The second quarter of 2021 should post an eye-popping 60% increase in S&P earnings, which might be the largest year-over-year gain ever recorded. Exceptionally strong GDP growth over 12.5% drove a 14% increase in revenues that was magnified by a rebound in profit margins. The second quarter will probably mark the peak level of earnings gains, since the third quarter earnings comparisons will become harder. Most investors have already taken this into account.

THE CONTINUING PULL OF GROWTH VS. VALUE

After Chairman Powell's press briefing, equity investors rotated away from some of the economically sensitive stocks associated with the reopening theme. The perception of a mildly more hawkish Fed, combined with lower interest rates, helped drive valuations higher for last year's favorites: the big-cap growth names. In many ways, second quarter equity performance was a reversal from the first quarter results. This kind of back and forth movement is common in the early phases of a recovery, when the economy is improving, but it still appears to be fragile. In the earliest stages, the riskiest and most volatile stocks tend to do the best (e.g. the "meme" stocks this time), but nothing moves in a straight line in the financial world. As spreads in relative valuations widen, sector performance rotates, causing the leaders to fade and allowing the laggards to catch up. Once economic momentum begins to build and investors have more confidence it will be sustained, stocks with value and quality characteristics tend to be viewed in a more positive light and typically assume market leadership. Even if the recovery is weaker than expected, stock market breadth should widen as more companies see solid demand and improving profitability.

OUR OUTLOOK

Valuation levels are high, as much of the future improvement in earnings appears to be anticipated by investors. Earnings may have to surpass the levels already discounted by the markets to impress traders. A greater dispersion of results around stock-specific fundamentals would also fit with historical patterns, once investors have more confidence in the long-term economic trend. It should be noted, however, that bonds still offer a sizeable yield advantage over money market funds and have a role in risk control in a balanced portfolio. Overly strong demand, combined with labor shortages, higher import prices and continuing supply problems have the potential to push inflation rates to levels that the Fed cannot ignore.