Stewart Capital

Market Commentary – Third Quarter 2021

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Laissez-faire

Laissez-faire: (lesā fer) noun: a policy or attitude of letting things take their own course, without interfering. In economics: the abstention by governments from interfering in the workings of the free market. (Oxford Languages Dictionary)

The more we look back on what has transpired over the past 18 months or so, the more we think that had governments taken a more laissez-faire approach to the global economy during the pandemic, the better shape we would be in right now from a supply/demand standpoint. This is not to say, however, that the closing of global economies didn't help to contain the spread of COVID and its mutations—it did, and it helped buy some time in terms of allowing the pharmaceutical industry to develop one or more vaccines.

However, we believe that it is equally clear that global governments did not think about the unexpected consequences of telling "non-essential" people to stay home and then giving them thousands of dollars to make up for their lost wages. Government(s) got to pick the economic winners and losers during the shut-down (Wal-Mart/Amazon were allowed to stay open and sell clothing, while local clothing stores had to close down, for example) causing many small businesses, and some larger ones, to close their doors permanently. Do we really want government(s) determining economic winners and losers? Have they shown any skill or aptitude for doing so throughout history? We will leave that for others to debate. What is clear to us is that last year's shutdown is creating all kinds of inefficiencies and dislocations in both domestic and global economies.

Let's look at inflation. History and economics have taught us that inflation is caused by too many dollars chasing too few goods. Yet, there is often little explanation or understanding of what led too many dollars to chase too few goods. Baby Boomers remember the bad old days of double-digit inflation and low wage growth in the 1970s and 1980s, and then point to runaway growth of the money supply as the reason. Indeed, long-past chair of the Federal Reserve Paul Volker is credited with putting the domestic economy on a money supply growth diet to break inflation's back. With the explosive growth of the money supply as a response to the short, sharp pandemic recession, is it any wonder that the markets are worried about a reprise?

What can cause too many dollars to chase too few goods? In our mind, it's really just as simple as the relationship between supply and demand.

In basic economics we are taught that supply and demand must remain in balance.

If there is too much demand for a limited supply of goods, then price must rise in order to bring supply and demand back into balance. Similarly, if demand falls and there are too many goods, then prices must fall in order to restore balance. Yet, demand can outweigh supply for two different reasons.

Back in the 1970s, as the Baby Boomer generation was entering the workforce and earning money, too many dollars (higher demand for goods) took the form of the largest generation in history (at that time), both in terms of raw numbers of people and as a percentage of population all demanding stuff. As the entire Boomer generation demanded stuff (houses, cars, furnishings, clothing, etc.), demand outstripped supply because businesses couldn't raise production fast enough. Looked at another way, the economy was producing stuff based on demand from a previous period (year) and the new year's demand was higher because there were more people demanding more stuff. The Fed was able, during the Volker era, to reduce demand by hiking interest rates in order to reduce the amount of money available to buy goods.

In the most recent pandemic-driven recession, expectations were, with no one working and everyone staying home, demand for stuff would drop. Indeed, just looking at the automobile industry as an example, most manufacturers terminated orders for parts (i.e., chips) as they fully expected demand for cars to drop, as typically happens during a "normal" recession. Instead, after a very brief decline, demand rebounded to pre-pandemic levels as people were leery of using mass transit or just wanted to upgrade or travel.

Businesses reduced production of "stuff" because they expected demand to drop, but it remained the same.

Demand outstripped supply not because demand grew, but because supply shrank.

Look at it another way.

If you are told that you have to stay home for an indeterminate period of time, you might be inclined to decide that you need to upgrade your home since you are spending more time there.

Upgrading the home leads to higher demand for lumber, which is in short supply because the factories that produce the lumber are shut down. In this case, demand rises while supply is artificially reduced, thereby creating significant price increases (inflation) for lumber. Inflated prices for lumber are transitory, as prices should fall once supply constraints are removed.

Supplies of many products have been artificially reduced, creating a supply/demand imbalance that has driven prices higher. Now we want to restart factories to produce more stuff to meet demand, but the supply of workers has been artificially reduced as businesses, schools, etc., are/were closed during the pandemic. This means that someone needs to watch the kids, thereby removing available workers from the labor pool. This creates a worker shortage, which exacerbates the labor problem since factories can't get to full steam as demand for stuff continues to build.

What if we had left well enough alone and allowed businesses, factories and schools, etc., to remain open and not flooded the economy with liquidity? Would we be better off from a supply/demand standpoint? Perhaps not, given the tenuous supply chain situation the pandemic exposed. Perchance, however, manufacturers would not have cancelled supply orders expecting a demand drop-off.

The Economy

Is it transitory or is it something less than transitory? That has been the debate for most of this year, as inflation has clearly lifted off to levels not seen in decades.

We have been squarely in the transitory camp as we believe that while inflation should spike, it should also subside somewhat once the bottlenecks work themselves through.

That is not to say, however, that we believe inflation will decline to pre-pandemic levels. Far from it. We fully expect inflation to remain above not only the levels of the last decade plus, but well above the Fed's 2.5% target.

Yet transitory inflation makes sense if one understands the "why" of the current economic situation. Demand outstrips supply not because more people want more stuff, but because the same people want the same stuff whose supply has been artificially limited due to a natural reaction to a global economic decline caused by artificial means—governmentally mandated economic shutdown. (It became official on July 19, 2021 that the recession ended in April 2020, just two months after it began. The shortest recession on record.) In our mind, expectations of an inflation reset to a non-transitory nature (aka, 1970s-style inflation) would assume that the extreme liquidity provided as a means of short-circuiting the recession would cause dramatic demand increases and, with it, associated higher economic growth. Growth we don't think will happen.

Indeed, while the second pass of second quarter 2021 GDP was revised marginally higher to 6.7%, expectations for the third quarter are somewhat more muted. If we assume that the Atlanta Fed's GDP Now forecast of real Q3 2021 GDP is accurate (1.3% as of October 5, 2021), then nominal Q3 GDP will likely post a 5.5% reading, with Q4 GDP declining further as supply chain bottlenecks persist and Christmas sales become more muted than expected. (Real GDP is the nominal or headline rate reduced by the effects of inflation. Nominal GDP of 5.5% and real GDP of 1.3% implies an inflation rate of 4.2%.) This will cause the full-year GDP to come in well below the 6.5% full-year expectations that the Fed had as the new year began.

The employment situation continues to add to the bottlenecks as people are not coming back into the labor force nearly as rapidly as employers would like, particularly among women who tend to bear the brunt of the burden for at-home care. (From the recession's official beginning to its official end, women accounted for approximately half a million more lost jobs than men.) This has shown up in the job gap growing to in excess of 2 million more jobs than unemployed people as of July's JOLTS data. (JOLTS: Job Openings and Labor Turnover Survey. July's Data was released on September 8, 2021.) We believe that the gap between jobs and the unemployed will widen further when the August data is released in October since many have stayed home and out of the ranks of the unemployed due to concerns over COVID, school restrictions, etc.

Interestingly to us, the persistent shortfall in available workers to job openings could well lead to sub-optimal economic performance. In fact, the persistence in high unemployment (even though there are plenty of jobs), the likelihood that economic growth will be sub-optimal (read slower than it should be) and higher than desired inflation has brought fears of stagflation back to the fore. When was the last time we experienced stagflation? You guessed it - the 1970s. And yet, for all of the hand-wringing that pundits will do worrying about stagflation, the current environment is nothing like the 1970s as the root causes are different.

So where does that leave us? Perhaps with stagflation lite. Yes, unemployment will run higher than desired, but it will not be for lack of jobs. Yes, inflation will run hotter than the Fed's 2.5% target, but the year-over-year CPI ex-food and energy reading of 5.3% for August could well be near a peak, with future readings falling back below the 5% level. While we understand that 5% inflation is certainly troubling, it isn't the 10%+ readings of the 1970s and early 1980s. Finally, while the economy should slow to levels more closely associated with the earlier part of this century, the sub-par growth will largely be the result of bottlenecks keeping the consumer from getting too overheated due to lack of product.

Market Overview

It ended up being kind of a rough quarter for stocks and a blah quarter for bonds. While domestic equities across the market cap spectrum are having another bang-up year, the quarter was a downer—both actually and figuratively.

Bonds are suffering from the early stages of a malady we have been warning of for some time: rising rates. Granted, the Federal Reserve has not done anything to increase short-term rates, interest rates are increasing even if the increase is modest. The modest increases we have seen are due to concerns that the extreme increase in money supply to remediate the fallout from the Pandemic Recession will spur inflation. Another lesser, but no less real, issue is that they (rates) simply had almost no other direction to go but up.

While most bond indices were flat for the third quarter (the Bloomberg 8–10 Year Municipal Index being the exception at -0.15%), the longer-term taxable indices we follow are still showing modestly negative returns through three quarters (Bloomberg Gov't 1–5 Yr Index -0.44%, the Bloomberg US Gov't/Credit Intermediate Term Index -0.87% and the Bloomberg US Agg Bond Index -1.55%). While the third quarter provided a bit of a respite from marginally higher rates, we would point out that with the Federal Reserve expected to begin tapering bond purchases before year-end, a Fed Funds rate hike or hikes expected next year, and the outlook for higher than trend inflation probably mean rates should continue to work higher.

Third quarter, as indicated earlier, was a rough quarter as news from China, dysfunction on the federal budgetary front in Washington and uncertainty about Federal Reserve actions (or lack thereof) have built in some uncertainty about the future.

News from China that one of its property development companies, China Evergrande Group, was probably going to be insolvent (although the Chinese government seems to by trying to forestall such a development) and would miss (has missed) dollar bond payments roiled equity markets. While we find it modestly humorous that many investors are just now questioning the veracity of data coming from the Chinese government and Chinese companies, it certainly has raised the risk profile of many companies—something which had not been priced into the market.

The prospect of higher interest rates had also not been fully priced into equity markets and the increasing likelihood that rates a year from now will likely be higher has caused some downward movement in equity values. Couple this with earnings expectations that will likely show lower growth than this year, and we ended up with what we got—marginally lower equity prices. Not to fear however, since domestic equities are still showing strong double-digit returns for the year-to-date period ending September 30, 2021.

Outlook

If markets climb a wall of worry, then we might be ok through at least year-end, as we seem to have worries in abundance.

Will there be enough product for consumers to give family and friends a normal Christmas, or will the combination of supply chain bottlenecks and panic buying/hoarding make the Christmas selling season a bit of a downer, with shortages and feared shortages in abundance?

Will we be able to coax able-bodied workers away from home or out of retirement in order to fill some of the many available jobs, or will people stay at home out of continuing COVID fears or sheer exhaustion? Will supply bottlenecks and poorly timed government mandates continue to create pockets of significant inflation, or will we finally be able to get out of our own way and begin to get back to some semblance of order? Will central banks and governments begin to pull back on some of the extreme liquidity injected into economies in order to fight the Pandemic Recession, or will they give in to political pressures and allow that liquidity to remain? These are but some of the worries that exist, and which need to get answered, as we work our way out of our current global crisis.

It is clear, at least to us, that the Federal Reserve and the European Central Bank are going to begin the process of tapering their bond purchase in support of market liquidity and lower longer-term interest rates. We are curious to see just how aggressive both central banks are in pulling back on purchases as this will mark the first time since quantitative easing was put in place that both banks will taper at roughly the same time. If the central banks taper at the rate expected, there will be far more liquidity drained from the market than the tapering accomplished during the waning years of the Yellen Fed. This could cause longer rates to move much higher much more quickly than either bank desires. If the Federal Reserve sticks with what the markets believe are its tapering expectations, then longer rates should move reasonably higher both through year-end and 2022. While we may not finish the current year at the 2% 10-year and 2.5% 30-year levels we had forcasted earlier this year, rates should move toward those levels. If tapering continues into 2022, as is expected, and the Federal Reserve responds to higher than target inflation (even if they move their target from 2.5% to 3%) by hiking the Fed Funds rate, then our early expectations for 2022 are closer to 2.5% 10-year and 2.75% 30-year Treasury rates.

While earnings are certainly important, interest rates have the biggest impact on asset values. That is because the level of interest rates is how one determines the discount rates to be used for asset valuation. Asset values and interest rates move in opposite directions. As such, if interest rates rise, then asset values must decline.

We realize that equity values and equity prices do not always move in lockstep. That said, equity prices are and should be related to equity values so that if the value of a stock declines, the price of the stock should follow—at some point. Therein is the crux of the issue. Right now, and for some time, stocks have benefitted and suffered from the same malady—TINA: There Is No Alternative. The third quarter certainly saw some volatility around stock prices as equity markets tried to discount both overseas and internal geopolitical risks and the potential for higher interest rates. Those issues/fears will not diminish in the near future, meaning that volatility should continue to be elevated.

Equities should be able to at least maintain current levels allowing domestic equities to end the year with nice double-digit gains. 2022, however, becomes less certain. Increasing geopolitical tensions, the 2022 mid-term elections, continued dysfunction in Washington and potentially higher interest rates all along the yield curve could mean that equities have a sub-par year. While we still have a couple of months to fine-tune expectations, our early estimate is for low single-digit equity returns.

Strategy Overview

Our concerns about both equity and fixed income markets remain heightened. There Is No Alternative (TINA) is a poor reason to make investment decisions. As a result, we are focusing our efforts to an even greater degree on the risks that we take in our portfolios.

Where uncertainty is heightened, vigilance is warranted.

Keeping a trained eye on the relationship between price and value is essential since returns are more dependable when you stay focused on underlying value.

Assessing appropriate value and determining the proper purchase price relative to risks taken has always been and will always be our primary focus.

Linking investment decisions to something tangible, like the cash-generating capabilities of a business or investment, and assessing a minimum acceptable rate of return to each decision should add value.

Elevated risks should translate to higher return requirements and lower valuations, all else equal. Looking at investments, as would any rational person, helps us focus on those things that are important: return of and return on capital.

Regardless of the environment or level of market uncertainty, when we see investment opportunities that allow us to earn returns higher than our requirements, we jump. Over time, this should allow us to be well-compensated for the decisions we've made. In our mind, the real risks are those not taken.

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