Stewart Capital

Market Commentary – First Quarter 2021

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Up and away. Apparently, that is the expectation of many regarding the U.S. economy's growth. One of the positions we were asked to discuss during an AssetTV panel discussion was whether we thought that the domestic economy would grow at the Federal Reserve's expectation of 6.5% for the full year (Source: Summary of Economic Projections, Federal Open Market Committee (FOMC), March 17, 2021). 6.5%! The domestic economy has not grown at a rate approaching six percent since 1984 (when it grew by 7.4%) and not consistently above six percent since the 1960s. In fact, the growth may come from nearly every segment (consumer, business and government) with the only drag really coming from trade, where the United States has been a net importer for decades.

The FOMC range of expectations for Gross Domestic Product (GDP) growth are all well above what we have come to expect over the last three decades, with the range of expectations running from a low of five percent to a high of 7.3%. While we understand the heightened expectations created by the mountain of stimulus dropped onto the economy over the last year ($5.3 trillion since May of 2020), we have a hard time believing that the party will get that wild. Besides, if we throw that big of an economic party, what kind of hangover could we then expect?

It has been an extraordinary 12 months.

First, we had the quickest, sharpest recession since the Great Depression, created by a pandemic that induced a global economic shutdown. Second, we had massive stimulus ($5.3 trillion in the United States so far) and global monetary policies intended to entice people to spend, ultimately hoping to spur a return to normalcy as quickly as possible. Pent-up demand caused by consumers being forced to stay home and away from traditional entertainment and shopping options, consumers and businesses taking advantage of the downtime to improve or build homes, and capital expenditures to improve or institute cost saving have brought significant cost increases, as demand has soared for limited supplies of goods.

Manufacturers found certain components needed for final assembly were in short supply. Factories have been limited to working off inventories during pandemic shutdowns, are simply lacking raw materials or have been facing socially distanced capacity constraints that did not allow them to fully satisfy demand. Additionally, they are rethinking supply chains because global sourcing, while keeping costs down, turned into a huge liability when global economies were locked down to reduce the spread of COVID.

The Economy

The Biden administration and democratically controlled Congress pushed through $1.9 trillion in stimulus spending early in its tenure by utilizing the budget reconciliation process, bringing the total stimulus to $5.3 trillion. They are proposing an additional $2.3 trillion in infrastructure spending which would push the total, if passed, to $7.6 trillion – all within 12 months! (This assumes, of course, that the $2.3 trillion in infrastructure proposals get passed – which is not a foregone conclusion.) Put in context, $7.6 trillion in spending would represent more than one-third of pre-pandemic GDP. We estimate this would increase the national debt by roughly $5 trillion, or approximately 20% from August 2020 levels.

The economy, by many estimations, is expected to be quite robust in calendar 2021.

With pent-up demand and fiscal spending, the Federal Reserve (as mentioned above) is expecting full-year GDP to be 6.5%, followed by a more modest, but still robust, 3.3% in 2022 and then 2.2% in 2023. If accurate, this will mark one of the more robust periods of domestic economic growth since the late 1990s (Source: Bureau of Economic Analysis, Annual GDP data from 1930 to 2020). While we do agree that growth should be higher this year than we have come to expect as normal, we would caution against getting hopes too high regarding growth in years beyond the current one.

Why? While Uncle Sam does giveth, he also taketh away. In our view, many of the proposals currently before Congress and a more normalized interest rate environment could well temper the economic excitement in years beyond 2021.

Within the infrastructure bill as proposed by President Biden's administration is a proposal to increase the corporate tax rate from 21% to 28% and increase the minimum corporate tax rate to 21%. The administration has also talked about increasing personal income taxes, capital gains taxes and estate taxes. While we could certainly debate the advisability of changing tax policies, in general, as costs increase (taxes are a cost) discretionary spending declines.

Similarly, the significant increase in deficit spending to fund stimulus payments to help both consumers and businesses weather the pandemic storm certainly helps encourage increased economic activity.

Unfortunately, when it comes time to pay for the government largesse, it can limit future spending desires, causing a concern for reduced economic activity.

As of July 2020 (the latest data that is available from the Bureau of Economic Analysis), the federal debt held by the public (national debt) stood at $26.9 trillion. The annualized debt service amounted to $546.5 billion, equivalent to a rate of 2.03%. Not too bad given current interest rates. However, if rates double (which would not be that outrageous of a possibility) to nearly $1.1 trillion it would represent more than 12.3% of government expenditures based on 2020 spending. The $546.5 billion in interest expenses also understates current interest payments since budgetary totals include interest accrued on the actuarial liabilities of defined benefits (DB) plans for government employees. Including those totals, interest payments increased in 2020 from $546 billion to $841 billion. So, doubling the rate paid on public debt from two percent to four percent and including accrued interest on DB plans for government employees would bring debt service payments as a percent of 2020 spending to 15.7%, which does not account for interest payments on the debt incurred after July 2020.

Modern Monetary Theory (MMT) has taken hold not only in the United States, but globally. While the pandemic is certainly the excuse given for the extreme monetary and fiscal stimuli, the question should remain, "when is enough, enough?" Or, perhaps as asked by an audience member at a recent presentation, "When will Modern Monetary Theory cease working?" The answer then, as now, in our view, is that it will work until it doesn't, and then it will probably not work with detrimental impact.

Readers may tire of hearing of this from us, but the real issue is demographic in nature. While the current helicopter money fiscal policies may help boost short-term economic activity, it should not have a meaningful impact on future spending beacuse Millennials (and younger generations) simply can't grow spending enough to offset the spending decline being experienced by Boomers.

In the same way, while we are certainly experiencing some inflationary pressures from materials costs due to supplies not keeping up with demands, we believe inflation to be transitory and that it should subside once supplies come back into balance with demand. As such, inflationary pressures should revert to what we have experienced the past decade or more, which would be sub-optimal relative to the FOMC's desires.

The other question to ask is, "do we really need continued fiscal stimulus?" While politicians may push for it to get people back to work and back on their feet, as the most recent Job Openings and Labor Turnover Survey (JOLTS) from the Bureau of Labor Statistics data seems to indicate, there doesn't really seem to be the need. January job openings were revised strongly upward from 6.917 million to 7.099 million. February data was equally strong, with preliminary job opening posting nearly 7.4 million openings (7.367 million) – less than 300,000 shy of the 7.626 million January 2019 peak and well above pre-pandemic levels. The available labor pool continues to tighten (we define the available labor pool as the number of job openings less unemployed persons) with the number of unemployed people greater than job of openings down to just 2.6 million – roughly where we were in the summer of 2015. This is at a level where employers can have difficulty finding qualified workers.

Market Overview

Up and away has also been an apt description of market performance.

Even though we have seen some leadership change from growth to value and from large-cap to smaller-cap, equity markets continue to power their way higher.

Through the first quarter of 2021, domestic equity indices have increased by double digits pretty much across the capitalization spectrum, with small-cap and mid-cap value leading the charge, up 24.17% and 18.43% respectively. The only laggard, if you want to call it that, were large cap stocks as described by the S&P 500, which gained only 6.17%. The value segment of the S&P 500 did manage to gain double digits, rising by 10.77%.

While equities have certainly provided admirable returns one quarter into a new year, we do get worried that all the good news and expected year-over-year earnings gains may have already been discounted into current stock prices. This could leave those same equities vulnerable, as markets like these don't always appropriately price in the potential for disappointment.

Of particular concern to us is the interest rate environment. While Jerome Powell, Chair of the Federal Reserve, has stated, "We are not even thinking of thinking of raising rates," indicating the FOMC's intention of maintaining a zero Fed Funds rate for the foreseeable future, bond markets don't just focus on the now. Rather, bond markets focus on the future – as should be the case. We have seen longer-term interest rates climb significantly since year-end as bond markets price in faster economic growth as well as concerns over higher future inflation. This should also cause, at some point, future earnings to be discounted at a higher rate that then translates into lower values. When will that happen? That is anyone's guess. The concern, on our part, is that giddiness over higher economic growth and higher earnings can lead to irrational behavior, which often leads to unfortunate results.

Does irrational behavior always lead to difficult circumstances? Yes, but not always in an easily predicted time frame.

As Sir John Maynard Keynes once said, "markets can remain irrational far longer than you can remain solvent."

Bond investors, however, have not had as enjoyable experience this year as equity investors. With the yield curve now nicely upward sloping (more normalized), bond investors have suffered through modest to reasonably significant negative returns. The only segment to escape relatively unscathed was short municipals, as described by the Bloomberg Barclays Municipal 1-3 Year Total Return index, which resulted in a barely positive return of 0.20%.

While we are not expecting rates to shift much higher throughout the year, we would expect that fixed income returns will remain modestly negative.

Outlook

We remain constructive on the outlook for 2021 and continue to believe that the first half of the year will tell most of the story, as stimulus spending that has already passed begins to work its way through the system. While we are not as upbeat as many pundits or the Fed regarding full-year GDP, we are increasing our expectations for 2021 growth to four percent.

Why don't we expect to see growth of 6.5% as indicated by the Fed? We continue to focus on the demographic underpinnings of the U.S. economy. Because the fertility rate in the United States has generally been below the replacement rate (2.1 births per couple) since 1972 and consistently since 2007, with the rate running below 1.8 births per woman since 2017, we expect economic growth to be less than robust.

Since younger generations provide the engine of growth for the future, and population growth absent immigration has been waning for several decades, we would expect that the trend in both GDP and inflation would remain sub-optimal.

The jobless rate, already where we expected it to be at year-end, should continue to improve with the unemployment rate moving into what we term the full-employment band of four to six percent unemployment. This should mean that employers will have difficulty finding qualified candidates and wage pressures should trend higher – even without a change to the national minimum wage.

We also believe that we are at the end of a secular decline in interest rates that began in 1980. If we are correct, then the general trend for interest rates should be up and expected returns for bonds would be well below what we have come to expect for pretty much the entirety of our career. Given that we expect the trend for rates to be higher and given the speed with which the yield curve shifted higher this year, we are also raising our expectations for longer-term interest rates. While we are not expecting any change to the Fed Funds rate, we now expect the 10-year Treasury to end the year at two percent and the 30-year Treasury Bond to end the year at 2.50%.

The equity market may well continue to push higher, calling into question the prospects for 2022. While many have been investing in the reflation trade, for the reasons indicated above we would be cautious of chasing something that may well be transitory. Inflation, other than pockets created by shorter-term supply and demand issues, should not be a problem.

For the most part, equities have already experienced the gains in the first quarter that we expected for the full year. While it is possible to extend those gains, and we are rather constructive on the possibility, we think it advisable to exert a certain degree of caution.

We would expect that value should continue outperforming growth – not the least because higher longer-term rates should lead to lower valuations.

We would be cautious about investing in names that depend on an extended robust recovery as well as commodity-centric names that are dependent on reflation, as we believe demand outstripping supply will be rather short-lived. We would prefer to focus on areas where the trends are just getting started, or for whom stability of earnings and revenues are a hallmark since they will be less impacted by rising rates.

Strategy Overview

We continue to believe that on a broad basis, downside risks outweigh the upside potential. Keeping a trained eye on the relationship between price and value remains 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 always will be our primary focus. Linking investment decisions to something tangible, like the cash-generating capabilities of a business or investment, and assigning 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 invested.

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

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