Stewart Capital

Market Commentary – Second Quarter 2021

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TINA, FOLO and a Few Other Acronyms

TINA – There Is No Alternative. While it really isn't a good reason to invest one's hard-earned dollars, it certainly seems to be the rallying cry for equity markets and investors since the depths of the pandemic. After all, are they going to invest in bonds that (so far this year) have lost money or leave it in money market earning (essentially) zero? Not likely. The TINA viewpoint probably isn't wrong. Yes, we know that equities, as described by the S&P 500 Index, have posted double-digit returns through the first half of 2021, and we know that equity markets were up more than 66% from the bottom on March 23, 2020. However, opportunities do remain — the Reddit crowd notwithstanding.

Inflation remains the biggest economic topic.

Whether you believe, as we do, that the current jump in inflation is transitory or you believe something more sinister is at stake, the result is the same.

Equity investments still provide the best long-term opportunity. We would encourage investors to not approach their investment with a FOLO (Fear of Losing Out) attitude, but one that encompasses dispassionate observation and rational decision-making. Unfortunately, FOLO does not usually allow for that type of thought process.

In a recent *Wall Street Journal* column, Jason Zweig quoted from a survey of 750 U.S. individual investors that found people expect to earn 17.3% this year after inflation. If we assume that inflation comes in at 5% for the full year (year-over-year CPI was reported to be 5% in the June 10, 2021 release), then the nominal return investors are expecting is greater than 22%! In fact, even an inflation rate equivalent to the Federal Reserve's target 2.5% rate would see equity returns of approximately 20%. (A nominal return includes inflation whereas the real return is the return after or excluding inflation.) That same survey indicated that people who answered the survey also expected a long-term rate of return from equities of 17.5% annually, after inflation. To borrow a phrase from the Eagles, "We haven't seen that spirit here since 1999," when we did a survey (as part of another firm) that showed people believed the long-term rate of return for stocks was 20%.

The question we should all be asking ourselves is this: Is it realistic to assume a 20% return for the current calendar year following a more than 18% return for the S&P 500 in calendar 2020 and beyond? Based on history, there is only one time when annualized returns averaged more than 20%, and that was the three-year period from 1997–1999, and we all know how that ended. That does not, however, mean that the current market frenzy must end the same as what became known as the *tech wreck*.

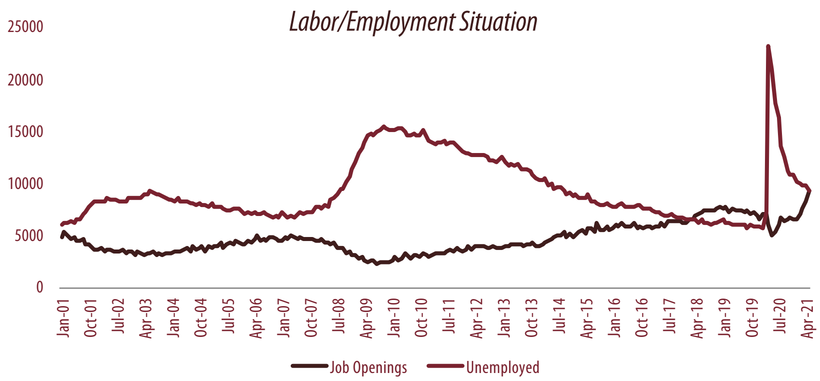
Dr. Ed Yardeni (Yardeni Research) had been warning for some time that the market of the last decade could end in the MAMU (Mother of All Melt Ups). Indeed, with the meme-stock frenzy and what we hear from average investors about stock market investing, it feels like what might be happening. When people see investing as a game, when we see and hear people talk about how easy it is to make money in the market, and when we hear of people who do not fully understand the risks of option investing but view it as a good way to make easy money it almost always ends badly.

The Economy

By all accounts the economy is doing very well. What we remain flummoxed by is that the National Bureau of Economic Research (NBER), which officially dates the beginnings and endings of economic expansions and contractions, has not yet called the end of the COVID recession. While we fully understand that the NBER typically dates the beginning and end of recessions in hindsight, we find it odd that a recession that was dated within a relatively short distance from the beginning (the recession was dated as of February 2020 in a June 8, 2020 announcement) cannot find an ending when it seems fairly obvious that it has ended. In fact, we would not be surprised that when the recession's end is finally deemed to be official that it is dated relatively close to the June 2020 announcement of its beginning.

It seems to us that the statistic they could be hung up on is employment. Indeed, if we only look at the unemployment rate and the number of unemployed persons, there is a compelling story as there are (as of June 2021 data) 9.5 million unemployed people in the United States. However, that does not tell the whole story. With the JOLTS (Job Openings and Labor Turnover Survey) data released in early July (for May Job Openings), there were just one hundred thousand more job openings than unemployed people to fill them. In other words, while there were indeed 9.3 million unemployed people in May, there were 9.2 million jobs available. That gap was not achieved in the last expansion until it was nearly 10 years old (June 2017 with an expansion that began in 2007). In fact, whether you speak with employers or simply look at all the help-wanted signs, it would appear that there is a dearth of available talent.

Figure 1



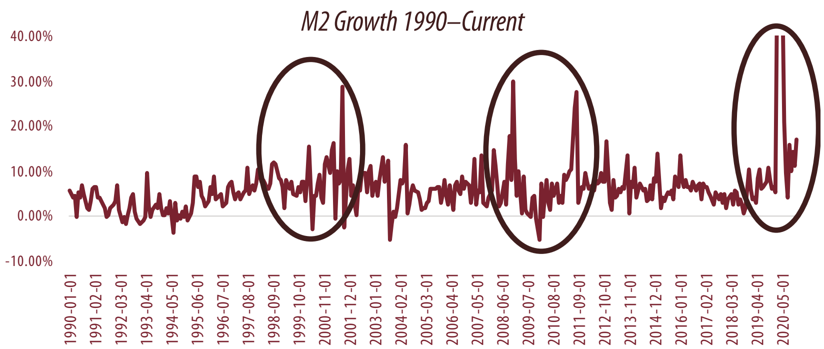
Source: Federal Reserve Bank of St Louis FRED database

GDP, another metric used by the NBER, also shows considerable strength, having recovered all the economic activity lost in the COVID recession (Q1 GDP estimated at $22.061 trillion versus peak GDP of $21.747 trillion in Q4, 2020). In fact, we believe that GDP could well have been significantly higher had it not been for numerous product and material shortfalls caused by pandemic-related supply chain disruptions.

It is these supply disruptions that are creating the most angst among investors as they discuss whether or not the resulting inflation is a sign of 1970s-style problems or whether they are, as the Federal Reserve believes (as do we), transitory.

What is the concern with inflation anyway? In a word, growth. Specifically money supply growth. Because we look at the past to help inform the future, when market pundits see rapid money supply growth, they remember what happened in the late 1970s and early 1980s and assume that the current explosive money supply growth will result in the same thing as then–double-digit interest rates and stagnant growth. However, we have had periods over the last 30 years of significant money supply (M2) growth without a concurrent rise in interest rates or stagnation of growth. This should tell us that something else must be afoot. Specifically, we believe that demographics played a much larger part in the 1970s–1980s inflation/stagnation story than can be explained simply by looking at money supply growth. In fact, if one looks at the correlation between money supply and inflation, we find that it is very poorly correlated (correlation between -0.074 to 0.16 depending on the definition of

Figure 2



Source: Federal Reserve Bank of St Louis FRED database

money supply growth and the lag to inflation; perfect positive correlation is 1 and perfect negative correlation is -1). That is not to say, however, that we won't have some inflation.

In a nutshell, rapid money supply growth is simply too many dollars chasing too few goods—demand (dollars) outstripping supply (goods). What happens, however, when supplies of goods fall short of the dollars available to purchase? Isn't this just a difference without a distinction? Not really.

The inflation we are experiencing today is not really being caused by too many dollars chasing too few goods, rather it is being caused by too few goods for the available demand due to disruptions and demographic make-up.

Once the supply chain disruptions normalize, the inflation should abate, but probably not to the sub 2% rate of the last decade due in large part to the wage pressures caused by a declining labor pool.

It is interesting that the markets seem to be caught in this tug-of-war between the transitory and rising inflation camps as if those are the only two options. In our mind it is not a binary decision.

The real issue is not transitory inflation or hyperinflation but rather where we are in a long-term secular cycle and what happens if inflation simply rises higher than (recent) past experience but not so high as to trigger a 1980s-style response.

In that kind of environment, interest rates do rise, but over a much longer time frame—think multi-decade. Concurrently, interest rates also rise, but don't reach nearly the levels feared. Indeed, if one simply studies history, we quickly see that over the last 250 years of US economic history, the only time that a long-term, secular upswing in interest rates approached the levels of the 1980s was at the founding of the Republic when our central government was still weak. One also discovers that it is much more normal to see interest rates peak in the 7% range, but that it has happened *over a period of 30–40 years.*

Market Overview

Domestic equities have had a banner year so far in 2021. All domestic equity indices have posted double-digit returns over the first half of the calendar year, with small-cap value leading the charge with a return greater than 30% (30.59%). Yet it doesn't really tell the entire story. While small and mid-cap stocks certainly led the charge through the first half, it was the performance of large-cap stocks (specifically those large-cap stocks described by the S&P 500) that boosted their returns by more than nine percentage points from the previous quarter, rising 15.25% for the first half. Indeed, while leadership throughout the half stayed with smaller companies, it has often moved rapidly between larger and smaller and growth and value stocks as various concerns about earnings, inflation and interest rates hit the news.

We believe that much of the news impacting the short(er)-term movements of stock prices is just noise. While it is interesting, it really doesn't have much to do with the longer-term trends. Over the long-term, stock prices really should reflect the present value of the future cash flow streams available to business owners (stockholders). The shorter-term noise simply provides us with the opportunity to buy or sell shares at attractive entry and exit points, nothing more.

The Federal Reserve has been making some noise in that they are now at least thinking about thinking about raising interest rates, as they discussed the topic in public comments by FOMC (Federal Open Market committee) members. Believed to have been a topic of discussion at its June FOMC meeting, the Fed is trying to avoid the taper tantrum experienced in 2013 when then Chairman of the Federal Reserve, Ben Bernanke, caused interest rates to spike in an attempt to signal the end of that round of quantitative easing (QE). If the FOMC does decide to officially begin to taper its open market bond purchases, we can expect the yield curve to continue to tick higher, with greater slope. Can higher Fed Funds rates be much farther behind? If one believes the dot-plot, that probably won't happen until 2023, but we will see.

Bonds, with expectations for rising inflation (transitory as it may be) and an expectation that the Fed will begin tapering sometime this year, have seen sub-optimal returns. Taxable bonds, whether they be short-term or longer-term, have provided negative returns so far in calendar 2021. Municipal bonds, in anticipation of higher federal taxes at some point, provided very modestly positive returns with the Bloomberg Barclays 1–3 Yr. and 8–12 Yr. total return indices providing 0.35% and 0.57% returns, respectively.

Outlook

Jobs will probably be the big story over the balance of this year and into next year. While some would want you to believe that there are no good jobs available and that we need to mandate an increase in the minimum wage, the markets are already largely taking care of that issue. With some states already beginning to end the additional pandemic-related unemployment compensation, which is scheduled to expire in September, we should see an increase in the ranks of the employed through year-end. This should help pull the unemployment rate down much closer to 5% with continued pressure on wages as employers try to find workers. We would not be at all surprised that the JOLTS data issued in August shows that there are more jobs than unemployed people to fill them. This will simply exacerbate a problem that, except for the past year, has been the norm since February of 2018.

Even though personal income has not shown much progress over the past year (thanks to the pandemic) and appears to have been stagnant for a decade or more, it belies the reality of wage inflation. Demographics have largely masked the reality of wage inflation—particularly among entry-level wage earners. We think that will remain for a while and may finally begin to show up in the headline numbers by year-end.

The transitory pandemic-caused supply disruption-led inflation we have been experiencing should begin to abate by the end of the calendar year.

However, the headline rate will probably hover above the Fed's preferred metric of 2.5%. This will give the market jitters and test the Fed's resolve to let the economy run hotter for longer before hiking short-term interest rates. While we are not expecting any rate moves this year, we also believe that they will act before 2023.

We continue to believe that interest rates will end the year closer to our targets of 2% for the 10-year and 2.5% for the 30-year Treasury bonds and Fed Funds will remain unchanged. The yield curve should not drastically change its slope, but the slope should steepen somewhat as longer-term rates trend toward our year-end targets.

With uncertainty over the direction of interest rates, concerns about inflation and uncertainty over government policies, the market will probably be more volatile through year-end than they have been to-date. We would not be surprised if equity markets finish the year with modest additional gains but with leadership changing often.

Strategy Overview

As we have stated for a couple of quarters now, 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 will always be our primary focus. Linking investment decisions to something tangible, like 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.