Investment Outlook - May 2021

Jobs and the Economy

The U.S. economy added just 266,000 jobs in April, far fewer than analysts had been predicting. The unemployment rate rose 0.1% to 6.1%, as more people began actively looking for work. The March job numbers were revised downward, as well, to 770,000 jobs from 916,000 reported initially. The report doesn't necessarily indicate that the jobs recovery is in trouble, however, as other indicators continue to show improvement. Initial jobless claims dropped below 500,000, a new pandemic-era low, and incomes rose. The stock market seemed to shrug off the negative surprise, rising 1% on the day of the report.

We would caution that a single monthly report does not constitute a trend, but neither is it likely to be an aberration. Rather, the disappointing April jobs report illustrates, again, that the road to full recovery will likely be bumpy. The dislocations that have occurred across industries over the past year have simply been too great to begin to plot a smooth path forward. Many industries can't find workers, even as millions of lower-income earners remain out of work. While consumers flush with excess savings are anxious to spend, shortages are popping up across supply chains, creating bottlenecks and dampening output. Some news reports have cited the generous jobless benefits in the American Rescue Plan, which was enacted in March, as a disincentive to look for work. But only the lowest paid workers can make more money by staying home than working. It's more likely that the people who are staying home are doing so because they're still afraid of the virus. A bigger threat to the recovery in the jobs market is the slowing pace of immunizations following the impressive progress we made in the early stages of the vaccine rollouts.

In all, total payroll employment remains 8.5-million below the pre-COVID peak, and 9.4-million below the level that would likely have existed absent the COVID recession. This comparison is important as the Fed is unlikely to signal a change in policy until employment levels begin to approach the pre-COVID trend growth.

Inflation

As we have written repeatedly in past *Outlooks*, we are emerging into this recovery period with historically high levels of cash in both the consumer and corporate sectors, the largest Fed balance sheet in history, and unprecedented levels of government spending. Many companies are reporting issues with supply chain interruptions and commodity pricing, and wage pressures may be next. The Fed has taken on a mandate which is inflation tolerant, if not inflation friendly, and therefore risks being too slow to act.

Against this backdrop, consumer prices rose 0.6% in March on a seasonally adjusted basis, after rising 0.4% in February. The March increase was the largest rise since August 2012. The all items index rose 2.6% for the twelve months ending in March before seasonal adjustment, a significant increase over the 1.7% reported for the 12-month period ending in February.

The number of headlines about rising prices is growing daily, it seems. Commodity prices are soaring as the global economy emerges from recession, with lumber, copper and steel prices now at all-time highs. Agricultural commodities such as corn and soybeans are at 12-year highs. The national average gas price has risen to $2.97 according to AAA, up 3.5% in the last month and more than 60% in the last year. A growing shortage of computer chips is threatening to drive up the prices of autos and consumer electronics. Consumers are being warned that price hikes are coming for a wide range of products from appliances to diapers.

The question of whether these price increases are transitory as the economy emerges from a generational economic shock, or are the beginning of a sustained upward trend evocative of the 1970s, is hugely consequential. The latter scenario would require the Federal Reserve to boost interest rates and/or taper its bond purchases sooner than expected, likely igniting a sell-off in equities and long term bonds. But the Fed has been clear that it believes that inflation will be transitory, stating, "An episode of one-time price increases as the economy reopens is not the same thing as – ***and is not likely to lead to*** – persistently higher year-over-year inflation into the future."

Most economists agree with this view, even as they acknowledge the massive stimulus measures already enacted as well as the additional measures currently being considered. Their main argument is that future spending is likely to be spread over a longer period of time, and is to be partially offset by tax measures that could limit overheating concerns.

We have no basis to contradict the Fed's position or the consensus that the current round of inflation will be a short term phenomenon. But there was a behavioral component to the inflation of the 1970s that is not being mentioned in any of the research of the current situation. Consumers and businesses making purchases, not on the basis of need but in anticipation of higher prices in the future, can create a self-propagating inflationary spiral that the Fed cannot easily squelch by raising interest rates or shrinking its balance sheet.

Reviving an economy in recession by pumping massive amounts of liquidity into it is a straight-forward proposition, as we have seen over the past year. But Paul Volcker Fed's battle against the inflation expectations of the 1970s took four years and required the Fed to raise interest rates to a peak of 20%, ushering in a recession that drove the unemployment rate above 10% and devastated the construction, farming and industrial sectors. We don't wish to be accused of fighting the last war, but we do want to illustrate why we should not lightly dismiss the concerns of those who are less sanguine about inflation prospects than the consensus.

Interest Rates and the Federal Reserve

As we have already mentioned, the Fed believes that inflation is not a long term concern, and a majority of economists agree. However, if inflation does becomes a concern, the Federal Reserve will have to act sooner than the market is currently discounting. In fact, some who believe that sustained inflation is an emerging risk argue that the Fed will begin to taper – or shrink – its balance sheet before the year is out, and may begin to raise interest rates in 2022. That would be far sooner than the Fed's previous guidance that it does not plan to raise interest rates until 2024.

In the past, the Federal Reserve faced criticism for moving too quickly to ward off inflation, choking off recoveries that had not yet run their course. The COVID crisis has caused the Fed to modify its past practices, abandoning its target inflation rate of 2%, and in its place adopting the goal of achieving inflation of 2.0% *on a sustained basis,* and it is willing to run the economy hot until full employment, roughly 3.5-4.0%, is reached. This goal is understandable given the Fed's mandate and the current economic condition, but we will keep a watchful eye on future Fed actions and guidance, given the implications for inflation, the economy, and the bond and stock markets.

Corporate Earnings

Earnings estimates have been steadily rising for many months, but actual results for the first quarter are exceeding even the most optimistic expectations. With 88% of the S&P 500 companies having reported, 86% of those have reported a positive earnings surprise and 76% have reported a positive revenue surprise. If these results hold through the rest of the reporting cycle, it will mark the highest percentage of companies reporting positive earnings surprises since FactSet began tracking results in 2008. The blended earnings growth rate over the same quarter last year is 49.4% which, if it holds, will represent the largest year-over-year growth rate since the first quarter of 2010. Earnings had been expected to grow by 23.8%. On average, companies are reporting earnings that are more than 20% above estimates.

By far, the financial sector has been the largest contributor to the increase in earnings. JP Morgan Chase reported earnings of $4.50, 45% above its estimate of $3.10, and Goldman Sachs, Citigroup, and other large banks reported similar surprises. Energy, consumer discretionary and communications services also reported results well above expectations, while the utility sector was the only one reporting results below estimates.

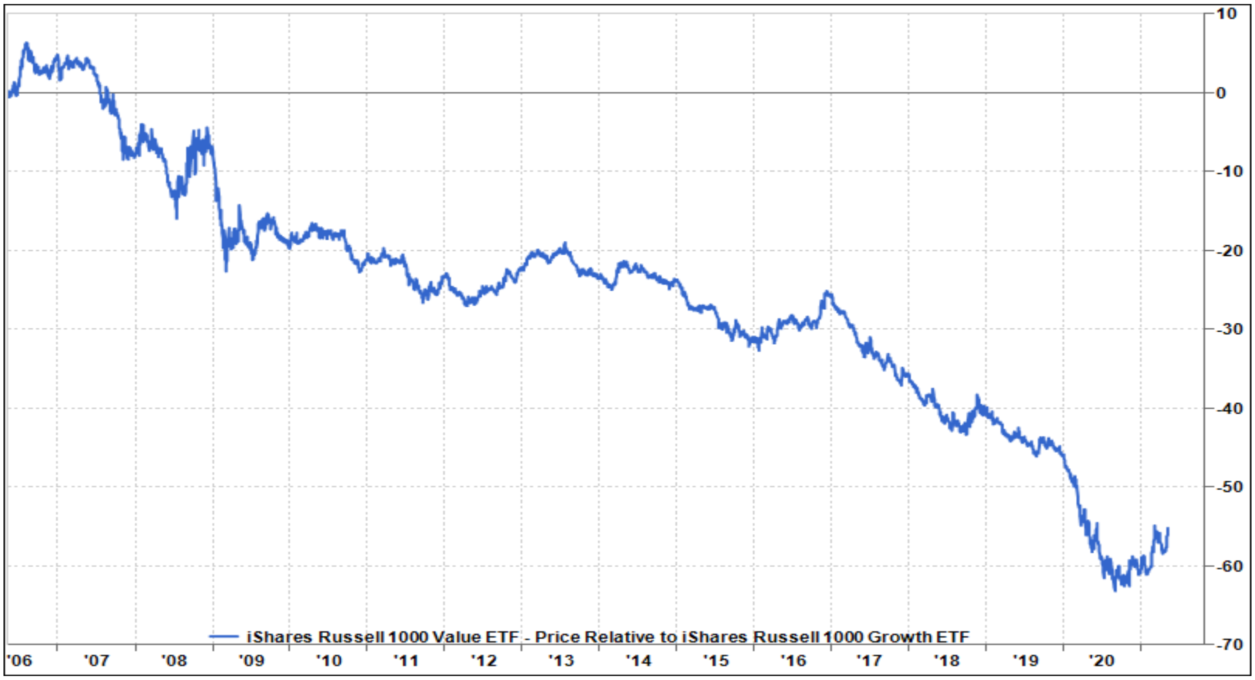
Looking ahead, 42 companies in the S&P 500 Index have raised guidance for future earnings while 29 have guided future estimates lower. This ratio is significant, as companies are generally more inclined to lower expectations than raise them. Projected earnings for all of 2021 are now expected to come in 33% above 2020's results, peaking in the second quarter and then decelerating in the second half of the year as comparisons to the same quarters of 2020 become more difficult.

The Stock Market

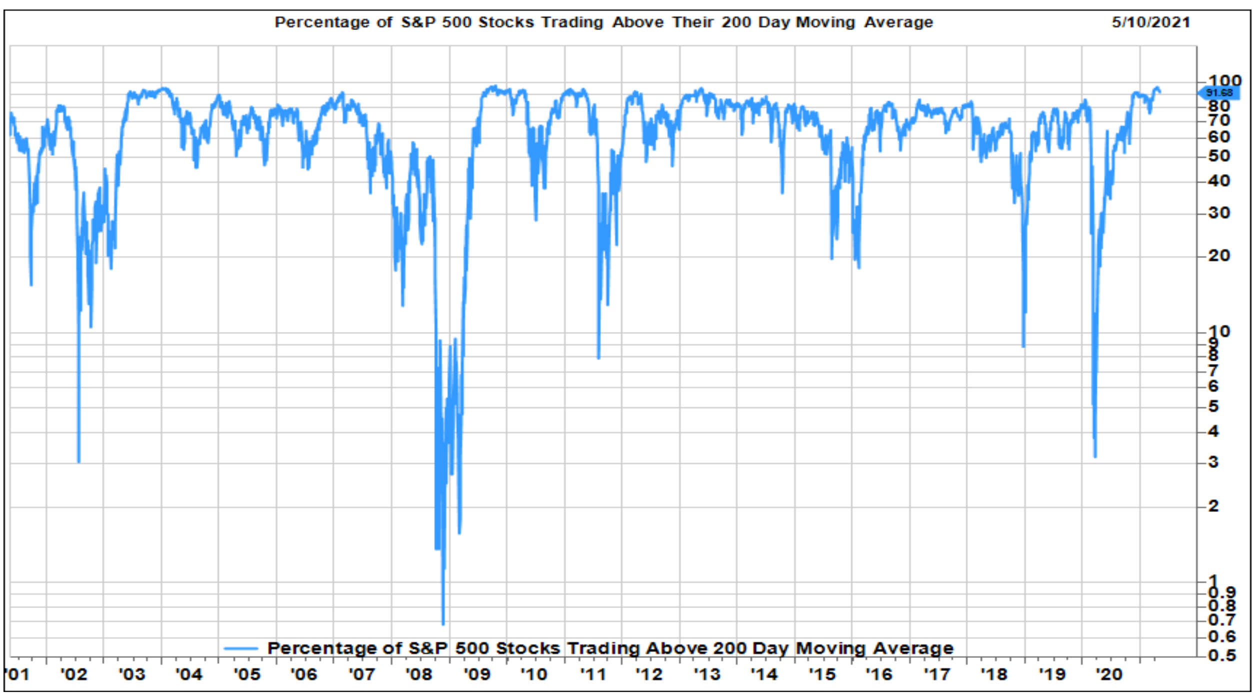
We have posited in the past few months that the outlook for the economy and corporate earnings had improved faster than might have seemed possible under the circumstances, but that the improved outlook was already largely discounted in stock prices with the market at historically high valuation levels. We felt that the best possible outcome over the near term was that earnings and economic results would continue to improve, while stock prices would rise at a slower pace allowing valuations to return to more normal levels. This scenario seems to be holding so far, given the market's muted, but generally positive reaction to the first quarter's series of blowout earnings reports. With the market benchmarks still at or near all-time high valuation levels, we continue to believe that opportunities lie in specific names under-represented in the index, rather than the Goliaths that drove returns through much of last year and, really, for most of the last ten years.

Our equity portfolios remain over-weighted in the cyclical "value" sectors (financials, energy, materials and industrials), with below benchmark weightings in the more "growthy" consumer discretionary and technology sectors. Keep in mind, though, that the discretionary and tech sectors account for nearly 40% of the S&P 500, so you can be underweight and still maintain significant exposure to those sectors.

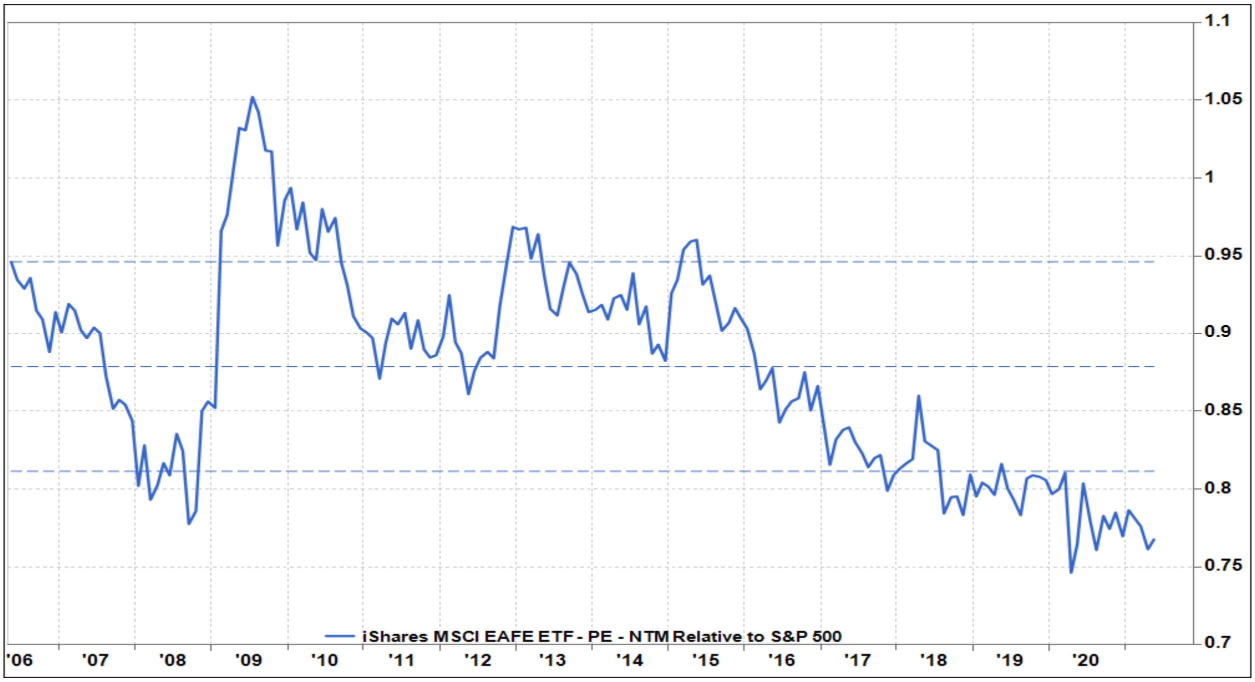
The Russell 1000 Value ETF has risen 39% since the 3rd quarter of 2020, more than double the Growth ETF's return of 17%. But this follows a 15-year period of sustained underperformance by value stocks that has left many value sectors severely undervalued in the current market. The market's increasing focus on inflation is at work here, as well. If there is a growing possibility that inflation and interest rates are going to rise, investors will want to own short duration companies that are generating earnings growth and free cash flow today, not biotech companies that will be cash flow positive in five years.



The technical condition of the market remains generally strong. Our major concerns are that the percent of all stocks trading above their 200-day moving average is at or near a 20-year high, and the index, itself, remains elevated at 13% above its 200-day moving average.



We should also mention that we have recently responded to high U.S. equity valuations by increasing our allocation to international stocks, particularly those in developed markets as opposed to emerging markets. The International Developed index is currently trading at a nearly 25% discount to the U.S. market, its deepest discount in the last fifteen years, and more than one standard deviation below its average discount over that time.



Longer term, investors should be prepared for more volatile markets. Value-led markets tend to be choppier than growth-led markets, as value stocks react to day-to-day news flow more than growth stocks. Tax and regulatory policies may become headwinds at some point, when the market becomes less focused on the pace of the economic recovery and moves on to what happens next.

For now, though, the investment outlook could hardly be more accommodative to risk assets. Inflation headlines are creating some turbulence in the markets at the moment, but we will be taking our cue from the Fed and the bond market for any signs that a change in our outlook is warranted.

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