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Interest Rates, Earnings & Inflation

December 2021

November was anything but calm where the financial markets were concerned; however, if you blinked, you may have missed it, except for Black Friday, when news of the latest iteration of Covid, the Omnicron, variant hit the markets hard. A relatively benign first three weeks of the month were punctuated by President Biden signing the Build Back Better bill and Federal Reserve President Jerome Powell testifying before Congress that the Fed is likely to commence its "tapering" operation in October 2021, somewhat sooner than previously expected.

Intended to soften the potential economic shock of the 2020-2021 Covid-induced economic slowdown, the Fed has been purchasing bonds in the open market, thereby injecting money into the financial system. The 10-year U.S. Treasury note, as an interest rate barometer, reached a closing low yield of 1.22% Thursday before Thanksgiving; promptly rose to close at 1.68% the next Tuesday on news of Mr. Powell's re-appointment to the Fed Presidency. The Omnicron announcement fueled a flight to high quality assets and out of equities, driving the 10-year Note yield back down to a closing low of 1.47% on Black Friday. To add to the excitement, on the last day of the month, Fed President Powell testified (yet again!) that the Federal Reserve was no longer referring to inflation as "transitory" and the "tapering" would begin sooner than originally planned. When the smoke cleared, the S&P 500 was off -1.0%, the NASDAQ -0.37% and the U.S. 10-year yielded 1.44%.

To be clear, this is a good thing. "Tapering" translates into buying fewer bonds each month, not turning off the spigot. It is also NOT an increase in interest rates by the Fed. Rather, while the Quantitative Easing served a purpose (depending upon whom you ask!), the current supply-chain shortages are exacerbating the monetary situation. There is indeed "*more money chasing fewer goods*" the classic definition of inflation; however, our current situation differs from the assumption underlying this tenet – the constraint of limited supply (i.e., product shortages) significantly reduces consumer's elasticity of the price function (demand).

Let me share three personal anecdotes to illustrate the dilemma:

1. Anyone who has experienced any home construction or renovation over the past two years has been faced with the choice of paying a premium to complete their project, scale it back considerably or postpone the improvements. Contractors are busier than they have been in the last ten years (remember 2008-09?). Raw materials prices are through the roof (no pun intended!). Lumber has traded as high as $1,670 per 1,000 board feet in May 2020, as low as $456.20 in August 2021, and currently are in the $980 neighborhood. Regrettably, many of the reasons for the shortages are legitimately beyond the manufacturers control. Supply limits our choices

2. A friend shared with me that the monthly rental of their storage unit had experienced five price increases in the past two years. The unit is now double the price of the original agreement three years ago. Her solution? Spend Saturday packing two trucks and three SUVs and capitalize on the "deal" offered by a competitor at 30% off for the first year….. This is an example of price elasticity – go to another supplier!
3. Another good friend in the manufacturing industry confided that the lack of semiconductor chips necessary to complete assembly of his product is constraining his sales. Talk about beyond one's control…. They are re-engineering their components.

To put this in perspective for the average consumer:

> *"At the close of October 2021, the average selling price of a new car in the U.S. was $46,036, up $5,266 from a year ago, according to Kelley Blue Book. Data from the Federal Reserve indicates that the average new car loan has increased from $25,000 in 2009 to around $34,000 in 2021, according to Car and Driver. Typical auto loans range from 24 to 84 months. While 36-month and 60-month loans are the most common for buyers, 22% of the new car loans issued so far in 2021 were for 84 months."* [1]

The average new car selling price has increased 13% in one year. We all have heard stories about the used car market, which has heated up given the lack of cars on dealer showrooms. As a result, balances on auto loans have increased and consumers have extended the term to reduce their monthly payments. One small example of how we get backed into a corner when our choices are limited (that "lack of elasticity" mentioned above.)

We are in the midst of some major cross-currents, socially, politically and economically. "Going to the office" will never have the same meaning or context again. At no previous time have we been more dependent on semiconductors in virtually every aspect of our lives. The majority of these chips are imported and the U.S. industry is working to build more U.S. manufacturing capacity, but such projects are measured in years, not weeks. The "Great Resignation" includes constituents retiring early, changing careers, and turning to entrepreneurism disappointed by the shift in career prospects from the shutdown. Many independent career options have been made possible by internet. And by the way, some people who have been working from home with greater flexibility in their workday have zero interest in going back to an office environment!

Ultimately, uncertainties regarding expectations for interest rates and earnings growth are fundamental drivers of stock prices and bond yields as investors change their expectations toward these fundamental variables.[2]

As the saying goes, history never repeats itself, but it rhymes. Those of us with a certain amount of gray hair recall the 1970s and 1980s (yes, my first home mortgage was 30 years fixed at 13%). Reflecting on that period, economist Brian Wesbury writes, "

> *What this reminds us of is the "stop-go" Keynesianism of the 1970s, where policymakers would whipsaw between goosing the economy through loose money and extra government spending, then battling the ensuing inflation by tightening monetary policy, slowing the*

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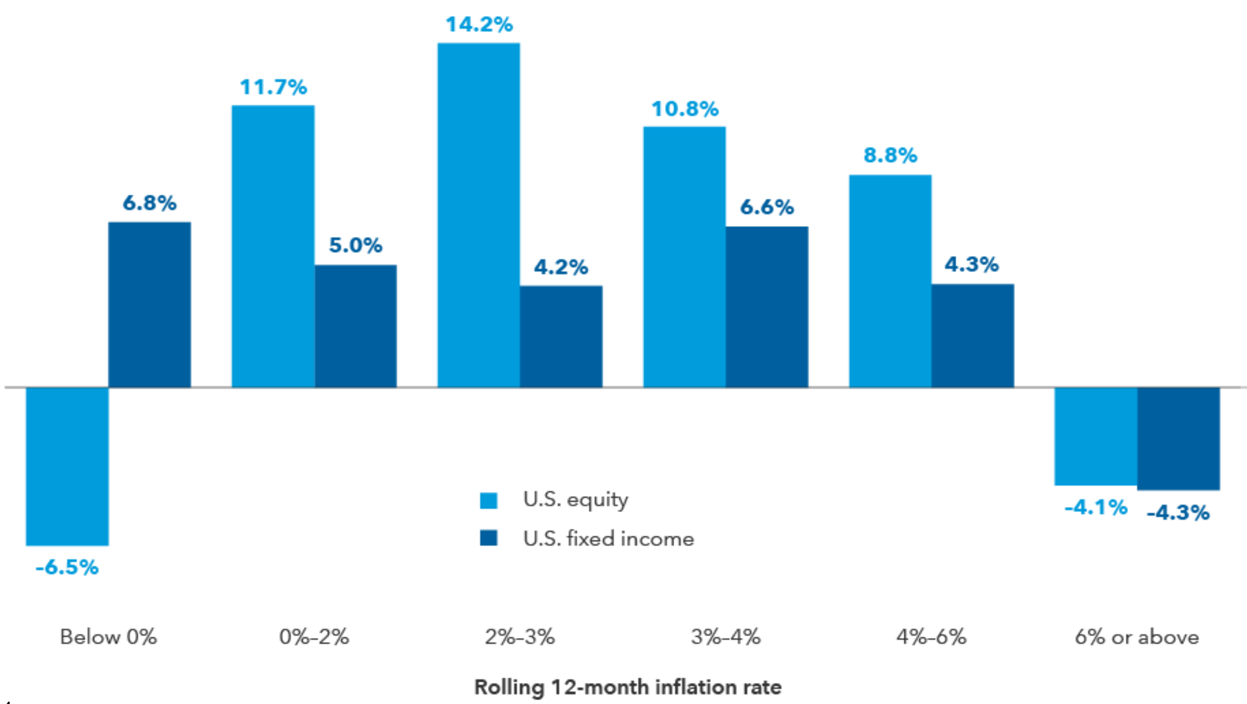
[1] First Trust *Market Watch,* Week of December 6th, 2021
[2] "A Century of Stock-Bond Correlations", Ewan Rankin and Muhummed Shah Idil, Federal Reserve Bank of Australia Bulletin, September Quarter 2014

> *growth of spending, or even by raising taxes. This ping-pong policymaking was not healthy for the stock market: the S&P 500 increased at a 1.6% annual rate in the 1970s as consumer prices rose 7.4%.*[3]

However, inflation itself is not necessarily an enemy. The traditional economic cycle entails rising interest rates, typically stimulated by the higher demand associated with economic growth, ultimately leading to constrains on economic growth, fostering a recessionary period as the economy retrenches for its next surge. A recent analysis by Capital Group illustrates U.S. Equity returns during various annualized inflation periods from 1970-2021. Equity returns average in excess of 10.75% during periods of moderate inflation; economic growth contributes to higher prices which contributes to inflationary pressures… up to a point!

Average annual returns at different inflation rates (1970-2021)



[4]

It is highly doubtful that policymakers will repeat the scenario recounted by Wesbrook. We DO tend to learn from our mistakes. That said, it is likely the need for stimulative monetary policy will eventually occur again and there is not much room for accommodation at the current level of excess money supply or interest rates that remain low by historical standards. Consequently, an incremental approach to reducing excess monetary reserves sloshing around in the system makes sense. As noted above, this is not "turning off the spigot"; the Federal Reserve's balance sheet is still expanding, albeit at a slower rate. When the Fed "tapered" before in 2014, the Fed did not institute an interest rate increase until the U.S. 10-year note yield exceeded 2.00%. Remember, the market is forward looking – and generally leads the Fed.

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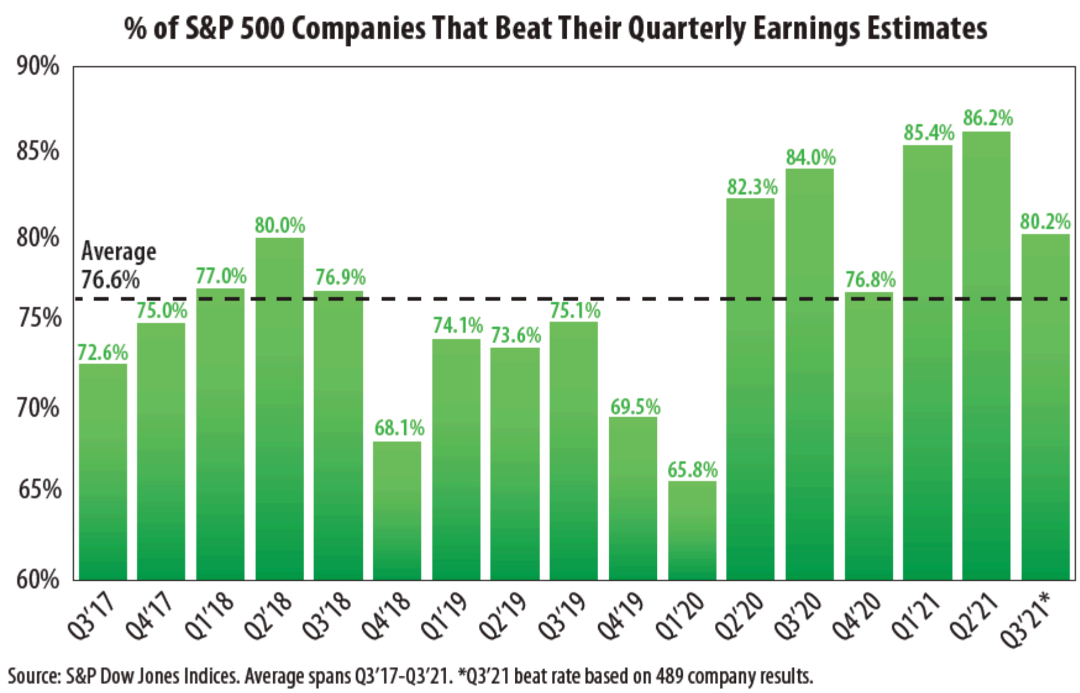
[3] First Trust Monday Morning Outlook, December 6th, 2021

[4] https://www.capitalgroup.com/advisor/insights/articles/2022-us-outlook.html

Wall Street analysts are looking beyond the horizon and expecting slower earnings growth for the last quarter of 2021, revising down their price expectations. A recent study by First Trust[5] reveals that 76.6% of S&P 500 companies quarterly earnings exceeded (or, in the vernacular of the Street "beat") analysts' quarterly earnings forecasts over the past 17 quarters (Q3 2017 through Q3 2021). Over the most recent six quarters (since Q2 2020) five of the six quarters have "earnings beat rates" over 80%.[6] With analysts guiding lower for Q4 2021, it is quite possible this trend will continue for the near term, supported by improving economic reports.



[7]

Companies who have pricing power; that is, their brand or product is such that their customers have little elasticity of demand, are able to pass along increased costs to a greater or lesser degree. Thus, as inflationary pressures erode their margins, these companies are able to maintain their profit margins. Companies with pricing power include industries such as consumer businesses with strong brand recognition such as certain beverage companies or streaming companies; industries with favorable supply/demand dynamics such as semiconductor and chip manufacturers and businesses that provide essential services such as healthcare companies. By most traditional metrics, stocks appear relatively expensive today. Ideally, one seeks a balance of stocks with long-term growth potential and companies that can still participate as the economy continues to recover. Stocks with rising dividends may provide some additional cushion.

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[5] First Trust Carey Blog Post, https://www.ftportfolios.com/Commentary/MarketCommentary/2021/12/2/a-snapshot-of-the-sp-500-index-earnings-beat-rate

[7] ibid

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The news is not all bad, but the cross-currents are creating a very choppy voyage. Stepping back from the firing line, we have a bout of inflation; it has identifiable causes and the global suppliers are working to adapt. Bottlenecks in suppl will eventually abate. Extremes in inflation are detrimental to stocks, but we are not there and are unlikely to see such extremes. "Normal" has taken on a new suit of clothes – we have to get used to this. As in all thing, excesses are eventually wrung out of the fabric (in this case the money supply), but it is more likely at this juncture that our comeuppance will be beyond 2022.

As the year draws to a close, we are thankful for another year of solid returns on our investments, thoughtfulness with regard to our future paths and our friends and family that encourage us each day.

HAPPY HOLIDAYS!

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