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2021 Third Quarter Review
"Inflation - Transitory or Fundamental Sea Change?"

We have just passed the 40th anniversary of the highest interest rates in US history. It all started in the early 1970's when the first OPEC oil embargo pushed energy prices to record levels and helped ignite a period of inflation that spiraled into the double digits by 1980. Interest rates followed suit. By September of 1981, the US 1-Year treasury bill yield had risen to a record of over 14.5% and the 10-year and 20-year bonds hit peak yields of over 15.5%. That moment marked the end of an era. Those yields have since plummeted to pandemic-related lows of 0%, 0.51% and 1.1% respectively in March of last year.

It was with much pain and perseverance that former Fed Chairman Paul Volker and his allies raised interest rates and were able to defeat a persistent spiral of inflation, precipitating a recession in the meantime. Volker and his policy-making pals judged that the pain would be worth the cost to set the American economy on a healthy non-inflationary footing. What followed was a forty-year period of declining interest rates that has been a boon for the American economy and financial markets.

It's no secret that inflation is now rising once again. The Fed has taken the position that the recent rate of +4% price increases in the PCE Index (Personal Consumption Expenditures) is "transitory" and will abate once disruptions in business supply chains are resolved. Skeptics point out that those index numbers underestimate the actual current inflation rate and that the tidal wave of money supply created by the central bankers will necessarily propel prices higher.

Economist and Nobel laureate Milton Friedman was a limited partner of my old firm Oppenheimer & Co. back when I was learning the ropes on Wall Street. He famously said, "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." We are soon the get a real test of that assertion. The recent tidal wave of liquidity has dwarfed the growth of economic output. The difference this time is that we don't have the same tools available to fix the problem. The Fed may not be able to return to normalized rates because the economy may not be able to withstand the strain.

The stock market has been taking all of this in stride for now, riding the tidal wave of liquidity while also benefitting from artificially low interest rates and rebounding corporate earnings following the reopening of the economy. But that may be about to change. The S&P 500 has risen 17% so far this year while long-term treasury bonds as represented by the iShares 20+ Year Treasury ETF (TLT) has lost 8% of its value.

The risks to the stock market are many, but it is often said that a bull market "climbs a wall of worry." So far, liquidity and low rates have provided the fuel for stocks to rise. However, if inflation continues to rise it may force interest rates higher. Both would be a negative for stocks. The Fed meets again on November 3rd and may announce that they will begin to "taper" the liquidity that they've been so amply providing. That may signal that the tide of liquidity will begin to ebb for the first time since the beginning of the pandemic. Markets often don't react well to those changes. (See the financial market "Taper Tantrum" of 2013). Also, the term of Fed Chairman Powell ends early next year, and the administration may be under pressure to replace him with someone who is more in the camp of the progressives. The leadership change could unsettle markets as well.

We have all now heard of, and perhaps experienced, the effects of labor shortages and supply chain disruptions. Art recently went to a Sherwin Williams store to buy paint for his porch and was told that they wouldn't have it for several months. No paint in a paint store! On the other hand, many companies have reported rebounding earnings growth that is not sustainable since the comparison period includes an economic shutdown. Investors appear to be paying prices for some stocks that include overly optimistic projections for recent earnings growth to continue. Estimates for the growth of the entire economy may also be too optimistic, especially since energy prices have risen and may shave as much as 2% from economic growth forecasts.

There are also rumblings of economic trouble coming out of China. The huge and hugely indebted Beijing-based property developer Evergrande is expected to default on a $250 million loan shortly. There's more where that came from. Chinese real estate bond defaults have more than doubled this year to $7.2 billion, and it may just be starting. Many fear this may spark a "Lehman Moment" where the domino effect of the collapse of the Wall Street firm precipitated a much larger financial crisis in 2008. Many economists are betting that the collapse of the Chinese real estate firms can be managed as a "controlled demolition." However, the risk of a financial chain reaction remains.

Given the growing complexity of the investment landscape and the range of possible outcomes, it is even more important that we allocate the assets in your portfolio (to equities, fixed income, and cash reserves) in a way that is consistent with your goals and financial situation. Interest rates on long term bonds are generally so low that we don't favor committing significant capital there because the rewards seem to be dwarfed by the risks. Cash reserves provide little return while only helping performance during downturns. Equities provide much better upside, but with more volatility. The proper mix may be more crucial than ever if the tide of inflation and interest rates is indeed changing.

Enclosed you will find your portfolio reports and statements. Please review these at your leisure and give us a call to discuss your particular mix of assets as we begin to approach the end of 2021.

Sincerely,

Claude R. Carmichael　　　　Arthur E. Creel