

The Advisor

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Market Update – Second Quarter, 2021

THE GREAT DEBATE took center stage during the first quarter and we are not talking about politics – we are talking about inflation. From afar, it appeared as just another quarter of solid gains for the S&P 500 and the Dow Jones; and it was. But, up close, we witnessed improving Covid and vaccination data, in conjunction with fiscal and monetary stimulus, spark a great inflation debate that underpinned a swift rise in bond yields and a pronounced rotation away from growth stocks and into value stocks. It's been 20 years since value outperformed growth by this magnitude on a quarterly basis. Sectors punished by Covid and economic shutdown, such as Energy, Financials and Industrials roared higher while Utilities, Information Tech and Consumer Staples, large beneficiaries of the global economic disruption, performed the worst. Oh, and those rising treasury yields, yes, they pushed the fixed income market into one of its worst quarters in decades.

Let's take a look at the two prevailing narratives in this inflation debate.

(Re)inflation New Normal

In this camp the belief is the first and second rounds of stimulus that were pumped into the system to stave off a Covid induced depression, combined with the recently passed \$1.9 trillion American Rescue Plan Act, plus the proposed \$2 trillion infrastructure bill will set the table for economic expansion that has not been seen in decades. Furthermore, a rebound in employment, wage growth and strong consumer balance sheets are meeting constrained and disrupted supply chains that will only force prices higher. Couple all this with vaccine efficacy and pent-up demand and the economy will be pushed beyond reflation, past healthy inflation and force the Fed's hand to raise short term rates or risk a hyperinflationary environment. In other words, we're sitting on a powder keg of inflation that, in all likelihood, puts the Fed in checkmate and by extension

risks the stability of financial markets and the economic recovery.

Inflation Normalizes

On the other side of the debate the argument goes like this – inflation will rise given the utter collapse of economic activity during the heights of Covid and the headlines will likely show an extraordinary surge of inflation due to the base effect or the mathematical fact that comparisons of data over time periods can become highly distorted when prior year periods were abnormally depressed or elevated. In this case, Covid abnormally depressed inflation. Now, a year later, with the recovery underway, inflation data may run hot, scary even, coming from such a low base one year ago. However, this rise in the costs of goods and services is to be expected and will be transitory in nature as the economy heals. It is unlikely a structural shift to sustained inflationary pressures.

This thesis largely hinges on the belief that the supply and demand imbalance will begin to normalize as capacity and production come back online. In addition, the jobs recovery is far from complete and the sugar high from the stimulus will eventually burn off. Also, Covid is still in-play and the rollout of vaccinations across the globe will take time.

Concerning the steepening yield curve, it is a reflection of growth expectations. Plus, there is evidence of buyers at current levels as the U.S. Treasury offers attractive yields on a relative basis to other sovereign debt. This demand helps contain the long-end of the curve while the Fed has consistently expressed its accommodative stance and commitment to keeping short-term rates near zero until its dual mandate of maximum employment and 2% average inflation is reached.

So, there you have it, the basic arguments from both sides. Which one is correct? From our view, both sides make a good argument. Yes, inflation will pick-up; it already has. We do not

question the magnitude of the current economic environment where government intervention in the form of relief packages – amounting to over 26% of GDP, the highest level since WWII – helped U.S. households accumulate nearly 1.6 trillion dollars of excess savings and everybody is chomping at the bit to get back out and live a normalized life.

However, what the consumer will buy, when and how much are the variables that truly matter. If we look to the 5-yr forward inflation expectation rate, as compiled by the Federal Reserve Bank, we find it sitting at 2.2% as of March 31. We don't believe this is a damaging level of inflation, even if it ticks up further and lasts a year or two. This view is also supported from a historical perspective having to go back to the early 90's before finding the U.S. experiencing sustained inflation above 3%.

It is difficult for us to conclude that normalization of rates and inflation due to improving economic recovery and forecasted growth is somehow a bad thing. We will continue to monitor the data for signs of a more permanent, structural, shift in the variables that could change the inflation landscape, but for now, we side with a healthy inflation level that will normalize as the recovery lengthens out over time.

This entire debate boils down to answering what are the market implications? As seen in Q1, rising yields imply a higher discount rate that must be used in valuing future cash flows and growth. Remember, a dollar today is worth more than a dollar in the future. For one, today's dollar can be invested while the future dollar, logically, cannot. Moreover, given inflation expectations, the buying power of the future dollar is eroded, making it worth less than today's dollar. What this looks like in the market, depending on the severity of inflation expectations, is bonds are sold off as are growth stocks. Investors don't want to be left holding an asset that is priced based on cash flows in the distant future when they can own companies and assets that are forecast to generate strong levels of cash flow now or the immediate future. In the equity market this is known as a rotation away from growth and into value.

Here is where we will insert a word of caution that focusing too narrowly on the debate of inflation, growth and value misses the forest for the trees. Sure, diversification matters. The economic cycle matters. But, in the end, it's about good companies compared to the not so good companies and how they are respectively positioned and executing inside economic and secular shifts. Investing in a specific category or factor simply due to its label can miss the bigger picture. We see selective opportunities for both playbooks, inside the current conditions of inflation and reopening just as we see growth, innovation and disruption continuing to thrive in a post-Covid world.

In closing, keep in mind we are currently dealing with extremes in economic activity and data that makes the accuracy of forecasts and estimates difficult, if not impossible. This feeds a market that is sitting near all-time highs which makes it ripe for volatility as it digests new information and tries to reconcile that with previously priced-in assumptions. When volatility occurs don't let fear overtake your long-term focus and strategy. Choose patience and discipline. They are table stakes for creating success in capital markets. Warren Buffet said it best, "The stock market is a device for transferring money from the impatient to the patient."

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a second perspective on your investment accounts, please feel free to contact us. As fiduciaries, we will happily provide you with an unbiased opinion.

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