Market News 2021

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Third Time is a Charm

By Scott Loyek, CFA,® Managing Director, Portfolio Manager

As the U.S. emerges from the economic disruptions of the pandemic, we find ourselves in an environment consisting of labor shortages, supply chain disruptions, rising commodity prices and other concerns that we have not experienced for many years. The reason for these challenges is straightforward but more importantly; how long will these circumstances persist?

Scott consults with TWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low-cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TWM in 2006.

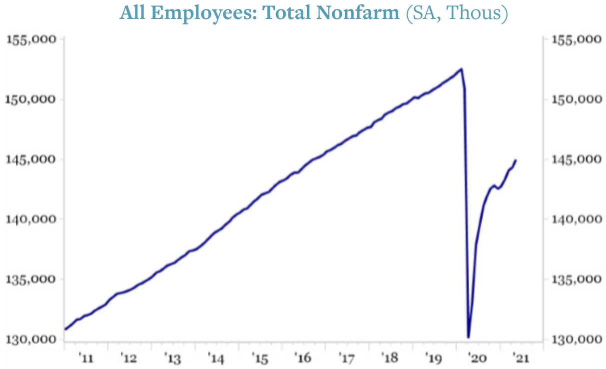
The Global Unsynchronized Recovery

The globally connected economy in which we operate is out of sync with shortages and mismatches in supply and demand. The primary factor influencing this trend is that the U.S. has been very fortunate to emerge from the pandemic faster than most of the rest of the world. We have set the global standard in both the development and distribution of vaccines and are seeing many aspects of day-to-day life return to normal. Unfortunately, the rest of the world has not fared as well. Every day we learn of challenges in India, Japan, Europe, and other areas of the world still struggling to rebound.

It turns out it is much easier to move an economy from full speed to full stop than it is to restart it.

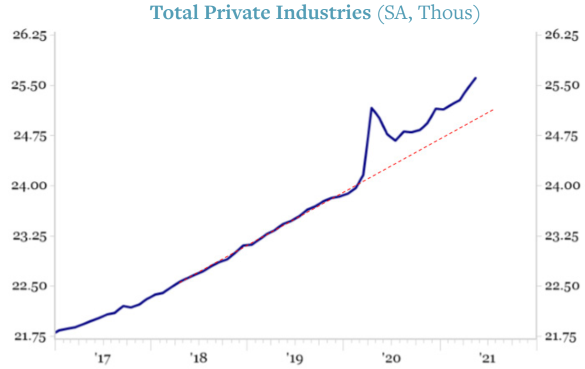
Many businesses are ready to ramp back up, however, they are unable to find the workers needed to do so. The combination of increased unemployment benefits, lack of childcare and health concerns has the labor force apprehensive about returning to work, even if offered a higher wage.

All Employees: Total Nonfarm (SA, Thous)



Source: Bureau of Labor Statistics

Avg Hourly Earnings: Prod & Nonsupervisory: Total Private Industries (SA, Thous)



Source: Bureau of Labor Statistics

Businesses are also facing supply chain disruptions. The challenges created by the semi-conductor shortage is perhaps the most well publicized. As technology has advanced, semiconductor chips have spread from computers and cars to toothbrushes and tumble dryers. The shortage of microchips has led to large companies, like automobile maker Ford, and tech giant, Samsung, to have to reduce or limit production. There are similar shortages in many other areas of the economy as producers struggle to catch up with rising demand while facing capacity and labor shortages.

Anyone attempting to build or remodel a home has also seen the prices of materials like lumber soar. This creates an interesting dynamic as much of the world has been living with a surplus of materials for some time. The rising costs and current shortages have many worried about inflation.

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This is very much a case of be careful what you wish for as the Federal Reserve and other central banks have been trying to generate inflation since the Great Recession. The word we will all become very familiar with over the next year is "transitory." Transitory applies to the Fed's belief that while there will be inflation associated with the recovery, it will be relatively short lived and fade as the economy ramps back up. This outcome would be very consistent with the Fed's revised policy which allows for a more flexible target for inflation.

What Should Happen

Much of the strong market performance experienced last year was a function of the bullish recovery scenario that took hold. This was predicated on the successful development and distribution of vaccines limiting the duration of the economic impact of the virus. This scenario has generally played out positively and investors have been rewarded with very strong market returns following the initial panic. As I am fond of saying, investment returns are generally the best when things go from "absolutely terrible" to "not so bad". We certainly have seen that happen in the last year.

The next step in the recovery scenario is perhaps not as exciting for investors in the short-term but will be very important for the long-term. This is the point in the recovery where we expect to see the economy catch up to the stock market. As the chart below shows this is a common occurrence in market expansions. These are healthy adjustments as the rise in earnings combine with modest price increases to bring the P/E ratio of the overall market down. As we can see, the average bull market lasts around five years so this could be the start of a prolonged period of growth. Should things play out in this manner, investors will find themselves

S&P 500 Bull Markets

Start Date	End Date	Duration (Months)	Total Pct. Chg.	Returns from Trough In Year 1	Year 2
6/1/1932	3/6/1937	57	324.3%	121.4%	-3.7%
4/28/1942	5/29/1946	49	157.7%	53.7%	3.4%
6/13/1949	8/2/1956	86	267.1%	42.1%	11.9%
10/22/1957	12/12/1961	50	86.4%	31.0%	9.7%
6/26/1962	2/9/1966	43	79.8%	32.7%	17.4%
10/7/1966	11/29/1968	26	48.0%	32.9%	6.6%
5/26/1970	1/11/1973	32	73.5%	43.7%	11.1%
10/3/1974	11/28/1980	74	125.6%	38.0%	21.2%
8/12/1982	8/25/1987	60	228.8%	58.3%	2.0%
12/4/1987	7/16/1990	31	64.8%	21.4%	29.3%
10/11/1990	3/24/2000	113	417.0%	29.1%	5.6%
10/9/2002	10/9/2007	60	101.5%	33.7%	8.0%
3/9/2009	2/19/2020	131	400.5%	68.6%	15.7%
3/23/2020	5/21/2021	14	89.4%	74.8%	?
All Periods Average		62	182.7%	48.7%	10.6%

Source: Strategas Research Partners, LLC

in an environment not encountered in a long time. The current environment represents the first time we have seen the effects of coordinated fiscal and monetary stimulus since the Great Recession. One side effect of this stimulus, combined with pent up demand from the pandemic, is that we may see a return to a more normal business cycle. This would be a positive in my mind as we could have a sustained period of above average growth. It is this growth that to a certain degree would justify the large cost of the various stimulus packages. What remains to be seen is if we will finally have the political patience to let that happen.

Learning from past mistakes

In 2009, the Obama administration passed The American Recovery and Reinvestment Act. This attempt to jump start the economy is estimated to have cost approximately $830 million. This plan was launched in conjunction with very accommodative monetary policy from the Federal Reserve. Historically, the combination of nearly a trillion dollars of stimulus and low interest rates would have been a powerful economic force. Unfortunately, the much hoped for benefits of these economic conditions never really materialized.

Faced with a still sputtering economy in 2017, the Trump administration passed The Tax Cut and Jobs Act with an estimated price tag of $1.9 trillion. This plan was also launched with relatively low; all be it rising interest rates. Though there were a few "head fakes", this stimulus also failed to live up to expectations, at least initially.

In both these cases, I would argue that other policy actions ultimately short circuited or at least delayed the economic benefits of these stimulus attempts. In 2009, the combination of extremely restrictive financial regulation as well as uncertainty and costs around The Affordable Care Act offset much of the benefit of the stimulus plan leaving us with a relatively stagnant economy for several years. Similarly, the 2017 tax cuts saw their impact blunted first by a tightening from the Federal Reserve and then by the disruptive trade policies. To add insult to injury, when we finally appeared to work through the trade headwinds and had an accommodative Fed, the economy was derailed by the COVID-19 pandemic.

Conclusion

For the third time in 12 years, we have a new president faced with the challenge of rekindling our economy. In the wake of the COVID-19 pandemic, the Biden administration has already spent $2 trillion and is looking to double that amount.

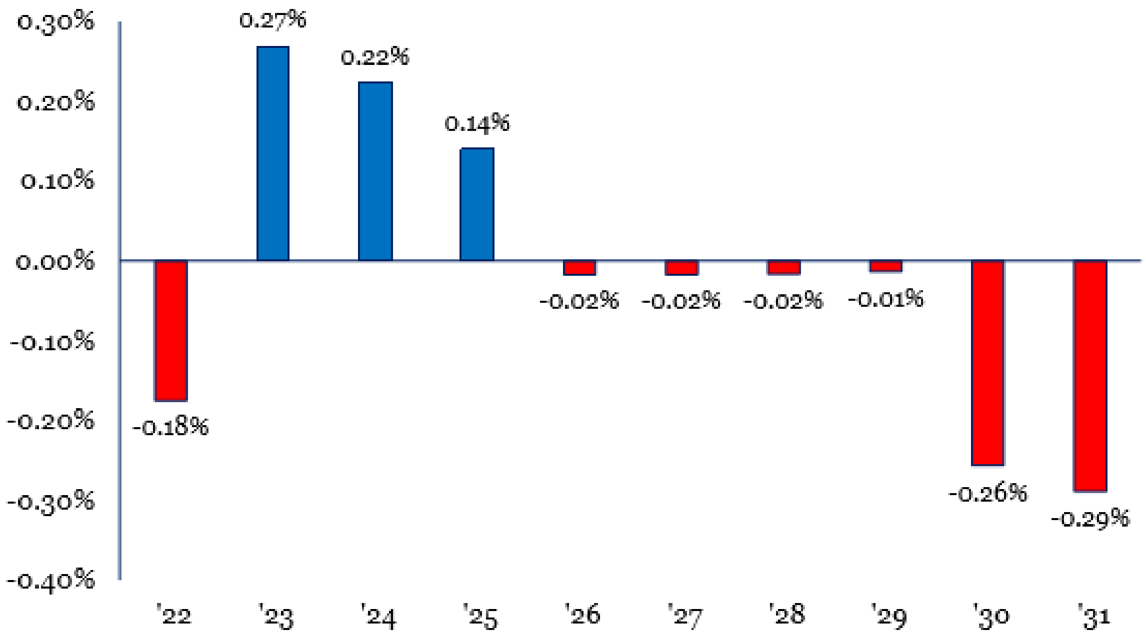
Covid-Era Fiscal Stimulus

When	What	Amount	% GDP
6-Mar-20	Coronavirus & Vaccine R&D	$8 Billion	0.0%
18-Mar-20	Paid Sick Leave & Un. Claims	$192 Billion	0.9%
27-Mar-20	CARES ACT	$1.7 Trillion	7.9%
21-Apr-20	Payroll Protection Plan	$483 Billion	2.2%
27-Dec-20	Phase 4	$900 Billion	4.2%
11-Mar-21	American Rescue Plan	$1.9 Trillion	8.8%

Source: Strategas Research Partners, LLC

The question to me appears to be "will the politicians again short circuit the potential benefit of these policies before they are realized?". The problem with the current plan is that it is accompanied by substantial tax increases. Obviously, we would expect taxes will need to rise as we pay for the aggressive fiscal actions of the last 16 months. The problem we foresee is the timing and magnitude of the tax increases. Because much of the infrastructure spending outline is spread over 10 or more years and the tax hikes take effect immediately, we will experience fiscal policy having a net negative impact on the economy. The risk is that we, once again, short circuit our attempt to restart our economy before the most recent stimulus has a chance to work.

Net Y/Y Incremental Fiscal Impact of Biden Infrastructure Plan, % of GDP



Source: Strategas Research Partners, LLC

As advisors focused on the long-term, we obviously need to consider what could happen but also pay attention to what is happening. The economy is recovering, and there is currently a strong tail wind in place to continue to push that recovery higher. Interest rates are at historically low levels and are likely to move gradually higher. Taxes on capital gains and corporations are currently as low as they will be given the likelihood these rates will rise soon. With this backdrop, we are taking several steps to position clients for the current environment while being careful to maintain perspective and objectivity.

We have adjusted the risk profile of our fixed income investments to reduce the impact of possible inflation and rising interest rates. We continue to rebalance portfolios and, as a result, have been positioned to benefit from the strong performance of both growth and value style investments. Similarly, we have been focused on ensuring clients keep as much of the growth as possible. Last year we aggressively harvested tax losses and this year rebalancing is a priority while capital gains rates remain low.

Over the next several months, we will hear a lot about inflation, taxes, and politics. Ultimately these factors do matter but are only part of the story. It will be important to maintain perspective. For example, inflation will likely rise in the coming months, but it will rise from historically low levels to more normal levels. Interest rates will likely follow the same path. After the Great Recession, the concept of a "new normal" economic environment was much talked about with slow growth, low rates, and little economic volatility as its key features. Now, perhaps, we are beginning the transition from the "new normal" back to the "old normal." Should this come to pass, it also may be the final signal that we have truly recovered from the Great Recession. Hopefully, the third time will be the charm.

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