2Q 2021
Market Commentary

"The Fed woke up in June, but it just couldn't get out of bed."

– Anonymous quote from CNBC broadcast.

May's year-to-year 5% CPI gain jolted awake the Federal Reserve Board and Chairman Powell. It clearly implied the Fed was behind the curve in addressing the smoldering price inflation threat. In mid-June, the Chairman announced the Fed would likely raise the Fed Funds rate twice in the second half of 2023 and take the rate to near 0.6% by the end of that year. This was a clear change from prior forecasts that no rate changes would be made until after 2023. Just the idea that the Fed might actually act on price inflation fears caused the Treasury yield curve to flatten as short-term T-bill yields rose and T-bond yields fell. In the meantime, however, the Fed restated it had no plans to taper its $120 billion in monthly Treasury and Agency bond purchases. No "taper tantrum" here.

But the stock market decided to have a tantrum anyway with economically-sensitive stocks taking the brunt of the hit in June. By the beginning of the following week at his testimony before Congress, Powell walked back his statements about responding to the price inflation numbers, repeatedly emphasizing that the inflation problem is entirely transitory. No worries here. We disagree.

While the first half of 2021 once again demonstrated the benefit of SKBA's value-style portfolios, the second quarter, particularly June, witnessed the seesaw back and forth between growth and value, aided and abetted by Fed policy and its announcements. With its massive monetary stimulus, the Federal Reserve Board is stuck in a box of its own making. It won't be easy to get out of it. So let's examine some the reasons offered as to why the inflation threat is likely to be more than just transitory.

- **With Real GDP growth of 6% in the face of constraints on supply and workers, corporations should be able to pass on most of their cost increases in higher prices.**
- **Rising employment will allow the output of goods and services to rise as well, but with an acceleration in business costs.** The shortage of workers willing to work has been exacerbated by the federal government's payment of $1,200 per month in additional unemployment benefits through the end of September. A significant number of workers earn more by remaining unemployed, which is part of the reason over nine million job openings (from the latest JOLTS survey) remain unfilled. The wage increases accompanying the growth in employment will permanently raise business costs and fuel consumer demand.
- **Product shortages are here to stay.** With the continued administration of vaccines against COVID, the U.S. economy is roaring back to life. Caught with depleted supply chain inventories, it is quite understandable that shortages exist everywhere: semiconductors, commodities, transportation and ports, packaging, housing, retailers and others. In semiconductors, double ordering is rampant just to get the inventories needed to manufacture electronics and autos. While output growth might ease some of the price pressures, the commodity price slide in response to the Fed's comment is likely to be temporary as demand is likely to continue to outstrip supply for quarters to come.
- **Federal fiscal stimulus remains in high gear with huge unfunded spending plans.** With the reopening of the economy, such spending may not be needed to pump prime any further. The follow on spending plans beyond infrastructure, if passed, would just throw fuel on the inflationary fire.
- **The Fed's extreme monetary policy ease continues to debase the exchange value of the U.S. dollar, whether reflected in domestic prices or in currency markets.** As we've stated, price inflation appears to be experiencing a great awakening, and the Fed continues to feed the excess growth of dollars that contribute to longer term price inflation.

Between real demand growth and price inflation, business revenues could rise 9-10% in 2021 and possibly another 7-8% in 2022. Such gains haven't been seen in decades. Even if some margin pressure exists, corporate profit growth should grow in line with these estimates or even slightly better, with the biggest beneficiaries being companies in the center of the cyclical recovery.

Yet with overall stock and bond market valuations high, as sequential gains are reported in producer and consumer prices, the broad market indices could come under pressure. Further pressure could occur from the Administration's plan to significantly raise the capital gains tax rate. The combination of price inflation, a return to rising interest rates and taxing inflated gains would hurt the overall market, with growth stocks understandably taking a significant hit.

Furthermore, if the bipartisan infrastructure bill gets through the House and Senate, considerable new dollars will flow capital expenditures into asphalt, concrete, steel and cable (the electric grid), creating all kinds of ancillary demand for goods and services as part of each project. While commercial office space will only slowly be repopulated, the companies that benefited the most from the work at home environment during the COVID pandemic, are not likely to be the winners in the stock market over the next year or two.

While the U.S. and Europe have already made great strides in vaccinating their populations, such is not the case in the Southern Hemisphere. The surge in COVID cases, including highly transmissible variants, burden the economic recoveries in countries such as Brazil, India, and South Africa. Even though the data is intentionally hidden by the Chinese government, it appears COVID infections have accelerated in China as well. The worldwide recovery in goods and materials production could be further interrupted by these developments. At the same time, the reopening of the world economy is fueling an economic boom—the likes of which we have not seen in this century. The combination should still contribute to rising output, rising employment and rising prices. All the while, the Fed will have to figure out how to get out of the box in which it finds itself.