CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 12, 2021

The stock market flourishes...
...on momentum and speculation

The transfers from the federal government to eligible citizens are of a heretofore unimaginable scope.

The payments have certainly mitigated the damage caused by the pandemic, but they have not built a base for sustained economic growth in the future. The result has created a stop-and-go effect.

The most recent $1.9 trillion dollar relief legislation creates strong growth now, but its effects will have ended come the summer.

The stock market sees only the short-term boom and it marches higher.

Related to this is the wide-spread belief that a surge in inflation is at hand. The inflation numbers for the next three months will be high on a year-over-year basis as the deflationary effects of last year's lockdown fall away. After that, all will be quiet.

By

Jack Mayberry

In recent sessions, the S&P 500 surpassed the 4000 level for the first time in the most robust fashion imaginable. I have felt increasing concern about valuations in stocks, noting in my last letter that, by most measures, stocks were more overvalued than at any time except for the market crash in 1929 and the dot.com bubble at the turn of the millennium. The market having pushed higher still, more valuation hurdles have been surpassed. Although one can argue--as I have--that stock prices are divorced from economic reality and corporate profits, there is no denying the persistence of the buying.

The vaccination progress in America is impressive, but the rising level of new cases and the alarming spread of the Coronavirus variants are worrying. Hospitalizations and deaths in the US have not yet begun to rise, but, as we have all learned, these follow new cases. The optimism that the ever-more successful vaccination program engenders gives rise to predictions of economic boom.

Stop. Go. Stop. Go. Stop. Go. The huge pandemic relief payments from the government to citizens have certainly mitigated some disastrous economic effects of the disease, but the federal spending has not created an enduring foundation for growth. After the collapse in the economy that began last March, the federal support enacted late that month gave rise to economic growth at an annualized rate of 33% in the quarter from July to September. But, after the money distributed after the March 2020 legislation got spent (or saved or invested), economic growth slowed markedly in the fourth quarter. In December 2020, in the waning days of the Trump administration, came another relief bill, this one sending $600 to eligible citizens. Retail sales boomed in January as that handout got spent. Then retail sales contracted by 3% in February. Oops. Then last month's enormous relief legislation put more federal dollars in pockets of Americans. We will surely see another boost in sales in upcoming reports, but, as surely as night follows day, things will slow once again in the summer.

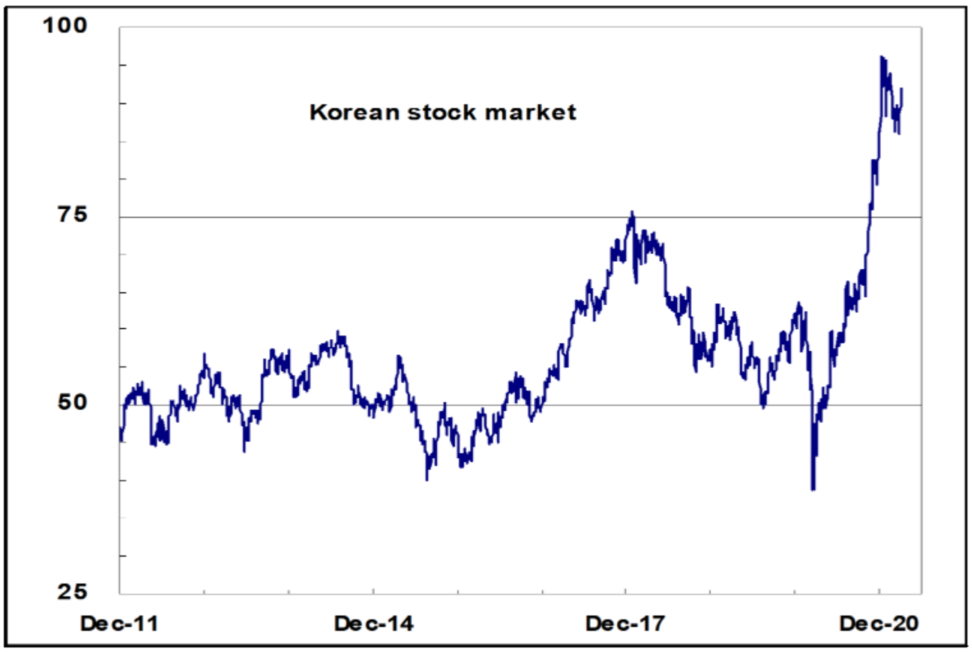
Inflation is set to rise sharply, or so says the narrative in which many believe. The expectation of imminent inflation has caused bond yields to rise and the corresponding bond prices to fall. This has brought down the prices of our large bond investments, particularly in long-term Treasury bonds. But inflation is a mirage. There is nothing to cause inflation to rise in a meaningful way in the next couple of years. The Fed is clear that disinflationary forces still hold sway and its formal estimates of upcoming inflation (as measured by its core Price Consumption Expenditures (core PCE) are 2.2% for this year, 2.0% for 2021, and 2.1% for 2023. For the year ending February 2021, the core PCE was all of 1.4% and was flat for the month of February.

The inflation narrative—a false one to my mind—has caused the prices of the long-term Treasury bonds we hold to fall and their yields to rise.

Although yields my rise more in the short-term, this is a temporary effect.

The chart below shows Korean stocks. Our principal stock investments are in East Asia and they are doing very well.

Commodities, including crude oil, copper and other industrial commodities, have risen since the plague-panicked levels of a year ago, but wages and salaries, which really must rise for inflation to take hold, have fallen in the last twelve months. (Real personal income excluding government transfers, has declined by 2.5% in the last year.) Slack in the labor market is enormous; despite recent employment gains as more parts of the economy reopen, the job losses for the last twelve months still total 8 million. Had the pandemic not occurred, job growth would have been about 3 million, so we are now 11 million jobs behind where we would have been. Moreover, and perhaps unsurprisingly, productivity has increased by more in the last year than in any year in the last decade. That is to say, businesses have used the last year to learn how to produce more with the same amount of labor. There is a negative 83% correlation between productivity and inflation. To say it differently, as productivity increases, inflation falls. In the recent widely celebrated employment report, it was little noted that hourly earnings fell by 0.1% in the month.



There is occasional comment—most recently from Mitch McConnell—to the effect that we had the greatest economic boom in fifty years before the pandemic. Well, not really. Economic growth was lackluster over the last decade and the NBER, the agency that determines the dates of beginnings and endings of recessions, tells us the this recession began in February 2020, prior to any economic effects in the US from the disease.

Treasury bonds and our portfolios. As noted, the inflation narrative has driven down the prices of bonds, especially the long-term Treasury bonds we hold. These have fallen by a bit more than 12% this year bringing our total portfolios down by a bit less than 3% for the quarter, our first negative quarter for some time. I plan to hold these Treasuries, based on my views for quiescent inflation and the likely continuation of our stop-and-go-and-stop-and-go economy, dependent as it is upon periodic infusions of federal government grants to individuals to avoid economic contraction.

Our holdings in East Asian equities, including Korea, Taiwan and Japan, continue to perform well. (The chart above shows the path of Korean stocks over the last decade.) They are undervalued when compared to US stocks, making them somewhat less risky. We also hold US financial stocks and pipeline companies, both attractively priced as we evaluate it. As is often the case, financial markets are somewhat perplexing, as short-term disturbances and episodes of optimism push things to and fro. The vaccine progress in America is worthy of cheer. Let us hope that the positive trajectory it suggests will be borne out, despite Coronavirus variants.

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