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

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Stasis and Distortion

Bond and stock markets stall, while the confusions created by Covid disrupt almost everything.

Stasis in the markets and pandemic distortion in everything else--our lives, the economy, politics. In the last three months, most markets, including the bond and the stock markets, have essentially traded up and down within a narrow ranges and with no progress in either direction. This indecision, if that it what it is, reflects the changes in everything wrought by the pandemic. Given that the course of the pandemic is so uncertain, we may well be stuck with indecisive markets for some time to come.

The onset of the Delta variant in the summer caused new cases, hospitalizations and deaths to rise markedly. Although across America these are all falling now, we are approaching the cold season, when it is likely that infections will again rise, even without any new variants, because more people will be indoors where infections spread more readily. Came an announcement yesterday of a new variant, an apparent descendent of the Delta, of probably higher transmissibility. And, given that in much of the world few people are vaccinated, the coronavirus has plenty of opportunity to develop new and worse variants.

Economic distortions brought to bear by Covid are many. Shipping ports in East Asia have had lockdowns and slower loadings because of Covid. The California ports of Long Beach and Los Angeles that receive shipments from Asia have unheard of congestion and backlogs related to Covid disruptions. The results just of these shipping matters have caused supplies of countless things to be held up. Unusual patterns of spending and demand for goods and services have similarly distorted decisions about manufacturing. To give one example, in the 2020 lockdown days, people spent previously unheard of sums on various electronic goods, for watching things on Netflix and Amazon, for ordering their groceries online, for working from home, and the like. By some measures spending on durable goods increased five-fold. This caused some manufacturers to slow production on the reasonable assumption that demand for such things would fall. This rendered supplies of some components, semiconductors included, quite short. Although manufacturing of such supplies has increased, delivery has been screwed up by the port and shipping problems.

By

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The staggeringly huge US government support from March 2020 also greatly skewed spending, pushing it up dramatically as the three Covid-related federal relief packages pushed $5 *trillion* into public hands. The Federal Reserve did its bit as well, keeping interest rates at essentially zero and purchasing $120 *billion* per month of Treasury and mortgage-backed securities. As a result of this largess, personal incomes rose dramatically, despite huge increases in the numbers of the unemployed. Federal handouts exceeded the loss of work-related income.

Supply constraints caused inflation in some goods and services earlier this year; some have now abated while others have risen, keeping inflation at higher levels after more than a decade of very low inflation. There are now reports that demand is softening in various areas just as supply delivery bottlenecks are set to ease. This suggests that inflation rates will decline again; numerous recent reports from various Federal Reserve banks make this point. The reasonable conclusion to draw would be that inflation rates will decline, but there has been little that has been 'reasonable' so far in our Covid times. Indeed, the Fed governors, seemingly ignoring the work of Fed staffers, suggest that in November or December the Fed will begin to slow its asset purchases.

What does this portend? The Biden administration is having considerable trouble pushing its spending plans forward, plans opposed outright by virtually all Republicans in Congress, and by two key Democratic senators, Joe Manchin and Kyrsten Sinema. The fiscal cookie jar may not be passed around again any time soon. And if the Fed begins to tighten monetary policy this autumn, as Fed governors appear set to do, we may well see a considerable decline in demand, a weakening in economic activity and, perhaps, another recession. Note that the expanded unemployment benefits, a crucial part of the legislation to counter the economic effects of Covid and its lockdowns, came to an end last month. The big checks sent to many Americans will not be renewed. Only the modest child tax credit payments continue and, unless renewed by new legislation, these end this year.

The markets. As noted above, in recent months, the stock market's rise has stalled and the Treasury bond market has bounced around within a narrow price and yield range. In previous letters, I have discussed the extent to which the US stock market is overvalued. By the highly-regarded CAPE measure (Cyclically Adjusted Price Earnings ratio), US markets are more overvalued now than at any time--except one--in well over a century. If demand falls, if the economy slows, if the Fed cuts its asset purchases, there will be little to sustain prices at these elevated levels. As for Treasuries, also rather directionless for some months, the slowing economy with moderating inflation would be a tonic for its prices. Treasury bond prices should rise and yields fall in the environment outlined above.

Although not a direct concern for our investment work, a comment on housing prices: Similarly to stock prices, housing prices in many parts of the country have risen dramatically and relentlessly during Covid. By widely used measures known as the Case-Shiller indices, prices have risen by 20 percent in the last twelve months. Typically it has taken five years of median wages to buy a median-priced house. Now it is eight years!

History does not repeat itself, however much it may rhyme. And pandemic distortions make predictions even more perilous than usual. But, when markets move to extremes, the common outcome is reversion to the mean, often though with a trip to the other extreme first. Caution! Red flags are flying.

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