DICKMEYERBOYCE
FINANCIAL MANAGEMENT, INC.

August 16, 2021

2021 2nd Quarter Review: Peak Growth – Variant Concerns

Executive Summary

- **The recovery in the economy continues to be strong with spending on services picking up the pace.** Total consumer spending now exceeds the pre-pandemic peak by over 3% adjusting for inflation. Spending on services exceeds the pre-pandemic peak on a nominal basis, but still trails the peak by 3% after inflation.
- The Delta variant of Covid-19 is driving a spike in cases. **It is difficult to estimate the potential drag on services spending as the Delta variant wave of infections works through our population. Studies of behavioral changes show a potential for a slow-down in services spending growth in Q3.**
- Transfer payments (stimulus) from the government declined by $1.67 Trillion in Q2 from Q1, but they still exceed normal levels by $1.1 Trillion. **Government stimulus is still exceptional.**
- Absent the Covid-19 wild card, **we expect demand for goods and services to continue rising over the next two years.** Supply of goods and labor remains constrained with gradual improvement seen. We still anticipate inflation to return towards, but above 2% in 2022.
- **Peak growth** in year over year GDP (6.5%) and corporate earnings (90%) **likely occurred in Q2.** Yet **projections for economic and corporate earnings growth continue to be solid for the remainder of 2021** (6+% and 20+%, respectively) **and 2022** (3.5% and 10%, respectively).

Macro-Economic Perspective

Let's review what we learned about economic comparisons to the pre-pandemic peak levels in Q1. In addition, what direction did we trend in Q2?

Fiscal and Monetary Support (reduced but still high) and Vaccinations:

- GDP exceeded the Q4 2019 peak in Q1. The advanced estimate of Q2 GDP growth is 6.5%.
- Enormous government transfer payments in 2020 and early 2021 enabled a bit above average Personal Income increase in 2020 at 4.8%. Transfer payments have again enabled above average Personal Income gains at 5.2% through Q2. Transfer payments aided the economy significantly last year and so far, this year.
- It is interesting to note that Personal Income managed a 1% gain in 2020 and a 0.2% gain through Q2 this year with transfer payments excluded. This would not have kept up with inflation, but it is surprising none the less.
- Disposable personal income (income after taxes) was up 5.5% in 2020. This is the highest rate of growth since 1984. The blip in disposable personal income that occurred in Q1 was tamed by the lower transfer payments in Q2. But, if you go back to 2019 - year end, the annualized growth of disposable personal income has been 6.7% through Q2.
- The savings rate was 13.7% last year, was 20.5% in the Q1, and was 10.9% in Q2. Prior to the pandemic, the U.S. savings rate was about 7.5%.
- After the massive increase in M2 money supply (cash, checking and savings deposits, money market, mutual funds, and CDs) of 24.2% in the last year ending Q1 2021, M2 growth has slowed to an analyzed rate of 5.74% in 2021, with a decline of 0.8% in the month of June. This annual pace is more in line with typical Federal Reserve practice of maintaining a 3% to 6% increase in the money supply each year.
- The velocity of money (the frequency at which one unit of currency is used to purchase goods and services within a given period of time) continues at a very low level. So far, this has countered the inflationary pressure caused by the massive increase in money supply.

- Household net worth peaked at $111.04T at year end 2019. Since then, it has risen 16.6% to $129.45T at Q1 end. The gain in net worth achieved in five quarters exceeds the growth achieved over the two years leading up to the previous peak.
- Total personal consumption was up 11.3% in the 1st quarter, 4.5% in the 2nd quarter, and is 7% higher than the pre-pandemic peak.
- Incidence of Covid infection had peaked at 437 cases per million (7-day average) were down to 10 cases per million by the end of Q2. Covid deaths over the same time frame dropped from 8 per million to zero. As of August 11th, cases have risen to 131 per million and deaths to 1 per million. We shall see what the impact on consumption will be as a result of the variant driven spike in cases.
- The securities markets faith in the vaccination project and fiscal stimulus appears to have been well placed.
- **Consumers are well equipped with cash and feeling wealthy. Expectations for continued economic growth is well founded. Behavioral reaction to the path of Covid-19 will determine the level of economic success achieved in the near term.**

Key Economic Data Points:

Inflation expectations realized.

Last quarter, we covered this topic extensively. Below are two excerpts from our 1st quarter review letter.

1. **The Federal Reserve's view is that the price pressures are the result of temporary shocks. They do not believe higher inflation will persist once the supply chain bottlenecks are resolved by year end. We tend to agree. In many cases, the factors driving up prices appear fleeting. Depleted inventories are leading to big restocking orders, thereby putting premiums on near term deliveries of raw materials. Some of the price gains have been sharp but they have just completed their recovery from the pandemic market panic. We admit that the massive increase in money supply, personal income, and personal savings could lead to very high levels of demand that may be difficult to meet.**

2. **Longer term, we have concerns regarding slow growth and limited inflation. History of world economies indicate that high Federal debt (greater than 100% of GDP) leads to sluggish economic growth and difficulty fending off deflation**. Japan has been an extreme example of high government debt (greater than 100% of GDP since 1997 and greater than 200% of GDP since 2010), sluggish growth, and very low inflation over the last three decades. The FED has not been able to orchestrate an inflation rate at or above their 2% target for more than a decade. They have been open about their desire to allow inflation to exceed their target for a period of time. This may give the FED some market credibility that they can orchestrate a higher level of inflation in the short term. **However, we will need to deal with escalating debt which cannot be funded by the FED perpetually without adverse consequences.**

Inflation continues to run hot due to supply constraints and the base effects of comparisons to the data during the Covid shutdown. **In order to work around the base effects upon inflation readings, let's go back two years to get a reading on inflation. In this case, recent headline inflation readings would be 2.25% per year.** This is within the Federal Reserve's preferred window for inflation.

Counter to our opinion that higher inflation will be tamed in 2022, rising wages (up 5% in the last three months) and housing costs (30% of the Department of Labor's reading on inflation) may have more persistence. Wages may continue to rise to attract workers back into the labor force (increase in the employment participation rate).

Economic Growth spike: Q1 real annualized GDP growth rate was 6.3%. The advanced reading on Q2 GDP growth was 6.5%. Expectations for Q2 were as high as 8.5%. Is this the result of the Delta variant impacting activity?

Estimates for GDP growth for 2021 in other major economies in the world have slipped a bit due to the Covid spike: Canada and Mexico +5%, China +8.4%, Korea +3.6%, Japan +3.3%, U.K. +5.3%, Euro area +4.4%, Latin American countries +3% to +6%, Russia +3.8%, Australia +5.2%, Africa +3.3%, and India at 8.9%. The International Money Fund projects world growth at 6% for this year and 4.9% for 2022. The World Bank projects 5.6% for 2021.

Employment: T**he FED is forecasting a full job recovery with unemployment back down to 3.5% by 2023.** The unemployment rate and the number of unemployed in February 2020 was 3.5% and 5.8 million. At that time, the potential gain in working adults was 3.2 million people. The number of unemployed by April 2020 was 23.1 million. 16.7 million people have been employed since that time. By June this year, there were 9.5 million people unemployed. There are 10.1 million job openings. Net job gains averaged 900,000 in May and June. The participation rate is 1.7% below the February 2020 level and 5.6% below levels enjoyed in the late 90's and early 2000's. **The big unanswerable question remains, what will happen with the employment participation rate? DBFM estimates that the potential for employment gain is 10.5 million people. This will be important to curing supply of goods and services bottlenecks that exist now and thereby fending off continued high inflation.**

Consumer spending (70% of GDP): Personal consumption expenditures (annualized) topped out in February 2020 at $14.88T. They bottomed out in April 2020 at $12.1T, a decline of 18.7%. For comparison purposes, the decline in personal consumption expenditures during the Great Financial Crisis was 3.9%. **As of June, of this year, personal consumption expenditures exceeded the February 2020 peak level by 8.6% at $16.15T.** The Institute of Supply Management (ISM) reading for service rose to 63.7 in March and was down to 60.1 in June, but back up to 64.1 in July. A reading of 50 is the dividing line between decline and growth. These are exceptionally high numbers.

Manufacturing (11% of GDP): The ISM reading for manufacturing had steadily risen to 64.7 in March this year from 41.5 in May 2020. It has declined to 60.6 in June and 59.5 in July. **Manufacturing output (data recorded quarterly) at Q2 end has continued to recover significantly (3.8% annualized) but remains 1% below the recent peak, which was attained in Q4 2019, halving the shortfall from Q1.**

Construction (4.1% of GDP): The pre-pandemic peak was in March of 2020 at $1.502T annualized. Construction spending bottomed in June of 2020. It has leveled off throughout Q2 at around $1.552T annualized. **Total construction is up 8.2% from one year ago. Residential construction is up 28% and non-residential plus public construction is down 6.6%.**

Home sales: Last quarter, we discussed the shortage of construction versus new household formation since the housing crisis in 2008. New household formation has steadily increased from 1.2 million per year in 2008 to over 1.5 million per year. Annualized permit issuance for residential construction has ranged between 1.5 million and 1.8 million over the last past 12 months. **One can assume that construction is keeping up with new household formation, but not adding to inventory of existing homes for sale.** According to the National Association of Realtors, **the median price for a home is setting new records every month.** It was up 22.9% at Q2 end from the year ago level to $357,900. Supply has risen very slightly but remains at a very low 2.6 months up from the record low of 1.9 months in January. Six months is considered a balanced marketplace for buyer and sellers. **This data bodes well for construction prospects and home prices, but affordability and availability may limit housing potential. The typical monthly mortgage payment rose to $1,215 from $1,019 a year ago. Housing cost is rising faster than the advantage of low interest rates.**

Securities Market Perspective

By the end of the second quarter, a 100% stock portfolio with 20% invested in international was up approximately 14.6% with dividends reinvested. Intermediate term bonds (Barclay's Aggregate Bond Index) were down 1.67%, an improvement from a decline of 3.57% by the end of Q1, and short-term bonds were flat at no gain (Barclays U.S. Gov't Credit 1 to 3 Year Bond Index). It is interesting that bond prices have improved (interest rates down) all the while concerns about inflation abound. There are outside influences keeping bond yields in check (supporting bond prices) such as Federal Reserve massive monthly bond purchases and the existence of $16T in negative yielding bonds outside the USA. But bond markets have a higher I.Q. than equities markets, thereby suggesting concerns about inflation are overdone. Although, we do expect yields to rise (bond prices down) before year-end by about 0.5%.

Valuation discussion points:

- By the end of the second quarter, as measured by price to book value, **growth stocks were 175% above their long-term average** of 4.83 at 13.29 (up from 131% at the end of Q1 2021). **Value stocks were 19.7% above their long-term average** of 2.18 at 2.61 (up from 14.6% at the end of Q1 2021).
- At the second quarter end, growth stocks were up 12.7% and value stocks were up 18.51%.
- This reversal of fortune for value stocks began on 7/10/20 and gained strength on 11/5/20 when Pfizer announced the effectiveness of their Covid-19 vaccine. Value stocks were more impacted by the Covid restrictions and are being appreciated as the economy opens. In addition, higher interest rates (threat of higher inflation) cause the value of greater future earnings of growth stocks to be more discounted. Stocks with higher P/E ratios are more impacted by higher inflation. That said large cap growth stocks have rebounded relative to value stocks since approximately early June with concerns about the Covid case count rebound seen in India and the U.K**.**
- <u>It is still the case that low interest rates continue to validate higher valuations</u>.
- <u>Growth stock valuations are significantly more threatened by higher inflation and interest rates than Value stocks</u>.
- The prospect of peak earnings growth is somewhat tempered by the base effects of poor earnings a year ago. **Although projections for earnings growth for the rest of 2021 (at 20%) and 2022 (at 10%) still are attractive, the fact that we are beyond the peak will cause gains in equity prices to come along more grudgingly.**
- So far, the stock market rise has not created economic excesses. On the other hand, one does not have to look far to see examples of excessive valuations.
- The Federal Reserve's zero bound interest rate policy continues to force investors to increase risk via investing in stocks and pursuing lower quality bonds. The spread in yields between high yield bonds and Treasuries are at an all-time low. One should be careful in maintaining investments in lowest quality bonds.
- There are plenty of high-quality companies with dividend yields well in excess of interest rates available in bonds.

Valuation conclusions:

- The threat of higher inflation is causing a decline in relative return for growth stocks in comparison to value stocks. In addition, there are plenty of examples where growth stock valuations remain out of touch with reality.
- To a lesser extent, low interest rates continue to provide cover for higher valuations.
- It is safe to say that growth stocks are over-valued by historical standards and value stocks are not cheap, but they are still within the range of fair value.
- Success of the vaccination effort appears to have led to a more freedom of movement and a strengthening of the rotation out of growth stocks and into value stocks. The spread of the Delta variant of Covid-19 is attracting investors back to large cap tech stocks.
- Peak earnings growth will place a hand on the valuation weighing scale.

Bonds:

- Yields on all types of bonds are being anchored at very low levels by Federal Reserve policy action of holding the Federal Funds rate at nearly 0% and monthly bond purchases. DBFM continues to pursue additional avenues to enable positive bond return and portfolio income in this low interest rate environment. This is becoming a daunting task.
- Interest rates will likely rise a bit before year end. Federal Reserve action to raise rates isn't likely until mid to late next year. Avoidance of long-term bonds is the order of the day in the investing world. High quality intermediate term bonds are in place to counter-balance potential stock market pullbacks. DBFM is maintaining a heavy concentration on shorter term bonds without sacrificing yield.

Wrap up:

- Manufacturing output is rising but remains below the pre-pandemic peak level by just 1%. Consumer spending and construction well exceed the pre-pandemic peak level. Not surprisingly, GDP is reaching new heights.
- If the market has correctly anticipated inflation, there is no extra money to be made betting on inflation.
- Wage growth needed to raise the employment participation rate and housing cost are threats to inflation returning down within the Federal Reserve's target range.
- Supply chain bottlenecks must be resolved including a significant gain in employment to ward off continued higher inflation.
- The U.S. is awash in money. High personal savings rates continue and gains in mobility freedom from successful vaccinations point to strong demand growth.
- Significant gains in U.S. personal wealth will also drive strong demand growth.
- The surge in the Delta variant of Covid serves as a reminder that we have not reached a point where Covid is a moot issue.
- Potential Risks: Inflation forcing the Federal Reserve's hand to clampdown by raising interest rates, tax increases, supply constraints (material and labor) not resolved, or reversal of progress against Covid-19 severe enough to alter spending behavior for services.

Please feel free to contact us with any questions, or if you would like to schedule a virtual, face to face, or phone meeting. We are back in the office.

Thank you,

Dave Dickmeyer, M.B.A.
Wealth Advisor
Principal Owner

Ian D. Boyce, CFP®
Certified Financial Planner™
Principal Owner