Market Commentary

September 30, 2021

AAMA
ADVANCED ASSET MANAGEMENT ADVISORS

An Update On Inflation

The Federal Reserve continues to describe the current bout of inflation as "transitory". Literally, transitory means 'temporary' or 'not persistent'. However, without a time frame, transitory can mean anything.

If the recent jump in inflation abates over the next 6 months, we will likely all agree that it was transitory. Yet, the last 40 years of disinflation looks transitory when viewed in the context of the last 107 years of inflation. The last 107 years of inflation looks transitory relative to the 245 year history of the United States. At some point, the U.S. Dollar will cease to exist and therefore be viewed as a transitory currency relative to the 5,000 year history of representative money systems.

Material supplies and labor shortages coupled with stimulus driven demand form the basis for the transitory reasoning. Supply issues drive the volatile components of measured inflation. Housing and labor costs drive the stickier components. The question for future inflation is whether the anticipated fixes in the supply chain and in the labor market will offset the likely continuing rise of the sticky components.

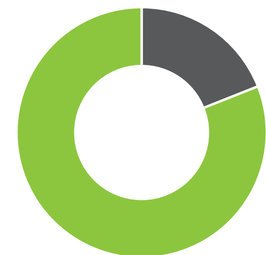
The Federal Reserve board continues to raise its chronically inaccurate forecast for inflation and Chairman Powel just stated in congressional testimony that inflation will be higher and last longer than originally expected. It is unclear if he has dropped the term "transitory" or simply redefined its duration. Which leads us to…

What To Expect From Interest Rates

Before the advent of quantitative easing ("QE") the Fed controlled short-term interest rates and left long-term rates alone. Since the implementation of QE 12 years ago, the Fed has accumulated 19% of all Treasury debt and 22% of mortgage debt. The Fed's buying has reduced long-term Treasury rates and mortgage rates.

Last week the Fed all but assured they would start reducing QE purchases in November and eliminate all purchases by mid next year. With this sizeable buyer out of the market one would expect higher Treasury and mortgage rates. After QE winds down, the Fed's next step towards "normalization" would be to sell assets and/or raise short-term interest rates. Their own projections have moved these events forward on the calendar. All signs point away from the easy monetary conditions than we have enjoyed over the last 18 months.

Total Treasury Debt



Total Mortgage Debt

Fed Owned   Other

Whether or not they actually move to tight conditions will depend on inflation and other economic trends. With savings accounts paying a negative return (after inflation) of -5.2% it will take a lot of interest rate increases to reach 'normal'. The Bloomberg Long Term Treasury Bond index has returned negative -7.49% year-to-date. Our short term, high quality bond holdings have weathered the bond market decline relatively well. Extremely loose monetary conditions lead us to…

Headwinds In Economic Growth

The economy is expected to grow by 3% to 5% in the third quarter… down significantly from the rebound-charged Spring numbers. Despite price increases and widespread shortages, consumer spending has been strong.

Low interest rates and low inventory have contributed to housing price gains of 20% over the last year. As prices advance, the housing market becomes more sensitive to changes in interest rates. Surveys from the University of Michigan show that 65% of consumers feel it is a bad time to buy a house or a new car, and 51% a bad time to buy large household goods. If prices remain at current levels and interest rates normalized, a large segment of home buyers would have no choice – they would simply be priced out of the market.

Consumer Sentiment Survey

What percentage of consumers feel it's a bad time to purchase:

→ **65%**

New House or Car

→ **51%**

Large Household Goods

Inflation is causing demand destruction. Product shortages and lower demand have brought third quarter growth expectations down from 6%-9% in June to 3%-5% currently. Federal Reserve forecasts are notoriously inaccurate. Given the volatility of fiscal policies, recent inflation, and supply chain issues, economic growth has a much higher chance to either over or under-shoot anyone's forecast. Which leads us to…

Market Valuations Today

Corporate earnings drive the long-term value of common stocks. Earnings which fell off a cliff a year ago, as the economy was shut down, have since rebounded. Trailing 12-month earnings should be 50% higher through September 30, as compared to pandemic-depressed levels. Forecasts over the next year call for continued growth, but settle down to a 10% growth rate a year from now.

We are currently experiencing peak earnings growth rates. However, just as we see increased risk in economic forecasts, the same risk exists in earnings forecasts. Chances to either over or undershoot expectations are elevated. But bear in mind, the exact path of earnings is somewhat immaterial to market valuations. Stock prices are high relative to past earnings, expected earnings, sales, book values, and cash flow. The only traditional methodology that indicates the market may be "cheap" is when one compares earnings yields to interest rates. The late September slide in growth stocks is a solid reminded of how higher interest rates can negatively impact stock prices. Stock prices ended little changed for the quarter with large cap indices up less than 1% and mid and small cap indices down 2% to 3%.

Some market sectors are more over-valued than others, and some are more sensitive to interest rates. We continue to lean away from the more over-valued and susceptible sectors, but have yet to initiate an all-out allocation. Which leads to one anecdote…

The Tax Drag Effect

Economists generally agree that taxes reduce economic efficiency. Irrespective of one's opinion of the social goods gained from government spending, governments are simply less efficient at spending money. The overhead tends to be higher.

Current trends suggest there will be higher taxes in the future, creating a drag on the economy. However, one major tax increase has already occurred—inflation.

Inflation is a regressive tax. A median income household ($75,000) that experiences a ten percent increase in half of its spending basket must find $3,750 of budget cuts or substitutions. For the lowest 20% of households, the inflation tax is devastating.

Moving Forward

Over the last three years we have described the elevated volatility in the economy, corporate earnings, interest rates, and stock prices. A few months ago we described "The Grand Experiment" in fiscal and monetary policies. Because we are in the still in the early stages of the grand experiment, we continue to see elevated uncertainty in forecasts and likely wider range of surprising outcomes. We will continue to monitor progress on all fronts and stay with our disciplines.

Your AAMA Team

Want to Discuss?

If you would like to discuss this content, please feel free to reach out to our President, Bob Baker, at **614-726-3622** or our National Sales Manager, Aaron Ploscowe, at **614-726-3627**. We'd love to speak with you.

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