# Monthly Commentary

June 3, 2021

## Huff & Puff

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Do you ever "huff and puff'? Is this question relating to breathing heavily with exhaustion, or is it expressing annoyance in an obvious or threatening way? In life, we huff and puff when winded or short of breath, from wheezing or feeling done-in; even spent or exhausted. Often, despite much huffing and puffing about the "bus" service, traffic, or government policy, nothing happens. Recall the wolf in "The Three Little Pigs"? The mother pig sent her three little ones out into the world to make their own way. Each built their own shelter. The wolf traveled the lane where each lived, and smelling the little pig inside, pounded on the door, "Let me in! Let me in!" Each pig yelled, "Not by the hair of my chinny chin chin!" The wolf was annoyed, declaring "Then I'll huff and I'll puff and I'll blow your house in!" He blew in the straw house, the wood house, but not the brick house (where all 3 were finding refuge). The wolf lost his frustrating endeavor after bounding up the roof and climbing down the chimney, where he fell into a huge pot of boiling water in the fireplace. Whether weary from exhaustion or expressing annoyance, we never know when fear is going to come knocking, or pounding, on our door.

The new bull market, started 14 months ago on March 23, 2020, continues to progress, albeit slower. It advanced forward during May, but slowly. The trend is still up, but momentum behind the move is waning. Not bad – a breather should be expected following the rapid advance of the last 12 months. The S&P500 (stocks) achieved a new high on May 7, and proceeded to travel an up/down experience to end the month with a small +0.7% gain. YTD, this stock index is up +12.6%. Client portfolios also continue to benefit from appreciating stock values; bond returns (soft) reflect concern for the future of inflation.

| Style | May | YTD |
|---|---|---|
| Foreign Stocks | +3.3% | +10.3% |
| Small-Cap Stocks | +1.3% | +20.2% |
| Large-Cap Stocks | +1.0% | +13.0% |
| Mid-Cap Stocks | +0.9% | +17.1% |
| Avg US Stock Fund | +0.9% | +16.0% |
| *S&P 500* | *+0.7%* | *+12.6%* |
| Barclays Bond Idx | +0.3% | -2.3% |

| Client Objectives (Stocks/Bonds) | May | YTD |
|---|---|---|
| 20/80 | +0.1% | +2.1% |
| 35/65 | +0.3% | +4.2% |
| 50/50 | +0.5% | +6.1% |
| 65/35 | +0.6% | +8.3% |
| 80/20 | +0.9% | +10.0% |
| 95/5 | +1.0% | +11.5% |

We mentioned the market trend is still up, but momentum behind the move is softer. Stock leadership is rotating. The hood ornaments of speculators – the hot "click stocks" during the great lockdown (Netflix, Amazon, Microsoft, Apple, Tesla, even Bitcoin) are off noticeably from their recent highs. Meantime, yesterday's laggards are becoming leaders and punching through to new highs – value style stocks are more cyclically oriented to a reopening global economy (oil, bank, industrial, materials and chemicals, autos (not Tesla), and industrial metals; even services relating to restaurants, travel, and etc.). The key factors for current stock success focus on low valuation and high quality. Reopening of the domestic and global economies is behind this transitioning leadership from growth to value. If sustained, this would be a notable change after more than 12 years of growth outperforming value by a whole lot. Growth needs a breather - too much huffing, and too puffed up!

The stock market moving slower/more sideways in May and recently, should be viewed as healthy. Valuations of all assets were/are extended. Stocks in particular, are a leading indicator; they advance 6 to 9 months in front of the economic reality. So, while the economy remained in various degrees of lockdown last year, the huge growth in money supply traveled into asset values creating a rapid advance. Now in 2021, the economy is unlocking and swiftly growing while the market moves more sideways, closing the valuation gap to more normal (as the year progresses). This is the normal pattern for a new bull market following a sharp economic contraction – up fast in the first year, followed by a slowing volatile advance in the second. And, when you add to second year market action with the historical experience of the first year of a new administration (in the White House), we should expect a slower upward direction but with increased volatility. That's happening. Remember, 2021 is likely to feel frustrating from up/down action; even a 10% correction is normal and should not be ruled out. But such volatility is not fatal when the economy is growing. Frustration is a natural, yet uncomfortable feeling in a perplexing environment; it relates and describes the dynamics of change.

The markets may be "huffing and puffing" for a breather from exhaustion following its fast rise; and it may now be evolving its "huffing and puffing" to an expression of concern for prospective inflation

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from government policy and the public response to it. We know there is "no free lunch". The stimulus-boosted demand is still outpacing supply at the present. Consumption is starting to shift from goods to services, and will accelerate over the next several quarters. There is plenty of fuel (money) for growth. In the meantime, we will experience some inflation. It is the pace of inflation which creates a growing sense of unease that the Fed may find itself behind the curve (market), and be forced to tighten in a dramatic way. Expect a "tug-of-war" (call it volatility) in the bond and stock market, with the Fed showing resolve to stay the course for the short and intermediate term. The Fed believes inflation is transitory, and is likely to pursue its current path to restore employment rather than signal an incorrect inflation outlook. Question is: does its route put inflation expectations on a higher path?

Inflation is currently the result of stimulus-boosted demand that exceeds supply. Until supply bottlenecks are resolved (labor disincentives, hesitancy about vaccine rollouts, schools return to fully open, chip shortages and autos, homebuilders backed up), businesses must rely on increased hours by those willing to work and raising prices to slow supply delivery challenges. A client, hearing about Ohio's "Vax-a-Million" lottery - to award 5 vaccinated people with $1 million each, and another 5 students with 4-year paid tuition+ to a state university - when added to the various forms of government "free" money, commented (shall we say, huffed and puffed) "money is fiction." Interesting observation. Look at the facts:

Source: Bureau of Labor Statistics

- Back 50 years, money grew +9.6%/year (1970 to 1986, with high inflation rates); and +5.4%/year (1986 to 2020, with low inflation rates)
- During 2016 to 2020, money supply grew +5.3%/year, transitioning in 2020 where money grew +25% year-over-year (double the rate in 2008 when the bank debt bubble burst)
- Last financial crisis (2008), Fed created money stayed in the banking and financial sector to recapitalize the banks; it was not loaned to businesses or consumers; meaning it was contained in M1 with no inflation.
- This time, created money is going directly to business and individuals (checks to everyone); meaning M2 money is into checkbooks – a more potent force. This will hit inflation. [M2 money growth will not come out of the monetary system; the growth rate can slow, but it cannot be easily removed.]

Expect inflation to rise; even the Fed expects it to rise to 3% or so. It may even be closer to 4-5% for a few years. But don't expect the government to act on debt until interest rates are high enough to hurt. It is critical that government manage its fiscal house.

What does that mean to investors and the structure of your investment portfolio? Bonds of longer maturity will experience near-term return pressure; stay short (price volatility will be low) where current maturities can be reinvested in current higher rates. Bonds still offer a diversification and stability benefit. Convertible bonds historically provide good protection to inflationary conditions. Stocks do well during moderately rising rates of inflation (not hyper-inflation). In fact, stocks, particularly small company stocks are historically strong inflation fighters; they also offer good liquidity. Commodities and oil are good inflation fighters; gold is surprisingly not a strong protector. In general "variety is the spice of life" with investments too. Investors must closely monitor government policy direction. Higher taxes (corporate and personal) could be problematic, as it slows economic growth and profits; taxes and inflation will lower returns on all asset types. We are in the early days of a new bull market wherein the economic fundamentals will determine its duration and advance. Remaining invested with growth assets is a key to battling one of your biggest investment enemies – inflation. The bond and stock market are both saying COVID lockdowns are over!!

We never know when the big bad wolf will come knocking or pounding on our door. Fear or worry may be suggesting you react inappropriately to proven long-term investment principles. Don't succumb. Always remember, time is every investor's greatest ally. Your investment portfolio is built with asset flexibility, which we call "buckets of time." If together we planned correctly when establishing your investment objective (mix of cash, bonds and stocks), then its construction is built on "rocks" and built of "bricks", not straw or wood that struggle to stand against the "huff and puff" of various investing enemies. Flexibility of asset mix and investing to the "numbers" also prevents exposures from becoming "pigs" (staying too long at too much exposure) and getting slaughtered from too much risk. Investment success accrues to those who pursue disciplined, do it over and over again, investment processes.

Let us know your thoughts – call or email, or coordinate a convenient time to visit.