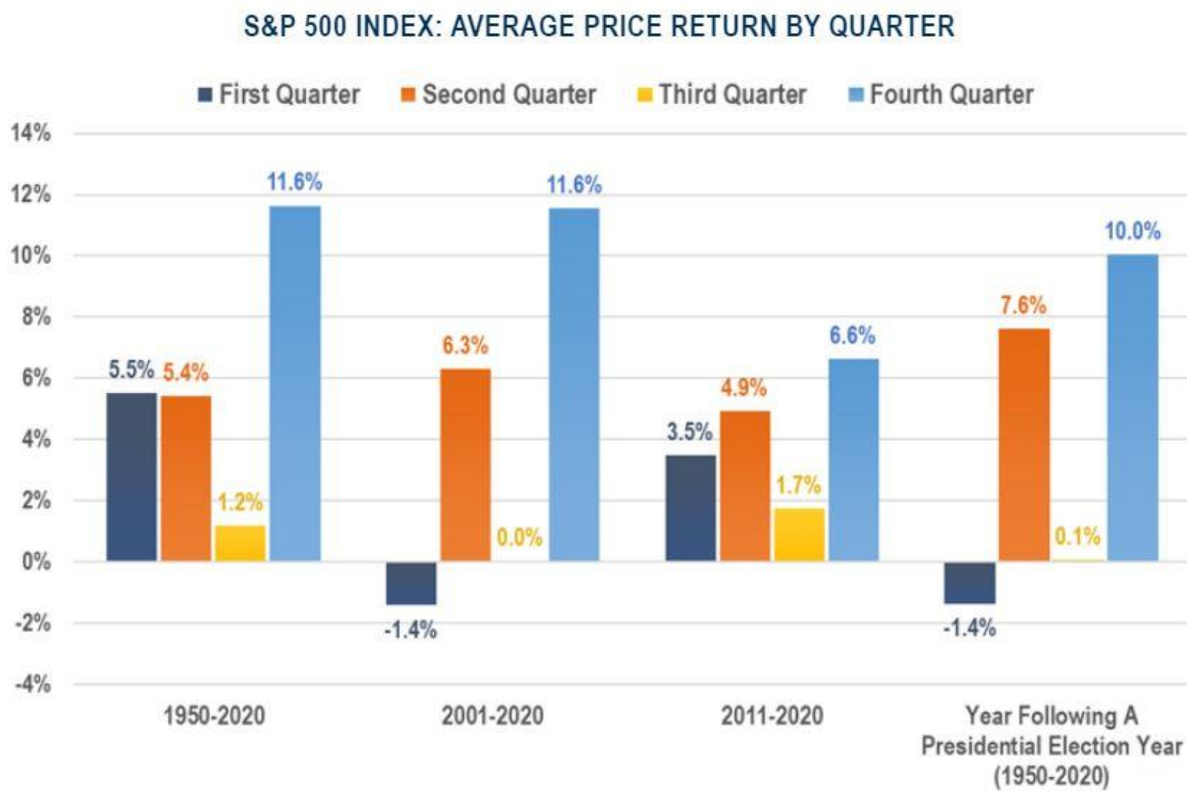
A Second Half Not So Pretty - What Has Changed? | 2021

Greetings from Goldenstone!

September closed out as the roughest month in the US stock market since March of 2020. This is hardly a surprise since historically September has been a volatile month. On average, every year over long-time horizons, we expect to see one 10% correction, and three 5% pullbacks – the first six months of 2021 saw markets that kept climbing higher. But that changed quickly as multiple factors brought fear back into investors' minds as unpredictable events unfolded. Policy missteps pose the highest risks – begging the question – can we trust those in charge?



- Inflation expectations have quickly moved from being transitory to being more stubborn – leading to serious concerns about future GDP growth both in the US and globally. The high inflation rate averaging more than 5% in recent months, arising primarily due to higher input costs, severe supply chain disruptions, higher energy costs, and rising wages in the face of a labor shortage – remind us of past periods when the fallout was bad, and in the worst case resulted in stagflation. All one has to remember is the late 1970s early 1980s when inflation, unemployment, and consumer interest rates were all double digit, ultimately causing havoc in our economy and the stock markets. This time, the Federal Reserve seems poised to begin tapering as early as November (next month).

Many emerging market countries have already experienced high inflation and raised central banking rates as a result. We are seeing a spillover into the developed world with the United Kingdom showing signs of raising rates in the next couple of weeks.

- Severe supply chain disruptions are showing up around the world. The cost of containers to ship goods from China to the US has more than quintupled. Large cargo ships remain parked outside US ports for weeks unable to find enough labor to quickly unload and load. COVID shutdowns in many parts of the world such as Vietnam are causing severe production shortages affecting the supply chain for companies such as Nike. Factories in China have been forced to shut down causing an energy shortage affecting companies such as Apple. While demand continues to rise due to a strong consumer, the supply side of the equation has not been able to keep up. Many US stores have empty shelves and are starting to sound the alarm regarding declines in Christmas sales.

- The US economy is growing more slowly than predicted. The Delta variant of COVID has caused a big share of the economy to remain constrained through mask mandates or inability of the economy to fully reopen. Airlines, cruise lines, and the hospitality industry relying on increased travel and a full reopening remain grounded and disappointed. Growth estimates have been negatively revised not just for the US, but also for the global economy. Third quarter GDP growth numbers are likely to show very subdued performance. China just reported and it came in under 5% for Q3 – and given the reliance of global growth on China, which is the second largest economy in the world, fears are now justified about the overall slowdown.

- The labor market continues to confound everyone. While the official unemployment rate has declined nationally to 4.8%, many remain unemployed either by choice or involuntarily. The labor participation rate has declined, with several people not returning to the labor force at all. The economy reliant especially on minimum wage labor is facing rising labor costs, increased no-shows, competition for the same skilled or unskilled labor, and a wide skills gap. The end to federal supplements to unemployment insurance has not resulted in masses of workers coming back to work as predicted. All of this is raising fears about wage inflation that will hurt businesses.

- The Biden administration appears now out of the honeymoon period, struggling to increase vaccination rates among those eligible, unable to get traction on policy issues such as the infrastructure package, unable to resolve the breakdown over the debt ceiling, unable to handle the growing migrant crisis on the southern border, and caught up in growing infighting in its own party on solutions – all of these resulting in a loss of confidence and lower approval ratings. A key challenge in our minds is also the rumor that Jerome Powell, who has done a great job handling the economic crisis due to COVID, may not be reappointed. In the meantime, our deficits keep rising, the government keeps printing more money, and the federal debt is now upward of $26 Trillion.

- As we predicted, some technology companies are already doing a U-turn on work from home policies and encouraging/requiring their employees to return to the office for collaboration and innovation.

- In spite of the challenges that are increasingly leading to rising fears about the economy and markets, we remain optimistic and confident that markets will close out 2021 higher than from current levels due to several tailwinds. Earnings season for Q3 has just begun and is looking very promising. The consumer who is 70% of our economy remains strong. Household savings are at record levels, corporate America is well positioned, and the amount of liquidity in the markets will sustain the momentum. Historically, the last quarter of the calendar year (includes the "Santa Rally") has been strong and we believe it could very well hold true this year as well.

Our forecast for the remaining three months of this year is listed below:

- Travel and entertainment industries will remain under pressure.
- Widespread consolidation (M&A), and bankruptcies will highlight winners and losers.
- Work from home will continue to disrupt our lives just as Uber and Airbnb did.
- Shrinking expenses will boost net earnings and operating leverage.
- Inflation will creep up, but eventually the supply-demand will come into alignment.
- Low interest rates and slow normalization of earnings will keep the market trend higher.
- Emerging markets will rebound as vaccine distribution ease fears and re-openings expand. The Indian stock market is a good gauge.
- Small caps and midcaps will outperform large caps. Growth will still dominate value.
- We still like technology, consumer discretionary, and healthcare.
- Housing prices will continue to rise, albeit less, because of eroding affordability.
- Policy missteps will pose much higher risks than economic fundamentals.

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"I try to avoid being stupid… The single most important thing is to know where you are competent and where you aren't. The Human mind tries to make you believe you are smarter than you are."
- Charlie Munger (Berkshire Hathaway Vice Chairman)

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