Fox-Smith Wealth Management Quarterly Commentary

Second Quarter - 2021

"Higher Inflation appears to be Unavoidable."

1921, 1978, 2007, or 2021?

Economic Outlook and Market Commentary – Gustin D. Fox-Smith, AIF®, ChFC®

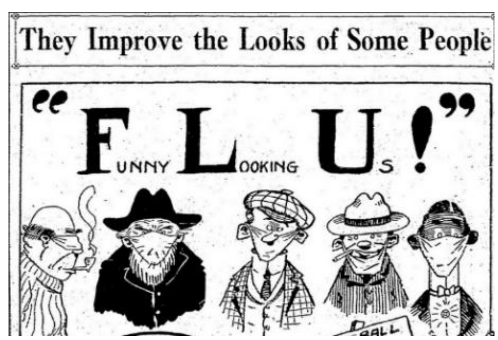
I have been closely watching global economic activity in the first quarter of 2021, trying to discern the current state of the recovery from the Covid recession. In volatile times like these, it is much more likely for dislocations to occur in the market. Dislocations are very profitable if they can be identified early, so these are the times I am most attentive to the data coming in from all sources. As I have been analyzing the macroeconomic data, I keep being reminded of the quote "History does not repeat itself, but it often rhymes".

<u>We have been here before</u>

Looking at economic history, we are all familiar with the Great Depression as well as the years of excess immediately preceding it. Consumption and leisure spending were at such high levels that the decade leading up to the depression has become known as the "roaring 20's".

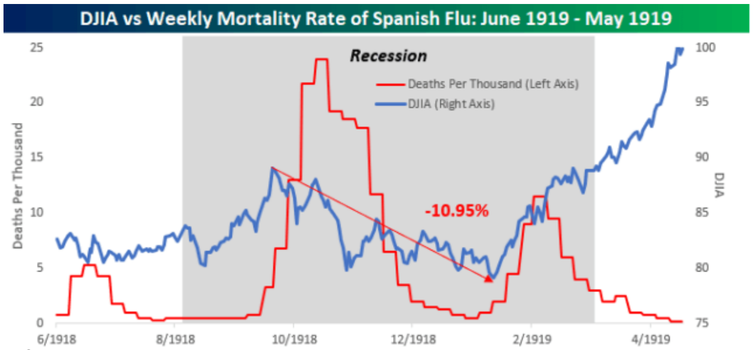
The depression did not begin with a stock market crash. The economic contraction started in 1928 and deepened rapidly, eventually resulting in the stock market crash of 1929. But what happened before the 1920's? Did earlier events contribute to the boom and bust seen in the following decades? Is there anything we can learn from the timeline that might help today and allow for accurate predictions?

Just prior to the roaring 20's the world learned about the first cases of Spanish Flu. It was highly infectious and far more fatal than the typical annual Flu virus. The truth is few people died from the Flu itself. The vast majority of fatalities were caused by pneumonia, which was often contracted as a secondary infection. Without antibiotics to treat it, pneumonia can be very deadly.

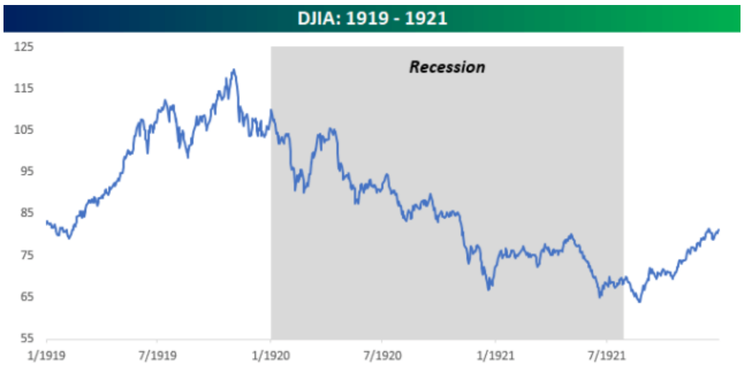


Now this is where events begin to rhyme. The first major U.S. city with a confirmed Spanish Flu case in 1918 was Philadelphia. The response initially was to continue with business as usual, which would turn out to be a huge error. The result was that Philadelphia had exponentially higher infection and fatality rates because they did not do anything to address the outbreak until it was too late.

Seeing the disaster in Pennsylvania motivated other cities to act quickly and seriously to try to stop the spread of the virus. Many adopted mask policies and social distancing guidelines even before any local cases were confirmed, but certainly once the first positive test result was seen. I have included some headlines from 1918 that might seem familiar.



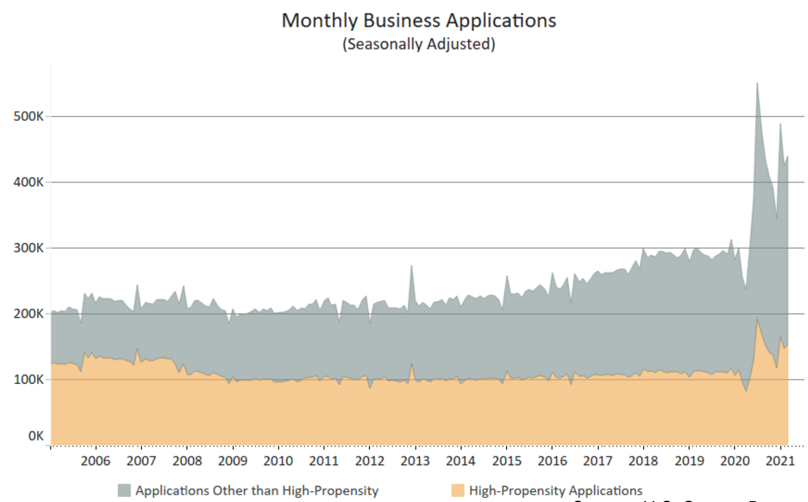
Source: NBER



Source: NBER

As you can see, there were mask mandates and even the same confrontations with those who refused to wear them in public. There were also broad shutdowns imposed on many industries in hopes of slowing the spread of the Flu. This resulted in a short recession lasting from August 1918 until April 1919 and another that lasted from January 1920 through July 1921. (see charts)

Eventually, after a lull and a second wave, as we are seeing with Covid, the Spanish Flu began to subside, and people were able to get back to normal life. Just like today, people were anxious to travel, gather, worship, and shop after a long period of avoiding these activities. The austerity of life under the Flu pandemic caused people to spend more, travel farther, and consume more in general to celebrate life returning to normal. Behaviors in response to the end of the lockdowns directly caused the booming years of the roaring 20's.



Source: U.S. Census Bureau

Today I see the same things in our economic data. People have been cooped up at home too long and are dying to take vacations and participate in their favorite leisure activities. When combined with record levels of cash in the private economy and household debt service at record lows, the urge to splurge will be satisfied in what the FED recently described as a "tsunami of economic activity." This will be a very good thing for the world economy.

Additionally, every major downturn in the U.S. causes high unemployment which results in many people deciding to exit their careers to start the new business they have always dreamed of. If you are already out of work, that is one less risk to worry about so why not try, right? Because of this, it is customary to see a spike in small business formation during what might logically seem like the worst time to go out on your own, during the second half of the recession. We are now seeing this in the data, giving me another reason to believe we have already seen the worst. (See chart)

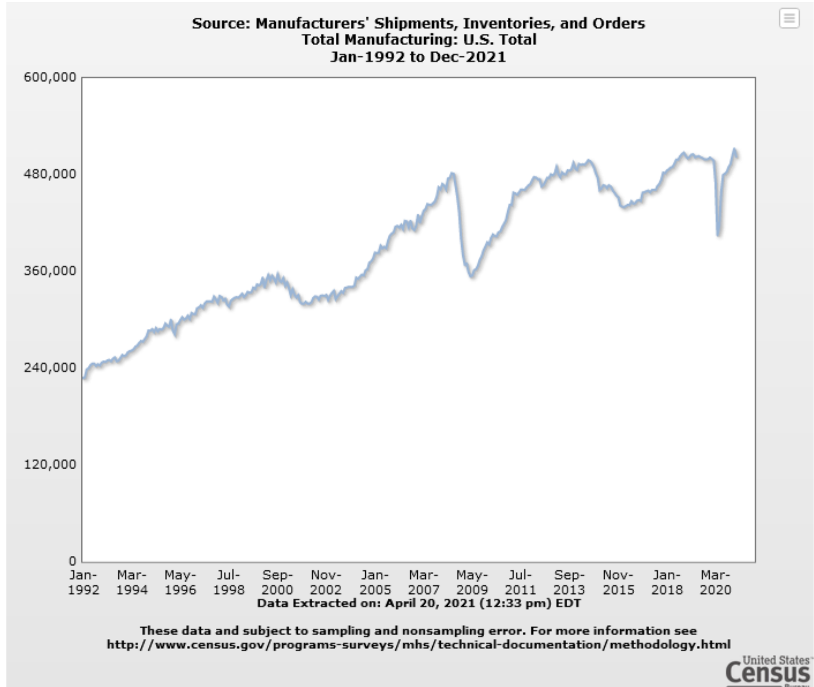
Inflation

Many have wondered how we could have printed so much money in recent years without seeing much inflation. Is it not a truism of life that inflation is an inescapable result of capital dilution through money printing? As I write this, 40% of all U.S. dollars that currently exist were printed (or created, digitized, etc.) in the last 12 months. That is a staggering amount of currency creation in a very short period of time and should generate inflation, right?

CFO asks CEO: "What happens if we invest in developing our people and then they leave us?"

CEO: "What happens if we don't, and they stay?"

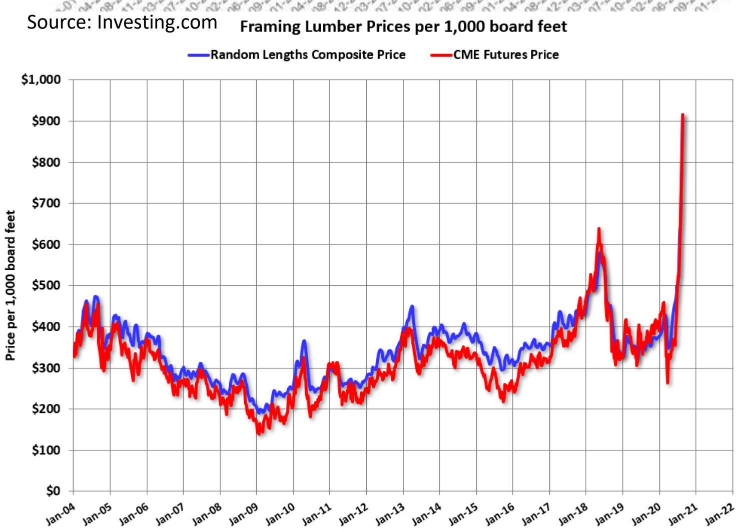
Many factors can cause rising inflation, but all of the variables that feed into inflation boil down to the most simple concept; "Inflation is caused by too many dollars chasing not enough stuff". It is that simple and nothing else can cause inflation but this simple imbalance. "Doesn't money printing cause inflation?", you might ask. The answer is yes, partly, as currency creation feeds ½ of the problem by providing too many dollars.



But no matter how many dollars are in the private economy, inflation cannot appear until you also have more demand than stuff, meaning demand for goods and services outstrips supplies. Until the last few months, global manufacturing activity was running at about 50%-60% of capacity. In that environment, no matter how many dollars were created, we could always increase production of stuff to meet demand and avoid inflation. That is, until now.

At the close of 2020, global manufacturing activity had gone back to pre-pandemic levels and the consumer spending surge was just beginning. Today we are seeing consumers continuing to ramp up consumption month after month and the early signs of shortages are showing up in a lot of areas.

Source: Investing.com

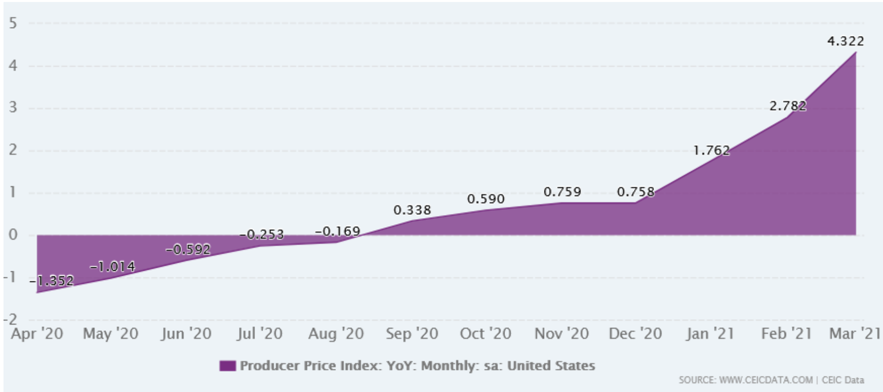


The "stuff" side of the inflation equation is further magnified due to supply chain disruptions in unpredictable places. For example, if a light manufacturing facility in India that produces metal parts and rubber o rings for various large-scale manufacturers was forced to cease operations or decrease staff due to the virus, their parts and gaskets would become scarce quickly. This could affect an electronics manufacturer that builds televisions that rely on the metal electrical connectors they produce. Also, a company that makes plumbing fixtures would not be able to get the O rings it needs for making faucets. As you can imagine, this one factory slowing down production could have a direct effect on the production of countless consumer goods that rely on their parts.

So now we have too many dollars, shortages of stuff due to supply chain issues, and we have just reached full manufacturing capacity. As demand grows into the summer, I believe inflation is inevitable and may reach levels not seen in 40 years.

<u>How bad will it get?</u>

While I do not expect inflation to reach 13.3%, the level seen in 1979, I do see it potentially reaching as high as



8%-10%. This is high enough to be financially painful if you are not positioned correctly for it. I expect the rate will be high enough that we may see the return of regular updates of a long-ignored indicator created in the late 70's, the Misery Index. The Misery Index is the sum of inflation plus the unemployment rate and is meant to gauge the ease or difficulty felt from the economy by the average worker. With low unemployment it may not hit the record highs of 1980 and 1981 where inflation ran between 12% and 13.3% and unemployment was 7.6%, resulting in a Misery Index of 19.6 – 20.9. For comparison, at the end of 2019 before Covid became a factor, the Misery Index stood at less than 6.

Interest rates will climb due to direct market forces but also because the FED tends to raise rates when inflation goes up in an attempt to cool demand a bit. We may see interest rates none of us have seen in decades, however, I do not expect a return to the 16% mortgage rates we saw in 1981-82. Globalization makes that almost impossible since an increase in our rates above a certain level will invite foreign banks to begin lending here to take advantage of what they can earn. The additional availability of international lending should help keep rates from getting too out of hand.

<u>What to do</u>

Inflation acts as a thief that steals your hard-earned savings, but in this case, your money remains intact. Instead, what is lost is the amount of goods and services that can be purchased with your money. As buying power decreases due to rising prices, it is imperative that you have your money positioned in places that are at least shielded from inflation. It is better to have investments that can keep up with inflation and more so if you have positions that actually benefit from it.

Historically, in high inflation periods the broad stock market has grown slightly faster than the inflation rate. This makes sense because stocks are valued at a multiple of their current and expected future earnings. When prices rise, corporate sales volume increases even if the same amount of goods are sold because each item is being sold at a higher price. With increased sales comes increased profits and higher stock prices.

There are certain assets and sectors that directly benefit from inflation. Commodities, real estate, and precious metals, for example, have a direct correlation with inflation and can protect your money from it. One of the sectors that usually outpaces inflation by a wide margin is financials. Banks pay you an interest rate on your deposits and charge a higher rate to loan the same funds out to other customers. The bank's profit is derived from the spread between deposit and loan interest rates. When rates are very low as they are today, the spread Is very narrow, which limits the profitability of financial institutions. However, the more rates increase the wider the spread

<u>Financial Trivia</u>

Last quarter's trivia question was: "Who said 'In this world, nothing can be said to be certain except death and taxes.'?" Answer: Benjamin Franklin: The complete sentence that Franklin wrote in November 1789 letter to the French scientist Jean-Baptiste Le Roy goes as follow: "Our new constitution is now established and has an appearance that promises permanency, but in this world, nothing can be said to be certain, except death and takes."

The client who had the right answer and became the proud owner of a brand new, shiny Amazon gift card was Joe L. Congratulations!

This quarter's question:

What is the oldest company in the Standard & Poor's 500 (S&P 500)?

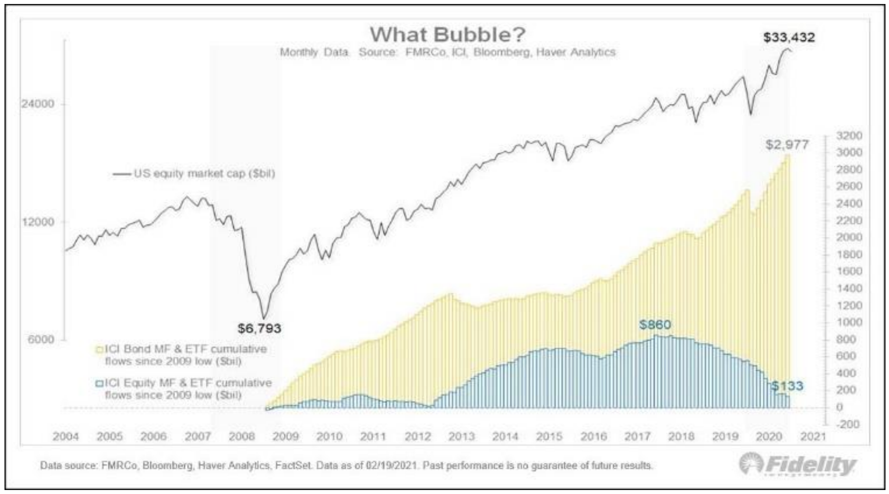
E-mail your answers to Erin at <u>erin@fswealth.biz</u> and we will award a prize to the first correct answer *(Be honest, no "googling" it!)*

becomes, and banks make a lot more profit on the same asset base. You will be pleased to know that in anticipation of the coming inflation wave, we have very recently increased exposure to these areas in our managed portfolios and we intend to further add to these sectors in the short term.

Source: JP Morgan Guide to the Markets

Assets to avoid in inflationary periods include traditional corporate and government bonds, illiquid investments, and bank cash products like savings accounts and CD's. Bonds suffer when rates climb, and bank deposit accounts do not pay interest that will stay ahead of the inflation rate.

<u>General Market Outlook</u>



With so much cash in the financial system it is hard not to be optimistic about the near term. If the record level of cash does not directly benefit the economy and market, it certainly provides some downside protection. Warren Buffet once said, "You know you are near a market top when you are getting stock picks from your office building's janitor." What he meant by this is by the time even the janitor has become a stock investor, there are no more buyers left. With all available capital invested, the market has nowhere to go but down since no buyers remain to prop it up. The good news is we are nowhere near that point today.

With all this liquid cash available, long and severe market declines like 2008 are very unlikely to happen because once stock prices decline 25% - 30%, those with cash rush in to buy the bargains and push prices back up in a matter of weeks. It is when the cash dries up and we are leveraged that we can see market events that drop 40% - 50% or more and then take up to 5 years to recover.

Another reliable predictor can be seen by watching the flows of capital into and out of stock and bond mutual funds. Market tops are almost always accompanied by record capital flows into stock mutual funds as investors pile in at the fastest rate right near the top. In addition, market bottoms generally see just the opposite as investors pour out of stocks the fastest near the bottom and rush into bonds for safety.

My expectation is that the market will be very positive going forward, but that the political climate after the recent election may temper the growth rates some. I am glad to be seeing the end of the Covid disaster at last and hope you and yours are vaccinated and back to traveling and doing the things you love very soon. What I am sure of is that once you do, you will have 330 million of your closest friends and fellow Americans going right along with you. Expect delays, crowds, and shortages, but when you experience them just be thankful we can do these things at all, even in a crowd. Be well and Happy Summer!

Get To Know Your Fox-Smith Wealth Management Team

In order for you to better know your team that are here to serve you at Fox-Smith Wealth Management, we will highlight one of our team members each quarter. This quarter we are featuring one of the most incredible, ethical, and devoted Advisors we have ever had the privilege to know:

Dahna Clarke

Financial Advisor

Dahna grew up in Hockessin, Delaware. Most people tell her they never met anyone from Delaware before. Her neighborhood was full of kids that spent their free time together playing every kind of game, whiffle ball, kickball and tag, just to name a few. They also spent time outdoors, hiking, sledding, building dams, and catching frogs and crayfish.

In High School, Dahna was an accomplished athlete and captain of a State Championship Volleyball team. Dahna came to Colorado expecting to ski one season in Breckenridge and loved it so much that she spent the next 10 years skiing and traveling. Among her favorite ski adventures were ski seasons spent in Mt Hood, OR, Val D'Isere, France and Queenstown, New Zealand.

Dahna majored in art in college and never expected to be involved in Finance. Out of college, she started out as a Visual Merchandiser for a chain of retail stores, doing window displays and arranging merchandise on store floors. She worked her way up in retail management and became the Operations Manager of a big box store, supervising the artist/merchandiser. Desiring more reasonable working hours, she moved to a position as Administrative Manager of a Prudential office in downtown Denver.

Her years of previous management experience prepared her well for this new position. She acquired the Series 63 (Uniform Securities Agent State Law Registration), Series 7 (General Securities Representative License) and the Series 9 &10 (General Securities Sales Supervisor Registration) quickly and later completed a Professional Human Resource Certification and passed the Equity Compensation Professional exam. Just this year, she passed the Series 65 (Uniform Investment Advisor Law Exam).

Dahna has always been athletic, and loves running, yoga, biking and working out. During the past few years, however, she found her focus centered around political and volunteer activities, instead of athletics. She still loves art and has painted most of the paintings in her home.

If asked to share her advice, she suggests that it is important to volunteer your time in any, and all, of the communities you are a part of, whether it be your church, your school district, your city, your workplace, and/or your neighborhood.

Dahna has been with Fox-Smith Wealth Management since 2013. Her dedication, brilliance and ethics are beyond reproach; and are just a few of the qualities that make her such an integral part of the team.