EverGuide
FINANCIAL GROUP

100 Connell Drive, 2nd Floor
Berkeley Heights, NJ 07922
P (908) 376-3041 M (215) 203-6673 F (908) 264-0723

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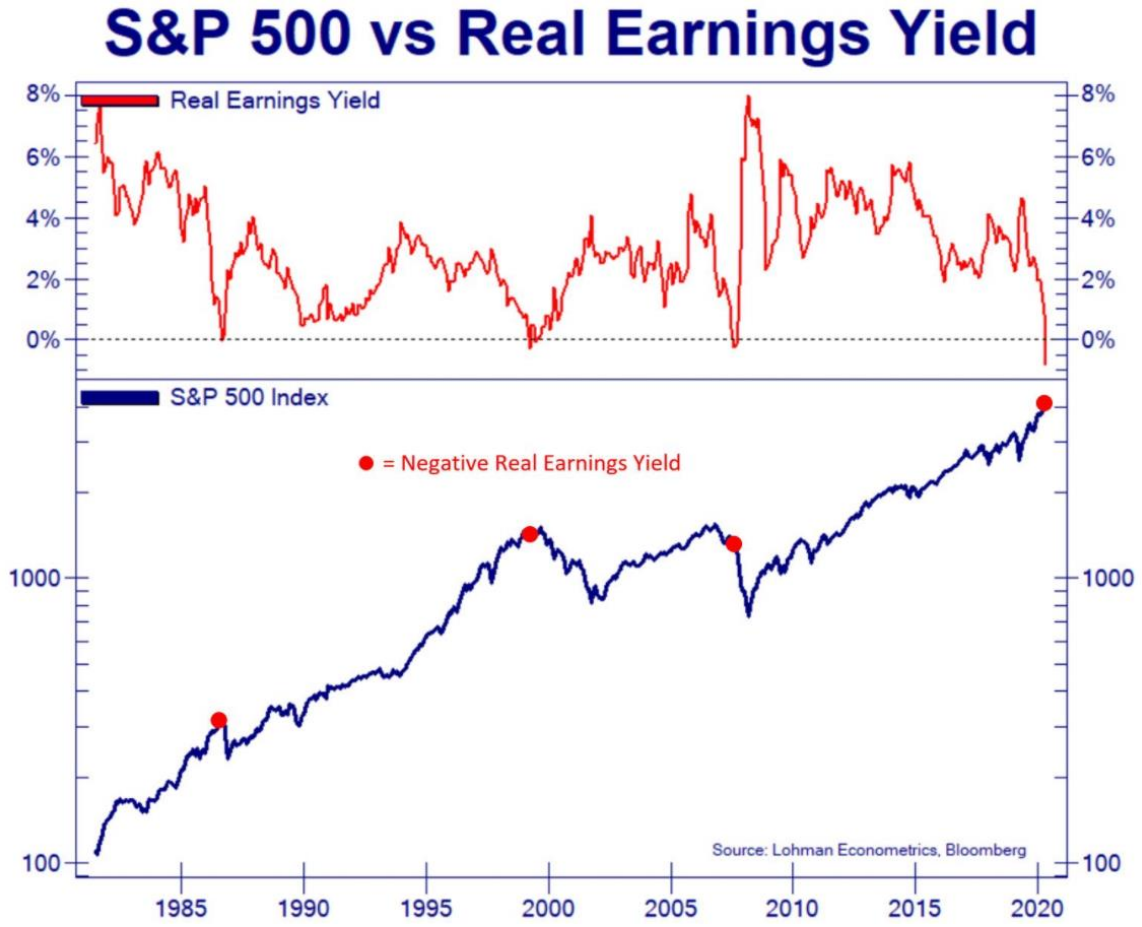
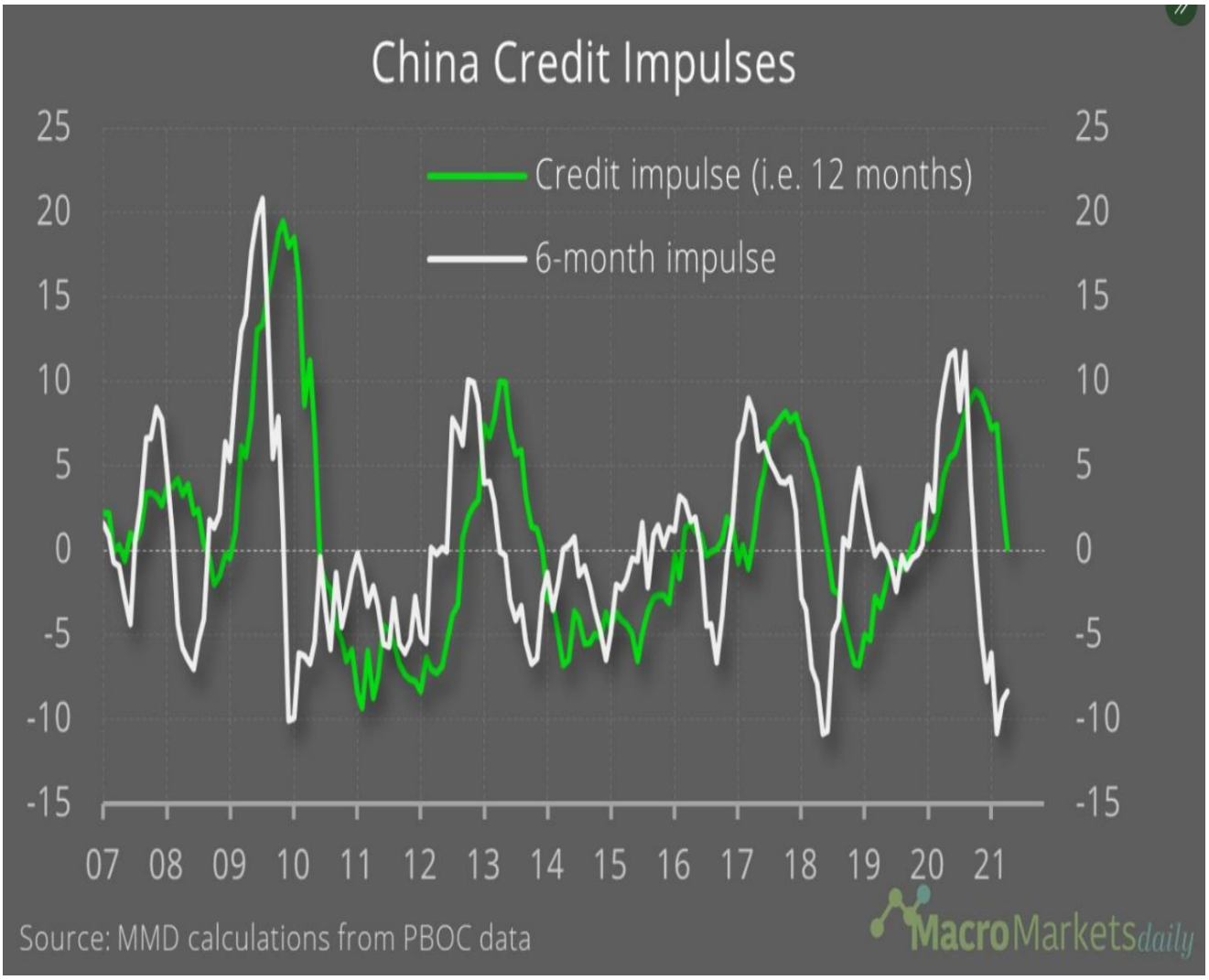
Investor Update

May saw some of the beaten down names come roaring back in the second half of the month as liquidity dried up across the board. Apparently, everyone left for summer vacation early as volumes were less than what you typically see during Christmas week. This left the S&P 500 with a slight gain while the Nasdaq still had losses of over 1%.

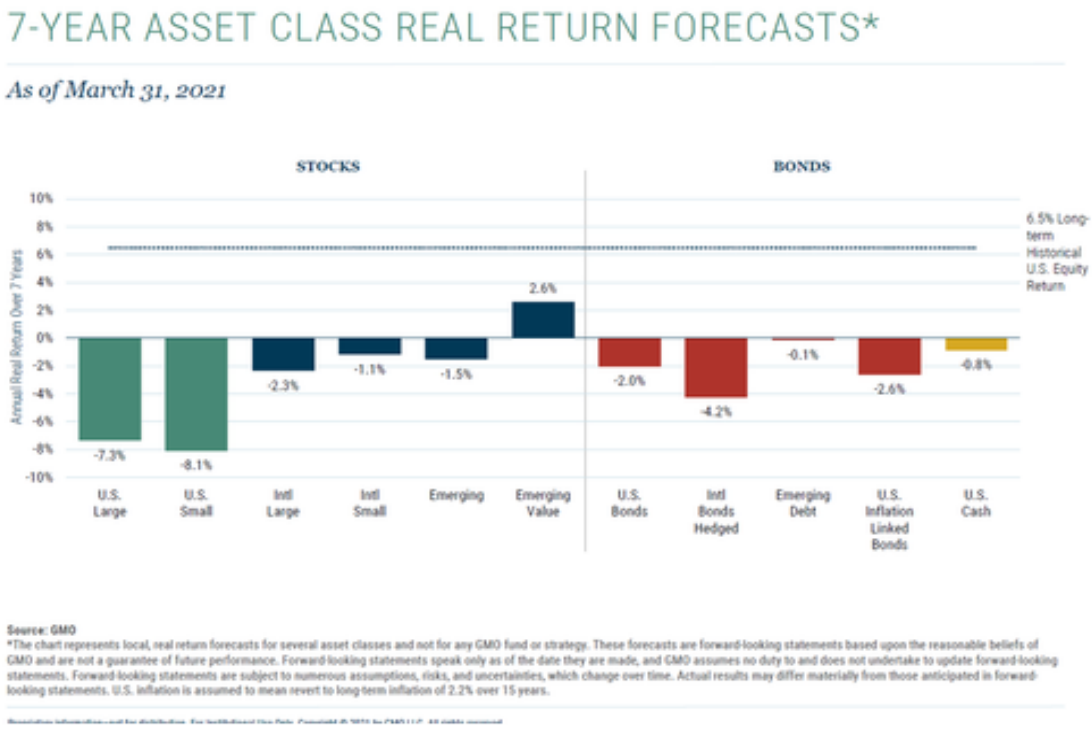
This month we are going to focus on inflation. A lot of people have never really experienced persistent inflation and this could have huge consequences across many asset classes. Inflation in its simplest form is when prices go up. This can be a problem because if prices go up and your income does not go up the same amount than you are worse off. This is called "real" terms. This is an important metric to consider and is used to adjust many measures of the economy and market. The below chart adjusts corporate earnings for inflation and shows that while headline earnings were great this quarter, "real" earnings went negative for the first time since 2007 and became the most negative in the last 40 years. The last 3 times were not good to stock investors.



What is interesting about right now with inflation is that most people are blaming the amount of money the federal reserve is pumping into the system on a daily basis. This ignores a very important factor which is China. As much as we do not like to admit it, China is a more powerful global economic force than the United States especially when it comes to commodity prices. Right now, China is cracking down on money supply and reducing credit at a very quick pace. This tends to lead prices and markets by 6-12 months. This would actually lend itself to a moderation of economic activity over the next year. A slower economy typically leads to lower prices, thus easing the inflationary problems we are currently seeing. The fascinating thing about the current situation is that supply bottlenecks are causing prices to increase (No one wants to work). If supply problems persist there is a possibility you get a slowing economy with prices remaining high. This is called "stagflation" and is a bad scenario for almost all investments.



The inflation outlook going forward is going to play a major role in what direction markets move. Right now, there are huge forces counteracting each other, Central Banks pumping liquidity while China is pumping the brakes. In the past, this type of uncertainty has led to market disruptions as the data gets sorted out. Right now, we are more focused on bitcoin, meme stocks, and our first vacation in two years to care. This is a great recipe for a short-term surprise, which at this juncture could come from hotter for longer inflation or a complete collapse in inflation. Instead of trying to guess which direction this goes, we like to fall back to long term projections based on current prices and valuations. The below chart illustrates just how grim the long-term projections are.



Overall, we keep our view that the short-term markets will continue to see rotation back and forth as the inflation outlook evolves. This can be very frustrating for investors as the narrative changes and prices move very rapidly. As we get into the 4th quarter the data will become cleaner as the lockdown effects will roll off and this will give a much clearer picture of economic direction and market leadership. With forward returns on a long-term basis at some of the worst levels in history we remain cautious to a market shock that no one is looking for right now. Covered call writing, income generating investments, and an active approach are going to be the best way to generate return and protect principal for the remainder of the year.

If you have any questions or would like to talk in greater detail, please contact me at 908-376-3041 or via email: markpainter@everguidefinancial.com.

Sincerely,

Mark R. Painter, CFA, CEPA