Daniel Wildermuth's
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Growth Continues on Good News Despite concerns over COVID and Market Bubble

July appears set to deliver another strong month for U.S. equities with the market up around three percent through the 29th. Gains were a little less predictable over the past 30 days with the market declining through the third week before bouncing up strongly.

The market's ongoing strength derives from substantial good news coming from various areas. During the second quarter, U.S. gross domestic product grew at a 6.5% annual rate—up slightly from earlier in the year. Notably, this growth driven by business re-openings and government aid, pushed the economy's size beyond its pre-pandemic level for the first time.

Still despite the strong quarter, growth fell short of forecasts of 8.4% according to economists surveyed by The Wall Street Journal. Growth is expected to slow in coming months as government handouts diminish and the economy must increasingly cope with material and labor shortages in addition to unpredictable COVID variants.

Employers added 850,000 jobs in June to record the biggest gain in 10 months. Workers' wages also rose briskly as demand for all kinds of workers remains high. While the unemployment rate rose to 5.9% last month from 5.8% in May, the increase came as more Americans entered the job search, expanding

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the labor pool. A broader measure of unemployment that accounts for workers in part-time jobs and those too discouraged to look for work fell sharply last month. In addition, big hurdles to hiring are melting away with rising vaccination rates, easing government restrictions on businesses and probably most importantly, the expiration of unemployment benefits in many states.

As jobs continue to grow in numbers and workers' paychecks increase, people appear to be growing more comfortable spending their pent-up savings. Makers of all kinds of retail goods report strong surges in demand. As most people have experienced, supermarkets have been hit by price increases as well as their sales continue to climb, up a whopping 15% since June 2019. Not surprisingly, with increased demand comes shortages and price increases.

The makers of some of the world's bestselling food and drink brands warned they would continue to raise prices as they grapple with the strongest inflation in years. Nestlé, Diageo, Anheuser-Busch, and Danone all said Thursday that sales were rising as key markets rebound from the pandemic, but that the recovery was also leading to rapidly increasing costs for ingredients, packaging and transport. This story is being repeated across industries ranging from autos to airfares to groceries as the world reopens.

As a result, U.S. inflation continued to accelerate in June at the fastest pace in 13 years with prices rising 5.4% from a year ago according to the Labor Department. Overall prices jumped at a 9.7% annualized rate in the three months ended in June, on a seasonally adjusted basis, faster than the 8.4% pace in May.

Federal Reserve Chairman Jerome Powell conceded that inflation is uncomfortably high and well above their 2% target the fed seeks, but he added that he believed high inflation was temporary and would abate as the economy readjusted

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post COVID. This sentiment also seemed to be held by many of the world's bond traders as bond yields have dropped to record lows. This also suggests waning optimism about the global economic recovery.

The yield on the 10-year Treasury inflation-protected security, or TIPS, finished July 27th's session at minus 1.132%, according to Tradeweb. That is the lowest close on record in data going back to February 2003. Yields have also reached new lows on inflation-protected securities in Germany and the U.K with the 10-year German inflation-protected note fell to minus 1.775% Tuesday, a record low, while the yield on the U.K.'s 10-year inflation-protected gilt rose to minus 2.868%.

Yields on inflation-protected government bonds are considered proxies for so-called real yields. At current levels, they imply investors will lose money holding 10-year government bonds to maturity after factoring for inflation. Investors appear to be investing in money-losing prospects due to TINA – There Is No Alternative. The lack of attractive investment opportunities is pushing investors into buying riskier assets such as stocks in search of higher returns and has driven up equity market valuations to their current levels.

A major driver of today's high equity prices is the individual investor. A July survey by retail brokerage E*Trade found that bullishness among the platform's individual investors recently hit more than a three-year high, rising to 65%. Additionally, the often-watched equity put-call ratio—which measures the volume of bearish options bets placed on stocks versus bullish ones—earlier this year notched sustained levels of optimism not seen since 2000.

Americans' stock allocations reached nearly 60% at the end of March, a figure just below the all-time high of 61.7% reached during the dot-com bubble, according to data from Ned Davis Research stretching back to 1951.

It's very notable that when households' stock allocations have risen to 54.6% or higher as they did during the dot-com bubble and the years leading up to the 2007-09 recession. The average annualized return for the S&P 500 over the next 10 years has been 4.1%. In contrast, when stock allocations have hovered around 29% or lower, the average annualized return over the next 10 years for the benchmark index has been 16.3%.

Jeremy Grantham, an investor famous for calling the three bubbles of the 1989 Japanese asset-price bubble, the 2000 tech bubble, and the 2008 real-estate bubble, recently told Reuters that, "Bubbles are unbelievably easy to see; it's knowing when the bust will come that is trickier." He went on to say, "What you find is that even the cheapest parts of the market are way more expensive than in 2000." He concluded by saying, "But this bubble is the real thing, and everyone can see it. It's as obvious as the nose on your face."

As we move through the third quarter, there is much good news to potentially keep stocks grinding higher. Still, a reassessment of currently high valuations or a sudden jolt to earnings could easily cause a significant drop in values. For example, a drop of 30% would just bring markets back to average 25-year valuations. Regardless, looking longer-term, it seems highly unlikely that the market will continue to generate returns above 3-5%/year, and the ride is likely to get much rougher. But, as this market has demonstrated, anything is possible.