"Transitory Inflation Is Here"

Market Commentary – June 2021

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 6.4% in the first quarter of 2021. This is the same as the advance estimate. With the economy growing at a torrid pace, inflation is creeping into the headlines. The Consumer Price Index (CPI) rose 4.2% over the last 12 months ending April 2021, which is the largest 12-month increase since a 4.9% reading in September 2008. One third of the CPI increase was driven by the index for used cars and trucks, which rose 10.0% in April, the largest 1-month increase since recordkeeping began in 1953! Carving out the volatile food and energy sectors, CPI rose 0.9% in April, the largest monthly increase since April 1982. In terms of jobs, the unemployment rate stood at 6.1% in April, which is up from 6.0% in March (vs. a cyclical low of 3.5% in February 2020). Anecdotally, though, companies in many industries are complaining about a shortage of workers. The moral hazard of COVID-19 policies of juicy payments for workers to stay home are coming home to roost.

The Federal Reserve is in a tricky position with respect to its accommodative monetary policy. As it reminds us in its Federal Open Market Committee (FOMC) statement every month or two, the Fed "seeks to achieve maximum employment and inflation at a rate of 2% over the longer run". The Fed has stated in recent weeks that it will tolerate transitory inflation "moderately above 2% for some time". One factor driving this is the mandate to reduce unemployment post-COVID-19. But what happens when unemployment is higher because workers would rather sit at home and inflation heats up? This is a conundrum for Fed policy going forward. In the meantime, as of May 19, the Fed's balance sheet has swelled to $7.97 trillion. The stock market loves this, but how long will this continue? Investors will carefully scrutinize the next FOMC monetary policy announcement on June 16 for clues.

If the Fed raises short-term interest rates to combat inflation, we need to carefully watch what happens to long-term interest rates. Higher interest rates would put a damper on the bull market investors are enjoying in stock prices. The fair value of a stock is calculated as future cash flows discounted to present value. Consider the following example of a fair value calculation of an actual stock (the name is redacted because that is not relevant for the point being made). The stock, a large-cap company, is currently trading near $170. Since beta is only 0.65 (much less than the 1.0 beta for the S&P 500), the discount rate we use in the discounted cash flow model is 7.0%, yielding a fair value for the stock of $280. If the discount rate jumps to 8.0%, fair value for the stock falls to $215. Similarly, a 9.0% rate leads to a $174 fair value (near the current price). Higher interest rates would weigh on stock prices.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) during 2021 is $186.18, which implies a price-to-earnings (P/E) ratio of 22.6 with the S&P 500 at 4,201. The earnings yield (E/P) of 4.43% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.61%. Expected earnings for the S&P 500 in 2021 shot up by 4.5% over the past month, which helps explain the resilience in stock prices.

The S&P 500 continues to hover near 4,200, just below its all-time closing high of 4,233 on May 7. The 50-day moving average continues to provide support, as this level has not been meaningfully breached since October 2020. Support levels should be near 4,110 (50-day moving average) and 3,750 (near March 2021 low and 200-day moving average). The longer we go without a correction, the more severe it will be.

Multi-cap value investors are being rewarded in 2021 for their patience from 2017-2020. Year-to-date, mid cap stocks are outperforming large cap stocks, and small cap stocks are outperforming mid cap stocks. At each capitalization, value indexes have returned more than two times their growth counterparts. Value stocks could enjoy another wave of buying as rising interest rates put the technology bubble at risk.