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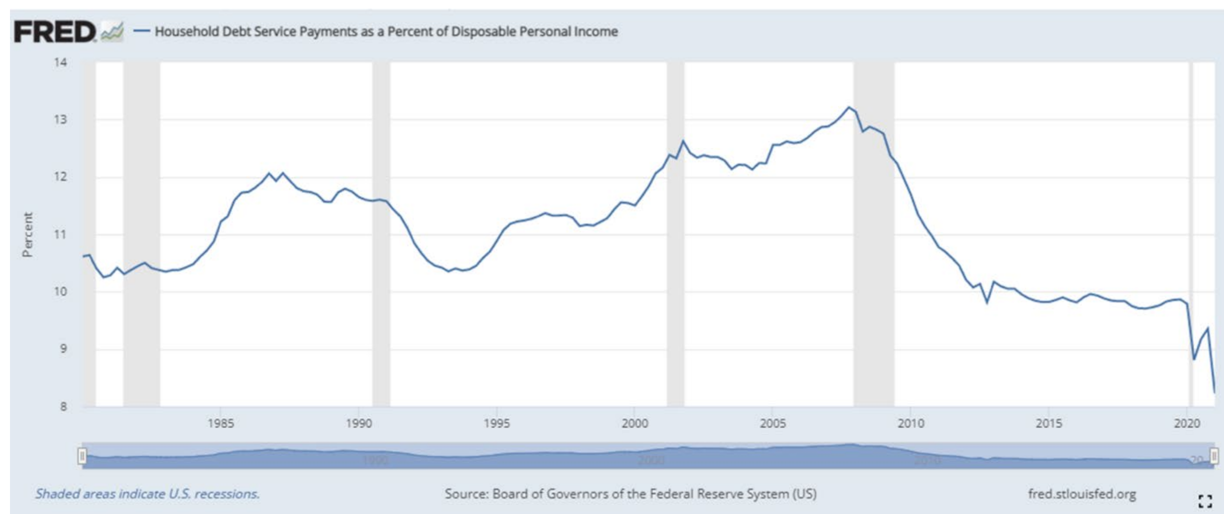
Current Market Environment

Cases of whiplash must have spiked lately. After all, in a few short months, market commentators have abruptly transitioned from: "inflation is transitory" to "inflation might be more persistent" and now "prepare for stagflation!" As discussed in our last writing, the stock market had appeared to be fully in the Fed's camp, perceiving the recent spike in inflation as a temporary phenomenon. This sentiment persisted through much of the third quarter, as COVID-19 cases once again ramped higher due to the rise of the more transmittable Delta variant. The increase in cases triggered concerns of a slowdown, a reduction in some estimates of economic growth, a continued decline in U.S. government bond yields, and investors flocking back to technology and growth stocks. These market trends quickly reversed late in the quarter, as the Fed increased their expectations for inflation and indicated they would start tapering asset purchases sooner than expected. Government bond yields quickly lifted, with the all-important 10-year Treasury rising from around 1.30% to 1.54% over the next several trading days. Value stocks, especially banks and financial service companies, rallied in tow.

While concerns over a Delta-variant induced slowdown have abated somewhat, supply bottlenecks around the world have become markedly worse as demand for goods has outpaced the ability to get those goods to market. Part of the blame has been placed on a lack of truckers to transport the goods. It was recently reported that nearly half a million cargo containers were sitting off the coast of California as cargo ships are waiting to be offloaded – with some potentially waiting for a month. This not only puts the Christmas shopping season at risk for retailers, but has also already led to an increase in the price of many goods. Meanwhile, energy prices around the world have taken off, also due to supply/demand imbalances. For example, liquefied natural gas prices (heavily relied upon in Europe and Asia) have skyrocketed on those continents to $40/mmbtu from $6/mmbtu in late February, while oil has been driven up to over $80 a barrel, from near $50 at the beginning of the year.

While most of these supply issues will prove to be temporary, the inflationary impacts may well be more persistent – especially if labor shortages lead to wage increases, which tend to be sticky. Will these inflationary pressures be such that they cause enough demand destruction so as to lead to stagflation? As we've stated before, we do not purport to be economists, however, we do take some comfort in the overall health of the consumer. As can be seen in the chart below, the U.S. consumer's balance sheet is currently in great shape, with debt service as a percentage of disposable personal income at record lows. This has undoubtedly been aided by massive government stimulus, and should help consumers withstand this period of rising cost pressures much more readily than they would have, say, a decade ago.



With that said, it is appropriate to consider the portfolio implications if we are indeed headed towards a period of persistent inflation and stagnant economic growth. While no two periods are directly comparable (for example, the environment today is very different than that of the 1970's, when we last saw stagflation), we would expect defensive sectors such as consumer staples and healthcare to outperform given their more stable business models and ability to exhibit pricing power. We would also expect a flight to quality generally, including the outperformance of companies with above-average balance sheet strength. Notably, Morgan Stanley recently issued a report which looked at

periods in which "...markets assigned a non-trivial probability to stagflation as a tail risk..." Their data showed that defensive sectors did indeed outperform during these periods, as did energy. In addition, credit spreads widened as fears of stagflation entered public discourse, adding credence to our belief that quality would outperform in such an environment. Also worth noting: according to work performed by RBC, banks outperformed through three stagflationary periods during the 1960's and 1970's.

Outlook

2021 looks to be a transitional year. We continue to be in the midst of an economic recovery, following the coronavirus-induced recession of 2020. Continued progress on vaccinations and therapeutics should allow the U.S. economy to return to more familiar footing with the resumption of dining out, air travel for business and pleasure, and large group gatherings. The 2020 United States elections, although closely contested, ushered in a change in administration with attendant changes in the agenda around stimulus, spending, taxes, and trade. The razor-thin margins in Congress are likely to temper any radical policy shifts.

While interest and mortgage rates have lifted, they are coming off historically low levels. We are seeing reinflation in many areas of the economy, and are watching this closely given the historically high levels of government spending here and around the world. We are carefully monitoring aggregate corporate debt levels (especially BBB- debt which is a single notch above junk status), currently above pre-2008 crisis levels and loom as a potential problem absent continued aggressive Fed support. Unemployment has shown significant improvement, but labor continues to be an issue, as the participation rate continues to be low and labor shortages are impacting many industries.

In our estimation, overall equity valuations remain at elevated levels. The high valuations of a small number of enormous technology companies certainly exert upward pressure to the overall averages. Aggregate earnings are quickly recovering, however unevenly. Certain industries such as hospitality, entertainment and travel, which are tied to the success of the vaccine rollout plan, will take longer to return to pre-coronavirus levels. Treasury and high-grade corporate bond yields look unattractive. In any case, we believe value investing is ripe for a period of outperformance.

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