Notes From the North: Market Outlook

November, 2021

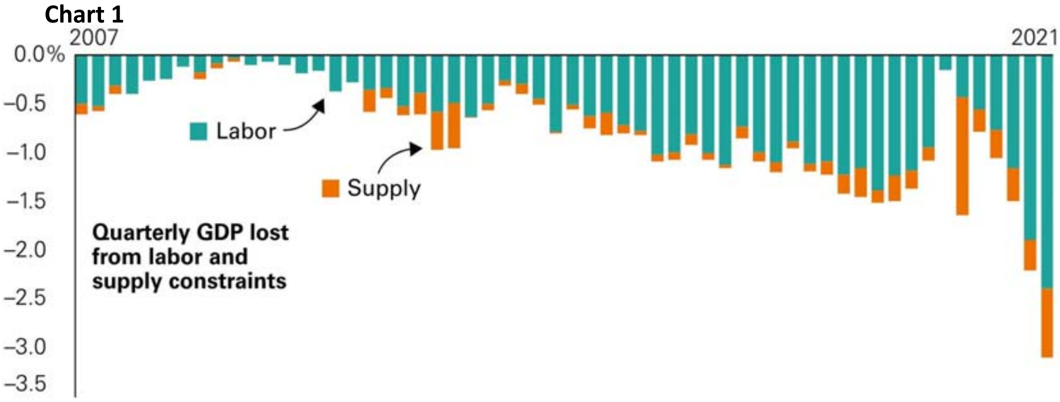
Stocks in the U.S. are near their highs for the year despite the combination of slowing economic growth during the third quarter and an accelerating rate of inflation. Animal spirits remain high! One recent datapoint might be the greeting that electric-vehicle Rivian received when its Initial Public Offering hit the market last week. With an IPO price of $78, it opened trading at $107.80 and is now at $145 or so. This puts its market value well over $100 billion. For perspective, Ford's market capitalization is $79 billion and General Motor's is $92 billion. Although Rivian has taken 48,390 deposits on pre-orders for its electric pickup and SUV, it has not yet produced or sold a single car. It will be interesting to see just how many deposits turn into actual car purchases, as we note that the $1,000 deposit is fully-refundable *and* it allowed the depositor to take an allocation from the IPO.

Happily, third quarter earnings for S&P 500 firms were supportive of stock prices. Corporate sales rose 17.5% over last year's depressed results and earnings rose a whopping 43.3%. Seventy-eight percent of reporting companies beat earnings expectations, but many warned that shortages of supplies and labor combined with higher costs are expected to restrain future results. The ability to raise prices will be crucial to maintaining profit margins.

Vanguard has just published two interesting charts dealing with these issues. Chart 1 (below) suggest that labor shortages are restraining GDP more than supply shortages. Chart 2 (over) confirms that we need more workers more than we need job openings. The Federal Reserve continues to pour money into the economy in the hope of getting the number of employed people back to the historic highs reached just before the Covid pandemic, but monetary policy was never designed to bring workers into the work force. The federal policies currently on the negotiating table will likely have more impact. A recent study from the University of Chicago warned that without work requirements, the expanded child credit could cause 1.5 million working parents to quit the labor force. Funding for child care and universal pre-K/Kindergarten would, on the other hand, make it easier for a working parent to rejoin the labor force. An interesting side-note to any social policy discussion might be the observation that a stay-at-home parent contributes virtually nothing to the measurement of GDP, while a working parent contributes doubly to GDP measurement through their earned wages and through the wages of those employed to help care for their children while they work.

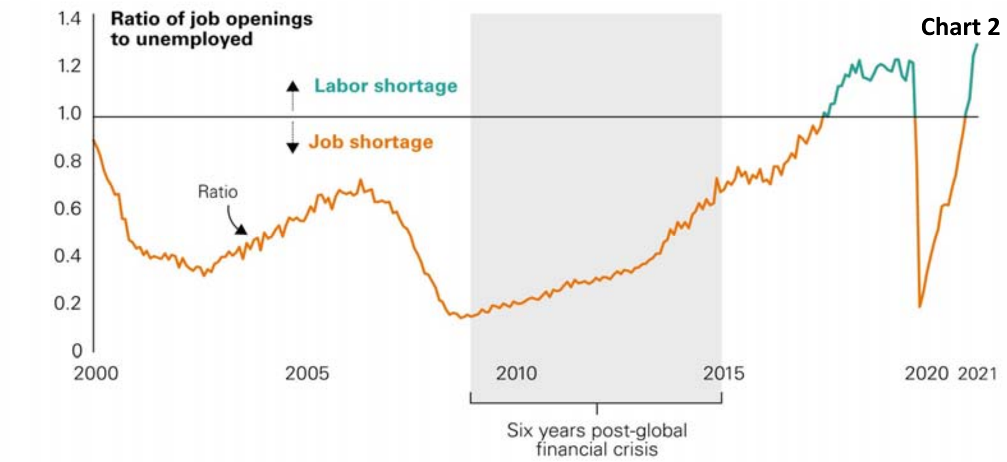
One thing that the Federal Reserve's easy money policies are likely influencing is the spike in inflation. October's 6.2% year-over-year increase in the Consumer Price Index in October is a 30-year high. Wage-push inflation has not been an issue for decades, but many, including BCA, expect wages to rise much faster in the year to come. Labor negotiations

Chart 1



Source: Vanguard calculations, using data through September 30, 2021, from the U.S. Bureau of Economic Analysis and the U.S. Bureau of Labor Statistics. https://advisors.vanguard.com/insights/article/highinflationbutnotstagnation

Chart 2



Source: U.S. Bureau of Labor Statistics, accessed August 30, 2021, through the Federal Reserve Bank of St. Louis FRED database.

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at Deere should be sending a shiver throughout the corporate world. Deere offered its unionized workers a 10% increase in the first year of the proposed new contract, 5% each in the third and fifth years, 3% lump sums in the second, fourth and sixth years and a bonus of $8,500 when the contract is signed. They offered to cap health insurance costs at current rates, and to calculate cost-of-living adjustments for inflation every three months. Deere's workers, who compared to the typical worker are already reasonably well paid, voted to reject the offer and continue their strike!

Some analysts claim that the Federal Reserve is further behind the inflation curve than at any time in history. Jerome Powell has indicated that the Federal Reserve will begin to reduce the amount of bonds they are buying, but it is important to recognize that their planned policies will remain stimulative throughout 2022. Most FOMC members see the Fed funds rate rising to only 2.5% this cycle and expect only one rate hike in 2022. This, at a time when real interest rates (the nominal rate minus the inflation rate) are at record lows.

Sharp rises in inflation and interest rates have historically been problematic for both bond and stock prices. Peter Berezin of BCA, who is one of our favorite prognosticators, thinks inflation will surprise on the upside next year. While he projects GDP growth will slow, he notes that it is peaking at much higher levels and will likely stay above trend levels until the second half of 2023. At that point, he expects hikes in interest rates at a level that could unsettle the stock market. Between now and then, he envisions falling bond prices but a continued rise in stock prices. He would shift money from growth and defensive stocks to large cap value and cyclical stocks. He also thinks small cap stocks will outperform. Our current general strategy fits this overall outlook. We expect no change in our bond portfolios (which are quite defensive against the prospect of rising rates) and within stocks, to continue to trim growth in favor of value, to seek those few quality issues that are still reasonably priced, and to be open to searching overseas and down the market-capitalization spectrum if need be to find them.

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