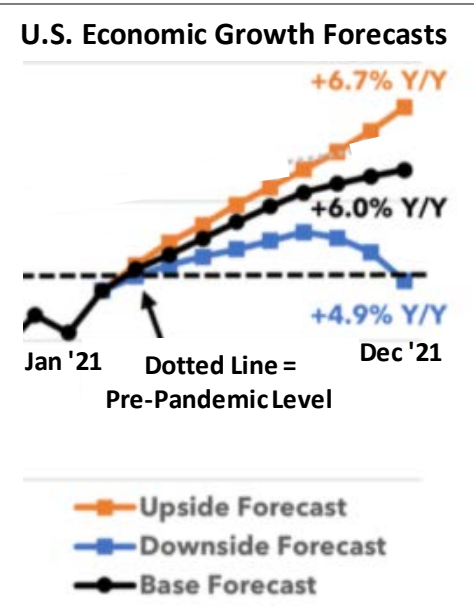


From: Aequitas Investment Advisors

Re: **Not So Fast!**

*Walter Spencer*

Since the Coronavirus Stock Market Crash in March of 2020, the investment markets have benefited from massive economic stimulus and relief measures from the Federal Reserve and the federal government. Not only did those measures forestall a much more severe economic recession, they helped jump-start the economy which, coupled with the unprecedented rollout of vaccines, created one of the fastest recoveries on record. As of this past June, consumer confidence was at its highest point since the onset of the pandemic and investor sentiment has



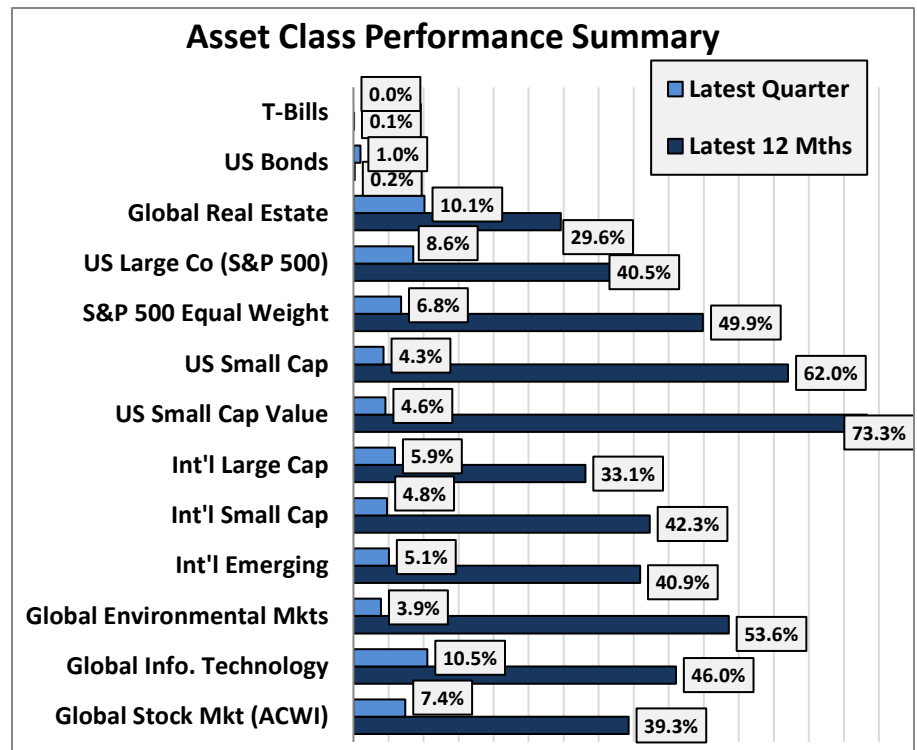
propelled the stock market to record high levels. At the beginning of this second quarter, economists at The Conference Board were forecasting a “base-case” annual growth rate of 6.0% for the U.S. economy which, granted it is relative to the onset of the pandemic, would represent the highest growth rate since 1984. By most accounts, this was a particularly rosy outlook which had some wondering if it was too optimistic. The Conference Board also published a “downside” forecast with a less robust growth rate of 4.9% (a healthy growth rate nonetheless). The key assumptions behind the downside scenario were: (1) a more contagious COVID mutation emerges, (2) the vaccination campaign

is prolonged and (3) the Federal Reserve “signals that it will begin to tighten earlier than expected.” As of this writing, two of the three conditions underlying the downside scenario have become reality while the third (the Fed’s signal) does not appear likely given the Fed’s most recent statements which leads us to believe a more muted scenario is likely. As such, many investment strategists do not believe the stock market has priced in such a slower growth economic scenario which might ultimately lead to downward pressure on stock prices. The bond

market, on the other hand, appears to be pricing in a slower growth scenario given that bond yields have fallen sharply as evidenced by the yield on the 10 Year Treasury Note having fallen from 1.7% in April, when the forecast was rosier, to 1.3% as of early July. Should we actually experience the downside forecast (i.e., 4.9%, or lower), that would imply very little additional economic growth for the remainder of the year. Further on in this letter we will discuss some of the risks to the economic outlook in greater detail, but first, we will review performance of some of the major asset classes for the latest twelve months and calendar quarter.

**Asset Class Performance Review – Stocks Continue Their Advance!**

With businesses reopening and the economy continuing to recover, stock prices over the most recent twelve months have risen dramatically with returns ranging from a “low” of 30% (Global Real Estate) to a high of 73% (U.S. Small Cap Value stocks). Small Cap stocks were among performance leaders as they rebounded after being severely hit during the pandemic downturn. The Global Stock Market

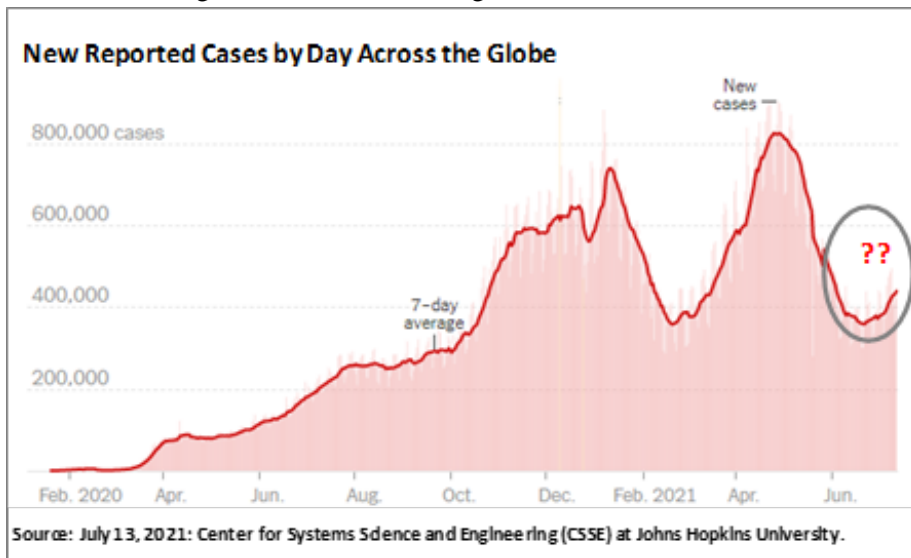


gained 39.3% for the trailing twelve months. Two of the focused sub-asset classes in our model portfolio, Global Environmental Markets and Global Information Technology, posted strong returns once again (+53.6% and +46.0% respectively). Reflective of extraordinarily low interest rates, T-Bills returned a barely measurable 0.1% and U.S. Bonds returned a mere 0.2%.

For the latest calendar quarter, returns within Equities were also positive across the board ranging from 3.9% (Global Environmental Markets) to 10.5% (Global Information Technology). This is one of the few quarters where we did not see a negative return on any of the major asset classes. The all-encompassing Global Stock Market posted a robust gain of 7.4%. Within Fixed Assets, T-Bills delivered no return and U.S. Bonds gained 1%.

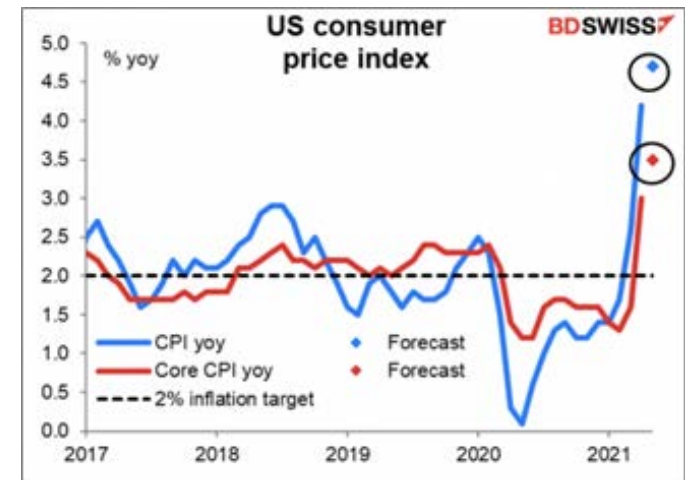
### Pandemic Resurgence – the Biggest Risk to the Outlook?

While our country has made great strides in administering vaccinations, less than half of the U.S. population is fully vaccinated. The new Delta variant has become the dominant strain leading to flare-ups in some of the most under-vaccinated regions of the U.S. (unsurprisingly), including pockets in Missouri, Arkansas, Utah and Florida. Health experts fear that with the surge in new cases, we will see more hospitalizations and deaths in the coming weeks and months. As a result, economists warn there may be setbacks in reopening the economy which could derail the more optimistic growth scenarios. As of this writing, the markets do not yet reflect this potential risk to the outlook. To help reduce this risk and forestall such a preventable outcome, we need to encourage those who remain unvaccinated to get their shots, including booster shots when available.



### Inflation – Another Risk to the Outlook?

The Federal Reserve has two primary mandates: (1) to implement monetary measures to achieve “maximum sustainable employment” which the Fed currently defines as an unemployment rate of less than 4%; and (2) to implement policies to keep prices stable which the Fed currently defines as an inflation rate of 2% (i.e., their long-term inflation target). As the economy has been rebounding from the pandemic, consumer demand has dramatically increased in certain economic sectors causing inflation to spike to levels not seen since 2008. The Consumer Price Index soared to an annual rate of 5.4% as of June 30<sup>th</sup> which is much higher than the Fed’s long-term target of 2%. The major components which contributed to the inflation spike were energy prices (gasoline prices rose by 45%), used car and truck prices (+45%), car and truck rentals (+88%), fares (+25%) and hotels and motels (+17%).

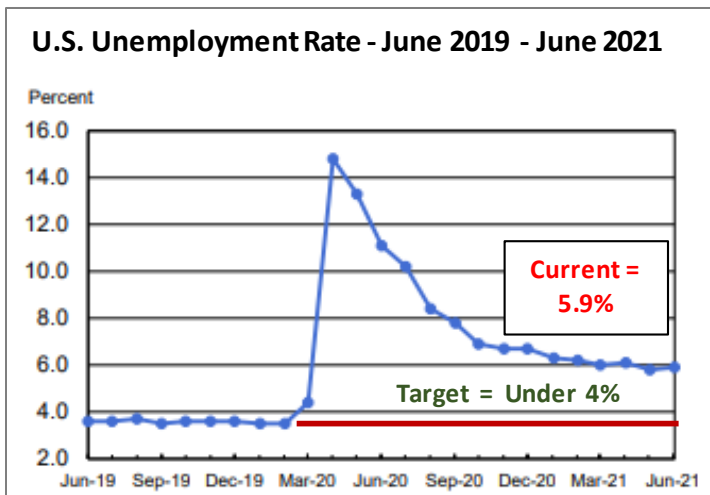


At this point, the Fed believes this inflation spike is “transitory” and they expect it will drift downward toward their 2% long-term target. According to the most recent testimony to the House Financial Services Committee, Powell remarked that labor conditions have been improving, but “there is still a long way to go” toward achieving the Fed’s employment objectives and he acknowledged that inflation will “likely remain elevated in the coming months before moderating.” He added that the Fed “would be prepared to adjust the stance of monetary policy as appropriate if we saw signs that the path of inflation or longer-term inflation expectations were moving materially and persistently beyond levels consistent with our goal.” For the time being, at least, the financial markets appear to have accepted the Fed’s rationale as evidenced by elevated stock prices and falling bond yields. However, the markets have not priced in a prolonged high rate of inflation which would be detrimental to economic growth.

## A Brief Look at the Unemployment Picture

As mentioned previously, the Federal Reserve is more concerned about the unemployment picture than inflation. Prior to the pandemic, the U.S. economy had achieved a rather steady unemployment rate of under 4%. At the height of the pandemic in March of 2020, more than 20 million U.S. workers had lost their jobs and the unemployment rate spiked to 14%. The economy has made steady progress since that peak, but we appear to be stubbornly stuck around the 6% level which equates to about nine million workers remaining unemployed.

The Fed clearly has its eye on these figures which is why Jerome Powell is putting more emphasis on remaining accommodative to stimulate employment rather than putting the brakes on the economy to curtail inflation.

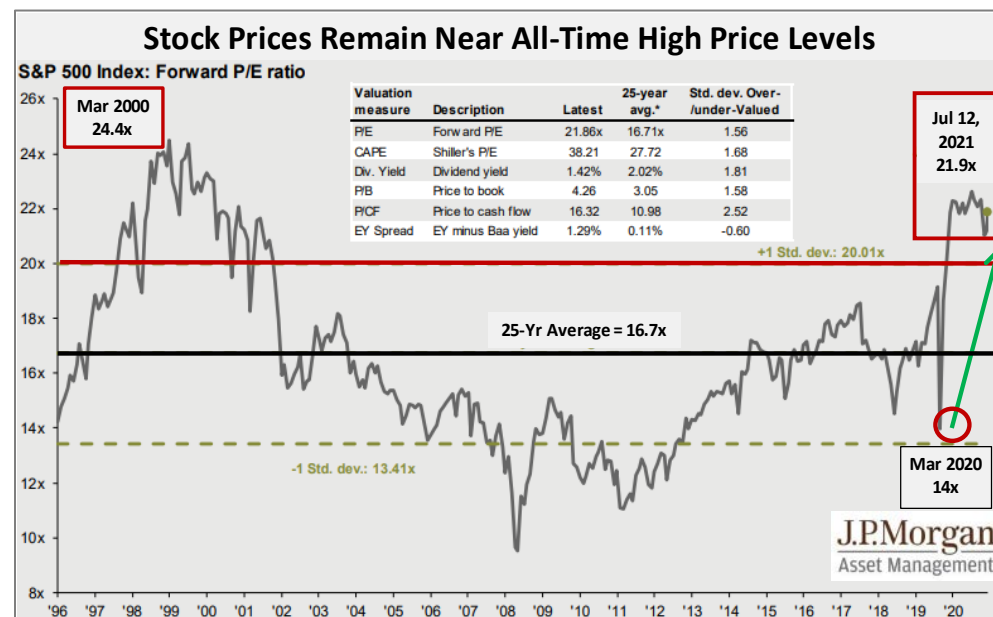


unemployed. The Fed clearly has its eye on these figures which is why Jerome Powell is putting more emphasis on remaining accommodative to stimulate employment rather than putting the brakes on the economy to curtail inflation.

## Exceedingly High U.S. Stock Prices

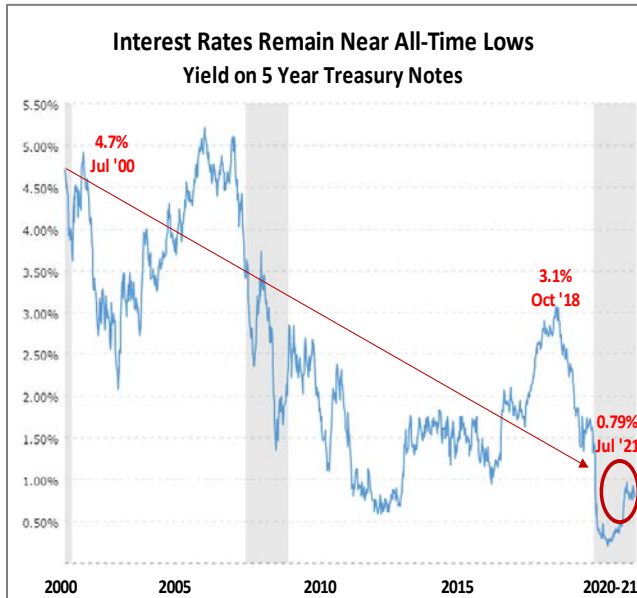
Less than seventeen months ago when the pandemic reached our shores and the economy began shutting down, stock prices plunged by close to 40% with many economists forecasting even steeper declines. At that low point in late March of 2020, the S&P 500 Index was trading at a Price-to-Earnings ratio (P/E ratio) of about 14 times earnings (i.e., an investor would pay an average of \$14 for every \$1 of corporate earnings). To put that into context, the 25-year average P/E ratio for the S&P 500 has been 16.7 times earnings. When stocks trade at significantly high P/E ratios, they are considered over-valued (as they appear to be today); and when trading at significantly low P/E ratio levels, they are considered under-valued (as they were briefly in 2020, but more significantly in 2009). As of early July, the S&P 500 Index was trading at a P/E ratio of close to 22 times earnings which is about 32% higher than its historic average. Of course, these are not average times and there are many factors which have led to high stock prices, including government fiscal stimulus, the Fed's monetary policies as well as an abundance of investors with cash to invest who are willing to pay higher prices.

Some stock market historians see parallels between today and the late '90s when the technology stock bubble was forming (left hand side of the graph below). While there are similarities, one of the biggest differences is that interest rates, as represented by the 5-Year Treasury Note, were close to 5% in March of 2000 compared to less than 1% today. Shifting out of stocks into bonds during the tech bubble was less painful when bond yields were so much higher. Furthermore, corporate earnings are still recovering from the pandemic, and as the economy continues to reopen and expand as predicted, earnings may rise to levels more supportive of current stock prices (perhaps the best-case scenario). Alternatively, there may be setbacks to the economy which might trigger a significant stock market correction (potential economic setbacks might include a significant resurgence in the pandemic or higher than expected inflation causing the Federal Reserve to reverse its accommodative policies). Without attempting to predict the future, history has taught long-term investors that high stock prices correct to more normalized valuation levels sooner or later; either as a result of corporate earnings rising to support higher stock prices, or as a result of stock prices falling to better reflect lower earnings levels (or perhaps a combination of both). Regardless of how such a correction might occur, most economists are forecasting lower than average future returns on stocks over the next 5-10 years as was the case following the technology stock bubble of 2000. (Bear in mind that while the chart below is focused on U.S. Large Cap stocks prices, there are more reasonably priced stocks in other asset classes in the U.S. and in other regions around the globe.)



## Exceedingly Low Interest Rates

Low interest rates have been quite supportive of higher stock prices as mentioned previously. And while low interest rates remain quite stimulative to the economic outlook, we expect that as the economy continues to recover, interest rates will eventually rise (we are maintaining a short average duration in the bond section



of our model portfolio for this reason). Given that interest rates are not expected to rise significantly in the near-term, the primary role of bonds at the present time is to provide downside protection and liquidity should we experience stock market weakness. Eventually, bonds will provide higher returns, but in the meantime the ballast which bonds provide may well prove to be invaluable in safeguarding our clients' financial plans.

## Other Risks We're Monitoring

Having reviewed some of the biggest risks to the economic outlook, there are others we are monitoring, including:

- **Regulatory and Antitrust Pressures:** Many of the largest U.S. companies, including Amazon, Apple, Facebook and Google, are facing growing regulatory and anti-trust pressures from Congress, foreign governments, the Federal Trade Commission, the Justice Department and individual states. How this will unfold is uncertain, but we are probably just in the beginning stages of a regulatory phase for these Big Tech giants.
- **China's Regulatory Crackdown:** The situation in China is problematic and complicated for a variety of reasons. China remains a communist country, but as stated in a recent Wall Street Journal article (*Is China's Communist Party Still Communist*), Chinese leaders "...have long embraced capitalist methods and encouraged entrepreneurship to deliver

the economic prosperity they see as essential for maintaining one-party rule." As of 2020, the digital economy in China made up 38% of its GDP which is a remarkable success story – so remarkable that the Chinese government is “coaxing” (read, cracking down on) its big tech giants to share their data with the state. According to a recent article in Time magazine, “In April 2020, China released a policy document that significantly listed data as a *factor of production* alongside the four traditional factors of socialist economic policy: land, labor, capital and technology.”

As you probably know, our model portfolio includes a dedicated mutual fund position focused on consumer growth in Emerging Asia managed by Matthews Asia. Our rationale is Emerging Asia represents the fastest growing consumer market in the world led by China and India. In fact, Asia is expected to contribute more than half of global consumer consumption over the next decade. However, given growing concerns about the Chinese government's crackdown, we are engaged in discussions with Matthews to ascertain whether the investment merits continue to outweigh the potential drawbacks given growing geopolitical concerns.

- **Tax Legislation:** While the outcome is far from certain, there are various proposals currently being discussed in Washington for infrastructure spending which might lead to higher tax rates on realized capital gains and taxable income. While the infrastructure spending would likely be positive for the economy and for job creation, the proposals for paying for such expenditures through higher taxes would likely be negative for many high-income earners and potentially for the stock market as well.

## A Tricky Time to be an Investor

Market risks must be considered fully when developing a financial plan and constructing a portfolio to support that plan. Yet the current set of risks and uncertainties seem particularly challenging. As outlined in this letter, we still do not know how the pandemic will play out, we do not know if inflation will become a long-term risk rather than just transitory, and there is great uncertainty about the direction of interest rates and how the stock market will ultimately correct to more sustainable price levels. What we do know is that experience has taught us to carefully consider each of our client's specific financial goals and associated time horizons and to construct a portfolio strategy designed to achieve the goals without taking on more risk than necessary. Our experience has also taught us that constructing a balanced portfolio comprised of high-quality bonds (the safe

haven) and highly diversified global stocks for long-term appreciation remains a prudent investment strategy; one that is designed to withstand various economic scenarios and, through regular rebalancing, take advantage of market volatility to improve the likelihood of successfully achieving favorable long-term investment results.

### **Closing Words**

We often think of uncertainty in a negative context, yet it is uncertainty which can open up a realm of possibilities. Consider the recent achievement of Sir Richard Branson who boarded his company's *SpaceShipTwo Unity* spacecraft on July 11<sup>th</sup> after years of development and despite one disastrous test flight. While knowing the risks and uncertainties, he and five other crewmembers boarded their craft and successfully reached the edge of space where they experienced weightlessness. At that pinnacle, Branson stated the following, "I was once a kid with a dream looking up to the stars, and now I'm an adult in a spaceship looking back to our beautiful earth. To the next generation of dreamers: If we can do this, just imagine what you can do. And I look forward to you all following your dreams and doing wonderful things."

