Post Oak Private Wealth Advisors

Advisory, Consulting & Investment Management

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Quarterly Market & Economic Commentary

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Another quarter-end saw the major U.S. stock indexes flying at or near record levels. Investors had lots of reasons to cheer—strong corporate earnings, the swift re-opening of local economies, the return of restaurants and air travel and soaring home prices, just to name a few. The resumption of economic activity helped companies rake in strong profits to start the year. Much of the same is expected when Q2 earnings are reported this summer. All this good news seems already priced in to stock valuations, which closed the quarter at lofty levels. As the quarter came to a close, the S&P 500 Index price/earnings ratio sat at 37.2 for the trailing 12 months, higher than one year ago although the P/E ratio for the next 12 months is estimated to be lower at 22.5.

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Despite all the good cheer in the markets over the last three months, there was also plenty of drama for investors to mull over. Suspense hangs over inflation numbers, interest rates and what steps the Federal Reserve may take going forward to keep the economy on an even keel. The Fed's stated view on the recent rise in consumer prices is that they are "transitory"—temporary spikes in the prices of select goods and services that would be expected as the economy roars back after last year's slowdown. The consensus of Fed watchers and market analysts largely agrees with this view. I generally back this view as well, but there are also some economists who think otherwise. Speculation about inflation and the Fed's path to monetary normalcy appears to be the number-one issue driving the market right now. I suspect this speculation will be with us for the remainder of this year.

Which way is up?

Let's wade into the inflation debate, starting with the facts. The jump in the Consumer Price Index (CPI) for May was 5.0% on an annualized basis, the biggest jump in headline inflation since August 2008. The headline number includes food and energy prices, which tend to be volatile. The Labor Department also reports a core CPI number, removing food and energy prices. For May, core CPI jumped 3.8% from the prior year. That's the largest annualized rise in core inflation since June 1992.

But much of this jump in inflation occurred in a select range of goods and services, many of which experienced a surge in demand as consumer activity returned after a year of lockdowns. The most notable inflation spike in May was for used vehicles. Prices for used cars and trucks in May rose 7.3% from April and contributed to one-third of the increase in the overall CPI. Prices for furniture and apparel also climbed during the month, as did consumer costs for airfares, hotel rooms and rental cars. Inflation in the hospitality sector isn't surprising with many Americans fleeing the confines of their homes as coronavirus case counts plummeted and travel restrictions eased. These price increases reflect the release of pent-up demand, which is why the Fed considers this inflation transitory.

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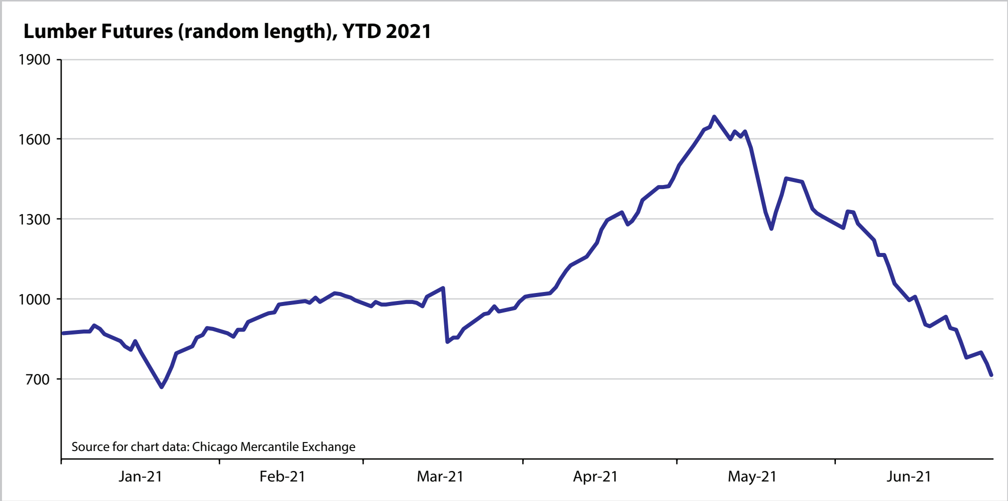
Moreover, when we see these alarming numbers in headlines, we should remember they are coming off a low base. The 2nd Quarter of 2020 marked the low point in the COVID recession, so any comparison of this year's positive numbers with last year is likely to be skewed. For a better perspective, we can compare CPI in 2021 with two years ago when the economy was more normal. Consumer price inflation over a two-year period averaged around 3.5% in the decade prior to COVID-19, according to a Wall Street Journal analysis. The CPI number in April 2021 was 4.5% higher than two years ago. That reflects a rising trend but one that's not as dramatic as the one-year inflation number suggests.

A perfect storm brewing

But inflation wasn't only present on the consumer side. Producer price inflation also showed a marked rise in Q2. Here as well, we saw notable increases in prices for select components and materials. Lumber prices, for one, saw significant price spikes in May as future and spot prices hit record levels. You would expect higher costs for lumber given the rising demand for new homes and remodeling of existing homes, but also apparent in all the wooden picnic tables built to accommodate outdoor dining during the pandemic. But lumber prices subsequently tumbled in June, seemingly to confirm the Fed's position of transitory inflation. (See chart below.)



Businesses also had to contend with rising costs for getting their products to buyers, including higher prices for packaging materials and shipping. The rise in economic activity, including robust e-commerce sales, contributed to a cardboard shortage, which was exacerbated by winter weather issues and shortages for packaging inputs such as fiber and chemical adhesives. Imported goods have also been impacted by rising prices for shipping containers. According to Freight Waves, the cost to ship a container from Shanghai to Los Angeles in June was 200% higher from the previous year. We haven't yet seen if these higher shipping costs will be passed to consumers in higher prices for imported goods, but it's becomes more likely as the demand for shipping containers persists.

Shortages are becoming more common for both producers and consumers, another complication for the economy as it adjusts from sudden shutdown to fast re-opening. Many suppliers curtailed production at the outset of the pandemic, uncertain how widespread shutdowns would impact demand for their goods and services. Many of these firms are still ramping up as economic activity gathers pace. That's creating shortages of different products and inputs throughout the global economy, from the semiconductor chips that are integral components of every new car and

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kitchen appliance, to the oat milk and hazelnut syrup that go into Starbucks beverages. As it is in many industries, several factors are contributing to material shortages and price increases—a perfect storm of supply chain constraints arriving concurrently with an outflow of pent-up consumer demand.

We should also bear in mind that the coronavirus pandemic is not over yet, especially when we look at the global impact of the health crisis. While the prevalence of vaccines in the U.S. has helped lower positive COVID case counts here, other countries continue to struggle to contain the virus—especially its more contagious variants—with limited access to vaccines. These issues can reverberate globally in our interconnected world. As one example, the pandemic is one driver behind the global shipping container shortage; the port in Shenzhen, China (the world's third busiest container port) is currently operating at reduced capacity because of a COVID outbreak among port workers. Fewer than two dozen positive COVID cases have been identified in Shenzhen, yet it impacted 250,000 residents and workers in and around the port who were required to isolate and restrict close contact with other people.

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Employment: Help wanted

Many of these supply and demand issues will work themselves out over time, and therefore are likely to have less impact on inflation going forward. But one indicator that could lead to more sustained inflation is wage growth. That's been a separate concern among economists and business owners as many firms struggle to find workers and solve the current labor shortage. There are plenty of unemployed workers showing up on the monthly job reports; non-farm payrolls remained below pre-pandemic levels at the start of June. Job growth was still positive during Q2, but the pace of growth has definitely slowed with just 278,000 new jobs reported for April, well below economists' expectations. May's job report showed a gain of 559,000 in non-farm payrolls, an improvement but still leaving a wide gap with pre-COVID employment levels.

The May employment report counted around 9.8 million Americans as unemployed. That's not too far off from the 9.3 million job openings in the U.S., according to a Department of Labor survey. It's hard to miss the multitude of "Now Hiring" signs that many businesses have posted, offering hourly pay well above current minimum wages along with signing bonuses and enhanced benefits. Rising wages for workers are beginning to show up in the monthly job reports, but affecting some sectors more than others. For instance, hourly wages in May rose 2% over the previous year, but the jump in pay was bigger in hospitality and leisure businesses with a 4% increase from one year ago.

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Similar to what we see in consumer and producer price inflation, there are many different factors at work in the labor shortage and wage inflation. The enhanced unemployment benefits included in the recent COVID relief stimulus package are keeping many unemployed people from looking for work, although these extra payments are due to expire in September. Many states have decided to end these enhanced benefits sooner, to help push unemployed workers back into the labor market. But there are also supply and demand issues that the economy must work through before balance is restored in the employment pool. Many workers found new higher-paying jobs when their employers closed or scaled back during the pandemic. Now, these businesses face challenges in luring these workers back and higher wages may not be enough. Additionally, some workers aren't keen to return to jobs where the health risks are high and the prospects for steady employment are tenuous.

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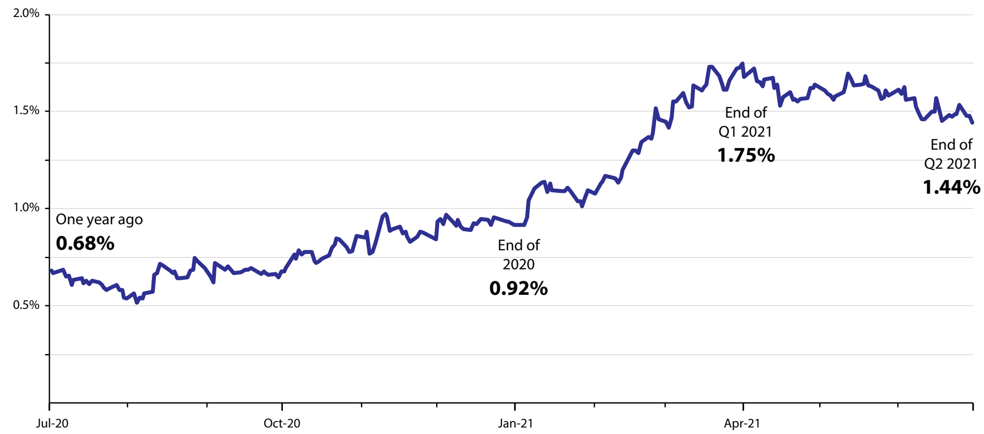
Waiting on the Fed

The speculation over inflation was largely visible in the bond markets over the last three months. Interest rates rose steadily during Q1, mostly over fears of rapidly rising inflation, with the benchmark 10-year U.S. Treasury note hitting a year-to-date peak of 1.75% on March 31. Since then, it's been all downhill with the 10-year rate dropping below 1.5% in June to end the quarter at 1.44%. (See chart below.) If inflation was more than transitory, we would likely see interest rates move higher, not lower or just treading water. The tentativeness in the bond market indicates investors are waiting for signals from the Federal Reserve on how monetary policy may change as the economy gains strength and prices threaten to rise.

10-year U.S. Treasury yield, July 2020 to June 2021



The Fed announcement following June's FOMC meeting showed a slight change in tone in the central bank's posture, as they projected their expectation to keep interest rates at near-zero levels until late 2023. Prior to the June announcement, the Fed had projected keeping rate rises on hold through 2023, so the recent rise in inflation and expected burst in economic growth is on the Fed's mind. Markets are also awaiting word from the central bank on when they plan to start tapering asset purchases. Fed chairman Jerome Powell gave no indication of a plan to taper in the press conference after the June meeting, although the topic was discussed among FOMC members last month.

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For the time being, investors are left the contemplate the impact of another "taper tantrum" in financial markets. In the equity market, that means we're likely to see more churning of good and bad weeks, with rotation wavering between growth and value stocks. Concerns over rising inflation and the end of easy money from the Fed fueled the rotation toward value in Q1, but that trend seemed to stall as inflation worries eased. Value had the momentum coming into the 2nd Quarter, but they underperformed growth stocks in April, rebounded in May, then slipped again in June. Growth seemed to regain ground over the past few weeks as tech stocks rallied, ending the quarter with a 11.9% increase, while value stocks eked out a mere 5.0% return. Along with technology, real estate, energy and communications were Q2's top equity sectors. Utilities were the only sector with a quarterly decline, falling 0.4%.

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The recovery rolls on

In most economic environments, the key to investment success is to own quality companies and broad-based indices, coupled with a touch of protection against inevitable downturns in the market. This approach was effective again in the 2nd Quarter, and it appears will likely continue to be as the year progresses. The economic engines are firing on all cylinders and we should continue to see robust reports on GDP and employment. This will naturally stoke inflationary concerns, so any headlines that emerge in the next 3-6 months should be carefully scrutinized. All indications we see as we head into the second half of 2021 tell us this remains an excellent time to continue building wealth for the future.

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