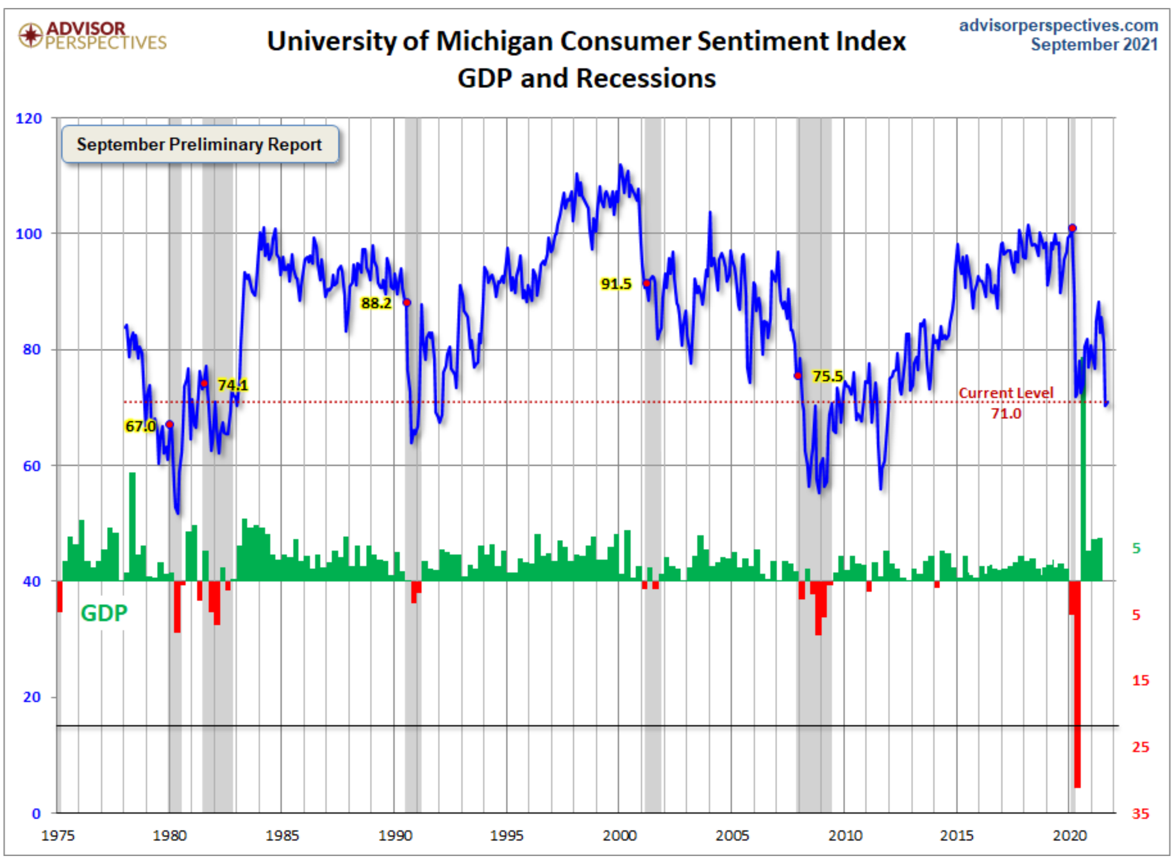
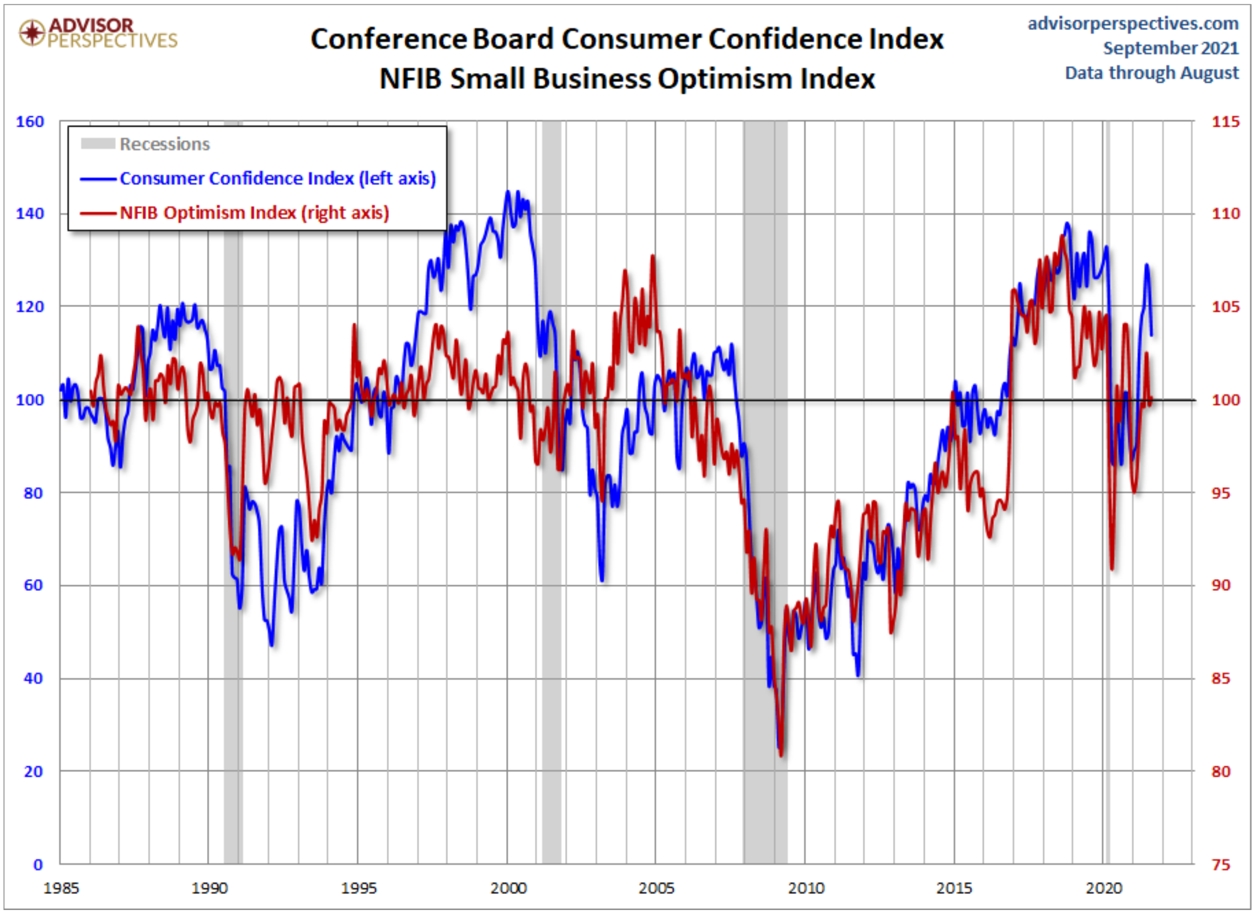
THE EROSION OF CONSUMER OPTIMISM

The erosion of consumer optimism over the past month is a disconcerting storm cloud. We have noted a couple of historically worrisome relationships which we will discuss in this issue.



The Consumer Sentiment index (above) declined significantly in August.

It’s important to note that the Consumer Sentiment Survey conducted by the University of Michigan is more closely tied to how respondents feel about their personal situation. On the other hand, the Consumer Confidence Survey from the Conference Board (blue line below) reflects how people perceive the broader economy.



As shown in the chart above, Consumer Confidence (blue line) has begun to suffer. Notably, the NFIB Small Business Optimism Index (red line) remains in a greater downtrend, as small business owners are struggling to deal with the dual headwinds of rising input costs and a shortage of qualified labor.

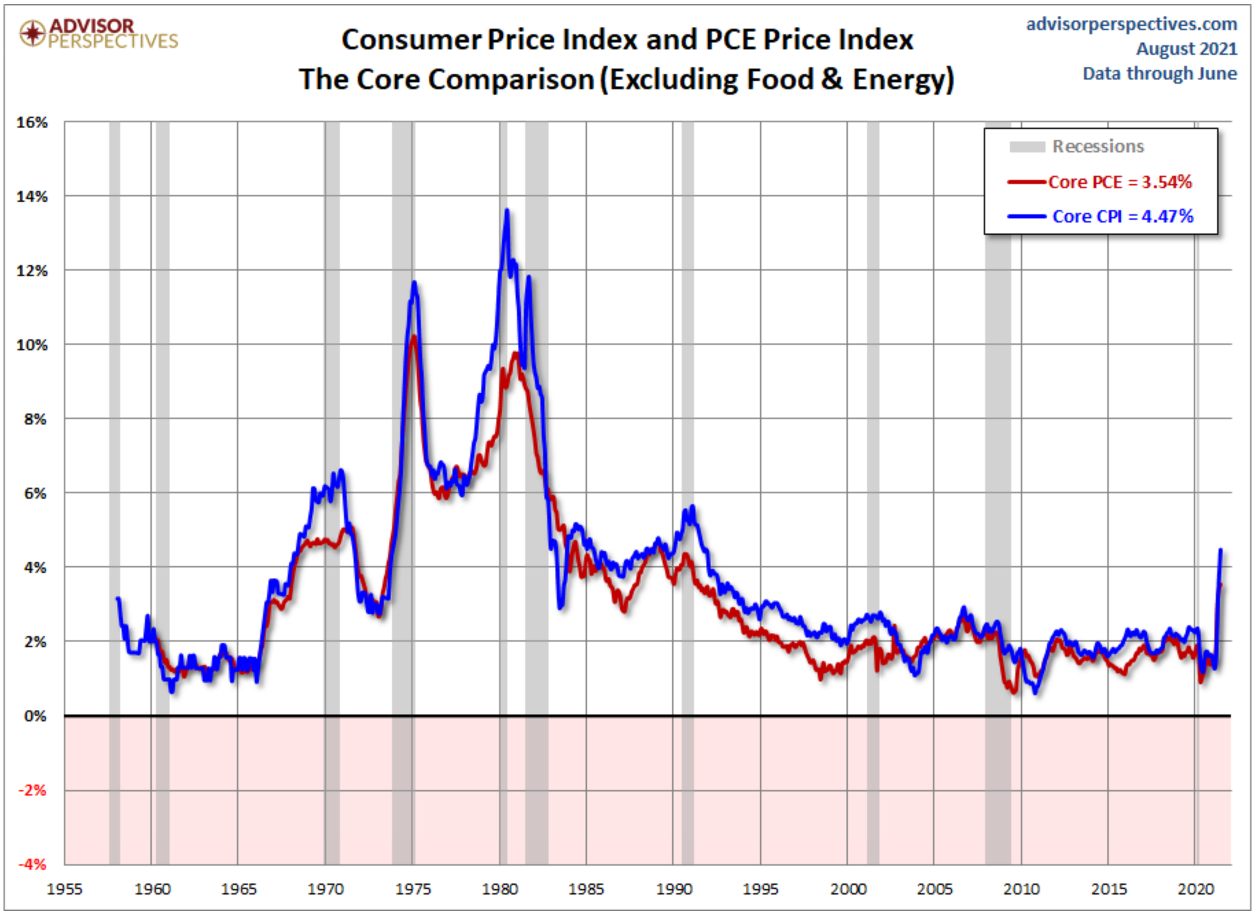
In fact, a record 50% of small businesses surveyed had job openings in August, yet 91% of those hiring said that they had few or no qualified applicants. Furthermore, small businesses are scrambling to pass on higher costs to their customers, as 49% of respondents reported raising prices last month, a level which hasn’t been reached since the days of double-digit inflation in 1980.

In its latest report, the National Federation of Independent Business (NFIB) stressed the inflationary risks to small businesses by stating: *“Then there’s inflation. Not a problem as long as firms can pass rising input costs (including wages) on to customers in higher selling prices. But if consumers become price-shy, then profits will be squeezed and firms will have to adjust costs quickly, including labor costs.”*

With business looking to the future with supply, hiring, and inflation concerns, there is a very real risk that the dilemma now facing small businesses could amplify.

Another worrisome trend within the Conference Board's Consumer Confidence survey is the fact that the Future Expectations component is falling notably faster than the Present Situation component. Consumers have spent the summer remaining confident in today while growing less positive about tomorrow. Such negative disparities in future/present confidence are sometimes a precursor of a recession ahead. And the starting point often occurs when falling confidence starts to impact consumer behavior and spending. These fears, as well as those of the COVID-19 Delta variant, could be a stumbling block for the U.S. economy (and the markets) until these concerns are resolved.

The Inflation Picture



Fed officials remain adamant that inflation will prove to be "transitory," yet their preferred inflation measure has continued to surge past its 2.0% target rate. The Bureau of Economic Analysis reports that Core Personal Consumption Expenditures **(CPE),** which excludes food and energy prices, increased to a 30-year high of 3.6% and marked the fourth consecutive month above 3.0%.

Even Fed Chairman Jerome Powell acknowledged that the surge in prices caught the Fed off guard, stating that inflation "*has been higher than we've expected and a little bit more persistent*." Prices have continued to trend even higher in the two months following his statement, which has played a part in the central bank's decision to likely begin tapering its asset purchases later this year.

Home prices have exploded over the past year, yet the corresponding measure of owners' equivalent rent in the Consumer Price Index **(CPI)** calculation remains depressed. Owner's equivalent rent **(OER)** is the single largest component in the Consumer Price Index. Owners' equivalent rent measures what a property owner would pay in equivalent rent.

Historically, OER has not reflected large moves in home price data until well after the surge begins. Consequently, OER has only recently started to accelerate, and could have a lot further to rise in the months ahead, which means that a continuation of its uptrend will likely keep inflation at an elevated level going forward.

Real-world rent inflation, as measured by the over 5 million rental units listed on Apartment List.com has surged by more than +12% from a year ago. And just as OER is beginning to capture the rise in actual housing prices, the Rent of Primary Residence component of CPI has only recently started to reflect the massive and ongoing surge in rents. Rent of Primary Residence, along with OER, comprise over 31% of the CPI, which further adds to the probability that inflation will be more persistent than expected.

While it's clear that housing costs will likely place upward pressure on inflation in the months to come, accelerating wages could prove to be an even bigger inflationary risk. Discrepancies between the supply/demand of labor were starting to emerge prior to the pandemic, and these dislocations have reached unprecedented levels over the past 18 months.

Consequently, according to InvesTech Research, a record-high 41% of small businesses reported raising compensation over the past three months, and a record number of businesses are planning to continue raising wages in the months to come. Small businesses are passing on these increased labor costs to their customers. And unless the end of the enhanced federal unemployment benefits causes a sudden improvement in the shortage of labor, this will continue to function as another upward force on inflation.

Our Strategy

Technically the market remains in an overall uptrend. Fundamentally, however, it has become more worrisome. We have taken some profits in certain areas and raised some more cash in a few of our portfolios, as we often do when the markets are coming off of new highs.

As developments continue to unfold, we'll be closely monitoring indicators we have identified for you in the past two issues as well as others. We remain completely open to any eventuality that the market brings, and we are confident that our indicators will help us successfully navigate whatever happens.

Summary

It is clear that surging inflation is having a substantial negative impact on the confidence of both consumers and small business owners, in spite of the Fed's continual reassurances that today's inflation is transitory.

If the Fed continues to turn a blind eye to the inflation problem, it significantly raises the probability that a drop in investor confidence will ensue. These and other indicators are raising yellow warning flags that support our preemptive defensive allocation reductions and will likely keep us moving in a cautionary direction until the situation improves.

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