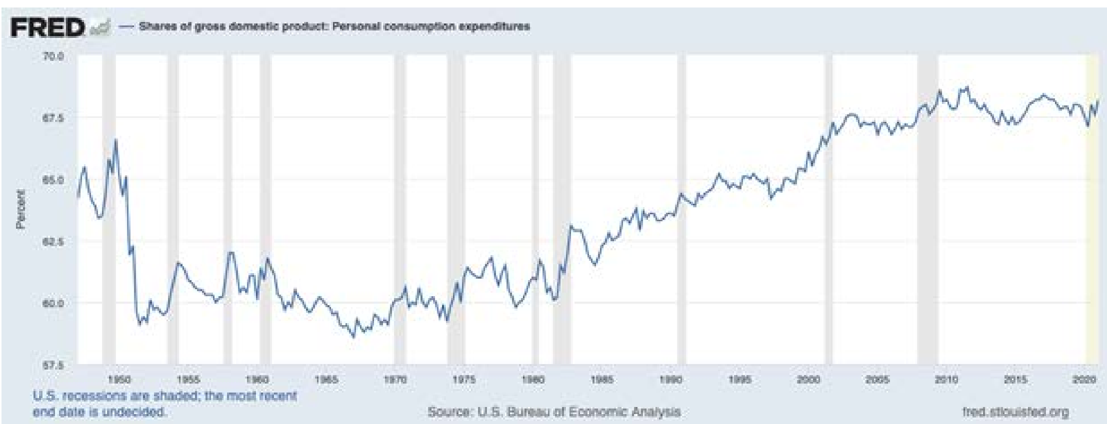
The Case for a Continuing Bull Market

The U.S. is a service and consumer-based economy. The U.S. is the biggest and most diverse economy in the world, and it is not a stretch to label the U.S. consumer as the single most important factor in the global economy.



Source: Federal Reserve Bank of St. Louis[4]

Consumption makes up roughly two-thirds (over 68%) of the entire economy, a share that has consistently moved higher since the mid-1960s (chart above).

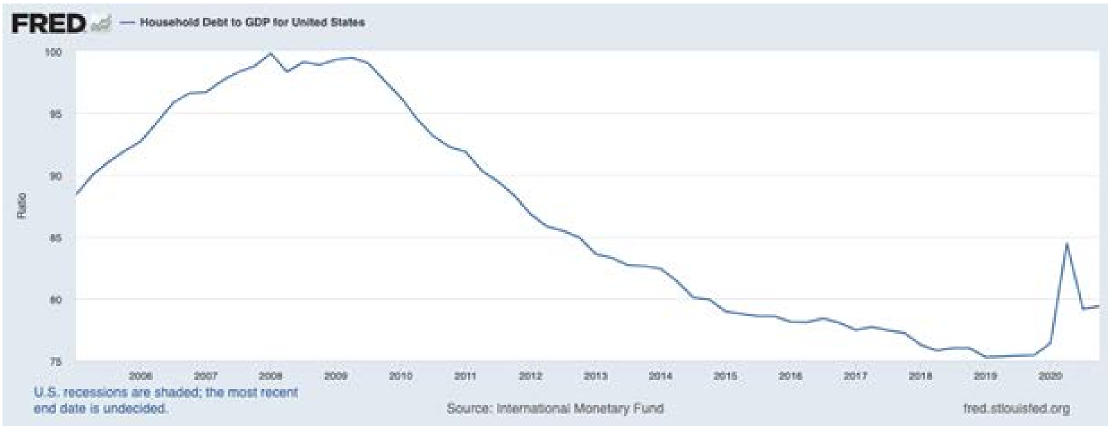
Clients continue to wonder what is currently driving the markets and what the prospects look like for the second half of 2021. As you well know, we don't have much faith in market predictions and don't manage your assets relying on them. However, we do have to be able to anticipate different market scenarios based on the markets continuing to rise, experience the "summer doldrums", or sell off. Currently there is good reason to believe the markets can sustain their momentum for the second half of the year. As long as consumers continue to spend money as economies reopen and the Fed remains accommodative, the market could continue its march higher.

Ironically, unemployment is still high based on recent figures, yet jobs all over the country are going begging. There is a debate over whether expanded unemployment benefits are even needed, or whether American households needed three rounds of government stimulus at all. A growing number of states have announced they would stop allowing residents to receive federal pandemic-related unemployment benefits. Another ironic development has been the market's reaction to the jobs reports for the last two months. While they showed job growth badly missed expectations for each of the last two months, the market reacted positively. What was bad news for the economy, was good news for the market, with the belief that a slower economic recovery would keep Fed policy where it's at, ultra-accommodative with low interest rates and continued bond purchases.

As to where much of the stimulus money that's been sent out has gone, according to the Federal Reserve Bank of New York, consumers on average are only spending about a third of each stimulus check. With many households either saving their money, paying down debt, or both.

The key conclusion from the NY Fed's surveys is that consumers have been strengthening their balance sheets over the last year. A full economic reopening could support strong spending trends over the next year and beyond. The chart below indicates that disposable personal incomes are at all-time highs.

Source: Federal Reserve Bank of St. Louis[4]



Source: Federal Reserve Bank of St. Louis[7]

The chart above shows household debt-to-GDP in the U.S. is still at a low level relative to the pre-2008 expansion.

Consumer strength and confidence have been showing up in retail sales. The Census Bureau says retail sales were up 51.2% in April 2021 from the previous year, which is to be expected given the low comparison with April 2020. But a better view of sales comes from looking at the jump from February 2021 to March 2021, which showed a 10.7% increase. As the pandemic risk decreased, the U.S. consumer re-engaged strongly.

But What About Inflationary Pressures?

Fear of rising inflation has been a counterargument to a strong U.S. consumer. If consumer prices rise too much, the argument goes, consumers could be discouraged from spending. Inflation poses a real risk. Neither the bond nor the stock market likes inflation surprises. Stocks can come under pressure if Treasury yields rise due to inflationary concerns. But if Treasury yields move higher while corporate earnings continue exceeding expectations, it may not be much of an issue and the markets seem to be expecting inflation to level off. Problems arise if inflation is rising, rates are rising, and corporate earnings are falling short of expectations. For now, earnings are firmly outperforming expectations, but as ever they will be a key factor to watch going forward.

Inflation is Heating Up

A year ago, as the pandemic ravaged country after country and economies shuddered, consumers were the ones panic-buying. Today, on the rebound, it is companies that are furiously trying to stock up. Corn, coffee, wheat and soybeans, lumber, semiconductors, plastic and cardboard for packaging. The world is seemingly low on all of it.

The price of lumber, copper, iron ore and steel have all surged in recent months as supplies constrict in the face of stronger demand from the U.S. and China, the world’s two largest economies. Mattress producers to car manufacturers to aluminum foil makers are buying more material than they need to survive the primal fear of running out.

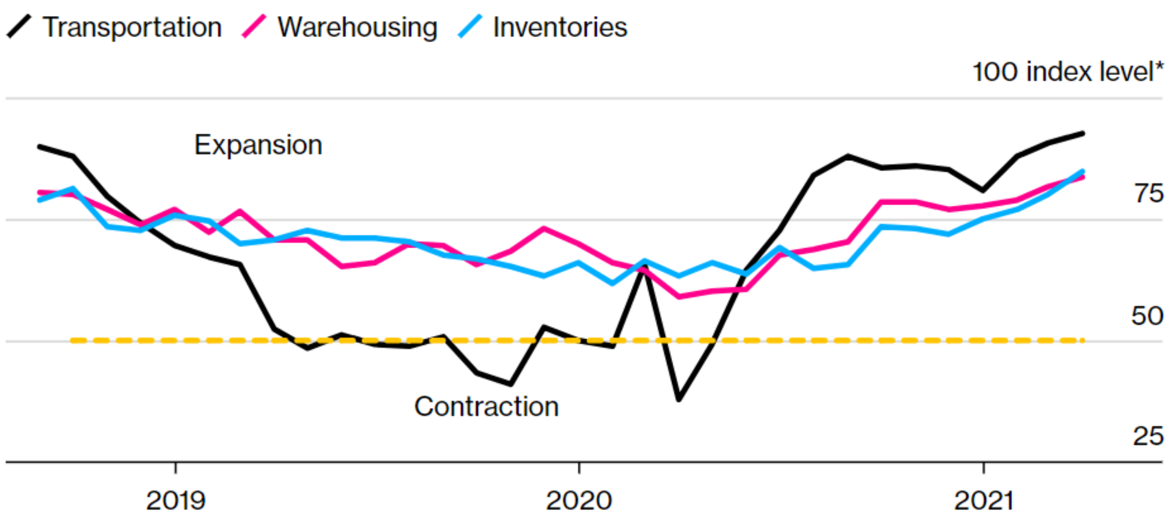
Shortages, transportation bottlenecks and price spikes are nearing the highest levels in recent memory, raising concern that a supercharged global economy will stoke inflation. The difference between the big crunch of 2021 and past supply disruptions is the sheer magnitude of it, and the fact that there is — as far as anyone can tell — no clear end in sight.

Europe's largest fleet of trucks, Girteka Logistics**,** says there has been a struggle to find enough capacity. Monster Beverage Corp. of Corona, California, is dealing with an aluminum can scarcity. Hong Kong's MOMAX Technology Ltd. is delaying production of a new product because of a dearth of semiconductors.

Further exacerbating the situation is an unusually long and growing list of calamities that have rocked commodities in recent months. A freak accident in the Suez Canal backed up global shipping in March. Drought has wreaked havoc upon agricultural crops. A deep freeze and mass blackout wiped out energy and petrochemicals operations across the central U.S. in February. Recently, hackers brought down the largest fuel pipeline in the U.S., driving gasoline prices above $3 a gallon for the first time since 2014.

A Logistical Nightmare

Transport, storage and inventory costs are near record highs in the U.S.



Source: Logistics Managers' Index
*The LMI is a diffusion index where 50 is the dividing line between expansion and contraction.

For anyone who thinks it's all going to end in a few months, consider the U.S. economic indicator known as the Logistics Managers' Index (above). The gauge is based on a monthly survey of corporate supply chiefs that asks where they see inventory, transportation and warehouse expenses — the three key components of managing supply chains — now and in 12 months.

The current index is at its second-highest level in records dating back to 2016, and the future gauge shows little respite a year from now.

In the past, the three areas indicated on the chart above were optimized for low costs and reliability. Today, with e-commerce demand soaring, fatter inventories are in vogue. Transport costs, more volatile than the other two, won't lighten up until demand does.

"*Essentially what people are telling us to expect is that it's going to be hard to get supply up to a place where it matches demand, and because of that, we're going to continue to see some price increases over the next 12 months"* according to Zac Rogers, an assistant professor at Colorado State University's College of Business who helps compile the Logistics Manager's index.

More well-known barometers are starting to reflect the higher costs for households and companies. Both core and headline inflation jumped more than forecast for April and May. In April, the index of U.S. consumer prices that excludes food and fuel jumped by the highest percentage month-to-month since 1982. The year over year surge of 5% in May was the highest since 2008.

Stay Calm?

Government policy makers have laid out several reasons why they don't expect inflationary pressures to get out of hand. Over and over this year you've heard Federal Reserve officials say this is "transitory", or short-term. Fed Governor Lael Brainard said recently that officials should be "patient through the transitory surge."

Among the reasons for calm: U.S. retail sales stalled in April after a sharp rise in the month earlier, and commodities prices have recently retreated from multi-year highs. Supply-demand imbalances should moderate from current unsustainable levels as supply chains improve.

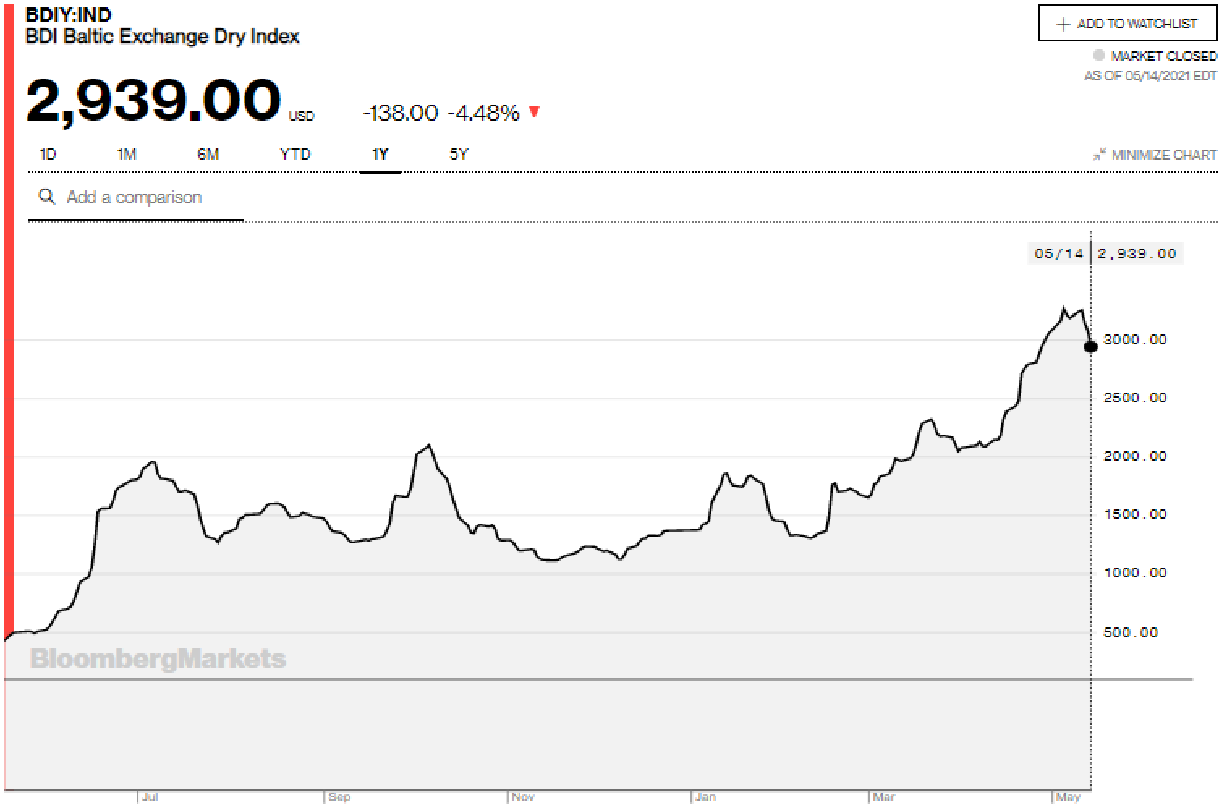
Nevertheless, a growing chorus of observers are warning that inflation is here.
The threat has been enough to send tremors through world capitals, central banks, factories, and supermarkets. The U.S. Federal Reserve is facing new questions about when it will hike rates to stave off inflation — and the perceived political risk already threatens to upset President Biden's spending plans.

Crude oil is also on the rise, as are the prices of industrial materials from plastics to rubber and chemicals. Some of the increases are already making their ways to the store shelf. Reynolds Consumer Products Inc., the maker of the namesake aluminum foil and Hefty trash bags, is planning another round of price increases — its third in 2021 alone.

Earlier this month, the Bloomberg Commodity Spot Index touched the highest level since 2011.

A United Nations gauge of world food costs climbed for an 11^{th} straight month in April, extending its gain to the highest in seven years. Prices are in their longest advance in more than a decade amid weather worries and a crop-buying spree in China that's tightening supplies, threatening faster inflation.

Across the world's manufacturing hub of East Asia, the dearth of semiconductors has already spread from the automotive sector to Asia's overly complex supply chains for smartphones. Instead of proving to be a short-lived disruption, the semiconductor crunch is threatening the broader electronics sector and may start to squeeze Asia's high-performing export economies. In an indication of just how serious the chips crunch is, South Korea plans to spend roughly $450 billion to build the world's biggest chipmaking base over the next decade according to Vincent Tsui of *Gavekal Research*.



Source: Bloomberg

Full Speed Ahead

The Baltic Dry Index, a shipping bellwether, reached an 11-year high in April. Meanwhile, running full tilt between factories and consumers are the ships, trucks and trains that move parts along a global production process and finished goods to market. Container vessels are running at capacity, pushing ocean cargo rates to record highs and clogging up ports.

Executives at A.P. Moller-Maersk A/S, the world's No. 1 container carrier, say they see only a gradual decline in seaborne freight rates for the rest of the year and they don't expect a return to the ultra-cheap ocean cargo service of the past decade. HSBC trade economists estimate that the surge in container rates over the past year could raise producer prices in the euro zone by as much as 2 percent.

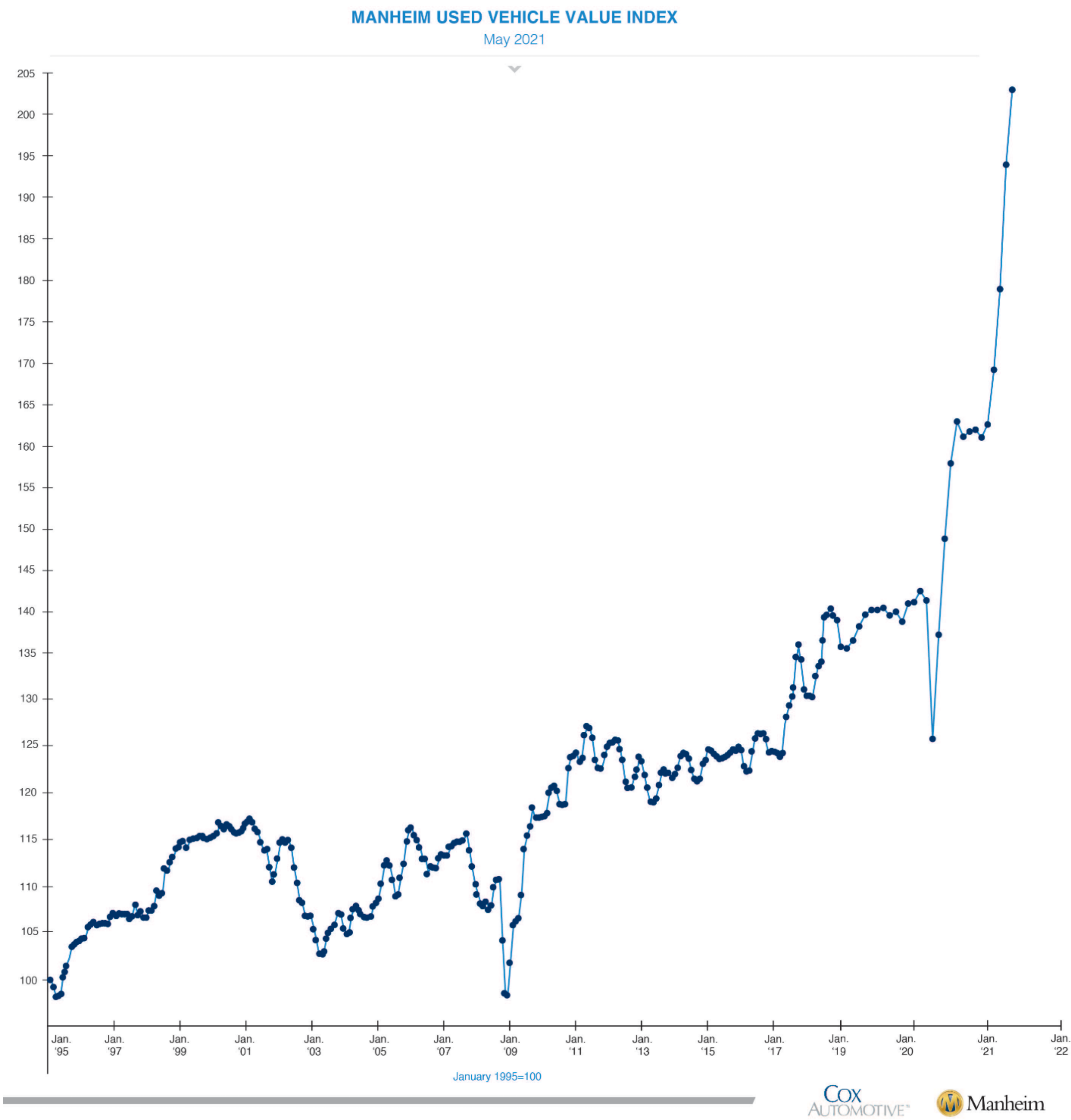
Rail and trucking rates are elevated, too. *The Cass Freight Index measure of expenditures* reached a record in April — its fourth in five months. Spot prices for truckload service are on track to rise about 30% this year compared with 2020, according to Todd Fowler, a KeyBanc Capital Markets analyst in a May 10 note.

"We expect pricing to remain elevated given lean inventories, seasonal demand and improving economic activity, all of which is underpinned by capacity constraints from

truck production limitations and driver availability challenges." Todd Fowler told Bloomberg News.

Perhaps more importantly, business owners are also facing higher wage costs as qualified labor is becoming an increasingly rare commodity. The NFIB reports that a record 44% of small businesses have unfilled positions, and over half of those with job openings reported that there were few or no qualified applicants.

RECORD PRICES FOR USED CARS



Record prices for used cars and trucks were the biggest contributor to inflation last month, according to the government's Consumer Price Index report.

Prices for used vehicles surged 7.3% just last month, following an even bigger 10% gain in April. Why are the prices of used vehicles skyrocketing? In short, there are more people buying cars than there are cars in the market. New car trade-ins are usually the biggest source of used cars, but supply chain disruptions, especially a widespread of specialty semiconductors used by auto manufacturers, have limited availability of new vehicles—causing prices of scarce used vehicles to catapult higher.

The Manheim Vehicle Value Index, a widely followed industry yardstick shown in the chart, was described by industry observers as "shocking."

All of this is stressing networks, creating bottlenecks in the supply chains and capacity constraints according to Lee Klaskow, senior analyst at Bloomberg. This is exactly the kind of news that Wall Street usually hates and that has slammed stock markets in the past. But this time Wall Street hasn't hit the panic button. Perhaps that's because investors are now separating out core inflation caused by too much money in circulation from the effects of the pandemic reopening.

Throughout the economy, supplies are tight as the reopening gains steam and boosts demand for everything from cars and trucks to furniture and electronics to construction materials. Some of that will no doubt abate in the months ahead as producers begin to meet demand by leveling out their supply chains.

Bottom Line

The prospect of a fully reopened economy, coupled with the past year of strong stock market returns, has pushed growth expectations considerably higher. The U.S. consumer is re-engaging in the economy – and they are also in a good financial position to do so. Many investors are wondering if everything has moved too far, too fast. Surging demand has upended global supply chains, limiting supplies and creating an inflationary environment. So far this year it has not upended the stock market. Certain growth areas of the market that should struggle during times of inflation have actually outperformed over the last month. Our indicators have continued to be positive, giving us reason to be more risk-on in certain portfolios. We will not try to predict or guess when the market will eventually correct, we'll wait for the evidence to unfold and react. Being in the right areas of the market will continue to be as important as ever. *Stay tuned…*

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