



The Long & Short of It

Quarterly Newsletter
Third Quarter 2021

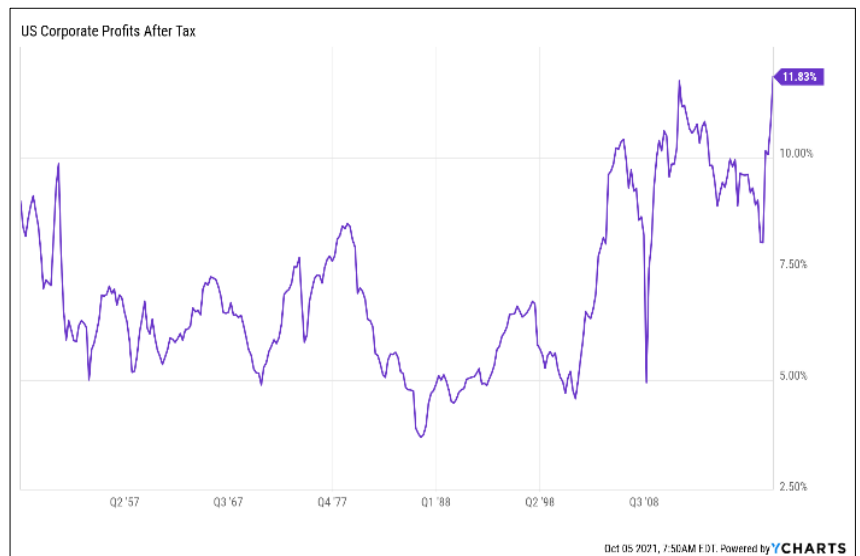
Goldilocks Worries: “Have I Stayed Too Long?”

As cooler weather arrives, Americans look forward to changing leaves, outdoor activities, and holidays with family. Washington shifts its focus to budgeting, planning for the collection and allocation of tax revenues and bringing home the bacon for their districts.

Uncertainty surrounding the budget process often scares the stock market. After the spending spree and money print-a-thon that prevented the normal contraction that one would expect in a pandemic, it may be difficult to engineer and maintain a soft landing. Inflationary pressures and an activist Federal Reserve, combined with limitations on the government’s ability to continue to increase spending, should create a dynamic and somewhat unpredictable environment for stocks over the near term.

After a strong start to the year, the third quarter of 2021 saw a downward turn in investor enthusiasm. The S&P 500, while up 15.9% year to date through September 30, only picked up 0.6% during the quarter after losing 4.7% in September. By contrast, the consumer price index (CPI), the most common measure of inflation, demonstrated robust growth at a 5.3% increase over the past year ending August 31.

Second quarter corporate profits after tax came in at an unusually high 11.8% of GDP. So far, corporations appear to be benefiting from the late-pandemic resurgence in economic activity. This strength may be attributable to the natural dynamics of a pandemic, the largess of the Treasury/Federal Reserve, or simply the typical time lag after a rise in inflation before it impacts earnings. If current stock market price levels are to be maintained, profitability will need to sustain and/or rise further. Expectations for profits to remain strong are high as Jerome Powell has investors convinced that inflation is transitory and our economy will soon return to a “just right” Goldilocks pace—albeit just a bit faster due to his promise of the higher 2% average rate of inflation.



A variety of news impacted stock performance during the quarter, especially in September. Concerns over tightening monetary policy, continued microchip shortages, container ships’ inability to unload cargo, rising energy prices, and increased transportation costs weighed on markets. In addition, concerns over China—its crackdown on tech companies, real estate failures, and impending energy shortage—created uncertainty for investors and further stressed global supply chains and prices. In yet another indication that this economic cycle may be winding down, wages rose. These and many other bits of bad news are expected to impact the margins and profitability of publicly traded companies in the quarters to come, though to what extent has yet to be determined.

In the short run, barring some exogenous event, the most important thing for investors appears to be the ability of government spending and the current budget process to perpetuate the Goldilocks economy.

But Wait, Weren't There Three Bears?

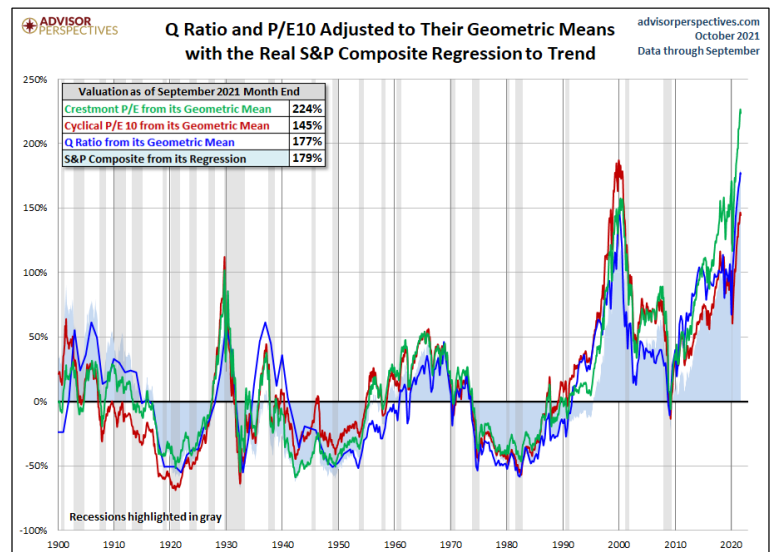
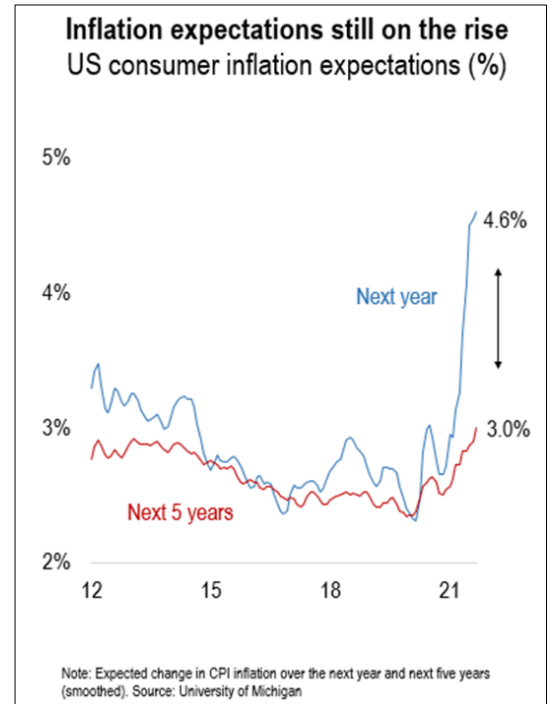
Papa Bear just might return. As the story goes, he liked his porridge "very hot." While inflation may be transitory this time as Chairman Powell boldly promises, it is typically intransigent. Crude oil prices affect the prices of nearly everything in our modern economy, from parts to packaging and transportation. As demand for crude oil continues to grow and reserves do not (they have been stable since 2013), its price may rise further or at least not come down quickly. Owner equivalent rents, now 24.3% of the Consumer Price Index, also seem poised to drive inflation higher as rising home prices push rents up over the coming year. In addition, wage rates are also on the rise, now 4.6% higher than a year ago and continuing to accelerate. Expectations of future inflation (see chart) reflect a growing recognition of these trends, although government officials and promoters of the promise of Goldilocks still envision the always successful management of the economy.

Unlike Papa Bear, Mama Bear liked cold porridge. As the excessive pandemic spending winds down, the growth of federal government spending should slow or even reverse, making economic growth and earnings more difficult to come by. The Congressional budgeting process will determine the eventual trajectory. However, federal government deficit spending estimated at 16.7% of GDP this year is projected to drop to 7.8% next year. Any normalization of spending after the pandemic spending spree could be very detrimental to economic growth and earnings, but without some normalization, inflation appears likely to become a problem.

And what of our third bear? Baby Bear is currently trading meme stocks through Robinhood. Stock market valuations are unsustainably high by so many different measures. They remain attractive as other investment alternatives are scarce and uncertainty has been tamped down in response to COVID. There is no way to use excessive valuations as a timing tool, as bull markets typically last longer than most investors can imagine. But, as much as the pandemic drove stock prices higher by giving us a reason to stimulate during a period of price deflation (a recipe for blowing bubbles that Powell seems to ignore), falling stock prices may bring all of the bears home at once. This would yield a period of slow growth with higher inflation (i.e., significantly negative real growth and wealth destruction).

The Feds Choose the Bowl

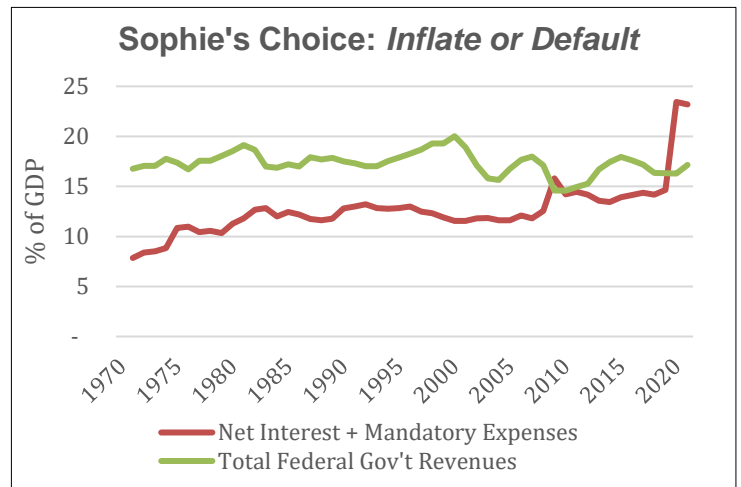
With total government revenues now providing fewer funds than mandatory expenses plus interest on the debt, (see chart on next page) the federal government faces an increasingly stark choice. If Congress will not reduce the mandatory obligations of our government through new legislation, it will be forced to either default on those obligations or continue to honor them and print the money with which to do so. Deficit money printing is the historic formula for currency devaluation and inflation, and it is the path Washington has selected thus far. Until recently, investors have turned a blind eye, hoping inflation is temporary and terminates upon the resolution of





COVID-19. But both money printing and COVID-19 now appear to be endemic. We may just have to learn to live with them.

We appear to be in a perfect environment for high stock market prices: easy money, a bit of inflation accompanied by the perhaps irrational perception that it is under control, GDP propped up by unprecedented government spending, and a Federal Reserve that accommodates the Treasury's debt issuance with large purchases of whatever the Treasury offers. Common sense suggests this will likely change, but knowing exactly when is impossible.



The stocks of industry leaders with clean balance sheets, strong and durable competitive advantages, and significant barriers to entry, make for good, solid holdings. With these types of securities, volatility is certain but risk is carefully calibrated for the purpose of sustaining and growing wealth in a prudent way. Fear of permanent loss or giving up your wealth to the ravages of inflation is thus minimized. Shareholders own part of the means of production that would be required in nearly any economic outcome. With confidence about the long run, we can make volatility our friend. There will always be cycles, and in them the market tends to overreact, thereby providing buying opportunities to calm and resolute investors.

Amy Abbey Robinson, CIMA®
amy@robinsonvalue.com

Charles W. Robinson III, CFA®
charles@robinsonvalue.com

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