Investment Commentary

April 16, 2021

The economy continues to slowly reopen as we put the worst of the pandemic behind us. A number of factors are coming together that support a brighter economic outlook. But we will not be going back to the same economy we had before the pandemic. It will be different economy and not everyone will benefit from the recovery.

The Economy

The economic outlook is improving but mixed. Unemployment is still high and many businesses remain closed. Pent-up demand in coming months will provide a boost to the economy on a short term basis. And the small business sector will not ramp up as quickly as large companies. The overall economy will be favorable this year and likely into next year. But there is concern the sub-par growth of the past 12 years will return once the stimulus wears off.

The massive government stimulus is providing a boost to the economy in the short term. And there is the possibility of an infrastructure spending package in coming weeks/months providing an additional boost.

Inflation Expectations

Inflation concerns have risen lately due to the stronger economy. But any increase in the rate of inflation will be short-lived. It has been below 2.0% for the past 12 years while the historical average is 3.0%. The Federal Reserve's goal is a steady rate close to 2.0%.

In another day and time, the onset of recession would result in policies of lower interest rates, lower taxes and higher government spending. And then those policies would be reversed when the economy started to recover. If not, the result is higher inflation.

Since the financial crisis of 2008/09, there has been a perpetual state of low interest rates, low taxes and ever higher government spending. Economic growth has been modest and deflation has been a concern due to the low inflation rate.

Many governments now pursue policies referred to as "Modern Monetary Theory" (MMT) which is a departure from traditional economics. In effect, countries that have their own currency can run deficits to grow their economy to full capacity. As long as there is unused economic capacity or unemployed labor, increased government spending will not create more inflation. And inflation can be controlled by spending less or increasing taxes. While the jury is out over the effectiveness of MMT and economists debate the issue, many governments have quietly adopted MMT policies. And since the economic crisis of 2008/09, MMT Theory has proven to be correct. The problem with MMT is that it might not work when inflation takes hold and interest rates move up. But that is a problem that is years if not decades away.

Many factors have an effect on inflation and it is difficult to see higher than normal inflation over the next several years. This year, inflation will increase due to the effects of an economic recovery. But this increase will likely be closer to the normal rate of inflation, or 3.0%. The current discussion about inflation focuses more on the effect of higher interest rates on stock and bond markets than the actual cost of living. In the near term, inflation will not increase much and only for a short period of time. The bond market has built in expectations of inflation at 2.15% on average for the next 10 years.

And while inflation will increase this year, the Federal Reserve will not increase short term interest rates. Increases are likely on hold until 2023 at the earliest.

The Stock Market

The U.S. stock market has performed well and is up over 10% year to date. Small cap stocks have outperformed large cap stocks and the value style has outperformed the growth style. This is typical during an economic recovery.

With an environment of improving economic growth and higher interest rates, the value style and small cap stocks have performed well in recent months as the growth style has underperformed. However, as it has for the past several years, the value style will perform well for a short period of time then fizzle out. In the last few weeks the rally in value stocks appears to have slowed down as growth stocks are regaining their dominance.

Growth stocks are overvalued and performance continues to be driven by the same handful of stocks (Amazon, Apple, Google, Microsoft, Tesla, etc.). And the value style has been driven primarily by what are known as "cyclical" stocks which respond to growth in the economy.

Speculation in the stock market has increased dramatically since the start of the pandemic. Amateur investors are buying "stocks that go up" in a manner similar to what we saw in the late 90's with internet and technology stocks. This will end badly at some point but probably still has much further to go. In the meantime the speculation will continue to drive the stock market higher.

International stocks continue to underperform U.S. stocks. The vaccine rollout in Europe has not gone well which is slowing their economic recovery. And many developing countries are far behind in obtaining a sufficient supply of vaccine. But international stocks in general continue to be undervalued as compared to domestic stocks.

The Bond Market

The yield on the 10 year U.S. Treasury note recently moved up as high as 1.75% after starting the year at .92%. This is a big move in a short period of time but the rate is still lower than it was prior to the start of the pandemic. Rates may drift higher in coming months but not significantly.

So far this year investment grade bond funds are down about 3.0% or so. Some of the multi-sector bond funds I follow are slightly outperforming the overall bond market. As the year progresses and bond funds receive interest payments, the rate of return will improve.

Real Estate

It continues to be a seller's market for residential real estate. Over coming months, the shortage in housing inventory should ease somewhat. Homeowners have been reluctant to move during the pandemic but that is starting to change. And homebuilders are ramping up construction of new homes.

Prices are rising rapidly as buyers compete for a limited number of homes. And large, expensive homes make up a greater share of home-building activity.

Cryptocurrency

Coinbase Global Inc, the first major cryptocurrency-based company to go public, debuted on Wednesday. It surpassed a valuation of $100 billion on its first day of trading and ended the day valued at $85 billion. And all the company does buy and sell crypto.

The company is most certainly overvalued at these levels and potential investors should be hesitant to buy the stock. And there is no doubt that since the company is based on the value of cryptocurrencies, there will be wild swings in the price of the stock. Calculations of potential profits indicate the valuation should be closer to $19 billion rather than $100 billion.

U.S. regulators have been skeptical of cryptocurrencies since they are used by criminals to launder money. And even Fed Chairman Powell hesitates to call them currency since they are rarely used to purchase goods and services. He believes they should be thought of more as “crypto-assets” since they are really vehicles for speculation.

There is a “feeding frenzy” in the stock which should persist for a period of time. But there will certainly be a substantial pullback at some point. Ultimately, the stock will be extremely volatile and is best left for those who engage in speculative trading.

Cryptocurrencies have gone up to wildly extreme levels. And some prognosticators are saying prices will go even higher. That could be the case but it is hard to understand what is driving these extreme valuations. They will eventually come back down to earth and those who bought in at the current levels will suffer big losses.

Overall Perspective
We are getting closer to the end of the pandemic and there are reasons to be optimistic about the economic recovery. Investment portfolios should continue to perform well for the next several months.