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Economic and Market Outlook

March 31, 2021

The Sun Will Come Out Tomorrow

Whip Inflation Now
- President Gerald Ford (1974)

Section I. Inflation

The financial media has been talking a lot about inflation lately. The U.S. Government policy from 1974 that promoted voluntary disciplined spending and greater savings to bring inflation down from 12.3% is now forced upon us because of the pandemic. The Federal Reserve is now trying to do everything it can to achieve a 2% inflation rate. Currently the Consumer Price Index (CPI) is 1.7% on an annual basis, and core CPI is even lower, at 1.3%. The last time we had a reading above 2% for the CPI was February 2020 and for core CPI it was March 2020, not coincidentally right when the pandemic began. Why? People could not go out and spend money. Chart #1 is the personal savings rate for the U.S. After averaging about 7% from 2000 to 2019, it peaked in April 2020 at 33.7% and the reading for January 2021 was 20.5%.

Some bit of inflation is not a bad thing. Milton Freidman, American economist and winner of the Nobel Prize in 1976 said,

> "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output. ... A steady rate of monetary growth at a moderate level can provide a framework under which a country can have little inflation and much growth. It will not produce perfect stability; it will not produce heaven on earth; but it can make an important contribution to a stable economic society".

- *The Counter-Revolution in Monetary Theory* (1970)

The fear is that inflation will spike once the country opens up again. We agree that there may be a momentary spike but it will not be sustained. Between the $1.9 trillion stimulus package and pent up demand from the lock down, a spike in inflation is certainly possible, but it will be temporary. Remember the definition of inflation;

> ***Inflation:*** *A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of goods and services.*

The key word here is persistent. That is why we believe inflation will not be a long term problem.

Section II. Interest Rates

The financial media has also been very focused on the rise of interest rates. We have been spoiled by historically low rates through the pandemic. The reality is that historically, rising interest rates accompany a strengthening economy. In addition the ultra-low rates we have experienced hurt savers and retirees.

We believe the rise in rates is slowing. A 2% 10 year note is still very low historically and there other factors that should limit the climb moving forward. Japan has been a net seller of U.S. Treasuries for the last 5 years. Japan may be come net buyers of U.S. Treasuries because of the recent rise in rates. This is because the recent rise in the 10 year yield combined with currency hedging costs collapsing makes the U.S. 10-year bond much more attractive to Japan. In addition Chart #2 implies an oversold condition for the 10-year Treasury in general, showing a reversion to the mean would support price and help hold rates down.

Section III. The Recession Model

As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions are the major reason you see corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and can happen multiple times each year.

But how can we attempt to predict which is happening in real time?

We have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below the 40 week moving average, this is a very strong indicator that a recession is near or may be already underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of February, the unemployment rate was 6.2% and the 12 month moving average was 8.57%. Therefore this indicator is positive. It is also important to note that if the unemployment rate remains around 6% or lower for the next 6 months it should remain positive.

Indicator number two is represented in Chart #3. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. As you can see, the Covid-19 shut down had a major effect on this index in early 2020. This indicator bottomed in April 2020 at -20.2% and had recent high of 4.6% in September 2020. Currently the reading is 4.5% for February, so this indicator is positive. Any reading above 0 is positive.

Indicator number three is represented in Chart #4. This shows the year over year change in Industrial Production. This indicator bottomed in April 2020 at -16.3%. Even though the reading has steadily improved, it was still -4.2% in February 2021. This indicator remains negative.

For indicator number four (Chart #5), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator has dropped in the last couple of months and stands at –3.73%. A zero reading represents neutral therefore this indicator is also negative.

Indicator number five (Chart #6) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Once again, this indicator bottomed back in April 2020 at -7.69%. Currently the reading is –1.19%, so while improving, this indicator also remains negative.

Currently three of the five indicators remain negative but the S&P 500 Index is 10.70% above its forty week moving average. As long as the S&P 500 is above the forty week moving average this model is not giving any warning signs.

These indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we use three month moving averages as our indicators.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average sits at -0.46, and the divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average sits at 0.47.

Therefore the two "early warning signs" are not predicting recession at this time, but they are not very strong either.

Section IV. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently all of the price/volume indicators remain positive including the indicator where we weight negative volume greater than positive volume. We track this indicator because historically markets correct faster than they rise.

Our advance/decline line remains positive as well as our model that measures the first and second derivative on price and volume. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data.

Section V. Covid-19

Vaccinations continue to roll out to the public and we believe that by the summer the lockdowns will come to an end. While there are some variants of the coronavirus appearing, most the vaccines seem to be somewhat effective against them. With the speed at which vaccinations can now be developed with these platforms, booster shots for these variants will probably be quickly developed if needed. We remain hopeful but vigilant.

Section VI. The Economy

Indexes that measure manufacturing data have had readings recently that are off the charts. The Philly Fed Manufacturing Index hit nearly a 50 year high in March, with a

reading of 51.8 (0 is the line for growth or contraction). The Empire Manufacturing Index hit an eight month high of 17.9 (0). The national ISM manufacturing index reached 60.8% (above 50 is considered growth, above 55 is considered exceptional growth).
If the lockdowns do end as expected, the service sector should quickly match the growth in manufacturing and lower the unemployment rate. Multiple Wall Street and Federal Reserve predictions for GDP range from 6% to 7% for 2021. We believe this bodes well for investing.

Section VI. <u>Conclusion</u>

With the conclusion of the electoral process we now have a clearer understanding of which sectors to focus on for investment opportunities. We continue to research, looking for opportunities for future investment with an emphasis on balanced portfolios. We remain cautiously optimistic moving forward on both the economy and the stock market long term.

Scott B. Williams, CFA, CFP
Kent Stone

CHART #1

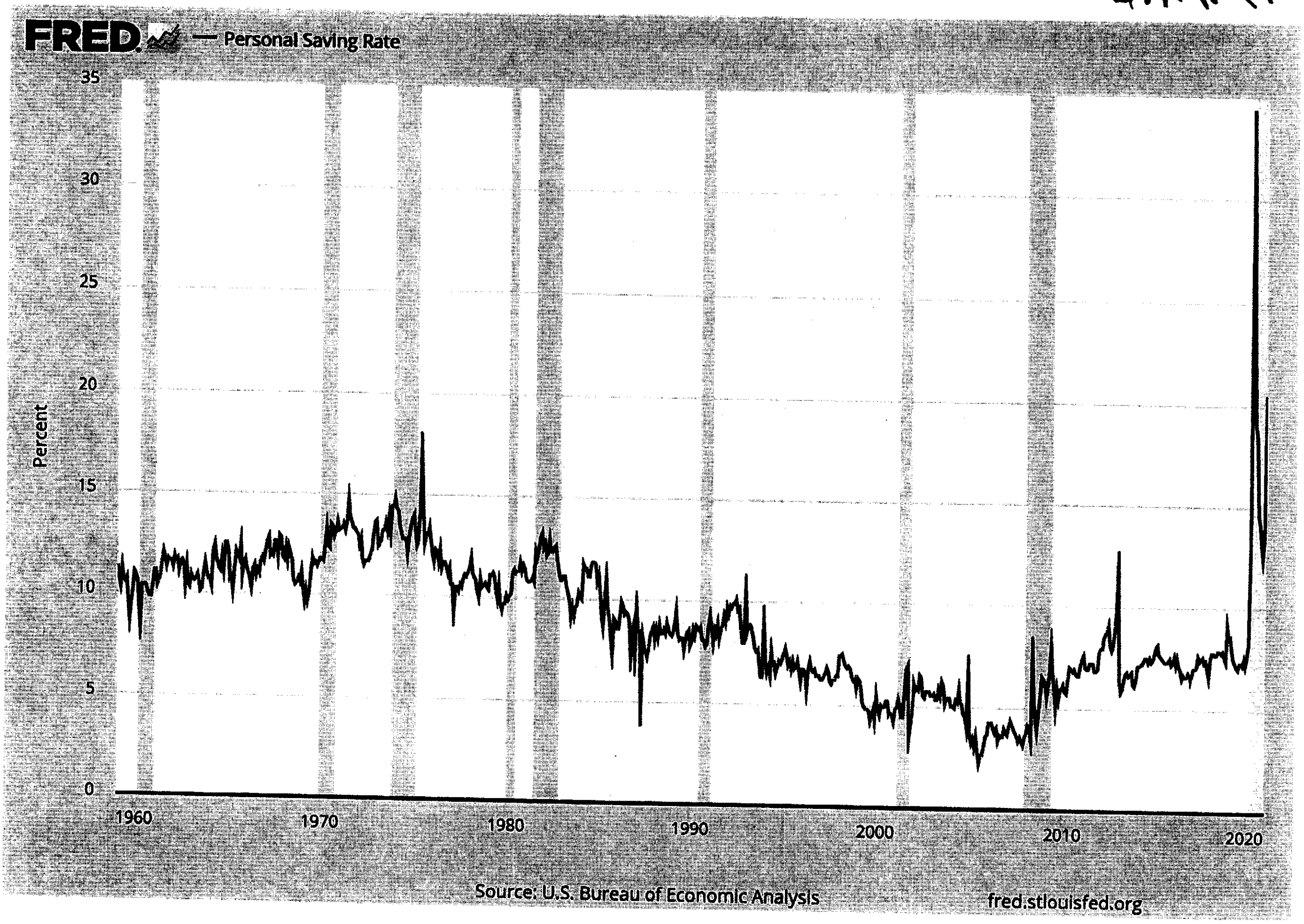
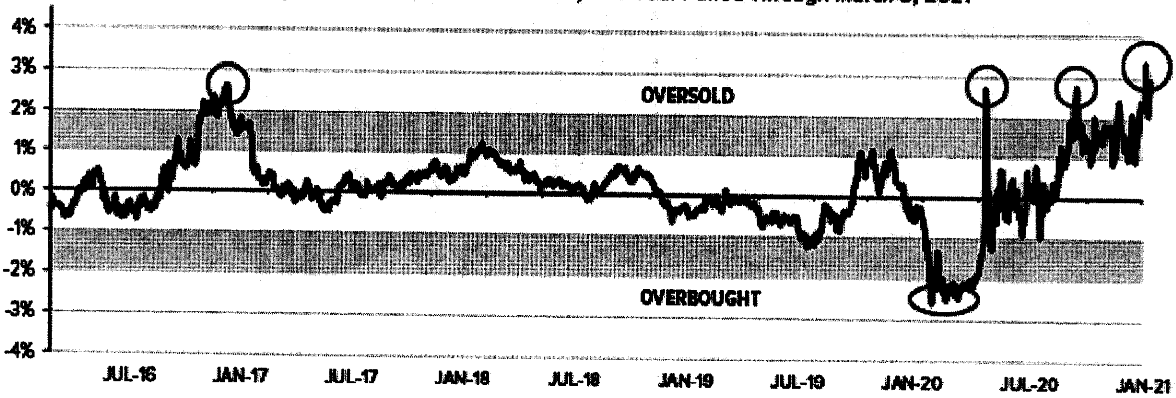


CHART #2

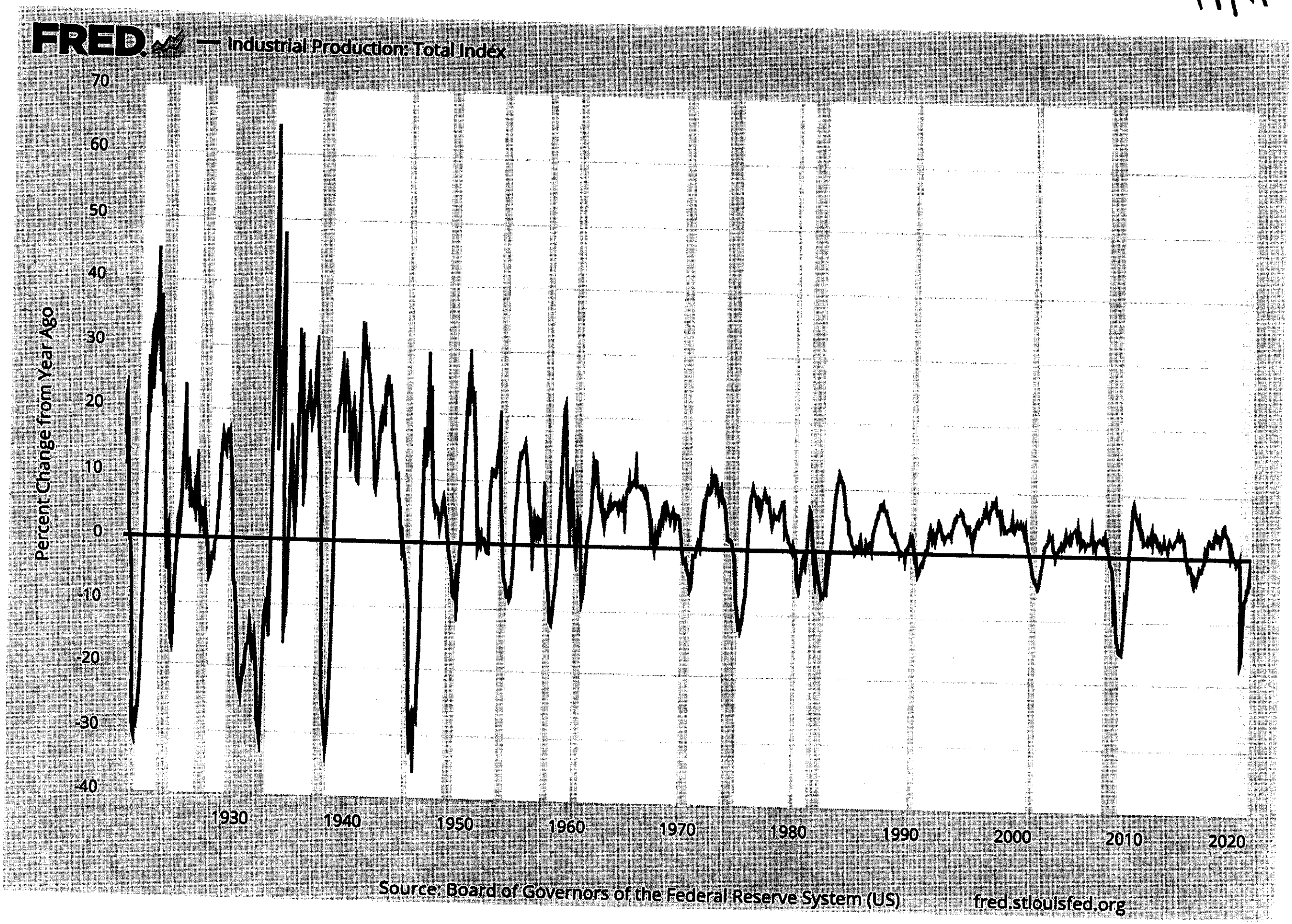
Bond Selloff Looks Overdone, Ready to Revert to the Mean

10-Year Treasury Yield 60-Day Standard Deviation Oscillator, Five-Year Period Through March 5, 2021



Source: Bloomberg, U.S. Global Investors

CHART #3



FRED
Industrial Production: Total Index
Percent Change from Year Ago
70
60
50
40
30
20
10
0
-10
-20
-30
-40
1930
1940
1950
1960
1970
1980
1990
2000
2010
2020
Source: Board of Governors of the Federal Reserve System (US)
fred.stlouisfed.org

CHART #4

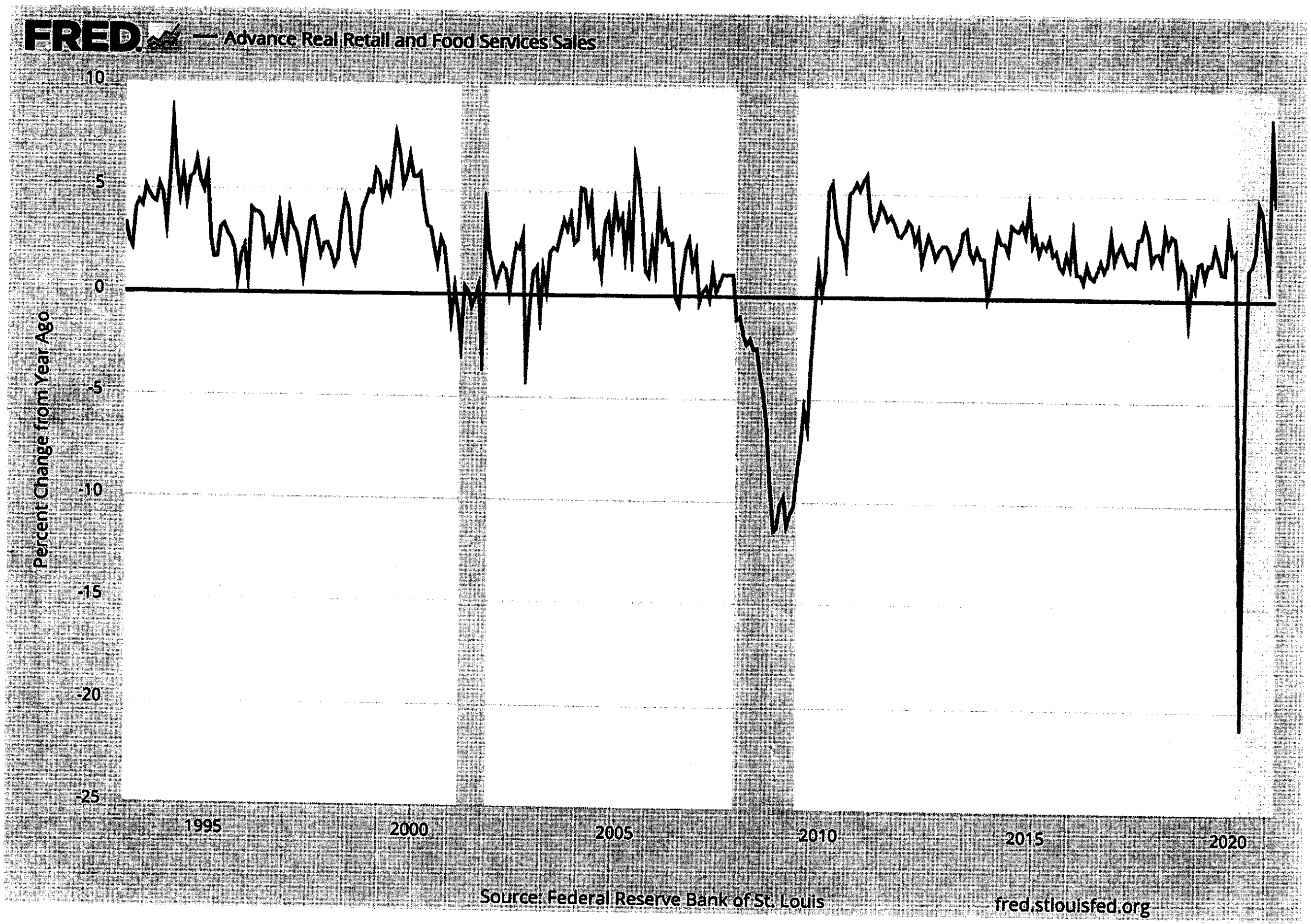

FRED
Advance Real Retail and Food Services Sales
Percent Change from Year Ago
10
5
0
-5
-10
-15
-20
-25
1995
2000
2005
2010
2015
2020
Source: Federal Reserve Bank of St. Louis
fred.stlouisfed.org

CHART # 5

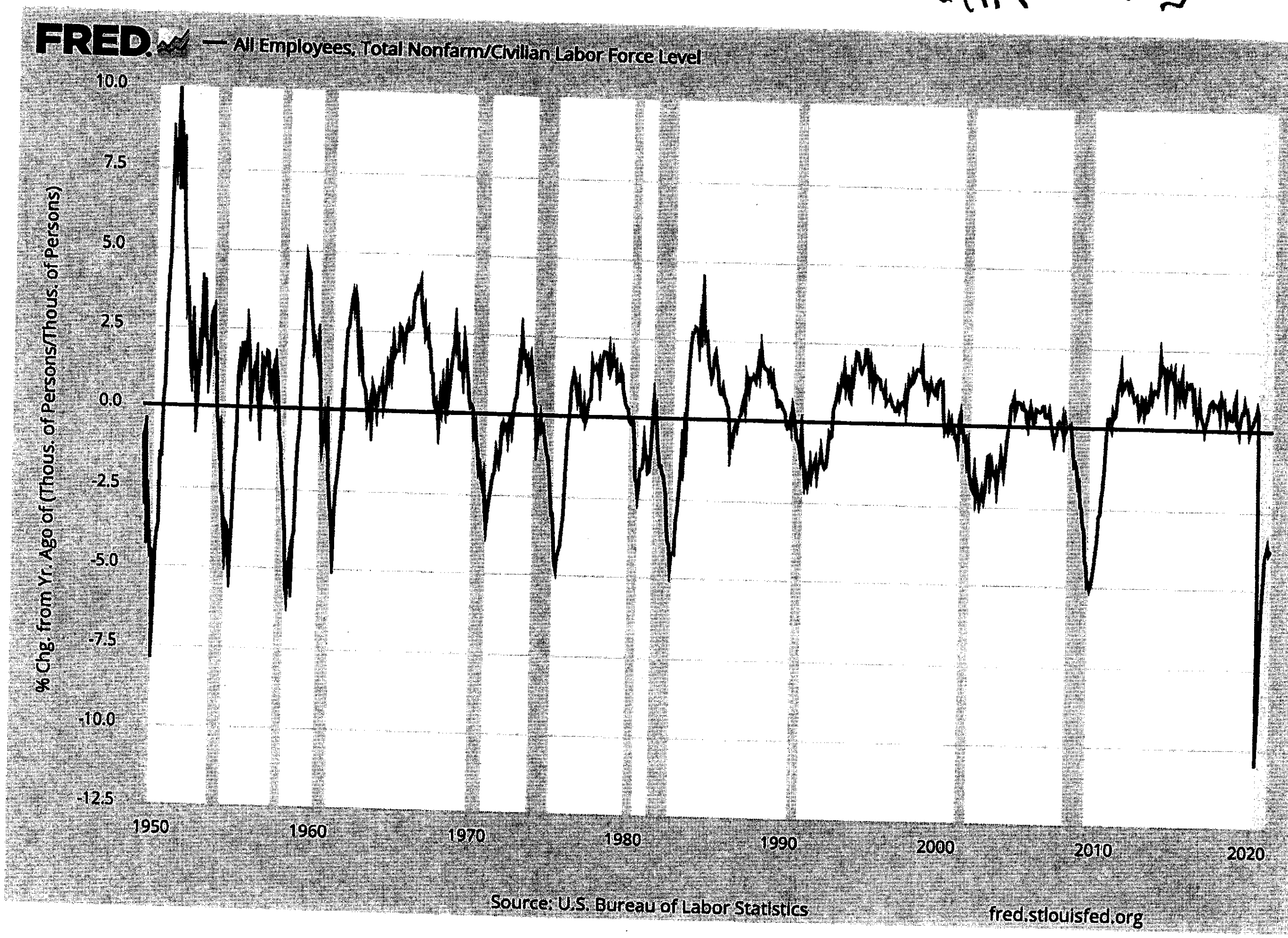
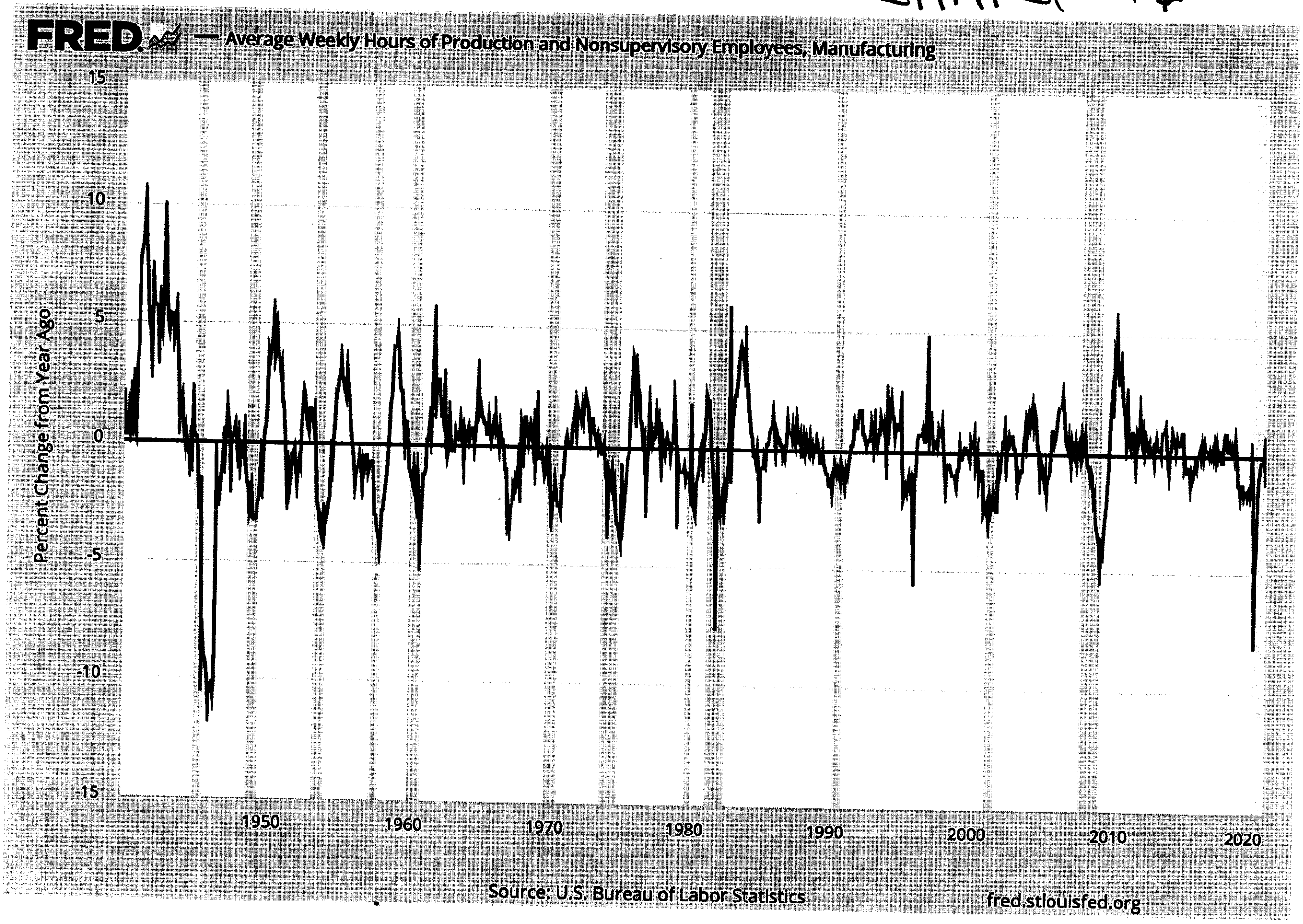

FRED
All Employees, Total Nonfarm/Civilian Labor Force Level
% Chg. from Yr. Ago of (Thous. of Persons/Thous. of Persons)
10.0
7.5
5.0
2.5
0.0
-2.5
-5.0
-7.5
-10.0
-12.5
1950
1960
1970
1980
1990
2000
2010
2020
Source: U.S. Bureau of Labor Statistics
fred.stlouisfed.org

CHART #6


FRED
Average Weekly Hours of Production and Nonsupervisory Employees, Manufacturing
Percent Change from Year Ago
15
10
5
0
-5
-10
-15
1950
1960
1970
1980
1990
2000
2010
2020
Source: U.S. Bureau of Labor Statistics
fred.stlouisfed.org