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Economic and Market Outlook

September 30, 2021

Tis the Season…for Volatility

"In the short run, the market is a voting machine but in the long run,
the market is a weighing machine"
- Benjamin Graham

Section I. Volatility

Benjamin Graham, the author of The Intellegent Investor and the Father of modern investment theory, fully expected investors to experience volatility. The above quote really means that short term movements in the market can be influenced by many different and mostly irrelevant news stories of the day, but the investor measures his success over the long term. Volatility comes from the news of the day and traders reacting to that news. With proper analysis of individual equities, an investor will, over the long term, benefit from time, patience and unemotional decision making.

History shows that for the last fifty years September has been the worst month with a -0.61% return on average. Most casual observers might think that October is the worst month because of historical market crashes of more than 10%. The fact is it only happened 4 times in 95 years (1929, 1932, 1987 and 2008). September's positivity rate is 52.6% versus October's 63.1% since 1925.

The market historically has three 5% corrections and one 10% correction a year on average. This calendar year, however, we have not experienced any 5% corrections. In addition, a 500 point move in the Dow Jones Industrial Average (DJIA) does not carry the same weight as it did 10 years ago. At that time the DJIA was at 9712.28, meaning a 500 point move was 5.15%. Today that same 500 point move is only 1.4%. Hearing moves of such a large numbers still catches investors' attention.

Short term movements in the market should not influence investment decisions. We will continue to base our decision making on sound earnings and economic analysis to determine possible major turns in the market, and filter out the short term emotions of the market.

Section II. Inflation

The readings for inflation have continued to increase. Currently the Consumer Price Index (CPI) is 5.2% on an annual basis, and core CPI, which excludes food and energy, is at 4.0%. This is well above the Federal Reserve's 2% target. While the pandemic has dragged on, consumers have spent some of their savings that they accumulated during the lockdown. This created some transitory inflation. 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%, right after the beginning of the Covid-19 lockdowns. The reading for July 2021 is down to 9.6% meaning this pressure on inflation should begin to ease.

Not all inflation is proving to be transitory though. Wages continue to rise in an effort to lure people out of unemployment. These wage increases will not roll back and it is unsure how much further they will need to rise. Costco stated in its latest earnings release that they felt increased shipping costs were permanent and inflation was between 3.5% and 4.5%. The other problem for now is that rent increases due to increased home prices normally take 18 months to be reflected in the inflation numbers.

Other areas will eventually prove to be transitory but will take longer to work out than the Federal Reserve originally expected. Semiconductor chip shortages affect many parts of the economy from vehicles to technology. The Delta variant is still keeping people from returning to work and bringing production to full capacity at factories creating shortages for many goods. In addition, the lack of enough transportation workers is exacerbating the supply shortage.

The key concern for inflation is persistent price hikes. That is why we believe inflation will not be a long term problem but it will last longer than Federal Reserve first believed. Some of the current elevated inflation rate is transitory, but some is appearing to stick for the long term.

Section III. The Federal Reserve and Interest Rates

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

The Federal Reserve announced that they are finally talking about adjusting monetary policy. Federal Reserve Chairman Jerome Powell stated at his latest press conference that the committee is considering starting to taper the bond purchases. Currently the Fed adds liquidity to the economy by purchasing $120 billion a month in government and mortgage backed bonds. Even when they start to taper, it is estimated that there is still an additional $660 billion of bonds to be purchased. In addition, Powell has made it clear that there will be no rate hikes while tapering is ongoing. The 10-year Treasury yield is back to 1.5%. This is also a reflection on inflation expectations.

We still believe the rise in rates is coming but it will happen slowly. A 2% 10-year Treasury note yield is still very low historically and there other factors that still exist that should limit the climb moving forward. Japan has been a net seller of U.S. Treasuries for the last 5 years. Japan may become a net buyer of U.S. Treasuries because of the eventual rise in rates. This is because the eventual rise in the 10-year bond yield combined with currency hedging costs collapsing makes the U.S. 10-year bond much more attractive to Japan. In addition, rates in most European country bonds remain low in comparison to the U.S.

Section IV. <u>The Recession Model</u>

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 we experience 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 <u>and</u> the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of August, the unemployment rate was 5.2% and the 12 month moving average was 6.26%. Therefore this indicator is positive.

Indicator number two is represented in Chart #2. 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. Re-opening is also having a major effect. This indicator bottomed in April 2020 at -20.2% and had recent high of 45.2% in April 2021. Currently the reading is 9.4% for August, so this indicator is positive. Any reading above 0 is positive. The reading is also normalizing which should relieve some inflation pressure.

Indicator number three is represented in Chart #3. This shows the year over year change in Industrial Production. This indicator bottomed in April 2020 at -16.3%. This indicator is positive and moderating. It currently sits at 5.9% for August 2021.

For indicator number four (Chart #4), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator has moderated because of the difficulty companies are having hiring in the last couple of months caused by the Delta variant and stands at 3.82%. A zero reading represents neutral therefore this indicator is still positive.

Indicator number five (Chart #5) 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 only 0.97%, so this indicator remains positive but also reflects how the Delta variant has elongated the economic recovery in the last few months.

Currently all five indicators are positive and the S&P 500 Index is 7.49% above its forty week moving average. As long as the S&P 500 is above its forty week moving average this model does not give any recession warning signs. It is worth noting that the spread of the Index over the moving average has decreased.

The above 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 track three month moving averages.

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 has pulled back a bit and sits at 0.65, 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 slightly weakens and sits at 0.43.

Therefore the two "early warning signs" are not predicting recession at this time, but have weakened slightly in the last three months.

Section V. <u>Market Psychology</u>

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 most of the price/volume indicators remain positive, but 4 of the 12 are starting to flash yellow. This could be indicating that some short term correction is ahead in the 5% range. Once again, these are normal and part of market volatility.

Our advance/decline line has dipped slightly below 50%. Our model that measures the first and second derivative on price and volume remains positive. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data.

Section VI. <u>Covid-19 and the Delta Variant</u>

Chart #6 shows coronavirus daily cases in the United States and Chart #7 shows coronavirus daily cases in California. Both charts clearly show the second peak caused by the Delta variant is much lower than the original peak. Merck and Pfizer are both in Phase 3 trials for an anti-viral pill to take after you contract Covid-19. While the Delta variant caused the economic recovery to pause, it is our belief that the recovery remains on track and should regain momentum in the coming months. Whether it comes from vaccines, anti-viral pills or herd immunity, lockdowns no longer seem to be in our future.

Section VII. <u>The Economy</u>

Indexes that measure manufacturing data have continued to have strong readings. The Philly Fed Manufacturing Index hit a nearly 50 year high in April, with a reading of 50.2 (0 is the line for growth or contraction). After declining for a few months because of the Delta variant, the reading rebounded in September 2021 back to 30.7 The Empire Manufacturing Index hit a high in July of 43 (0). September's still strong reading was 34.3. The national ISM manufacturing index remained elevated at 59.9% in August and the ISM services index is at 61.7% (above 50 is considered growth, above 55 is considered exceptional growth). You can see the service sector quickly matching the growth in manufacturing, and lowering the unemployment rate. Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of the Delta variant for 2021. GDPNow currently estimates GDP at 3.2% annualized for the third quarter versus the July estimate of 6.1%. Once again this is evidence that Delta has delayed, but not stopped, the economic recovery.

Section VIII. Conclusion

Mark Twain quipped in 1893's The Tragedy of Pudd'nhead Wilson "October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February." We are investors not speculators. While we always expect some volatility during this part of the year historically, we see no indication of a coming recession at this point. If history holds true, November should be the start of another uptrend but as always we will remain diligent on our monitoring of the market and the economy.

Scott B. Williams, CFA, CFP
Kent Stone

Chart #1

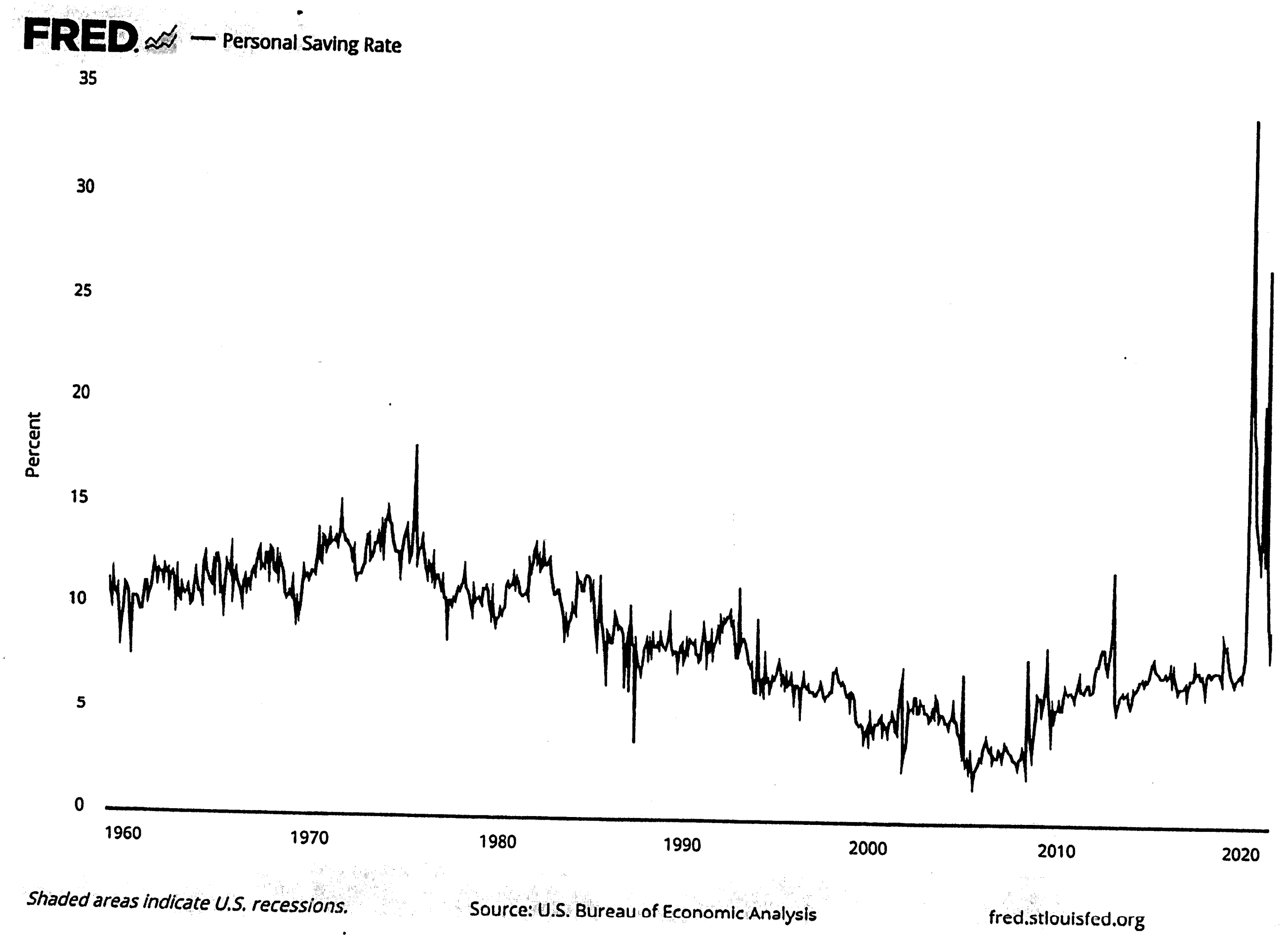


Chart #2

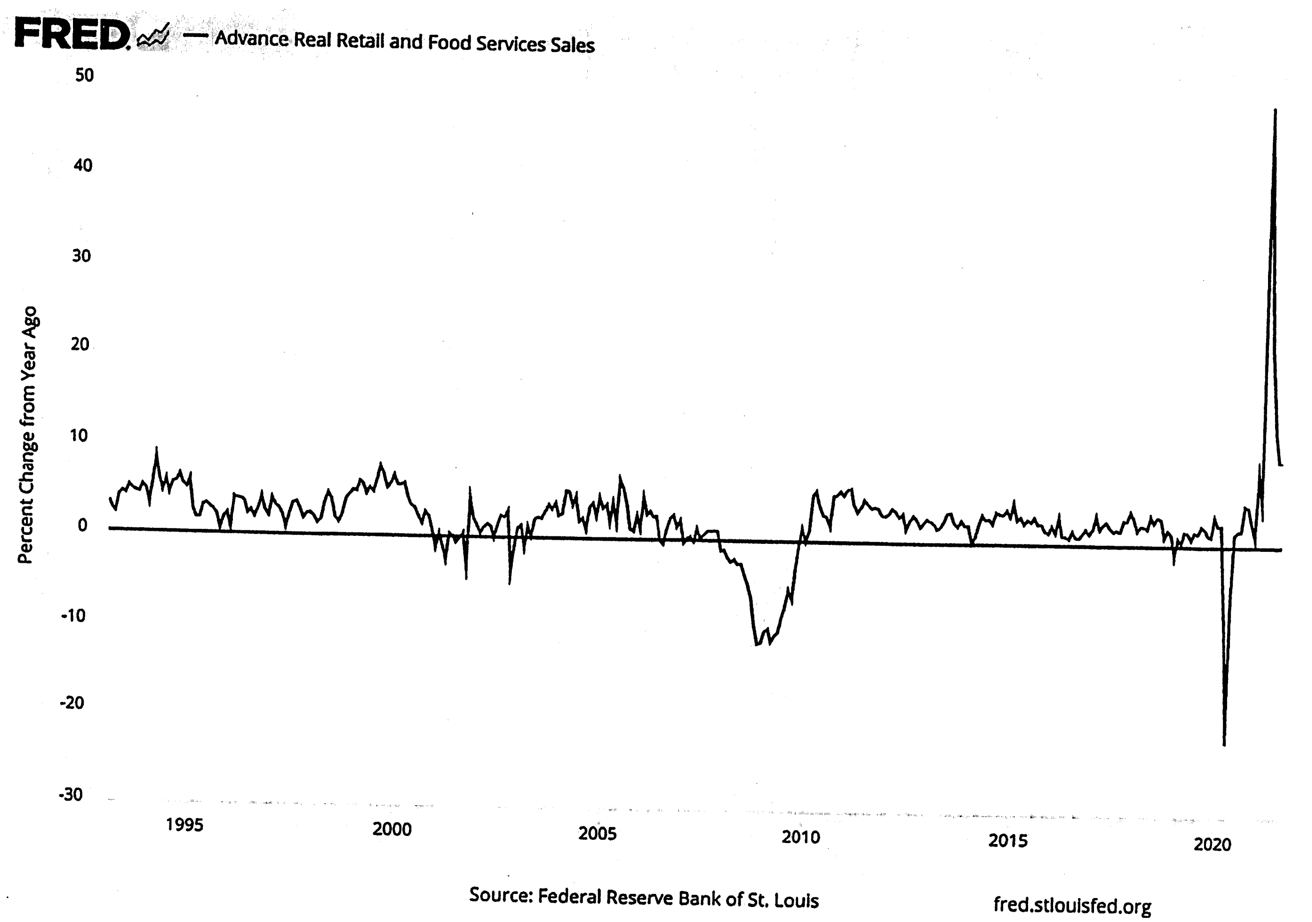


Chart #3

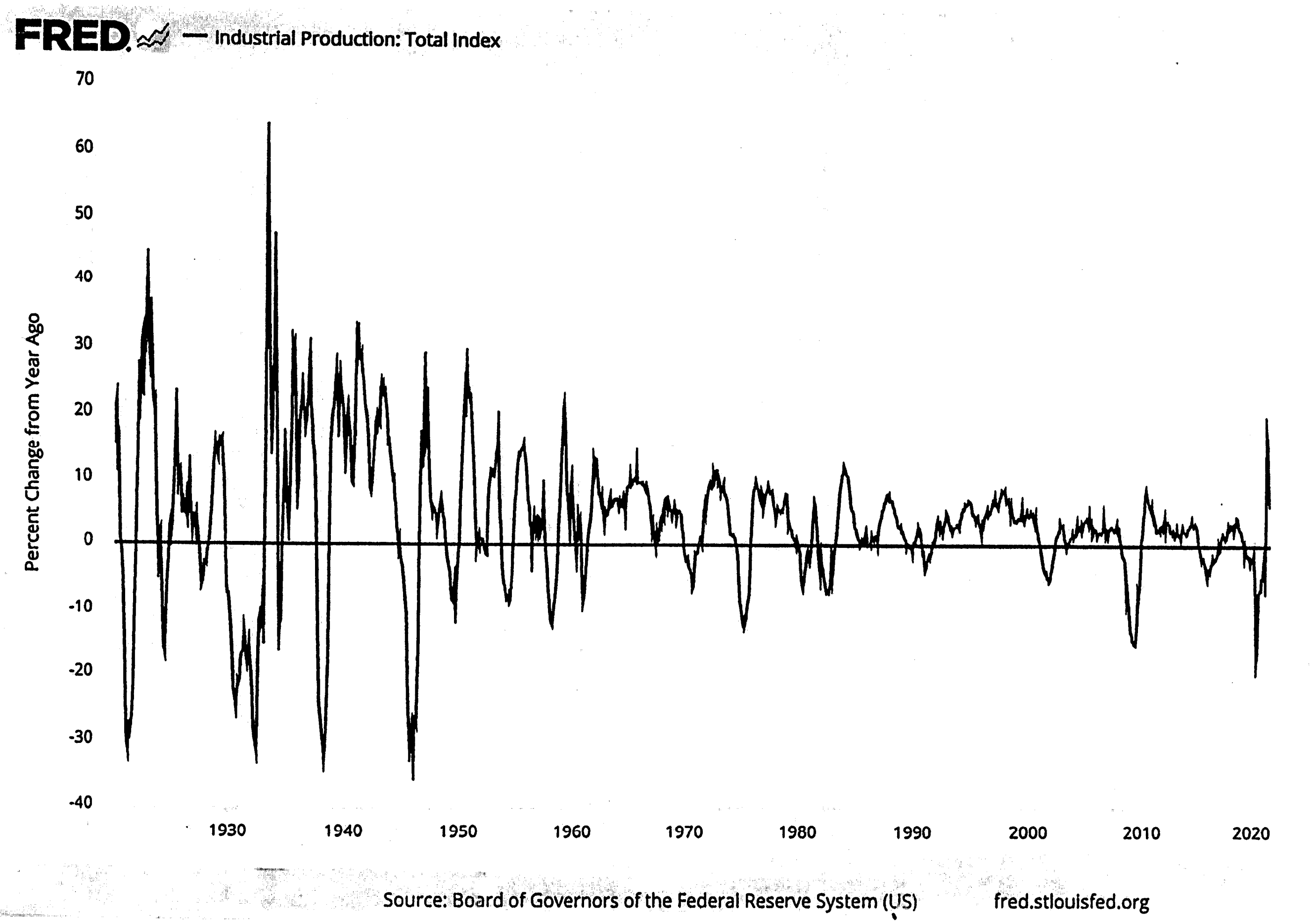


Chart #4

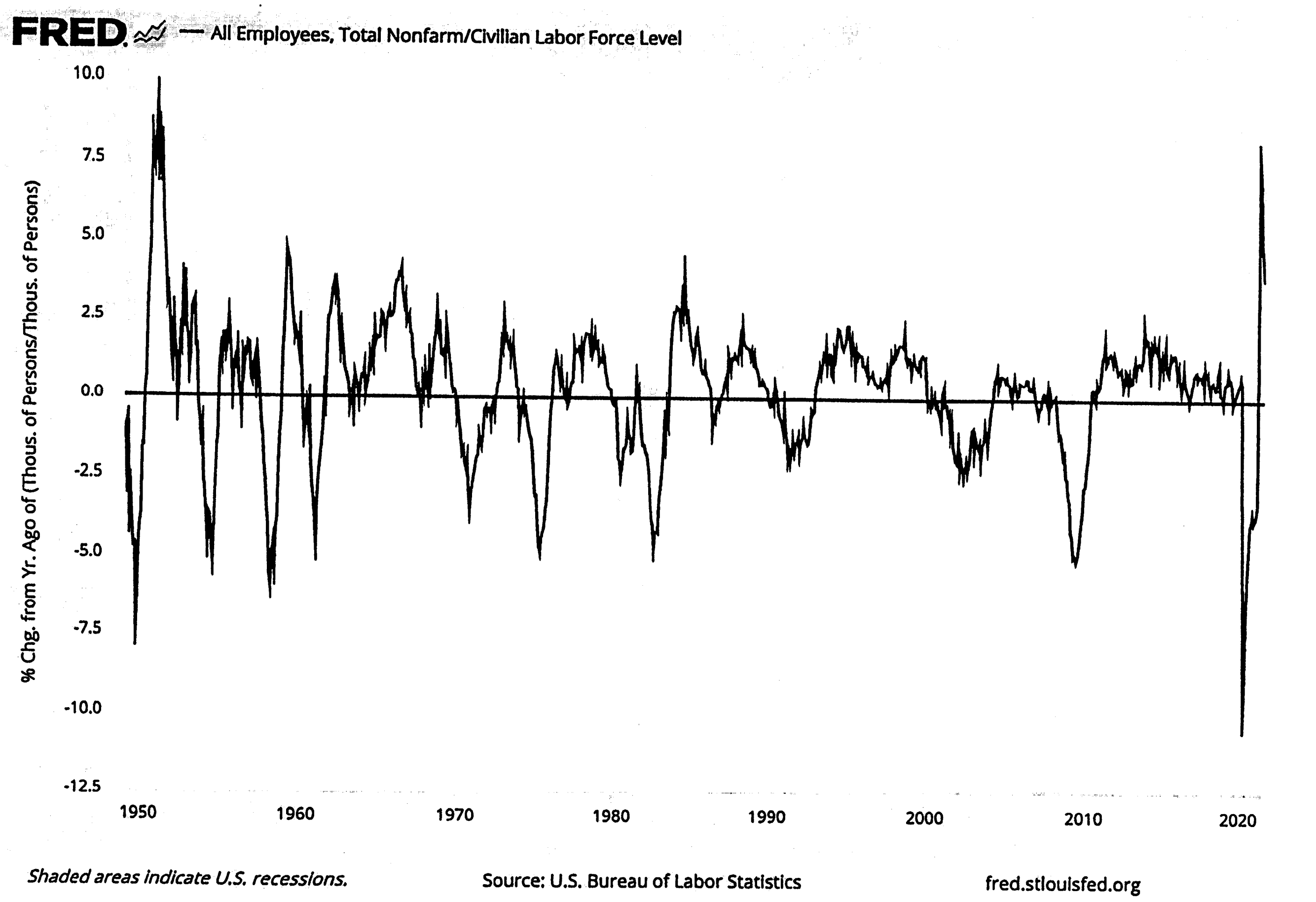
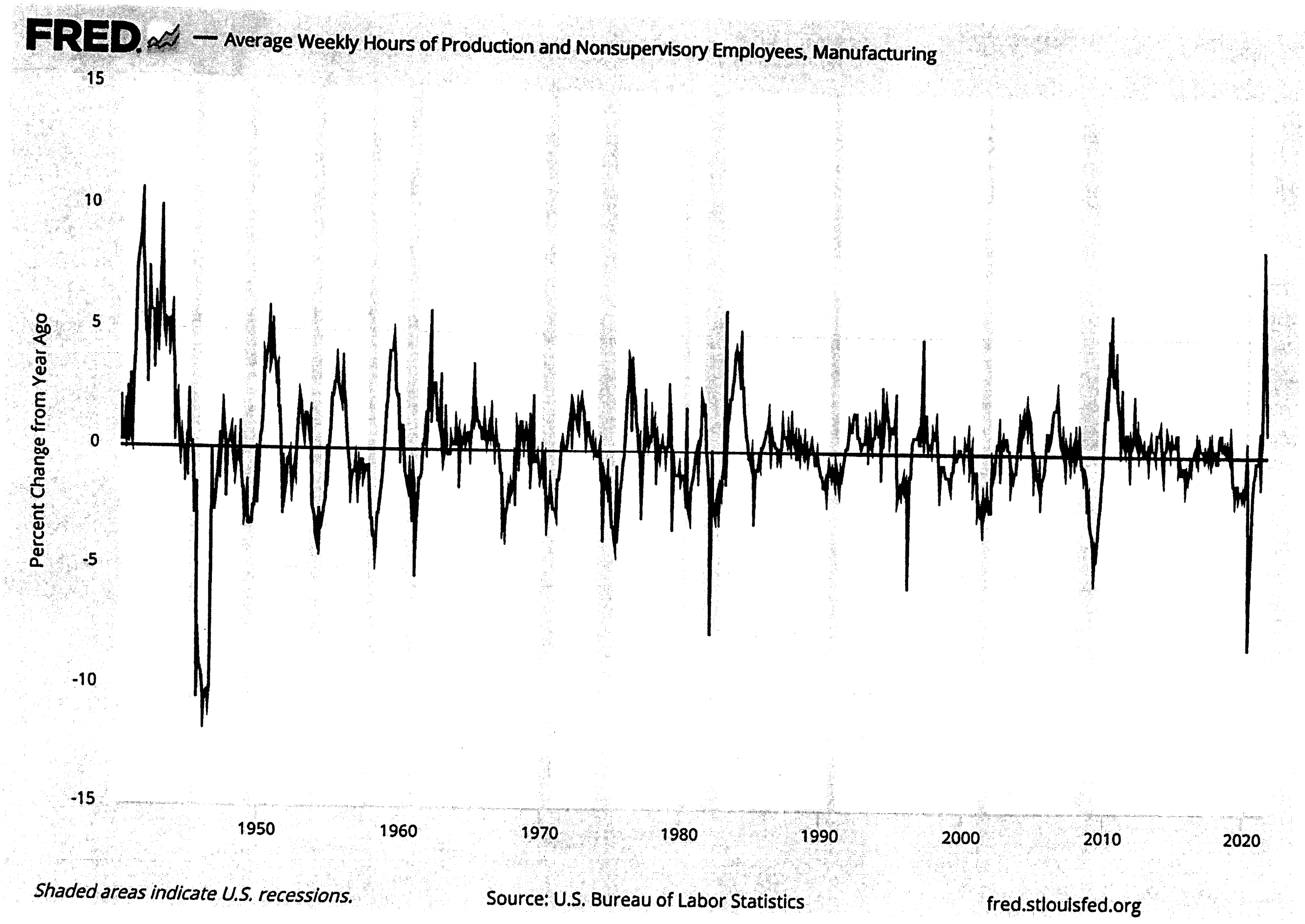


Chart #5


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
Shaded areas indicate U.S. recessions.
Source: U.S. Bureau of Labor Statistics
fred.stlouisfed.org

Google

Chart #6

cases

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COVID-19

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San Diego County, CA

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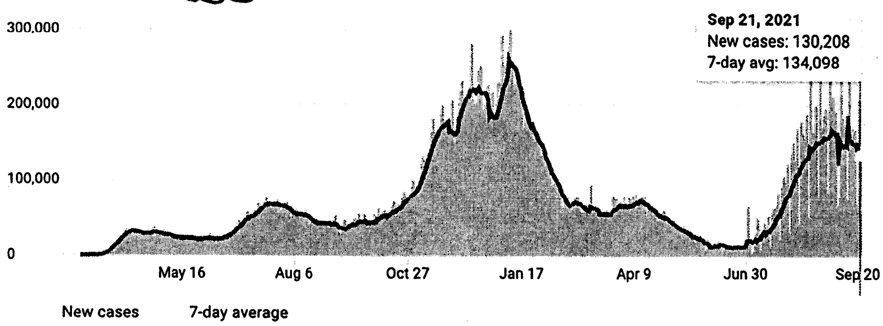
Statistics

New cases and deaths

From The New York Times · Last updated: 2 days ago

New cases · United States · All regions · All time



Each day shows new cases reported since the previous day · About this data

Cases

From The New York Times · Last updated: 2 days ago

Total · United States · California

Cases
4.68M

Deaths
68,339

Location	Cases	Deaths
San Diego County	**367K**	**4,021**
Los Angeles County	1.45M	25,893
Riverside County	359K	4,921
San Bernardino County	348K	5,520
Orange County	315K	5,357

"+" shows new cases reported yesterday · About this data

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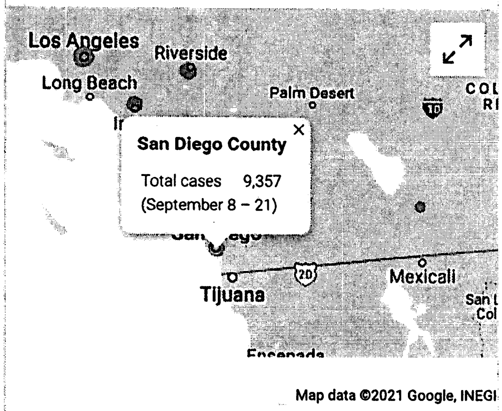
https://www.sandiegocounty.gov › 2019-nCoV › status

COVID-19 in San Diego County

Coronavirus Disease 2019 (**COVID**-19). Table updated September 22, 2021, with data through

Map of cases (last 14 days)

From The New York Times and others



About this data

Cases overview

From Wikipedia and others · Last updated: 20 days ago

San Diego County

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Deaths
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California

Total cases
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More locations and statistics

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COVID-19 is caused by a coronavirus called SARS-CoV-2. Older adults and people who have severe underlying medical conditions like heart or lung disease or diabetes seem to be at higher risk for developing more serious complications from COVID-19 illness.

Learn more on cdc.gov

For informational purposes only. Consult your local medical authority for advice.

Google **Chart #7** ases

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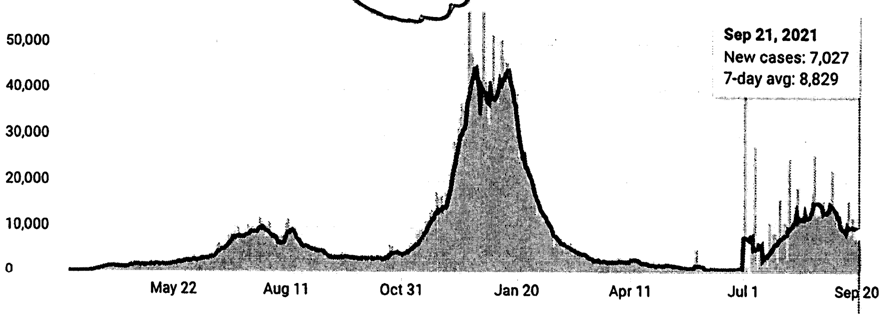
New cases | United States | California | All counties | All time



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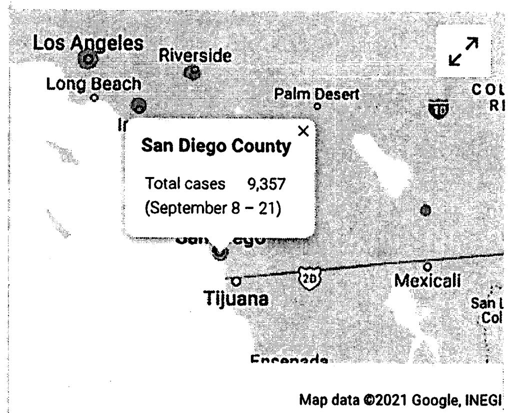

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