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Economic and Market Outlook

June 30, 2021

It's a Meme, Meme, Meme, Meme World

In academia, speculation is usually dignified as theory.
Speculation is an effort, probably unsuccessful, to turn a little money into a lot.
Investment is an effort, which should be successful,
to prevent a lot of money from becoming a little
- Fred Schwed Jr.
Where Are the Customers Yachts? : Or a Good Hard Look at Wall Street

Section I. Speculation

From meme stocks to Special Purpose Acquisition Companies (SPACs) to cryptocurrencies, rampant speculation is alive and well today. Meme stocks go up and down by ridiculous amounts because a group of young traders decide to unify and buy just because there is a large short position in the stock. There are no fundamental reasons behind these valuations. SPACs are the new way for companies to become public without following the traditional requirements of an Initial Public Offering (IPO). They can make wild predictions about profitability five to ten years out. Cryptocurrencies are an attempt to separate money from government support and seem to be used, among other purposes, by nefarious organizations to hide their activities. Bitcoin peaked about a month ago at $64,000.00 and is now down to $33,000.00 a coin, a pullback of almost 50%.

Fortunately, while all market values appear slightly elevated, speculation seems limited to these few areas. We have seen in history where speculation grips the whole market and economy, and it never ends well. The Tulip Mania of 1637, the South Sea Bubble of 1720, railway speculation of the 1840s, the market crash of 1929 and the Dot-Com Bubble all serve as reasons to be aware and diligent to this type of condition. As long as speculation remains limited we can hopefully avoid history repeating itself.

Section II. Inflation

As we predicted in our last report, readings on inflation have increased. Currently the Consumer Price Index (CPI) is 5.0% on an annual basis, and core CPI is at 3.8%. This is well above the Federal Reserve's 2% target. While the pandemic dragged on, consumers started spending some of their savings on goods. For example used car prices alone were up 10.0% in April and 7.3% in May. This reflects the fact that nearly one third of the inflation came from the price of used cars. 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%. The reading for April 2021 was 14.9%.

The fear has been that inflation will spike once the country opens up again. We believe the reality is that now that we are fully open, spending will shift from goods to services. This will have a downward effect on the inflation rate simply because of the way the rate is calculated. In addition many shortages will be addressed as workers can now return to factories.

Between the $1.9 trillion stimulus package and pent up demand from the lock down, a spike in inflation is here, but it will be temporary. Once again, please 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. Like the Federal Reserve, we believe that the current elevated inflation rate is transitory.

Section III. Interest Rates

The financial media has been very focused on 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.

The Federal Reserve announced that they are finally "talking about talking about" adjusting monetary policy. Then the 10-year Treasury yield went down. What? Yes, it pulled back to below 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 with the U.S.

Section IV. 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, 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 May, the unemployment rate was 5.8% and the 12 month moving average was 7.36%. Therefore this indicator is positive. It is also important to note that, while the spread is shrinking, 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 #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 22.1% for May, so this indicator is positive. Any reading above 0 is positive.

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%. With the economic burst due to re-opening this indicator has turned positive and sits at 16.3% in May 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 improved despite the difficulty companies are having hiring in the last couple of months and stands at 7.09%. A zero reading represents neutral therefore this indicator has turned 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 5.59%, so this indicator also has turned positive in the last two months.

Currently all five indicators are positive and the S&P 500 Index is 8.96% 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 turned up and sits at 1.045, 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 improved and sits at 0.81.

Therefore the two "early warning signs" are not predicting recession at this time, and have strengthened 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 3 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 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 VI. <u>Covid-19</u>

Vaccinations continue to roll out to the public and many states, including New York and California, have re-opened. Hopefully the lockdowns have come to an end. While there are some variants of the coronavirus appearing, most of the vaccines seem to be relatively effective against them. With the speed at which vaccinations can now be developed, booster shots for these variants will probably be able to be quickly developed if needed. We remain hopeful but vigilant.

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). The reading for June 2021 is 30.7 The Empire Manufacturing Index hit a high in April of 26.2 (0). June's still strong reading was 17.4. The national ISM manufacturing index reached 61.2% in May and the ISM services index is at 64.0% (above 50 is considered growth, above 55 is considered exceptional growth).The lockdowns are ending as expected. 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 range from 6% to 7% for 2021. GDP for the first quarter of 2021 clocked in at 6.4%. We believe this bodes well for investing.

Section VIII. Conclusion

While we do believe that market valuations in general are slightly elevated, we continue to find good value in individual stocks through our research. As mentioned, none of our recession indicators are giving warning signs at this time. A few of our technical indicators are flashing yellow so we expect one of two outcomes for now. Either we see a 5% to 7% correction, or we see a rolling correction moving from sector to sector underneath the surface while the indexes move roughly sideways.

We want to wish you all a Happy and Safe 4th of July Holiday as we celebrate the birth of our great nation!

Scott B. Williams, CFA, CFP
Kent Stone

Chart #1

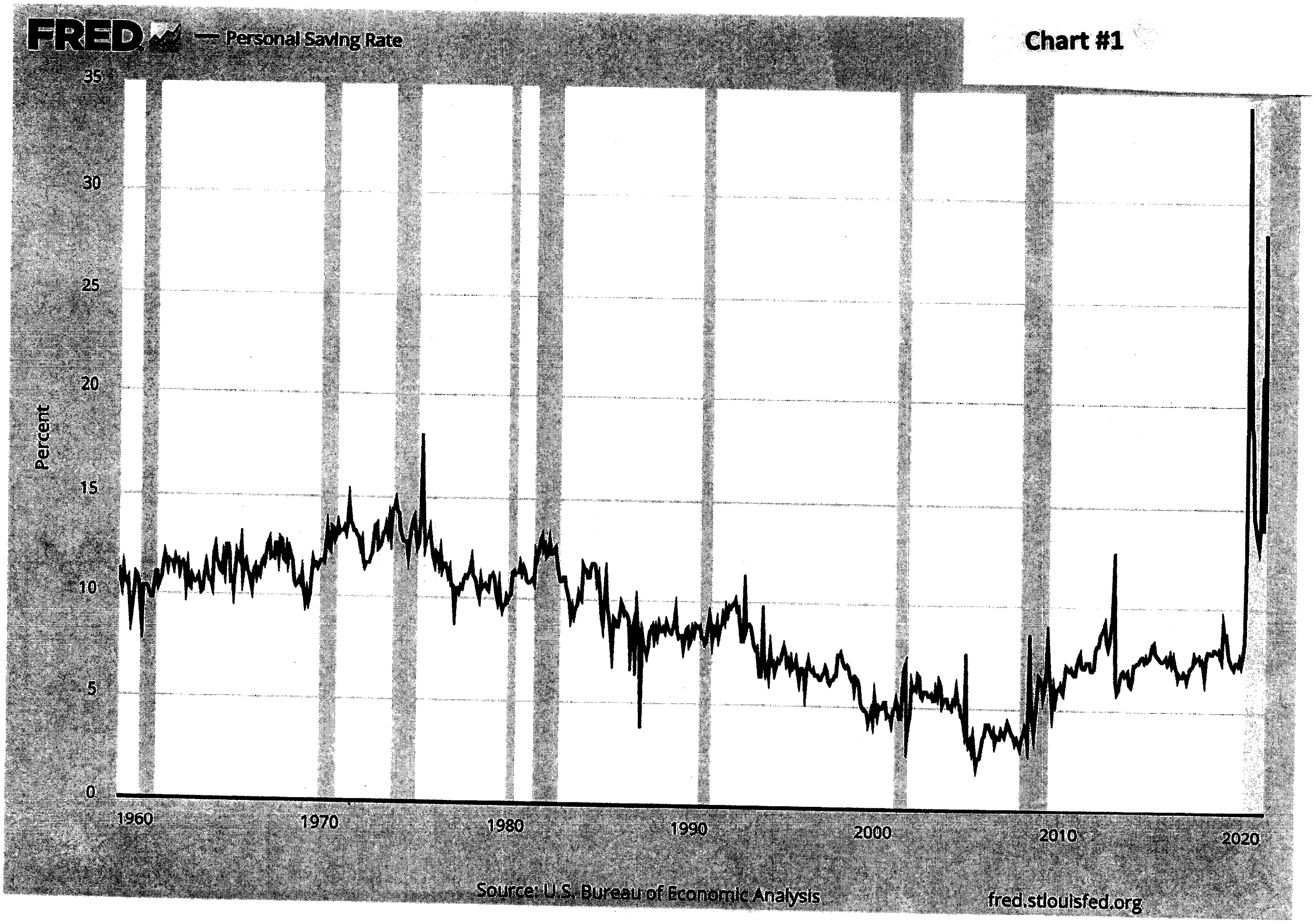


Chart #2

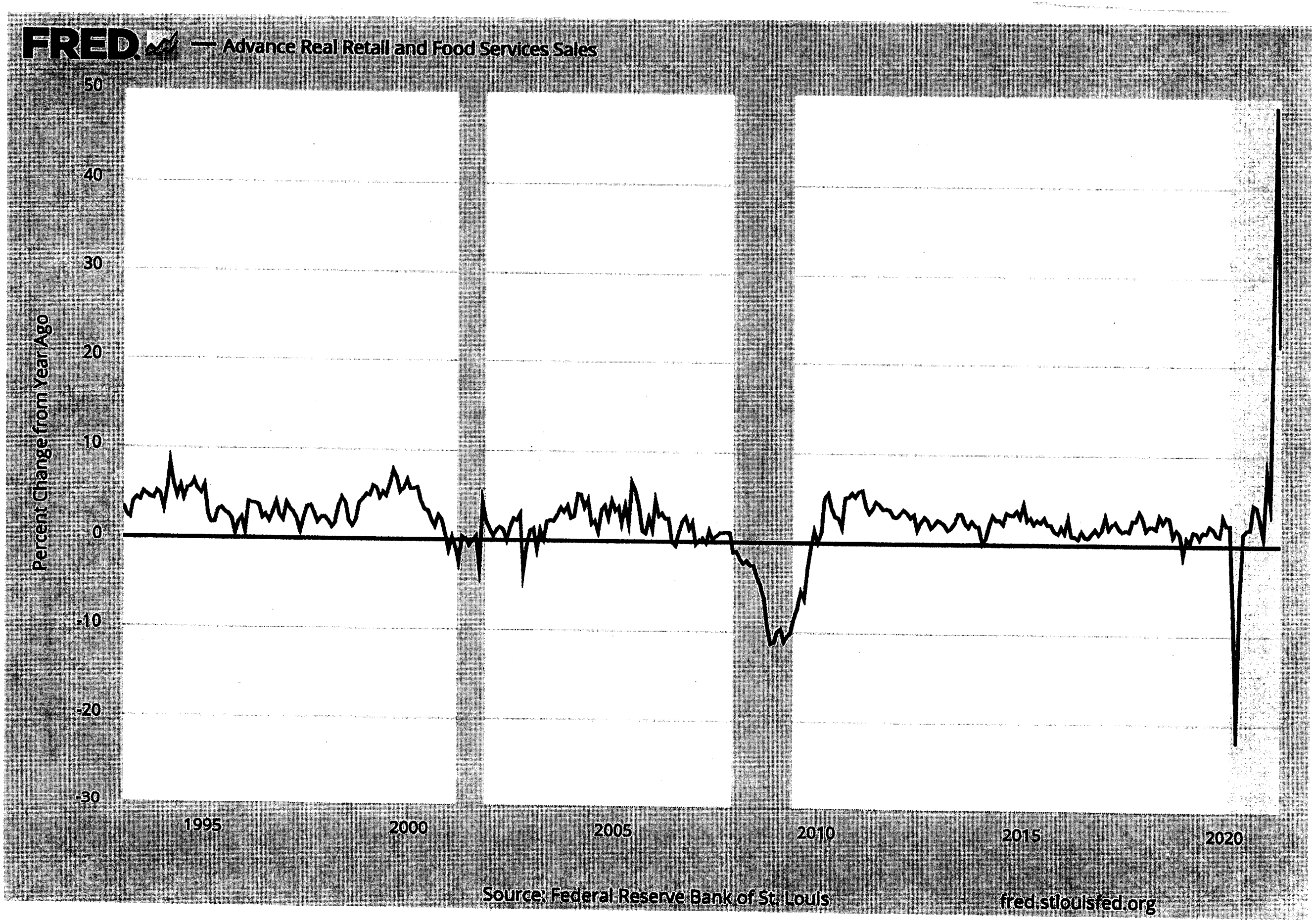


Chart #3

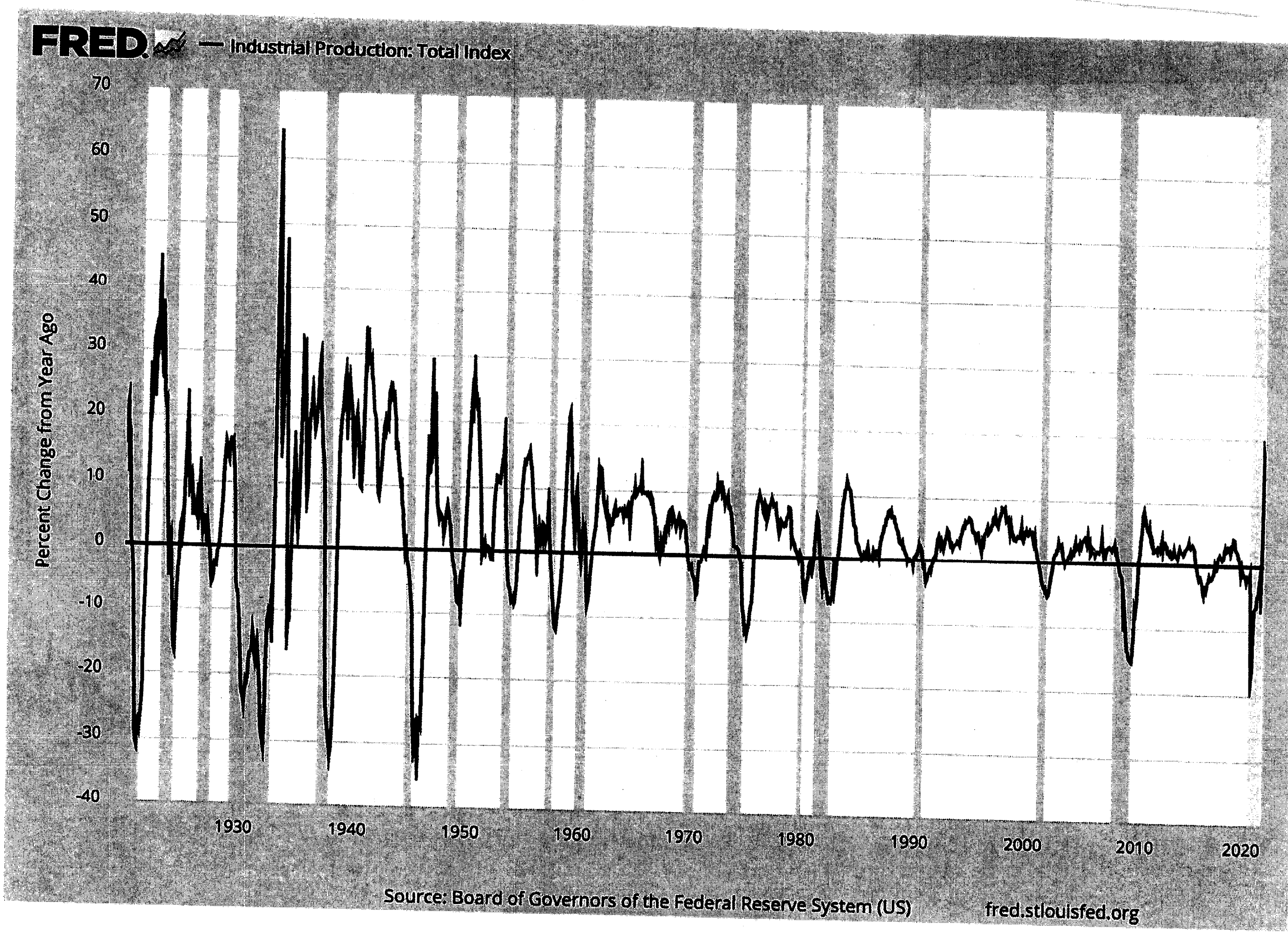


Chart #4

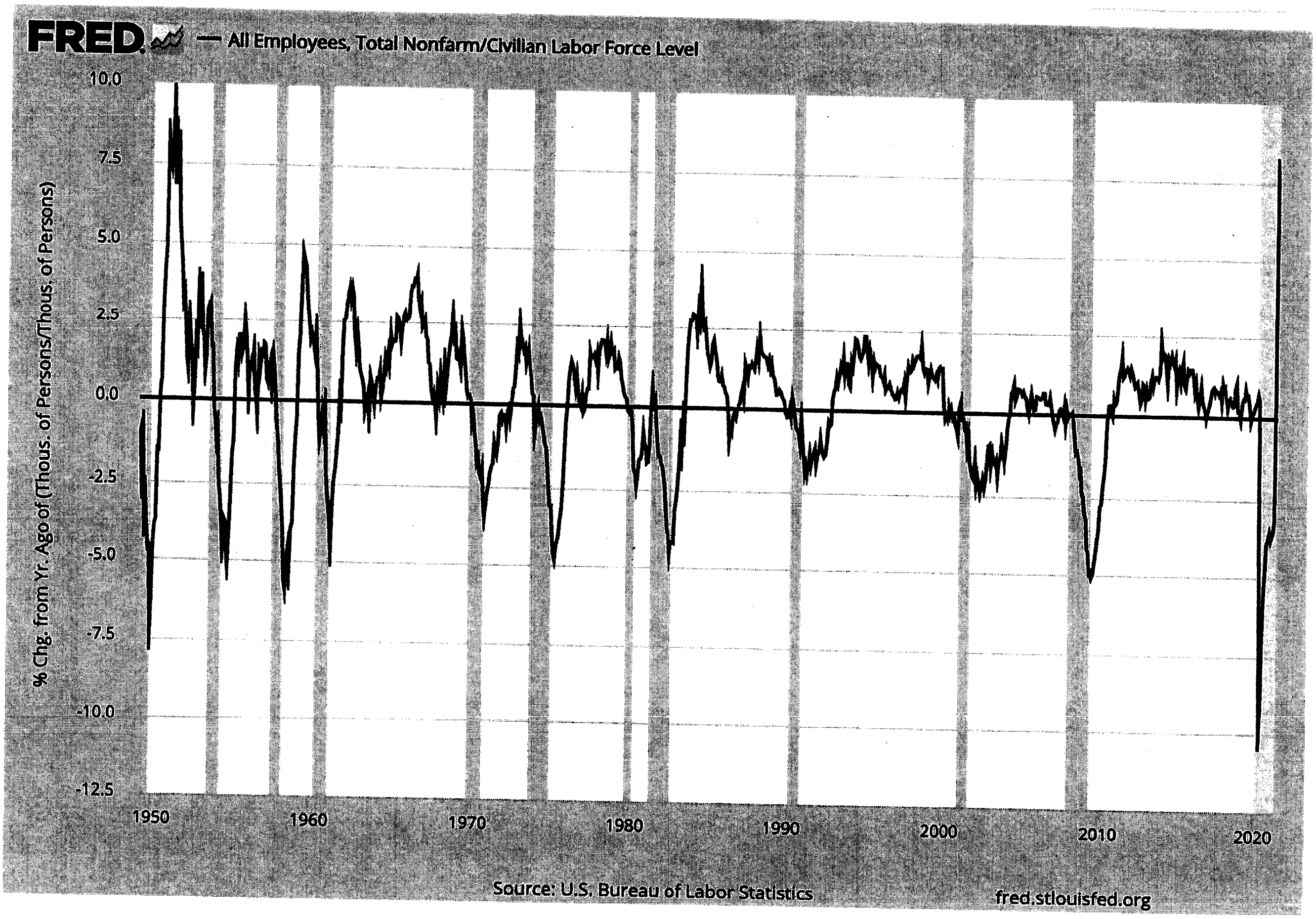
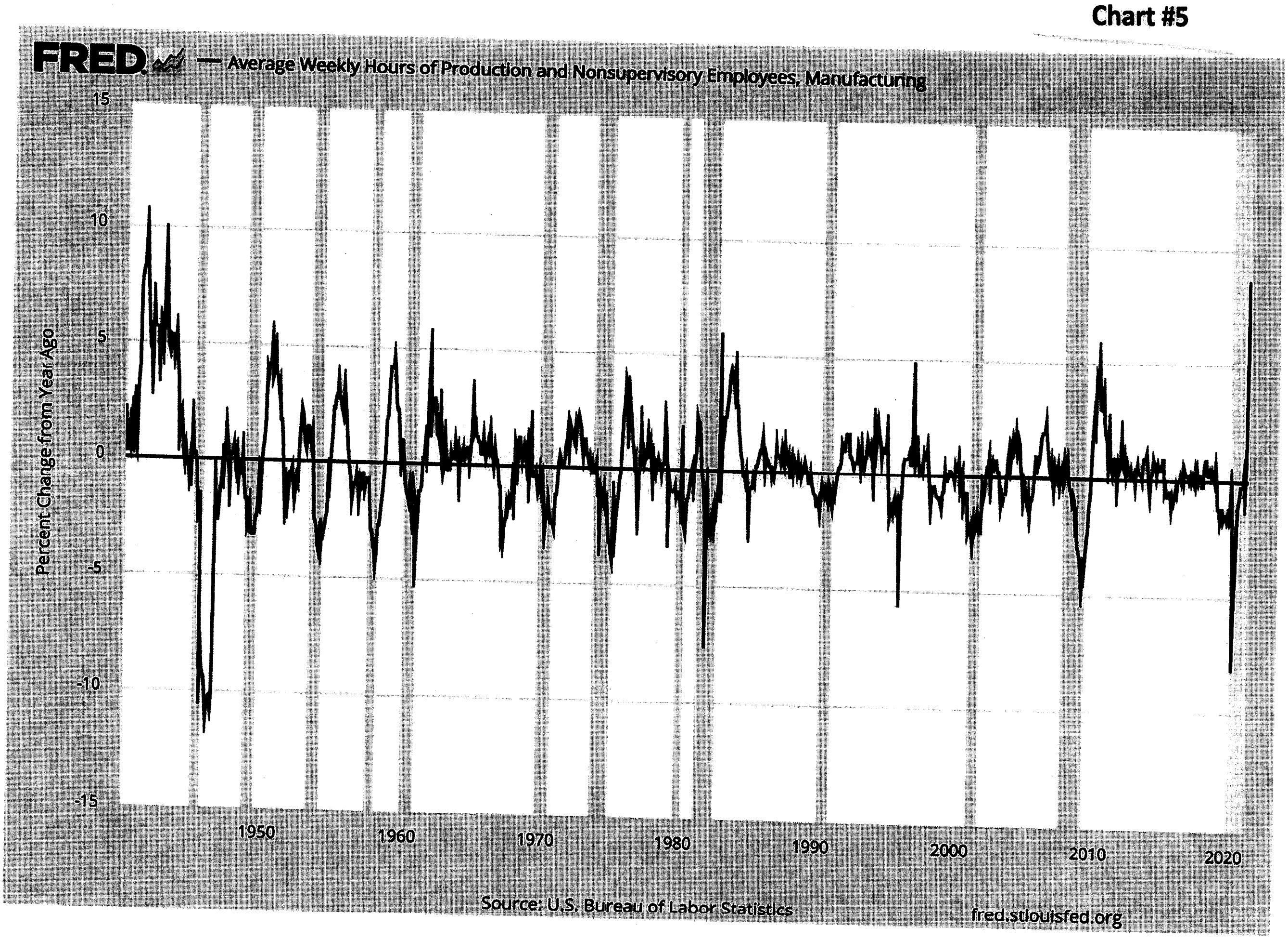


Chart #5



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