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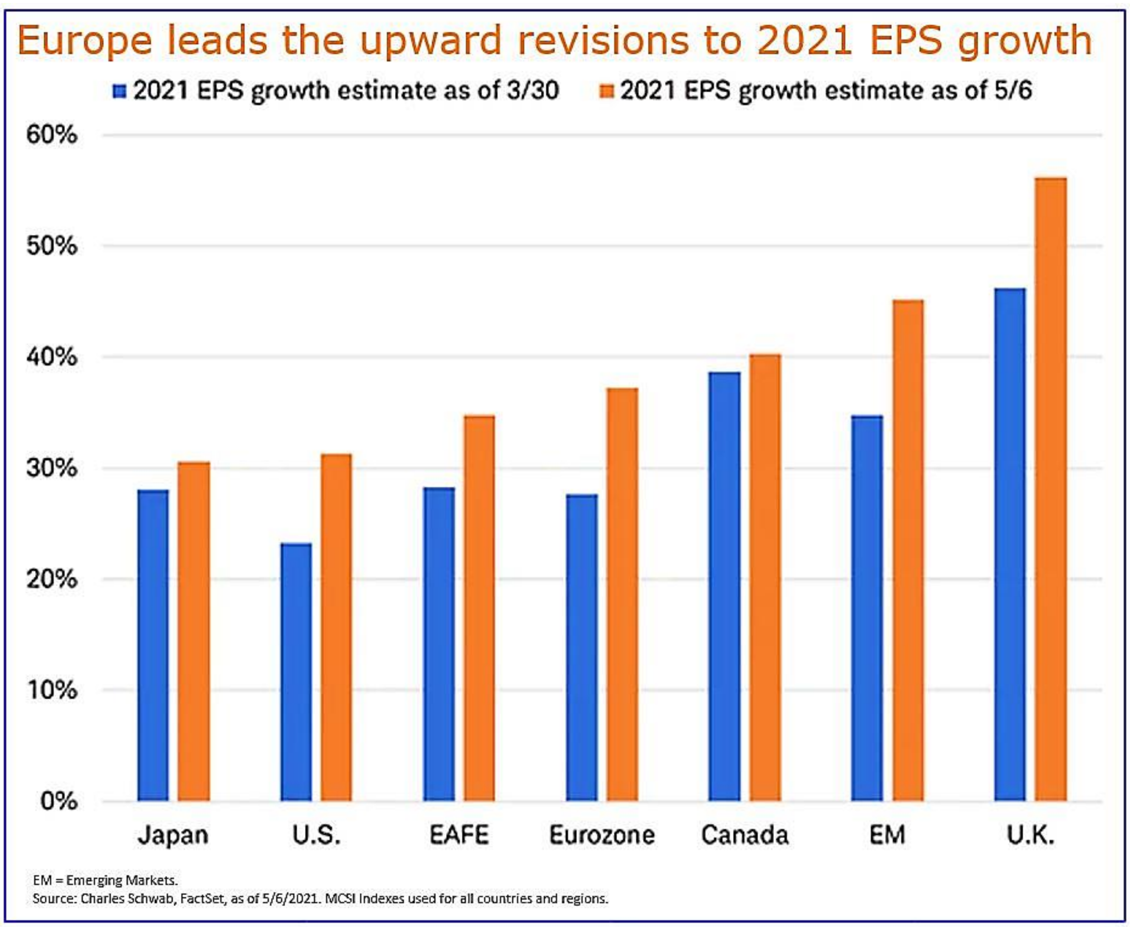
Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Poolside Chat.*

U.S. stock earnings reports continue to be spectacular, growing 50% comparing the depressed pandemic Q1 2020 to Q1 2021. While this increase is due in large part to equally spectacular low earnings reports of 2020, it also represents a cash-rich consumer with a healthy dose of pent-up demand. As discussed in previous *Chats*, high earnings are good for the company but also required to mathematically reduce the stretched valuations we've experienced in many areas of the U.S. stock market.

It's too soon to tell how the newly released CDC guidelines will impact consumer demand, but barring unforeseen outcomes (such as a resurgence in COVID-19 cases), a loosening of restrictions bodes well for jobs, the U.S. economy and perhaps even the U.S. stock market. Still, some U.S. stock sectors have experienced weakness in May, due in part to rising inflation fears. [Editor's Note – see our FAQ below for more on inflation.]

Europe's economy is likewise improving, in spite of ongoing lockdowns, slow vaccine rollouts, and held-up fiscal stimulus. A negative GDP reading of -0.6% in the first quarter is likely to reverse into positive territory in the second quarter. The easing of lockdowns – propelled by accelerating vaccination rollouts, increased bond purchases by the European Central Bank (ECB), and an expected unveiling of Europe's largest-ever stimulus plan – should further aid economic growth.



The brighter outlook for Europe is evident in analysts' forecasts for earnings per share. First-quarter earnings in Europe outpaced those in the United States for the first time in years. Estimates for Europe in 2021 are now up 10 percentage points to 38%, compared to 32% earnings growth year over year expected in the U.S. Upward revisions in Eurozone and U.K. earnings have risen the most among developed countries. https://www.schwab.com/resource-center/insights/content/market-perspective

SFG's Take: This is not a time for FOMO (Fear of Missing Out) driven investment decision making. Our three main pillars of recovery (COVID-19 vaccine progress, corporate earnings growth, and economic recovery) are still moving in a positive direction. However, much of this good news is already priced into areas of the stock market. SFG's fourth pillar of recovery, the wildcard scenario (shifting market sentiment, interest rate/inflation trends, tax changes, unwillingness to vaccinate, COVID-19 variant growth, and our new addition, a potential shift in Fed tone or even policy in the next 6-12 months), remains a concern and a reason to stay grounded for "core" (versus "explore") investment funds.

Key Points to Consider

- **COVID-19 Herd Immunity?** Earlier this year, Strategas estimated that sometime in early May the U.S. would be close to COVID-19 herd immunity. Their latest take: "Judging by this week's headlines and our estimate that 75% of the U.S. adult population has some form of immunity (already exposed to the virus or vaccinated), the U.S. is as close as can be. However, some states are still more than 50% closed and this is where most of the U.S. unemployment is concentrated.

  "Now that we are approaching herd immunity, states and schools that have refused to reopen will be forced to, given that health officials are sending an all-clear signal. We have found that the most closed states have been outliers in terms of their economic performance. Reopened economies and schools lead to lower unemployment."

  SFG reminder: We've heard numerous accounts of younger people, including children, getting COVID-19 and having multisystem inflammatory syndrome or various "long-haul" health issues. Andy Slavitt, White House COVID-19 senior advisor, knows this problem firsthand – his son suffers from long-haul symptom. He urges young people to get vaccinated. "…six months [after getting COVID-19], he still suffers from tachycardia (rapid heartbeat), shortness of breath and ongoing and frequent flu-like symptoms."

- **Jobs, Jobs, Jobs –** The April employment numbers for the U.S. were disappointing. The lower-than-expected job growth numbers were likely due to a supply issue, not a lack of demand for new workers.

  The historic levels of stimulus (especially extra unemployment benefits) and COVID-19-related fears remain major headwinds for understaffed businesses. Last week a number of notable headlines highlighted this:

  1) The CDC announced that vaccinated persons can stop wearing masks and no longer need to practice social distancing.

  2) The Jobs Opening and Labor Turnover Survey showed over eight million unfilled job openings.

  3) Businesses have begun to offer wage increases, either through one-time bonuses or permanent wage hikes.

- **Mr. Toad's Wild Ride** – Other than being a theme park attraction at Disney (based on Disney's adaptation of Kenneth Grahame's *The Wind in the Willows*), this describes the wild rollercoaster ride for Bitcoin and other cryptocurrencies recently. After Elon Musk said Tesla would no longer accept bitcoin for car purchases due to environmental concerns, and China cracked down further on cryptocurrencies, the sector dropped over 30%. While digital currencies will be important in the future, the current "frenzy" stage of crypto suggests caution except for those with very high risk tolerance. https://www.cnbc.com/2021/05/12/elon-musk-says-tesla-will-stop-accepting-bitcoin-for-car-purchases.html

  As if there isn't enough uncertainty around bitcoin and cryptocurrencies, U.S. Federal Reserve chief Jerome Powell turned up the heat on cryptocurrencies last week, saying they pose risks to financial stability, and indicating that greater regulation is warranted. The Fed also says they are closer to plans for launching U.S. digital currency that would be an officially regulated (and less volatile) currency alternative. The U.S. Treasury Department added its concerns that wealthy individuals could use the largely unregulated sector to avoid tax and said it wanted big crypto asset transfers reported to authorities. The IRS believes it can collect "large unpaid taxes" as they examine unreported crypto sales.

SFG in the News

- **Gates Divorce –** SFG Partner Haleh Moddasser, CPA, was interviewed on the recently announced divorce of Bill and Melinda Gates. While this is perhaps one of the most high profile gray divorces, Haleh's *Gray Divorce, Silver Linings* book helps those with more modest means consider the pros and cons of divorcing after age 50. https://money.usnews.com/financial-advisors/articles/what-financial-advisors-can-learn-from-the-bill-and-melinda-gates-divorce

Frequently Asked Questions

Q: Higher inflation is here! The recent CPI report was distressing, and it certainly upset the stock market. Is this the beginning of 4%+ inflation?

A: Probably not though consumers, and many of our clients, are worried. Consumer sentiment as measured by the University of Michigan survey declined from previous rising levels in early May, falling 5.5 points to 82.8. Both present and expectations for the future declined, while inflation expectations rose notably.

As mentioned above, U.S. and Global equities have become more volatile in May due in large part to rising concerns over inflationary pressures. **The headline Consumer Price Index rose more than 4% year-over-year, and was up 0.8% month-over-month for April, while the core index rose 3.0% and 0.9%, respectively, over the same time periods.**

This appears alarming until you unpack the increase. The unprecedented surge in prices for **used cars (!)** was the biggest contributor to the surprise jump in U.S. inflation last month. The cost of previously owned sedans, pickups and sport-utility vehicles soared 10% in April, according to the Bureau of Labor Statistics, the fastest climb ever in data that go all the way back to 1953. It accounted for more than a third of the 0.8% monthly increase in the consumer price index, which was four times the level economists estimated.

With fewer new cars being made amid a shortage in critical semiconductors, both retail consumers and rental car companies have gone to the used-vehicle market to get the cars they need. Wholesale prices have soared as a result, up a whopping 54% in April from a year earlier at Manheim, the nation's largest vehicle auction house.

While prices have generally increased across the board, much of the rise has been due to base effects, given that metrics like the consumer price index (CPI) are measured relative to the prior year (when the economy was broadly shut down). Unless you're affected by parts of the economy experiencing shortages in materials or labor, most notably, the building industry, prices have remained fairly constant when taking into account base effects.

Broader sustained inflationary pressures have historically come from a severe tightening in the labor market, which pushes up wages to a significant degree – generating the type of "wage-price spiral" inflation that became systemic in the 1970s.

Q: What about those hotter than a firecracker commodity prices?

A: Many point to rising commodity prices as a reason inflation could get "out of control." Commodity prices have increased sharply since the 2020 pandemic-driven lows. Recently we've seen modest declines in some commodity prices, including iron ore, following a commitment from the Chinese government to keep its cost under control.

The supply of agriculture products, metals, lumber and basic chemical products had all been curtailed early in the pandemic in anticipation of a large reduction in demand that never materialized. In fact, demand actually rose in some cases, such as lumber and paint for residential construction and DIY projects.

Demand for certain commodities will likely remain high for a variety of reasons. For example, demand for large amounts of agricultural goods will remain high due to the vast amounts of food needed by Chinese livestock. And the demand for specialty metals will likely remain high as the demand for electric vehicles continues to grow. Additionally, prices may remain elevated in some cases due to inherently slower "restocking" processes, such as in soybeans and corn.

Overall, our research sources expect the effects of commodity-driven inflation to be limited. In this environment, we think it is critical to focus on underlying supply and demand trends for each commodity to judge the pace of 'normalization' as economies begin to reopen.

The magnitude and duration of this inflation spike may be greater than originally anticipated. However, these pricing pressures should largely dissipate as supply chains recover and discretionary income shifts away from goods and commodities toward services and experiences, leading to a cooling of inflation fears, except in limited supply services and experiences.

SFG's Take: We still believe higher inflation will be with us in 2021, with a chance it will be prolonged. The chances of overall inflation being 4% or higher for years to come are much lower.

Summary

SFG's three pillars of recovery remain in positive trend territory. Wildcard risks in our fourth pillar remain elevated. SFG is balancing numerous opportunities and threats in our portfolios, customized to our clients' unique circumstances.

In **growth** portfolios, we are leaning into a variety of short- and intermediate-term asset classes and trends that we believe have favorable forward-looking risk/reward relationships.

In more conservative **growth and income** portfolios, we are taking more steps to be defensive, while still striving for positive real returns over inflation.

Our COVID-19 endgame investing approach can be summed up by six themes:

- Diversification with a balance of offensive and defensive measures, depending on the desired risk tolerance of our clients,
- Underweighting, or avoiding areas of higher future concern,
- A focus on higher-quality investment themes,
- Identifying and implementing buying opportunities that may be appropriate for more growth-oriented portfolios,
- A more defensive stance using different portfolio tools for more conservative growth and income portfolios, and,
- Utilizing select alternatives to traditional bonds and stocks.

~ Dax, Dennis, Glenn, Jason, John and PJ
(the SFG Investment Committee)

SFG ON-SITE OFFICE HOURS UPDATE

Our offices will be returning to more normal on-site hours beginning June 1.
We will be offering in-person meetings and virtual meetings depending on client preference, so please feel free to reach out and schedule accordingly.
At least initially this will be a hybrid plan to afford our staff members the flexibility to continue to work from home part time.
Please continue to call or email beforehand if you intend to drop by our office just to make sure we have the right person available to help you best on that particular day.

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