

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Valuations Stratospheric... ...Inflation Quiescent

Stock market valuations are useful, but they do not tell us what will happen in the short term. By most measures stocks are very overvalued, but over-valuation has persisted before and may persist now.

Against what I consider significant stock market risk, Core maintains only small stock market investments.

In this year's second quarter, just ended, the US stock market continued to rise, as did Treasury bonds and gold (our two large investments) as well as our other investments. This provided a good return for the portfolios Core manages, after a somewhat disappointing first three months of this year, when Treasuries and gold both fell in price. What's next?

Valuations. For some time, US stocks have been extremely overvalued by many measures, as I have been writing in recent *Core Comments*. Because of my sense that risk in stocks is high and prospective returns rather low, I have limited stock investments this year. By Robert Shiller's CAPE, discussed in my May 16th letter, US stocks are more overvalued than at any time in the last 160 years, except for the dot.com bubble of 2000. The present CAPE level is 38.21, implying very modest returns over the next decade. Valuations are quite meaningful in judging long-term returns, but they are not useful tools for determining prospective short-term returns. Stock markets certainly tend to revert to means of valuations, but periods of overvaluations and undervaluations may extend in time far longer than we expect.

Aside from Shiller's CAPE, consider this about US corporate profits: After-tax reported corporate income across America is down 2% from the end of 2018, while the S&P is up more than 60%! Yes, the Federal Reserve undertook exceptional measures in early 2020 when the Covid pandemic began and the federal government began a series of enormous transfers of wealth from the US Treasury to individual citizens. The combination of fiscal and monetary relief certainly provided a big tailwind to America's stock market, but the result (as we may learn in time) was to pull forward future stock market returns, in effect, to borrow future returns. One must admit that those who ignored history when the stock market crashed in February and March 2020 and who ignored high valuations were well rewarded by the unprecedented rise in US stocks.

Inflation. The two recent monthly inflation reports have shown the highest year-over-year change in consumer prices in a number of years and media are full of breathless reports that our long period of low inflation (around two percent per year) is over. The Fed regards the recent increase in inflation as 'transitory,' and the bond market does not believe that inflation is coming back. The benchmark ten-year Treasury yield peaked on March 29th at 1.765%. If inflation were really heading higher, bond yields would keep rising. Instead, three and one half months later, the ten-year now yields 1.363% as I write, a meaningful decline in yield (and a commensurate increase in price). In March

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Economic reports have been distorted by the pandemic lock downs and the huge transfers from the Federal government to citizens.

The strong labor productivity, brought about as businesses learned to adapt to the absence of many workers, implies that wages will remain subdued and that inflation will not rise for long.

Strength in Treasury bond prices is a strong indication that inflation will be quiescent.

and April last year, as the nation closed down because of Covid, consumer prices fell. Now, as economic activity returns to more normal levels, we observe an increase in prices.

While acknowledging the recently high inflation numbers, Jerome Powell, chair of the Fed, reminded us that the pandemic has made a hash of the monthly economic statistics. Consider for a moment the cycles of lock-downs and re-openings, the three waves of checks drawn on the US Treasury and sent far and wide, the sudden huge increases in retail spending (when those checks hit individuals' bank accounts) followed by sharp declines in spending, the notable decreases in inflation a year ago and the price increases now. A striking aspect of our plague year is that labor productivity has increased markedly from pre-pandemic days. Businesses adapted to the shut down by learning to produce goods and services with less labor. The government reports that productivity increased by 4.1% in the year ending March 31, 2021. (In the several years before 2020, productivity was generally 2% and lower.) By contrast, wage growth in the last year rose slightly more than 3%, less than productivity increases. With higher productivity, wage growth will be restrained. Without strong wage growth, inflation will remain quiescent.

As I wrote in May and believe still, the Fed is quite correct to minimize the significance of the two recent inflation reports. I also believe that investors in the bond market are correct in pushing up bond prices and pushing bond yields down. The anomalous action in the bond market was at the beginning of this year when, as US vaccination efforts gained force and infections and deaths dropped markedly, yields rose sharply and bond prices fell. Did that good pandemic news for America mean the end of the decades-long decline in inflation and the decades-long increase in bond prices? If so, how does one explain it?

The huge transfers from the federal government to individuals--beginning with the first round in the spring of 2020, the end-of-year round as Trump left office, and the large set of transfers during the early months of Biden's administration--have caused personal income to rise to sharply. Note, however, that wages and salaries--that is, earned income--has decreased slightly over this same period. Thus the apparent high level of economic activity now depends significantly on these government transfers. Some still remain, including enhanced unemployment benefits and the child tax credit, for which payments begin this month. Will there be another round of 'stimulus' checks? At present, it seems unlikely.

It is a very good thing that the federal government has provided so much financial support to its citizens over this last year and more. Things would have been much worse for many millions of people whose jobs suddenly disappeared last year had the government not stepped into the breach. There is, however, a bit of unreality to all this. Government transfers of this magnitude cannot be continued indefinitely. It is quite possible that as the programs and payments fall away, our seemingly robust economy will falter before it fully recovers. Most stock market investors seem unconcerned by this possibility, as witness the strong stock returns this year. The bond market foresees a less robust economy. My sense is that the bond market has it right. The very elevated stock market may well have a Wile E. Coyote moment ahead of it.

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