FFG Market Pulse Newsletter

Q2 2021 Edition

Newsletter Highlights

Latest Developments:

-What is latest on Inflation/Interest Rates?

-Labor Market?

-Taxes?

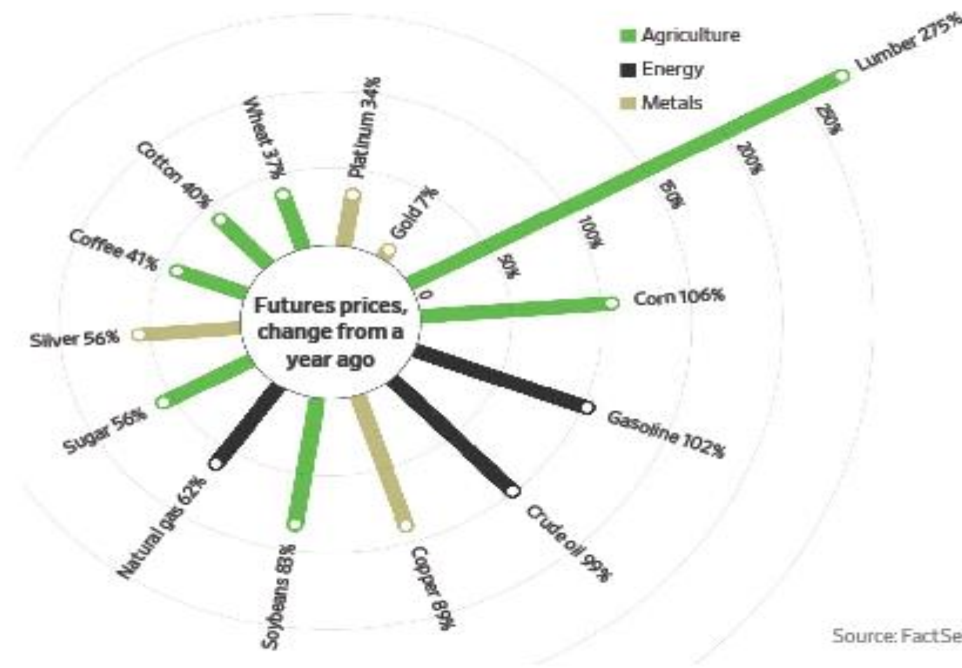
-125 Year Anniversary of the Dow Industrial Average

Latest Developments

We are in one of those unique periods in the markets when one long term dominating trend is starting fade and another is starting to emerge. For quite some time and rightfully so, the dominating talking point was the Covid pandemic and how all things were being affected. Now as mask mandates are being lifted and life is slowly starting to get back to some level of new normal, the markets are now fixated on inflation, the rise in interest rates and how that will determine policy for the Federal Reserve.   As a refresher, the Fed has kept rates artificially low to help stimulate the economy during the worst of the pandemic. They have also indicated they do not plan on raising rates anytime soon even if some inflation starts to appear. However, if the economy starts to heat up due to the pent-up demand from the Covid recovery that could change their plans because they would have to start raising rates to try to slow an overheating economy. This is where there are all sorts of opinions about how inflation can manifest itself and what the staying power of it is.

The recent inflationary data must be analyzed carefully. We have now reached the 12 month mark since the world shut down so the year over year comparisons are slightly skewed because in April-June 2020 there was very little economic activity going on besides essential buying. With that said, we are likely to see some levels of inflation in certain areas of the economy especially in the near to intermediate term.

Taking a look at the chart below, it is very easy to notice the various increases from prices from a year ago on different commodities. This is what will cause some of this near term inflation as these costs get passed on to the consumer.   The unanswered question is how much of this rise will last. From a portfolio perspective, it is prudent to prepare for inflation.   This means value or cyclical type companies likely starting to outperform growth in the near term. A rising interest rate or inflationary environment can boost value stocks because the profit from value stocks comes sooner whereas growth stocks are more profitable further into the future. As inflation picks up, profits in the future are discounted more making them worth relatively less today. This is why stocks of companies that have growth forecasted far into the future have been hit the hardest.   Those futures cash flows are worth less with rates rising. Owning quality companies is paramount in this environment which is something we preach all the time. We have rebalanced portfolio encompass more value exposure across various sectors.



These commodity prices increases have stoked fierce debate on Wall Street and in Washington, D.C.. At the heart of this debate is how much of the climb in commodity prices can be attributed to transitory, temporary shocks. Now some of this shock is clearly due to the extreme dislocations between supply and demand. The pandemic caused supply chains to be bottlenecked like never before. Manufacturing plants were either closed or slowed. This caused inventories to be depleted, leading to big restocking orders, orders based on fear of missing out on product which caused premiums on near-term deliveries of raw materials. Supply lines are jammed, creating pockets of scarcity and adding costs that are passed on to consumers. It will take some time but eventually supply chains should start to normalize which could assist with keeping inflation from spinning out of control or turning into hyper inflation.

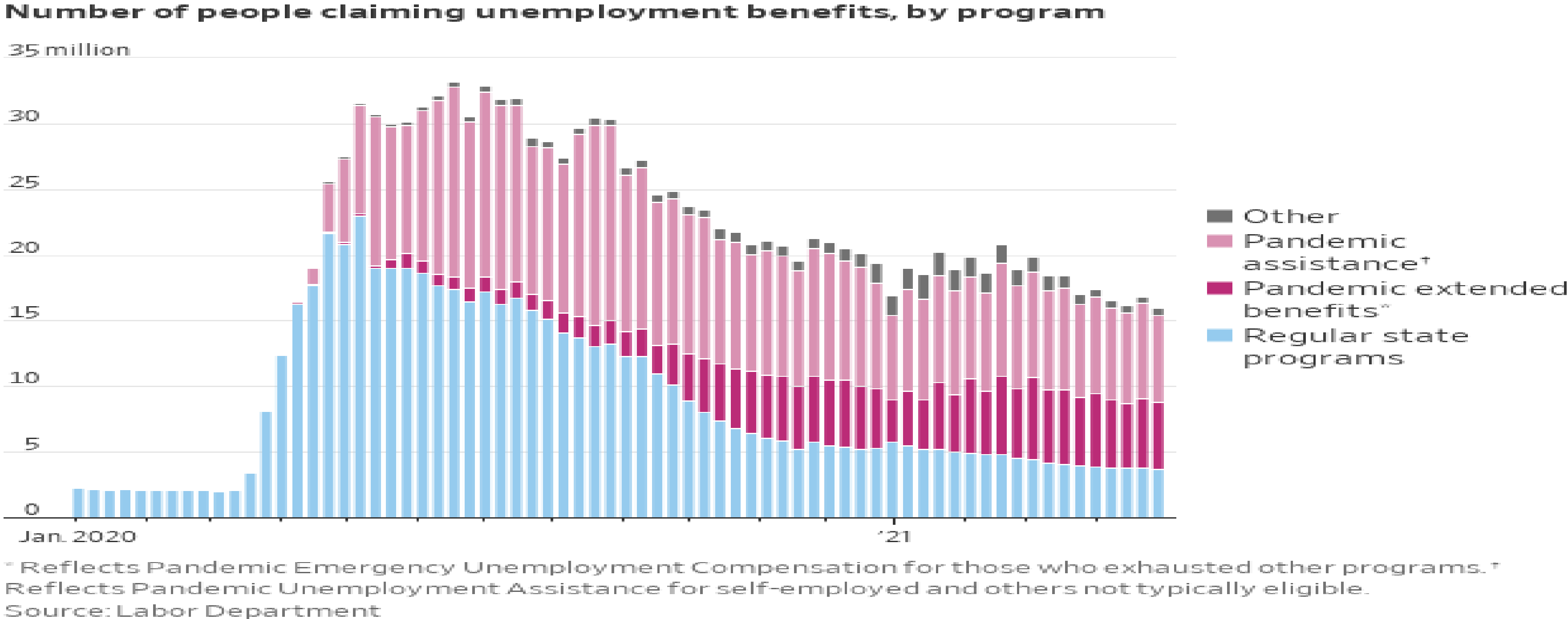
The demand for services/products is high as consumers start to venture out of their homes. When demand outstrips supply it creates havoc with pricing. We do not have to go back that far in history to get perfect examples of this. Does anyone remember what it was like trying to get toilet paper a year ago? How about hand sanitizer or disinfecting wipes? Take a look at the pictures below. This is what happens when demand surges and then supply then gets ramped up to meet that heightened demand. It doesn't happen overnight so we will likely see some levels of inflation but eventually supply and demand do tend to normalize.

The Fed believes that most inflation is transitory or temporary in nature. The transitory-or-not inflation debate is only just beginning because it will take months to determine to see how things shake out. But why does the Fed think that when there are clearly pricing pressures all around? This is because their preferred measure of inflation is different that what most consumers would consider inflation. Most consumers would look at gas prices, food, medical care and housing as their main sources of everyday inflation.

The Fed's preferred measure of inflation is the Personal Consumption Expenditure (PCE) price index. The FED also focuses core inflation. Core inflation strips out energy, food and home price increases as these tend to be more volatile from month to month. The PCE index looks at rents as the largest weighting in their index and not the prices of homes. Rent are currently up only 1.7% year over year while home prices are up 12% on average. The PCE also has categories for Education, Furnishings, Apparel and recreation which have not seen large increases year over year. This is the reason why they continue to say they believe that the inflation is transitory. The commodity driven inflation which is as clear as day does not reflect as much in their readings as it does in normal consumer's day to day life. Only time will tell if their preferred measure is correct and if it proves to be transitory.

THE LABOR MARKETS

With easing lockdowns and enormous amounts of federal stimulus aid are boosting consumer spending on goods and services. Yet employers in sectors like manufacturing, restaurants and construction are struggling to find workers. There are more job openings in the U.S. this spring than before the pandemic hit in March 2020, and fewer people in the labor force, according to the Labor Department. Surveys suggest why some can't or won't go back to work. Millions of adults say they aren't working for fear of getting or spreading Covid-19. Businesses are reopening ahead of schools, leaving some parents without child care. Most importantly, a very powerful force is many people are still receiving more in unemployment benefits than they would earn in the available jobs. As you can see in chart below there are still quite a few people on pandemic related benefits while the regular state unemployment programs have slowly reduced. Because of this shortage in labor, businesses are forgoing work, such as not bidding on a project, delivering parts more slowly or keeping a section of the restaurant closed to offset this shortfall. This can reduce the pace of the economy's expansion.



Another aspect of the labor shortage is just another divergence between small and large businesses. Per the Wall Street Journal, as Amazon, McDonald's, Costco and other large companies raise wages, small businesses are struggling to keep up. Some of the smallest firms said they are having a hard time finding qualified workers and can't easily match the pay increases, benefits and other perks that larger companies are offering to fill openings. The main reason that these large companies can offer these benefits is because they can access the capital and debt markets, raise capital on ultra low interest rates and offer higher salaries and benefits. In addition, since the large companies can borrow for little or next to nothing then the increased wages are not hitting their profit margins anywhere near as much as it would for their smaller counterparts. Mom and Pop businesses do not have the borrowing power to match. This is a trend that started prior to Covid and was only accelerated because of the pandemic. The chart below shows small business since about 2016 were having a much harder time filing positions that anytime since the 1970s. Today there are about 45% of small business with positions they are not able to fill. These are mainly our locally owned restaurants and other retail locations.

WASHINGTON POLICY UPDATE

Joe Biden's tax proposals have been a frequent topic of conversation among many. The lack of clarity around what a final bill may look like is also major source of confusion. Talk of tax increases in income, capital gains and inheritance taxes dominate the airways but nothing has been set in stone yet. There has also been no word on whether any of the policies would be retroactive for 2021 or start to be phased in until 2022. Under the proposals that have been released so far, for individuals with income of $400,000 to $1 million, the rate on ordinary income will rise from 37.0% to 39.6%. Long-term capital gains would remain unchanged at 23.8%. For individuals with more than $1 million in income, the top marginal rate on long-term capital gains and qualified dividends would increase to the same rate as ordinary income, nearly doubling to 43.4% from the current combined rate of 23.8% The other potential change could target the estate tax and step up in basis for inheritance. Currently, the tax code allows for assets of up to $11 million per person to be exempted from the tax. The new proposal would curtail that exemption to $3.5 million per person.

Democratic lawmakers will apply heavy pressure to address the SALT deduction cap in during these negotiations of the proposals. Given lawmakers can only lose votes in the House to pass legislation, the odds are increasing of some sort of compromise on SALT. As a refresher, the state and local tax (SALT) deduction permits taxpayers who itemize when filing federal taxes to deduct certain taxes paid to state and local governments. During the last tax reform SALT deductions were capped at $10,000. This caused higher tax states like NY and CA to be at a major disadvantage to lower tax states since property taxes tend to be higher in those areas. Losing that deduction put them behind the 8 ball. Expect to see those states use the SALT as their leverage during negotiations. In other words, it is likely that any increases in tax rates will likely be accompanied by higher tax deductions.

As far as infrastructure funding goes, the Colonial Pipeline ransomware attack raises the urgency around advancing infrastructure measures in D.C., and we are likely to see efforts at bipartisan talks continue. However, it is likely bipartisan efforts will fail to deliver on the scope of investment Democrats are seeking. This will mean that reconciliation will likely drive a significant portion of the Democratic infrastructure and economic agenda closer to the fall. Some level of stimulus is coming it is just a matter of how much and when. A reasonable expectation is D.C. moving infrastructure measures that approve $2 trillion range in new spending on traditional infrastructure and domestic policy priorities in the later part of this year. That has been recent chatter that the Biden admin will accept something closer to $1 trillion.

The debt ceiling will re-emerge as a theme this summer and raising the debt limit will only be possible via reconciliation. This further raises the probability of reconciliation being used for infrastructure with caveats. With additional IRS enforcement and adjustments to the corporate tax rate/international corporate taxes, we see about $1.5-2T in revenue on a traditional 10-year budget window and as much as $3T on an expanded 15-year window. This would allow the Biden administration to message their spending as fully paid for. The fully paid requirement has been on the table for Joe Manchin the most conservative Democrat. Without his vote then no bill can pass even through reconciliation process.

Happy 125th Birthday DJIA

This is what the big board looked like in 1929

One hundred twenty-five years ago, the Dow Jones Industrial Average made its debut. The index of 12 smokestack companies closed that first trading day, May 26, 1896, at 40.94. It included General Electric as well as long-forgotten names like American Cotton Oil and Distilling & Cattle Feeding. It has risen an average of 7.69% each year and notched 1,464 record closes, according to Dow Jones Market Data. It climbed above 100 in 1906, topped 1000 in 1972 and crossed 10000 in 1999. Just this year, as the U.S. economy continued to shake off its pandemic-induced slowdown, the Dow bounded above every milestone from 31000 to 34000.

The ascent has included numerous interruptions: There have been 70 years with no record closes, including the span from 1930 through 1953, as the stock market languished beneath its 1929 highs. There have been four years—1910, 1962, 1977 and 2008—in which the average closed each trading day below the previous year-end level. One day in October 1987, the Dow plummeted 22.6%, its only session worse than one last March during the coronavirus panic when it dropped 12.9%.

It is nice to look back especially during these historical milestone. However, the Dow Jones Index isn't the best barometer of the market or economy anymore. It only covers 30 stocks. It also puts too much emphasis on the price rather than a market's capitalization. In other words, the higher the price of the stock of the company in the Dow the more weighting it pulls inside the index. For example, as of today, United Healthcare is the highest priced stock in the Dow at about $414. United Healthcare is currently about 8% weighting of the entire DJIA. Apple on the other hand is about 5 times the size of United Healthcare by market cap. However, Apple is only about 2% weighting in the Dow ranking 22nd out of 30 companies in terms of weighting which doesn't make a whole lot of sense.

Useful or not, it is an American Institution that deserves to be recognized. Happy Birthday DJIA! Take a bow, you have earned it.

FFG Partners, LLC DBA Fiori Financial Group is registered as an investment adviser and only conducts business in jurisdictions where it is properly registered or is excluded or exempted from registration requirements. Registration is not an endorsement of the firm by securities regulators and does not mean the adviser has achieved a specific level of skill or ability. The firm is not engaged in the practice of law or accounting. Information presented is believed to be current. It should not be viewed as personalized financial advice. All expressions of opinion reflect the judgment of the author on the date the article was written and are subject to change. You should consult with a professional advisor before implementing any strategies discussed.Securities and advisory services offered by Registered Representatives and Investment Advisor Representatives through Private Client Services.Member FINRA, SIPC. FFG Partners, LLC DBA Fiori Financial Group and Private Client Services are unaffiliated entities.
The information contained in this report does not purport to be a complete description of the securities, markets, or developments referred to in this material. There is no assurance any of the trends mentioned will continue or forecasts will occur. Any information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. Investing involves risk and you may incur a profit or loss regardless of strategy selected.