



Torn between main street and Wall Street...

An Economy Expanding... Just Not for All



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Investment results come from money in motion and money will flow where it can be productive.

COVID-19 Update

After substantial progress in reducing cases and fatalities in the spring, the pace of vaccinations has slowed and the more contagious Delta variant has brought a resurgence of the pandemic. It's now estimated that between infection and inoculation, roughly 85% of the American people have some resistance to COVID-19. This should allow cases and fatalities to fall in the months ahead. Further, while the pandemic isn't over yet, many parts of the economy have adapted to operate in a pandemic environment. We hope the pandemic will fade as we move into 2022 but, whether it does or not, it should have much less of an impact in slowing the economy than it has over the last two years.

Economic Growth

The road to pandemic recovery has been bumpier than expected with the delta variant and severe supply shortages cutting into consumer and business spending. However, growth is expected to reaccelerate late this year as reopening resumes and companies try to rebuild inventories. Real GDP has nearly rejoined its pre-pandemic trend line. As we move into 2022, the economy should have fully recovered from the pandemic. Then, looking forward, a shortage of workers and much less fiscal and monetary stimulus should slow economic growth to its long-term trend of roughly 2% by the end of next year.

Unemployment

With surging labor demand and a higher cost of low-wage labor due to enhanced unemployment benefits, employers have had to raise wages to attract workers. As unemployment has fallen, wage growth has been rising and is above historical trends. While recent employment reports have disappointed expectations, rising wages and indicators of robust labor demand suggest slower job gains are primarily an issue of labor supply. This should keep wages elevated as the expansion continues, and is critically important for the Federal Reserve,—higher wages should feed through to higher inflation, implying that the economy could reach “maximum employment” sooner than past economic cycles may suggest.

Generally, those that want to work in this environment should be able to find a job. Job openings are near record levels. The problem during this pandemic has been the moral hazard of government intervention... paying extra to remain unemployed competed with businesses wanting to hire. As the pandemic eases (or we learn to live with it), government intervention should ease and this situation should correct itself over time.

Inflation

Inflation signals have heated up significantly as a surge in consumer spending continues to collide with supply shortages across major sectors of the economy. Some drivers of much higher inflation are beginning to abate and inflation is expected to moderate in 2022 as supply chain disruptions are ironed out and demand growth cools. However, strong wage growth, higher inflation expectations, a falling dollar and the lagged effect of higher home prices on rents should keep inflation more elevated than at the end of the last expansion.

Equity Markets

U.S. equities have trended higher during the course of the year, characterized by range-bound valuations and rising earnings expectations. Stock prices based on current forward PE ratios still look elevated—although they have come in somewhat as earnings have played catch-up. Looking forward to 2022, returns will depend more heavily on profit margins. Rising wages, supply chain disruptions, and higher taxes could all negatively impact profit margins over the next few years. However, while elevated valuations may pose a speed limit for the market, the outlook for returns remains positive amidst strong fundamentals and corporate profitability.

After multiple years of strong outperformance of growth stocks—most notably during the pandemic in 2020—value has begun to recover. Even after a good start to 2021, value appears to remain cheap relative to growth compared to long-term averages. Additionally, value generally tends to outperform growth during periods of above-trend economic activity and rising interest rates. However, investors would be wise not to abandon growth stocks altogether as the economy is likely to slow down to a slower pace of economic growth later in 2022 and into 2023, and growth stocks have traditionally outperformed value stocks in slow economic growth environments.

So far this year, US investors have seen their assets grow by nearly 16%. Those with overseas holdings have seen their overseas profits reduced due to a strengthening dollar. Despite the current scenario, there is value to be had in overseas assets.

While the expected synchronized global recovery has been delayed, it has not been derailed, and vaccination progress overseas has gained speed with many countries now outpacing the U.S. The global economy is expected to continue to grow above trend over the course of next year and for robust earnings growth to be an important catalyst for international markets. In addition, valuations remain attractive with both emerging market and developed market stocks at some of their cheapest levels relative to the U.S. in the last 20 years. This, along with a

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Continued from the front:

global post-pandemic economic rebound, lower trade tensions and the prospect of a lower dollar in the long run argue for a greater allocation to international equities, with a particular focus on East Asia and Europe.

S&P 500 valuation dispersions point to a widening valuation gap between the most and least favored stocks in the index. The current S&P 500 valuation spread is markedly higher than the 25-year average—this wide dispersion in valuations points to an opportunity for active management. Another way to look at the valuation dispersion in the S&P 500... The top 2% of stocks are nearly a third of the market capitalization of the index, over a quarter of all earnings, and are pulling up the overall PE ratio. There is room here for active managers to diversify portfolios among more attractive holdings in this environment.

The U.S. economy has had a bumpier recovery than expected but is still on strong footing as we enter the fourth quarter, and further progress on the pandemic at home and abroad will continue to be a tailwind for the global economic recovery. Given the substantial growth markets have had thus far in the economic cycle, investors would be wise to focus on fundamentals and maintain a diversified stance as we move forward to a—hopefully—better 2022.

The Fed and Interest Rates

While Delta poses a risk, the economic recovery has been robust and the Fed is keen to keep it on track. At its September meeting, the Federal Reserve gave markets an update on how it expects the broader economy to perform over the next few years. In general, the committee appears cautiously optimistic and still expects growth and inflation to run above historical trends—but cool down as we move into next year. Also, with companies paying more to attract workers, job growth should remain solid. While this is mostly good news, the Fed still wants to keep interest rates low for as long as possible, and may not begin raising rates until late 2022 or 2023. However, they are expected to begin to reduce bond purchases by year-end.

In August, the Fed adopted an “Average Inflation Targeting” strategy, by which they will aim to achieve inflation of above 2% for some time to make up for years of undershooting this target. In order to achieve this they have pledged to hold the federal funds rate at its current 0-0.25% target range until inflation is at 2% and on track to moderately exceed 2% for some time.

The combination of very easy monetary policy and a recession has left 10-year Treasury yields at very low levels. Interest rates will likely move higher into 2022, against the backdrop of rising inflation, faster growth, and a less accommodative Fed as they begin tapering. There continues to be a place in portfolios for fixed income to provide diversification and protection in the case of an equity market or economic relapse, but investors may want to focus on shorter duration bonds to be well-positioned if long-term rates resume their ascent. Those buying into 10-year Treasuries at this level are accepting negative real yields currently due to inflation and also the prospect of declining valuations when interest rates rise. Investors don’t like to have a lot in cash but make sure your emergency fund is healthy.

How much value could bonds lose in a rising interest rate environment? A 1% rise in interest rates from current levels—assuming a parallel shift in the yield curve—would see nearly 9% lost from 10-year Treasuries and nearly 20% from 30-year Treasuries. Those who invest in these securities to avoid the volatility of equities may find there are more ways than one to lose value in a portfolio. Diversification will continue to be important to investment success.

Searching for greater yield in the fixed-income markets can lead to a reduction in the benefits of diversification. Reaching for greater yield increases the correlation to equities. This means that the average investor, trying to use fixed-income as a diversifying asset to equities, has to accept low yields in this environment.

Federal Government Finances

The federal government has hit a record high debt-to-GDP ratio, levels that have not been seen since WWII. The \$1.9 trillion American Rescue Plan is still working itself through the system and will continue to support the economy through the end of the year and into 2022. Further, negotiations continue in Washington on additional spending aimed at infrastructure, child care and education, among other initiatives. However, new stimulus would be stretched out over a decade and at least partially financed by tax increases, providing much less stimulus to the economy than we have seen over the last two years. In 2022, the economy should be much healthier than over the last two years but it should also receive less government support.

Do Something

Investors should remain vigilant with their portfolios and review their holdings. I believe this environment is where the best managers will have an edge over “passive” managers that seek to match index performance. Sit down with your financial advisor and ensure your investments are prepared for the future and consistent with your objectives. Don’t panic when markets become volatile. The average intraday drop in the market for the last 40 years has been over 14%. Expect it. Be calm.

Plan for the future. Has there been a birth or a death in the family? Marriage or divorce? Graduation or retirement? Each of these will have an impact on existing financial plans.

Summary

My long-term outlook continues to favor equities over bonds—just don’t expect higher than average gains. This is an environment for strong investment managers and careful stock selection. Overseas holdings may benefit long-term investors with greater growth potential. Income-oriented investments may struggle in a low interest rate environment. Bonds may have value as a diversifier for managing portfolio risk. However, chasing higher yields may reduce much of the benefit of diversification. Shifting to bonds to reduce portfolio volatility could expose more of the portfolio to interest rate risk.

What to do now? **Take the long view with your investment assets and review financial plans.** When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing documents,

Source: General economic statistics are from JP Morgan “Guide to the Markets” 4Q2021.

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