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July 2021 Market Commentary

In the first half of this year, the S&P 500 Index increased an impressive 15.2%. The stock market narrative was dominated by unexpected strength in the post-Covid rebound in corporate earnings. For context, in 2019, before Covid, the S&P500 Index reported record earnings per share (EPS) of $163. Then, in March 2020, the economy abruptly shutdown, and EPS for the year declined 14% to $140. This year, EPS rebounded sharply, to an estimated $195, 20% higher than 2019, and next year, the EPS estimate is up another 13%, to $220! This values the S&P at an historically high level (19X EPS); however, the stock market's valuation is based not just on the level of earnings, but also its growth, which is unusually strong right now. The economy is reopening, as vaccines proliferate, and Congress and the Federal Reserve have provided massive stimulus.

Since March 2020, Congress has appropriated $5 trillion in Covid relief, and the Federal Reserve has purchased $4 trillion in bonds in the open market (Treasuries and mortgage-backed securities) to liquify the financial system and keep interest rates low. This $9 trillion in stimulus has been breathtakingly successful. Consumer Net Worth (investments, homes, and bank deposits including excess savings) has increased in the last five quarters by $32 trillion, to a record $142 trillion. This astounding *increase in wealth* is more than the total federal debt ($26 trillion)! Homebuilding, retail sales, industrial production, and capital spending on equipment are strong. GDP (total economic activity) has made a full recovery. Only total employment is lagging, as 7.6 million workers have either retired or delayed returning to work; the best measure of unemployment is 10%, compared to 7% in 2019. Fortunately, there are a record number of job openings, and employers are raising wages to fill them.

The Federal Reserve is focused on employment, not GDP, so its foot is on the accelerator at a time when the reopening of the economy has created shortages of materials and labor. As a result, inflation is on the rise, at 3.4% in May on the Fed's preferred measure, and probably headed to 4% by year-end, well above its 2% target. The Fed believes this inflation is temporary and should recede once the economy adjusts to reopening. In the prior record economic expansion (2009 to 2019), economic growth averaged 2.8% and inflation was only 1.6%. This explains why the Fed is confident that there are powerful secular forces restraining inflation, like automation, global competition, and a plentiful supply of labor. The bond market is accepting this rationale for now, as the yield on the 10YR Treasury is stable at an historically low level, 1.5%. However, the Fed has not distinguished itself as an economic forecaster. What if the Fed is wrong about inflation, and it continues to rise next year, to 4% or higher? In the past when the Fed has fallen "behind the curve" on inflation, it

has abruptly reversed policy, and the economy has suffered. To avoid this outcome, the Fed is now considering a gradual "taper" of its massive bond purchases, hopefully by year-end.

At least the Fed tries to be predictable; Congress on the other hand makes no such effort. Lawmakers have apparently reached bipartisan agreement on a $1.2 trillion infrastructure plan to repair our transportation system (including roads, bridges, and public transit) over the next few years. The White House also wants to spend $1.8 trillion on "human infrastructure" (family care, education, and health care), and raise taxes on corporations and wealthy individuals. The legislative outcome of these proposals, and their economic impact, are imponderables.

For buy-and-hold investors, economic policy, and the twists and turns of the economy, are not the primary determinants of long-term investment performance; timing is less important than stock selection. Of course, valuation is always relevant, and right now our quality growth stocks are expensive, already reflecting the outlook for higher earnings this year. Despite some temporary supply chain difficulties, most of our companies are reporting improving orders, pricing power, and profit margins. In this environment patience and discipline are required, allowing time for earnings to catch-up to stock prices. "Never give up your positions in a bull market," advised an investment legend.