Growth and Income Outlook
Third Quarter 2021

During the second quarter of 2021 the stock market moved higher, propelled by strong post-pandemic economic growth coupled with robust monetary and fiscal stimulus. While inflation did increase as pent-up demand for goods overwhelmed production and transportation capabilities, the Federal Reserve (Fed) and the markets remained convinced that these supply/demand imbalances were temporary and any pickup in inflation transitory. Whether this view is correct is the $64,000 question.

We believe that economic growth will remain quite strong as we recover from the Covid-induced shutdowns. The consumer is generally in good shape financially and eager to go out and spend. Businesses are hiring in order to re-open or expand. Many employers report difficulty finding enough qualified workers. Wages in many industries are rising. High single-digit GDP growth should persist for another couple of quarters. Thereafter, growth will probably revert to a more moderate, but sustainable, low single-digit pace.

As we pointed out above, the current surge in demand exceeds the ability of producers to supply and transport many goods. As a result, prices for commodities and certain finished goods have risen, pushing inflation higher. For instance, lumber prices tripled, but since peaking have fallen 56%. Likewise, copper rose from $3.52 to $4.80 per pound but has since pulled back. Once businesses are operating at full capacity, we expect supply/demand to rebalance and prices to normalize. But this is not entirely a given.

In the meantime, the market appears befuddled by questions around the transitory nature of inflation, how long the strong rebound will persist, and whether a resurgence of Covid threatens the recovery. As a result, the average stock has traded flat since the first quarter earnings season, with the most recent market advance coming from a flight to safety in large-cap tech stocks as bond yields have fallen. More interestingly to us, we see high daily volatility between small and large caps, and growth and value. This suggests a lack of market consensus about the next stop for the economy – is our destination a return to low growth and low inflation, which is favorable for higher multiple secular growers, or structurally higher inflation and a long duration cyclical recovery, which favors value and cyclicals? While we think this is one of the most important questions in the market today, the ultimate answer is likely a number of quarters in the future. With respect to Covid, the success of the vaccines suggests to us that any Covid-driven setback in the recovery would be temporary.

One school of thought foresees persistent labor shortages and long-term upward pressure on wages, reversing trends of the last 20-30 years. Since roughly the mid-1980s, the twin forces of globalization and technology have conspired to keep labor costs down. Globalization allowed the U.S. and other developed countries to tap into nearly limitless Chinese and other developing economies' low-cost labor pools. High-paying U.S. manufacturing jobs were shipped overseas. Union membership declined. Domestic wages stagnated.

Technological advances also worked to reduce labor input (and hence wages) and generally to make business processes more efficient. We see no let-up in technology gains but caution that globalization may have run its course. First, we see a trend toward re-shoring, i.e., bringing manufacturing back to the U.S. This would obviously lead to greater demand for domestic workers. Second, China's one-child policy has had a profound impact on its demographics. Simply put, China is running out of cheap labor. So much so that Chinese authorities have relaxed the policy. They need more workers to support their aging population.

China's demographic shift could have significant long-term implications for labor costs. If so, it would clearly be inflationary. The era of sub-2% inflation may be coming to an end. On the other hand, technology continues to advance and exert a deflationary force throughout the economy. At this point, it is impossible to say which trend – demographics or technology – will prove to be stronger. But should inflation rise, we would expect interest rates to rise, and this could put downward pressure on equity valuations. Then again, if inflation proves transitory, interest rates could stay lower for longer, resulting in what might well be a further surge in equity prices.

We should also point out that while some economists worry about the potential for accelerating inflation, others raise concerns about potential deflation. They point to a drop in Treasury yields from nearly 2% to below 1.5% and a significant drop in the prices of bitcoin and precious metals. While the Fed has been pumping money into the economy, the actual velocity of money has declined. That is, banks have not been lending aggressively, thereby blunting the stimulative effect of loose monetary policy.

At this point, we do not have a strong view on the inflation-deflation debate. We suspect that inflation will decelerate meaningfully in the back half of 2021, but over the longer-term we see the potential for upward wage pressure that may or may not be offset by technology and automation. Our best guess is that reality will probably fall somewhere in-between, i.e., the economy will again settle into a slower-growth, low-inflation pace where wages keep pace with inflation (which would be a positive change). Given all the monetary stimulus and the potential for marginal improvement in real household income, this could be very good for equity prices.

Since the second half of 2020, the stock market has wavered between its love of great secular growth stories (e.g., the tech giants) and the more cyclical recovery plays such as travel & leisure companies and many industrial names. We think this yin-yang will persist as investors vacillate between a desire to own persistent growth and an interest in buying companies with the greatest acceleration in earnings. We have sought exposure to each camp: persistent growth and fast recovery. Ultimately, we are stock pickers, and despite our fascination with broad macro-economic trends, in the end we look for investments in (1) companies with excellent long-term earnings potential that may not be fully recognized by the market, or (2) companies which we believe are about to experience accelerating earnings growth for reasons the market has yet to grasp. We further refine our focus by analyzing the shifting economic landscape, trying to identify those areas of the economy benefitting from secular tailwinds. These would include the shift away from carbon-based fuels to alternative energy, the shift toward electric vehicles, the shift from brick-and-mortar retail to e-commerce, and the digitization of the economy to name a few. These areas of the economy should grow regardless of the ups and downs of the business cycle. Within each such industry we try to identify those companies most likely to emerge as long-term dominant players. This, combined with a valuation discipline, has enabled us to build robust portfolios that we think should perform well through good and bad times and in both bull and bear markets.

Looking at fixed income, we believe much will depend on how inflation plays out beyond the next few quarters. If it is in fact stickier than expected, we may get earlier rate normalization than 2023 from the Fed. If not, they will likely be keeping rates low for as long as is practical. This, combined with the expectation that growth will inevitably slow from the current torrid pace, will likely keep interest rates from rising excessively over the next few years. Given that finding yield will likely still be challenging, and that investment grade returns may lag during a rate normalization regime, we still generally prefer the non-investment grade sector because of its lower duration, higher yields, and healthy fundamental backdrop.

Please let us know if you have any questions.

Sincerely,

John Osterweis Larry Cordisco Carl Kaufman

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[OSTE-20210720-0294]