July 10, 2021

Letting Some Air Out

Dear Investor:

When you work full time in the investment business, you realize that we always seem to be waiting to see what the Fed is going to do next, and when they are going to do it. While it's actually been that way since their creation in December 1913, it has been very pronounced the last fifteen years or so. Our economy has been through two boom and bust cycles and the Fed has been playing a very large role the entire time.

The recent Fed meeting that ended June 16, 2021 has let some of the air out of the market outlook, and I think it's a good thing. There was a general feeling that the Fed was not willing to acknowledge how much the recovery and inflation had both moved up since their earlier meetings this year. There were very strong feelings by many that their policy path was becoming more inappropriate by the day, and they were missing the mark.

The fears stemmed from the inflation numbers coming in much higher than expected. There is much debate if this inflation is transitory, as the Fed insists, or if we are going to be stuck in higher inflation for a significant period of time. Surprisingly, former Democratic Secretary of the Treasury under President Bill Clinton, Larry Summers, was one of those sounding the alarm. Being brief, he is concerned that heavy government spending, like we see right now, can raise inflation to damaging levels. Following that, he does not believe that history shows the Fed can bring that high inflation under control without pushing the economy into recession. To quote him, "The Fed has had almost no success gently bringing down inflation once an economy has started to overheat". If you know anything about Larry, he is no hawk, so this definitely caught people's attention.

The June 15-16 FOMC meeting was very significant in setting the tone for what may be ahead. The results of that meeting let everyone know that the Fed was not asleep at the wheel, and they were open to adjusting their policy if the incoming data demanded it. The notes from that meeting show us several important points which I'll briefly summarize:

- Economic growth and recovery are still not where they want them to be. This basically means there are still too many unemployed people.
- Reopening after a pandemic has a high level of uncertainty and requires extra patience in setting policy.
- Many Fed officials believe the inflation risks are "tilted to the upside".
- Dot plot projections show rates could be going higher as soon as sometime in 2022.
- The debate over when to begin tapering bond purchases has begun in earnest.

These points may not seem like a big deal to the casual reader, but in reality, the last three were very significant to investors and showed the possibility of accommodation being reduced much sooner than previously expected. In preparation, the Fed has a long way to go to taper their asset purchases down to zero. Current expectations are for them to announce their taper plans in August at their annual research conference in Jackson Hole, Wyoming. This meeting has been used frequently in the past to signal policy changes. If not there, then most likely at their regular September meeting. It's currently thought the taper would begin in January of 2022. If the economy continues stronger than expected or inflation stays high, some think the taper could start as early as October of this year.

As I said in the beginning, I think this is good news for investors. We don't want to see the economy or the stock market overheat to the point that only abrupt and painful actions can bring it under control. I've mentioned a couple of times recently that the best outcome we can hope for is a gradual reduction in these very high P/E's. Essentially, letting the air out of the sky-high valuations. In my opinion, this will be the very thing that allows the bull market to continue, and it's not only the stock market. Our bond markets and the housing market are also sky high. What the Fed has shown is they can at least see the day when they will be starting to unwind some part of the truly massive stimulus that got us through the pandemic.

Since that meeting, the June Payroll Report came in quite strong with an addition of 850,000 jobs. Around 40% of those jobs were in the sectors most affected by the pandemic; leisure and hospitality. Over 22 million jobs were initially lost when the pandemic hit. We now need less than 7 million more jobs to get to the pre-pandemic level of 152.5 million working in Feb 2020. This was seen as a good sign that the recovery is still on track. Putting the last group of people back to work may take longer due to the mismatch between the jobs available and the type of work people are looking for. There are several reasons for the mismatch, but over time most of this should work out, and people who want jobs will have them.

I'll conclude with a couple of comments on our GDP and growth for this year. The Conference Board is expecting annualized growth in the second quarter to be around 9%. This number sounds huge, but we have to remember that it is a comparison to the same time period last year when the lockdown was in full effect. Many things were close to a total standstill. So glad that's no longer the case. They expect the growth rate for the full year to be in the range of 6.6%. Further ahead they are expecting 3.8% in 2022 and 2.5% in 2023. In other words, if things unfold this way, we will be back to the trend line we have been on for some time where 2% to 3% seems like our normal rate of growth. I expect that will still be a reasonable environment for investors.

We hope you enjoy the summer, and please contact us anytime to discuss your investments.

Best Regards,

David E. Keim

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com