October 12, 2021

TIME TO TAPER

Dear Investor:

One of the most important issues in the economic outlook right now is the Fed taper. In addition to keeping interest rates pegged at rock bottom lows, the Federal Reserve is buying $120 billion dollars of US Treasury bonds and government backed mortgages every month. That's over $1.4 trillion a year. The "money" to purchase these securities is digitally created out of thin air. There is no physical or intellectual labor behind these dollars. Thus, you have to wonder about the value of all this "money" and how long this should go on. The Fed balance sheet has more than doubled since the end of 2019 and is up ten-fold since the era prior to the Great Recession. We can't forget that the Treasury has also run historically large deficits to pay for all the government relief programs they put in place. There's no free lunch, and bailing ourselves out of these huge problems has come at a big price. The Fed has been preparing the markets to start to taper these purchases in either November or December, if everything stays on track. As this is a gradual reduction of bond purchases, it will stretch well into next year. It's expected it could end sometime next summer with the balance sheet around $9 Trillion by that time. The economy has come much further in the last 18 months than anyone would have thought possible in light of the severity of the pandemic. While it appears that all this liquidity has held things together for us, it's time to reduce the excess stimulation and let the economy stand on its own.

As I discussed in my last letter, the notable rise in the level of inflation has caused the Fed to rethink and accelerate their timetable on the taper. Inflation in the US is currently running in the range of 4.3% to 5.3% depending on which metric you choose to use. There is also a strong case to be made that the housing component of inflation, which is approximately 35%, substantially underestimates the inflation in real estate. Thus, the real inflation rate could be even higher than stated. Months ago, the Fed was insisting that inflation would be transitory. Many market participants were very skeptical of this and pointed out that it always starts that way. Now the Fed has suggested inflation may be with us longer than they thought. Most economists believe that wage inflation is embedded and is very unlikely to be rolled back. Blackstone strategists have pointed out that if you average in these current readings with inflation measures over the last five years, the Fed has achieved their goal of average inflation above 2%. They need to reposition themselves to fight inflation if it stays elevated.

On the subject of housing, prices have taken a very big step up in the last year. According to the National Association of Realtors (NAR), the median existing single-family home price was $363,800 in August, up 15.6% from August 2020. The median price for a new home was up 20.0% over that time to $390,900. This is being driven by high demand and very low interest rates. While some are expecting these prices will moderate going forward, I haven't seen anyone predicting the prices will roll back. This makes it very hard on people entering the market for the first time. The Wall Street Journal just ran a story on some millennials teaming up to buy homes together. Friends, partners, and roommates are pooling their resources to buy homes together as it's the only way they can afford to buy. I'm not implying this is a bad thing, but it's being driven by high prices. As people's lives go in different directions over time, new arrangements will have to be made for one party to continue the ownership.

Another issue you hear a lot about is supply chain problems and labor shortages. These items are having a very direct effect on the economy and holding back growth. Perhaps a direct quote from the September Manufacturing PMI Report will give you a better feel for this issue than I could: "Business Survey Committee panelists reported that their companies and suppliers continue to deal with an unprecedented number of hurdles to meet increasing demand. All segments of the manufacturing economy are impacted by record-long raw materials lead times, continued shortages of critical materials, rising commodities prices and difficulties in transporting products. Global pandemic related issues – worker absenteeism, short-term shutdowns due to parts shortages, difficulties in filling open positions and overseas supply chain problems – continue to limit manufacturing growth potential."
I'll add a couple more which I'm sure you've heard about. The auto industry is being heavily affected now by the chip shortage they need for their vehicles. Many manufacturers have had to cut way back on the number of popular vehicles they can produce right now. Sales are down close to 25%, as dealers just don't have enough new cars on their lot to sell. This has driven used car prices sky high, also contributing to inflation. The second item you have likely seen on the news, and that is the problems with container ships at the west coast ports. The number of ships waiting to offload continues to climb. There are not enough workers, and there are not enough trucks and truck drivers, to distribute the goods around the country.

The growth numbers this summer came in lower than expected due to the Delta variant. This caused the market to pause, and it was essentially flat in the third quarter. It looks like Delta may have peaked and we are moving past it. Vaccine levels have increased substantially worldwide, and this should contribute to the economy reaccelerating. Looking ahead, the economy is expected to grow in the range of 5% to 6% this year and around 4% next year. If that happens, we would expect the market to try and move forward again. However, as I've talked about for quite a while now, prices remain very high relative to historical levels. Once the taper is behind us, it's expected that interest rates could begin to go up toward the end of 2022. Although they would likely be very low for several years, rising rates should begin to bring down the high valuations. As long as this happens along a slow and steady pathway, it should not cause too many problems. I would expect this to lead to lower returns than what we have seen recently. Please contact us anytime to discuss your portfolio.

Best Regards,

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