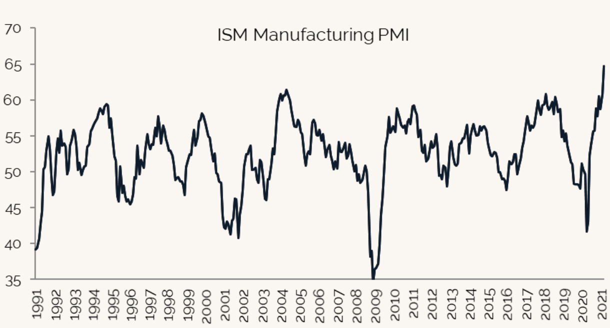
MULVIHILL

"If you watch 60 minutes, CNN and/or Fox News, you have to come to the conclusion the country is going to hell in a handcart"

The U.S. has now reached a level where over 50% of the population has received at least one dose of the vaccine. Reopenings continue apace giving us some real-time insights into what post-pandemic economic growth will look like. This does not currently apply globally as countries like Canada scramble to source new supplies of vaccines and even developed nations such as Japan are being forced to reintroduce emergency measures as the number of cases is again increasing rapidly. It came as a shock to me to read that only 1% of Japan's population has been given a vaccine. On the assumption that the pandemic will eventually come to an end around the world let's use the current U.S. experience as something of a road map on where we are headed. As often noted, some economic growth releases are strongly impacted by the so called "base effect", such that comparing today's numbers to the pandemic influenced reports of one year ago skews the numbers upward. Still, the growth is very impressive, in most cases exceeding even optimistic estimates, as people are allowed to get out and spend money. The ISM Purchasing Manager's Index (Figure 1) that attempts to measure the intentions of businesses, (reports over 50% indicating growth) was very strong in March. The Manufacturing Index came in at 64.7%; the Services Index at 63.7%; and the New Orders Index at 67.2%. Retail sales in the U.S. grew at a 9.8% rate in March with many strong sectors enjoying the effect of the reopenings. Sporting goods rose 23.5% (let's get out of the house); clothing and shoes were up 18.3% (the sweatpants won't work in the office); and champagne sales increased 103% (no explanation necessary). Between the stimulus checks and the large savings built up during the pandemic it appears the U.S. consumer has the wherewithal to spend and a desire to do so. People are calling it the start of another roaring 20's.

Figure 1:
ISM sits at the highest level in the past 30 years



Source: Bloomberg, Mulvihill Capital

The dark side of this strong growth is the risk of it being accompanied by rising inflation which has historically led to higher regulated interest rates and lower financial markets. Fed Chairman Powell has taken the position that there will be an initial burst of inflation but to use his word it will be "transitory" despite his belief economic growth will remain strong. It is the best of both worlds and I hope he is right. So far the Consumer Price Index has remained relatively benign with March reporting an increase of 2.3% comparing it to February last year to eliminate the "base effect". The food and energy sector though, increased over 4% which we can all relate to. Perhaps more serious in the long run is the rising costs of producing and delivering goods which can be more permanent as opposed to the inflation coming from a rebound in demand that might well be transitory. Lumber has been a poster boy for price inflation having risen 180% since last spring before a recent decline. While there is no argument new housing and renovations have increased demand, the supply chain became broken during the pandemic and lack of inventory and cost-push inflation and played a large role in the rise in prices. The expense of reopening sawmills and increasing wages to attract workers back are two examples of higher costs. Also more truckers are needed to get the product to market, which is another industry experiencing wage inflation. Companies are reporting having to offer salary increases as high as 40% and include free training to get bodies in the seats as the economy expands. Wage increases in a growing economy are very "sticky" and would be a major factor if inflation is to become more permanent. Procter and Gamble announced that it will raise prices in September, another example of rising costs translating to higher prices. The alternative if costs continue to rise but companies can't or don't raise prices is obviously lower corporate earnings, a negative for stocks.

Stock markets remain resilient but overbought on a short to medium term basis reflecting the strong increase in the past several weeks and months. I remain a fan of seeing a correction or consolidation to unwind the overbought levels and temper some of the enthusiasm and optimism currently in the market. As discussed above, the economy is growing at a rate supportive of stock values but it can be argued much of that is already priced in. For instance, cyclical and small cap stocks have been outperforming since last summer in anticipation of benefitting from the reopening but now that the recovery has arrived those stocks have been recently underperforming. The chief strategist at Deutsche Bank has noted that historically ISM growth rates peak about 10 - 11 months after a recession ends and there is a strong correlation between the ISM Reports rolling over and stock markets doing the same. That's about where we are now and could be justification for a correction or consolidation but without affecting the longer-term bull market we are in. It is old and overused, but Keynes hit the nail on the head when he wrote; "The market can stay irrational longer than you can remain solvent". The Fed and the Biden administration are committed to proving Keynes correct, perhaps not the irrational part but certainly the longer part.

Geopolitics has had little effect on markets for the past decade with the exception of a few blips like Brexit. The widespread idea that a more reserved presence in the White House would lead to calmer times has proven to be wishful thinking. Both in matters of foreign policy and internal U.S. politics the situation actually seems worse. Russia is amassing troops on the border with Ukraine and China is building its military presence in the South China Sea with a focus on Taiwan. I'm not suggesting either intends to attack but each seems intent on testing the resolve of the new President and if rumors that the two countries are coordinating their efforts are true the situation is much more serious. The domestic issues are more current but again not necessarily meaningful to markets. New restrictive state voting laws are being proposed across the country but will likely be invalidated at the Federal level much to the consternation of most Republicans. The Trump administration managed to appoint new Supreme Court justices such that there are now 6 so-called conservatives on the bench and only 3 liberals. Not to be outdone President Biden and Democrats have started a Supreme Court review with the intention of increasing the number of justices so that the majority would become liberal again. Of course Republicans say they will do the same on their next return to power. How many seats will there be on the court before it all sorts itself out? The idea of the Court was to interpret the Constitution not become a partisan organization. If you watch 60 minutes, CNN and/or Fox News, you have to come to the conclusion the country is going to hell in a handcart. We need a strong and stable U.S., let's hope things improve.

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