Portfolio Management, LLC

Building Wealth Wisely

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Risk on the Rise

An economic boom is underway. Housing is red hot. Retail sales are strong, and demand is surging. Business investment in equipment and intellectual property is rebounding, and inventories are being rebuilt.

Investors have charged into financial markets with a vengeance. Speculation is surging, as indicated by the significant cash pouring into Bitcoin, GameStop, Tesla, Robinhood, SPACs, and Non-fungible Tokens, to name a few. The stock market is on a tear this year, with the S&P 500 Index already up 12% through the end of April.

Fiscal and monetary policy has supported equity valuations. Given the massive amount of government spending and the unfolding benefits of the vaccine rollout, the economy should perform well this year. Most analysts expect the financial markets to end 2021 in positive territory.

The bond market hasn't fared as well. Exceptionally accommodative monetary policy and massive fiscal stimulus have put upward pressure on interest rates to start the year. U.S. Treasuries recently had the worst quarter in 40 years, with the U.S. 10-Year Treasury yield climbing by over 80 basis points.

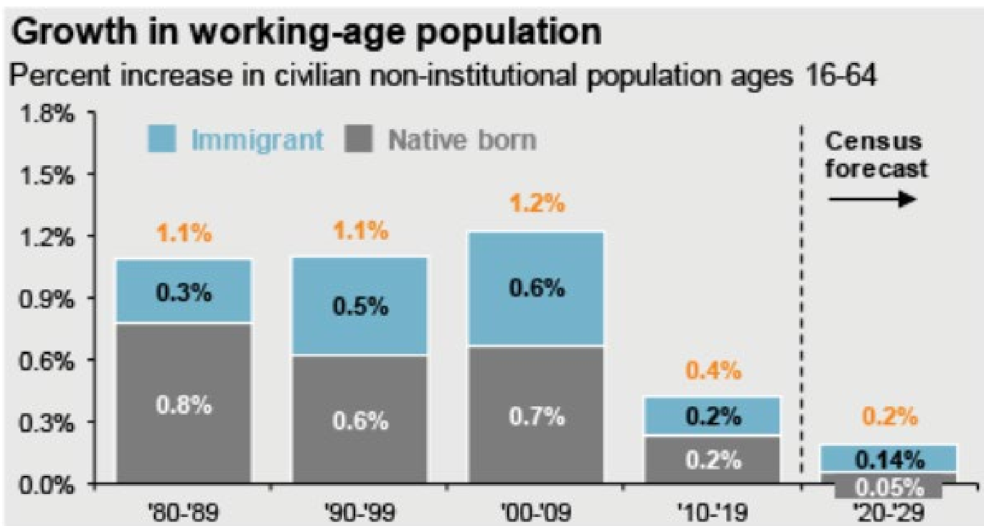
Our firm is growing concerned about stock market valuations and the prospects for higher inflation. While we're not predicting imminent doom and gloom, bonds could come under more pressure and stock market returns might be more modest in the coming decade.

Prices of aluminum, copper, oil, lumber, and other materials are all surging. Shortages and supply chain disruptions are widespread in every industry from semiconductors to steel. Shipping and ports around the world are bottlenecked.

A number of industries are already experiencing a shortage of labor, which is the main catalyst of entrenched inflation. A lack of labor leads to wage increases, a phenomenon which can feed on itself and snowball into further inflation.

A significant decline in birth rates, along with our aging population, is adding more upward pressure on wages. The number of births in the U.S. in 2020 was the lowest in over four decades. Furthermore, public sentiment and the coronavirus pandemic have combined to lower the number of skilled immigrants coming into our country.

In addition, there is a shortage of workers paying taxes to meet the cash flow needs of Social Security, Medicare, and other entitlement programs for retiring baby boomers. As shown in the chart below, there was significantly lower growth in the working-age population during the previous decade, and working-age population growth in the current decade is projected to be even lower.



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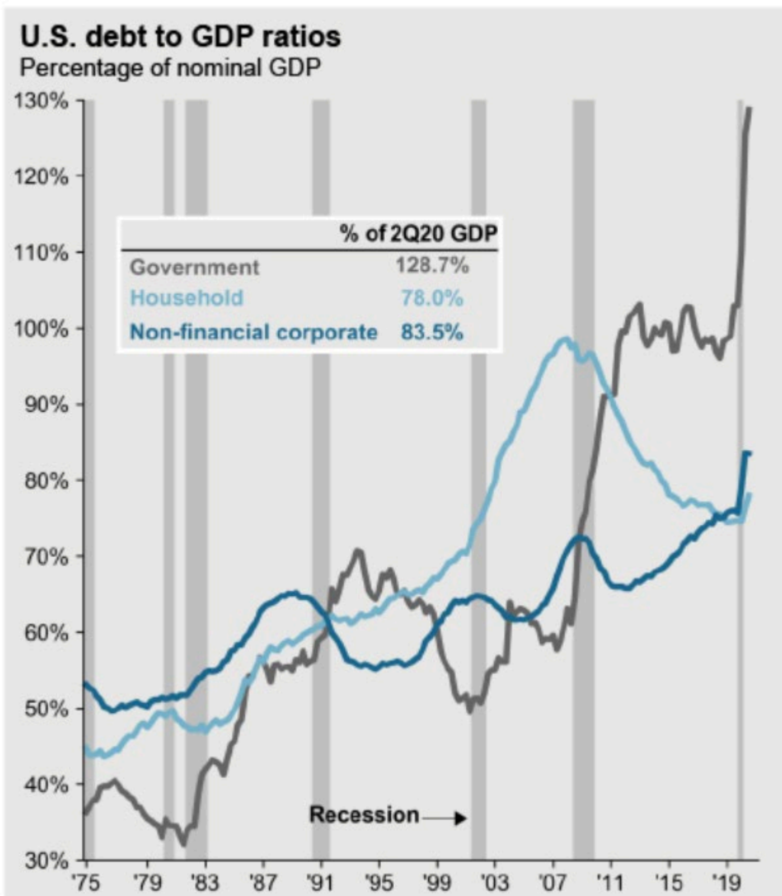
Federal Reserve Chairman Jerome Powell and Treasury Secretary Janet Yellen seemed determined to boost the economy to record levels, and they consider higher inflation an acceptable risk for the time-being. The Fed has downplayed the risks of higher inflation over the long haul.

> *"Our best view is that the effect on inflation will be neither particularly large or persistent."* - Chairman Jerome Powell

If the Fed is wrong, it will probably need to hit the brakes hard at some point in the next few years, which could trigger a deep recession.

On the Washington front, the scale of government spending over the past year dwarfs that of nearly every other period in history. The government stimulus package has already totaled more than $5 trillion, the majority of which is deficit spending. The current administration has proposed considerably more spending in the coming months.

Notwithstanding an unprecedented $24 trillion in budget deficits projected over the next decade, Democrats are recommending the largest spending spree since the Lyndon Johnson administration. Moreover, despite just coming off the deepest recession in 80 years, President Biden is calling for the largest permanent tax increase since World War II. The current debt-to-GDP ratio for the United States is now a sight to behold.



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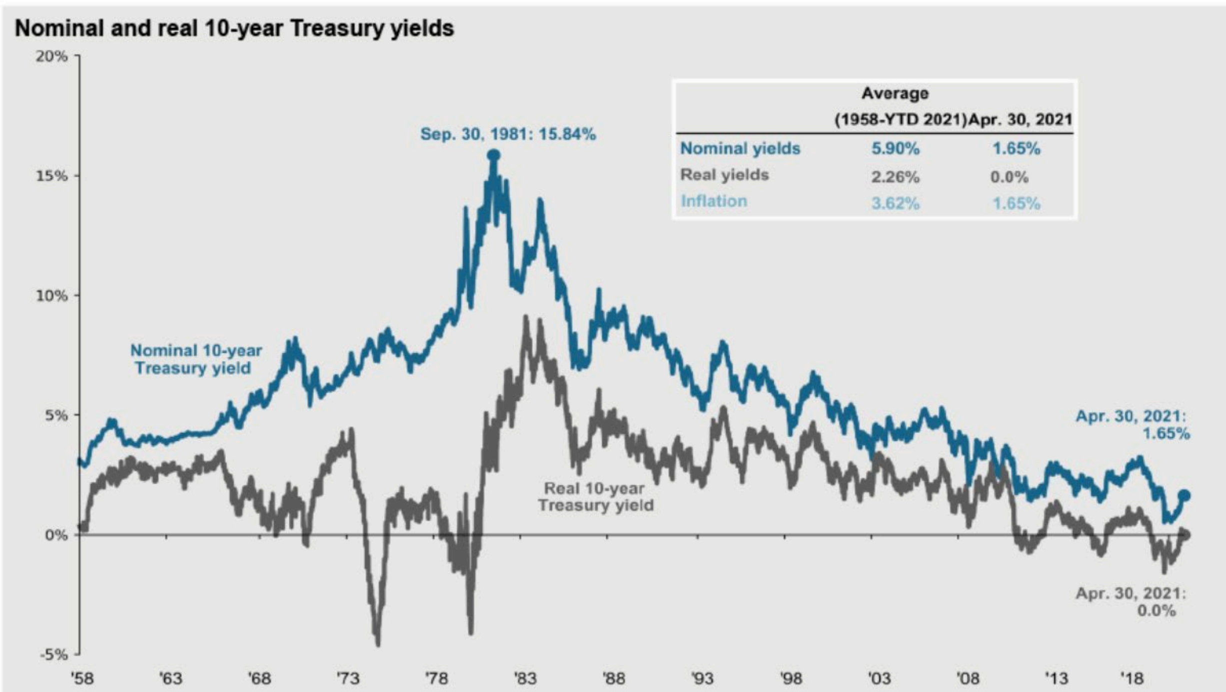
No one knows what the unintended consequences of current government policy will be. Besides the possibility of an overheated economy, our biggest risk in the long term is inflation.

Few prognosticators are predicting a return to the stagflation of the 1970s. From the Lyndon Johnson years to the Jimmy Carter years, not only did the economy stagnate but the yield on the 10-year Treasury Note skyrocketed from 2% to 16%.

It has been a long time since investors have had to deal with the impact of inflation. Our nation has been in a disinflationary environment ever since the Ronald Reagan presidency. This secular trend has been a tailwind for bonds. The following illustration highlights the dramatic rise and subsequent decline of interest rates since the ‘60s.



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Rising interest rates create a dilemma for bond investors. First, rising interest rates push the price of existing bonds down because older coupon rates are no longer competitive. Second, rising inflation rates erode the purchasing power of future coupon payments for existing bond holders. Eventually, rising rates would be a good thing for future bond investors because higher yields translate into higher returns.

Hopefully, our economy will be able to work through the challenging circumstances in which we find ourselves today. Higher prices for goods will help utilize more factory capacity, which could smooth out prices as supply and demand move closer to equilibrium. There is also still a lot of slack in the overall labor force for companies to draw upon. More people will be able to return to work with the continued rollout of vaccines and the reopening of schools.

Higher debt does not always lead to higher inflation. Japan – another developed nation with an aging population like the U.S. – has avoided higher interest rates for decades while carrying much higher debt-to-GDP levels than our nation.

We are not necessarily predicting protracted inflation or an overheated economy, but we don’t think investors can ignore these possibilities. Because we ultimately don’t know how inflation or the economy will shake out, we think it’s prudent for investors to increase their allocations to the types of investments that guard against these potential risks.

On the equity side of our client portfolios, our firm has been adding modestly to energy, natural resources, materials, metals, real estate, small cap stocks, and value stocks. The stock prices of many types of companies do well during inflationary times because they can raise prices in response to inflationary forces.

On the fixed-income side of portfolios, we are keeping duration shorter than average, with an emphasis on allocations to Treasury Inflation Protected Securities, floating rate bonds, and mortgage-backed securities, along with the increased use of individual bonds and target date bond ETFs.

While the economy and equity markets are moving in a positive direction, it is important for investors to be aware of rising levels of risk. Fiscal and monetary policy has the potential to lead to higher interest rates and inflation, which may prove challenging for the economic expansion. We remain committed to a long-term investment strategy that focuses on rebalancing diversified portfolios to meet evolving needs and circumstances.