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OBSERVATIONS ON THE MARKET

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Sometimes you can be rich, but still be poor. Let us say you are extremely fortunate and win $100,000,000 in the lottery. After taxes you have $75,000,000 in your account. Feeling a little overwhelmed, you decide the smart thing to do is to just buy three-month Treasury bills to give yourself some time to adjust to your new economic status. However, with $75,000,000 you decide working is for common people, so you quit your job. Now, your only income is interest on $75 mil. According to the US government, and everyone else who looks at your tax return, you are now in poverty. You will qualify for food stamps, subsidized housing, and any other assistance that is afforded someone who is a family of two and earns less than $15,000 per year. Your annual income on $75,000,000 earning .018% amounts to only $13,500. What makes this relevant to the rest of us common people is that inflation is currently running at 4.1% per year. The purchasing power of your $75,000,000 in one-year declines to $72,000,000. Take a few 0's off this example and you start to see the problem for the rest of us. The markets are also concerned.

In the real world, the market starts to compensate investors with a higher interest rate to account for higher inflation. We presently are not living in a world that is driven by the markets, we are living in a world controlled by the FED. They continue to buy $120 billion per month in bonds, and $40 billion in mortgages. This is preventing interest rates from adjusting to reflect higher inflation. The FED does not plan on letting short-term rates rise for another 2 years. The latest inflationary reading jumped from 2.6% just one month earlier to 4.1%. It is easy to see why. From Jan 2020 (before the whole pandemic became an issue) to May 2021, lumber prices are up 70%, oil up 27%, cotton 30%, copper 80%, corn 83%, wheat 12%, and hogs are up 100%. We all use one form or another of these commodities every day. The FED is betting this is a short-term issue and will soon reverse itself. Clearly, the stock market, which is not controlled by the FED directly, is not so convinced. There are other warning signs.

Corporate profits have already recovered from last year's economic hit. In 2019 the S&P 500 earned $157 per share in profits. This year the estimates are for $185. The 1st quarter saw earnings come in higher than any previous quarter. The economy is roaring back. More fuel for the fire is the personal savings rate. It currently stands at 21%, which is twice as high as normal, the consumer is ready to spend more money. Higher demand usually does not translate to lower prices in the short-term. In a normal world, higher interest rates help act as one of the brakes to slow the economy, however, the FED remains on the gas pedal. Not only are corporate profits up, but companies are also more profitable. Operating margins for the 1st quarter are 13%, a record. We have pent up demand, a profitable and efficient corporate environment, and investors who have made money in the stock and housing markets, otherwise known as the wealth effect. The FED seems to be taking a big gamble here.

The last time we had inflation this high was in August of 2008, it was 5.3%. We know what happened then, the economy collapsed. We do not seem to be in that position currently. Then you must go all the back to Dec 1990 when inflation was 6.1%. In 1990 10-year Treasuries paid 8%, in 2008 they were 3.8%. They are now 1.6%. The producer price index that was just released shows inflation at 6.1%. This makes the bond market a treacherous place to be currently. The stock market is a more complicated situation.

Stock prices are affected by both earnings and interest rates. Higher interest rates make stock prices worth less, just like higher interest rates means the house you can afford is smaller. Maybe the strong economy and robust earnings environment will offset higher interest rates (or the perception they should be higher), just like when you earn more - you come afford the higher payment higher interest rates have created. You are sort of back to square one. And you thought it was easy to be rich, or are you poor?