SOWING THE WIND?

A fundamental premise of nearly all traditional investment management is that, given time, stock prices will continue to climb and in general will revert to some historical mean. That has remained true for generations, as we have been fortunate to experience. But the premise, closely examined, can be naïve …

We thought we were nearly out of the woods.

Through spring and into the summer, the economy had been optimistic and resurgent, despite being still less than fully open. Over the past year, the economic leadership baton passed from housing to manufacturing to – finally – the huge services sector, and overall economic activity as measured by GDP was at the end of Q2 back above the pre-COVID level.

There remained much that needed to stabilize, readjust, recalibrate – in other words, the cumulative picture remained extraordinarily complex – but the path forward for the economy had begun to seem far less opaque than it did in the spring of 2020.

Now, viral mutation, and our response, have introduced additional layers of uncertainty; we're a long, long way from our hopeful belief early in the pandemic that we just needed to hunker down and get past a limited period of severe conditions before emerging again into a more "normal" environment.

Things can change so quickly that perceptions may be different by the time you read this. Markets have been roiled in recent weeks over a host of issues, from renewed inflation fears to the potential for Federal Reserve tapering of its bond-buying program, plus concerns of a potential debt default by Chinese real estate development firm Evergrande and the U.S. debt ceiling fight in Congress. Though the latter issues are being downplayed by many – who suggest the Chinese government will contain the first and Congress will ultimately settle that latter even if markets are spooked in the short run, all are for the moment serious concerns. In the meantime, equity market valuations remain extremely high, and, in general, all of the risk factors addressed in our last commentary remain fully in play - but let's first review the recent path of the economy before focusing on a newly emerging set of economic and of societal risks:

- GDP – At a very strong 6.5%, Q2 GDP nonetheless missed the predictions of double-digit growth, held down in part by declining inventories – not in this case a reflection of economic weakness but more likely due to supply constraints in an accelerating economy. An even stronger number was initially expected for Q3 – potentially even into double digits - but estimates have been revised progressively lower, with the Atlanta Fed GDPNow forecast tracking at only 2.3% as of the end of September, as the Delta variant of COVID-19 has clearly tempered consumer activity.
- Manufacturing – Though not accelerating, manufacturing has shown sustained strength for many months. Supply and demand appeared to be moving back toward equilibrium, though supply chains remain severely stretched. The pace of growth has softened, however - the IHS

Markit Manufacturing Index for August slipped from 63.4 to 61.2 - and overall business activity growth slowed for third consecutive month.

- Services – Have been soaring since early spring. The Institute for Supply Management (ISM) Non-Manufacturing Purchasing Managers Index hit a 20-year high at 64.1 in July, and with inventories depleted, there appeared to be room for further expansion. In the past two months, the index has eased lower but remains quite strong, acknowledging that, as with manufacturing, supply pressures are severe.
- Housing – New home sales, which had been falling sharply, began to stabilize in July and have moved modestly higher during July and August. New home inventory has rebounded to 6.1 months of current sales. With inventory rising and demand easing, the pace of price increases has begun to moderate somewhat, a hopeful sign for buyers who were in many cases being rapidly priced out of the market.

Inflation remains a broadly debated and critically important consideration, as addressed at some length in our May commentary. As a brief update:

- The case can still be made that inflation of "things" – lumber, used cars, oil, microchips, etc. – may indeed prove "transient", as the Federal Reserve has suggested, with prices either stabilizing at a higher rate or receding back to prior trends as supply chain bottlenecks ease. However, August CPI came in at 5.3% year-over-year compared with 5.4% in July, well above pre-pandemic levels, and at present, the market is very uncomfortable with the direction of things. With businesses reportedly growing more comfortable passing price increases along to customers, only time will tell how this plays out.
- It would seem that the larger question remains wage growth. Wage inflation would likely be much more "sticky," as wages that have been raised to attract workers are difficult to later roll back. Underlying wage growth is currently very strong and shows no sign of dissipating, as the employment situation will indicate …

Employment looms larger than ever. Unemployment data has improved somewhat; after flattening from mid-May through July near 400K, weekly jobless claims by late September were running generally in the neighborhood of 340-360K.

But job openings are ***soaring***, at nearly 11 million in August, for the fifth straight record high, even with 9.5 million still officially unemployed. From one perspective, such a surge in openings could be positive, as it suggests businesses see their opportunities expanding and are seeking to hire, but the persisting inability for businesses to close the gap is deeply concerning on two levels: 1) it undermines the fundamental ability of businesses to grow in the manner markets clearly anticipate, 2) it exacerbates the potential for significant wage inflation as companies compete for a limited supply of workers.

The scale of the problem is illustrated in comments from FedEx, as covered in a September 22 Yahoo Finance article:

"'The impact of constrained labor markets remains the biggest issue facing our business as with many other companies around the world and was the key driver of our lower than expected results in the first *quarter,' FedEx COO Raj Subramaniam told analysts on an earnings call. FedEx (FDX) said its quarterly results were drilled by $450 million due to labor shortages alone, notably at its ground segment. The company estimated a shocking 600,000 packages across the FedEx network are being rerouted because of the inability to find labor. Those processing bottlenecks stand to wreak havoc on the holiday season if FedEx is unable to address the worker shortage, which increasingly appears unlikely."*

The labor shortage is not new – we've been talking about it as a developing problem for years – but it has been significantly exacerbated by the disruptions of COVID-19. People have moved, many have retired, others have changed to different lines of work after prior jobs were lost – some simply remain afraid to risk public exposure, and parents with children have been constrained by school schedules – the list goes on. Part of the problem was expected to resolve as supplemental federal unemployment benefits ended and as children went back to school in the fall, but little material effect appears currently visible from either.

To further complicate, we are now facing another potentially material headwind, mentioned scarcely at all in economic commentary but now beginning to enter the direct realm of economic activity - vaccine mandates. It seems clear that the mandates may have two direct economic effects and on top of those may paradoxically feed into developing personnel issues in health care and public services, which become indirect economic impacts:

1) Impact on consumption – Businesses that restrict entry to vaccinated individuals could effectively remove from their potential customer base up to roughly 25% of the adult population. To further complicate this picture, an Ipsos/Axios survey conducted at the end of August found that only 68% of those currently vaccinated express a willingness to get an annual booster, if ultimately required. Doing the math, this could mean in a worst-case scenario looking forward that potentially only half of the population might voluntarily choose to remain "currently" vaccinated, further reducing the available customer base of those companies whose business is based on in-person activity. The specific percentage of potential customers who will be immediately affected will of course be far smaller – and there will be material offsets to the full effect that we will not take time to examine here – but if consumer mandates become broadly implemented, there will be an inevitable hit to restaurants, airlines, hotels, and many more types of businesses that are essential components of our service economy, with downstream effects on their suppliers and all kinds indirect effects on other businesses, likely putting a material drag on the economy.
2) Impact on the ability of employers to fill job openings – Perhaps even more significantly, with the employment picture already deeply challenged as noted above, a growing number of businesses – particularly with government-imposed mandates now looming - are beginning to terminate workers who do not elect vaccination. Though almost completely unaddressed in economic commentary, this is without question already an incremental factor in the growth of unfilled job openings. With more dismissals on the horizon, the employment outlook is not gaining in clarity - it is becoming even more problematically complex. This will further impact supply chains and may precipitate greater shortages not only of goods but of all kinds of services

we have traditionally taken very much for granted. And this does not begin to address the potential economic impact of productivity losses due to the morale of those who feel pressured against their will.

3) Impact on the capacity of the health care and public service systems – The challenges faced by our health care workers in the battle against COVID-19 have been overwhelming. Like many others, I have both close friends and immediate family who are front line workers in health care and other parts of the service economy – some who have themselves suffered through infection contracted in the treatment of others. Close up, I have tremendous respect for the courage and commitment of medical professionals who are fighting this battle directly day after day. Our doctors, nurses, and other health care professionals are in an extraordinarily difficult position, many working in hospitals often persistently understaffed even before COVID – and being stretched in some cases to the breaking point in areas experiencing sharp surges in COVID patients. Health care systems, with the best of intentions, are increasingly mandating that all employees be vaccinated. An unfortunate consequence is further reduction in available staff, at least at the margins. Even if only incremental, this could over time exacerbate a staffing shortage that could have effects in health care services far beyond COVID, particularly given the growing health care needs of the Baby Boom generation. I won't take time or space to address similar issues in more detail here, but this same challenge affects our supply of teachers, police, firefighters, other first responders, 911 operators, sanitation workers, public service workers of all types – the list is innumerable – creating the potential for an extraordinarily serious issue in basic services we often take very much for granted.

The official presumption, logically, is that mandates, particularly relating to one's employment, will succeed in motivating the hesitant to be vaccinated. Given the scale of this group, that is an economically critical presumption, so – rather than simply speculating - it is important to carefully examine the likelihood of its success. It seems crucial in this unique circumstance to understand the rationale of these individuals – because rationale speaks to their level of conviction. There is no question mandates will move the needle to some degree – people need their jobs. However, the information I have compiled would indicate that the overall mandate strategy stands a risk of failing to a degree sufficient to materially affect the economy in the near term, with potentially greater repercussions over time.

We know that the COVID-19 vaccines have dramatically reduced the incidence of hospitalization and death, and in so doing they have very significantly reduced what would otherwise have been in recent months an overwhelming burden on the health care system –materially greater than what it has already experienced.

This much is sufficient for most – and, given the high risk of COVID-19 to certain segments of the population and the tremendous strain it has placed on the health care system - understandably so. In terms of the critical issues that have been right in our faces, the push for near-universal vaccination seems to make sense. All want to stay well; all want to live; all want the same for their loved ones and friends; all, or certainly most, want to relieve the burdens on our health care workers, particularly those on the very front lines. It is safe to say that virtually all would love nothing better than a shot or a pill that would solve the whole problem, without concern, once and for all. In addition, very many of those who have found reason to forego the vaccines, if I read them accurately, do so under tremendous personal pressure, a deep and growing sense of social isolation, and, for many now, loss of their established livelihoods. Their decisions are not made lightly.

Given all this, why the resistance? There could be a very telling insight, among many, in a study released on July 26, conducted by scientists from Carnegie Mellon University and the University of Pittsburgh and based on survey responses from January to May of approximately 1 million Americans per month. Although overall “vaccine hesitancy” in the U.S. waned somewhat over the period, by May the most hesitant group was PhDs – the most highly educated category – and the level of hesitancy in this group, unlike others, held constant throughout the survey period. PhDs who were “hesitant” were unwavering in their response that they would “probably not” or “definitely not” take a vaccine; they had apparently not changed their minds at all based on their continuing assessment of the emerging data.

Given the economic importance of understanding whether this resistance will likely fade over the next few months, I have worked to better understand its underpinnings. My research into the kinds of sources likely to have been consulted by at least the PhD crowd and, by extension, others as well, illustrates that some of their key concerns are rooted in their takeaways from the very complex science.

The bottom line is that they’re apparently not going to change their minds unless the core information changes - and this could present an economic problem. What is also material, but even more complex, is the ultimate percentage breakdown between those who because of their convictions will actually give up their jobs and those who will comply to retain their jobs but deeply resent it. Both will likely have economic consequences, but with the latter group the economic effects will be less immediate and less direct.

(Because of the economic importance, for anyone who has an interest in reviewing for themselves the a summary of the source material to better consider personally the degree to which they may want to consider this analysis for purposes of their own portfolio positioning, I have compiled representative portions of my research in an addendum I am willing to make available upon request.)

Fortunately, as this commentary is being released, the surge due to the Delta variant is trending downward nationally, and sharply so in states - such as Arkansas, Louisiana, Florida – which were harder hit in its early stages, hopefully following a similar downward track to that previously observed in India, where the Delta variant first exploded into world view. Should we be fortunate to follow a similar course, it should provide some offsetting economic relief to the most immediate effects of the mandates. The employment situation, however, will remain unresolved, and this is at the heart of our concerns.

Unfortunately, as mentioned at the outset, this feeds into an already very concerning set of circumstances. As noted in our May commentary:

“… should labor conditions and/or various other factors spark a sharp uptick in inflation, the potential for a rate increase expands - and it does so in an environment of already quite stretched and deeply rate-dependent equity and debt valuations in a significantly leveraged market. Whatever the assurances being voiced by the Federal Reserve and many market participants, this is a very fragile set of circumstances, with conditions in place for a sudden downdraft and the potential bottom a long way below. … From a fully considered perspective, conditions are in fact far more complex than many popular narratives would have one believe. Market forecasts at present are little more than guesses, and risk is far greater than most appear to appreciate.”

In the near term, particularly given the current decline in COVID-19 cases, markets may find reason to continue to climb. But in the months since the May commentary, the degree of risk in which we currently operate has expanded, as the potential effects of vaccine mandates among other more publicized factors have further complicated this already extraordinarily complex and fragile financial picture.

In 1998, we began to warn of very serious market risk due to significant overvaluation in growth stocks. In retrospect, despite the brutality of the bear market that ultimately ensued, this could be viewed as a "normal" adjustment to an imbalance – things would correct, however violently, and then we could proceed again to grow, as has historically been the case from one market cycle to the next.

In 2005-2006, we began again to warn of very serious market risk, in this case based on a far more complex threat to the integrity of the financial system based on arcane excesses related to real estate finance. There was ultimately a credit crisis and a related market crisis. Dramatic "adjustments" were made, and thirteen years hence, the financial system continues to function. However, the jury is still out on the longer-term effect of some of the measures taken both at the time and in the years since – this was far more systemically serious than a mere correction of an imbalance.

I have a developing sense of foreboding similar to what I felt in 1998 and 2006 – though far less specific in anticipated cause and effect. In part, it builds upon the steps taken in 2008, right or wrong – which did not actually resolve, but rather, mitigated the problems - but current conditions have become far more complex, far more wide-ranging, far more uncertain in any sense of timing or particular manner in which they may all play out.

Magnifying the interrelated economic concerns outlined over the past two commentaries is the manner in which these feed into a developing cultural crisis that has seemed to sharply accelerate across the last two administrations. If we may try to look objectively at our issues - it seems we have empowered, on the right and on the left – whether by our adulation or by our silence - a style of "leadership" ever more willing to denigrate and bully individuals, private companies, and entire segments of our population.

In our history, this is most certainly far from new, but in its most recent expressions, it arrives in confluence with (1) a sustained pattern of Fed decisions (see May commentary) that have, well-intentioned or not, arguably enhanced over the past 20 years an expansion in the wealth of a small segment of the population at the relative expense of the broad middle class, and (2) a pandemic that has, perversely, even more dramatically elevated the fortunes of a class of super-rich even as others see their businesses fail and/or their personal economic circumstances become even more uncertain in response to conditions very much beyond their control. I have not yet had time to study these issues to a degree sufficient to comment in great detail, but the perception alone feeds into a deepening social divide playing out even as we proceed more and more deeply into an era of dangerous economic experimentation by the Fed, the federal government, and others, that in itself leads we know not where.

From the perspective of history – looking at numerous and diverse examples - it seems clear that we are on a slippery slope. Given the very considerable challenges we face, if we continue to succumb on such a grand scale to those who would pit us against one another – cause us in our self-perceived righteous indignation to dehumanize one another – we should face the reality that the American experiment, its noble ideals never close to fully realized but until now always there as a beacon to point us over and over again to our true potential – could wind to a close – to become at 250 or so years of age a mere afterthought in the sweep of human history. At the very least, if our established social order and the functioning of our society go into a bitterly contested period of decline, as civilizations do – the very premise that stocks "always" go up in the long run may begin to degrade.

Investors may be well-advised to proceed with considerable awareness of the full set of circumstances, although how best to navigate an environment of such uncertainty is difficult to determine far in advance – there will likely be course corrections required as circumstances continue to evolve. Given the specter of inflation, investors cannot afford to simply exit the market – we will together need to proceed thoughtfully and carefully as this drama plays out in front of us. It is not a time to be on automatic pilot.

As a firm, seeking at all times to navigate with eyes wide open for the benefit of investors, we are fortunate to have an investment team with a very unique combination of backgrounds and market perspectives, a team with insights derived from managing through market crises of various types dating from 1990s to the present. That provides no magic – no assurance of any specific result – but they operate with a broad awareness of potential pitfalls and with the pertinent issues very much in mind.

Gordon T. Wegwart
President, Chief Investment Officer