Westshore Wealth *Insights*

Stuck In Neutral

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October 2021

WESTSHORE WEALTH

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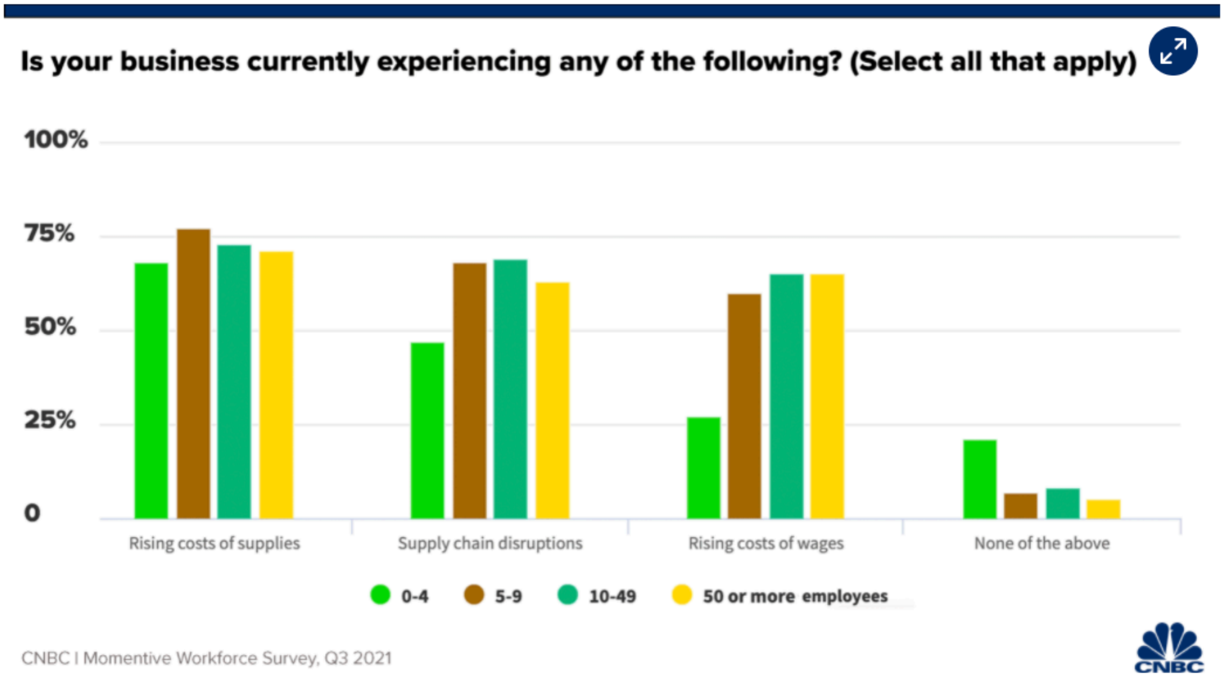
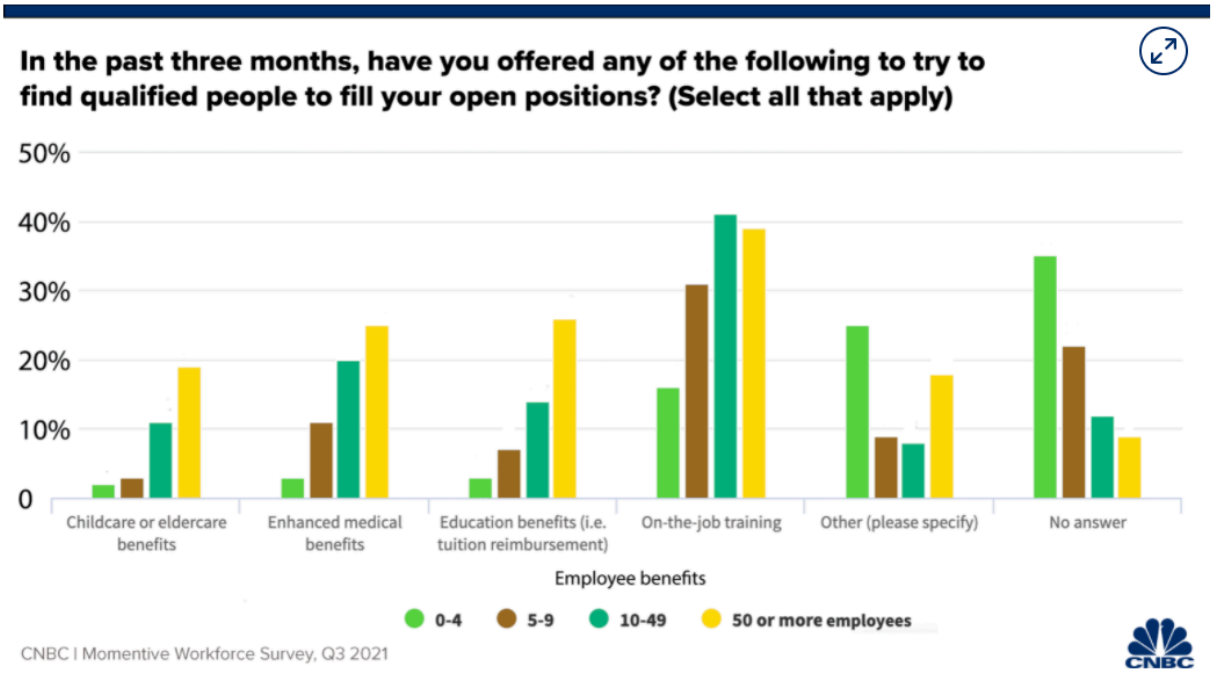
In a lot of ways, the market bears a strong resemblance to a prize fight between two heavyweight combatants. In the bullish corner, we have numerous favorable trends that should pressure the market higher. Those include exceedingly low financing rates, ample credit extension, and extremely accommodative Federal Reserve monetary policy. Secondarily, the Delta variant wave appears to have peaked in the United States, vaccination rates are picking up, and the service economy is rebounding. Adding fuel to the fire, there is thought to be as much as $1.5 trillion of excess consumer savings that can propel spending and growth. Finally, we are moving back to a fully employed economy. There are now more job openings than there are unemployed in the US, a phenomenon never experienced in this country. Unfortunately, the opponent in the bearish corner is no slouch. Valuations are historically expensive (99th percentile). Inflation continues to surprise to the upside, worrying some that the Federal Reserve is falling behind in efforts to curtail it. Fiscal policy is starting to take a turn towards tightening with initiatives that would raise personal income, capital gains, and corporate tax rates. All of these, as presently articulated, would slow GDP, reduce discretionary income, and erase roughly 5% of corporate earnings. Finally, there are exogenous risks out there that include the regulatory clampdown in China, the potential default of a prominent Chinese property developer, and finally a looming US debt ceiling, that if not raised, could cause the United States to enter into technical default, sparking contagion. Who will take the title? We don't see a quick knockout by either competitor. To continue our boxing analogy, we think this fight will be a drawn-out contest, with a split decision at the end.

Let's explore how we approach the puzzle. We believe GDP growth will continue to track well above trend for at least another two years to come with elevated job growth pushing unemployment levels back to 2019 lows. As mentioned, vaccination trends now favor reaching herd immunity in the United States with 77% of adults 18 years of age having received at least one dose. Additionally, with Pfizer/BioNTech regimen now approved to treat children ages 5 and up, that cohort of previously unimmunized should start to accelerate overall trends. The net result should be a slowdown in disease incidence, fewer hospitalizations, and a further normalization in behavior patterns. All of these are great for the service economy which continues to operate below prior peak levels. When combined with exceedingly high excess consumer savings, this should propel a very powerful spending wave. The net result should portend solid corporate earnings growth and set up a favorable backdrop for the stock market. However, the counter-punch to these overwhelming positives is the fact that we do believe the Federal Reserve is behind the curve in combatting inflation. We don't think the Fed is categorically wrong. We agree that many elements of inflation will be transitory. For instance, as the semiconductor shortage starts to wane, automobile companies will be able to ramp up production and used car inflation will start to moderate. However, in contrast to the Fed's view, we believe that wage inflation is here to stay. We don't see wages moderating at the lower end of the income curve, in fact we are seeing them accelerating. With more job openings than unemployed, employers are having to goose wages and raise benefits to attract workers. Case in point, Amazon just revealed that it would raise wages for its entry level employees to $18/hour and agreed to pay for 95% of tuition and fees for college education for full time employees who have accumulated one year of full-time service. There are a litany of Fortune 500 companies doing the same.


Is your business currently experiencing any of the following? (Select all that apply)

CNBC I Momentive Workforce Survey, Q3 2021


In the past three months, have you offered any of the following to try to find qualified people to fill your open positions? (Select all that apply)

CNBC I Momentive Workforce Survey, Q3 2021

Our sense is that the Fed will need to discontinue their asset purchases and start raising rates sooner and more vigorously than the market expects. What does this mean? Historically, rising interest rates cause investors to pay less for each unit of earnings (a lower P/E multiple). For the market to go up, earnings growth must outpace the decline in the P/E multiple. In essence, you are sailing into the wind. Tax initiatives will also prove to be an impediment. We expect the personal income tax rate changes, from 37% to 39.6%, to do little to discretionary spending behavior. Similarly, the 3% surtax on those earning over $5mm annually is also unlikely to put up any major roadblock to GDP growth. However, the corporate tax rate hike being discussed, from 21% up to 26.5%, would erase roughly 5% of corporate earnings power. That will be very hard for the market to ignore. In the end, our bet is that these two powerful, yet opposing forces, will cause a lot of volatility. You will have period of positivity where the market improves, only to cede the gains back when a series of bad news prevails. Our guess is the market does a lot of churning, but in the end is simply stuck in neutral.

If we are right, and the next stage is a volatile, yet directionless stock market, how do we position ourselves to win? Luckily, there are some peculiarities to this investing cycle that we believe are exploitable. For example, amid all the prevailing worries, the market has become defensively postured for a growth scare. Historically, playing defense in the market meant running to consumer staples, utilities, and healthcare. These names have a high degree of earnings predictability and generally produce high cash flow and dividends. However, the analogue seems to have shifted this market cycle. While similarly running to quality, meaning solid, low debt balance sheets, investors are also gravitating to those companies that can grow in all seasons. That Venn Diagram intersection is leading them right back to the old leaders - the huge technology, communications, and cloud software names that have powered the market for the past ten years (Alphabet, Microsoft, Facebook, Amazon, etc). Meanwhile, investors are avoiding all things cyclical - consumer discretionary, industrials, basic materials and financials. If we are correct that growth will continue to surprise to upside, and that the prevailing risk is really interest rates moving higher, investors will likely end up mispositioned. Unfortunately, technology is already expensive, over-owned, and carries a fair amount of future regulatory risk. If rates go up, the highest P/E names will be the ones that are vulnerable. By contrast, there will still be plenty of earnings growth to come in things like consumer discretionary, industrials, basic materials and financials.

There is another abnormality of this cycle as well. Everyone seems to have become extremely short-term focused. The rise of trading venues like Robinhood have turned the market into a casino where investors treat their picks like hands of blackjack. They expect immediate hits. This myopic behavior is causing investors to eschew all stories that aren't producing great results this instant yet have very good reason to do so in the future. As Warren Buffett said frequently over his long career, time is the greatest arbitrage of all. Short term trading is gambling. By contrast, investing is simply waiting for your seeds to grow. Patience is required. There are numerous stocks and industries where favorable trends exist, but issues like supply chain disruptions, parts availability, temporary worker shortages, or virus incidence has impaired near term earnings. These are stories where time should heal the wounds. Investors have traditionally valued these companies based on normalized earnings, looking through these episodic, one-off situations. However today, that isn't the case, hence the opportunity. Consider the example of General Motors. The average age of an automobile in the United States is over 12 years, the oldest in history. Replacement demand should be booming. Additionally, employment is improving and there is considerable pent-up savings, a great precursor to accelerating car sales. However, buyers haven't been able to buy a car because the semiconductor shortage has limited availability. As a result, inventories are low and dealers are receiving full price. What happens when the semi shortage eases? Availability picks up and demand skyrockets. Why not buy GM today, understanding that the long-term trend is your friend? There are literally hundreds of these stories, and they aren't confined to specific stocks. They also involve broader markets. For example, Emerging Markets as a whole today trade cheaper on a relative basis to the United States than they did after 9/11. That was a period where the US and the world were embarking upon a recession. Today, it is the fear that EM is woefully behind the US in terms of vaccination and COVID-19 conclusion. While that is 100% correct, is there anyone who believes that the world will not catch back up as developed nations turn the turret from vaccinating their own citizens to vaccinating the emerging world? The US just committed to provide 500mm doses to poorer countries. The World Bank approved vaccine rollout in 55 additional countries this week, amounting a $4.6B rise to the already $20B that it has committed thus far. In other words, it is just a matter of time.

At Westshore, our modus operandi has always been to deliver the highest increment of return while taking the least amount of risk. With some careful navigation, we believe solid results are still achievable despite a more challenging setup. We believe the gamblers will simply spin their wheels chasing trends back and forth. Our goal is to stick to our plan, remain patient, and keep the engine firmly in gear.

Important Disclosures

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