JAMESSON ASSOCIATES

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QUARTERLY NEWSLETTER

Recent Economic Events

The American economy slowed down considerably in the third quarter as both a jump in Covid cases and ongoing supply chain issues came to the fore. At the same time, prices spiked, raising the specter of stagflation. The hit to consumer confidence also contributed to the weakness. Labor market strength reduces the risk of the "stag" but boosts the probability of the "flation". The Federal Reserve initially tried to finesse these issues by suggesting that price increases would moderate. This game has ended, as "transitory" has been consigned to the dustbin of history. The FOMC's new approach involves accelerating the pace of tapering (reduced bond purchases) along with hints of an earlier push to raise short-term interest rates. The sad fact is that the price increases resulted from the massive shift in spending from services to goods, supported by government relief efforts, which slammed a supply chain already reeling from the effects of the pandemic. The Fed had little to do with it. Nevertheless, the Fed will be forced to act.

Third-quarter real GDP growth registered a disappointing 2.1%. A pullback from the buoyant consumer spending of the first half of the year was the key reason. However, spending was still up from the second quarter and continues to exceed the pre-pandemic trend regarding goods. Spending on services was the real culprit, as the Delta variant led to increases in Covid cases and a reluctance to travel, eat out, etc.

Inflation hit multi-decade highs, with October CPI registering a 6.2% jump from a year ago. Even core CPI, which excludes food and energy, posted a 4.6% gain. The former is the highest annual rate since 1990, while the latter was last this high in 1991. Needless to say, the impact on American pocketbooks is a major concern. It is the primary reason for consumer confidence indices dropping below even the low point we saw in the spring of 2020.

This lack of confidence contrasts with the strong labor market. Monthly job gains have been volatile as seasonal adjustments have been thrown off kilter by Covid. However, the unemployment rate has consistently fallen. It now registers 4.2%, which is the lowest print since the pandemic hit. On top of this, workers are quitting at a record pace, and businesses are cutting back on layoffs (lowest rate since the late 1960s). The average workweek is up, and wages (especially for those at the lower end of the wage scale) have jumped. It is the disconnect between unsettling price increases on very visible items and the power shift from employers to workers that has upended psychology.

The Federal Reserve is facing a textbook definition of an overheating economy (full employment, accelerating inflation), but with an outdated textbook and an unprecedented health situation. I don't envy them their task. While it appears that strong money supply growth boosted inflation, the fact is that at the height of money supply expansion (February 2021 at 27% year-over-year), inflation was still relatively contained. Annual money growth is already down to about 13% and is falling further with the last six months annualized below 10%. No, the fiscal relief packages which put dollars in the hands of consumers with only limited options for spending have caused inflationary pressures. Supply chains could simply not keep up. Businesses, finding that they could point to supply chain issues, took advantage and raised prices. The result has been record earnings for American businesses, both large and small.

Recent Economic Events *(continued)*

A perfect storm confronts the Fed. The clamor to reduce and then stop buying government bonds is deafening. After it does, it will begin to boost the overnight rate. Combined with a sharply shrinking Federal government deficit, these actions are likely to knock the economy's growth down to no better than potential by the end of 2022. Its impact on inflation is an open question. If price pressures haven't receded by next summer, we can really worry about stagflation. Until then, the economy is likely to power ahead based on strong worker/consumer demand and gradually normalizing supply chains.

Commentary

The United States is facing a labor market with too few workers for the jobs available. This imbalance was evident even before Covid arrived, but it has been exacerbated by the pandemic. The most obvious shortfall has been due to the jump in retirees, both because of concerns regarding health and because of the gain in retirement portfolio values. A second cause can be traced to the drop in immigration over the past few years. Admittedly, this began before the pandemic with the Trump administration's actions, but it has continued as border restrictions have stayed in place. Then there is the lack of affordable childcare, which significantly reduced the ability of parents (mostly mothers) to reenter the labor force once lockdowns, etc. ended. Finally, the combination of economic support and idle time led many to rethink their work/life balance. At least five million missing workers: not surprising.

Economic commentator John Mauldin recently wrote,

> "In sum, we are shifting from a *capital*-constrained economy to a *labor*-constrained economy. I don't think this is temporary.… this is generally the way it will be for a while. Corporate CEOs will spend less time finding capital and more time finding talent."

A slower-growing labor force was always in the cards because of aging demographics. But for most of its history, the US was able to outgrow others due to its welcome mat for immigrants. In fact, without a pickup in immigration, forecasts suggest no growth in the labor force over the next decade. Given the political polarization around this issue, I fear that we will face stagnation in net workers.

Throw in the explosive jump in workers quitting their jobs, and the pressure on employers grows further. The current imbalance is unlikely to resolve itself from the people side of the equation.

The pendulum is swinging in labor's direction. Workers will maintain leverage over employers. While the legal minimum wage in the United States ranges from the federal level of $7.25 to the California minimum of $14 ($15 come January), the effective minimum is much higher. Walmart now has a minimum wage of $12; Target is at $15; Amazon posts $18. Other large companies are at these levels or higher.

> "…WE ARE SHIFTING FROM A *CAPITAL*-CONSTRAINED ECONOMY TO A *LABOR*-CONSTRAINED ECONOMY."

This puts the onus on businesses to respond. Offering a competitive wage is table stakes in the new labor market. Close behind is more flexibility regarding hours and work location (work from home is here to stay). However, paying a worker $15 for $10 of value is a recipe for going broke, and businesses that persist in a model built on a ready supply of unskilled or low skilled workers with no better option will not survive. Some competitors will

Commentary *(continued)*

go by the wayside, opening opportunities for those who adapt to the new environment.

While I am not a management consultant by trade, I believe that there are two paths to go by in the long run. And contrary to Led Zeppelin, you probably won't have the time to change the path you're on.

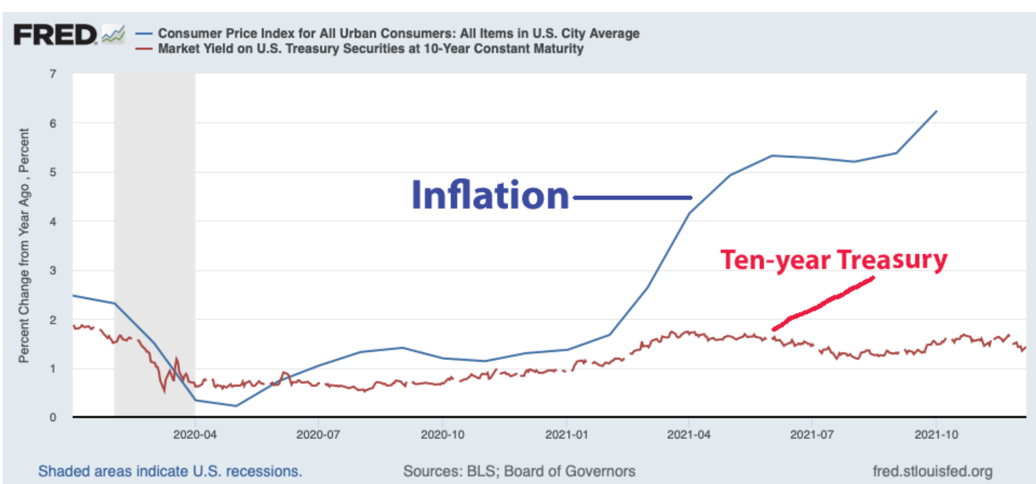
The most obvious course is to adopt more technology so that fewer, more skilled workers will be needed. Examples abound. Fast food restaurants now use AI to take orders in the drive-thru. Sit-down restaurants offer QR codes instead of physical menus. A recent story highlighted the use of an automated weeding robot which dramatically reduces the need for farm workers and boosts crop yields.

Another option is to look at the business, keeping those processes that are unique and value-generating while outsourcing as many non-critical jobs as possible. Apple, the most valuable company in the world, generates its value by designing and developing products while using third parties to manufacture them. Airlines long ago figured out how to get flyers to do the job of check-in agents.

The most durable legacy of the pandemic is a sea change in the labor market and the pressure this exerts on business models that haven't changed in decades. A wise man once said, "Never waste a good crisis." The pandemic certainly qualifies.

Market View

Financial markets are on a tear. Coupled with increased real estate values, US household net worth is up by some $20 to $25 trillion over the last year and even more from pre-pandemic levels. The amazing gain in wealth has been powered by a better than originally expected recovery from Covid and the combination of fiscal and monetary support. With a new Covid variant and less government largesse, the key investment question for 2022 is whether the markets can continue to advance.



An important consideration is what will happen to longer-term interest rates. If they rise in line with increased inflation, the financial markets could stall as would housing appreciation. To get at this issue, I pose the following: with inflation running hot at 4% to 6% depending on the index chosen, why is the ten-year Treasury yielding 1.50%? Can investors be unaware of the depreciating currency value?

My answer is straightforward. Fixed income investors certainly know that putting money to work at present rates will guarantee that they receive back less in real terms when their bonds mature. The decision is not whether they can win the inflation game but what the alternatives are. Investing is a relative process, not

Market View (continued)

an absolute one, for the top 10%. They control roughly 70% of total household net worth of around $150 trillion and are looking to hold on to their wealth rather than spend it.

The huge store of investible cash ($3 trillion plus) implies that interest rates are not destined to rise by much even as the Federal Reserve begins to increase them. If we look at expectations of future short-term rates, we see a peak toward the end of 2023 or early 2024. The implied level is about 1.30%, much lower than the top experienced in the last tightening cycle. While the market is not always right, the expectation is reinforced by the recently flattening yield curve.

A benign interest rate environment is supportive of asset values. The other key ingredient for keeping values growing is income. In the case of housing values, the income needed is that of the homebuyer. On this score, we are in good shape with both wage increases that have already occurred and the recent *Wall Street Journal* article indicating that companies are planning significant increases for 2022 in their budgets. Because the wage base is much higher than the monthly mortgage payment, housing prices (up around 20% from last year) can be supported by relatively smaller wage gains.

A similar calculation supports equity prices. Current expectations for SP 500 earnings next year by Goldman Sachs target $226, projecting a year-end 2022 value of 5000 on the index. Not one to contradict Goldman Sachs, I also believe that there is more modest upside in stock prices.

However, there is a big caveat: volatility. We are in a transition environment. Power is shifting from capital to labor; Covid is becoming endemic rather than pandemic; the Fed is going to reduce its monetary support; and the fiscal deficit is destined to shrink. Whenever big changes occur, it takes time for markets to understand the implications. This means a wide range of performance between winners and losers. I foresee a stock-picker's market.

For 2022, I believe longer-term bonds will be range bound, housing will stabilize at high levels while wages catch up, and equities will advance modestly with plenty of diverging fortunes. Commodities have had their day in the sun and will see declines as supply chains cure. Precious metals will experience periodic upswings due to uncertainty, but I see little lasting upside from current levels. While I have been pretty good on recommending crypto-currencies instead of gold this year, I am now more ambivalent.

Editor's Note

Delta and now omicron have entered our vocabulary list. This is a bittersweet experience for me because I know how to recognize and pronounce the letters. The ongoing use of the Greek alphabet for virus variants erodes my arcane knowledge. I was bilingual when I was four years old and learned the entire (all 24 letters) Greek alphabet near that time. The advantages of knowing a language that is uncommon comes in handy in many situations. My mother frequently would switch to Greek in stores to ask questions regarding prices or in other cases to comment on fashion faux pas. Sometimes this would lead to shared secrets while at others, sticky situations could occur. For example, while waiting in the foreign entry line on our trip to Greece in 1971, she started complaining about the inefficient Greek immigration officers. Clearly, they were not amused. I mention this in the hope that we limit Greek letters to Covid. Let's move on to Russian or Chinese for the next contagion.

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