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3rd Quarter 2021 Commentary

The S&P 500 notched a .6% gain in the 3rd quarter bringing the year-to-date return for 2021 to 15.9%. Even though investors have no reason to complain, the quarters return was hardly inspiring when compared to the past six (20.5%, 8.9%, 12.1%, 18.4%, 6.2%, and 8.5% sequentially). Still, the advance continued despite near record valuation levels based on future earnings estimates.

Wall Street currently expects earnings of companies in the S&P 500 to increase in 2022. For earnings growth to continue companies need to increase revenue or their margins or both. Analysts expect both with profit margins leading the way. (See fig. 1.) While we certainly would not rule out the possibility of continued earnings growth, we do find the likelihood of continued uninterrupted expansion more and more unlikely.


Fig. 1. Estimated S&P 500 Operating Margin (Source: Strategas)

Revenue growth could slow if the trends that led to surges in demand start to reverse as the economy reopens. Fiscal stimulus played an important role in backstopping consumer demand, but it is starting to fade. For instance, household stimulus checks were last received in the spring and enhanced unemployment benefits ($300 per week) ended in early September. Monetary policy is also expected to present a headwind. In November, the Fed hopes to reduce monthly bond activity initiated at the beginning of the pandemic. Increases in interest rates are expected to follow in 2022.

Changing consumer habits and tastes associated with the work-from-home culture have been well documented since the outset of the pandemic. From initial pantry loading (hoarding) to home improvements, the pandemic forced consumers to order greater amounts of everything.

The sudden surge in demand was ill-suited for an economy built on lean inventories and just in time delivery. The subsequent shortages were exacerbated by Corporate America's cost reductions and employee headcount cuts. Management teams after all did not anticipate stimulus and the record demand that followed. The rapid increase in demand in combination with cost cutting measures have resulted today in record high corporate profit margins. While certainly a positive development, record profit margins are typically associated with the end of a business expansion, not the beginning of one.

Margins also face several headwinds. Margins are affected in varying degrees by, among other things, changes in raw material, wages, research and development, marketing, shipping and logistics, and administrative expenses. Over the past year, we have witnessed substantial increases in raw material, wages, and shipping and logistics costs. Raw material costs today are 40% higher on average than pre-COVID levels[1]. Wages, while hard to quantify in any given year, are also increasing as businesses try to coax individuals back into the labor force. FedEx, for instance, recently announced that they have been paying package handlers 16% to 25% more than prior years[2]. Shipping rates have been the most startling, increasing over 1,000% or 10 times since the start of the pandemic for retailers looking to ship freight containers from Asia to the East Coast[3]. While rising costs in each of these areas impact businesses differently and may not reflect the entire economy, we expect the frequency of inflationary discussions to increase in the next earnings season. Further, we expect companies to continue passing along price increases to businesses and consumers.

It remains to be seen if consumers will accept price increases or simply change habits. This presents another risk to revenue growth.

Some businesses will perform better than others in an inflationary environment with supply constraints. Businesses with pricing power, or the ability to pass along cost increases, perform well in nearly all markets but particularly inflationary environments. Low-cost businesses also perform favorably. Low-cost businesses are generally more efficient and profitable and therefore less susceptible to cost increases than competitors. We focus on investing in these types of businesses in all environments.

Fading fiscal stimulus does not necessarily spell the end for revenue growth. Afterall, stimulus delivered the necessary drug to the patient. Consumer balance sheets, for example, have never been stronger and savings rates are still near record highs.

Further, the Federal Reserve has a history of attempting to taper monthly bond activity. The Fed attempted to reduce monthly purchase activity multiple times after the Great Recession only to reverse course when investors ran for the hills. It took the Fed nearly a decade to unwind support for the economy,

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[1] Grabinski, Ryan. Daily Macro Brief. Strategas. September 23, 2021.

[2] Lenz, Mike. 1st Quarter 2022 Earnings Call. FedEx. September 21, 2021

[3] Gryta, Thomas. Rising Shipping Costs Are Companies Latest Inflation Riddle. Wall Street Journal. September 16, 2021. https://www.wsj.com/articles/rising-shipping-costs-are-companies-latest-inflation-riddle-11631784602

and even then, the economy was still on the mend. We expect the recovery to be drawn out and well telegraphed. It is likely any market tantrum will be short-lived. (See Fig. 2.)

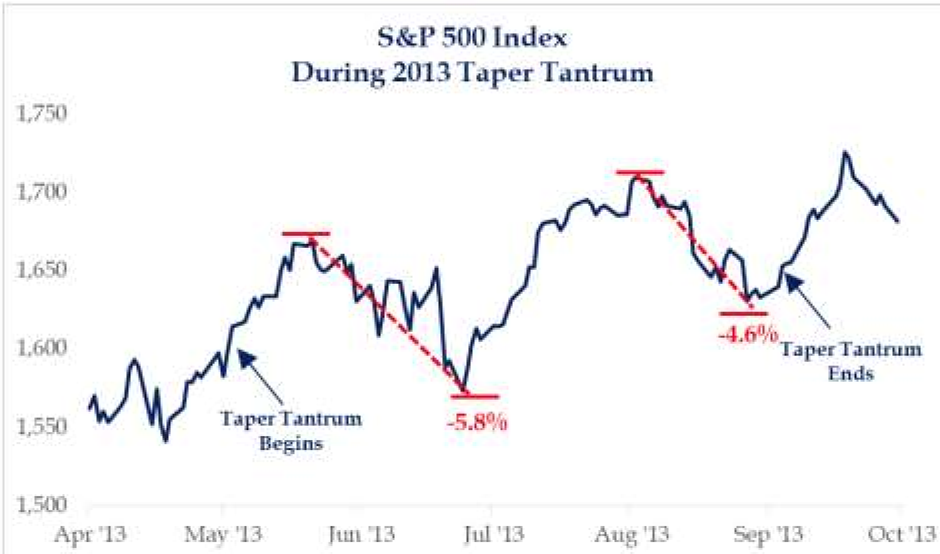


Fig. 2. S&P 500 Index During 2013 Taper Tantrum (Source: Strategas)

Investor sentiment also sits at a 2021 low. This suggests that investors may be underinvested or have already priced lower expectations into the market.

Regardless of the outcome, market volatility will likely increase. Afterall, market advances this year have not included a drop of greater than 4.5%. When volatility returns, we will be ready to put your capital to work in businesses with durable competitive advantages trading at attractive valuations.

Sincerely,

J. August Gerhardt, CFA

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