Third Quarter 2021 Outlook and Commentary

The U.S. stock market continued its steep ascent in the second quarter, with the S&P 500 Index returning over 8% and ending the quarter up 15% year-to-date. The U.S. economic recovery has had its bumps to be sure. Everyone has anecdotes about shortages, whether it's backordered furniture and appliances, a delayed auto purchase, or limited seating in short-staffed restaurants. Despite these bottlenecks the U.S. economy created 850,000 jobs in June and total U.S. employment is on track to reach pre-pandemic highs next summer, a rapid rebound compared to the slow climb back from the Great Recession of 2008-09.

Perhaps cheered by positive economic data, investors have overlooked the worrisome Delta variant of Covid-19 and embraced TINA--There is No Alternative (to stocks). With investment grade bond yields not much over two percent, investors have no choice (so the idea goes) but to invest in stocks. While TINA may have pushed share prices to uncomfortable heights, the logic is hard to resist.

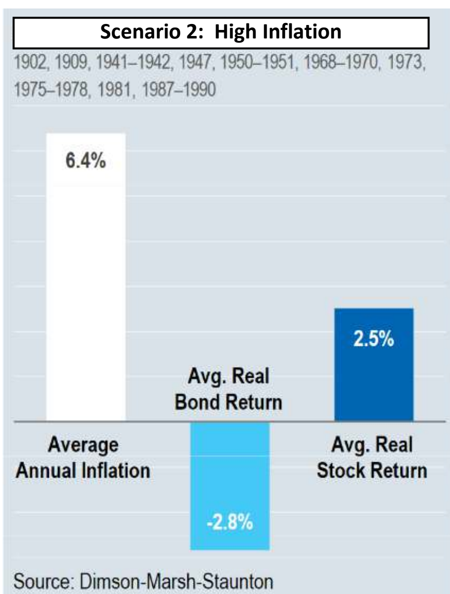
A rule of thumb for bonds is that the current yield will approximate future returns. Right now, unfortunately, the current yield may be more of a ceiling than a likely outcome. Bond yields and bond prices move in opposite directions. This was illustrated in the first quarter when the benchmark 10-year U.S. Treasury yield jumped from 0.92% to 1.74%, sending U.S. bond prices down over four percent. Yields fell in the second quarter, but as we approach a Federal Reserve rate hike cycle expected to begin in 2023 the general trend in interest rates and yields will be up, which will push bond prices lower. Low current yields and price declines from future rate increases will make it very difficult to get much more than a two percent return on U.S. investment grade bonds over the next few years. Inflation-adjusted returns may be negative. A major spike in inflation would push interest rates even higher leading to bigger price declines and a bigger inflation adjustment, making real returns downright ugly.

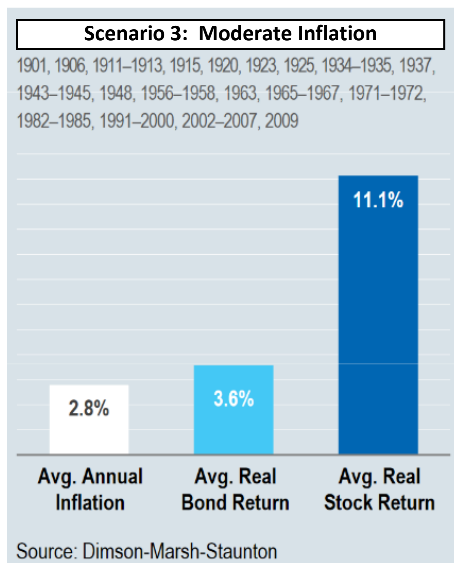
So protracted inflation would be terrible for bond returns. But would stocks fare any better? The question is very pertinent; to no one's surprise the latest Consumer Price Index showed core inflation over the last twelve months higher than any time in the last thirty years. In theory stocks offer natural inflation protection: stock prices tend to follow corporate earnings; inflation means that companies are raising their prices, and those price hikes ought to boost earnings. Of course, the devil is in the details and some companies may not be able to hike prices fast enough to keep up with rising costs. Even so, the correlation between inflation and earnings and between earnings and share prices suggests that stocks offer some degree of inflation protection. How have things worked in practice? We wouldn't normally cite 10-year-old research but with inflation quiet since 2008, Jim O'Shaughnessy's 2011 study[1] is still relevant. The study divided the period from 1900 to 2010 into five buckets: years with severe inflation (over 10.0%), high inflation (above 4.4% but less than 10.0%), moderate inflation (2.0% to 4.4%), low inflation

[1] https://www.osam.com/pdfs/research/_37_Commentary_Apr11.pdf. Based on data compiled by Elroy Dimson, Paul Marsh and Mike Staunton.

(0.0% to 2.0%), and deflation. The severe inflation of the 1970s seems unlikely for many reasons. Back then powerful unions negotiated big wage increases, forcing employers to raise prices, which in turn allowed other unions to demand even bigger wage increases, creating a "wage-price spiral." In addition, the Arab-Israeli conflict led oil producers to institute an embargo against the U.S. and other countries, which resulted in a severe oil price shock. Finally, the Federal Reserve of the 1970s was less vigilant about inflation than today's Fed. Weaker unions and oil producers and a more vigilant Fed make severe inflation mush less likely. The high inflation or moderate inflation scenario seem most relevant moving forward.

The charts below illustrate the average real (after inflation) returns for U.S. stocks and for U.S. bonds[2] during periods of high (but not severe) inflation and moderate inflation respectively. When inflation was high (on average 6.4% for the years in question) both bonds and stocks suffered, with bond returns significantly negative after adjusting for inflation and stocks delivering only 2.5% real, well below the 1900 to 2010 average of 8.2%[3]. Perhaps it shouldn't be too surprising that stock returns suffered in periods of high inflation. When inflation is high, investors may demand higher future returns from the stock market to compensate. Unfortunately, the simplest and quickest way to ensure higher **future returns** is a decline in share prices **now**. Consider a stock with a share price of $100 and an annual dividend yield of





4%. If investors want a dividend yield of 5%, the share price would need to decline to $80. Although stocks may eventually be correlated to inflation, there may be an initial adjustment when high inflation initially sets in. Even so, stocks maintained a clear advantage over bonds in years of high inflation, with the advantage only slightly lower than the 5.8% advantage that prevailed on average from 1900 to 2010.

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[2] Stocks are large company stocks measured by the S&P 500. Bonds are long term U.S. Treasuries.
[3] The average of 8.2% is misleading. One of the important facts about investment returns is that a negative return of 20% followed by a positive return of 20% doesn't get you back where you started. If you start with $1,000 you have $800 after one year and $960 after two years, down 4% from where you started, even though the average return was zero. So even though the average real return was 8.2%, investors would have actually gotten something more like a 6.5% real return.

The real eye-opener is returns in periods of moderate inflation (2.0% to 4.4%). This is the scenario that is most relevant over the next several years. Relatively few economists or market observers expect inflation to exceed four percent on a sustained basis any time soon. High inflation (as defined in O'Shaughnessy's study) is worth being prepared for but generally regarded as unlikely. The good news is that in years of moderate inflation, stocks did significantly better than their average in all years and crushed bond returns. An immediate caveat: stock market returns are heavily influenced by "starting point sensitivity." Given that we have had a twelve-year stretch in which U.S. stocks have generated average annual returns[4] of 16.0%, **do not expect anything like an 11.1% real return over the next five to ten years**. But it is reasonable to think that stocks could outperform bonds by an above-average margin if inflation rises without spiraling up.

Our overall takeaways on inflation and stock and bond returns are: (a) in the long run stocks should provide some inflation protection because corporate profits are correlated with inflation, (b) if inflation is high (but not severe), that would put pressure on stock returns but they would be likely to perform significantly better than bonds, and (c) in the more likely scenario that inflation is in the range of 2% to 4% or so over the next several years, the return advantage of stocks relative to bonds may be considerably above its historical average.

The words "in the long run" above are critical. The data above are based on averages which may play out very differently in any given year. In the short run inflation could squeeze profit margins in certain sectors, and the dramatic runup in asset prices over the last ten years or so leaves stocks more vulnerable than usual to some sort of shock. That is especially true in those parts of the stock market where valuations have become the most stretched, e.g., U.S. growth stocks. By almost any measure, overall stock market valuations are very high. Whether it would be triggered by an inflation scare, the Delta variant or something else, a correction seems overdue.

Near term risks in the stock market are important but investors should focus on the longer term in order to achieve their financial goals. How much of your portfolio should be allocated to stocks always depends on your investment time horizon, but that is especially true right now. If you are still building wealth for retirement, you may want to be at the higher end of the stock allocation range for your portfolio considering the very low returns bonds are likely to offer. The prospect of inflation over the next several years probably reinforces that view. If you are deep into retirement, however, or otherwise drawing aggressively from your portfolio, you might have less time to ride out any stock market declines, forcing you to be more cautious in light of elevated valuations.

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Boston, MA

[4] Based on a "compounded average," which eliminates the distortion referenced in the previous footnote.

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