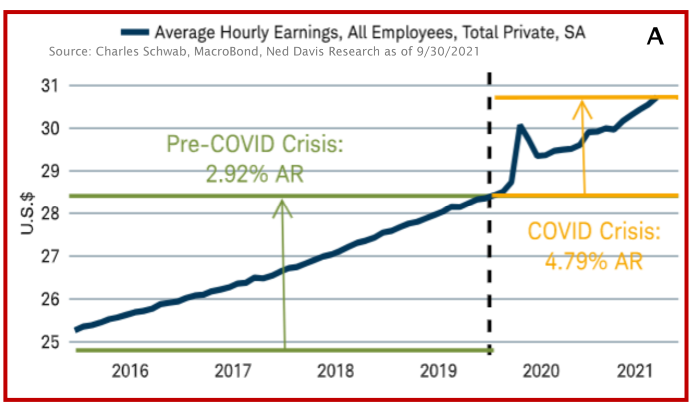
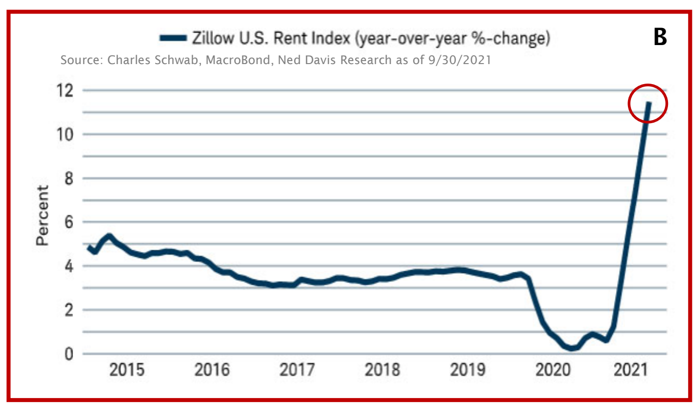
CROSSWINDS FROM ALL DIRECTIONS

Inflation is surging as it threatens to become less transient than the Federal Reserve hoped it would, Congress can't agree on an infrastructure package or be relied upon to pay the nation's bills, energy prices are surging, COVID is still an issue, the supply chain is unsynchronized, economic growth is slowing, and the Fed is on the cusp of reducing pandemic-related stimulus, yet corporate earnings remain strong and equity indices are at or near all-time highs. I'll try to unravel some of this.

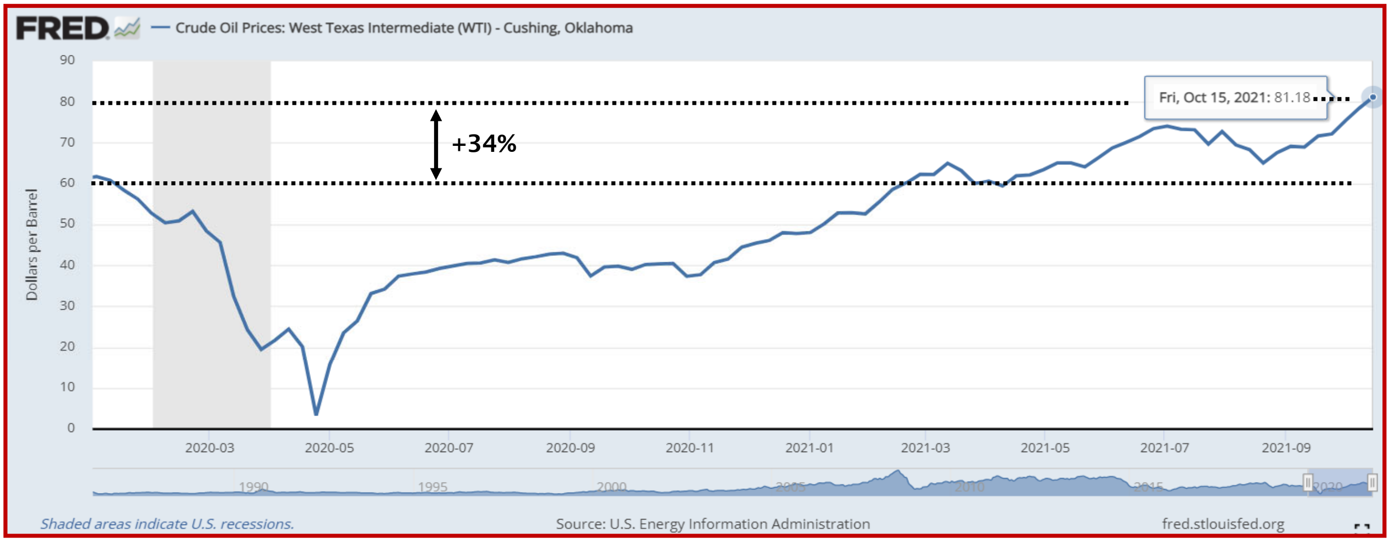
INFLATION IN THREE CHARTS

Prior to the pandemic, hourly earnings in the private sector had been increasing at an annual rate (abbreviated as "AR" in panel A) of about 2.9% per year. Since the pandemic began, that annual rate of change has risen to almost 4.8% as a result of Fed stimulus and the Fed temporarily sacrificing its usual, 2% inflation target in the quest of repairing a damaged labor market. Although this 4.8% figure is not outrageously higher than the Fed's usual target, it's important because it captures labor-related inflation for around 85% of the workforce and because employees are not often keen on working for less once they have worked for more.



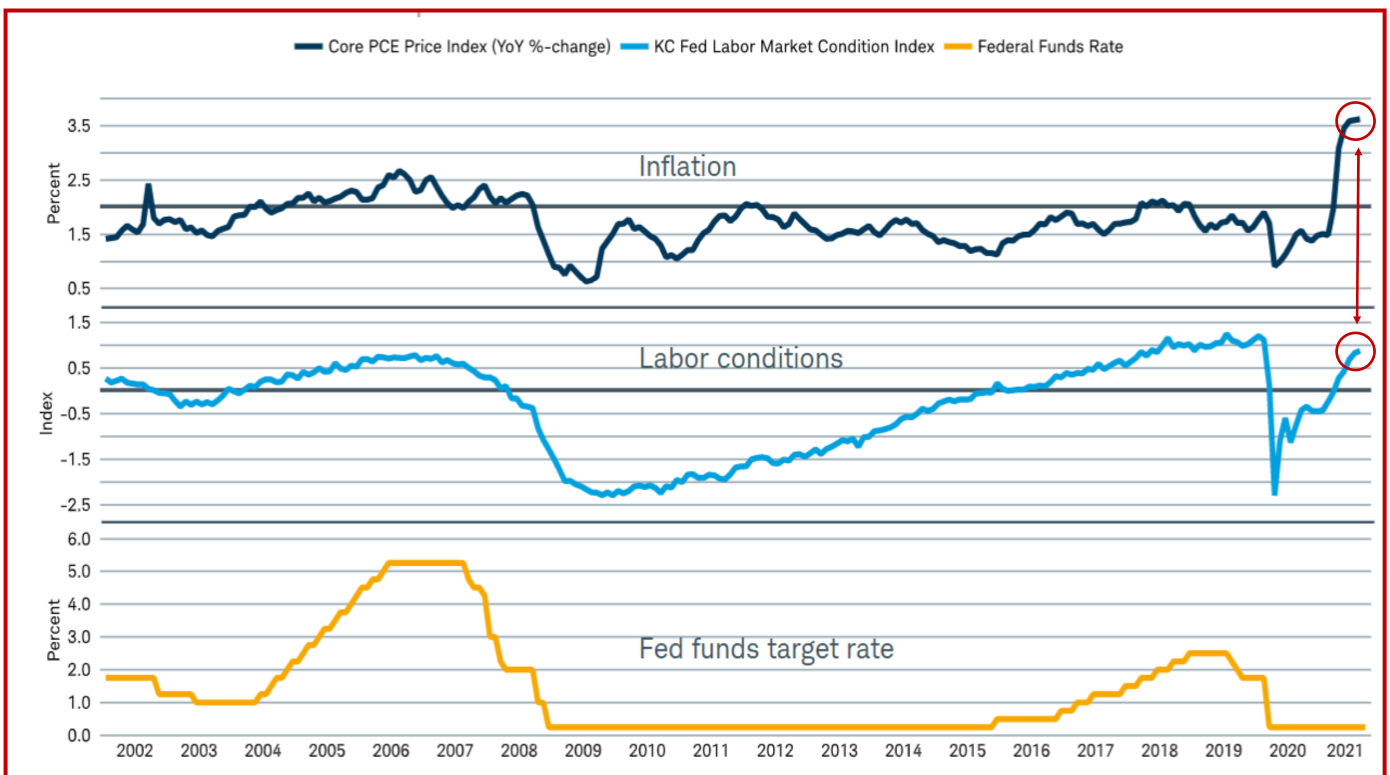


However, that surge in hourly wages is dwarfed by the rise in the cost of rental housing which has recently been increasing by over 11% per year (panel B). But even that increase pales in comparison to the change in energy costs which have spiked as a result of increased global demand and lower production within the U.S. For example, the cost of a barrel of West Texas Intermediate crude has risen some 34% since the beginning of 2020, as captured in the chart on the following page.



INFLATION SACRIFICED TO AID LABOR CONDITIONS

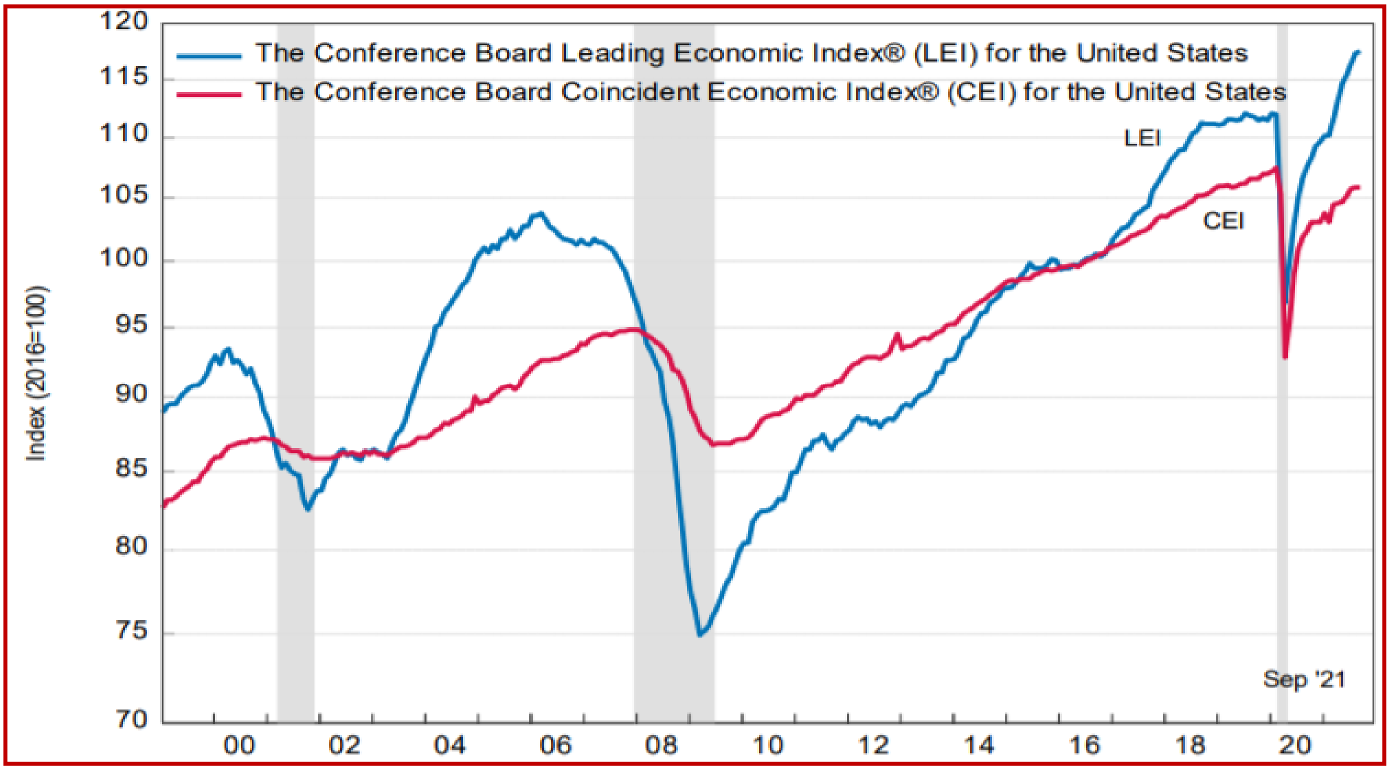
Since the pandemic began, the Fed has been injecting about $120 billion worth of funds into the U.S. economy as a means of repairing pandemic-related wounds. As previously mentioned, the Fed has temporarily sacrificed its usual, 2% inflation target to instead focus on repairing pandemic-related damage in the U.S. labor market. As you can see in the next chart, it's working.



Source: Bloomberg as of 9/30/2021.

LEADING ECONOMIC INDEX® VERY ENCOURAGING

In fact, Fed stimulus has been so effective that the Conference Board's index of leading economic indicators, which is designed to provide a glimpse into future economic conditions, is now higher/better than it has been for at least a couple of decades. For now, no real hint of recession seems to exist.



NEXT STEP: REDUCTION OF FED STIMULUS

As a result of this strong economic progress, the Fed has signaled that it may begin reducing the rate at which it injects additional stimulus into the U.S. economy sometime before year-end. The Fed is set to further address this issue in its next policy meeting in early November, but it has already signaled its inclination to begin reducing the $120 billion worth of stimulus it has been injecting into the U.S. economy each month by about $15 billion in the first month of reduction followed by additional $15 billion reductions during each subsequent month. If the Fed were to begin implementing this "tapering" schedule in November, it would then be finished injecting stimulus into the economy by June.

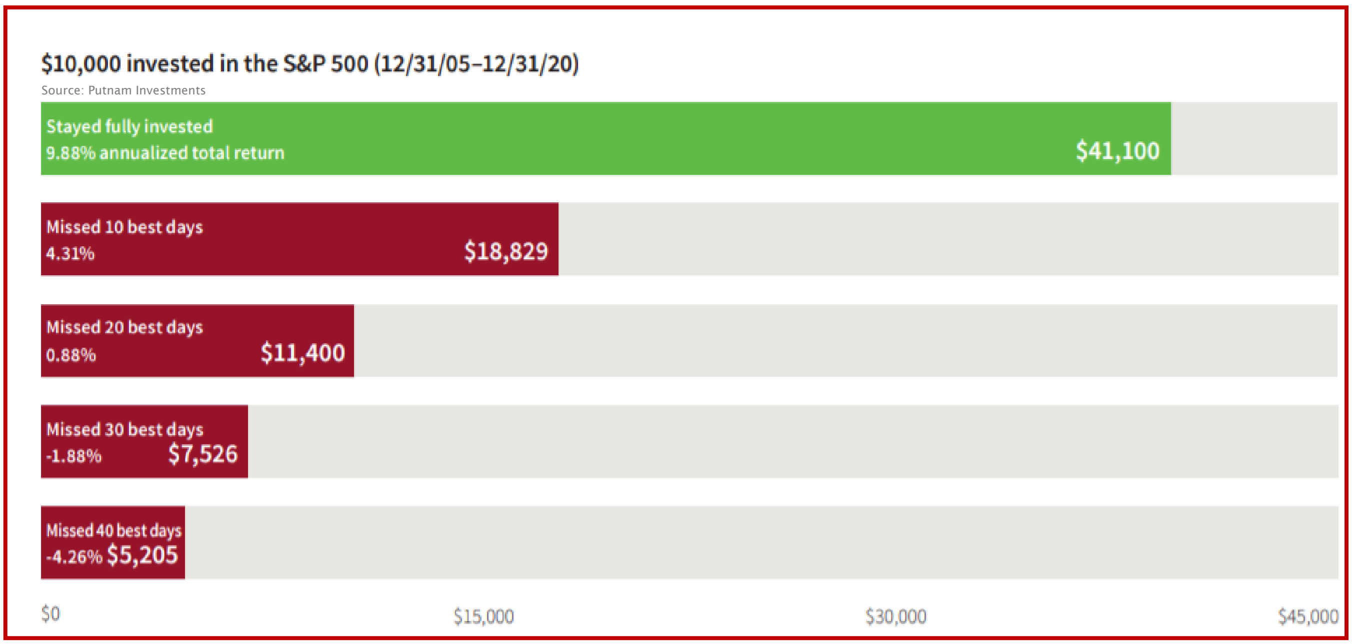
REDUCTION OF FED STIMULUS ≠ FED TIGHTENING

It's important to realize that even if the Fed were to implement its tapering program in November, a reduction in the rate of stimulus is not at all equivalent to reversing it.

EQUITY RETURNS DEPENDENT UPON NOT MISSING BEST DAYS

Equity valuations have surged to the point that even portfolios with only modest exposure to equities have performed well. In past notes, I've expressed angst over stretched equity valuations, i.e., equity prices being high in relation to meaningful financial metrics. Regardless of whether equity valuations are stretched, be aware that the returns available to equity investors have tended to be disproportionately concentrated across relatively few trading days.

Consider that a typical year offers investors 253 trading days. Over a 20-year period, there would then be a bit over 5,000 such days. The following chart, which covers the 20-year period through the end of 2020, illustrates just how dependent equity investors have been and, presumably, will continue to be upon being invested on those relatively few trading days where meaningful returns are on offer.



Unless the dynamics of the equities markets change, a rational investor would be induced to remain committed to equities, even during periods where equity valuations appear to be stretched.

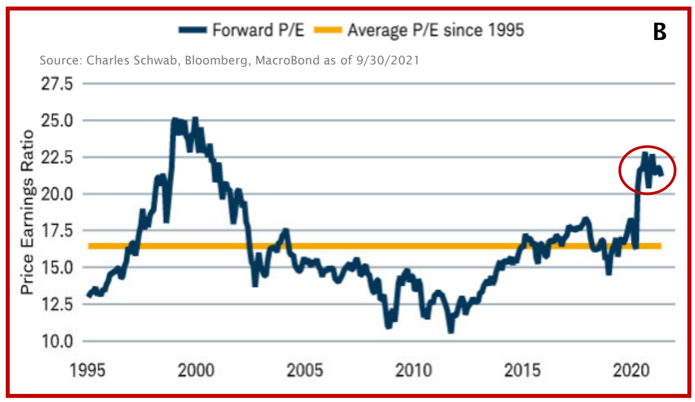
Again, I've groused about overvalued equities over the past year or so, but unless I were directed to do so, I would resist the temptation to liquidate them out of respect to the reality captured in the image above.

Although there never seems to be a shortage of reasons to fear a collapse in the equity markets, remaining committed to equities has generally allowed equity investors to capture double-digit returns during the first nine months of 2021.

EQUITIES APPEAR TO BE A BIT LESS OVERVALUED

By historical standards they are still overvalued, but less so. Because corporate earnings have continued to be extraordinarily good (six full syllables worth of earnings goodness or, depending where you live, seven), the price-to-earnings ("P/E") metric is no longer as far above the historical norm as it had been earlier in the year.

While equity prices have continued to rise generously during 2021, estimates of <u>future</u> corporate earnings have risen even faster. If you'll look at panel A, below, the recent upward trajectory of the dark blue line has exceeded the rate at which equity prices have risen (which is not shown).

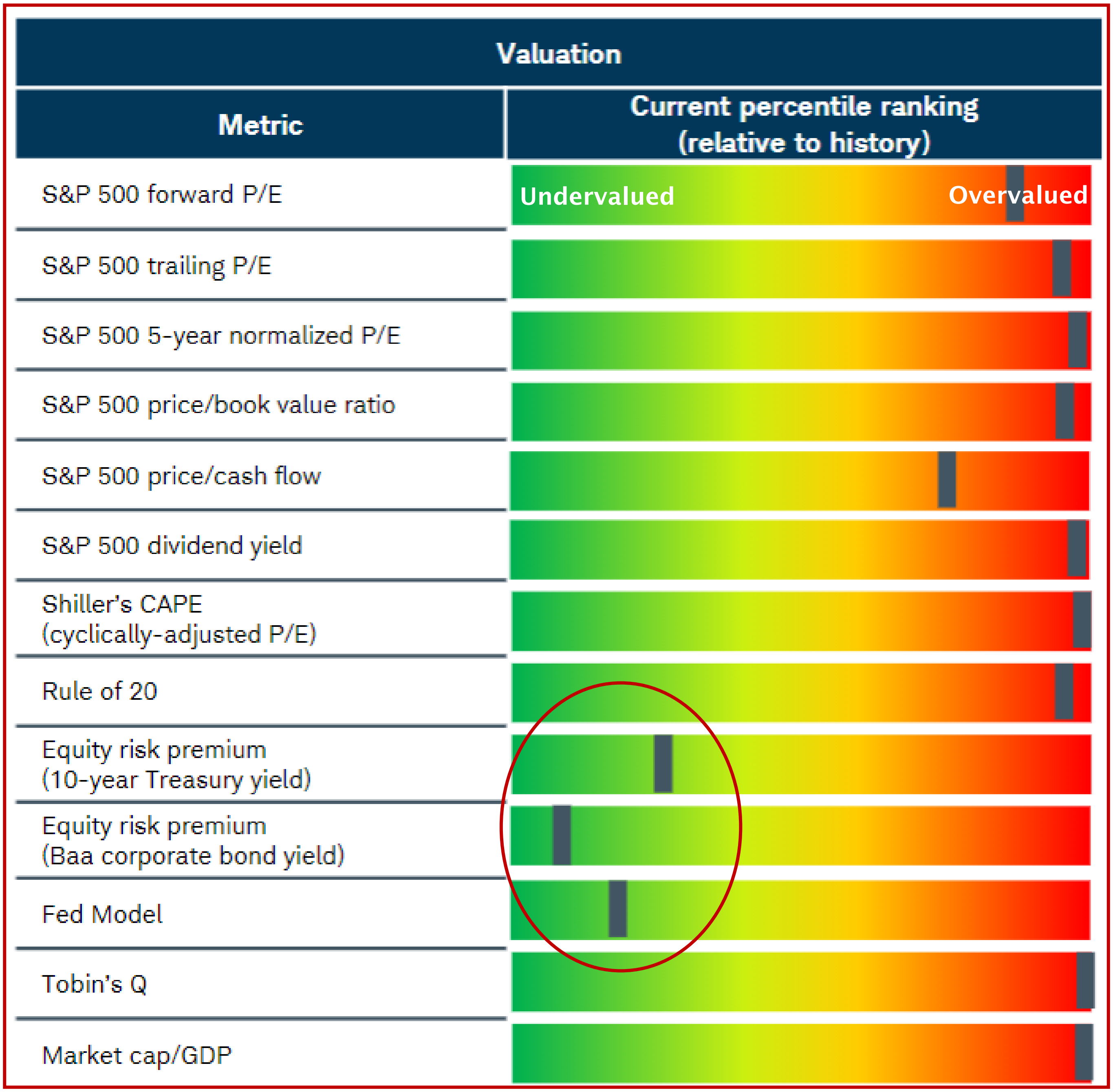


The impact of the strong, upwardly revised earnings estimates that are depicted in panel A can be seen in panel B. More specifically, the ratio of the prices of stocks to the earnings analysts expect those companies to earn in the next 12 months (the "Forward P/E") has actually declined a bit recently (circled). Like a kid who eventually grows into a pair of hand-me-down shoes, corporate earnings have continued to grow and, more importantly, are expected to continue to grow into the already stretched valuations about which I fretted in earlier notes.

STOCK VALUATIONS USING OTHER VALUATION METRICS

Comparing the price of a share of stock to the corporate earnings to which that share of stock may be entitled is widely regarded as a valid valuation metric although no one claims it to be a perfect measure of value.

Just as a real estate appraiser may value a given piece of real estate from the perspective of the cost to replace the property, the income the property could generate, or simply by referring to sales data for similar properties, equity investors have their own arsenal of valuation tools. When clarity is lacking or when the stakes are high, it makes sense to use those other methods. The following chart depicts how current stock prices compare to historical norms using a variety of valuation metrics.



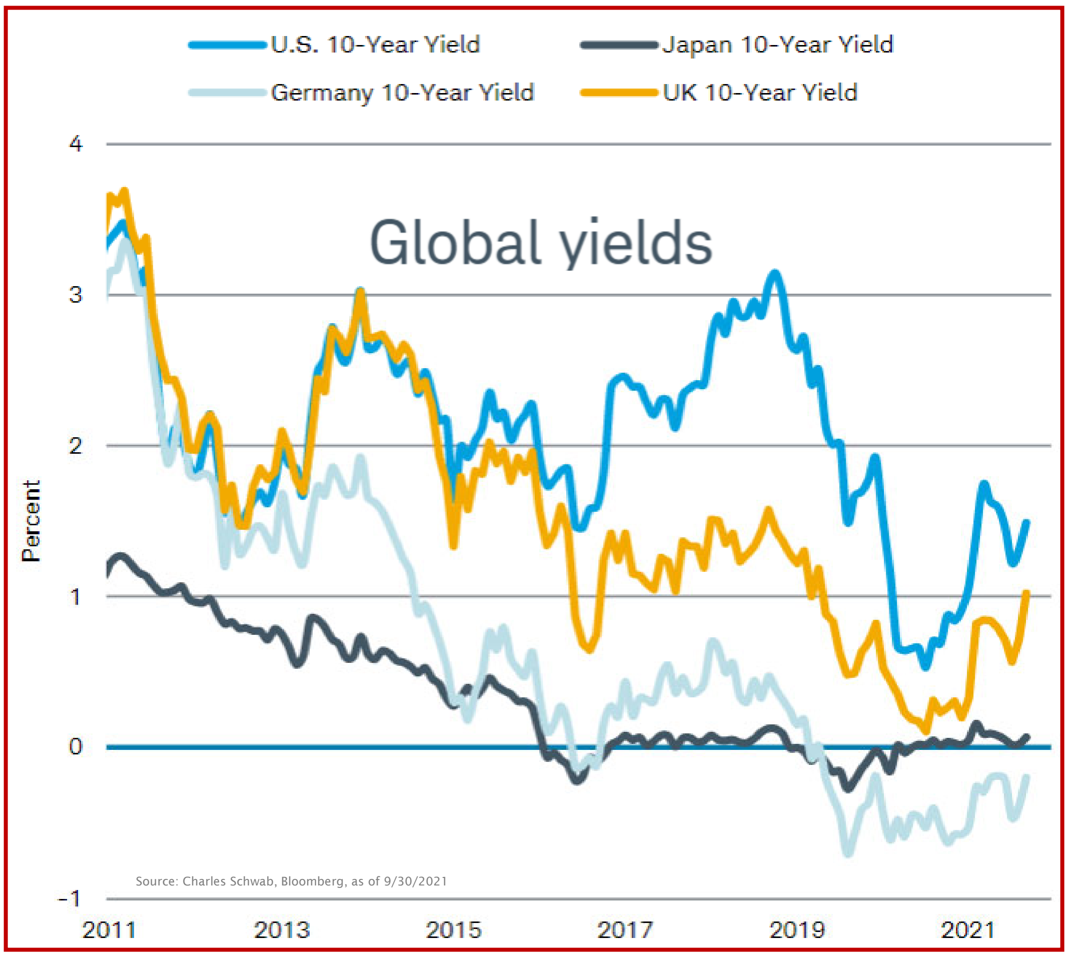
Source: Charles Schwab, Bloomberg, The Leuthold Group, as of 10/1/2021. Due to data limitations, start dates for each metric vary and are as follows: CAPE: 1900; Dividend yield: 1928; Normalized P/E: 1946; Market cap/GDP, Tobin's Q: 1952; Trailing P/E: 1960; Fed Model: 1965; Equity risk premium, forward P/E, price/book, price/cash flow, rule of 20: 1990. Percentile ranking is shown from lowest in green to highest in red. A higher percentage indicates a higher rank/valuation relative to history.

STOCKS: THE "CLEANEST DIRTY SHIRT"

I won't bore you with any unnecessary detail about the valuation metrics shown on the previous page but, in general, **stocks still appear to be quite overvalued by most measures**.

However, three metrics (circled) suggest that stocks could continue to provide good investment value to investors. In general, those three metrics compare the potential return from stocks to the potential return from alternative investment vehicles such as Treasury bonds that mature in 10 years, medium quality corporate bonds or, in the case of the "Fed Model," to the yield of bonds, in general.

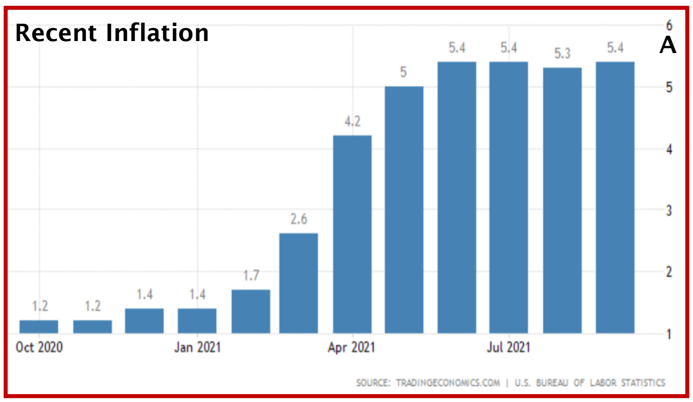
It's noteworthy that stocks score well only when their hypothesized future returns are compared to the paltry yields available from various kinds of bonds. The yields available on corporate bonds might be a couple percent higher than the yields available on the government bonds shown below, but even those yields wouldn't be much over 3%. In this respect, stocks may currently be akin to Johnny Cash's cleanest dirty shirt.

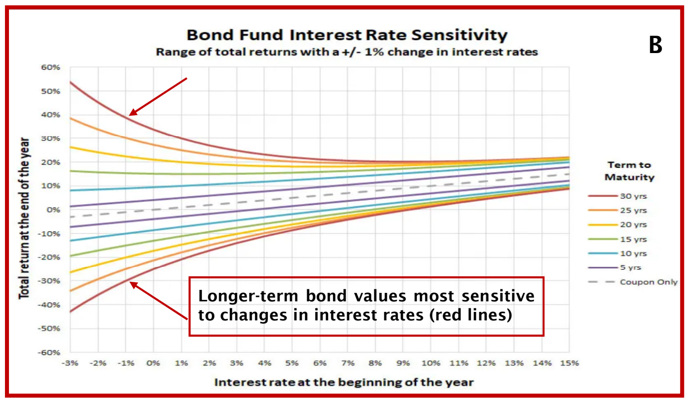


REALITY CHECK

Since stock prices have risen faster than the earnings that support them, stock price appreciation may then take a breather while earnings catch up. If interest rates rise, and the Fed intends for them to do just that, the yields on bonds would then become somewhat more attractive versus the dividend yields on stocks and the three circled metrics on page six would slide more toward the red, overvalued zone. Hopefully, some of the other metrics on that page will slide to the left, but that's certainly not a given.

Since June, inflation within the U.S. has consistently remained above 5% (panel A) which is 2½ times the Fed's usual, non-pandemic target. If inflation were to remain higher or more persistent than the Fed thinks or hopes it will, bond prices would tend to decline to create the higher yields investors would demand. As shown in panel B, long-term bonds would decline more in value than would shorter-term ones.





Rising rates are certainly not a death knell for investors, but rising rates are apt to pose a bit of headwind for equities as well as for bonds since both asset classes are already valued rather richly. This is why asset class returns are expected to be substantially lower than the returns to which investors have grown accustomed. — Glenn Wessel