Financial Markets This Week

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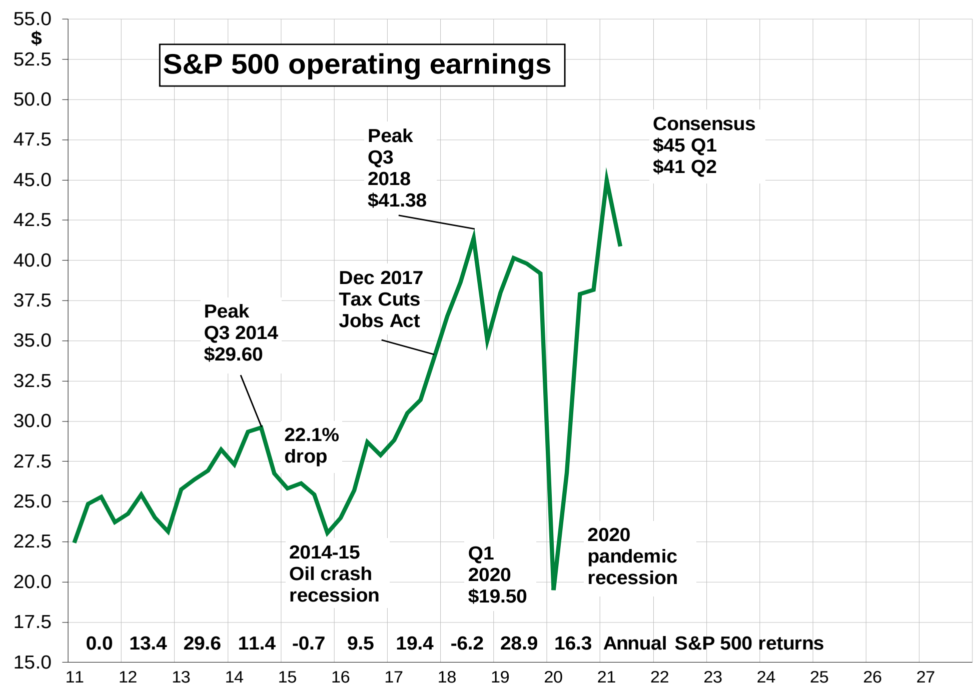
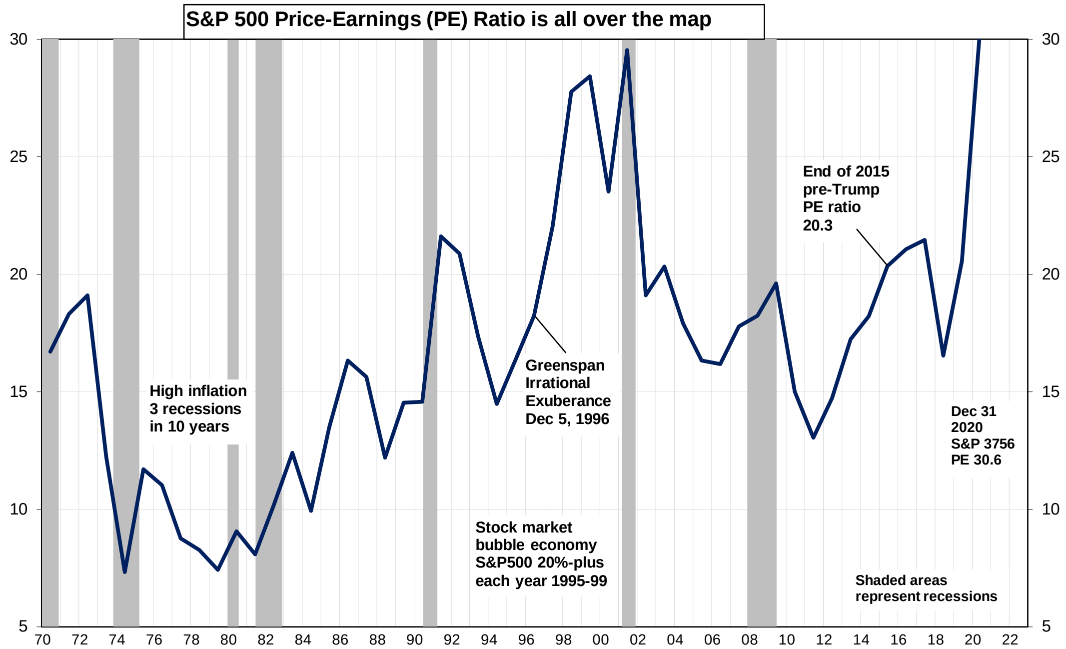
STOCK MARKET VALUATION



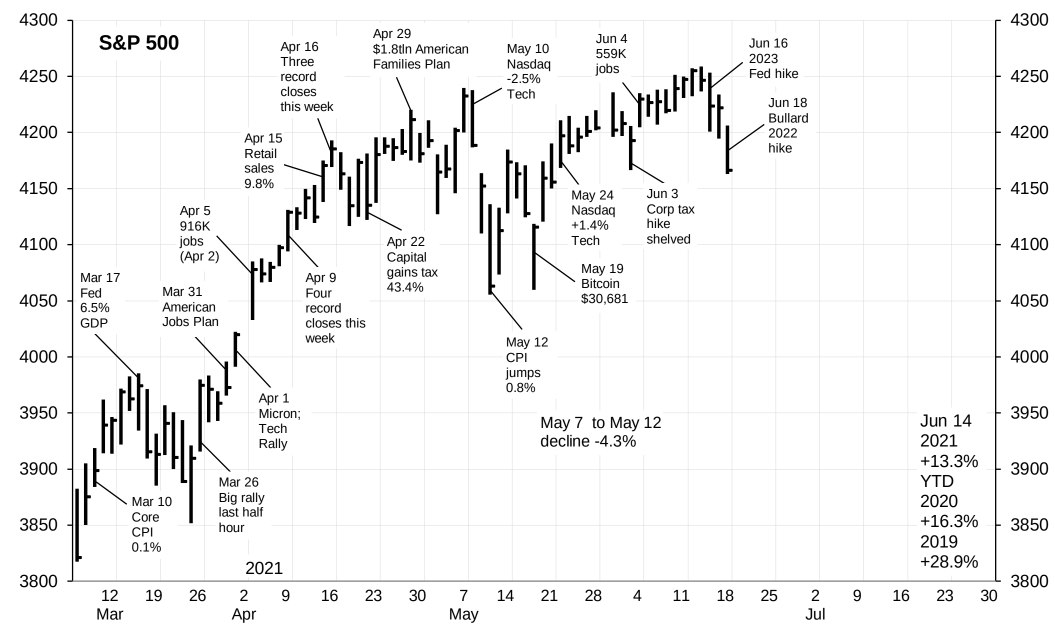
This has been the richest recession in history if you are in the stock market. There is a peak level before every recession, stocks fall and then recover to the old peak. If you sold out at the bottom as we always manage to do, you are out of luck. In the so-called Great Recession of 2007-09, it took the stock market four long, hard years for prices to recover and make new all-time highs. In the COVID recession the recovery took 5 months. The quickest recession in U.S. history is followed by the fastest stock market recovery in history. And the market isn't as overvalued like we thought it was going to be as companies actually made the money and lots of it with S&P 500 earnings at record highs in the first quarter this year. It still looks like Wall Street forecasts of earnings are way too bullish over the final three quarters of 2021 and into 2022, but then we are mostly a dismal lot of economists here.

<u>Supernormal Profits From the Pandemic Are Over</u>

The stock market gained steadily after the S&P 500 index fell over 30 percent from the highs in March 2020 at the start of the pandemic before the Fed pumped money in. It is hard to remember the Fed bought $500 billion Treasury securities in March last year and $900 billion in April before settling down to its current $80 billion monthly QE Treasuries pace. There were few stock market drops since March 2020. Nervousness over tech valuations brought stocks down 10.6% from record highs in September 2020. Stocks nearly recovered from that sell-off before tumbling 8.9% again in October ahead of the November 2020 election. There hasn't been a major decline in stocks since last November. The biggest retreat in 2021 was a 5.7% mid-February to early March sell-off with bond yields rising quickly above 1.5% and Powell saying there was some inflation ahead.

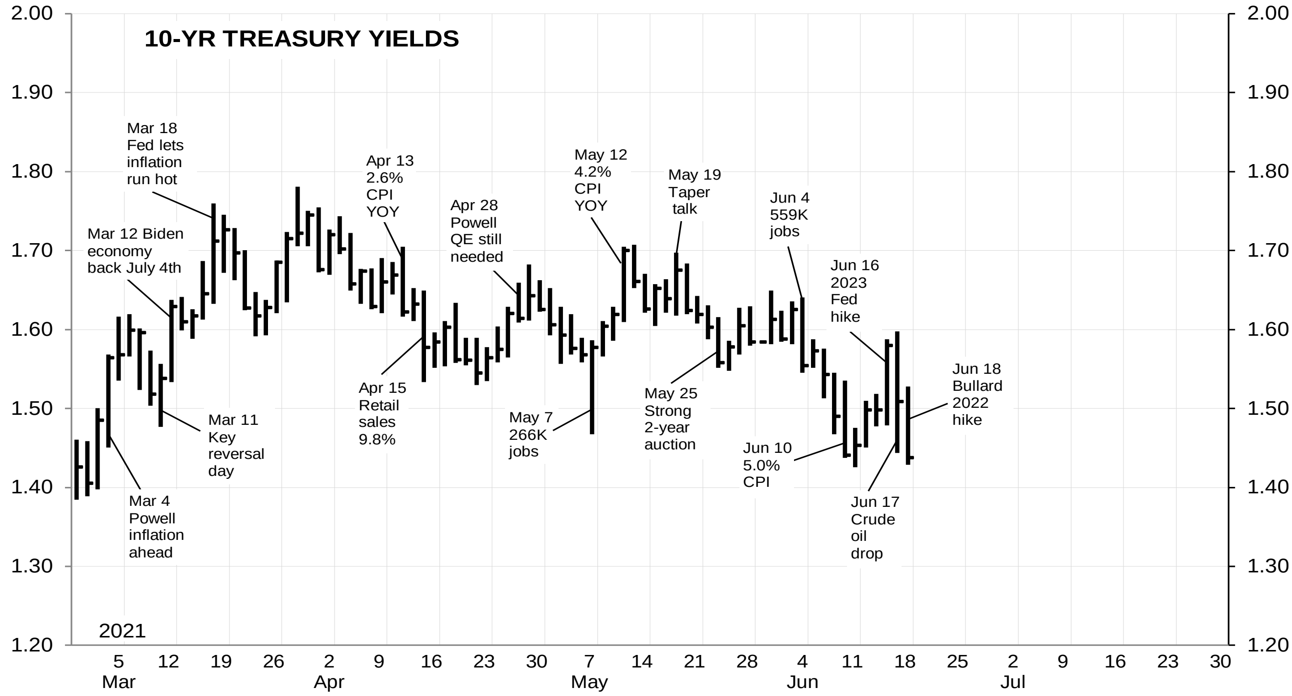


Valuation in the stock market is always tricky as sometimes investors will pay a lot for earnings with a high PE ratio, and other times they won't pay much at all. The PE ratio was around 10.0 in the late 70s early 80s with three recessions in ten years and double-digit inflation. Charles Schwab said once he was not a fan of the PE ratio although he believes you should invest gradually over time and not time the market. Greenspan once thought the market exhibited irrational exuberance back in December 1996 with what was then the highest price to earnings ratio in decades, but stocks kept going. The S&P 500 averaged annual gains of over 20% during the stock market bubble from 1995 to 1999, well, almost with 1999's increase only 19.5%.



Back to earnings as a means of valuation using operating earnings for the S&P 500. We have toned down the "Wall Street consensus" for how much money companies are going to make. The economy is past its growth peak and many companies made money during the pandemic where that opportunity will be gone once life gets back to normal and people aren't at home on their computers and companies won't be putting operations up in the Cloud in part because so many already have. The PE ratio finished the year a little above 30 based on operating earnings over all four quarters of 2020. Assuming Q1 2021 earnings are $45 and that earnings stay at $45 for the final three quarters of 2021, then the PE ratio comes down to 23.15 based on the S&P 500's close of 4,166.45 on Friday, June 18. The other problem with stocks at current levels is the Federal Reserve helped stock levels buy their way into the record books with its emergency QE purchases. What happens when the emergency and the Fed's QE purchases go away? Stay tuned. Story developing.

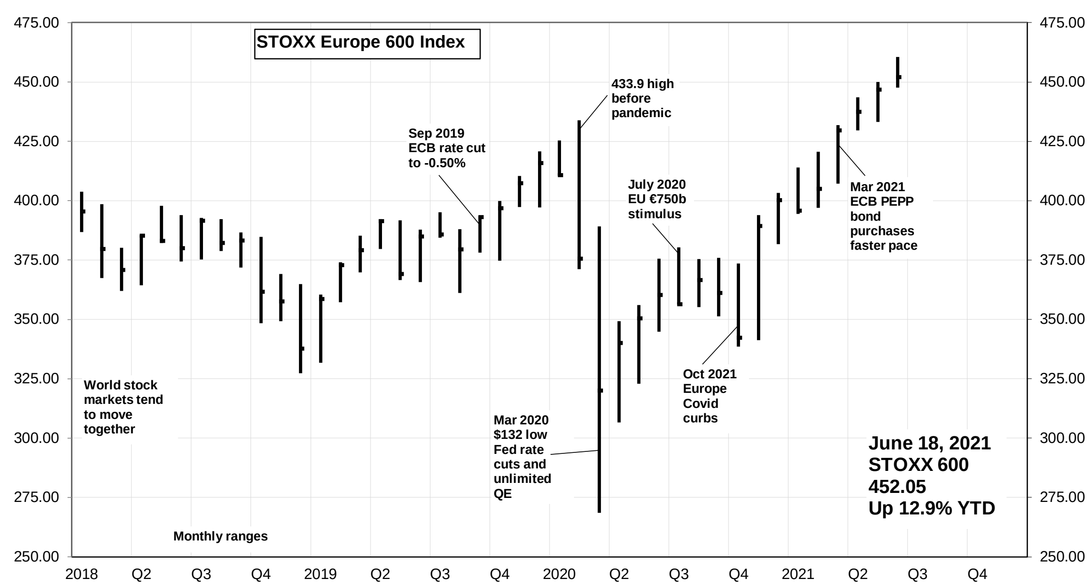
INTEREST RATES



The S&P 500 was down 0.3% ahead of the Fed's 2pm ET announcement that a majority now favored a rate hike in 2023. After falling a total of 1% on the day, stocks cut losses when Powell said Dots Forecasts were not a plan. The S&P 500 closed Wednesday down 0.5%. Bonds had more trouble with the Fed's announcement starting from 1.486% at 2pm ET Wednesday, 10-year yields kept rising going out at the highs of the session at 1.580%. That was just the start as yields fell Thursday with falling commodities and crude oil prices. Bullard's 2022 rate hike tanked stocks and yields Friday.

Europe STOXX 600 up 12.9% YTD

Stocks in Europe made new record highs. The Thursday, June 10 ECB meeting helped things along. Growth in the euro area is 4.6% in 2021 and 4.7% in 2022, where the March meeting forecasts were 4.0% real GDP in 2021 and 4.1% in 2022. Stocks missed the 2023 GDP forecast: unchanged at 2.1%. Europe STOXX 600 is up 4.2% from the record highs before the pandemic where the S&P 500 is 23.0% higher than its pre-pandemic high as of the Friday, June 18, 2021 close.



FEDERAL RESERVE POLICY

The Fed met on June 15-16, 2021 to consider its monetary policy. The market only wanted to hear about when they will start talking about when to talk about scaling back the monthly $120 billion of QE stimulus. It might be getting closer to the time to taper because for the first time a majority of the committee sees a rate hike by the end of 2023 and 7 of 18 see a rate hike in 2022. But frankly, it is too late to talk, they have to act now and stop pouring gasoline on the fire before it's too late. The Fed's monetary policy has stayed active for too long following the last couple of economic downturns. This is the quickest recovery from any recession we have ever witnessed which begs the question of what exactly Fed officials are doing. They risk their own credibility by providing emergency-level monetary policy stimulus this late in the game. Why are they printing $120 billion per month, why not $100 billion or maybe $75 billion? What are their reasons? They won't explain because they can't. If top Fed officials cannot explain adequately what the $120 billion of purchases are doing to help us, that policy is in trouble. It looks to many that money printing is setting off a bubble in the stock and housing markets and stoking a demand for alternative currencies like Bitcoin.

The amount of money the Federal Reserve officials are still printing is simply staggering given the financial crisis and depths of the recession are long gone. Even Bernanke started tapering after a year of QE. Providing the same level of emergency stimulus when the recession is over risks confusing the public about monetary policy's efficacy and may even shorten the business cycle by unleashing the inflation genie from her bottle and forcing Fed officials to pump the brakes on economic growth.

To conclude, prices are exploding everywhere we look from shares in the stock market to home prices to the sticker prices on new cars, dining out, or eating in, rental cars, airline tickets. The price of everything is going up. The economy is further down the road to recovery than Fed officials think. So far down the road that inflation is starting to rear its ugly head. The Fed maintains that their policy is somehow creating jobs, but higher prices are a tax on the wages of job holders and a heavy price to pay for everybody. The two-handed Fed stimulus giveth and taketh away. The good news is you have a job, the bad news is your paycheck doesn't buy a darn thing.

Meanwhile, back in March this year, only 7 of 18 FOMC participants wanted to raise rates by the end of 2023. Now after last week's 5.0% year-year CPI print, 13 of 18 want to hike rates by 2023, and 7 of 18 want the liftoff to start in 2022 which barely leaves time for the Fed to complete the full tapering of its $120 billion QE. In the forecast, the Fed sees inflation dropping back to 2.1% in 2022 from 3.4% this year. It also sees unemployment averaging 4.5% in Q4 2021, so if it falls faster, QE tapering might be in order sooner than later.

Fed Policy-key variables				Long
	2021	2022	2023	Term
Fed funds	0.1	0.1	0.6	2.5
PCE inflation	3.4	2.1	2.2	2.0
Unemployed	4.5	3.8	3.5	4.0
GDP	7.0	3.3	2.4	1.8
June 2021 median Fed forecasts				

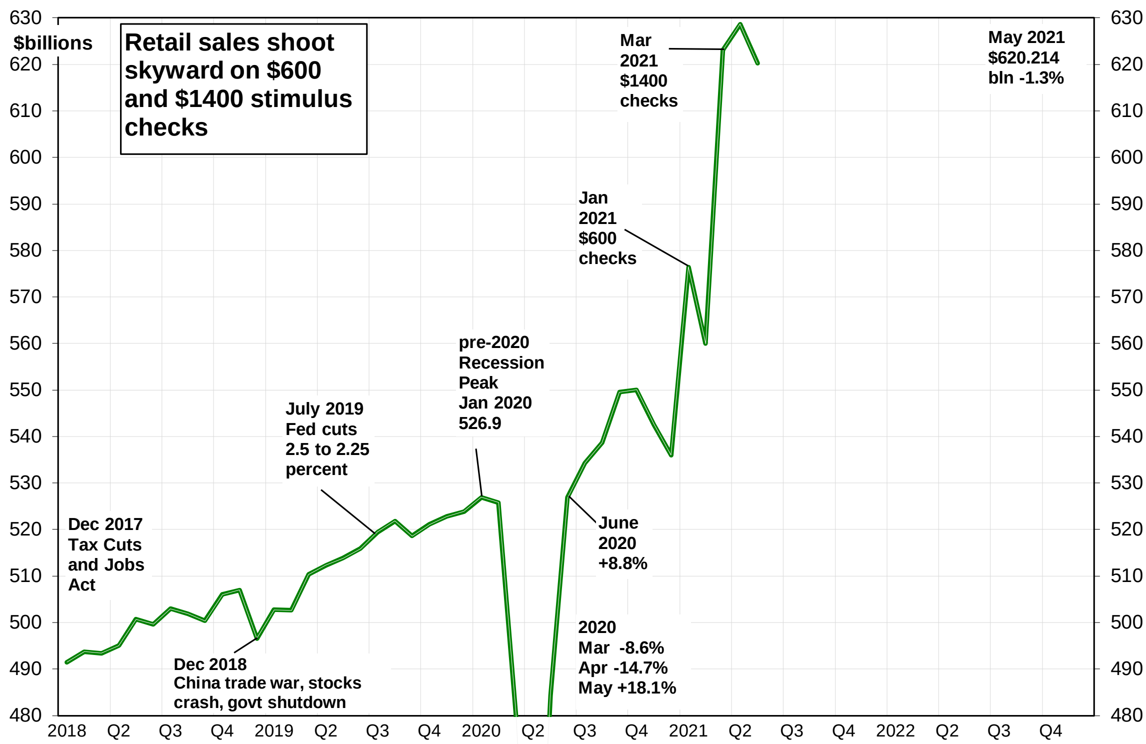
Fed Individual Forecasts				
Fed funds rate at year-end				Longer
Votes	2021 End	2022 End	2023 End	run
1	0.125	0.125	0.125	2.000
2	0.125	0.125	0.125	2.250
3	0.125	0.125	0.125	2.250
4	0.125	0.125	0.125	2.250
5	0.125	0.125	0.125	2.250
6	0.125	0.125	0.375	2.375
7	0.125	0.125	0.375	2.500
8	0.125	0.125	0.625	2.500
9	0.125	0.125	0.625	2.500
10	0.125	0.125	0.625	2.500
11	0.125	0.125	0.875	2.500
12	0.125	0.375	0.875	2.500
13	0.125	0.375	0.875	2.500
14	0.125	0.375	1.250	2.500
15	0.125	0.375	1.250	2.750
16	0.125	0.375	1.250	3.000
17	0.125	0.625	1.625	3.000
18	0.125	0.625	1.625	
Median	0.125	0.125	0.625	2.500
Meeting	Jun 21	Jun 21	Jun 21	Jun 21

OTHER ECONOMIC NEWS

The great economic slowdown starts with retail sales (Tuesday)

Breaking economy news. Retail sales in May fell 1.3% where the consensus was -0.6%. Fed officials will be briefed on the news as today's two-day meeting opens, but the stock market doesn't need to be told and it barely reacted to the news. Ignored perhaps as April retail sales are now 1.4% higher upon revision. Stocks shouldn't ignore the economic news as consumers could pull back their purchases even further if inflation doesn't stop making it more expensive to buy what the country needs. The inflation fires continue to rage out of control with PPI inflation data released the same time as retail sales this morning. PPI Final Demand goods prices ex-food and energy rose 1.1% in May after rising 1.0% in April which will make consumer goods stocked on the store shelves even more costly in coming months. This inflation doesn't look as transient as Fed officials originally hoped. The great economic slowdown of 2021 starts with retail sales today and retail sales tomorrow will be kicked down even further by producer goods inflation. Retail sales soaring 28.1% from last year levels is too good to last and it won't.

Net, net, retail spending by consumers at the shops and malls tumbled this month as the latest round of $1400 Federal stimulus checks has been spent. Sales were sky-high and many store owners thought the customers would never leave, but the reopening effect from the pandemic shutdowns and surge in pent up demand purchases was not going to last. Consumers are all caught up now after postponing their purchases during the period of stay-at-home restrictions. The money they saved from not venturing out has been spent. The Federal government $600 and $1400 checks in January and March, respectively, have been spent, so today's drop in sales is a real eye-opener of what lies in store for the economy's future. The American economy is past its peak in terms of the maximum growth seen in the aftermath of the recession. Economic growth is doomed to slow as the economy gets back to normal where the potential growth rate penciled in by economists is not even 2.0% in the years ahead.

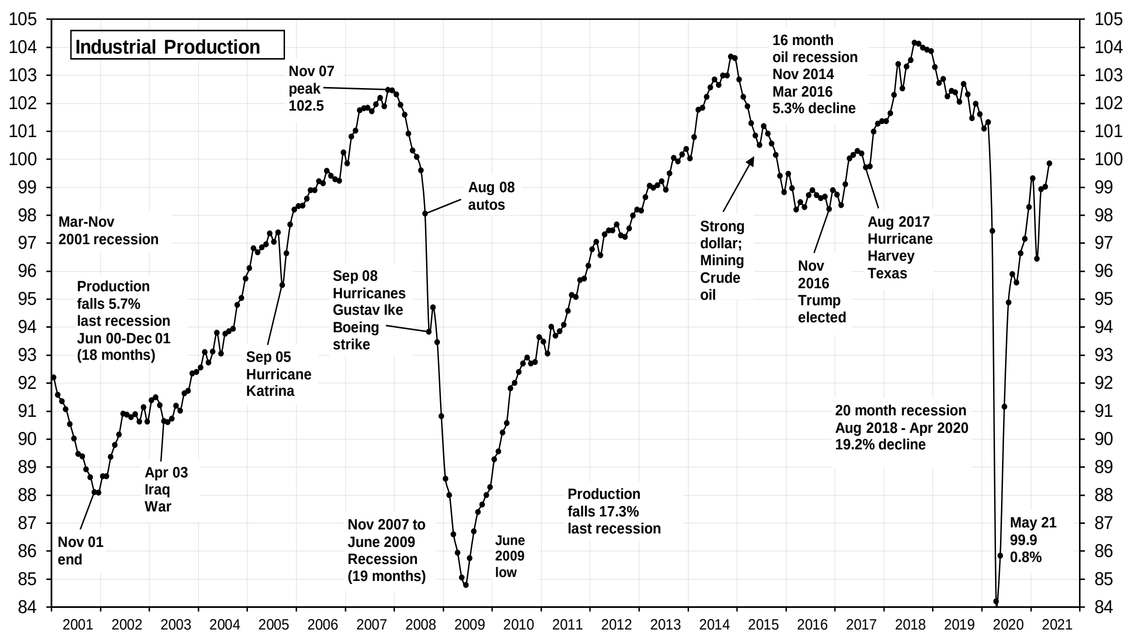


Industrial production one-step forward, two steps back (Tuesday)

Breaking economy news. America's factories continue to slowly restart their engines. Retail sales is miles above where it was before the pandemic, but industrial production is still 4.1% short of the all-time record set in August 2018 (production slowed well before the pandemic due to the trade wars being fought). A loss of 4.1% doesn't sound like much, but industrial production only fell 5.7% in the 2001 recession, so American factories are not back to normal. Industrial production was reported up 0.8% today for May, and manufacturing industrial production was up a solid 0.9%, but the measurement of industrial output needs to be released with a gigantic caution sign. In between the release of the May and April industrial production reports, the Federal Reserve released its annual revision of the data. Even if the annual revision was not followed widely by the markets, we were shocked at how the revision took down what we thought was a strengthening trend of industrial output under the prior Administration. If you thought the Tax Cuts and Jobs Act in December 2017 led to a rebirth of American manufacturing, you are mistaken because the stronger production trend in 2018 has been erased completely.

Percent changes			Industrial Production May 2021		
Mar	Apr	May	YOY		Weight
2.6	0.1	0.8	16.3	Total Index	100.0
3.1	-0.1	0.9	18.3	Manufacturing	73.9
11.9	-0.4	1.2	16.5	Mining	12.2
-8.8	1.9	0.2	3.6	Utilities	11.9
			Manufacturing payroll jobs 12.3 million +633K YOY 10.0% of Private Payroll Jobs		

Net, net, factories are seeing a slow recovery with the latest bump higher caused mostly by motor vehicle assemblies. Manufacturing production rose 0.9% in May, but it is barely above the level of activity in January 2021 before February's severe winter storms in Texas sent output reeling with big declines in petroleum refineries, petrochemicals, and plastic resin plants. Stay tuned. Story developing. Factories are still on the long road to recovery while the rest of the economy races ahead.



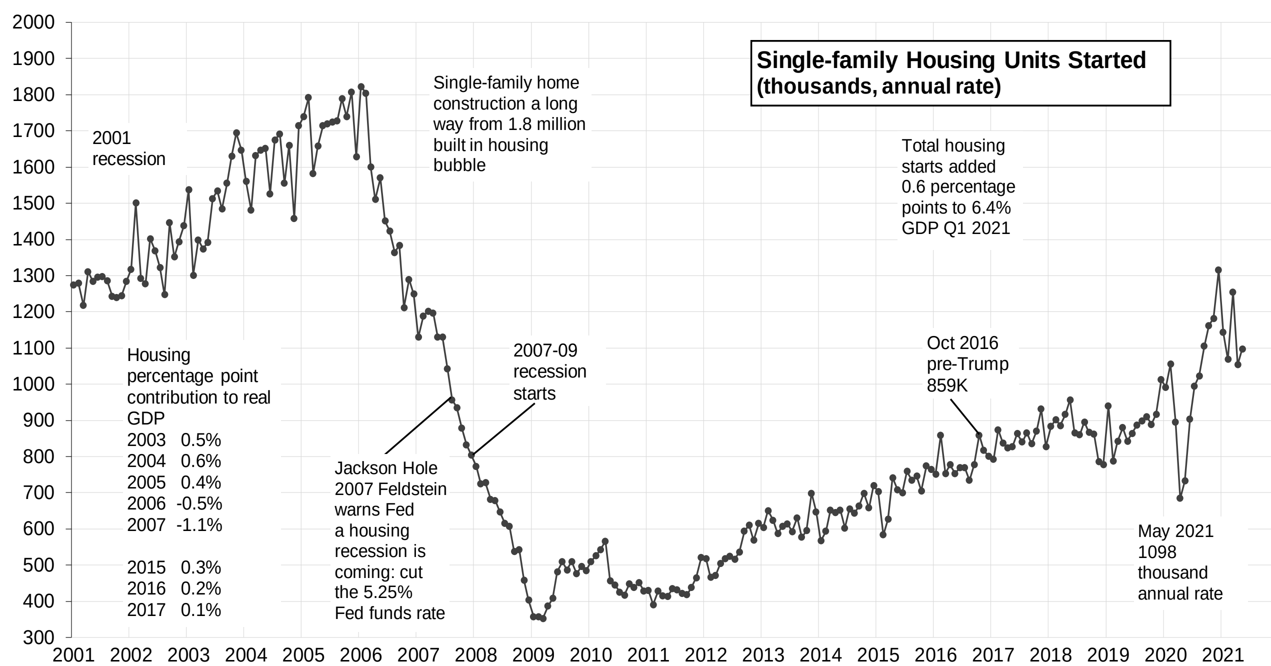
Not enough housing construction (Wednesday)

Breaking economy news. Residential housing construction data for May. The data have been choppy since late last year, and this month housing starts are back up. Single-family starts rose 4.2% to 1.098 million at an annual rate which is a long way from the housing bubble highs over a decade ago where over 1.7 million single-family homes were constructed at an annual rate in 2005 and early 2006 before the housing market collapsed. Back then home builders were putting up too many homes for too many years and this time they are not building enough homes which leads to huge price increases that only makes the cost of housing less affordable. It isn't interest rates, it is housing price inflation that is the problem. The Federal Reserve doesn't need to keep interest rates low to support the housing market as demand for new homes is through the roof given the shortages across the country. Not enough supply is the problem, not the cost of financing a new home purchase. Home buyers have plenty of money for a down payment given the unprecedented stimulus from Washington from the $1400 checks to the still-ongoing $120 billion emergency QE.

Housing Starts Total, Single-Family, Multi-Family

	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
May 2021	1572	1098	465	118	63	239	169	814	591	401	275
Apr 2021	1517	1054	447	152	73	184	145	784	575	397	261
May 2020	1046	733	305	70	35	144	99	510	403	322	196
% Chgs											
May/Apr	3.6	4.2	…	-22.4	-13.7	29.9	16.6	3.8	2.8	1.0	5.4
May/May	50.3	49.8	…	68.6	80.0	66.0	70.7	59.6	46.7	24.5	40.3

Net, net, the latest batch of residential housing construction data won't be music to Fed officials' ears as they meet today. There is not enough construction of single-family homes to alleviate the housing shortage in America and despite real GDP of nearly 10% this quarter this is one economic sector that isn't growing fast enough. There are 332 million Americans and not nearly enough homes to put them all in which means the housing price bubble will continue to worsen. We had one recession caused by the bursting of a housing bubble over a decade ago and we don't need another one. The increase in home prices doesn't look sustainable. Home price inflation will continue with no one down in Washington having a clue on what to do about it. Not enough homes means more inflation.



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