STRATIGRAPHIC ASSET MANAGEMENT, INC.

JAYUSIA P. BERNSTEIN
ALAN S. BERNSTEIN

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Investment Outlook

Equity markets continue to surprise. Notwithstanding relatively high valuations and tempered expectations, the stock market outperformed in the first half of 2021. The total return of the S&P 500 Index was 15.2%. This has been an astonishingly good period for common stocks. Volatility has been relatively low. The S&P 500 Index has not experienced a 5% correction since the third quarter of 2020. The outsized performance of equities can be attributed to the rapid recovery of the United States from the pandemic, especially in comparison to the rest of the world, the strong economic growth, which is accelerating through the second quarter, the better-than-projected rebound in corporate profits, and confidence that low interest rates will continue, which markedly enhances the attractiveness of common stocks relative to other asset classes.

Fixed income investments generally lost money in the first half. The Bloomberg Barclays U.S. Aggregate Bond Index had a total return of -1.6% reflecting the strong rise in interest rates since March.

Here are our major conclusions regarding the investment outlook:

- The positive fundamental backdrop for common stocks will continue at least for a while. However, U.S. economic growth adjusted for inflation should peak in Q2 2021 at roughly 10% and gradually decelerate as the impact of outsized government deficit spending dissipates. Longer-term, U.S. growth is not expected to exceed 2% per annum, which was the general expectation before the pandemic. The biggest killer for equity investors is recession, but prospects for a recession over the next couple of years seem virtually nil, which is good news for equity investors.

- Corporate profits are experiencing an extraordinary recovery through 2021 and are on track to do so through 2022. There are pressures on margins, which are currently at peak levels, and it is possible the administration will raise corporate income taxes, though higher taxes are expected to have only a moderate negative impact.

- The two biggest issues confronting investors are the prospects for inflation and the adverse consequences of huge government deficits. Higher inflation and massive new government financing could lead to a general rise in interest rates, which would pressure equity valuations. Our analysis suggests that inflation will be manageable, the government deficits financeable, and the potential rise in interest rates tolerable.

- Notwithstanding the relatively positive outlook, the prospects for investors seem limited. Valuations are currently in the 95th percentile and stretched. If corporate earnings do not keep up their current pace (they likely will not) or if interest rates rise (they likely will), price/earnings ratios are going to contract and act as a drag on performance. Market strategists (whose crystal balls are far from perfect) see no further common stock appreciation for the balance of the year.

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DOUGLAS ENTRANCE, 804 DOUGLAS ROAD, SUITE 363, CORAL GABLES, FLORIDA 33134
TELEPHONE (305) 447-0300 • FAX (305) 447-0385 • WWW.STRATIGRAPHIC.COM

A major source of optimism about capital markets is the strength of the U.S. recovery. Especially important is the progress that has been made in vaccinating the country and opening up the economy. At mid-year, 67% of adults had received at least one shot and significant further progress is expected in the second half. Real GDP, which grew at 6.4% in the first quarter of 2021, is expected to reach 10% in the second quarter. The big driver is the increase in consumption as families are flush with savings from a combination of government support and diminished shopping last year. With low interest rates, purchases of durable goods have surged; motor vehicles and home furnishings are especially strong. Recent press reports indicate that consumers are snapping up houses before they come on the market and paying above sticker prices for automobiles.

For the full year, real GDP is expected to expand in the 6.5% to 7.0% range compared to the decline of 3.5% in 2020. The economy will grow in 2022 in the 4% to 5% range. It is discouraging that by the end of 2023, based on consensus forecasts, the U.S. economy will be back on its pre-pandemic growth trend of 2% or less per annum. By 2023–2024 the impact of outsized government programs will have been largely realized unless pending legislation for infrastructure and other programs is passed.

As full recovery is achieved, most economists expect that the U.S. economy will advance at 2% per annum or less. The Congressional Budget Office (CBO), which is in the best position to evaluate the impact of recently enacted government programs, published real GDP growth estimates in early July of 1.5% in 2023 and trending in the 1.2% to 1.6% per annum range from 2024 to 2031.[1] These are very disappointing forecasts, which should be sobering to investors. The good times that we are now experiencing are not likely to persist.

In this environment, corporate earnings are exceeding previous projections. Bloomberg consensus forecasts indicate that the earnings gain for the S&P 500 Index companies will be more than 70% in the first six months of 2021, in part a reflection of how depressed earnings were at the height of the pandemic in the first half of 2020. For the full year, S&P earnings are now projected at around $191,[2] which is 17% higher than estimates in January, *but most amazingly are about 25% greater than pre-pandemic earnings levels in 2019 of $152.* The preliminary forecast for 2022 is a double-digit gain in earnings, which is well above our long-term trend forecast of mid-to-high single-digit annual growth.

The S&P 500 Index earnings estimates are based on analyst forecasts that tend to be optimistic. We have some doubts that the picture is as rosy as the consensus suggests. It has been well reported that companies are having to deal with higher commodity prices, bottlenecks in supply chains, and wage increases, exacerbated by challenges in certain sectors to attract adequate numbers of workers. These developments suggest that the risk to the earnings forecasts is to the downside.

An additional caveat is the possibility that corporate taxes will be raised. Recall that under the Tax Cuts and Jobs Act of 2017, corporate taxes were reduced from a maximum rate of 35% to 21%. The Administration is proposing to raise the corporate tax rate to 28%. Our best guess is that while rates will rise somewhat, perhaps to 25%, strong measures will be implemented to ensure that corporations pay

[1] Congressional Budget Office, "An Update to the Budget and Economic Outlook: 2021 to 2031." Released July 2, 2021.

[2] The corporate earnings of the S&P 500 Index are adjusted by analysts and research services to relate to the level of the Index. Accordingly, one can take the level of the Index at June 30 of 4298 and calculate the forward 2021 price/earnings ratio: 4298/190.88 = 22.5x. Historical earnings data can vary depending on how extraordinary charges, amortization of intangibles, stock-based compensation, and related expenses are treated. The imprecision is maddening for managers who rely on such data.

at least some reasonable minimum taxes. The reduction in S&P 500 Index earnings is estimated at around $10 or about 5% of estimated 2022 earnings per share of around $213 (which assumed no corporate tax rate increase).[3] In short, raising corporate taxes will not likely be very consequential for investors.

There are two major threats to the otherwise benign investment outlook: inflation, which would cause interest rates to rise; and the massive government deficits, which also could result in inflation and higher interest rates.

In regard to inflation, there is general recognition that prices in the United States are rising. The Bureau of Labor Statistics (BLS) reported that for the 12-month period ended in May, the consumer price index (CPI) rose by 5%. The annualized rate for May alone was more than 7%. By comparison, the long-term target of the Federal Reserve is 2% per annum. Yet Fed Chairman Powell in recent congressional testimony stated, “Inflation has increased notably in recent months. This reflects, in part, the very low readings from early in the pandemic falling out of the calculation; the pass-through of past increases in oil prices to consumer energy prices; the rebound in spending as the economy continues to reopen; and the exacerbating factor of supply bottlenecks, which have limited how quickly production in some sectors can respond in the near term. As these transitory supply effects abate, inflation is expected to drop back toward our longer-run goal.”[4]

Our concern is about wages, which are the principal driver of inflation. In the first quarter, unit labor costs, an important measure of the burden of wages on businesses, rose at an annual rate of only 1.7%. There is a lag between a rise in wages and the consequent rise in consumer prices. We believe that wage pressure will ratchet up. The rate of unfulfilled job openings reported by BLS in May represented 97% of reported unemployment for the month, which is a great indicator of the strength of the recovery but also a harbinger of some wage inflation. Anecdotally we are hearing of significant increases in wage rates and signing bonuses businesses are paying to attract personnel. We expect second quarter data to reflect these hikes.

Table 1

Consumer Price Index: Annual Rate of Inflation Forecasts

	Actual		Projected			
	2019	2020	2021	2022	2023	Long-Run
Federal Reserve*	1.8%	1.2%	3.5%	2.3%	2.2%	2.0%
Bloomberg Consensus**			3.5%	2.5%	2.2%	NA
Congressional Budget Office			3.3%	2.5%	2.3%	2.4%

* Price index for personal consumption expenditures (PCE). Economic projections of Federal Reserve Board (FRB) members and FRB Bank presidents, June 16, 2021.

** As of July 5, 2021

[3] Goldman, Sachs estimated the impact of raising corporate taxes based on the median sell-side estimates. “Digital Assets”, Investment Strategy Group Presentation, June 21, 2021.

[4] Jerome H. Powell, Statement, U.S. House of Representatives, June 22, 2021.

Table 1 shows the CPI forecasts of the Federal Reserve, the Bloomberg consensus of economists (more than 70), and the recent projections of the CBO. The point is that these parties generally buy into the Goldilocks scenario of the Fed. Investors, as reflected by the recent decline in interest rates, seem to agree. The 10-year Treasury and the 30-year Treasury yields fell from their peak in March to July 2 by 16.7% and 18.2% respectively.

Table 2	
Break-Even Inflation Rate Between TIPS *	
and Treasuries at Different Maturities	
Maturity in Years	Break-even Inflation Rate
1	3.1182%
2	2.6853%
3	2.6173%
5	2.5150%
10	2.3429%
30	2.2788%
* TIPS, Treasury Inflation-Protected Securities	
Source: Bloomberg	

One means of gauging inflation expectations is to calculate the break-even inflation rate at which investors would be indifferent to purchasing Treasury inflation-protected securities (TIPS)[5] and regular Treasuries that pay a fixed rate of interest. Table 2 provides the break-even rates for TIPS compared to Treasury bonds at different maturities. The point of the table is to show that inflation rates are expected to peak at around 3.1% over the next year and gradually decline to 2.5% in five years and to 2.3% in 10 years in line with the forecasts contained in Table 2. The 30-year break-even rate is under 2.3%.

We are skeptical of such forecasts—they are too good to be true! A recent study showed that looking backward, 10-year Treasury bond yields correlated well with inflation rates, while looking forward, the correlation, no matter the maturity, was not a reliable indicator.[6]

Federal program outlays in addition to the regular budget are staggering as set forth in Table 3 and could be inflationary. To date, legislation in support of the economy during the pandemic has amounted to $5 trillion or around 24% of 2020 GDP. Pending proposals include a bipartisan infrastructure plan of $579 billion and the administration's American Jobs Plan of more than $2 trillion. The spending in both programs would be spread over several years. The American Jobs Plan includes corporate tax increases designed to pay for the expenditures (including the infrastructure outlays) over a 15-year period. It is our impression that Administration funding forecasts rarely work out as projected.

[5] The principal of TIPS bonds is adjusted annually—upward for inflation and downward for deflation based on the Consumer Price Index.
[6] "Bond yields are not good predictors of inflation," Gagnon and Sarsenbayev, Peterson Institute for International Economics, February 17, 2021.

Table 3			
Special Federal Legislation Related to Pandemic and Infrastructure			
Legislation	Date	Billions $	% of 2020 GDP
CARES Act	3/27/2021	$2,200	10.5%
Consolidated Appropriations Act, 2021	12/27/2020	$900	4.3%
American Rescue Plan Act of 2021	3/11/2021	$1,900	9.1%
Total Passed		$5,000	23.9%
Bipartisan Infrastructure Framework	Pending	$579	2.8%
American Jobs Plan, Net*	Pending	$2,071	9.9%
Total Pending		$2,650	12.7%
Grand Total		$7,650	36.5%
* Excludes Bipartisan Infrastructure Framework expenditures shown above.			

It seems likely that an infrastructure bill will be passed by Congress. Regarding the American Jobs Plan, we are concerned about the inflationary impact. In a recent interview with *Time*, Larry Summers expressed similar concern over the legislation and a clear warning to Democrats: "I think … that when governments lose control over money, people tend to lose confidence in them. The inflation of the 1970s was an important part of the reason Jimmy Carter was not re-elected. The inflation of the 1960s was an important part of the reason why Richard Nixon was elected. And so I think progressives need to ponder the fact that when they're not able to keep inflation under control, that they can pay a very large political price."[7]

In addition to inflation, there are worries about the sustainability of the federal deficits and the massive amount of debt our government is assuming. In 2020 and 2021, the annual deficit will average 16.75% of GDP—a budgetary deficit under 5% of GDP is considered a normal target. Federal debt held by the public is projected to amount to around 103% of GDP by the end of this year; and this forecast excludes consideration of pending legislation. Twenty years ago, the debt-to-GDP ratio was under 30%.

Economist Olivier Blanchard in a widely circulated paper postulated that as long as the nominal growth of the economy exceeds the average interest rate on the debt, we should not be concerned as the debt will become progressively less burdensome. Virtually all economic forecasts indicate that the United States should be able to meet the Blanchard conditions. Using the CBO forecasts as a benchmark, the nominal growth in GDP over the next 10 years will be greater than 3.5% while the interest rate on the debt is projected at less than 2%.[8] In a more recent paper, Jason Furman and Larry Summers focused not on the size of the debt relative to GDP but rather the burden posed by servicing the debt, which is similar to an evaluation of corporate debt capacity. They argued that the zone of affordability is achieved when real debt service is below 2% of GDP.[9] Long-term forecasts prepared by the Office of

[7] "Former Treasury Secretary Larry Summers on Inflation Worries, Cryptocurrency and 'Our Greatest Long-Term Threat'," Eben Shapiro, Time Magazine, June 6, 2021.
[8] "Public Debt and Low Interest Rates," Olivier Blanchard, February 2019, Peterson Institute for International Economics.
[9] "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates," Discussion Draft, Jason Furman and Lawrence Summers, November 30, 2020.

Management and Budget, the official budgetary arm of the government, show that real net interest as a percentage of GDP will remain below 1% through 2031.[10]

Adjusting Expectations

Common stocks are expensive. We rendered that same opinion in January when estimated forward price/earnings ratios of the S&P 500 Index were 22.9x and 19.6x for 2021 and 2022 respectively. The market is now 14% higher and yet due to earning performance, price/earnings ratios have barely budged as shown in the last line of Table 4.

Table 4				
S&P 500 Index Levels, Earnings and Price/Earnings				
Current Price Earnings Ratios	2019	2020	2021	2022
S&P 500 Index (at December 31)	3,231	3,756		
S&P 500 Index Year-Over-Year Change (Price Appreciation)	28.9%	16.3%		
S&P 500 Earnings	$163.50	$125.58		
S&P 500 Price/Earnings	19.8	29.9		
Forward Price Earnings Ratios				
S&P 500 Index (at June 30, 2021)			4,298	4,298
S&P 500 Earnings, Estimated, Bloomberg Consensus			$190.88	$213.17
S&P 500 Price/Earnings			22.5	20.2

We believe investors may have already realized most of their market returns for the year. Corporate earnings projections will be adjusted down for cost inflation, higher interest rates, and new taxes. Corporate earnings will have to “grow” into existing multiples with the likelihood that equity returns over the next five to seven years will be in the mid-single digits…better than bond returns, but not as good as in the recent past.

Jayusia P. Bernstein
Alan S. Bernstein.

[10] Office of Management and Budget, Budget of the U.S. Government, FY 2022, The White House, Table S-1. Budget Totals.