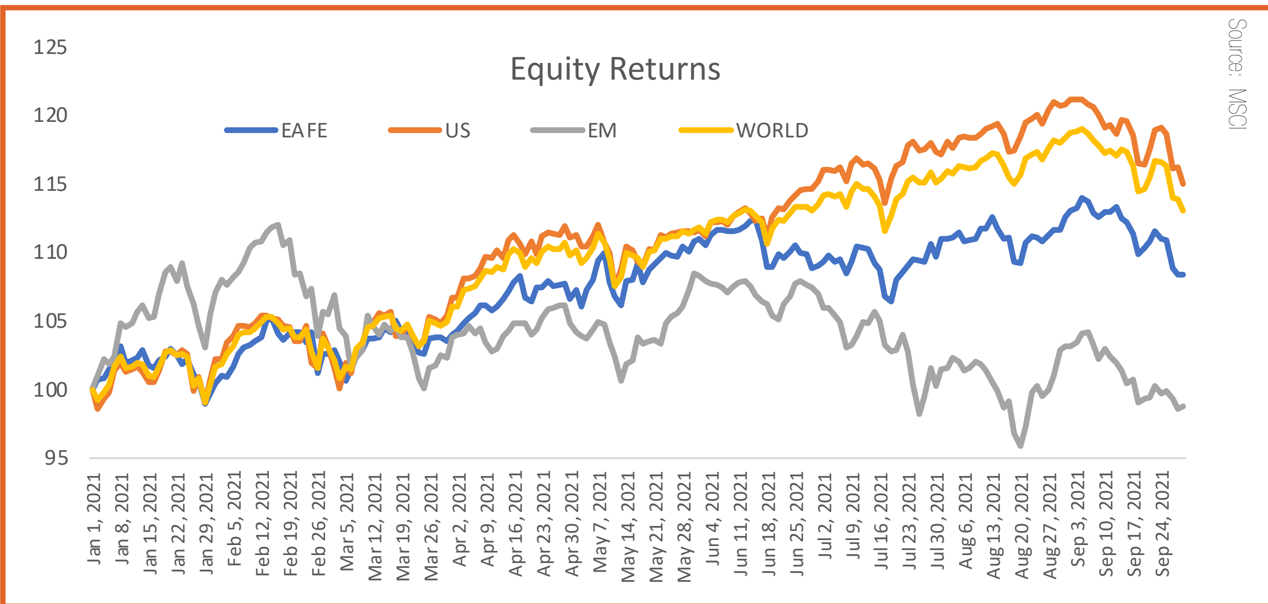
SOWELL AFFINITY

2021 Q3 Market Review

The long-awaited correction in markets may be in the offing. The most-watched equity indexes for international and global investors all stalled out in the third quarter. The MSCI EAFE, MSCI World, and the MSCI All-Country



World Index were down slightly for the quarter. However, the declines in the final month of September were more significant – MSCI EAFE (-2.83%), MSCI World (-4.11%), and MSCI ACWI (-4.09%). While these numbers in and of themselves are probably not newsworthy – this kind of market movement is hardly out of the norm. However, what makes these kinds of reversals noteworthy is the possibility that the most anticipated bull market peak in recent memory could be near.

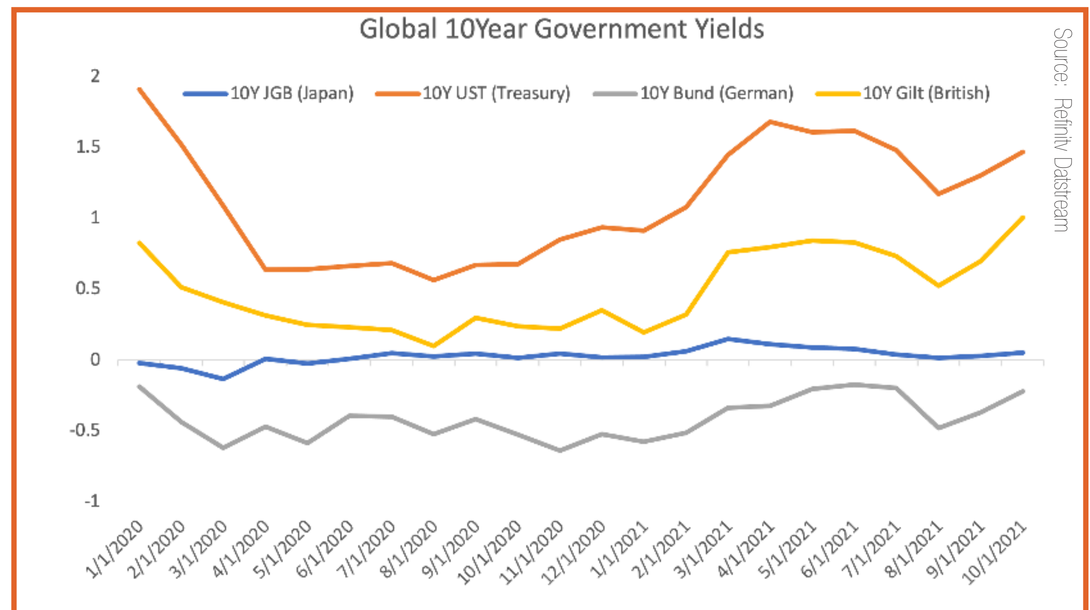
So what has changed recently or at least received the markets' attention? Two interrelated issues: inflation and supply chain bottlenecks.

Shortages in just about everything is adding fuel to the fire. This year, energy costs rose the most (15.4%) as gasoline and oil prices are up 50%, and crude could hit $90/bbl. Shipping rates are up almost triple over last year as ships continue to back up. A few short years ago, the big concern in the shipping industry was excess capacity. Labor shortages abound, requiring businesses to raise wages. Parts

shortages, particularly semiconductors, have hindered automobile production worldwide.

Many, particularly those in official government capacities, think this is temporary due to supply chain restarts. All the major central banks are trying to reassure their citizens that this is all temporary. However, the massive injections of fiscal stimulus have yet to work their way entirely through the economies. German inflation rose, and U.S. inflation was the highest in 30 years - up 3.4% in September following a 3% rise in August.

The return of inflation has taken up more and more of the economic and business conversation. The main hope is that the current rise in prices on everything from food to copper to shipping costs is merely a supply chain readjustment. However, Eurozone inflation is at its highest point in the decade at 3% in August after 2.2% in July (annualized), but the European Central Bank has stated it is keeping interest rates negative through 2022.



Government yields were little changed for the quarter. The U.S. 10-Year Treasury yield closed just under 1.5% by the end of the quarter, close to where it started three months earlier. Moderating economic growth, rising inflation, and a generally dovish Fed all contributed to yield movement during the quarter.

So how does this play out for the next year and beyond? Looking back to the inflation of the 1970s may provide a lesson. In the 1960s and early 1970s, the prevailing economic thinking was an acceptable tradeoff between inflation and employment, i.e., the Keynesian view. Critics of this, notably Milton Friedman, argued that employment was determined by structural factors and some "natural" level of unemployment. Therefore, any attempt to push unemployment below that level would merely fuel inflation. Combining these has now created a new theory on employment (the idea that it is difficult to push unemployment below its "natural" level of 4%) and inflation that is governed by three main factors, not only in the U.S. but in other countries as well:

Supply shocks – of the three, the easiest to make a case for being short-lived as the economies and businesses make their adjustments. This appears to be the ECB's stance.

Capacity constraints or surpluses – this is a more intermediate to longer-term issue as capital movements and additions are longer-term by nature.

Inflation expectations – if this takes hold, this will be a longer-term and more intractable issue and tends to become a self-fulfilling prophecy. As the effects of supply and capacity issues drag on, the mindset that inflation will be longer-lived can start a ratcheting of consumer behavior, prices, and expectation.

The supply shocks were one of the catalysts for the inflation of the 1970s from the Arab Oil Embargo. While relatively short term in nature, they ignited an inflation

mindset that put longer-term implications in place. A critical economic input, energy, worked its way into other parts of the economy and caused inflation in food and other products. Today's supply issues will eventually self-correct.

The capacity question could be a source for longer-term inflation pressure. The massive spending that all the world's economies have engaged in will have to unwind. The danger is that the fiscal stimulus has pushed demand above the productive capacity of the economy. The effects could be more significant for Europe and Japan, whose economies rely more on manufacturing than the U.S. Adding manufacturing and distribution capacity requires a long lead time. The stable global balance of supply and demand has upended to some degree. We've been living through two decades of low inflation and accommodative monetary policy worldwide. Also, investments have started taking on political and environmental objectives and not just financial returns.

Lastly, inflation expectations, while difficult to measure, are already starting to take hold. Oil prices have reached $80/bbl., a level last seen in 2014. Employers are raising wages to entice workers back into the workforce. Wages have a ratcheting effect that means, minimum wage legislation or not, the new floor for unskilled labor becomes $15/hr. It appears the 2% inflation target that many economies have undershot for years may finally be exceeded. Japan's inflation rate, stubbornly stuck below policy targets of 2% for years, was 6.3% at wholesale in September, a 13-year high. Inflation in Europe also hit a 13-year high of 4.1% in October.

The big question is how this is going to affect the investment markets. Is this just a temporary blip as the supply chains restart, or is this going to be a longer-lived situation? For a generation of investors, inflation has always been under control, interest rates have always been low, and markets have always gone up. In historical terms, 2008 seems like a blip in the market progress. Going forward, official inflation projections anticipate a rise slightly above 2% over the next few years.

However, if these predictions are too optimistic and inflation expectations rise, is anyone really satisfied with earning 1.3% in a Treasury for the next ten years? How about 1.9% for 20 years? For 30? If so, what happens to companies when cheap debt is no longer a given and starts to roll over?

The problems in the world's economies are not things that can be expediently addressed by a government's usual tools of fiscal or monetary policy. Those have both reached their reasonable limits of efficacy. The possibility of falling into a 1970s stagflation is a genuine possibility. Over time, the problems will sort themselves out and eventually correct to whatever the new normal will be.

Q4 Preview: Looking Ahead

In the near term, economic policy formulation should be constrained by the size of the total burden of Treasury debt and a very enlarged Fed balance sheet. Unfortunately, within the context of an economy experiencing signs of declining real growth and rising inflation, proposed changes in economic policies represent a threat to market valuations and economic growth. The Fed has announced it will end quantitative easing in the not-too-distant future, and the current Administration has announced plans to increase tax rates on personal income, capital gains, and corporate income. Rising tax rates and a reduction of the growth rate of the money supply characterize economic policies that have brought distress to markets and economic prosperity in the past.

The Biden Administration is proposing a tax rate increase on corporate income from 21% to 28%, an increase in the tax rate on capital gains from 29% to over 48%, and an increase in the top tax rate on personal income from 37% to over 39%. These increases in tax rates are intended to increase tax revenues sufficient to cover the additional $3.5 trillion in spending proposed by the Administration. JFK once tried to explain to Congress the difference between raising tax rates and tax revenues. The current Administration should revisit the lesson. Tax revenues are likely to fall well below expectations. Market participants will manage their capital gains realization to minimize the impact of the increase in the tax rate. Combining a reduced rate of growth of the money supply and increased tax rates will likely slow economic growth and reduce income and income tax revenues. The number of unrealized capital gains will fall as economic activity, and corporate profits fall.

If market participants believe that tax rate increases will come to pass in 2022, they will likely alter their behavior to minimize the impact of the increases. On the margin, capital gains and income are more likely to be realized by the end of 2021 before the increases take place. This behavior will place downward pressure on valuations, all other things being equal. Assets that have unrealized capital gains are more likely to be sold than those that have no gains. In cases where there is flexibility, income will be brought into 2021, producing a spike in corporate profits and personal income during the end of the year. Still, tax realizations will fall below expectations in 2022.

Fortunately, if history repeats itself, the most destabilizing aspects of proposed policy changes are not likely to materialize. President Roosevelt raised tax rates and suffered a resounding defeat in the off-year elections of 1938. The magnitude of the defeat was eclipsed in 1994 after President Clinton raised tax rates in 1993. The Democrats lost control of the House to Republicans for the first time in forty years and lost control of the Senate. President Clinton then changed course and cut tax rates. President Obama suffered a similar fate. Off-year elections have produced changes in control of Congress and a dampening of enthusiasm for increases in tax rates in the past.

The Fed will face the daunting task of reigning in inflation while not precipitating a decline in real economic growth. The Fed has not been very adept at accomplishing this mission in the past. If the Fed does not alter its current policy, it is almost certain inflation will increase. An increase in the inflation rate will likely lead to a rise in interest rates as market participants seek to preserve actual returns. The stock market will face significant challenges in the near term. With a valuation of forty times trailing earnings, expect increased volatility in stock prices while new economic policies unfold.

Advisory services offered through Sowell Management, a Registered Investment Advisor. This document is for Investment Adviser Use Only and is not intended to be presented or distributed to clients or investors. The views expressed represent the opinion of Sowell Management. The views are subject to change and are not intended as a forecast or guarantee of future results. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment. Stated information is derived from proprietary and non-proprietary sources that have not been independently verified for accuracy or completeness. While Sowell Management believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and Sowell Management's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions that may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. Investing in securities involves risks, including the potential loss of principal. While equities may offer the potential for greater long-term growth than most debt securities, they generally have higher volatility. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations. Past performance is not indicative of future results. Performance numbers are gross of fees, and include the reinvestment of income. The information and statistical data contained herein have been obtained from sources, which we believe to be reliable, but in no way are warranted by us to accuracy or completeness. This report includes candid statements and observations economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct.