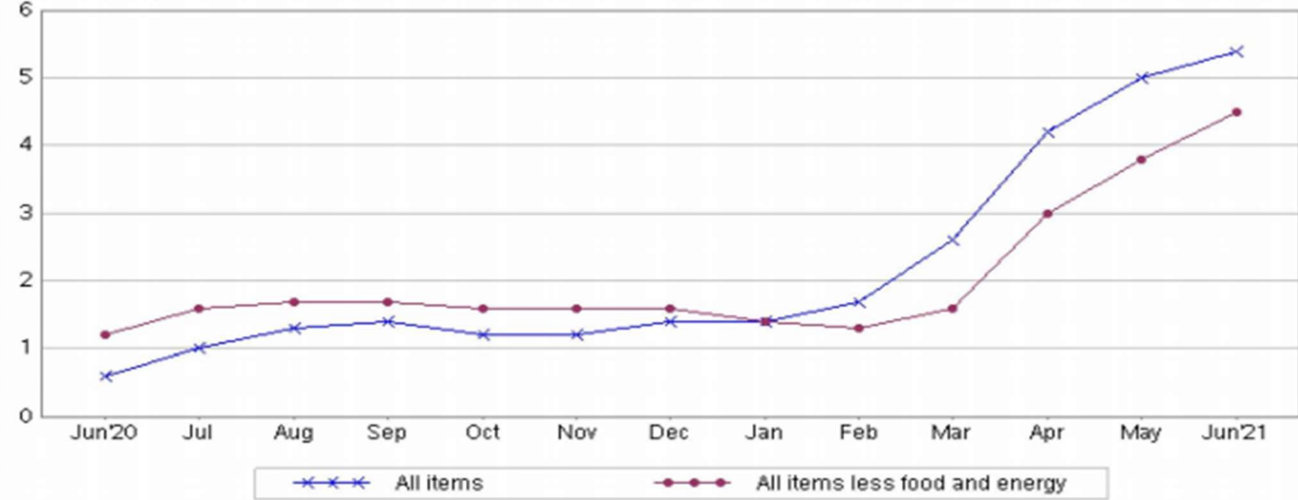
The CFO Third Quarter Client Update

In our 2020 year-end report to our investors, we presented a positive outlook for both the U.S. and global economies and financial markets based on two fundamental reasons. First, the fiscal and monetary responses by the world's key governments and central banks including most importantly our own Federal Reserve have continued to be very aggressive. It appears that the latest fiscal spending program, a $1.2 trillion bipartisan infrastructure deal, will be added to the $1.9 trillion American Rescue Plan which followed the $900 billion fiscal spending package passed in December of 2020. Along the way, Chairman Jerome Powell has repeatedly reiterated in his Congressional testimony that the Federal Reserve's forward guidance of a near-zero federal funds rate and bond purchases of $120 billion a month will continue until the labor market returns to "maximum employment", and core Personal Consumption Expenditures (PCE) inflation averages "moderately above 2% for some time." The Fed expects this policy to remain in place until at least the first half of 2022. In short, Fiscal and monetary policies continue to be highly accommodative, with any future policy normalization awaiting "too much" inflation, which we address below. Second, with the accelerating vaccine rollout worldwide, most notably in the U.S., the global economy is growing faster in 2021 than originally forecasted. Ned Davis Research [NDR] upgraded their outlook for 2021 U.S. and global real GDP to +6.5% and +6.1% respectively. The Conference Board's Leading Economic Index (LEI) increased +0.7% in June, up for the 14th consecutive month, although by less than the consensus of +0.9%. Eight of its ten components increased, led by fewer initial jobless claims and stronger manufacturing new orders. On a six-month basis, the LEI increased +5.0%, the most since January 2010 (excluding the pandemic).

The above positive economic news notwithstanding, this is a very different economic cycle, with the U.S. and major foreign economies coming out of a deep recession that was driven not by underlying economic and financial strains, but rather by voluntary social distancing and government-imposed lockdowns, which brings a higher-than-usual amount of uncertainty in any forecasted outlook beginning with the reality that the COVID-19 pandemic is still not behind us. Rather, medical experts are taking the Delta variant, a mutation of COVID-19 that first surfaced in India then in Great Britain and now in the U.S.A., very seriously starting with the scary fact that the strain is much more contagious than the other strains. Vaccinated individuals have increased protection, but only about 50% of the U.S. population has been vaccinated, and outside of the U.S., vaccine deployments have been woefully lagging. Numerous countries are still mired in lockdowns with the number of new cases rising. There is the material risk whether the fiscal stimulus, even with the forthcoming "$1.2 trillion" spending package, will be enduring enough to materially close the U.S. employment gap that is still over 9 million jobs below its pre-pandemic level.

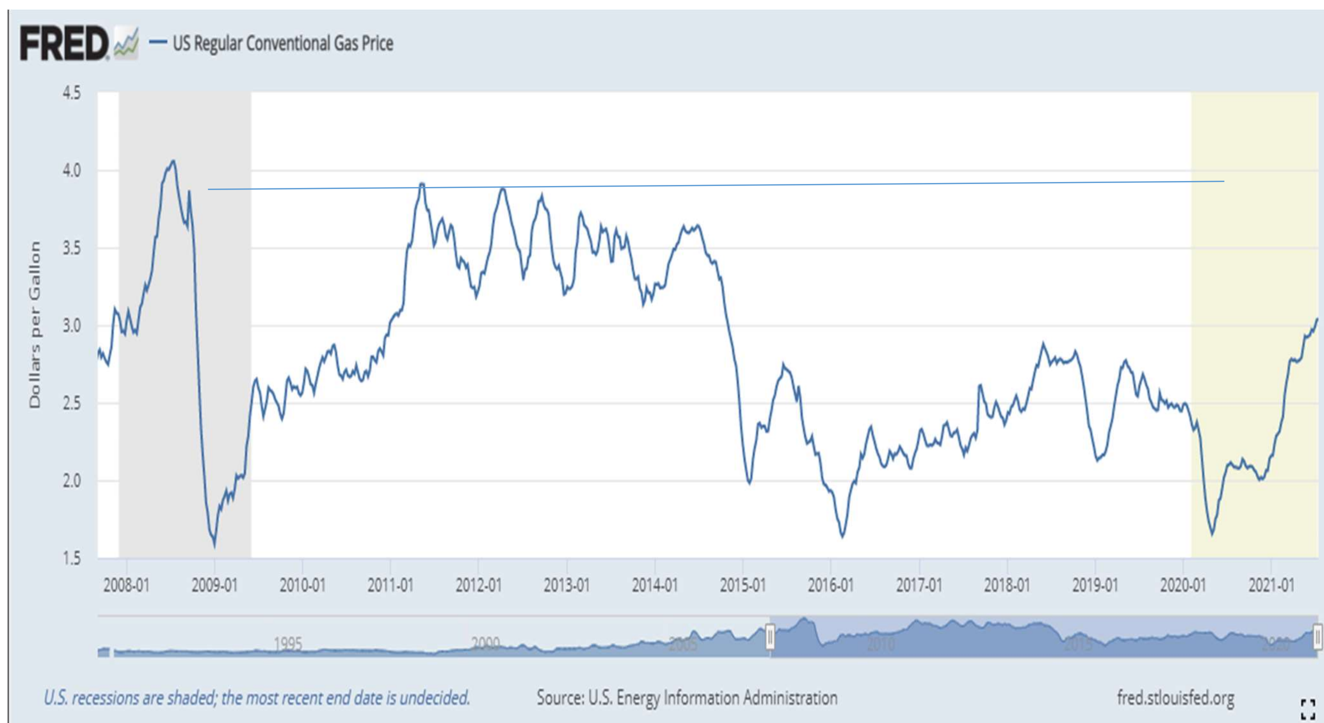
As mentioned above the Fed has been consistent in reaffirming its ongoing accommodative policies. However, inflation has become a major theme over the last several months. The Consumer Price Index for All Urban Consumers (CPI-U) increased +0.9% in June, the largest 1-month change since June 2008 when the index rose 1.0%. CPI-U increased +5.4% over the last 12 months through June 2021. The index for used cars and trucks increased +10.5% in June, accounting for one-third of the rise in inflation. Higher food (beef, poultry, eggs), energy, new vehicle, and airline ticket prices were also major contributors to inflation while the medical price index declined for the month. Will inflation continue its upward trajectory? Perhaps not as short-term supply chain issues are eventually overcome. As an example, one need look no further than lumber prices, which at one point this year had quadrupled but are now down for the 2021 year.

[Chart Follows]

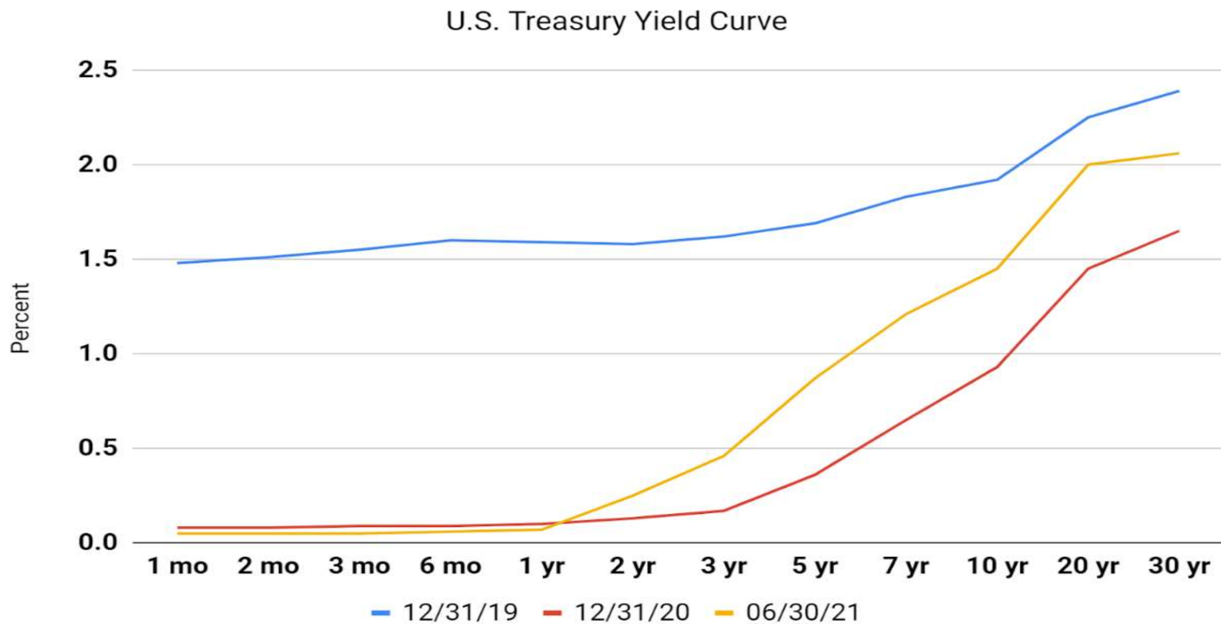


Source: https://www.bls.gov/news.release/pdf/cpi.pdf

Moreover, the increase in the price of gasoline over the last three months has also received a lot of attention on cable news. However, it does not seem all that abnormal for gasoline to revert closer to its mean price of $2.75 a gallon for the last ten years.



The sharp reversal in longer maturity Treasury yields is also an area of concern as we move past mid-year. The pullback in the 10-year U.S. Treasury yield from 1.74% to 1.37% over the last three months is surprising given inflation has been running over +5% annually [at least] over the short-term. This would imply a negative real interest rate of almost -4% on the ten-year bond. The bond market appears to believe the Fed, and that the recent rise in inflation is not sustainable or it senses that we may be entering a period of much higher volatility in asset prices, or maybe both….



A fast backup in interest rates could negatively impact housing and big-ticket consumer purchases. NDR's outlook for 2021 annual PCE inflation is that it will remain stable in the 2.5% range. Over the next few months, however, a combination of base effects, such as increasing energy prices, will likely push year-over-year inflation rates materially higher. Bottom line, the risk of a sustained breakout in inflation needs to be very carefully monitored. Another clear and present risk to the stock markets are valuations. From the March 2020 pandemic lows, the recovery in the U.S. stock market over the past year looks very similar to the track of the market rally over the year following the Great Recession of 2008-09 (next chart), except for a bit of backtracking in the latter part of 2010.

Custodial & Securities Services Offered Through TD Ameritrade Institutional [TDA] • Member: FINRA & SIPC
Advisory Services offered through CFO Capital Management. CFO-CM and TDA are not affiliated.
Westport Office: 19 Ludlow Road, Suite 301, Westport, CT 06880 • Phone 203-221-0202 • www.cruicefinancial.com

We have also previously written about the high valuations in the stock market in recent quarterly reviews, and the concern remains. The S&P 500's price to earnings (P/E) ratio, based on trailing 12-month reported earnings, stands around 30 versus the recent historical average of around 17, however, there has been much variability around this average. The latest reported trailing 12-month earnings per share (EPS) was $128.20, with S&P Global projecting $175 a share for 2021 (25 P/E based on current index price), and projecting close to $200 share for 2022 implying what would be a reasonable 22 market P/E. But when you think about it, does a +53% increase in corporate earnings in less than two years seem within the realm of possibility? It is optimistic but also very possible.

Given the positive but nevertheless challenging U.S. and global economic backdrop, investors should maintain portfolio flexibility and liquidity to be able to respond to market events in what will likely be a challenging and volatile investment environment. We believe that asset category diversification is critical, including allocations to non-equity/fixed income and cash equivalents as a hedge to risk assets. A material correction is overdue, but the early-to-mid economic cycle ingredients are in place for the current cyclical bull market in stocks to continue through year end. With low stress in the financial system and readily available credit, it is hard to foresee a near-term recession or bear market. To reiterate, estimates for continued economic growth have been steady for several months. Retail sales are strong, and employment is expanding. We expect that the stock markets can move higher over the next year, and if stock prices move higher slowly on the back of a steady growth in earnings, stock prices should not get ahead of value, and we would not expect to see equity valuations reach dangerous, widespread "bubble levels". If, however, stock prices ***surge*** higher along with a sudden, sharp rebound in the 10-year Treasury yield, that would be our signal to get defensive. We do not expect that to occur but we will be closely monitoring valuations. As we move forward in Q3 of 2021, we expect to maintain our target allocations to global equities. Sector selection will remain important, and we favor cyclical stocks over defensive. We also still favor equity markets in the U.S. and Asia, regions most likely to emerge from the pandemic earlier and stronger but we have also been gradually increasing our allocations to Europe where we think post-pandemic opportunities are expanding.

Please do not hesitate to call us directly with any questions that you may have about portfolio strategy or your investment account(s).

The CFO Capital Management Team