MLL INVESTMENT ADVISORS

October 2021

INVESTMENT REVIEW AND OUTLOOK

The Sum of All Fears

Against a backdrop of several concerning developments, the stock market, as measured by the S&P 500 Index, had a modest total return of 0.6% during the third quarter. The COVID delta variant spread rapidly and global new COVID cases rose over 40% from June to August, according to the World Health Organization. Inflation, which has been rising steadily during 2021, rose over 5% in the month of August as measured by the 12-month change in the Consumer Price Index. A survey of commodity prices shows some notable year to date increases in a variety of categories including coffee (+34%), poultry (+31%) and gasoline (+42%). Concurrently, several barometers of economic activity ebbed over the summer: consumer confidence declined as did the Purchasing Managers Index (a measure of industrial activity).

In the geopolitical realm, there was unsettling news on a number of fronts. The Chinese government continued to tighten its restrictions on a cross section of companies in the technology and services industries. During the quarter, the U.S. listed share prices for many of these companies declined 20-30%. Meanwhile, Evergrande, among the largest Chinese property developers, defaulted on its loan obligations late in the third quarter. In the U.S., Congress struggled to reach agreement on President Biden's $3.5 trillion spending legislation and $1 trillion infrastructure package. Events in the quarter were capped by the chaotic withdrawal from Afghanistan and the return of Taliban rule to that country.

Given the foregoing backdrop, it seems perplexing that the stock market would post a positive return in the quarter. However, several longer-term trends that are supportive of stock prices remain intact: the global economy continues its expansion, interest rates remain low by historical standards and financial liquidity remains plentiful. As we have written in recent letters, the size and scope of global central bank activity has been unprecedented, and these actions have had a beneficial impact on both the economy and the stock market.

What is the Cost of Money?

This seemingly simple question actually has a multi-part answer. For businesses, consumers and government borrowers, the cost is typically the market-determined interest rate, and this varies according to the length of time the money is borrowed and the creditworthiness of the borrower. For example, the U.S. Treasury, generally considered a high-quality borrower, can borrow money for 5 years at 0.9% per year and, at current interest rates, is able to borrow for a 30-year term at around 2%. An individual, with a strong credit history, might borrow for a home purchase at 3.5% for a 30-year loan. Borrowers with a poor credit record would incur a higher interest rate. For example, a corporation with sub-par credit might pay 4.5% to borrow for 10 years.

The prevailing level of interest is determined by a number of factors such as the overall demand for credit, the rate of inflation, general economic conditions and, importantly, the policies of governing central banks. Central banks affect interest rates through the establishment of a “discount rate,” or interest rate at which member banks can borrow. Central banks also impact interest rates through “open market” activity, or outright purchases of securities.

In recent years, prior to the COVID pandemic, global economic activity was fairly steady, inflation was subdued, and central bank policies remained accommodative, but restrained in relation to the extraordinary actions taken during the 2008-2009 financial crisis and the 2011-2012 Euro crisis. In the months following the outbreak of the COVID pandemic in early 2020, global central banks took unprecedented actions in the form of open market purchases of government and private issue securities. As we wrote in our second quarter letter, it is estimated that the U.S. Federal Reserve has increased the value of assets on its balance sheet by over 90% since the start of the COVID pandemic and this is equivalent to over 13% of 2020 U.S. GDP.

The impact of these extraordinary actions is both known and unknown. Short term interest rates, which are most influenced by central bank activity, remain low by historical measures. Sectors of the economy which are the most sensitive to interest rates, such as housing and durable consumer goods, are quite robust. The rate of interest for most consumer borrowing remains low versus modern financial history.

What is less well understood is the path that interest rates may take in the absence of central bank open market purchases. Also less understood is the impact that recent central bank actions may be having on investor activity. We have written in recent letters about the heightened level of investor speculation in areas such as “meme” stocks, and other speculative phenomenon. However, the impact of historically low interest rates has been felt broadly in all investible asset classes including areas such as venture capital, private equity, high yield bonds and commodities, to name just a few.

In answer to the question above, it is fair to say that, in general, the cost of money in recent years has been low by historical standards, and this is particularly true for high quality borrowers where the interest rate differential, or “spread,” between borrowing cost and the risk-free rate is historically low. However, there is one other factor which we must consider and that is the rate of inflation. A dollar borrowed at 1% would cost $1.01 to repay in a year’s time. However, at even a low rate of inflation, say 2.0%, that dollar would be repaid, on an *inflation adjusted basis*, at only $0.99. As a result, recent increases in inflation rates in the U.S. and abroad have had the effect of further reducing the cost of money.

With the strengthening economy and the uptick in inflation readings, the U.S. Federal Reserve has communicated that it expects to begin the process of “tapering,” or reducing its open market bond purchases. While the precise timing of this action is not certain, it is likely to begin in the fourth quarter of this year.

Experience has taught us that predictions about the stock market, economy or interest rates have a low probability of success and often serve as a distraction from the task of selecting long-term investments for our clients. With this consideration in mind, it is worth noting that both the reduced level of central bank activity and the recently increased rate of inflation are likely to have an impact on the investment environment in the future.

“Be Fearful When Others are Greedy”

The above quote is taken from the 1986 Berkshire Hathaway annual report, and the full quote from Warren Buffet reads, “We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.” At this juncture in the investment cycle, this quote is worth bearing in mind. There are several reasons for this: signs of speculation, while having cooled over the summer months, still abound as evidenced elevated valuations for “meme” stocks, robust trading in various crypto currencies and a full calendar of initial public offerings. Despite the COVID pandemic (or perhaps because of the policy responses related thereto), stock market returns for the years 2019 – 2021 have been strong and the trailing 10-year *annualized* return for the S&P 500 through September 30, 2021, is 16.6%, in comparison to the long-term average return of approximately 10% for U.S. common stocks since 1927. In short, returns for the stock market over the last decade have been well above-average and it would be a fair characterization to say that investor enthusiasm for stocks today is also well above-average. These developments do not spell the end of the current bull market in stocks. However, they *do* suggest that investors should adjust their expectations for future returns and adopt a more conservative posture.

As discussed in recent letters, we have taken steps in client portfolios to reduce our exposure to segments of the stock market that have become richly valued. We have also tilted portfolios in favor of sectors of the economy where we see attractive relative value: companies with strong balance sheets, ample free cash flow and above-average dividend yields. Where appropriate, we have increased cash reserves modestly.

As always, we welcome your comments and questions.