

KANAWHA CAPITAL MANAGEMENT

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STILL ON THE MEND

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Autumn's approach brought a spate of disquieting headlines, prompting investor angst and choppy financial markets. The S&P 500 stock index pulled back in September, the first monthly decline since January. So far, the total drawdown has been mild, amounting to just over 5%. Nevertheless, while stocks may have appeared remarkably resilient overall, there has been a lot of churning below the surface this year: Nine out of ten S&P 500 constituents have experienced a 10% correction at some point in 2021.

Despite all the noise, the economic environment still seems mostly favorable. The rate of growth may have peaked but most forecasts suggest that it will remain *above trend* over the next 18 months. The International Monetary Fund (IMF) projects global GDP to come in at a 5.9% clip in 2021, dropping to 4.9% growth in 2022. The Organization for Economic Cooperation and Development (OECD) expects that all 45 major economies will expand in 2022, half experiencing accelerating growth.

Cresting wave

Progress in the COVID war should support the ongoing economic recovery as more areas ease restrictions. After surging higher from the virulent delta variant, new cases have peaked — once again and hopefully for good. Worldwide, 3.5 billion individuals or about 45% of the population, have received at least one dose of a vaccine. In the United States, three-fourths of the 12-and-over cohort have been jabbed. Widespread vaccine adoption will lower the threat of viral mutations.

The latest wave of new cases has coincided with far fewer severe outcomes or fatalities. With 67 million Americans (12 and over) unvaccinated, it is premature to declare victory; however, the medical community's arsenal of weapons continues to proliferate. Pfizer recently announced favorable results from a vaccine trial among children ages 5-11. And Merck just revealed an anti-viral therapeutic, *molnupiravir*, that purportedly cuts the rate of hospitalizations in half. If approved, this first oral treatment for COVID-19 could be taken at home over five days, reducing symptoms and speeding recovery.

Pent not spent

Meanwhile, there's still plenty of dry powder to be unleashed from bank accounts as consumers feel more comfortable resuming typical spending patterns and as goods

in short supply become readily available. By some accounts, U.S. households have over \$2 trillion of excess savings from the cumulative impact of lower spending during the pandemic (primarily on services) along with sizable transfer payments from Uncle Sam. Not all those stimulus funds have found their way into the economy yet.

At the same time, businesses must replenish depleted inventories. Extensive worldwide inventory shortages should lead to production rising faster than end demand. Corporate America has also stepped up its capex plans as evidenced by soaring capital goods orders. So there is a runway for meaningful spending and investment by consumers and businesses.

Clogged arteries

COVID-19 has jolted global supply chains, underscoring the fragility of a system with production on one side of the planet and consumers on the other side, connected by ports, ships, trains, and trucks that must work seamlessly together as would a relay team.

A variety of factors have conspired to disrupt international trade. The pandemic has forced many overseas production lines to be temporarily idled. In southeast Asia — most notably the manufacturing hubs of Vietnam, Malaysia, and Thailand — fresh outbreaks continue to shutter factories. The region is a key production zone for autos, computers, electronics, and apparel. In Taiwan, factory shutdowns have exacerbated a painful global semiconductor shortage. COVID cases have also impacted the operations of certain ports.

Additionally, China has been rationing electricity to energy-hungry businesses because of a coal shortage (coal fuels 70% of the country's electricity generation). Factories in the industrial heartland have been directed to limit energy consumption even as they face surging orders. And since Beijing sets electricity prices, many coal-fired plants are shutting down because they cannot cover their costs, compounding the problem.

The distribution of goods has also proven a major bottleneck. A spike in orders from Americans trapped at home has overwhelmed freight channels. Dozens of cargo vessels linger for days off the West Coast waiting to be unloaded. Inadequate port infrastructure and a shortage of longshoremen confront super-sized ships that carry many more containers than pre-pandemic. The cost of shipping a standard 40-foot metal cargo container from China to the West Coast hit a record \$20,586 in September. Two years ago, that same container cost \$2,000 to transport goods. No wonder three of the nation's largest retailers — Walmart, Home Depot, and Costco — have chartered their own ships.

Buck stops here

Supply disruptions will persist into next year and possibly extend to 2023. Fortunately, monetary

policy should stay generally supportive of economic activity for a while. Since the 2008-09 financial crisis, the Federal Reserve has used two primary levers — short-term interest rates and asset purchases — to add fuel or remove it from the fire, as needed. When the economy slammed into a wall in March 2020, the Fed quickly allowed short-term rates to drop to zero and embarked on a massive bond-buying program. This was the 2008-09 policy response on steroids.

Although stresses abound, the U.S. economy has clearly regained traction. Therefore, one is hearing chatter about the nature and timing of the central bank's eventual change of course. Las Vegas may not have odds on Fed tightening but the bookmakers on Wall Street and talking heads on financial networks certainly do. This debate has contributed to market volatility.

For the past year and a half, the Fed has been buying \$120 billion of Treasuries and mortgage-backed securities each month, bolstering the money supply to encourage lending and suppress long-term rates. Central bank officials recently signaled an intention to begin withdrawing that pandemic stimulus. The policymaking committee will likely announce a *tapering* of the bank's asset purchases at their November meeting.

Note that such a shift would not immediately represent *tightening*. The Fed will continue to be a net buyer of bonds into 2022, albeit at a diminishing rate. Chairman Powell has indicated that interest-rate policy will not change until the asset purchase program has ended. Consequently, short-term rates could begin moving up in the second half of next year and certainly by 2023.

Tightening tantrum?

A low interest-rate environment has been a boon to stock prices in the period after the *Great Financial Crisis*. Over the decade preceding the pandemic, the 10-year Treasury yield ranged between 1.5%-4.0%. Currently, that benchmark security yields 1.6%, after dipping to an almost unfathomable rate of 0.52% in August 2020.

The threat that rising yields ultimately pose to equity markets will depend on the speed and the levels at which they reset. Clearly, long-term rates have room to increase before moving into restrictive territory — hobbling economic activity and punishing stock multiples. Stocks often do suffer some heartburn when bond yields move up, but history indicates that as long as the economy is not imperiled, stock prices usually end up recovering.

Shouldn't be temp to perm

Inflation will be the swing factor. Since spring, headline inflation pressures have intensified. The Consumer Price Index (CPI) has been rising at or above a 5% annual rate; core CPI (excludes food and energy) has been increasing by 4%, a pace significantly above the Fed's target range. High and sticky

consumer inflation would force the bank's hand, prompting more aggressive tightening than currently anticipated.

Prices of many commodities (such as lumber) and intermediate goods (such as memory chips) have also spiked. Prices of imported goods have been driven up by exploding shipping costs. However, the upsurge appears to primarily reflect shortages and other supply-side pressures and they have begun to abate a bit.

And as for consumer inflation, the CPI's recent acceleration has been driven by a few categories. For instance, if one excludes new and used automobile prices from the tally, core inflation remains below its pre-pandemic trend. Importantly from an inflationary standpoint, there is no evidence of a broad-based wage-price spiral; only the low end of the income distribution range has seen a meaningful increase in wages this year.

Cycle continues

On balance, the backdrop for equities currently appears more benign than threatening, despite all the noise. As COVID is corralled and supply-side disruptions ease, economic growth should proceed at a decent pace. Fed policy will ultimately determine the duration of this business cycle so shifting inflation expectations will prove critical.

Stocks have recovered sharply from their pandemic lows, going on to record new high after high. Valuations have come down but are still stretched from an historical standpoint. So while stocks should continue to have a modest tailwind, returns should be less robust than those of the last several years.

— Christopher J. Singleton, CFA, Managing Director

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