Traub Capital Management
Quarterly Outlook Q4 2021
October 5, 2021

Where Are We?

The third quarter of 2021 closed on a bit of a sour note with almost a 5% loss for the S&P 500 in September. But all of the losses and more have been made up in October as we write this. There is a gain of about 23%, including dividends, for the year overall now- a very strong year by any measure. Readers of these outlooks will not be surprised by the setback in September. There is just too much random movement and that movement could be up, or it could be down. The point is not to be too upset over short-term losses and keep focused on a term that is a bit longer than a month or quarter.

The Outlook

Our outlook for the economy and earnings is not markedly different from what it was one quarter ago. As you recall, we were more optimistic than most. The economy itself performed better than even we expected and much more so than the average forecaster had predicted. Last quarter, we expected earnings for the S&P companies to be $207 and $235 for 2021 and 2022, respectively. These projections have not changed. Valuing the overall market at 20 times earnings, would equate to a value of 4,700, (235 X 20) which is a bit over 2% above where we are now.

For the next couple of quarters we are expecting the growth pattern we have seen during the recovery from the pandemic to continue, but the rate of improvement will be tailing off a bit. We will have more detail in the 2023 outlook in a couple of months.

That said, our outlook of the economic and earnings picture continues to be more optimistic than the average forecast. FactSet Research Systems compiles the forecast averages into a consensus view. The FactSet consensus puts earnings for 2022 at $215, vs. the $235 that we are expecting. We expect that an overall improving economic climate will compel the average consensus to increase over the next couple of quarters and the overall market values to follow.

Possible Upside

We continue to believe there is potential for positive surprises and further positive upside. In June of this year, the P/E ratio of the S&P 500 reached 23x based on the consensus earnings projection. That ratio has now declined to about 21x. Getting back to 23x would give an S&P value of 5,404 (23 x 235). We would hold this view to be optimistic. But with the overall strength of the economy, we do see some potential for upside and more so than for downside surprises.

Inflation

Readers of these outlooks will know that our outlook for inflation is not sanguine. The spikes we have recently seen, we do not believe are “transient”. However, the overall inflation rate will fall from the 5% and 6% annualized increases the US economy saw in the second and third quarters respectively. We expect the overall rate for both 2021 and 2022 to be about 3.5%. Inflation is simply not going to get back to rates under 2% any time soon. At some point, the Fed and other market participants will realize that inflation is not transient. There will most likely be some sort of panic at that point. However, that panic can only be justified by extrapolation of inflation continuing to increase at a rapid rate – which is also something that we do not believe is justified.

Right now, there are considerable imbalances in the US and world economies as we get back on track after the pandemic shutdown. You see this evidence all over the headlines – sky high shipping rates; no shipping containers available; ships cannot unload at Los Angeles area ports; car manufacturing held up for lack of chips; blackouts in China from lack of electricity; steel prices doubling, etc., etc. These imbalances lead to newspaper headlines and price premiums for things in short supply, i.e. inflation.

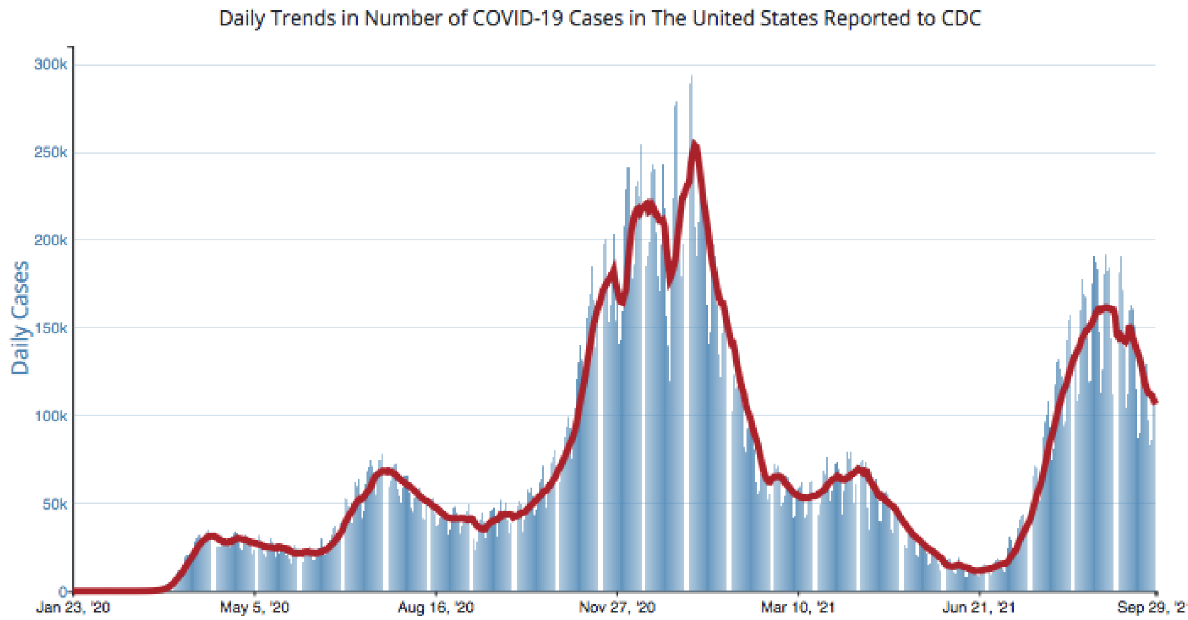
We believe that these imbalances will get worked out through 2022 and 2023. From what we can see, there are no fundamental shortages of "things", or raw materials. The world does not have enough of all the things in the right amounts in the right places at the right times. There certainly are constraints involved with getting the right amount of stuff in the right place at the right time, but there is no fundamental shortage of iron ore, oil, or even natural gas. We can build factories to make chips. It just takes a couple years to do it. We have 8.5 million people unemployed in this country and 11 million job openings. The demand for certain skills and the supply of those skills will always be imbalanced, but also over time, the two will come into better balance than they are today. So, we expect inflation to be considerably higher in both 2021 and 2022 than the consensus belief, but with the world's supply chains coming back into balance, it will mitigate the price spikes for things that are currently in short supply. Inflation will stabilize and we do not see any justification for expectations of increasing rates of inflation.

The Outlook for Interest Rates

We expect interest rates in general to be headed up. However, in line with our "up but stable" forecast for general inflation, we see interest rates generally up, but not too much and then stable. We will probably see a couple of rate hikes from the Fed in the Federal Funds rate by the end of 2022. These are widely anticipated and if the Federal Funds rate is under 0.1% or under 0.6%, it is not really much change. We see a rising yield curve with 10 and 30 year rates still higher than shorter term rates, but probably not going over 2.5%, which are up a bit from around 2% today on the 30 year, but not a significant change all told. Compared to any historical average, interest rates will remain low. The increase in rates we anticipate is small, but in line with those increases, we have reduced our projected P/E multiplier on corporate earnings from 21x to 20x. We believe this adjustment is prudent.

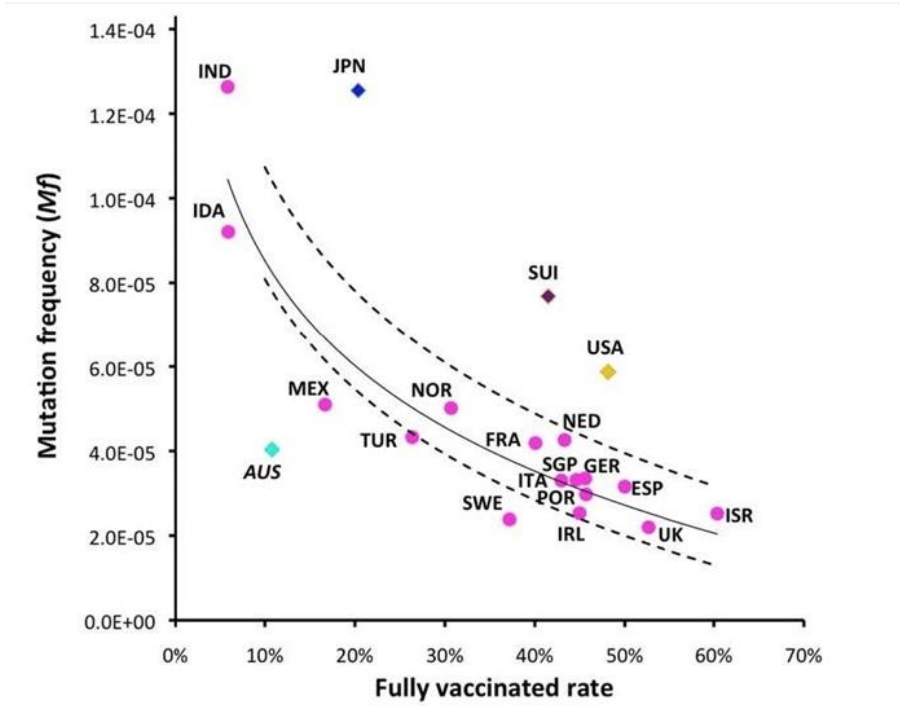
Continuing Impact of COVID-19

Perhaps we should have led off with the COVID-19 outlook as it has garnered a lot of headlines. The really good news is that the COVID infection rate in the US is now headed down again. It is interesting to look at the shape of the infection data. This chart is shown below and up to-date information is available here: https://covid.cdc.gov/covid-data-tracker/#trends_dailycases.



There was a peak in January that started to decline fairly rapidly and before any impact from vaccinations would have had an impact. The Delta variant has resulted in another spike that seems to have peaked at the end of August. The shape of these two spikes is quite similar, since the Delta variant spike appears to be on the downward slope. If you chart out the same shape as the first spike, it looks like the impact from the Delta variant should work its way down to a fairly low level by Thanksgiving.

The lack of further rapid mutations bodes well for keeping COVID under control. Intuitively, you would think that fewer people infected, combined with high vaccination rates, would give the virus less opportunity to grow, reproduce and hence mutate. A recent study by the University of Maryland and published in August, 2021 confirms this intuition. The study analyzed all of the reported genome sequences on the SARS-CoV-2 virus as reported in the Global Initiative on Sharing All Influenza Data database. The chart plots the rate of mutation of the coronavirus and the vaccination rates in various countries. No reason to get too technical on the chart; it is the shape that is important. That shape says unequivocally that higher vaccination rates lead to fewer mutations.



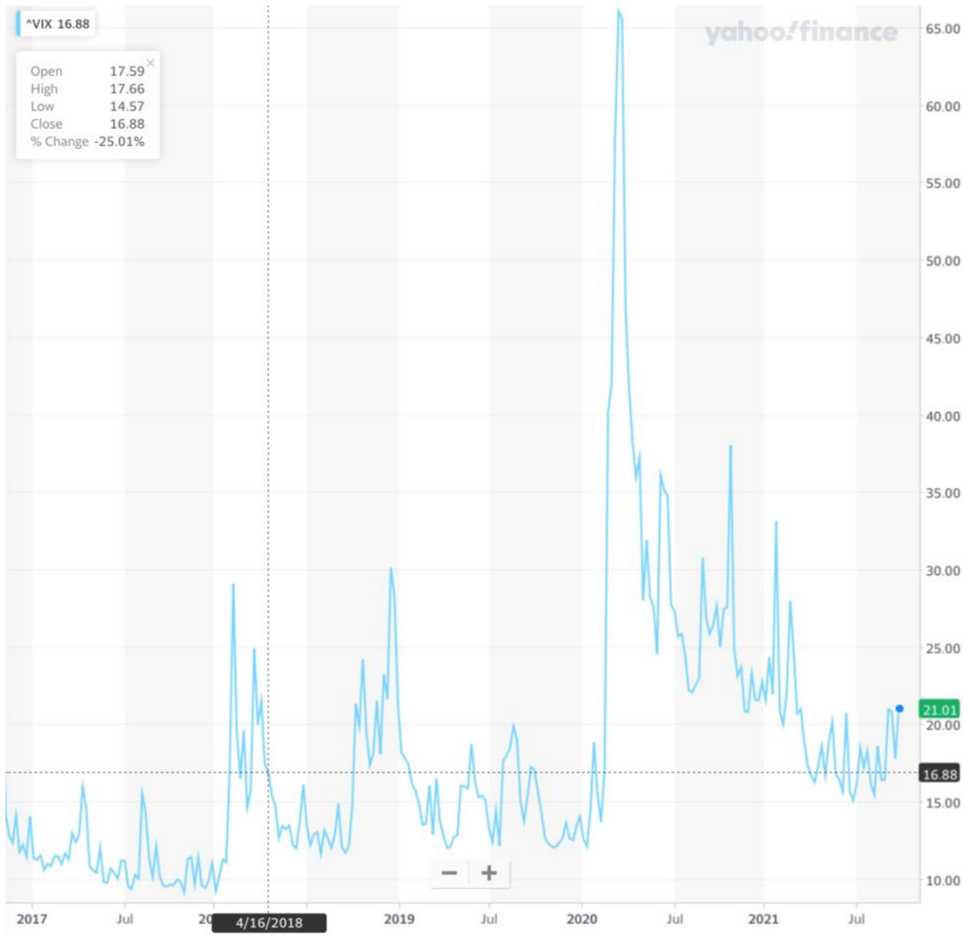
In 2020, the virus produced major mutations named Alpha, Beta, Gamma, Delta, and Delta + variants. So far in 2021, there has been a major surge of the Delta variation infections, but no reported new major mutations. It is possible that with the Delta variant under control that we will not see another significant mutation driving another resurgence.

As of the end of September, a total of 6.2 billion doses of vaccine have been administered worldwide. The world population is about eight billion, so there have been a lot of vaccinations since commercial quantities of vaccines became available this past January. Full vaccination generally requires two doses per person and the world vaccination rate is 31 million doses a day or roughly a billion per month. Production is still ramping up and we have a ways to go before we get a significant portion of the world population fully vaccinated. However, we are expecting that by the middle of 2022, a very substantial portion of the world population will have been vaccinated, mutations of that virus will subside and the COVID-19 pandemic should be under control.

Continuing Impact of Volatility

Market price volatility is not going away. You can count on that. The expected stock market volatility is measured by the VIX index. Any chart of the VIX will show the volatility. You can look at the last five years in the chart below:

The peaks in the VIX just “come with the territory”. Trying to anticipate these peaks or valleys in the VIX and then sell around them is a fool’s errand.



Continuing Impact of Political Uncertainty

Political policy is one of the big factors of uncertainty and volatility. Today is no exception. Right now, Congress is in the process of changing the income tax code once again. The changes will of course "close loopholes", "make taxes fair", "not impose a burden on our hard-working families", etc. A tax code change is probably a good bet, but just how much of the current thinking will survive the legislative process is quite uncertain. The general theme is - higher taxes on "the rich", higher capital gains taxes, an increase in the corporate tax rates, and drawing a curtain on some income tax practices that will be labeled as "loopholes." To what extent each will get crafted into a piece of legislation is unclear. It is clear, however, that the 10-year horizon that was set on the Trump changes in 2016 will most likely expire at least by 2025 and that there will be some higher rates – particularly on certain transactions the extent of which are not codified at present.

We are watching this process closely. One of the considerations that is on the table is to change the ability to convert regular IRA's into Roth IRA's. Making that conversion is an action that we very frequently recommend for prudent income tax planning over a projected retirement. It is hard to tell if changes to the Roth Conversion capability will make it into the tax code, but we will be monitoring this possibility and we will write a note to our clients once things settle down on that front if significant changes to Roth IRA conversions do make it into fully approved legislation.

Conclusions

Overall, the economy and earnings are tracking our forecasts and expectations for the year. The volatility we saw in September is pretty normal and the ups and downs will continue to be a standard artifact of the equity investment environment. We expect higher earnings than the consensus and we expect higher inflation than most people are expecting as well. We expect the direct impact of the coronavirus to be on the wane, but it will take well into 2023 for the imbalances created by the COVID-19 economic shutdowns to get lined out.

All-in-all, we continue to expect a good economic climate through the end of the year and into the beginning of 2022. We will be watching the unfolding changes to the tax code in Washington to ascertain what changes make it through the legislative process and how those changes might impact our clients' investment planning.