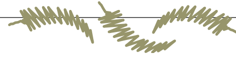
C Y P R E S S

ASSET MANAGEMENT, INC.

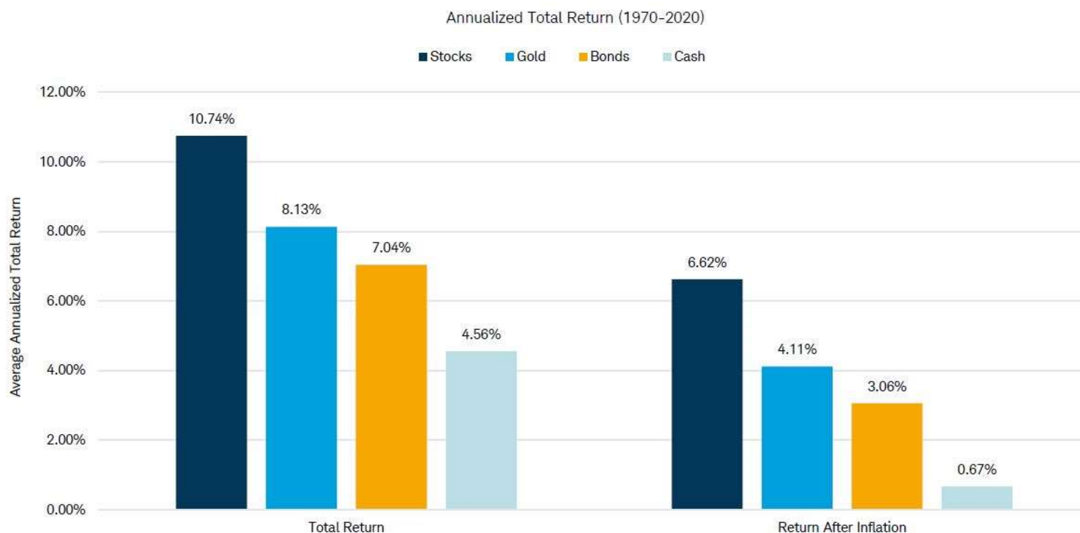


MARKET COMMENTARY **October, 2021**

The S&P 500 finished the 3Q2021 essentially unchanged on a price basis after inflationary and supply chain headwinds led to a 5% correction in September. While the backdrop for stocks remains favorable, given continued strong global economic momentum (growth could even surprise to the upside next year as supply chain disruptions improve) and still extraordinarily accommodative monetary policy, we expect volatility to rise. A combination of uncertainty over the new post-covid inflationary environment and tighter financial conditions in 2022 should increase market volatility and keep investors wary and sentiment subdued. These issues should resolve over time, but could get worse before they get better. Equities remain better positioned than other asset classes to navigate inflationary challenges and higher rates. As shown in the chart below, stocks have provided a superior return, especially when adjusted for inflation.

Equities hedge against inflation

Equities have historically been an effective hedge against inflation over the long term. Gold can be a good diversifier in a portfolio, but long-term returns have been similar to bonds.



Source: Schwab Center for Financial Research

Inflation as measured by the Core PCE deflator is currently running about 5% and is forecast by Evercore ISI to remain at levels close to 4% in 2022. While the Fed believes the current supply chain issues in manufacturing and logistics are largely "transitory", inflation will remain elevated next year. U.S. Nominal GDP (output plus price) is forecast to be better than 10% this year, the highest level seen in 27 years. In fact, Nominal GDP is running at almost 2x the rate of Real GDP. The good news is nominal GDP drives corporate revenues which in turn drive S&P 500 earnings. S&P earnings then drive equity performance. Most S&P 500 companies have pricing power, some more than others, and our Cypress portfolio has always emphasized dominant global companies with strong pricing power, and it is pricing power that enables equities to outperform in inflationary periods. However, if growth stagnates that is a much less bullish scenario. History has shown that equities hold up better than other assets over time but are not immune to a slowing economy.

The Roaring '20s Runs into a Supply Side Problem

As it has turned out, Covid is much more of a supply shock than a demand shock to the U.S. economy. We did not experience soaring prices and container ship shortages after the 2008 Financial Crisis, after 9/11, or after the dot.com tech bubble burst in 2000. Since the 1970s, the economic crises we have dealt with have been caused by negative demand shocks to the economy. The response to this has led to increasingly higher doses of Keynesian governmental stimulus to boost demand to increase growth and pull the economy out of recession. This has taken the form of both government spending – according to the Brookings institute an enormous $5.2 trillion U.S. fiscal response to the COVID-19 pandemic to date - and massive monetary stimulus. The response has been more money, lots more money, and this has supported asset prices as well as consumer spending.

At this point, however, more fiscal stimulus could prove ineffective or even counterproductive and worsen supply chain problems to the point of crisis. There has been a deceleration in growth since mid-year as the recovery has run into higher prices and supply chain disruptions and bottlenecks affecting ports and shipping, trucking, and even the production of critical manufactured components like semiconductors. While these problems should prove transitory there are also structural issues and if not taken seriously, they could threaten the recovery. It would be a mistake to write off supply chain issues as simply a series of bottlenecks. Even before the onset of the covid pandemic, the global supply chain infrastructure was stressed. A year and a half after the onset of the covid pandemic, more spending to stimulate consumer demand for a shrinking supply of products is likely to lead to still higher prices and more shortages. A wide variety of products are now routinely out of stock or delayed to the point of being effectively unavailable. Energy markets and other raw materials are experiencing shortages and sharp price increases. Food prices are also moving significantly higher as shoppers can attest. Even labor is increasingly scarce and costly.

If the supply chain is not fixed and production of critical products increased, more spending will simply bid up prices for the products still available in a smaller economy. Growth will stagnate. Higher prices act as a market mechanism to allocate scarce labor and resources in a supply constrained economy. The point of higher prices is to ultimately kill demand. Either increase supply or the demand side must shrink to meet it. Taken to an extreme, we have seen this movie play out in places like the Soviet Union, Venezuela, Latin America, and even the U.S. in the 1970s. Policy going forward needs to be more focused on fixing supply chain problems and increasing the supply side of the US economy. Major players like Amazon, Walmart and UPS have committed to help with supply bottlenecks through enhanced spending on operations and logistics but policies must also address structural shortcomings.

In the 1980s the Reagan Administration successfully pushed for lower taxes, reductions in governmental regulation of business and labor, and incentives to increase capital spending and business investment to combat the stagflation of the 1970s and early '80s. A strong recovery began in 1982 and essentially lasted some 25 years until the financial crisis. The single unifying theme behind supply-side economics is that production (i.e., the "supply" of goods and services) is most important in determining economic growth. This is in contrast to the Keynesian demand driven growth model. In a macro economic sense, a stimulative monetary policy and Keynesian fiscal stimulus are no longer compatible, resulting in more money chasing fewer goods. In short, a supply side response along with an accommodative monetary policy is required at this point in the recovery.

Climate Change, Nat Gas & Energy Supply, Inflation and Security

Energy prices are at 7-year highs even as the energy sector has shrunk from 15% of the S&P 500 in 2008 to 2.5% today. Inflation, and particularly higher food and energy prices, hurts working class and lower income Americans the most. The very wealthy are most insulated from its regressive effects. While the push for alternative greener energy and electric vehicles may mean peak oil demand is not too far off, these same policies have actually increased the demand for natural gas over the near term. Natural gas now powers 40% of the electrical grid and has replaced coal as the primary source of power generation for most utilities. It is providing heat and electricity for businesses, computer data centers that power the on-line economy, homes, schools and of course electric vehicles. In a sense natural gas is now a substitute for gasoline and other driving fuels. Every Electric Vehicle sold today will increase the demand for natural gas at the expense of oil. Peak oil demand may not be far off but peak natural gas is much further into the future and will be harder to reliably substitute. It is no wonder that nat gas now trades at levels near the post financial crisis highs.

The UK and Europe (except for France where nuclear power generates 70% of the country's total electricity production) are experiencing soaring energy prices and shortages. The U.S., however, as the biggest producer of natural gas in the world, is in much better shape and should benefit from the growing global demand for natural gas and LNG exports. It does not make sense from either an environmental or a national security perspective to pursue policies which curtail our own energy and natural gas production while encouraging others in the world to increase theirs. A move away from U.S. production and towards importing more costly energy from overseas while exporting jobs, security and control of our supply chain would be an economic and strategic blunder.