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QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

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THE INGREDIENTS FOR AN UPTICK IN INFLATION

Just like everything else in today's upside-down world, it appears new rules are being written each and every day. Or at least it feels that way! We recognize the significance of maintaining an open mind and being intellectually flexible, but it is of equal importance not to forget some of the academic fundamentals that have shaped our thinking for literally decades. On the topic of rising inflation, we continue to be amazed at the complacency of the majority of market analysts on the subject. One analyst went so far as using the phrase, "of little concern." There appears to be great confidence in the Federal Reserve's macroeconomic forecasting abilities and the prospects for productivity gains from new technologies. If successful on both fronts, it would certainly reign in the magnitude of future price increases, but is the solution that simple?

As students of the market and economic history, it is hard to identify a period of time in the past 30 years in which so many factors in combination could contribute to inflation measures well above the 2 to 3 percent range we have experienced over the past thirty years. The factors listed below have to be considered as all of the right ingredients for a recipe that could result in well above average inflation levels.

Unprecedented Fiscal Spending

Back in April of last year when the U.S. economy was going into its lockdown phase, it was quite apparent that it was going to take extraordinary measures from the Federal government to avoid a sustained economic contraction. As we fast forward a year later, Congress has passed two major measures and several other smaller bills to provide an historic level of fiscal stimulus to the economy. Through this legislation, primarily via the CARES Act and the American Rescue Plan Act, nearly $5.4 trillion has been earmarked for COVID relief. The American Jobs Plan, just recently announced by the Biden Administration, would add an additional $ 2 trillion in expenditures on infrastructure and job creation initiatives. In order to put these amounts in perspective, the cumulative total U.S. national debt as of December 2019 (Pre-COVID) was $17.2 trillion.

Accommodative Monetary Policy

On March 16th of 2020, the Federal Reserve (Fed) established their short-term interest rate target of zero percent, a reduction of a full percent and a level not seen since the trough of the Great Recession in December of 2008. Quantitative Easing was a new concept back then as the Fed was forced to provide additional liquidity to the credit markets. In the most recent iteration, the Fed has issued additional currency reserves to not only provide liquidity and reduce long-term interest rates but to also purchase securities that are being used to finance this historic level of new fiscal expenditures. In terms of the order of magnitude, the Fed's balance sheet today is approximately $6.4 trillion, of which $3.2 trillion has been added since March 22nd of last year. Of that balance sheet expansion, the Fed has purchased nearly $2.2 trillion of U.S. Treasury debt.

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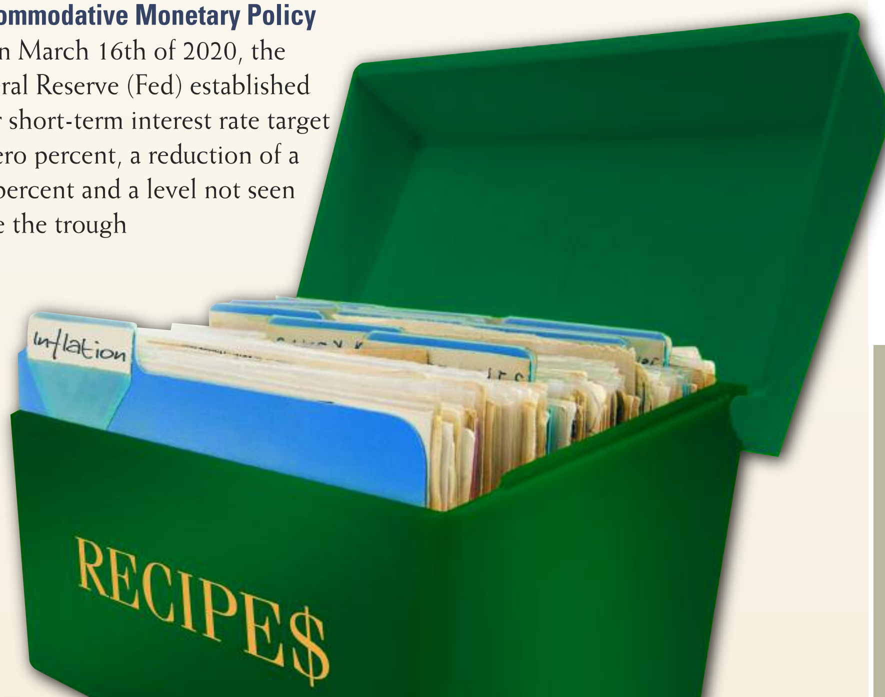

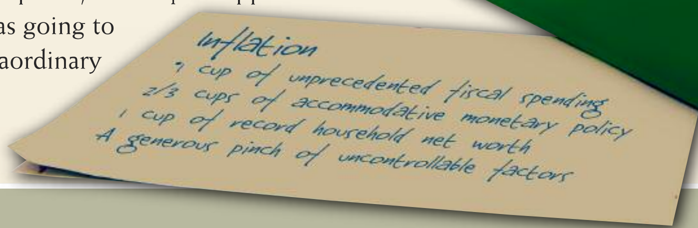

Brian Christensen, CFA
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THE TIDE IS TURNING… BUT FOR HOW LONG?

Value stocks have finally begun to outperform their growth stock peers. The last time large cap value stocks outperformed large cap growth stocks on an annual basis was 2016. As unapologetic value investors, that has felt like a lifetime.

More specifically, the recent rotation into value started in September 2020. From September 1, 2020 to March 31, 2021 the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by 19.08 percentage points. The chart on the next page tracks the trend.

The obvious question is, "How long can this trend continue?" To answer that question, it is helpful to review some of the economic and market fundamentals that support value stocks: specifically, interest rates, inflation trends, economic cycles, and commodity prices are relevant.

Interest rates have bottomed and now are trending higher. In the last twelve months, the yield on the 10-year U.S. Treasury Bond has risen from a low of 0.51% on August 4, 2020 to 1.73% on March 31, 2021. Despite Chairman Powell of the Federal Reserve saying they "...aren't even thinking about thinking about raising interest rates," financial markets are responding to improving economic statistics and anticipating more robust growth.

As interest rates rise, growth stock valuations will look even more excessive given the longer duration of their earnings growth cycles. Value stocks perform well in rising interest rate environments and will benefit from that as a tailwind.

Unprecedented stimulus programs from the U.S. Government in response to the pandemic are flooding the financial system with free cash for many. This process is undoubtedly leading to higher inflation. Simply look at the housing market, demand for new and used automobiles, and trends in commodity prices as examples of inflationary trends. Year-over-year, lumber prices have, on average, tripled. Used vehicle prices are up 23.7% since March 2020 per the Mannheim Used Vehicle Value Index. Crude oil has increased from $19.33 to $61.50 per barrel since last March, and, correspondingly, gasoline prices have risen nearly 25%. As prices for goods and services rise, so will interest rates.

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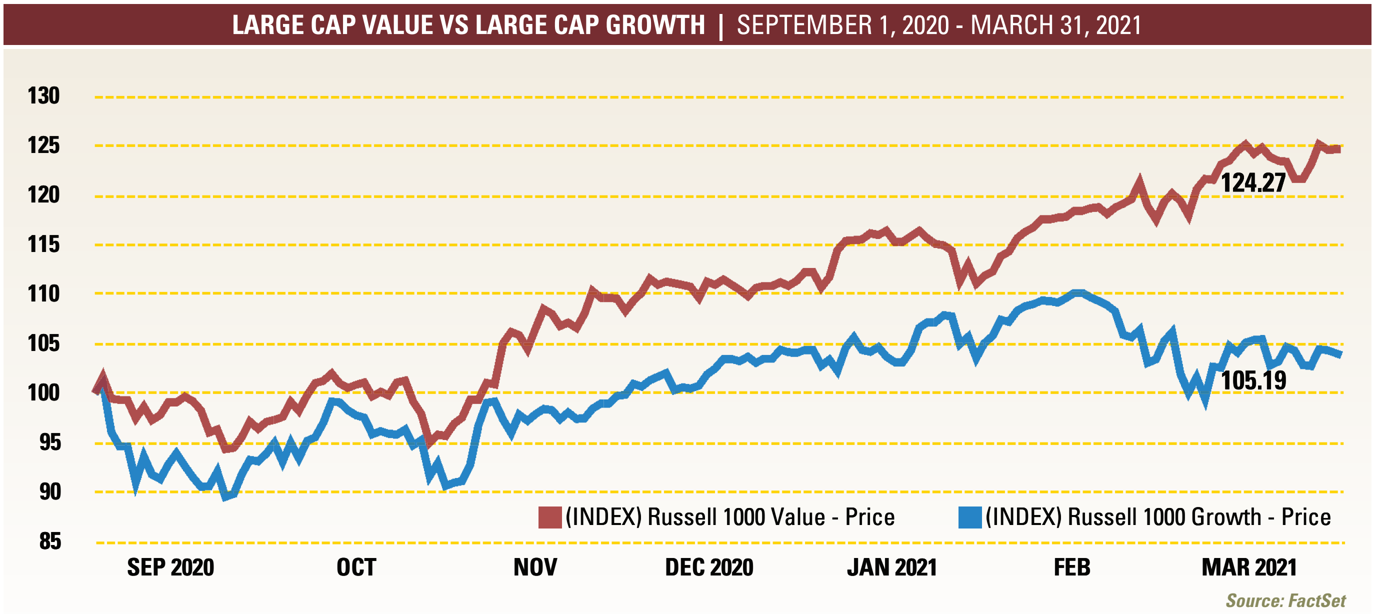

The economy is improving from the pandemic-led recession. As the economy continues to reopen, investors are becoming more confident in the sustainability of a long-term recovery. Cyclical industries (energy, financials, industrials, materials, retailers, restaurants, etc.) will thrive in the recovery. Cyclical industries can represent as much as 50% of a large cap value stock universe.

So, how long can the relative strength in value stocks continue? During the 2000 – 2009 decade, following the bursting of the tech bubble, value stocks outperformed growth stocks in eight of ten years. Citi Research recently published data going back to 2000 measuring timeframes where value stocks outperformed growth stocks. The details are shown in the chart below.

Clearly, market fundamentals are aligned for an extended period of value stock outperformance. Based upon past cycles, the run could be lengthy and substantial. It has been a long time coming!

VALUE RECOVERY PERFORMANCE

Start Date	End Date	Start Level	End Level	Absolute Returns	Excess Returns	Days	Months
Feb-00	Mar-02	2.14	4.39	105%	72%	761	25
Sep-02	May-07	2.9	9.22	218%	20%	1704	57
Feb-09	Aug-15	2.89	15.83	449%	41%	2283	76
Jan-16	Jan-18	12.74	20.76	63%	8%	71	24
Mar-20	Mar-21	12.22	24.45	108%	26%	351	12

Source: Citi Research

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Record Household Net Worth

In 2020, we saw the unemployment rate climb from a record low of 3.5% to end the year at 6.7%. U.S. Gross Domestic Product (overall economic growth) contracted at a rate of 3.5%, the first negative reading since 2009 when the U.S economic growth rate declined by 2.9%.

Despite the economic headwinds caused by COVID-19 in 2020, the U.S. consumer has never been in better shape. The combination of government cash payments and extended unemployment insurance plus a significant reduction in expenditures has led to a historic high in the personal savings rate. Household debt also decreased significantly as U.S. consumers paid down personal debt at a record clip. An abundance of liquidity and record low interest rates led to record high stock market prices and a surge in the U.S median housing price to an all-time high of nearly $350,000. With (1) Liquidity, (2) Home Equity, and (3) Financial Assets comprising the majority of household net worth, it should come as no surprise that here, again, we hit record levels.

Various Other Factors

- A shortage of skilled labor is already impacting economic sectors that are in full recovery mode. The housing sector, as an example, is facing inventory issues with the lack of new homes. The industry is already pointing to labor shortages as an ongoing challenge. Hospitality companies are finding that recalling employees will take some time as well. Workers are likely to take advantage of the extended unemployment insurance benefits included in the recent COVID-19 legislation.
- The Evergreen container ship in the Suez Canal captured global headlines as to the supply chain issues that were the side effect of its grounding, but that is the tip of the iceberg. Most industries are having a tough time keeping up with the surge in demand as they are challenged by widespread component shortages due to production shutdowns in 2020.
- Commodity Prices are also on the rise, with the S&P/Goldman Sachs Commodity Index nearly doubling over the past year, reaching levels last seen in 2018. With input prices climbing, companies such as Kimberly-Clark have recently announced plans to push these mid to high single digit price increases on to the consumer.

Behavioral Finance

For decades, since Former Fed Chairman Paul Voelker broke the back of inflation in the early 1980s with record high interest rates, we have come to expect a modest inflationary backdrop. The current Fed, under Chairman Powell, has established an inflation goal of price stability around an average of 2 percent. The current rate of inflation is actually running at rates well below that objective, with the February CPI (ex food & energy) release showing 1.3 percent.

However, based upon the factors as outlined, it is highly likely that inflation rates will be moving much higher in the near future. This might be a short-term phenomenon as all of the extraordinary events of the past 12 months are worked through the system and things begin to normalize. The alternative outcome is that inflationary pressures become more structural in nature. The Federal Reserve continues to monetize debt, consumers and businesses alike pay up for finished goods to avoid future larger price increases, wage increases are pushed through in response, and the inflationary spiral is off to the races.

We are hopeful that we can avoid replicating policies that have fueled past sustained inflationary periods. There needs to be a growing awareness that the monetary and fiscal stimulus spigot must be turned off and do so without causing additional unintended consequences. In absence of recognition of the significant challenges that lay ahead, we are highly unlikely to formulate the ingredients for sustainable future economic success.

CORE INFLATION (CPI EX FOOD & ENERGY)

Source: U.S. Bureau of Labor Statistics *myf.red/g/CVfZ*