SUMMER 2021 | VOL. 29 | NO. 3
QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

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TRAN·SI·TO·RY

Words appear to emerge out of thin air to describe prevalent economic events or developments. Do you remember the term, "green shoots" used repeatedly as analysts described the early signs of economic recovery back in 2009? Now transitory has emerged as the economic buzzword of the summer. It seems to be one of Fed Chairman Jerome Powell's favorite adjectives, as he provides his commentary and insights on the nature of price increases that have emerged since the fall of last year. There is a school of thought that the inflationary pressures that we are experiencing today will be temporary in nature as we transition from the COVID-19 influenced lockdown to a more normal economic environment. Those that are in the transitory camp suggest there are three primary factors contributing to the current higher rate of inflation: (1) the Base Effect, (2) Supply Chain Disruption, and (3) Pent-Up Demand.

The Base Effect

As the economy fell out of bed beginning in March of last year, non-farm payroll numbers collapsed by nearly 22 million jobs by April month end. As such, most economic indicators were under pressure for much of the summer and consequently pushed inflation measures lower as well. As the hope for a successful vaccine rollout began to emerge in the fall of last year, the economic backdrop began to recover. The argument for inflation moderation derived from the base effect is that the worst monthly statistics will roll off by early fall, and thereafter, the year over year statistics will begin to reflect more normal economic conditions. So, in effect, it is all just a matter of time before we return to 2 to 2.5 percent core inflation rates.

Supply Chain Disruption

Most businesses went into survival mode as the impact of the pandemic placed the economy in a lockdown. Production facilities were shuttered, orders were cancelled, workers were furloughed, and freight transports were put on hold. All in preparation for a lengthy economic contraction. Who would have predicted the sharp reversal of fortune and the unprecedented recovery in demand? As you recall, vaccine development was anticipated to take several years, not months! With a dearth of on-line production capacity and just-in-time inventory depleted, shortages for many items became widespread and market forces drove prices considerably higher. Now, with the economy no longer at a standstill, supply is coming back on-line and logistic driven bottlenecks are slowly being addressed. We are not back to pre-pandemic levels, but as supply and availability improves, it is thought that price pressures should subside.

Pent-Up Demand

The savings rate as a percentage of personal disposable income rose to an all-time high of nearly 34 percent in April of 2020 and has remained in double-digit territory ever since. These high rates of savings were influenced not only by reduced consumption but also by the extraordinary COVID related transfer payments to individuals from the Federal Government. To provide a historical context, the monthly savings rate generally runs around 6 percent and has been as low as 2 percent in modern economic times. U.S. consumers postponed their normal discretionary

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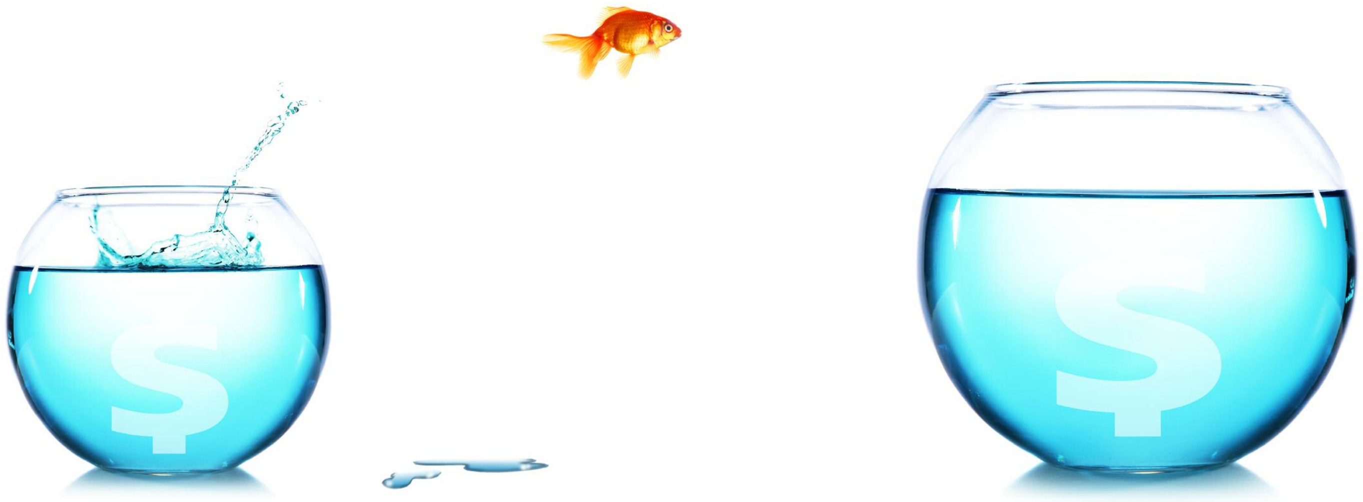
TEMPERING EXPECTATIONS



The unprecedented free flow of cash provided by Uncle Sam during the last twelve months continues to drive asset prices higher. Commodities, real estate, and stocks have all been strong performers post-pandemic. Historical rates of return for many asset classes are near or at all-time highs. The natural question then is what should we expect going forward?

Let's look at the historical returns for the major asset classes below to gain perspective.

Clearly, recent investment returns have exceeded long-term averages. Tempering expectations seems prudent in light of past results. Many of the world's largest asset managers publish their long-term (10 years) capital market assumptions. These assumptions guide their investment strategies and asset allocation decisions into the future. A survey of capital markets assumptions is provided on the following page.

The capital market assumptions shaping the strategies for the institutional investor community indicate reduced expectations going forward. The low starting point for

HISTORICAL RATES OF RETURN AS OF JUNE 30, 2021

ASSET CLASS - BENCHMARK	3 YRS.	5YRS.	10 YRS.	20 YRS.	30 YRS.
U.S. Large Cap Stocks - S&P 500 Index	18.67%	17.65%	14.84%	8.61%	10.73%
U.S. Small Cap Stocks - Russell 2000 Index	13.52%	16.47%	12.34%	9.26%	10.65%
International Stocks - MSCI EAFE Index	8.27%	10.28%	5.89%	5.78%	5.98%
International Emerging Market Stocks - MSCI Emerging Markets Index	11.27%	13.03%	4.28%	10.08%	NA
Long Term U.S. Bonds - Barclays LT Govt/Credit Index	9.92%	5.45%	7.30%	7.27%	7.97%
Intermediate Term U.S. Bonds - Barclays Aggregate Index	5.34%	3.03%	3.39%	4.56%	5.65%
Short-Term U.S. Bonds - Barclays 1-3 Year Govt/Credit Index	2.96%	1.88%	1.49%	2.74%	3.97%
High Yield (Junk) Bonds - Barclays High Yield Index	7.45%	7.48%	6.66%	7.82%	8.12%

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bond yields translates to weak outlooks for bond returns. Truly safe assets (money markets, CDs, short-term government bonds), no longer provide any income. Recent strong performance from equity markets leaves valuations elevated. Our "reversion to the mean" mindset simply has us believing a period of below average returns are likely as long-term averages will remain constant.

As we build financial plans for clients and search for compelling investment ideas, our expectations remain high yet realistic. As evidenced by the historical returns table below, we have enjoyed above average investment returns for the last decade. Our first priority is always risk management, which leads to our tempering expectations.

LONG-TERM CAPITAL MARKET ASSUMPTIONS | ANNUALIZED 10-YEAR FORWARD RETURN PROJECTIONS

	STOCKS				BONDS			
	U.S. Large Cap Stocks	U.S. Small Cap Stocks	International Developed Stocks	International Emerging Market Stocks	Long-Term U.S. Bonds	Intermediate Term U.S. Bonds	Short-Term U.S. Bonds	High Yield (Junk) Bonds
State Street	5.60%	6.10%	6%	8.40%	NA	0.30%	NA	2.70%
Blackrock	6.60%	6.80%	7.40%	7.40%	2.00%	1.80%	NA	3.70%
JP Morgan	4.10%	4.60%	6.50%	7.20%	1.60%	2.50%	1.70%	4.80%
BNY Mellon	6.20%	7.00%	5.90%	8.50%	2.50%	2.30%	2.00%	4.50%
T. Rowe Price (5 Year)	4.70%	5.20%	6.80%	7.20%	-0.30%	1.10%	NA	4.10%
Morgan Stanley	4.30%	6.40%	4.70%	7.80%	NA	1.10%	0.50%	1.20%
Callan Associates	6.50%	6.70%	6.50%	6.90%	1.80%	1.75%	1.50%	4.35%
Envestnet PMC	5.35%	5.68%	6.22%	7.28%	2.42%	1.62%	0.77%	3.14%
AVERAGES	**5.42%**	**6.06%**	**6.25%**	**7.59%**	**1.67%**	**1.56%**	**1.29%**	**3.56%**

TRAN·SI·TO·RY

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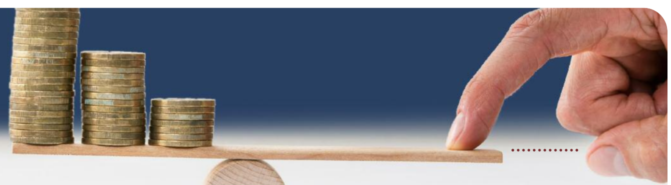

spending as travel and leisure spending were put on hold and certain durable goods were simply not available. As the economy has gradually reopened, consumers are back in force and are feeling a bit flush. Purchases made above the stated MSRP have become more prevalent as consumers are willing to pay more for the gratification of immediate delivery. Those in the transitory camp would suggest that demand pressures will ease over time as the current pent-up demand will subside and a more measured consumer behavior will re-emerge.

As we read the forecasts and predictions of large well respected investment firms that rely heavily on their macro-economic forecasting acumen, most of these firms are of the belief that the current spike in inflation will be transitory in nature. One firm, PIMCO, even went to the extent of characterizing it all as an inflationary "head fake". Despite the credibility and sound rational of their perspectives, could the consensus quite possibly be in error? Is there a persuasive argument that might lead to a different conclusion? Could it be that higher rates of inflation will be the new normal? Here are a few factors that deserve our attention.

Negative Real Interest Rates

Who would have thought UST 10-year notes would yield

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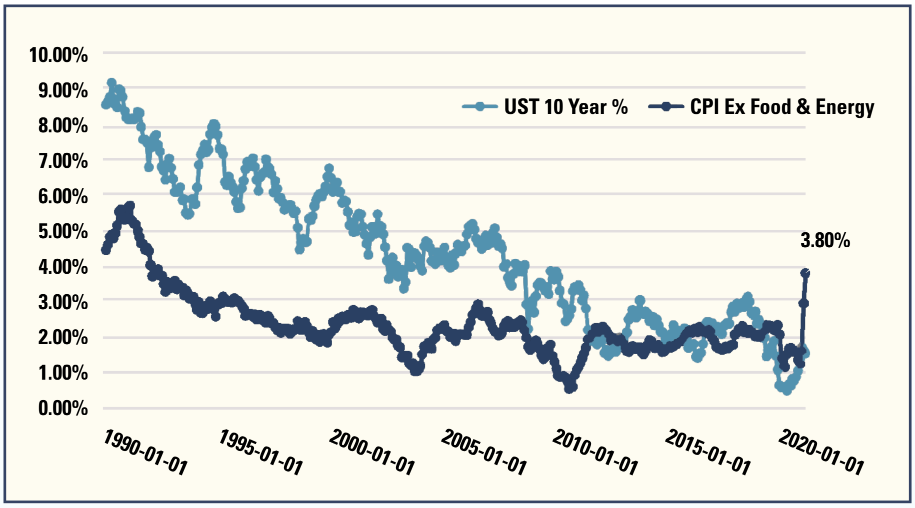

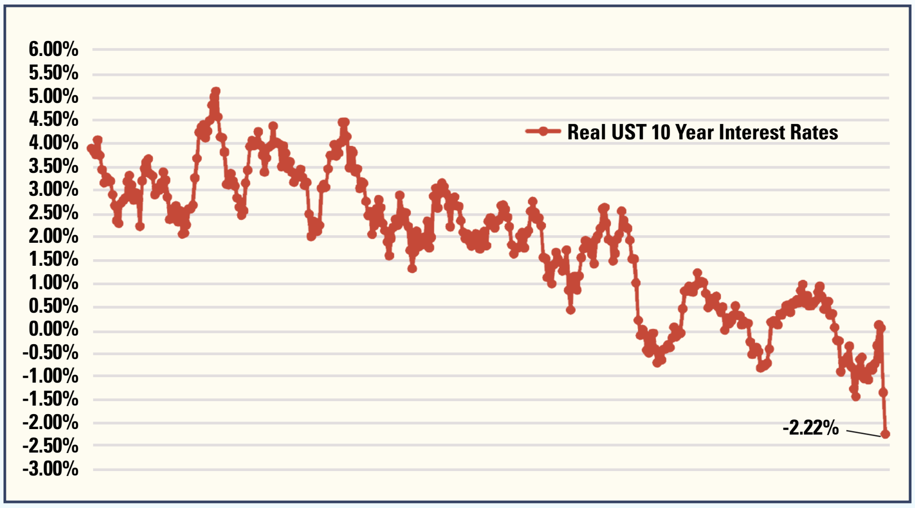

Source: St. Louis Federal Reserve Bank — FRED Data

nearly 1.6 percent while core inflation registered 3.8 percent in the month of May? On an annual basis, real interest rates would be a negative 2.2 percent. The term cost of money takes on a whole new meaning in the current environment. Something is certainly amiss. Either interest rates are artificially too low, or core inflation rates are viewed as too high and will soon adjust to lower levels. The Federal Reserve continues to purchase securities in the open market as part of their monetary stimulus plan. In addition, net foreign acquisition of U.S. debt has also risen significantly in the months of March and April of this year (the most recent data available). It is hard to argue that both activities are not placing a cap on interest rate increases, at least for now.

Record Fiscal Stimulus

Even though full year Real GDP growth is forecasted to be 4.5 percent for 2021 and non-farm payrolls have gained nearly 16 million jobs since April 2020, Washington continues to embrace the concept of deficit spending to shore up the nation's economy. On July 1, the U.S. House of Representatives passed the Moving Forward Act, a $1.5 trillion bill to address infrastructure priorities ranging from surface transportation and aviation to climate change related de-carbonization initiatives. This is a skinnied-down version of the original $2 trillion proposal by President Biden dubbed the "American Jobs Plan". There is talk of another Stimulus and Relief Package in the offing as well, which would be the sixth piece of legislation to come out of Washington to address the economic turmoil caused by Covid-19. The phrase, we are from the Federal Government, and we are here to help, has rarely been more prevalent.

So Far – So Fast

We have come so far so fast; I am not sure if anyone can really have a handle on what is going to come next. But in environments like this, there are always surprises and unintended consequences. Who would have predicted a year ago that the equity market would be registering all-time highs, median home prices would be soaring (up 24 percent year-over-year) to record highs, and Corporate America ready to post record earnings for 2021? There just seems to be an abundance of momentum in the U.S. economy.

As to the transitory nature of inflation, it might be a soft landing as many of the experts are predicting, but soft landings are rarely achieved. We are suspicious that this topic will be a source of debate and consternation in the coming months. Higher inflation is not a bad thing for equity markets, its impact on Fed interest rate policy will be the key.