

May 2021

A Return to Normal Faces Potential Challenges

As expected, economic activity boomed in the first few months of 2021. Widespread vaccinations, pent-up consumer demand, and a massive injection of government stimulus brought the economy roaring back to life. GDP jumped 6.4% in the first three months of the year. Aside from the initial reopening surge in the third quarter of last year, this is the best period for GDP since 2003.

That said, a raft of disappointing economic data in recent weeks—disappointing jobs numbers and flat retail sales—suggests that the economy may face stronger headwinds than initially thought. A robust rebound is likely already priced into the market, and further lackluster economic data may unsettle investors and roil the markets.

Despite these initial stumbles, the economic rebound is likely to continue. As enhanced unemployment benefits expire, the labor market's recovery should accelerate. American consumers, sitting on \$2.3 trillion in excess household savings, will continue to spend as business restrictions and mask mandates continue to lift. Expectations that this year will see GDP growth of 6% to 7% are not outside the realm of possibility. The more important question, however, is how sustainable this growth will be.

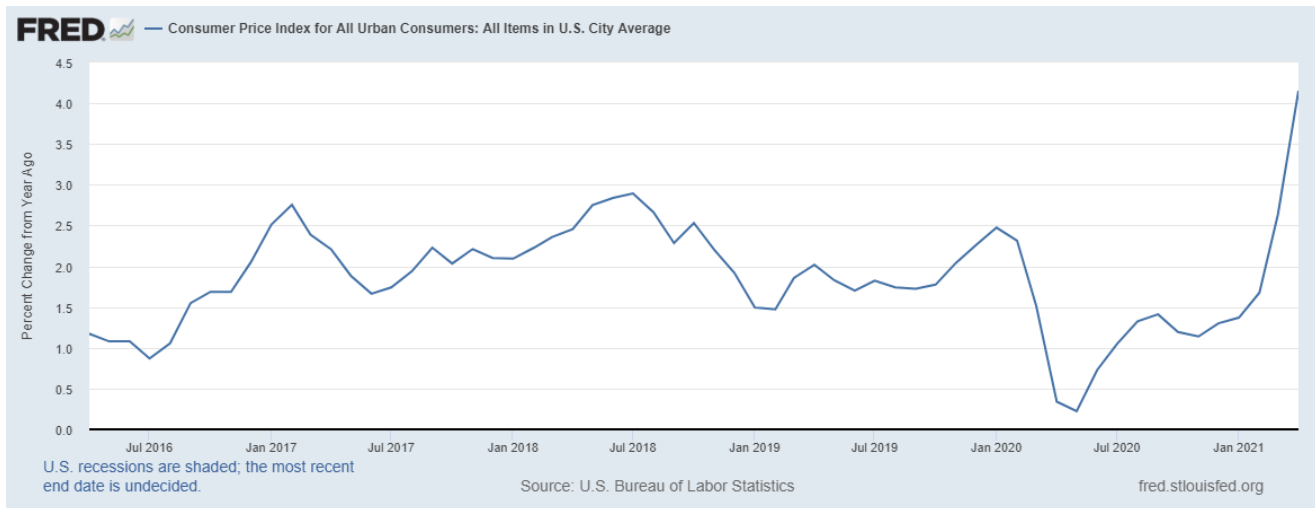
The current fiscal and monetary policies were intended to kickstart an economy that had ground to a halt during the pandemic. They will likely accomplish that goal but are unlikely to generate long-term growth. The effect that these policies have on the economy diminishes over time, and their impact on the stock market is limited by the fact that the markets have already priced them in. Moreover, should we encounter an unforeseen downturn or economic crisis, our policymakers will be unable to adequately address it, having already used all the tools at their disposal. Beyond the next 12-18 months, we will likely see economic growth moderate.

Within that timeframe, we remain cautiously optimistic. There are, however, two potential near-term risks that investors should be aware of: the impact of rising inflation and the possibility that rampant speculation is building a bubble in the stock market.

Are Inflation Worries Overinflated?

In the past year, the price of lumber has increased more than 300%. Prices for staple crops have surged. Corn prices have doubled, and soybeans are up about 80%. Home prices have climbed more than 12%. All of this finally trickled down to consumers in April, when the consumer price index (CPI)—which tracks a basket of common con-





sumer goods, energy, and housing costs—rose 4.2% from a year earlier, well above economist expectations.

The Federal Reserve has described the spike in inflation as “transitory,” essentially saying that they will all but ignore the next few months of inflation data, and they may ultimately be right to do so. The 4.2% annual CPI may sound more dramatic than it really is, comparing prices to last April, when the initial lockdown deflated prices. Some of the price jumps we are seeing are likely to be temporary, as supply chains work out the kinks and catch up to resurgent demand. However, for investors, perception matters as much as, if not more than, reality. We have already seen higher-than-expected inflation reports spark a sell-off in the stock market, and periods of volatility are expected to continue.

More worryingly though, the Fed may be wrong. The inflation we are seeing may be prolonged and persistent. Both the central bank and the government seem unconcerned with the possibility of inflation, focusing on the short-term growth generated by their spending and accommodating policies. While some argue that rampant inflation is unlikely with the labor force still so slack, we are seeing stronger pushes for labor rights and declining birthrates, both of which historically drive wage and price growth. Furthermore, many economists are arguing that globalization, which has long been seen as the primary reason inflation has been so tepid for decades, has peaked, and the post-pandemic world will be a less globalized one. The Economic Cycle Research Institute (ECRI), which tracks and analyzes macroeconomic trends, recently saw its proprietary Future Inflation Gauge jump to its highest level in 30 years. In ECRI’s estimation, this means that inflation is likely to trend up over the next six months.

None of this is to say that the sort of hyperinflation we saw in the 1970s will make a return, but even moderate inflation of 4% over a sustained period of time would be a shock to the markets and individual finances. Were that to happen, the Fed would eventually be spurred to act, either by tapering off their asset purchases or by raising short-term interest rates. The problem is that if the Fed waits too long, their actions could roil an already turbulent market, or come too late to make an impact.

In a high inflationary period, investors should be sure their portfolio carries hedges against inflation, especially in the bond market, which has seen big bouts of volatility this year among concerns about the economy overheating. The most secure way to do so

is with Treasury Inflation Protected Securities (TIPS). These are special Treasury notes that are pegged to the CPI, so their purchasing power will always be protected, but their long-term returns are anemic. Stocks in general are a good hedge against inflation, but international stocks in particular tend to generate better returns during periods of elevated inflation. Commodity stocks would also likely generate healthy returns, but can be risky, so diversification is key.



The Fed and The Growing Asset Bubble

The infusion of stimulus cash from the government and continuing dovish policy from The Fed are not only setting the stage for higher inflation, but they may also be fueling the financial market's biggest excesses. Some investors look at the stock market's post-pandemic rally and see more than a rebound, they see a market that has come disconnected from economic reality and a potential bubble in the making. Valuations that far outpace earnings, frenzied issuances, and speculative retail investors recall the fervor of previous bubbles, such as the 2000s-era dotcom boom. Pessimistic analysts are forecasting a double-digit correction on the horizon.

Certainly, there are areas that are being driven by purely speculative folly, like Bitcoin. Charlie Munger, Warren Buffett's number two and a legendary investor in his own right, recently declared Bitcoin to be "disgusting and contrary to the interests of civilization." While this is perhaps overstated, it has become clear that, despite cryptocurrency evangelists' claims about the benefits of a decentralized currency, the entire sector is essentially speculative gambling and there is little to justify current valuations.

The S&P 500 has similarly seen sky-high valuations, but unlike cryptocurrency, meme stocks and SPACs, these valuations may be justified. Much has been made of the fact that by many metrics, the stock market has not been this overvalued since the dot-com boom and ensuing crash. Take for example the so-called "Buffett Indicator," a ratio that compares total stock market capitalization to GDP, which reached an all-time high earlier in the year, topping the previous record set in 2000. Many have taken this as a warning sign that we are on the precipice of the bubble bursting.

However, the world has changed substantially since the dotcom era. Globalization means that the corporations that trade on the U.S. stock exchanges make a substantial portion of their revenue and profits, 40-50% by some estimates, overseas. This makes comparisons between market cap and U.S. GDP less relevant. An alternative valuation method that compares after-tax corporate profits to world GDP suggests that the stock market is only slightly above historical valuations. Moreover, after decades of mergers, acquisitions and corporate consolidation, there are fewer corporations being traded today, meaning that there is more money chasing fewer assets, further skewing historic valuation comparisons.

It is easy to see headlines about fortunes being made and lost overnight with

things like cryptocurrency and NFTs, but the reality is that most investors are treating this market the same they would any other. The AAI sentiment survey tracks how bearish and bullish individual investors are. In recent weeks, more investors have been bullish (37%) than bearish (26.3%), but these investor attitudes are largely in line with the historic averages (38% bullish and 30.5% bearish). In fact, the portion of investors who are neutral recently reached its highest level since January 2020, suggesting that many investors are cautious and likely to act rationally.



It has been said that history does not exactly repeat, but it does rhyme. The warning signs that prefaced past bubbles bursting do not mean that we are inevitably heading toward the same crash, but they should not be discounted. With valuations so stretched, the market is vulnerable to a major correction. While we remain fully invested in the stock market, we are continuing to build in hedges and look for opportunities to limit exposure in case there is an unforeseen downturn.

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