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PWM Weekly Observations

October 2, 2021

Can Inflation Pop an Over-Inflated Stock Market?

- ***"By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens."*** **- John Maynard Keynes**
- **Over the last 20 years, an era known for low inflation, the CPI Index has nonetheless managed to increase about 53%. That is, on average, items cost about 53% more today than 20 years ago.**
- **"Real" inflation is now rearing its ugly head and the question is how can we protect our financial assets from inflation? Are equities good protection?**
- **The solution to inflation is higher interest rates, which negatively impacts valuation. At first, inflation can also hurt profit margins, but once more realistic assumptions are made, many stocks are ultimately good inflation protection because sales and profits also reflect inflation.**

Inflation is the unseen drain on wealth that affects everyone, but impacts the poor much more so than the wealthy. We were listening to an interview this week with Ron Baron, an iconic growth stock investor, and he was saying that he assumes that the value of the dollar will fall in half about every 17-18 years. In other words, prices double every 17-18 years. The data point above shows that we have experienced a period of relatively low inflation thus far in the 21st century, but we were clearly not without inflation as prices on average are up over 50% in the last 20 years.

Last week, when the Fed took another step toward reducing their bond purchases and ultimately raising interest rates. The initial reaction of the bond market was a big yawn, but the following day bore no resemblance as markets had a significant hiccup and interest rates rose quickly. **The reason for the overnight change in sentiment isn't clear, but it hit with force and the 10-Year Treasury Note yield went from roughly 1.30% to over 1.50%. That might not sound like much, but in the financial world, that is an earthquake.**

Our view is that the concern of a less accommodating Fed along with the inflationary trends created by mixed-up supply chains and continuing product shortages raises question about where inflation, and therefore, interest rates, are headed over the intermediate term. Rising rates hurt equity valuations and if we add inflation into the mix, that can be an excuse to expect rates to increase even more. Needless to say, stocks did not react well this week, and that trend could continue a bit longer.

Commodities and inflation protected bonds are one way to combat inflation in a portfolio, but equities can be a bit confusing. The positive is that revenue and earnings are earned in inflated dollars and the earnings get reflected in the stock price, also in inflated dollars, so **the argument can easily be made that equities are a good inflation hedge, as long as the company is able to increase prices along with inflation and maintain profit margins.**

The other side of that coin is that **higher interest rates (which are the primary tool to fight inflation) serve to place downward pressure on equity valuations** (mathematically, increases in the discount rate reduce the present value of future cash flows).

To translate all that, as inflation initially hits, the reaction can be negative for stock valuations, but after that adjustment, many stocks can be very good inflation hedges.

Be Careful What You Wish for Because You Just Might Get It

- The easiest part – **a continuing resolution to keep the government open beyond Sept. 30, has passed and was signed by President Biden.** That will keep the government funded through December 3.
- **The progressive wing of the Democrats is standing firm against passing the bi-partisan infrastructure bill, unless the $3.5 trillion Build Back Better plan is passed first.** At the moment, those negotiations appear to be at an impasse. In the Senate, both Sen. Manchin and Sen. Sinema are openly opposed to the $3.5 trillion plan, with Manchin on record as wanting a a top line number limited to $1.5 trillion.
- **The progressives can pass nothing on their own, but they appear to have the power of 'No'. The question is whether they are willing to risk losing all of what they want in the effort to get all they want, or if some compromise can be reached.** It's a high stakes game of chicken and success or failure in the midterms may well be at stake. **Don't be shocked if this lasts several more weeks before it is resolved.**
- **The elephant in the room is the debt limit**, which is getting significantly less attention. The debt ceiling sets a legal limit on how much the government can borrow, and the government will unable to avoid breaching the debt ceiling around Oct. 18. **The risks here are more significant because without an agreement, the U.S. could default on its obligations in about 3 weeks. This is by far the worst possible outcome as it calls into question the full faith and credit of the United States. Although we view a default as unlikely, it could produce a partial government shutdown in the interim and another excuse for market volatility.**
- **Getting all of these thorny issues resolved and through Congress over the course of a few weeks is a major challenge. Congress doesn't easily act that fast**.

We try not to get political here and focus on how legislation impacts investments and financial planning, however, our frustration with the current political situation is mounting. **As citizens, we need to be more concerned when politicians can only view the world from election to election while disregarding longer term impacts.** That is not a criticism of the right or the left, it is a criticism of the right AND the left. **We appear to have a hard line drawn in the center that neither side can cross without serious repercussions, and that is not productive for the people they supposedly serve.** We sense that the fracturing of the left and right might ultimately result in the hard internal fractures morphing into multiple independent political parties, much like we see in Europe. With no one party able to lead, compromise becomes a requirement rather than an option. That would be a tough road, but may be the best thing that could happen to American politics.

There are many attractive aspects to the Build Back Better plan, but pumping more money into an economy that is experiencing record demand and constrained supply appears likely to exacerbate the current inflationary problem, not make it better. There is a time and place for everything, but this does not appear to be it. **The larger the plan that is ultimately passed, the greater the risk of serious, unintended consequences.**

What We're Reading

- *Merck Covid treatment reduces risk of hospitalization, death by half for some*
- *Most Americans Today Believe the Stock Market Is Rigged, and They're Right*
- *Iron Battery Breakthrough Could Eat Lithium's Lunch*
- *Covid Leading Indicators Improving For Gaming and Leisure*
- *Stocks may be in trouble. Should you turn to bonds?*
- *There's more inflation set to hit consumers as holidays approach*
- *Mortgage demand falls as rates rise to highest level since July*
- *Supply-Chain Bottlenecks Could Lead to Somewhat Longer Interval of High Inflation*
- *From chips to ships, shortages are making inflation stick*
- *JPMorgan's Jamie Dimon cautions a U.S. default would be 'potentially catastrophic'*

Markets This Week

It was an ugly week for markets. Interest rates were on the rise, which made life difficult for technology and growth stocks as well as the bond market. The only place to hide was in Commodities. Broad commodities were up almost 3% this week, while gold rose 0.79% and energy stocks rose 5.78%. Homebuilders were also hit hard as rising costs began to eat into demand. Financial stocks were also down for the week, but only marginally, as higher rates improved

US Equities	1 week	YTD	Fixed Income	1 week	YTD	Sector Breakdown	1 week	YTD
S&P 500 (SPY)	-2.18%	16.52%	20+ Yr. Treasuries (TLT)	-1.07%	-6.89%	Consumer Disc. (XLY)	-2.22%	12.80%
Dow (DIA)	-1.35%	12.99%	Barclays US Aggregate (AGG)	-0.36%	-1.52%	Info. Technology (XLK)	-3.28%	17.11%
NASDAQ (QQQ)	-3.62%	14.96%	Intermediate Municipal (MUB)	-0.56%	0.23%	Financials (XLF)	-0.18%	30.52%
Russell 1000 Growth (IWF)	-3.51%	15.16%	US Corporate Bonds (LQD)	-0.87%	-1.69%	Health Care (XLV)	-3.52%	13.07%
Russell 1000 Value (IWD)	-0.83%	16.86%	Barclays US High Yield (HYG)	-0.57%	2.21%	Utilities (XLU)	-1.93%	3.43%
Vanguard Mid-Cap (VO)	-2.06%	16.64%				Industrials (XLI)	-1.66%	12.70%
Vanguard Small-Cap (VB)	-1.02%	14.67%				Energy (XLE)	5.78%	45.04%
						Materials (XLB)	-0.86%	11.98%
International Equities	**1 week**	**YTD**	**Commodities**	**1 week**	**YTD**	Consumer Staples (XLP)	-2.27%	3.56%
MSCI EAFE (EFA)	-2.62%	8.64%	Commodities (PDBC)	2.74%	40.10%	Comm. Services (XLC)	-1.20%	21.15%
MSCI Emerging (EEM)	-0.89%	-2.16%	Gold (GLD)	0.79%	-7.72%	REITS (VNQ)	-1.54%	23.12%
						Homebuilders (XHB)	-4.03%	25.32%

The table above is an analysis of the weekly and year to date returns of various markets/sectors that we follow (More RED = worse performing markets/sectors; More GREEN = best performing markets/sectors). Source: IEX Trading & PWM Research.

Retirement Planning:

Worried about inflation? Here's how to protect your retirement portfolio

Rising inflation suddenly has Americans even more worried about their retirement.

Estate Planning:

House Democrats' tax proposal may affect life insurance for the rich

The rule aims to curb use of grantor trusts, and could mean that life insurance becomes part of one's taxable estate.

Tax Planning:

Tax Planning Opportunities You Might Not Be Aware Of

To save on taxes over all your years, not just right now, try these four different strategies.

Health:

Time-restricted eating: Does it work?

Animal studies have shown significant metabolic benefits of time-restricted feeding. Preliminary human studies suggest these findings may be applicable to humans.

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