July 1, 2021

What a difference a year makes! This time last year, we were in the midst of lockdowns with a recovery in the stock market beginning to form as technology and stay-at-home stocks propelled the market higher off of the March Covid lows. Now, a year later, the domestic economy has reopened, and cyclical stocks, which benefit from a strong economy, have taken over market leadership. While we expect cyclical sectors to continue to lead during a strong economy, we believe long-term secular trends and habits created during the pandemic will persist. For example, the way we shop (more online shopping), the way we transact and pay (mobile, card not present), and the way we work (Zoom and videoconferencing) have changed forever. On its most recent earnings call, Mastercard highlighted a recent study that found that about 70% of consumers plan to use ecommerce more than they did pre-pandemic even when the pandemic subsides, 70% will use digital banking more than they did pre-pandemic, and 60% say they will use less cash. The migration to a digital economy has taken root, and it seems inevitable that it will continue.

While much has changed in the economy over the past year, Federal Reserve policy of the past decade remains largely the same. Despite the surprising announcement in mid-June that it may boost interest rates sooner than expected, in 2023, the Fed continues to remain extremely accommodative. Easy monetary policy, in combination with a recovering economy, has spurred the rally in risk assets, including an increase over the past year of more than 20% in home prices and more than 40% in the stock market. In our opinion, Federal Reserve policy has inflated the price of finite assets that cannot be printed and created out of thin air. With accommodative Fed policy in place for more than a decade, we believe most market participants underestimate how difficult, if not impossible, it will be to unwind this stimulative policy. In addition, we believe the combination of high levels of government and corporate debt relative to GDP, an aging US population with a propensity to save more and spend less, and the deflationary nature of technology will serve as a headwind to growth and interest rates.

The economic debate that currently takes center stage is around whether the recent spike in inflation will prove to be transitory or persistent. We are monitoring the data on inflation closely and see strong cases being made on both sides of the debate. Since late April, the Fed has mentioned on multiple occasions that it believes inflation is transitory, while softening its stance on the position more recently. There is no doubt that supply chain disruptions and higher prices from the re-opening of travel and service-related industries have placed upward pressure on prices. Yet, the Fed believes inflationary pressures should ease as the economy normalizes. On the other hand, a continuation down the path of constant fiscal stimulus and transfer payments – putting dollars directly in the hands of average consumers – would seem to be inflationary. For now, absent a consistent stream of additional fiscal stimulus, we believe the long-term deflationary trends mentioned above remain in place and will likely lead to inflation normalizing at lower levels than we are currently witnessing. In the near term, policy out of Washington (or lack thereof) will likely determine the direction of inflation.

Following the level and direction of inflation and interest rates is important, particularly when building the fixed income portion of our clients' portfolios. Yet, the complex and dynamic nature of the economy we live in makes it difficult to predict these metrics with any certainty. We can guarantee that there will be surprises in the years ahead that will move inflation and interest rates in unforeseen directions. Because of this uncertainty, we continue to focus our efforts on purchasing the shares of high-quality companies with strong balance sheets, durable cash flow streams, strong competitive advantages, and pricing power. At times, some of these companies will fall out of favor with the market. Yet, over the long run, we believe strong fundamentals will ultimately be the driver of returns. Additionally, we plan, where appropriate, to maintain an allocation to uncorrelated asset classes, like gold, and to maintain adequate liquidity via cash and Treasuries. This portion of the portfolio should be beneficial if there are any hiccups in monetary or fiscal policy. As always, we thank you for your continued trust and confidence in our firm.

Sincerely,

Gamble Jones Capital Management