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Bradley F. Richardson

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The strong stock market continues

The stock market, as represented by the S&P 500 index, ended the first half of 2021 up 15.3% (including dividends). This exceptional result continues last year's impressive 18.4% return. These strong results are due to America's robust economic recovery powered by COVID-19 vaccines, the massive government stimulus and historic Fed actions, and the fact that interest rates (e.g. cost of money) have been nearly zero for the past year with current projections suggesting insignificant near-term change.

Inflation Fears

Given the role that low interest rates have played in boosting the stock market, investors are understandably concerned about excessive inflation. These fears were heightened by the June Consumer Price Inflation (CPI) report which showed a 12 month increase of 5.4% -- the highest yearly increase since 2008. This contrasts with the past 13 years during which inflation has averaged about 1.7% per year, which is less than the Federal Reserve Bank's 2% target.

The current debate is whether the recent inflation trends are temporary or the start of a new long-term paradigm? The Federal Reserve Bank's Open Market Committee (FOMC) -- which is in charge of setting our nation's benchmark interest rates -- believes the current inflationary forces are transitory and will dissipate once our economy can adjust from the pandemic's impact. Outside of the FOMC, economic opinion ranges from near total agreement with the Fed to those who think the Fed is 100% wrong to something in-between.

What we do know is that the economic impact of the COVID-19 pandemic has changed our economy in ways that we are still trying to understand. Federal Reserve Chairman Powell was quoted by the WSJ as telling the Senate Banking Committee on July 14, 2021: "This particular inflation is just unique in history…. We are humble about what we understand."

Given this uncertainty, the Federal Reserve Bank Governors are watching the situation closely. Recently, several FOMC members have adjusted their inflation expectations. Their latest predictions show 40% of its Open Market Committee members see an interest rate increase in 2022 and 70% see at least two increases in 2023. These numbers are double those of three months earlier.

What we can do about this inherently unknowable situation? Plan for the worst and hope for the best. Thus, I will be giving extra attention to see how our holdings are managing their inflation exposure. I have always favored companies with pricing power and given potential headwinds of inflation, this has become an even more important factor going forward.

Latest RMD News

Effective January 1, 2022, the tables that are used to determine the amount of Required Minimum Distributions from retirement accounts for anyone who is at least 72 years old by 12/31/22 will be adjusted for changes in average life expectancy. For example, assuming the value of an IRA on 12/31/21 was $1M, using the current table, the RMD would be $39,062.50 where under the new table it would be $36,496.35 which is a drop of $2566.15 (7%). While the exact differences between the old and new tables vary by year, the withdrawal rates of the new table are roughly 7-8% lower per year until one reaches the age of ninety-one.

What's Next?

During the past decade plus, we have had 3 tailwinds helping the stock market: a) low interest rates, b) high corporate profits as a percentage of Gross National Product (GDP), and c) a strong annual rate of GDP growth. As a result, the S&P 500 index, as of June 30, 2021, had yearly gains of nearly 18% during the past 5 years and almost 15% during the past 10 years.

Looking forward, interest rates are most likely to either stay the same or go up while corporate profits as a percentage of GDP — which are already at an elevated rate — are unlikely to increase further due to competition and/or government regulations. Thus, future stock market growth will most likely depend upon corporate earnings which are tied to overall GDP growth. What impact, if any, the COVID-19 pandemic will have upon future corporate earnings remains unclear. The trajectory of both the virus' evolution (including more variants) and efforts to mitigate this crisis are dynamic and will likely change in unforeseeable ways over time. Regardless of how things play out, we should be prepared for lower stock market returns during the next few years than we have seen in the recent past.

During the question-and-answer portion of the Berkshire Hathaway Annual Meeting in May 2021, the company's two leaders — Charlie Munger and Warren Buffett — were asked to reflect on lessons they had learned during the past year. Munger said, "If you're not a little confused by what's going on, you don't understand it. We're in sort of uncharted territory." Mr. Buffett looked ahead, "we've seen some strange things happen in the world in the last year, in 15 months. We always recognize the fact that stranger things are going to happen in the future."

Regardless of what happens (strange or not), our long-term, inflation-ready investment approach should serve us well going forward.

Thank you for your confidence.

Brad