MARKET OBSERVATIONS
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SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

Unusual

From an event so unusual as a global pandemic, other unusual outcomes were likely to emerge. And so they have – in economies, in markets, in government policies, and in societal norms. A continuing challenge is to assess what, if any, of the recent unusual transitions to the future usual. The timing and magnitude of any such transitions then will determine what responses are appropriate. Abandoning past practices and principles only to see the recent unusual vanish has implications as does a lack of response to the unusual that endures. A review of some recent unusual outcomes can provide perspective for investing yet ahead.

PERSPECTIVE

Declining job openings and rising unemployment are not unusual during an economic slowdown let alone a recession. Unusual at this time is the concurrence of a large number of available workers with a large number of job openings. Chart I shows the ratio of available workers to job openings over the past twenty years. In April 2020, there were five available workers for every job opening. As of the latest data in May, there was one job for every available worker. Also shown is the total number of job openings which stands at a record level. Two concerns arise from this unusual mismatch. Wage inflation could rise as businesses look to maintain momentum or the rate of economic growth could slow as businesses are forced to scale back without needed employees. Anecdotal evidence suggests both are occurring.

In the conduct of normal monetary policy, the Federal Reserve is both a buyer and a seller of U.S. Treasury securities. The extraordinary response to the Great Recession and its policy aftermath saw the Fed become a net buyer of U.S. Treasury and other securities on an unusual scale. Pre-pandemic, expectations had been building for a return to more traditional transaction levels. Instead, even more unusual outcomes prevailed. Chart II shows the sharp rise in both the amount of debt issuance and the amount of that debt being purchased by the Fed. Total debt issuance has been running at an annualized rate in excess of $4 trillion and the Fed has been purchasing one half of it. Less debt issuance seems unlikely in the near term, and the Fed has indicated it will continue its purchase level for now. Policy errors for either could raise inflation, lower growth or result in some of each.

The Fed has maintained an inflation target of 2% for some time. Market expectations for forward inflation can be seen in the yield difference between nominal and inflation protected U.S. Treasury securities. Chart III shows the five-year ahead expectation so derived. In response to the recent reports of higher inflation, expectations now have pushed decidedly above the policy target. The Fed argues the case that recent higher inflation levels are "transitory", i.e. unusual, and reflect pandemic related factors. Actual and expectation levels merit close monitoring.

INVESTMENT IMPLICATIONS

Market cycles are not unusual but unusual attributes of any cycle prompt a review of investment strategy. One attribute that has been usual for some time is the low level of interest rates. The resulting pursuit of higher yields, especially from reserve type investments, is understandable. What remains usual is the maxim that higher promised yield is associated with higher potential risk. Abandoning sound principles in response to unusual conditions is not advisable.

CHART I

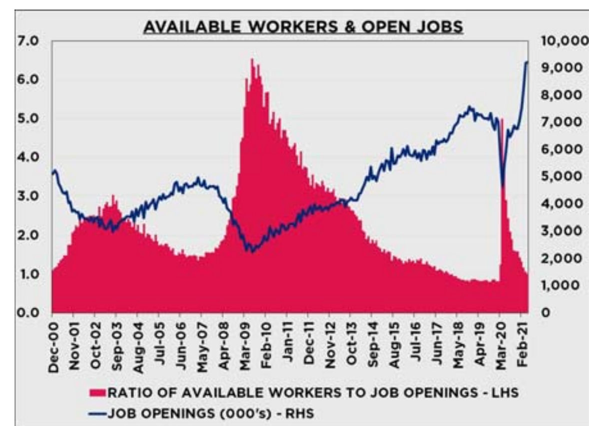

CHART II

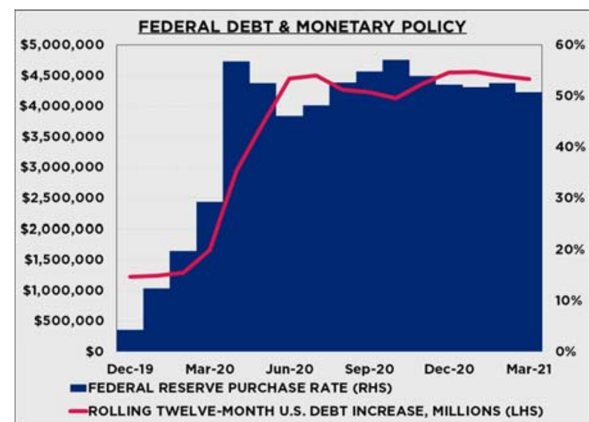

CHART III

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