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Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Poolside Chat.*

Don't fight the Fed. This often-used comment refers to the fact that when the U.S. Federal Reserve decides to become accommodative (another word for stimulative), they generally have been a key force in protecting against worst case economic scenarios and helping engineer a future recovery. Some argue that they were part of the problem in creating the 2008 housing sub-prime loan bubble, and so only get partial credit for bailing the system out while Congress was stuck in the mud debating TARP (Troubled Asset Relief Program) in the fall of 2008.

In **SFG's three pillars of recovery** (COVID-19 progress, corporate earnings and U.S./global economic growth), U.S. Federal Reserve actions remain powerful. Apart from the spectacularly quick development of vaccines, which the Fed had nothing to do with, the U.S. Federal Reserve is credited with pulling out all the stops after the March 2020 pandemic panic. While the Federal Government struggled to roll out their Paycheck Protection Program to help businesses (and fired their fiscal rescue bullets, as one noted economist said, like a drunken cowboy riding a bucking bronco), the U.S. Federal Reserve launched highly targeted measures to protect against worst outcomes. Had the RNA revolution led by Pfizer and Moderna not happened and the pandemic-induced recession deepened, would the Fed and U.S. government rescue programs have kept us out of a depression? Thankfully, we will never know.

Fed Chairman Powell's recent comments following the Fed Open Market Committee meeting were both upbeat in some areas and not surprising in others. He said that the economic recovery is far from complete and that U.S. central bank will remain accommodative as long as unemployment remains high, even if that means allowing inflation to run above the Fed's 2% target for a period of time. As we highlighted in our recent Live Chat Session, several Fed members projected interest rate hikes in 2022 and 2023 in the "dot plot," acknowledging improving economic growth and rising inflation prospects. We could see growing dissension in the Fed ranks regarding monetary policy if the U.S. economy does experience a boom in 2021 as we emerge from the pandemic winter. However, concerns around a potentially decelerating U.S. economy in 2022 and 2023 complicate matters for the Fed and may engender support for infrastructure stimulus as a means of creating a more sustainable growth trajectory in the years ahead.

> **"The recovery has progressed more quickly than generally expected and looks to be strengthening."**
>
> – *Federal Reserve Chair* Jerome Powell

We expect Fed policy and statements to prompt higher stock and bond market volatility as investors grapple with the inevitable "wildcard" issues of an expanding global economy. Economic and earnings growth should keep the reflation trade intact, favoring small caps and COVID-19-sensitive value stocks even as rising interest rates, the new proposed corporate tax rates that are coming and regulatory pressure from both political parties create headwinds for some growth and momentum stocks.

In last week's Live Chat Session, SFG partners John Thomas, CFA, CFP® and Glenn Joyce, CFA, CFP®, reminded us that the stock market is not the economy given the market's anticipatory nature and reviewed the wildcards that could throw a bit of cold water on the good news happening in the three pillars. The list of potential headwinds for some sectors of the economy and stocks include:

- Corporate tax increases to pay for the upcoming infrastructure bill
- Irrational exuberance giving way to unexpected setbacks
- Interest rates and/or inflation rising too quickly
- Geo-political colder weather (relations with China and Russia in particular have been getting chillier)
- Spot increases in COVID-19 outbreaks as pandemic fatigue has given way to pent up party demand (and not just with spring breakers in Miami)

Still, it is hard to argue with the progress being made in COVID-19 vaccinations, along with lower deaths and hospitalizations in the U.S. (despite Brazil's new COVID variant outbreak and Europe having challenges due to a botched coordination of the vaccination rollout), continued upward revisions in stock earnings (thank goodness given stretched stock valuations!) and the significant gear up happening towards full reopening of the economy by summer.

According to the latest Deloitte CFO Signals Survey, 67% of Chief Financial Officers are somewhat or significantly more optimistic for their organizations' financial prospects, compared to three months ago.

Overseas, more COVID-19 endgame drama – British Prime Minister Boris Johnson inflamed tensions with the European Union by telling some lawmakers in his Conservative Party that the U.K.'s successful vaccine rollout was "because of capitalism, because of greed my friends." He then repeatedly asked his colleagues to "forget I said that." No such luck!
https://www.thesun.co.uk/news/politics/14434076/boris-johnson-vaccine-row-greed/

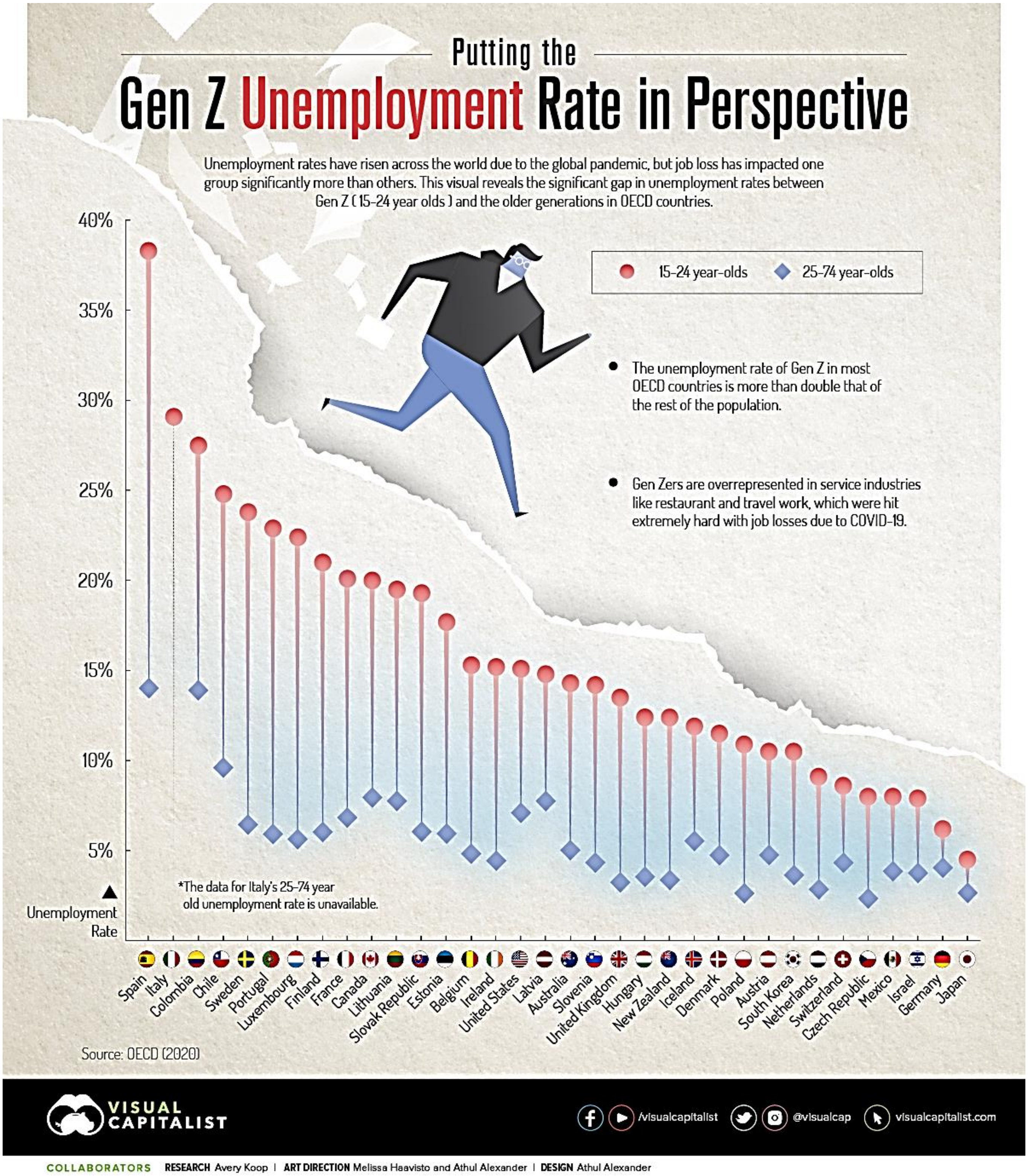
To view the recent **SFG Live Chat Session discussing wildcard scenarios** visit this link:
https://youtu.be/KUpMrl13FK0

SFG's Take: Our three pillars of recovery are still moving in a positive direction. We would say the forecast is for sunny spring skies if it weren't for the pesky wildcard scenarios buzzing around. SFG remains positive on certain investment areas and cautious in others.

Key Points to Consider

- **Reminder that more mundane risks still persist in the world:** Desert winds blew a giant container ship into an awkward position in the Suez Canal, blocking the whole waterway – through which 12% of the world's trade volume passes – for what could be days. The Ever Given was heading to Rotterdam. Tankers are now piling up on both sides, and there could be an impact on oil and gas flows.
https://edition.cnn.com/2021/03/24/middleeast/suez-canal-container-ship-intl-hnk/index.html
- **Gen Z – a powerful future force around the world, still struggling in the pandemic**: There are more than **two billion** people in the Generation Z age range globally. These individuals, born between 1997 and 2009, represent about 30% of the total global population – and it's predicted that by 2025, Gen Z will make up about 27% of the workforce. https://mccrindle.com.au/insights/blogarchive/gen-z-and-gen-alpha-infographic-update/

Due to the global pandemic, unemployment has been on the rise across the board – but Gen Z has been hit the hardest. The following chart, using data from the OECD, displays the difference between the unemployment rate for Gen Zers and the rate for older generations. https://data.oecd.org/unemp/unemployment-rate-by-age-group.htm



- **Work from home update:** One year after the COVID-19 pandemic forced millions of workers to start working from home, many companies are thinking about how to bring their employees back into the office. Many companies believe the past 12 months have proven the merits of remote work, and have pledged more flexible schedules. But increasingly, there are signs the work-from-home revolution could have its limits.

Most major global companies no longer intend to trim their physical footprint after the pandemic, according to a KPMG survey of 500 CEOs published this week. Only 17% of CEOs expect to make reductions, versus 69% in August. The "hybrid" work week estimates: 30% said they would have most employees working remotely two to three days a week.

"This suggests that either downsizing has already taken place, or plans have changed as the impact of extended, unplanned, remote working has taken a toll on some employees," KPMG said in its report.

Citigroup is barring video calls at the end of the working week and encouraging vacations. CEO Jane Fraser designated May 28 as a firm-wide holiday called "Citi Reset Day" and encouraged staff to avoid meetings outside of normal pre-pandemic working hours. Blurring the lines between home and work is "simply not sustainable," she said in a memo.

A survey of 1,450 corporate executives in North America published by Accenture last month also showed that **the shift to home working may not be as dramatic as first expected.** Executives estimated that 18% of employees had permanent flexible arrangements before the pandemic hit. After the pandemic, they predicted that would increase to just 25% on average.

- **Credit update:** The American Banks Association recently released its Credit Conditions Index. The report showed that **credit quality and availability expectations** improved for both consumers and businesses. The headline credit index surged more than 34 points to 77.9, its highest reading since mid-2014 and the biggest single-quarter increase in the Index's history.

  It is interesting to note that several recent surveys suggest many who are receiving stimulus checks intend to either pay down debt or save the money.

Better Decision Making

SFG has been featuring a variety of better decision-making tools to help avoid fumbles at any age, or find more ways to be more resilient when life throws us the inevitable career, business or personal curve ball. In this interview, Wharton's neuroscientist Michael Platt and his co-authors explain the neural basis of perspective taking and why it may lead to more innovation and better business outcomes. **And interestingly, better relationships with friends and spouses!**
https://knowledge.wharton.upenn.edu/article/perspective-taking-brain-hack-can-help-make-better-decisions/?utm_source=kw_newsletter&utm_medium=email&utm_campaign=2021-03-23

SFG in the News

The 12 "Just Do It" Keys to a Successful Fourth Quarter of Life – Dennis Stearns, CFP®, author of *Fourth Quarter Fumbles: How Successful People Avoid Critical Mistakes Later in Life*, was recently interviewed by TheStreet.com on key areas that people approaching retirement, or already there, should consider to improve their odds of success. This 70-minute webinar is for those who want to take a deeper look at key issues and ways to avoid fumbles, including those who are in the third quarter of life who want to prepare better for the future.
https://www.thestreet.com/retirement-daily/learning-center/how-successful-people-avoid-lifes-4th-quarter-fumbles

Frequently Asked Questions

Q: You've been talking in both written and live *Chats* about the competitive threat from China. What about the U.S. dollar? Do you think the Chinese have the ability to replace the U.S. dollar in world trade?

A: China would like to replace the U.S. dollar, but is far away from having the ability to threaten the dollar's dominance. The biggest hurdle for China is that its currency's value is managed. It isn't freely convertible to other currencies, so companies or countries can't be sure whether capital controls could be used to limit access to their holdings. So far, it has very limited usage in global transactions, with the Chinese yuan representing just 3% of global transactions compared to about 80% for the dollar.

Having the world's reserve currency is very important. It means there is underlying demand for U.S. bonds from foreign central banks and other large investors looking for a safe market in which to invest. Given the U.S.'s growing budget deficits and federal debt, our ability to finance the debt at low interest rates is critical to future economic stability and health.

When the U.S. is unhappy with a country over military mischief, human right abuses or other posturing, the U.S. dollar provides stronger leverage than threatening military action. Sanctions can be imposed under legislation including the International Emergency Economic Powers Act, the Trading with the Enemy Act and the Patriot Act.

When combined with access the U.S. obtains from Swift, the Society for Worldwide Interbank Financial Telecommunication's global messaging system, **the U.S. exerts historically unprecedented control over global economic activity.**

Former French President Valéry Giscard d'Estaing used the phrase "exorbitant privilege" to describe the benefits accruing to the U.S. from having the world's reserve currency.

Reserve currencies are typically issued by large, developed countries with records of financial stability. To be held in reserve by a foreign central bank, a currency typically needs to:

1) be freely convertible (not pegged by the government);
2) have a large and liquid debt market that foreign investors can access;
3) have an independent central bank;
4) be widely used in trade and global transactions.

Over the years, the euro's usage in global transactions has grown, the Japanese yen's usage has been largely stable, and there has been a slight increase in the Chinese yuan/renminbi's role. The European Union would love for their currency to grow even more in trade use, but the "large and liquid debt market" isn't available since the EU's partners are fragmented, with each having their own debt markets.

Most commodities and many other goods are traded in U.S. dollars – oil, copper, and agricultural goods – to name a few. Investors need to hold dollars to trade in goods and services and need to have a large and liquid bond market to in which to invest those dollars.

The U.S. dollar remains a safe-haven asset. During times of global stress, the dollar generally moves up as investors seek a large, liquid and reliable place to put their money. When the pandemic struck in early 2020, the dollar soared to its highest level in decades compared to a wide range of other currencies due to global demand.

Summary

SFG is balancing numerous opportunities and threats in our portfolios, customized to our clients' unique circumstances. We are being more cautious as parts of the U.S. stock market have exhibited irrational exuberance in response to positive developments in ongoing stimulus, corporate earnings and COVID-19 vaccines.

In **growth** portfolios, we are leaning into a variety of short- and intermediate-term asset classes and trends that we believe have favorable forward-looking risk/reward relationships.

In more conservative **growth and income** portfolios, we are taking more steps to be defensive, while still striving for positive real returns over inflation.

Our COVID-19 endgame investing approach can be summed up by six themes:

- Diversification with a balance of offensive and defensive measures, depending on the desired risk tolerance of our clients,
- Underweighting, or avoiding areas of higher future concern,
- A focus on higher-quality investment themes,
- Identifying and implementing buying opportunities that may be appropriate for more growth-oriented portfolios,
- A more defensive stance using different portfolio tools for more conservative growth and income portfolios, and,
- Utilizing select alternatives to traditional bonds and stocks.

~ Dax, Dennis, Glenn, Jason, John and PJ
(the SFG Investment Committee)

REMINDER THAT COVID-19 OFFICE HOURS ARE STILL IN EFFECT

Please keep in mind that we continue to maintain limited in-person service hours at our offices in Chapel Hill and Greensboro, NC until we can all return to the office safely.
If you have a need to meet with us in person or to pick up or drop off documents, we are glad to accommodate you. We also have a number of traditional and virtual tools to facilitate document transfers. Please contact us in advance if an in-person meeting is needed.

FT FINANCIAL TIMES | Top Financial Advisers 2020 | ria FUTURE 2019