# Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Poolside Chat.*

One of the major emerging trends of the next decade is the competitive battle between the U.S. and China. It's not easy to find a topic both sides of the aisle agree on, but this one fits the bill (no pun intended).

U.S. trade relations with China heated up recently as delegates from both countries held what was billed a "candid, pragmatic and constructive" phone call. The Biden administration has expressed its intent to leave the policies of the January 2020 trade agreement intact, while also noting the relationship between the two countries will be centered on "intense competition" going forward.

Consequently, President Biden issued a new executive order barring Americans from investing in Chinese firms that are linked to the country's military or that sell surveillance technology used to repress dissent or religious minorities, both inside and outside China.

The new order expands on an earlier, Trump-era blacklist and brings to 59 the total number of Chinese firms banned from U.S. investment. The move intensifies a commercial and ideological battle between Beijing and Washington, one that Mr. Biden has termed the struggle between "autocracy and democracy."

Mr. Biden has also kept tariffs on Chinese goods in place, as leverage in negotiations. In the new executive order, Biden administration officials say they were acting in part to rectify the order issued by President Donald J. Trump last November, which has been successfully challenged in American courts because it did not clearly lay out the factual basis for banning investments in Chinese firms linked to the defense industry.

It is unclear how effective Mr. Biden's order will be at stopping the spread of Chinese espionage technology. To make the investment ban truly effective, Biden will have to persuade the European allies, Japan and South Korea, among others, to join in the effort.

Getting Japan and South Korea on board with the ban begins with Biden's first foreign trip as president to the Group of Seven summit, followed by a meeting of NATO allies. China will be a major subject. In preparation for the meeting, Biden faced resistance from nations like Germany and South Korea who rely on China as a big export market for luxury cars, software and electronics.

The drama intensified in March when China imposed sanctions on 10 European Union politicians and four other entities in retaliation for Western sanctions on Chinese officials accused of severe human rights abuses in Xinjiang. In a quid pro quo move, the European Parliament last month paused the ratification of a new investment pact with China until Beijing lifted sanctions on the EU. Many experts believe this was a blunder by the Chinese and strengthened the case put forth by the Biden administration that a united front is the only way to change Chinese expansionism and abuses.

In other "Intense Competition with China" news, the U.S. Senate passed one of the largest industrial bills in U.S. history in a bipartisan effort to ensure the U.S. remains competitive with China as one of the globe's technological powerhouses. The bill, which passed the Senate chamber 68-32, commits roughly $250 billion in funding for scientific research, subsidies for chipmakers and robot makers, and an overhaul of the National Science Foundation.

Many Democrats and Republicans have voiced support for the package to "counter Chinese expansionism and technology development." **We anticipate a greater degree of federal investment in the technology sector given the amount of bipartisan support for keeping the U.S. competitive (and protected) in a future dominated by a digital global economy.**

The new legislation still needs to be ratified by the House of Representatives, but a bill like this coming out of the senate is likely to land favorably in the House. In the House of Representatives, some lawmakers are spearheading another proposal, branded the **NSF for the Future Act**. It's more modest in scope, primarily refreshing and renewing NSF's funding.

Assuming a bill passes similar to what the Senate came up with, it would change the structure of the National Science Foundation (NSF), the agency responsible for funding much of the U.S.'s research. This could cause a major shift in how NSF allocates its research funding – and it's a shift that will certainly impact tech research.

Importantly, the proposed money isn't going to defense-related spending. According to Russell T. Harrison, IEEE's Director of Government Relations, "It's targeted in parts of the federal budget that are traditionally not especially big," including agencies such as the National Institute of Standards and Technology (NIST), the Department of Energy's Office of Science, and the NSF.

The NSF would play host to the bill's centerpiece: a new "Technology Directorate" with its own independent funding stream. It would be limited to research in **10 delineated, if broad, research areas**:

1. high-performance computing,
2. quantum computing,
3. disaster mitigation,
4. biotechnology,
5. energy technology,
6. semiconductors,
7. robotics and automation,
8. advanced communication (such as 5G),
9. cybersecurity, and,
10. in Harrison's words, "anything else that's necessary to do the other nine things."

NSF would still be able to back broader research as it does now, deciding which fields get what funds. But these limitations would mark a drastic shift in how NSF operates. It "is Congress's way of telling NSF, 'You need to prioritize these 10 areas of research,'" says Harrison.

It's no coincidence that those engineering and technology-heavy fields are some of the same fields that consistently make headlines.

**SFG's Take:** Competition with China will be in the headlines for many years, perhaps decades, to come. Many of our portfolio companies are competing with China or using China for some or all of their supply chains. In many cases, public multinational companies are both competing and collaborating, utilizing China for their supply chain. With Chinese intellectual property theft still rampant, a number of companies are shunning Chinese markets in favor of areas with better legal protection.

Many of our alternative investments, including infrastructure, are going head-to-head with China directly in buying port facilities and other infrastructure projects. And several of our premier international investment managers have been selectively investing in China or in areas that will benefit from the powerful global Chinese **Belt and Road initiative** profiled in a previous *Chat*. Many of our research sources consider this the **most ambitious global infrastructure program ever initiated.**
https://www.cfr.org/backgrounder/chinas-massive-belt-and-road-initiative

## Key Points to Consider

- **Proposed Corporate Tax Changes Update – [Warning:** watching too many political negotiations may be hazardous to your health!] – President Biden signaled he would **be open to taking the corporate tax hike off the table as part of the future stimulus negotiations.** The president still intends to seek some type of corporate tax increase, which means the White House could pursue the policy outside of the infrastructure debate – or through the reconciliation process if bipartisan negotiations ultimately collapse.

  Meanwhile, **U.S. Treasury Secretary Janet Yellen surprised many by getting the G-7 nations to agree on a minimum global corporate tax rate of at least 15%.** That is consistent with the president's goal of tightening up loopholes that allow many public companies to pay zero tax. This has been a long running issue as nations have raced each other to lower corporate tax rates trying to lure companies to base themselves in their country, but has also had the effect of eroding their collective revenues.

  It remains to be seen if the broader G20 nations will agree to this minimum, in which case countries like Ireland will no longer be the tax havens of multinational companies around the world (Ireland has a corporate tax rate of 12.5%).

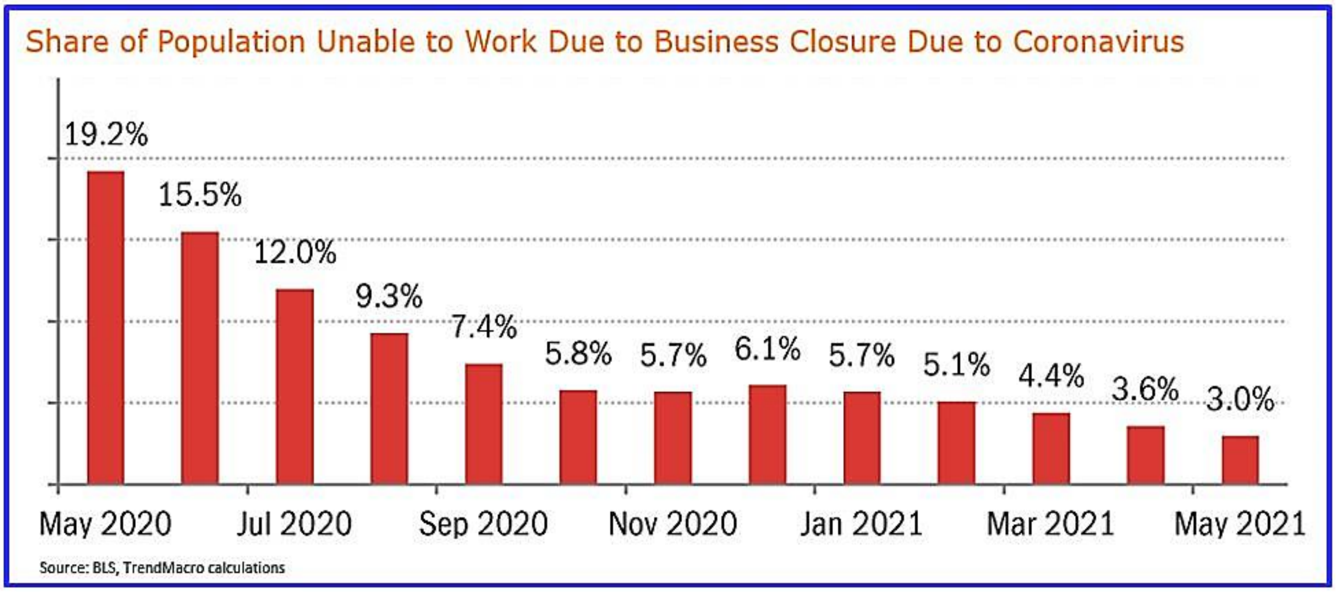
  **Big technology companies will be the most impacted by the global 15% minimum tax.**

- **Cracks in the Housing Market?** One of our favorite "there's a dark cloud somewhere in this sunny sky" investment prognosticators is Gary Shilling. He believes the housing boom has peaked – sales have slowed, the number of months to exhaust the supply of existing homes on the market at current sales rates rose in each of the first four months of 2021. Lenders' willingness to issue mortgages is at its lowest level since 2014, according to the Mortgage Bankers Association, and those with less than pristine credit scores and without sizeable down payments are finding it harder to obtain financing. In 2020, 70% of new mortgages were issued to borrowers with credit scores of at least 760, up from 61% in 2019, according to the Federal Reserve Bank of New York.

  Hard to fathom in a time when multiple offers are bombarding home sellers? We're a bit skeptical that this "bubble" will rapidly deflate as Shilling predicts, but we do believe the seeds have been sown for a more balanced supply and demand going forward, and some hot areas will cool off noticeably.

- **Jobs, Jobs, Jobs –** 559,000 net payrolls were gained in May, which was better than April but less than consensus expectations for 675,000. The unemployment rate fell because the labor force shrank despite a booming re-opening.

  **One point four million fewer workers this month reported being unable to work due to pandemic-related business closures, yet payrolls grew by less than half that.**




**Job shortages are extensive** with many businesses (public and private) reporting that high unemployment benefits remain an impediment to going back to work for many lower wage workers. Twenty-five governors have opted their states out of the enhanced unemployment benefits programs that are paying people more *not* to work than to work and holding back labor market recovery. Officially, all federal unemployment subsidies end on Labor Day.

Average hourly wages moved up at an annual rate of over 6% across the entire employed labor force, with many retail businesses paying signing bonuses. The rise in hourly wages is good news for many lower wage employees who have seen their income struggle to keep up with inflation in recent years.

## Frequently Asked Questions

**Q: Your list of wildcard problem areas seems to grow with every *Chat*! What's the latest on each of these concern areas?**

**A: Here is our current list of primary issues that could de-rail the economic recovery or stock markets here and abroad:**

1. **High Inflation –** higher inflation is already in the cards in many areas. The question is how high it could go in certain areas and will it be at sustained high levels, or just a bounce off pandemic lows? Many of our top research sources believe certain inflation areas will stay elevated for longer, including key materials in short supply as the world reboots from the pandemic.

   As we look at our client's own budgets, generally we only see 30-40% of those budgets heavily impacted by inflation. However, "lifestyle inflation" is lifting many of our client's budgets as they decide to kick up their heels a bit after the pandemic lockdown and spend more on enhanced trips and new cars.

   **Risk to Markets/Economy**
   **Investments: Moderate**
   **U.S. economy: Low**
   **Overseas economies: Mixed, Low**

2. **Higher Interest Rates** – this wildcard became more intense in the first quarter of 2021 but has eased back more recently. Higher interest rates create more opportunities for

investors (for example, investors can consider bonds versus dividend paying stocks). However, from a corporate point of view, higher interest rates increase a firm's borrowing costs while also forcing earnings projections to be discounted at higher rates, making current valuations less attractive. Consequently, high growth companies in technology and other sectors came under intense selling pressure as the first quarter interest rate increase accelerated.

For much of the last five decades, rates of 4-5% for the 10-year U.S. treasury note were responsible for increased volatility and corrections in the stock market and volatility in valuation multiples in income producing real estate. The 10-year treasury note is currently under 1.6%, perhaps rising to 2% by year end. There is speculation that the "increased volatility scenario" in this cycle could occur if interest rates rise to 2.5-3%, rather than the historic 4-5% of the past 50 years.

Major institutions we talk to who remain the largest investors in stocks and income producing real estate are not concerned by modest interest rates increases, but it's good to note that the challenging fourth quarter of 2018 was triggered by Federal Reserve comments of modest increases in interest rates and less accommodative fiscal policy. (See #3 below.)

**Risk to Markets/Economy**
**Investments: Low-Moderate (depends on investment type)**
**U.S. economy: Low**
**Overseas economies: Low**

3. **Change in Federal Reserve Accommodations and Fiscal Policy –** as mentioned above, investors of many stripes closely watch U.S. Federal Reserve actions. Every single word in Fed meeting notes and live comments is parsed and analyzed. We believe major changes are still at least six months away, but increasingly various Fed governors from different regions of the U.S. are signaling a declining need for Fed support.

Fed officials are "talking about talking about" tapering asset purchases, and investors are fearing another taper tantrum like that of 2013. Recent statements are not new information – the April FOMC minutes show they are already talking about reigning in their super accommodative policies. From the 2008/09 Great Recession, the Federal Reserve was very accommodative for a number of years to allow the U.S. economy to heal. Then in 2013, a "taper tantrum" was set off by then Fed Chair Ben Bernanke's warning of an imminent policy change, not just the beginning of debate about it. "Tapering" describes the Fed buying back less bonds, which infuses the economy with more cash.

In 2013, the 10-year yield had already risen from lows experienced during the depths of the Great Recession to when Bernanke first hinted about tapering, and only continued to rise after. When tapering was begun, yields fell to below where they were when Bernanke spoke. Equities, as a proxy for economic growth, had only a small and brief correction after Bernanke's warning. They rallied through the onset of implementation and after, suggesting that tapering did nothing to harm economic growth.

**Risk to Markets/Economy**
**Investments: Moderate (but possibly violent)**
**U.S. economy: Low**
**Overseas economies: Low (dependent on each country's own central bank actions, or in the case of Europe, the collective central bank)**

4. **COVID-19 Economic Re-opening Issues or Variants –** most of the COVID-19 news in the U.S. and many developed nations overseas is trending in a positive way, with fewer and fewer infections and fewer hospitalizations. Herd immunity, the combination of those vaccinated and those who have already had COVID-19, appears to have been reached in the U.S. We are constantly reminded by our infectious disease friends that "herd immunity" and lower infections doesn't mean that no danger still lurks for some people. Several friends of our firm have been affected by COVID-19 endgame infections, with several now experiencing "long haul symptoms" and one who recently died (unvaccinated). https://www.nature.com/articles/s41591-021-01283-z

   Experts believe the biggest risk of COVID-19 variants comes from overseas areas where vaccine rates are still low. The new Delta strain of COVID-19 (originating in India) outbreak in China's Shenzhen trading port already has some companies in the U.S. scrambling as yet another problem erupts with their global supply chain.

   There is some risk that current vaccines won't cover some future variant, but so far, the COVID-19 vaccines have performed much better against variants than flu vaccines have with flu variants – that often completely circumvent the original flu vaccine protection.

   **Risk to Markets/Economy**
   - **Investments: Low probability/ high impact**
   - **U.S. economy: Low**
   - **Overseas economies: Low-Moderate**

5. **Higher Taxes – Personal tax increases** have generally been less correlated with downturns in the economy or investment markets over the short term (periods of five years or less), but have a bigger impact over longer time periods if taxes get high enough to be a disincentive for capital intense growth projects and entrepreneurial growth. History tells us that capital gain tax rates above 28% produce less revenue over time rather than more revenue. Those companies or individuals subject to higher tax rates sell less frequently or use tax planning techniques like tax-free exchanges, which could disappear for higher income individuals in the proposed new tax law.

   **Corporate tax increases** that are modest are forecasted to be absorbed more easily by public and private companies. Higher rates would be a problem for many companies as they recover from the COVID-19 induced recession, but based on Mr. Biden's recent comments, it appears that either a lower rate increase, or even no increase, may be a more probable outcome.

   **Risk to Markets/Economy**
   - **Investments: Low**
   - **U.S. economy: Low**
   - **Overseas economies: Not applicable**

6. **Geo-political risks** have been elevated with the China trade issues discussed in this *Chat* being both an immediate and a longer-term issue. Cyber-tensions persist with some experts saying the U.S. is already in a constant state of offense and defense with China, especially in cybersecurity breaches.

   At the end of May, *Kiplinger* released its executive briefing with the provocative title: *Preparing for War with China*. It goes on to say that the U.S. doesn't want war with China but it's preparing for one, just in case. Taiwan is cited as a major potential hotspot. Other items cited:

   - Chinese shipbuilding has accelerated recently to the point that Beijing now has the world's largest navy by a number of ships. China is on track to have 420 warships by 2030, up from 350 now. By contrast, the U.S. hopes to have 355 ships in 2030, compared with 293 now.

- The U.S. fleet is more capable than China's, with Beijing still lagging Washington in several areas, most notably aircraft carriers and submarines. China already possesses so-called carrier-killer missiles, which can neutralize American aircraft carriers. As in other areas, both China and the U.S. continue to upgrade their capabilities.
- Swarms of unmanned aircraft are considered crucial to the Air Force's future plans to ensure U.S. victory in a war with China.

Other geopolitical issues include the relationship with the EU and China. The European Union has the second most widely used currency for global trade (China is miniscule in comparison) and remains an important trading partner for the U.S. A drift of the EU towards China was occurring during the Trump years, but has moderated as President Biden has made inroads into strengthening EU-U.S. relations and cooling the EU-China romance (helped by the Chinese blunder mentioned earlier in this *Chat*). However, certain countries remain fully committed to increasing trade with China as much or even more than with the U.S.

The departure of Angela Merkel as Germany's leader after 15 years also poses some potential risk, as her deft political skills have been heralded as keeping countries like Poland and Hungary in the Eurozone mainstream while dealing with occasional flareups of tensions in the other 25 European Union member states. France and Germany have competing visions for Europe's future, and Merkel has helped calm trade tensions. Without Merkel, the continent's COVID-19 economic recovery would likely have been more precarious.

**From Eurasia Group: "..., Merkel has been Europe's most important leader. Her departure later in 2021 after 15 years as chancellor drives the continent's top risk."**

Meanwhile, other rogue nations pose various threats, with Russia leading the pack. Note that cyberattacks sourced out of Russia are at an all-time high, with examples of ransomware such as the Colonial Pipeline incident making recent headlines. In short order, the incident created a gas shortage along with higher prices along the east coast for several days.

**Important note: Most geopolitical events have little impact on investments beyond a one- to two-year time frame. A few of the items mentioned above could create multi-year issues if the "peace dividend" disappeared.**

**Risk to Markets/Economy**
**Investments: Low probability/ high impact**
**U.S. economy: Low probability/ high impact**
**Overseas economies: Low probability/ high impact**

**SFG's Take:** While most of these wildcard scenarios could upset the U.S. and global economic recovery, or investments of various types, most of the higher impact items are lower probability. It's good to remember that when assets are priced high with lower margins of safety as they are today, even small expected or unexpected headline news can create short-term corrections of various magnitudes.

## Summary

SFG's three pillars of recovery remain in positive trend territory. Wildcard risks in our fourth pillar remain elevated. SFG is balancing numerous opportunities and threats in our portfolios, customized to our clients' unique circumstances.

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 more balanced 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)*

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## SFG ON-SITE OFFICE HOURS UPDATE

Our offices returned to more normal on-site hours effective June 1.
We are offering in-person meetings and virtual meetings depending on client preference, so please feel free to reach out and schedule accordingly. At least initially this will be a hybrid plan to afford our staff members the flexibility to continue to work from home part time.
**Please continue to call or email beforehand if you intend to drop by our office just to make sure we have the right person available to help you best on that particular day.**

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