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Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Poolside Chat.*

The COVID-19 Delta outbreaks have many investors and economists wondering whether we are in the pandemic endgame, or facing yet another prolonged surge. Strategas research, one of our go-to think tanks, provides the following:

> "The threat of COVID re-emerging in the U.S. is coming at a time when U.S. real growth is coming in lower than expected, inflation readings are hotter than expected, and fiscal policy stimulus is rolling off. This will take some time to sort itself out with the best-case scenario being that the rise in cases is similar to last year's short seasonal summer pick up, hospitalizations do not meaningfully increase, and the re-opening moves full speed ahead (**40% probability**).
>
> "Alternatively, we could see a temporary delay in the re-opening, which lowers growth expectations in 2H (**45% probability**).
>
> "The worst-case scenario is that state officials impose lockdowns (**15% probability**)."

Weaker than expected second quarter economic growth in the U.S. suggests one of the biggest obstacles to higher GDP was the supply chain constraints we discussed in our recent Live Chat. In the short term, supply constraints make it more difficult for both fiscal and monetary policymakers in Washington D.C. to understand the true impact of the stimulus they have provided over the last 16 months. For those worried about the possibility of inflation, these constraints could have the unintended consequence of pushing policymakers into more stimulus than necessary. However, a little gasoline on the economic fire given the Delta variant outbreaks is not worrisome.

Last week, Federal Reserve Chair Jerome Powell said the Fed will stay patient in assessing the timing of reducing its "easy money" strategy of bond purchases. Powell noted in his press conference that U.S. labor force participation is still being affected by health concerns, child-care issues, and unemployment insurance.

At the same time, The Fed acknowledged the improving U.S. economy, but said there hasn't been enough progress made to reduce quantitative easing (QE). Looking beyond our supply chain issues, the Fed continues to consider inflation as "transitory." Consequently, the U.S. central bank will continue buying $80 billion of Treasuries and $40 billion of mortgage-backed securities (MBS) each month. This remains a cautionary yellow flag since the official announcement signaling the end of the Fed's accommodative policy, which will likely come in the next 6-12 months, will no doubt create additional stock market jitters.

The Biden Administration's spending plans for both infrastructure and social spending ($3.5T) comes at a time when Congress has to raise the debt ceiling and has little chance of finding the votes. Note the debt ceiling has been raised over 100 times in our history, so in and of itself, this is not a catastrophic event. With that said, the 2011 debt ceiling debate led to a rating downgrade of U.S. federal debt, which in turn led to a 20% correction in equities. This represents yet another wildcard, though our research sources believe a reasonable solution will be hammered out.

SFG's Take: U.S. investors have become more jittery for a variety of reasons. A grinding higher scenario is most likely for U.S. stocks, while international stocks have more room on the upside in many areas. Many of our alternative assets have good return vs. risk potential plus additional inflation hedging and diversification benefits.

Key Points to Consider

- **Infrastructure odds improving?** – An infrastructure bill is slowly working its way through the senate. Given that it will be paid for from sources other than new personal taxes, it is becoming increasingly likely it will pass and provide needed funds for a variety of infrastructure projects.
- **Chinese stock weakness** – Education and Tech stocks in China were slammed with a massive selloff that wiped out hundreds of billions of dollars in market value as investors reacted to Beijing's increasingly aggressive actions. Chinese officials are curtailing operations of China's for-profit tutoring industry along with an ongoing campaign to rein in Chinese technology companies.

  In the U.S., public offerings by Chinese companies are also under increased scrutiny following the "punishment" applied to DiDi by China, which tanked its stock following its recent IPO.

  China's "brand" has taken a major hit in the aftermath of the pandemic. At the same time, China is becoming more aggressive politically with respect to Hong Kong, Taiwan, and the United States.

  From Strategas research: "Any pretense of China becoming a Western-style economic partner is now over…The recent crackdown on China's technology sector is a reminder that the state's primary goal is to maintain social stability."

  Chinese state media sought to steady the markets, asserting the government's commitment to allow companies to access capital markets.

SFG Thought Leadership

Paula McMillan, CFP®, CPA/PFS, CGMA spoke on a panel on Investing Strategies to the AICPA (American Institute of CPAs) national meeting in Las Vegas. Her key points:

- Thoughtful financial planning helps inform the right investment strategy. Investing strategies that are too conservative or too aggressive need special analysis to avoid plan failure.
- Diversify well but don't over-diversify (we call this "de-worse-ification").
- Achieving solid real returns over inflation requires different strategies today than 10 years ago.
- Consider the many alternatives to bonds, like infrastructure and real estate. Some of these options may also be good diversifiers to stocks.

Frequently Asked Questions

Q: Lots of inflation discussion going on – how much faith should we put in the published Consumer Price Index?

A: The CPI data collection process is extensive. Despite the large effort by the BLS (Bureau of Labor Statistics) to track price variations related to everything from salted, unsalted, and organic butter, the CPI is often dismissed as a "manipulated government index." This may be partially true, but we've tracked client budgets over decades and found the CPI is often indicative of price movement ***trends***, even if the actual inflation rates our clients experience are almost always higher or lower than published rates.

Why does this matter? The CPI is used extensively to adjust incomes, lease payments, retirement benefits, food stamps, school lunch benefits, alimony, and tax brackets. Because the CPI is based on the buying habits of the "average" consumer, it is certainly not a perfect reflection of every individual price experience.

Here are a few of the Bureau of Labor Statistics frequently asked questions (Source: https://www.bls.gov/cpi/questions-and-answers.htm) that clients often ask us about, along with some of SFG's comments in bold:

- **"How is the CPI market basket determined?**

  "The CPI market basket is developed via a survey of families and individuals on their expenditure history. Naturally, there is a time lag between the expenditure survey and its use in the CPI. For example, CPI data in 2016 and 2017 was based on data collected from the Consumer Expenditure Surveys for 2013 and 2014. In each of those years, about 24,000 consumers from around the country provided information each quarter on their spending habits. To collect information on frequently purchased items, such as food and personal care products, another 12,000 consumers in each of these years kept diaries listing everything they bought during a two-week period.

  "Over the two-year period, data was collected from approximately 24,000 weekly diaries and 48,000 quarterly interviews. This data was then sorted by importance, and weighted to create the CPI index structure."

  [**SFG: This doesn't mean inflation trends are out of date by two years, it means that spending habits (not prices) of consumers are only updated every two years.**]

- **"How is the CPI sample created?**

  "A particular item enters the CPI sample through a process called initiation. This initiation process, typically carried out in person by a CPI data collector, involves selecting a specific item to be priced from the category that has been designated to be priced at that store. For example, suppose a particular grocery store has an outlet where cheese will be priced. A particular type of cheese item will be chosen, with its likelihood of being selected roughly proportional to its popularity.

  "If, for example, cheddar cheese in 8 oz. packages makes up 70 percent of the sales of cheese, and the same cheese in 6 oz. packages accounts for 10 percent of all cheese sales, and the same cheese in 12 oz. packages accounts for 20 percent of all cheese sales, then the 8 oz. package will be 7 times as likely to be chosen as the 6 oz. package. After probabilities are assigned, one type, brand, and container size of cheese is chosen by an objective selection process based on the theory of random sampling. The particular kind of cheese that is selected will continue to be priced each month in the same outlet.

"This item will be repriced, monthly or bimonthly, until it is replaced after four years through sample rotation. Repricing is usually done in person, but may be done via telephone or the internet. The process of selecting individual quotes results in the sample as a whole containing a wide variety of specific items of a category roughly corresponding to consumer purchases. So, the cheese sample (or the new auto sample, the television sample, etc.) contains a wide variety of styles and brands of cheese, autos, televisions, etc.

- **"How is the CPI calculated?**

"The CPI is a product of a series of interrelated samples. First, using data from the U.S. Census we select the urban areas from which data on prices are collected. Next, another sample (of about 14,500 families each year) serves as the basis for a Telephone Point-of-Purchase Survey (TPOPS) that identifies the places where households purchase various types of goods and services, forming the basis for the CPI outlet sample. Using data from the Consumer Expenditure Survey, BLS statisticians assign quotes in the CPI item categories to specific outlets. A specific item is then chosen for selection using a process which bases the probability of selection for an item on the share the item composes within the outlet's revenue in that item category.

"Recorded price changes are weighted by the importance of the item in the spending patterns of the appropriate population group. The combination of carefully selected geographic areas, retail establishments, commodities and services, and associated weight, gives a weighted measurement of price change for all items in all outlets, in all areas priced for the CPI.

"Additional information on how the CPI is calculated is available in the CPI section of the BLS Handbook of Methods.

- **"How is the CPI used?**

"The CPI affects nearly all Americans because of the many ways it is used. Some examples of how it is used follow:

- **"As an economic indicator.** The CPI is the most widely used measure of inflation and is sometimes viewed as an indicator of the effectiveness of government economic policy. It provides information about price changes in the Nation's economy to government, business, labor, and private citizens and is used by them as a guide to making economic decisions. In addition, the President, Congress, and the Federal Reserve Board use trends in the CPI to aid in formulating fiscal and monetary policies.
- **"As a deflator of other economic series.** The CPI and its components are used to adjust other economic series for price changes and to translate these series into inflation-free dollars. Examples of series adjusted by the CPI include retail sales, hourly and weekly earnings, and components of the National Income and Product Accounts.
- **"The CPI is also used as a deflator of the value of the consumer's dollar to find its purchasing power.** The purchasing power of the consumer's dollar measures the change in the value to the consumer of goods and services that a dollar will buy at different dates. In other words, as prices increase, the purchasing power of the consumer's dollar declines.
- **"As a means of adjusting dollar values.** The CPI is often used to adjust consumers' income payments (for example, Social Security), to adjust income eligibility levels for government assistance, and to automatically provide cost-of-

living wage adjustments to millions of American workers. As a result of statutory action, the CPI affects the income of millions of Americans. Over 50 million Social Security beneficiaries, and military and Federal Civil Service retirees, have cost-of-living adjustments tied to the CPI.

- **"Another example of how dollar values may be adjusted is the use of the CPI to adjust the Federal income tax structure.** These adjustments prevent inflation-induced increases in tax rates. In addition, eligibility criteria for millions of food stamp recipients, and children who eat lunch at school, are affected by changes in the CPI. Many collective bargaining agreements also tie wage increases to the CPI.

- **"Whose buying habits does the CPI reflect?**

"The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers. **The all urban consumer group represents about 93 percent of the total U.S. population.** It is based on the expenditures of almost all residents of urban or metropolitan areas, including professionals, the self-employed, the unemployed, and retired people, as well as urban wage earners and clerical workers. **Not included in the CPI are the spending patterns of people living in rural nonmetropolitan areas, those in farm households, people in the Armed Forces, and those in institutions, such as prisons and mental hospitals.** Consumer inflation for all urban consumers is measured by two indexes, namely, the Consumer Price Index for All Urban Consumers (CPI-U) and the Chained Consumer Price Index for All Urban Consumers (C-CPI-U).

"The Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) is based on the expenditures of households included in the CPI-U definition that also meet two additional requirements: more than one-half of the household's income must come from clerical or wage occupations, and at least one of the household's earners must have been employed for at least 37 weeks during the previous 12 months. The CPI-W population represents about 29 percent of the total U.S. population and is a subset of the CPI-U population.

"The CPI does not necessarily measure your own experience with price change. It is important to understand that BLS bases the market baskets and pricing procedures for the CPI-U and CPI-W populations on the experience of the relevant average household, not of any specific family or individual. For example, if you spend a larger-than-average share of your budget on medical expenses, and medical care costs are increasing more rapidly than the cost of other items in the CPI market basket, your personal rate of inflation may exceed the increase in the CPI. Conversely, if you heat your home with solar energy, and fuel prices are rising more rapidly than other items, you may experience less inflation than the general population does. A national average reflects millions of individual price experiences; it seldom mirrors a particular consumer's experience.

"Additional information on this topic is available in the *Why the Published Averages Don't Always Match an Individual's Inflation Experience* factsheet."

[**SFG: This factsheet is helpful when trying to compare your own spending to the CPI consumer. https://www.bls.gov/cpi/factsheets/averages-and-individual-experiences-differ.htm]**

- **"Is the CPI a cost-of-living index?**

"The CPI frequently is called a cost-of-living index, but it differs in important ways from a complete cost-of-living measure. We use a cost-of-living framework in making practical decisions about questions that arise in constructing the CPI. A cost-of-living index is a conceptual measurement goal, however, and not a straightforward alternative to the CPI.

“A cost-of-living index would measure changes over time in the amount that consumers need to spend to reach a certain utility level or standard of living. Both the CPI and a cost-of-living index would reflect changes in the prices of goods and services, such as food and clothing that are directly purchased in the marketplace; but a complete cost-of-living index would go beyond this role to also take into account changes in other governmental or environmental factors that affect consumers' well-being.”

[**SFG: This includes shrinkflation, where product companies shrink the size of a product like cereal but charge you the same. It also includes quality inflation, which is in your control, where you buy nicer products that have extra perceived value.]**

“It is very difficult to determine the proper treatment of public goods, such as safety and education, and other broad concerns, such as health, water quality, and crime, that would constitute a complete cost-of-living framework. Since the CPI does not attempt to quantify all the factors that affect the cost-of-living, it is sometimes termed a **conditional cost-of-living index**.

“Traditionally, the CPI was considered an upper bound on a cost-of-living index in that the CPI did not reflect the changes in buying or consumption patterns that consumers would make to adjust to relative price changes. The ability to substitute means that the increase in the cost to consumers of maintaining their level of well-being tends to be somewhat less than the increase in the cost of the mix of goods and services they previously purchased.

“Since January 1999, a geometric mean formula has been used to calculate most basic indexes within the CPI; in other words, the prices within most item categories (for example, apples) are averaged with the use of a geometric mean formula. This improvement moves the CPI closer to a cost-of-living measure, because the geometric mean formula allows for a modest amount of consumer substitution as relative prices within item categories change.

“The Chained CPI (C-CPI-U) also allows for substitution across item categories, and is thought by some to be a closer approximation to a cost-of-living index. However, the expenditure data used to compute the final C-CPI-U isn't available until 10-12 months after the reference month, so a preliminary estimate of the index is published and later revised.

“Additional information about the Chained CPI is available on the Chained Consumer Price Index webpage. https://www.bls.gov/cpi/additional-resources/chained-cpi.htm

- **“How are CPI prices collected and reviewed?**

“BLS data collectors visit (in person or on the web) or call thousands of retail stores, service establishments, rental units, and doctors' offices, all over the United States to obtain information on the prices of the thousands of items used to track and measure price changes in the CPI. We record the prices of about 80,000 items each month, representing a scientifically selected sample of the prices paid by consumers for goods and services purchased.

“During each call or visit, the data collector collects price data on a specific good or service that was precisely defined during an earlier visit. If the selected item is no longer available, or if there have been changes in the quality or quantity (for example, a 64-ounce container has been replaced by a 59-ounce container) of the good or service since the last time prices were collected, a new item is selected or the quality change in the current item is recorded.

"Prices used to compute the CPI are collected during the entire month. CPI data is published monthly, with the index value representing an estimate of the price level for the month as a whole, rather than a specific date. Since certain prices, particular gasoline, might move sharply within a month, it is useful to understand the timing of price collection. A month is divided into three pricing periods, each period corresponding to roughly the first 10 days, second 10 days, or third 10 days of the month.

"When an item is initiated into the CPI sample, its pricing period is established, and it will be repriced during that same period until it exits the sample after four years. Data collectors have discretion within pricing periods, so they can collect quotes at any time during the period. So, it's not necessarily true that data collection is spread perfectly evenly through the month; however, roughly equal amounts of data are collected in each pricing period. Rent prices are an exception to this, as prices in the rent sample are not divided by pricing periods, and specific rent quotes can be collected at any time during the month.

"Pricing information is then sent to our national office, where specialists who have detailed knowledge about the particular goods or services review the data. These specialists check the data for accuracy and consistency, and make any necessary corrections or adjustments. Adjustments can range from an adjustment for a change in the size or quantity of a packaged item, to more complex adjustments based upon statistical analysis of the value of an item's features or quality. Thus, commodity specialists strive to prevent changes in the quality of items from affecting the CPI's measurement of price change."

SFG's Take: The CPI (and widely distributed CPI-U) is helpful, but has limitations when it comes to the way a specific person spends money and the impact of inflation on their budget. It is easier than ever for consumers to shift purchasing habits if they want to lower the impact of inflation on their budget, but some items will be higher in price no matter where you shop.

Shrinkflation is a major tool used by companies to avoid stated price increases but nevertheless, increase the cost per unit sold.

As we have mentioned in previous *Chats*, there are many areas of client budgets subject to zero inflation or even deflation. Items purchased frequently that experience above average inflation often make up less than 25% of our client's budgets.

Summary

SFG's three pillars of recovery remain in positive trend territory although COVID-19 scenarios are less certain now, possibly slowing the pace of the economic recovery. Wildcard risks discussed in this and previous *Chats* remain, suggesting some caution despite the stellar upward pace of corporate earnings growth.

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 maintaining good diversification while striving for positive real returns over inflation.

Our COVID-19 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)

COVID-19 PROTOCOL UPDATE

In an effort to comply with recent health guidance, we have reinstituted a mask wearing policy for all in-person meetings and for all visits to our offices.
We request that you wear a mask, be fully vaccinated and exhibit no signs of illness in order to meet in person. We understand that these efforts, while intended to protect the health of our clients and staff, can be onerous.
If you prefer, we are happy to schedule a Zoom call.
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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