2ND QUARTER 2021 UPDATE

July 14, 2021

There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know….(it) is the latter category that tend to be the difficult ones.

Donald Rumsfeld

So far, the year 2021 has been full of surprises, many of them positive. The most obvious has been the rapid development of effective COVID-19 vaccines and their wide acceptance by the American public. Tied for second place is our rapidly rebounding economy and a stock market that has been responding enthusiastically to that growth. Closely following in third place is a booming residential real estate market. The negative side of this is a host of stories of young couples being outbid multiple times on homes they had hoped to purchase and where they planned to embark on a career and start a family.

Another development, encouraging to us at Peak but not surprising, is the long-awaited ascendance of so-called value stocks, a category of companies we have long followed and invested in that have until recently been ignored in favor of rapidly growing asset-light tech and internet businesses. Financial and energy-related companies compose part of the value segment, along with cyclical ones such as the producers of automobiles and machinery.

With the surprises of the recent past in the rear-view mirror, investors are faced with the task of forecasting what the future "unknown unknowns" will be, to quote the late Donald Rumsfeld. An article in the Wall Street Journal highlighted a recent survey of individual investors, saying they expect to earn 17.3% this year after inflation, and 17.5% annually over the long run, also after inflation. If that actually happens it will be more than twice the annual 7.1% return after inflation on U.S. stocks since 1926. Clearly, this is more a dream than a rational forecast.

So what might the next few years look like? At the current inflation rate of 5%, a look at the lessons of the past would be helpful. Those of us who were young adults in the 1970s and early '80s remember "stagflation": a time characterized by four recessions, steadily increasing inflation as high as 9% annually, such that even the most sophisticated investors lamented a permanent loss of purchasing power of the dollar, and an S&P 500 Index that seesawed dramatically but went nowhere for 12 years. In 1979 Paul Volcker became Chairman of the Federal Reserve. To combat inflation and restrain the money supply, under his leadership the Fed raised rates on Treasury Notes as high as 16%, and the Prime Rate shot up to 21%. By taking the punch bowl away while the inflation party was still going strong Volcker succeeded in tamping down imbedded expectations that prices would continue to rise forever. He also cemented his place in history as a legendarily effective Fed Chairman. And he endeared himself to an entire generation of people who had the nerve and foresight early in his tenure to buy blue chip stocks at bargain prices and invest in long term U.S. Treasury Bond ladders at deep discounts.

If our current inflation rate, which has risen in the past five months from 1.4% to 5%, continues to escalate, current Federal Reserve Chair Jerome Powell will have to make some difficult decisions, just as Paul Volcker did. Fortunately, the available evidence suggests that the recent rise is temporary, due to the economy rapidly rebounding from COVID-19. Demand for goods is exceeding the rush for supplies and factories and shipping firms are often short-staffed and unable to return quickly to their previous capacity.

It must be stressed that our present time is far different from the ‘70s: stocks have risen for over a decade and are fully valued or even overvalued and bond yields have fallen steadily to almost nothing since the early ‘80s. The stakes are high for those of us who are fortunate enough to own homes and have low basis stock portfolios. Many would welcome a return to a world in which they can rely on Treasury Bond ladders for their retirement income. But how would we get there and at what cost?

Perhaps the solution would be a Lost Decade of low inflation, subpar investment returns and stagnant house prices, allowing corporate earnings to catch up to their stock valuations and letting first-time home buyers pay a reasonable multiple of their annual income for the home of their dreams. That would take the pressure off Jerome Powell and his Federal Open Market Committee and not necessitate the tough love approach Paul Volcker was forced into.

In the meantime, we continue our commitment to owning top-quality companies bought at reasonable prices and have maintained comfortable cash and short-term bond cushions to guide us and our clients through the inevitable fluctuations of the next few years. We appreciate the trust you have placed in us and will continue to work hard to earn it. Please consider passing our contact information to anyone you know who needs help in building and maintaining financial security. We are happy to share our perspective with them and to explore if there would be a good fit for working together.

Best regards,

Noel F. Bennett