Wentz Weekly

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Stocks Hit A Wall of Worries

Stocks have hit a wall of worries – issues that have been building over the last several weeks. The first is in regard to the Fed and the latest FOMC meeting. The 'dot plot' indicated the first interest rate increase will happen in 2022, up from the prior expectation of 2023. This is pulling forward the market's expectations with yields rising across the curve. The rising yields has also resulted in the outperformance of areas such as small caps and value stocks, in particular cyclicals. Also relating to the Fed, last week Elizabeth Warren called Fed Chairman Powell, whose term is up in February, a "dangerous man" and does not support him for renomination. Powell has been more dovish as Fed Chair and has emphasized transparency, which the market appreciates. Markets do not like uncertainty and took these comments as a lower probability Powell will get renominated for another term by President Biden.

Staying on the topic of politics, Congress is working on two massive spending bills – a $1 trillion infrastructure spending bill and a $3.5 trillion reconciliation bill that includes spending on social issues which is partially offset by tax increases on corporates and individuals. The $1 trillion bill is ready for a vote on the House floor, until Biden asked the House to hold the vote until the Senate passes the $3.5 trillion reconciliation bill. The Senate is split 50-50 between Republicans and Democrats, but one Democrat, Joe Manchin from West Virginia, has reiterated he will not support a spending bill with that large of a price tag. We believe the total cost of the reconciliation bill will need to come down closer to $2 trillion before gathering enough support. Congress is also being challenged with a U.S. debt ceiling that needs suspended or raised. Treasury Secretary Janet Yellen said the government will exhaust all of its measures by October 18, at which point it will not be able to make interest payments on its debt and default. This would be a massive market moving event as investors view US debt as the risk-free asset.

Last but not least is the ongoing supply chain issues and labor shortages that is leading to higher inflationary pressures. A list of companies have made comments and even cut or forgone forecasts for the just-ended third quarter because of these issues. FedEx cut its forecast because higher labor costs and network inefficiencies due to inadequate staffing, reducing results by $320 million, memory chip maker Micron said its PC customers reduced demand because they cannot finish PC builds due to a shortage of other components, and Sherwin Williams lowered its forecast for the second time this month citing worsening raw material availability and higher input prices. At the end of the day stocks are driven by company profits and if company's profits are cut because of tax increases in the reconciliation bill, or higher costs from inflation or supply chain issues, investors are going to react. We believe the upcoming third quarter earnings season will reveal the extent of these issues, possibly leading to a pause in stock's 2021 rally. Growth forecasts have been reduced for 2021 to account for these supply chain issues, but at this point we believe growth will not be lost forever but postponed into future months with 2022 growth revised higher as a result. For that reason, we still favor U.S. equities right now, especially small caps and value stocks.

The monthly S&P Case-Shiller home price index reported last week that home prices in the U.S. are 19.7% higher in July compared to the same month a year ago, the highest year-over-year pace since data began in 1987 by S&P. The gain marks the fourth consecutive month of record y/y gains and the 14th consecutive month of accelerating home prices, following a 18.7% gain in June and 16.9% gain in May. It is not only the level of price gains, but also the consistency across all regions of the country. Phoenix led all cities with the average home price up 32.4% from a year ago while several Midwest cities see the lowest increase, including Chicago and Minneapolis at 13.3% and 14.5%, respectively. Cleveland sits in the middle with a 16.2% increase in home prices. Home prices in 19 out of the 20 cities the index tracks now stand at all-time highs, with Chicago only 0.3% below its 2006 peak. The strength in the U.S. housing market and home prices is being driven in part by the Covid pandemic – buyers are moving from urban places to suburban homes. In addition, record low interest rates and record high stimulus is helping drive home buying.

The monthly update on personal income and spending shows the trend continues with income increasing another 0.2% in August, as expected, driven by a 0.5% increase in wages and salaries. Through the first half of the year, income surged as Americans received stimulus and Child Tax Credit payments, combined with higher wages, particularly in the lower income tier. Spending picked up in the month with consumers spending 0.8% more in August compared to July. This was well above expectations with the gain being split between spending on goods and services. Spending on goods was held down more from lower vehicle purchases because of the shortages but offset from strong spending in other areas like apparel. Services increased as well, following the trend as the economy continues its reopening and vaccination rates increase. The savings rate moved lower because of higher spending but approaching a more normal level. The savings rate was 9.4% in August, down from 10.1% in July and a 2021 high of 26.6% in March.

Company News

- General Motors said its third quarter sales dropped 49% to 446,997 vehicles, a much larger drop than the 31.5% decline expected. Sales of new vehicles are being significantly impacted from a semiconductor shortage. The company also said going into the fourth quarter, "a steady flow of vehicles held at plants will continue to be released to dealers."
- For the second time in a month, Sherwin-Williams said its third quarter and full year earnings forecast will be lower than previously expected, citing worsening raw material availability constraints and higher input costs. It also no longer expects to see improved supply or lower raw material pricing as previously thought.
- Memory chip maker Micron reported its quarterly results that were much better than expected. However the current quarter forecast was revised lower due to lower chip purchases form PC makers due to shortages PC makers are facing with non-memory components that are needed to complete PC builds.

The Week Ahead

The economic and earning calendar are light again this week, but politics is expected to stay in the headlines. Congress has extended government funding to December but need to focus now on raising or suspending the debt ceiling or risking default. At the same time, two major spending bills are working through Congress, but more negotiating needs done on the reconciliation bill. The notable event on the economic calendar for the week is the DOL's employment report on Friday where the consensus sees between 400k-500k new jobs added in September. Outside of that, on Tuesday trade data is released and economists are expecting the trade deficit to have widened again in August to $70.7 billion, on Wednesday ADP releases its payroll figures where 425k new payrolls are expected in September, and on Thursday we will see the latest on unemployment claims. The earnings calendar has several notable earnings releases including PepsiCo on Tuesday, Constellation Brands and Levi Strauss on Wednesday, and Conagra Brands on Thursday. Investors will also be focused on several analyst events including an investor day event from Marvell Technology and VMware and Tesla's annual shareholder meeting.