MARKET AND ECONOMIC REVIEW & OUTLOOK

AN UPDATE FROM THE ADVISORS AT GASKIN ASSET MANAGEMENT *CHARLOTTE, NORTH CAROLINA*

The following letter was written for you by the undersigned. The opinions expressed are those of your advisors at Gaskin Asset Management and do not necessarily reflect the opinions of Raymond James or its affiliates. We know this is a long letter, but we hope you will invest five minutes in reading it. Thank you.

EMPLOYMENT, INFLATION & THE MONEY SUPPLY

As I write this letter to you, one of my daughters and her husband are waiting for a flight home from Houston. Their flight has been delayed and rescheduled twice since this morning. Simultaneously, another son-in-law at a different airport had his flight cancelled but it now looks like he might manage to find a seat on the last flight out for tonight. The culprit? Well, it is summertime, so you might expect thunderstorms are to blame. Alas, it turns out the skies are quite clear. The airlines were quick to place the blame on personnel shortages. Maybe you have had a similar experience recently. Whether it's the limited hours or shorter menu at your favorite restaurant or possibly the lightly stocked shelves at your local retail establishment, you have likely experienced the ongoing supply/demand imbalances brought about by the pandemic, the shutdown and resulting economic contraction from last year.

A recent article by Lisa Beilfuss of *Barron's* highlights a challenge experienced by business owners, managers, and patrons across the nation over the last several months – labor shortages.[i] Fadi Achour is the general manager for Delta Hotels in suburban Detroit. He is currently operating with less than half his pre-pandemic staff which means that services for guests have been cut or eliminated along with two-thirds of his available rooms. If you have visited a restaurant, hotel or practically any retail establishment in the last few months, you likely noticed less staff, reduced hours of operation, shortened menus or other noticeable efforts by management to keep the business running efficiently with fewer employees. Human resources shortages are but one of many issues facing businesses today along with supply shortages and increased shipping costs.

At only two (2) months in length, the recession of last year was the shortest and possibly oddest contraction in U.S. economic history.[ii] A recession is normally defined as a period of economic contraction lasting two or more quarters. In the case of the pandemic recession of 2020, U.S. economic activity only declined for two months but due to the depth of the decline at negative 31.4%, the National Bureau of Economic Research (NBER) identified the period as a recession.

INFLATION

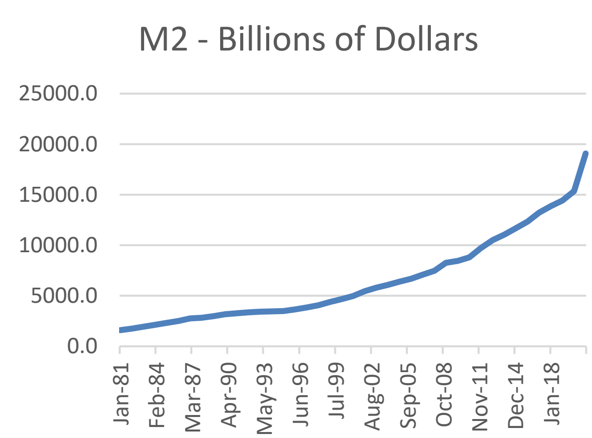
It is not unusual to experience short periods of inflation when the economy recovers from a recession. Federal Open Market Committee (FOMC) Chairman Jerome Powell has repeatedly stated that the current inflation is "transitory" and expected to moderate in the coming months. With the economy still recovering and the expectation that inflationary pressures will moderate, the FOMC ("Fed") continues to resist calls to begin raising short-term rates. According to Nick Temiraos in *The Wall Street Journal.*, Powell has indicated that the economy "is still a ways off" from reaching the standard of full employment.[iii] However, the "full employment" goal could be a difficult target this time around in our judgment. There are many potential reasons why airlines are cancelling flights and restaurants are cutting hours. This letter is too short to fully evaluate the many reasons. However, we found an interesting outlook from Randall Forsyth in a recent issue of *Barron's*. [iv] Forsyth notes that while there were 9.5 million unemployed in June, there were more than 9.2 million job openings available. How can this be? What's going on? Lack of affordable childcare, persistent fear of Covid-19 and increased jobless benefits are a few of the reasons given for the disparity. It's also interesting to note that many workers are reconsidering the work-life balance question while others are pushing employers for more flexible schedules and more pay. We like to look at the numbers so here's an interesting figure. Forsyth notes a 15.66% increase in the "reservation wage". Never heard of it? The reservation wage is the minimum paycheck a worker would accept for a new position according to labor economists. An increase of nearly 16% in this wage would seemingly increase inflationary pressures since wages generally do not decline once raised. Employers cannot cut wages in the future as easily or quickly as we might see changes in oil prices, for instance. So, while Powell refers to the inflationary pressures as transitory, wage inflation tends to be more lasting in our judgment.

U.S. MONEY SUPPLY

Do you remember the last time you were stuck in bumper-to-bumper traffic on the interstate? It seems that I'm always in a hurry or running late when I get stuck in traffic. I usually go through a quick mental evolution from selfish frustration at my delay to concern for the poor souls who may have suffered the accident which resulted in the clogged interstate highway. Sound familiar? Well, you may also remember how you felt after waiting an hour plus for traffic to clear only to see no evidence of a wrecked or stalled vehicle. What happened? Once disrupted, busy interstates and roadways require time to return to normal patterns. Traffic can remain jammed long after the accident or construction has cleared. Not unlike interstate highways, the economic shutdown of last year threw virtually every company into a new "traffic pattern". In fact, many companies are still struggling to adjust to the new pattern while some are attempting to return to the old pattern while encountering new difficulties such as the Covid-19 Delta variant. As stated earlier, it is the Fed chairman's opinion that most of the inflationary pressures impacting the economy are related to supply issues and will be self-correcting once we have recovered from the pandemic.

We remain hopeful that Chairman Powell is correct, and inflation slows and returns to the long-term 2% FOMC goal in the coming months as the economy returns to "normal". However, we have one concern that remains beyond the recovery – the U.S. money supply. Money supply is measured in terms of M1 and M2. M1 is limited to cash and checking accounts. While M2 includes M1 (cash & checking accounts) plus savings deposits, money market securities, and other time deposits.[v] Put simply, M2 is the money that is either in the hands of individuals or readily accessible. This is money that can be easily spent on good and services, if desired. Therefore, monitoring the money supply (M2) is vitally important when considering inflation risks. After all, money supply represents available money to purchase limited goods and services. So, if the supply of used cars that are available is restricted, for instance, but the supply of money to purchase those cars has increased, the price of available cars will naturally rise as more dollars chase after limited used cars. This applies to all goods and services and represents inflation.

We decided to do a little study of M2 going back to 1980 when inflation and interest rates were much higher than they are today. This information is available through the Federal Reserve Economic Data (FRED) website.[vi] We found that M2 has increased each calendar year since 1980 by an average of approximately 6.1%. During that same timeframe, the Consumer Price Inflation (CPI) rate (inflation) has increased annually by a rate of 2.91%.[vii] There were five (5) years during that timeframe wherein M2 increased by about 10% on an annualized basis. In most cases it was in response to economic contractions. Remember, however, that the Covid-19 contraction, while deep, only lasted two (2) months. So, how did the Fed respond? It stimulated the economy by increasing the money supply by nearly 32% since the beginning of the



Source: Federal Reserve Bank of St. Louis

Covid-19 pandemic. We have not seen an increase in the money supply at this rate since WWII.

With such a dramatic increase in the money supply over the last year, we believe it is likely that inflation will not be transitory but lasting. We believe this is reason for concern but not yet alarm at this point. We believe it is likely that inflation will need to increase at a higher rate than we have seen in recent years for the M2 money supply to reach equilibrium in the U.S. economy. However, there are moderating factors such as increased supplies of goods and services as supply imbalance gaps close which should have a dampening effect on inflation pressures. As stated earlier, this is the Fed's current position.

INTEREST RATES

If you have recently visited your local bank branch to refinance a mortgage or to make a deposit, you may have noticed that inflation has not yet reached the finance markets. Rates on both the credit and debit sides of the ledger remain near their historical lows. I recently spoke with an old friend in the mortgage business. He's been working 14-hour days seven days a week and personally closed 57 mortgages just last month. We believe the inevitable increase in interest rates driven by increasing inflation will likely allow my friend to spend the weekends with his family while simultaneously making depositors happy to see increased earnings on their deposits. Bond holders, however, might be a little less enthusiastic as rates rise.

In his February letter to shareholders of Berkshire Hathaway Inc., Warren Buffet commented on interest rates and specifically the 10-year U.S. Treasury bond which had fallen 94% from its high of 15.8% in September of 1981 to 0.93% at yearend 2020.[viii] As of this writing, it hovers around 1.23%[ix]. While not known as a fan of fixed-income (bond) investing, Buffet commented that "Fixed-income investors worldwide – whether in pension funds, insurance companies or retirees – face a bleak future." Bleak may be a bit harsh in describing all bond investments for the foreseeable future in our judgement. However, we believe bond yields and prices which respond to inflationary pressures could be impacted in ways we have not seen for quite some time. As noted in the chart below, bond yields have been in a general decline since Ronald Reagan was President of the United States and China ranked 8th in global Gross Domestic Product (GDP)[x]. The U.S. still holds first place, but China is now a close second. The global economy has changed. As evidence of current inflationary trends, the U.S. consumer-price index rose 5.4% in June from a year ago which was the highest growth rate since 2008 with the prices of cars and trucks rising 10.5%.[xi] Of course, some of this rise in prices is due to the severe contraction of one year ago. According to Gynn Guiford of *The Wall Street Journal.*, much but not all the increase in vehicle prices can be explained by semiconductor chip shortages.[xii]

Relationship Between Bond Prices and Yields*
When Yields Increase, Bond Prices Decrease

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INVESTMENT MARKETS

We have established why we believe inflation to be an important concern for investors going forward. However, the solution to inflation concerns is not to simply "get out of the market" and "head for the hills". After all, inflation represents a weakening of the purchasing power of a dollar in the future. If we believe dollars will hold less purchasing power in the months and years to come, then earning more investment return with those dollars becomes an even greater necessity in our judgment. And while the bond market has provided a nice buffer to equity investments for the last 20+ years, we believe bond returns may prove even more difficult to achieve as Buffet noted in his annual letter. So, herein lies the rub.

Stock valuations can be driven temporarily by hype, fear, greed, and everything in-between. We've seen all those factors impacting individual stocks and the market over the last year. Ultimately, however, stock prices are sustained long-term by corporate earnings. According to Karen Langley of *The Wall Street Journal*., analysts are now projecting that "earnings from companies in the S&P 500** grew 90% in the second quarter from a year earlier".[xiii] Earnings look quite strong when compared to last year. However, at an average price-to-earnings ratio (P/E) of 21 when compared to a five-year average of 18.5, stocks may be getting expensive. So, this too is a concern.

BOTTOM LINE

Stocks are getting expensive. Bonds are past due for a correction. Cash is paying almost nothing. What are we to do? Tread carefully. Stay short-term with bond holdings. Stick with the stock investment basics while also seeking unique opportunities. We believe that the intrinsic value of underlying securities should always be in the forefront of investment decisions. Bull markets, however, tend to reward the good along with the not-so-good stocks while corrections have the healthy effect of separating the wheat from the chaff. We do not know when the next correction will come so we remain confident and disciplined in our strategies for stocks, bonds, and cash.

Allow me to close with another reflection from Warren Buffet's comments in his annual letter to shareholders. He struck an upbeat tone with virtually no mention of the pandemic which defined 2020 and continues to influence virtually every financial and social issue today. With his unique perspective from 90 years of life and 56 years at the helm of Berkshire Hathaway, Buffet chose to acknowledge the challenges which face the United States while highlighting the opportunities. Buffet stated, "In its brief 232 years of existence, however, there has been no incubator for unleashing human potential like America … We retain our constitutional aspiration of becoming 'a more perfect union.' Progress on that front has been slow, uneven and often discouraging. We have, however, moved forward and will continue to do so. Our unwavering conclusion: *Never* bet against America."[xiv] While not unique to him, Buffet's view is likely shared by many, if not most, Americans and so many others who sometimes risk life and limb to seek refuge and opportunity here.

We remain hopeful that the pandemic will recede in the coming months. We wish you continued safety and good health in the days to come. Thank you for your continued faith and confidence.

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[ii] https://www.cnbc.com/2021/07/19/its-official-the-covid-recession-lasted-just-two-months-the-shortest-in-us-history.html
[iii] Timiraos, Nick, "Powell Expects Inflation to Moderate, but Will Likely Remain Elevated This Year", The Wall Street Journal., July 15, 2021, p. A1
[iv] Forsyth, Randall, "Beware! Stocks Enter The Most Dangerous Stretch of the Year", Barron's, August 2, 2021, pp.6-8.
[v] https://www.investopedia.com/terms/m/m2.asp
[vi] https://fred.stlouisfed.org
[vii] https://www.minneapolisfed.org/about-us/monetary-policy/inflation-calculator/consumer-price-index-1913-
[viii] Buffet, Warren, "Berkshire Hathaway Inc. 2020 Annual Report", February 27, 2021, p.5
[ix] https://www.cnbc.com/quotes/US10Y, CNBC July 29, 2021
[x] https://countryeconomy.com/gdp
[xi] https://www.bls.gov/news.release/pdf/cpi.pdf
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[xiii] Langley, Karen, "Record Pace for Corporate Earnings Keeps Stocks Buoyant", The Wall Street Journal., Aug. 9, 2021, p.B1
[xiv] Buffet, Warren, "Berkshire Hathaway Inc. 2020 Annual Report", February 27, 2021, p.10