Argent Capital Management LLC

Market Overview – May 2021

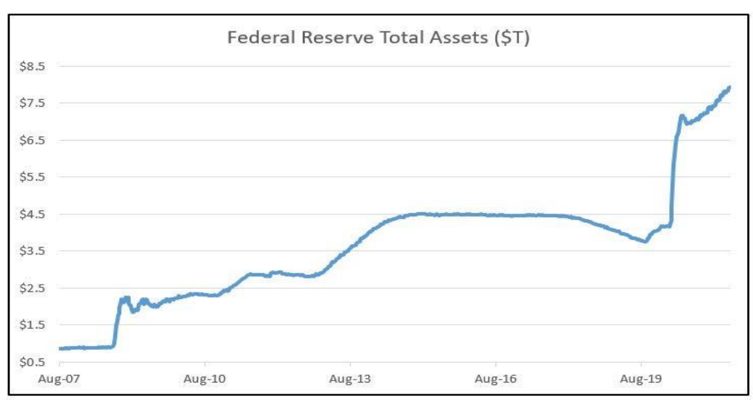
The good news is that the economy is improving. The bad news is….the economy is improving? One of the issues the market is wrestling with is the impact of reopening on the economy and what the Federal Reserve may or may not do as a result. Below are a few headlines I thought might shed light on what is happening.

National Association of Homebuilders - 4/29/21
Lumber prices have indeed spiked… Prices rose by more than 250% in the last year, according to Business Insider. The National Association of Homebuilders said the increases added more than $24,000 to the price of the average single-family home.
CNN - 5/6/21
After bottoming out around $460 last year, U.S. benchmark hot-rolled coil steel prices are now sitting at around $1,500 a ton, a record high that is nearly triple the 20-year average.
The Conference Board - 5/7/21
The Conference Board forecasts that U.S. Real GDP growth will rise to 8.6 percent (annualized rate) in Q2 2021 and 6.4 percent (year-over-year) in 2021. Following solid economic growth in Q1 2021 we anticipate further acceleration in growth in Q2 2021 and Q3 2021. The primary driver of this rapid expansion will be a surge in consumer spending as the economy fully reopens.

During the COVID-driven recession, businesses stopped ordering. They were not selling anything – the definition of a recession – so they stopped buying. Inventories were drawn down to very low levels. Using good logic, investors applauded these efforts. Businesses were hoarding cash, a good thing during a recession. Now the tide has turned, and the problem confronting businesses today, and also the economy as a whole, is that we are coming out of the COVID-driven recession as quickly as we went into it. Not surprisingly, consumers want their stuff - NOW!

With demand spiking and supplies very lean, shortages are cropping up all over. Basic economics says when demand rises, resulting in shortages, prices increase. So, while investors are happy to embrace the recovery, they are increasingly worried about the higher prices that seem to be tied to that recovery. At the center of the debate is what does the Federal Reserve think about this bout of inflation and what will it do?

So far, the Fed has maintained that higher prices are a function of the recovery and lean inventories. Once inventories are replenished, once folks get back to work, once the gears of the economy are greased and running smoothly, inflation will fall. In other words, according to the Federal Reserve, this is a *transitory (i.e. short term)* spike in prices. Why all the fuss now? One of the drivers of the recovery is very low interest rates. Low rates make borrowing cheap, allowing consumers to take out affordable mortgages to buy new homes. Low rates make business expansion less expensive, so companies can increase capital spending to grow. Low interest rates have been one of the drivers of our recovery. And, the Fed controls interest rates.



This is what the Fed has been doing to keep interest rates low and help pull the U.S. economy out of recession. The chart to the right illustrates the Fed's balance sheet. As you can see, it has grown, some might say 'mushroomed' during the pandemic to over $8T. Investors are worried that if the Fed determines inflation is other than temporary it will react. Each month the Fed is in the market, buying $80B of U.S. Treasury bonds and $40B of mortgage-backed securities. Those purchases are one of the reasons interest rates are so low. With the Fed as a huge buyer of bonds, there is a lot of demand. Lots of demand allows the seller of bonds to keep interest rates low. (If there were less demand sellers would need to raise rates to attract interest from buyers.) The concern for investors is that, if the Fed decides inflation may be other than ‘temporary,’ it may back off from its bond purchases.

As mentioned, if the Fed decreases its bond buying, demand for bonds will fall and interest rates will likely rise. That is why investors are watching current inflation rates very closely and watching any and all indications of a shift in policy from the Federal Reserve. Stay tuned.

We are open for business and welcome your interest in Argent Capital. In addition, if you like our market letters, we hope you will pass them on to friends. We have four very successful equity strategies–Large Cap U.S., Small Cap U.S., Dividend Select and Mid Cap U.S.

Sincerely,

Ken Crawford

Ken Crawford, Senior Portfolio Manager