Despite Rate and Inflation Concerns, Market Continues Higher

After stumbling through most of June, stocks are generally up with many indices posting new highs towards the end of the month. In the middle of June, equity markets suffered their worst weekly performances since January as traders digested Federal Reserve statements that appeared to suggest increases to interest rates as early as late 2023.

Yet, as has been typical over the past five years, the market ultimately tossed these concerns aside and powered forward after its poor week. Many investors expect that the market could continue up given the low bond yields and strong monetary support for the economy. Still, there are concerns that the market's rise is slowing and could even pull back a bit over the slower summer months.

As we moved through second quarter, inflation has arisen as a potential threat to markets. Over the past three months through May, consumer prices, excluding volatile food and energy, have risen 2%, equivalent to a shockingly high annual rate of 8.2%. This measure, referred to as the core-price index, jumped 3.8% in May from the year before – the largest increase for that reading since June 1992. May consumer prices were up 5.4% – the biggest increase since 2008 according

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the Labor Department.

In addition, the world has not seen such across-the-board commodity price increases since the beginning of the global financial crisis of 2008, and before that, in the 1970s. Lumber, iron ore, and copper have hit records disrupting the building industry among other areas. Corn, soybeans, and wheat have jumped to their highest levels in eight years. Even oil recently reached a two-year high. The run-up in commodity prices is casting a cloud over the global economic recovery, hitting vulnerable businesses and households.

Housing costs are up sharply as well. The S&P CoreLogic Case-Shiller National Home Price Index, which measures average home prices in major metropolitan areas across the nation, rose 14.6% in the year that ended in April, up from a 13.3% annual rate the prior month. April marked the highest annual rate of price growth since the index began in 1987. The median existing-home sales price in May rose almost 24% from a year earlier, topping $350,000 for the first time according to the National Association of Realtors. A separate measure of home-price growth by the Federal Housing Finance Agency also released Tuesday found a 15.7% increase in home prices in April from a year earlier, a record in data going back to 1991.

The combination of various sharp price increases has increased fears that inflation could become more persistent.

In reacting to inflation concerns, Fed Chairman Jerome Powell said it is highly unlikely that inflation will rise to sustained high levels. Still, he also openly acknowledged significant uncertainty as the economy reopens. He went on to stress his view that shortages – including of used cars, computer chips and workers

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– will fade over time, bringing inflation closer to the Fed's 2% long-run target. When Mr. Powell was asked if the spending of Congress and the Fed printing money were taking us back to the high inflation of the 1970s, he replied that it was "very, very unlikely," in part because the central bank "is strongly prepared to use its tools to keep us around 2% inflation."

In addition, commodities play much smaller roles in final production as businesses become more efficient, according to research by economists at the Federal Reserve Bank of New York. The U.S. roughly tripled its economic output per kilogram of oil consumed between 1990 and 2015, according to the World Bank.

After equity markets were originally rattled by inflation fears, they eventually shrugged these concerns off to continue ever higher. At the same time, investors mostly piled into Treasuries leaving little margin for error around forecasts. Investors pushed 10-year yields back down to late February levels and five-year rates declined to just 2.23% implying inflation rates slightly below Fed targets. It seems that confidence in the central bank remains unquestioned, at least for now.

Further bolstering the Fed's position on the recovering economy, the jobs market continues to recover strongly. U.S. employers added 559,000 jobs in May and the unemployment rate fell to 5.8%. The jobs gains came despite employers' difficulty with filling many jobs, particularly in states that are extending generous unemployment benefits through September.

Against all this news outlining an ongoing recovery, there could be a dot-com bust occurring right now. A drop in prices that looks remarkably similar to the dot-com plunge in 2000 is happening in clean-energy, electric cars, cannabis stocks, and SPACs.

The late-1999 fear of missing out (FOMO) on internet stocks inflated the Nasdaq Composite 83% from the end of September to its March 2000 top. From September last year to this year's highs, Invesco's solar exchange-traded fund jumped 88%, Blackrock's global clean energy ETF jumped 81%, and Ark innovation ETF was up 70% (through mid-June).

Yet, despite today's S&P's values trading at 21.6 times forward earnings (JP Morgan, July 28th) against 22.6 times in June 2000, the highly valued sectors of today's markets are dramatically smaller than they were during the top of the market in 2000. Nasdaq's bubble gave it a value of about half that of the S&P at its 2000 peak, while despite having Tesla, today's frothy sectors are a fraction of that value.

Still, this market remains expensive. Much of the current pricing seems to result from FOMO, like in late 1999, or TINA (there is nothing else). When the Fed takes its foot off the gas, we could quickly see the market correct or plunge. But for now, most investors seem fairly confident with future Fed actions, leaving them comfortable supporting current valuations. Every minor pullback attracts enough new money to act as support. The next six months should be more telling as the economy begins to fully reopen and people return to more normal lifestyles. The market may not be seriously tested again until the Fed starts raising rates.