# Market Keeps Powering Up with Fed's Support

Various equity markets notched new highs throughout August, and the S&P 500 and the Nasdaq Composite reached record closes late in the month. Recent investor optimism was helped by comments from Federal Reserve Chairman Jerome Powell. In his August 27th speech, he focused on explaining his confidence in the temporary nature of currently high inflation. Despite some slowdowns from the COVID delta virus, disrupted supply chains, wide-spread shortages and a rebound in travel have pushed inflation to its highest readings in decades, and producers across industries are grappling with ongoing challenges with securing goods and people.

Markets continue to trade at rich valuations, although most markets have pulled back slightly from valuation highs as earnings levels have been released. Still, equity markets are trading at levels reminiscent of the highs of 1999.

Against the rich valuation backdrop, billionaire bond investor Jeffrey Gundlach, founder and CEO of $137 billion DoubleLine Capital, says that as long as the Federal Reserve's stimulus continues, "The stock market can stay in very overvalued territory." He said that "(as) overvalued as stocks are relative to historical measures—like the price-to-earnings ratio, or Dr. Shiller's CAPE ratio, or price-to-book and all that sort of

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stuff—as overvalued as they look by historical measures, they still are cheaper than bonds, treasury bonds. And that's one of the things bolstering the U.S. stock market in addition to the stimulus and the economy." The yield on the 10-year Treasury was trading at a paltry 1.304% on Monday, August 30th.

Good news from many areas of the economy—despite recent COVID concerns—is powering the market forward. The U.S. housing market remained strong in July, with sales of previously owned homes rising at a faster pace than in June. High prices provided motivation to many owners to put their properties up for sale helping to push sales up 2% during the month. July sales were up 1.5% from a year earlier according to the National Association of Realtors (NAR) after an increase of 1.6% in June.

Prices have also reacted with house prices soaring across essentially all markets including big cities, suburbs, and small towns. In 94% of the 183 metro areas tracked by NAR, single-family existing-home prices rose more than 10% in the second quarter compared with a year earlier. Still, as we are exiting COVID, markets appear to be calming a bit as prices of higher-priced homes are easing somewhat as inventory builds. Competition for lower-priced homes remains fierce, however, with many first-time buyers facing sharply higher prices.

Retail sales also showed strength. Although spending at U.S. retailers fell in July amid surging COVID cases and a shift toward more consumption of services continued, overall retail spending was strong with sales well above pre-pandemic levels. July sales were 17.5% higher than February 2020, the last month of full sales prior to the pandemic shutdowns. U.S. Manufacturing output—the biggest component of industrial production—jumped by 1.4% in July compared with the previous month, driven by a sharp 11.2% gain in motor vehicle and parts production. This sales increase occurred despite

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the chip shortage which acted as a drag on production.

Reflecting rising demand seemingly everywhere, available U.S jobs reached another record high at the end of June, pushing openings above the number of unemployed Americans seeking work, signaling an unusually tight labor market. Unfilled job openings reached a seasonally adjusted 10.1 million in June, the highest level since record-keeping began in 2000, according to the Labor Department. The increase was driven by rising demand across nearly every employment sector. The report also showed the rate at which workers quit their jobs, a proxy for confidence in the labor market, rose in June to just below the record high touched in April.

Not surprisingly given the increased economic activity, inflation has become a growing topic of interest. While the Federal Reserve originally said inflation would only be with us a short time, and now claims that it will end soon, cost increases are becoming a more normal part of life. In July, the economy continued to rebound amid pandemic-related shortages of labor and supplies, and the Labor Department reported its consumer-price index was up 5.4% in July from a year earlier. This rate matched June's increase and results in the highest rate of increase since 2008. Bank of America reported that mentions of inflation on corporate earnings calls are setting new records, up 900% over the past year. Markets are watching the Fed's moves to see if their policies will continue to prop up unusually high demand and provide continued fuel for future price increases. The Fed's August 27th conference seemed to signal the Fed is not pulling back on any of its stimulus in the near future despite lingering internal differences over when exactly to pull back support for an economy growing more rapidly than projected earlier this year.

While the Fed's position may support the current equity market valuations, Bank of America departed from the positive path banks usually tread to issue a gloomy warning about stocks. The bank reported that record high prices and placid volatility are signs of a looming big correction. More specifically, the bank says that the equity market is underpricing the risk of a Fed policy change, and that when it comes, the correction will hit like a hammer. They even gave a name to these bouts of volatility/correction: "fragility shocks".

According to the bank, "We believe the US equity market is underpricing the risks of a looming tapering cycle. After all, the equity market has feasted on record monetary support post-COVID, and the Fed's outlook remains impaired by the extreme uncertainty in the macro forecasts on which they base their decisions." Bank of America becomes only the latest of many to predict a coming crash. One of these days, the doomsayers may be right, but for now, equity markets just keep setting new highs.

Against the increasingly common calls for a coming market correction, however, investors may be wise to assess their current holdings. Valuations remain high, and the primary reason investors are pushing stocks higher is the lack of alternatives. But, if the Fed removes the punchbowl, or even hints at a "last call", a rush to the exits could create challenges.