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Market Commentary

Wildermuth WEALTH

Fed Tapering and Omicron Rattle Markets

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During the last few days of November, the market suffered a couple of strong daily declines to take some of the shine off its continued runup to new heights. Investors are nervous about the new COVID-19 variant, Omicron, which drove down markets on a thin day of trading the Friday after Thanksgiving. Losses on Tuesday, November 30th, were worsened by comments from Federal Reserve Chairman Jerome Powell saying that risks of higher inflation have risen making it now appropriate for the central bank to consider wrapping up asset purchases more quickly in preparation for raising interest rates.

Omicron has garnered much of the recent press, however it will likely be less important over the longer term as early reports suggest that it is fairly mild, or at least no worse than existing variants. Probably the bigger news was the Fed's signaling that they are finally ready to consider pulling back their support.

Criticism of the Fed's incredibly accommodative policies is certainly growing. Former Treasury Secretary Lawrence Summers recently said he sees no more than a 15% chance that "it's all going to work out well" for the U.S. economy, with the probabilities much greater for either stubbornly high inflation or a slump in growth.

Increasing evidence suggests that inflationary pressures are broadening out which further supports the argument that inflation will remain elevated for much longer than Fed officials expect.

The explosion in federal spending is the primary driving force behind surging inflation as Congress and the Fed sought to help citizens cope with the pandemic disruptions through turning on the taps. Total federal outlays skyrocketed by 47% in 2020 and 54% in 2021. This spending created a 35% surge in personal government transfers, some 4.2 times the postwar average. Americans hold an amazing $4.7 trillion in their checking accounts, more than three times their pre-pandemic holdings. Much of this has ended up in the stock market as individual investor participation has fueled the continued rise. While this increase in disposable income stopped accelerating in March of 2021, based on past history inflation, will remain stubbornly high through the first half of next year and possibly beyond. And all these numbers predate Biden's "Build Back Better" spending spree.

It's notable that inflation has now reached the point that John Deere recently included automatic cost-of-living adjustments in their new union contracts, a feature hardly seen since the 1970s. This type of contract can lead to wage-price spirals and much more durable inflation.

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The acute shortage of workers certainly played into John Deer's negotiations. Employers across the US are having to pay more to keep and attract talent. The number of Americans filing claims for unemployment benefits fell to a 20-month low last week as the U.S. created 531,000 jobs in October. The unemployment rate has fallen more than half a percentage point in just the last two months to 4.6% in October, according to the Labor Department. Despite the increase in wages, weak labor-force participation left millions of workers on the sidelines. The participation rate is at 61.6%, its lowest level since the 1970s.

Over the past month, investors have continued to push stocks to new highs. Currently, the deviation from the long-term monthly moving average is at the most extreme since 1997, according to an RIA

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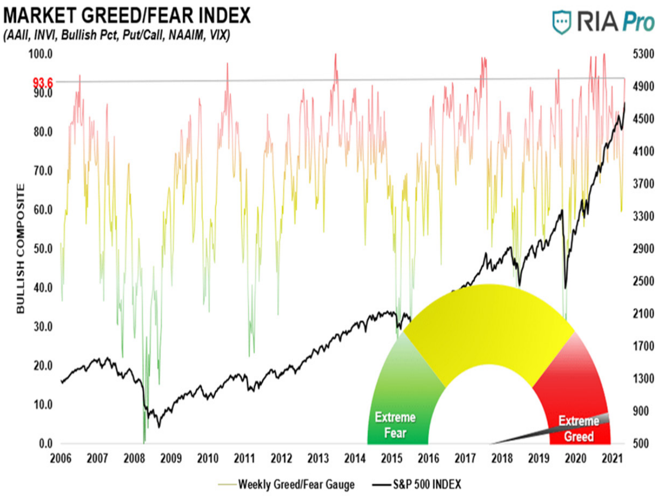
Pro measure, and levels at this height have typically preceded more significant market corrections. The organization's fear/greed gauge (chart shown), constructed from various measures of investors allocations, calculates individual exposure to equities as extremely high leading to a greed reading 93.6. Previous market peaks routinely occur when readings breach 90.



Source: Seeking Alpha, 5-Signs Stock Market Investors are Too Bullish

Investors currently also believe the risk of a correction is minimal as the volume of protective "put" options has plunged to a new 12 months low.

Looking forward over the next year, we see significant headwinds building. The rush from various COVID-19 programs is fading and trillions of dollars of relief are expiring. We believe the result will be a rapid downshift in income growth for essentially the whole country.

Fed policy probably is tightening via the planned shrinking of its balance sheet followed by rising rates. With inflation staying stubbornly high, the Fed must act, and as the price of borrowing increases, the economy will ultimately slow.

Corporate profit growth appears extremely likely to slow. Corporate profits are estimated to surge about 43% for 2021 versus last year, driving equity markets higher. But profit growth is slowing because of rising wages, soaring freight costs and higher materials prices. Estimations are only 7% for 2022 which is respectable, but nowhere near where they have been.

Despite these challenges, market valuations are lofty remaining around 22 times 12-month forward earnings or about 30% above the average of the past two decades. Valuations are often ignored by investors on the run up, but when conditions are less favorable, investors tend to focus on fundamentals. Minimally, after this year which has seen the S&P 500 climb over 25% for the year, a repeat performance appears extremely unlikely, particularly given current valuations.

Against this backdrop, one could easily argue that the easy money has already been made and that future returns are likely to be bumpier. Recent performance has been driven by a rare combination of above-trend economic and earnings growth, exceedingly loose fiscal policy by Congress, and an incredibly accommodative monetary policy that has kept interest rates low.

Still, the party may continue for a while and equities will likely outperform bonds and cash for the near future, particularly as earnings are likely to remain solid. As we head into the Christmas season, there is ample good news which is hopefully not derailed by the new COVID-19 virus strain. However, looking forward into next year, there are many potential challenges that could deliver a much rockier ride, particularly as the Fed starts tapering.

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Wildermuth Advisory, LLC is an SEC- Registered Investment Adviser that advises the Wildermuth Endowment Fund.

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You should consider the shares to be an illiquid investment. Even though the Fund seeks to make periodic repurchase offers to repurchase a portion of the shares to provide some liquidity to shareholders, only a limited number of shares will be eligible for repurchase by us.

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