RIVERSTONE
ADVISORS, LLC

July 1, 2021

Subjects: Stock Market Update, Inflation, Economic Temperature

Market Rotation

As we have written before, market participants have diverse goals. Some are short-term investors, and some are long-term investors, and some are teenagers. We liken it to a swimming pool with everyone in the pool. The market goes off in one direction, then changes its swimsuit and heads off in another direction. Then, it gets out of the pool to go to the snack bar to get a burger. This rotation is all over the markets this year.

In the first-quarter, the value style took the lead; this changed when the second quarter began. In April, growth stocks returned 7.1% as compared to the market at 5.3%. In May, the swimmers returned to value, which returned 3%, while growth returned -2.1% in May. Then in June, growth stocks dominated with a return of 7.7% while the market returned 2.5% and value stocks returned -1.7%. We will be watching as July begins.

Inflation?

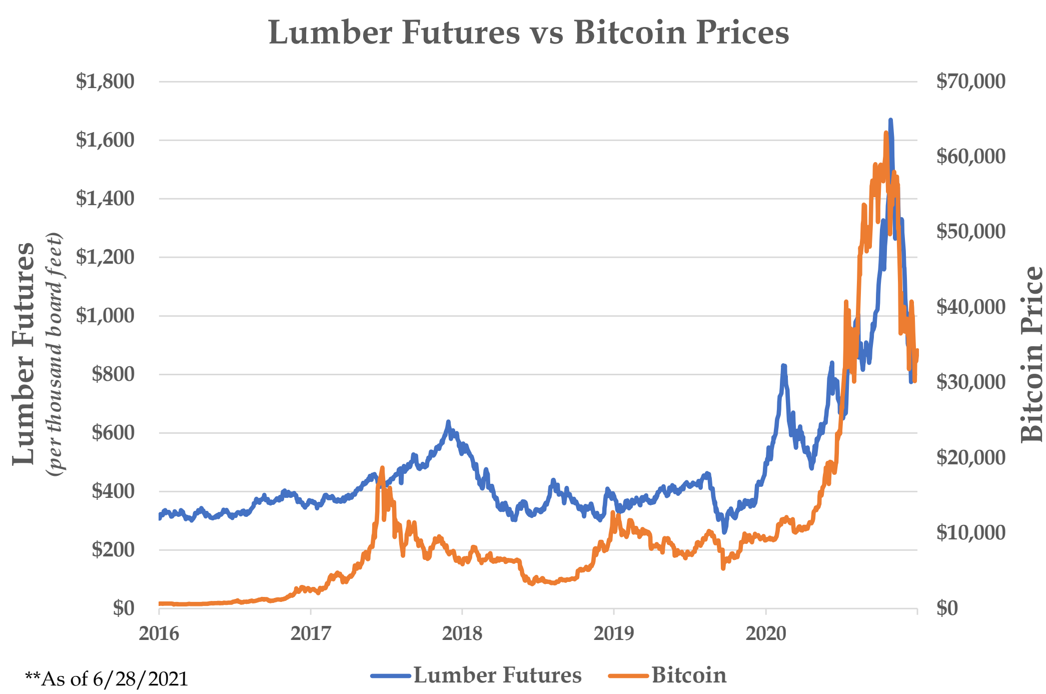
In March of last year, 582,998 domestic airline flights were flown. April followed with a 66% drop in flights. Rental car companies suffered. How did they react?

Rental car companies dealt with this mess by selling about half their fleets to stay in business. Usually, rental car companies refresh their fleets by buying new cars and selling their existing cars into the used car market. Having sold lots of cars last year, they have no used cars to sell this year. Instead, they are trying to buy used cars.

The lack of supply of cars contributed to the price of used cars rising 30% year over year. This is <u>sudden</u> inflation. Inflation occurs when you have too few goods and too much money wanting those goods.

In another example of sudden inflation, increased demand for new homes has caused lumber prices to inflate. Pre-pandemic, the construction industry was steady but not overly strong. Millennials had not started buying homes in mass. When the pandemic hit and demand for space and privacy boomed, hysteria sent lumber prices to the moon. May lumber prices reached a record of $1,711.20 per thousand board feet compared to $380 pre-pandemic.

Articles said that inflation was finally here and predicted that lumber prices would remain higher for longer. Sawmills raced to catch up with demand so they could capture the higher prices. Soon lumber inventory flooded the market, lumber prices tumbled, and are now down more than 50% from their May high. To show the level of hysteria, we have charted lumber with Bitcoin going back five years. This chart is very telling.



It tells you that speculation is present. As Bitcoin and lumber are unrelated, there is no reason why they should spike so similarly. Given that we know bitcoin is speculative, we can conclude from the similar chart pattern that speculation is in lumber. Just think, there are investors right now trying to determine what to inflate next.

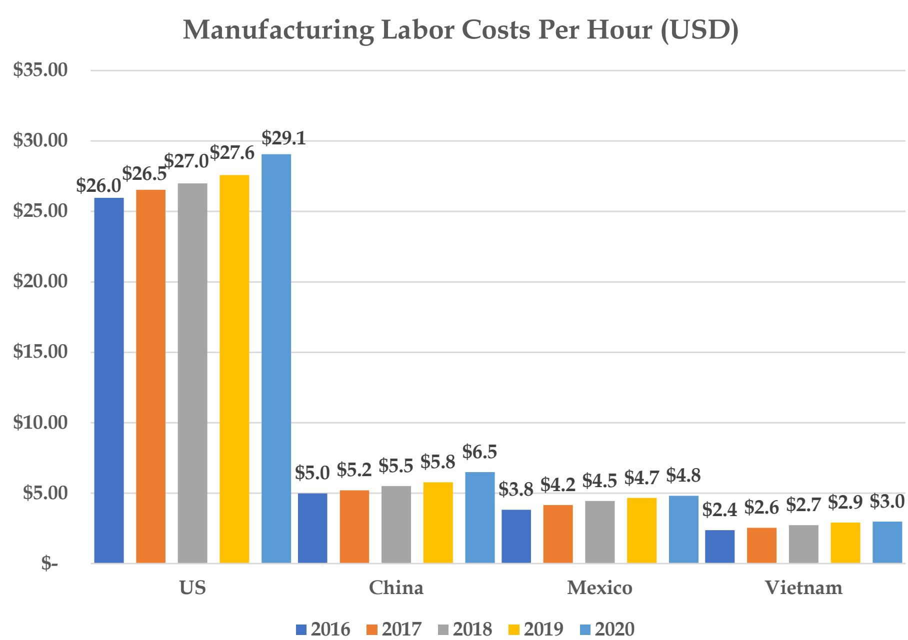
Both rental cars and lumber experienced sudden inflation. Lumber was already tight before the pandemic. Lumber is on its way lower, while rental cars have not yet rolled over (a.k.a. the U-turn at the top of a price chart). In these cases, inflation is and should be **transitory**. This inflation will pass as supply increases and demand is satiated; supply and demand will probably come back into balance later in 2021 in many categories as the world economy continues to re-open. In some goods, supply will overshoot demand, and prices may fall.

To summarize, sudden inflation arrived as demand came back faster than supply.

Gradual Inflation

Let's look at an example of gradual inflation where prices increase slowly due to ongoing supply and demand changes. This category of inflation is nothing new and is unlikely to cause inflation to run hot in the future. An excellent example of this is labor cost increases.

For many years, the U.S. has depended on China for inexpensive imports. China can produce products much cheaper than the U.S. due to lower labor rates, as shown in the following chart. Since 2016, labor costs have gone up every year in China, the U.S., Mexico, and Vietnam.



China's labor costs used to be very low, but they have been rising because their labor force is not growing due to low birth rates and government policies. In 2020, labor costs in China grew 12%+.

Vietnam and the U.S. both have population growth below 1%.

When the U.S. and China lit a trade war three years ago, U.S. manufacturers faced their overreliance on China and began moving production to Vietnam and other inexpensive production hubs.

The import cost inflation from China and Vietnam is unlikely to be transitory. These costs will not decline unless we have a worldwide recession or move a massive dollar amount of imports to a cheaper country like Vietnam, or currency changes dramatically strengthen the dollar.

The following table shows how imports from Vietnam have grown since the trade war warmed up. At the same time, while imports from China have fallen, they are still over five times those from Vietnam.

US Imports from China and Vietnam (millions of USD)		
Year	Imports from China	Imports from Vietnam
2020	$434,749	$79,618
2019	$450,760	$66,461
2018	$538,514	$49,139
2017	$505,165	$46,477

You can see the U.S. would have to dramatically grow imports from Vietnam and other low-cost countries to reverse the growing cost of our imports from China.

Gradual inflation such as this is not a problem for the U.S. While manufacturing labor costs have gone up the last 5+ years, the increase has not led to a significant push on inflation rates in the U.S. We don't foresee a dramatic pick-up now.

To summarize, the sudden inflation we have seen in rental cars and lumber and other similar demand and supply imbalances will be short-lived.

The Bond Market Speaks

Unlike journalists, the bond market is unemotional. It presently expects inflation of 2.47%.

The bond market calculates inflation based on the difference between the return on the 5-year Treasury bond and the 5-year inflation-adjusted Treasury bond. These returns differ by 2.47%. Investors with skin ($) in the game are expecting an inflation rate of 2.47%.

Update on the Economy

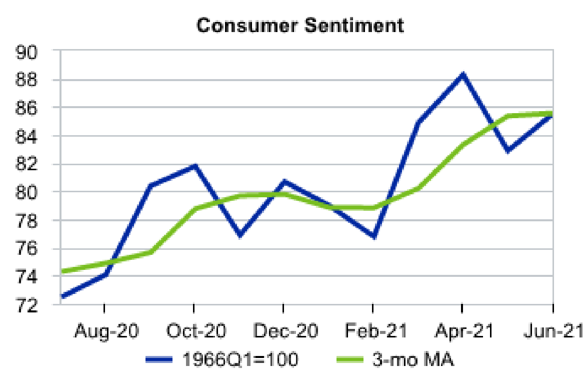
When we wrote last quarter, the 10-year Treasury was at 1.74%. We stated it had risen too fast, and we expected it to decline. It has, and is now at 1.49%, down 14.3%. Of course, this helps keep mortgage rates low, thus benefiting those house buyers lucky enough to find a house to buy.

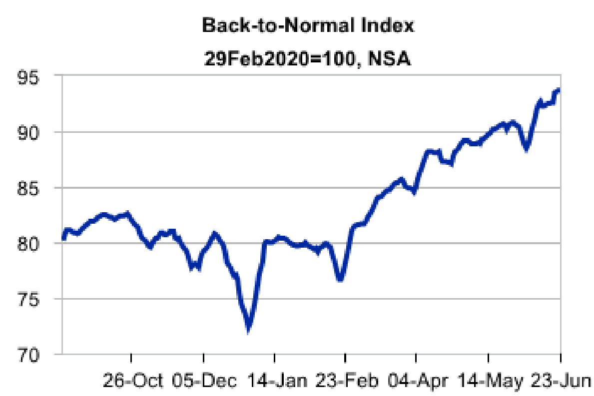
First-quarter 2021 earnings came in 44.9% higher than the same quarter in 2020 and 29% above the expected growth. Second-quarter earnings are expected to be 64.4% above last year's Q2 quarter. Corporate earnings are getting better and better because companies cut costs and improved their operations during the pandemic. You may know the saying, "never let a crisis go to waste."

Second-quarter Gross Domestic Product is on track to increase 10.5% at an annualized rate. The U.S. has recovered 100% of the GDP growth it lost in the pandemic, yes, fully covered.

Consumer spending is on track to rise 11% in the second-quarter (expressed as an annual basis).

Consumer sentiment continues to move toward the high level of 99.8 from January 2020 before the pandemic. The following charts are from Moody.





Moody has compiled 37 variables into a "Back to Normal" index. The righthand chart above shows the progress that the U.S. has made towards returning to the "normal" we had on February 29th, 2020. Our progress is good.

The savings rate is 12.4%, about 70% above pre-pandemic levels.

Employment is the weakest area of the economy. There are job openings, but workers have been reluctant. Fortunately, new employment shows 850,000 workers accepted jobs in June.

The next shoe to drop on employment occurred this week when 25 states discontinued the extra unemployment insurance of $300 per week. The remaining states cease these extra unemployment benefits on September 6th. There is hope that more people will return to work.

In sum, the U.S. economic numbers show a strong snapback. You may recall the media debate about whether the recovery would be V-shaped, U-shaped, or non-existent. It is very V-shaped.

<u>Conclusion</u>

Will inflation cook our goose? Is the sudden inflation here to stay? Will it cause the Fed to raise interest rates to tamp down the economy? We hope you know the answers from the first half of this letter. Existing inflation contains both transitory inflation and here-to-stay inflation. As the supply shocks causing sudden inflation dissolve, the U.S. is most likely to return to low inflation, and interest rates will be tame.

We have been through 15-months of constant change. The pandemic called on U.S. corporations to meet the challenges, and they did admirably. We find them highly investable.

Change brings investment opportunities. We are optimistic until the seasonal September/October volatility.

Sincerely,

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Enclosures

[1] Sources: *Yardeni.com, Moody's Economy.com, Bureau of Labor Statistics (bls.gov), Federal Reserve (https://fred.stlouisfed.org/), Morningstar, Returns are Time Weighted Returns and Net of Fees*