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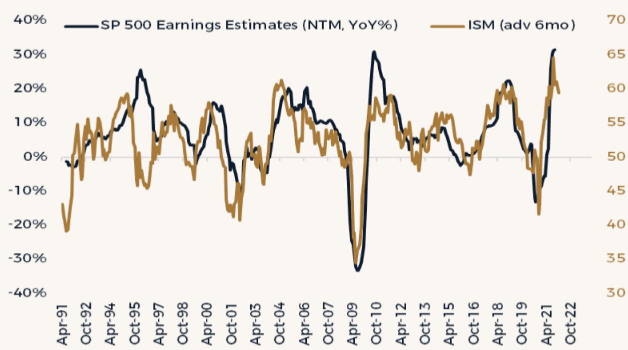
"It's more important to ensure survival under negative outcomes then it is to guarantee maximum returns under favorable ones." – Howard Marks

The S&P 500 continues to toy with all-time highs and ignore my call that a consolidation or correction would take place. However, there are signs that I may yet be proven correct. The quality of the rally is suspect as a few mega cap stocks are sustaining the index while the majority of stocks are actually correcting. Declines are outnumbering advances by a significant margin, and down volume is much higher than up. Looking at broader indexes, the S&P Small-cap 600 and Mid-cap 400 have 30% of their members already down over 20%. I still believe the bull market is in place and short-term market calls are often a fools errand, but now is not the time to let down our guard.

As mentioned in the last letter, the action in the bond market has been surprising if not actually worrisome. In the face of a reopening economy, high inflation and the Fed finally talking about a less aggressive monetary policy, one would expect yields to increase, but in fact they are down markedly. The yield on the 10-year U.S. Treasury bond at the end of April was at 1.75% but by last Monday had fallen to 1.18%. This has provoked a debate that the consensus outlook for a strong economy is overly optimistic or maybe even dead wrong. There are other less negative explanations for the rate decline, most of which involve the supply and demand for safe assets. Supply is limited by the lack of public issuance by foreign central banks since places like Japan and Europe own the lion share of their own bonds. Demand is strong as buyers such as pension funds are balancing their assets and liabilities over a very long-time horizon, (which is math beyond my comprehension). It's common in the investment industry to suggest players in the fixed income markets are smarter than the rest of us, so we shouldn't ignore the possibility that growth will be much lower than expected. However, it is also worth remembering that bondies by nature are a pessimistic lot.

I remain of the belief that global economic growth will remain strong for the remainder of this year and into next. While comparison with the strong recovery of last year's second half will make it appear growth is slowing, the economy will still be very healthy. As an aside, the National Bureau of Economic Research, the arbiter of recessions, reported that the 2020 recession lasted only two months, the shortest on record. The one caveat of course is that a significant worsening of the COVID-19 pandemic could derail everything. So far that is not the case. In the developed world where vaccine rates are good, infection rates are rising but serious illness, hospitalization and death are not and therefore the economic recovery is not being negatively impacted. The sad state of affairs in less developed countries where vaccine supply is limited is heartbreaking, but markets have no heart and will ignore these numbers given the small impact on the overall global growth outlook. It is shocking that of the last million deaths from COVID, 44% were in Brazil and India but only 4% in the US.

Figure 1:
ISM indicating earnings estimates are set to decline



Source: Bloomberg, Mulvihill Capital

The disaster that was the second quarter of 2020 has made this year's earnings comparisons a walk in the park, but they are surpassing even optimistic estimates. In the first 6 months of this year estimates for the just completed quarter rose from an expectation a 45% growth to 65% and yet actual reports are beating even that number. Company managers always try to under promise and over deliver but traditionally the spread has been around 3%-5%, for the past year it's been closer to 20%.

Undoubtedly we are seeing the peak, but estimates continue to be strong as 3rd quarter growth is currently expected to be 27% and 4th quarter 20%. Fears that inflationary cost increases and supply chain interruptions would erode margins have so far proven unfounded. Companies have been able to raise prices to offset their own cost increases, and cost cutting that took place during last year's slowdown has in many cases remained in place and helped to provide stronger margins.

The standoff in Washington continues with much important legislation upcoming. Some or all could have repercussions on financial markets. For example, the size and timing of an infrastructure package will influence GDP expectations. Also, our friend the “debt ceiling” will raise its head again in late October as the U.S. government is running out of money to operate the country and requires legislation to allow it to borrow more. GOP Senate leader McConnell has already stated no Republican will vote for it. The only alternative would be to cut costs to balance the budget, and that is somewhere between impractical and impossible. John Mauldin who writes “Thoughts from the Frontline” recently quoted from a book written in 1941 by Neil Howe “The Dilemma of Modern Democracy”. The quote would seem to have great relevance for what is happening in the US today.

> *“Democratic government, being government by discussion and majority vote, works best when there is nothing of profound importance to discuss, when the rival party programs involve the superficial aspects rather than the fundamental structure of the social system, and when the minority can meet defeat at the polls in good temper, since it need not regard the decision as either a permanent or a fatal surrender of its vital interests. When these happy conditions no longer obtain, the democratic way of life is always in danger.”*

I suppose the fact the book was written in the early days of World War II and democracy survived that and another 75 years should give us some comfort, but it still makes me apprehensive.

In an effort to press the Democratic party platform and avoid Congressional rancor, President Biden has issued an executive order titled “Competition in the American Economy”. The intention is to slow corporate consolidation that has led to monopoly like pricing, pressure on wages and other anticompetitive policies by certain mega sized corporations. Mergers and acquisitions will face increased scrutiny and antitrust laws will be more vigorously enforced. There are a number of specific proposals I found interesting: lowering prescription prices by importing from Canada; cleaning up internet bills to make switching cheaper; making refunds on airline tickets easier; and my favorite, “Right to Repair” which will make it okay to have a third-party fix something without losing one's warranty. There will be many barriers to implementation but putting my consumer hat on I wish the President well.

I'll leave you with a quote from Howard Marks, one of the smartest and most reasoned market commentators: “It’s more important to ensure survival under negative outcomes then it is to guarantee maximum returns under favorable ones.”

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