HUDOCK CAPITAL GROUP, LLC

WEALTH PARTNERS WITH PURPOSE®

Hudock Capital Group Newsletter

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Our core purpose, our passion, is to make a positive and profound difference in the lives of our clients and in the communities we serve.
~Hudock Capital

Inside this Issue

Economic Commentary

Five Things You Should Know About Q2

1. Inflation Spikes: Inflation growth spiked to its second highest level in nearly 30 years (surpassed only by the housing bubble in mid-2008).

2. Fed Surprises with First Hawkish Comments: The Fed, in its June 16th announcement, surprised markets with its first hawkish statements in over a year, citing inflation concerns.

3. Treasury Yields Fall: Treasury bonds rebounded sharply, driven by concerns of reduced Fed stimulus and Fed bond purchases outpacing new Treasury issuance.

4. Commodity Prices Rise, Especially Oil: Industrial commodities continued to rise in Q2 and oil prices surged. The reopening is expected to cause supply to lag demand, especially in the US.

5. S&P 500 Makes New Highs: The S&P 500 pushed to fresh highs in Q2, rising +8.4%, driven mostly by a rebound in mega-cap tech stocks.

Q2 — Inflation Surges

The rapid US economic recovery continued in Q2 as business re-openings accelerated and consumer confidence rose. Unemployment levels continued to fall towards pre-Covid levels. The combination of strong demand, supply bottlenecks. pervasive labor shortages and steadily rising commodity prices helped push inflation to near 30-year highs, reaching an annualized growth rate of +5.0% in May.

This spike in inflation commanded the Fed's attention. In its June 16th release, the Fed surprised markets by updating its median interest rate forecast to two hikes—previously zero—in 2023. Paradoxically, this surprise triggered a further decline in longer-term Treasury yields, a trend strengthening since mid- May. The reason Treasury yields fell despite these expected rate hikes appears to be two-fold. First, the Fed simply acknowledging inflation risk caused longer-term inflation expectations to fall. Second, Fed bond purchases in Q2 exceeded new issuances, possibly distorting the Treasury market. The Fed's hawkish surprise, combined with falling bond yields derailed the so-called "reflation trade" in late June, causing assets like precious metals, commodities (ex oil), and value stocks to underperform. Still, the quarter finished with nearly every asset class solidly positive with US stocks making new all-time highs.

To follow we will discuss the drivers that could push US growth to even higher levels. Second, with inflation now firmly in the spotlight, we will unpack whether the current surge in inflation might be temporary or permanent.

Market Outlook

The US is in the midst of an ongoing surge in economic growth unlike anything we have seen in several decades. Before now, the most obvious drivers of the growth surge have been the massive coordinated fiscal and monetary stimulus deployed by the US government. Businesses have steadily reopened, and pent-up demand is being unleashed at a time when the ability to meet that demand is still impaired, especially because of labor shortages and supply chain bottlenecks.

This combination of strong growth during a period of constrained supply has pushed inflation to levels not seen in decades. Yes, there are some obvious pandemic-related shortages driving higher prices (e.g. semiconductor chip shortages, lumber, and used car prices) that will likely normalize in the next few months. Still, there is an array of structural factors that could cause higher levels of inflation to stay.

The Case for Higher Future Inflation

Commodities (and US oil in particular) have seen big declines in investment in new production over the past several years, only exacerbated by the pandemic lockdown. Some of this decline is part of the commodity cycle (where investment lags demand, overinvestment follows the inevitable price surge, then a lagged period of oversupply causes prices to collapse). Though, this time around, there appears to be some more structural issues modifying the traditional commodity cycle. As an example, socially responsible investing (SRI) has skyrocketed in popularity. Given SRI's pessimistic view of commodity producers (US oil fracking in particular), these producers are no longer finding easy access to investment capital —particularly after a decade of dismal returns, the result could be structurally higher commodity prices going forward that reflect a more permanent increase in the cost of capital.

Labor costs (i.e. household incomes) are rising, particularly for lower income workers. Again, some of this is likely transitory, such as the temporary unemployment benefits. Employees are quitting their jobs at record rates, and employers are giving signing bonuses from fast food workers to executives like never before. Structurally speaking, politics and de-globalization may end up playing a bigger role in rising labor prices going forward. Government policy is currently targeting high wages for low-income workers. Globalization—long a force that has capped labor's bargaining power by making lower skilled workers compete on a global stage—is now reversing. The pandemic, of course, only accelerated this trend. Together, the reshoring of jobs could end up delivering workers more bargain power than they've had for decades.

Monetary policy - the overhaul of the Fed's inflation policy relative to emerging structural inflation pressures should also be addressed. As we discussed in last quarter's commentary, the Fed has introduced a completely new inflation targeting policy (i.e. equally focused on deflation). This symmetric inflation targeting combined with the Fed's demonstrated willingness to aggressively print money to stimulate adds additional upside pressure to inflation.

Counterpoint: The Case for a Return to Low Inflation

There have been several powerful disinflationary forces that have kept inflation at bay for the past decade, despite aggressive monetary policy around the world. Since these disinflationary forces remain largely intact, it is difficult to assess who is likely to win the inflation tug of war.

Technology and automation remain ongoing drivers of deflation. A digital economy can easily expand capacity with minimal investment or expense. Further, automation is a robotic labor force that lower skilled laborers will permanently have to compete with. When workers succeed in temporarily extracting higher wages from employers, it gives employers that much more incentive to invest in robotics that could permanently displace the worker. Precisely how quickly and affordably these solutions will come online is difficult to estimate (for instance, how

soon before tractor trailers drive themselves?). What seems obvious, to us, is that this trend will only continue.

Aging demographics, especially in the world's largest economies like the US, Europe and China, imposes ongoing deflationary impulse. People in retirement simply don't borrow and consume as much as they did when they were working—and since most retire just after they are at peak income, the reduction in spending is acute. This affects aggregate demand and can depress prices for years to come.

Also, there is the **enormous personal and private debt loads** pervasive across the world's largest economies. While secularly low interest rates make the carrying-cost of this debt more or less equivalent to levels in the 1980's, the sheer magnitude of the current debt makes new credit consumption less likely. This removes an important lever for demand, and pressure on prices.

Conclusion

There are many things about the current inflationary environment that are without historical precedent. Keeping score in the tug-of-war between inflationary and disinflationary forces is challenging. Evaluating them in the presence of a host of transitory pandemic-related inflationary pressures further clouds the analysis.

We think politics will eventually play the biggest determinant in how serious and significant inflationary risks present themselves in the next decade. That is, the willingness of governments and central banks to continue coordinating money printing and spending (our last structural inflationary force).

What is well known is that deflation (which effectively increases the real value of goods, but also outstanding debt) is not a tolerable option for the US or other major economies. With future rate cuts unlikely to inspire new credit-fueled demand (the primary monetary policy tool of the past 100 years), governments will have fewer options to stimulate a slowing economy. The Fed's willingness to continue aggressively spending with printed money will likely be the tie breaker in the inflation/disinflation tug-of-war.

What does this mean for your portfolio? We think it means investors should do everything in their power to remain balanced to inflation risk. This is how we like to approach portfolio construction—by holding a balanced mix of inflation seeking assets (e.g real assets) that can effectively offset other traditional holdings (e.g. stocks and bonds) that generally do best in low inflation regimes. In this way, the value of your portfolio can be protected from any inflation surprises, positive or negative.

Reference: Economic Commentary with permission from Almanack, July 20, 2021. Redistribution is prohibited.

If you are ever uncertain if an email is from us, please call our office.

Hudock Happenings

Marcia Pauling and her husband, Allan, celebrated their 45th wedding anniversary on July 31st.

Happy Anniversary, Marcia & Allan!

Upcoming Events

November & December

Veteran's Day Event
Community Theatre League
Thursday, November 4th
Presenter: Jari Villanueva, Taps Bugler
Music by the Repasz Band

White Christmas
Community Theatre League
Thursday, December 2nd
Pre-show reception: 6:30 pm
Show: 7:30 pm

Holiday Event
The Club at Shepard Hills
Tuesday, December 7th
11:00 am – 2:00 pm

Holiday Event
Williamsport Country Club
Friday, December 10th
11:00 am – 2:00 pm

Holiday Event
Williamsport Country Club
Saturday, December 11th
11:00 am – 2:00 pm

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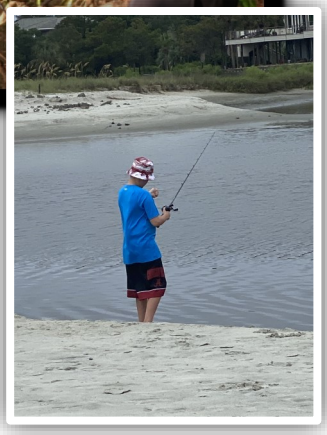
After the Closing Bell

Going fishing...

So, never in a million years did I ever imagine that I would be going fishing. As a child, I found it boring and always ended up in the water swimming when someone put a fishing pole in my hand. I just couldn't understand what the attraction was!

However, my twelve-year-old grandson, Michael Joseph (known to us as MJ because we have three Michael Josephs' in our family!) took a real love for fishing. Now, I LOVE spending time with him while he's fishing. We just returned from a family vacation and I spent hours taking him to the local fishing hole and just watching him. A picture of the first fish he caught (locally a few years ago) and a picture of him last week is attached! Last night, we hired a fishing guide to take us on the river for a few hours - the last picture is of him with one of the SEVEN fish caught! He was ecstatic! He's really committed. Isn't it amazing how much our interests change as our children/ grandchildren grow???



Barbara