WASATCH
CAPITAL MANAGEMENT OF
RAYMOND JAMES®

"YOU REALIZE YOU REALLY WEREN'T SUPPOSED TO TRY TO KEEP UP WITH THE KARDASHIANS?"

MAY 2021

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To Infinity and Beyond -Article by Mark Lazar

The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. **Ernest Hemingway**

April was another good month for stocks. The Nasdaq, S&P, DJIA, and Russell 2000 gained 5.40%, 5.24%, 2.71%, and 2.07% respectively.

The biggest driver of returns was earnings. Thus far, 25% of the S&P 500 companies have reported Q1 results; of these companies, 84% have beaten their earnings forecast, which is a trend that should continue. Bloomberg estimates corporate earnings will increase 28% this year. Part of this extraordinary increase is due to the expected bounce from the pandemic-induced recession of 2020, but most can be attributed to record government spending.

In addition to higher stock prices, both real estate and commodities were also beneficiaries of a good month; the FHFA index, which measures home prices, rose 0.9% in February and is up 12.3% over the past year—the largest twelve-month increase on record. If that's not enough, first quarter real GDP grew 6.4%.

Item	YTD Change
Dow Jones Ind Avg	10.68%
S&P 500 Index	11.32%
EAFE Foreign Index	5.63%
Barclays Agg Bond Index	-2.61%
10-Year Inflation Forecast	2.41%
2021 GDP Growth Forecast	6.3%
Unemployment Rate	6.0%

**Market index data as of 4/30/2021*

Milton Friedman taught us that *inflation is always and everywhere a monetary phenomenon*, meaning at the end of the day, the Fed is always the culprit. From 1913 until 1978 the U.S. central bank had a single objective: fight inflation. However, in 1978 Congress gave it a second mandate; maintain full employment. Ironically, after decades of fighting inflation with tight monetary policy, the Fed is now attempting to do the opposite; spur inflation, with unprecedented loose monetary policy.

It's important to understand how inflation affects various asset classes; some of which benefit while others suffer during inflationary periods. The following is a list of some of the primary investment types and how they tend to be affected by inflation:

Winners

- **Stocks**-Stocks are typically a good, long-term inflation hedge and have historically provided positive real returns. Between 1926 and 2017 stocks returned 10.22%, whereas inflation averaged 2.89%, meaning stocks provided a real return of over 7%.
- **Real estate**-Real estate, in general, appreciates faster than the rate of inflation. Both the value of real estate as well as rents tend to rise equal to or faster than the rate of inflation.
- **Commodities**-Commodities (e.g., copper, nickel, wheat, corn, etc.) tend to be positively correlated with inflation, meaning prices generally increase/decrease with the expectation of higher/lower inflation.
- **Convertible bonds**-Have a feature which allows the holder to convert the bond to common stock once the underlying stock price reaches a predetermined value. Convertible bonds tend to have characteristics of both a bond and a stock and can provide returns over and above inflation while still providing regular income.
- **TIPS**-TIPS are designed to protect investors from the corrosive effect of inflation on fixed income investments. The principal is adjusted/increases with inflation, as measured by the CPI. Additionally, the rate of interest paid can increase as well.
- **High yield bonds**-High-yield, or junk bonds, tend to be more correlated with the stock market and are less interest rate sensitive than their higher credit quality, investment grade brethren. Consequently, they can potentially increase in value during times of rising rates.
- **Debt**-Rising price levels benefit holders (borrowers) of fixed rate debt, but is toxic for lenders of the same. Inflation reduces the real value of debt and allows borrowers to make payments with devalued dollars while enjoying rising income due to wage inflation.

Losers

- **Fixed coupon bonds**-Inflation hurts fixed coupon bonds two ways; first, since higher inflation leads to higher interest rates, the market value falls. Second, as price levels rise, the coupon payments have reduced purchasing power.

- **Cash-**If the interest rate earned is less than the rate of inflation, the real return is negative. Earning .25% interest when inflation is 2.25% results in a real return of -2%; your money would lose 2% of its purchasing power annually. In an inflationary environment, cash is a great way to lose money safely.

Neutral

- **Inflation-adjusted bonds**-Pay a base rate of interest plus some amount over and above their reference rate. Consequently, if rates rise, the rate they pay tends to increase as well. In general, the price of inflation-adjusted securities doesn't fluctuate nearly as much as fixed coupon instruments.

According to the Consumer Price Index, the YOY inflation rate is 2.6%; slightly above the Fed's long-standing 2% target rate. Upon further investigation, at 33%, "Shelter" is the single biggest component in the CPI. However, home prices aren't part of the calculus; only rents, and rents have been artificially suppressed due to a government-imposed moratorium on evictions and foreclosures, meaning the government's inflation gauge is currently a poor barometer of rising price levels. To this point, commodities, which are highly correlated with inflation, YTD are up 23%, which is virtually identical to the 24% increase in the US money supply.

Opposing factors, such as slowing population growth, technology/creative destruction, and globalization/outsourcing, make it unlikely we'll experience Carter-era inflation, or something even close to that. But with the Fed's current Buzz Lightyear monetary policy battle cry, *To Infinity and Beyond*, inflation is here and moving higher. Savvy investors understand that what feels safe, such as cash and bonds, will be punished by Jerome Powell's panacea to address everything from underemployment to climate change.

Mark Lazar, MBA
Senior Vice President-Investments
Certified Financial Planner™

Wasatch Team Updates

Wasatch Capital Management is growing! This month Kiera Blinzinger and Kendall Jackson join us. Michelle comes from Wells Fargo and Kendall comes from outside of the financial industry. We are excited to have them both on board!

Mark & Stan

Mark & Stan hiking in AZ with Stan and friends

Stan

Birthday desert at Bear Lake house. Daughter Kambrie turned 20 and Stan turned 21!

John

John out for sushi at his favorite restaurant, Sapa.

Beth
Beth at her daughter’s lacrosse game

Michelle
Michelle enjoying time with her dog Stella

Mark Lazar, CFP®, MBA, Vice President - Investments | 385-275-3609

Stan Goodell, CFP®, Vice President- Investments | 385-275-3792

John Bergerson, CFA®, MBA, Investment Portfolio Associate | 385-275-3608

Beth Winter, Client Service Associate | 385-275-3593

Michelle Bilanzich, Client Service Associate | 385-275-3799

2750 E Cottonwood Parkway, Suite 520, Cottonwood Heights, UT 84121

1389 Center Drive, Suite 200, Park City, UT 84098