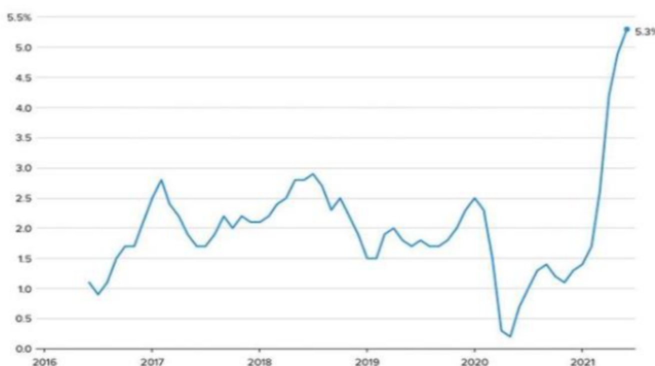
Third Quarter 2021 Investor Update

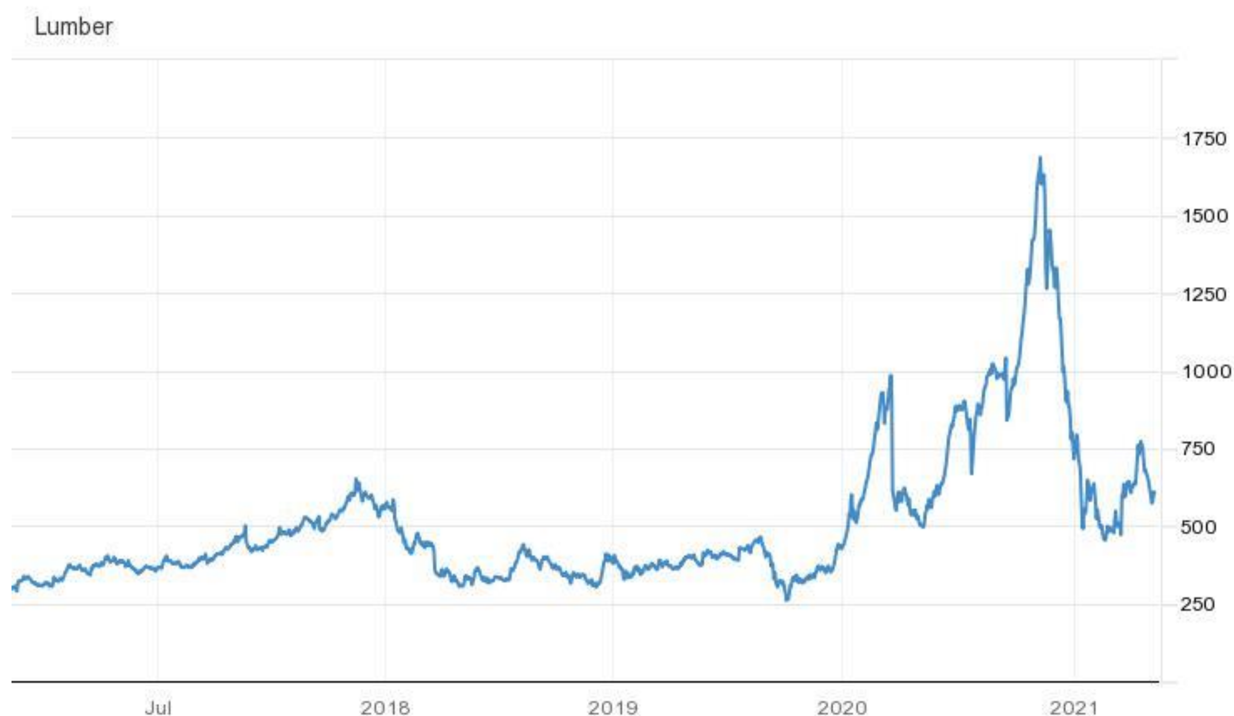
The stock markets took a pause in Q3 as the world dealt with a resurgence in Covid-19 compliments of the highly contagious Delta variant. The reopening of the world's economies slowed and the ability of international commerce to flow became more and more restricted. The CWC Large Cap portfolio returned -1.39% for the quarter, bringing the year-to-date return down to 15.11%. That compares to the S&P 500 that eked out a 0.58% return in Q3 and a year-to-date return of 15.92%. The CWC Small Cap portfolio lost 2.80% for Q3 bringing the year-to-date return down to 23.27% vs the Russell 2000 index's Q3 performance of -4.36% and year-to-date return of 12.41%. The large cap indices have caught up to the early gains in the small cap stocks, but the CWC small cap portfolio has continued to enjoy a great year of out-performance.

The topic dominating investment discussions around the country is inflation. Nobody is arguing that we are not experiencing inflation today. Everyone can see costs rising all around them. Gasoline, housing, meat, automobiles, restaurant prices, wages, lumber, shipping, stocks; everything seems to cost more and more. Indeed, the latest reading on the Consumer Price Index (CPI) has all goods rising at an annual rate of 5.4%. When food and energy are excluded, the rate is still 4.0% (I've never understood why these numbers are reported without food and housing; most people need a place to live and something to eat). These numbers are higher than we have seen in the U.S. in many years. The question being debated around the country is whether this rate of growth in prices is sustainable, or are these high prices caused by a bubble that will deflate when global economies return to a post-pandemic normal? We know very smart economists on both sides of the debate. We will try to lay out both sides, then our thoughts on the answer and how it relates to our portfolio management.



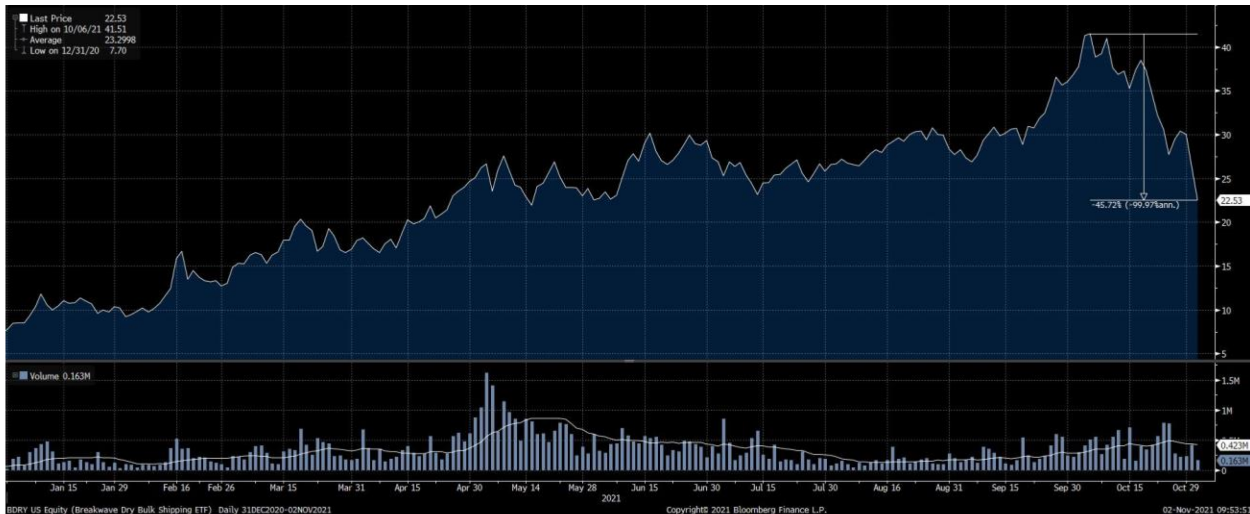
- Used car prices accounted for more than a third of CPI increase as production continues to lag due to chip shortage.
- Ford June sales dropped ~27% and they plan to curtail production in half a dozen U.S. plants in July in response to shortage
- BMW claims it produced 30,000 less vehicles than planned this year due to chip shortage

Those in the camp of transitory inflation that will quickly subside point to the disruptions in the production and transportation of products that have been slowed (or temporarily stopped) due to restrictions caused by Covid-19. For example, lumber prices took an unprecedented spike in 2020 as mill production was shut down, or curtailed, in conjunction with an unexpected spike in demand for housing. The price of raw trees did not increase substantially, creating a massive profit potential for someone who could produce lumber. Consequently, we have seen production increase beyond pre-pandemic levels to take advantage of the potential profits. This excess production eventually caught up with the unmet demand and lumber prices plummeted. They remain above normal, but at a level that will allow builders to continue building. This shows eventually, prices will return to “normal” where supply matches demand and the producers of lumber make an acceptable return on their investment in the production of lumber. That is the definition of “transitory inflation”.



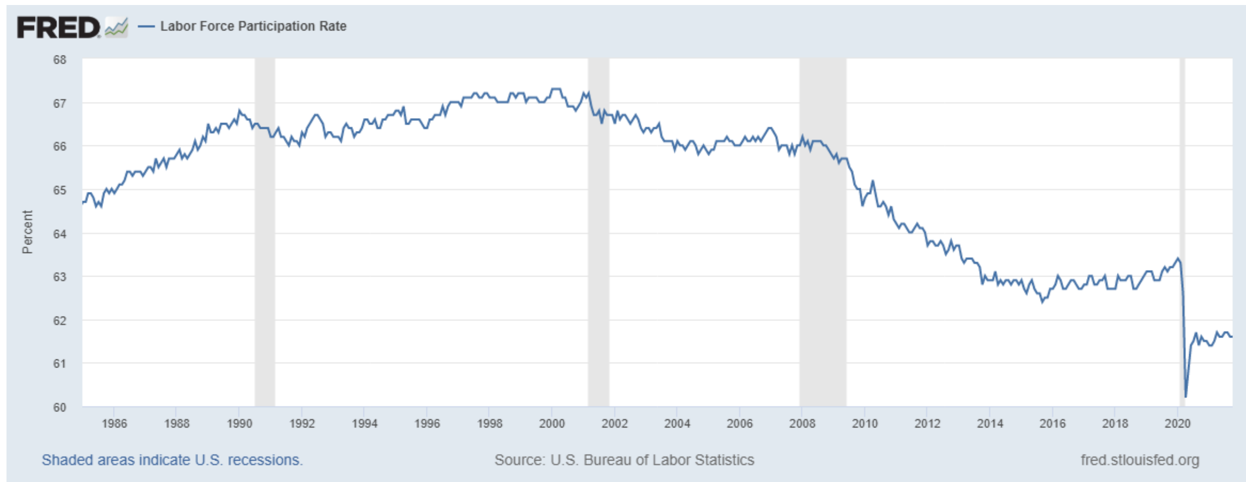
One other ballooning cost affecting almost every product is the cost of transportation: specifically international shipping. A 20-foot container shipped from China to the U.S. typically cost ~$2,500. Recent prices have approached $20,000. Even if you decide to pay that price, the delays in receiving the goods have been months. As you can see in the following chart depicting dry bulk shipping rates, costs have recently plummeted. Like lumber they are still elevated above past norms, but the trend is toward supply/demand equilibrium. Logic dictates the amount of goods needing to travel is not more than pre-pandemic (adjusted for world GDP growth) and the number of ships available to transport those goods is not meaningfully different than pre-pandemic. Therefore, market forces will eventually adjust prices for shipping back to a supply/demand balance that allows shippers to earn an acceptable return on their investment of buying an incremental ship.

Freight futures rolling over BDRY – Dry Bulk Shipping ETF



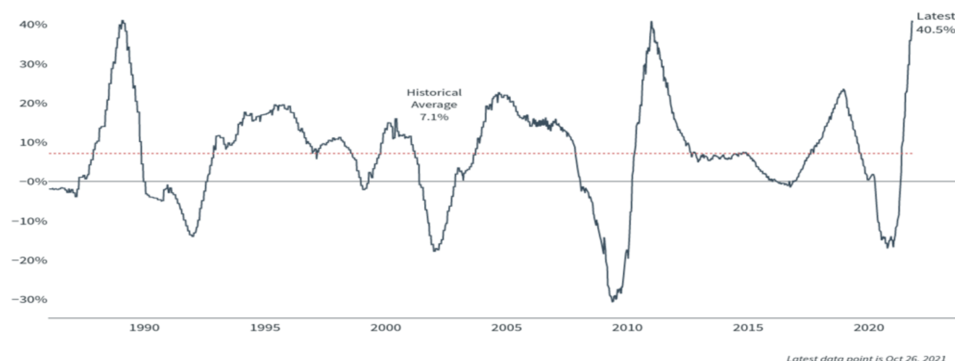
As is the case with most debates, there are exceptions to the transitory inflation argument. The cost of labor has risen. For the first time in many years, workers are scarce, and employers have been forced to raise the compensation paid for labor. Even offering higher wages, many employers cannot fill vacant positions. While it is true the dislocation of supply and demand in labor was initially caused by the pandemic and our response to it, the resolution is not as clear cut. In our opinion, the cost associated with labor will not return to pre-pandemic levels and this part of inflation will be systemic and not transitory. We feel labor costs will decrease, but not back to pre-pandemic levels. As seen in the following graph, labor participation rates trended higher through the 1980's and 1990's, then started to trend down after the technology

bubble burst in 2000, then took another leg down after the great recession in 2008. The economic shutdown of 2020 caused a spike down and we have only recovered about half of that loss. There are several potential causes of this phenomenon which we will not explore today. The real question is whether the workforce will eventually continue its recovery when the pandemic truly ends, or will we have a sustained labor shortage for the foreseeable future keeping the cost of labor elevated.



The U.S. Federal Reserve has targeted 2.0% inflation as a healthy rate for our economy. We have generally fallen short of that goal since the great recession starting in 2007. We feel the factors causing 5+% inflation will be with us for 12-24 months and will cause a great deal of consternation in the press and investing circles. But we also feel that inflation will subside to more sustainable levels in 2023-2024. We also believe inflation will remain elevated above the 1.0% to 1.5% we've seen over the past 15 years. We forecast inflation to average slightly above the 2% Federal Reserve goal at a level between 2.0-3.0% over the next decade.

We believe the markets will enter a period of increased volatility; however, returns should still be positive. We feel they will not be as strong as the fantastic returns enjoyed over the past several years. Two factors appear to be driving the market's returns and we think they will continue to spur the market over the short term. First, the Federal Reserve remains accommodative and money is cheap and available to businesses and investors. Second, corporate earnings are fantastic and growing.



There are always concerns on the horizon that we are aware of and planning for, but if the two factors above remain true, a major correction is unlikely. The tremendous returns in the stock market over the past several years have moved most asset allocations to the high end of our client's equity weightings. In response, prudence requires us to begin tilting our balanced portfolios away from our overweighting to stocks. We are not looking for an imminent correction in equities, but we also feel the rate of growth of the past few years is not sustainable.

One great thing about analyzing economies and businesses is the availability of new information every day. New data needs to be viewed with fresh, unbiased understanding and over time, opinions can change as inputs evolve. We feel that flexibility and the ability to consider opinions contrary to our own is essential in successful portfolio management. We thank you for trusting us with your portfolios and we will continue to manage them with utmost diligence.