April 2021

Here we are again, with the U.S. stock market rising nicely and hitting new highs. I am getting two questions almost daily. The first is: "Is this real?" That's a way of asking, "Can you trust this rally?" Our firm has, since the middle of last year, been consistent in arguing that the market would move higher. Thus, we do believe this advance is justified. This belief required neither a bold prediction of the future nor a heroic level of optimism on our part. Rather, we've simply lived long enough that we've watched many economic cycles and have observed how the markets usually behave in and around them.

Cyclical *bear* markets begin as soon as the stock market "sniffs" a recession is on the horizon. They usually don't last long (six to nine months is normal), but they can do real damage. Cyclical *bull* markets, on the other hand, usually begin as soon as the market senses that the economic trough is near. These usually last much longer, simply because recovery from recession almost always transitions into a new economic expansion, which usually lasts several years. Our optimism for the stock market was driven by our understanding of the probabilities. (You probably recall me writing in the past that we are not forecasters, but odds-makers.)

As we wrote in our last quarterly letter, the current rally is driven by "the economic recovery underway, the Fed's extraordinarily favorable monetary policy, and the likelihood that COVID-19 will recede over the next two years." To those three factors that argue positively for growing economic activity, we can add a fourth: extraordinary fiscal stimulus from the federal government. President Biden recently signed a $1.9 trillion stimulus bill (called the American Rescue Plan Act). This is an astounding sum of money slated to leave the U.S. Treasury and to be spent in the economy. Now, Congress is trying to pass yet another stimulus bill, reportedly focused on infrastructure spending, in the range of anywhere from $800 million to over $2.0 trillion. While such spending programs rarely achieve the specific objectives they aspire to, from an economic perspective this rate of spending cannot help but stimulate additional economic growth. (Of course, the president and Congress are also talking about taking funds out of the economy through increased taxes. If passed, these taxes could be a depressant on economic activity, an action we are watching closely.)

All this economic and governmental activity is generating the second question I'm hearing daily: "Aren't we going to see inflation come roaring back?" This is an important question: it reveals that the questioner understands inflation to be a real threat to investors. Rising inflation silently confiscates an investor's returns. For example, in an environment of 2% annual inflation, a 6% nominal return produces a 4% *real* return. But in a time of 4% inflation, that same 6% nominal return results in a real return of just 2%, that is, it is cut in half from the prior example.

I like the old, homespun definition of inflation: *too much money chasing too few goods*. This definition properly brings our attention to three things: the supply of money, the supply of goods, and the velocity of money (the “chasing” part, i.e., how rapidly consumers spend their money). Most of us focus on the supply of *money*. This is easier to measure than the other two items, and we boomers remember that the high inflation of the 1970s was accompanied by high money supply growth. Given the rather dramatic increase in money supply we are now seeing, this inflation question is logical.

We at Confluence believe that, while we will likely see spurts of inflation in the near term, inflation will remain subdued in the long run (about 2% or less). Why are we so sanguine about inflation? The answer lies in the other two elements of the homespun definition. There is still no shortage of *goods*. While the re-opening of the economy has revealed bottlenecks here and there (e.g., semiconductor chips, certain food items, etc.), we expect these shortages to clear over the next year. In a globalized economy with rapid application of new technologies, any shortage of goods isn’t likely to last very long. Major reductions in economic globalism and the application of technology would cause us to revisit our opinion of inflation.

Finally, the *velocity* of money remains historically low. Consumers are not afflicted with the inflation mentality of the 1970s. That mentality (“buy today because it will be much more expensive tomorrow”) took about 30 years to develop. It’s rarely seen today. Statistics show that Americans are not spending their higher levels of cash, but rather saving it. Many are investing it; some are speculating with it. The inflation we are seeing today is *asset inflation,* an increase in the prices of stocks, real estate, and other forms of investment. That is a potential problem that worries us more than consumer price inflation. For the time being, however, we are simply glad to see the economy and the markets in recovery mode.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

This letter was prepared by Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.