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The Oak and the Reeds

Why Economic Storms Call for Flexible Investment Strategies

The classical Greek storyteller, Aesop, is often associated with lessons that we teach our children. Each of his fables is a compact pearl of wisdom that is easily understood by the very young. Yet, his perspectives can have great practical value even for those of us who are now a little beyond our childhood. His wisdom even resonates in the investment world.

The "Oak and the Reeds" is Aesop's fable about an oak tree that stands proud and strong on a riverbank, but that is completely uprooted and washed downstream by a violent storm. At the end of its brief journey the oak lodges against a marsh of reeds. Puzzled by its fate compared to that of the wispy reeds, the oak asks aloud why it was unable to withstand the mighty storm while the thin reeds were able to remain in place. To that the reeds replied, "We bent our heads to the storm, and it passed over us. You stood rigid and inflexible till you could stand no longer."

The moral of the story couldn't be clearer. Flexibility means survival, while rigidity almost certainly spells trouble. For the serious investor, flexibility in both strategy and outlook can often make the difference between safely weathering the market's inevitable storms, or being completely swamped by them.

Cloudy, With a Chance of Inflation

The investment world is often buffeted by storms that test our investment assumptions and that challenge us to find new solutions.

The latest storm forming on the near-horizon is inflation, which is a direct result of two other tempests that took the world by surprise over the past three years.

The tariff wars of 2018/2019 strained supply chains and brought a cloud of uncertainty into corporate planning. They were then followed by the Covid-19 pandemic that closed economies around the world for more than a year-and-a-half, further cutting supply chains, and causing widespread hardship and loss of life.

In recent weeks, prices of consumer goods and services in the U.S. have been rising at an annualized rate of 5%. Since 2000, inflation has been relatively tame at roughly 2% per year. Now, the sudden rise has become palpable. The inflation storm that some predicted during the tumult of the past three years has finally arrived.

For long-term investors, the duration of this bout of inflation is a key question. Will it be long-lasting, or only transient? Beyond the impact it has on consumers, inflation affects corporate profits by increasing the price of inputs such as labor and materials. Profits are the catalysts that move stock prices over the long-term, so this question is more than academic.

Two Views on Inflation

Generally speaking, the investing world is divided into two camps on the question of inflation and its stickiness.

The first set of investors believes that inflation is here to stay for a long time, possibly years. They cite as their rationale the massive money printing that has taken place in the United States since March 2020. In that period over $4 trillion has been injected into the pockets of companies, households, and individuals. Washington's goal has been to prevent an economic collapse during the pandemic. Much of that money has already been spent and has produced some inflation. Another portion has been funneled into asset markets such as stocks and real estate, helping to propel them higher. However, Bank of America reports that some of it has also gone into savings. To investors in this camp, that delay in spending spells potentially higher inflation down the road. The underlying concern seems to be that even then, as now, supply may not meet demand and the price of goods and services will have to rise further and faster.

The members of the second camp, whose views more closely represent my thinking on this question, believe that today's inflation is mostly transitory and is the result of the Covid-19 pandemic. I would also cite the trade wars as a contributing factor. Both events were once-in-a-century occurrences that upended supply chains around the world. Disrupted supply chains meant disrupted production schedules, disrupted work schedules, shortages of goods, and shortages of people to offer needed services. Shortages have meant higher prices for a wide variety of things that we count on every day. The toilet paper shortage is perhaps the most noteworthy and comical example of this disruption, but it is emblematic of the situation.

A Recipe for Inflation: Supply Constraints and Rising Demand

Economists would probably agree that there is not always a clear-cut and detailed recipe for cooking up inflation. However, there are two broad concepts that apply. Inflation can be either "cost-push" or "demand-pull" in nature, or it may be both.

Cost-push inflation arises from a shortage of goods and services - the world needs everything from toilet paper to semiconductor chips to telephone repair services on some regular basis, but there may not be enough supply due to external constraints, such as a pandemic.

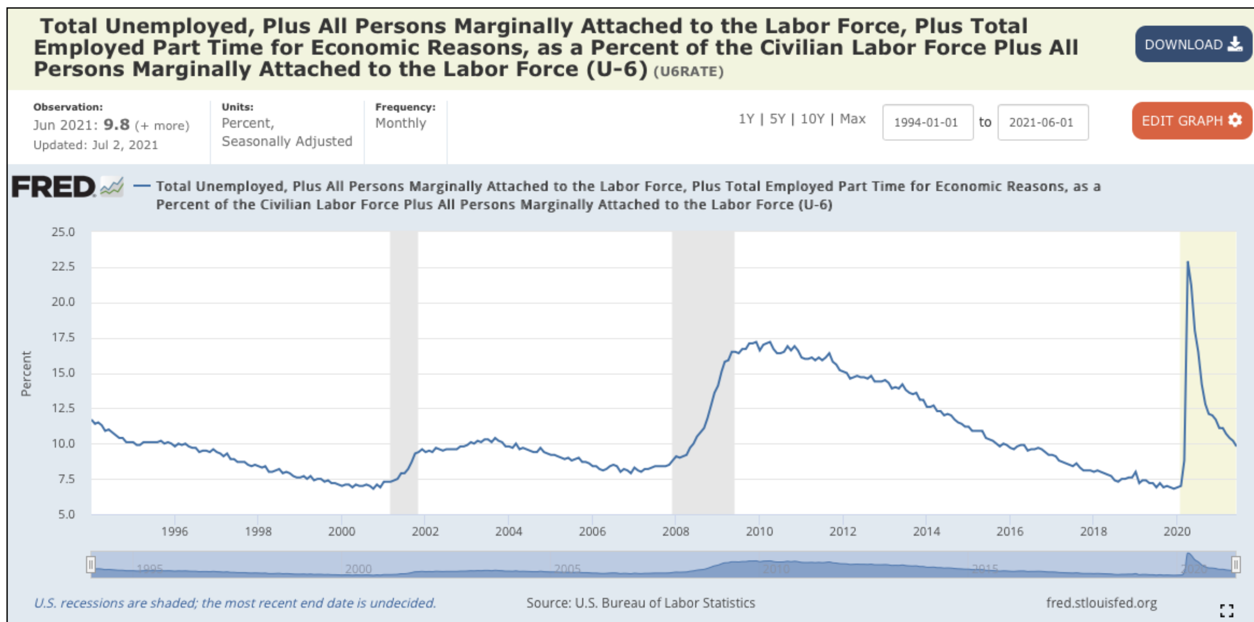
Demand-pull inflation comes from a sharp rise in demand for certain products or services and can be associated with minor or major bubbles - for those who remember the Beanie Baby craze of the early 2000s where marketing "buzz" around a simple toy sent demand through the stratosphere, that is a good example.

Today, rising inflation may be attributed to a combination of cost-push and demand-pull factors.

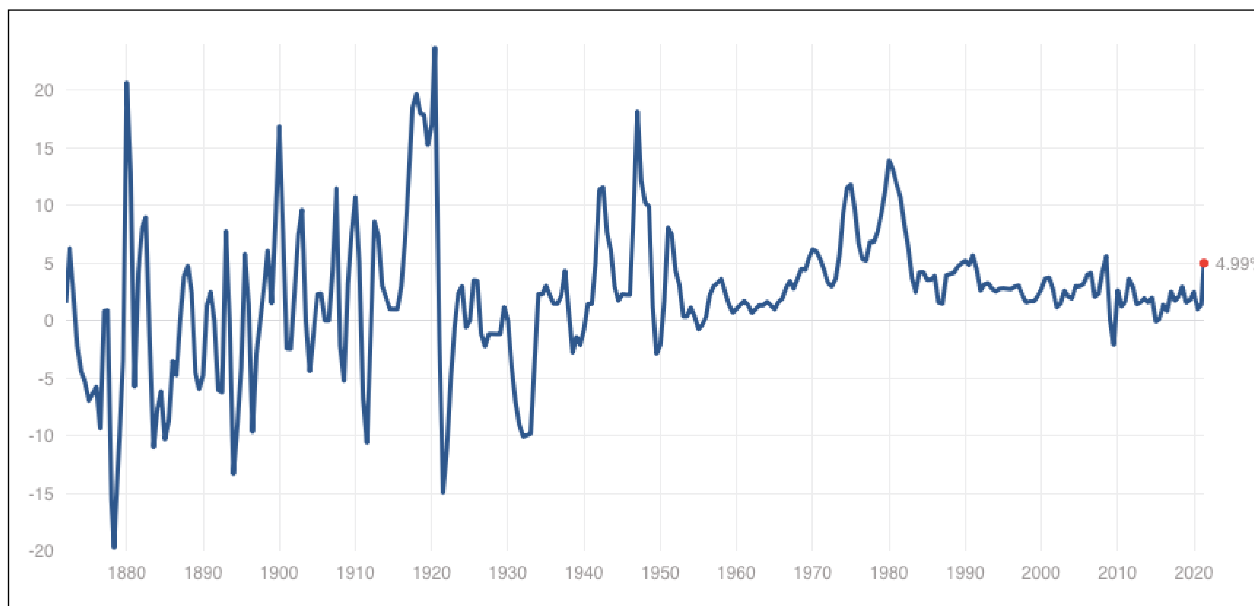
Cost-push inflation has entered the economy from the noted supply chain disruptions over the past three years. Demand-pull inflation, on the other hand, has been generated by the government's injection of trillions of dollars into the $23 trillion U.S. economy over the past year. That sharp rise in liquidity has influenced demand-pull inflation and may continue to do so until supply chains normalize. Invariably, free dollars in our pockets make us want more of almost everything, whether the desired supply is there or not. Long-term inflationary pressures could build in this way if the money supply is left unchecked by Washington, or is made to increase further.

Broadly speaking however, an increase in the money supply alone may not necessarily be enough to turbo charge long-term inflation. That may especially be true if the country's economic strength is unsustainable and is largely dependent on government transfers and low interest rates.

Low unemployment levels and rising wage growth offer a better environment for more sustained inflation, especially when combined with the magnitude of money printing that we have seen to-date. The U.S. economy is almost 70% consumer driven. If we have a low unemployment rate, as well as healthy wage growth, then we might more reasonably expect inflation to endure over time. Currently however, we have neither. Unemployment is higher than optimal and wage growth is small. The broad U-6 unemployment measure stands at almost 10%. Prior to the pandemic it was about 6.5%, as the chart below illustrates. That means that somewhere around 9 million people are not working today, while they were employed prior to the pandemic.



Perspective is always important, so it is worth noting that since the 1980s inflation has been relatively subdued and has moved up and down within a fairly narrow band of 0% to 5%. The chart below illustrates this.



Source: multpl.com

Two important factors may be responsible for keeping inflation low over the past 40 years, namely the aging population, particularly the Baby Boomer generation, and a rise in the use of technology. Aging populations tend to spend less than younger populations, while technological advancements reduce labor costs and increase productivity. Under such macro conditions, sustained long-term inflation becomes almost moot.

It remains to be seen which inflation camp is ultimately correct. For now, resurgent inflation adds to the set of challenges facing consumers, companies, and investors, and it needs to be figured into any investment strategy.

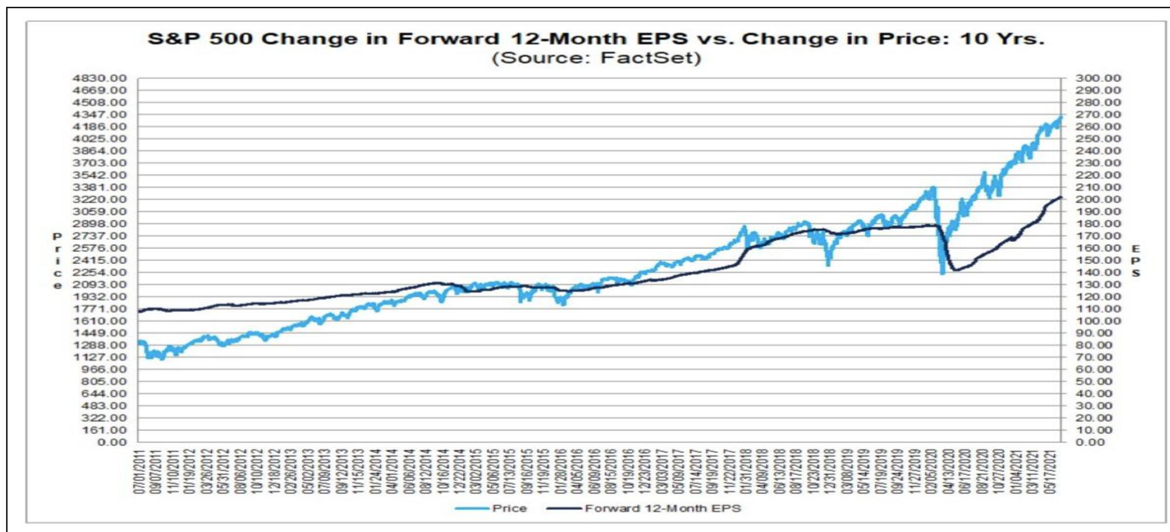
Inflation Poses a Near-Term Risk to S&P 500 Earnings

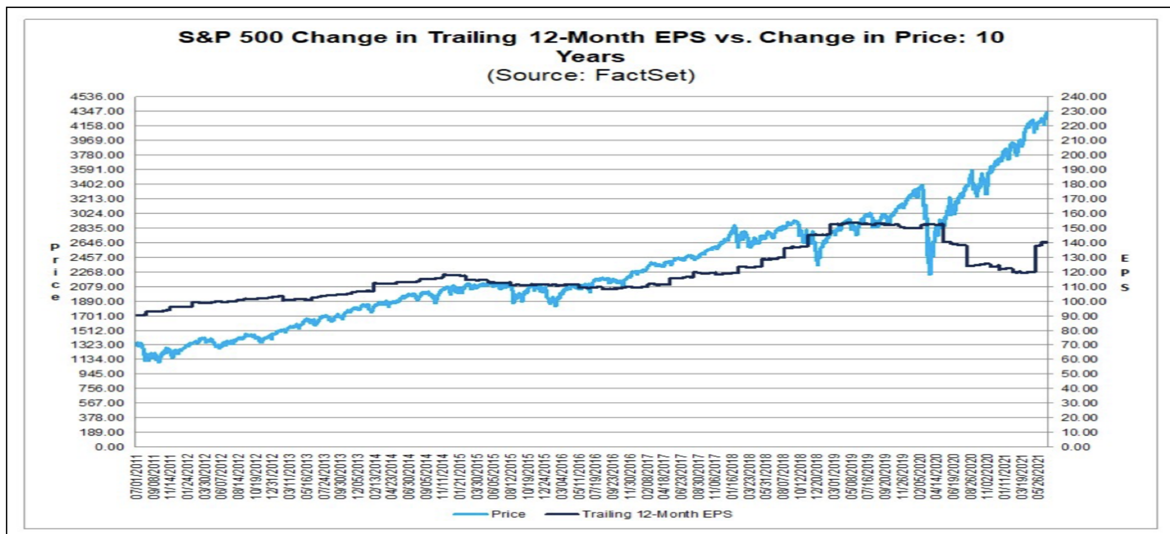
For companies across the board, the cost of inputs has risen, while consumer demand has exceeded corporate America's capacity to produce and to deliver. Where possible, companies have raised prices, though perhaps not to the extent necessary to cover costs. In the near-term, inflation may negatively impact corporate earnings including those of S&P 500 companies.

That view contrasts with the way Wall Street analysts see things. They tend to be overly optimistic in their earnings projections for both individual stocks and the S&P 500 Index. Over the course of a year, they often peg their estimates high at the beginning, and then slowly reduce their outlook until their estimates and the S&P's actual year-end earnings intersect. To some extent, this is done in order to avoid being down on the stock market which has a long history of rising more than falling.

The two FactSet charts below help to illustrate this divergence between predicted and actual earnings during the pandemic period. The black lines in each chart represent S&P 500 earnings, while the blue lines are the S&P 500 Index.

Predicted and actual earnings in the period from March 2020 are disconnected from one another. Analysts have been forecasting a quick rebound in both economic activity and corporate profits back to pre-pandemic normalcy. However, reality so far has proven to be more stubborn. The S&P 500 Index has risen throughout that period primarily on the basis of projected corporate earnings rather than actual earnings results.

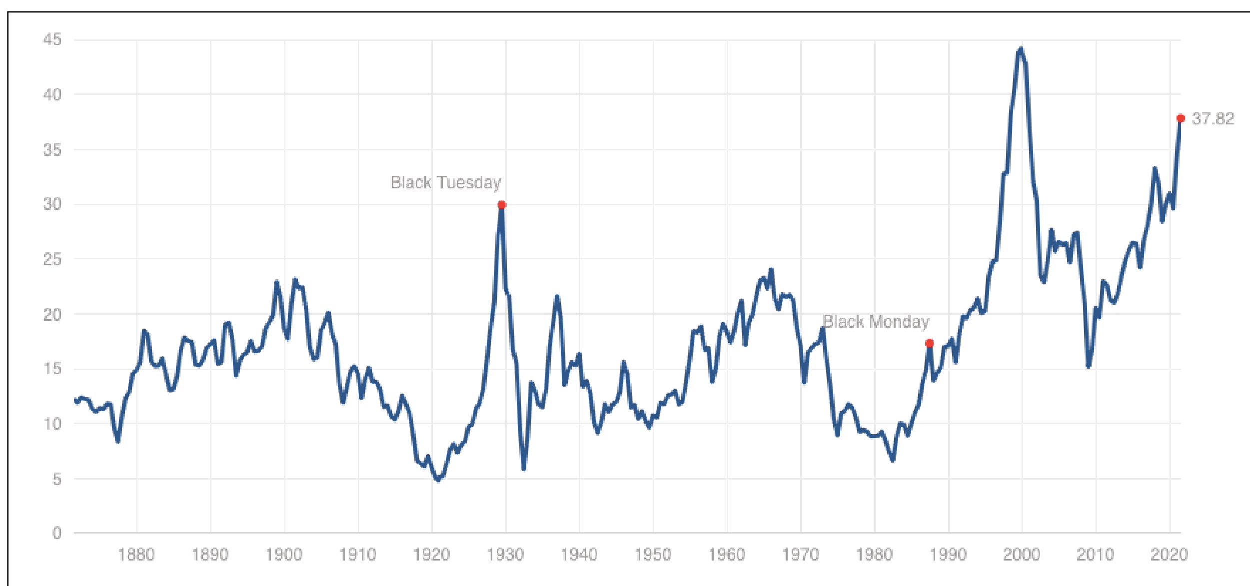




Continue to Focus on Quality, and Be Selective

The market's focus on expected future earnings means that share prices have risen substantially at a time when actual corporate earnings have either risen less than anticipated, or have not risen at all. Consequently, valuations have soared and still remain historically elevated. One measure of valuation, the Shiller P/E (chart below), continues to climb higher, signaling that ***the risk of a correction or a bear market is also rising.***

In this environment, finding attractive stocks that meet our conservative investment criteria has become more challenging than ever. Eventually this will change and valuations will become more reasonable, either through a decline in share prices or by a substantial boost in corporate earnings. Better buying opportunities will present themselves in time. ***For now, the prudent thing to do is to focus on risk while holding onto good quality stocks and investing selectively.***



Source: multpl.com

The Reeds Had it Right

Waterstone's investment approach takes a lesson from "The Oak and the Reeds". Flexibility is a vital underpinning to our investment strategy, especially in times when new challenges test existing investment concepts and approaches.

Flexibility focuses on understanding what is important for success, and what is not. It is based on the recognition that the markets are completely independent of us and our opinions. It aims to avoid the dogma and the rigidity that often plagues the investing mindset. Flexibility means that our investment decisions are based on well-considered cues taken from the markets and tempered with research, analysis, reason, mindfulness, and patience.

Cultivating flexibility in one's approach to investing is not an easy task - it can take years. But the effort can mean the difference between profits on the one hand, or losses on the other. With-

out the ability to respond to changing circumstances, a strong investment position can be uprooted in an unexpected storm. As Aesop's oak tree discovered, being a bit more like the reeds has its benefits!

V. Henry Astarjian

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