

## INVESTMENT COMMENTARY & OUTLOOK

### October 2021

The third-quarter was essentially a “washing machine” where stocks “sloshed” around. The bumpy summer months are now over and the seasonally strong time of year is now here. October has been strong in the past 20, 50 and 100 years, according to our friends at Bespoke. November is even stronger, and December is also strong. The strongest seasonal month is actually January, when new pension money likes to pour into the stock market. So essentially, the next four months should be wonderful.

Our fundamental growth stocks are poised to announce wave after wave of better than expected third-quarter sales and earnings announcements in the upcoming weeks. The analyst community revised their consensus earnings estimate up over 14.9% for our average growth stock in the past three months, so we are expecting at least 25% earnings surprises in the upcoming weeks. That is the good news.

The bad news is the stock market continues to climb a wall of worry. We get a lot of questions about what is going to happen when China takes over Taiwan after tormenting the island nation an untold number of times with the Chinese air force invading Taiwanese airspace. Our answer is that “China will not harm Taiwan’s infrastructure, since they need the semiconductor chips too!” This was confirmed by Chinese President Xi Jinping when he recently called for a “peaceful reunification” with Taiwan. Not surprisingly, Taiwanese President Tsai Ing-wen said that Taiwan would not bow to Chinese pressure.

China currently has its own economic problems. Based on the official Purchasing Managers Indexes (PMI), both its service and manufacturing sectors are now in a recession. Furthermore, the Trump Administration’s sanctions on 5G pioneer Huawei has been severely hurt by these sanctions, so its 5G market share is shrinking. Since the Biden Administration did not lift the Trump Administration’s tariffs on China, if China invades Taiwan, they not only risk a military reprisal, but also potentially more tariffs from the Biden Administration. In conclusion, our Taiwanese semiconductor companies remain great near-term buys, since we do not expect China to invade Taiwan in the near future.

China also has a problem with its real estate sector where apartment sales have stalled and some of its real estate developers are missing bond payments. Yields on Chinese dollar-denominated junk bonds reached 17% this week, which is higher than the highest rate they saw in the middle of the COVID crash last year. The Chinese government is keeping a tight lid on any information regarding problems with its real estate developers, but this situation has the potential to cause big issues in the Chinese economy since more people own real estate as an investment in China than own Chinese stocks.

What has also been dominating the mainstream and financial news lately is soaring inflation and supply chain/port bottlenecks. The good news is that as inflation continues to heat up and push China and other

countries into a recession, the U.S. remains an oasis. The port bottlenecks and supply chain glitches persist, but at least the U.S. is not expected to be crippled by high coal and natural gas prices that are now hindering China and much of Europe.

The Fed is now blaming inflation on the port bottlenecks and still believes that inflation is “transitory.” It is important to remember that slightly over a year ago, the U.S. economy was characterized by deflation, which the Fed definitely fixed with its easy money policies, ultra-low interest rates and quantitative easing. The only problem is the Fed “overshot” its 2% inflation target.

This is why the Fed will soon be announcing the rate at which it will taper QE. Recent statements estimate the rate of taper to be in the \$15-20 billion/month, taking the present rate of monthly Fed bond purchases to zero by the middle of 2022. Reducing purchases and ultimately stopping them is not the same as quantitative tightening. However, because of the present \$120 billion monthly rate of Fed purchases, both stocks and bonds should react to it. By pulling support away from the Treasury and mortgage markets, Powell will also be reducing support for the stock market. If QE depressed the credit spreads and yields in the fixed income market, removing the monthly infusions may cause both yields and credit spreads to increase some without Fed support.

The fact that the Fed is tapering QE means they think the economy no longer needs the extra help and that both the bond and stock markets can stand on their own. The Fed sees the glass as half full, as do we, but any large Fed open market operations of this kind should lead to increased volatility in both stocks and bonds.

The bottom line is that U.S. economy remains an oasis around the world, which is why the U.S. dollar is near a one-year high. Not only does the U.S. have positive economic growth, but it also has higher interest rates and continues to attract foreign capital. Furthermore, although the pace of economic growth in the U.S. is slowing, the consumer remains healthy based on personal income and many companies have robust order backlogs due to the port bottlenecks and other supply shortages. Finally, growth stocks are a great inflation hedge.

## SUMMARY

The fourth-quarter is seasonally strong and is characterized by positive gains for October, November and December. We should add that January is also a seasonally strong month, so we have four straight months of seasonal strength to look forward to. November is the strongest month in the fourth-quarter, since we typically get an “early January effect” just before Thanksgiving, when small capitalization stocks seasonally surge. The primary reason that November is such a strong month is that Thanksgiving is a “happy time of year” as we gather with family and friends and kick off the holidays. When we are happy, investors are typically happy and the good feeling seems to rub off on the stock market.

The order backlog for major economies, like China, Germany and the U.S., remains very high and has been affected by the Taiwan semiconductor chip shortage. This strong order backlog is a positive development for GDP growth in the upcoming quarters. So, although GDP growth decelerated in the third-quarter, we expect GDP growth to re-accelerate in the New Year.

The news on the inflation front looks bad, but we found some positive tidbits. The Labor Department reported recently that the Consumer Price Index (CPI) rose 0.4% in September, which is a dramatic declaration from a 0.9% surge in June. Food prices rose 0.9% in June, while energy prices rose 1.3%. Excluding food and energy, the core CPI rose 0.2% in September. In the past 12 months, the CPI and core CPI are running at an annual pace of 5.4% and 4%, respectively.

We found it interesting that the Labor Department report showed a chart of the CPI increase for the past 13 months to illustrate that the CPI is cooling off since its June surge. Essentially, this Labor Department CPI chart was apparently designed to make the argument that inflation is largely “transitory.” Nonetheless, due to a tight labor market and higher service costs, we expect that inflation will continue to remain elevated for the foreseeable future.

In an inflationary environment, your best inflation hedges remain residential real estate, and dividend growth stocks as well as our growth stocks. In other words, an investor’s best defense remains a strong offense of fundamentally superior stocks. We are very optimistic that the fourth-quarter will be very positive. Even better, January is a seasonally strong month and aided by positive inflows from new pension contributions. We expect a strong finish to the year and a prosperous start to the New Year!

Enjoy the holidays with your family and friends.



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