Goods-Services Whiplash

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When lockdowns went into effect in 2020, the nature of consumer spending and the economy changed enormously. During the summer of 2020, most of us stopped going on cruises, eating out at restaurants, and driving, and instead bought Pelotons, larger houses, and Traeger grills. On top of the behavioral change, the government flooded the economy with $4.7 trillion in stimulus by essentially printing money out of thin air.

When the economy reopened in early 2021, the good-services spending trend reversed. We started going back to restaurants, travel, and driving. As a result, spending on Traegers and Pelotons plummeted. Peloton was up 450% in 2020 and down 77% in 2021, now trading lower than its IPO price. While spending trends have flipped, government spending has not. President Biden also launched two massive stimulus plans, printing an additional $3.1 trillion. Stimulus has helped us tread water in 2022 and 2023, but at some point, the bill for the spending will come due and possibly give investors whiplash as the Fed tries to slow down inflation.

The Fed has two ways to slow down inflation. First, it can raise short term interest rates which disincentivizes investment. In a "normal" economic environment, higher rates prohibit people from buying houses and cars. In our opinion, we are nowhere close to a normal economic environment. Higher rates still aren't slowing housing down because supply is extremely tight. Higher rates not only hurt home buyers but also home builders at a time when we need more inventory. Further, home buyers would face whiplash selling their home with a 3% mortgage in favor of a home with a 7% mortgage. These factors combined lead us to believe rents and housing prices could continue rising steadily for longer. The initial 40% price increase from 2021-2022 is behind us, but families in the market for new homes are likely to face a challenging low supply, high interest rate environment for awhile. At some point, new home builds should reach parity with demand. Warren Buffet & Berkshire Hathaway recently took a position in D.R. Horton, Lennar and NVR in a bet that prices will continue rising for some time.

Headline inflation indicates prices are coming down across the board, however, after closer examination, decreasing energy prices are the primary driver of lower CPI. For a typical family though, inflation isn't budging as much as reports suggest. CPI is 32% shelter, 14% food, 13% transportation, 7.5% energy, and 7% medical services. With median home prices hovering around $416,000, the average family is paying $3,000 per month to finance a home purchase, including taxes and insurance, roughly 51% of median household income, not the 32% number that goes into CPI. In 2019, the median home price was $325,000 and at 4% rates, average mortgage payments were $1,836 with taxes and insurance. 2019 numbers placed housing at 32% of median household income, matching the CPI pie-chart. The reality today is that housing prices are a much higher portion of spending than the data suggest. The same goes for car prices. The average new car costs $48,000 in 2023 vs. $37,000 in 2019. The average car payment is now $716 for new vehicles, a new record high. In our opinion, these increases are not fairly represented in CPI headline data.

While we still haven't turned bearish on U.S. large cap stocks, we've urged caution in lower quality geographies, sectors, and market caps. Small caps in particular appear to be struggling much more than analysts initially thought. Profit margins are compressing rapidly amidst record high financing, labor and materials costs. In low interest rate environments, companies with a lot of leverage can outperform. In high interest rate environments, those same high-debt companies can get wiped out. We don't think the pain is completely over for emerging market, small cap, or regional bank stocks that still haven't fully absorbed the whiplash from 0 to 5% short term rates. Expect more volatility as we digest third and fourth quarter earnings. It wouldn't be surprising to see a 10-15% intra-year correction, even in a year where the S&P 500 posts a double-digit return.

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