Wealth Management

The Crescent Group

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The Crescent Group

Carsten Frederiksen, CFP®
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
Direct: 214-775-6401
NMLS#: 1321563 City National Bank
The Crescent Group website

Paul Hendershot
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
NMLS # 1370978 City National Bank

Lindsey Vickers, MBA
Client Service Associate
214-775-6458

Andrew Ielmini
Investment Associate
214-775-6448

November 2021 Crescent Commentary

"If it seems too good to be true, it probably is." – A wise person

What impact will the omicron variant have on your investments? Given that the world has learned to adapt to and live with covid-19 over the past two years, we don't see omicron having the impact that the initial covid wave and delta variant had in terms of lockdowns and travel disruption. The world economy and financial markets advanced past the delta variant, and we expect the same of omicron and future variants. Of course, that doesn't rule out the standard market volatility associated with sensationalized news headlines, which we experienced at the end of November.

While economic reactions to covid variants have come and gone over the past two years, one potential impact from omicron could lead to continued economic hardship: inflation. We say "potential" because it depends on how the world responds to the variant. Our Group has written about the inflation threat a few times this year. Most recently, consumer prices in October increased 6.2% over the prior year. For almost a year, the Federal Reserve called our inflation problem "transitory". They would not even publicly acknowledge the possibility that accelerated inflation might persist. They continued to stimulate the U.S. economy, even though the unemployment rate fell below the 5% level considered "full employment". As you might have noticed, all this stimulus resulted in what we would describe as an economic and financial sugar high. Assets with no fundamental underpinning have skyrocketed in value. Companies with no revenues or profits have a stock market value greater than companies with established revenues and profits. Bidding wars have erupted over homes. Demand for premium and luxury products has surged[(1)(3)(4)(5)].

But something big happened on November 30th, when the Fed told Congress they were retiring the use of the word "transitory" to describe inflation. This marks a pivot of the Fed away from stimulating the economy and towards fighting inflation, which requires more economically restrictive policies. The Fed did this even in the face of the new covid variant. In the past, the Fed would have probably talked about how much uncertainty the new variant created, and would have felt the need to keep stimulating the economy. But instead, the Fed told Congress they would look at removing their economic stimulus more quickly. Why? Because the inflationary side effects of too much stimulus for too long have finally grown too large to ignore. We can no

longer afford to shut down society and try to make up for it with massive stimulus because we now know that the end result is an inflationary spike. It turns out that if something is too good to be true, it probably is[2].

What does this mean for your investments? It's our opinion that much of the gain we've seen in asset prices over the past five to ten years has been driven by too much economic stimulus for too long. You can look to what happened in 2018 as an example. In October of 2018, the Fed said the U.S. economy was strong enough to start reducing the interest rate stimulus the Fed was providing. Following that public statement from the Fed, some of the most popular investments fell 20% in one month. The stock market as a whole fell 20% over the next three months. The Fed was spooked by this market decline – they reversed course, and once again resumed using interest rates to unnecessarily stimulate our economy. They provided this stimulus despite a very strong economy with record low unemployment. This drove further speculation in financial assets. Then covid-19 hit and our government pulled out all the stops. Trillions upon trillions of stimulus which continued even after the economy recovered. That led to even greater speculation in unproven investments[6][7].

If the Fed is indeed forced to reverse the course of stimulating policies and adopt economically restrictive policies to fight inflation, it could mark the turning of the tide from the financial sugar high and bubbles we've witnessed over the past several years. It means that more than ever, investors must own sound businesses with established and proven profits, trading at reasonable valuations. If you look at past periods where bubbles deflated, you can see the importance of this. For the time period 1999 to 2009, the U.S. witnessed the collapse of a stock market bubble, and then a home price bubble. Over that ten-year period, U.S. stocks as a whole declined 7%. Yet individual sectors generated gains over that period, with Consumer Staples increasing 66%, Health Care increasing 30%, and Industrials increasing 8%. At the present time, our Group sees the potential for a similar dynamic as the stock market appears to look like a seesaw – with overhyped assets overpriced and poised to do poorly in the future, and mundane but solidly profitable companies available at reasonable and depressed prices and poised to do well in the future[8][9].

While the restrictive economic policies needed to fight inflation point to a potential change in the status quo of chronic stimulus we've experienced over the past thirteen years, it's important to realize that no one can predict the future. The best and most prudent course for any long-term investment strategy is to invest today in a manner that gives you the best chance of a good outcome no matter what happens. That is what we have done and will continue to do for you in order to protect and grow your irreplaceable wealth.

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Carsten Frederiksen, CFP® | Paul Hendershot | Andrew Ielmini | Lindsey Vickers, MBA

Sources:

(1) CNBC
(2) NBC
(3) Bureau of Labor Statistics
(4) Fortune
(5) Reuters
(6) S&P Dow Jones Indices LLC
(7) Yahoo Finance
(8) DQYDJ
(9) Richard Bernstein Advisors

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