The Kiplinger Letter

FORECASTS FOR EXECUTIVES AND INVESTORS

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Dear Client:

Washington, June 16, 2022

COVID-19 Positive Tests per 100,000 Residents

U.S. daily average: 32

11 to 20
Conn., Idaho, Ind., Iowa, Maine, Neb., N.H., N.D., Okla., S.D.

21 to 30
Ala., Ariz., Ark., Ga., Kan., Md., Mass., Mich., Minn., Miss., Mo., Mont., N.Y., Ohio, Pa., S.C., Tenn., Texas, Vt., W.Va., Wis.

31 to 40
Del., D.C., Ill., La., Nev., N.J., N.C., Ore., R.I., Utah, Va., Wash.

41 to 50
Calif., Fla., Ky., N.M.

51+
Colo. (53), Alaska (56), Wyo. (61), Hawaii (80)

Seven-day average, June 8-14

<u>This is the worst inflation since 1981</u>.
<u>And it hasn't peaked yet</u>. Here's our take on what comes next and how you should prepare.

INFLATION

<u>The situation will likely worsen until Sept</u>... a few more months of painful increases in the inflation rate, which we think will top out around 9% by late summer. And after that...

<u>Inflation will stay stubbornly high</u> even after it crests, ending the year around 8%, unless a recession hits and cuts back demand (an inflation remedy even worse than the disease).

<u>Hence the Federal Reserve's urgency</u> to bring inflation down, as shown by its decision to raise its benchmark short-term interest rate by three-quarters of a point this week. The Fed hasn't hiked that much at one time since 1994.

<u>More big interest rate hikes are coming</u>.

<u>The Fed has no choice</u>. There are signs that the inflation the central bank once believed was "transitory" is getting embedded. Consumers and businesses are starting to expect higher prices to continue, which can become self-fulfilling. The Fed must break that cycle, even if rapid tightening risks causing a recession.

<u>Expect the Fed to boost its rate by another two percentage points this year</u>.

<u>Price increases should cool next year</u>, as the effects of higher interest rates and gradual improvements in supply chains start to show up. Some of the shortages and scarcities contributing to higher prices now figure to abate. The flood of money Congress spent in 2020 and 2021 in response to the pandemic has ebbed. The days of blowout spending bills are over for now, despite Democratic calls for new programs. Soaring energy prices have less effect on general prices now than in the energy crises of the '70s. Fewer workers get automatic cost-of-living raises now versus then, too.

<u>But even so, inflation isn't going back to the low levels of the prior decade</u>.

<u>Look for prices to continue rising at an elevated clip</u>: <u>Perhaps 3%-4%</u> in the longer term, after the 8%-9% surge this year...better, but nothing to celebrate.

<u>When it comes to investing, keep a few things in mind</u> as markets gyrate.

<u>Expect continued volatility</u>. <u>And stocks may well be headed even lower</u>.

<u>But some good values are starting to emerge</u> amid the carnage. Stocks in the technology, communication services and consumer discretionary sectors are good places to look for bargains. Bonds, which until recently sported tiny yields, have also been beaten up, and now offer higher payouts. Ultrashort-term bonds finally offer a decent yield. Muni bonds look attractive. Most issuers' finances are solid. And don't overlook Series I bonds from the Treasury Dept., now yielding 9.62%.

<u>Don't try to time the bottom</u>. <u>Stay diversified</u>. <u>If you buy, do so gradually</u>, in steady increments. The rules that did well in prior bear markets still apply now.

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U.S. ECONOMY U.S. manufacturing employment is on track to surpass prepandemic levels in the next couple of months. The sector now has 12.8 million employees, only 17,000 fewer than it did in Feb. 2020. In some subsectors, employment is well above prepandemic levels. Leading the pack: Food manufacturing (up 41,800) and chemicals (up 40,600). Other segments with more workers: Wood products, miscellaneous nondurable goods, plastics and rubber products, electrical equipment and appliances, miscellaneous durable goods, and furniture and related products.

Through May of this year, manufacturers have added 213,000 workers, building on the 365,000 that they added in all of 2021, the most since 1994.

But the pace of job gains may be set to slow, as consumers shift spending from goods to services, and high inflation starts to crimp growth. Manufacturers added only 18,000 jobs in May, the weakest monthly increase in over a year.

Regional Fed surveys point to a coming slowdown in factory activity, though so far national manufacturing readings have remained surprisingly resilient.

FINANCE Most banks continue to relax credit standards on consumer loans. Banks have lowered credit scores or increased credit limits for credit cards and auto loans. They've also continued to ease lending standards across nearly all of the real estate categories, excluding subprime mortgages. However, demand for mortgage loans has cooled. Delinquency rates remain low across the board.

But the likelihood of tighter standards later this year is high, as inflation chips away at real incomes. Delinquency rates will rise and demand will dip, too.

Note that more folks are financing purchases with debt. Consumer borrowing surged in April, after a record jump a month earlier, according to government data.

Plus, more consumers are paying off their debts a little more slowly, shown by the share of active credit card accounts with revolving balances rising.

A major overhaul to stock trading rules is in the works at the SEC… Securities and Exchange Comm. A recent proposal by Chairman Gary Gensler would create an order auction mechanism to decide which trading groups get to handle retail investors' orders. That would amount to a big change to the current system, where brokers can send orders directly to individual firms that they choose, which sometimes pay brokers for sending orders to them. For example, Robinhood, the app that popularized commission-free trading, makes about 80% of its revenue from selling customers' orders to market makers. Companies such as Citadel then execute the transactions, keeping the difference between the bid and ask prices. This system has been around since the 1980s.

The SEC says its proposal will strengthen competition for retail investors when they buy and sell equities, with the ultimate aim of reducing trading costs.

But it faces fierce opposition from trading companies and brokerages, which say that the current setup already gives retail investors the best price. Nasdaq, the New York Stock Exchange and other exchanges have welcomed the rules after lobbying for regs that help them compete with off-exchange trading groups.

New crypto legislation would treat most digital assets as commodities. The Responsible Financial Innovation Act creates a sweeping regulatory framework and provides a definition of different types of digital assets, among other things. Overall, the bill is largely friendly to the industry when compared with other proposals. Some issuers of digital tokens could see lighter disclosures than publicly traded firms.

More power to regulate cryptocurrencies would go to the CFTC… Commodity Futures Trading Comm. Digital currencies that are "decentralized" to a sufficient extent…such as bitcoin…would be treated as commodities like gold or wheat. The SEC would remain in charge of crypto tokens used to raise money from the public, as a stock offering would. The bill sets rules for stablecoins, too. Congress is mulling dozens of other similar bills, but this is the most comprehensive.

WHITE HOUSE

The Defense Production Act is having a moment. The Cold War-era law has been invoked several times over the past few years by Donald Trump and now Joe Biden, for everything from kick-starting production of vaccines to securing supplies of critical minerals for electric-vehicle battery production.

Among other things, the DPA lets Uncle Sam install equipment, paid for by the government, in private manufacturing facilities, experts say.

This could improve the cost-competitiveness of U.S.-made solar panels, which have historically been at least 30% more expensive than foreign-made ones. Ditto, other clean-energy and grid tech, including heat pumps and transformers.

It could also make vital building materials more abundant, like insulation, key to improving home energy efficiency. The Environmental Protection Agency estimates that properly insulating and sealing a house can result in homeowners reducing their annual energy costs by 15%. But half of U.S. homes were built before building codes required the use of modern energy-saving insulation.

Still, the DPA is not a blank check. While it enables immediate action by the White House, officials still need Congress eventually to replenish funds used to execute DPA authorities. This is normally handled in the annual NDAA... National Defense Authorization Act...usually a noncontroversial, bipartisan bill. But such funding may become more contentious as use of the DPA expands.

CONGRESS

Congress is close to passing its biggest gun control measure in three decades. But a tentative Senate deal isn't yet complete, despite the critical endorsement of 10 Republican senators, which could help the Senate avoid the filibuster rule that has derailed past efforts to pass legislation in the wake of mass shootings.

In the meantime, here is a quick rundown of the bill's likely provisions:

Resources for states to adopt and expand "red flag laws," which allow courts to temporarily confiscate firearms from individuals deemed to be a risk to themselves or others. So far, 19 states plus Washington, D.C., have such laws on the books.

Extra scrutiny of criminal and mental health records for buyers under 21.

Investments to improve security and mental health services at schools.

Elimination of the "boyfriend loophole," meaning the FBI could add anyone convicted of domestic violence against a partner to its background check system.

A crackdown on gun traffickers and people who buy guns for felons.

The House has passed its own, more expansive gun control legislation along party lines. Some House Democrats are unhappy with the Senate's approach, which could make agreement on a final bill to send to the president's desk difficult.

FOOD

Amid escalating input costs and ongoing supply chain disruptions... Vertical integration is becoming increasingly popular in the food industry, as companies seek greater visibility into and control over their supply chains.

One recent example: Restaurant chain Wingstop is considering acquiring or building its own poultry complex for both raising and processing chickens. Should it take such a step, Wingstop would be following in the footsteps of Costco, the big-box store chain that owns and operates its own hot dog processing plant. Walmart, too, owns a meatpacking facility in Ga. to serve regional customers.

Chicken is increasingly the meat of choice, not just for the U.S., where per capita chicken consumption is 67% higher than beef and 94% than pork...

But also the world. Global chicken consumption is on track to account for 41% of all meat eaten in 2030, making it the most popular protein for the first time on record. One reason: Chickens can be raised and slaughtered more quickly... as little as six weeks...and cheaply than cows, which usually take at least 12 months.

HEALTH CARE Nursing homes face alarming staffing shortages, causing many facilities to cut back on new admissions while forcing many staffers to log overtime. 87% of nursing homes face moderate-to-high staffing shortages, says a May survey by the American Health Care Assn. Nearly all report having difficulty finding help.

There's no quick relief in sight. The worsening situation has gotten so dire that nearly three-quarters of survey respondents worry about having to shut down.

The vast majority of facilities have offered wage increases and bonuses.

But those sweeteners aren't enough, as most lack the funds to offer wages that are competitive for new hires. Most nursing homes are using temporary staffing as they deal with their top obstacle: Finding interested and qualified candidates.

Surging operating costs since last year are exacerbating the problems.

TELECOM Some noteworthy recent actions from federal telecom regulators:

Launching an inquiry into new offshore spectrum uses for wind turbines, cruise ships, oceanography research and more. The Federal Communications Comm. is eyeing more airwaves for everything from faster internet on ships to tsunami alerts.

Looking into tech that can more precisely route 911 calls from the location of the caller to the correct call center. The effort aims to speed up response times and spread improved types of location-based 911 routing to more of the country.

Proposing faster internet speeds for small rural broadband providers. The FCC is looking at additional universal service support for certain rural carriers that hit high-speed benchmarks...good news for rural telehealth, precision ag, etc.

Adopting new rules to crack down on international scam robocallers. Certain telecom providers that are the entry point for international call traffic will have to comply with FCC authentication guidelines that combat illegal spam.

TRAVEL A new overnight sleeper bus service is making its debut this month.

Napaway will start with a Washington, D.C., to Nashville, Tenn., route that features passenger chairs that fold down into a 6.5-foot-long, 40-inch-wide bed.

One-way tickets start at $125 and more routes will be available soon.

This isn't the first time in recent years a company has tried a sleeper bus. A coach company called Cabin tried a trip between Los Angeles and San Francisco in 2017, for example, but later shifted to offering only private charter services.

Long-haul bus journeys take longer than a flight or train, of course.

Riders complain of bumps and noise, too. But note some key advantages that could lure folks. Beyond lower prices, there are no airport-type security hassles to navigate, and they generally pick up and drop off passengers in downtown areas.

POLITICS The only state that's still never sent a woman to Congress? Vermont.

But the Green Mountain State is poised to shed that distinction in Nov. The top candidates vying to replace Rep. Peter Welch (D), who is leaving the House to run for the Senate seat to be vacated by retiring Patrick Leahy, are all women. Of the four Democratic candidates running, the top three fund-raisers are women. On the Republican side, two women are on the ballot for the Aug. 9 primary.

Vt. became the last state to never have a female representative in 2018, when Miss. Republican Cindy Hyde-Smith was appointed to fill a Senate vacancy.

Yours very truly,

Knight Kiplinger

June 16, 2022 THE KIPLINGER WASHINGTON EDITORS

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