# Economic and Market Newsletter Spring 2021

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**WHICH WALL STREET ADAGE APPLIES?**

The stock market moved past the one-year anniversary from the worst of last year's COVID plunge and the results from the bottom were truly astounding. Despite the ongoing economic disruptions from the pandemic, the S&P 500 Index managed to surge 76% from the prior-year's market nadir: the largest twelve-month gain since April 1936. After such an enormous run, strategists' opinions differ about which Wall Street adage best fits the current situation. Bullish pundits point to the old saying that bull markets "climb a wall of worry" to defend their optimism. They argue that investors look to the future, not the past, and that with increasing vaccination rates and the economy about to fully open up, business conditions should improve dramatically. Those with a bearish bent, however, cite Warren Buffet's saying that "one should be greedy when others are fearful and fearful when others are greedy." They see the rapid rates of appreciation in some of the riskiest securities and begin to tremble at the intensity of investor euphoria. Rampant speculation has gone beyond a relative handful of meme "stonks" to include other risky investments such as SPACs, penny stocks, CCC junk bonds, cryptocurrencies, total-return swaps and options. The fact that much of the risky investing was coming from novice traders, often on margin, set the bear's teeth on edge. In the most recent data, investors had borrowed a record $814 billion against their portfolio holdings, up 49% year-over-year. This was the fastest increase in margin debt in the past twelve years and rivaled the pace of borrowing seen during the Internet Bubble.

**PERHAPS ANOTHER OLD SAYING IS BETTER**

The fact that each side has plenty of evidence to back up what are essentially polar opposite positions probably only demonstrates how atypical the past year has been. While the current environment has many similarities to past cycles, some differences truly stand out … the largest being the amount of liquidity pouring into the financial system from D.C. A more fitting Wall Street adage for today might be: "Don't fight the Fed," with the proviso that it is probably not a good idea to fight the U.S. Treasury either. Our past quarterly letters noted the imposing size of last year's $2.7 trillion liquidity injection from the Fed, combined with the additional $4 trillion in grants and loans from the first COVID relief bills. Little did we realize then that policy makers were just getting started. Congress released another $1.9 trillion in the American Rescue Plan Act that was passed last month, which when combined with the relief legislation from the final days of the Trump Administration, totaled 13% of GDP. On top of that, $2 to $3 trillion of additional spending has been proposed in the Biden Administration's Infrastructure Bill, which by itself, is equivalent to about 10% of GDP. This amount of fiscal stimulus exceeds anything seen before in the U.S. during peacetime and at a scale that is far beyond any other country today.

This massive amount of anticipated spending would be difficult to fund without the assistance of the Federal Reserve. Thanks to the Fed's previously announced asset purchase program, a large portion of the $5 trillion in newly issued debt will end up on the Fed's balance sheet. Opinions vary widely on the wisdom of running such a large Federal deficit, or if that degree of monetary intervention by the Central Bank is warranted. Pro or con, however, investors cannot afford to concentrate on what ought to be done, but rather, they must focus on what officials are actually doing. In the current environment, it is enough of a challenge to judge how these fiscal and monetary policies may impact the financial markets.

**CONSUMERS ARE READY TO SPEND**

The flow of cash coming from Washington will soon be combined with the vast amount of private savings that have built up over the past year. Many households, especially higher income families, were forced to curtail their normal expenditures on travel and entertainment due to pandemic-related closures or restricted hours. Although some consumers redirected their spending budget toward goods, a great deal of money ended up being saved. U.S. savings rose by approximately $3 trillion in 2020, triple the increase that occurred during 2019. The savings rate increased from an average of roughly 8% prior to the pandemic to as high as 15% last year. With all that cash, Americans are ready to spend. Therefore, a $2 trillion torrent of pent-up demand could burst into the economy, only to arrive simultaneously with the money flowing from the wide-open Federal floodgates. The economy has already been showing signs of improvement, even before this additional spending has arrived. Indicators from the labor markets, retail sales, the regional manufacturing indexes and housing markets all show gathering momentum. Thanks to the anticipated spending spree, many Wall Street strategists are increasing their forecasts for real GDP growth, which now range between 5% to 6.5% for this year. If that level of expansion could be achieved, it would be the fastest rate of growth in almost forty years. This recovery could be unlike anything in recent memory.

**A STRONG ECONOMY SHOULD BE GOOD FOR STOCKS**

Such an optimistic GDP forecast should be a positive sign for the stock market, since equities have generally performed admirably when economic growth was that high. After all, faster economic expansion generally leads to robust corporate revenue growth, which often can be leveraged into higher profit margins. With economists becoming more bullish, Wall Street analysts have been raising their earnings projections for the S&P 500 Index companies. Their consensus estimate now anticipates a 32% increase in S&P earnings-per-share this year, compared to last year.

There is one caveat we should note, however. While it would be unusual for the stock market to decline significantly during a boom, it also was highly abnormal for stocks to roar ahead in the midst of a sharp recession, like many did during 2020. Given how well stocks have done, there is a possibility that all the good news has already been incorporated into current prices. Instead of only focusing on economic growth, investors may start to shift their attention to other indicators, such as the rate of inflation, to determine if the rally in equities continues from here. That is a risk worth considering. We think the bond market will be the barometer to watch.

**HOW MUCH INFLATION DO BOND INVESTORS EXPECT?**

Bonds are an unusual asset class, where bullish or bearish economic outlooks can provide equally valid explanations for falling prices. Rising nominal interest rates, and the associated falling bond prices, could be caused by bearish expectations of higher inflation, or just as easily, by prospects of a strong economic recovery increasing borrowing demand. Determining which force is more prominent now has become increasingly important after the sharp rise in intermediate and long-term interest rates over the past six months. Yields on ten-year U.S. Treasury notes doubled from less than 0.8% last October to over 1.6% now. It is true that interest rates last Fall were unusually low and probably at unsustainable levels, but, even then, interest rates have increased more quickly than most investors anticipated. While concerning, investors can take some comfort in the fact that the ten-year Treasury yields are only back to the bottom of the range that prevailed from 2012 to 2019. We also note that although rates spiked, credit spreads were resilient, with high-grade bonds retaining only a narrow yield premium to Treasuries. Now that rates are higher, the question is what happens next. Jerome Powell has made it very clear that monetary policy will remain extraordinarily loose until the economy reaches full employment, even if inflation rates start to increase, but bond investors can have a mind of their own.

For the first time in over a decade, there is a plausible case that inflation could overshoot the Fed's long-held 2% target. Comparisons are about to be made against the abrupt price declines from the early stages of the pandemic, making the year-over-year percentage changes look very high. Beyond that, recent supply chain disruptions, compounded by the shipping bottleneck in the Suez Canal, have led to product shortages that are bound to put pressure on wholesale prices. Indeed, the seasonally adjusted Producer Price Index jumped 1% in March, double the monthly increase in February to an annual rate of 4.2%. If left unrevised, that would be the highest annual increase since September 2011. Beyond wholesale prices, services inflation, usually quite stable, also could show increases this year that would be considerably above normal. As we noted earlier, consumer demand for services is likely to rebound sharply after having been curtailed for over a year. If a surge in demand is too strong, it could outstrip the pace at which staff can be hired and businesses can fully reopen, putting pressure on both prices and wages.

The Fed's official view is that these inflationary pressures are likely to be transitory and that conditions are likely to ease when supply eventually catches up with demand. Their forecast also counts on the past relationship between the Consumer Price Index and the Wholesale Price Index continuing into this year. Usually, consumer prices respond to higher commodity prices with a lag, which the Fed hopes will help to keep the CPI at an acceptable level long enough for the surge in wholesale prices to abate. In the past, however, the lag has been quite variable, so there is a risk that wholesale prices could flow through more rapidly than the Fed expects. Over the next few quarters, it may become clearer if a persistent trend toward higher inflation is starting to build. Bond investors will probably be the first to notice if it does, revealed in the interplay between various fixed-income securities. Perhaps they already have.

One measure of inflation expectations are the changes in the spread between nominal yields on U.S. Treasuries and inflation-adjusted TIPS notes. When the pandemic hit a year ago, these spreads plummeted to near zero, but they have widened rapidly since then. Based on the yield difference, investors anticipate that inflation will rise somewhere around a 2.5% to 2.7% rate in the future. So, bond prices already incorporate a much higher rate of inflation than we've seen recently. To compare, actual inflation, as measured by the Consumer Price Index, was only 1.4% during 2020 and it averaged about 2.1% for the three years prior to that. In fact, the last time inflation moved above 2.5% was over a decade ago. The last time the U.S. experienced a sustained rate of inflation above 3% was during the early 1990s. We will be watching carefully to see how the bond markets react if even higher inflation statistics are reported in the coming months.

**THE TUG OF WAR BETWEEN EARNINGS AND MULTIPLES**

Simplistically, a stock price rises because the underlying company's earnings prospects have improved, or because higher valuations on those earnings are warranted. One of the most common reasons for higher Price/Earnings multiples is because of a decline in general interest rates. In the recent rally, investors seem to be primarily focused on the stronger economy and the better outlook for earnings and they have largely ignored the increase in interest rates. This optimism has pushed Price/Earnings multiples to levels not seen in twenty years. If bond investors become convinced that the Fed's policy stance was wrong and that higher inflation will be imbedded in the economy, further increases in interest rates could upset this relationship.

The negative effect of higher interest rates on stocks could go beyond just lowering Price/Earnings multiples. After all, higher interest rates have a ripple effect on housing, autos and business investment and can slow the economy no matter what the Fed does. Already this year, the steepening yield curve increased the cost of a home mortgage, which put a noticeable dent in the growth of mortgage applications. Higher rates also have an impact on the foreign exchange markets. Higher interest rates in the U.S. would appear increasingly more attractive to foreigners living with negative interest rates in their own countries. If foreigners were to choose to shift more of their assets here, it could have the effect of strengthening the U.S. dollar. This matters to stock investors because foreign exchange differences can also impact the reported earnings for U.S. domiciled companies. Somewhere between 40% and 50% of the revenues of the S&P 500 Index companies are generated abroad and a stronger dollar makes those sales less valuable when converted back into U.S. currency.

**OUR OUTLOOK**

Given these risks, there is probably no statistic more relevant to U.S. shareholders that the ten-year Treasury rate. For the time being, the bond markets seem content to give Chairman Powell the benefit of the doubt and accept the idea that any uptick in inflation will be temporary. The dispute between inflation hawks and doves will continue to draw everyone's attention, however. We are also open-minded about the longer-term risks of higher inflation. Interest rates may not have finished rising and the yield curve could steepen further, even if the Fed holds short-term rates where they are. With Price/Earnings ratios high and bond yields low, we will remain laser-focused on the inflation numbers and the bond market's reaction to them to determine whether to change our asset mix as we go forward.