Economic and Market Newsletter Winter 2021

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BORING WOULD BE NICE

Seasonally, this is when many of our research sources provide their market forecasts for the upcoming year. Given the tumultuous course of 2020, we are surprised that anyone, other than an astrologist, would venture to provide an outlook beyond the next few weeks. Regardless of the forecasts, our fervent wish is for the return of a level of normality to the economy and the markets over the next twelve months, even at the risk of occasional boredom. Given the flow of daily headlines, however, this may seem like a pipe dream. Virtually every year suffers through at least one stock market correction, so this year, like all others, the financial market will probably have its share of challenges. At least some of last year's concerns, such as the outcome of the election, completing the Brexit deal and the timing of an effective COVID-19 vaccine, are either resolved or well on the way to resolution. The perennial problems of climate change, immigration, tensions in the Middle East, Chinese trade tensions, and Russian antagonism with the U.S. will remain, but investors have long been accustomed to dealing with these issues.

The calendar may show a new year, but we have yet to flip the page on the pandemic. While last year was dominated by questions about effective treatments and vaccines, as the healthcare crisis lessens, the focus of 2021 will start to shift toward the pace of vaccination and economic recovery. Realistically, one must assume that COVID-related pressures are likely to suppress economic growth in the first half of the year, but the outlook should improve in the second half as vaccines are increasingly rolled out. Consumer spending should pick up after small businesses can reliably reopen and individuals feel secure enough to return to a more normal lifestyle. After months of deferring travel and shopping, we suspect many households have a great deal of pent-up demand. Hopefully, these gains can be achieved without suffering through bouts of heightened volatility along the way. Bond prices may suffer somewhat as the economic recovery takes hold in the second half, but monetary authorities seem focused on capping interest rates until the economy is solidly on its feet. Our dreams of impending boredom could be shattered, however, if Jerome Powell signals any wavering from the Fed's current monetary policies.

MONEY MAKES THE MARKETS GO AROUND

From March through December, the notable feature of the financial markets in 2020 was the enormous rally in virtually all risk assets and the riskier, the better. You name it - junk bonds, options, precious metals, and cryptocurrencies all saw active trading with huge inflows, leading to some examples of eye-popping returns. This explosion in risk taking can be traced to many causes, but one reason stands above the rest: the flood of money that the global central banks pumped into the financial system. The aggregate money supply of the world's largest economies rose by $14 trillion last year, almost 67% more than the previous annual record of an $8.38 trillion increase. Much of this money was inserted directly into the markets, as central banks bought corporate bonds and other financial assets. The Federal Reserve alone has injected around $120 billion/month into the financial system through its various methods.

Demand from the major central banks helped push bond prices higher around the world, lowering inflation-adjusted yields to miniscule, or negative, levels. With rates so low, corporate bond issuance hit a record last year, with the proceeds used to refinance existing high coupon debt, fund capital spending and buy back stock. Beyond this, however, much of the force-fed liquidity found its way into riskier assets. Most investors are reluctant to accept minimal returns on their savings, so as markets stabilized and began to improve, their appetite for risk increased. Momentum investors accentuated these trends and the dispersion of returns within and among asset classes was abnormally large last year as more and more investors jumped on the risk bandwagon.

So far, the lion's share of the added liquidity from the Fed has remained within the financial system, with very little flowing into the "real" economy. The result has been the kind of inflation most people like, higher securities prices, with very little acceleration in the Consumer Price Index. Most of the other major central banks around the world are primarily charged with maintaining price stability, but the Federal Reserve was given a dual mandate: to seek maximum sustainable employment along with stable prices. With inflation rates holding below the Fed's targets, monetary policy has been predominantly focused on the spike in unemployment during the pandemic. Every indication from Chairman Powell is that the Fed will continue to add liquidity until the labor market is repaired. Achieving this goal, however, will necessarily be dependent on inflation rising at a controlled rate.

DOES MORE MONEY EQUAL HIGHER INFLATION?

Many economists are increasingly concerned that the policy response to COVID will ultimately prove to be inflationary. We can't cite the source, but we've seen it written that a third of all the dollars that have ever existed were created in the last ten months. We do know from Government documents that Federal debt increased by a record $4 trillion last year spurred by the massive CARES Act. Unfortunately, very little of the relief spending could be directed to projects that would enhance U.S. productivity The emergency required spending to get the unemployed through the crisis, but with available job openings few and far between, too many people were forced to sit at home and watch TV: not the best use of resources. Even at low interest rates, the burden of unproductive debt does put a strain on Federal finances. If our math is right, a 0.30% increase in total Federal debt is roughly equivalent to the annual budget for the U.S. Marine Corps. How much the Federal deficit increases next year will depend on the incoming Biden Administration's allocation of resources to fund additional COVID relief, along with added spending in other areas. As the deficit grows, policy makers may view higher inflation as a means of decreasing the real cost of the debt burden.

There are other inflationary forces in addition to the deficit. COVID-related supply chain disruptions continue to ripple through the economy, which could put upward pressure on prices. Even before the onset of COVID-19, inventories had been growing more slowly than the economy and stockpiles have only tightened further due to curtailed production from social distancing restrictions and slowdowns from the number of employees falling ill. With inventories so low, once the economy fully opens up, the available supplies may not be able to meet the higher level of demand. When customers finally return to their old way of life, they may find that many of the small businesses they used to frequent were forced to permanently close due to the pandemic. The surviving firms may reap the benefit of added customers, but they also could achieve some enhanced pricing power. The Fed is aware of this and Chairman Powell has indicated that monetary authorities may look through some temporary price hikes, but they have not communicated how much of an increase in inflation they are willing to tolerate.

TIMING IS THE ISSUE

There appears to be a powerful case for higher inflation eventually, but when? Despite the influx of liquidity, inflation rates have held fairly steady so far. Why hasn't higher inflation arrived? It is because the deflationary shocks from the pandemic have not passed and capacity utilization levels remain well below the pre-pandemic levels. Large portions of the economy are functioning far below normal levels. Those without income couldn't spend as much and we all know that many Americans with jobs chose to defer their travel and leisure plans, along with other spending. As more households chose to increase their savings, it lowered the velocity of money, putting downward pressure on inflation. Another factor has been the greater use of online shopping, where it has been easier to compare prices and gravitate to the cheapest option.

As the economy reopens, we fully anticipate that some pockets of the economy could see rapid price increases due to the temporary inventory shortages. At that point it will be difficult to determine if the price increases are simply a short-term cyclical snapback or the start of a long-term inflationary cycle. As we saw during the high-inflation 1970's, there is a strong behavioral component to a self-sustaining acceleration in inflation. When people become convinced that prices are rising more quickly, they begin to alter their spending. Rather than wait for higher prices, they begin to buy more quickly, before the things they want get more expensive. This acceleration in demand puts more pressure on prices, which spurs more anticipatory buying, ending in a vicious cycle. We don't see signs of that yet.

Fixed income analysts can mathematically estimate investor's inflation expectations through an analysis of interest rate differentials. While the market's expectations of future inflation have recovered from the extremely low levels reached last March, they have only returned to the trading range of late 2019. With too many Americans grappling with unemployment, lack of rent money and trying to keep food on the table, fear of inflation is low on their list of priorities. It has taken the unprecedented fiscal and monetary stimulus of the past year simply to offset the deflationary shock of the lockdowns and restrictions. Indeed, inflation doves have significant doubts as to whether the current policies can overcome the deflationary forces so present in today's economy.

Eventually, a better economy and the prospect of higher inflation will probably put some pressure on bond prices. In the December press conference following the Fed's Open Market Committee meeting, Jerome Powell made it clear that monetary authorities would not view the initial rise in inflation with alarm. Their perspective will probably shift, however, as the jobless rate approaches a level that is consistent with full employment. Interest rate risks are not solely about inflation then, but also how quickly the economy recovers. Ironically, if the economy recovers to full capacity faster than policy makers or market participants expect, it could actually turn out to be a negative for the financial markets if it caused interest rates to rise suddenly. We will be monitoring the economic statistics carefully in the coming months to assess if this is a potential risk.

INFLATION'S EFFECT ON STOCKS

Historically, inflation has benefitted Value companies more than Growth companies, since slower growing firms are more reliant on achieving price increases to enhance their profit margins. Also, as higher inflation increases interest rates, it lowers the present value of future earnings. This tends to depress the P/E ratios of Growth companies more than Value companies, since their future earnings are expected to be larger. With the Fed intentionally holding down interest rates, it is unclear how equity investors will react if inflation rates start to accelerate. Will they respond more to inflation or rates? Over the past three or four months, we have seen a sector rotation toward parts of the value-cyclical sectors of the market, driven by expectations of a stronger economy in 2021.

This trend has helped the relative performance of our equity holdings. While we are encouraged by this, given the Fed's overwhelming focus on unemployment, rather than inflation, we believe that investors' response to inflation may be more nuanced than in the past. We continue to see our blend of both Growth and Value stocks as appropriate in the current environment.

If that sounds rather unexciting, maybe a little boring, perhaps some of our wishes may come true.