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Weekly Commentary

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By Hubert Marleau

The New Triumvirate: Powell-Yellen-Biden

Submitted January 24, 2021

A Snapshot of the Week Ended January 22, 2021:

Last week may have been a monthly low for economic prints but was highly important because the new triumvirate announced its wishes. Its public declaration made it clear that over the next two years investors will have to contend with a regime change that will bring a different investment landscape than the one which we experienced in the past four years.

Fed Chairman Powell Made a Call for Continuing Accommodation
He said, “It is much too early to discuss an exit from policy accommodation”.

Treasury Secretary Yellen: Made a Call to Act Big
She said, “The world has changed. In a very low interest rate environment like we’re in, what we’re seeing is that even though the amount of debt relative to the economy has gone up, the interest burden hasn’t...Right now, with interest rates at historic lows, the smartest thing we can do is act big”.

President Biden: Made a Call for Unity
He said, “We must end this uncivil war that pits red against blue, rural versus urban, conservative versus liberal. We can do this if we open our souls instead of hardening our hearts”.

The stock market responded positively to the new regime with the S&P 500 hitting a new all-time high on Thursday. Investors embraced the idea of Powell’s preparedness to accommodate Yellen’s blowout spending plan and that Biden thinks that he will be able to broker by getting enough votes in Congress to get the program through. Even though many Republicans will push back, Biden will toot bipartisan support in the hope of avoiding wasteful dithering. Brian Deese, the President's top economic advisor has already made

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arrangements to discuss a stimulus deal with Republicans whose position on the American Rescue Plan seems to be hardening.

Unfortunately, the market took a left turn on Friday. Speculators and traders alike lightened their exposure because their mood darkened when Fauci referred to new data showing that the vaccines may be less effective against the new virus mutations. It was enough to raise concerns that governments may have to extend coronavirus restrictions and lockdowns at a time when the pace of the recovery is slowing down. Nonetheless, the S&P 500 racked up a weekly gain of 1.9% because it's not all bad news. The Atlanta Fed's High Frequency Economic Model estimate for R-GDP growth for Q4 inched up this week to 7.5%. Moreover, economists in this month's WSJ survey were nearly unanimous in their view, raising their GDP growth prediction for 2021 to 4.3% for 2021 from 3.7%.

As a matter of fact, there is more than housing which is doing very well. If one were to base his faith on the December IHS Markit's PMI, he would be convinced that the US economy is pressing ahead in January. The gauge came in at 58, up from 55.3 in December, well ahead of expectation. The report conclusively showed that private sector businesses were off to a strong start in 2021, as output and new orders rose further. The report added, "Rates of expansion in business activity accelerated at manufacturers and service providers, with goods producers registering the sharpest upturn in output since August 2014." Interestingly, South Korean exports, a very reliable and advanced indicator of world economic activity, rose 10.6% y/y in the first twenty days of January, under pinned by sales of chips, cars and mobile phones. Exports to China and the U.S. were up 18.6%, and to Europe 16%.

Rethinking the Direct and Indirect Effect of Government Debt:

Until now, the actual prints on selling prices have not yet reflected the input costs stemming from supply shortages, disruptions and delays including soaring transportation costs and raw material prices. Businesses have only partially passed on cost burdens because they have feared political repercussions which price gouging could bring, but also because they have been satisfied with strong revenues. Nonetheless, price pressures are building and there is no better place than the bond market to see it. Across the entire yield curve, breakevens are solidly overshooting the 2.0% inflation target amid pro-cyclical elation. This enthusiasm is based on the assumption that all the extra personal savings, money supply plus budget deficits that have already been produced by the actions of the monetary officials and congressional lawmakers will continue in 2021. Thus, not only has a large amount of pent-up demand been created by previous actions but much more of the same is anticipated. The reflation scenario is essentially founded on the axiom that the anticipated reduction in personal savings resulting from the vaccine rollout will force the expected increase in the federal

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budget to be financed with either higher corporate profit and/or foreign capital. Although corporate profit will undoubtedly surge in 2021, it will not be enough to cover the budget deficit. Since the Fed will be reluctant to raise rates, the only way to lure capital inflow will be with an attractively cheap dollar---that is definitively inflationary. And, yet it's not even the end of January and the reflation narrative is coming into question.

Even though the U.S. appears to be set up for a boom in the next two years, potentially boosted by pandemic-induced productivity gains and buoyed by a solidifying consensus that deficits don't matter, it would be unwise to disregard the deflationary effects of higher debt which deficits bring. Trillions of dollars of additional government spending will increase the already $21.6 trillion debt load above the current 100% N-GDP threshold. The ratio of debt to national income is at the highest point since World War II. It was 20% in the 1970's. Many investors are befuddled by the elite claim that developed countries can commit humongous sums of stimulus without limit or consequences. Are we certain that low interest rates should liberate governments to borrow and spend in unlimited amounts? According to Morgan Stanley's chief global strategist, the dismissal of reality is an issue, for it could lead to a "debt trap", arguing that a small increase in interest rates would make the debt burden unsustainable. It creates "What If" narratives.

Currently, the gap between interest and growth rates is negative, suggesting that the economy is getting a free lunch of sorts. Unfortunately, the situation is allowing unproductive companies to prevail, heavily indebted zombies to survive and the government to transfer earned cash to entitled recipients. The OECD, BCA Research and Ned Davis Research warned in recent studies that countries with big government spending, rising government debt levels and easy money, tend to suffer slow economic growth, falling productivity and little inflation. A Summers-Furman study argues that it's ok for policy makers to focus on the cost of borrowing rather than the debt levels for as long as net interest payments on the debt are expected to stay below 2% of the national output over the next decade. In the fiscal year ended September 2020, interest payments totaled 1.6% of national output. This ratio will increase over the next two years but not over 2.0%. The projected increase in N-GDP will prevent this from happening, but careful monitoring is warranted.

Gary Shilling in a Bloomberg article this week, wondered what if Americans were to decide not to part with the savings that they have already accumulated and hoard future federal checks. He argued that prudence and satisfaction may prevent them from spending freely. There has been a reduction of debt in relation to after-tax income commencing in early 2008 when debt was 132% of income. This ratio fell to 84% in Q3/2020 but still above post-war World War 11 norms of 60% that held until the consumer debt explosion beginning in the early 1980s. Should this recent trend proceed to be the case, the highly counted on inflation scenario would turn into a disappointment. A higher level of personal savings would make it unnecessary for corporate

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profit and foreign capital to pay for the government spending deficit. The outcome would tend to be deflationary and in turn keep the dollar stronger, inflation and interest rates lower than they would otherwise be.

What it means is that the govermnent spending deficit effect on the debt load could be sufficiently deflationary to prevent the anticipated fall in the dollar and decrease in personal savings to allow inflation to get out of hand over the next two years. It is probably why sophisticated investors do not seem to be too worried about the possible ill-effect of inflation.

They are aware that the price of most commodities has risen including gold, copper, wheat and cotton—but they remain significantly lower than they were ten years ago. The Barron pointed out that the prices of inflation options imply only a 1-in-5 chance that the consumer price index will rise more than 3% each year over the next five years, on average, and only a 10% chance that it will rise more than 3.4% each year. Those implied odds are far lower than the implied odds in 2012, and about the same as in 2017-18. While I include myself on the reflation team, I do not expect to win every game played against the deflationary club. Thus, my portfolio is mildly tilted to the cyclical, value and inflationary side of the ledger because that is where new money is placed. However, I have not sold any technology-related and other growth stocks because I don't think the expected increase in inflation will be large enough to hurt the discounted value of future earnings.

Rethinking on Market Bubble: Mammorism

I'm bewildered at the prevalence of the word "bubble" in the financial press. There is no clear definition of what constitutes a bubble. It's a subjective expression of an opinion that connotes speculative excess. Interestingly, the billionaires are the ones that make the most use of the bubble superlatives. Yet market observers have rightly put the blame on digital traders that buy stocks when they start going up and abruptly sell them when it stops. It's called momentum trading. Momentum trading has been going on for a long time. But what makes it so wild is the networking effect that the internet and social media has been able to create. What is at play here is not monetary considerations that many allude to. In the words of Bof A's Michael Harnett, it's not about investors who want to stay rich but about players who want to get rich. In this connection, I also suspect that there are specific places where exponential price gains may be unsustainable. However, it's far from being the case everywhere and in everything. Ben Carlson, the writer of Wealth of Common Sense, feels like we've been debating a stock market bubble for a decade. The chorus of bubble-callers is loud but to no avail. Plus, there are plenty of sectors that are not in a bubble---Emerging markets, European stocks, Japanese stocks, Value stocks, Energy stocks, Financial stocks, Mining stocks.

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Tom Essay, president of Sevens Report Research, in its Alpha Webinar of last Thursday, concluded that air pockets are always possible but valuations, sentiment and technical are not bad enough to warrant pre-emptively de-risking out of stocks. Investors should bear in mind that corrections are infrequent, and crashes are very rare. These incidents are usually caused by unforeseen catastrophic events like an abrupt tightening of financial conditions, a rash of serious geopolitical problems, a precipitous collapse of a major currency or an acute health hazard.

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