April 14, 2021

INFLATION EXPECTATIONS

Dear Investor:

There are big expectations for GDP growth this year. Estimates are coming in anywhere from 4% to 8%. The Federal Reserve Bank of New York and the Atlanta Fed are both right at 6%. The FOMC is a bit higher at 6.5%. This would be well over $1 trillion in growth if things unfold as expected right now. This is not a surprise in light of the massive stimulus that has been provided by the Fed and the Biden administration. We hear so much talk about the "reopening", but large chunks of the economy are already open for business and doing well. The latest ISM Manufacturing report hit a 38 year high in March. Most industries were reporting increases in production, new orders, and employment. They stated that their problems were obtaining needed parts and finding suitable people to hire. The story was the same in the ISM Services report which includes over 80% of our economy. New orders, prices, and hiring were all accelerating. Our recovery is well under way.

This is leading us into a different set of problems. In the month of March, the nonfarm payrolls increased by 916,000 jobs, and the overall unemployment rate dropped to 6%. Great news, however, we know there is still significant unemployment in a few sectors. The Fed has insisted they will keep their foot on the monetary gas pedal until unemployment drops back down to levels seen before the pandemic. You may be aware they are buying $120 Billion of US Government securities per month, and our Fed Funds interest rates are pegged as close to Zero as possible. This super loose monetary policy is leading to many discussions of rising inflation. As they continue to focus on the labor market, there is a heightened risk of prices and inflation beginning to accelerate. While many in the FOMC are talking about keeping rates at rock bottom through 2022, and maybe well into 2023, this may not be realistic or possible if inflation begins to move substantially higher. The Fed has stated they are willing to let inflation run above their targets for a while, but it may not turn out as they hope.

When you look at things from this angle, you can see why the stock market has been booming. We are in a rapidly accelerating economy, with the potential for an extended time period of continued low interest rates. The current administration is pushing a major new infrastructure/green new deal package which some have said would be like putting lighter fluid on a barbeque. We will let the politicians fight that one out. From an economic view point, you would expect it to add even more juice to the economy and the stock market.

There has already been an increase in the longer-term interest rates. The 10-year US Treasury rate has come up well over 1.0% since its low point last summer, and is currently around 1.64%. The markets have been able to absorb this, however, the increase has taken some air out of the large growth stocks in the tech sector that led the market most of last year. There has been a very noticeable shift in market leadership this year to the value and cyclical sectors that need a rebounding economy to do well. We don't know how long this trend will continue. I've commented in several of my recent letters on how expensive stocks are as measured by their P/E ratios. We know that trends can persist for much longer than expected in the market, but at some point in time, there is always an adjustment. Right now, I can see a few ways this could happen. The first is for earnings to come up very big in the next year or two and "grow into" these high multiples. That would bring P/E ratios down to more normal levels and into a better balance for the future. A second scenario is that as the economy continues to improve, interest rates will continue rising. Unless the Fed specifically intervenes to stop them, this will slow the projected earnings growth and bring stock prices down to some degree, or perhaps they would plateau for a period of time. If this is a gradual process, it won't be too painful for market investors. A third scenario could occur if there is strong economic growth and inflation that distinctly gets ahead of the Fed. This could force them to respond with higher rates on a timetable that is more aggressive than we would like. I would expect this to cause a significant and relatively painful market correction. The market is working very hard to try to figure out if this third scenario is the one we will experience.

You may be aware of some very significant developments going on in China's monetary system. The Wall St. Journal has reported on this, and they are my source for most of this information. The Chinese Central Bank has created its own digital currency. While the US and others have been working on this in the background, China has taken the lead. They have created a digital yuan that is issued directly by their central bank and is legal tender. They ran experiments using it with the public in 2020. The digital yuan was directly downloaded to the mobile phones of over 100,000 citizens who were given modest amounts of money by the government to spend. From what I read, most of the people liked it and found it very easy to use. This seems like a simple thing, but it raises many issues. Some of the considerations are: the continued role of the dollar as the world's reserve currency, the threat to the US national security, unprecedented levels of tracking and surveillance of the citizens using digital currency, the future role of banks and other financial intermediaries, and the potential to replace all crypto currencies over time as the US, and others like Europe, respond with their own digital currencies. These are some of the issues right off the top and they are big. In the US, Coinbase just went public this week at a huge valuation. It's essentially an exchange to trade cryptocurrencies, and many investors are very excited about it. They may be successful for a period time, but it seems obvious to me the government has the ability to put the cryptos out of business if they choose to. I've always thought that in the end, the governments of the world will control what is "legal tender". Once the major players have their own centralized digital currencies, why would they allow competition? These are very big developments, and I will likely talk more about them in the future.

Please contact me anytime to discuss your portfolio.

Best regards,

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