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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF MARCH 15, 2021

Where is the Inflation Bogeyman?

"In short, this remains one of the slowest moving, most proactively predictable reflationary trains in memory. February was the last base effect stop before trough Covid Comps begin flowing through the reported price data … and note that, as it stands, trough comps, the vaccination/reopening procession, the prospective acceleration in hiring/organic consumption capacity and the prospective deployment of accumulated excess household savings are all converging on roughly the same timeline … carrying the potential for a combustible inflationary cocktail and a (transient) wonderland for reflation-philes." – Christian Drake

Inflation is on everyone's mind (for a good reason). Yet the data reported last week suggests that maybe these fears are grossly overblown. First, take a look at the inflation coming out of the second largest and strongest economy on planet earth. China's GDP has grown rapidly, and economic output is higher than pre-pandemic levels, but there is no inflation. As a matter of fact, China's February Consumer Price Index (CPI) data showed prices deflating -0.2% year-over-year and is lower than it was in December 2009.

Many believe Biden's massive stimulus injections will drive inflation higher in the U.S. But, then again, maybe not. For the past two decades Japan has blown hole after hole in its balance sheet. The government debt-to-GDP ratio has ballooned to 225% today from 97% in the past two decades. The fiscal deficit has been around 5% since 2000.

Did inflation rear its ugly head? Unequivocally no. Even with this constant massive fiscal largess, Japanese inflationary pressures have been and remain non-existent. As shown

THIS WEEK

- **INFLATION TO SOAR?**
- **DEBT TRAP**
- **JOBS UPDATE**

PORTFOLIO STRATEGY

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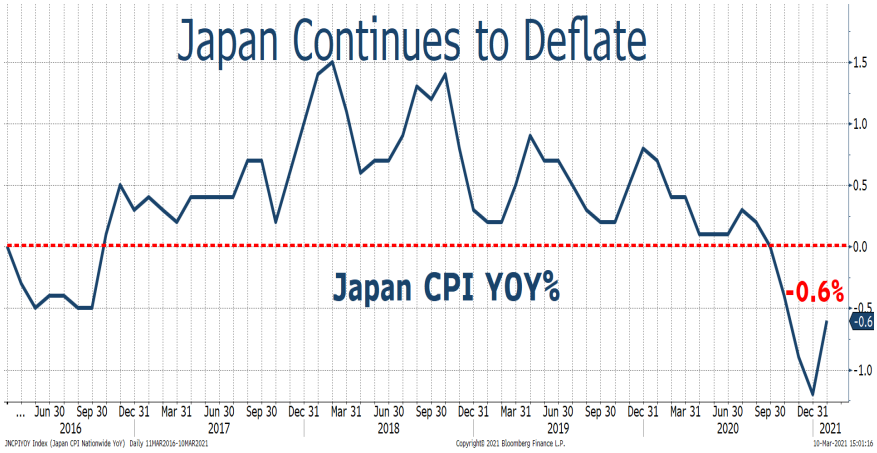
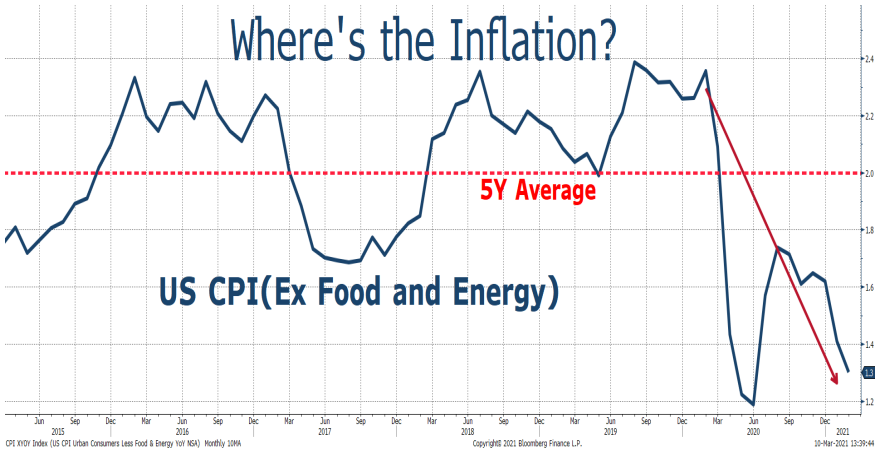
below, year-over-year the nationwide CPI is -0.6%. Thus, despite years of negative policy rates and massive quantitative easing (QE), deflation continues to be the clear and present danger. And for those bond bears out there I should add that the 10-year JGB (10-year Treasury equivalent) at the start of the Japan's grand fiscal experiment more than two decades ago was 1.8%. Where is it today? Try 0.1%. Case closed.



To the surprise and chagrin of the ever-growing legion of bond bears, the weak Chinese inflation print was followed by a lower-than-expected U.S. CPI reading for February. Core CPI (excluding food and energy) for February rose 0.1% month-over-month. Year-over-year, as shown below, core inflation is well below the Fed's target at 1.3%. Could it be that in a globalized economy it is very difficult for inflation to rise domestically if prices are declining around the world? At any rate, we'll have to wait a bit longer for the inflation bogeyman to show up.



The 10-year breakeven rate measures the difference, or gap, between 10-year nominal Treasury Bond and Treasury Inflation Protected Securities (TIPS). The rate serves as an indication of the markets' inflation expectations over the 10-year horizon. The breakeven has risen sharply to 2.2%.

But it is important to note, that commodity prices have the strongest correlation to this index. And we all know that commodity prices have soared. But as the economy fully reopens, extra supply capacity will come back rapidly which should tamper, if not reverse, the recent dramatic jump in commodity prices. I should note that There is no commodity

super cycle without Chinese demand and the country has already hoarded what is needed. Finally, we also know that rising commodity prices alone are not enough to drive inflation higher.

The 10-year breakeven is now pricing in 2.28% inflation. It should also be noted that the 10-year breakeven is market based and trader driven and historically the TIPS market has not had strong predictive powers in forecasting inflation. Simply put, I would not take the 10-year breakeven literally.

On the other hand, the Cleveland Fed's 10-year inflation expectations are currently at 1.42%. This is important because it has a higher labor component and better reflects the weak labor market environment.

As shown below labor is the driving force for inflation.

Typical Cost Structure for Business	
Cost Inputs	**% of Total Costs**
Freight	5%
Rent	10%
Raw Materials	15%
Labor	70%

Source: Rosenberg Associates

Without a strong labor force and strong wage growth, it will be a challenge to manufacture a secular rise in inflation on the back of commodity prices alone. In other words, there is no rising inflation cycle without wage trends breaking "consistently" into a 3% to 4% range or more.

"For inflation to be sustainably within the 2-3 per cent target range, wages growth needs to be materially higher than it is currently. The evidence strongly suggests that this will not occur quickly and that it will require a tight labor market to be sustained for some time. Predicting how long it will take is inherently difficult, so there is room for different views. But our judgment is that we are unlikely to see wages growth consistent with the inflation target before 2024. This is the basis for our assessment that the cash rate is very likely to remain at its current level until at least 2024." – Dr. Philip Lowe, Australian Financial Review's Business Summit.

INFLATION TO SOAR?

"Inflation is poised to soar, 3% by June is almost certain." – Jeffrey Gundlach

Gundlach is referring to year-over-year impacts, not a sudden spike of 3% in one month. It's not that inflation will be rampant. Rather, it's the impact of year-over-year comparisons, goosed by a huge COVID-related dip in energy prices in April and May of 2020. And for March through June/July, the comparisons will probably show inflation rates well above 2%. Before the end of summer, combined with the recent stimulus package, it could actually approach 3%. However, if you go back two years inflation will still look benign. So, we are going to see a pop in year-over-year inflation, but then what? Whether these year-over-year comparisons spook the bond market remains to be seen. If the market expects 4% or even 3.5% and the CPI comes in at 3.4% or lower, a huge bond rally could be in store.

DEBT TRAP

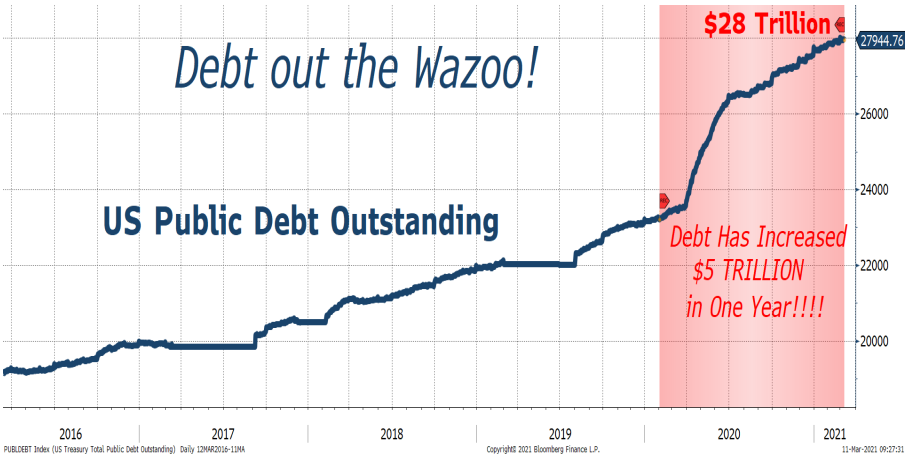
"It's shocking that households with $150,000 of income and three children will get $6,000 from the government," he said, in reference to the $1.9 trillion stimulus. "This looks a lot like a monetizing experiment." – Jeffrey Gundlach

Did the $800 billion Obama infrastructure program decade ago or the Trump tax cuts in 2017 unleash a secular rise of inflation and interest rates? No! That's because stimulus programs are transitory and have no lasting power. Did $4 trillion of QE and zero interest-rate policy (ZIRP) for 7 years drive inflation higher? Again, no!

The total economic stimulus passed by the U.S. government over the past year is $5.3 trillion. That's a number so mind-bogglingly enormous that it becomes almost impossible to comprehend, so here's another way to put it: More than $43,000 per U.S. household.

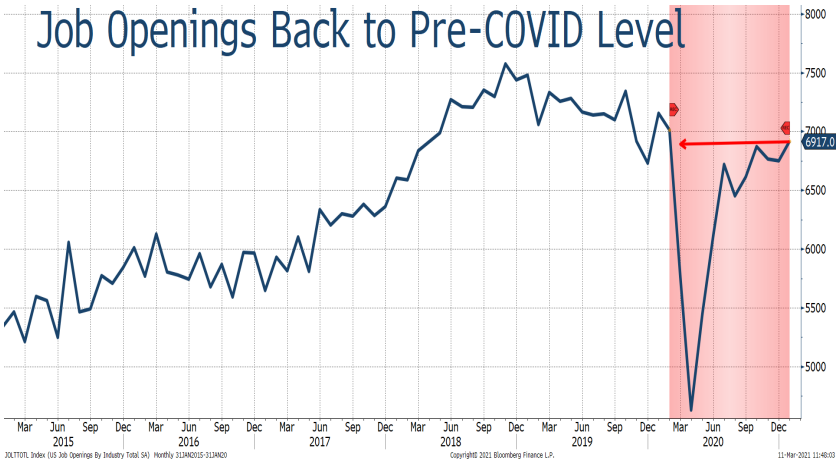
So, as we exit the pandemic, we look ahead to a post-COVID-19 future. The Atlanta Fed is at 8.4% for Q1 GDP growth. The Organization for Economic Co-operation and Development (OECD) raised its 2021 GDP growth for the U.S. to 6.5% from 3.2% and sees 4.0% growth for 2022. Economists now predict the economy will grow at a 6% for the entire year. Morgan Stanley raised its 2021 forecast for GDP to 7.3% from 6.5%, a pace unsurpassed since the Korean War boom.

But here's the thing, it's all temporary and it's all on borrowed money and time. And make no mistake there is a cost. A big cost! The U.S. has spent over $5 trillion on fighting the pandemic and U.S. debt levels, which were ridiculously high pre-pandemic, have soared to ungodly levels.



JOBS UPDATE

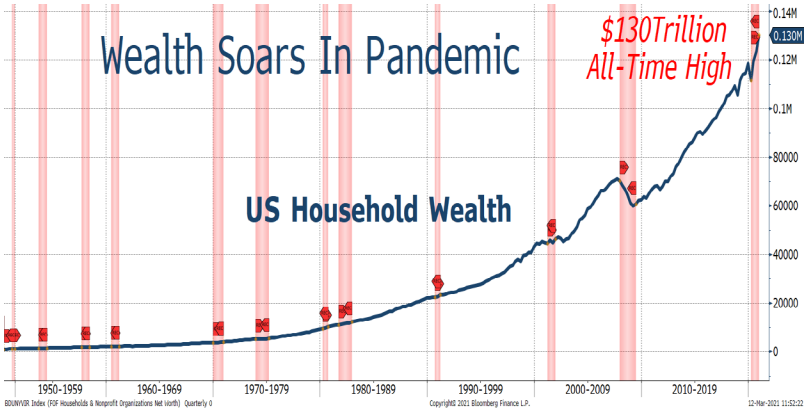
Initial jobless claims came in at 712k for the week of March 6 – though still elevated compared to before COVID-19, this was a "beat" of the consensus estimate and a substantial drop from the previous week. That good news was followed by more good news. Job openings rose 165k to 6.91 million, though this did follow two months of decline. The fly in the ointment was – even with the new openings – hiring levels were reduced. In fact, they plunged 110k, the third drop in as many months and down in four of the past five – a cumulative reduction of 1.13 million.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

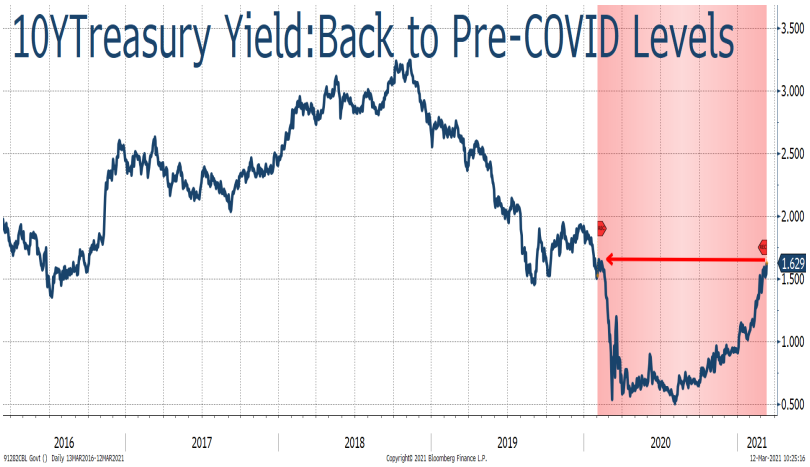
"President Biden's American Rescue Plan is what the name implies. It's a short-term relief measure meant to address an economic emergency... But the great bulk of the spending will fade within a year." – Paul Krugman

The Modern Monetary Theory (MMT) crowd must be in a very gleeful mood. Last week, Secretary of the Treasury Janet Yellen put the final stamp on the stimulus package when she said the checks will be sent out this past weekend. Get ready for two quarters of boom-like growth. And there is no more Tea Party to complain. In fact, the public support for this current fiscal stimulus plan, which is way over the top, is sky high. Everyone likes a freebie!



Who would have thought that pandemics are great for economic growth and wealth creation? As noted above, economic growth is expected to soar to levels not seen since post-Korean War. Personal income has soared on the back of one stimulus check after another. Asset prices have soared on the Fed's ongoing manipulation. Housing prices have reached new record highs.

Overall aggregate net worth of households and non-profits at a whopping $130 trillion; that was up more than 10% from the end of 2019. Just pump me up with more stimulus. You seriously cannot make this stuff up, but it happened. Aliens visiting Earth would be wondering what the heck is going on. Tongue in cheek, when looking at the prosperity created one can be forgiven for wishing pandemics came around more than once a century.

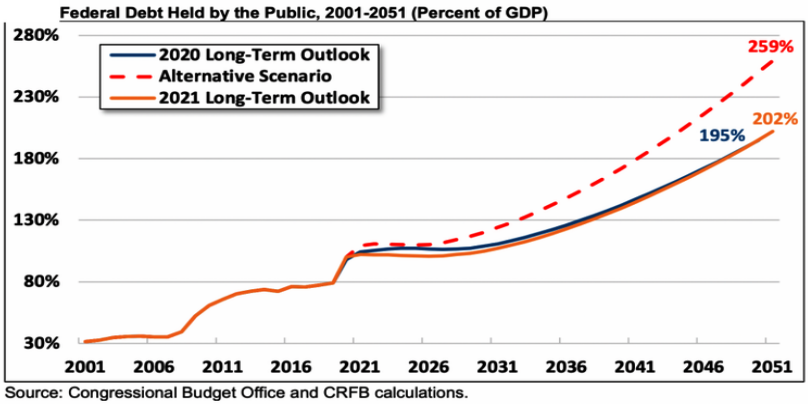


And bond investors can be forgiven for believing that the Biden team has created the near-term conditions for a reflationary boom. Year-to-date, the move on the 10-year Treasury yield from the low to the high is 0.52% to 1.63%. Frankly, the rise has been modest, comparable to the "taper tantrum" of 2013 and minor compared with some interest rate surges of the 1990s. Also, even with reopening and the massive fiscal splurge, yields have only risen to where they were pre-COVID.

Despite the recent heightened market volatility, I do not believe that the most leveraged economy of all time can withstand a secular rise in rates. The reason is debt. To wit: The non-partisan Congressional Budget Office (CBO) estimates that federal public debt will reach double the size of the economy, rising from 79% of GDP at the end of 2019 and 100% of GDP at the end of 2020 to 202% of GDP by 2051.

"The projected long-term growth in spending is largely driven by rising health, interest, and retirement costs. CBO expects spending in these three areas to rise from 12.3 percent of GDP this year to 24.4 percent of GDP by 2051. Interest spending will be the largest federal program by 2045." – CBO

Read that last sentence again and again until this sinks in. How the heck is the Fed ever going to hike rates again? How can bond yields back up for very long? We are stuck in a massive worldwide debt trap.



The Fed has gone on record stating that any inflationary increase is temporary and transitory. They have pledged to keep the fed funds rates low for a long time. So how does the Fed prevent the bond vigilantes from pressuring long-term rates higher and thereby short circuiting the economic recovery? The Federal Reserve is going to become the buyer of last resort, exactly like the central banks in Japan, the European Central Bank (ECB) and to some extent the U.K. are. How long can this go on? Probably longer than we can imagine. It will continue until it doesn't. Japan and Europe have gone on for a long time. There is no reason to think the U.S. can't. Jerome Powell and whoever succeeds him will echo Mario Draghi's "whatever it takes" line.

Regarding forecasts of an economic boom, what if much of the $800+ billion to households ends up getting saved and not spent? These soaring GDP estimates based on $1.9 trillion may be overstating how much of this pork actually gets on the economy's plate. Or what if the boom turns to bust, given the transitory nature of the stimulus?

Not only that, but as we move forward, we will face higher taxes, not lower taxes, more government, not less, more regulation, not less. On this file, check out *Biden Weighs How to Pay for Agenda* on the front page of the WSJ.

In many households the stimulus checks will be viewed as a savings cushion or pay down debt as well as play the market. Also there also is a ton of "stimulus" for colleges and universities and huge spending to state and local governments, which will be used to plug revenue holes. This is not a prescription for the second coming of the "Roaring Twenties."

And once the big spending is behind us, what if we return to "secular stagnation" in which the economy struggled with below trend growth, lower inflation even with ultra-low interest rates for the past decade? Let's face it, if gargantuan debt and deficits were anything more than a means to generating sustainable reflationary growth, Japan to this day would not be sitting with bond yields and inflation very close to zero.

As I have highlighted over the past 2-3 weeks, we have seen many selloffs over the past 10 years. But every time rates have increased the economy has slowed or asset prices have crashed. And then rates reversed and trended lower again.

At this point, Treasuries look oversold. However, being oversold does not mean they can't become even more oversold. The Treasury market, from purely a technical perspective, still confronts a challenging backdrop and there may well be better entry points in the future. Possibly we see 2% on the 10-year Treasury. Then again, maybe not.

Where to from here? From a risk management perspective, only fools try to pick the top-or bottom and timing these moves is next to impossible. Nonetheless, I believe we are closer to the end of selling rather than the beginning. With so much excess liquidity (more coming) and the Fed on hold (cash will underperform) we continue to advocate a disciplined buy program of dollar averaging into market selloffs. As always, maintaining the appropriate risk profile is paramount.

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