

"one can only go out to dinner once a night"

We live in a time when the middle ground is virtually empty. A new administration in Washington has not changed that fact. Everybody seems to pick a side, stake out their turf, adapt all news to fit their preconceived view of how the world should be and ignore any evidence to the contrary. Therefore, finding even a relatively safe subject that almost everyone agrees on is both rare and somewhat refreshing. It's a simple matter and timing is imprecise given vaccine supplies, variants, and more waves of the disease but it has become accepted that we will see a sharp increase in world economic growth sometime in 2021. It does however lead to another bone of contention as to whether this burst of activity will result in a short-term rise in inflation as we recover from the effects of the pandemic or more seriously lead to a longer-term high level of inflation that would necessitate putting the brakes on the economy to the detriment of stock markets.

It is hard to argue with the notion that global GDP will be strong this year. There are lots of signs it is already happening as reopening takes place. Most leading economic indicators suggest the future also remains relatively bright: consumer confidence is strong, initial jobless claims continue to trend lower, purchasing managers indices and their new order sections are strong and everyone's favorite leading indicator the S&P 500 is at new highs. A Wall Street Journal survey estimates global GDP growth at 4.7% and the Economic Department of the U.N. puts the 2021 increase for China at 8.1%, the European Union at 4.0% and the U.S. at 4.5%. With the exception of a dramatic turn for the worse in the pandemic numbers, the path appears clear.

The U.S. government support for this recovery is astounding. The recently passed stimulus package amounted to \$1.9 trillion which if you say it quickly doesn't sound like much but in reality is 10% of the country's GDP. President Biden and his party are already working on an infrastructure spending package which is said to be around a further \$3 trillion. (This bill would likely require Republican support.) This despite as I mentioned above

an economy that seems to be recovering on its own, and a U.S. 2021 deficit already estimated to be between \$4 - \$5 trillion. Politicians have no interest in considering those types of numbers and are happy to just stand on the accelerator. For the sake of future generations we better hope that the Modern Monetary Theory argument that debt and deficits don't matter is correct because it's going to be very unpleasant for them if it isn't.

Fed Chairman Jerome Powell had a press conference last week where he remained strongly committed to a policy of monetary ease in spite of an economy that looks strong. He even admitted a boom is possible but there still would be no increase in regulated rates before 2023. On the question of his concern about an overheating economy, Powell responded that the rate of recovery has limits since "one can only go out to dinner once a night". While everything is subject to revision it appears relatively certain that the Fed will let the economy and inflation run at a higher rate than what in the past was considered normal. The big question is that if they let inflation track at 3% for a period of time can the Fed then reign it in or will it risk losing control of interest rates. One possible policy option if things get out of hand is "yield curve control" where a treasury bond yield is set as a target by the Fed and it will intervene in the market if necessary to ensure that target is met. The Japanese Central Bank already operates with such a policy and it seems to work but the bank now owns most of the country's treasury bonds as a result. What nags at me however is that the Fed has spent the last decade trying to encourage inflation without much success. Why should I now feel confident the Board will have the ability to discourage inflation if necessary?

It is hard not to anticipate a buoyant economy for the next year given the monetary and fiscal stimulus; economy sectors like travel and hospitality are already showing rapid growth; the \$2 billion of pent up household savings ready to be spent and another approximately \$7 trillion in liquid assets on the balance

sheets of S&P 500 companies. (Buyback binge coming?) The inflation concern is much more uncertain as history tells us that too high inflation will cause interest rates to rise and stock markets to fall. I lean toward the reflation outlook, that CPI will rise significantly in the near term as the recovery becomes a reality but retreat to more workable levels in the second half of the year. We are definitely walking a tightrope though, so we must be prepared to switch horses if the need arises.

In an effort to quantify what higher interest rates mean to stocks the Wall Street Journal conducted a survey asking fund managers what level of rates would trigger the stock market to sell off. The answer was 2% (3 years ago it was 3 1/4%). That is frighteningly close to where the U.S. 10-year Treasury is currently trading at 1.65% and since we have come from 0.5% last August and 1% in January it is not that hard to see the potential to reach 2% given strong economic growth and rising inflation fears. As yet there are no signs of strain, we aren't at 2% yet and surveys don't make things so, but it merits our consideration. Despite that and the many other reasons to worry about stocks the S&P 500 continues to trade at all time highs and a strong economy will raise earnings and improve valuation levels. Mitigating that earnings outlook is the intention of Congress to raise taxes to finance the fiscal stimulus and reduce income inequality. The lions share of that increase will fall on corporations and the wealthy. Trump's corporate tax cuts will almost certainly be rescinded and a capital gains tax is also considered very likely. As an aside, Democrats in Congress are also proposing a transaction tax on stocks, bonds and derivatives. It's interesting that investors over the age of 40 have long been told to own stocks when young and working and move to fixed income securities in retirement. The very low level of interest rates has forced many into equities because of TINA (There Is No Alternative). Higher yields might well entice that group to abandon stocks and buy bonds. A near term correction or consolidation seems likely as reflation concerns are processed by investors but should provide a stronger base for what I believe will be better markers in the second half.

There are other matters that bother me but might have no impact on markets. Relations with China continue to deteriorate as China becomes more aggressive militarily in the South China Sea and is renewing closer relations with Russia and North Korea. I referenced last month the State of Georgia legislation

that appeared, at least to me, as an attempt at voter suppression particularly aimed at minority groups. That has now expanded to over 100 similar bills in 28 different states. Finally two more thoughts on Bitcoin: 1. The amount of energy consumed by computers to "mine" the Bitcoin is staggering and I haven't seen the "greens" complaining yet: 2. Every major central bank is in some way investigating having its own virtual currency, an indication that this medium and method of exchange is finding more credibility.



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