Weekly Market Summary

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Inflation … What Inflation?? C'mon Man!!
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A few catch phrases in presidential history have risen above the debates themselves. There's Ronald Reagan's "*There you go again*." Or Clinton's "*It's the economy, stupid*." Joe Biden made his own attempt at catch-phrase history during his last presidential debate, with "*C'mon*." On the prospects for a second COVID economic relief package, Donald Trump accused the Democrats of holding up relief for political reasons; "*Nancy Pelosi doesn't want to approve anything because she would love to have some victories on a date called November 3rd*." Biden was not amused, pointing to the fact that House Democrats passed a massive additional relief package in May; Senate Majority Leader Mitch McConnell (R-Ky), Biden noted, "*will not support that…C'mon. What's the matter with this guy*?" 😊

Speaking of fresh fiscal stimulus aimed at further enhancing US growth, President Joe Biden's $ 1.9 trillion Covid-19 Relief Bill did clear its final Congressional hurdle on Wednesday, with the House passing the bill on a 220-to-211 vote, sending it to the president for his signature (signed, sealed and delivered overnight!). The vote caps a nearly two-month rush from the time Biden first unveiled his American Rescue Plan, through tough negotiations in the Senate, to its final approval and represents a major political victory for the new president, displaying his influence over a Democratic Party in control of Congress by the thinnest of margins (an influence least hindered by the President's inability to handle a press conference or struggle to name his defense secretary … C'mon Man!) At the same time, the partisan divide over the bill foreshadows the difficulty Biden will have in enacting the multi-trillion dollars, longer-term economic program he wants later this year (surely the Fed's money-printing machine can benefit from a short maintenance break! 😊)

This latest massive fiscal aid, the second-largest injection of federal cash in US history (only last year's Cares Act was bigger, but that came at the start of the pandemic, when the deepest recession in decades laid directly ahead) is projected to bolster the finances of hard-hit individuals and corporations following the Covid-19 pandemic, though more worryingly support a further fast rise in asset prices and market rates. "*It's one of the most far-reaching federal relief efforts to ever pass Congress and another reason to be confident of the outlook for US equities*," said Willem Sels, chief investment officer at HSBC Private Banking and Wealth Management. Yesterday, the Dow Jones Industrial Average rose 0.58% to 32,486 whilst the S&P 500 closed 1.1% higher at 3,940, both hitting all-time highs. Bonds, on the other hand, remain out of favor - with dealers and investors continuously dumping US Treasuries over the past month (the yield on 10-year US government debt was last at 1.62% - a 13-month high).

There are plenty of potential culprits in the latest bond market tumble, from improving economic readings to more technical drivers. Ultra-loose Fed policy and fresh US fiscal stimulus have investors rightly betting on quicker growth and inflation. Add to that a wave of convexity hedgers (traders that unload Treasury bonds due to unexpected moves in the duration of their mortgage portfolios), as well as unwinding by big trend-following investors (such as commodity trading advisers - CTAs), and you have the perfect recipe for regular panic selling in the $21 trillion market that forms the bedrock of global finance. Whilst stocks are prone to sudden swings, such episodes are supposed to be few and far between in the *"supposedly"* most liquid market (the US government debt market that is) that sets the benchmark risk-free rate for much of the world (one would hope that the Fed will extend an easing of capital requirements for banks put in place early-on in the pandemic, which is set to end on March 31st. The measure makes it easier for banks to add Treasuries to their balance sheet).

Inflation …. What Inflation?

President Biden's $1.9 trillion economic relief plan is providing much more stimulus than any reasonable dollar estimates of the economy's underlying need. That in turn has provoked a debate among policymakers, economists and investors about the risk of sustained, runaway inflation, with warnings of the clear dangers posed by widening deficits countered by assurances that the US Federal Reserve possesses the tools to keep prices and wages under control (Hoo-ah! 😊). Even without the additional $1.9 trillion, the economy in 2021 was poised for a strong increase in consumer demand for goods and services with the projected vaccine-driven return to normal; Also, Congress had just passed a $900 billion stimulus last December whilst households are sitting on $1.8 trillion of excess savings that would soon be largely spent as the pandemic fades and states re-open.

The combination of this extraordinary amount of fiscal support and unusual macroeconomic environment has already resulted in a large jump in inflation expectations, with markets currently expecting inflation to average 2.5% over the next five years, up from around 1.5% prior to the pandemic and 1.6% prior to the presidential election in November. Should those inflation expectations translate into real inflation down the road (a lot will depend on money velocity, i.e. the frequency with which the Fed's new money changes hands, as people / companies use it to buy goods and services, rather than hoard it), it could become a serious problem for the bull run in stocks. After all, the latest rally in equities (and other asset classes) has been founded on the Fed's intentions (be it their implicit or explicit references) to keep short-term borrowing costs unchanged till early 2023 whilst also pumping $120 billion monthly into the financial system well into next year.

For now, both newly appointed Treasury Secretary Janet Yellen and current Fed Chairman Jerome Powell continue dismissing market inflation concerns, insisting the world's most powerful government and central bank will go full speed with their efforts to reduce slack in the US economy and revert back rapidly to full employment. Elsewhere, Congress and the White House are already talking about spending trillions more this year on climate, infrastructure and health care - apparently unconcerned about the negative effects of more deficit spending (lower creditworthiness, weaker currency and higher inflation). Combine that with the Fed/Treasury's surprising lack of concern about inflation, and markets and households could soon be facing unpleasant surprises: An above-target underlying rate of inflation, periodic bursts of rapid price growth (March and April CPI readings will be crucial) and concerns about multi-asset bubbles on the verge of bursting are three factors that will soon add up to a bad situation for the Federal Reserve, which would be put on the defensive about its seemingly blasé attitude towards an overheating economy and later pushed to deal a hard blow to the economy through monetary tightening measures.

Let's be very clear: A comeback in inflation is no less likely because it has been absent for the past 30 years. On the contrary, the conditions are now ripe for US inflation to easily overshoot the 2.0% target, the level that the US Federal Reserve gauges as consistent with its mandate. Typically, inflation meets its match in the form of monetary tightening, but the Fed has lately recast its objective. Under its new approach unveiled last year, it has signaled it will tolerate an overshoot of the target for a period of time to compensate for persistently low inflation in the past. The problem is when investors realize that inflation is about to overshoot the overshoot levels the Fed is comfortable with (2.5%? 3.0%? Take your guess!).

To some, the current inflation scare is still missing some inflation; John Authers, a Bloomberg columnist, recently noted that the inflation scare has already started, at a point when actual figures don't look alarming in the slightest (February's annual rise in Core CPI & PPI stood at 1.3% and 2.5% respectively, although someone should remind John that inflation data is a major lagging economic indicator). Mr. Authers goes on to argue that the Federal Reserve wants inflation to run above 2.0% for an extended period, and hence some inflation in the short run – without a return to a true inflationary regime and psychology – should be seen as outright good news. Others, though, are not convinced: The famous "Big Short" investor Michael Burry is warning investors to prepare for very high inflation. The Scion Asset Management Chief has underscored the rising threat of inflation in a flurry of follow-up tweets, comparing Germany's path to hyperinflation in the 1920s to America's current trajectory. Burry draws parallels between mania in Germany before inflation took off, and the Reddit-fueled buying of meme stocks this year that led Robinhood to temporarily halt purchases of certain stocks. "*Before the German hyperinflation in the 1920s, everyone from the elevator operator up was playing the market and volumes became such that the financial industry could not keep up with the paperwork and the Bourse was obliged to close. Sound familiar? #Robinhood down*," he recently tweeted!

Whose predictions will be most accurate in a year time? Dr Janet Yellen or Dr Michael Burry? Guess only time will tell! (I, for sure, will bet all my chips on Michael 😊).

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