1Q 2021
Market Commentary

The Boom Is on the Rose! It is quite remarkable that we are in the midst of an economic boom in the U.S. the likes of which we have not seen this century. Our typical definition of a booming economy is one in which real GDP growth meets or exceeds 4% (and price inflation accelerates above 3%). Yet, the combination of reopening the economy as the COVID 19 pandemic recedes along with the massive federal stimulus programs, 2021 real GDP could rise well above 6%.

This is good for Main Street but might not be so good for Wall Street, at least from the perspective of broad market indices.

The positive economic perspective begins with the rapid decline in COVID 19 hospitalizations and deaths. We have not seen such a tragedy in a century where over 550,000 lives have been lost in the U.S., nearly 25% more than that of World War II. It is natural that people might fear the warnings that a fourth wave of infection might be starting. Yet since the January 16th peak, the increase in vaccinations of the most vulnerable population and the spread of asymptomatic infections combined to produce a sharp drop in ICU hospitalizations and a 70% plunge in 7-day average of daily deaths. The recent uptick in COVID cases has not generated a resurgence by these measures, at least not in the U.S. Simply the reopening of the economy from restrictions on activity is enough to allow the "rose" of economic regeneration to "blossom" into 4% annualized GDP growth over the next couple of years.

As corporations attempted to cope with the government-mandated shutdown starting in March of 2020, supply chains were emptied of inventories, and factory output was massively curtailed. Not surprisingly, with the rebound already experienced and with growth likely to continue this year, shortages have emerged. Just consider how semiconductor chip shortages have prevented many automakers from ramping up production in the face of renewed demand. When demand exceeds supply, prices rise, orders skyrocket, and delivery lead times are stretched. These problems were further exacerbated by the deep freeze that shutdown Texas and other states in February, but as spring arrives along with the new quarter, we should see many months of employment gains with over one million new jobs per month.

Why then did the Federal government believe we needed a $1.9 trillion COVID relief package when a more modest amount would cover the immediate need of those still unable to return to work? The American Rescue Plan Act of 2021 heaps a massive amount of stimulus on top of the stimulus already present in the economy. This is all occurring in conjunction with the natural rebound from simply reopening the entire economy. It is not difficult to understand that fueling demand when supply is constrained is a recipe for rising prices. The first place this is typically seen is in commodity prices. As worldwide oil consumption heads back toward 100 million barrels per day, we were not surprised that the price of Brent rose back to the mid-$60s per barrel. The surge in prices is widespread and includes copper, iron ore, crops, chemicals, packaging and transportation. Shortages in residential housing have also fueled large price gains. The strong real economy is creating pricing pressures both with demand-pull from factories and consumers, and with cost-push from raw materials to consumer goods.

Furthermore, massive federal deficits are being fully funded by the Federal Reserve Board's loose monetary policy as the Fed is committed, under its adoption of Modern Monetary Policy, essentially to purchase whatever amount of federal debt is created. Just let the economy run "hot" and simply print more money! While booming demand and supply shortages are likely to fuel price increases above the Fed's inflation rate target over the next couple of years, the Fed's loose-money policy is likely to fuel "The Great Inflation Awakening" as we wrote about in a recent client newsletter. One can observe this happening in just the last 90 days as the 5-year inflation expectations imbedded in the price of 5-year TIPS (Treasury Inflation Protection Securities) has risen 0.6% to its current forecast of 2.5% annually. It was not a good quarter to own 30-year Treasury bonds as the rise in yield produced a negative -16% total return.

It is not difficult to observe the permanent changes in the economy from the pandemic. More employees will work from home, and the investment in home office equipment has exploded. More consumers will continue to benefit from streaming services. With so many restaurants and retail stores having closed permanently, curbside pick-up and home deliveries will not go away anytime soon. Yet at the margin, the reopening of the economy will cause consumer activity to shift away from work from home and shelter in place activities. Corporate revenue growth is accelerating, but margins may come under pressure. Still, the areas of the economy that suffered the greatest profit penalty in 2020 are the ones likely to see the greatest rebound in 2021-22.

Businesses are still evaluating how much office space they need. Manufacturers are reconsidering where they source supply (especially the supply from China) and whether they need to invest more in U.S. manufacturing. The demand for suburban homes, second homes, and RV's appears to be a lasting trend. In addition, manufacturers and distributors must be reevaluating whether "just in time" inventory policies should shift toward "just in case" inventory planning. These trends have already begun to be reflected in the resurgence in the industrial economy and in the stocks that serve these markets.

After lagging badly for much of 2020 and much of the last decade, returns for value strategies shined in the first quarter. Large-cap value benchmarks Morningstar, S&P, and Russell all reported value-style returns above 10%. In contrast, these same firms large cap growth benchmarks gained less than 2%. While the seesaw between growth and value occurred daily and weekly, the shift toward active value management appears to be the beginning of a trend that has legs with long strides to go.

Having already blown the bank on the American Rescue Plan Act of 2021 and all of its earmarks, where will the money come from for the $2.25 trillion of proposed infrastructure spending? Such spending, even if efficiently done, would further add to the demand side of the economy, during and beyond the next two years. Not much can halt the boom underway.

But here's the rub. Certainly airports, roads, bridges, and dams need repair and expansion. So do electric plants capable of providing peaking power to stabilize supply on the electric grid when demand spikes. One can name many worthy projects. Yet the proposed massive increase in taxation and regulation to fund these activities are likely to hinder not help real economic growth in the period beyond 2022. Furthermore, pumping up demand while raising the costs of doing business puts further upside pressure on price inflation. The rise in interest rates (Treasury bond yields) would place the greatest return penalty on the mega-cap growth stocks that everyone currently owns. And investors won't wait to see if it will all pass muster in Congress to shy away from stocks that won't be beneficiaries of an increase in the rate of price inflation. The first quarter is an example of the beginning of this.

Ultimately, we will get through this period of uncertainty as we have in the past—by sustaining of the uniqueness of the U.S. economic miracle. The U.S. historically has: upheld physical and intellectual property rights, defended freedom of expression, sustained a strong national defense, maintained the separation of powers in government, protected its independent judiciary, and established a reserve currency not subject to fiat debasement. These are worth defending as they inherently sustain our long-term prosperity even when shorter-term trends go awry.