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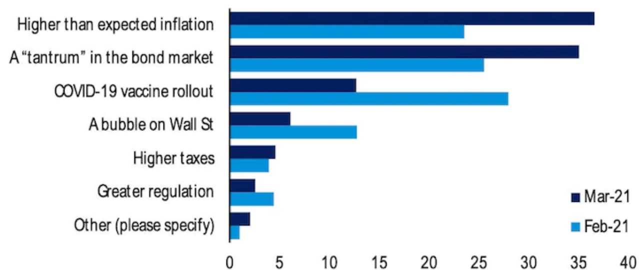
The most recent Bank of America Fund Manager Survey of 220 institutional portfolio managers managing $630 billion revealed something quite extraordinary. For the first time in a year, the COVID-19 pandemic was not named as the biggest risk to the stock market. In fact, it wasn't even close. Six percent of respondents listed a potential "bubble" on Wall Street as the biggest risk, as a result of today's very high stock market valuations and some signs of speculative excess, while thirteen percent listed the potential of a botched COVID vaccine rollout as the biggest risk faced by equity investors. Both concerns certainly make sense in light of the current environment.

However, what is much more telling is that the two biggest concerns noted in the survey both relate to issues that we have written about extensively over recent commentaries: inflation and interest rates. Thirty-seven percent of respondents noted their belief that higher-than-expected inflation is the greatest risk and, in a closely-related response, thirty-five percent of respondents noted that the greatest risk to equities was a so-called "taper tantrum", where both stocks and bonds decline sharply in response to a withdrawal/reversal of monetary stimulus (reduced asset purchases, and potentially even sales, by the Fed).

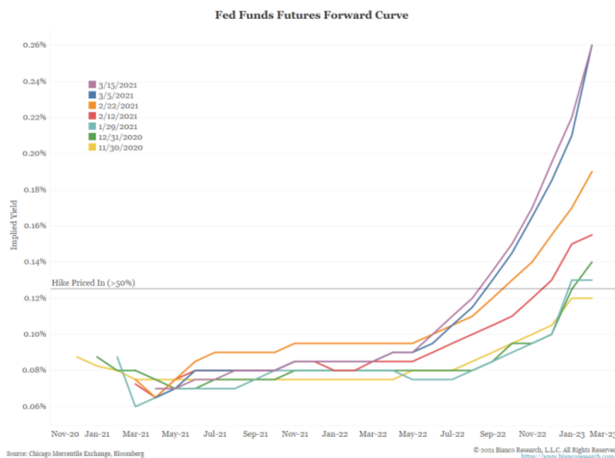
Put another way, seventy-two percent of respondents believe that the greatest risk faced by equity investors is that the current extraordinary levels of both stimulus and money supply growth will combine with the Fed's novel desire for higher inflation to create an environment where inflation gets out of hand and ultimately forces the Fed to slam on the economic brakes, thereby ending the economic expansion.



Importantly, according to almost all classic economic theory, this inflationary outcome is a virtual inevitability, as is the aforementioned response from the Federal Reserve, and that it's simply a question of "when" rather than "if". Further, Wall Street is concerned that the current wave after wave of stimulus is accelerating the "when".

You can actually see this happening in the following chart of the expected Federal (Fed) Funds rate at different periods of time, based upon pricing in the futures markets. These futures contracts quantify when the market consensus thinks that the Federal Reserve will start raising short-term rates, and the fact that estimated dates keep moving from right to left means that the markets keep increasingly moving forward the estimated date for that first increase in rates.

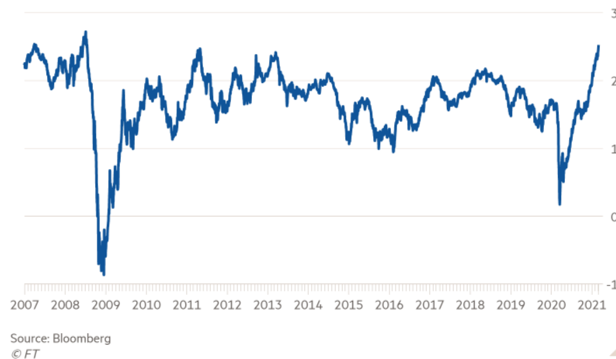
Importantly, this also means that the market has a different outlook on rates than does the Fed. Indeed, Fed Chairman Powell just reiterated the Fed's commitment not to raise the Fed Funds Rate until they have reached their goal of average inflation sustaining at or above 2%, saying that "we believe we can do it, we believe we will do it. It may take more than three years".



Chairman Powell even doubled down on that commitment last Friday, when he announced that the Fed expected to keep short-term interest rates unchanged through 2023.

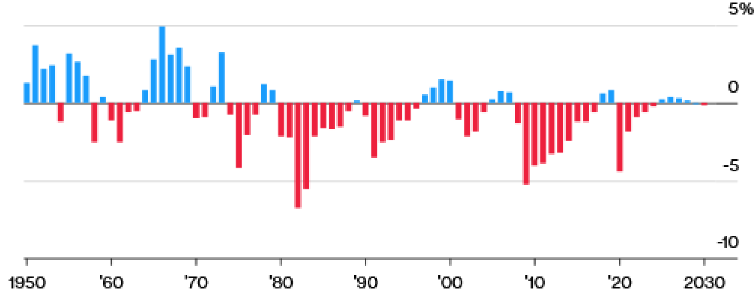
In contrast, the Fed Funds futures market is predicting that the first official rate hike will come much earlier than that, in the late summer to early fall of 2022. Further, the aforementioned Bank of America survey revealed expectations for an end to quantitative easing (the Fed's purchasing of securities) in November of this year, and for the first rate hike by the Fed to take place in November of next year, while the latest Fed "Dot Plot" shows that seven of the eighteen members of the Fed's Federal Open Market Committee expect for the first rate increase to occur by the end of 2023, although Fed Chair Powell was quick to respond that "We're not going to act preemptively based on forecasts".

From our perspective, this divergence in expectations raises the risk that the Fed's inflation-fighting credibility will ultimately be called into question by investors, in which case the market itself may very well snatch control of interest rates away from the Fed, and drive all but ultra-short-term interest rates notably higher. If anything, the fact that we have just witnessed a 28.8% decline in the value of the 30-year Treasury bond (the second largest decline of all time) and the worst annualized returns ever for the general bond market on a year-to-date basis suggests that this process of the markets wrestling the control of interest rates away from the Fed may have already started.



As noted, according to virtually all classic economic theory, undesirable levels of future inflation may be a foregone conclusion, in light of current macroeconomic conditions. However, some of those core economic tenets are increasingly being questioned, and newer economic theories like Modern Monetary Theory (MMT) suggest that the Fed has spent recent decades fighting a war against inflation that they effectively won forty years ago, and that the government can essentially pay for everything that it wants, including universal basic income and 100% employment, by just printing and distributing money ("printing the way to prosperity"). Moreover, MMT maintains that the government can pursue such policies without creating either undesirably-high inflation or a collapse in the value of the dollar.

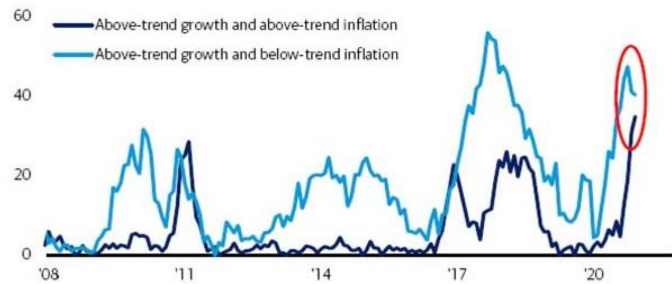
While we question the practicality of MMT largely because its functionality is dependent on politicians being willing to make politically-unpopular decisions, the progressive wing of the Democratic Party has long supported MMT. Moreover, while it is not being referred to by that name by the Biden administration, there are many elements of MMT threaded throughout current fiscal and monetary stimulus programs, with reports of more to come.



Indeed, according to Raymond James, the administration's next major push will be for "a targeted infrastructure package addressing road, bridges, utility repair, clean energy investment, enhanced broadband access, and potentially housing in the $1-1.5 trillion range", and that it will be followed by "social infrastructure investments such as universal child care, tuition-free community college, and an extension of the expanded Child Care Tax Credit". While not full-blown MMT, it is getting remarkably close.

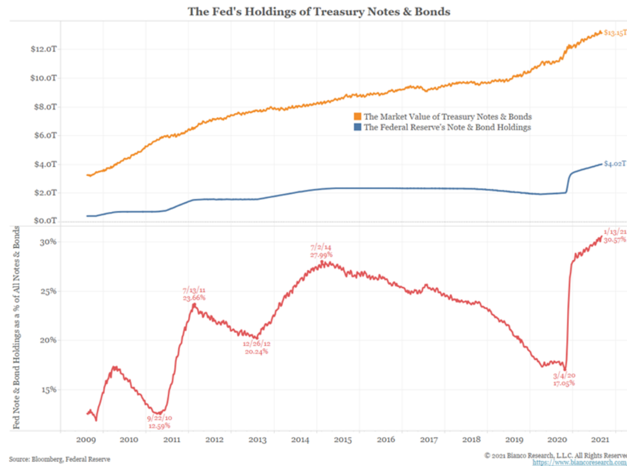
Of interesting note, even the Fed's current policy of keeping short-term interest rates at effectively 0% is also a key component of MMT. This is hardly a surprise, as the Federal Reserve long ago adopted very interventionist policies in regards to the capital markets, where it is openly distorting the prices of financial assets and keeping interest rates unjustifiably low relative to current levels of economic growth and inflation.

Now the Biden administration has set out on a course that will likely prove to be either the most irresponsible and profligate fiscal policy in the history of the United States, or the long-overdue unlocking of the non-inflationary potential of the American economy, after decades of following policies purposely designed to keep a governor on economic growth, in the name of controlling inflation.

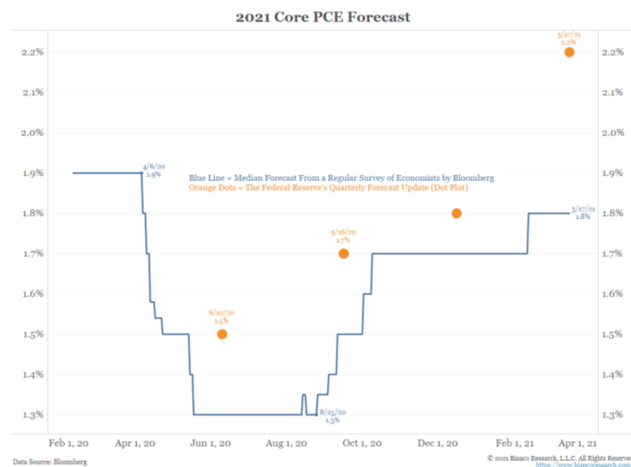


For over a decade, the Fed has been pleading with Congress for them to supplement the Fed's monetary stimulus with generous fiscal stimulus, and they are now getting their wish in spades. Excluding the $3 trillion infrastructure program that President Biden is expected to propose within a week, current U.S. fiscal stimulus already represents more than 27% of the size of the entire U.S. economy. On a relative basis, it is four times larger than was the government response to the Global Financial Crisis. Indeed, if one were to add together Roosevelt's 1933 New Deal (5.9% of the economy), Roosevelt's 1935 Second New Deal (6.7% of the economy), the 1947 Marshall Plan (5.4% of the economy) and the Obama fiscal stimulus package (5.5% of the economy), they only total 23.5% of the economy (each at their respective times), well short of the 27% of the size of the economy represented by current fiscal stimulus alone.

Equally remarkable, with three notable exceptions, including the World War II era, the post-Global Financial Crisis period and now, monetary and fiscal policy have traditionally offset each other throughout most of modern history. A recent example was the Fed raising rates to offset the perceived inflation-risks associated with the Trump tax cuts. Now, they are acting in coordination and virtual unison, which should be expected, at least according to classic economic theory, to sow the seeds of inflation, particularly when the Fed's balance sheet, which represents the Fed's holdings of financial assets, represents an additional $13+ trillion of monetary stimulus. To add some perspective, the Federal Reserve now owns almost one-third of total U.S. debt securities, and monetary stimulus is now equivalent to almost two-thirds the size of the U.S. economy.



It is noteworthy that these concerns about excessive levels of stimulus are being echoed by Lawrence Summers, who previously served as Chief Economist of the World Bank, Treasury Secretary for President Clinton, and Director of the National Economic Council for President Obama. In a March 20th interview on Wall Street Week, he called current spending programs, "the least responsible fiscal macroeconomic policy we've had for the last 40 years". In regard to inflation, Summers said, "what was kindling, is now igniting".



Summers assigned equal odds to each of three outcomes: 1) that inflation will accelerate in the coming years and the U.S. could face stagflation (slow growth and high inflation), 2) that there will be no inflation because the Fed will be forced to slam on the brakes and cause a recession, and 3) that the Fed and Treasury will successfully produce rapid economic growth without undesirably high inflation. Summers noted "there are more risks at this moment that macroeconomic policy will cause grave risks than I can remember".

From our perspective, this coordinated wave after wave of fiscal and monetary stimulus seems destined to produce a relatively binary outcome. If successful, and the unprecedented levels of current and expected government stimulus are able to bring the economy to its maximum sustainable potential, and by doing so, elevate the standard of living of virtually all Americans, all without generating undesirable levels of inflation, then President Biden's policies are unquestionably brilliant, the fiscal and monetary authorities need to wholly reexamine how they manage the U.S. economy, and investors in both stocks and bonds can probably breathe a big sigh of relief.

However, if all of this stimulus catalyzes a move in inflation to undesirably high levels, and thus causes the Federal Reserve to curtail quantitative easing (asset purchases) and raise interest rates, thus slamming on the economic brakes, and leaving policy makers to service a massive federal deficit in an environment of higher interest rates and a slowing economy, then the sigh that you hear from investors is likely to be one of something other than relief.

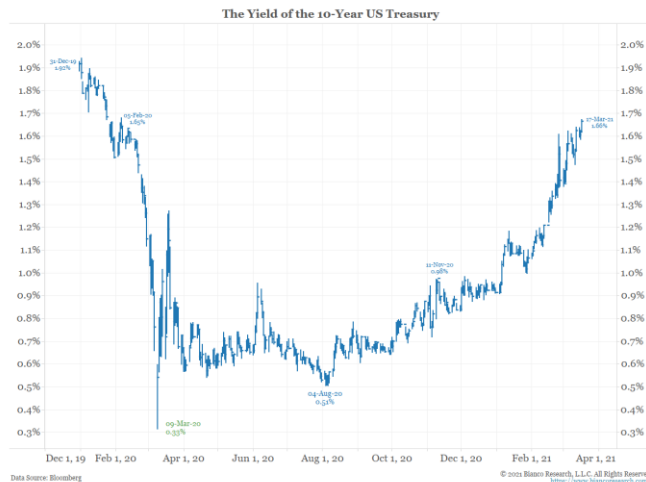
Debt as share of gross domestic product

Source: Congressional Budget Office

This is a grand experiment, and the levels of future inflation will be the final arbiter of whether or not history will view it as a transformative success or abject failure. Magnifying the impact of these massive stimulus programs is the fact that they are taking place against the backdrop of a seminal change in how the Fed is targeting inflation.

Specifically, the Federal Reserve currently finds itself in the very unfamiliar position of actually wanting more inflation and, as a result, is not going to step in to protect the bond market when inflation starts to emerge. The recognition of this fact is pushing longer-term rates higher, as fixed-income investors demand higher yields to help offset the risk of future inflation.

Further, the Fed's approach to inflation has gone from being proactive to reactive, and Chairman Powell has made it very clear that they are not going to tighten monetary policy until interest rates move high enough to start having a negative impact on financial conditions.



The very fact that they are forecasting an extraordinary 6.5% economic growth rate and a *de minimis* 3.5% unemployment rate, and yet are not on the verge of raising rates today is something that would have been almost inconceivable less than two years ago. There is an old saying that, "when interest rates start going up, they tend to keep going up until something breaks". The Fed has made it very clear that they will respond to inflation, but only after current policies cause it to reach potentially problematic levels. As economist David Rosenberg just noted, "the Fed is not going to keep the dishes from breaking, but they will help you to clean up the mess".

The potential problem with this reactive approach was just pointed out by one of our favorite economists, Jim Bianco of Bianco Research, who pointed out that, while higher interest rates are very effective at keeping undesirably-high levels of inflation from gaining a foothold, it takes really high rates to reverse inflation, once consumers become more accepting of higher prices and producers and retailers rediscover that they have pricing power.

Such a sharp spike in interest rates would likely be highly problematic for most stocks, and potentially even worse for virtually all bonds, due to the fact that interest rates and bond prices must move inverse of one another for purely mechanical reasons.

Importantly, we believe that this change in the dynamics between the Fed, interest rates and the bond market is potentially more secular than it is cyclical. For decades, the Federal Reserve has acted as a sort of guardian angel that looked out for savers and income investors by keeping economic growth and inflation rates on the low-end of potential. Because of this long-standing practice, savers and investors have been willing to tolerate *de minimis* interest rates that do not protect the purchasing power of their money from future inflation.

Real Interest Rates in the Developed World (Nominal Minus CPI)

As of 2/11/2021

Country	Inflation Rate	Policy Rate	6-Month	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	30-Year
Switzerland	-0.80	0.05	0.01	-0.01	-0.02	0.04	0.11	0.17	0.23	0.25	0.31	0.37	**0.43**	0.62	0.69
Germany	1.00	-1.50	-1.63	-1.66	-1.72	-1.75	-1.74	-1.71	-1.69	-1.65	-1.59	-1.52	**-1.46**	-1.26	-0.98
Netherlands	1.60	-2.10	-2.24		-2.29	-2.32	-2.31	-2.27	-2.23	-2.18	-2.13	-2.00	-1.93	-1.90	-1.50
Denmark	0.60	-1.20	-1.14		-1.18			-1.16			-0.60		-0.96		-0.60
Finland	0.20	-0.70		-0.86	-0.92	-0.91	-0.90	-0.84	-0.82	-0.73	-0.66	-0.59	**-0.51**	-0.22	-0.05
Austria	1.20	-1.70		-1.89	-1.88	-1.86	-1.84	-1.78	-1.76	-1.69	-1.62	-1.53	**-1.46**	-1.26	-0.91
Japan	-1.20	1.10	1.09	1.07	1.08	1.08	1.09	1.11	1.12	1.16	1.19	1.23	**1.28**	1.48	1.87
France	0.60	-1.10	-1.24	-1.24	-1.25	-1.29	-1.26	-1.22	-1.14	-1.08	-1.00	-0.92	**-0.84**	-0.53	-0.05
Belgium	0.26	-0.76	-0.90	-0.89	-0.97	-0.95	-0.92	-0.89	-0.84	-0.74	-0.70	-0.62	**-0.54**	-0.28	0.27
Ireland	-1.00	0.50		0.37		0.37	0.40	0.46	0.53	0.60		1.00	**0.86**	1.04	1.48
Spain	0.60	-1.10	-1.13	-1.12	-1.14	-1.06	-1.02	-0.94	-0.94	-0.79	-0.73	-0.64	**-0.48**	-0.15	0.41
Portugal	0.30	-0.80	-0.83	-0.83	-0.92	-0.83	-0.72	-0.64	-0.52	-0.43	-0.36	-0.29	**-0.23**	0.13	0.72
Italy	0.20	-0.70	-0.66	-0.65	-0.64	-0.53	-0.44	-0.30	-0.22	-0.10	0.02	0.14	**0.26**	0.63	1.18
United Kingdom	0.60	-0.50	-0.60	-0.67	-0.65	-0.61	-0.60	-0.54	-0.47	-0.38	-0.30	-0.19	**-0.13**	0.10	0.45
Australia	0.90	-0.80	-0.91	-0.84	-0.80	-0.80	-0.63	-0.38	-0.31	-0.12	0.01	0.16	**0.29**	0.63	1.28
New Zealand	1.40	-1.15		0.33	-1.17			-0.70		-0.42			**-0.10**	0.44	
Canada	0.70	-0.45	-0.60	-0.57	-0.51	-0.47	-0.37	-0.21		0.02			**0.29**		0.89
United States	1.40	-1.28	-1.35	-1.33	-1.29	-1.21		-0.94		-0.60			**-0.25**		0.53

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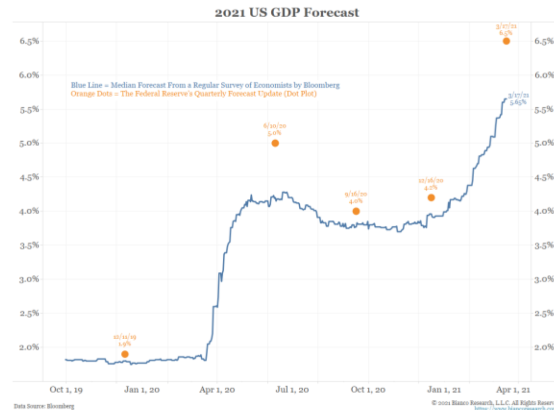
Forward to 2021 and, if you look around the globe, there are no guardian angels to be found. Instead of protecting savers and fixed-income investors from inflation as a primary central bank objective, today's central bankers are actively courting inflation through both their policies and their forward guidance, while simultaneously employing a practice called "yield curve control" to keep interest rates from moving higher in response to economic recovery and an increasing risk of inflation.

In other words, instead of being guardian angels for savers and fixed income investors, central bankers are now essentially rigging the game against them by creating an environment where future inflation is increasingly likely to cause bonds to lose value, while simultaneously creating headwinds that make it difficult for interest rates to move higher now to compensate bondholders for the increased risk that they face.



This has already created a situation where the "real" interest rates (net of inflation) being paid to investors around most of the globe is already negative, despite the fact that current inflation still remains quite low (above).

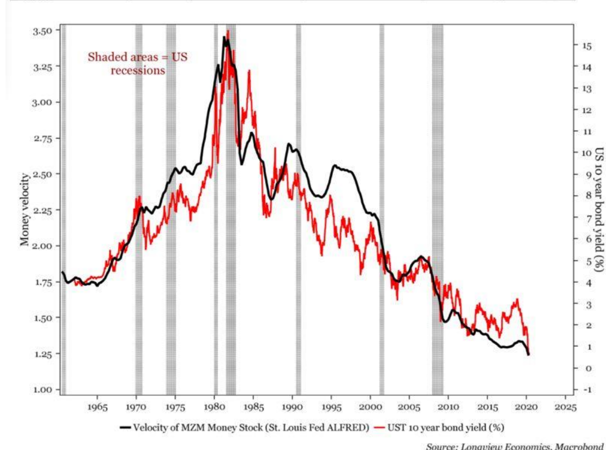
The other factor that makes current government policies so extraordinary is that this massive combination of fiscal and monetary stimulus is being injected into an economy that is already exhibited some of the fastest growth that we have seen in decades, and that there has historically been a very tight correlation between excessively fast economic growth and higher inflation.

In our opinion, if the bond market ever perceives (we believe correctly) that the Fed is more committed to full employment, maximizing sustainable economic growth, and monetizing the national debt than it is to its more traditional role of keeping inflation quiescent and protecting bond portfolios, we could see interest rates really surprise to the upside, and quickly overwhelm any Fed efforts to keep rates contained.

That said, we have been living in an era dominated by deflationary macroeconomic factors, such as technology (the internet, in particular), demographics, the globalization of supply chains and labor, digitization, etc. that have held inflation in check, and help to explain why there is very little inflation to be found in the economy today, at least outside of financial asset prices. It is at least possible that these deflationary influences remain strong and sustainable enough to offset the inflationary impact of all of the current stimulus over the intermediate term.

Regardless, we believe that a significant jump in inflation is almost inevitable over the near term, albeit for primarily calendar-related reasons, as most inflation gauges are measured on a year-over-year basis, and almost exactly a year ago was the country-wide economic shutdown, and a corresponding and very significant drop in prices for almost everything ranging from office rent to energy prices.

When measured against near-depression lows, there will almost certainly be a period over coming months when inflation is going to look very elevated. The question is whether it will be only a temporary phenomenon, or if higher prices become embedded in the economy, and inflation is allowed to become problematic. We believe that the answer will probably depend on two things. The first is whether or not the government is satisfied with the currently planned levels of stimulus, or if they are going to continue pushing the envelope on stimulus. If the former, it is at least possible that the aforementioned deflationary forces allow the stimulus to be integrated into the economy in a non-inflationary way. If the later, then we suspect that interest rates will keep meandering higher and higher "until something breaks".



We believe that the second major determinant of inflation is likely to be something called monetary velocity. To explain, monetary liquidity is a function of not only the amount of currency that is circulating in the financial system, but also how often each unit of that currency changes hands. Money supply growth has been epic in size, which would normally be expected to generate significant inflation. However, at least partially because of pandemic-related restraints, the rate at which dollars are actually changing hands has been plunging, as you can see in the inflation (CPI) versus velocity chart. In the same chart, you can see the very tight correlation between the money turnover rate (velocity) and inflation. Not surprisingly there is also a very tight correlation between monetary velocity and bond yields. We expect for both the current historic levels of stimulus and the post-pandemic reopening to accelerate velocity, but acknowledge that the future outlook for inflation remains an open, albeit all-important question.

It would not be unreasonable to say that, over recent decades, the number one requisite for a successful equity portfolio has been that an investor "never fight the Fed". In other words, it has been true that, as long as the Fed was lowering interest rates and loosening monetary policy, it was pretty much a green light to be bullish on equities, almost regardless of whatever else was going on in the world.

However, with the Fed now adopting a stance that seems to be putting the best interest of Main Street ahead of that of Wall Street, one must question whether or not that correlation still holds true. This is a period of profound change, with fiscal policy moving away from macroeconomic "trickle-down" policies to directly targeting money on a bottom-up basis to those most in need, and monetary policy moving from being proactive and preemptive to being non-anticipatory and reactive.

While this is likely, at least over the short-term, to improve economic conditions for the vast majority of Americans (obviously, a truly worthwhile goal), it may or may not be so kind to the vast majority of American portfolios, as equities tend to struggle if interest rates move up in response to higher inflation (as opposed to in response purely to better economic growth), and bonds will suffer when rates go up, regardless of the catalyst, but particularly if it looks like future inflation will erode away the purchasing power of the fixed income stream that bonds provide.

In the meantime, there is a certain irony attached to the results of the Bank of America survey referenced at the beginning of this commentary, which illustrated that investors had become rather complacent about the ongoing pandemic, as over the past week or two, smaller-capitalization stocks, value stocks and economic reopening-related stocks have been giving up significant gains, and interest rates have moderated, as the U.S. COVID case count has started edging higher, and we are seeing a new surge in cases in Brazil, Western Europe and India, along with new shutdowns in Europe, all of which call into question the timing of the "normalization" that the stock and bond markets were already largely pricing in.

There is so much changing in regard to how the government interacts with the economy, and dramatic change increases uncertainty and uncertainty almost always increases volatility. It also reduces clarity about the future. That lack of clarity extends to what parts of the market will emerge as leaders.

That said, we expect for the remainder of 2021 to be very volatile in the equity markets, and that we are likely to see an ongoing rotation from growth sectors like technology and biotechnology, to economically-sensitive, cyclical stocks in sectors like industrials and basic materials, that should benefit from the infrastructure program and all of the stimulus in general, to value stocks and economic reopening stocks like theaters, restaurants, airlines and cruise lines. We believe that it makes sense to maintain exposures to all three types of stocks in this environment, and to also emphasize domestic equities over their foreign counterparts, despite the fact that domestic stocks tend to be more expensive.

While we tend to favor growth stocks over the longer term, such highly valued stocks are most at risk to higher interest rates, and we are in a unique environment where the stimulus programs and reopening may temporarily allow investors to find aggressive growth-type earnings from "average" stocks that are less expensive and less risky. It is also very possible that the Fed's new approach to inflation will benefit these "average" stocks in the future.

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