Volume 127

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

May 2021

"The Great Fire of Rome" was reportedly started in 64 A.D. upon secret orders from Emperor Nero, who wanted to clear the way for a giant new palace called the Domus Aurea.

By the time that the fire burned itself out nine days later, two-thirds of the city had been destroyed and Nero, by ignoring the plight of Rome's citizens and reportedly "fiddling" while the city burned, had effectively assured that his name will always remain synonymous with apathy, disinterest, and irresponsibility.

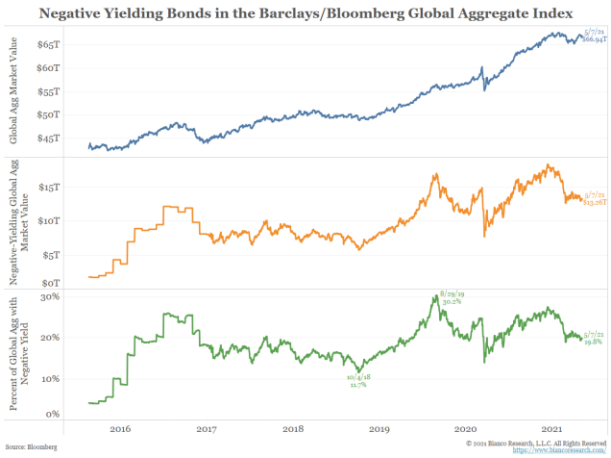
While the motivations are certainly not similarly nefarious, there is a growing risk that the Federal Reserve has been similarly "fiddling" as "hot" levels of inflation are spreading throughout the economy. Most recently, this includes the highest monthly reading for consumer inflation in almost forty years (since September of 1981).

In a sharp departure from history, this is not just being tolerated by the Fed, it is being encouraged as part of their new reactive approach to monetary policy. Suddenly gone are the days when the Fed would take proactive steps to slow economic growth as soon as it started to approach what was perceived to be the economy's non-inflationary potential.

This approach was rooted in the hyper-inflationary experience of the 1970s and early 1980s, and the extraordinary lengths that Fed Chairman Volcker had to go through, including ramping short-term interest rates all the way up to 20% in June of 1981, and forcing the economy into a period of deep and prolonged recession, just to get inflation under control.

The Fed's decision to adopt a new and reactive approach to monetary policy is a tacit recognition of the fact that the previous, decades-old proactive approach to inflation fighting had left unemployment too high and the U.S. economy consistently running well below its potential, while unnecessarily shortening the duration of economic expansions. If anything, this long-standing policy had been so effective that it has left interest rates and inflation not only too low, but at such incredibly low levels that it effectively deprived global savers of any reasonable source of income, and left the Federal Reserve without their most important tool (lower interest rates) with which to battle future recessions.

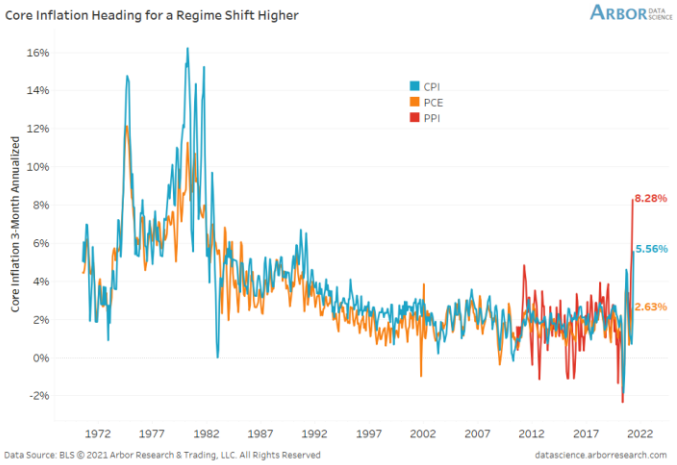
This newly-adopted, revolutionary, and untested approach to monetary policy is largely attributable to former Fed Chairman Ben Bernanke, who wrote a series of highly influential papers while at the Brookings Institution (after his Fed Chairmanship), which provided the working premise for the Fed's new "Statement on Longer-Run Goals and Monetary Policy Strategy", which is largely dictating today's monetary policy decisions.



Bernanke's premise was that the world, largely as a result of aging demographics, excessive global debt levels, globalization and technology, had entered into a new era of chronically low inflation, and very low inflation-adjusted interest rates.

As noted, this left the Fed in a very precarious position, with interest rates already effectively at 0%, thus leaving the Fed with little option in the event of a recession, but to push interest rates below 0%. While Japan and Western Europe have, over recent years proven that it can be done, the experience has also shown that negative interest rates tend to actually depress growth, as they essentially so weaken the banking system that banks are too ill-capitalized and highly disincentivized to make loans.

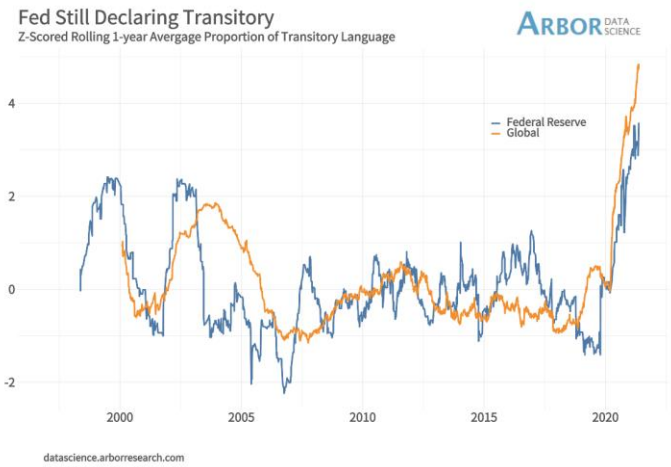
The other great risk identified by former Chair Bernanke is that, because inflation has tended to fall during recessions, but not fully rebound during recoveries, the economy seemed destined for continued disinflation (slower rates of price increases) and eventually even deflation (falling prices across the economy). Deflation is of particular concern to central bankers, as they have tools to address inflation, but only very few options to try to reverse a macro-trend of falling prices.



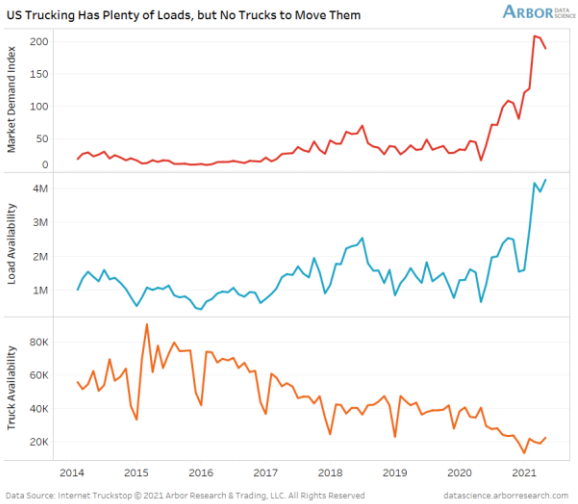
Falling prices for consumer goods is of particular concern in the U.S., where 70% of the economy (GDP) is attributable to consumer spending, and where falling prices encourage consumers to delay purchases into the future, thus essentially making a recession inevitable.

The conclusion drawn in Bernanke's research papers, and adopted virtually in its entirety by the Powell Fed, was for the Fed to change 2% inflation from being the Fed's nominal target to an average target, and to commit to the markets that they will keep interest rates nailed to the floor until the economy averages 2% on a sustainable basis before taking any steps to moderate the economy. This is why Chairman Powell has maintained that the Federal Reserve is currently "not even thinking about thinking about raising interest rates" despite what has been a sharp move higher in wholesale inflation (PPI), and increasingly in retail inflation (CPI & PCE).

The other reason given for the Fed's continuing decision to "keep fiddling" despite these growing inflationary pressures is because the Fed believes (or is just hoping with all of its might) that these inflationary pressures are only transient, and will "burn themselves out" in relatively short order.

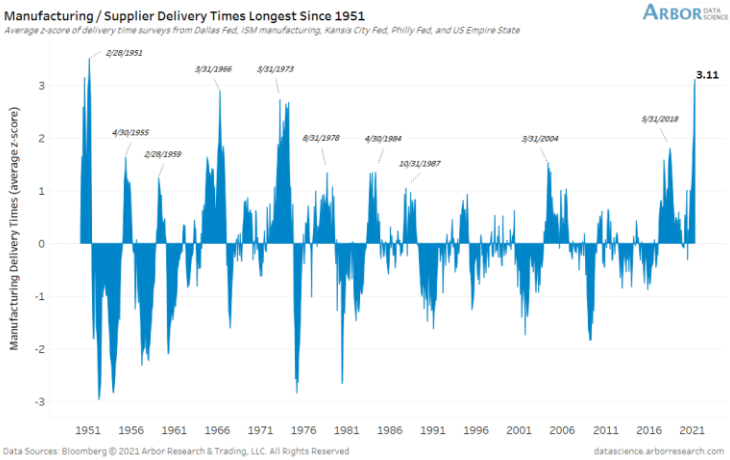


Indeed, an analysis of the language coming out of not only the Federal Reserve, but also central banks around the world, shows just how committed they are to the premise that this inflationary surge is just temporary, and is largely attributable to pandemic-related supply chain disruptions and inefficiencies in the macro-economy, and that they will work their way through the system as the global economy reopens.



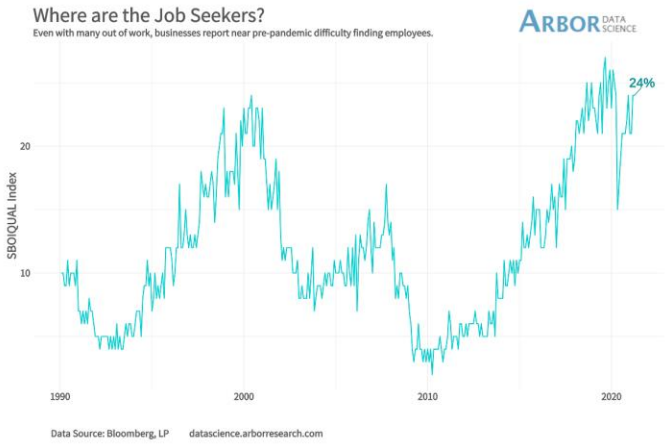
Chairman Powell has been very emphatic that "There's a difference between essentially a one-time increase in prices and persistent inflation. Inflation tends to be dictated by underlying inflation dynamics in the economy, as opposed to things like bottlenecks." In other words, if it requires a singular increase in prices to restore an efficiently functioning global economy, that is not necessarily something that would justify a response from the Federal Reserve.

There is, of course, every possibility that the Fed will be proven correct, as economic inefficiencies tend to be very inflationary, and because there are signs of economic inefficiencies everywhere that you look, whether it be the extraordinary mismatch between shipments that need to be moved and the number of trucks and drivers available to move them, or the blistering 469% one-year increase in the cost of trans-ocean shipping.

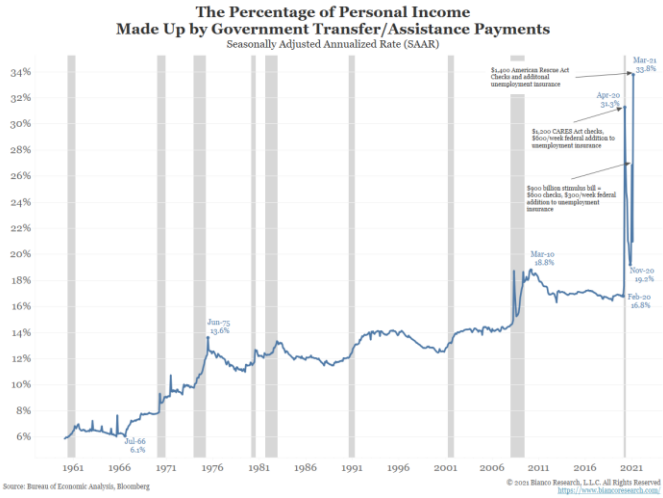


Equally problematic is what might best be termed an economic enigma, which is the fact that businesses in much of the country are suffering from an acute labor shortage at a time when the U.S. has 8.5 million more unemployed workers than it had prior to the pandemic.

Part of this enigma is due to the government paying such generous unemployment benefits and stimulus payments that many are making as much money sitting on their couch as they would returning to the workforce. So significant is the labor shortage that 20 states have ended the extended unemployment benefits ahead of schedule. In theory, they end for everyone else in early September (if not extended).



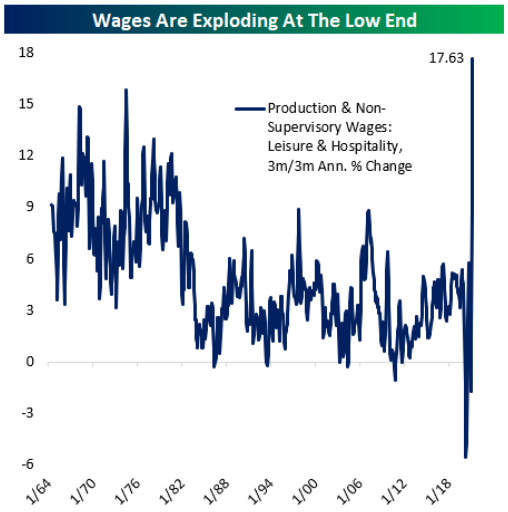
To put the scope of these government payments into some perspective, the personal income of the average American increased by a massive 27% over the past year, and almost 34% of the average American's total personal income over the past twelve months has come from federal government stimulus and assistance programs.



The outcome of all of this government generosity was arguably predictable. The April unemployment report was expected to produce over 1,000,000 new jobs, and instead produced only 266,000. By many measures, it was the biggest gap in history between expected and realized job gains.

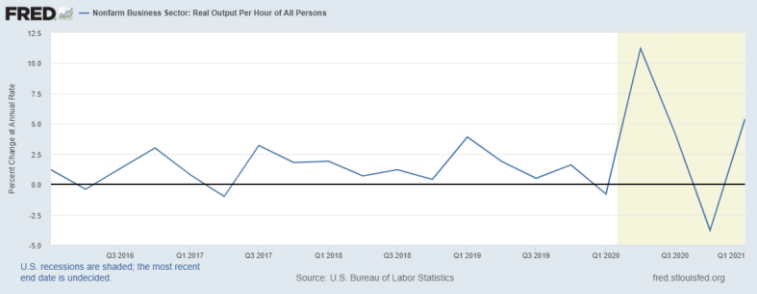
Granted, not all of the undershoot was caused by an excess of government payments. Some of it is due to a shortage of viable childcare or because of a mismatch of worker skill sets and job requirement. Some of it may be vaccine-reluctant workers who are afraid to come back to the office, and some of it is that certain industries are being slow to reopen. Regardless of the motivation, the bottom line is that the huge April jobs report miss had nothing to do with a lack of available jobs. The NFIB and the Job Openings and Labor Turnover Survey reported job openings for the month of 8.4 million and 7.4 million respectively, which is almost enough to put the whole of America's 8.5 million unemployed back to work.

This is forcing employers to significantly raise wages to attract workers, which is serving to further reinforce the growing array of reasons to be concerned about inflation, particularly since the Fed has made it very clear that it is strongly emphasizing its mandate of maximum levels of employment over its mandate to keep inflation well in hand.

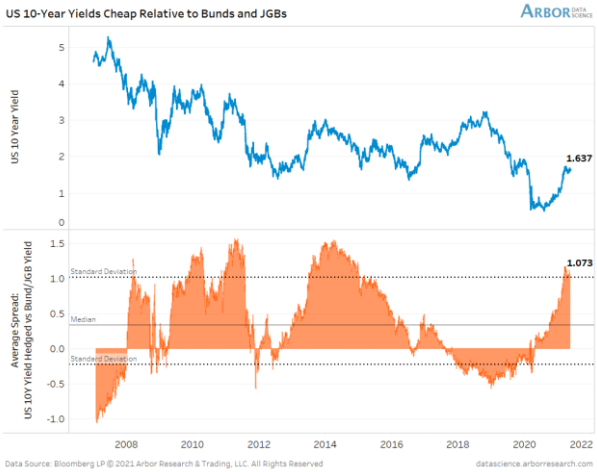


Importantly, inflation is caused by higher unit labor costs rather than higher wages. In other words, if an employee gets paid another 10% per hour but is 20% more productive during each respective hour, it actually drives unit labor costs (and therefore inflation) down, and this is where the Federal Reserve, and the American economy as a whole, may be bailed out by the one good thing (other than vaccines) that came out of the pandemic, and that is a quite significant surge in worker productivity. Indeed, according to Rosenberg Research, there is an "inverse 80% correlation between the trend in productivity and the trend in underlying consumer prices".

As such, if these productivity-related gains can be maintained, it would be an exceptionally bullish development, as it would allow for higher wages for workers without sacrificing corporate profits or generating unwanted levels of inflation.



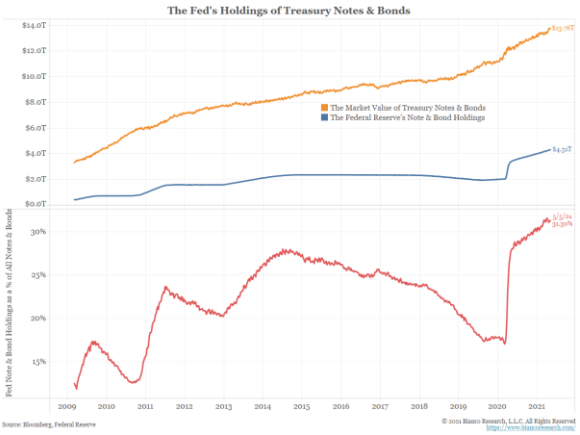
While this surge in productivity is quite bullish, it doesn't seem to be providing much comfort to Wall Street, which is clearly starting to worry about higher inflation, although that concern is thus far only having a modest impact on bond yields, which we believe can be explained by two potential explanations.



The first is that the bond market may agree with the Federal Reserve that the spike in inflation is only temporary and that it will abate as the global economy reopens, and even that the productivity gains will help to keep inflation at bay.

A second explanation may be even more likely, which is that U.S. interest rates are higher on a relative basis versus Japanese and German interest rates than they have been in eight years, and it is drawing significant new money into the U.S. markets from overseas (particularly from China), thus keeping bond yields well contained. As the old saying goes, money is fungible and flows to where it is treated best.

In addition, with the Federal Reserve currently holding almost one-third of all outstanding Treasury securities, it is hard to view Treasury yields as a reliable indicator of anything beyond the Fed's commitment to its quantitative easing programs.

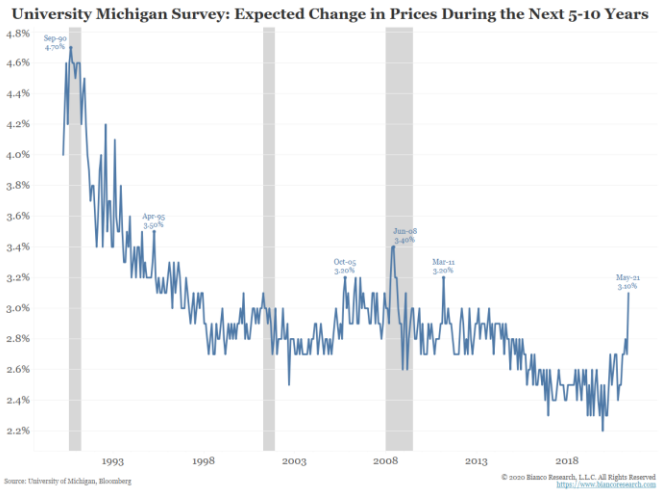


In sharp contrast to current Treasury rates, where the Fed's asset purchases are combining with increased foreign buying to keep rates relatively low, almost everything else is pointing to a growing risk of higher and potentially even undesirably elevated levels of inflation.

There are numerous places where the growing risk of inflation is becoming very evident, including in the futures and long-term options markets, where the U.S. is leading what is expected to be a global rebound in inflation. The notable exception is in Japan, which has suffered through decades of disinflation and deflation ever since the popping of its real estate and stock market bubbles in 1989 and 1990.

You will also find growing concerns about inflation in virtually all of the surveys, whether they be of consumers, economists, or corporate executives.

It is important to emphasize that virtually no one is predicting a return to the hyper-inflation days of Chairman Volcker, or likely even to mid-single-digit inflation. That said, there is at least a reasonable probability that we will experience the highest prolonged inflation that we have seen in decades, and a level of inflation that is likely to impact the prospects for stocks, bonds, commodities, homes, etc. To paraphrase Warren Buffett, inflation is like gravity in that it weighs on the value of all financial assets.



It also weighs on corporate profits, particularly if companies are unable to pass through to the consumer their increased labor and raw materials costs. Indeed, inflation-related comments have increased by 800% in this quarter's corporate earnings calls versus those same calls from a year ago.

Even the treasury markets themselves are starting to price in a growing risk of inflation based upon the so-called "breakeven rate", which measures the yield difference between an inflation-protected Treasury security and a non-inflation-protected Treasury of the same maturity, and which is now showing an accelerating expectation of higher inflation rates.

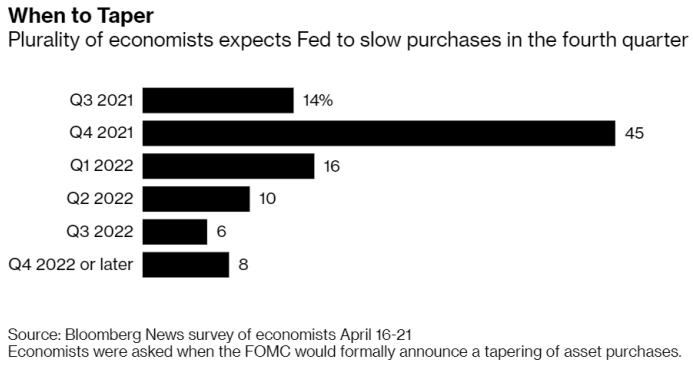
As was noted by Mr. Buffett, high levels of inflation have historically proven to be a headwind in the face of both stocks and bonds, albeit generally beneficial for commodity prices and inflated-protected securities. In fact, the only environment in which stocks and bonds have failed to outpace inflation in a majority of years is one of high and increasing inflation.

Losses in bond portfolios tend to be both proportionate and inverse of the increases in inflation, as interest rates go up in response to inflation, and because bond prices and interest rates always move inverse of one another. The impact of inflation on the equity markets, while not as directly correlated, is arguably similarly influential. Indeed, according to data from NYU that goes back to 1928, the S&P 500 averages gains of 6.3% per year when inflation is above 3% and a massive 15.6% when it is below 3%. Moreover, the same database shows that the S&P 500 averages gains of 6.7% per year when inflation is rising, versus a huge 16.5% per year when inflation is falling.

It is highly interesting that former Fed Chairman Bernanke, as the primary architect of the Fed's new approach to monetary policy and inflation, literally asked the question "So what could go wrong?" with this revolutionary new approach in a 2019 blog post.

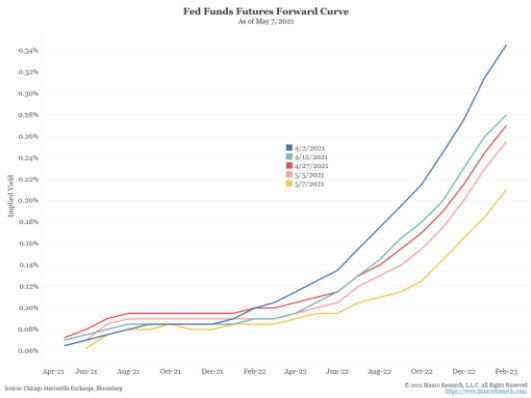
Specifically, he questioned what would happen if the Fed successfully raised inflation sufficiently above 2%, such that it raised the average inflation rate to the Fed's 2% target, and yet the markets don't have trust or faith in the Fed that they can bring inflation back down again and not let it get out of hand. As he wrote in the blog: "If people don't understand or believe the Fed's strategy—if the Fed is imperfectly credible—and their expectations of inflation become un-anchored as inflation rises above target, then inflation could be more persistent and the costs of the policy could be much higher than anticipated." We believe that Bernanke likely has a pretty good point, as this is the first time in decades that the Fed is no longer serving as the protector of savers and investors, and is instead actively encouraging inflation, so it seems reasonable that the Fed's credibility would be questioned.

Indeed, we believe that the Fed's credibility with investors is already suffering from their continued and seemingly intransigent insistence that "we are not even thinking about thinking about raising rates" at a time when the evidence is becoming less and less supportive of their perspective. Moreover, in a month when we have seen estimates of employment gains and inflation that turned out to be massively lower and higher than expected (respectively), and by historic proportions, the Fed's seeming unwillingness to adjust their guidance to the changing data seems like they are "fiddling" while inflation is potentially burning.



There already seems to be a growing concern on Wall Street that the Fed's apparent complacency may be viewed as an indication that the Fed is no longer as committed to controlling inflation, and that could create a sort of self-fulfilling prophecy, where businesses raise prices now to get ahead of expected inflation and consumers accelerate purchases ahead of what they expect to be higher prices in the future, which is exactly the kind of activity that has catalyzed inflation in the past.

The Fed finds itself in a very unenviable position, as it will need maintain the market's confidence while they "taper" (slow and ultimately reverse) their assets purchases. A similar effort in 2013 caused a 1.4% surge in the 10-year Treasury yield in the four months after Bernanke first uttered the term "taper" during a congressional testimony, and a planned "tapering" in 2018, which was presented to the markets by Fed Chairman Powell and former Fed Chairwoman Yellen as being like "watching paint dry", caused a vicious fourth quarter equity bear market, due to fears that the Fed's "autopilot" approach would push the economy into recession (something that they have committed to avoid under the new policy).



Tapering must almost inevitably be followed by higher interest rates, which the markets are now expecting to see beginning in early 2023, and our expectation is that both stock and bond markets are likely to react quite negatively when they come to the realization that this period of historic monetary stimulus, record low interest rates, and explosive money supply growth is finally coming to an end.

Our expectation is that markets will react negatively when these changes are announced and will probably do so again as soon as these changes are implemented. While we believe that the outlook for bonds will be challenged for the foreseeable future, we maintain that the bull market in equities will likely survive for as long as Wall Street has confidence in the Fed and in their ability to plot a "golden mean" monetary policy.

It should be quite the balancing act, and one that will hopefully be more reminiscent of Goldilocks than of Nero.

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The Consumer Price Index (CPI), which is produced by the Bureau of Labor Statistics, is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

The Personal Consumption Expenditures (PCE) price index, prepared by the Bureau of Economic Analysis (BEA), is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The Producer Price Index (PPI) program, which is produced by the Bureau of Labor Statistics, measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The Bloomberg Barclays US Aggregate Bond Index measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Standard & Poor's 500 (S&P 500) is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

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