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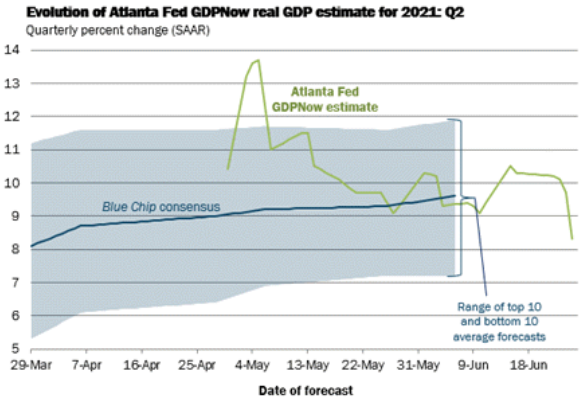
Is it possible that we just witnessed "peak everything" (or at least peak many things)? Did we just witness a peak in the growth rate of money supply, in the pace of government fiscal stimulus, in the rate of increase in monetary stimulus, in corporate profit growth, and in economic growth? Could it be that we just witnessed peak interest rates, the peak in the relative outperformance of value stocks, and perhaps even a peak in inflation (or at least in inflationary expectations)?

If so, such a macro-driven and virtually simultaneous shift would represent an almost unprecedented sea-change, and would likely require an enormously powerful catalyst from an incredibly influential source…like we are potentially currently witnessing from the Federal Reserve.

The messaging is not dramatic, as Chairman Powell is doing everything in his power not to spook the capital markets and cause the type of market turmoil that we saw in 2000 (when the Fed withdrew massive liquidity from the economy once Y2K turned out to be a non-event), in 2013 (when the Fed's announcement of reduced asset purchases caused the so-called "taper tantrum", which catalyzed a bear market in bonds), or in 2018 (when the Fed's announcement of a modestly tighter monetary policy caused a forth quarter bear market in equities, despite Fed assurances that the impact of the policy change would be as dull as "watching paint dry").

Nonetheless, while the messaging from the Fed has been subtle, and even sometimes purposefully conflicting, there are hints and signs everywhere that the Fed has already started watering-down the punchbowl, and this potentially has great significance to an economy and a consumer spending spree that has been powered by a punchbowl full of 150-proof punch.

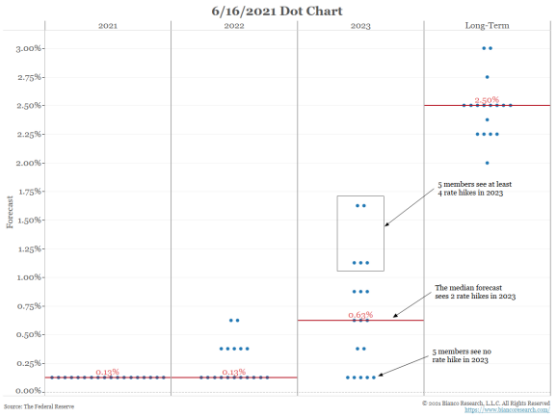


Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Starting last Fall, and largely catalyzed by three powerful factors, including 1) the approval of multiple very effective COVID vaccines, 2) the outcome of the Georgia runoffs, which gave Democrats control of all three branches of federal government, and 3) the resulting historic explosion in government fiscal stimulus, the domestic economy has grown at levels unseen since the early 1950s, in the midst of the Marshall Plan.

Indeed, according to the Atlanta Fed's GDP Now model, which attempts to gauge the rate of economic growth in real time, U.S. economic growth had actually surged to an absolutely blistering 13.5% growth rate, before retreating to a still very impressive 8-plus percent rate.

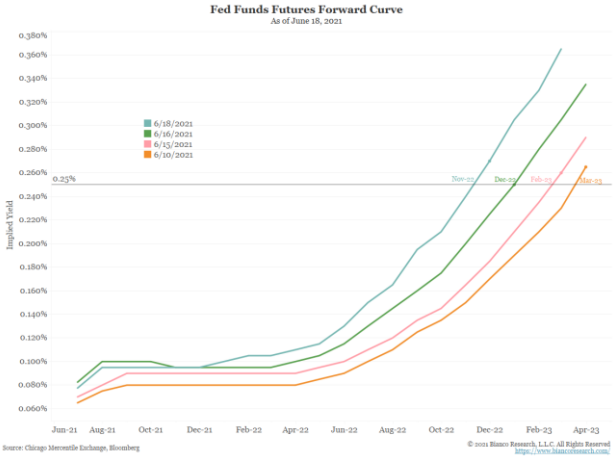
While this downgrade brings this measure more in-line with the estimates of top Wall Street economists, it is still at almost unprecedentedly high levels. That said, there is a growing body of evidence that the U.S. has already experienced peak economic growth for this cycle.



The markets are also starting to adjust to the prospects for the major driver of economic (and market?) growth since the pandemic lows, monetary stimulus, also approaching peak growth, as was suggested by the latest Fed "Dot Plot", which showed that Fed Governors are increasingly expecting the Fed to start raising rates much sooner than previously expected. This perspective has been further reinforced by recent comments from an array of Fed Governors stating that it is time to start planning for both higher short-term rates and, even before that, a "tapering" (gradual reduction) in the Fed's purchases of financial assets.

Indeed, over the past three months, the number of Fed Governors who expect interest rate hikes to start in 2022 has doubled from six to twelve (out of a total of eighteen). Even Treasury Secretary (and former Fed Chairwoman) Janet Yellen is guiding the markets to expect monetary policy tightening. As she noted in a recent Bloomberg interview, "If we ended up with a slightly higher interest rate environment, it would actually be a plus for society's point of view and the Fed's point of view".

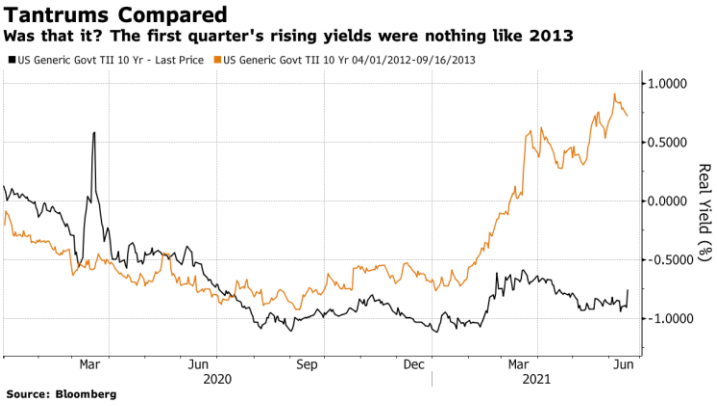
We are also seeing more tangible signs of a modest tightening, and the Fed's attempts to slightly lessen its direct involvement in the capital markets. This includes both the Fed's recent move to increase the interest rates earned on excess reserves held at the Fed and on its overnight reverse repurchase-agreement facility. In addition, on June 3rd, the Fed announced that it had started the process of selling off all of its $14 billion corporate bond and ETF portfolio. While not expected to have any significant impact on prices, it is yet another indication that the Fed is already trying to slowly extricate itself from its direct involvement in the financial markets.



The markets are reacting to these indications of a modestly hawkish shift in Fed policy by pulling forward expectations for the first hikes in interest rates, as you can see reflected in the Fed funds futures charts

This is a point of significant consternation in the capital markets, as the Federal Reserve has a long history of tightening monetary policy too early and too aggressively, thus unnecessarily restraining economic growth and shortening the duration of economic expansions, all in the name of preventing undesirably high levels of inflation. Ironically, their policy has been so effective that both interest rates and inflation have been driven to undesirably low levels.

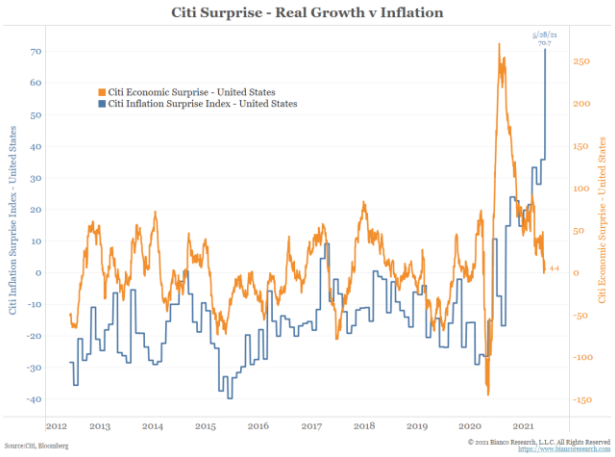
As was just noted by renowned economist David Rosenberg, "once the Fed embarks on a rate-rising cycle, the historical odds of the process tipping the economy back into recession are 80%, likely higher for today's backdrop given an $80 trillion national debt burden —the economy has never before been this remotely sensitive to a new rates cycle".



That theme was just reinforced by Guggenheim CIO, Scott Minerd, who noted in a June 16th article that, "Except for the pandemic, every post-war recession was due to the Fed raising interest rates. Until the Fed raises rates, any thought of a recession is off the table".

However, there is some question this time as to whether or not this historic precedent provides particularly useful insight as, on August 27th of last year, the Fed announced at the Jackson Hole Economic Symposium a sea-change in their approach to inflation and monetary policy. Indeed, Chairman Powell introduced what he called a "robust updating" of Fed policy. He essentially said that the Fed had learned their lesson, amended their ways, and committed not to repeat these mistakes of the past.

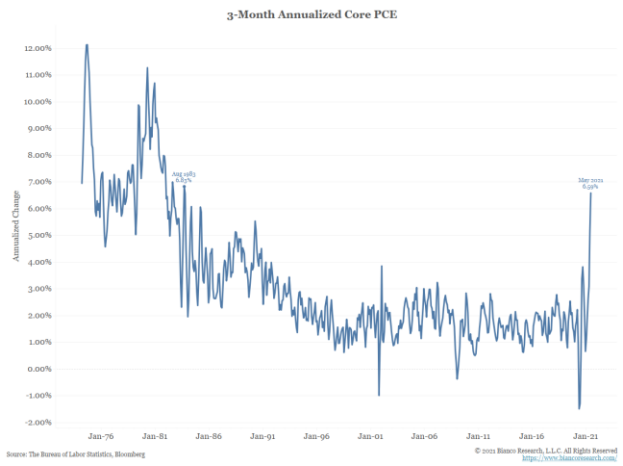
Instead of its traditional strategy of taking proactive steps to slow the economy at the first signs of it approaching what was perceived to be its non-inflationary capacity, the Fed has committed to let the economy run at or above its non-inflationary capacity in the name of maximizing employment and improving the distribution of wealth throughout the economy. Under this new policy, they have committed to let the economy run unabated until they see actual evidence of undesirably and sustainably high levels of inflation.



As Chairman Powell noted at the time, "Many find it counterintuitive that the Fed would want to push up inflation. However, inflation that is persistently too low can pose serious risks to the economy."

A year ago, the Fed's policies pushed economic growth to levels far stronger than economists and markets expected, and it produced both a massive bull market in equities and one of the worst quarterly losses in the history of the domestic bond market. A year later, Fed policies are helping to push inflation to much higher-than-expected levels (in both instances, expectations are associated with the "zero-level" in the above chart). In other words, the outlook for growth has gone from being better than expected to being as expected, while the outlook for inflation has gone from slightly less than expected to much higher than expected. From the perspective of most investors, both trends are moving in the wrong direction. This is important given the fact that a primary driver for changes in securities prices is when reality turns out to be different than what was expected.

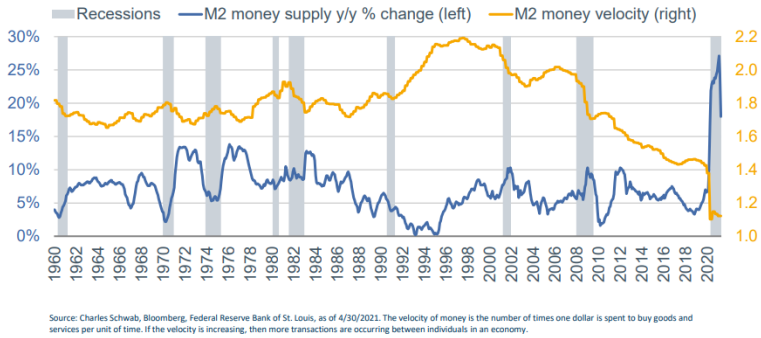
This new policy also included a very important change from 2% being a "hard ceiling" inflation target not to be exceeded, to an <u>average</u> of 2% being the inflation target. Implicit in this change was the fact that, since inflation had remained anchored below 2% for so long, it would need to persist at higher-than-2% levels for some time, in order to bring it up to the Fed's average 2% target, where the Fed would ideally like to re-anchor inflationary expectations.



A major risk associated with this new approach is a phenomenon called monetary policy lag, which is just a fancy way of saying that the amount of time that it takes for Fed changes in monetary policy to impact the economy has traditionally been as much as 12-18 months, which means that they never know with any degree of certainty whether they have understimulated or overstimulated the economy until well after the fact (and oftentimes when it is too late to undo the damage, thus the aforementioned dismal track record).

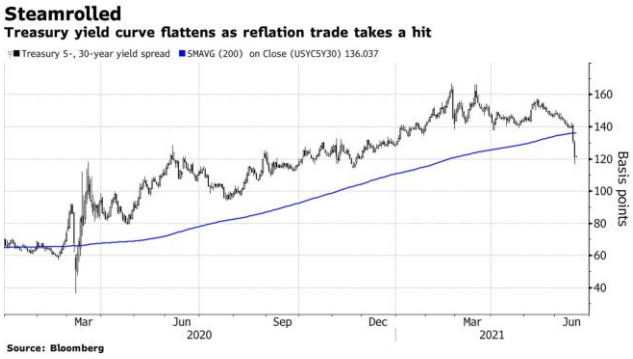
This is one of the major reasons why the Fed has, over the past forty years, tightened policies as soon as the economy approached its perceived non-inflationary potential (i.e., because the higher interest rates and/or constricted money supply will take a year or more to slow the economy). As noted, it is also one of the primary and largely ignored risks associated with the Fed's new policy of targeting higher inflation because, when it arrives, most of the tools that the Federal Reserve has to moderate it are unlikely to have any significant corrective effect for a year or more. Particularly in light of the historically high levels of money supply and fiscal/monetary stimulus, that is likely more than enough time for inflation to potentially start getting out of hand.

Actually, one could argue that inflation is already a clear and present risk, as you can see in the above Personal Consumption Expenditure Index, which is the Fed's preferred measure of inflation.



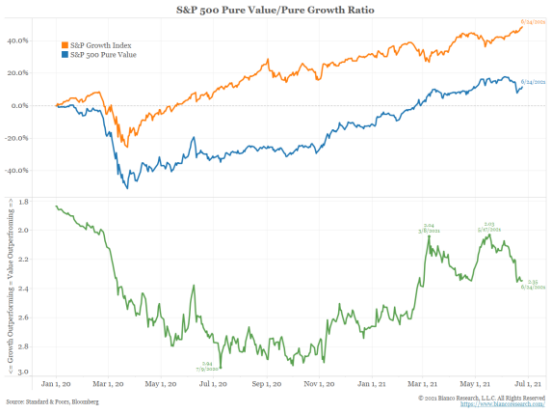
Of note, the aforementioned growth in money supply (M2-blue line-above) is another of those major macroeconomic factors that may have just peaked, and this could have huge implications for everything from inflation to the capital markets. From an inflation perspective, an increasing supply of money chasing a fixed amount of goods has always been a recipe for inflation. In this instance, it is even worse because the pandemic and associated supply bottlenecks have shrunken the supply of many items, while the expanding money supply and massive stimulus payments (U.S. household wealth jumped to a record $136.9 trillion at the end of March) have dramatically ramped-up demand. While last year's spike in money supply was quite inflationary, this decline in the rate of money supply growth should provide some relief.

Importantly, this apparent reversal in money supply growth may be as impactful on the capital markets as it is on inflation. To explain, the Federal Reserve normally grows the money supply at about 1% above the economic growth rate. Last year, money supply grew at about 27%, while the economy actually shrank about 3%, which means that the Fed literally expanded the money supply by trillions of dollars more than could be utilized in the real economy, and the excess liquidity poured into the financial markets. It will be important to watch for flows out of stocks and bonds as more of the money supply gets deployed in the real economy and monetary liquidity becomes less abundant.



One other major macroeconomic phenomenon that may have just peaked is a somewhat arcane measure called the yield curve, which simply measures the difference in yield between a shorter-term debt instrument and a longer-maturity debt instrument (normally of similar credit quality). In the case of the above, it measures the difference in yield between a five-year Treasury note and a thirty-year Treasury bond, which is the narrowest in a decade. When the line is rising, it is an expression of the market's belief that future economic growth will be stronger and/or that future inflation will be higher.

When the line is falling, as it has been since putting in a potential double top in mid-February and early March, it suggests that the rate of inflation and the rate of economic growth may have already peaked for this economic cycle.

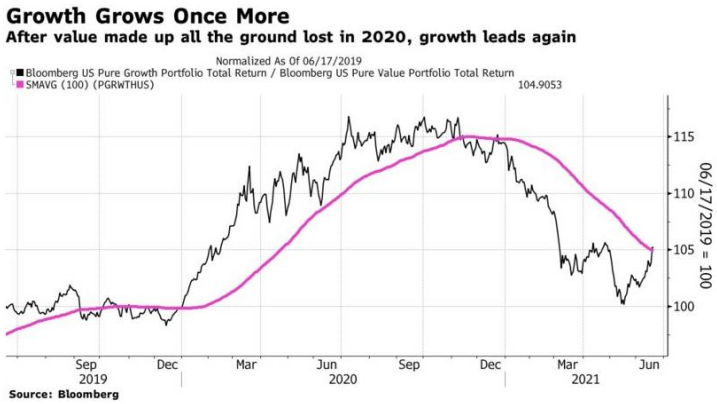


This perspective is further supported by yet another macroeconomic phenomenon that may also be showing signs of having peaked.

In this instance, we are referring to the TIPS breakeven rate (above), which measures the difference between inflation-protected Treasury yields and traditional fixed Treasury yields of the same duration. In other words, it is a measure of the future inflation expectations of investors, and may have peaked on May 17th. You will recall that the yield curve potentially peaked on or around March 8th.

These two dates become particularly notable when you look at the above chart, which measures the relative performance of growth stocks versus value stocks, which has strongly favored value stocks since the third quarter of last year. However, that trend appears to have potentially also peaked, with a double top (green line) on May 17th and March 8th.

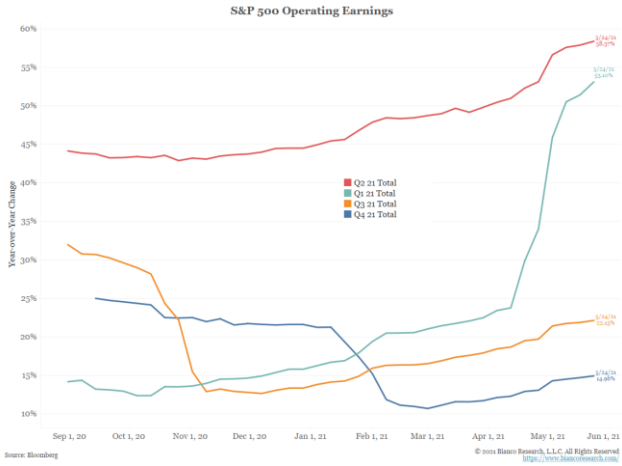
This reinforces our belief that, if inflation, interest rates and growth are peaking, then growth stocks should outperform value stocks. In contrast, if these "peaks" ultimately prove to be only temporary, and that we are just witnessing a pause in the economic growth rates and inflation rates before they resume their ascent, then it is more likely that economically-sensitive and value-oriented stocks will resume their previous outperformance over their growth stock brethren.



As we continue to examine the potential peaks in this allegorical economic "mountain range", another area where expectations are being trimmed back from peak levels is fiscal policy in general and government spending in particular. Just over the past week alone, the President announced a bi-partisan infrastructure agreement of $579 billion, but that was a dramatic reduction from the original $2.2 trillion proposal. Moreover, over the weekend, conservative Democratic Senator Joe Manchin blew a hole in the Democrat plan to force through a $6 trillion "human infrastructure" plan via the reconciliation process, when he announced that he would not support any purely partisan plan in excess of $2 trillion.

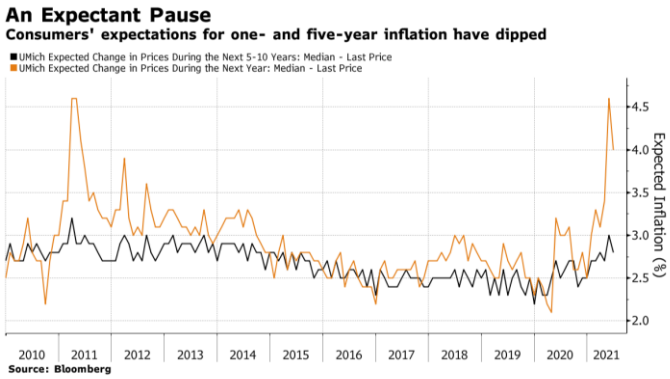
One final potential summit is the very likely peak in corporate earnings, which is largely an inevitability, as they are being benchmarked against year-ago levels, when the economy was still mired in deep recession. That said, stock prices reached historical extremes compared to company earnings during the pandemic, and it is the recent explosive earnings growth that has not only helped to drive equity prices sharply higher, but also moderated somewhat the market's lofty valuations.

However, in light of the expected decline in earnings growth rates, which many analysts expect to slow to an average of only 6% for the next several years, it will leave U.S. stocks still selling at very high multiples, which could be particularly problematic if interest rates resume their ascent.



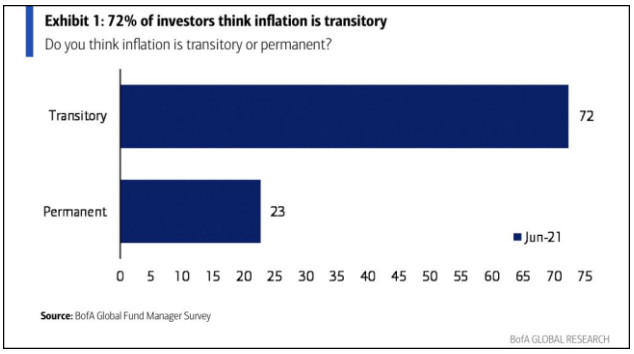
All of the above notwithstanding, the one factor that will likely have the single biggest influence on whether each of the aforementioned potential peaks are of longer-term significance or are only transitory in nature, is inflation, pure and simple. Is the current powerful surge higher in prices only transitory, and caused primarily by temporary pandemic-related supply chain problems that will resolve themselves over time, which is the emphatic perspective of Fed Chairman Powell, or will current inflation pressures become imbedded in the economy and into consumer expectations for inflation and have a long-lasting impact on the purchasing power of consumers and the valuations and profitability of both companies and capital markets?

The surprising, albeit modestly hawkish shift by much of the Fed Board, as reflected in the aforementioned "Dot Plot", actually seems to have restored some inflation-fighting-credibility to the Fed, at a particularly timely juncture.

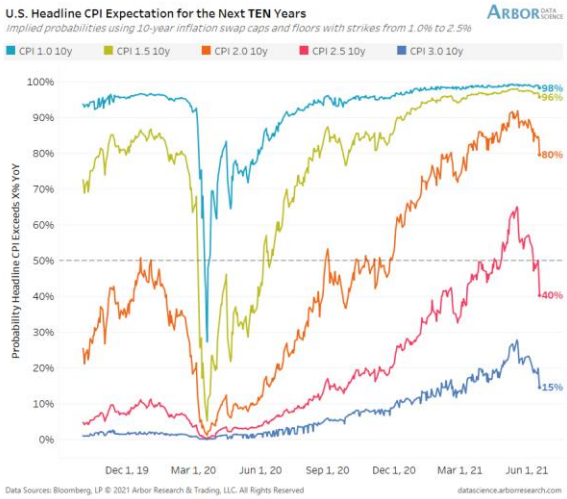


Specifically, the Fed is directed by Congress to balance its dual mandates of maximum employment and sustainably low inflation, and there was a growing concern that the Fed was increasingly willing to tolerate undesirably high levels of inflation in the name of maximizing employment and more evenly distributing wealth across the population. This renewed inflation-fighting-credibility is being reflected in a variety of measures ranging from the previously discussed yield curve and TIPS breakeven rates to consumer and money manager polls.

The futures and options markets also seem to be breathing a sigh of relief that the Fed is at least starting to plan for some removal of the emergency stimulus measures that still remain in place despite the economy's blistering growth pace, and which remain as a potential catalyst for long-term inflation potentially getting out of hand.



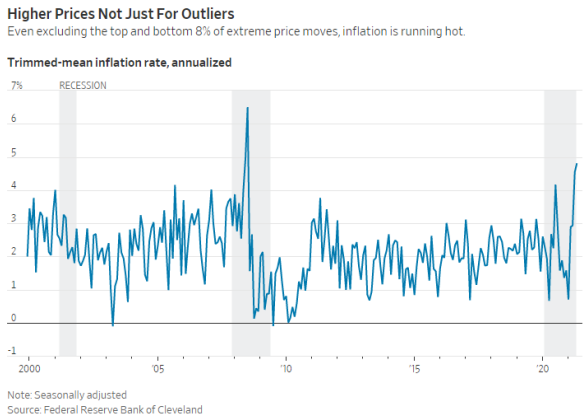
You can see this in the market's assessment of longer-term inflation risks, where the odds being assigned to inflation remaining elevated over the longer term have taken a rather sharp downturn since the Fed's modestly hawkish shift.



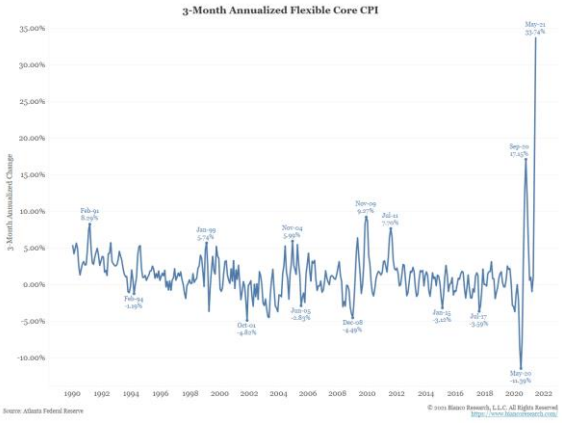
Also helping sentiment are some signs that supply chain snafus are slowly starting to work themselves out, and this is allowing some prices to come down. A very notable example would be the cost of lumber, which has recently fallen by 50% from the peak prices caused by many lumber mills being shut down during the pandemic.

As Fed Chair Powell just noted during a recent testimony in front of the House Select Subcommittee on the Coronavirus Crisis, "A pretty substantial part, or perhaps all of the overshoot in inflation comes from categories that are directly affected by the re-opening of the economy such as used cars and trucks... Those are things that we would look to stop going up and ultimately to start to decline." However, he also acknowledged that the inflationary "effects have been larger than we expected and they may turn out to be more persistent than we expected."

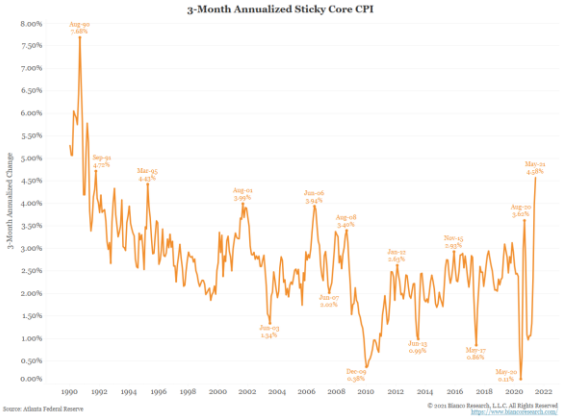
Rosenberg Research has been echoing the Fed's perspective that inflation is "transitory" and almost entirely pandemic-related. Their research shows that the "80% of the CPI [Consumer Price Index] that is not being distorted by supply-chain issues or the effects from the re-opening trade has been rising at a mere 1.6% annual rate over the past six months", and that "The other COVID-19-centric 20% of the index is up at a 22% annual rate". As such, Rosenberg maintains that inflation will automatically revert back to the Fed's desired average range of around 2% with the passage of time.



However, there is also evidence that inflation is not limited to just a few pandemic-impacted areas, as both Rosenberg and Chairman Powell are suggesting, starting with the Cleveland Fed's trimmed-mean price index, which tries to eliminate such outliers by removing the 8% largest price moves in each direction, and yet it is still showing the second fastest three-month surge in inflation since 1991 (exceeded only by the 2008 oil bubble).



Also concerning is research from the Atlanta Federal Reserve, which breaks down inflation between "sticky inflation" (defined by items like rent, furniture, restaurant meals, and utilities that almost never change prices) and "flexible inflation" (defined by items like gasoline, car prices, clothing and footwear that tend to vary significantly in price based upon cyclical and supply/demand factors). As expected, flexible inflation has been booming in the current pandemic/post-pandemic period, and it would be reasonable that (like lumber) their prices will moderate once the world gets past the pandemic and efficient supply chains are reestablished.



However, what is much more concerning is that "sticky inflation" is showing signs of becoming unanchored and, when you throw in the fact that wage and housing inflation is unlikely to be transitory, and that they combine to make up a huge percentage of overall inflation, one must wonder if the Fed is being overly optimistic in regards to the perceived transitory nature of the current surge in inflation.

Some of the inflation is no doubt temporary, but still likely longer lasting than most anticipate, and some inflation is going to be "sticky" and hard to reverse. While how high and how transitory remain as open questions, we are absolutely confident that it is the outlook for inflation that will ultimately determine the outlook for almost everything else.

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Real gross domestic product (GDP) is a comprehensive measure of U.S. economic activity. GDP measures the value of the final goods and services produced in the United States (without double counting the intermediate goods and services used up to produce them). Changes in GDP are the most popular indicator of the nation's overall economic health.

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 16% Trimmed-Mean Consumer Price Index, prepared by the Federal Reserve Bank of Cleveland, is a weighted average of one-month inflation rates of components whose expenditure weights fall below the 92nd percentile and above the 8th percentile of price changes.

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