Volume 129

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

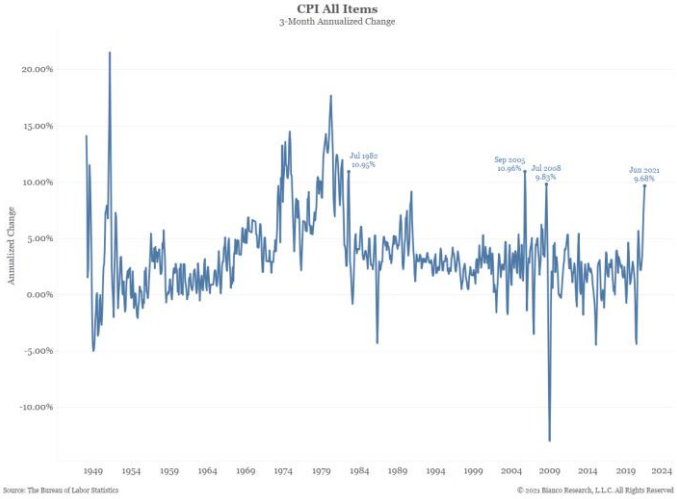
July 2021

"From that day on, we was [sic] always together. Jenny and me was [sic] like peas and carrots." -From the movie Forrest Gump.

As was noted by this classic Tom Hanks character, whether it be Texas and hot summers, birthdays and cake, or higher inflation and higher interest rates, there are certain things that just naturally go together.

We will turn our attention to the last of these relationships, that of inflation and interest rates, where the correlation is ultimately logical, particularly for more traditional income-oriented investments, where interest rates are fixed, and do not automatically adjust to changes in inflation.

Fixed-income investors essentially lend money to governments, institutions and/or companies for a specified period of time in exchange for an income stream that will not change over the life of the investment. As such, the change in purchasing power that the investment provides (if held to maturity) is ultimately a function of the yield on the investment minus the level of inflation experienced over the period. This is because inflation erodes away the purchasing power of the fixed income stream.



For example, if one were to purchase a five-year note that pays an interest rate of 1.5% and inflation averaged 1% during the five-year period, then the value of goods and services that could be purchased with the income stream would increase by one-half of one percent per year (1.5% minus 1.0%). By the same token, if inflation averaged 2% over the period, then purchasing power would actually decrease by one-half of one percent per year, which is why investors will "always" demand higher interest rates when they anticipate high and/or increasing inflation.

That is, "always" except now, when we have this seemingly counter-intuitive mis-match between economic fundamentals and interest rates. The U.S. is experiencing a dramatic surge in both current inflation and expectations for future inflation, each of which, like peas and carrots, goes together with higher interest rates. At least that is how it is supposed to work. Instead, we have seen interest rates do the exact opposite. They have come down sharply. As an example, the yield on a ten-year U.S. Treasury note fell from a yield of 1.78% at the end of March to below 1.20% just a few days ago, before rebounding modestly.

Indeed, the phenomenon has become so extreme and so global that, when you look at nominal interest rates around the world and subtract from them the inflation rate in each respective country, you can see that virtually the entire world is losing purchasing power.

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

As of 7/14/2021

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	0.60	-1.35	-1.42	-1.41	-1.39	-1.38	-1.32	-1.24	-1.16	-1.11	-1.03	-0.97	**-0.91**	-0.73	-0.64
Germany	2.30	-2.80	-2.96	-2.97	-2.98	-3.01	-2.99	-2.92	-2.87	-2.80	-2.77	-2.71	**-2.62**	-2.36	-2.13
Netherlands	2.00	-2.50	-2.66		-2.72	-2.70	-2.65	-2.60	-2.54	-2.53	-2.46	-2.29	-2.21	-1.92	-1.75
Denmark	1.70	-2.20	-2.24		-2.28			-2.20			-1.70		-1.74		-1.70
Finland	2.00	-2.50		-2.64	-2.69	-2.70	-2.60	-2.58	-2.47	-2.38	-2.29	-2.18	**-2.09**	-1.84	-1.55
Austria	2.70	-3.20		-3.40	-3.38	-3.35	-3.31	-3.22	-3.19	-3.10	-2.99	-2.91	**-2.82**	-2.55	-2.18
Japan	-0.10	0.00	-0.03	-0.03	-0.03	-0.05	-0.05	-0.03	-0.03	-0.02	0.01	0.06	**0.11**	0.31	0.76
France	1.50	-2.00	-2.14	-2.14	-2.15	-2.12	-2.14	-2.07	-1.90	-1.78	-1.67	-1.58	**-1.49**	-1.21	-0.70
Belgium	1.63	-2.13	-2.28	-2.26	-2.32	-2.30	-2.24	-2.16	-2.05	-1.99	-1.89	-1.79	**-1.65**	-1.50	-0.87
Ireland	1.60	-2.10		-2.24		-2.18	-2.14	-2.07	-1.98	-1.89		-1.60	**-1.55**	-1.33	-0.85
Spain	2.70	-3.20	-3.26	-3.23	-3.23	-3.14	-3.13	-3.01	-2.85	-2.76	-2.64	-2.52	**-2.39**	-1.86	-1.42
Portugal	0.51	-1.01	-1.10	-1.12	-1.13	-1.12	-1.01	-0.93	-0.76	-0.66	-0.56	-0.37	**-0.23**	0.07	0.72
Italy	1.30	-1.80	-1.82	-1.77	-1.71	-1.55	-1.42	-1.27	-1.07	-0.99	-0.84	-0.71	**-0.59**	-0.12	0.41
United Kingdom	2.50	-2.40	-2.50	-2.45	-2.42	-2.33	-2.29	-2.20	-2.11	-2.04	-1.93	-1.85	**-1.87**	-1.56	-1.40
Australia	1.10	-1.00	-1.09	-1.08	-1.04	-0.79	-0.56	-0.39	-0.22	-0.08	0.04	0.17	**0.24**	0.61	1.03
New Zealand	1.50			-1.50	-0.62			-0.33		-0.03			**0.25**	0.62	
Canada	3.60	-3.35	-3.41	-3.35	-3.15	-2.96	-2.76	-2.69		-2.51			**-2.31**		-1.79
United States	5.40	-5.28	-5.35	-5.33	-5.18	-4.97		-4.61		-4.30			**-4.05**		-3.43

https://www.biancoresearch.com

With the exception of the few countries and debt maturities shown in green, investors around the globe are currently willing to accept interest rates well below the inflation rate.

So extraordinary is the differential between inflation and interest rates in the U.S. that bond investors are losing approximately four or five percent of their purchasing power per year (at current inflation rates), virtually without regard to maturity. The conundrum is why investors remain willing to invest at such low yields in such a highly inflationary environment.

In a sharp departure from history, the link between inflation and interest rates appears to be at least temporarily broken (or more likely, the relationship is being overwhelmed by an even more important influence). As you can see from both the previous CPI (Consumer Price Index) chart of current inflation and the following chart, which measures expectations for future inflation, interest rates are moving independently (even inversely) from inflation.

Ultimately, we are witnessing a reduction in "real" or inflation-adjusted yields. Put another way, despite what has historically been a very tight correlation between them ("peas and carrots"), the recent decline in interest rates is not a response to an improving outlook for inflation. As such, something is clearly different this time, and there must be a novel impetus for the recent trend towards lower interest rates.

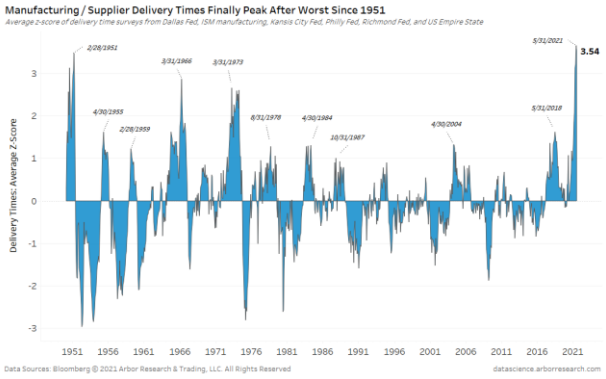
Indeed, we suspect that there are several catalysts for this inflation versus interest rate conundrum, and that it will ultimately be a combination of these elements that are responsible for this divergence.

Source: Haver Analytics, Rosenberg Research

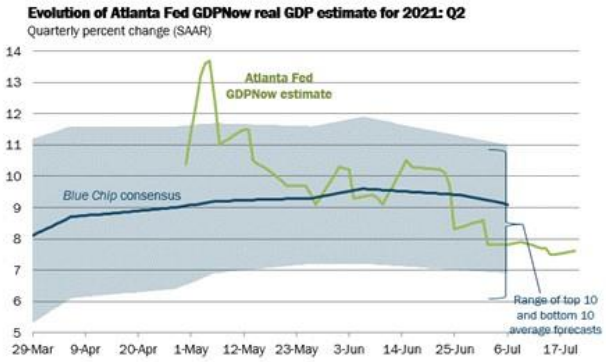
One potential explanation for this divergence is a growing confidence among investors and analysts that the Fed's base case will prove correct, and that the current surge in inflation will ultimately prove to be only "transitory". The Fed maintains that the current spike in inflation is due to the demand side of the economy recovering from the pandemic and recession much faster than has the supply side of the economy and that, as a result, supply chain snafus and labor and materials shortages are causing a surge in inflation that will reverse itself (or at least moderate) automatically once supply catches up with demand.

We absolutely agree that some of the inflation will resolve itself as the Fed anticipates. However, we also suspect that this reversal/moderation will take longer than many expect, and that some of these higher prices will prove very long-lasting, if not permanent.

Supporting the Fed's rather optimistic premise are some encouraging, albeit very early, signs that some of these supply chain issues are starting to resolve themselves. This includes a slight downtick in delivery times, a decrease in the backlog of shipping loads waiting to be picked up, and even a drop in trucking costs, as more truckers rejoined the workforce.

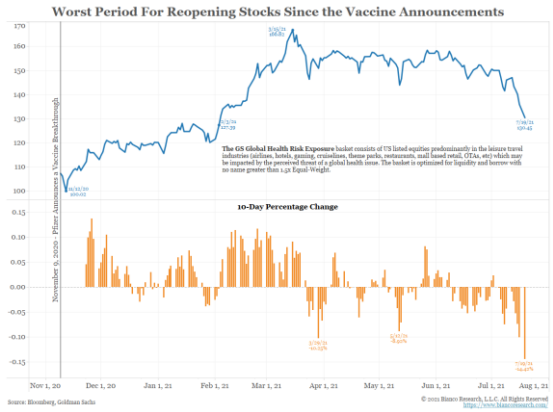


Even commodity prices have started trending lower, as supply chains normalize. We do view all of this as evidence that the Fed is already being proven at least partially correct. However, while these are encouraging signs, we suspect that these trends are too early and too unproven to be a primary catalyst for the recent counter-trend decline in interest rates.



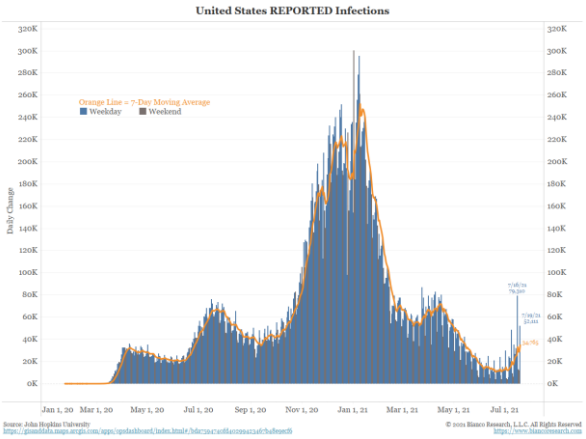
Instead, we suspect that the explanation lies elsewhere and, while we acknowledge that there are likely many contributory factors, we believe that there are three that stand out above the rest. This first factor, which we addressed in detail in last month's commentary, is that we may have "hit peak everything", whether it be 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 even in peak inflationary expectations.

However, rather than cover that ground again in this commentary, we will instead concentrate on what we consider to be the other two major drivers of this downturn in rates. The first is the growing body of evidence that the U.S. economy is already slowing significantly from peak growth rates. This can clearly be seen in the various Fed "Nowcasts", such as the above Atlanta Fed model, that attempt to gauge the level of economic growth in real time.



This explanation is not only consistent with the message of the bond markets, as a slowing economy should diminish future inflationary pressures (thus pushing rates down and bond prices up), but is also very consistent with the message of the stock market where, ever since the May peak in inflationary expectations, the stocks related to economic reopening and recovery have been badly underperforming the stocks of companies whose fortunes are less tied to economic recovery (i.e., the types of stocks that performed so well during last year's pandemic-driven recession). If anything, this rotation and the forward-looking nature of equities suggests that the economy may be slowing both more significantly and more quickly than expected.

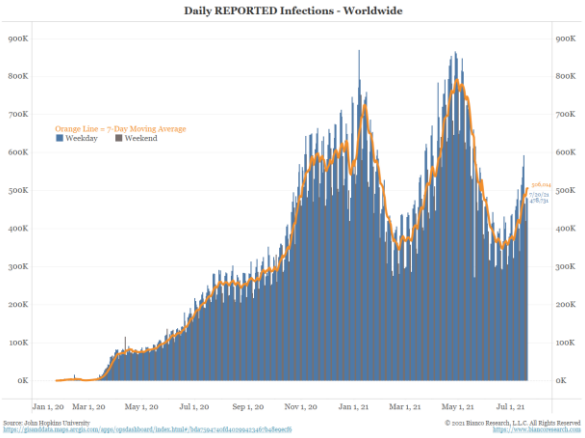
As you might anticipate, the other major influence that we suspect may be responsible for the recent and seemingly counter-intuitive decline in interest rates is the increasingly resurgent state of the global pandemic, and its potential implications for everything from economic growth levels and inflation, to the functionality of global supply chains and the prospects for economic reopening (both globally and domestically).



Ironically, while the above-described environment of an economy that may be losing momentum in the face of slowing levels of fiscal and monetary stimulus, combined with an aggressive new wave of COVID spread as we approach the Fall, may sound like a dire scenario for investors, we suspect that it may turn out to be one of those scenarios where "bad news is good news".

From our perspective, the biggest concerns for a bond (i.e., income) investor is either that inflation gets out of hand and both erodes away the purchasing power of their income stream and pushes bond prices lower, or that the Fed will slow the rate of bond purchases (quantitative tightening) or start raising short-term interest rates, either of which could push bond prices lower. We would argue that this slower growth/worsening pandemic scenario actually lessens or delays each of these risks.

Similarly, we believe that today's greatest fear for most equity investors is that inflation gets out of hand thus forcing the Federal Reserve to tighten monetary policy (by raising rates and/or constricting money supply) so aggressively that it forces the economy into recession, thus putting to an end what has been a period of explosive profit growth. As is the case with the bond markets, we believe that a slower growth/worsening pandemic scenario actually lessens or delays this significant risk.



As for whether or not the state of the pandemic is of relevance to the Fed, San Francisco Fed President Mary Daly just noted her concern that "the Delta variant poses a threat to the global economy", and Fed Chairman Powell just testified in front of Congress that "the pace of vaccinations has slowed and new strains of the virus remain a risk."

Remember that bond investors almost always celebrate bad news, and equity investors tend to fear the prospect of news becoming too good, and for the Fed to tighten policy in response, which has historically not ended well for investors. While a resurgent pandemic and a slowing, albeit still expanding, economy are not ideal from a humanitarian perspective, they may introduce the kind of balance between good news and bad new that the markets will often draw comfort from, as long as it lessens, or even just delays, the Fed's anticipated tightening of monetary policy.

Over recent weeks, we have been gathering feedback from the firm's advisors and clients about how to improve the utility and value of this monthly commentary. Among the recommendations were that these commentaries be shorter and more narrowly focused, and that we try to avoid industry jargon whenever possible. We have attempted to implement these changes into this report.

If you have any comments about these commentaries in general and/or these changes in particular, please do let your advisor know. We are always looking for ways to increase our value to you and our other clients, and your feedback is always both welcomed and encouraged.