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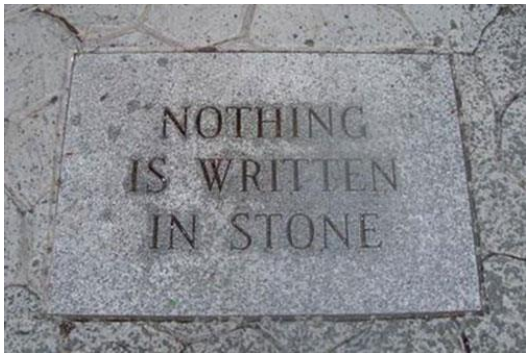
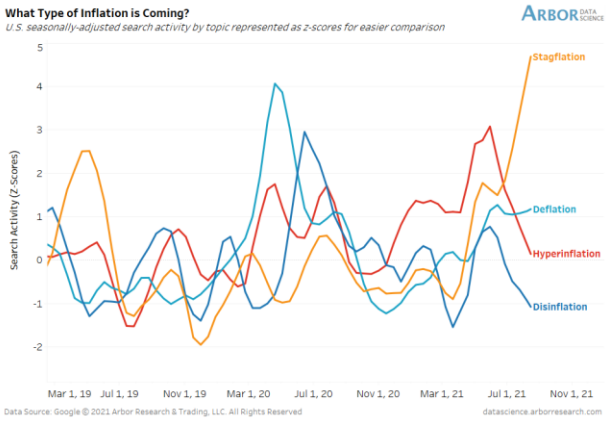
Whether it is "bittersweet", "jumbo shrimp", or "plastic silverware", there are words or combinations of words that, despite many of them being commonly-used components of the American lexicon, are on their surface counter-intuitive and nonsensical.



They are referred to as oxymorons, and their economic equivalent is almost certainly "stagflation", the existence of which, when it first reared its ugly head back in the early 1970s, was considered by many economists to be an economic impossibility. Indeed, the word itself seemed incongruous, as its two components "**stag**nation" and "in**flation**" were considered by most economists to be mutually exclusive, as inflation was viewed as a consequence of the economy growing too fast (not too slow), and in excess of its non-inflationary potential.

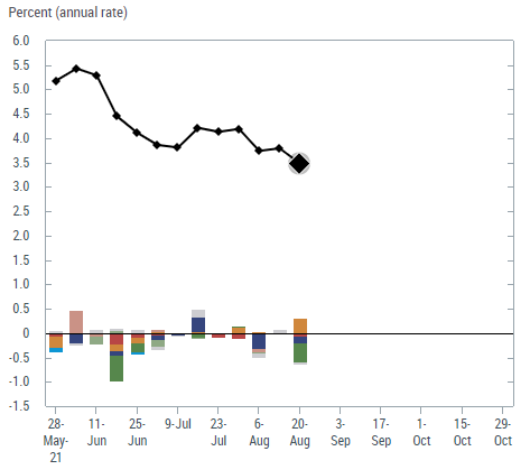
The lesson from the 1970s and the first half of the 1980s is that inflation can also be caused by an external shock like the 1973 and 1979 oil embargos, which catalyzed an aggressive monetary policy response on the part of the Federal Reserve, which sought to cushion the blow of the oil shocks by flooding the economy with money, so that American consumers could afford to both fill their cars with gasoline and put food on the table.

Stagflation represents a worst-case scenario for the Federal Reserve, as it "ties" their monetary policy "hands". If they raise interest rates and shrink the money supply to dampen inflation, it further slows the economy and exacerbates stagflation. On the other hand, if they lower interest rates and expand the money supply to offset the slowing/stagnating economy, it just exacerbates inflation. Fortunately, stagflation has proven to be a very rare phenomenon, and the traditional relationship between economic growth and inflation has generally held true outside of such exogenous shocks to the economy.



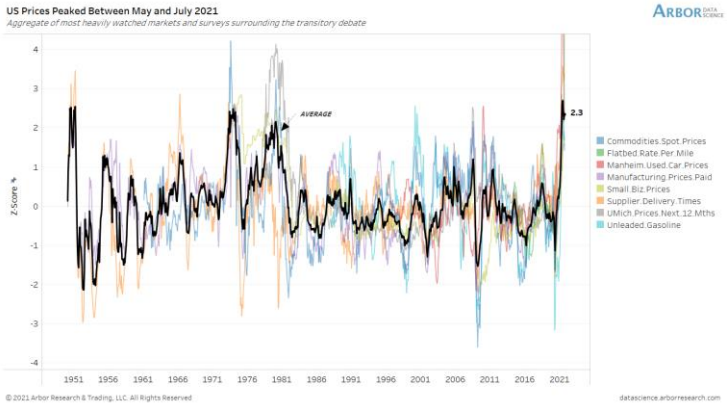
Unfortunately, we once again have a major external shock to the economy in the form of the pandemic, which caused the sharpest and deepest contraction since the Great Depression and, just as was the case in the 1970s, catalyzed the Federal Reserve to pursue very aggressive monetary policies which, on one hand, absolutely rescued the American economy but, on the other, reintroduced stagflation as a potential economic threat. This long-absent concern is being reflected in everything from the soaring number of web searches for the word "stagflation" to the growing chorus of calls from Federal Reserve Governors to start "tapering" the Fed's asset purchases and to start preparing for higher interest rates.

While there is no doubt that the U.S. is currently experiencing elements of stagflation on at least a temporary basis, we still view stagflation as a longer-term threat to be more potential than inevitable. After all, while the domestic economy is slowing significantly from what had been, according to the New York Fed "Nowcast", an 8.68% growth rate back in late February to a 3.48% rate today, an economy running at almost 3.5% is hardly stagnant. Indeed, it would normally be considered a robust growth rate for such a mature, industrialized economy as that of the United States. The problem is that, as fiscal and monetary stimulus wanes and the resurgent pandemic takes its toll, economic growth is heading in the wrong direction, and it appears to be doing so at a quickening pace.

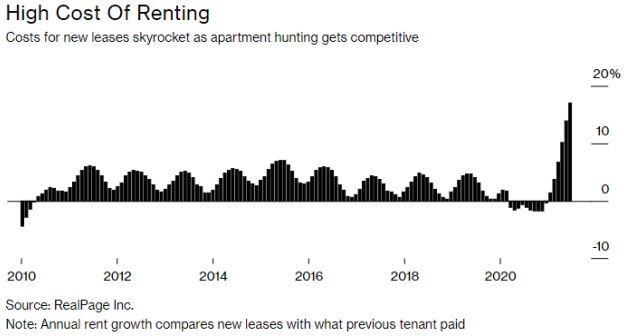


The same can be said of inflation, which has rocketed to levels that we have not seen in the domestic economy in forty years, but which is showing signs of abating somewhat as supply chains are being restored and indexes of prices being paid by both consumers and businesses are showing early, albeit hopeful, signs of inflation starting to moderate.

The major caveat to this rather optimistic generalization is the virtual inevitability that inflation in housing costs (rent and potential rent) will move sharply higher over the course of the year.

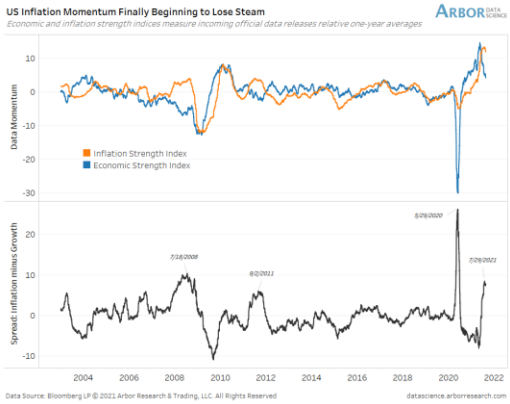


This is primarily due to the just-expired eviction moratorium holding shelter-related costs at deceptively low levels (someone not paying rent registers as free rent), and the fact that the government only surveys for housing data twice a year and averages the new data in over time. While the significant jump in housing costs that we are almost certain to see over the remainder of the year is at least partially a statistical anomaly, and while it is only one of the inputs that make up the inflation data, it does represent approximately one-third of the entire measure, and thus may more than offset the falling prices that we are starting to see in other parts of the economy, thus potentially exacerbating the current spike in inflation.



Economic theory suggests that there is a significant risk of inflation getting out of hand and higher prices becoming imbedded in the economy if the Fed does not start pulling back on its monetary stimulus programs, starting with a tapering of quantitative easing (i.e., "QE" or asset purchases by the Fed).

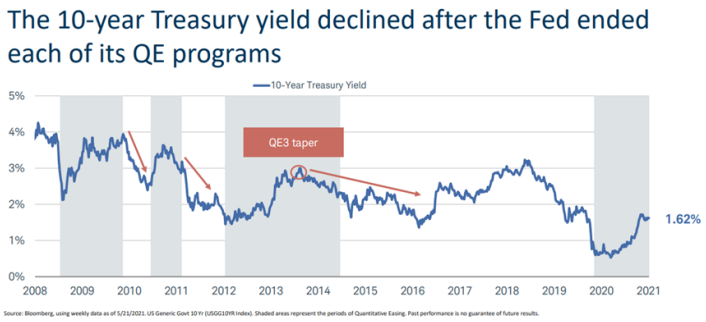
Dallas Federal Reserve President Robert Kaplan recently explained the need to "taper" (i.e., start reducing) the Fed's quantitative easing programs by comparing the Fed to a doctor, the economy to a patient, and QE to a medicine that performed very well and helped to return the patient to good health, but which is no longer appropriate in light of the patient's full recovery, and is instead now causing negative side-effects, like speculation in the capital markets, froth in the housing markets, and distortions in the efficient pricing of bonds and stocks (particularly bonds).



Removing a support that the economy and financial markets no longer need should not, on its surface, seem like something that should be problematic, but that is not necessarily the lesson from history and, as was posited by Mark Twain, "history does not repeat itself, but it oftentimes rhymes". It should be noted that, in this regard, the lessons of history are less compelling and less consistent in regards to bonds than they are to stocks.

For example, when the Federal Reserve ended the three quantitative easing programs (known as QE1, QE2, and QE3) that were introduced in response to the Global Financial Crisis, bond yields actually fell in each instance. This was counter-intuitive, as logic would dictate that yields should move up (and prices fall) when you remove one of the largest buyers of debt from the market. Instead, bond prices rallied, presumably under the premise that the end of Fed asset purchases would ultimately lead to a weaker economy and lower inflation.

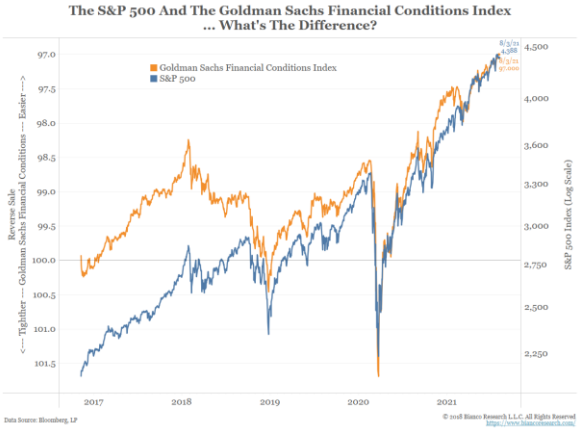
In sharp contrast, in 1993 Fed Chairman Bernanke catalyzed a panic in the bond markets (the so-called "taper tantrum") when he surprised the investors with his comments during a May 21st congressional testimony that, "If we see continued improvement and we have confidence that it is going to be sustained, then we could, in the next few meetings, take a step down in our pace of purchases".



In response, the yield on the 10-year Treasury note soared from 1.94% on May 21st to 2.96% on September 10th, and bond investors suffered through a bear market. In sharp contrast, in 1998 the Fed took a very different approach and, rather than surprising the markets as they had done in 1993, they spent most of the fourth quarter telling the markets to expect a "tapering". As a result, by the time that the tapering was actually announced on December 19th, the ten-year Treasury yield had actually fallen from around 3.25% to 2.55%, to the delight and profit of bond investors.

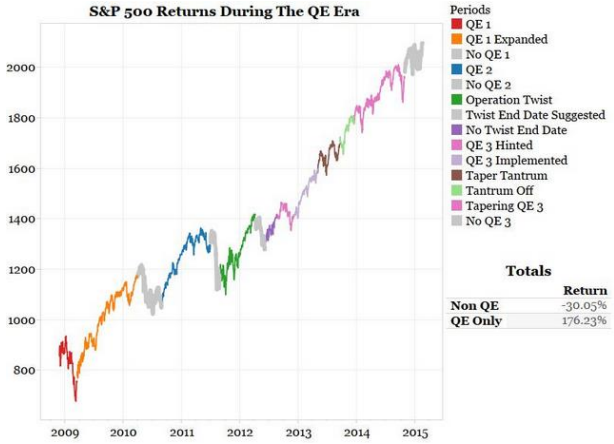
Importantly, while the bond markets appear to have "gotten the message" well in advance of the Fed announcement and avoided a repeat of the 2013 "taper tantrum", the equity markets had no such luck. Indeed, it is noteworthy the consistency with which the equity markets have declined in response to these reductions (or even hinted at reductions) in monetary stimulus.

This should be no surprise, particularly when you consider the very tight correlation that has historically existed between the equity markets and the amount and availability of monetary liquidity, in this case represented by the Goldman Sachs Financial Conditions Index, which considers interest rates, currency exchange rates, equity market valuations and credit spreads (i.e., the difference in interest rates between debt securities of different credit ratings). Both tapering and eventually higher short-term rates should tighten financial conditions and weaken this important support for equity prices.



With deference to Mark Twain's comment on history "rhyming" rather than "repeating", we believe that the following chart from Bianco Research is both insightful and instructive. The colored, non-grey areas illustrate the various phases of the Fed's quantitative easing programs, through which they were purchasing financial assets, and the grey areas illustrate the pauses in these "QE" asset buying programs.

While history does not necessarily repeat itself, it is at least very noteworthy that, over this seven-year period, the S&P 500 appreciated by a cumulative 176% during periods of quantitative easing and declined by a cumulative 30% during the pauses in the Fed's asset-buying programs.



In the post-Global Financial Crisis period, the domestic stock market has experienced two additional tapering-related declines. The first of those, in 2013, produced only a fairly modest decline of around 6%, which took place between May 22nd and June 24th. In contrast, the 2018 "taper tantrum" catalyzed a full-blown bear market in equities and actually resulted two weeks later in the so-called "Powell-pivot", when Chairman Powell reversed his hawkish language and said that the Fed would instead be "patient and flexible."

What seemed to exacerbate the 2018 equity market decline was Powell's comment that the tapering would be on "autopilot", which caused concerns that the Fed would over-tighten policy and cause a recession, as has often been their history.

While there is every possibility that the anticipated announcement of a Fed tapering may yet again catalyze a negative reaction in equities, it is important to keep the above-described history in some perspective. First, whether it was the tapering-related declines associated with the end of the initial quantitative easing programs or the experiences in 2013 and 2018, equity declines have generally been short-lived, and have presented great buying opportunities (remember that history "rhymes" instead of "repeats").

In addition, there are a few reasons why any equity market reaction may be somewhat more muted this time than it has been in the past. First of all, the Fed has been openly guiding investors to expect tapering, as part of their efforts to make sure that this reduction in stimulus is almost entirely priced into the markets before it ever takes place. This guidance is likely to be further reinforced over the next two months, as current expectations are that the actual tapering announcement will not take place until the Fed's November meeting.

Second, the Fed has gone to great lengths to divorce the tapering decision from the decision about raising rates, and has even said that it will not raise rates until after the tapering process is already completed. As such, unlike past periods when the markets assumed that tapering would be automatically and almost immediately accompanied by higher interest rates, investors should be less likely to assume that one necessarily follows the other this time around.

This guidance was just reinforced in Fed Chairman Powell's much-anticipated August 27th Jackson Hole Economic Symposium speech when he said, "The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test".

Of note, investors are probably much more concerned about the Fed raising rates than they are of the Fed tapering, as higher rates are an actual tightening of monetary policy, while tapering is simply a slowing in the amount of additional stimulus that is being injected into the economy. Indeed, it is estimated that, if the Fed were to start tapering today, they would still be injecting an additional $660 billion of stimulus into the economy before they complete the process.

Further, we fully expect for the Fed to position tapering as being data-dependent, as opposed to being on "auto-pilot", which should give the markets some comfort that this reduction in the growth rate of Fed stimulus is less likely to catalyze a recession than has been the case in the past.

All things considered, we believe that tapering will start later this year (or early next year at the latest), with the timing being heavily influenced by the course of the pandemic, and that it will ultimately be followed by the Fed starting to increase short-term interest rates in the second half of 2022 or early 2023.

While the announcement of either tighter monetary policy or a reduction in the pace of additional stimulus is not likely to be viewed by investors as good news, we do believe that it is less likely to automatically cause the kind of knee-jerk reaction in the equity markets that we have witnessed in the past, and that almost any reaction that does occur is once again likely to present equity investors with an attractive buying opportunity.

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