Outlook Memorandum

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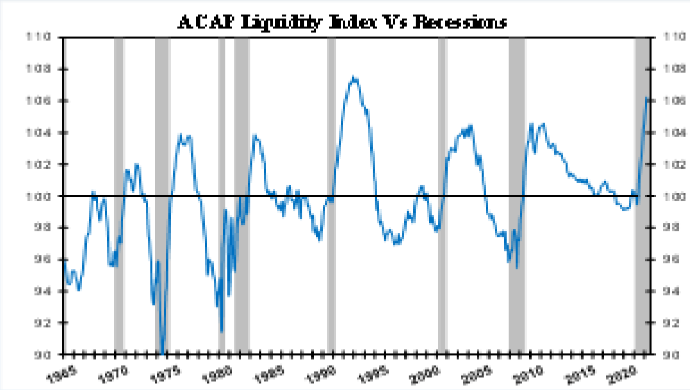
SURGING TOWARD NORMAL…AND BEYOND

After a pause in January, broad stock market indices resumed their upward march as investors cheered rising vaccination rates and signs that a strong cyclical economic acceleration was underway (diminishing macro risks on the one hand, expanding profit opportunities on the other). For the quarter, the S&P 500 gained 6.2%. Beneath the surface, however, companies poised for the largest cyclical upswing in profitability following a dismal 2020 ripped higher. The financials and energy sectors, for example, rose 16% and 31%, respectively; the more richly valued NASDAQ, which delivered handsomely last year on the back of resilient demand for technology (particularly in a work from home environment), squeezed out a comparatively pedestrian 2% gain. Importantly, the market's overall performance in the quarter reflects that the broad indices skew heavily towards tech and digital (which generally thrived during the pandemic), representing almost 40% of the S&P 500. The historically important energy sector, in contrast, started the year representing less than 3.0% of the market. Overseas, European stocks fared well, gaining 5% for the quarter, while Japan, China, and emerging markets gained between 1% and 3%. The bond markets, in contrast, declined more than 3% as interest rates and inflation expectations continued to recover off their pandemic lows (10-year Treasury yields leapt from 0.93% at year end, to a high of 1.75%) reflecting both the strengthening economic outlook and the Fed's commitment to prioritize a recovery in employment over near-term price stability (which has prompted a recalibration from deflation risk toward inflation risk).

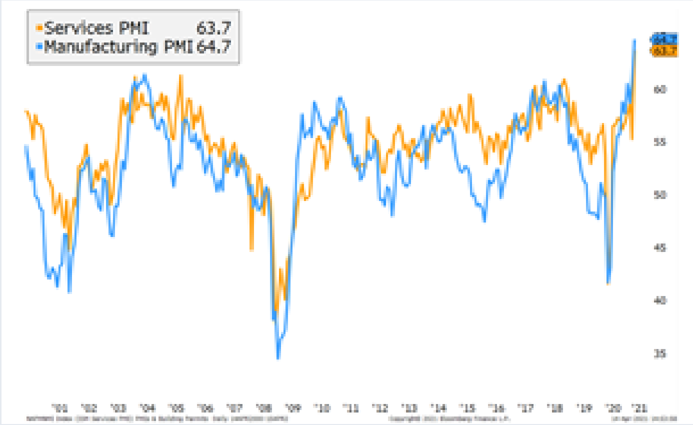
Amidst the accelerating vaccination rate (recently topping 4.6 million doses administered in a single day), the economic reopening is not going to stall due to a lack of stimulus. Policymakers pumped trillions of dollars of liquidity into the economy over the past year, largely erring on the side of too much. Some of that liquidity contributed to the proliferation of SPACs, game-like trading apps, and other speculative outlets – but on balance, households accumulated nearly $2.5 trillion in excess savings (beyond what normally would have been expected). Now the vaccination enabled reopening of the economy is starting to unleash excess savings, which is fueling demand for restaurants, travel, vacations, and other pandemic-restricted activities. To this point, the economy added almost one million jobs during March (a nearly 50% jump from February) – and the frantic pace of hiring should continue as excess savings power resurgent spending, especially with the latest $1.9 trillion stimulus now working its way into the economy. Leaving nothing to chance, the Biden administration is also queuing up a large, multi-year infrastructure bill.

Markets are maintaining a sanguine view with respect to the inflationary potential of all the stimulus that is being mobilized. Near-term, the imbalance between surging demand and businesses scrambling to reestablish supply is destined to manifest in higher prices in the months ahead – which may challenge investors' mettle as the extrapolation of short-term trends can prompt pockets of volatility. On the margin we are increasing exposure to more cyclically exposed stocks (particularly those with tangible capacity constraints and, thus, pricing power), while maintaining short maturities within our bond investments. Longer-term, we continue to believe that ending the disinflationary backdrop of the past forty years requires a more concerted rebalance of the economy, in which policy prioritizes employment and household income growth among the lower half of earners as the primary mechanism for promoting domestic business investment and economic growth – and to this point, we believe the recent policy posture represents initial steps in that direction.

The nearly $5 trillion of liquidity that has been pumped into the financial system is hard to fathom. The current environment is one of the most super-charged policy backdrops on record and is stoking pent-up demand with a cocktail of excess savings, repeated stimulus checks, enhanced unemployment benefits, buoyant asset markets, and the anticipation of additional infrastructure spending. The ACAP Liquidity Index is nearing a record level, reflecting the cumulative total of monetary easing and fiscal stimulus in response to the pandemic. Banks are flush with cash as households (in aggregate) have had no choice but to largely save the successive rounds of fiscal support programs. At the same time, bank lending opportunities have been constrained due to the limited need for traditional business and consumer loans amidst a partially paralyzed economy. Simply put, the financial system's capacity to make new loans is at its highest level in decades, while demand for capital to fund new equipment, working capital, and other capacity upgrades is poised to accelerate as households begin deploying a portion of their excess savings (roughly equal to approximately 20% of their total annual spending in 2019).



The reopening is just beginning, but initial indications point to a powerful cyclical recovery currently underway. Shipping delays for overseas products are moving from weeks to months (even before the blockage of the Suez Canal in late March), service and manufacturing PMIs are hitting record highs (see chart below), building permits have climbed to a 15-year high and hotel and airline prices have returned to pre-covid levels. Gone, at least temporarily, are the days of renting a car while on vacation for $20 per day (of course, before all the fees are tacked on) – sporadic reports are popping up with costs as high as $300 per day. General Motors, Ford, and other auto manufacturers are struggling with acute chip shortages – somewhat self-inflicted as they took steps to conserve cash in the early days of the pandemic, but nonetheless notable given resilient unit sales since last summer.



Liquidity is poised to remain highly accommodative. Interest rates, adjusted for inflation, are currently negative – a level which provides a strong growth impulse for the economy as businesses and households access cheap financing once growth takes hold. Importantly, the Fed is steadfast on driving employment higher, with a new awareness for supporting gains among lower income households. Fed Chairman Powell has openly embraced a willingness to tolerate higher inflation over the short-term (which represents a historic shift in policy compared to the track record of persistently falling short of its stated 2% inflation target).

In fact, the combination of accelerating growth and negative real rates stands to amplify the stimulative potential of all the liquidity currently sloshing around the economy, even if the Fed takes steps in the direction of withdrawing some accommodation. Recent Fed commentary has stressed the dual mandate of inflation and full employment and talking points have focused on "average inflation targeting" – which we view as purposely vague and enabling policymakers some wiggle room to adjust course as conditions merit. Notably, recent regulatory updates are, in our view, logical steps that the Fed must take prior to contemplating any change in monetary policy (whether quantity of bond purchases, short-term interest rates, or more technical intrusions). These steps include allowing banks to resume buybacks and reactivating the temporary Supplementary Leverage Ratio (SLR) – with both updates signifying a transition from protecting the financial system to promoting the recovery. The Fed is navigating the narrow path between keeping their message simple (no change in their accomodative policy) while, in our opinion, providing essential flexibility to stabilize negative real rates at their current level and prevent a classic “falling behind the curve.” From a practical perspective, that means that to the degree that inflation rises the Fed can raise interest rates without hindering the pro-growth bias of its policies so long as the level of real interest rates remains stable (higher inflation without a change in policy increases the Fed’s pro-growth posture by pushing real rates lower).

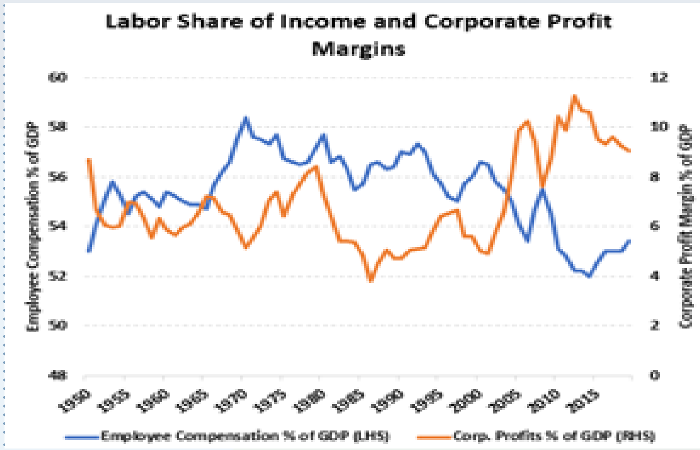
Fiscal and monetary policy coordination will shape the inflation outlook. Despite a cadre of economists analyzing data and building models, the underlying drivers of inflation remain inadequately understood. The shifting policy stance of the Fed is an acknowledgement that the heavy emphasis on containing inflation during the past several decades may have contributed to lower growth, and exacerbated income and wealth inequalities. Part of the Fed’s shift recognizes that other factors such as slower demographic trends and the globalization of the economy may have been far more persistent disinflationary forces than anticipated. The corresponding build-up of debt as households and policymakers adapted to the negative consequences of a rising trade deficit (in which the brunt of globalization was felt by lower income, lower skilled jobs) progressively weighed on consumption, hindering wage-based demand growth and capacity investments.

Importantly, trade policy (including globalization as promoted by the WTO, of which China’s admission was significant) exacerbated the inequity of domestic fiscal policy. As many countries pursued a traditionally mercantilist economic policy, favoring investment, manufacturing, and exports – the resulting excesses, not just in terms of production but also in terms of savings (as structural impediments suppressed consumer spending), found their way into the U.S. economy. As time passed, domestic jobs leaked overseas, impeding real wage growth, and forcing the brunt of the economic adjustment to be shouldered by lower skilled, lower wage jobs with a persistent need for fiscal stimulus to mitigate the economic consequences.

A lasting hallmark of the pandemic might well be the coincidental coordination between monetary policy and fiscal policy – the Fed has gobbled up nearly $4 trillion worth of bonds and in the process ensured Congress had a cheap and ready source of funds. Successive stimulus packages are steering toward needs testing – with enhanced unemployment benefits and income thresholds for the latest stimulus checks or the qualification for PPP loans narrowing.

Stimulus measures are still a windfall for many that have a lower financial need, but to the degree the money is spent it will still help stimulate the economy. But in a sign that barriers to progressive stimulus are fading, 20 Democratic senators recently called for making stimulus checks recurring.

The nuance that we are highlighting is that for the past forty years policy has prioritized business profitability as the primary mechanism for promoting employment, investment, and prosperity. This has involved a mix of tax incentives intended to encourage businesses to invest and hire, and monetary policy overly focused on preventing a repeat of the 1970s inflation. The structural lag, however, between the transmission of monetary policy into financial markets versus the real economy (as accentuated by the record rebound for stocks following the initial pandemic rout) was always destined to nurture rising wealth inequality as this policy mix definitively caps wage gains in favor of corporate profits and asset values (and is clearly visible in the divergent proportion of GDP accounted for by wages versus profits).



Continual stimulus, like an investment, will need to generate a return to be affordable. The reality is there are limits to the amount of debt financed stimulus that can be deployed prudently and the degree to which this spending will generate enduring benefits. But given the large output gap caused by the pandemic, as well as the recognition that the economy has been operating below potential GDP since at least the Great Recession, there is an opportunity for the additional debt to fund productive investments and translate into a higher level of longer-term GDP growth (which would also support a slightly higher rate of inflation and an erosion in the real cost of the debt). Stimulus has been channeld toward households most affected by the economic dislocation of the pandemic, which also happens to be the same households that have historically struggled to participate in the general prosperity of the economy and, coincidentally, have the highest propensity to spend stimulus money (compared to the wealthy, in which an extra thousand dollars may not change any of their spending intentions). The implication is that by channeling fiscal policy toward lower income, underemployed segments of the population policymakers can start closing the income gap, narrow the wealth gap, and get the highest inflationary impact per dollar of new debt.

However, these efforts risk being undermined if policymakers are unable to direct spending toward more domestic production and investment, and away from additional imported goods (which is the classic leak of domestic demand to the benefit of foreign exporters).

Looking ahead, daily new infections, particularly on a regional basis such as in Michigan or even Brazil and India, are a reminder that new, more problematic mutations can still emerge and postpone the recovery. Fortunately, the mRNA-based vaccines are more easily tweaked to address this risk, though new versions will still take some time. As we move into the next phase of recovery there is a risk that the gradual withdrawal of extraordinary fiscal support and transient inflation from a reopening economy will test policymakers' resolve. Nevertheless, the reopening – driven by stimulus and pent-up demand – is setting the economy on a course to spur broad investment and hiring that should lift wages and drive growth over the next 18-24 months.

For investors, this means the deflationary backdrop of the past decade that benefited risky assets on the back of falling interest rates will be supplanted by an economic environment characterized by earnings growth as the primary driver of investment returns (rather than higher prices per dollar of earnings).

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Faster economic growth suggests earnings revisions will likely trend higher, not lower, and provide a consistent tailwind for equities. At the same time, a stronger economy should put upward pressure on inflation and interest rates, particularly to the extent we see above trend income/spending growth among historically lower income households – suggesting that fixed income returns may face headwinds. Ultimately, there will be some volatility as investors digest the counterbalancing effects of higher growth on the one hand, and prospectively higher discount rates on the other (as interest rates inch higher). For these reasons, our focus is on companies that have more cyclical exposure (with pricing power) and can outgrow any changes in discount rates. Within bonds, we continue to prefer shorter maturities and opportunities for significant credit improvement.

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