SMITH AFFILIATED CAPITAL

SECOND QUARTER 2021
INVESTMENT COMMENTARY

After The Summer Heat Wave, the Economy Will Cool and Chill Inflation Concerns

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With the $1.9 trillion American Rescue Plan now on the books, the Federal government has injected or committed more than $5 trillion of stimulus into the economy over the past year, about 25 percent of GDP. Fiscal stimulus of this magnitude is unprecedented outside of war periods. The cocktail of fiscal and monetary stimulus and the accelerated pace of vaccinations has led to a feeding frenzy of upgraded growth forecasts by economists and policy makers. The consensus of private economists sees the economy advancing by close to 7 percent this year, which would be the strongest since the early 1980s, and the Fed upped its GDP growth forecast by 2.3 percent to 6.5 percent at its March meeting.

No doubt, the economy is in for a bumper year. It will turn particularly hot over the spring and summer months when businesses are able to more fully reopen and consumers, armed with the unspent funds from three rounds of stimulus checks, unleashes pent-up demand. We expect GDP to surge by double-digits during the second quarter, driven primarily by consumer spending. The surge in output will also be accompanied by a temporary pick-up in inflation, as businesses restore prices that were deeply cut during the height of the pandemic. When compared to those depressed prices of a year ago, the annual inflation rate will surge for a period of time until those so-called base effects age out of the calculation later in the year.

Not surprisingly, this near-term economic and inflation backdrop has raised concerns among some prominent economists that fiscal policy has gone too far relative to the economy's needs. Whether or not such an enormous amount of stimulus is needed to bring the economy back to full employment is a legitimate question. Critics argue that an outsized fraction of the stimulus has yet to hit the spending stream, as households have accumulated almost $2 trillion of savings over the past year due to the lack of spending opportunities. This is a formidable amount of purchasing firepower that, in their view, will lead to an overheated economy and uncontrollable inflation, spurring a surge in interest rates and, ultimately, prod the Fed to overcorrect, bringing on the next recession.

Clearly, the risk that growth and inflation will exceed the Fed's projections has increased, and its commitment to keep rates at near zero while the economy runs hot for a while will be tested. That said, we believe that the growth and inflation concerns are overblown, and the era of lows over the last decade – low GDP growth, low inflation and low real interest rates – will continue in the years ahead.

The fiscal stimulus and elevated savings will not be as powerful or have as lasting an impact on the economy as alarmists fear. Likewise, we concur with the Fed's conviction that the expected inflation pick-up will be transitory and fade as growth moderates later this year and in 2022.

To be sure, the administration has an ambitious spending agenda that could further stoke inflation fears, including the proposed $2 trillion infrastructure spending plan announced recently. But that plan needs to overcome many hurdles, including Republican opposition to higher taxes that would be needed to cover costs, before it becomes enacted. With an evenly split Senate and skepticism by some moderate and progressive Democrats over elements of the plan, it's unlikely that anything of that magnitude would pass Congress before the mid-term elections. And lest we become overly optimistic with the accelerated pace of vaccinations, cases of infections are once again on the rise, as new variants are spreading. Simply put, the growth-retarding health crisis may not be over as soon as hoped.

Fiscal Thrust, Not So Much

The $1.9 trillion American Rescue Plan passed in December is poised to give the economy a meaningful shot in the arm. We estimate that the fiscal impulse will amount to around 4.3 percentage points, lifting the growth rate in GDP to 7 percent in 2021. Most of the impact, as noted earlier, will be delivered in the spring and summer months as the economy continues to reopen and accommodate consumer pent-up demand fueled by stimulus checks. But assuming the aforementioned infrastructure plan is stymied or severely scaled back in Congress this year, the fiscal thrust in 2021 will morph into a fiscal drag in 2022, as the budget deficit is projected to plunge from 15 percent of GDP to 6 percent next year.

That's a steep fall-off that will take a big slice out of activity next year, when we expect GDP growth to slow to 3.0 percent. Importantly, that 4.3 percent impetus from the American Rescue Plan is much less than the boost implied by the $1.9 trillion size of the plan, which equals around 10 percent of GDP. The difference reflects the sizeable leakages that dilute its impact. For one, the direct stimulus checks do not translate dollar-for-dollar into spending. The New York Fed analyzed how households used their payments received under the Cares Act last year and found that only a small share – 29 percent – was actually spent. Instead, households put 36 percent into savings and 35 percent of the payments was used to pay down debt.

Significantly, a similar pattern occurred among low-income households. This is the cohort deemed to be most likely to spend all of the payments quickly.

But the NY Fed found that low-income households were most likely of any group to use last year's payments to pay down debt. Indeed, those payments probably kept many households from taking on new debt in the first place, something that helps explain why consumer credit actually contracted in 2020. There is every reason to believe that the stimulus checks from the AMR will deliver even less bang for the buck in terms of spending.

That Savings Firepower Has Some Blank Bullets

A big reason critics believe fiscal policy has provided more stimulus than the economy needs and will ultimately stoke an uncontrollable inflation outbreak is that so much of it has piled up in household savings accounts, representing a massive pool of purchasing power. Following three rounds of stimulus payments and enhanced unemployment benefits, households have accumulated nearly $2 trillion of savings during the pandemic. For the most part, the build-up reflects the lack of buying opportunities, as much of the economy has been closed for business even as government transfer payments have boosted personal incomes well above pre-pandemic levels. Some believe that those funds are just sitting there, waiting to be unleashed on a capacity- constrained economy that will send prices sky high.

No doubt, the enforced portion of these savings will be quickly spent when buying opportunities expand, feeding a torrent of demand that will outstrip supply and spur price increases in coming months. But once the bottlenecks ease and pent-up demand is satisfied, the pace of consumer spending will subside and supply will grow into demand, easing price pressures. The question is, how much of the vast savings built up in 2020 will be retained instead of spent, and how much of the "lost" spending will be made up. We believe that more of it will be retained than expected and much pent-up demand will remain lost.

Keep in mind that most of the savings have been accrued by high-income households who have a low marginal propensity to spend. These households, in turn, realize that there is no free lunch and that the massive fiscal intervention that is propping up the economy will require higher taxes down the road. According to the Federal Reserve's latest survey of consumer expectations, the highest share of upper-income households expects their tax burdens to increase over the next year than any time since the survey began. Odds are, some portion of their elevated savings is being earmarked for higher taxes and will not be used for spending purposes.

Likewise, households further down the income ladder are likely to retain a higher savings balance than normal. For one, many of them, particularly low-wage earners, entered the pandemic with too little savings and will use the stimulus checks to replenish their depleted balances. For another, following two major shocks over the past decade – the financial crisis and the pandemic that vaporized millions of jobs – many households will prefer to keep a higher level of precautionary savings than otherwise. Indeed, homeowners are facing about $500 million in unpaid principal from mortgage forbearance granted under the Cares Act. To the extent savings are earmarked to pay down that principal to avoid foreclosure, those funds will also not be available for spending.

Finally, how much of the excess savings is spent may also depend on whether the build-up of cash balances is treated as extra income or wealth. Typically, people spend a higher proportion of an increase in income than wealth. It may turn out that the longer these balances remain unused the more likely they are considered to be additional wealth, reducing the spending impetus when restrictions are lifted. The fact that so much of these savings have been used to pay down debt or buy assets supports the view that the savings surge is being treated more as a wealth shock.

Another Wolf Call by Inflation Alarmists

Despite the real and persistent deflation threat posed by the financial crisis in 2008, it did not take long for the inflation hawks to emerge from the woodwork as soon as Washington cobbled together a very moderate $800 billion stimulus package to jump-start the economy and backstop the financial system. Then, as now, inflation worriers believed that the aggressive turn of the twin levers of monetary and fiscal support would send the economy into overdrive and spur runaway inflation.

Of course, no such thing came to pass. Not only did the economy's growth engine fail to rev up to maximum speed, it actually remained stuck in second gear over most of the next decade. More than ten years after the GFC, the economy finally reached the point of full employment and capacity usage, measured by historical yardsticks, and even then inflation failed to accelerate. Reflecting the persistence of low inflation despite unprecedented monetary support, the Federal Reserve overhauled its policy framework last year, committing to not act preemptively to declining unemployment or strengthening growth until it sees the whites in inflation eyes.

The inflation hawks believe that prospect is not far off, as the stimulus-fueled growth spurt in coming quarters will quickly close the output gap and prod businesses to scramble for workers, driving up labor costs. Once again, those concerns will fail to materialize. For one, the output gap is a moving target. The economy's potential to produce goods and services is flexible and its ability to expand when demand presses against capacity limits has been demonstrated time and again. If anything, the pandemic highlights the growing importance of technology in generating output, which amplifies the productivity capability of the economy. The proliferation of remote working, which is here to stay, undercuts the relevance of brick and mortar facilities as a measure of the economy's productive capacity.

For sure, bottlenecks will still occur from time to time and spur episodic price spurts. Commodity prices have surged over the past 11 months driven by supply chain disruptions and bottlenecks and the quicker than expected reopening of the economy – all of which are temporary and transitory. But ingrained inflation is a process that builds over time. Temporary inflation binges, like the one in commodity prices, have often been seen in the past, reflecting numerous catalysts – energy spikes, geopolitical events, trade wars that create supply disruptions as well as outright military conflicts, among others. But unless these catalysts are reinforced by ongoing wage increases that exceed productivity gains, they should not lead to a sustained pickup in inflation. From our lens, there is little on the horizon that suggests a wage-price cycle is in the cards any time soon.

Despite the recovery of 12.4 million jobs over the past eight months through February, there are still 9.4 fewer workers earning paychecks than there were prior to the pandemic. What's more, millions of workers have dropped out of the labor force entirely, either voluntarily – for health-related reasons or school closings that require home care – or involuntarily, long laid-off workers believing that no jobs are available to match their skills. As a result, the labor force participation rate is a full two percentage points below pre-pandemic levels and hovering near the lowest level since the 1970s.

Simply put, there is still considerable slack in the labor force that is underestimated by the current 6.2 percent unemployment rate. The real unemployment rate, adjusted for labor force dropouts as well as involuntary part-time workers, is closer to 9 percent. With this much labor on the sidelines, it is hard to imagine workers gaining enough bargaining power to demand strong wage packages that would put upward pressure on prices and stoke a sustained increase in inflation. Indeed, the February income and spending report revealed that wages and salaries were unchanged over the past 12 months compared to a 1.4 percent increase at the end of last year. There is an 80 percent correlation between wage increases and core CPI inflation. Not surprisingly, the trend in core inflation is moving decidedly lower; the 3-month annualized rate tumbled to 0.7 percent in February from 1.2 percent at the start of the year.

Bond Bears Will Hibernate Again

The spike in government bond yields since the start of the year has led some to argue that the long bull market in bonds is over and a bear cycle is poised to begin. We disagree. The increase raised concerns because of how quickly it took place, not to where it landed. Indeed, the 10-year Treasury yield has only returned to around its pre-pandemic lows. From our lens, the fallout from the pandemic will cement the trend in safe haven bond yields remaining low in coming years. Despite record issuance of U.S. as well as other governments, the rise in private sector savings and demand from central banks will keep the flows of demand and supply roughly in balance. Overall, the world still suffers from a shortage of safe assets, which indicates that any near-term rise in yields will be gradual and limited.

The likelihood of a steeper rise in bond yields would increase if the inflation dynamics differ from what we see unfolding. In the next few months, we are forecasting a rise in inflation fueled by base effects, one-time price increases due to the reopening of the economy turbo charged by fiscal stimulus, and some pass-through of higher prices from supply chain bottlenecks. These influences should lift core inflation to 2.5% y/y in the spring, while headline PCE inflation will flirt with 3.0% y/y. Then, inflation should moderate but remain slightly above 2% into 2022 – which would be the longest period of above-2% inflation in the past decade. But if this happens, it will anchor inflation expectations that would prevent core inflation from spiraling up and help guide the pace back towards 2%.

The argument that the new administration's move towards a more expansionist fiscal policy will generate stronger growth, and, hence, inflation is understandable – and may cause bond yields to overshoot for a while. However, the last round of stimulus is front-loaded and its multiplier effects are muted. Recent events give a hint of what's to come. After the $600 stimulus checks that boosted spending in January were used up, everything collapsed in February – consumer spending, industrial production, housing activity and durable goods orders. The new $1400 checks that went to 95 million households in March will likewise jump-start the growth engine over the spring but they too will have run their course later in the year. We suspect by then the bond bears will once again go into hibernation.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	3/31/2020	12/31/2020	3/31/2021	Last Quarter	Last Year
6-Mo. Bill	0.10	0.09	0.03	0.05	0.16
2-Yr. Note	0.23	0.12	0.16	-0.04	0.21
5-Yr. Note	0.38	0.36	0.93	-2.46	-2.01
10-Yr. Note	0.70	0.91	1.74	-7.02	-8.11
30-Yr. Note	1.35	1.64	2.40	-15.84	-20.58

Municipal Bonds	Yields (%)			Total Return (%)	
	3/31/2020	12/31/2020	3/31/2021	Last Quarter	Last Year
Barclays GO Bond Index	1.73	0.87	1.00	-0.54	4.81
Barclays State GO Bond Index	1.68	0.77	0.89	-0.44	4.68
Barclays Local GO Bond Index	1.78	0.97	1.12	-0.63	4.94
Barclays Revenue Bond Index	2.20	1.22	1.32	-0.29	6.08

Equities	Levels			US $ Terms (%)	
	3/31/2020	12/31/2020	3/31/2021	Last Quarter	Last Year
S&P 500	3230.78	3756.07	3972.89	6.17	56.33
DJIA	28538.44	30606.48	32981.55	8.29	53.78
NIKKEI (Tokyo)	23656.62	27444.17	29178.8	-0.18	52.61

Commodities	US $			Percent Change (%)	
	3/31/2020	12/31/2020	3/31/2021	Last Quarter	Last Year
COMEX Gold Active Monthly	1583	1895.1	1713.8	-9.57	8.26
CRB Future Com. Pr. Index*	121.7868	167.79	184.96	10.23	51.87
West Texas Intermediate Crude ($ per bbl.)	20.48	48.62	59.16	21.68	188.87

Currencies	Levels			Percent Change (%)	
	3/31/2020	12/31/2020	3/31/2021	Last Quarter	Last Year
Yen	107.54	103.25	110.72	-7.23%	-2.96%
Sterling	1.242	1.3672	1.3783	0.81%	10.97%
Euro	1.1031	1.2216	1.173	-3.98%	6.34%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	3/31/2020	12/31/2020	3/31/2021	Last Quarter	Last Year
German 10-Yr.Bond	-0.55	-0.66	-0.41	-5.70	5.86
Japanese 10-Yr.+ Bond	-0.07	-0.04	0.04	-7.01	-2.77
UK 10-Yr.+ Bond	0.24	0.14	0.77	-3.94	7.49
Emerging Market (USD)	7.19	3.50	4.05	-3.48	13.58

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices