Points to Ponder

February 19, 2021

The First Tee...

Fleeting or Foreboding?...the specter of inflation growth exceeding the boundary of desired limitations is creating concerns among investors and consumers ***(At the Fed, not so much)*****:**

- The impact of unrestricted global money creation, combined with supply shortages and disruptions caused by the pandemic, are pressuring prices for goods and services:
  - The current focus on rising price trends is a reversal of the Federal Reserve's strategy to re-inflate the economy, going back several decades beginning with Alan Greenspan's chairmanship:
    - This era of lax monetary policy has been a panacea for leveraging debt as well as a catalyst for appreciating equity valuations, but debilitating for savers...while also creating a 30-year bull market in bond prices and forcing investors out the risk curve.
- Emergence from the pandemic is expected to create a surge in consumer activity:
  - The populous is anxious to get back to normalcy and enjoy many of the activities they have been precluded from during the extended quarantine...consumers have discretionary dollars burning in their pockets.
  - Business closures and supply chain disruptions are expected to create shortages and price pressures in sectors such as commodities (energy, food, building materials), restaurants, entertainment (sporting events, concerts):
    - Accelerated commodity inflation is already evident in many categories (weather has also played a role for commodity prices):
      - The rising cost of oil has been one of the most focal price recoveries...crude has risen 110% in value since last April's low.
        - Anticipated rising global demand, combined with OPEC remaining disciplined in production limits, has pressured the cost of oil higher.
      - Food inflation is on the rise as grain prices are trading at a seven-year high, impacting processed food and animal feed costs:
        - Grain prices have been impacted by inclement weather in South America and Russia, and a spike in demand from China.
        - Corn and bean prices are trading 42% and 45% respectfully higher than they were a year ago...the price of wheat is up 16% from a year ago.
        - Feed costs for cattle, hogs and poultry have increased 30%, causing ranchers to reduce the size of their herds due to lost profitability.
      - The surge in housing demand, especially single-family units, has pressured building materials higher as supplies remain tight:
        - The price of lumber is trading at record highs, rising 47% in value in just the last 3-weeks...tariffs on imported Canadian lumber is playing a role.
        - The price of copper is trading at a 9-year high, rising 84% in value since the start of the pandemic last March...strong demand from China.
    - A resurgence in demand for services could be predicated on a sharp increase in costs to offset shortages of supply:
      - The restaurant sector (one of the hardest businesses hit by closures due to the pandemic) could be over-ran by a spike in demand.
      - Medical care could see a rise in demand as resumption of delayed voluntary surgeries are expected to boost hospital profits.
- **Bond market tea-leaves**...the recent steepening of the yield-curve is sending inflation signal:
  - The bond market is off to its worst new year start since 2013 as investors are selling longer debt:
    - Despite the Fed purchasing $120 billion monthly in Treasury issues and mortgage-backed securities, yields have been pressured higher by rising energy prices, government stimulus and a record supply of bonds:
      - Since the end of the Great Recession in 2009, U.S. government debt has increased 133% to almost $28 trillion.
      - Since the start of August, the yield on the 30-year bond has increased 86 basis points to 2.06% (up 72%)...the spread between the two-year T-Note and 30-year T-Bond has widened by 85 basis points to 196 basis points (this spread was 81 bps at the start of 2020)
        - The yield-curve is currently trading at its steepest level since 2015...the Fed has short-rates locked down with a 0% benchmark target.
      - A steeper yield curve has historically been an indicator of rising inflation expectations, but with the excessive amount of Fed intervention in the bond market it is difficult to get an accurate read of the appropriate value of market driven interest rates
- **Too much of a good thing**...Fed projects any run-up of inflation beyond target will be transient:
  - The FOMC is betting the pandemic price pressures will be relieved by the slack in the labor force:
    - There remains almost 11 million people out of work versus a year ago, leaving less leverage on wages:
      - The unemployment rate is 6.3%, but some analysts believe, factoring in the contraction in the labor force participation rate last year the resulting jobless rate is closer to 9%...reviving the Phillips Curve relationship between employment and rate of inflatiion.
    - The Fed has also adjusted its inflation parameters to allow the Personal Consumption Expenditure Index to rise above policy makers 2% target without triggering a tightening of monetary policy *(the fudge factor)*:
      - The PCE Index is currently running at 1.3%, so even with a post pandemic price surge, the Fed has bought extra time.
  - Over the last 50 years of economic cycles, recessions have consistently proven to be disinflationary:
    - Consumer inflation typically trails the broader economic trend by approximately a six-quarter lag.

At the turn...

The Back Nine…

The Three Bears...speculative excess appears to be rampant in the financial market, the Goldilocks investing environment is seeing cash pouring into trendy risky debt:

- Unsustainable excess is inflating asset valuations in equities, bonds and cryptocurrencies:
  - Bear market probabilities are increasing as bubble designations are reaching historical definitions:
    - These characteristics are especially perceptible in high-growth/high-multiple stocks, non-investment grade bonds, Bitcoin and special purpose acquisition companies (SPACS)...see below for additional information on SPACS.
  - Buying behavior has become predicated on price momentum and away from value assessment:
    - Bandwagon buying and chatroom induced investment strategies are erosions from rational financial analysis:
      - The current trend of loading-up on shares of companies yet to show a profit (betting on the come) is the same investor behavior seen prior to the dot-com market crash (the NASDAQ lost 255% in value from 2000 to 2001).
  - A key driving force for valuation gains has been the record liquidity injected into the market:
    - The Fed's balance sheet is projected to reach 42% of GDP this year...while the U.S. budget deficit will rise to 33% of GDP:
      - As mentioned on the Front 9, the financial market has been addicted to accommodative monetary policy for several decades:
        - Cheap money has been easy for the Fed to deliver during the era of low inflation, but if price pressures intensify, the party could be over:
          - Cheap money is generally a pre-condition for a bubble, its removal is almost universally the catalyst for a financial (and possibly economic) collapse.
    - The Fed has created the high risk-taking environment as policy pushed interest rates to record low levels, forcing investors to move into riskier assets for returns (this is especially evident in retirement accounts that had utilized high-grade bonds and CDs):
      - Duration extensions have also raised the possibility of larger value depreciations if interest rates rise in the future.
    - The Fed can keep expanding the money supply, but 1980's double-digit inflation is a reminder of what can result.

SPAC Splurge...the new method of taking companies public is the current hot thing:

- SPACs are a publicly-traded buyout shell company that raises investment funds to complete an acquisition of an existing private company...versus the traditional initial public offering method:
  - SPACs have a regulatory advantage over IPO's, as they can avoid disclosure rules for pro-formas:
    - SPAC targets can publish multi-year financial projections regarding growth and profitability without risk of litigation:
      - Most SPAC target firms are in product development and testing phases (many are tech related), revenue estimates can be iffy:
        - Investors typically do not know how or for what the company is going to use the money raised by the SPAC.
  - Most SPAC offerings are sold at $10 per share, with warrants to purchase additional shares later:
    - SPAC sponsors very from institutions to celebrities, who typically receive 1 share for every 4 purchased by investors:
      - In SPSC deals, hedge funds get arbitrage opportunities and investment banks collect fees for processing the deal:
        - **Once sponsors, hedge funds and bankers get their cuts, the remaining shareholders receive what is left of the diluted stake:**
          - **An analysis of 47 SPACs consummated between January 2019 and June 2020, estimated investors retained only $7 per share when the deal closed**
  - Since the beginning of 2020, SPACs have raised over $100 billion in funding for companies.

19th Hole...

From the sublime to the ridiculous is but a step. **Napoleon Bonaparte**

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