Points to Ponder

August 28, 2020

The First Tee...

A Wrench or Whopper in the Works?...in hibernation for over thirty years, inflation may be waking from its slumber, which could either boost or derail the Fed's strategy:

- The Central Bank has adjusted its policy stance on inflation to be more flexible, but a rapid rise in prices could force the FOMC to abandon their easy money stance:
  - The Fed instituted its 2% inflation target in 2012, but the Personal Consumption Expenditure Index (the Fed's preferred inflation growth measure) has only averaged a 1.4% annual gain over the past eight years:
    - Fed Vice Chairman Richard Clarida had promised "evolution, not revolution"...*be careful what you wish for!*
- The Great Debate...the pandemic's impact is speculated to have either inflationary or deflationary impacts on the economy...here are some of the arguments for the two cases:
  - **Con Inflation**...this camp sees the current state of low inflation persisting for many years (the Japanese syndrome):
    - **Phillips Curve pause**...theory that prices face upward pressure when economy is using full labor force:
      - Global employment has tumbled the past six months, with expectations of a slow revival in the post pandemic environment
    - **Saving for a rainy day**...household spending has slowed as consumers have poured money into savings:
      - Spending for restaurants, entertainment and travel has stalled, and are expected to be remain slow to recover as consumers remain concerned about health issues and job security *(Government COVID relief checks will not last forever)*:
        - In a recent survey, 2 out of 3 consumers interviewed stated they had become more frugal *(unfortunately, my wife was not on the list!)*
    - **Using dollars**...the supply of money is bulging, but this is not a guarantee these dollars will be spent:
      - The frequency money changes hands to purchase goods and services is called the "velocity of money"...this monetary exchange slowed during the financial crisis and has remained low ever since, while hitting new lows since the pandemic.
    - **Excess capacity**...despite the quarantine of the labor force, manufacturing infrastructure was not damaged during the pandemic, which makes the current disaster different than the impact from natural disasters and wars:
      - Consumer demand has taken the largest hit the past half-year, supply had some shortages due to supply chain disruptions.
  - **Pro Inflation**...this group sees global monetary policy stimulation and spend oriented fiscal policy pressuring prices:
    - **Uncle Miltie**...economist Milton Friedman asserted inflation is always a monetary phenomenon:
      - **Lots of money**...in many countries, money supply is growing at the fastest pace in history (government deficits are growing just as fast):
        - During the 70's and 80's monetarist's had nightmares over double digit inflation growth as money supply expanded:
          - Money supply growth in the U.S. is currently expanding at over 25% on a year-over-year basis (keeping the printing presses busy).
        - In 2008, most of the cash creation remained on bank balance sheets, whereas this year, it is going to consumers and businesses...a key variable regarding money supply growth that is different during the current crisis compared to the financial crisis a decade ago:
          - There could be an inflation surge as the broader measures of money expand, the lockdown eases and a recovery ensues.
    - **When doves comply**...the Fed's latest policy announcement shows its growing inflation tolerance:
      - In future economic cycles the Central Bank will keep rates lower longer and let pace of inflation rise higher:
        - The Fed wants to see higher inflation, which should equate to higher wages...increasing consumer buying power.
    - **Out of stock**...disruptions in supply chains are pressuring prices; cheap imports may be downsized:
      - Technology advances and lower foreign labor costs have allowed corporations to suppress wage growth, resulting in lower manufacturing costs...the coronavirus has escalated trade tensions (especially with China), threatening a cheap labor source:
        - This trend could lead to finding new supply and production sources...governments may also become more reluctant to outsource over-seas the manufacturing of strategic goods; Made in the USA means more expensive labor costs.
    - **The wealth effect**...spending is expected to rebound faster than seen during the financial crisis as household finances took less of a downturn due to aggressive government relief programs and stimulus...pressuring prices higher:
      - The stock market has recovered and moved into new record territory in less than six months from hitting lows.
      - Home prices barely hiccupped when the pandemic began, as year-over-year real-estate price growth is exceeding 4%.
      - The relief checks distributed to furloughed workers raised average hourly earnings numbers above pre COVID levels:
        - A majority of these payments are expected to be spent on goods and services, creating demand-pull inflation pressure.
- The Fed's new policy plan has analyst projecting a 0% rate target for a least 5 years:
  - If inflation can find a renewed life, the Central Bank's easy money plans could be derailed:
    - Inflation is kind of like the Titanic...once it has forward momentum it is hard the change course, even when you see the iceberg coming.

At the turn...

Capital Markets Group

The Back Nine…

Rural Real-Estate Rodeo...the lure of city living has diminished with the pandemic, creating a rush to purchase homes in the far-suburbs (or less populated adjoining counties):

- Households are looking for space (social distancing) and shunning claustrophobic apartment living ...there is also a security factor as many people do not feel safe living in the inner-city:
  - The home buying rush has been intensified by the record low level of mortgage rates (sub 3%):
    - Programs freezing foreclosures, combined with stimulus payments, helped to keep the housing market afloat:
      - The shift from multi-family to single-home buying has been seen in the most expensive large metro areas, such as New York, Boston, L.A. and San Francisco...condo sales contracts in New York fell 60% in July from the prior year, while bedroom community home sales doubled.
- Delaying a crash, inflating the boom?...there are concerns that if the virus persists and the unemployed cannot find jobs, homeowners may be forced to sell their homes or face foreclosure:
  - The government's relief program has been helpful in keeping unemployed workers in their homes, but has intensified the pace of real-estate inflation to the point of reaching asset bubble levels (recalling the housing market collapse of 2008):
    - Buyers who purchased homes recently and have little or no equity in their home are the most vulnerable to another housing crash:
      - 16% of borrowers with FHA loans were delinquent in the 2nd quarter, highest on record and double the conventional loan rate.
- *Keep Manhattan just give me that countryside!*

Too Big to Fail?...the current view of the economy has rarely been so closely correlated to stock market gains; the mega company dominance is creating new concerns:

- Consumer confidence is being impacted by the S&P 500 by the most in over thirty years:
  - The largest five companies in the S&P 500 comprise a record 23% of the entire index:
    - Stocks have played such a large role in boosting income and confidence, the government is likely to intercede if some of the larger firms start having problems that could pull the market down (some believe the Fed is already taking this tact):
      - Share values currently stand at a record-highs relative to the size of the U.S. economy (the same applies to debt outstanding):
        - Equity values and dividend income are dominating household compensation at a record level...expanding the income divide between classes.
  - The U.S. has a history of protecting certain sectors, such as autos, airlines and large banks:
    - There have been government efforts to reduce the monopolistic tendencies of the mega-cap companies:
      - Regulatory scrutiny is intensifying, but targeting industries that are giving a lift to the economy and creating jobs is probably not politically appetizing in the current environment (especially during an election year).
- *The big get bigger...the rest, well good luck!* **(722 U.S. companies filed Chapter 11 in June, up 48% from filings in June 2019)**

19th Hole...

You cannot escape the responsibility of tomorrow by evading it today.

Abraham Lincoln

Ross Elford, First Vice President

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