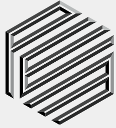

PALUMBO WEALTH MANAGEMENT
PARTNERING TO DELIVER STRENGTH

Weekly Commentary

May 18, 2020

Chief Investment Office PWM | 18 May, 2020
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No One Knows the Future

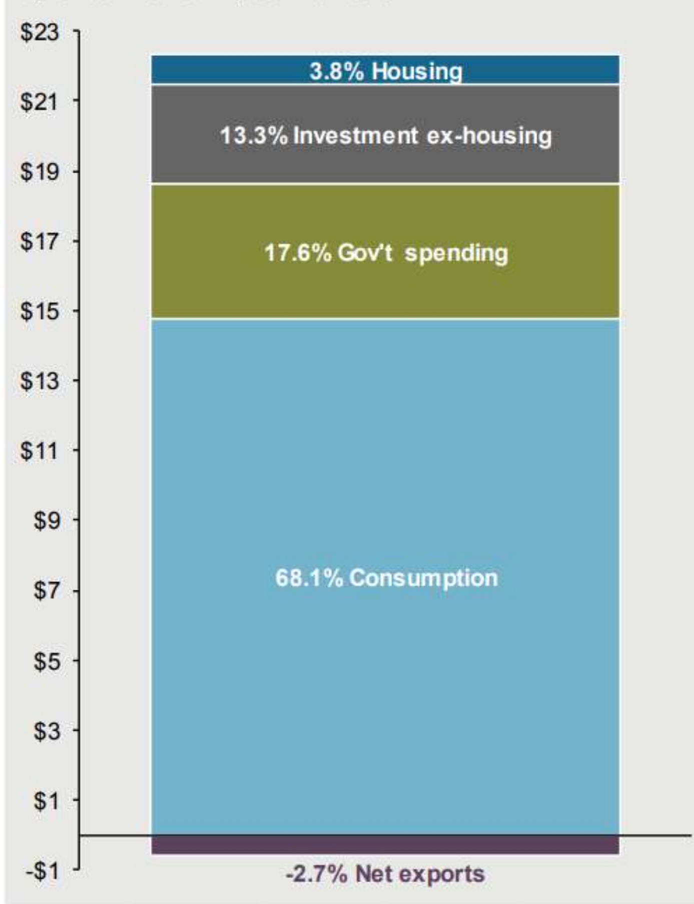
The current uncertainty in the world is at a fever pitch as it relates to the markets and the intermediate and longer-term opportunities investments. This is obviously as a result of a global pandemic we have not experienced in our lifetime. Markets do not like uncertainty, and as a result are unsettled, and no one truly knows how the future economic and market scenario will play out.
The two radically different scenarios which are being actively debated are a world of deflation and future of inflation. As a result, we felt it valuable to discuss both scenarios along with their ramifications. As you review these two scenarios, and their ramifications for the markets, it should offer you some insight as to our thinking at Palumbo Wealth Management regarding the construction of our “Risk-Balanced Portfolio” that serves as a foundation for our investing philosophy.

Inflation or Deflation? That is the $64,000 Question

If you have been reading any financial news, you are probably aware that some prognosticators are arguing that inflation lies ahead, while others are more concerned about the current deflationary trend. That debate can easily appear non-sensical and make one wonder if anyone knows what they are talking about. How could we be headed for both inflation and deflation at the same time? The quick answer is that we are not headed for both at the same time, but possibly in succession.

Deflation Now

The closing of the economy causes a sudden shock. Stores close, people stop working, consumer spending, which is some 70% of GDP (see below) slows dramatically. This sudden drop in demand was unexpected and as a result, there is too much inventory and/or production capacity. That is corrected by reducing prices. As an example, summer clothing sales are now expected to be far short of projections. Stores need to clear inventory and when they do, prices go down. This is a common occurrence we are all familiar with, but when it is widespread, it creates a deflationary environment, which is what we are experiencing now.



Of course, the word deflation always conjures up images of the Great Depression. While that is a possibility, it is not a probability during this economic downturn. Without detailing the many causes of the Great Depression, suffice it to say that the relatively new Federal Reserve did not really know how to address deflation and their policy errors played a major role in the depression that followed. Those lessons were well-learned a long time ago, which is why we are seeing massive monetary and fiscal responses from governments all over the world in response to COVID. That makes a 1930's style depression unlikely, but it does not imply that we don't need to be concerned about deflation. A deflationary period has near term investment implications and the solution, massive stimulus, can present long term problems of its own, specifically inflation resulting from the massively large bail-outs (read: money printing). This very short video explains.

First, let's make sure we all understand the basic concepts of inflation and deflation. Inflation is a bit easier to understand because most of us lived through an inflationary time. Inflation is a period of rapidly rising prices. In the classic sense, this is defined by too much money chasing too few goods.

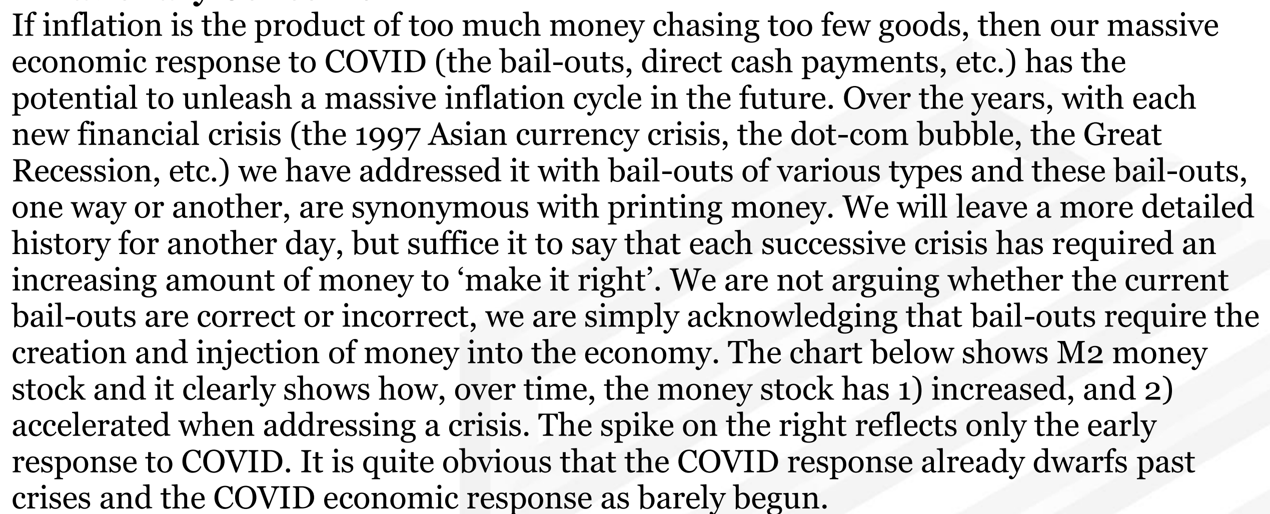
An example here might be helpful understanding this concept. What would happen if we made dirt, money? If dirt were money, would everybody be rich because they would have access to theoretically unlimited resources? No, they wouldn't. If an iPhone

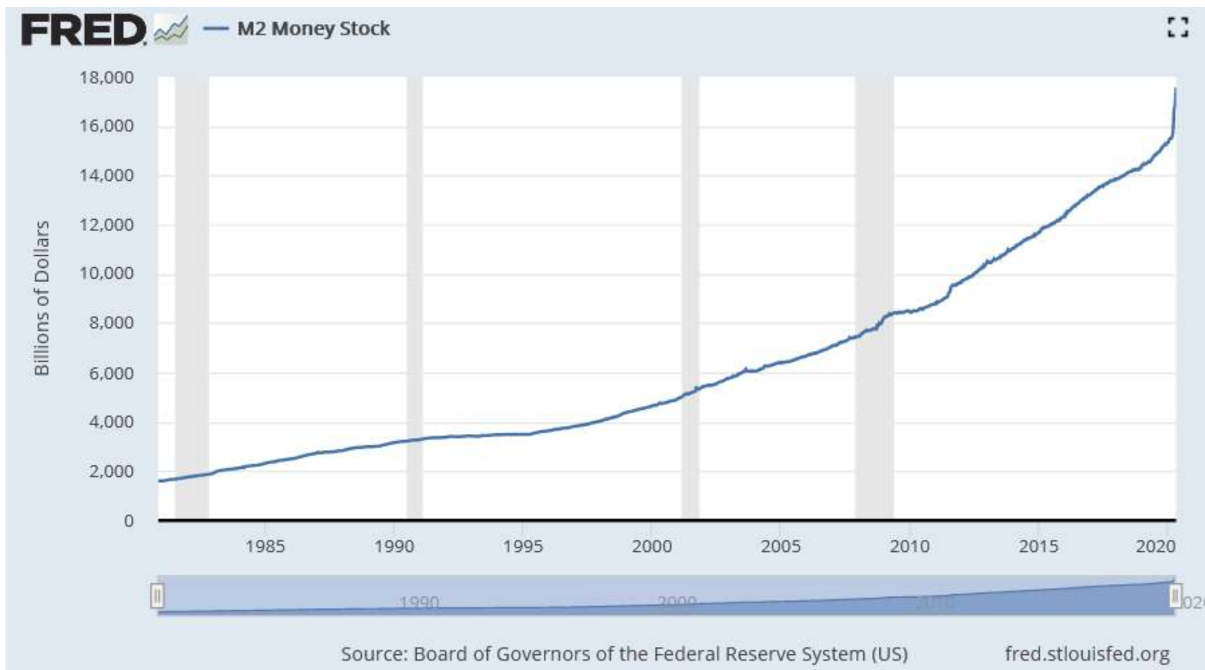
costs one box of dirt, someone that is unwilling to wait for the new iPhone could easily offer two boxes of dirt, and someone else would offer three boxes. Milton Friedman, the Nobel prize winning economist, explained inflation as being a monetary phenomenon, that is, the result of too much money, and as only government can print money, inflation was always laid at the feet of government policy. In this short video Professor Freidman explains that concept.

On the other hand, deflation is more of a foreign concept as most of us have never experienced deflation first hand. To compound that, there is also the notion of 'good' deflation vs. 'bad' deflation to consider. Good deflation is typically the result of innovation. Technology has often lowered the cost of many items. When we can do things better, cheaper and faster using technology, that lowers costs and is good deflation. On the other hand, bad deflation is created by the opposite of inflation. That is, too little money chasing too many goods, i.e. there is an aggregate demand problem. If the economy is unwilling to spend enough to buy up the productive capacity of the economy, there is excess supply/inventory which must be reduced. Prices, specifically lower prices, are the mechanism used to eliminate the excess. In a weak economy, lower prices drive out weak competition, that increases unemployment, and reduces demand even further in a positive feedback loop. The risk is that this deflationary trend spirals out of control as it did in the Great Depression, although as we said, that is unlikely due to the massive monetary and fiscal stimulus put in place, with more on the way.

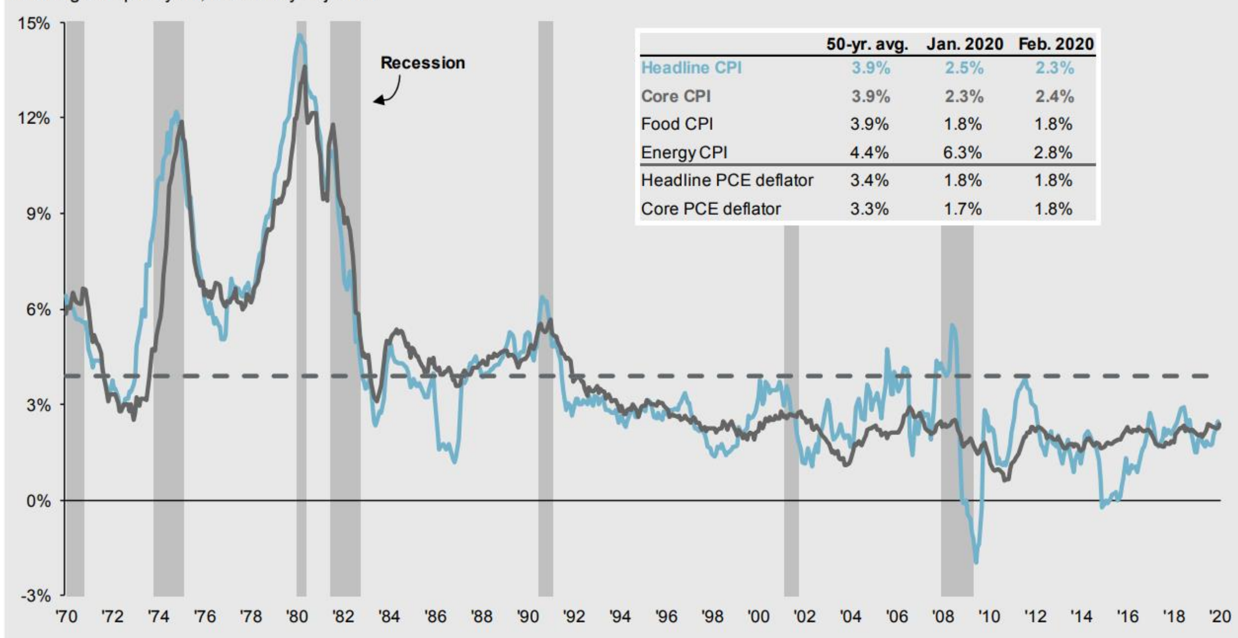
Inflationary Concerns

If inflation is the product of too much money chasing too few goods, then our massive economic response to COVID (the bail-outs, direct cash payments, etc.) has the potential to unleash a massive inflation cycle in the future. Over the years, with each new financial crisis (the 1997 Asian currency crisis, the dot-com bubble, the Great Recession, etc.) we have addressed it with bail-outs of various types and these bail-outs, one way or another, are synonymous with printing money. We will leave a more detailed history for another day, but suffice it to say that each successive crisis has required an increasing amount of money to 'make it right'. We are not arguing whether the current bail-outs are correct or incorrect, we are simply acknowledging that bail-outs require the creation and injection of money into the economy. The chart below shows M2 money stock and it clearly shows how, over time, the money stock has 1) increased, and 2) accelerated when addressing a crisis. The spike on the right reflects only the early response to COVID. It is quite obvious that the COVID response already dwarfs past crises and the COVID economic response as barely begun.





This massive response begs the question of whether it will create an inflationary problem. Recent history suggests that it won't. We had what was until recently a massive monetary response to the Great Recession of 2008-09, but 12 years later, it has not created inflation. In fact, the FED has had trouble meeting its 2% inflation target since that time. (see chart below).



Source: BLS, FactSet, J.P. Morgan Asset Management.
CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.
Guide to the Markets – U.S. Data are as of March 31, 2020.

J.P.Morgan

On the other hand, there are those that argue that inflation was created by all that money printing. It was simply confined to financial assets, producing the massive runup in the stock market and other financial markets over the last 12 years. The reason it did not create a more generalized inflation was that the money never really made it into the hands of the average citizen. The bailout was focused on Wall St., not Main St. and as a result, the inflation accrued to Wall St. and this has been the primary driver of the growing wealth disparity. It is the wealthy that own financial assets, so inflation of financial assets benefits the wealthy, not main stream America.

The COVID bailout has been spread a bit more widely, but the primary beneficiaries are still corporate America, not Mom and Pop. A one-time deposit of $1,200 into a taxpayer checking account simply isn't going to do much when lockdowns and lack of work are lasting months. It is important to understand that the bail-outs did not exclude the general population by design. In theory, that benefit should 'trickle down' to the masses, but that simply did not happen after the Great Recession of 2008-09. The question we ultimately need to answer is whether this stimulus reaches Main St. or not.

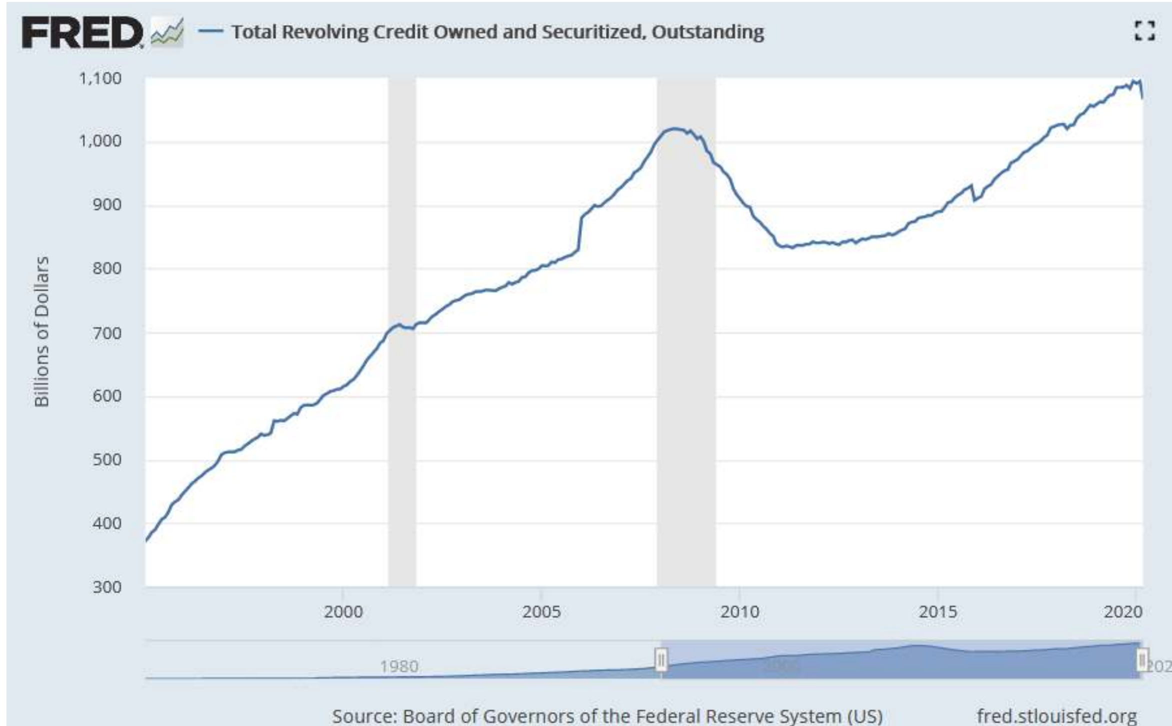
The COVID response is far from over and we expect additional action in Congress to pump money into the economy. Only time will tell, but at this point, there is reason to believe that any inflationary impact will continue to be focused on financial assets and can extend market gains. Certainly, recent market action has been biased to the optimistic side of this crisis and that may be a function of a lesson well learned 12 years ago. However, it brings with it a widening wealth disparity that must be addressed at some point, either via policy changes or social unrest, or both.

If the continuing government response to COVID changes direction and begins to feed the bailout money directly to the populace, then the risk of a more generalized inflationary problem probably becomes more of an issue, especially considering how massive the response has been (and needs to be).

Will COVID Change the US Consumer?

Eventually businesses open and supply returns. The bigger question is whether we start spending again. For the wealthy, that isn't really a question, but for main stream America – the 40% that were unable to cover a $400 extraordinary expense, that we discussed last week – returning to old spending patterns is more problematic. They come out of this lockdown hopefully with a job, but maybe not, and almost certainly with back rent or mortgage payments to make. Whatever money they spend is likely to be focused on non-discretionary items and if anything is left over, on savings, because nobody wants to go through this again.

The fact that middle class wealth was down about 15% to 20% since the Great Recession didn't stop them from spending in the interim. As shown below, revolving credit, declined following the great recession, but within a few years it surpassed its previous high-water mark. That is clearly an unsustainable trend and this crisis could be the point where the trend reverses. As we said last week, we would not be surprised if the effects of this crisis permanently alter spending and savings habits just as the Great Depression altered the spending habits of that generation.



Those are the seeds of bad deflation. Consumers pull back quickly; demand does not return to prior levels; businesses have too much inventory and reduce prices in response. That only provides incentive to wait a little longer to spend your hard-earned money. Why buy it now if prices are going lower? That becomes a self-fulfilling prophesy and is how a deflationary spiral develops.

The term unprecedented has recently become the most overused word in America and for good reason. It is important to remember that the pandemic response is equally unprecedented. As in 2009, the Federal Reserve is responding with methods that until now were only theory. They have never been used in practice before. Wall St. has enormous confidence in The Federal Reserve, but unprecedented actions using tools never before implemented present risk. The Fed is the expert and they are trying to do the 'right thing', but when that right thing is not entirely clear, there is room for error and for that reason, it is critical that we keep in mind the enormously damaging effects of expert failure (1930) and be vigilant in tracking events over time.

Investment Implications

Inflation and deflation are opposing ideas. During inflation, the value of your dollars is eroding and assets that can offset that erosion can perform well. That would obviously exclude bonds as bonds offer a fixed interest rate and repayment of principal in dollars that have been devalued by inflation. Preferred assets include hard assets, like gold, (as opposed to fiat currencies) as the scarcity value of gold cannot be altered by money printing. Although gold is far from a perfect inflation hedge, we note that in 1930, a kilo of gold could purchase a new Chevy. In 2020, a kilo of gold can purchase… a new Chevy. You can't say the same about dollars. Over the long term stocks can also be good inflation hedges as revenues and profits are subject to inflation as well.

Deflation, on the other hand, is the polar opposite. If prices are declining, the dollar buys more, or said differently, the value of a dollar is increasing, so bonds are the place to be. The interest is paid in dollars with increasing value as is the principal at maturity. Socks are not the place to be as revenue and earnings are subject to the declining value of the dollar.

The clear problem for a portfolio manager is how to position a portfolio for two possibilities with opposite impacts. Our balanced portfolio is prepared for both.

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