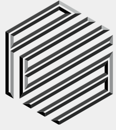


PALUMBO
WEALTH MANAGEMENT
PARTNERING TO DELIVER STRENGTH

Weekly Commentary

August 17, 2020

Chief Investment Officer PWM
Philip G. Palumbo, Chief Investment Officer, philip.palumbo@palumbowm.com

What does Kamala Harris mean to the Biden Ticket?

She is clearly the safe choice based on the parameters that Biden laid out, as well as the choice with the best chance to complete a winning team in November.
The following outlines a few of her economic and financial policies that NBC news points-out that are similar to former VP, Joe Biden.

1. The Pandemic:
    - Her policy is to help hard-pressed households that have been slammed by the pandemic by sending them a $2,000 monthly stimulus check during the pandemic.
2. Health care:
    - Harris discussed many proposals to shore up the Affordable Care Act over a 10-year plan, such as, changes to income, payroll and estate taxes to make them more progressive in addition to higher taxes on businesses and the richest Americans.
3. Housing Affordability:
    - Harris advocated for helping people struggling with a high cost of rent, proposing a tax credit for renters paying more than 30% of their income in rent and utilities.
4. Income and Taxes
    - Harris supports a national $15-an hour minimum wage, and would penalize companies that skirt the rules.
    - She promises to reverse President Trump's trillion-dollar tax for big corporations.
    - One of the ways to pay for an overhauled healthcare system would be to tax Wall Street trades by .2%, or $2 per $1,000, and bond trades would be taxed at half that.

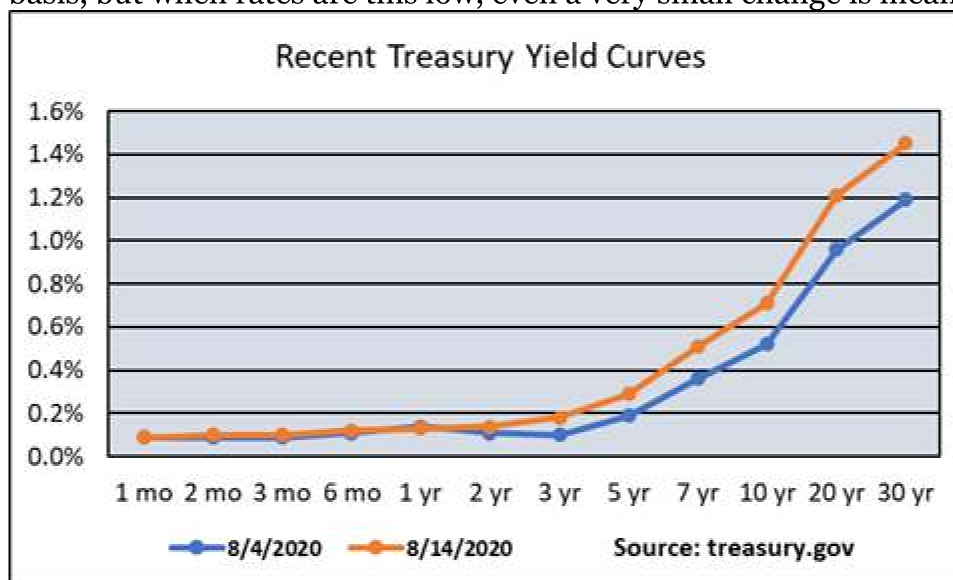
Due to many of these policies, many prognosticators are predicting that a Biden-Harris win, would cause volatility in the equity markets mainly on the potential reversal of the tax cuts that reduce corporate tax rates. If that were to occur, then a higher tax on corporations would mean lower profits, which essentially translates into lower stock prices.
You might recall that four years ago, the prognosticators were calling for the stock market to decline if Trump won. They could not have been more wrong. Trumps demeanor as a leader was already in full view and we suspect that played a large part in

drawing that conclusion. If you looked at Trump purely in economic terms, the stock market rally that followed made plenty of sense.

This time around we think there is an element of 'Trump fatigue' which will play to Biden's favor. Our advice is to stop looking at the polls. **This election is far from secure for the either parties. A lot can/will occur from now until the election.**

Interest Rates Were Declining but have Now Spurted Higher. What's Going On?

At Palumbo Wealth Management, we do not believe anyone can accurately forecast rates. **There are any number of factors tugging on interest rates at a given moment in time. Right now, the biggest factor is the FED buying securities in the open market.** Although the FED is not buying longer term securities, the massive buying of shorter-term securities is not without impact on the long end of the yield curve. The yield curve is the range of yields on Treasury securities from three-month Treasury bills to 30-year Treasury bonds. (See chart below.) The rise in rates from last week to this week is clearly shown. The rate increase is small on an absolute basis, but when rates are this low, even a very small change is meaningful.



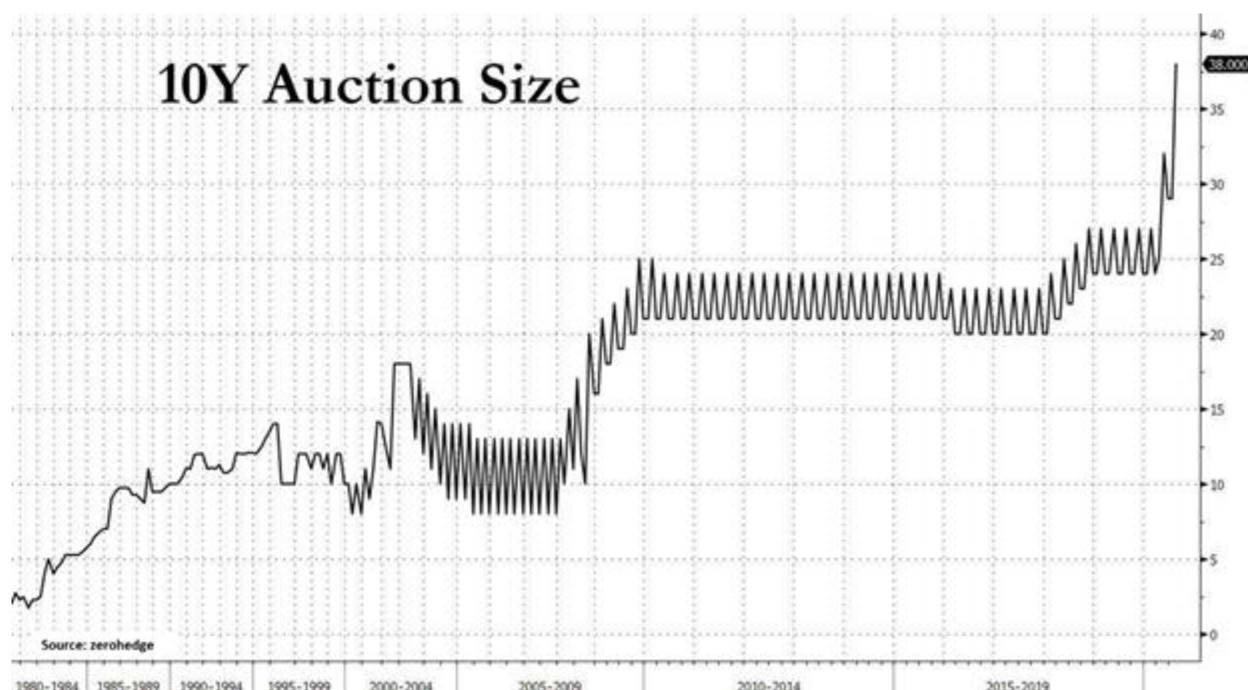
The FED's Hand Remains Active in Markets

Recall from prior comments that when faced with economic turmoil, **the primary tool of the FED is to reduce very short-term rates**. Historically, this has influenced long term rates as well, without exercising outright control, and the impact of lower interest rates has been sufficient to catalyze an economic recovery.
Beginning in 2008, this strategy failed to the job and the FED turned to a previously untested strategy called Quantitative Easing (QE). All this means is that the FED moves down the yield curve and buys some slightly longer-term securities.

The idea is that if 2-3-5 year rates also decline, it is a greater incentive to invest and re-start the economy.
From 2008 until early in 2020, rates have remained relatively low in a continuing effort to recover from that crisis. That recovery was not yet complete when the pandemic hit and **with the incredible speed of the economic decline, the FED quickly brought short-term rates back to zero and re-started QE. That was sufficient to get us through the initial shock, but as we struggle to recover from the pandemic, more fiscal help is certainly necessary from Congress** (which has failed to act) and the FED could be forced to up the ante to keep rates down.

Interest Rates and Massive New Bond Supply are on a Collision Course

This week, markets got caught between the proverbial rock and a hard place. **Rates had been coming down and were approaching the interest rate lows hit at the peak of the market hysteria in March. That trend collided with a very heavy calendar of Treasury bond auctions this week,** as shown on the chart below. The 30-year auction has an almost identical pattern.



Back in the early 1980's, the typical auction for the 10-year Treasury Note was in the $2 billion area. The 10 year auction this week was for $38 billion and far above any previous auction of 10-year notes. The thirty-year auction, a day later, totaled $26 billion. In addition, there is also $25 billion auctions of 20-year bonds to be held on August 19. **That is $89 billion of new bonds sold in a span of 8 days!**
The 10-Year auction went well with the bonds yielding 0.677%, a bit lower than the When Issued trading at 0.681%. Dealers (who look re-sell) 19.8% of the auction.
The 30-year auction was not nearly as well received and drove yields higher on Thursday afternoon. The bonds were priced to yield 1.406%, which was 2.4 bps above the 1.382% When Issued rate. In this case dealers took down 28.3%, the highest in a year.

The impact of these auctions is not obvious. The FED, when it buys securities, always buys in the open market. The reason is that their intention is to inject liquidity into the economy. That means that when they buy securities, someone in the economy needs to be paid in order to get those funds into the economy. That in turn, requires that the Treasury be able to sell all these new bonds to investors at each auction. Again, in turn, the rates on these new bonds need to be high enough to be attractive to investors. In Street parlance, this is called the concession. So **at least part of the run up in rates this week was of a technical nature in order make the auctions a bit more attractive and result in have successful auctions.**

The FED has promised to do whatever it takes to keep rates low in order to do their part in promoting economic recovery. As we fund pandemic response with larger and larger auctions, this collision between the need to sell and the higher rates required to have a successful auction can become problematic. In effect, there is a threat of a treasury oversupply. Like any market that is oversupplied, prices come down to adjust. If bond prices come down, that means that the interest rate must rise (bond rates and price move inversely). **An oversupplied market makes it difficult to maintain the current delicate balance between rates high enough to attract buyers and rates low enough to promote recovery. What happened this week was not a big deal, but it may portend difficulties in the months ahead.**

Many on Wall St. have are already projecting the collision and anticipate that the FED will once again use a technique called Yield Curve Control (YCC), something which has not been used since the era of WWII through the Korean War. YCC simply means that the FED buys long dated securities, potentially out to the 30-year bond, in order to bring long term interest rates down and keep them there.

Yield curve control has worked in the past, but it is not without risk. We think the St. Louis Fed made those risks very clear in a recent blog post on their web site.

> *"However, it is important to acknowledge that every policy has drawbacks. For example, if the Fed were to adopt such a policy and if the public perceives that the Fed is engaged in deficit financing, then it is possible that inflation expectations could rise, threatening the Fed's long-run goal of price stability; this happened in the U.S. in the 1940s and early 1950s and led to the Treasury-Fed Accord in 1951."*
> *"Another worry is that YCC could distort market signals, thereby diminishing the value of information that monetary policymakers glean from the Treasury market. Finally, if the Fed were to adopt YCC, policymakers would have to grapple with the challenge of how to exit from policies designed to be temporary departures from normal. Thus, once the economy normalizes, it would be important to convey the YCC exit strategy to the public in a clear manner to avoid potentially destabilizing outcomes."*

So, What Does That Mean?

We can't discount that aside from the size of the Treasury auctions, the rise in rates was also a function of higher inflation data and a drop in new and continuing jobless claims. Evidence of a recovering economy can also push

rates (and the stock market) higher. Don't let the stock market rally fool you. Despite the rapid recovery in the stock market, we remain in a very tenuous economic and financial situation. In our view, stocks are up more because of the FED's liquidity injections than signs of a recovery. **In order to maintain current valuations, we need a vaccine and we need as full a recovery as possible. The longer that is delayed and the longer Congress fails to act rationally in addressing COVID stimulus, the more at risk we become.** The FED can't do this forever. There are limits. We have no desire to discover where those limits lie, but watching rate movements and FED auctions can provide some hints about where we stand. **If rates come back down next week, it implies that the increases this week were more a function of substantial supply hitting the market. If they don't revert, it implies that the market is bit more of a believer in the recovery story.**

No One Really Knows Where Rates are Headed

Even the best and brightest at the FED don't know where rates are headed or how a YCC implementation will work out. **We are confident only that the instability in the economic environment implies that the rates are likely to remain volatile.** What we do know is that over the long run, interest rates reflect the economic and market conditions. It is for this reason that Palumbo Wealth Management utilizes a highly diversified portfolio rather than attempt predict changes in the market.

Deal or no deal?

It seems that politicians don't understand the gravity of the situation. With the stock market recovered and an election nearing, politics is the number one issue for both sides and as a result, Congress can't come to a deal for the next round of stimulus. We can only hope that they soon realize they are playing with fire. The biggest loser in the argument is the public that is in need of additional measures to get them through this pandemic. It is time for Congress to think about those they represent. Until then, we remain at a standstill, and that can only work against economic recovery. **We would expect that the longer this new stimulus is delayed, the more problematic it may become for markets.**

Palumbo Wealth Management (PWM) is a registered investment advisor. Advisory services are only offered to clients or prospective clients where PWM and its representatives are properly licensed or exempt from licensure. For additional information, please visit our website at www.palumbowm.com

The information provided is for educational and informational purposes only and does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your attorney or tax advisor.

The views expressed in this commentary are subject to change based on market and other conditions. These documents may contain certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Any projections, market outlooks, or estimates are based upon certain assumptions and should not be construed as indicative of actual events that will occur.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.