PWM Weekly Observations

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What the Vaccines Might Mean for Inflation

- ***Successful Vaccines Imply that an Old-Fashioned Recovery Begins***
- ***An Old-Fashioned Recovery Implies Increasing Inflation and Upward Pressure on Long-Term Interest Rates***

We have spent a fair amount of time over the past few months discussing the on-again, off-again rotation in the stock market, which flips from the **'COVID trade'** to the **'Reflation trade'**. We thought it was time to make sure that everyone knows what we are talking about. **The COVID trade focuses on companies that have benefitted from the pandemic, centered around technology companies that allow us to work from home, like Zoom Video, or provide direct delivery service, like Amazon or Netflix.**

The reflation trade is comprised of those companies that were hurt by the pandemic, but would clearly benefit from a vaccine and a return to a relatively normal economy. In this case, think about old school cyclical stocks, like industrials and materials, as well as airlines, travel and leisure.

These two very different trades have been see-sawing back and forth with one winning over several days, only for sentiment to switch back again. **We certainly can't predict the moment that the reflation trade will become a relatively permanent feature, but as long as vaccines roll out as expected AND they function as expected, we think it is safe to assume that day is coming. And when it comes, it will logically present some difficult issues for the Federal Reserve and for markets.** Allow us to explain.

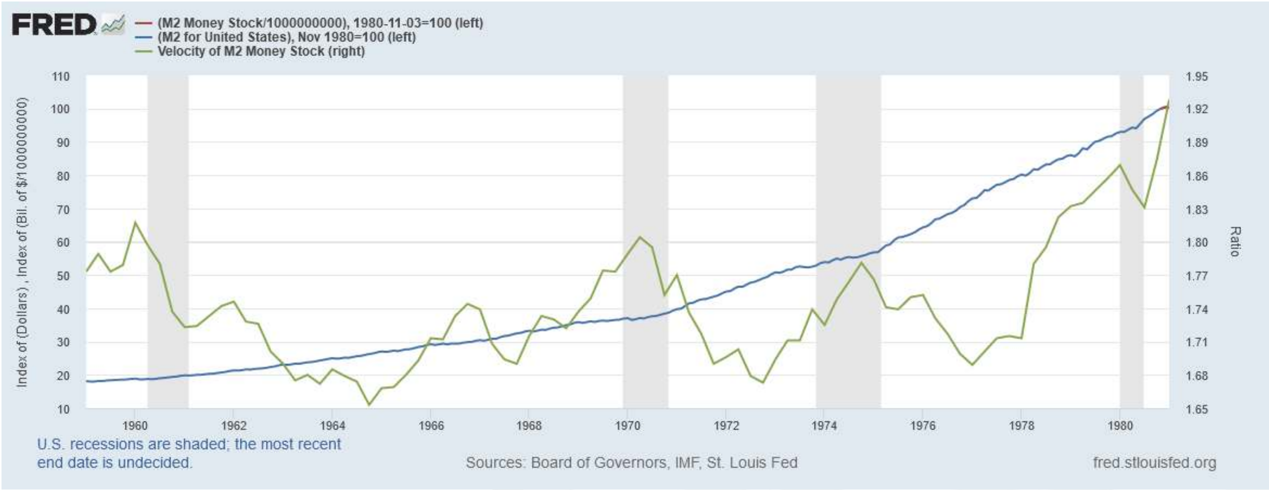
When the economy is in recession, interest rates are typically low, relative to where they had been before the recession. However, **history shows us that when economic recoveries begin, interest rates, especially longer-term interest rates, will begin to reflect the increasing optimism by rising.** This is a normal, natural reaction, and one that is based on a resumption of some longer-term inflationary pressure in the economy. **Higher expected inflation would require higher bond yields. But this may place the Federal Reserve in a bit of a dilemma.** On one hand, the Fed has promised to keep interest rates low for an extended period with the express idea of getting inflation not only up to their target 2% level, but to allow inflation to **exceed that level** in an attempt to produce an average of 2% inflation (after a long period of almost no inflation). **Creating inflation, but not too much inflation, is a very difficult task.**

- ***Money Growth and Inflation are Inexorably Tied - Milton Freidman***

We subscribe to Milton Friedman's belief that **inflation is "always and everywhere, a monetary phenomenon".** Friedman was a master at taking complex economic topics and making them understandable to the masses, so **we highly recommend the short (15 minutes) video in the "What We're Reading" section** for more color on the subject. For now, suffice it to say that Friedman believed that inflation was created by excess printing of money by government.

Friedman's comments were made back in the late 1970's and early 1980's when inflation was the raging economic problem and, the problem was being blamed on the oil embargos of the 1970's, labor unions, and even consumers. Below is a picture of that era. The blue line, using the left axis, shows that the **M2 money supply rose from an Index value of under 20 to roughly 100. That is a fivefold increase over roughly 20 years, and the growth was becoming exponential (it was growing faster and faster) as time went by.**

The green line is a measure of the **velocity of money. Think of velocity as how fast a dollar moves through the economy and is used again. The faster it is used and re-used, the faster the velocity. So, if a dollar is used and re-used 10 times per year, in effect it is the same as $10 used once in a year. Clearly a higher velocity of money would give the appearance of more money in the economy.**



In the era of Friedman, the velocity of money fluctuated only modestly, until the late 1970's, while the money supply (blue line), was growing rapidly. This increase in velocity created the last inflation push that led to Fed Chairman Paul Volker finally killing inflation by increasing interest rates and causing a recession.

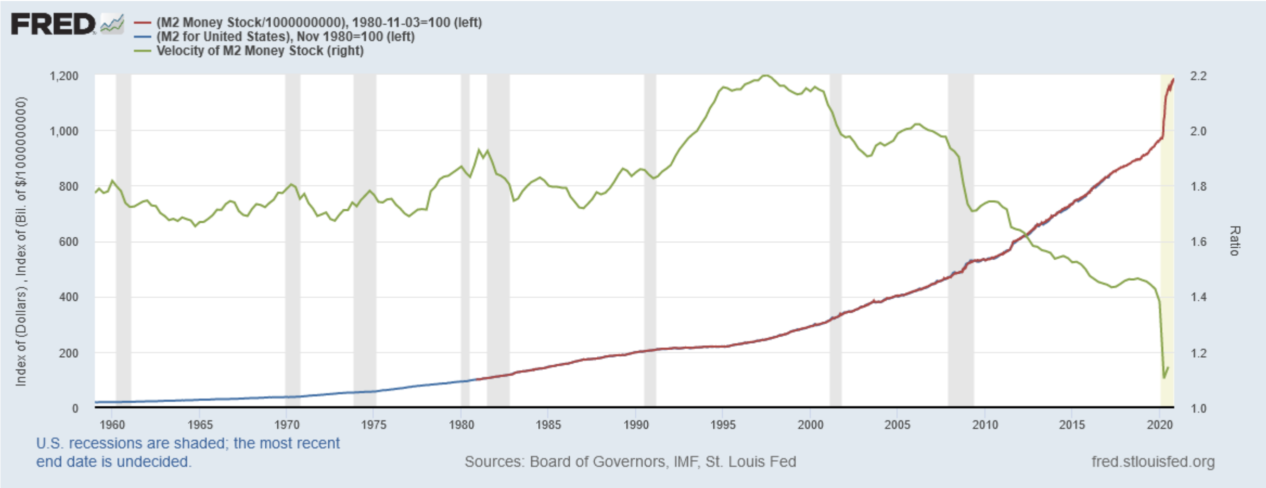
- ***Declines in the Velocity of Money have Delayed the Inflationary Impact of Money Creation***

In the next chart, we show the same time series but over a longer time frame and some massive shifts become evident. In the early 1990's the money supply leveled off while money velocity increased. Since that time, **money supply has been back on a growth track, but velocity has steadily declined. It is this decline in velocity that has prevented the FED from producing the 2% inflation rate it desires.**

At the far-right side of the chart we see what has happened since the pandemic took hold. **Money supply has spiked up as the FED and Congress injected massive amounts of money to get us through the pandemic. At the same time, the velocity of money has absolutely collapsed.** This decline should not be a shock. When most of America was effectively closed, it was literally difficult to spend money as fast as we had previously, and the fear of economic ruin caused even those that had money, to save more, allowing the savings rate to spike higher at this time.

- ***If and When Velocity Returns to Historical Norms, the FED Faces another Problem***
- ***The FED Currently Desires More Inflation, but They Could Get More Than They Bargained For***

With the summer recovery, we are starting to see velocity inch up again. **It would certainly appear that when the velocity returns to normal, we should expect higher inflation, unless the Fed is able to pull the stimulus money out of the market. That would be very difficult to do without markets reacting poorly.** If the Fed begins to sell all the securities it has been buying to support the economy during the pandemic, the selling pressure would present a huge headwind to markets.



- ***The Method to Deal with Our Massive Debt Just Might be High Inflation***

All signs suggest that it is time to begin to worry about inflation rearing its ugly head once again, and if that happens, how will the FED respond to that inflation. The presumption today is that the FED would prefer to keep inflation at the stated 2% target, however, that could be a mistake. **The economic situation over the last 12+ years has created a massive debt problem for the U.S. and we believe the most logical way out is to allow inflation to reduce the purchasing power of the debt, which of course makes it easier to pay off that debt. That would argue that the FED could allow inflation to run hot (i.e. above target)**.

- ***High Inflation Is, in Effect, a Devaluation of the Dollar***

A weaker dollar presents its own problems. The world's reserve currency is supposed to be a currency that has a stable value and inflation is a destabilizing factor that reduces the value of the dollar, other things being equal. A weaker dollar makes imports more expensive, which is inflationary, and exports cheaper, which would spur growth in the U.S. Naturally, global export economies would then be pressured to devalue their currency as well as a means to stay competitive. **One asset class expected to perform well in this environment would be gold.**

The fix for inflation, as demonstrated by Former Fed Chair Paul Volker in the early 1980's, is very high interest rates, with the associated cost of a recession. **The FED, however, is somewhat constrained in doing this as increasing rates would increase the already high interest costs on our debt which reached $327 billion in 2019, before the pandemic, when rates were higher. To put that in perspective, the total deficit in 2019 was about $984 billion. With that limitation, it is hard to envision a way to avoid meaningful inflation in the intermediate term.**

Over a longer-term horizon, we have put ourselves in a difficult spot. One that may well require some considerable pain to correct.

The Pandemic Pain is Increasing and There is No Help in Sight

- ***Politics, not public service, remains the order of the day in Washington***
- ***Without fiscal stimulus, the risk of a double dip recession grows each day, as we discussed weeks ago***
- ***More lock downs will produce more bankruptcies and longer lasting economic damage***
- ***But even a double dip should be short lived as vaccinations grow in 2021***
- ***Any vaccination bad news (unexpected reactions/efficacy) is potentially devastating to the stock market***
- ***Any measures to add stimulus is likely to be broadly welcomed by the stock market***

It seems inconceivable that one headline this week quotes Dr. Fauci as saying there is light at the end of the tunnel and another headline that says New York City schools are closing again due to COVID, yet here we are. **These new lock-downs may not be as successful in holding the virus at bay as there is no question that we are suffering from COVID fatigue**. Europe is on a similar path and there are already protests in the street. We may be on our way to the same fate. However, there is little doubt that these lock-downs only magnify the economic damage.

Several weeks back we discussed the possibility of a double dip recession if Congress did not pass additional stimulus. We aren't quite there yet as we are still seeing growth, but that growth will eventually buckle under the weight of more lock-downs. **The FED, with only limited tools to address this problem, is begging Congress for more fiscal stimulus, but none appears forthcoming.** The bad blood from the election is still fresh in the minds of the political class and thus there appears to be no reason to compromise on a stimulus plan. **We may well have one more, brief bout with recession before the blue skies appear**. We are still optimistic, but we now have another river to cross before the vaccination recovery can begin. However, **the vaccination news has been stellar, and any indication that these vaccines are not as effective as advertised, or any indication that there is some unexpected reaction, would be unnerving to markets.**

Oddly, having that last river to cross could be a boon to markets as well. If the FED is able to pull one more rabbit out of its hat, or if Congress can get its act together and pass a stimulus bill, we would expect that added liquidity to push markets higher.

What We're Reading

Milton Friedman - The Nature of Inflation (15-minute video)
Charting America's Debt: $27 Trillion and Counting
Fed's Powell Says Rising Coronavirus Cases Pose Threat to Economy
How Renewable Energy Can Pay Off for Big Oil (Barron's subscription req'd.)
Can Active Equity Managers be Replicated Using Factor Funds?
FDA Approves Emergency Use for First At-Home Covid-19 Test Kit
Lael Brainard could be Goldilocks Treasury Chief
FAA clears Boeing 737 Max to fly again
Inside the effort to get Americans a COVID-19 vaccine (60 Minutes - 14 min video)
Is AI finally closing in on human intelligence? (FT Subscription req'd.)

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Markets This Week

This week Energy was again the leading sector in the market posting a 5.70% week-over-week gain following up on its 17.11%-week last week. Small Caps, Emerging Markets and Fixed Income asset classes all had solid gains on the week while equities again fell behind in comparison. After being negative on the week last week, long-term Treasuries rose 2.11% along with other fixed Income asset classes. Commodities within the past two weeks have put up over 1.60% returns while Gold suffers its second consecutive down week this week. It's interesting that Healthcare was a big loser on the week especially after major breakthroughs with vaccines.

US Equities	1 week	YTD	Fixed Income	1 week	YTD	Sector Breakdown	1 week	YTD
S&P 500 (SPY)	-0.77%	11.98%	20+ Yr. Treasuries (TLT)	2.11%	20.60%	Consumer Disc. (XLY)	0.16%	23.68%
Dow (DIA)	-0.89%	4.40%	Barclays US Aggregate (AGG)	0.55%	7.09%	Info. Technology (XLK)	-0.90%	32.37%
NASDAQ (QQQ)	-0.20%	37.11%	Intermediate Municipal (MUB)	0.63%	4.27%	Financials (XLF)	0.55%	-9.88%
Russell 1000 Growth (IWF)	-0.46%	29.06%	US Corporate Bonds (LQD)	1.33%	9.85%	Health Care (XLV)	-2.96%	8.22%
Russell 1000 Value (IWD)	0.12%	-2.62%	Barclays US High Yield (HYG)	0.56%	1.55%	Utilities (XLU)	-3.86%	1.00%
Vanguard Mid-Cap (VO)	0.86%	11.15%				Industrials (XLI)	1.05%	8.10%
Vanguard Small-Cap (VB)	2.13%	9.12%				Energy (XLE)	5.70%	-37.22%
						Materials (XLB)	1.09%	15.52%
International Equities	1 week	YTD	Commodities	1 week	YTD	Consumer Staples (XLP)	-1.53%	7.66%
MSCI EAFE (EFA)	1.41%	2.75%	Commodities (PDBC)	1.91%	-14.64%	Comm. Services (XLC)	-0.36%	19.94%
MSCI Emerging (EEM)	1.51%	9.98%	Gold (GLD)	-0.83%	22.95%	REITS (VNQ)	-0.90%	-6.48%
						Homebuilders (XHB)	1.96%	26.63%

The table above is an analysis of the weekly and year to date returns of various markets/sectors that we follow (More RED = worse performing markets/sectors; More GREEN = best performing markets/sectors). Source: IEX Trading & PWM Research.

Retirement Planning:

[Here's how much your company's 401(k) match could be worth in retirement.]

It's always stressed that saving for retirement now will greatly benefit you in the future. When It comes to a 401(k), your employer's match can help you fund more than you thought toward your retirement.

Estate Planning:

[Power-of-Attorney Abuse Can Drain Your Retirement Savings. Choose One Wisely.]

Durable power of attorney is one of the most Important and useful documents you will ever sign. It is also one of the most dangerous If it falls into the wrong hands.

Tax Planning:

[11 Year-End Moves to Lower Your 2020 Tax Bill.]

What you do between now and the end of the year can have a significant impact on how much tax you have to pay next April.

Health:

[COVID-19 conspiracy theories erode belief in safety measures.]

A new study suggests that reading about COVID-19 conspiracy theories can make people ignore the proper measures needed to protect ourselves and others.

Entrepreneur:

Mark Cuban on why he refuses to mentor people.

Many successful people have credited a business coach to helping them succeed. But billionaire Mark Cuban isn't a big proponent of hiring a coach and his reasons why may surprise you.