The Long & Short of It

Quarterly Newsletter
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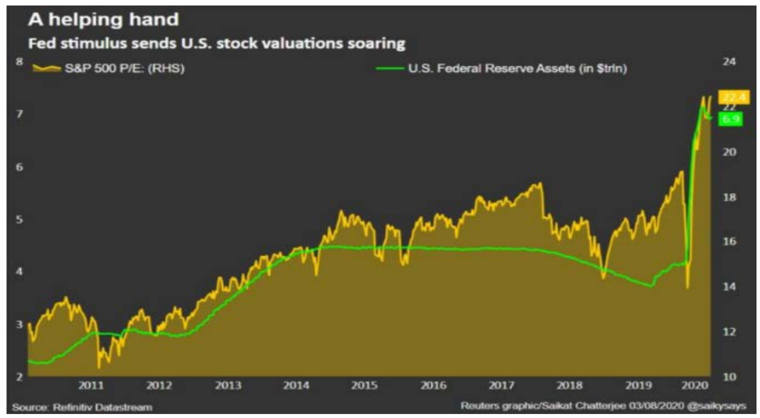
Mr. Market's Wild Ride

In his children's book *The Wind in The Willows,* former Secretary of the Bank of England Kenneth Grahame presents "Mr. Toad," a fickle character apt to drive cars too fast and crash them. Jerome Powell, current Chairman of the Federal Reserve, must surely feel a bit like Mr. Toad after attempting to manage a COVID-19 economy. The S&P 500 took quite a volatile ride in 2020. It careened upward in January, then crashed down roughly 30% as the pandemic unfolded, subsequently bouncing 68% off the bottom to finish the year with a total return of 18.4%. We can't help wondering if this solid result is actually a reflection of a modern Fed's extraordinary skills or if, in the long run, we will discover that Mr. Powell was more like Mr. Toad than previously thought—and did not pass the driving test.

As noted in our earlier newsletters, the confidence of Mr. Powell's Fed knows no bounds. The Fed is undertaking trillions of dollars of programs designed to flood the economy and to buffer it against known and unknown assailants. As a result, "capital doesn't have a price thanks to all of this stimulus," according to Rob Almeida with MFS. All of this aggressive monetary and fiscal policy continues to wreak havoc on pricing mechanisms and asset valuations, thereby damaging real long-term growth. Moreover, "the COVID-19 crisis has accelerated the trend of short-termism in investing." As illustrated in this chart, the Fed stimulus has and continues to directly impact stock market performance.

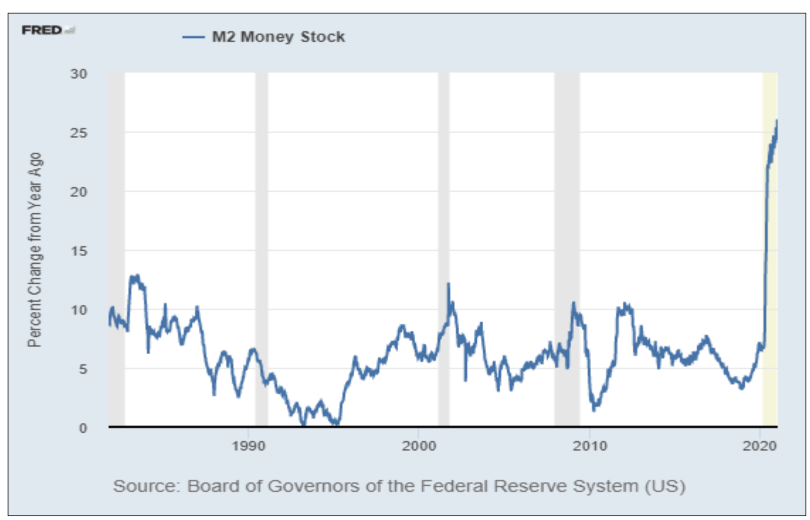


The Other Half of the Tale

Most of the stimulus and money printing went into the stock market. The rest primarily went to personal savings, bank capital, and business savings. In other words, much of the money is waiting to be deployed until the uncertainty around COVID-19 lifts. Employers are not hiring; they are conserving capital and delaying new investments. Consumers are neither borrowing nor spending. Investors are speculating rather than investing. Much like it was in 1999, day trading is popular again and average holding periods for stocks are around five months.

The resolution of COVID-19 is uncertain as new strains of the virus emerge and deployment of the vaccine moves slowly. We know from history that although it took several years, the global economy did eventually recover from the Spanish Flu epidemic of 1918. One key difference is the magnitude of total government spending today. From just before World War I until the end of the Spanish Flu in 1920, US spending as a percentage of GDP was about 10-13%. Today, 100 years later, government spending is almost five times as much at roughly around 50% of GDP.

The size of government combined with the high savings rate of consumers and businesses results in an unusual environment of extraordinary monetary and fiscal stimulus and not much inflation. Once COVID-19 passes, the economy should pick up steam as consumers and businesses begin spending again. There could be a pickup in inflation not seen since the 1970s, for at least a brief period of time.



Inflation Primer

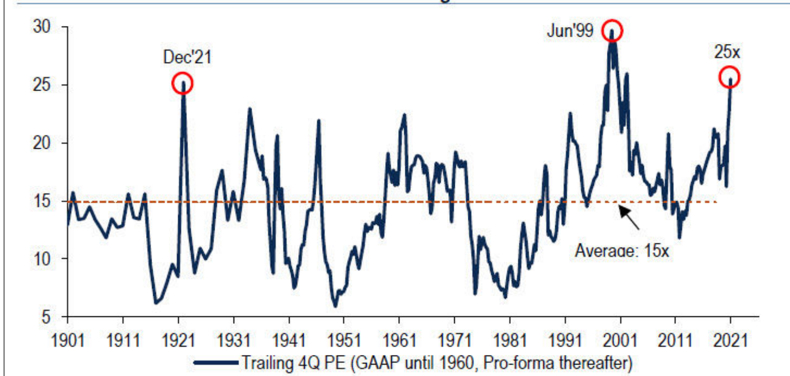
It is indeed so 1970s to talk about inflation, but are investor portfolios truly ready for this? The chart at right shows the unimaginably large amount of money on hand. For reference, "M1" is a measure of money supply that includes funds readily accessible for spending such as currency, traveler's checks, demand deposits, and other checkable deposits. "M2" includes a broader set of financial assets that are principally held by households. This includes all of M1 plus savings deposits, small-denomination time deposits, retail money market mutual funds, etc. As shown in the chart, the growth rate of M2 money supply has exploded, rising from about 6% to more than 25% in 2020.

The federal government ran a deficit of over $3.1 trillion and issued over $4 trillion in net new debt for the fiscal year ending September 30, 2020. The Federal Reserve grew its balance sheet by just over $3.1 trillion. Therefore, unlike the 2008 recession, this is not quantitative easing ("QE"), i.e., printing money to buy long-term treasuries and other debt from banks to shore up the quality of bank reserves.

In contrast to 2008, the Federal Reserve printed money in 2020 to buy debts of the US Treasury used to finance checks and forgivable loans given to Americans and their businesses. In the short term, this policy feels soothing but the medicine may be worse than the disease. What might be the long-term effect on investment markets?

Initially, asset prices would rise. Stocks and bonds now reflect an economy running on unsustainable rates of debt issuance. Once confidence is restored and people and businesses deploy their excess cash, it is quite possible we will see a brief overheating of the economy. Too much money will be chasing too few goods, resulting in higher rates of inflation. The Federal Reserve will get the steeper yield curve it seeks, perhaps sooner than expected, thereby allowing it to tighten monetary policy, reduce debt purchases, and raise the federal funds rate.

Exhibit 10: The Stock Market's Excess Valuation heading into 2021



Source: BofA US Equity Strategy, Factset.

It is not the case that inflation is always either good or bad. It is the case that inflation under control is good. As inflation moves toward the Fed's targeted levels, the stock market rises. If it moves away from target, perhaps reflecting an increase in uncertainty that Washington cannot manage, the stock market declines. Goldilocks likes her inflation "just right."

No Children's Story

All the elements of a classic tale are present: writers (our media), a dragon taking everyone's gold (Washington's "District of Confiscation"), and pestilence (COVID-19), along with the evils and redeeming qualities of humankind. In our version of the story, long-term fundamentals are every investor's Prince Charming. But today's stock market is no fairy tale. For more information on how the key characters will continue to impact investors, please look to future issues of the "The Long & Short of It." Until next time, know that we are driving carefully, stewarding your portfolio along the wild and bumpy road of today's markets.

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