CUMBERLAND
Private Wealth

Chairman's Market Commentary

April 20, 2021

Don't Worry, Be Happy

This time last year we were in a pretty dark place. The economy was being shut down, COVID-19 was out of control and the stock market was crashing. The worst was feared and the only glimmer of hope was a government recovery bill for an astronomical $1.9 trillion that had just been passed by Congress. We'd seen recessions before, but nothing like this one.

Yet, here we are today. The markets are at all time new highs. The economy has almost fully recovered in GDP. There is still unemployment, but it is improving, and COVID is still around but on the decline, unless you live in Canada.

I can't help but believe we are witnessing financial history in the making. Winston Churchill is credited with saying, "*Never let a good crisis go to waste*", and all the politicians on both sides of the boarder are fully embracing this.

Monetary policy, social reform, the environment and more are all being swept along on this ride to respond to a virus.

The immediate consequences of all this feels pretty good right now. The stock market is up, the economy is recovering, spring is here and the vaccine, at least in the US, will have us back to normal by summer. This cocktail of one part vaccine and two parts stimulative monetary policy and fiscal spending could lead to a party that gets out of control.

So, let's delve into some of this and I'll try to make the boring stuff, like the economy, either interesting or short. I'll start with the Federal Reserve's monetary policy and free money before getting into the stock market.

Federal Reserve

The Federal Reserve is in the lead on rewriting conventional policy. Historically, the Fed worked through the commercial banks to effect monetary policy. When they decided to stimulate the economy they would traditionally buy government bonds from the banks, which would create free reserves. Free reserves could be leveraged by the banks. They were allowed to lend $10 for every $1 of reserves. So, bank lending would rise. Consumers could buy a car, a house or run up the balance on their credit cards. Corporations could borrow to build a new plant or buy a piece of new equipment. It worked.

But, after the 2009 recession, the Fed initiated Quantitative Easing. They bought trillions of dollars of bonds from the banks, but lending didn't pick up. The banks kept the money to replace bad loans and investments. So the economic recovery, after the Financial Crisis, was weak. During the Covid crisis, the government has apparently decided not to leave something as important as the economy to the banks. They decided they would get the money directly into the economy by either increasing their spending or by sending checks directly to their citizens. Ben Bernanke, a former Fed Chairman, referred to this as helicopter money. The government does this by borrowing the money and the Federal Reserve gives them the money but by buying those bonds. We've never seen this before and academics refer to it as Modern Monetary Theory. So far, this experiment is into the trillions of dollars without any true understanding as to how the deficits ever get resolved. But for sure, it accomplishes a couple of things. It gets the government directly involved in the economy deciding who should get the money and how much instead of the commercial system. It also means the government doesn't want to see interest rates go up when it owes so much money. As Lloyd Blankfein, former head of Goldman Sachs, says, *"A commodity, including cash, won't be allocated efficiently if it is free. You need some kind of scarcity."*

So, the two players in this event are the Federal Government and the Federal Reserve. It's worth reviewing what they have done before getting into the results.

US Federal Government

The first major COVID response was last March with the CARES Act. It totalled $1.9 trillion and sent $1,200 to each citizen, which amounted to $275 bn and raised unemployment benefits to $551 bn. For perspective, the Labor Department estimates that unemployment benefits and personal income amounted to $550.2 bn last year compared to $27.7 bn in 2019. In January of this year, an additional $600 per person in stimulus cheques were mailed. These first two rounds totalled $438bn.

Recently, President Biden got the American Rescue Plan Act, ARPA, approved for another $1.9 trillion. It provides for an additional payment to 287 million Americans (80% of the population) of $1400 totaling $402bn.

These three payments amount to $11,400 for a married couple with two kids. Furthermore, the Wall Street Journal estimates that under this new bill that same unemployed couple would be eligible for $135,000 in unemployment benefits if they lived in Kansas and $170,000 should they live in Massachusetts.

The Biden plan also extended unemployment benefits from March 14th to August 26th. We'll come back to why this is important later.

So far, it is estimated that the total cost of the COVID relief bills is $5.3 trillion.

But the stimulus doesn't end here. The stimulus packages that have been approved get spent almost immediately, however there are other programs on the docket which are large but spread the stimulus out over several years. The most recent proposal is the America's Jobs Plan. It is represented as an infrastructure bill. It asks for $2.3 trillion, would be spent over eight years and paid for by tax increases over fifteen years. This is under debate in Congress. But, it doesn't stop here. There is a second round of spending expected that will also be in the trillions under the guise of Build Back America Better and focus on "social infrastructure " which would expand health care, paid-leave and extended child care.

In the context of never letting a good crisis go to waste, I'll quote Treasury Secretary Yellen's statement in her Senate appointment hearing, "*Indeed, the reason I went from academia to government is because I believe economic policy can be a potent tool to improve society. We can, and should, use it to address inequality, racism and climate change."*

So, these enormous spending bills that are being ushered through Congress aren't just about transitioning the economy through the Covid Crisis, this is also about social change. There is nothing wrong with that, so long as a government has a mandate. But to push it through under the cover of a pandemic response without knowing how the financial issues will be resolved is worrying.

Federal Reserve

The other half of this duo is Fed Chairman Powell. Where does he stand? On unemployment he stated "*This means that we will not tighten monetary policy solely in response to a strong labor market. In particular, we expect that it will be appropriate to maintain the current accommodative target range of the Federal funds rate until labor market conditions have reached levels consistent with maximum employment and inflation has risen to 2% and is tracking to moderately exceed 2% for some time. In other words, "Don't worry, be happy."*

And, don't worry about missing out in Canada. Last year's budget deficit is expected to be as high as $354 bn. For comparison to the US multiply everything by ten. Finance Minister Freeland, like Ms. Yellen, stated that the pandemic has created a window of opportunity for a national childcare plan and a shift towards a more sustainable economy. A green and innovative recovery plan. The government's new budget is expected to project a deficit of around $155bn in order to get the economy back on its feet. However, of the three million people that lost their jobs to the pandemic it is now estimated that only 296 thousand remain unemployed and the economy has expanded for nine straight months.

> So, what has all this stimulus resulted in?
> Well, the economy is ripping.

So, what has all this stimulus resulted in? Well, the economy is ripping. The Fed has recently raised this year's economic guidance and now expects the GDP to rise by 6.5%. That's up from an earlier estimate of 4.2%. And, they see further growth of 3.3% in 2022. Yet, private forecasters such as Morgan Stanley think the economy could show even greater strength and will improve by 8.1%.

Furthermore, the Fed sees unemployment dropping to 4.5% by year end and improving further to 3.9% next year. Inflation is seen rising to 2.4%. Yet, the Federal Reserve Open Market Committee which sets interest rates doesn't see an increase until 2024.

So, why is the economy so strong when you still have so many unemployed? A lot of it has to do with government policy. When they shut the economy down last spring they also sent people a lot of money. Some of it went into savings, but some of it got spent on stay at home type goods, not services like restaurants because they were shut down. This was a classic manufacturing recovery. Stores like auto show rooms ran out of merchandise so manufacturing was ramped up to not only meet the consumer demand, but to also rebuild inventory levels. This is generally what happens coming out of a recession and why the Purchasing Manufactures Index (PMI) expands rapidly until the inventories get rebuilt and then slows to the sell-through level. When these numbers are released, there are a number of other facts that are released as part of the survey, which gives us better colour on what is going on.

The release of the March PMI showed the index had risen to 64.7, the highest reading since Dec. 1983. Non mfg PMI (ie services) rose to 63.7, its highest reading since July 1997. The prices index rose to 74, the highest since July, 2008. The Fed Philly Region's survey provides a little more colour. It suggests that business conditions are at their highest level since April, 1973. New orders have also surged at the fastest pace since 1973 while the work week lengthened at a record pace. Manufacturers also reported a backup in UN-filled orders, slower inventory builds by their customers and more delays in supplier deliveries. The future employment index posted its highest level since October 1976, while 64% of firms reported labor shortages and 59% reported jobs/skills mismatches. They further reported input price pressers surged at the fastest pace since March, 1980, partially due to higher wages and they anticipate being able to pass higher costs on to their customers. However, seemingly inconsistent with these reports has been an increase in initial jobless claims. In total, there were still more than 18 million claiming State or Federal unemployment benefits. Yet, total job openings rose to 7.37 million, the highest since January, 2019 and the ratio of unemployment to openings declined to 1.35, the lowest level since last March when unemployment was 4.4% vs 6% today. Overall, 42% of independent businesses had openings while 19% of small business owners plan to raise worker compensation over the next three months. Furthermore, the number of commodities that rose in price or were in short supply hit record levels last month. These conditions are usually associated with an impending inflation.

For perspective, let's look at where we have come from. Last spring payroll employment dropped by 22.4 million people. Eight million dropped out of the labor force leaving 17.4 unemployed. GDP dropped 19.2% in the first half of last year then soared at an 18% rate in the second half. Employment is still 8.4 million below its record 152.5 million in February last year.

Is there some reason for the disconnect between the demand for employees and their reluctance to return to work?

So, the point I'm trying to make is that there is some reason for the disconnect between the demand for employees and their reluctance to return to work. For sure, some of it could be due to a member of the family having to stay at home to take care of children. It's estimated this could be five million people. But substantial unemployment benefits could also be causing people to stay home to collect these payments. $140,000 in Kansas for a couple probably goes along way and now that summer is almost here and benefits last until September, there is probably no hurry to get a job.

The picture this paints is a strong economy that has yet to see the services side engage, but which will as vaccines roll out. Stresses in manufacturing from supply shortages, rising commodity prices and labor shortages are likely to result in higher prices and inflation, which could be the most critical variable effecting interest rates and the market. From the Fed's perspective, they feel that inflation in the near term will be higher due to the "base effect". This is the year over year difference between last year's depressed prices and where they are today. Furthermore, they have already conceded to inflation reaching 2.4% this year and have said they wouldn't mind seeing a period of overshoot before getting concerned. Others believe that secular forces such as technology, globalization,

demographics and excessive levels of debt will contain inflation in the long term. Maybe so, but I have my doubts. Out sourcing manufacturing jobs to China may be last decade's theme. Going forward, a lot of jobs will be created in healthcare, especially caring for the elderly at home. It's hard to outsource that. Also, the Financial Crisis of 2009 threw thousands of homes on the market at depressed prices. Housing prices are, dare I say, going through the roof and will eventually back into home owner's equivalent rent, which is one third of the consumer price index. Furthermore, the Producer Price Index, which reflects a lot of commodity prices, showed the highest annual gain in nine and a half years in March. It takes a long time to build a new copper mine or steel mill. And although people may start coming back into the workforce this fall, the hourly compensation for all workers is already rising at 5.3%.

But supply and demand will also play a role in determining interest rates. Debt, which the government is relying on to stimulate the economy and accomplish its social goals is beyond anything that I have ever witnessed. The sum of all government and corporate debt is now about 2X GDP. Bonds issued by non-financial corporations rose from $355 bn in 1980 to $6.38 trillion in 2020. Year to date, the US Treasury has issued $4.1 trillion in debt, up 50% from a year ago, while globally the supply of new government debt has risen 78%. One has to ask, how does the government ever get off this treadmill without the economy falling off a fiscal cliff? Modern Monetary Theorists say don't worry, the Fed will keep buying. But the caveats is that there would be a reaction if inflation heats up. Taxes would have to be raised. Unfortunately, I don't see how raising taxes helps an economy.

On the supply side, personal savings rates are the highest since the mid 1940's. Last April savings soared to $6.4 trillion on the CARES Act distributions before falling back to $2.3 trillion in December as people were able to get out and spend. This January saw savings climb $1.6 trillion to $3.9 trillion on the distribution of the social benefits from the second stimulus bill. That leaves us with about $2.4 trillion in excess savings over base line which amounts to about 11% of GDP. Furthermore, revolving credit dropped $118bn adding even more firepower to the consumer's war chest. Maybe an even better way to look at it is through M2 which is the aggregate of all savings, currency, money market funds, etc., which rose 27.1% year-over-year to $4.2 trillion an unprecedented level.

Deposits at commercial banks that include corporations rose $2.9 trillion last year causing banks to buy $758 bn in Treasuries bringing their total to $4.8 trillion. Along with the Federal Reserve, this has helped finance the government's deficit. The trouble with this is that consumer savings short circuit the government's stimulus objectives just as the banks did after the Financial Crisis by not sending and getting the funding into the economy. With the vaccine being rolled out, services like travel and entertainment coming back and summer weather arriving, it is likely consumers will start to spend more aggressively and add to what is an already robust economy.

The Stock Market

So, where does this leave our investment strategy? Well, the first quarter treated us very well and was a nice follow up to a strong year-end finish. In Canadian dollars, the S&P 500 finished +4.9%, while the TSX improved 8.1% and the Canadian bond market declined -5.04%. However, below the surface there was a lot going on. Value outperformed growth which can be measured in a number of ways. Using the S&P indices value outperformed growth 10.664% to 0.746%. The NASDAQ, home to a number of technology companies saw over a 10% decline from its mid-February peak. And, as I said, the first quarter was a follow-through to a trend that started September 1st, last year, which has seen the value companies appreciate 18.5% while growth marked time up only 1.9%. There are a number of explanations for this divergence, but the one that probably has the best correlation and fundamental rationale is interest rates.

As measured by the 10 year US Treasury, rates bottomed at 0.54% last August and increased to 0.93% by the year end. They then moved significantly higher to 1.74% by March 31st. This increase in rates reflects both the strength of the economy and the perception that inflation could heat up. Fundamentally, it will help the bank stocks as higher rates will help their earnings and financials are the poster child for value. If higher rates correlate to higher

inflation and a stronger economy, that means good things for commodity producers and economically sensitive companies which again are generally value stocks. To the contrary, higher interest rates tend to hurt growth stocks and any long dated assets such as bonds. It doesn't effect growth company earnings, but it does hurt their valuations as most carry high price earnings valuations. These valuations are determined through discounted cash flow models and the higher the discount rate, the lower the valuation. Goldman Sachs did a study that equates a 100bps rise in rates to a 14% impact on DCF models. In fact, the 70bps rise in rates that we witnessed this year seems to correlate well with the 11% drop in the NASDAQ Composite that we saw from February 12th to March 8th. This also explains why the bond market experienced its worst quarterly performance since 1976 as the 30 year Treasury fell 15.66%.

The question we now face is whether this value versus growth competition is about to flip back in favour of growth. It could, but from our view on the economy and inflation it seems like interest rates will continue to support value. As we stated above, the economy is quite strong, about to get another jolt of fiscal stimulus and will see vaccine relief open up the service sector. Inflation should heat up even if only transitionally as workers wait for benefits to run out creating a labor shortage until at least this fall. Finally, the government is going to continue to float more bond issues, but will need even greater reliance on the Fed if banks start to sell their treasuries to make loans.

Furthermore, growth hasn't had any kind of a setback, so it is still expensive. The elite eight which includes the FANG stocks still trade at 40X earnings. For context, the S&P 500 trades at an elevated 22X forward earnings. That is expensive and one has to hope this is resolved through continued earnings growth which is what is now expected. But that growth is likely to come from the more economically sensitive companies. Value on the other hand has outperformed for only seven months after underperforming for thirteen and a half years, the longest stretch on record. Previous underperformance was during the tech bubble from 1998 to 2000 and before that, the second longest underperformance was the biotech bubble in the early 1990's that lasted 3.8 years. And finally, there was the devastating period for value in the early '70's when the "Nifty Fifty" took charge. So, I'd give value the benefit of the doubt right now.

As for the market generally, we might start looking out for a correction. Working against this caution is the enormous amount of liquidity that could come into the market. Some of the money from President Biden's latest bill will find its way into the equities. But as we proceed through the summer and the economy picks up further, liquidity will have to come from somewhere if there are no more cheques from the government. Historically, it comes from financial assets. Furthermore, as you get closer to 2022, the prospects aren't as compelling as they are now. You're likely going to be looking at tax increases. They are already built into corporate earnings forecasts of roughly $20.00 per share but I'm not sure there are not more on the way. The economy could overheat and inflation could move higher than the Fed antipicates, and I would expect Powell to do an about-face as he did in January, 2019 when his rising interest rate policy caused a dramatic stock market sell off. His last two policy changes have been market driven and a bad reaction in the bond market to higher inflation would force him to act.

You will also have the prospects of the current government losing some seats in Congress which traditionally happens in off-year elections. You could then return to a more divided agenda and less likely stimulation.

So, we'll stay with a value bias and remain somewhat cautious as we move through the summer.

Gerald R. Connor
Chairman

Credits:	Yardeni Research
Ned Davis	John Aitkins
Grant's Interest Rate Observer	Wall Street Journal