



On the Radar Screen

- 1. Household consumption has surged in 2021.** The trajectory from here is unclear. Will sales hold at elevated levels roll over as direct stimulus fades further into the past?
- 2. Millions fewer people are working today than pre-pandemic, yet employers report significant difficulty filling positions, implying frictions are present.** How this is resolved has implications for both inflation and growth potential.
- 3. A surge in demand fueled by both the reopening of the economy and extraordinary policy support has run headlong into supply constraints.** The speed with which these can be resolved will speak to whether the inflationary pressures currently evident will be transitory or more enduring.
- 4. The Federal Reserve Bank's ongoing reaction to inflationary signals** as they arrive will have a profound impact on both economic activity and capital markets

Asset Solutions' Portfolio Managers

“Longer term, the Fed, like most other central banks, must confront the vexing problem that the interest rate necessary to prevent asset bubbles from frequently forming may be higher than the rate necessary to keep the economy near full employment.”

– unidentified analyst at BCA Research

Watermelon Sugar. So here we are, COVID new infections, hospitalizations and deaths are down some 90% from their wintertime apex as an ever-larger percent of the population becomes fully vaccinated. Most businesses are open, and consumers are fully engaged propelling record economic output and a new peak in both corporate profits. Job availability is at an all-time high, according to the Job Openings and Labor Turnover Survey (JOLTS). Consumer confidence has levitated back toward pre-pandemic levels.

Gross domestic product (GDP) is widely expected to grow at its fastest pace since the early '80s, excluding the print from the third quarter of last year when reopening following springtime lockdowns produced chart-busting numbers.

Yet for all this, government policy remains very much in emergency response mode. Overnight lending rates are pinned near zero and the Federal Reserve Bank is purchasing roughly \$100 billion in marketable securities every month, flooding the financial system with liquidity. Large scale deficit spending is firmly entrenched as some American Recovery Act programs—e.g. supplemental unemployment benefits—are still operational. Bipartisan agreement appears to have been reached on a massive physical infrastructure bill, and Democrats in Congress are intently focused on passing a still larger social infrastructure bill via the budget reconciliation process later this summer.

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All this money needs to find a home somewhere. Through this prism, it's perhaps not surprising to find record-setting house price gains, stocks at their all-time highs, and bond yields not far from historic lows. While all this may sound virtuous, it comes at a potentially steep cost in terms of potential consumer price instability and capital market disruptions.

Generalized inflation: excess money creation leads to excess aggregate demand, which drives up the price of everything, not just certain things. The supply of money in the U.S. has swelled by roughly one-third since the start of the pandemic. It would be hard to argue that the absolute volume of goods and services produced by our economy has risen by the same amount. If all dollars are spent purchasing all goods, then the arithmetic implication of money growth outpacing growth of goods production is that it would require more dollars to purchase each good—the same goods are manufactured and consumed, but more dollars are used to pay for them. That's inflation (demand pull inflation).

Of course, that's not how it actually works. Our fractional banking system recycles money at a varying rate known as the velocity of money. Overtime, the velocity has declined, meaning a considerable amount of money is effectively parked idly on bank balance sheets. However, multiple sources of price pressures are growing in the economy. And rising prices resulting from both demand-pull and cost-push sources are increasingly visible among a wide range of products.

A fierce debate is being waged. Will these rising prices prove to be transitory pressures stemming from lockdown conditions or something more enduring. If the latter, this is a significant risk to capital markets in two respects: 1) the present value of future cashflows (e.g. the return of principal on a bond or the more distant earnings of a fast growing technology company) erodes significantly, and 2) the Fed may need to tighten policy to curb price instability, increasing the cost of capital, thereby retarding business activity and potentially pushing the economy into recession. As such, the evolution of inflation expectations is likely to be the predominant driver of capital markets over the next several quarters.

“The definition of a bubble is when people are making money all out of proportion to the knowledge upon which the investment decisions they are making are based.” – Jared Dillian.

It's not just the prices of goods and services that rise in an inflationary environment, but also the prices of capital (houses, art) and financial (stocks) assets too. 2021 has seen some pockets of extraordinary speculation. SPACs, NFTs, crypto-currencies, and meme stocks have been driven 'to the moon' at least in part by surplus liquidity. The hazard is that these prices will return to earth in rather painful fashion once that excess liquidity fades.

Let's focus on the last of these, meme stocks, to illuminate the potential danger. Meme stocks are those of a group of companies that have seen their price rise meteorically not in response to company performance, but rather after being hyped on social media platforms such as Reddit. GameStop is often perceived as the original

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meme stock, but AMC Entertainment (the theater chain, not to be confused with AMC Networks, the content producer behind The Walking Dead) makes for a still more illuminating example. The traditional movie theater business has for years been seen to be in structural decline as new technologies and changing consumer preferences eat into box office sales – streaming is winning the day. AMC has until very recently been flirting with bankruptcy, but after catching the attention of the Reddit-crowd, small investors have driven the market capitalization toward \$30B, a 60-fold increase year to date! Jeremy Grantham, a legendary investor and noted bull market skeptic, has described this kind of meme-based investing as “a totally nihilistic parody of actual investing” and the “biggest U.S. fantasy trip of all time.” We lack the courage to employ such bold language ourselves, but the sentiment is one we share. There are segments of the investment universe that look prone to extreme disruption. But to find out just how far beyond AMC Entertainment they extend, we will have to patiently wait.

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