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Risk Commentary: Massive Disconnect (July 2021)

The Disconnect

All around us are indications of rising inflation: labor shortages, material price increases, and delayed product deliveries. A tangible indication is the housing market, which has seen steady price increases across the board. Regarding overall inflationary expectations, the Federal Reserve Bank of St. Louis via its FRED service provides a summary of inflation expectations and the 5-year forward rate is currently approximately 2.1% as can be seen in Figure I below. Also, as can be seen, the rate has been rising since a low near .89% as of March 2020. Meanwhile, the 5-year Treasuries are currently yielding only .89% as can be seen in Figure II. So, there you have it: holders of the risk-free U.S. Treasuries are losing approximately 120 basis points over five years. Furthermore, if one believes the real inflation rate is greater than 2.1%, which it probably is based on the typical citizen's housing, clothing, and food prices, the loss is greater than 120 basis points. (Figure II sourced from Macrotrends.)

Figure I: 5 year, 5 Year Forward Inflation Expectations

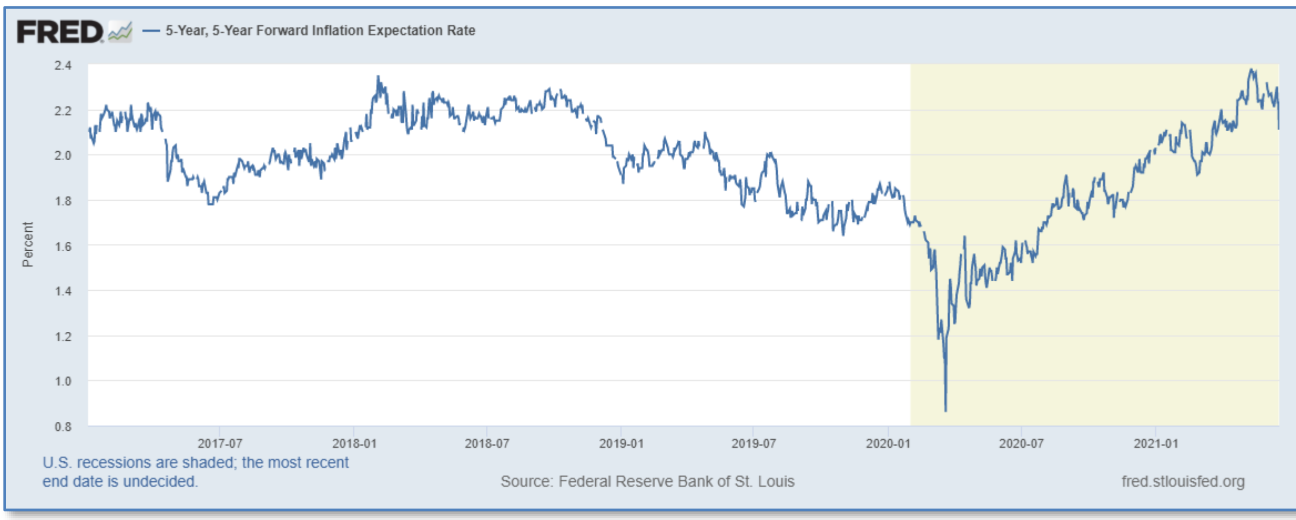

Figure II: 5 yr. Treasury Yields

Before attempting to explain this phenomenon, it is probably worthwhile considering where this condition has left some particularly vulnerable sectors. In the case of the money market industry, firms simply cannot make enough from investments to cover expenses, let alone provide a reasonable rate of return. Hence, if conditions do not improve soon, watch for a shrinkage of sponsors.

Impact of the Disconnect

The markets are not operating normally; interest rates typically reflect overall inflation and currently they are not. Regarding the underlying reason for the disconnect, in our opinion the elephant in the room is the central banks. The banks have created a massive amount of new currency and used that currency to suppress interest rates. To provide some perspective, the Fed's balance sheet has ballooned to $8T, and a good portion of those funds have been used to purchase Treasury securities with the result being suppressed rates. Nothing new with the QE (quantitative easing) process other than the fact that inflation is now kicking in and the market disruption is exacerbated. The underlying reason for the central banks' QE has been an attempt to make capital more affordable and accelerate the recovery (with a significant additional benefit of making sovereign debt more manageable). Turning to possible harm stemming from suppressed interest rates, one obvious concern is speculation as the cost of establishing and maintaining positions is lower than normal. Another risk is one of fueling inflation, which is the concern of many market observers currently. Lastly, there is the loss of key segments of the financial system such as money market funds and other providers of short-term credit for corporate obligors which cannot support the cost of operations from the low yields. Below is a summary table:

Figure III – Potential Impact of Continued Interest Rate Suppression

	Commentary	Consequences
Inflation	Increased demand overwhelms supply	Social unrest
Asset Bubbles	Increased asset prices are easier to finance	Investment in non-productive assets; pain when bubble breaks
Restricted Access	Low risk assets push out higher risk assets	Under-investment in productive assets
Interest Rate Rebound	Rebound in interest rates as investors question policies	Increased burden on obligors

Collectively, all the developed countries are facing similar risks and are struggling with the best set of policies to address the problems. Perhaps in retrospect, QE and Modern Monetary Theory will be viewed not so much as a solution but rather as a temporary fix for perplexing problems. Hopefully the situation remains manageable although social unrest typically follows periods of economic instability. Perhaps the country at the forefront of this issue is Italy, which has been hard hit by COVID and will probably need some support from the EU to make ends meet. (To date, the EU and ECB have been supportive.)

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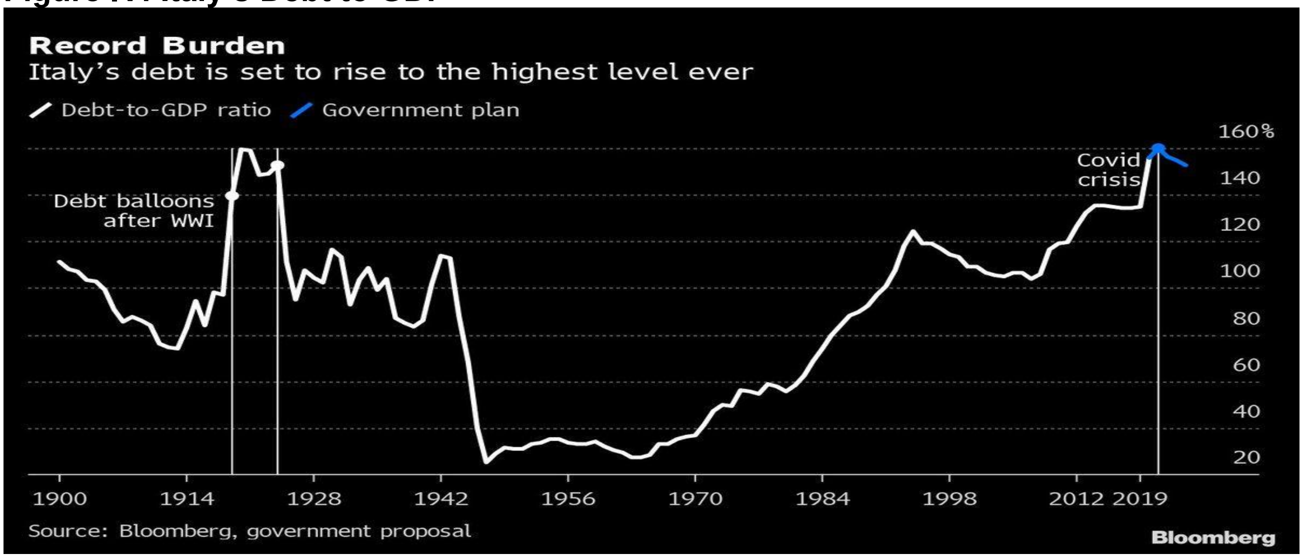
Figure IV: Italy's Debt to GDP



Inflation

On to other aspects. On the inflation front, it is comforting that lumber prices have broken back although remain elevated: Likewise, copper prices remain elevated.

Figure V: Lumber Futures Price

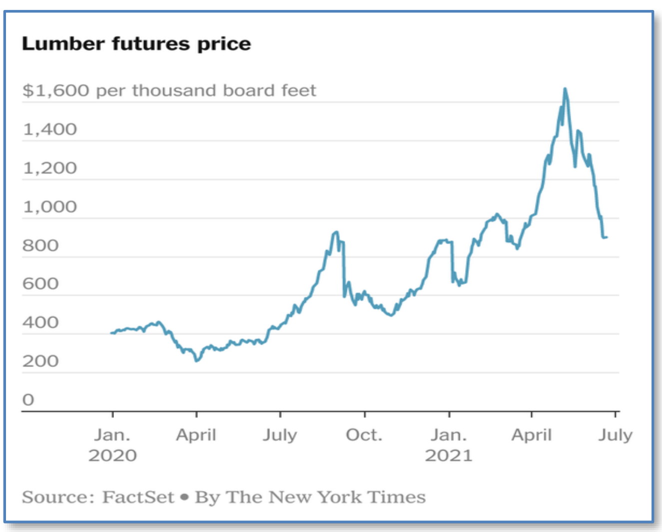
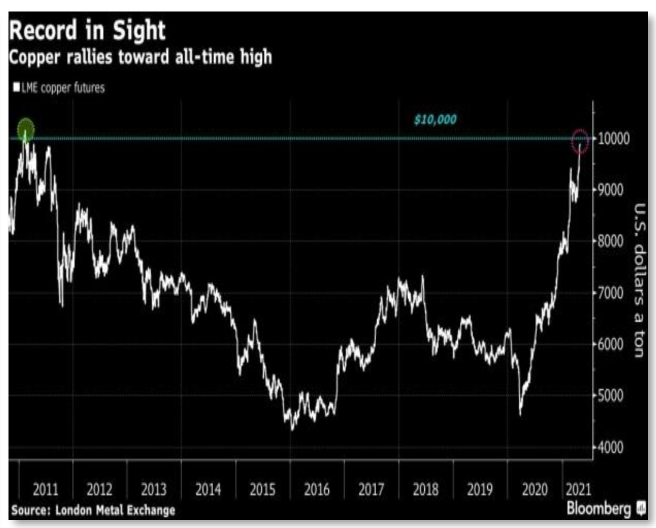


Figure VI: Copper Prices



There is little that has not changed over the past 90 days such that many market participants are only beginning to grasp the breadth and depth of the changes. On an optimistic note, it appears the brunt of the recent COVID19 infections are behind us (at least domestically) and that most of the economy is beginning to open-up. On the negative side, the new Delta version of COVID appears particularly pernicious, interest, taxes, and possibly inflation rates are higher which is likely to create headwinds for most businesses. Bellwhethers for the change are (i) prices for copper, which is used in many manufacturing operations, particularly housing, and

(ii) overall futures prices. In the case of copper, as can be seen in the above chart, prices are at a ten- year high. Taking measure of the recent changes, we have organized the below chart which might be helpful:

Figure VII - Changes in Major Market Forces

	Result	Inflationary	Deflationary
COVID Recovery	Increased Spending	Yes	
Central Bank Quantitative Easing	Suppressed Interest Rates	Yes	
Increase Social Spending	Increased Spending	Yes	
Increased Taxes	If passed, only partially offset higher spending		Yes
Rising Deficits/ Indebtedness	MMT Concerns	Yes	

Assuming we have properly identified some of the major forces driving the market over the next couple of quarters, it appears those forces leading to increased inflationary pressure outweigh those on the deflationary side. Hence, perhaps the recent rise in interest rates is here to stay. A major assumption in the above chart is whether the current administration is going to continue its approach; our view is that despite the protestations of the Republicans, the current administration is likely to be remembered as one of the most progressive since FDR and will succeed in advancing a variety of pro-spending legislation. For those Milton Friedman followers, the expansion in currency beyond the growth in the economy, normally results in inflation. ***In retrospect, the first few quarters of 2021 might be remembered as a major inflection point in the economy***.

Prospective Changes

So where does that leave us? Time will tell, but our suspicion is that for every action, there is a reaction. If one country is printing currency faster than others, the profligate's currency over time will slip, adjusting for differentials in productivity and investment flows. Unfortunately, some countries are rapidly approaching an inflection point whereby it is increasingly obvious that debt cannot be repaid via normal sources. Japan appears to have reached that point long ago but has been saved by the low need for external capital. Italy appears to be approaching the event horizon (i.e., the point in a black hole where nothing, including light, can escape) but currently has the support of the ECB (see the return of Mario). All this discussion is interesting but perhaps the more relevant point is market sentiment; one can be right on the fundamentals but wrong on the timing. Periodically, the markets deliver such a reminder with the latest example being the burning of short sellers of a few high-profile stocks. Nonetheless, normally the fundamentals win and therefore it may be wise to bear them in mind but to watch the madness of the crowds. Below is a summary of our expectations for the various economies:

Figure VIII: EJR Normalized Economic Expectations (next 12 months)

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	2.0%	2%	4%	5%	6%
Stimulus Change	Moderating	Slight Rise	Moderating	Moderating	Little change
Earnings Trend	Slight Rise	Slight Rise	Slight Rise	Rise	Rise
Interest Rates	Negative	Negative	Low	Low	Varied
Asset Valuations	Flat	Flat	Varied	Varied	Slight Rise

Regarding interest rates, the EU countries and credits cannot afford significant increases in rates. The periphery EU countries (e.g., Italy) are likely to see continued pressure because of increased credit quality concerns. Regarding trends, we had expected a slight rise in rates as economies recover but the market turmoil and central banks' money creation are depressing rates.

Figure IX: Current and Expected Interest Rates

	5 year		10 year		30 year	
	Current (%)	Year End (%)	Current (%)	Year End (%)	Current (%)	Year End (%) *
United States	0.81	0.88	1.62	1.58	2.3	2.36
Germany	-0.59	0.03	-0.209	-0.02	0.294	0.39
Italy	0.07	0.19	0.793	0.95	1.818	1.96
United Kingdom	0.33	0.43	0.71	0.85	1.23	1.40
Japan	-0.10	0.01	0.035	0.11	0.676	0.73

Source: https://tradingeconomics.com/bonds
https://www.bloomberg.com/markets/rates-bonds/government-bonds/us
*expected to trade in 12-month time

Below are our expectations for major currencies:

Figure X: Currency

	Current	EJR Est. Year End
USD-EUR	1.19	1.25
Yuan to Dollars	6.47 $/RMB	6.45 $/RMB
JPY-USD	111.5	109
USD-GBP	1.38	1.32

Source: https://www.x-rates.com/table/?from=USD&amount=1