FINANCIAL FOCUS

PETERSON FINANCIAL SERVICES

Limited Liability Company ◆ Registered Investment Advisory Firm

First Quarter 2021

April 1, 2021 – no foolin'

BOTH FISCAL AND MONETARY POLICIES ARE AT ODDS WITH MARKET SIGNALS.

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QUARTERLY MARKET RECAP

The inaugural quarter of 2021 continued to be volatile but definitely made headway. Some of the sectors and individual stocks that led last year's markets fell out of favor in a sector rotation. For the last quarter, the DJIA advanced 7.76%, the S&P 500 gained 5.77%, the NASDAQ lagged a bit adding 2.78%, and small-caps continued to lead as the Russell 2000 rose 12.44%. But this was contained to value issues, as growth stocks sold off. Foreign equities picked up 4.52%. The big news for the quarter, and this quarter's topic, is the Federal Reserve's tin ear to market signals regarding inflation concerns. With interest rates set to zero and the Fed stating they'll continue that regime and announcing they're essentially unconcerned about inflation, fixed income losses were substantial as long-term rates rose, with the Barclay's Aggregate Bond Index diving 3.52%.

With the previous administration's marginal tax rates and basic regulatory structure still in place – at least for now – the employment situation continues to recover, albeit at a slowing pace, with the unemployment rate for February at 6.3%. This policy foundation will likely reverse with the power shift in DC.

The pandemic front is brightening with lock-downs easing as cases decline and vaccines being administered on a widespread basis.

DISCONNECTED POLICY MAKERS ARE STILL IN CRISIS MODE DURING A NICELY STRENGTHENING ECONOMY

There comes a time when the monetary and fiscal levers that were pulled during dire risks need to be scaled back before they do serious long-term damage. We are now at this point, and the recent market action is warning our policy makers of this, if they'll pay attention. So far, they aren't.

The large tech growth companies that provided stellar gains during last year's recovery from the Covid Crash into the first half of the first quarter, have reversed course in a sector rotation that is still playing out. This is due to the markets not believing the Fed pronouncements that it can continue quantitative easing and zero interest rates but not fuel inflation. On top of that, after just passing another $1.9 trillion spending blowout, on top of 2020's $2.7 trillion crisis spending (which itself was on top of the already-allocated $4.5 trillion budget), President Biden is getting ready to propose another $3 trillion infrastructure and green energy spending extravaganza. There is very little concern in Washington as to how any of this will ever be paid back. The markets are flashing warning signs about that.

The federal deficit in FY 2021 will be over $4 trillion and 18% of GDP, *without* this next $3 trillion. This is by far the highest since WWII. Historically, investors can finance about 4-5% of GDP, so the Fed is doing the rest. However, the low demand during the February and March auctions are flashing warning signals. Who else is going to buy this mountain of debt?

The $1.9 trillion "Covid relief" bill was un-necessary and mis-identified. Only 8% went to actual virus mitigating efforts, as the rest went to pet constituency payoff pork – 92%! GDP is expected to grow 7.2% without it – if the politicians don't raise tax rates, which may very well happen. If they do, we won't see that level of growth and unemployment will rise. As it is, employers can't find enough employees, so the economy is doing fine if we just stop paying people not to work. And to make matters worse, the wealth tax that we've been warning about for a decade is now being seriously considered. This is ill-advised, anti-free market, and backfired on European countries when they tried it, prompting them to quickly reverse course. Market-killing capital gains tax increases are also on the table.

All this has led the 10-year Treasury note yield just this year to skyrocket from sub-1% to as much as 1.7%. This is a massive percentage increase and has cratered fixed-income values and led to a sell-off in growth stocks – notably large tech stocks which rely on future earnings growth. Feeding the politician's spending addiction, the Fed has said it will keep buying Treasuries as long as the political class keeps issuing them. Senior bond trader Daniel Mulholland of Credit Agricole says the size of Treasury debt auctions "are completely out of control." This is ill-advised. The markets are getting nervous.

Fed chairman Jerome Powell has gone to extraordinary lengths to keep bond yields low, but the bond market keeps raising them. What does he make of that? The obvious conclusion is that investors are seeing the combination of organic economic recovery (if not interrupted by growth-stunting changes in policy), loose monetary policy, and irresponsible massive government spending leading to higher inflation expectations. Data on producer price increases from the beginning of this year are at a post-2009 high, just off the credit crunch.

Asset and commodity prices have soared, with metals, food, housing, and cryptocurrencies rising at substantial rates. Even oil prices have rebounded in anticipation of a resumption of normal economic activity, though they have recently backed off. This is not a global economy in need of continued emergency-level stimulus, but we're injecting the addict anyway. More evidence is that there has been a phenomenal 26% increase in M2 money supply. This, too, risks inflation.

So, our question is, what makes the Fed so sure that inflation can be contained in the 2% range for an indefinite period of time in the face of all this monetary and fiscal stimulus? What laws of economics have been repealed that would support that notion? And if inflation does start to escape its cage, what will the Fed do about it? At what point will they realize they've reached the level where action needs to be taken?

Up to now, the central bank had a 2% consumer price inflation target ceiling. But now, they've announced this as merely a "average inflation target" that can be pushed around. This may give them more wiggle room to save face when inflation takes off, but it won't help the economy. Powell views this as a promise to "look through" upcoming periods of inflation to compensate for previous periods of below-target inflation. Just how far will he 'look through" future inflation data? When will he know when he's reached that "look through" period limit? Will the Fed then be able to control it? History suggests otherwise.

All of this will sound just fine to a Congress that has no spending discipline and an administration that views government as the provider of prosperity. But the markets aren't fooled. And we'll all come to regret this if it is allowed to get beyond the point of reigning it in. We're getting close to that. If the ruling political class piles on another $3 trillion of additional spending, the central bank keeps the money spigots wide open, and the public's appetite for buying all this debt really drops off, we'll be in for real trouble.

"It is so easy to be wrong – and to persist in being wrong – when the costs of being wrong are paid by others." - *Dr. Thomas Sowell*

ABOUT PETERSON FINANCIAL SERVICES, LLC

As an aside, we wish to remind our clients of our various services. While we've specialized in portfolio management over the last several years, we continue to provide financial planning and insurance services. Longtime clients may have forgotten this, and newer clients may not be aware of this. Additionally, we build our business through referrals, and much appreciate them. Please keep us in mind as you come across friends, family and colleagues who might benefit from our financial services. We appreciate your business.

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