Inflation, Rates, & Everything Else

In a world where Jack Dorsey's first tweet as an NFT is bid at a value of at least $2,500,000, anything is possible. My first reaction was, that's crazy, but as I think about it, why not? Twitter has been transformative to many. My almost 25,000 followers have had an impact on me. It shapes finance, influencers, and even presidential elections, so why not? I'm not sure why baseball cards are worth X, or why certain pieces of art (especially modern) are worth what they are worth, so why should this be any different?

But I'm digressing from today's attempted goals:

- An assessment of **inflation**, the risks, and the outlook.
- Translating that to a view on **rates**, both domestically, but globally as well, as foreign bonds and the reduced foreign demand for U.S. bonds are helping to move markets.
- What that means **for everything else** as the Treasury market is driving everything.

Inflation

Without a doubt, current inflation, along with inflation expectations, have been rising. So far, the Fed seems completely unconcerned, maybe even dismissive about inflation. Markets have not liked that.

Transitory. Since there is no denying the recent rise in inflation, the first stop is the **"transitory" argument**. Don't worry about inflation, what we are seeing is transitory. There is a lot of merit to this argument and it is the direction I'm leaning**.**

- **Easy comparisons**. For the next 6 to 9 months, we are comparing data between an economy that is re-emerging from periods of total lockdown. It is completely logical that almost any year on year comparison is going to be better and inflationary. Heck, last April, the front oil futures contract briefly traded at negative prices. The current front contract, the April 21 contract, is trading at $66, a big jump. But it is important to remember, that even with the excitement of negative prices, this contract (last April) barely traded below $30. So even then, at the worst of the oil glut when storage was overwhelmed, the outlook for a year down the road wasn't as bleak. So, as we push through time, say next April, these easy comps could **become difficult comps** as the year on year starts to reflect a normal economy versus one that was surging out of a lockdown. I chose oil, but many commodities and almost **every piece of economic data will follow this pattern.**
- **Supply disruptions will ease.** Companies are scrambling to catch up to the surge in demand. Supply chains were affected across the globe and in many cases are still not fully functional. Factories were shut down. With just in time manufacturing, all it takes is one or two parts of the chain to fail, before the disruptions are severely felt. It takes time to fix that. It is happening, across the globe, but will take time. Baltic Dry, a measure of shipping costs (though I view it as a dubious measure at best) has been rising as the economy gets back to business. Story after story of price increases from China are hitting my desk, which makes sense, since China was the dominant supplier to begin with and was the first economy to start emerging from the pandemic. Finally, I believe that many companies will shift their supply chains, but that process has barely begun, as we first need to get through the crisis, before we can start fixing things.

- **Current Stimulus.** I think in the coming days, the market will **weigh this stimulus bill and find it wanting**. One time checks are the very definition of transitory. I find very little beyond 'band-aid' stimulus in this bill (from what I have gleaned from reports as I'm not about to read 700 odd pages of this stuff, which seems fair given many of the people who voted for or against it didn't read it either). **Job creating stimulus will be inflationary**. That was not what this bill was about. I think we will, sadly, get very little "bang for the buck" on this bill, which will let the market quickly settle on the fact that it is transitory in nature. More on the next stimulus in the next section.

Overall, I remain skewed to the view that much of what is showing in current inflation and even creeping into expectations is transitory.

Longer Term Inflation Pressures

So, I am convinced that for the next 6 months to a year, we should see higher inflation, but what happens then? What drives inflation after that?

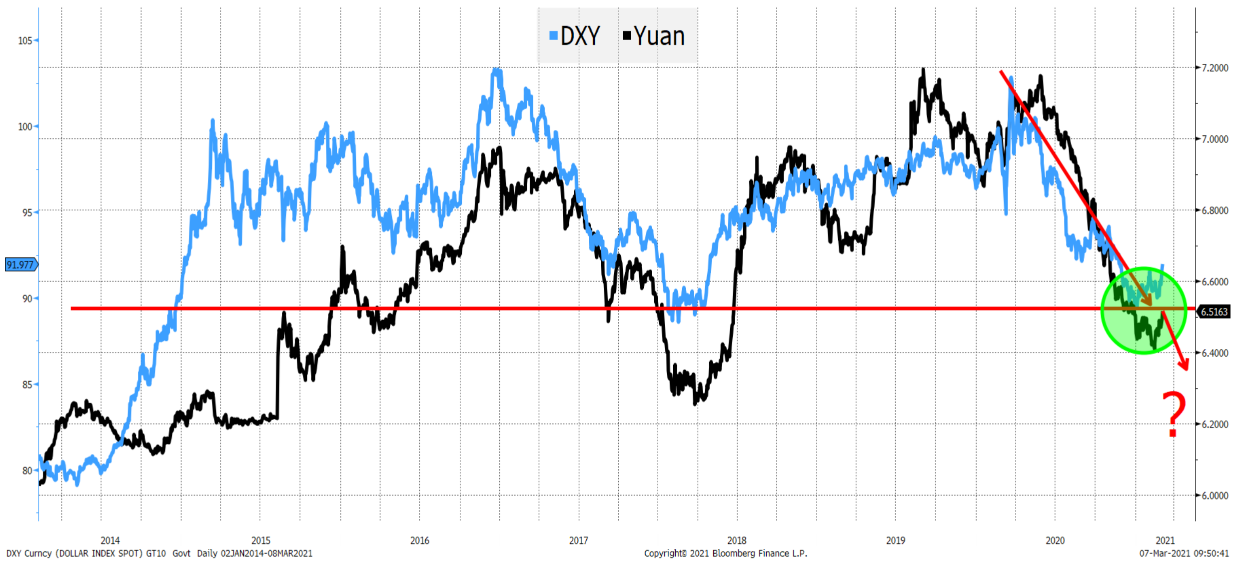
- **Job Creating Stimulus.** We need to move to the next wave of fiscal stimulus, and I expect we will. Having said that, I am increasingly nervous, based on what has gone on in the past month. Rather than highlighting all the good that I think can (and will) come, I'll highlight my doubts:
  - The current stimulus took a **long time to pass**, especially considering it never went down the bipartisan route.
  - **The price tag is high** and is already receiving some backlash, which could impact the size of the next stimulus.
  - I struggle to characterize the spending as "well targeted". The more inefficiencies that creep into bills, the less we get.
- **ESG Induced Inflation**. I don't think that the inflationary pressures of ESG get enough attention. I use the ESG term here very broadly, but with an eye towards the social and qualitative side even more than the sustainable side.
  - **If it was the cheapest way to produce goods, companies would already be doing it**. From a practical standpoint, companies are constantly looking at how to lower their production costs. If they had decided that the investment in new manufacturing techniques had a really positive NPV, they likely would have done it. So, as companies shift how they produce goods (and services), their costs are likely to increase. Over time, as efficiencies occur, those projects might be NPV positive in their own right (certainly that is the goal of many public policies), but for now, the evidence points to that not being the case yet.
  - **Certain places produce goods cheaper for the 'wrong' reasons**. As companies examine their supply chains (or, more accurately, as investors force companies to examine their supply chains), it will be clear that some cost savings come because workers aren't treated the same way that they are treated in countries like the U.S. Maybe they are treated well, but maybe not? Maybe the competitive advantage of some areas comes down to skimping on environmental concerns? Maybe no one cared if it was someone else's pond getting polluted, but maybe we now care if coal fired plants are providing

the power. Either production gets shifted, and costs go up, or those areas try to change their behavior, which will cause costs to rise, and some will be passed on.

- **Two things need to happen for ESG induced inflation to be large enough to impact markets**:
    - **Consumers have to be willing to pay more for ESG friendly products**. If one company can sell their ESG friendly widget at a higher price than a non-ESG friendly widget, then they will go ahead with it, because they can pass on some (or all of their costs) to the consumer. There is evidence that consumers are willing to pay more for ESG friendly goods and if that continues, or even accelerates, it will be inflationary because the consumer (not the company) bears the higher cost of manufacturing.
    - **Investors have to be willing to pay more for ESG friendly companies.** If, over time, there is a noticeable difference in PE ratios (or some other obvious metric) between companies viewed as ESG friendly and those that are not, then companies will accelerate their shift to ESG, as investors will basically bear the increased cost of production/service delivery. Companies can afford to make less, if shareholders reward them significantly more for every ESG friendly dollar earned vs for every non-ESG friendly dollar earned. **I'm not sure that this is inflationary in a classical sense**, but it smells inflationary to me. I characterize this behavior to the Debt Diet many companies went on. Companies didn't go on the debt diet to help creditors; they went on a debt diet because the equity market was punishing them for the debt. Companies will do what they can to increase share price and as the amount of money earmarked for ESG investing surges globally, companies will position themselves to benefit.
    - **Two more thoughts on ESG.** Since I opened the floor to ESG discussions, based on my view that it will contribute to inflation, I should describe where I see ESG investing headed. **These thoughts explain how I would position my portfolio for more ESG fund flows.**
        - **Best of Breed.** I lean towards a world where ESG investors have a wide range of industries (and choose from the best in those industries) from an ESG standpoint. That is different than a view where some industries are inherently ESG friendly and others are not. I may not be right in this view on direction of ESG investing, but it is the approach I favor, and think will win.
        - **Where You are Headed, Not Where You Are.** If I have one wind farm, I'm pretty ESG friendly. If I make most of my money getting oil out of the ground, then maybe I'm not? But I think this is what is going to shift. **Big companies, maybe not the ESG leaders of today, may be the ESG leaders of tomorrow.** Companies with established histories of strong management, the know-how and the skills to make "stuff" on a global scale are adopting ESG rapidly and many have legitimate paths to being extremely ESG friendly in the future. That vision will be rewarded, if I'm correct.
- **China as a Domestic Consumption Economy.** Is China allowing its currency to strengthen because they are increasingly a domestic focused economy and as an importer of raw materials, they see the net benefit of a stronger currency? Is China raising export prices because exports are a declining part of their economic plan? Is China flexing its muscles in the South China Sea

and increasingly jabbing the global community with a stick over Taiwan because they don't care as much what we think or do as they shift towards a domestic consumption economy? China, truly becoming a domestic consumption led country would be massively inflationary. It might not be happening, but there are signs and it is their stated goal, so betting against it might not be wise.

- **Rising India.** Of all the emerging market countries (many already see India as already having emerged), India could spur global inflation like the rise of China in the 2000's. I do not have a strong opinion on this, but it is coming up in conversations with more frequency.
- **Dollar Weakness.** I remain convinced that dollar weakness is structural. Yes, DXY has rebounded significantly, but that makes sense, since my view that the dollar weakness is structural is tied to my view that U.S. yields will remain suppressed.



I do see a path to sustained inflation.

Rates

Whenever I think about rates, especially when they are "headline grabbing news" and whipping markets around, I try to do a few things:

- Repeat, **Don't Fight the Fed**, over and over.
- **Bang my head into a wall**, to remember how that feels.
- Repeat, **Don't Fight the Fed**, over and over.

The Fed wants inflation!!! So, for bond bears, getting higher inflation is what the Fed wants, so from that respect, you are not fighting the Fed. But the Fed also wants low yields, so you might be fighting the Fed. My view is that the Fed has been happy to let some air leak out of the stock market, especially since it is primarily the most "bubblish" sectors getting hit (a nice mention in Barron's Up and Down Wall Street).

The Fed will not change their view on Fed Funds any time soon. They will have many reasons to justify sitting on zero for Fed Funds for the foreseeable future.

- **Say it is transitory**. They are already saying it, but not convincingly, especially since we all have the same data and their transitory argument doesn't seem to be based on better data than someone else's "inflation run amok" analysis. That is especially true when we knew their starting position was going to be 'transitory' no matter what.
- **So what?** That is the next line of defense and will translate directly into **no rate hike talk.**
  - First, they are going to admit, for a variety of reasons, 3% unemployment is their target. The **Phillips Curve** is as popular at the Fed as [insert something not popular, like a porcupine at a balloon factory] because it hasn't worked and no one believes that it represents the current state of the economy or labor market. I still have a visceral response to things like the Taylor Rule. It isn't a rule, it is at best a somewhat educated guess, based on certain sets of circumstances, that seemed to work out reasonably close enough, often enough that it deserves some attention, but was in no way, shape or form a "rule", at least not in any other scientific discipline!!! (ahhh, deep breath).
  - Second, they will talk about **3 year averages**. That they are really thinking about inflation over very long-term averages and given the lack of inflation we've had, they will be extremely comfortable not responding.

That leaves me with the conclusion that no change (or even hint of change) to their policy of no rate hikes for years.

What About the Curve? This is far trickier as there are limitations to what the Fed can do to impact rates the further away you move from Fed Funds.

- **Operation Twist**. I doubt it happens at the March meeting (but that depends on if rates move another 30 bps and cause havoc in the equity markets, which could happen as we are entering the sell "what you can", not "what you have to" phase. People prefer to sell things that are unchanged vs those positions that are already down 20%, which is how the tech wreck would spread. **This is the easiest thing for the Fed to do as it isn't viewed as QE**. The Fed views QE on a notional, rather than duration basis. So, selling a bunch of 2-year and shorter bonds to buy a bunch of longer dated bonds, is not QE, and is neutral from a "notional" perspective, even if it takes a lot of duration out of the market. It won't be as effective as last time, largely due to the composition of the long end, but that is for another time and a deeper dive into this subject! There are some technical issues at the front end of the Treasury curve, so this would actually be welcome there too and **kill two birds with one stone.** I think the idea makes sense, and the only reason it might not get done in March is a fear that they will have caved in to the bond vigilantes (yes, that is a thing again), too quickly.
- **Changing their ongoing buying**. I could see them shifting their purchases to the long end, especially if they implement Operation Twist, but I doubt they bother. I would be surprised if they added to their purchases unless something goes awry from here in a material way (10-year above 2% for example).
- **Yield Curve Control**. Doubt it happens. As someone who makes some part of his living from trading Treasuries, I really hope it doesn't happen. **Talking about it could happen.** They would only talk about extending to a year or two. They would frame it as providing clarity and conviction in their Fed Funds guidance (rather than telling us that they know where things

should be priced better than the market). It would scare the heck out of the curve. As we've seen with virtually every "non-traditional" policy implemented since the start of the financial crisis, it is easier to bet on those policies expanding than ever being scaled back. If they know where 2 years should be, why not 5 years? If 5 years, why not 10 years? Japan has already implemented targets on its longer dated bonds. **I do NOT think we get yield curve control, but I expect to be reminded that it is in their toolkit.**

Bottom Line

There will be a battle at the long end of the yield curve. The Fed will lose over time, especially if some of the longer term inflation risks start to become evident. They may win in the short term.

Trade treasuries and yields from the long standpoint here. Be careful and quick, but I like buying dips in Treasuries.

Be cautious on equities. For this week, bitcoin might be a better indicator of where stocks go than even Treasury yields. **Bitcoin**, back above $50,000, likely offers support to the "beleaguered" segments of the stock market (segments that are down 20% from their highs, but still up 100% from November).

The "everything else" risk really does seem to depend on bitcoin as much as anything else. Which is insane or just a sign that I've had too little sleep this week.

My highest conviction view is that the market will quickly decide that the stimulus bill was costly, but won't deliver the growth or equity buying that was hoped for.

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