Summary

Economic data for the week included little change in 4th quarter GDP, while improvements were seen in personal income, durable goods orders, consumer confidence, and various housing sales metrics.

Global equity markets fell, as rising interest rates, fears of inflation, and general profit-taking appeared to dominate sentiment. Bonds also lost ground, being affected by rising rates even more directly. Commodities gained on the heels of stronger crude oil prices.

Economic Notes

(0) The second edition of **U.S. GDP** for the 4th quarter of 2020 was revised a tenth higher from 4.0% to 4.1%, although this fell a tenth short of expectations. While very little changed under the hood, personal consumption and government spending growth were revised down, while business fixed investment, residential investment, and inventories all rose to largely offset the difference. Core PCE inflation in Q4 remained steady at a 1.4% annualized level, which matched the year-over-year rate—although that's expected to pick up this quarter and beyond.

Some prognosticators have revised their estimates for Q1 2021 GDP upward to 5-10%. The Atlanta Fed's GDPNow model is predicting 8.8%, with the New York Fed Nowcast just behind at 8.7%. The key questions are about the remainder of the year, though, with the pace of vaccine distribution and eventual 'herd immunity' playing a key role in how quickly growth reaccelerates. It could, of course, be knocked off track by delays and/or wider contagion from Covid variants, if these prove problematic to vaccine effectiveness. This period of 'normalization' is estimated to be late Q2 into Q3, but 'late 2021' is generally a base case by a variety of economists.

On the bullish side, there has even been some comparison of the pandemic to the pent-up demand disruptions of World War II, when industrial production shifted to war efforts and away from consumer goods—which had to be rationed and fell under short supply. If a similar 'unleashing' of consumer activity occurred as it did post-1945, growth could remain above-average for a time. While online shopping has obviously kept consumerism stronger today than at that time, and one can't attend two concerts at the same time to make up for the one not attended, there could still be a potential catch-up effect.

(0) **Personal income** for January rose by a sharp 10.0%, beating median expectations of 9.5%. The extreme result was led by Phase 4 stimulus transfer payments and extended unemployment benefits. **Personal spending** reversed course by rising 2.4%, which was a tenth below expectations. Accordingly, the personal savings rate rose by 7.1% to 20.5%—an extremely high level, and evidence of a mismatch between transfer payments and consumer behavior. Over the past year, spending for durable goods far outpaced that of services, which is in line with Covid lockdown activity. **PCE price inflation** rose a rounded 0.3% on both a headline and core level for January; this brought the year-over-year increase to a rounded 1.5% for each. This is, of course, well below the Fed's 2% target, and is a continued justification for their accommodative policies.

(+) **Durable goods orders** in January re-accelerated by 3.4%, which surpassed market expectations calling for a 1.1% gain. This pushed the year-over-year increase to above 6%, and up over 50% since the trough of April 2020. Transportation orders represented the bulk of the headline increase, as on a core level, the increase was pared to 0.5%, which fell a few tenths under consensus; however, this also included a positive revision for the prior month by nearly a percent. In the core segment, metals processing and electrical equipment saw gains. Core capital goods shipments gained 2.1% in January, which exceeded the median forecast calling for 0.6%.

(0) The **S&P Case-Shiller home price index** rose 1.3% in December, which matched consensus expectations. Every city that reported (all but one) showed a gain, led by Seattle, Boston, Washington, Cleveland, Miami, and Phoenix all up 1.5%. Year-over-year, the national rate of growth inched up by another percent to an extremely robust 10.1%.

(+/0) The broader and less urban-focused **FHFA house price index** similarly rose 1.1% in December, beating expectations by a tenth of a percent. Regionally, the East South Central (states of KY, TN, AL, MS) and Mountain regions led with gains around 1.5%. Year-over-year, the growth rate ticked three-tenths higher to a very strong 11.4%. The FHFA features a broader geographical focus than just the largest U.S. cities, and this strength perhaps reflects some 're-ruralization' during the pandemic.

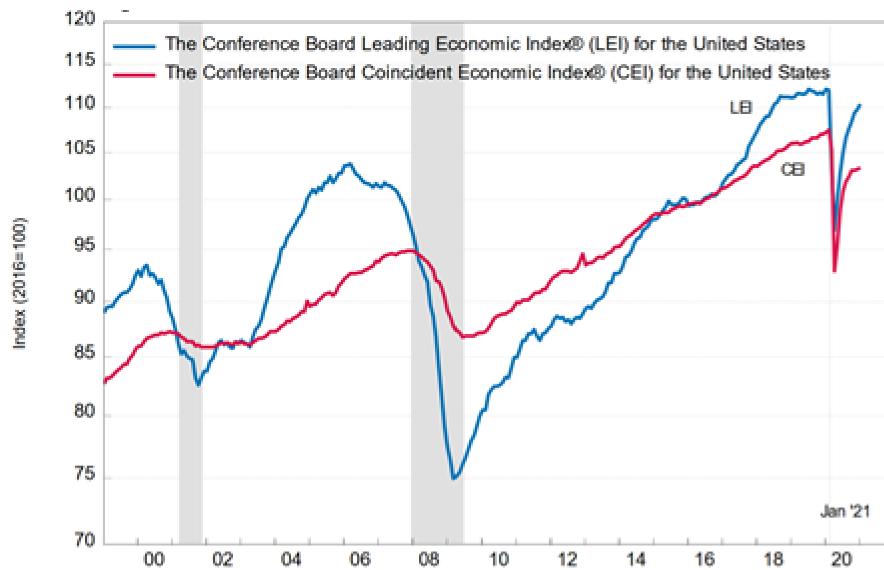
(+) **New home sales** for January rose by 4.3% to a seasonally-adjusted annualized rate of 923k units. This surpassed market expectations calling for only a 1.7% gain to 856k units, and also included an upward revision of over 40k units in December. For January, three of the four national regions experienced gains, led by the South and West, while sales in the Northeast fell slightly. This was a strong month even on a non-seasonally adjusted basis, comparable to the mid-2000s era. Inventory remains low as well, at only 4 months sales. The total figure represented a 19% increase from a year ago, which represents substantial progress considering the unusualness of 2020. Interestingly, this was led by a 40% increase in the Southern U.S., while several other areas, such as the Northeast and West saw declines. It's possible that this ongoing trend toward lower-density, lower-cost, and lower-tax destinations could be behind the numbers.

(-) **Pending home sales** in January fell by -2.8%, which underperformed expectations of no change. The year-over-year pace of increase also declined substantially, but remained strong at over 8%. Regionally for the single month, only the South experienced a minor increase, while the West and Northeast saw declines of over -7%. This measure tends to bode negatively for upcoming existing home sales releases for the next several months.

(+) The Conference Board's **consumer confidence** index rose by 2.4 points to 91.3, beating expectations calling for 90.0. Assessments of present economic conditions rose by nearly 7 points, while expectations for the future fell by a fraction of a point. The labor differential, measuring the ease in finding employment, rose by several points as well.

(+) The final February report of the **Univ. of Michigan index of consumer sentiment** ticked up by 0.6 of a point to 76.8, just above the median forecasted level of 76.5. During the month, consumer assessments of current conditions were flat, while expectations for the future improved by nearly a point. Inflation expectations for the coming year were unchanged, but remained high at 3.3%. Those for the next 5-10 years were also flat at 2.7%. These high inflation expectations readings are a mixed blessing. On one hand, the Fed has been seeking these types of numbers, which are seen as economically bullish, relative to the opposite and pessimistic message that expectations for deflation would send. Of course, there's a limit as to how much future inflation is desirable—as noted below in this week's question.

(+) The Conference Board Index of **Leading Economic Indicators** rose by 0.5% in January which continued a string of recent strong showings over the past several months. The gains were broader-based, and led by building permits, manufacturing hours, and ISM new orders. The coincident indicator rose by 0.2%, while the lagging indicator fell by -0.6% for the month. The leading index has experienced a six-month annualized gain of 10.6%, which was a strong improvement over the -12.3% annualized result for the six months prior (ending in July). While this represents a sizable recovery, the cumulative index has yet to get back to the pre-Covid highs of early 2020, yet it appears to be inching ever closer.



Source: The Conference Board. Shaded periods indicate recessions as defined by NBER.

(+) **Initial jobless claims** for the Feb. 20 ending week fell by -111k to 730k, far below the 825k expected by consensus. **Continuing claims** for the Feb. 13 week fell also, by -101k to 4.419 mil., which was below the 4.460 mil. level expected. The state-by-state results were mixed, with sharp declines in initial claims of over -40k each in OH and CA, while IL and other Midwest states saw increases. However, when total emergency programs and extended benefits were included, it appeared that continuing claims ticked back up by over 1 mil. to nearly 11 mil. in early February, however data remains largely mixed week-to-week on these efforts. The bottom line is that, while labor data has improved, a significant proportion of U.S. workers remain on the sidelines.

Question of the Week

How much inflation risk is really out there?

Treasury rates have ticked higher in recent weeks, due to investor worries about a pickup in inflation. This is not a new concern, but has gained steam as a large ($1.9 tril.) stimulus package appears to be on the verge of passage in Congress, as well as the economy showing signs of broader recovery otherwise, with help from prior stimulus.

Some of this concern has been fueled by comments from well-known economists, such as former Treasury Secretary Lawrence Summers, who warn about potentially negative side effects from the massive size and spending priorities of the stimulus. From a classical economic sense, inflation represents one risk from such a large cash outlay. The fact that he's served under several Democratic administrations was especially noteworthy to markets.

The classic definition of inflation is too much money chasing too few goods. The notable economist Milton Friedman classified inflation as 'always and everywhere a monetary phenomenon.' On the consumer side, government stimulus money can end up in a variety of landing places, including the buying of goods and services (the main hope), being invested into asset markets, or saved as rainy-day funds. For those employed and able to work from home, one impact has been far stronger household balance sheets, from debt pay-downs and lack of opportunity to spend discretionary funds (like restaurants and entertainment). In addition, it seems some degree of social boredom, leading to the 'gamification' of financial markets (Gamestop saga), shouldn't be underestimated. Already, the measure of 'M2' (cash plus checking plus savings/money market assets) is up 25% on a year-over-year basis. This is more than double the 10% year-over-year increase in 2009 during the financial crisis (where stimulus was more directed to the financial system). This is strong wave of money, some of which is going toward living and expenses and rent, while some isn't.

On the other hand, the pandemic created a large economic dislocation, on the order of the financial crisis and 1930's Great Depression. Such a drop widens the output gap—this is the difference between the actual level of GDP and 'best case' GDP if the economy were running at full potential. This gap can't be measured well in real time, but the 'hole' from the decline must be repaired before normal trend growth can resume. This 'backfilling' of economic damage before moving on has been argued by economists to be far less inflationary, since this technically isn't considered excess.

Realizing that inflation has been both feared and welcomed for several decades, despite staying under control, there are a few currently-debated scenarios. It's also key to separate inflation into shorter-term rebound effects vs. longer-term secular effects.

- Rising inflation/rising rates. This could be caused by that build-up of spendable savings in the banking system, as well a release of pent-up demand generally. This can lead to rising asset prices, rising commodity prices, and possibly rising wages if it continues for long enough and becomes more entrenched in the economy. This is what occurred in the 1970s, accompanied by President Ford's 'WIN' (Whip Inflation Now) buttons. This has taken place to some degree this time, as cash coupled with low interest rates have fueled portions of the stock and residential real estate markets.
  - There are some fears of a weaker dollar as a corollary to this, as higher inflation in a country tends to weaken that currency's future prospects versus other currencies. This has made the most sense in isolation, but in this case, European and Asian nations have provided sizable stimulus as well. It's just as likely that a weaker dollar is due to a reflation of the broader global economy, which rewards more cyclical currencies, such as those in Europe and EM nations. This is simply the opposite of funds flowing to the U.S. dollar, which is often seen as a safe haven. This U.S. dollar currency weakness can be a benefit, as it encourages more attractive U.S. exports, as well as enhanced returns in unhedged foreign stock and bond investments for U.S. investors.

- Stable long-term inflation/continued low rates. Due to the unique event-driven nature of the pandemic, other economists argue that the output gap hole created is more severe than can be measured by usual metrics. Therefore, it may take longer to recover from. This could end up dampening recovery growth and keep inflation more contained than the worst-case scenarios. Aside from the Covid downturn and recovery, secular global demographic and productivity trends continue to point to lower growth than in past decades. As long-term inflation has been closely related to long-term growth, these slower trends could tend to keep inflation somewhat in check (at least lower the probabilities of 'hyperinflation'), and have a downward effect on interest rates. Additionally, the advent of continued more productive technology and cheapening of many services (such as many things done online, Amazon effect, etc.) would serve as a downward force on prices as opposed to an upward one. In recent decades, the transition of jobs from the goods-producing to less capital intensive services sector, as well as the weakening of labor unions, has held down the power of workers to demand wage increases.

In short, economists disagree about the presence or absence of inflation pressures. But even in a more severe case, the probability of 'hyperinflation' (like that seen in the 1970s) appears to be an out-of-mainstream view. It's also important to decompose inflation into its respective parts. While higher food prices added to trailing 12-month inflation, energy prices have dampened it. On the core inflation side, shelter costs have been boosted by strong housing prices, continued higher inflation rates in medical care services, as well as one-off pandemic events like a scarcity of used cars. Inputs such as copper and lumber are also more expensive, although these are less captured in broader inflation indexes. On the other hand, prices for apparel and general recreation have barely budged over two decades, while technology and communications inputs have been deflationary.

Even if actual trailing inflation remains in check, rising inflation expectations can create pressure on the economy and financial assets. This is the crux of what's happened in recent weeks. Higher rates negatively affect bond prices directly, but also equities, as interest rates represent a key input into valuation models of future cash flows. When rates rise, the present value of these future flows falls, and lowers overall equity fair values—causing current prices to appear more expensive by comparison. This is an important input for all assets that have cash flows, and explains why financial assets are so sensitive to changes in base interest rates.

In fact, even a half-percent seems like a fair amount, compared to today's low starting levels. How high can rates climb? Bond investors selling their holdings cause prices to fall and rates to rise, often in anticipation of more inflation coming, coupled with stronger economic growth. On the other end of the teeter-totter sits the Fed, which is committed to keeping rates low by keeping bond-buying intact. The Fed is extremely sensitive to rate levels, particularly as they relate to borrowing costs (for consumers, businesses, and the government) so may use language and continuing operations to keep rates contained. (Jerome Powell was effective in doing this during his Senate testimony last week.) At some point, though, rates may have to move somewhat higher to keep pace with a normalization in inflation. This will require a careful balance as to not rattle risk markets. But, due to the longer-term slower growth influences mentioned, a sudden spike toward far higher rates does not appear to be a high-probability option, either. Of course, interest rates have the habit of being unpredictable and noisy, on the way to being self-correcting. If rates edge high enough to rattle equity markets, often a shift in investor preferences for low-risk assets can raise bond prices and pull rates back down again to some extent.

From a portfolio perspective, historical asset returns have been mixed during periods of inflation and/or rising rates, but are time-dependent, based on the amount of inflation, speed of increase, and period reviewed. It depends on whether inflation is occurring by itself, or is accompanying stronger growth, which markets reward. You might think bonds would perform terribly, and those with a very long duration can be hit with sharper immediate price losses, but broader bond market indexes that include a variety of bonds may show more tempered results. This happens as older bonds are retired and replaced with higher-yielding debt, which boosts future returns. If the environment of rising rates persists, being tilted a bit lower in duration and including assets such as floating rate bank loans may help, which takes advantage of rates resetting higher. Inflation is a mixed blessing for stocks, depending on location in the business and earnings growth cycle, which have been

considered more important. Naturally, firms that are better able to pass higher input costs on to customers may fare better than those that cannot. Inflation could also be helpful to assets such as real estate, due to expectations of rising rents; and commodities, which are directly tied to higher goods prices, as well as a weaker dollar, if that were to continue.

As always, the fact that there are so many current questions about inflation in mainstream media make one think that inflation may not be the right question to be focusing on after all.

Market Notes

Period ending 2/26/2021	1 Week (%)	YTD (%)
DJIA	-1.70	1.41
S&P 500	-2.41	1.72
NASDAQ	-4.90	2.47
Russell 2000	-2.87	11.58
MSCI-EAFE	-2.80	1.15
MSCI-EM	-6.34	3.85
BBgBarc U.S. Aggregate	-0.36	-2.15

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2020	0.09	0.13	0.36	0.93	1.65
2/19/2021	0.04	0.11	0.59	1.34	2.14
2/26/2021	0.04	0.14	0.75	1.44	2.17

U.S. stocks declined across the board last week. The primary equity concern as of late appears to be less on the vaccine distribution (which is plugging along slowly in the U.S., and hampered by poor weather), but the incremental rise in interest rates across the middle and longer end of the curve. Thursday was an especially negative day, with more broad market concern over potential inflation pressures causing equity investors to question the current bull market recovery, and higher treasury rates.

By sector, energy gained over 4% along with strength in petroleum prices, while consumer discretionary, technology, and utilities were the worst-performing groups. The Nasdaq experienced its most severe decline in several months, as 'long duration' growth stocks were hit hardest by interest rate fears.

Foreign stocks in developed Europe and the U.K. fared slightly better than those in the U.S. A stronger British pound helped that region, as the recovery from Brexit is proceeding, lockdown removal plans are in place, and valuations there appear better than in other regions. Emerging markets declined sharply, by nearly -7%, led by weakness in Brazil and China. A stronger U.S. dollar and rising rates continues to often act as a headwind for EM nations, as it implies tighter liquidity and more difficult financing conditions.

U.S. bonds pulled back as the above-noted inflation concerns weighed on demand and pushed interest rates higher. Treasuries performed better than corporates, as spreads widened across the board. Foreign bonds performed negatively in developed and emerging markets as well, hampered by a rise in the U.S. dollar.

Commodities gained overall, despite the headwind of a rising dollar. This was led by gains in energy and agriculture, while precious metals fell back (gold's relationship to inflation fears is inconsistent, but is generally inversely correlated to rising real yields). The price of crude oil rose by nearly 4% to $61.50/barrel, led by continued rising demand and contained supply. This offset a -7% drop in natural gas as the blizzard conditions nationwide tempered last week to more normal temperatures.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.