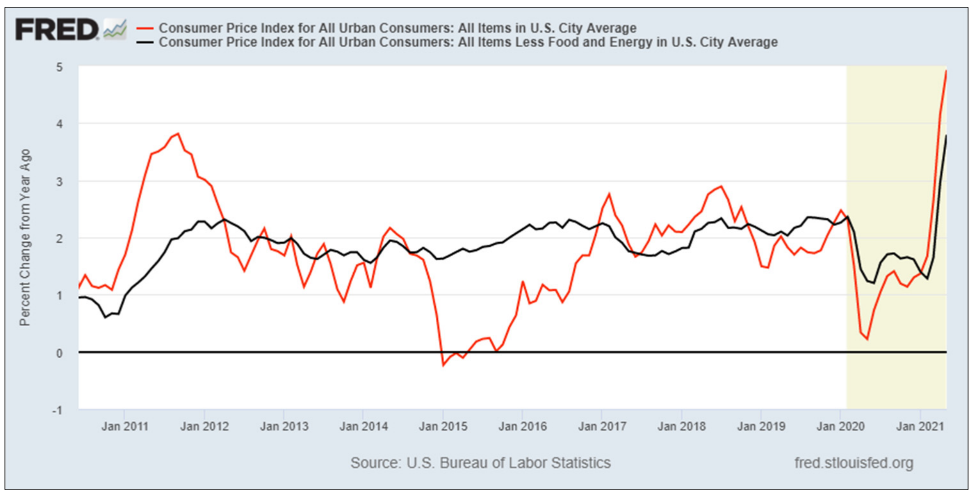
The Long & Short of It
Quarterly Newsletter
Second Quarter 2021

Powell's Promise…
On August 27, 2020, the Federal Reserve made a significant and more accommodative policy shift. If we translate Chairman Powell's Fed speak into layman's terms, it might go something like this:

> *We are "fed up" with the inflation bogeyman. It is so 1970s. The stimulus coming from interest rates pegged at zero is just not enough. Taking interest rates below zero is scary when you're the world's reserve currency, so we will have to print money. Blame demographics. We will no longer let overheated labor markets scare us from even more stimulus because inflation seems dead. In addition, we actually met with real people around the country in 2019 and they said they like a strong labor market. We were surprised. But with that political cover, we can proceed to buy all the Treasury bonds Congress needs us to buy and will only slow down when actual inflation has "averaged" at least 2%.*

...Has Arrived
So, Powell promised more price inflation and here it is! The Consumer Price Index for All Urban Consumers increased 5% from May 2020 to May 2021, the largest 12-month increase since June 1992. Over the same time frame, the National Association of Realtors reported that the median home price rose 24% (from \$283,500 to \$350,000) and the S&P 500 rose approximately 40%. Same song, third verse. Bubble anyone?



Unfortunately, much of the gain in the stock market doesn't represent true wealth creation but rather asset price inflation from excess dollars sloshing around while the Fed waits for inflation to reach an objectionable level. Stock market gains and IRA distributions add up to about 200% of US Personal Consumption Expenditures (PCE) growth. PCE comprises about 65% of US GDP, so it appears that stock market performance is actually a prerequisite for sustaining positive GDP growth. Historically, this wasn't the case because it was economic growth that drove stock market performance, not the other way around.

What's Next?
Now that inflation is on the rise, what might that mean for the economy and the stock market?

Let's consider four possible scenarios:

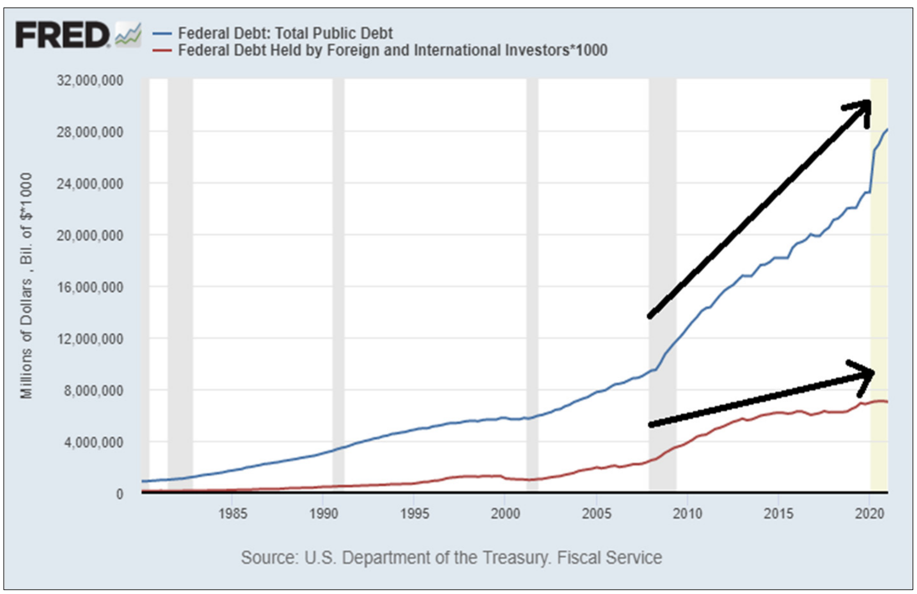
1. **Transitory Inflation – Goldilocks**. This is what the Fed is wishing will happen. COVID-19 is increasingly under control and supply chains adapt to the global recovery's rising demands, resulting in another "just right" economy wherein the Fed's money printing slows and interest rates and inflation normalize at slightly higher levels.
2. **Transitory Inflation – Recession**. The Fed or the markets overreact to inflation and require excessive tightening of monetary policy. Alternatively, new COVID-19 variants could accelerate their spread or

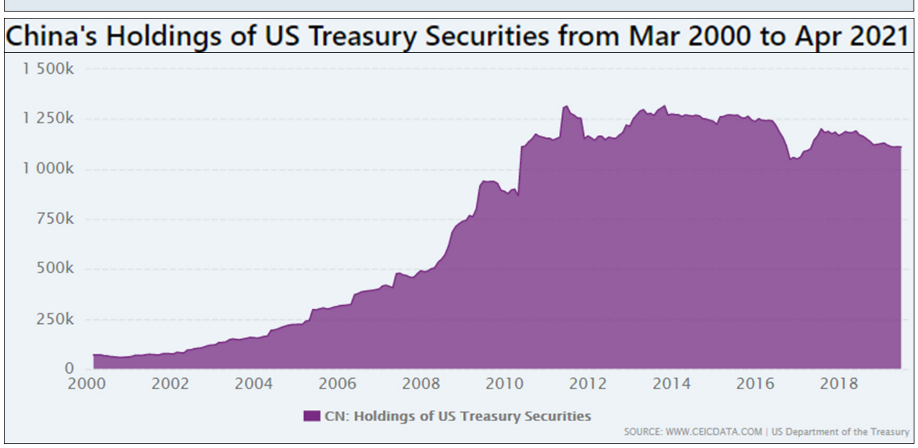
some other exogenous event could disrupt world economies again. The ensuing recession would require aggressive stimulus, such as more money printing, leading to increased asset price inflation.

3. **Grinding Inflation**. Inflation sticks around over the longer term due to continued challenges with global supply chains and rising labor rates. Interest on the debt and cost-of-living adjustments for the federal government's many mandatory programs (Social Security, food stamps, etc.) would increase, forcing Congress to spend, and the Fed to print, more money.
4. **Hyperinflation**. Some combination of the first three scenarios is a possibility. However, the one scenario investors and economists each dread is the public losing confidence in the US government and the world's reserve currency, the US dollar, thereby setting off a currency crisis.

This is a list of *possibilities*, not *probabilities*, and is a reminder that the future is uncertain. One notable element common to all scenarios would be the acceleration of Fed money-printing to fund deficit-spending.

Irrespective of outcome, the federal debt and mandatory spending obligations as a percent of total economic activity are growing beyond what has been seen before. But now, unlike the last 50 years, US Treasury bonds are not the only game in town. Before 2009, the Fed engaged in a lucrative shell game of keeping the banking system afloat as federal spending and government programs began to mushroom. The US sold its debt to others but rarely purchased its own bonds because the credit quality of our federal finances was good enough to attract willing buyers of sufficient size to absorb the supply.

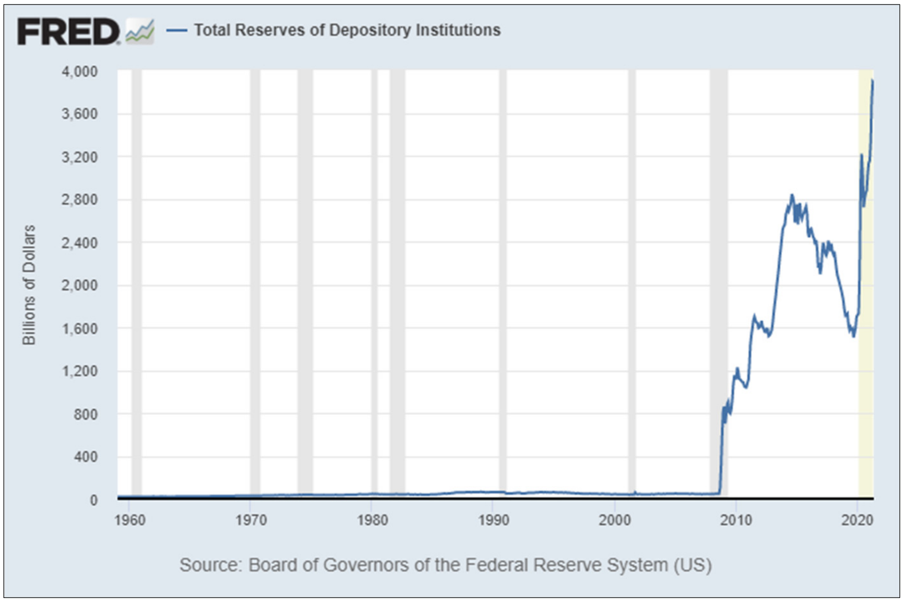




Who's the Patsy?

Either by choice or necessity, it appears that foreign and international investors are purchasing a declining portion of the rapidly increasing US Treasury debt issuance. China has gone beyond buying less debt to actually reducing the dollar amount of bonds that it owns. There is greater supply than there are available buyers; therefore, the Fed is forced to buy back much of the issuance in order to keep interest rates down and markets functioning.

This has been the trend for years as Congress' accelerating deficits drove debt issuance rates higher. As overnight rates began to spike higher in 2019, the only solution for the Fed to avoid a money market meltdown was to become the buyer of last resort. Mostly, this has resulted in the Fed buying today's maturities and new-issue bonds then reissuing them 7 or 14 days later through repurchase agreements to give buyers time to show up. The Fed also continues to purchase the US Treasury's new issuance and add it to the balance sheet of both the Federal Reserve and other banks (money printing).



One could say, "The government has printed money since our country's founding, so who cares?" To that we say, "More should care than do." It is one thing to expand the currency to match population growth and productivity gains, and quite another to print dollars to fund excessive federal spending and/or to avoid disrupting the stock market.

The "Professional"

While the innovations of prior "PhD economist" Federal Reserve chairs have often been criticized, those "innovators" remained constrained by tradition and their academic backgrounds. Today, Jerome Powell, a non-economist, makes the old guard look like amateurs as he aggressively reinvents the Federal Reserve.

These are very challenging, historic times, and perhaps Powell is the correct man for the job, but so much change could tarnish the reputation of the green-eyeshade institution and perhaps even threaten its very existence.

The merits of Powell's approach have yet to be determined. Only time will tell. The good news is that volatile and unpredictable markets create individual opportunities and mispricing of stocks, an environment that historically has favored stock pickers and value-oriented managers.

At Robinson Value Management, though the market is quite frothy and expensive, we are still seeing occasional individual opportunities and wish to remind investors that despite their volatility, stocks have tended to maintain and grow purchasing power better than other investments.

Focus on staying well and safe so you can enjoy the fruits of investing for the long term.

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