"BELIEVE YOUR LYING EYES"

April 12, 2021

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The Roaring Twenties are back. Nothing as emblematic as flappers, or flagpole sitters, yet. Historians will identify the symbols in good time.[1]

They are flat out lying to you. There is no money tree. You will be stuck with the check. And expected to leave a huge tip in gratitude. The "Great Confiscation" is underway.

The Biden administration is advocating economic policies that do not have a proven track record of success, driven by an ideology foreign to cherished American ideals. The ability to drive that agenda successfully in our divided Nation requires political capital, much more than an inconclusive election, as well as strong, capable leadership to forge consensus.

The unprecedented number and scope of the orders issued by the stroke of President Biden's pen was an inauspicious start. It has been compounded. Reconciliation is another legislative process used when consensus cannot be achieved.

Patently false narratives destroy credibility and public confidence. Only the willfully blind and indifferent can dismiss the harm to our country and to the victims of the human trafficking on the nation's border.

The human tragedy occasioned by the mass incursion of foreign nationals on the Southern Border is an ongoing disaster that must be addressed.

Not that there is a shortage of additional confrontations, fumbles, stumbles and gaffes.

[1] https://www.washingtonpost.com/health/social-distance-covid-getting-closer/2021/03/26/61962630-8693-11eb-bfdf-4d36dab83a6d_story.html **Are we heading for a post-pandemic 'Roaring 2020s,' with parties and excess?**

Not all are domestic, our "competitors" (enemies) are flexing their muscles, testing the administration's resolve. The recent behavior of China, Russia and Iran are challenging and unfortunately unmet.

It would normally be too soon to consider the 2022 mid-term elections, but not this year. Mr. Market is handicapping the races and likes the policy outcomes. Politicians are likewise aware of the challenges and challengers coming at them. Mr. Market is happy with split government and has concluded that more extreme radical policies will not come to pass.

Investors should not be deluded by dissembling, if not knowingly false statements by politicians masquerading as serious economists. Their forecasts are biased and unreliable.

Rapid, massive increases in the money supply are inflationary.[2]

This time it is different, we are assured, our central bank and the Treasury department have been educated by past errors. And, if you believe that I have a bridge to sell you.[3]

It is an extravagant fiscal policy, spend, spend, spend. There was some talk about significant tax increases to pay for the excess, but in my opinion, that is unlikely to become law.

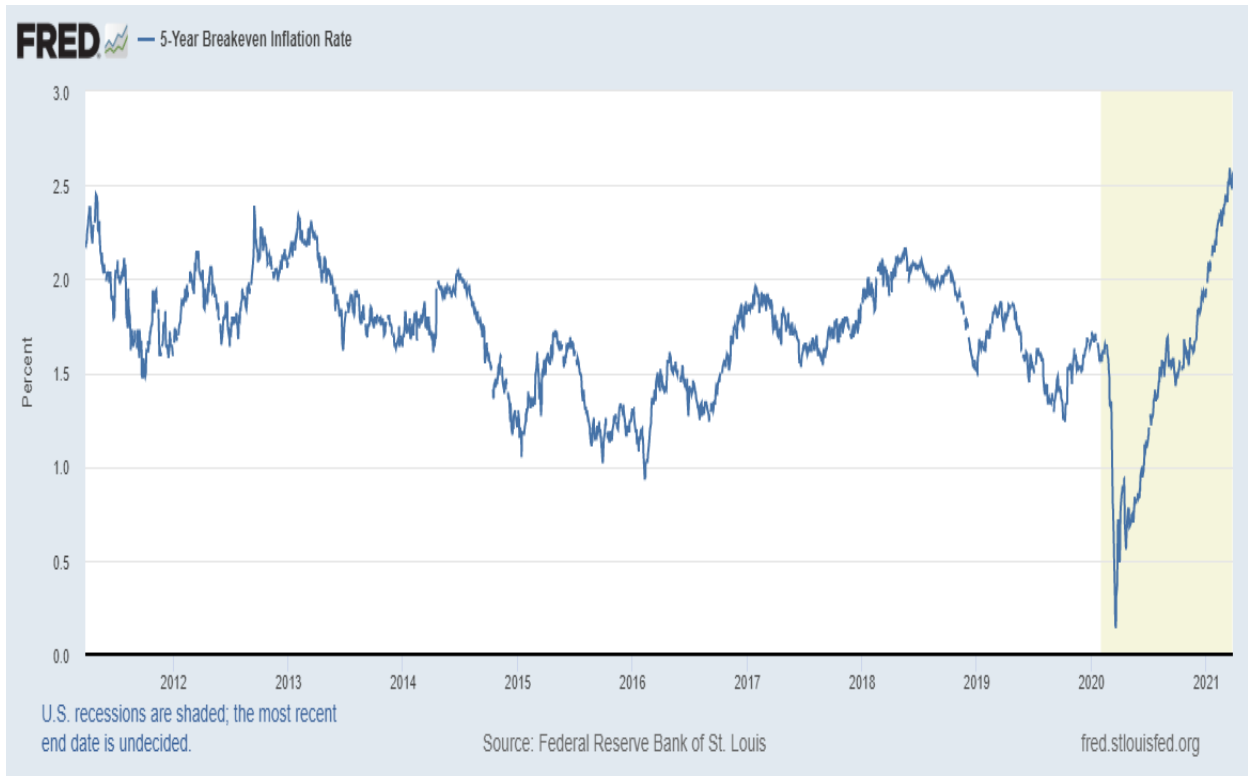
Mr. Market knows increasing taxes significantly is political suicide for too many representatives and senators. Not going to happen – or equity prices would be marked down dramatically.

The honeymoon is over. The truth is apparent at the gas pump, in home prices and at the grocery store. But this is not "real" inflation according to the FED or Treasury. Consumers who give up heating their homes, using their cars or eating will be immune from this supposed temporary spurt in inflation.

[2] the equation of exchange is a simple model of a macroeconomy during a time period. MV represents the total amount spent by buyers, and PQ represents the total amount received by sellers. Because this is an equation, one side must equal the other. If there's a change of the variables in one side of the equation, then this must be reflected by a change on the other side of the equation in order to keep MV equal to PQ.
I asked M to raise her letter, and Q and V to remain steady. In this example, what happens to P? P must increase in order to keep both sides of the equation equal. In other words, when the money supply increases, and neither velocity nor quantity changes, the price level must also increase—we call this inflation.
https://www.stlouisfed.org/education/feducation-video-series/episode-1-money-and-inflation

[3] George C. Parker was an American con man and prophet best known for his surprisingly successful attempts to "sell" the Brooklyn Bridge. He made his living conducting illegal sales of property he did not own, often New York's public landmarks, to unwary immigrants. Wikipedia

Inflation is the enemy of bond investors and their actions are telling. Inflationary expectations are often measured by comparing the yield spread between Treasury Bonds with TIPS.[4]



Inflationary expectations for five years are at a higher level than before the pandemic crash, the 2018 Powell crash, and even the post 2008 recovery high in 2011. **The current level has not been seen since 2005.**

[4] The breakeven inflation rate represents a measure of expected inflation derived from 5-Year Treasury Constant Maturity Securities (BC_5YEAR) and 5-Year Treasury Inflation-Indexed Constant Maturity Securities (TC_5YEAR). The latest value implies what market participants expect inflation to be in the next 5 years, on average.
Starting with the update on June 21, 2019, the Treasury bond data used in calculating interest rate spreads is obtained directly from the U.S. Treasury Department.

Federal Reserve Bank of St. Louis, 5-Year Breakeven Inflation Rate [T5YIE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T5YIE, March 29, 2021.

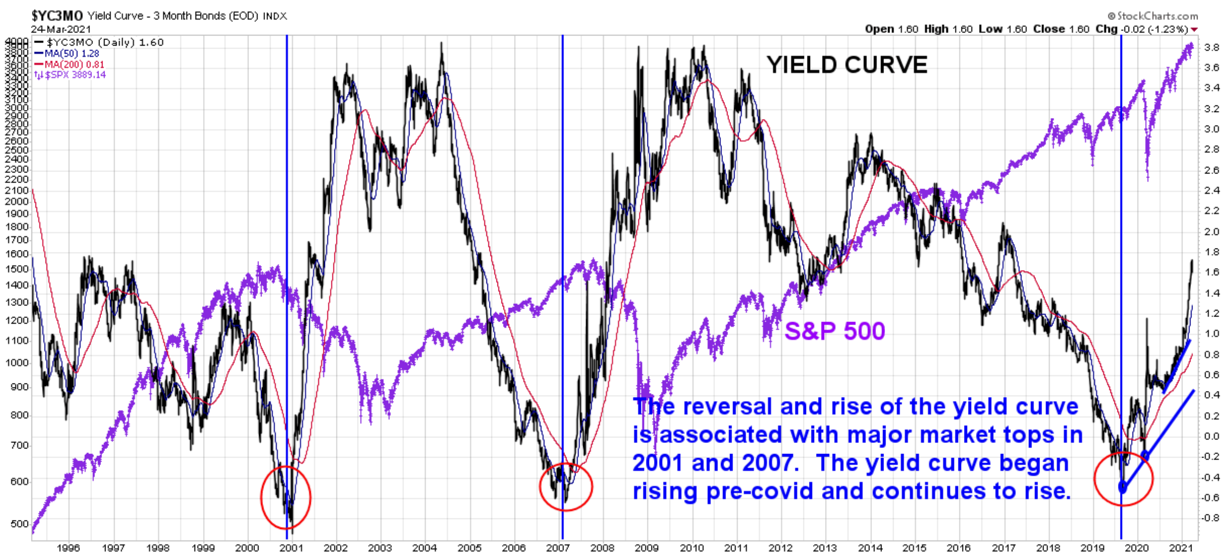
Probably a short term over reaction, a bit of an overshoot, but directionally correct.

Much has changed in the U.S. inflation dynamics, in part because of the success of the US energy industry. Abundant energy supplies played a significant role in the lower inflation levels during the past decade. That advantage has diminished.

Inflationary expectations translate into higher interest rates and a steeper yield curve. The FED continues to experiment with yield curve distortions, an academic exercise with disruptive consequences for the real economy.

Short term interest rates are being suppressed at artificially low levels, by a variety of tools. Not quite subterfuge, and counterproductive vis a vis monetary velocity. Regardless, long-term rates are almost completely beyond central bank control.

Bond investors are demanding higher rates to compensate for the increased risk. Even the FED's purchase of **120 billion** dollars a month cannot stem the increase in rates.[5] The yield curve is rising, rapidly, a directional change last seen near the end of the bull markets in 2001 and 2007.



Equity market leadership changed dramatically in the first quarter. Stock sectors are undergoing a rotating correction, adjusting to a cyclical recovery, accompanied by higher inflation and interest rates.

[5] https://www.newyorkfed.org/markets/domestic-market-operations/monetary-policy-implementation/treasury-securities/treasury-securities-operational-details Recent purchases have been dominated by coupon purchases.

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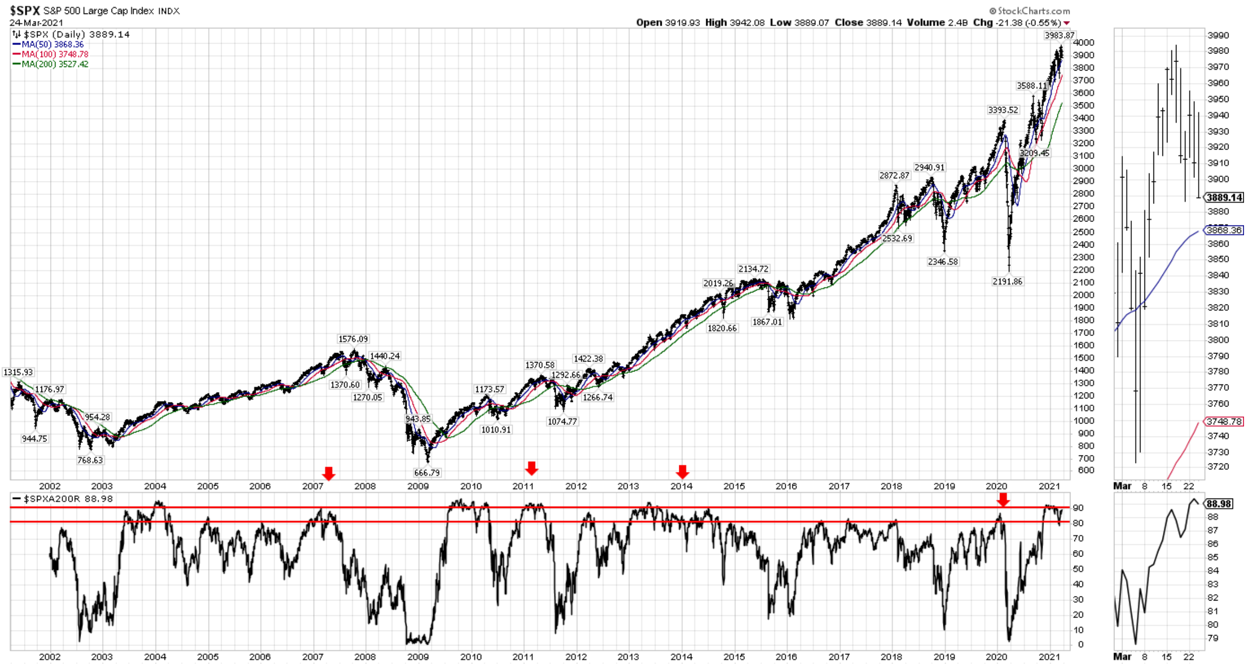
During this rotation, the number of shares trading above their 200-day moving averages fell sharply in March. While this signal may be premature, it should be respected.



Whether this is merely a pause, or an early indication of a more substantial correction, or both, remains to be seen.

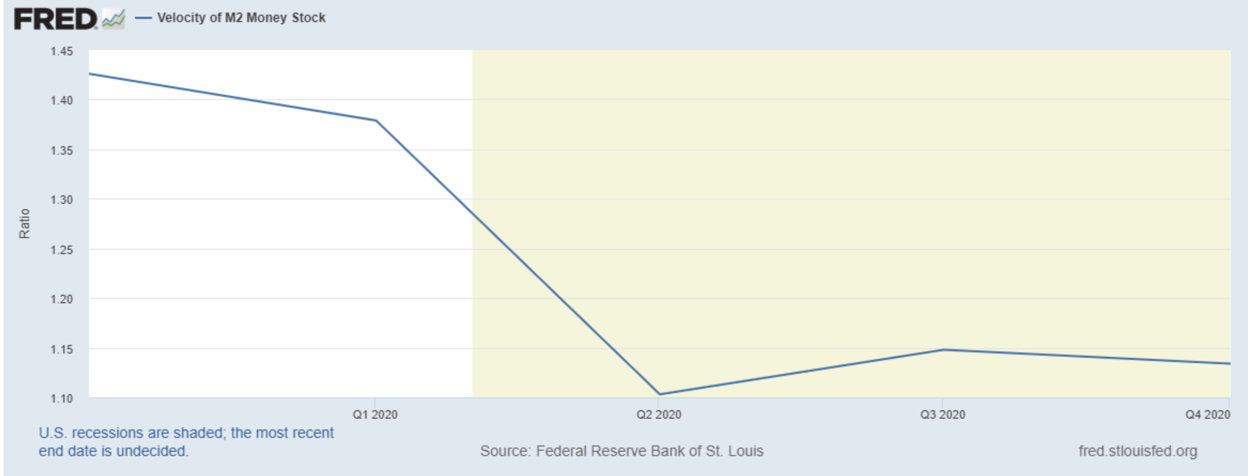
Equity prices are being supported by a flood of money, many magnitudes larger than in 2000 and 2006. The eventual end of that profligacy was harsh.

FED led Interest rates increases in 2001 and 2007 coincided with massive bear markets and recessions.

The FED knows the ramifications of interest rate increases. Despite this certain knowledge, in 2017 the FED acted aggressively to slow the economy. The discount rate was raised 8 times in two years, ostensibly to prevent another inflationary surge. The equity market to these higher rates, it crashed.

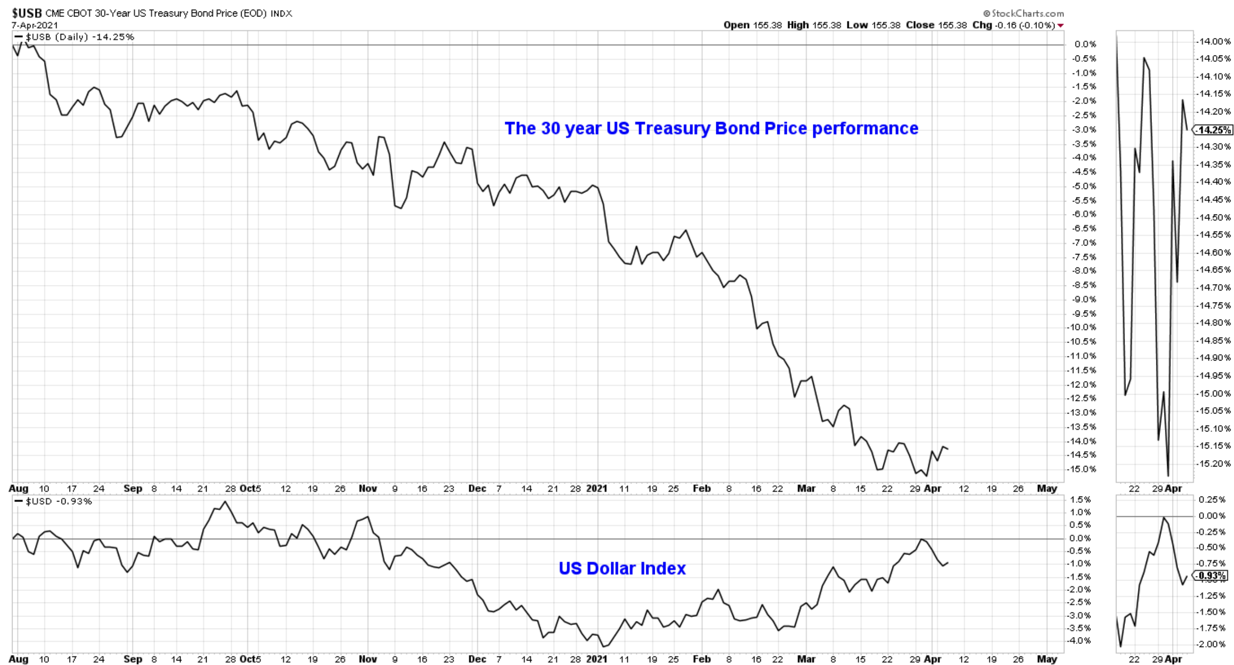
Despite these past follies, when the money supply must be yanked off the table, again, miraculously the china and crystal will remain in place and intact. NOT!

Interest rates are the price of money - set by supply and demand. The recent sharp rise in rates is the result of borrowing demand exceeding the supply of *available* money. There is enough money, but monetary velocity remains subdued.



Probably a combination of perverse FED incentives, ***crowding out*** *by government borrowing* and *a* **strike by bond buyers**. Losing 3+% to inflation is preferable to losing 3% and 12% of your capital as bond prices fall. Another certainty, the Treasury will continue to increase borrowing for many years to come.

The recent rise in interest rates has stopped the deterioration in the dollar.



Bull markets in equities can coexist with rising inflation and higher interest rates for an extended period. But not forever.

Disregard traditional economics if you want to understand monetary policy. Politics, not economics is the pole star.

Mid-term elections are often a rebuke of the incumbent party. Historical precedents point to significant Republican gains in the House of Representatives. Regaining control of the Senate is more difficult, there are 34 seats to be filled, the current mix is 20 Republicans and 14 Democrats. But early forecasts are for a close split.

There is already enough political antagonism to expect that the 2022 elections will resemble the 2010 midterm "shellacking" that saw the most Democrats turned out of Congress since WWII.[6]

Average Americans are not focused on the mid-term, but President Biden and his progressive backers are. Investors should as well.

Anything that might poll negatively with voters will not become law, a massive tax increase is highly improbable. Same for interest rate increases.

A strong rebound was certain once the virus came under control. The recovery is well underway. As the economy continues to strengthen labor costs will inevitably rise. The shape of the yield curve and rising commodity prices suggest that the FED should be changing course.

As monetary velocity continues to increase the FED could act modestly now to rationalize policies, postponing the need for more restrictive policies later, when inflation *inevitably* requires control. It would be courageous and politically inconvenient– so Fuhgeddaboudit.

Until the FED and Treasury are forced to act to restrain money supply growth, the equity markets, or sectors of the equity market will remain attractive.

Mr. Market can be irrational short term, but long term always sane. Investing in sound businesses with solid long-term prospects, at a reasonable price[7] [8] is the basis of traditional and successful investment. Very difficult with market valuations at or very close to all-time highs.

Irrational exuberance is often tempered by experience. If not the first hangover –the second. It is another investing phenomenon to the rational investor. But not to those caught up in the moment.

Fear Of Missing Out – FOMO, is not a rational motivation. On the other hand, TINA - There Is No Alternative to holding cash is a legitimate investment theme, for the risk conscious.

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6 Biggest Midterm House Losses Since WWII: Obama (-63), Truman (-55), Clinton (-54) | CNSNews
7 https://www.investopedia.com/terms/g/garp.asp
8 https://www.investopedia.com/terms/p/pegratio.asp

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