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Market Perspective

How the Economic Recovery Impacts Markets, Inflation and Productivity

What a Difference a Year Makes.

In 2020, we were in the early stages of a global economic shutdown to slow the spread of COVID-19. Global equity markets tumbled during March and governments around the world moved to supply both fiscal stimulus to assist those out of work, and monetary stimulus to support liquidity in the fixed income markets.

After Easter Weekend, it is beginning to feel that we are on the brink of a new dawn. Vaccines are being administered, and economies are beginning to positively respond as more people are vaccinated. Unemployment rates are coming down, though still well above pre-pandemic levels, while fiscal and monetary stimulus remain. As a result, the financial markets are anticipating improved growth and earnings.

Equity markets have recovered from the depths of last March; the global equity market, as measured by the MSCI All Country World Index, returned 54.6% over the last twelve months, and 4.6% over the last three months. More encouraging is the markets have broadened out. It is no longer a large-cap growth story. The equal weighted S&P 500 has outperformed the capitalization-weighted index by over 5% year-to-date, and by over 15% for the last twelve months! This broadening of performance is also seen in the value/growth dynamic as value has outperformed growth this quarter by approximately 10% as measure by the Russell 1000 indices.

The return of economic growth is positive for the equity markets, though it has been accompanied by increased volatility in the fixed income markets. This has been especially evident in the U.S. market given the extent of both monetary and fiscal stimulus. Long-term Treasuries have declined almost 16% for the last twelve months, with most of the decline occurring this past quarter (-13.5%).

Yield Spread – 10yr vs 3mo

Source: FactSet

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Prospects for Higher and Lower Inflation

Investors are now faced with determining whether the increase in yields is due to the cyclical improvement in economic expectations, or whether given the global stimulus (particularly in the U.S.) is foreshadowing an environment of significantly higher inflation.

We will analyze the U.S. environment as a proxy for the global inflation outlook among the key currency markets: Dollar, Euro and Yen.

The Federal Reserve recognizes that over long periods monetary policy cannot affect output and employment, but that it can control the level of inflation and therefore the volatility of output. This means the Fed's optimal policy is to target a desired level of inflation.

Furthermore, the Fed has stated why it is targeting a level of 2% inflation over time: "Over time a higher inflation rate would reduce the public's ability to make accurate economic and financial decisions. On the other hand, a lower inflation rate would be associated with an elevated probability of falling into deflation… a phenomena associated with very weak economic conditions. Having at least a small level of inflation makes it less likely that the economy will experience harmful deflation if economic conditions weaken."

Recent research also has suggested that the case for minimizing any possibility of a recession is magnified because there is no reason to expect that the output lost in a recession is subsequently regained in a subsequent recovery. As a result, the Fed recognizes that the risk around a 2% inflation target is not symmetrical and the risk of undershooting the target is greater than overshooting for a period of time.

The table below shows how the Fed has performed over time in hitting its inflation target. The Fed, despite periods of significant monetary stimulus, has consistently **undershot** it's 2% inflation target with the exception of the early 1990's. This suggests that there continues to be deflationary forces in the global economy.

One doesn't have to look far to see these forces in action, particularly in the technology companies that increase consumer pricing power: Amazon, Uber, Airbnb, and VRBO, to name a few.

In addition, we have written about the drivers that can cause lower economic growth. These factors include decreases in both the labor force and productivity that are both growing slower since 2000 than we have witnessed in previous decades. These forces have produced two conditions. First, the long run, neutral real rate of interest has declined. Estimates put this rate at about 1%, a decrease from over 2% just a few years ago. Also, the normal growth rate is closer to 2% rather than the historical 3.5%. With current interest rates at near 0%, all these factors limit the Fed's ability to prevent a recession.

As a result of these factors, we expect the Fed will look to error on the side of more inflation rather than less. Since consumer prices have increased at rates lower than their objective, there is room for an "overshoot." While we do expect to see an increase in inflation in the short-term, as global economies recover from the pandemic, we do not expect a long-term increase in inflation. Furthermore, central banks worldwide have developed tools following the 1970's inflationary environment to control inflation. The world has been in a disinflationary environment for over 40 years. Now that economies have reached low levels of inflation, it is unclear whether the central banks, working in isolation, can increase the rate of inflation. We suspect fiscal policies will be required to support long-term growth.

Inflation Undershot Fed Target

PERIOD	INFLATION RATE
From 1990 to Present	1.90%
From 2000 to Present	1.72%
From 2010 to Present	1.60%

Source: FactSet

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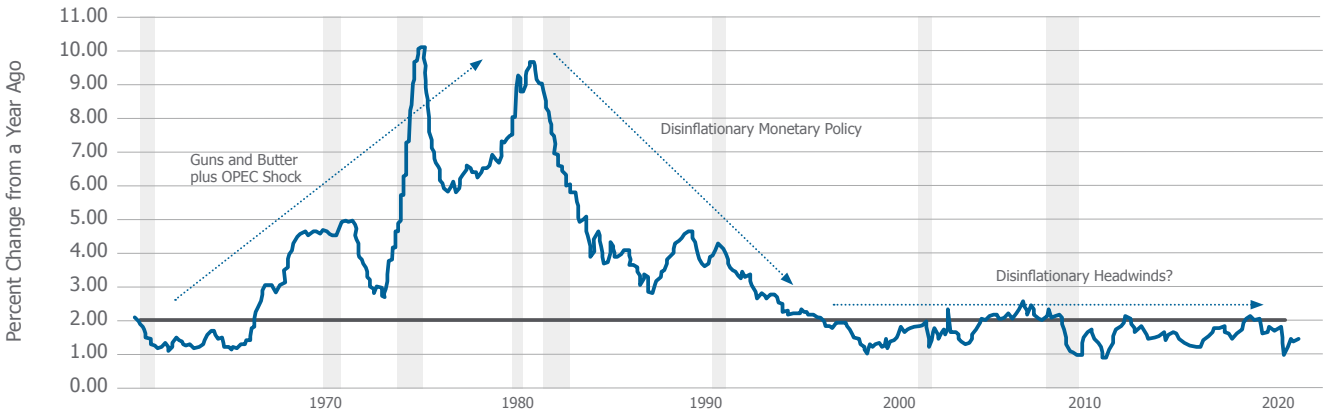
Fed Developed Tools to Combat Inflation



Source: U.S. Bureau of Economic Analysis

The Importance of Infrastructure Spending

Regarding fiscal policy, we are beginning to see signs of policies moving away from short-term support stemming from the impact of COVID-19 to more meaningful investment programs, particularly in the U.S. with President Biden's administration's infrastructure proposals. While not delving into the debate on how to pay for infrastructure investment, we do want to comment on the long-term "return on investment" from infrastructure spending. Importantly, is an investment in infrastructure an efficient use of taxpayer dollars or should it be left to the private sector?

First, let us define what we are talking about. Infrastructure investment that is publicly owned is often referred to as the public capital stock[1]. This capital stock is comprised of the roads, buildings, bridges, ports, utilities, airports, etc. that are financed by public funds and whose ultimate owners are local, state or federal governments. Many of these infrastructure investments result in a monopoly. After all, once an airport is built, the marginal cost of another airplane taking off or landing is minimal, while the upfront cost of constructing a new airport provides a barrier to entry for a profit-seeking entity to build a competing facility.

A strong public role is therefore required to promote economic efficiency. Furthermore, there are infrastructure projects that society has decided should be available to all, such those that provide safe drinking water, sanitation, electricity, etc.

We have highlighted the lower, long-term expected economic growth rates, and how the central banks cannot influence long-term growth. However, infrastructure investment has been estimated to be a much more efficient fiscal stimulus policy than almost any tax cut or spending programs. This is because "the primary virtue of infrastructure investment as fiscal stimulus is that

[1] The Potential Macroeconomic Benefits From Increasing Infrastructure Investment, Economic Policy Institute, July 18, 2017

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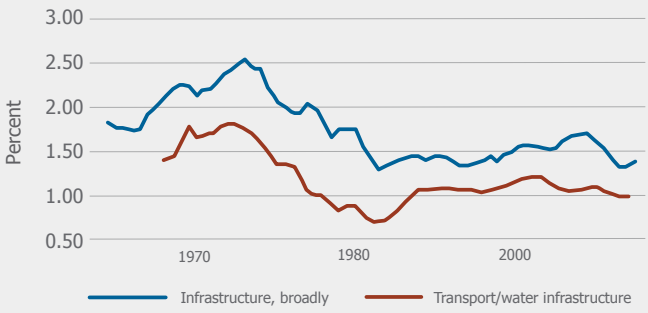
it is spent,"[2] while, tax cuts and direct transfer payments can be saved, reducing the stimulative effect of the spending. Also, the output multiplier from infrastructure investment has been estimated to be almost 1.6x. In other words, for every dollar of infrastructure spending, gross domestic product increases by $1.60. Compare this to the multiplier of an across-the-board tax cut of 1.03x.[3]

One of the reasons for the high output multiplier is that infrastructure investment has been shown to have a direct relationship to increases in private productivity. As shown in the graph below, investment in infrastructure has been in a steady decline since 1949. However, other studies[4] have found that any economic gains from infrastructure spending increased productivity, while also significantly raised future GDP.

Public Investments in Infrastructure has Never Regained its Earlier Levels



What Does This All Mean for Investors?

1. Central banks will maintain low short-term interest rates and maintain a stimulative position until inflation exceeds the 2% target for a period of time.
2. 10-year U.S. Treasuries would be fairly priced between 3-4% in this scenario. (At the end of the month, the 10 year yield was 1.74%)
3. The implied bond P/E would range between 25-33. Yields have room to move higher before there is a significant impact on the equity market.
4. While there is concern about the level of debt to GDP, efficient Federal spending, particularly in infrastructure, can boost long-term productivity, and GDP. This can enable economies to deleverage their debt levels through growth.

Notes: The broad infrastructure series includes public investment in hospital and educational structures, highways, sewers, transportation facilities, and conversation and development. Each series is scaled against measures of potential GDP from CBO 2017.

Source: Author's analysis of data from the Bureau of Economic Analysis (BEA) fixed asset series (Tables 5.9.5A and 5.9.5B) and the Congressional Budget Office (CBO 2015)

[2] Ibid
[3] Zandi, Mark. 2011. "US Macro Outlook: Compromise Boosts Stimulus." Economy.com (Moody's Analytics)
[4] Bovino, Beth Ann, Oct. 11, 2019, Infrastructure Investment As An Elixir for Ailing U.S. Productivity Growth, S&P Global. (https://www.spglobal.com/_division_assets/images/special-editorial/iif-2019/infrastructureinvestment_new.pdf)

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