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2021 1st Quarter Review: Economic Comeback Juiced with Vaccines and Money

Executive Summary

- The recovery in the economy has been strong, although uneven. Spending on services is down but improving while spending on goods exceeds the pre-pandemic level. Combined, consumer spending now exceeds the pre-pandemic level.
- **Full vaccination of all adults may not be achievable, but with 50% of adults vaccinated the infection and death rates are down 75% since January 1st and still declining. The economy is opening at a rapid rate.**
- Fiscal stimulus and monetary support have been and continue to be massive. Personal savings is very high.
- Demand for goods and services is rising. Meanwhile supply was reduced at the hands of the pandemic shut down. As a result, inflation has risen significantly. What will inflation's future path look like?

Macro-Economic Perspective

In this section, we try to measure the present economy against peak levels attained prior to the pandemic. **Gross Domestic Product (GDP) reached $21.561 Trillion at Q1 2020**; this was $0.625T higher than GDP at 2019 year end. **At the end of Q1 this year, GDP was up 2.26% on the year at $22.049T**.

Fiscal Support, Monetary Support, and Vaccinations:

- Clearly, the fiscal and monetary support in 2020 and 2021 worked very well. Securities markets recovered profoundly and there was plenty of evidence of a V-shaped recovery in most parts of the economy. **Personal income** (the amount of money collectively received in a country) rose from $19.11T in February to $19.49T in December, an increase of 2%. But the gain was a result of government transfer payments that exceeded recent norms by $2.8T. From 1975 through 2019, the personal income growth rate was 6.1% per year. From 2009 year end through 2019, the personal income growth rate was 4.4%. **By March of this year, personal income ballooned to $24.2T, that is an increase of 24.2% in just one quarter which was assisted by two stimulus packages totaling $2.8T within a period three months**.
- **When you include last year's first stimulus of $2.1T, the total stimulus has been $4.9T. The gain in total personal income over the same period was $5.1T. Excluding the extraordinary stimulus/transfer payments, personal income rose 1.05% over the last year.**
- Disposable personal income (income after taxes) was up 5.5% in 2020. This is the highest rate of growth since 1984. **Since last year end** (December 2020)**, disposable personal income has risen from $17.2T to $21.9T, an increase of 27%.**
- **The savings rate was 13.7% last year and is averaging 20.5% in the 1st quarter this year**. Prior to the pandemic, the U.S. savings rate was about 7.5%.
- **M2 money supply** (cash, checking and savings deposits, money market, mutual funds, and CDs) **is up 24.2% in the last year**. M2 is closely watched as an indicator of money supply and future inflation. Typically, the Federal Reserve maintains a 3% to 6% increase in the money supply each year.
- The **velocity of money** (the frequency at which one unit of currency is used to purchase goods and services within a given period of time) **has remained very low. So far, this has countered the inflationary pressure caused by the massive increase in money supply.**
- Goods expenditures continues to grow beyond the pre-pandemic peak. By March of this year, it exceeded the previous peak by 13.6%. Services expenditures are still below the pre-pandemic high by 3.3%, an

improvement from over 6% below the pre-pandemic level at last year end. **Total personal consumption was up 11.3% in the 1st quarter and is 1.9% higher than the pre-pandemic peak.**

- **Incidences of Covid infection and deaths are down 75% from the January 1 level. The vaccination program in the U.S. will likely enable services expenditures to hit a new peak by the end of the 2nd quarter.**
- The securities markets faith in the vaccination project and fiscal stimulus appears to have been well placed.

Key Economic Data Points:

Inflation expectations realized.

The annualized rate of headline inflation rose to 4.2% in April from the year ago level. Core inflation which excludes the more volatile food and energy items rose 3%. The rise in inflation was predictable as well as predicted. Prices declined in April last year when much of the country was shut down. In addition to the base effects of last April's price comparisons (expected to dissipate from June through December), supply of goods and services were severely impacted by shutdowns, employee furloughs, and layoffs. The low supply of goods was met with high goods demand as the pandemic continued and stimulus payments supported a quick uptick in demand. Now that the economy is opening back up, demand for services such as dining out and travel is rising as well.

The Federal Reserve's view is that the price pressures are the result of temporary shocks. They do not believe higher inflation will persist once the supply chain bottlenecks are resolved by year end. We tend to agree. In many cases, the factors driving up prices appear fleeting. Depleted inventories are leading to big restocking orders, thereby putting premiums on near term deliveries of raw materials. Some of the price gains have been sharp but they have just completed their recovery from the pandemic market panic. We admit that the massive increase in money supply, personal income, and personal savings could lead to very high levels of demand that may be difficult to meet.

An example of possible transitory price inflation is the cost of lumber. Production was low during the pandemic shut down, lumber was not shipping across the Canadian border, and demand jumped with home improvement, mortgage refinancing cash-outs, and new construction. The cost had quadrupled. Since May 10th, the lumber futures for July have dropped 15%. Builders with whom we have spoken estimate that cost of materials will approach more normal levels by the end of this year. Sometimes, high prices alone are the cure for high prices. Builders are turning away business.

The wealthy have a proclivity to save, thereby lessening the potential for higher velocity of money via an increase in their spending. The less fortunate have a greater propensity to spend. The stimulus money is more quickly spent. Therefore, as the thinking goes, as the stimulus payments go away so will the additional demand that it had created.

There appears to be exceptions to the short-term nature of some of the pricing issues. The semi-conductor shortage appears to be real (and made worse by a fire at a major supplier in Japan) and additional capacity takes a year to two years to come on board. Miners are hesitant to add capacity given experience with heavy investment to meet demand spikes that dissolved. Lithium and cobalt capacity including projects under construction is estimated to cover only half the demand requirements by 2030. These metals are key components to batteries for electric cars and energy storage.

Longer term, we have concerns regarding slow growth and limited inflation. History of world economies indicate that high Federal debt (greater than 100% of GDP) leads to sluggish economic growth and difficulty fending off deflation. Japan has been an extreme example of high government debt (greater than 100% of GDP since 1997 and greater than 200% of GDP since 2010), sluggish growth, and very low inflation over the last three decades. The FED has not been able to orchestrate an inflation rate at or above their 2% target for more than a decade. They have been open about their desire to allow inflation to exceed their target for a period of time. This may give the FED some market credibility that they can orchestrate a higher level of inflation in the short term.

However, we will need to deal with escalating debt which cannot be funded by the FED perpetually without adverse consequences.

Economic Growth spike: At first quarter end, Gross Domestic Product (GDP) exceeded peak GDP prior to the pandemic by 2.26%. This year, projections for GDP growth in the U.S. range from 5.5% to 8%. In December, estimates for 2021 centered around 3.5% real growth. This improvement points to the success of the vaccination project and is confirmed by the advanced estimate of Q1 real GDP growth at 6.4%.

Estimates for GDP growth for 2021 in other major economies in the world are: Canada and Mexico +5%, China +8.4%, Korea +3.6%, Japan +3.3%, U.K. +5.3%, Euro area +5.5%, Latin American countries +3% to +6%, Russia +3.8%, Australia +4.5%, Africa +3.3%, and surprisingly India at 9%.

Employment: T**he FED is forecasting** f**ull job recovery with unemployment back down to 3.5% by 2023. This is an improvement of a year from the forecast in December.** The unemployment rate and the number of unemployed in February 2020 was 3.5% and 5.8 million. At that time, the potential gain in working adults was 3.2 million people. The number of unemployed by April 2020 was 23.1 million. By April this year, there were 9.1 million people unemployed and 3.9 million had left the workforce. **The big unanswerable question remains, what will happen with the employment participation rate?** It is expected to remain subdued given early retirement of Baby Boomers, parents of young children leaving the workforce (60% of largest school districts were fully open in April), fear of Covid (polls indicate that 15.5% of adults definitely or probably will not get vaccinated) and receiving more pay on unemployment than by working (it is estimated that 42% of people receiving benefits are earning more by not working). **DBFM estimates that the potential for employment gain is 11.8 million people. This will be important to curing supply of goods and services bottlenecks that exist now and thereby fending off continued high inflation.**

Consumer spending (70% of GDP): Personal consumption expenditures (annualized) topped out in February 2020 at $14.88T. They bottomed out in April 2020 at $12.1T, a decline of 18.7%. For comparison purposes, the decline in personal consumption expenditures during the Great Financial Crisis was 3.9%. **As of March, of this year, personal consumption expenditures exceeded the February 2020 peak level by 3.5% at $15.4T.** The Institute of Supply Management (ISM) reading for service rose to 63.7 in March but declined to 62.7 in April. A reading of 50 is the dividing line between decline and growth. These are exceptionally high numbers.

Manufacturing (11% of GDP): The ISM reading for manufacturing has steadily risen to 64.7 in March this year from 41.5 in May 2020. **Manufacturing output (data recorded quarterly) at Q1 end has continued to recover significantly but remains 2% below the recent peak which was attained in Q4 2019.**

Construction (4.1% of GDP): This data is more volatile than other economic measures, but **total construction spending at Q1 end is 5.3% higher than the year ago level**. Residential spending is up 23.3% and non-residential spending is down 7.4%.

Home sales: New household formation has been averaging around 1.2 million per year since the housing crisis in 2008. **New home unit construction and sales** have struggled to reach 1 million per year until 2019 and 2020 after dropping to 500,000 in 2009. **Residential building permits** have risen to 1.75 million units (includes single unit and multiunit housing) over the last year. **Existing home sales** peaked in the 4th quarter of 2020 (approximately 6.6 million) at the highest level since 2006 (7.25 million). According to the National Association of Realtors, the **median price for a home is at a record of $344,500, up 18.4% from one year ago**. **Supply has risen very slightly but remains at a very low 2.4 months** up from the record low of 1.9 months in January. Six months is considered a balanced marketplace for buyer and sellers. **The National Association of Realtors expect gains in inventory with less fear of Covid and a falling number of homes in mortgage forbearance**. **Interest rates are still low**, and the Federal Reserve intends to keep them lower for longer. **This data bodes well for construction prospects and home prices, but affordability and availability may limit housing potential.**

Securities Market Perspective

By the end of the first quarter, a 100% stock portfolio with 20% invested in international was up approximately 6.61% with dividends reinvested. Intermediate term bonds were down 3.52% (Barclay's Aggregate Bond Index) and short-term bonds were down 0.04% (Barclays U.S. Gov't Credit 1 to 3 Year Bond Index). Concerns about inflation have driven interest rates up and bond prices down.

Valuation discussion points:

- By the end of the first quarter, as measured by price to book value, **growth stocks were 131% above their long-term average** of 4.83 at 11.17 (down from 144% at the end of 2020). **Value stocks were 14.6% above their long-term average** of 2.18 at 2.5 (up from 9.6% at the end of 2020).
- At the first quarter end, growth stocks were up 1.45% and value stocks were up 7.80%.
- This reversal of fortune for value stocks began on 7/10/20 and gained strength on 11/5/20 when Pfizer announced the effectiveness of their Covid-19 vaccine. Value stocks were more impacted by the Covid restrictions and are being appreciated as the economy opens. In addition, higher interest rates (threat of higher inflation) cause the value of greater future earnings of growth stocks to be more discounted. **Stocks with higher P/E ratios are more impacted by higher inflation.**
- <u>Low interest rates continue to validate higher valuations, but to a lesser extent</u>. The 10-year Treasury is presently yielding about 1.6% (or 0.016). So, a company with a P/E ratio of 50 would have an earnings yield (E/P ratio) of 2% (or 0.02), exceeding the yield of the 10-year Treasury. Therefore, a hypothetical company could be considered reasonably valued on a relative basis if it had a P/E ratio of 62.5 (1/62.5 = 0.016) which is equivalent to the yield on the 10-year Treasury. For comparison, Amazon and Tesla have P/E ratios of 62 and 625, respectively. The P/E ratio for the Dow Jones Industrial Average and S&P 500 are 29 (E/P = 3.44%) and 37 (E/P = 2.7%), respectively. During the Dot.Com era, the market index E/P ratios were in line with the 10-year Treasury yield.
- So far, the stock market rise has not created economic excesses. Although, there are more examples of excessive risk taking, like cryptocurrencies and GameStop stock.
- The Federal Reserve's zero bound interest rate policy continues to force investors to increase risk via investing in stocks and pursuing lower quality bonds. There are plenty of high-quality companies with dividend yields well in excess of interest rates available in bonds.

Valuation conclusions:

- The threat of higher inflation is causing a decline in relative return for growth stocks in comparison to value stocks. Although, there are plenty of examples where growth stock valuations remain out of touch with reality.
- To a lesser extent, low interest rates continue to provide cover for higher valuations.
- It is safe to say that growth stocks are over-valued by historical standards and value stocks are not cheap, but they are still within the range of fair value.
- Success of the vaccination effort appears to have led to a more freedom of movement and a strengthening of the rotation out of growth stocks and into value stocks.

Bonds:

- Yields on all types of bonds are being anchored at very low levels by Federal Reserve policy action of holding the Federal Funds rate at nearly 0% and monthly bond purchases. DBFM is pursuing additional avenues to enable positive bond return and portfolio income in this low interest rate environment.
- With successful vaccination of America, the economy and interest rates will likely trend up. Avoidance of intermediate and long-term bonds will become the order of the day in the investing world. DBFM is well-positioned for such an environment with a heavy concentration on shorter term bonds.

Wrap up:

- Major pieces of our economy have more than healed from the restrictions put in place to contain the spread of coronavirus. Services spending (45% of the economy) remains below the pre-pandemic level, but ground is being recovered at a quick pace enabled by the progress made through immunization.
- If the market has correctly anticipated inflation, there is no extra money to be made betting on inflation.
- The U.S. is awash in money. High personal savings and gains in mobility freedom from successful vaccinations point to strong demand growth.
- Supply chain bottlenecks must be resolved including a significant gain in employment in order to ward off continued higher inflation.
- Potential Risks: Inflation forcing the Federal Reserve's hand to clampdown by raising interest rates, tax increases, supply constraints (material and labor) not resolved, or reversal of progress against Covid-19.

Please feel free to contact us with any questions, or if you would like to schedule a virtual, face to face, or phone meeting.

Thank you,

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