Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY March 29, 2021

Will the Massive Stimulus Trigger Inflation?

The recent passage of the $1.9 trillion American Rescue Plan – and the trillions of dollars in stimulus that came before it – have revived inflation fears. Many readers remember the period of double-digit inflation in the 1970s and early 1980s, which culminated in a major, global economic recession. With all the current spending, some fear history is bound to repeat itself.[1]

Early inflationary signs are appearing. One of the best places to look for future inflation is in the cost of risk-free debt, i.e., long-dated U.S. Treasury bonds. If the market expects higher future inflation, it will demand a higher yield on risk-free bonds today to compensate. That's why in the late 1970s and early 1980s, investors could buy U.S. Treasury bonds yielding double-digit interest rates.

In 2021 to date, we have seen sustained upward pressure on the 10-year and 30-year U.S. Treasury bond yield, a signal that inflation expectations are rising. The 10-year started 2021 yielding 0.93%, and as I write, is now yielding 1.70%.[2] That's a significant move.

We're also seeing price pressures in the real economy. The housing market is a good example. Lumber prices have never been higher, and crude oil – which is used in paint, drain pipes, roof shingles, and flooring – has rallied over the past several months. Copper prices have also jumped by nearly 40% since last fall, and brick, concrete, and insulation prices are all higher as well, with many hitting new records in 2021. Taken together, these higher prices for raw materials are putting upward pressure on the overall cost of homes in the US today.

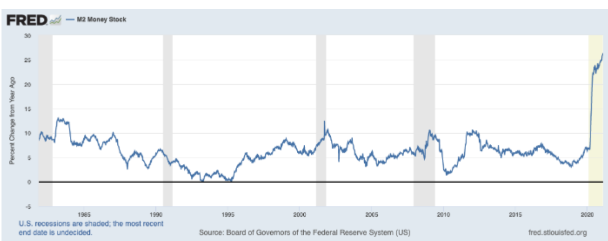
I expect more inflationary pressures in the coming years, but I also believe the Federal Reserve has ample tools to keep it in check. Allow me to explain both positions.

To understand why additional government spending could impact inflation going forward, I think it's useful to look back to the 2008-2009 Global Financial Crisis. Back then, the federal government also spent trillions to revive the economy, and many expected runaway inflation. It never happened.

If you go back to 2009, however, quantitative easing (QE) and other liquidity programs just served to recapitalize banks after the devastation of the financial crisis. Banks desperately needed capital reserves, and most of the stimulus just ended up parked on bank reserves. In order to trigger inflation, dollars need to move around the real economy – not sit on bank balance sheets.

Fast-forward to 2021. Banks are already well-capitalized, and a lion's share of government stimulus payments have come in the form of direct transfers – stimulus payments to families, PPP and Main Street loans (which essentially become grants), expanded unemployment benefits, child tax credits, and more. Though many American families are saving their stimulus payments, a significant portion of stimulus payments are not sitting on bank balance sheets. The money is moving around the real economy.

The end result is that the M2 money supply is rising at an unprecedented 25% year-over-year rate, which is faster than during the inflationary period of the 1970s:



***Source: Federal Reserve Bank of St. Louis*[3]**

In short, I think the case for future inflation is pretty strong. But I'm also not too worried about it today. The U.S. economy still has plenty of slack, and rising money supply is a good driver of growth. If inflationary pressures start in earnest, it will be a sign that the economy is returning to full health. Remember, some – but not too much – inflation is a good thing.

The Federal Reserve has made it clear they are comfortable seeing inflation run above their long-term target. So, seeing inflation in the 2% to 3% range would be acceptable, and would not put the economic expansion at risk. If inflation runs hotter than that, the Fed can easily step in and raise interest rates and sell bonds to tighten monetary policy. There are plenty of tools available to fight inflation, but I don't think the Fed will have to use any of them in 2021.

Bottom Line for Investors

I agree inflation is a growing concern. I just disagree with framing it as an urgent concern today. The U.S. economy still has plenty of runway to return to pre-pandemic strength, and there is plenty of spare capacity and slack in the labor market to keep prices from moving too high too quickly, in my view. Inflation could very well become an economic issue down the road, but I just don't think it will be a major concern in 2021.

At Zacks Investment Management, every decision we make on behalf of clients is data-driven and fueled by the power of independent proprietary research. If and when inflation becomes a significant concern, we will factor it into our decision-making process.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. March 21, 2021. https://www.wsj.com/articles/stimulus-checks-have-left-u-s-households-flush-to-spend-11616335200

[2] U.S. Department of Treasury. March 22, 2021. https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2021

[3] Fred Economic Data. February 23, 2021. https://fred.stlouisfed.org/series/WM2NS

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

• Gas prices climbing higher

• The Fed Chairman talks inflation

• Housing market strength continues

• Ship stuck in Suez Canal and its impact on supply chains

Noticing Higher Gas Prices? They Could Keep Climbing

It's not just your city or town where gas prices are inching – or perhaps even climbing – higher. Gas prices reached a national average of $2.88 a gallon last week, which reflects a 30% increase from the same time last year. Of course, looking back one year, the U.S. and global economy were on lockdown, and gasoline refiners were anticipating the impact of a major recession. An outlook of plummeting demand pushed refiners to make major cuts to output, bringing both supply and demand – and thus prices – downward. The opposite seems to be true looking ahead to this spring and summer, as vaccination rates are up and Covid-19 deaths and hospitalizations continue to trend lower. Americans are hitting the road for spring break vacations and are likely planning even more travel over the summer, which has put upward pressure on crude oil and gas prices. The winter freeze in Texas also knocked back supply just as demand was starting to trend firmly higher.[1]

The Fed Chairman Talks Inflation

Federal Reserve Chairman Jerome Powell testified before lawmakers this week, and one of the main topics of interest was the elephant in 2021's room: inflation. The financial news media has been abuzz in speculation over how the new $1.9 trillion stimulus bill – and all the stimulus that came before it – may or may not lead to high inflation in the coming quarters or years. Chairman Powell seemed to err on the side of not worrying: "[The Fed] might see some upward pressure on prices. Our best view is that the effect on inflation will be neither particularly large nor persistent." He also added that the Fed, for now, remains strongly committed to the accommodative policy given that the economic recovery still has plenty of runway. Overall, Mr. Powell set out to make clear that he did not believe a one-time spending surge would lead to sustained inflation, particularly since the economy has been battling deflationary pressures for over a decade now. Even still, the Federal Reserve has tools to beat back inflation if it becomes an issue.[2]

Housing Market Strength Continues. Can It Last?

Housing market strength in the U.S. continues apace, and for the second time ever, there are more real estate agents than there are homes for sale. At the end of January, there were 1.04 million homes for sale and 1.45 million agents, which marks a 26% decline in homes for sale and a 4.8% increase in agents available to sell them. The record-low number of homes available for sale could ultimately place even more price pressure on the market, as the spring season generally tends to boost demand. Existing home sales fell 6.6% in February, which still marked a 9.1% increase from the previous year. On average nationwide, houses are selling in less than three weeks. Low-interest rates and remote-work capabilities have driven a big part of demand, which begs the question of whether a full reopening coupled with upward pressure on interest rates will abate the trend.[3]

Ship Gets Stuck in Suez Canal, May Lead to Even More Supply Chain Bottlenecks

Supply chains have already been compromised by the pandemic, but matters may have been made slightly worse this week when a ground container ship got stuck in the 120-mile canal connecting the Red Sea with the Mediterranean. The Suez Canal is a key route for tankers carrying oil and natural gas, as well as manufactured goods like electronics and machinery from Asia and bound for Europe. If the vessel clogs the canal for any more than one day, the implications on supply chains can become significant, adding costs and delays to a logistics industry already far behind.[4]

ZACKS INVESTMENT MANAGEMENT, INC.

[1] Wall Street Journal. March 24, 2021. https://www.wsj.com/articles/unusual-leap-in-gas-prices-puts-3-a-gallon-in-sight-11616578202

[2] Wall Street Journal. March 23, 2021. https://www.wsj.com/articles/powell-yellen-set-for-first-joint-appearance-in-congress-11616491801

[3] Wall Street Journal. March 21, 2021. https://economics.cmail20.com/t/d-l-qyuhutl-jdhijihhuy-h/

[4] Wall Street Journal. March 24, 2021. https://www.wsj.com/articles/the-suez-canal-is-blocked-by-a-giant-container-ship-11616560437?mod=article_inline

DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm’s research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable.

Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns, which will be reduced by fees and expenses.