Capital Markets Brief – “Inflation expectations”

4/9/21

“Looking forward into 2021, it appears we are headed into a full tilt equity bubble… With an absolute avalanche of stimulus, and more seemingly on it’s way, it is difficult to see investors wanting to sell stocks…” – from our 1/11/21 capital markets brief entitled “Its all about the dollars.”

We are happy to observe that not only was our January prediction accurate, but we can currently observe a similar mix of conditions immediately present.

1. The US government has just recently passed more than $1 Trillion in stimulus and is actively marketing another stimulus package of more than $2 Trillion thus keeping pressure on the dollar.
2. Most major US equity indices have started Q2 with Wall Street net short of them… which is wild considering investor sentiment is near bullish extremes.
3. Inflation is present and accelerating.

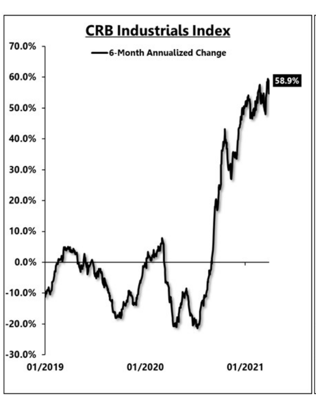
This leads us to the overwhelming conclusion that the environment for equities remains distinctly bullish.

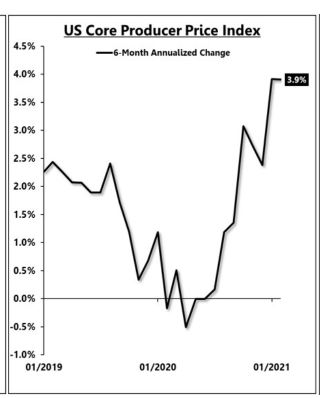
Equity markets will likely continue to make all-time highs for most of Q2 2021. With the US dollar still looking weak, inflation is poised to pop with year over year comparisons for March and April likely to produce a near term peak. If you think back to last year, the US economy experienced its worst drop off of all time in the March and April months with recovery just barely starting back up in May. Inflation is measured in year-over-year terms and will therefore show its most pronounced measurement in March and April of 2021. Coordinated global stimulus has indeed produced its desired effect of jump- starting economic activity. The lull in most commodity price complexes (such as energy and mining) over the last 7 years resulted in under-investment in certain areas where demand is likely to remain persistently strong over the next few years. As a result, in Q1 of this year, Goldman Sachs published research making the case that we are at the very beginning of another commodity super-cycle which is likely to see stubbornly high prices throughout the commodity complex.

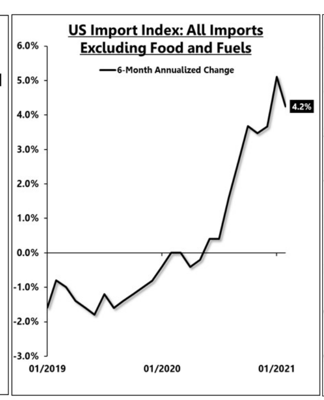
Prior 12 month change:

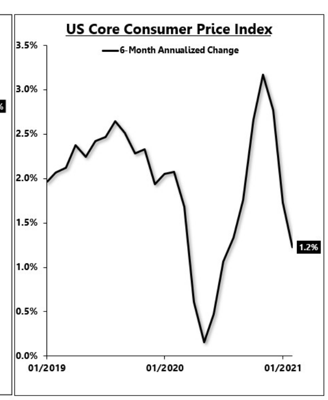
Silver	+65%
Copper	+76%
WTI Crude	+125%
Nat Gas	+45%
Rare Earths	+150%
Platinum	+60%

While we are not quite as bullish as Goldman, we can easily observe several areas of the commodity complex where respective industries have experienced meaningful weakness resulting in over-indebtedness and significant constraints on capital spending. The result of such an environment has the direct impact of limiting current supply as well as a likely sluggish response to increased demand. The tidal waves of stimulus being thrown at the US economy will also hurt the US dollar and need to find a home in the global marketplace somewhere. Certain commodities such as Rare Earth elements as well as copper, platinum, and oil and gas share a common cocktail of fairly limited supply and relentless (stimulus fueled) demand. While it is difficult to predict how long the “super-cycle” may last, so-called experts think it will take at least 2 years before supply chains are able to catch up to demand. We will see… but for now: the dollar looks weak + inflation looks strong + more stimulus is being promised = commodity prices should continue to move higher over the coming year or more.









Looking Further Ahead:

As we get into the back half of the year, we see a very challenging environment for equities. Year over year comparisons will get tougher as the third quarter of 2020 had GDP growth of 30%. The rise in commodity prices will inevitably squeeze profit margins just as the economy is slowing (still growing but at a much slower pace of ~2.5%). Add to this challenging environment the current tax hikes the Democrats are proposing and the market will have a very difficult time attempting to advance.

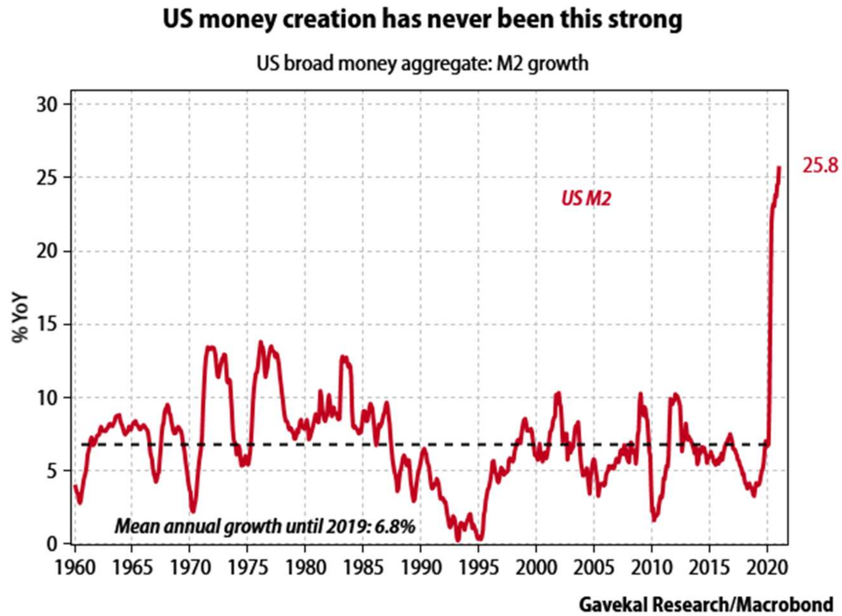
Bloomberg recently ran an article on April 3rd of this year entitled "A Century of Data Show Markets are Far from Impervious to Tax Hikes" which showed "the average return on the US benchmark index in the years of the hike is 2.4% and drops to -0.9% for the year following. That compares with a long-run average of 7.7%." Current proposals are to boost the corporate tax rate to 28% from 21% and are estimated to shave 3% off of S&P500 earnings. Further, CNBC ran a piece on 4/7 reviewing the Penn Wharton Budget Model which projected that the proposed Infrastructure Stimulus package would actually reduce GDP, increase deficits, and decrease hourly wages! I can't believe I just typed that last sentence, but you can click on the hyperlink to see a summary clip or follow this link:
https://twitter.com/CNBC/status/1379838126835687427

Hourly wages falling seems very bad for further social unrest. And, even if the analysis by Wharton (one of the most prestigious business schools in the world) is wrong, it probably isn't off by much, and it would appear we are not gaining much (if any) efficiency from a $2+ trillion dollar infrastructure plan, which is extremely disappointing.

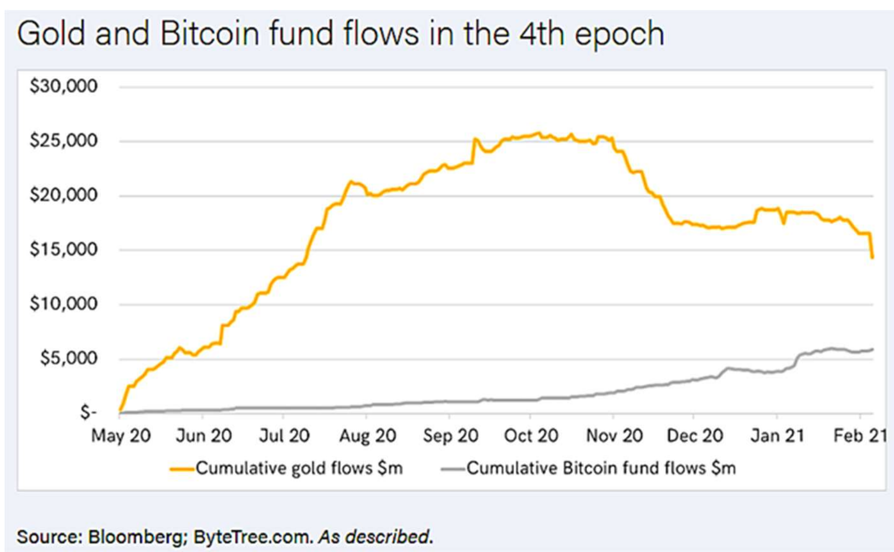
Bitcoin:

We are almost constantly being asked about bitcoin and other crypto currencies. The truth is, up until March of this year, these crypto currencies had nothing tangible supporting their adoption into the global financial super-structure. The "silk road" was probably the best piece of evidence that it may become a real factor, but these "currencies" were purely speculative. That however, has changed, as in March the Federal Reserve opened a special facility for the holding and exchange of crypto-currencies. This is by far the single most tangible thing we can observe happening to the crypto world to legitimize their existence and future. China as well seems to have taken several steps in the last few months which communicate further legitimacy to these "currencies." They do however remain extremely speculative, and investors should remember that bitcoin experienced an 80% decline in value in 2018!

Due to the Fed's action in March, we have poured a significant amount of effort into analyzing crypto-currencies and Bitcoin in particular. We now have a bitcoin and crypto tracker, designed and run by the single best research firm we have ever partnered with, which has provided clear buy and sell signals on a daily basis for bitcoin over the last year or more with extremely high accuracy. The tracker is currently telling us that Bitcoin and most major crypto currencies are in a bullish trend with substantial near-term upside. It appears Bitcoin, and possibly the other crypto's as well (we need more time and data to confirm), absolutely love inflation. The chart above gives a cycle-oriented view of Bitcoins progress over the last several years as well as an indication for its potential move in the present cycle.



At the bedrock of the commodity super-cycle as well as this latest crypto-currencies wave seems to be our governments willingness to spend both through fiscal means (govt stimulus) as well as monetary policy (The Fed). New evidence is beginning to suggest that Bitcoin is starting to become a very real competitor to gold as a hedge against inflation, currency devaluation and the potential for a global meltdown. While we do not see a global meltdown on the horizon (though officials could always make a major policy blunder), we clearly see the components for persistent inflation pressures as well as US dollar devaluation.



On a practical note, we have been allocating a small percentage of our more aggressive portfolios to some of the Bitcoin miner companies, MARA, in particular struck us as undervalued based upon its one-year outlook, though several are attractive if an investor believes Bitcoin and other crypto's will continue in their uptrends over the coming months.

Energy was the number one performing sector in Q1, but usually experiences some seasonal weakness in the spring and fall. We still like the pipelines within energy, though the whole energy sector remains unloved and undervalued. In speaking with the head of the pipeline group at Goldman Sachs on a recent conference call, he told us that they expect oil to remain between $70-80 per barrel for the better part of the next 2 years. They also think natural gas will spend most of the next 18-24 months over $3/mcf. As we have stated before, we think the energy space has experienced under-investment over the last 5-7 years and as a result think prices will surprise to the upside, but we would take the lower end on Goldman Sachs forecast for oil and nat gas.

In summary, we remain bullish on equities and inflation sensitive assets for Q2 of 2021; however, we will likely be de-risking portfolios to a meaningful degree at some point in the early to mid-summer due to the factors mentioned above.

We hope you and your families are healthy and happy and looking forward to a quarantine free Summer.

Blessings to you and your families,

BTW & team