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MARKET COMMENTARY

April 1st, 2021

How Much is Too Much?

After spending much of the past year opining about COVID and its impact on the economy, we'd like to try a slightly different tack. Nothing elicits yawns like the subject of fiscal policy, (which our significant others frequently remind us) but to understand today's markets, needs must. We promise to make it quick.

There are two primary ways to influence an economy, the first is monetary (think interest rates and money supply) the second is fiscal (tax policy and government spending). The Federal Reserve sets the first, Congress sets the latter. Because Fed Governors are appointed not elected, they can be fairly nimble. We saw this last March when the Fed cut interest rates twice in two weeks and announced a bond-buying program that immediately placated a jittery credit market.

But thanks to political maneuvering, election cycles and the inestimable difficulty of getting 535 politicians to agree on anything, fiscal policy can be slightly more cumbersome. There's a reason the U.S. tax code is 2,600 pages.

Not only can Fed Governors change policy quickly, but the results are immediately apparent. If they adjust the overnight lending rate, several hundred billion in loans reprice *that night*. In contrast, taxation and spending proposals can take a year to debate, another year to pass and may not be felt for several more (if at all). By necessity, last year's policy always confronts next year's economy. We've never had the opportunity to pilot an aircraft carrier, but we suspect it's not dissimilar.

While Congress deserves credit for immediately passing the CARES Act in March of 2020, there have been a total of six relief packages approaching $6 trillion and the prospect of an additional $3 trillion infrastructure bill. The amount of relief would account for 27% of US GDP, which dwarfs the response to both the *Financial Crisis and the Great Depression combined*.

It's almost impossible to say what was the right amount of fiscal stimulus required to resurrect an economy hobbled by COVID. GDP has never declined 34% in a quarter before. Direct payments, enhanced unemployment benefits, and small business backstops were appropriate to alleviate economic suffering, support workers who lost their livelihood and shore up industries that voluntarily closed to save lives. But spend even a few moments unpacking the contents of the relief package(s) and you'll discover that much of it is government largess wrapped in a relief wrapper. While it may be impossible to say just how much spending was necessary to healing an ailing economy, Congress decided the risk of doing too little outweighed the risk of doing too much.

GDP declined 3.5% in 2020. Congress spent 27% of GDP to ensure it wasn't worse. Most agree that herd immunity, through a combination of vaccination and prior infections will be achieved sometime in 2021. Meanwhile, the stimulative effects of recent policy will accelerate an economy already on the mend. It's as if a patient was released from the hospital, but a doctor decided to give him 5mg of adrenaline just to be sure.

This has led to an expectation that economic growth could be ‘bonkers’ in 2021. GDP is now forecast to exceed 6%, which would mark the fastest growth since 1984. Consumers eager for a sense of normalcy are armed with both higher personal incomes and net worth. Homeowners have gotten the twin benefits of lower mortgage payments and higher resale values in an extremely tight real estate market. Due to disruptive weather, shipping bottlenecks and the normal friction of restarting an economy, inflation expectations have reset meaningfully higher.

The probability of robust growth in 2021 hasn’t nudged investors into risk-assets so much as shoved them. Equity inflows are on pace to set new records. Many stocks with the most sensitivity to economic growth (read riskiest) are the best performers. Numerous companies with the worst balance sheets have doubled or tripled. The IPO market is frothy, retail speculation is rampant and risk appetite seems insatiable.

This is a hard environment for investors like us. We try to be measured in all economies, to weigh the potential for value creation against capital loss. We prefer businesses with secular growth that aren’t reliant upon a rapidly (or rabidly) expanding economy to succeed. Our predilection is for businesses with pricing power, not prone to the whims of inflation. Many of these businesses haven’t had their outlooks rapidly change, which is part of why we liked them in the first place.

Those of you who check your performance regularly, may see some holdings have temporarily lagged an extremely ‘risk-on’ market. This is as it should be. The world is full of investors who believe they can market time inflection points in economic cycles and get in (and out) before the tides change. Not only does this approach require being right twice, it typically generates significant tax consequences.

The market currently fears inflation will get out of hand, that Congress went a step too far with the checkbook and that after a decade of underperformance, value stocks are finally due for their day in the sun. Our process is intentionally agnostic between value and growth, and we don’t jettison half of a portfolio when one style experiences a period of under-performance. We strive to generate consistent returns across market cycles, which requires discipline, process adherence and a willingness to ‘look wrong’ for periods of time.

In our experience, principles always come with a cost; a time where they seem inconvenient or can cause temporary discomfort. A phenomenon like GameStop, where a company’s stock price appears to outpace its fundamentals, will occasionally make investing in quality companies with sound capital allocation seem old-fashioned or out-of-step with the times. But in our experience, unlevel heads seldom prevail for long.

A current GDP estimate is for a more ‘normal’ 3.2% in 2022. This year, inflation is expected to be elevated but we suspect could eventually moderate. Trillions of debt will require repayment which can act as a governor on future growth. Most expect taxes to increase. In other words, this economic surge may be temporary. We thank you for your business and if you have questions or comments, please don’t hesitate to contact your relationship manager.

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Coronavirus Aid, Relief, and Economic Security Act (CARES Act) is an economic stimulus bill signed into law on March 27, 2020. Historical economic and GDP figures from the US Department of Commerce's Bureau of Economic Analysis. Personal income, net worth, and mortgage data from Federal Reserve Economic Data, Federal Reserve Bank of St. Louis. GDP 2022 estimate from Wall Street Journal Economic Survey Projected Q2 2022 estimate. Data is the property of their respective owners, all rights reserved.

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