Weekly Market Insights

February 22, 2021

Biden declares America is back and investors in a quandary

Equity Markets

Equity markets took a break from their seeming relentless gains this past week. The Dow gained 0.11% while the S&P 500 lost 0.71% and the NASDAQ lost 1.57%. There are a number of reasons for the weakness in the equity markets. Some investors and analysts think the United States is in for a serious bout of inflation. There are a few explanations for this. One reason is due to all of the fiscal stimulus enacted in 2020 and the expectation of more to come under the current administration. Another one is the perceived success of the vaccines and the increasing pace of distributions. These, along with an overwhelming amount of liquidity in the system from Federal Reserve action, will create a burst of demand and inflation. We addressed part of this in last week's discussion of economics, and this week we continue the discussion.

Economics

The argument for inflation can be a persuasive one. We wrote last week about the debate between Larry Summers and Paul Krugman, both famous and highly qualified economists. You can read our take on their debate by going to our website, www.1919ic.com.

Our argument is not so much will there be an inflationary response but when and how much.

There is enough liquidity in the system to refloat the Titanic, and depending on what happens in the next week or two, more will come with the upper boundary being $1.9 trillion. Last week, we agreed with Mr. Summers' argument that the need for more stimuli is certainly present, but the $1.9 trillion price tag is too much, even if political reality demands it. More of the package should be focused on infrastructure spending which creates jobs and pays for itself over time. This, unfortunately, does not appear to be the case. Remember, Treasury Secretary Yellen and the economic leadership in the administration are labor economists,[1] meaning their primary concern has been and continues to be the health of the labor market. Therefore, it is no surprise this is where their focus lies. The pandemic is very likely to slow down in the coming months, freeing up the economy, but, the growth of the economy will not be so rapid as to bring the economy to full employment for some time. So, excess demand is in the indeterminate future but certainly not in the immediate future. We appear to have greater faith in Federal Reserve Chairman Powell to tighten monetary policy when needed than many other analysts. We have always argued that, as a rule, inflation must have an excess demand component in both the labor market and the real product market. Given the extraordinary weakness in both, even with excess liquidity and powerful fiscal forces at work, inflation should not be a problem for at least 18 months. Remember, economic forecasting is not a sure thing. Economic movements are dependent on human behavior which has always been difficult to divine. John Kenneth Galbraith, a famous and very clever economist, quipped, "Economic forecasting was invented to make astrology look good," and John Maynard Keynes, a far more serious economist, stated, "Mathematics is a far better describer of economics than predictor of economics."

[1]No one should confuse the use of labor economist with the use of the term labor as in the U.K Labor Party meaning left leaning, it merely means that they concentrate on the economics of labor.

Weekly Market Insights (cont'd)

Where does this leave the investor? When most investors started, often with the help of an advisor, they worked out how much risk they could tolerate and worked hard to create an asset allocation model within those parameters. Those decisions were made not under stress of rapidly moving markets but with quiet reason. That's where investors should return. Investors should go back to that model, and, if the markets have moved enough to unbalance their allocation, investors should rebalance!

International

Last week, President Biden told an international audience, "America is back!" This has many implications—diplomatic, military and economic. All are related in one form or another. We, of course, focus on economic impacts. The United States will be rejoining, or becoming much more active in, the World Trade Organization, NATO, and most all other international organizations. We and most economists will applaud this move.

Some have written that it will take a long time for the United States to regain its former status, but we do not agree. The U.S. economy is just too large not to be accepted back on the former terms. As time passes, we hope people will view that having a mild isolationist view of the world has been an aberration. There is so much to gain by global reengagement.

We have written in the past that globalization is not going away, but mutates, evolves and continues to move forward. This may be one of those points.

Frictions will continue and that is to be expected. Globalization generates friction. Countries or groups of countries, such as the European Union, will continue to strive to gain market share. The original economic philosophers of international trade and globalization not only expected this but also encouraged it. Globalization encourages innovation, excellence in product, and prevents economic and business complacency. It keeps new and better products coming and consumer prices down. Of course, it has downsides, and adjustments often come with a significant time lag. These are the times that can be governments' finest hour. Here is where they should step in, and an example of this is already available in the United States—the earned income tax credit. The program can easily be expanded to help those who have been hurt by trade.

Conclusion

At the moment, there is an exceptional number of moving parts influencing the economy, business, and investor confidence. These of course are the important factors for market behavior. In our view, the current situation reinforces our belief in asset allocation.

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