PANDEMIC COUNTERMEASURES DOMINATE

OPTIMISM REIGNS

In October, the International Monetary Fund expected economic growth within the U.S. to approximate 5.1% for 2021. Earlier this month the IMF issued a press briefing amending that estimate to 6.4%. Similarly, it had been estimating global growth of 5.5% for 2021 whereas it now envisions a figure of 6%. If the IMF is correct, the revised figure would represent the highest rate of global economic growth since 1980.

Within the U.S. people are obviously anxious to recapture some semblance of normalcy as the country continues to work toward herd immunity to COVID-19. Here's a recent box score.

People Vaccinated	At Least One Dose	Fully Vaccinated
Source: CDC; April 24, 2021, 6:00 A.M.		
Total	138,644,724	93,078,040
% of Total Population	41.8%	28%
Population ≥ 18 Years of Age	136,993,180	92,656,311
% of Population ≥ 18 Years of Age	53.1%	35.9%
Population ≥ 65 Years of Age	44,477,440	36,695,327
% of Population ≥ 65 Years of Age	81.3%	67.1%

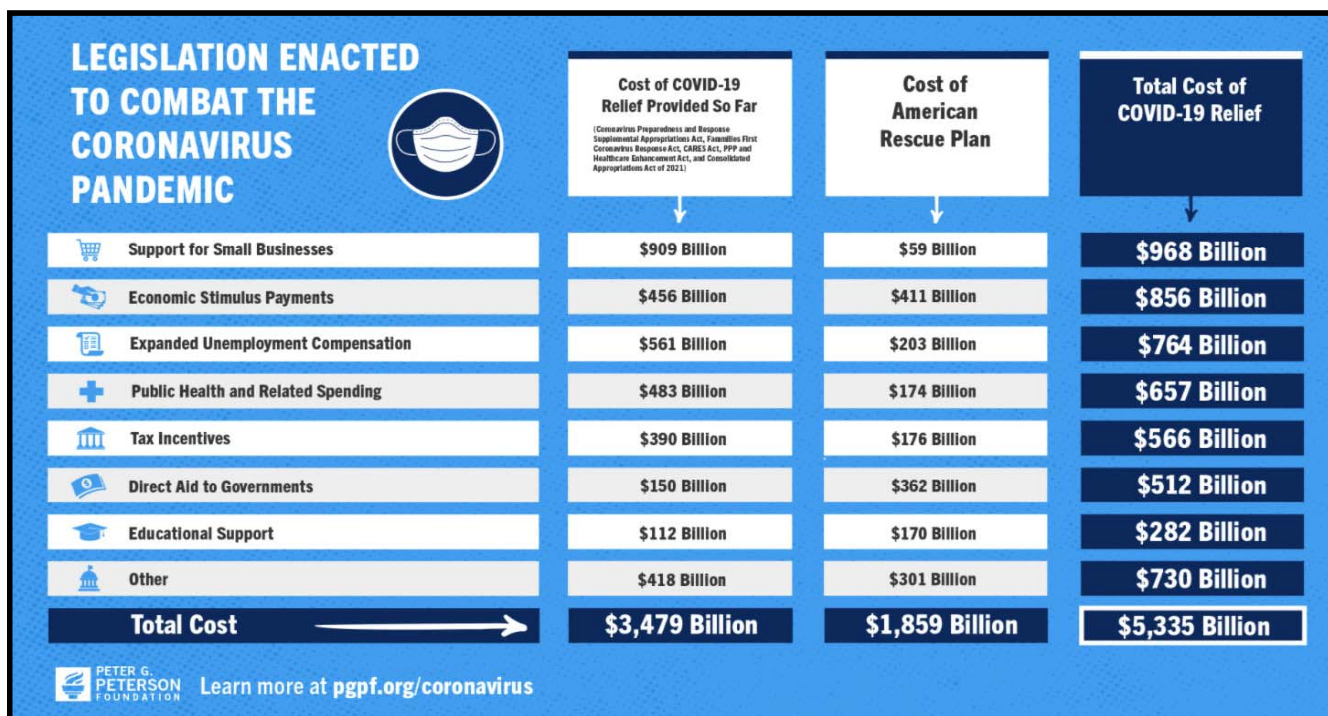
SURGING STOCK VALUATIONS

One obvious way in which optimism has manifested itself is in the form of surging stock indices. The S&P 500 provides a representative example of that surge.

Since there's widespread agreement that the pandemic has damaged economies around the world and since we're still in the midst of the pandemic, it seems fair to wonder why that black dot would be sitting so far above the green one.

REASON #1 — CONGRESSIONAL STIMULUS

Prior to the adoption of the American Rescue Plan, the U.S. economy had already been infused with some $3.5 trillion worth of stimulus from a host of relief bills. After the American Rescue Plan became law in March, an incremental $1.8 trillion is now being funneled into the U.S. economy. As shown below, Congress will eventually have approved about $5.3 trillion worth of relief in response to the pandemic. To the extent the funds flowing forth from these relief packages are financed, and they are, they will be stimulative to the economy, at least in the near term.



LEGISLATION ENACTED TO COMBAT THE CORONAVIRUS PANDEMIC

	Cost of COVID-19 Relief Provided So Far (Coronavirus Preparedness and Response Supplemental Appropriations Act, Families First Coronavirus Response Act, CARES Act, PPP and Healthcare Enhancement Act, and Consolidated Appropriations Act of 2021)	Cost of American Rescue Plan	Total Cost of COVID-19 Relief
Support for Small Businesses	$909 Billion	$59 Billion	$968 Billion
Economic Stimulus Payments	$456 Billion	$411 Billion	$856 Billion
Expanded Unemployment Compensation	$561 Billion	$203 Billion	$764 Billion
Public Health and Related Spending	$483 Billion	$174 Billion	$657 Billion
Tax Incentives	$390 Billion	$176 Billion	$566 Billion
Direct Aid to Governments	$150 Billion	$362 Billion	$512 Billion
Educational Support	$112 Billion	$170 Billion	$282 Billion
Other	$418 Billion	$301 Billion	$730 Billion
Total Cost	$3,479 Billion	$1,859 Billion	$5,335 Billion

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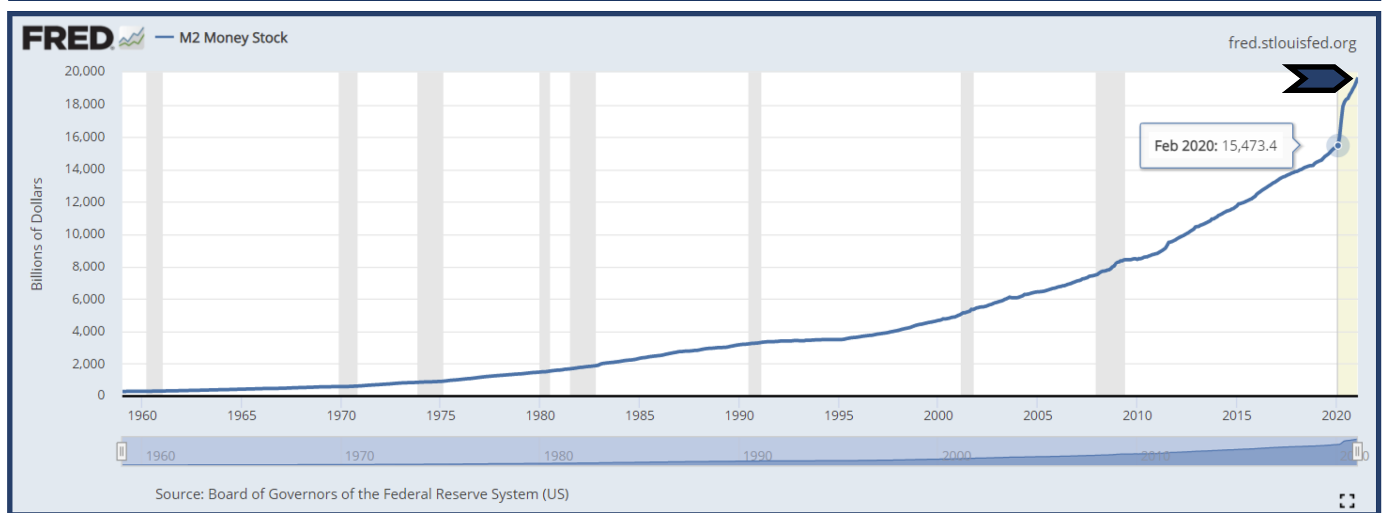
REASON #2 — FED STIMULUS

Like the hormone that regulates the production of red blood cells according to the needs of a body, the Federal Reserve regulates the stock of money within our economy. When referring to our stock of money, economists use several measures which are colloquially referred to as M1, M2 and M3. M1, is comprised of currency, checkable deposits and travelers checks that have been issued. M2 consists of M1 plus savings and time deposits of less than $100,000 as well as money market fund balances. M3 includes M2 plus larger time deposits. For reasons that are beyond the scope of this note, M2 tends to be the measure of choice for forecasting purposes.

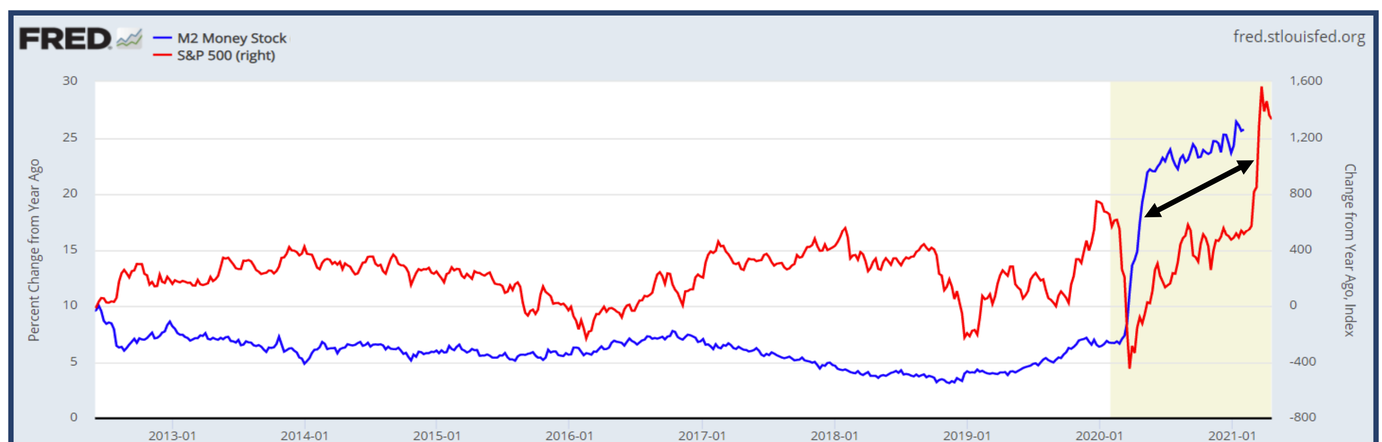
In February of 2020, prior to the world understanding it had a health crisis on its hands, M2 within the U.S. stood at about $15.5 trillion, as shown next.



This February (latest figures), it stood at $19.7 trillion (arrow). The Fed typically increases the stock of money more or less commensurately with the expansion of the economy as a whole. Since last February however, the stock of money within the U.S. has ballooned by a whopping 27% and recent comments from the Fed suggest further expansion to the monetary base is likely. Combined with the $3.5 trillion worth of relief Congress has already undertaken, recent stimulus to the U.S. is already on the order of $7.7 trillion.

THE IMPACT OF THAT $7.7 TRILLION ON EQUITIES

Instead of explaining the impact this stimulus has had on equities, you can see the spike in the S&P 500 that occurred subsequent to the spike in M2. Of course, correlation isn't necessarily causation, but there are reasons to believe it is in this case. And, remember, not only does the American Rescue Plan promise another $1.8 trillion worth of stimulus, the Fed is not necessarily finished injecting stimulus, either.



WHY NO DRAMATIC IMPACT ON ORDINARY GOODS & SERVICES?

Assuming one concurs that this stimulus has dramatically impacted equity valuations, one might then wonder why the prices of more ordinary goods have not been similarly impacted. The answer to that question is complicated, but one facet of that answer has to do with how the marginal propensity to consume differs across the population. For things like ketchup ("catsup" for anyone who has a davenport), financial relief received by a struggling family may allow it to buy the ketchup it would otherwise have purchased with regular income lost due to the pandemic. However, a family that is not struggling that, nonetheless, receives financial relief is not likely to consume more ketchup than it otherwise would have. The result is that the demand for ketchup and other consumables like it remains relatively steady because that demand is said to be inelastic.

Because the algorithms used to determine who is and who is not entitled to economic relief are relatively crude, many people who may not have needed any pandemic-related financial relief received some anyhow. People in that category are likely to already have all the ketchup they can tolerate. Consequently, they are more likely to invest some or all of any COVID-related relief they receive in stocks, real estate and other capital assets for which demand tends to be more elastic. Combined with that elasticity, that increase in demand expresses itself in the form of higher valuations. Again, there are other reasons for equity valuations to have surged relative to more ordinary goods that I will not address here, but I did want to mention that it makes sense for capital asset values to have surged relative to more ordinary goods.

REASON #3 — INFRASTRUCTURE SPENDING

Congress recognizes the need for infrastructure renewal within the U.S., but it is divided as to an appropriate level of spending. The plan put forth by the Biden administration would entail about $2 trillion worth of incremental spending whereas Republicans have proposed a $568 billion package.

To the extent the U.S. incurs incremental indebtedness to finance any of the infrastructure spending that is now being kicked around, it too would fall under the umbrella of economic stimulus. Even if an eventual infrastructure package of *only* $568 billion were to be adopted (I still remember when hundreds of billions of dollars was actually considered to be a lot of money), the total tally for recent and/or near-term stimulus would exceed $10 trillion.

For the sake of context and scale, if you compare that $10 trillion figure to the level of M2 a decade ago (refer back to page 2), you'll see that the recent actions of Congress and the Fed are about as large as the entire stock of money was in the U.S. at that time, and that's before factoring in an additional $1.5 trillion of spending that could result from the adoption of an infrastructure package that conforms more closely to the larger, $2 trillion package the Biden administration has proposed. In short, all this dough is causing some distortions.

WHAT THE FED GIVETH ...

Last month, the Fed indicated that it had no plans to remove any stimulus through at least 2023. While investors are currently taking comfort in this stance, they also know it is temporary. Or, if the Fed's easy-money stance does somehow turn out to be permanent, there can be no advance assurance of that permanence. Therefore, as we roll through this year and the next two, investors are likely to become increasingly anxious as they attempt to weigh the gains they might capture by participating in an equity market that's on the verge of no longer being fueled by easy money against the increasing risk that they may see the value of their gains vanish if competing investors make a sudden move toward the exits a bit faster than anticipated.

And, any sudden move toward the exit need not necessarily be driven by an actual signal from the Fed that it intends to remove stimulus. If a large institution makes a sudden move for the exits that is not warranted by forthcoming Fed action, it may not matter. As that anxiousness intensifies in anticipation of the Fed reversing its easy-money stance, investors may become increasingly apt to respond to the slightest hint of a Fed reversal, whether it occurs or not, rather than hanging around to pontificate about it.

I do not intend any of this to suggest that equity investing is dead. Now that interest rates have clearly been on the rise, I think equities may hold more of an advantage over bonds and cash than they previously did. However, I do want to stress that because the Fed has already announced that the unprecedented easy-money policies that are now in play are up for review during or after 2023, the clock is clearly ticking. As it does, I would expect an increase in that anxiousness to manifest as an increase in volatility.

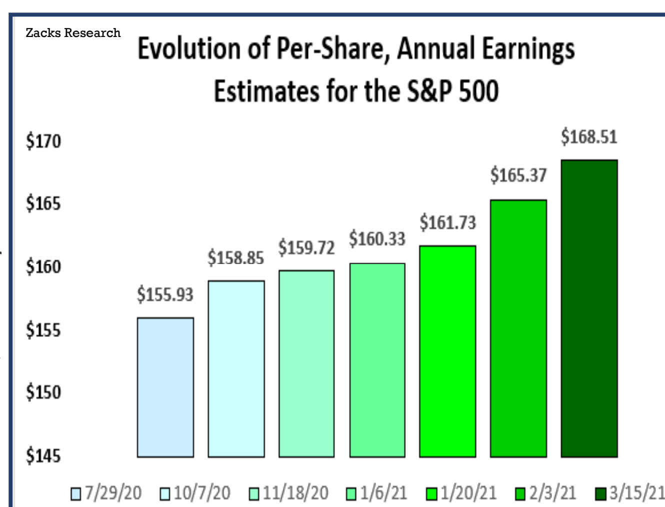
CORPORATE EARNINGS LOOK GOOD

In addition to all the money sloshing around in our system, corporate earnings estimates have rebounded sharply since the pandemic began and they're expected to grow further.

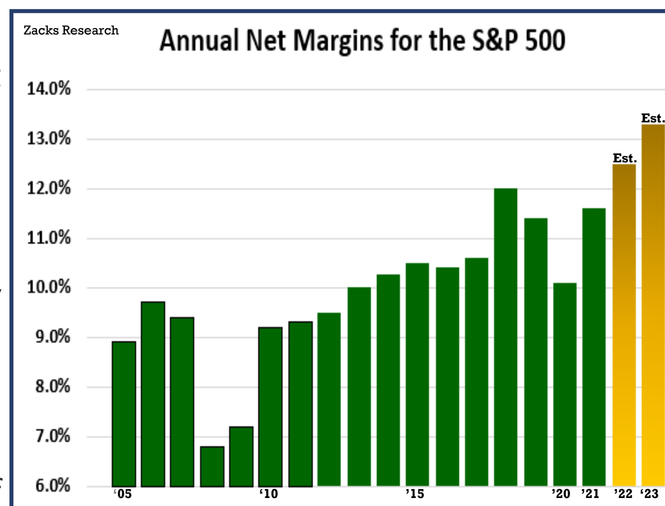
Last summer, before vaccine success was in hand and before the ameliorative impact of efforts by Congress and the Fed were as apparent as they are now, the prognosis for a recovery was much less clear. Accordingly, estimates for corporate earnings, which are the primary driver of stock prices, have rebounded sharply since then.

A particularly useful way to assess the direction of corporate earnings is to estimate a hypothetical investor's share of corporate earnings if that investor were to own a *single* share of *each* company within some stock index and to then see how those estimates vary over time.

As shown here, a hypothetical investor who owned one share of each of the 500 companies that comprise the S&P 500 might have, *last summer*, expected those 500 companies to earn about $156 over the course of a year on that investor's behalf. If analysts are at all accurate, that investor's share of annual earnings might now approximate $169. That 8% change in expectations is just one of many factors driving the surge in equity values.



Although profit margins help determine earnings, healthy profit margins explain at least part of the reason earnings are expected to be as robust as they are.



AN EQUITY PARTY … FOR NOW

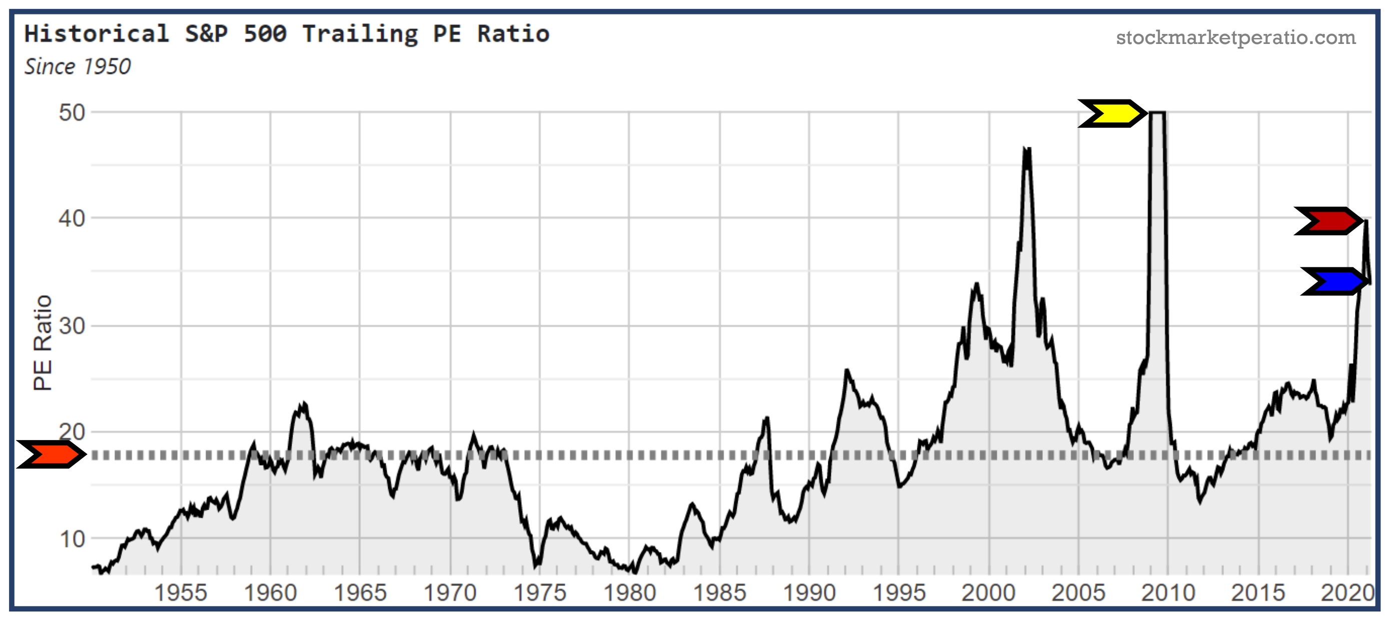
Unlike the Fed, investors need not worry about Congress unwinding any of the trillions of dollars worth of relief measures it has already approved or will approve. Instead, the associated debt incurred to finance the relief measures I've already outlined will sit on our country's books until a bolt of fiscal discipline stirs Congress to begin repaying it, or until our sun envelops the earth as it transforms into a red giant.

Equities continue to benefit from the various tailwinds I've already discussed, but again, assurances from the Fed that it is disinclined to begin unwinding any stimulus it has or will pump into the U.S. economy should be viewed with the realization that this is the Fed's *current* posture.

EQUITY DISTORTIONS

I previously mentioned that all the new money sloshing around in our system is distorting equity valuations. In January, investors were being asked to pay, on average, about $40 for each dollar's worth of corporate earnings (red flag, next image). That is, the price-to-earnings (P/E) ratio of the stock market, as represented by the S&P 500, was 40:1, or "40." Because corporations have been reporting higher earnings since then, that ratio has relaxed a bit to about 34 (blue flag). By historical norms, being asked to pay $34 for each dollar's worth of corporate earnings still represents a rich premium, (orange flag). During the meltdown of 2008-9, P/E ratios soared (yellow flag) as corporate earnings temporarily collapsed. As earnings recovered, P/E ratios normalized. Today, the situation is quite different. The previous high for annual per-share earnings from companies that comprise the S&P 500 occurred in 2019 with a figure of $142.75 … 15% lower than the most recent estimate of $168.51 that appears on the previous page.

Whereas investors were willing to pay huge premiums to own stock in 2009 while they anticipated an earnings recovery, investors today are being asked to pay a still substantial premium (a P/E of 34) to historical norms (a P/E of about 19) even though corporate, per-share earnings are *already* 15% *higher* than their previous high.



Stated differently, corporate earnings would have to increase by 79% from their current, record high to bring the market's P/E ratio of 34 down to the historical average of 19! To the extent those future earnings increases do not materialize, equity valuations could experience quite a downdraft as investors realize current premiums lack justification.

BONDS FACE HEADWINDS, TOO

As a result of efforts by Congress and the Fed to mitigate pandemic-related damage, the yield on the benchmark 10-Year Treasury Note has increased by about 1% since the onset of the pandemic last March when it stood at .54% (not a coincidence).

Economic forecasting firm, Capital Economics, estimates 10-Year Treasury Yields will rise to 2.25% by the end of this year and to 2.5% by the end of the next, partly as a result of improving growth prospects and partly as a result of expectations of higher inflation within the U.S. Since the yields on other types of bonds tend to move in relation to the yields on Treasury securities and because bond values tend to move inversely with changes in interest rates, **bond valuations are also apt to face some downward pressure if rates do, in fact, continue rising as Capital Economics predicts.**

Imagine a scenario where an investor holds an 8-year bond that offers a 3% coupon in an environment where interest rates rise 1% over the course of a couple years. That investor would receive 6% worth of coupon payments, but that rise in interest rates might also result in the value of that bond declining by about 5%. The result of those cross currents might be a net return of around 1%, and that's for that entire, two-year period. If rates rose more than Capital Economics predicts, that paltry return could easily turn red.

There are some ways to cope with the issues associated with owning bonds in an environment where rates are expected to rise from a low base and it's generally nice to retain some bonds for the sake of flexibility and liquidity, but it's a tricky time to be a bond investor, too. — Glenn Wessel