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Dear Client:

February was another busy month for market participants as an increase in vaccine availability and Congressional legislation to deliver a gargantuan fiscal shot in the arm, fed a robust outlook for a post-pandemic economic recovery. While fiscal injections and monetary support are typically met with stock market enthusiasm, the outlook of a raging economy while borrowing rates remain near all-time lows has stirred the bond market and unsettled traders. Inflation expectations have shot higher and treasury investors in longer-dated maturities have panicked, driving the 10YR treasury bond yield from 1.07% to 1.40% during the month. As a result, we are spending more time discussing the outlook for inflation and its impact on bond yields.

The thesis fanning concern is relatively simple: more liquidity = more inflation = higher interest rates. The onset of Covid caused a collapse in growth, inflation, and yields so, it is argued, as the pandemic fades, we will see a rapid recovery in growth, inflation, and yields. This thesis discounts two points: 1) post-pandemic levels of government debt require ongoing Fed intervention and ultra-low interest rates in order to keep servicing costs manageable; and 2) continuous deficit spending, ultra-low interest rates and unprecedented quantitative easing didn't spur inflation in the decade after the 2008-09 financial crisis, so why should we expect a different outcome today? Still, listening to the market chatter, we're on the precipice of the Fed being forced to hike rates quickly, setting off an unwelcome chain of events.

It is often forgotten that treasury yields are a *perception* about the future, and a rise in yields does not reflect a present rise in growth, only that investors *anticipate* there will be higher growth. The 10YR treasury yield rose quickly to 1.5% near the end of February but remains below where the yield was as the pandemic struck in February 2020 (1.65%). The recent 5-year peak was 3.24% (November 2018), while the trailing 10 years saw a peak of 3.59% (2011). It was 6.56% at start of the 21st century (2000). The fact is inflation as we know it has been non-existent because consumer inflation is not the same as asset inflation. Stimulus is flowing into assets and securities and driving animal spirits, but as recent quarterly earnings illustrate, businesses are experiencing difficulty in passing along higher raw material costs, which is traditionally the tip of the inflation iceberg.

We are not suggesting that cyclical inflation has not reappeared -- there are pockets of inflation where there are material shortages and prices have crept up in essential goods and services like food, energy, education, healthcare, and utilities. Certain supply chains and ocean-going transportation are in disarray as a result of the pandemic, and a boom in commodity prices has resulted, causing areas of acute price pressures. But as we seen repeatedly this century (*especially* the 2002-07 cycle), rising commodity prices don't have the lasting inflationary impact like they did in the 1970s. Compounding the issue is how much can be passed on to consumers when there are 10 million more unemployed than prior to the pandemic. While the economic impact of wide-spread quarantine and high unemployment has been masked by fiscal and monetary backing, without a steady surge in job growth, the central impediment to rising prices is *sustainability*.

The economy has been flooded with liquidity for years with no inflation to show for it. Higher job *and* wage growth are necessary ingredients for sustainable growth, that enables companies to feel comfortable charging more, and consumers comfortable spending more. This cannot happen with so much excess capacity in the labor market, so step one is to grow enough to reach full employment…then maybe we think about inflation.

Regards,

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