

# Market Viewpoints

by Manish Singh - Chief Investment Officer

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“It’s not whether you’re right or wrong that’s important, it’s how much money you make when you’re right and how much you lose when you’re wrong.”

George Soros

## Summary

The US budget balance has been in deficit for the last two decades. It is a deficit that just keeps on growing. It now stands at -16.3% of US GDP, the largest since 1945, a time when the country was financing massive military operations to help end World War II. Granted that the current pandemic is a significant reason for this record deficit, but the trend line indicates things started going south well before, at the time of the Great Financial Crisis of 2007-08, and it hasn’t reversed since. Continued stimulus and the “check is in the email” are now looking like regular promises for US households. The \$1,400 check just received, follows the \$600 check received in December and \$1,200 early last year. This new round of stimulus will cost US taxpayers \$1.9 trillion. The administration of US President Joseph Biden, is now crafting infrastructure spending plans that could cost as much as \$3 trillion. All of it paid for through debt and a resulting increase in the deficit. The big question is therefore: Can the US wean itself off stimulus?

Thankfully, the major part of the pandemic seems to be behind us, as vaccinations globally have accelerated. We are moving ahead to the economic re-opening that everyone so keenly awaits - everyone except bond investors that is. In my view, rising bond yields are not currently of concern, and are more an indicator of things heading back to normal. The risk to equities will only come from an anticipated change in monetary or fiscal policies - be it the threat of increased taxation or relaxing the stimulus sooner than the market anticipates. It was very clever of US Federal Reserve Chairman Jerome Powell at a recent press conference, to warn the markets that the Fed “will not act on forecasts but will wait to see actual data.” That’s a sharp jab at the markets anticipating inflation that may or may not materialize over the short to medium term. If the “supply” can meet the “demand” created from the economy re-opening, then an inflation overshoot can be contained and indeed will be transitory. Expect earnings surprises to abound when the re-opening is in full throttle. Barring the volatility that inflation prints (or anticipation of such) will bring, the risk to equities remains to the upside.

## Can the United States wean itself off stimulus?

The US Federal Reserve (Fed) met this month and concluded that there was no need to ease monetary policy further and I don’t disagree. By any standard, monetary policy is currently ultra-loose and US economic growth and inflation are both looking up. However, the US fiscal authority is, at this time, in no mood to rein in debt or the deficit. Continued stimulus and the “check is in the email” are now looking

like regular promises of cash for US households.

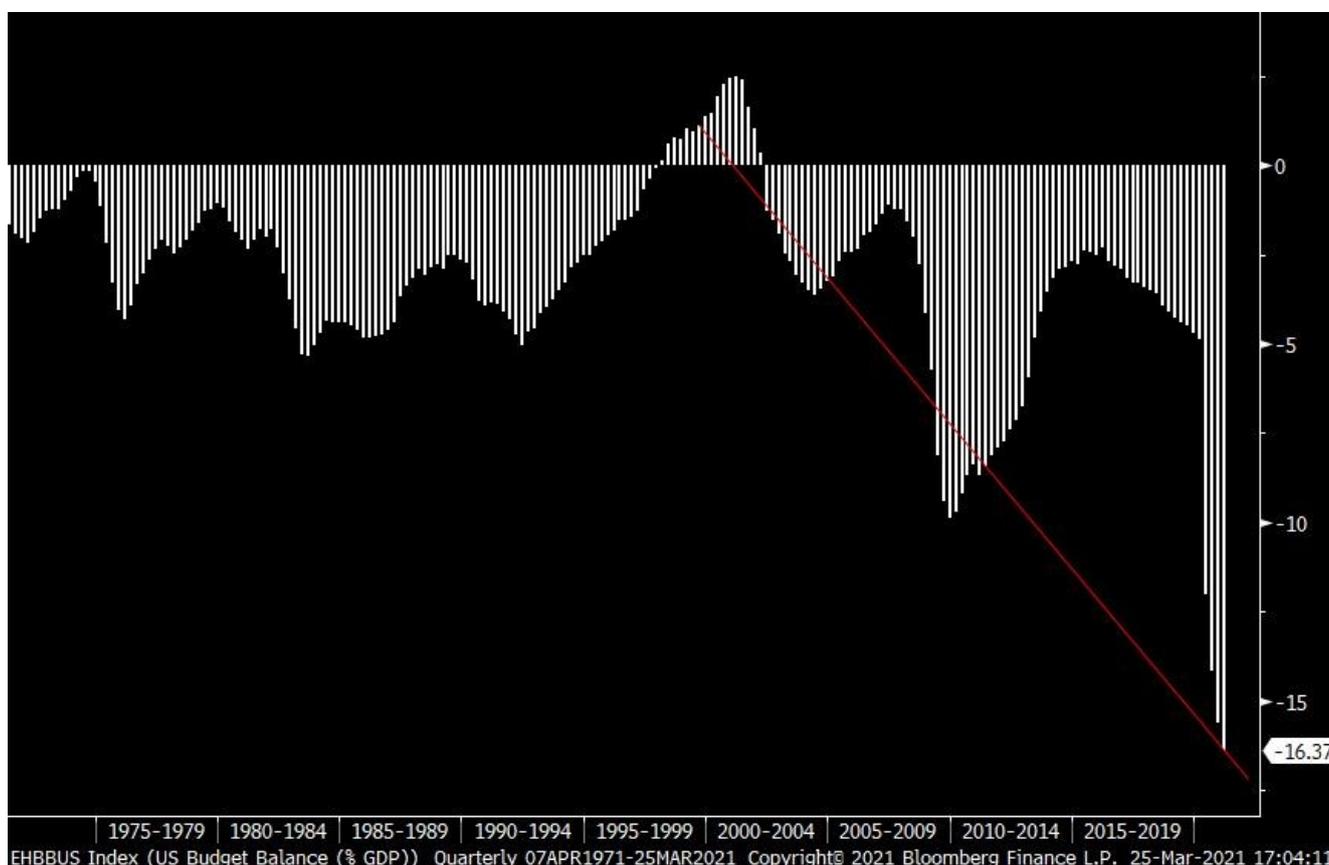
Last week, a third round of “stimulus checks” started showing up in the accounts of millions of Americans. The \$1,400 check, follows the \$600 check per recipient received in December and \$1,200 early last year. This new round of stimulus will cost US taxpayers \$1.9 trillion. The administration of US President Joseph Biden, is now crafting infrastructure plans that could cost as much as \$3 trillion. This would go towards much needed spending to repair roads, bridges and other infrastructure projects, nonetheless all of it paid for through debt and a consequent increase in the deficit.

Therefore I ask - Can the US wean itself off stimulus?

As the chart below indicates, the US budget balance has been in deficit for the last two decades. As the trend line indicates, it is a deficit that just keeps on growing. The deficit now stands at -16.3% of the US Gross Domestic Product (GDP), the largest since 1945, when the country was financing massive military operations to help end World War II.

At the same time, US Federal debt is over 100% of the US GDP for the first time in 70 years and that has put the US in same league as Greece, Italy and Japan, as among the most heavily indebted nations in the world. Granted that the pandemic is a significant reason for this record deficit, but the trend line indicates things started going south well before the pandemic, at the time of the Great Financial Crisis of 2007-08, and it hasn't reversed since.

### US Budget Balance as % of US GDP (1971-2021)



Source: Bloomberg

To the best of my knowledge, there is not a single instance in history that a developed nation successfully reined in its deficit and debt after such an expansion. So let's see what lies ahead for the US, and this is the reason why so many question the fate of the US dollar.

One instance of an attempt to rein in loose fiscal policy is worth taking note of however. It happened in Japan in the 1930s - with a tragic ending. Japan's Finance Minister Korekiyo Takahashi, the architect of Japan's loose fiscal policy that got Japan out of the Great Depression, was assassinated by rebellious Japanese soldiers in 1936, for trying to dial back the fiscal stimulus.

In 1931, the US and Europe were in the middle of the Depression and Japan feared the worst, as this threatened to spread to its shores. Takahashi was summoned from retirement at age 77 to once again run the Finance Ministry. Takahashi was a brilliant man who worked his way up from lowly beginnings to occupy the highest positions in his country. Born illegitimate and adopted into the lowest stratum of the Samurai class, he became Finance Minister seven times between 1913 and his untimely death in 1936. He was also briefly Prime Minister and in 1905 secured crucial foreign funds for Japan's military victory over Russia.

### **Viscount Takahashi Korekiyo (27 July 1854 - 26 Feb 1936)**



Source: Wikipedia

Takahashi's predecessor at Finance ministry favoured tight money policy - a strong yen and fiscal discipline, while Takahashi preferred - powerful stimulus, deficit financing and progressive taxation. No wonder he is such a role model to many Keynesians including the former Fed Chairman Ben Bernanke who gave a 2003 speech noting how "Takahashi brilliantly rescued Japan from the Great Depression."

To steer Japan out of the great depression, Takahashi abandoned the gold standard, driving down the Yen's value and lifting exports. He cut interest rates and started deficit spending. His most controversial act however, was to direct the Bank of Japan, then controlled by the Finance Ministry, to buy newly issued bonds directly from the government i.e. printing money to directly fund government deficits. It is a line few central bankers dare to cross even to this day.

The effort helped pull Japan out of depression and deflation, well before the United States and Europe.

Happy with the success by 1935, Takahashi decided to cut spending to prevent economic overheating. This made him a target of Japan's increasingly aggressive military, which was demanding funds for its expanding China incursion. At 5 a.m. on Feb. 26, 1936, two rebel officers plotting a coup stormed Takahashi's bedroom. One officer shot him with a pistol and the other slashed him with a sword.

It was a case of feeding the stimulus hydra that led to such a brutal end for Takahashi. Takahashi was right in stimulating the economy at the time of depression but it was for his attempt to moderate and balance his actions that he was murdered by those used to stimulus and free government spending.

Modern proponents of stimulus, whether at the central bank or in politics, will do well to heed the lessons of the past. Do not turn stimulus into a habit, else it will be very difficult to turn off the taps. The withdrawal symptoms could lead to bigger troubles, if not a tragedy. I particularly fear this for the Eurozone where the prospect of economic growth is bleak, while the debt and deficit keep piling up, without any degree of structural reform at the national levels.

There is also lesson in what happened after Takahashi's murder. Inflation in Japan spiked to double-digits as confusion ensued. In the decades since his death, policymakers blamed Takahashi, and not the military, for the high inflation. Nearly half a century later, referring to Takahashi's Depression-era policies, the Bank of Japan wrote in its official chronicle marking its 182 centennial - "This is the bank's biggest mistake in its 100-year history."

It took Prime Minister Shinzo Abe's decisive election victory in 2012 to restore Takahashi to some extent. Abe, in a speech after taking office said, "My forerunner Takahashi has emboldened me," and *Abenomics* policies soon ensued.

## **Markets and the Economy**

What a 12 month we've had! Negative interest rates, negative oil prices, a global pandemic, the undermining of an effective vaccine in a pandemic by certain leaders, the S&P 500 index (SPX) up over +70% from its March'20 lows, "roaring kitty" talking up certain stocks and most recently, a 1,300 foot long ship blocking world trade.

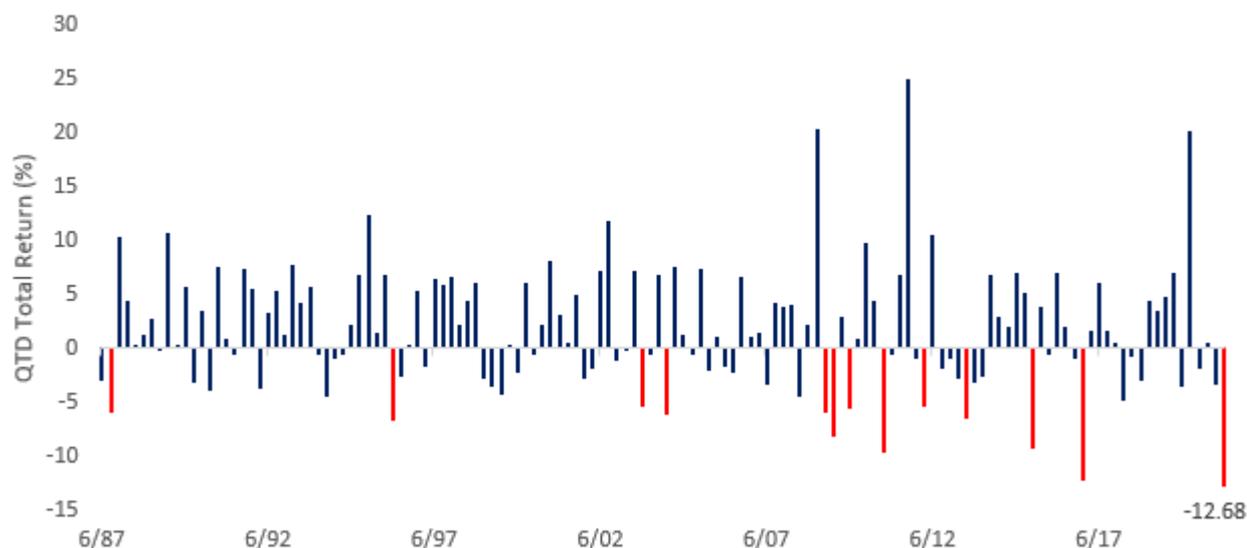
In a few years, when my children are old enough to understand it all and I tell them about the last 12 months, I do not expect them to believe me.

Thankfully, the major part of the pandemic seems to be behind us, as vaccinations have accelerated. We are moving ahead to the re-opening that everyone so keenly awaits - everyone except bond investors that is!

The chart below shows the historical returns of the Long term US Treasury Index. On a quarter-to-date (QTD) basis and up to but not including the final week of the quarter, with a decline of -12.68%, Q1 2021 is the worst quarter for the index in over 30 years. It's also just one of two quarters where the index was down over -10%.

This clearly shows us the extent to which the bond market has so far this year rerated risk in anticipation of inflation and an interest rate rise.

### QTD Performance of Long Term Treasuries Heading into Last Week of Quarter



Source: Bespoke Invest

In February's [Market Viewpoints](#) I wrote that rising yields are grounds for anxiety, but not yet a cause for alarm. I continue to hold this view. Rising bond yields are more an indicator of things heading back to normal, as vaccine distribution accelerates, social distancing measures ease and economic activity picks up.

The risk to equities will only come from an anticipated change in monetary or fiscal policies - be it the threat of increased taxation or relaxing the stimulus sooner than the market anticipates.

This is also borne out by survey data. For the first time since February 2020, the pandemic is no longer the biggest risk for fund managers surveyed by Bank of America (BofA). Inflation and tapering of Quantitative Easing (QE) purchases by the Fed ("taper tantrum") are now more feared by investors.

Investing doesn't come without risk. Last March, Covid-19 took the market by surprise. At least now the risk is clear - i.e. inflation (or the anticipation of it). Now, whether we get that anticipated inflation or not, is an entirely a different thing.

I thought it was very clever of Fed Chairman Jerome Powell at his press conference following the March

Federal Open Market Committee (FOMC) meeting, to warn the markets that the Fed “will not act on forecasts but will wait to see actual data.” That’s a sharp jab at the markets anticipating inflation that may or may not materialize over the short to medium term. While there will be plenty of speculation regarding the forward path of rates, the actual data is what matters, not an evolving Fed reaction function as was the case in the last few iterations of QE and tightening since 2012. If the “supply” can meet the “demand” created from the economy re-opening, then inflation overshoot can be contained and indeed will be transitory.

The Fed expects:

- US GDP to grow by +6.5% in 2021 (up from their December expectation of +4.2%)
- Unemployment to fall to 4.5% by year’s end (from 6.2% in February)
- Most of the 18 Fed officials want to stay put at zero rates, but 7 now expect to start lifting rates in 2022/23 (up from 5 in December)

In summary therefore: No tapering in asset purchases anytime soon, no rate hikes for a long time, strong economic recovery and transitory inflation pressures. I don’t know about you, but in my investing career of nearly 18 years, I haven’t seen a US GDP growth of high single-digit the likes of which the US Fed predicts.

I would hazard a guess that the management team at many of the listed companies haven’t seen such growth either. One has to go back to 1984 to see an annual US GDP growth of over +6%. So how are these management teams supposed to provide forward guidance on earnings? will they be able to model it?

Expect earnings surprises to abound when the economic re-opening is in full throttle. Barring the volatility that inflation prints (or anticipation of such) will bring, the risk to equities remains to the upside.

## **Benchmark Equity Index Performance (2020 and 2021 YTD, MTD)**

Ticker	Name	Country	2020 Performance (Lcl Ccy)	2021 Year-to-Date Performance (Lcl Ccy)	2021 Month-to-Date Performance (Lcl Ccy)
HSI Index	HANG SENG INDEX	Hong Kong	-3.4%	4.9%	-1.4%
MXEF Index	MSCI EM	Emerging Markets	15.8%	1.5%	-2.2%
NKY Index	NIKKEI 225	Japan	16.0%	7.2%	1.6%
MXIN Index	MSCI INDIA	India	16.8%	3.7%	0.4%
CCMP Index	NASDAQ COMPOSITE	US	43.6%	1.0%	-1.3%
SX5E Index	Euro Stoxx 50 Pr	Europe	-5.1%	10.5%	8.0%
CAC Index	CAC 40 INDEX	France	-7.1%	9.7%	6.7%
IMOEX Index	MOEX Russia Index	Russia	8.0%	7.2%	5.3%
FTSEMIB Index	FTSE MIB INDEX	Italy	-5.4%	10.8%	7.8%
SPX Index	S&P 500 INDEX	US	16.3%	5.2%	3.6%
INDU Index	DOW JONES INDUS. AVG	US	7.2%	7.9%	6.8%
UKX Index	FTSE 100 INDEX	Great Britain	-14.3%	4.8%	4.5%
IBEX Index	IBEX 35 INDEX	Spain	-15.5%	6.5%	4.5%
SHCOMP Index	SHANGHAI SE COMPOSITE	China	13.9%	-0.5%	-1.5%
DAX Index	DAX INDEX	Germany	3.5%	9.4%	8.9%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	2.9%	-2.0%	6.0%
MXTR Index	MSCI TURKEY	Turkey	12.6%	-13.3%	-7.8%

Source: Bloomberg

I do not doubt that if inflation does start setting higher than 2% for a few months in a row, then the Fed will intervene to control the long end of the yield curve and ensure an orderly move to higher levels of bond yields. Powell also stressed that financial conditions remain accommodative i.e. the FOMC still sees little reason to push back on higher longer-term rates.

While Powell has said repeatedly in recent weeks that the Fed is in no hurry to change its easy-money policies until it attains its goals for higher inflation and a strong labour market, the US Treasury Secretary, Janet Yellen, has been more circumspect on tax hikes though she has ruled out any tax increase in the near term. In a hearing before the House Financial Services Committee, Yellen's first since being sworn in as Treasury Secretary, she said post-pandemic spending plans will likely need to be paid for with an increase in corporation tax but that wouldn't come until the pandemic is over. Yellen said – "a package that consists of investments in people, investments in infrastructure, will help to create good jobs in the American economy, and changes to the tax structure will help to pay for those programs." i.e. she kept the door open to possible tax hikes in not too distant future.

I am not sure if it was by design or by chance, but so long as the risk of a tax increase remains, it will act as a downward pressure on spending and thus inflation i.e. it aids the current stance of the Fed's monetary policy – delay the rate increase for as long possible.

While the horizon looks bright in the US and the UK, it's cloudy on the European continent, as the Covid-19 crisis in the European Union (EU) deepens.

The EU muddled the procurement and approval process for the vaccine and national leaders like President Emmanuel Macron of France and German Chancellor Angela Merkel, made it worse by casting doubt on the efficacy of the Oxford-AstraZeneca vaccine. The result – surging cases and death numbers on the Continent that seem to be getting out of control.

In France, which has vaccinated less than 10% of its adult population, about 2,000 people a week are dying of Covid-19 and 41,682 new cases were recorded last Sunday. The corresponding number for the

UK which has vaccinated nearly 60% of its adult population is 150 and 3,800 respectively.

Macron’s hubristic policy of delaying the lockdown and talking down the Oxford-AstraZeneca virus, has backfired tragically for the French people who are now paying the price. The situation is made worse by the shortage of vaccines in the EU. Last week, Merkel apologized to Germans for making a mistake in her handling of the pandemic. Macron on the other gave himself top marks - “We were right,” he said of his delayed lockdown strategy. “I have no mea culpa, no remorse, no sense of failure.”

One would think there would be lessons in humility, instead the EU lead by Macron sought to fight a “vaccine war” with the UK. Mercifully for the people of the EU, Macron’s efforts were overruled by the level-headed leaders of Holland, Belgium and Ireland. Merkel backed talks with the UK to resolve the AstraZeneca dispute, rather than use export bans. Former EU Commission President Jean-Claude Juncker issued a stern rebuke to Ursula von der Leyen, his successor, for her attempts to wage a “stupid” vaccine trade war on Britain and added - “What the EU is asking for cannot be dealt with in a war atmosphere. We are not in war and we are not enemies - we are allies.”

Let’s hope the EU gets past this crisis soon and the UK, as a good neighbour, offers all the help it can. A true re-opening of the UK economy cannot happen if there is a fire burning across the channel.

### Benchmark US equity sector performance (2020 and 2021 YTD, MTD)

Ticker	Name	Country	2020 Performance	2021 Year-to-Date Performance	2021 Month-to-Date Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	US	-36.9%	30.8%	3.0%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	US	-4.2%	16.4%	6.2%
XLC US Equity	COMM SERV SELECT SECTOR SPDR	US	25.8%	8.1%	1.9%
XLRE US Equity	REAL ESTATE SELECT SECTOR SPDR	US	-5.5%	8.6%	6.3%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	US	17.9%	9.5%	7.7%
XLI US Equity	INDUSTRIAL SELECT SECTOR SPDR	US	8.7%	11.5%	9.0%
XLY US Equity	CONSUMER DISCRETIONARY SELECT SECTOR SPDR	US	28.2%	3.0%	2.7%
XLK US Equity	TECHNOLOGY SELECT SECTOR SPDR	US	41.8%	0.3%	-0.2%
XLV US Equity	HEALTH CARE SELECT SECTOR SPDR	US	11.4%	2.8%	3.6%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	US	-3.0%	0.9%	8.4%
XLP US Equity	CONSUMER STAPLES SELECT SECTOR SPDR	US	7.1%	1.9%	8.5%

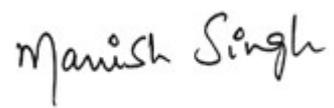
Source: Bloomberg

In terms of sectors to invest in, the recent sell-off in Technology (XLK), Healthcare (XLV), Biotech (XBI) and Communication (XLC) sector stocks provides a good opportunity to add to one’s holdings. As the table above indicates, XLK and XLV are now laggards, as investors have rushed to trade them for value stocks - Industrials, Financials, and Energy. The Biotech ETF (XBI) is now down -25% from its all-time high in February. Both the Healthcare and Biotech sectors seem oversold to me and provide an opportunity to add to ones holdings. It’s not like the world will not need vaccines and cures once the pandemic is over. Big pharma gets the blame but just imagine how much worse the Covid-19 crisis would be right now if the world didn’t have such an innovative pharma and biotech sector. Schools closed for years on end and lockdowns forever.

I, continue to be bullish on equities and see any sell-off as an opportunity to “buy the dip.” My favourite sectors to pick stocks from - Consumer Discretionary (XLY), Healthcare (XLV), Technology (XLK) and Communications (XLC).

For specific stock recommendations, please do not hesitate to get in touch.

Best wishes,

A handwritten signature in black ink that reads "Manish Singh". The signature is written in a cursive, slightly slanted style.

Manish Singh, CFA