Market MUSINGS
EDWARDS ASSET MANAGEMENT

March 1, 2021

IS IT TIME TO ADJUST FOR RISING INFLATION AND INTEREST RATES?

The financial media have focused this month's fear mongering on rising interest rates and inflation. But we will have none of it. As lifetime - and beyond - investors, intent on compounding wealth, we won't become unmoored from our investment principles by such speculative noise. Let's take a closer look and see if we can't put these fears in their place.

Recent data released from the Federal Reserve show that US household savings have increased, from a year ago, by more than $3 trillion. This record savings marks the first recession in US history where households did not draw down their savings. That's $3 trillion of excess GDP in accounts, ready and available to be spent or invested. The savings boost is partly due to the stimulus, with more on the way, and partially from locked down families being blocked from spending it.

With all that pent-up savings, what we are facing isn't just a V-shaped economic recovery. It's likely to be a downright, spending-spree-induced economic boom. And it's not that the consumer isn't already in great shape. Again, turning to recent Fed data, we find that consumers and businesses have the lowest debt service levels in at least 50 years. This is not an overleveraged world as in 2007, with too much debt service and not enough savings. This is a world of low debt service, vast credit capacity, and $3 trillion of new savings burning a hole in pockets. Consumers, I suspect, will give up on staying home and venture out to travel, bars, restaurants, theaters, and stadiums. I believe this period may be more similar to 1945 and the post-WWII boom as the soldiers came home, unleashing a consumption mania.

But what of those rising interest rates? May I remind you that the rates have risen to a long-term 1.44%, 10-year US Treasury rate, as of this writing? Not exactly a compelling incentive to sell our stocks and pay the capital gains taxes. If rates increase because of a new trend of inflation, that's worth discussing, as we shall below. But if rates rise because investors no longer desire a heavy allocation in low-earning, safe-haven investments, then in my view, that's good for stocks. I believe bond yields are rising for the same reason, historically, that stock prices have, as we came out of prior recessions and entered robust economic expansions.

What of the risks of rising inflation? Indeed, if prices of soft commodities, such as soybeans, sugar, wheat, and some industrial commodities like steel, timber, and oil, have all been rising, isn't that proof of inflation? It's important to note that some rising prices are not a sign of all prices rising and may not be inflationary at all. I believe these increasing commodity prices have been caused by lockdowns and low inventories followed by a reopening demand surge, which have created supply-chain constraints and bottlenecks. I don't believe this is a new trend of inflation.

As a quick review, many of the significant inflation drivers over the past six decades - healthcare, unions, education, rents, and oil - are now exhibiting potential for deflationary behavior. Capping it off, technological innovations create downward price pressure affecting every industry. As a final witness, we call upon the markets that trade inflation and find that the 5-year US TIP spread is pricing inflation for the next 5 years at 2.34% - not an inflation rate likely to choke off the expansion.

So that's our story: With $3 trillion in new savings to spend and invest, consumers are at record low levels of debt service to income, and credit is available. The US corporate world is financially strong and ready to reopen. Inventory shelf restocking and Covid supply constraints have boosted some commodity prices in the short run but may not result in long-term inflation trends. Finally, low-interest rates resulting from safe-haven investments and a recent rate increase to 1.44% are unlikely to attract new investment and reflect an expectation of robust economic expansion instead. Tallying it all up, I recommend turning off the TV, ignoring the flash-mob, meme-trading internet, and staying the course with compounding principles geared to long-term investment success.

We are grateful for your business and invite your questions and your portfolio reviews. Be safe, and we look forward to seeing you soon.

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