᠎# INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

FIRST QUARTER 2021: INOCULATING THE ECONOMY

Maybe all I need is a shot in the arm.
Maybe all I need is a shot in the arm.
Maybe all I need is a shot in the arm.
–Jeff Tweedy, Jay Bennett, John Stirratt

Left deltoid, or right? That's the question millions of Americans are asked as the COVID vaccination process rolls out in earnest.

As of this writing, more than 100 million Americans have received at least one shot, on their way to becoming immunized against the effects of the coronavirus. The clunky, disjointed initial rollout of the vaccination process has given way to an all-out, massive effort to protect the population from the spread of the COVID-19.

This is, first and foremost, a healthcare imperative. In the US alone, more than 30 million cases have been confirmed, and more than 550,000 deaths have been recorded. Some mutant variants of the virus have proved to be more contagious and perhaps more deadly,

But the vaccination effort is also an economic imperative. The failure to contain the virus last winter led to lockdowns that resulted in a sharp recession. US GDP, the broadest measure of the nation's economy, contracted by 31.4% in the second quarter, and 3.5% for all of 2020. Over 26 million people lost their jobs in the space of less than two months.

The US economy began to expand again in the third quarter of 2020. The recovery, however, has been uneven. The unemployment rate peaked in April at 14.8% and, while having fallen considerably, remains elevated. Many small businesses have shut, and others are barely hanging on. The service sector remains below trend, as areas such as travel, lodging, dining, and entertainment continue to struggle.

Small wonder, then, that many policymakers have advocated for legislation to support the economy—and to support economic participants, otherwise known as people. And to enable the economy to get through this challenging period to a point where the pandemic is not suppressing economic activity.

Like the first two approved COVID vaccines, this fiscal relief has come in two shots.

In December 2020, Congress passed the Consolidated Appropriations Act, a $900 billion coronavirus aid package. The emergency coronavirus relief package provided funds for the unemployed, small businesses, COVID-19 testing and vaccination, and checks to most US households.

Then, in March 2021, President Biden signed into law the American Rescue Plan Act, a $1.9 trillion package that extended enhanced unemployment benefits, made direct payments to individuals, provided relief to small businesses, supported state and local governments, and funded COVID-19 vaccines, testing, and contact tracing, among numerous other funding provisions.

The two bills will inject trillions of dollars into the economy, in an effort to inoculate the economy against a host of economic ailments coming out of the pandemic and its consequences. Is this insurance against a possible third wave? Or is it unnecessary? Will it have unintended consequences?

MARKET REACTION: OUT OF REHAB

I find the great thing in this world is not so much where we stand
as in what direction we are moving.
–Oliver Wendell Holmes

The economy may be in need of fiscal therapy, but not so financial markets. Stocks continued their strong run, which began in earnest last fall.

Asset Class	Index	1st Quarter Returns
US Large Cap Stocks	S&P 500 Total Return	6.2%
US Small Cap Stocks	Russell 2000	12.7%
International Developed Markets Stocks	MSCI EAFE	3.5%
Emerging Markets Stocks	MSCI EM	2.3%
Real Estate Securities	MSCI US Real Estate	8.8%
Commodities	Bloomberg Commodities Futures	6.9%
Bonds	Bloomberg Barclays US Aggregate	-3.4%
Cash	FTSE 3-month UST Bill	0.1%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

US markets have been lifted by optimism that the economy will 're-open' as vaccinations become more widely available and the nation moves closer to herd immunity. More domestically focused smaller US companies are the biggest beneficiaries of such optimism.

International markets posted positive but more modest returns in the face of generally less rapid and successful vaccination programs. Slower rollout of vaccination programs in much of Europe and in some emerging markets implies the economic recovery in these regions will trail the US, in time if not in magnitude.

Real estate securities posted robust gains, after weak results in 2020. The 're-opening the economy trade' was most apparent in the lodging and retail sectors, bouncing off large declines last year.

Consistent with the narrative of global reflation, commodities jumped 7%. Oil rose 22%, given expectations of greater demand and supply discipline from OPEC+, while some agricultural commodities went parabolic. Lean hogs were up 44%, and corn rose 17%.

Only bonds posted negative returns, as yields rose and prices of bonds fell. During the quarter, the 10-year US Treasury yield increased from 0.9% to 1.6%. This market action is consistent with the equity market message, suggesting a resurgent economy and, perhaps, rising inflationary pressures.

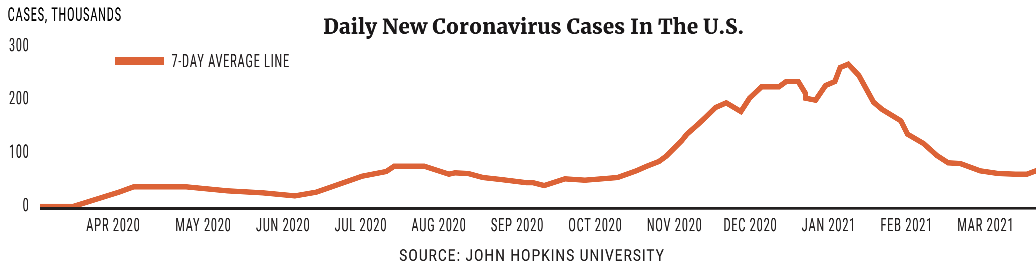
Cash continued to be a yield-free holding.

ROLLING UP OUR SLEEVES: VACCINATING OUR WAY OUT OF A PANDEMIC

You know you haven't stopped talking since I came here?
You must have been vaccinated with a phonograph needle.
–Groucho Marx

We know that markets anticipate the future, and the action in markets for the past two quarters strongly suggests that the future will not be clouded by pandemic concerns. But is that right? Are markets ahead of themselves? The CDC and other public health authorities warn that it is premature to let our guard down, even as we race to vaccinate the population.

Here's where we stand, as of this writing:



New Cases 7-Day Average

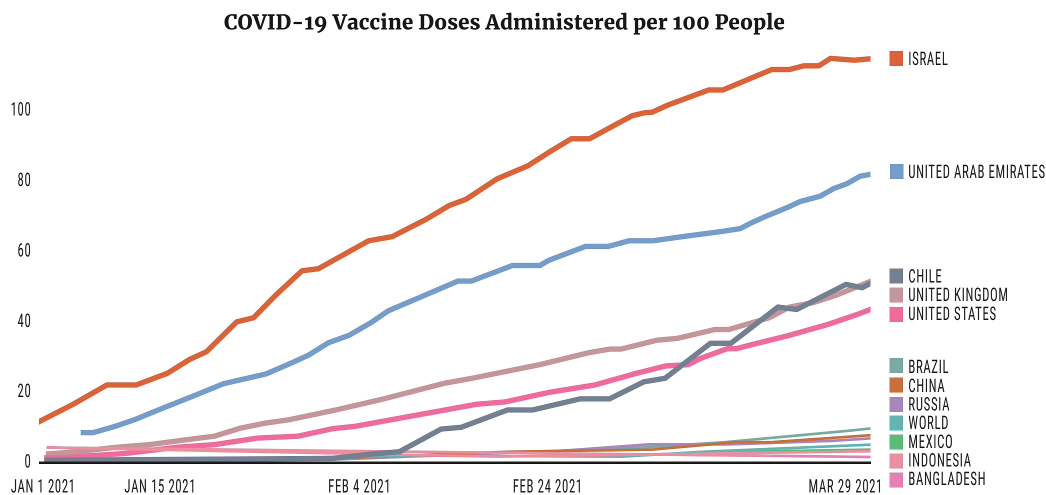
COVID-19	TOTAL REPORTED	ON MARCH 29	14-DAY CHANGE
Cases	30.4 Million	70,794	+18%
Deaths	550,486	685	−29%
Hospitalized	–	40,317	−4%

A post-holiday wave led to a peak in cases in mid-winter, followed by significantly lower cases, hospitalizations, and deaths. But those data points have plateaued and are no longer improving. In fact, cases have recently turned up, justifying health officials' concerns.

That said, the vaccination effort is under way in earnest. The US is now averaging almost 3 million jabs per day. The CDC reports that 53 million people have been fully vaccinated, and 100 million people have received at least one dose of a COVID-19 vaccine. At this rate, it appears possible that all Americans who wish to be vaccinated will have had this opportunity in the current quarter, well ahead of prior timetables. And as more people become vaccinated and begin to feel safer, they are likely to re-engage in a wide variety of activities that should boost the economy. High frequency data points—passengers clearing TSA checkpoints, restaurant reservations, public transit passengers—confirm that this is occurring.

Of course, the pandemic is a global phenomenon, and the overall global production, distribution and injection of vaccines badly lags the US.

This suggests, at a minimum, that the world is not likely to experience a synchronized global re-opening.



Total number of vaccination doses administered per 100 people in the total population. This is counted as a single dose, and may not equal the total number of people vaccinated, depending on the specific dose regime (e.g. people receive multiple doses).

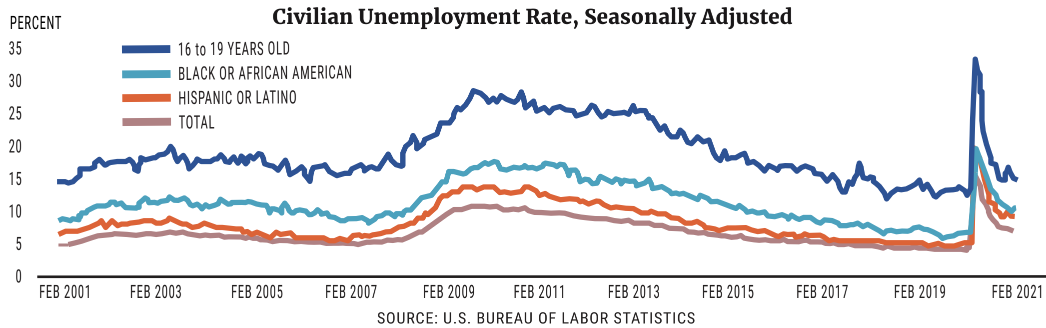
SOURCE: OUR WORLD IN DATA

DIAGNOSING THE PANDEMIC ECONOMY

If you can make the diagnosis, the treatment is easy and the damage can be reversed.
But, making the diagnosis is tricky.
–Ralph Green

The economic fallout from the pandemic, including lockdowns and restrictions, has not been equally distributed, as economists would say. Let's look at a few indicators to illustrate that point.

Civilian Unemployment Rate, Seasonally Adjusted



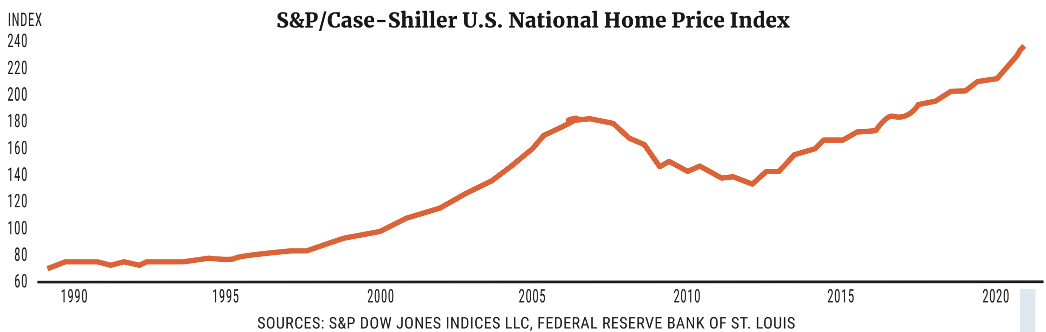
SOURCE: U.S. BUREAU OF LABOR STATISTICS

Perhaps the greatest economic pain has been experienced in the labor market. At the nadir of the recession last year, American businesses shed 26 million jobs. Of course, those jobs aren't just jobs—they're people. And 8.4 million of them have not become re-employed. Further, younger and minority workers have been more challenged to re-attach to the labor force.

Contrariwise, the housing market has been one of the biggest beneficiaries of the pandemic-driven lockdowns. Working and learning from home have driven American families to seek more space. Many urbanites have relocated to suburbs and more rural areas, as broadband connections allow many people to work remotely. And long-term demographics are also driving the housing market, as the millennial generation moves into prime household-formation and home purchasing stages. Of course, record-low mortgage rates have also contributed to improved housing affordability measures, in turn supporting higher real estate prices.

The S&P CoreLogic Case-Shiller Index, measuring year-over-year home price changes, rose 11.2% in February 2021. So if you are a homeowner, you may be basking in the good feelings that emanate from the so-called wealth effect.

S&P/Case-Shiller U.S. National Home Price Index



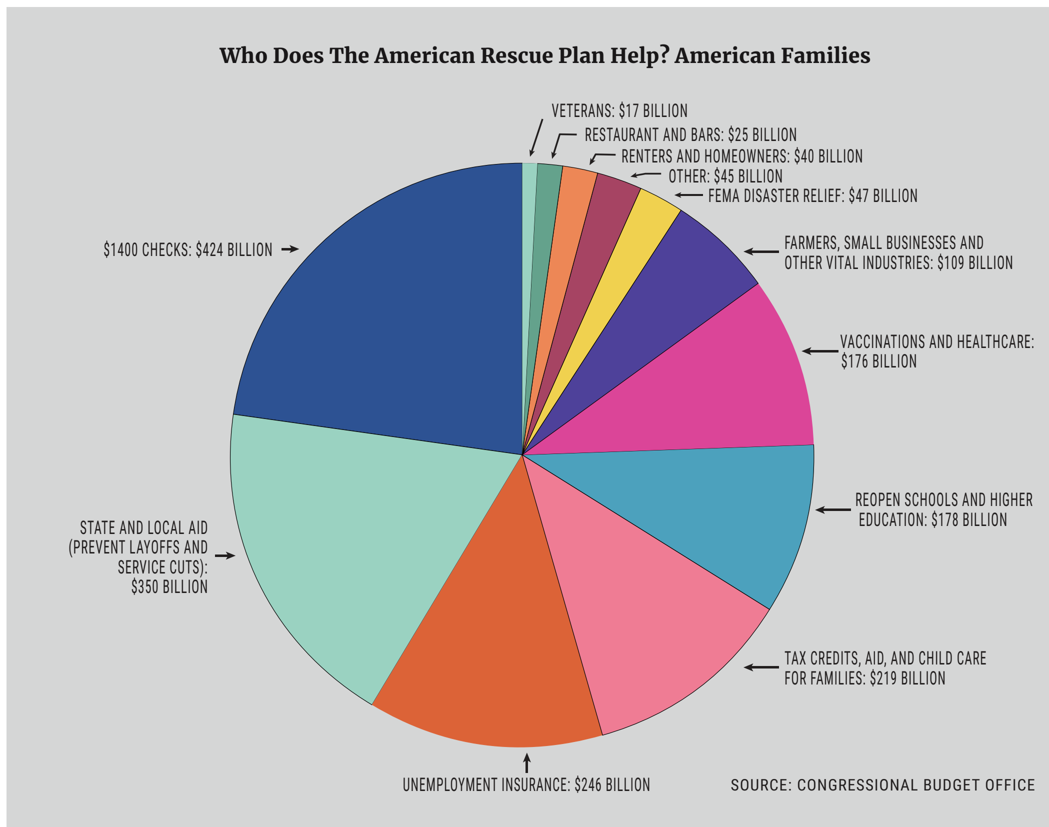
SOURCES: S&P DOW JONES INDICES LLC, FEDERAL RESERVE BANK OF ST. LOUIS

And then there is small business, the locus of the American entrepreneurial dream and the historical source of almost half the nation's jobs. The state of Main Street business owners was captured in a recent CNBC/SurveyMonkey Small Business Survey. While just over half of small business owners report that they were able to remain open during the pandemic, 20% report having temporarily shut down their businesses and then reopening them at limited capacity. An additional 10% say they've shut done and have yet to re-open. And *Fortune* magazine reports that more than 110,000 restaurants and bars closed for business permanently last year.

VACCINATING THE ECONOMY

Hit me with your best shot
Why don't you hit me with your best shot
Hit me with your best shot
Fire away
–Edward Schwartz

Economists vary in their opinions as to whether or to what extent the economy needs fiscal support to see it through to a post-pandemic expansion phase. The Biden Administration and Democrats are not in doubt, having passed and signed into law the $1.9 trillion American Rescue Plan Act of 2021.



The bill primarily addresses two priorities. The first is to contain the pandemic itself, with funding for vaccinations, testing, health care providers, and so on. The second is to mitigate the economic and social costs of the pandemic, to tide over families, small businesses, and state and local governments; to get schools re-opened; to provide mortgage or rent relief, etc. There are cash payments for families earning less than $80,000, enhanced unemployment benefits for workers who have lost their jobs, assistance to farmers and restauranteurs, and so on.

This is a huge bill. Small wonder that some don't believe the additional fiscal support is needed—or, at least, not to this extent. And the spending is not paid for, which means yet greater deficit financing.

Think of it as a vaccination for the economy. It's a preventative for the economy at large, so that it doesn't lose forward momentum before the coronavirus inoculation process plays out, enabling re-engagement with the economy. Thus, the direct payments to lower- and middle-income families. And think of it as relief for those most profoundly affected by the pandemic and its economic costs—the unemployed, the small business owner, select beleaguered industries.

VACCINES: INTENDED EFFECTS AND UNINTENDED SIDE EFFECTS

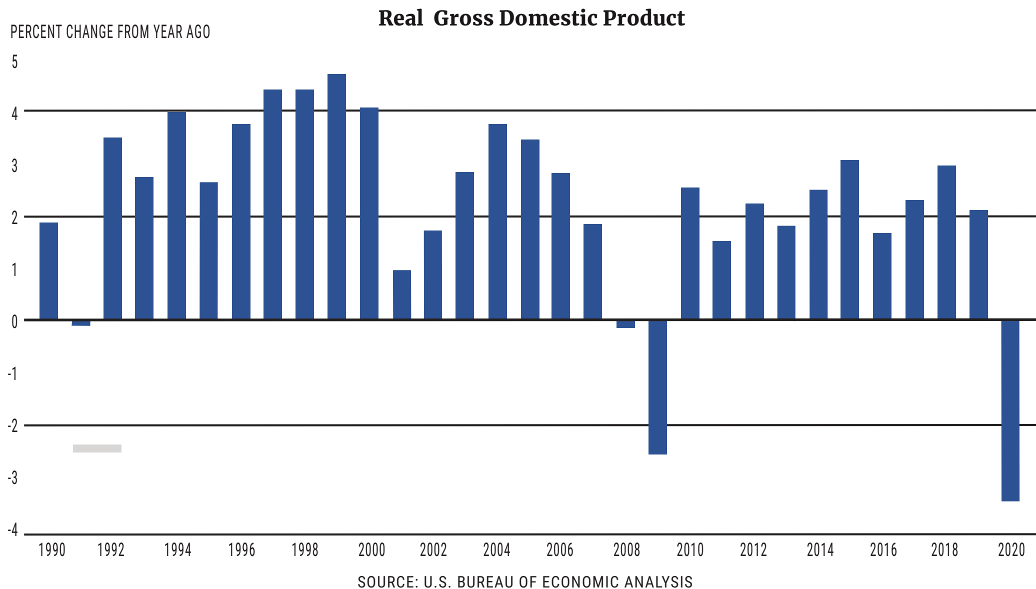
Ask the Aztecs and Incas whether or not they would have liked to have vaccines available to them. Oh, wait—you can't. They're dead. Vaccination is one of the best things that has happened to civilization.
–Jennifer Wright

Vaccination causes a lot of behavioral problems not the least of which is increased rage and aggression, also anxiety. These behavioral changes are scientifically proven in both human and animals.
–Patricia Jordan

Vaccinations are controversial. As if we needed one more issue to divide the American public. But the debate is over, the American Rescue Plan Act is law, so we focus instead on winners and losers, opportunities and risks, and unintended consequences.

Economists have been repeatedly raising their forecasts for GDP growth, even before this large spending bill. Recently, the Fed raised its full-year 2021 GDP growth estimate to 6.5%. Goldman Sachs forecasts growth of 8%; The Conference Board's estimate is 5.5%.

Real Gross Domestic Product



SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS

As the chart above makes clear, this would be the fastest rate of economic expansion in many years.

From a policy perspective, the American Rescue Plan is conceived as a means for the economy to recover to pre-pandemic levels of activity, to re-employ workers who lost jobs in the lockdowns and restrictions, and to ease the burden of individuals and businesses until the economy has, in fact, recovered. The generally accepted wisdom in economic circles is that the fiscal policy response to the Global Financial Crisis was grossly inadequate to re-invigorate the economy, leading policymakers to believe that the bigger risk to recovery is doing too little rather than too much. Thus, the effort not only to respond more wholly to the many Americans still suffering from the negative impacts of the pandemic, but also to engender a more robust and sustainable economic recovery.

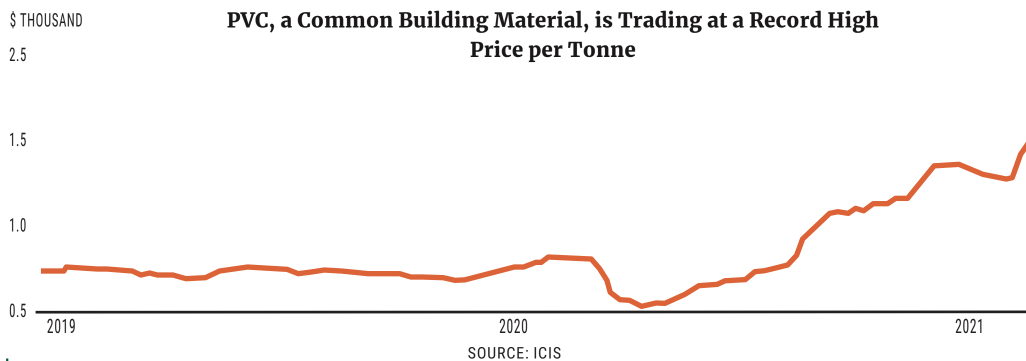
There are two concerns raised by the enormous stimulus spending and the similarly enormous borrowing needed to support it: will the economy overheat and spark inflation, and how worrisome is the mounting US government indebtedness?

POWELL: NO INOCULATION FOR INFLATION; IF WE GET IT, WE'LL TREAT IT

An ounce of prevention is worth a pound of cure.
—Benjamin Franklin

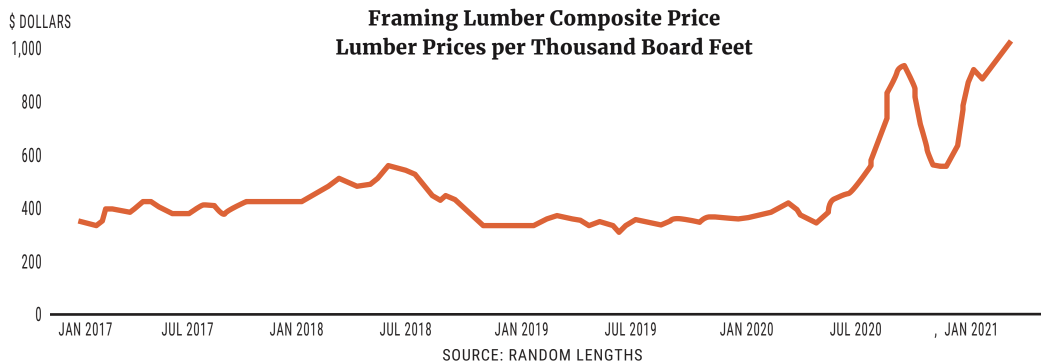
Both Fed Chair Powell and Treasury Secretary Yellen have been dismissive of the inflation threat, seeing price increases as transitory (especially versus weak year-ago readings—so-called base effects). The Fed's perspective is, no doubt, colored by its inability over the past decade to achieve its inflation target of two percent. And it has reminded us that it has time-tested, efficacious tools to respond to inflation if or when it arrives.

Is the Fed too sanguine? Incipient signs of emerging inflation are increasingly visible. Inflation can be seen in asset prices, including equities and real estate. Inflation can be seen in commodities prices, which rose 7% in the first quarter. And inflation can be seen here:



SOURCE: ICIS

And here:



SOURCE: RANDOM LENGTHS

And there are other nascent signs of inflation. A shortage of semiconductor chips has hobbled automobile production. Imports are backed up on container ships lined up outside the Port of Los Angeles. Such supply chain interruptions seem likely to spark higher prices—even as some companies report higher input costs, including raw materials, transportation, and labor.

Interesting, on the flip side, that gold—an asset that is frequently viewed as an inflation hedge—fell during the first quarter, by 9.5%.

Time will tell whether the Fed or the *inflationistas* are correct. With substantial slack in the labor market, and much of the world lagging the recovery in the US, the Fed's insouciance may prove justifiable. Among long-term secular disinflationary forces—technological innovation, slow productivity growth, demographics (aging populations), globalization—the influence of the latter two may be waning.

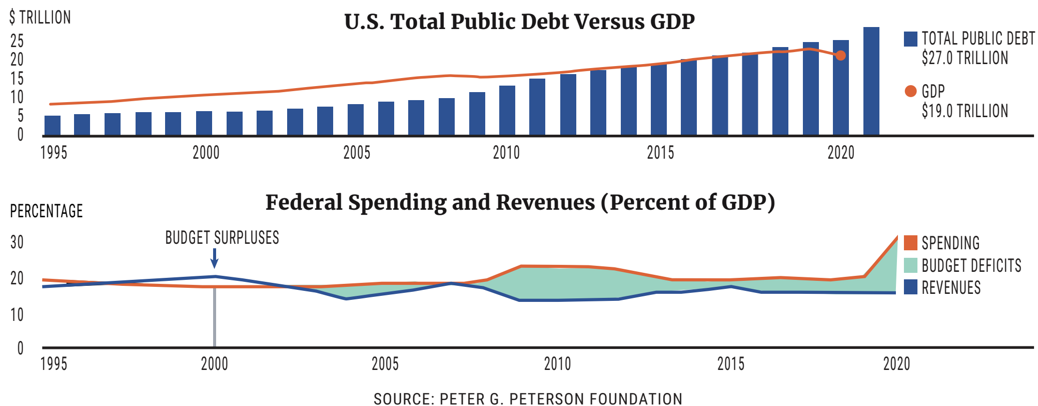
So, stay tuned. We're monitoring price and wage data closely. We take some comfort knowing that a diversified portfolio includes some asset classes that may be expected to perform well—or at least hold value—should inflation inject itself into the economy.

DEFICITS AND DEBT: A SHOT ACROSS THE BOW?

Small debts are like small shot: they are rattling on every side, and can scarcely be escaped without a wound; great debts are like cannon; of loud noise, but little danger.
—Samuel Johnson

If you think no one cares if you're alive, try missing a couple of car payments.
—Earl Wilson

Politicians of all stripes have always found it easier to spend and harder to raise funds to cover that spending. Put another way, Americans have over time sought more and greater support and services from the government but often are reluctant to tax themselves sufficiently to pay for those services. And, increasingly, though we avoid the label, we are socializing the cost of various crises. Whether it's FEMA to the rescue when a tornado or a hurricane hits, or a global financial crisis requiring government intervention to salvage the financial system, or a worldwide pandemic that constitutes perhaps the greatest health threat in a century, recent financial history suggests an acceptance by Congress of the dependence on the US balance sheet to fund solutions to a wide range of problems besetting the nation. These crises are financed with borrowed funds that simply add to the nation's indebtedness.

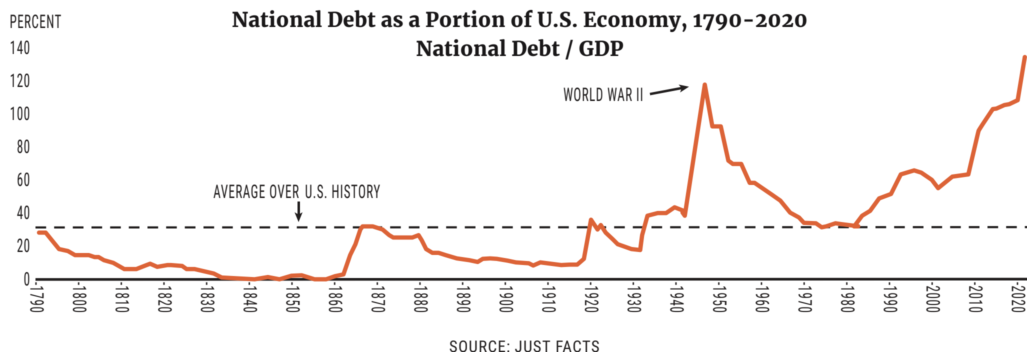


SOURCE: PETER G. PETERSON FOUNDATION

This seemingly endlessly expandable balance sheet has been enabled by the Fed, which has lowered rates to substantially ease the interest cost of outstanding IOUs. The Fed has also facilitated the nation's borrowing spree by buying a substantial portion of bonds issued by the US Treasury. (If this sounds like sleight of hand, from the left hand to the right….) Some would call this monetizing the debt.

Just a refresher: the deficit is the amount in a given year by which expenditures exceed revenues. The public debt is the cumulative amount of all prior deficits.

The Congressional Budget Office estimates that the US deficit will reach $2.3 trillion this fiscal year (ending September 30, 2021), as revenues are projected to provide only 60% of outlays. Total debt outstanding is projected to reach $27 trillion by year-end. From an historical perspective, this is *terra incognita*.

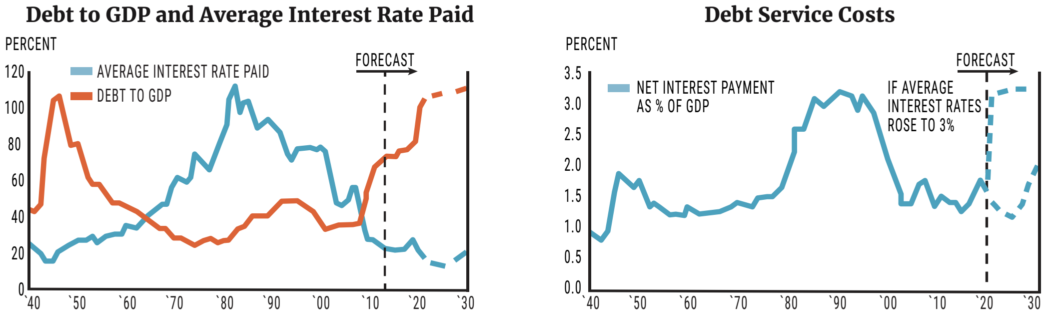


SOURCE: JUST FACTS

Policymakers seem unfazed by the burgeoning US indebtedness. They believe that with the US dollar as the world's reserve currency, we can spend our way to prosperity.

What about the rest of us? For some of us, it's hard not to worry. Will financing the deficit crowd out other borrowers? Will foreign US debt buyers, who hold around 33% of outstanding US debt, continue to buy our bonds? Will ballooning deficits and rising interest costs lower long-term growth? Will investors eventually demand higher rates to finance ever-greater US indebtedness?

In the near term, these concerns are academic, abstract. Thanks to generationally low interest rates (notwithstanding a recent rise), interest on the national debt—amounting to $378 billion this year—remains substantially below the levels of the 1980s and 1990s as a percentage of GDP. From a federal budget perspective, interest expense is currently about 8% of all federal outlays, down from around 15% in the 1990s.



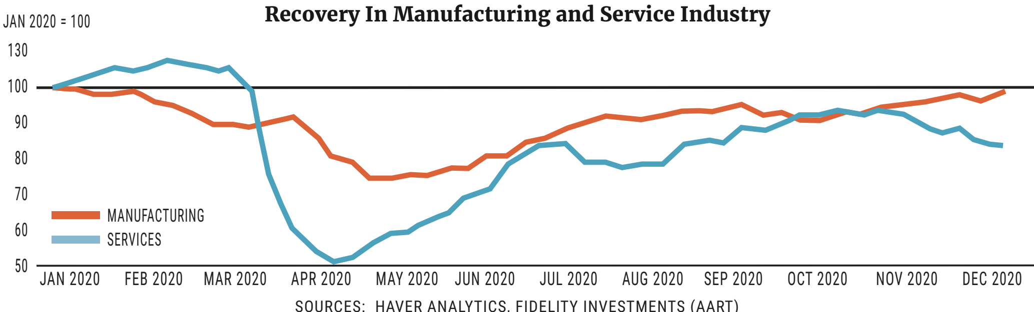
SOURCE: CONGRESSIONAL BUDGET OFFICE, J.P. MORGAN ASSET MANAGEMENT.
FORECASTS BASED ON CBO DATA AS OF SEPTEMBER 2020. DATA ARE AS OF JANUARY 11, 2021.

A friendly Fed is likely to maintain low interest rates, which should keep debt service costs manageable for the foreseeable future. And, the era of Congressional deficit hawks has given way to proponents of Modern Monetary Theory, which espouses a view that monetarily sovereign countries are not constrained by revenues when it comes to federal government spending. In other words, deficits don't matter. Economists actively debate this position. We are closely following demand for US debt instruments at Treasury auctions as one indicator of the sustainability of US government borrowing.

STICKS, JABS, SHOTS: VACCINES TO THE RESCUE

Warren Buffett once wrote that value investing is like an inoculation --it either takes or it doesn't--and when you explain to somebody what it is and how it works and why it works and show them the returns, either they get it or they don't.
--Seth Klarman

It is the job of physical therapists to help patients recover from surgeries, accidents, and various medical conditions, thereby regaining strength and vigor. The fiscal therapists in Washington today are performing a similar function, in their efforts to help the nation recover from the pandemic-driven recession of 2020 and strengthen the nation's economic growth potential.



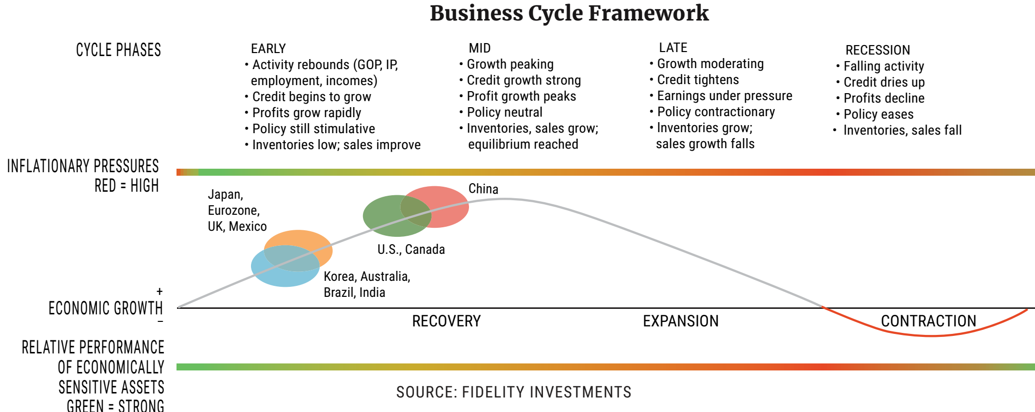
SOURCES: HAVER ANALYTICS, FIDELITY INVESTMENTS (AART)

If the vaccination rollout proceeds without serious hiccups, the narrative of economic reacceleration, an improved labor market, and higher corporate profits should prove credible. With 3 million doses being administered daily, the US is on track to achieve universal availability of vaccines by mid-year. Pent-up demand for the service economy should boost the fortunes of the leisure, travel, and hospitality sectors. Barbers and hairdressers, flight attendants and pilots, waiters and cooks, housemaids and porters will all be winners—as will their employers.

We can't be sure if the Biden Administration's initiatives will succeed, in the long term, to create a more robust and more resilient economy. But, nearer term, it seems likely to create a boom-like economic expansion the likes of which hasn't been seen in more than a decade.

Such an environment is more equity-friendly than bond-friendly. Rising corporate profits are a strong prop for stock prices, whereas potential incipient inflation undermines bond prices. Trend reversals that began last fall—from growth stocks to value stocks, from bonds to stocks, from large cap stocks to small cap stocks—seem largely intact, and may well show some persistence. The interruption in strong relative performance for international equities may resume, as and when the vaccination process improves overseas.

Business Cycle Framework



But small wonder that the US leads most of the world. Both monetary and fiscal responses to the pandemic-induced recession were proportionally larger and speedier than the rest of the world.

And now, with the Biden Administration proposing a $2.25 trillion infrastructure bill, embarking on further efforts to inject the economy with additional fiscal stimulus, we hope the preventative works. And that, on the downside, we experience nothing worse than the economic equivalent of the 24-hour malaise some of us suffered after our second vaccine—that, and a sore left or right deltoid.

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