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BALANCE IN A CHANGING WORLD
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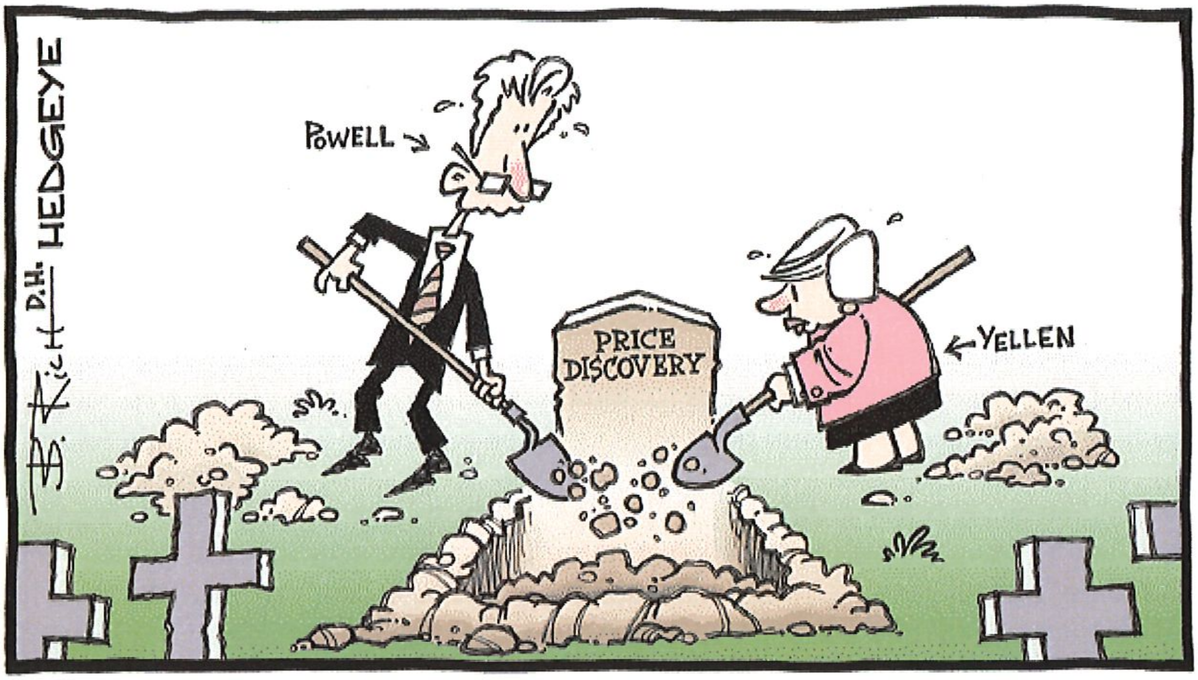

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FIRST QUARTER 2021 INVESTMENT ADVISORY REPORT

~ "A trillion here, a trillion there, and pretty soon you're talking real money"

It's almost hard to recall, but at this time last year we were in the midst of the onset of the covid pandemic and we were conjuring up comparisons with the Great Depression. In our Report then, we quoted Lowry's Research which said "the 37% plunge in the DJIA in under 4 weeks puts the decline in the same conversation with the Crashes of 1929 and 1987… In fact, the eight 90% Down Days over an 18- day span represented the most intense period of selling since the 1940's…"[2] Bob Doll of Nuveen called the drop "unprecedented", and observed that after climbing "44% from December 2018 to

[1] Hedgeye Cartoon of the Day; B. Rich; 3/26/21 https://app.hedgeye.com/feed_items/97476-cartoon-of-the-day-buried?single_item=true

[2] Lowry Market Trend Analysis for the Week Ending March 27, 2020; pg. 1.

February 2020, stocks then dropped more than 20% in just 16 trading days making it the fastest bear market in history."[3]

Fast forward to today, and (as of April 16, according to Morningstar.com) the S&P 500 is at an all-time high closing value of 4,185.47. This represents a gain for Q1 of 6.17%.[4] Below the surface, however, the gains across the broader market were very uneven as money rotated into areas set to benefit from the "reopening". This benefitted the Dow and smaller-cap stocks in particular which are more represented by pro-cyclical sectors such as energy, industrials, commodities and financials. The growth indexes such as the Nasdaq – the driver of most of last year's strong gains – lagged badly and barely showed any advance at all. Some of the former FAANG stock darlings such as Apple, Tesla and Netflix were actually negative for the quarter.[5] The growth sector was also hurt by a significant rise in interest rates which caused a revaluing of discounted future values.

Much of the market gains were a positive response to the seeming success of the vaccination efforts as we have now administered some 130 million vaccines at this point, or nearly one-third of the population.[6] But clearly, the unprecedented amounts of fiscal and monetary stimulus that were unleashed had a major impact. As noted (perhaps ad nauseam) in previous reports, in response to the 2008 financial crisis the Fed increased its bond holdings by $3.7 trillion ***over a 6 year period***, pushing their total balance sheet to over $4.5 trillion.[7] By contrast, in response to the covid crisis the Fed added $2.3 trillion almost immediately[8] and increased their balance sheet by over $3.3 trillion ***in less than one month***![9]

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[3] https://www.fa-mag.com/news/a-bottoming-process-begins--10-themes-to-consider-54669.html

[4] https://www.troweprice.com/financial-intermediary/us/en/insights/articles/2021/q2/global-markets-quarterly-update.html?action=notification&notificationid=3973940&PlacementGUID=emFAI_2021_q2_global-markets-quarterly-update&uniqueId=YJCAMB5K-OL9Z-MFJ9-HYVL-WT7UGP3SEWKC

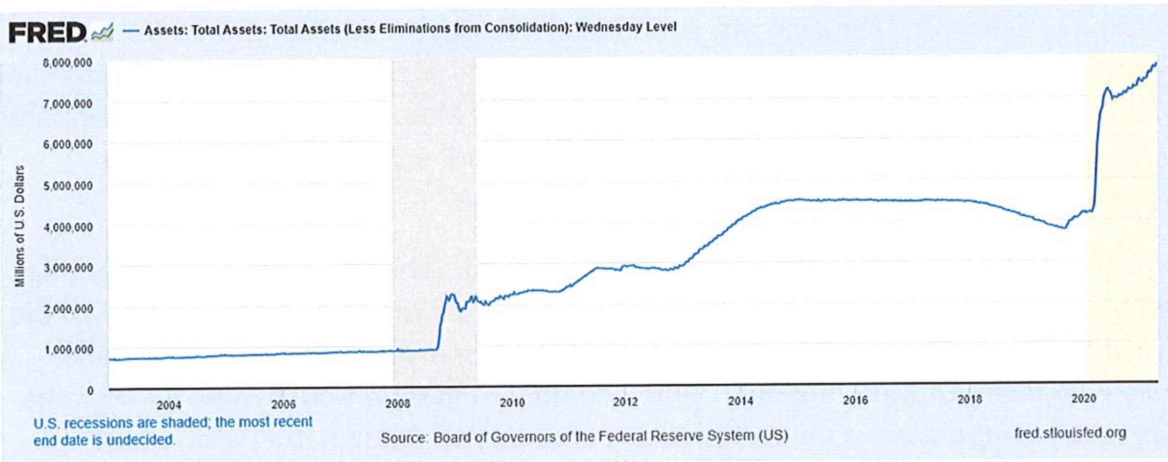
[5] Stock data from Morningstar.com

[6] https://www.google.com/search?q=how+many+covid+vaccines+have+been+given+to+date&rlz=1C1CAFC_enUS847US847&oq=how+many+covid+vaccines+have+been+&aqs=chrome.3.0j69i57j0l8.17627j0j7&sourceid=chrome&ie=UTF-8

[7] https://www.cnbc.com/2020/03/23/fed-is-helping-the-markets-more-than-it-did-during-the-financial-crisis.html#:~:text=Indeed%2C%20the%20Fed%20starting%20in,operations%20that%20spanned%20six%20years.

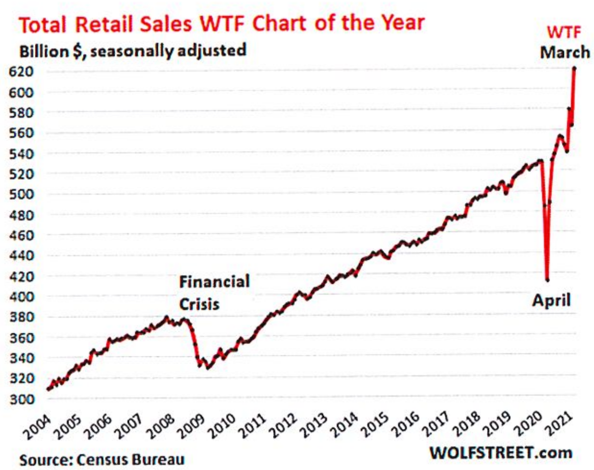
[8] https://www.brookings.edu/research/fed-response-to-covid19/

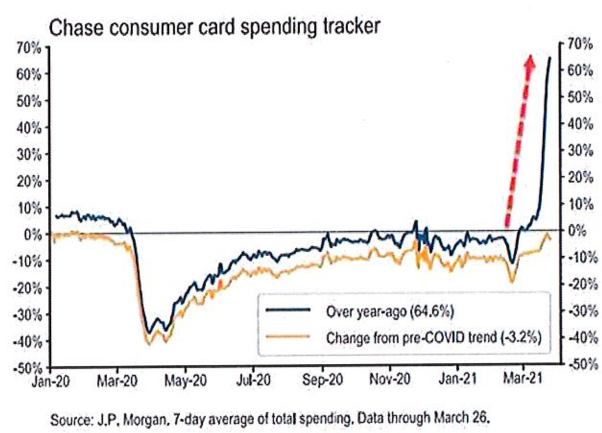
[9] Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WALCL, April 17, 2021.



In addition to the Fed's response, US lawmakers have so far enacted six major spending bills totaling $5.3 trillion in response to the pandemic.[10]

As the title of this report suggests, if you spend a trillion here and a trillion there, pretty soon you're spending real money and, not surprisingly, the economy is responding in kind. There are any number of superlative data points to convey this, but below are two – one showing total retail sales[11] and the next showing JP Morgan Chase's spending tracker on their own consumer (debit and credit) cards.[12]





[10] https://www.pgpf.org/blog/2021/03/heres-everything-congress-has-done-to-respond-to-the-coronavirus-so-far

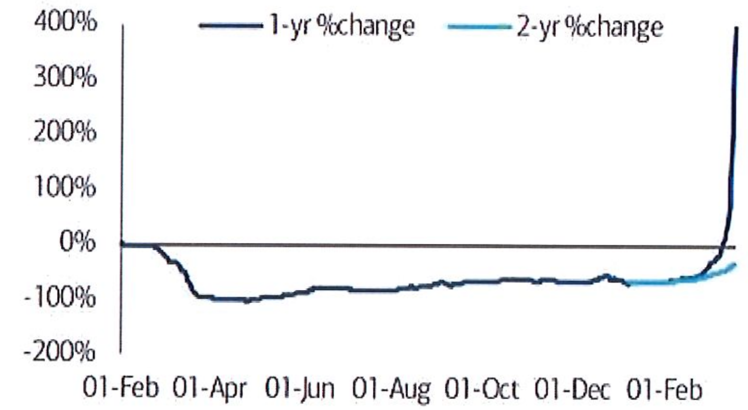
[11] https://wolfstreet.com/2021/04/15/retail-wtf-charts-of-the-year-powered-by-1400-stimmies-and-massive-price-increases/

[12] **https://www.zerohedge.com/markets/here-come-most-stunning-base-effect-charts-great-depression?utm_campaign=&utm_content=Zerohedge%3A+The+Durden+Dispatch&utm_medium=email&utm_source=zh_newsletter**

According to Barron's, "Housing starts bounced back by 19.4% last month from February's weather-depressed levels. New claims for unemployment benefits fell under 600,000 in the latest week, the lowest total since last March. And inflation was apparent, with consumer prices up 2.6% in March from their level a year earlier – a sharp acceleration from February's 1.7% year-over-year rise."[13]

The positive data goes on and on, and so far so good. The problem is, however, that these are year-over-year comparisons and the numbers are strong only relative to the depression-like weakness exhibited in the economy one year ago when economic activity essentially ground to a halt. When compared to data from two years ago, the growth story evaporates. One extreme example can be seen in the below chart showing both one and two year changes in spending on airlines. One year comparisons (as in the spending charts above) are vertically up and off the charts. Two year comparisons though are *negative* as we have still not returned to levels seen back in 2019.

Exhibit 20: Spending on airlines, based on BAC aggregated card data (1-yr and 2-yr %change of the 7-day moving avg of spending levels)
1-yr %change for airlines spend soars on base effects, 2-yr %change remains negative



Source: BAC internal data

BofA GLOBAL RESEARCH [14]

This is a bit self-selective as airlines have been especially negatively impacted by the pandemic. However, while the recent March retail sales numbers came in at +9.8%, the same year-over-year comps last year in March of 2020 were -18.1% and April's were

[13] "Up & Down Wall Street", Barron's; April 19, 2021; pg.7.

[14] https://www.zerohedge.com/markets/here-come-most-stunning-base-effect-charts-great-depression?utm_campaign=&utm_content=Zerohedge%3A+The+Durden+Dispatch&utm_medium=email&utm_source=zh_newsletter

even worse at -39.3%.[15] As once said, when you're looking at scorched earth, everything looks like green shoots. Further trillions are on their way as the recently enacted Covid relief bill extends $300 per week unemployment insurance benefits until September 6, and $1,400 checks for individuals earning under $80,000 annually have already gone out and are percolating their way through the economy as we speak.[16] This past year has certainly been "challenging", and there's no doubt that many people have been/are suffering and are in need of help. Yet we do not really see how more trillions directed towards maintaining consumption levels will ultimately address many of the underlying imbalances existing in the economy.

For example, along with the many positive data points in March was strong employment data. According to the U.S. Bureau of Labor Statistics, total nonfarm payroll employment rose by 916,000 in March, and the unemployment rate edged down to 6.0%.[17] However, as a Guggenheim research report recently noted, "Despite the encouraging March jobs report, full employment remains far away. A simple way to see the depth of the jobs hole is the employment to population ratio, which accounts for both job loss and labor force dropouts. At 57.6 percent, it sits over 3 percentage points (representing over 9 million jobs) below the pre-pandemic level...But consensus forecasts imply the ratio will struggle to return to 2019 levels despite strong gross domestic product (GDP) growth, reflecting industry shifts and the adoption of labor-saving technologies accelerated by COVID."[18]

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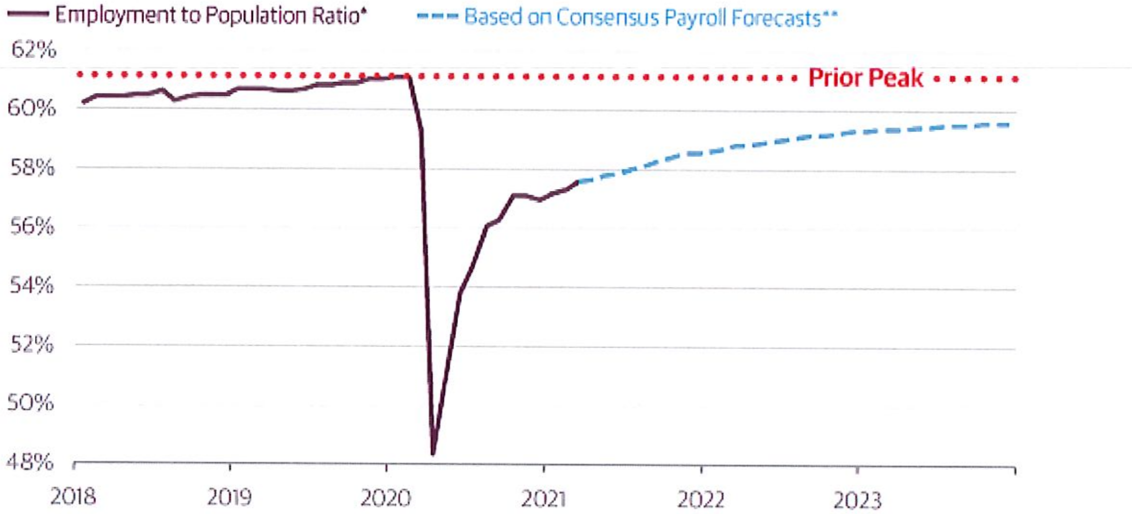
[15] https://www.statista.com/statistics/1104339/coronavirus-year-over-year-monthly-retail-sales-comparison-by-sector-us/

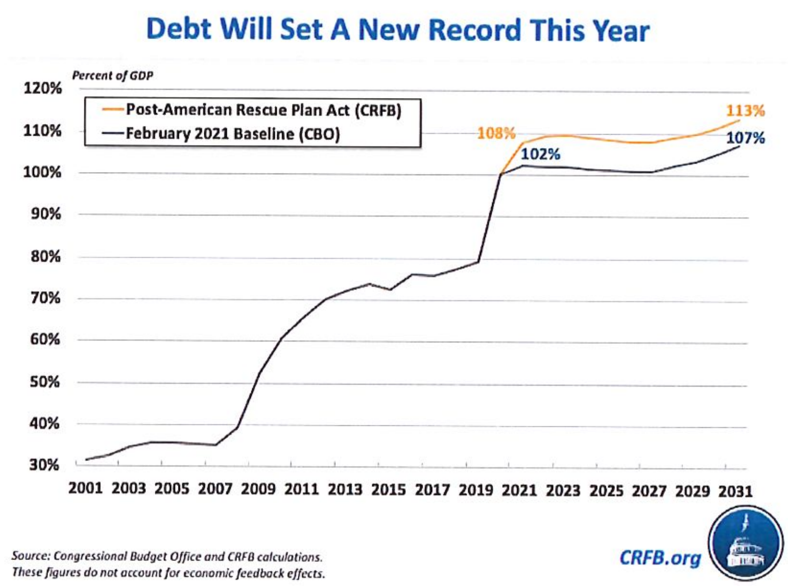
[16] https://www.cnbc.com/2021/03/10/stimulus-update-house-passes-1point9-trillion-covid-relief-bill-sends-to-biden.html

[17] https://www.bls.gov/news.release/empsit.nr0.htm

[18] "Don't Mistake Rapid Jobs Gains for a Strong Labor Market"; Guggenheim Macro Alert; April 5, 2021



And, although we're now informed that deficits don't really matter, we thought we'd just add in an update, courtesy of reporting by Mauldin Economics;



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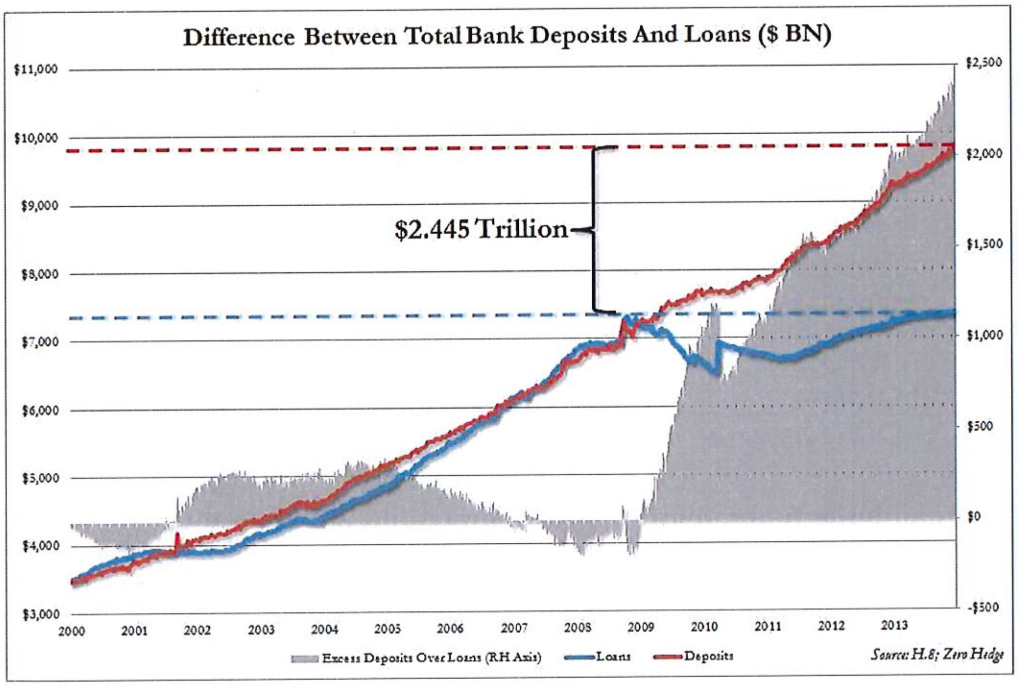
As the authors note, "Visually, the difference as percentage of GDP doesn't look so great, just 7 percentage points 10 years out. But in nominal dollars, the 2031 debt will be $2.1 trillion higher, according to CRFB's estimate. The fact that such a huge number can look insignificant is notable in itself"[20] A trillion here and a trillion there!

[19] "Clips That Matter"; Over my Shoulder; Mauldin Economics; March 31, 2021; pg.5

[20] Ibid. #19.

Another truly striking example of how the trillions are not addressing the deeper structural changes needed in our economy can be seen in the disparity between the growth of bank deposits vs. the creation of new bank loans. This gets very nuanced and technical, but in a recent Zerohedge article entitled "'Stunning Divergence': Latest Bank Data Reveals Something Is Terminally Broken In The Financial System", they report on a research piece from JPMorgan strategist Nick Panigirtzoglou. He details the massive increase in deposits on the books of banks as the excess reserves being pumped into the system by the Fed sit dormant on the banks' balance sheets. JPMorgan itself reported that in Q1 of this year, it had 100% more deposits than loans![21] This is starkly depicted in the below graph. The red line is bank deposits and the blue is the amount of loans extended by the "Big 4" major banks. Note how these two items tracked each other almost identically until 2008 when the Fed embarked on its "Quantitative Easing" programs in the wake of the Lehman Brothers collapse.

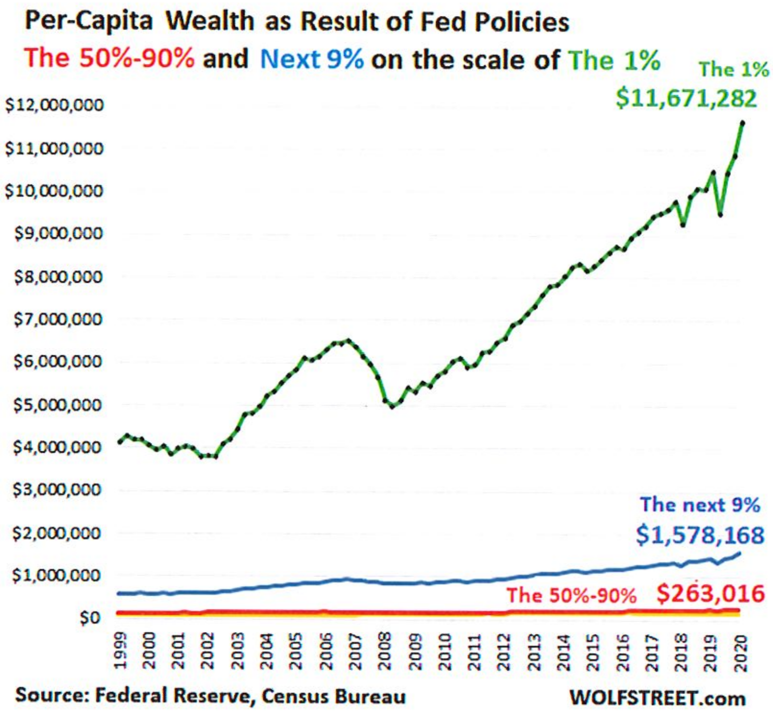


As the above chart indicates, loan growth in the US has been essentially at 0% for over a decade now! This has profound ramifications for "Money Velocity", GDP growth and inflation. Whether the zero percent rate of loan growth is a supply issue or a demand

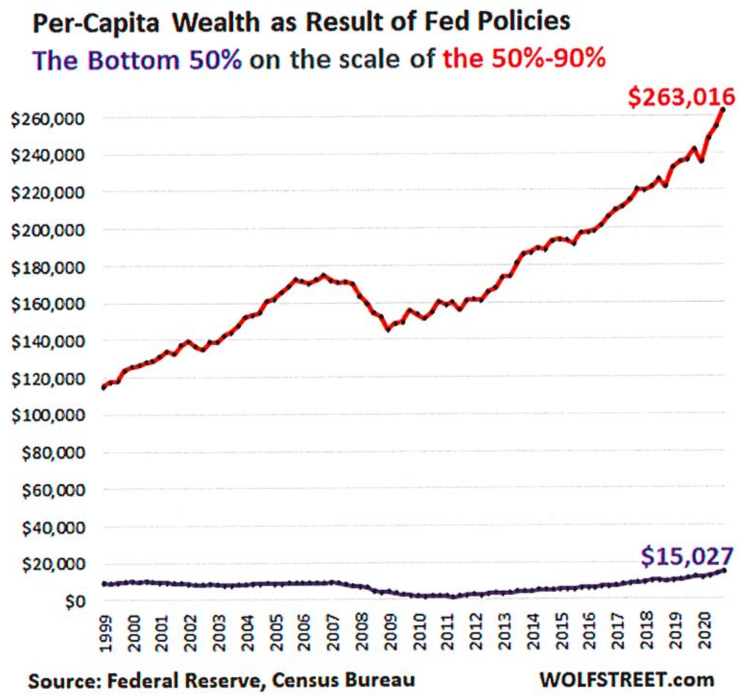
[21] https://www.zerohedge.com/markets/stunning-divergence-latest-bank-data-reveals-something-terminally-broken-financial-system?utm_campaign=&utm_content=Zerohedge%3A+The+Durden+Dispatch&utm_medium=email&utm_source=zh_newsletter

issue is all a topic for a future report, but suffice it to say (in our humble opinion) until loan issuance begins growing again, creating a pickup in velocity, we will remain gripped in the throes of secular deflation.

In addition to the "progress" we've made in growing bank deposits and government deficits, we also continue to make great progress in furthering the disparity of wealth distribution in the country. In a recent article, Wolf Richter does an excellent job of tracking this. The next two charts show the growth of the "1%" relative to everyone else, and then the growth of the bottom 50% relative to the top 50-90%.[22]



[22] https://wolfstreet.com/2021/04/12/i-now-track-the-most-important-measure-in-the-feds-vision-of-the-economy-the-wealth-effect-and-how-it-impacts-americans-individually/



It's hard to say how long these trends can continue before the social fabric of the country gets even more frayed than it already is. But one thing seems to be certain - the government and Federal Reserve policies driving these results are still in place and if anything are being double-downed upon. Possibly future reports will be discussing quadrillions of new debt and stimulus. Yet the prices being signaled by the markets show no evidence of any of these distortions. Bond yields remain below inflation levels in the US, (and remain below zero in much of Europe). There are many ways of measuring stock valuations, but none of them suggest that stocks are cheap. Markets are supposed to be vehicles of "price discovery". In particular, the values assigned to bonds become the reference point for valuing all other financial assets. The unlimited flow of liquidity plus a price insensitive buyer renders the valuation of all financial assets suspect. We are considering valuing our investment accounts in something more stable like Bitcoin (belated April fools)!

By next quarter, the economic data comparisons will begin to become less flattering. On the other hand, we might have another stimulus package by then which will allow new trillions to begin flowing. For now, we believe the onus remains on the bears and the longer term trend of the stock market remains up. In the nearer term, there are technical reasons that will provide headwinds to the markets and volatility could well increase. Most notably, T.Rowe Price estimates that last year potential government fiscal stimulus and central bank liquidity injections pumped $28.47 trillion into the global economy![23] This is now slowing at the margin and next month tax payments flow out of the system. In more aggressive models, we are trimming gains from last year and redeploying the cash into more value oriented, cyclical areas such as small cap stocks and overseas markets (e.g. Europe and Japan) where valuations are cheaper and they are behind the US in their economic recovery cycle. We remain bullish on springtime here in the Northeast. The tulips and daffodils are exploding and we are so very much looking forward to a pandemic-free return towards normalcy. We hope you are all safe and healthy and are enjoying the same.

Thanks for reading,

Jason

[23] "Investing Amid Rising Rates: Is 60/40 Dead?"; T.Rowe Price Asset Allocation Viewpoints Webcast; April 20, 2021; pg.17/22.