



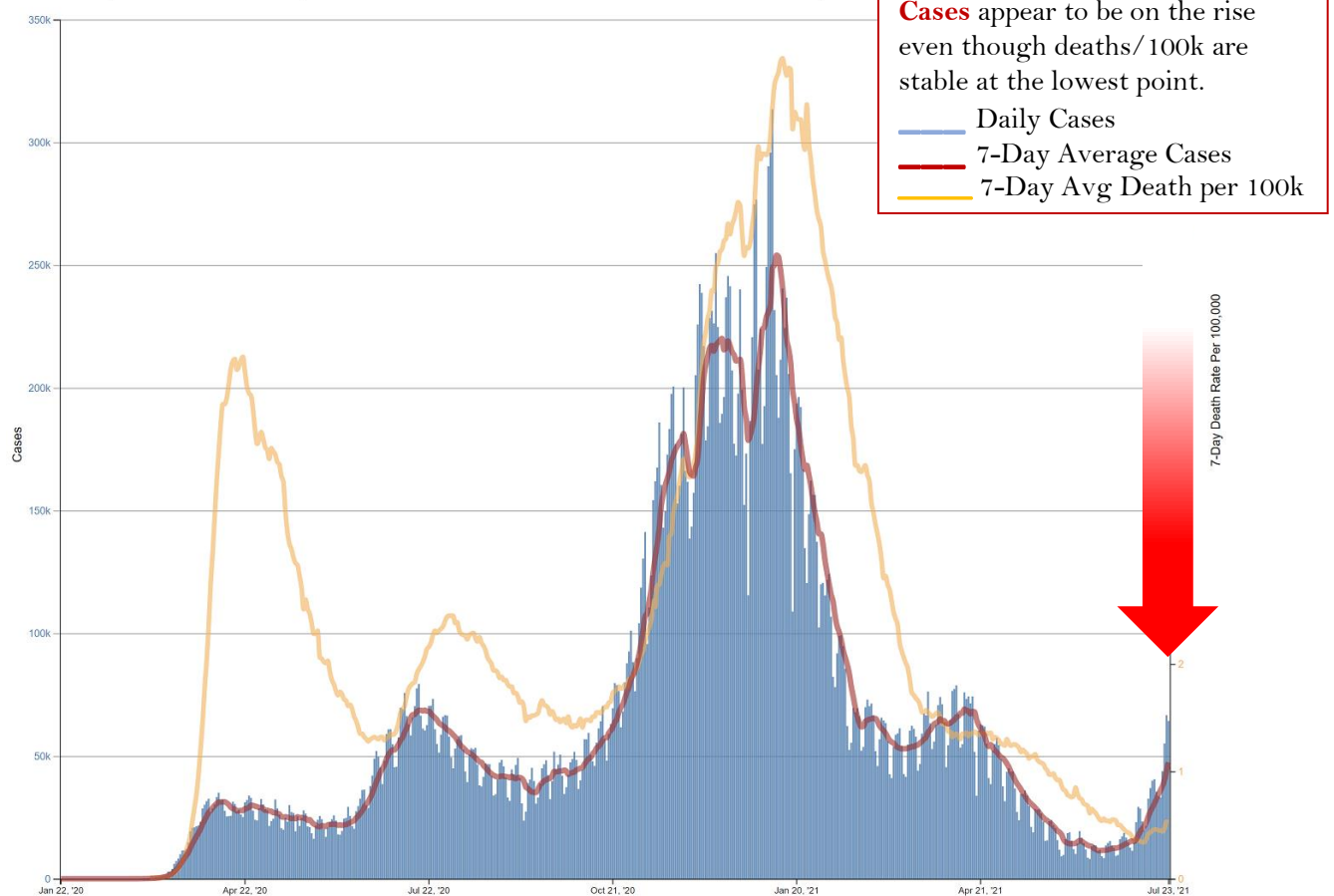
July 29, 2021

Executive Summary
<ul style="list-style-type: none"> <li>Resurgence of Covid cases and the anti-vaxers could dampen economic activities and thus diminish demand driven inflation pressure.</li> </ul>
<ul style="list-style-type: none"> <li>The U.S. economy has likely passed peak growth, and the path forward (rate of slowing growth) will depend on the resurgence of Covid cases which could dampen economic activities and thus inflation pressure.</li> </ul>
<ul style="list-style-type: none"> <li>Speedy reduction of employment slack, especially in the lower income economic sectors, would support increasing aggregate demand which would contribute to higher inflation. Labor data, although speedily improved, has stalled, and the number of unemployed plus the number of workers not in the labor force remain high. The speed of labor market recovery, which is a focus of the Fed, will partially be dependent on the path of Covid/Delta resurgence.</li> </ul>
<ul style="list-style-type: none"> <li>Much of the inflation is transitory, but since transitory is not defined, we believe that peak inflation is likely behind us. However, there will be a longer tail of above 2% inflation for some time, and it is not just transitory.</li> </ul>
<ul style="list-style-type: none"> <li>If peak growth and peak inflation are behind us, the Fed will have more time to wait before taking action. The technical factors are pushing interest rates lower and are not structural. This should dissipate by the year-end, and we expect 10-year treasury to rise from closer to 1.75% to 2%.</li> </ul>
<ul style="list-style-type: none"> <li>The Fed has a new framework of abandoning an ex-ante approach of taking action in anticipation of a change in favor of an ex post approach of witnessing the data with a trend fully established and then take action. This approach, by definition, is reactionary and, as such, would likely be late. (A hotter economy leads to higher, more sustainable inflation above 2%.) The Fed's insistence that the current inflation is transitory and the desire to bring employment equity to all have been consistent and that means lower rates for longer...for now.</li> </ul>
<ul style="list-style-type: none"> <li>The next two quarters will likely be jagged for the stock market since it continues to reach higher highs and is priced for perfection. At this point, it is not too hard to be disappointed and the market takes a tumble. Similarly, bonds are very richly priced with spread getting ever tighter (a result of the sustained dovish monetary policy). There is also very little room for error. We are concerned with the potential positive correlation between stocks and bonds going forward and the benefit of diversification vanishing.</li> </ul>

## Covid is Beaten Back but not Beaten

According to the CDC, on July 9<sup>th</sup>, the U.S. had 26,742 new cases, and averaging over the past 7-days, there were 17,736 new cases. The following chart from the CDC<sup>1</sup> shows the number of COVID-19 cases since January 2020, and it appears that COVID cases are on the rise again.

Trends in Daily COVID-19 Cases and 7-Day Cumulative Incidence Rate of COVID-19 Deaths in the United States Reported to

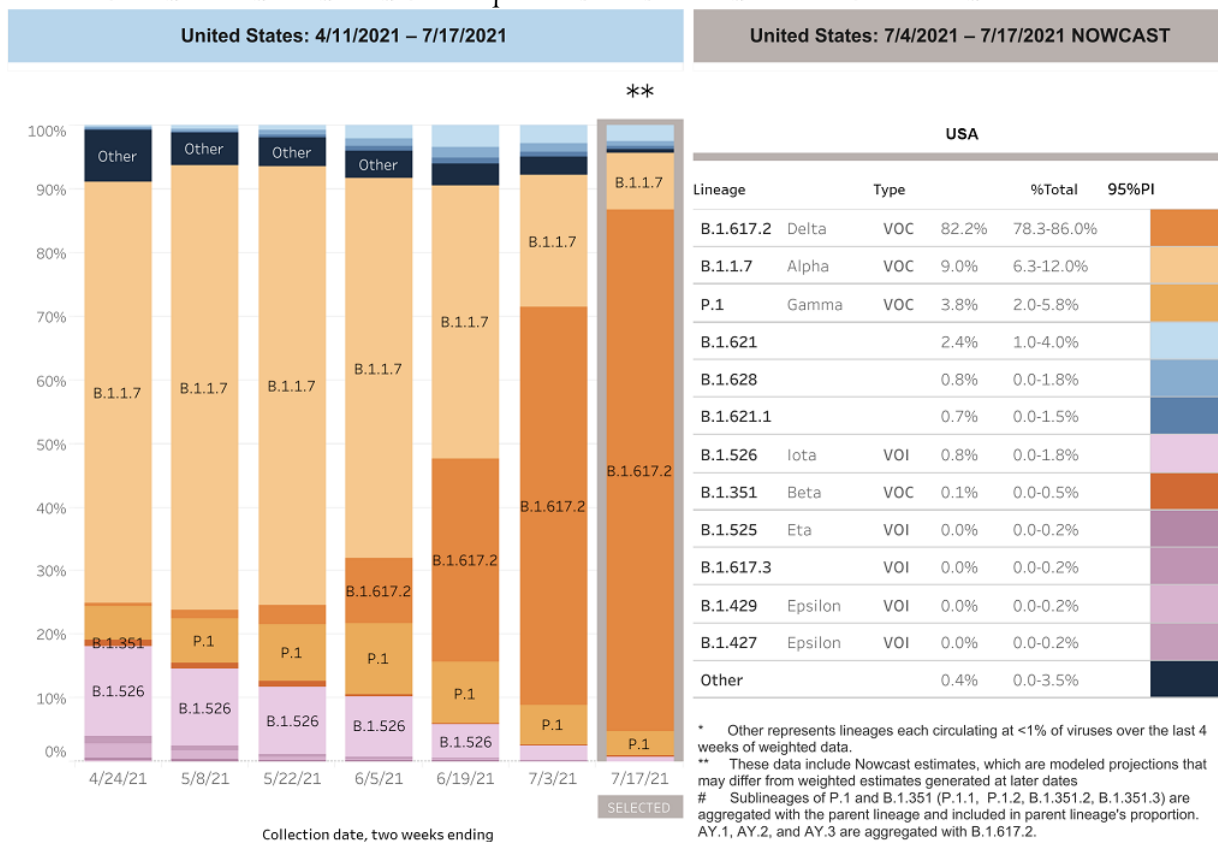


Mutations are changes in the genetic code of a virus that naturally occur over time when an animal or person is infected. While a certain amount of genetic variation is expected to occur as SARS-CoV-2 spreads, it's important to monitor circulating viruses for key mutation(s) that happen in important regions of the genome. Many mutations do not affect the virus's ability to spread or cause disease because they do not alter the major proteins involved in infection; eventually, these are outcompeted by variants with mutations that are more beneficial for the virus. The main reason for reaching herd immunity quickly is to minimize mutations.

According to the CDC's national genomic surveillance program, they've identified new and emerging variants to determine implications for COVID-19 diagnostics, treatments, and vaccines authorized for use in the U.S. Monitoring the spread of emerging variants in the U.S. relies on widespread, rapid sequencing. Based on these data, sequences with similar genetic changes associated with important epidemiological and biological events are grouped into lineages. A viral lineage is a group of viruses defined by a founding variant and its

<sup>1</sup> [https://covid.cdc.gov/covid-data-tracker/#trends\\_dailytrendscases](https://covid.cdc.gov/covid-data-tracker/#trends_dailytrendscases)

descendants. The proportion of lineages circulating in the U.S. are tracked and characterized to determine if they are considered variants of high consequence (VOHC), variants of concern (VOC), or variants of interest (VOI). These data, along with data from many other sources, are used to inform national and state public health actions related to variants.



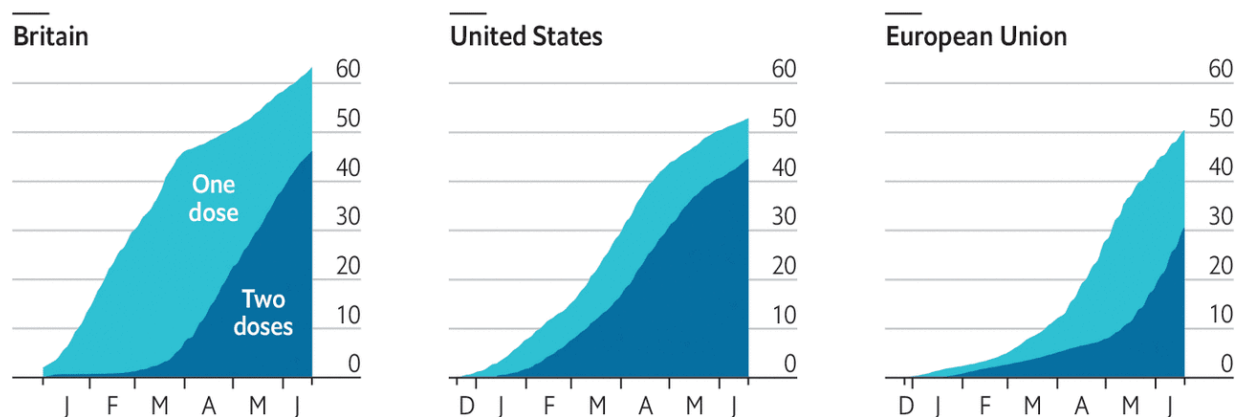
The CDC table above shows the two-week lagging data from April 11th through July 17th. The Alpha variant (a.k.a. the original COVID-19 variant) remained dominant in the U.S. through June 5th. Beginning in the June 5th reporting period, the B.1.617.2 variant (a.k.a. the Delta variant first discovered in the U.K. September last year) has shown significant spreading. Early data suggest that B.1.617.2 now makes up more than 80% of COVID cases. In some parts of the country, this percentage is even higher, especially in areas with low vaccination rates. Delta seems to be around 60% more transmissible than the already highly infectious Alpha variant. According to Nature, “cases of the Delta variant in the UK are doubling roughly every 11 days. But countries with ample vaccine stocks should be reassured by the slower uptick in hospital admissions. A recent Public Health England study found that people who have had one vaccine dose are 75% less likely to be hospitalized, compared with unvaccinated individuals, and those who are fully protected are 94% less likely to be hospitalized. According to the CDC data tracker, 67.6% of adults over age 18 have had at least one dose of a vaccine.

On June 22nd President Biden announced that the U.S. would probably fall short of its July 4<sup>th</sup> target of 70% adults having been given at least one dose of a vaccine. According to The

Economist<sup>2</sup>, the U.S. rate of vaccination shows sign of topping out while Britain and the EU (after a slow start) continue to be on the rise.

## Job sessions

Share of population given the covid-19 vaccine, 2020-21, %



Source: Our World in Data

The Economist

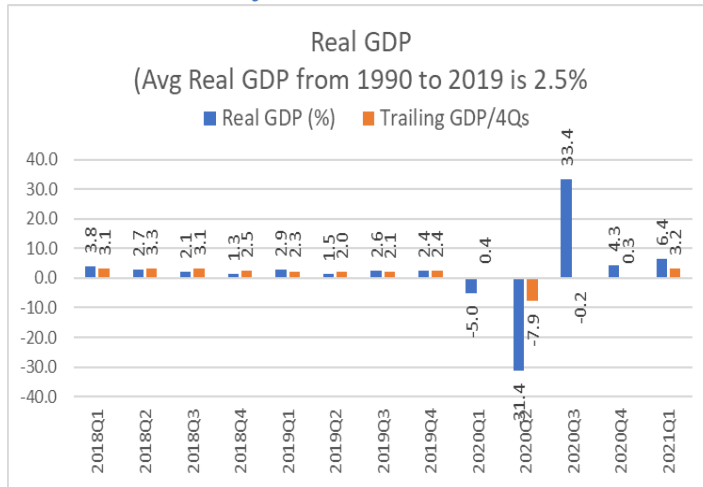
It is clear that after almost 15-months of varying degrees of lockdown, face masks and social distancing, many have adjusted while many more are looking for more freedom of movement and normalcy. The pent-up demand for goods and now services, as the economy reopened across the U.S., has ignited economic activities (i.e. GDP growth) and contributed to inflation (higher demand meeting supply chain bottleneck).

At the same time, the U.S. vaccination rate is slowing as many of the remaining 33% of adults who have not yet had a first dose do not want one (anti-vaxers). This group is now the most at risk under rising infections from the Delta variant. As people pile back into restaurants, hotels, theaters, concert halls, airplanes and other closed environments without social distancing and often without masks, it should not be a surprise if the U.S. continues to see an increase in infection and hospitalization rates as we go through the summer and especially into the fall flu season. Although we are not predicting a repeat of the 2020 experience of the country lockdown or spiking death rate nationwide, the resurgence of Covid-related infection could dampen the reopening enthusiasm and the economic recovery timetable as children are scheduled to be going back to school in-person in the fall. This rate of change backward would put pressure on the sustainability of the current GDP level, employment improvement rate, and stock market valuation.

Resurgence of Covid cases and the anti-vaxers could dampen economic activities and thus diminish demand-driven inflation pressure.

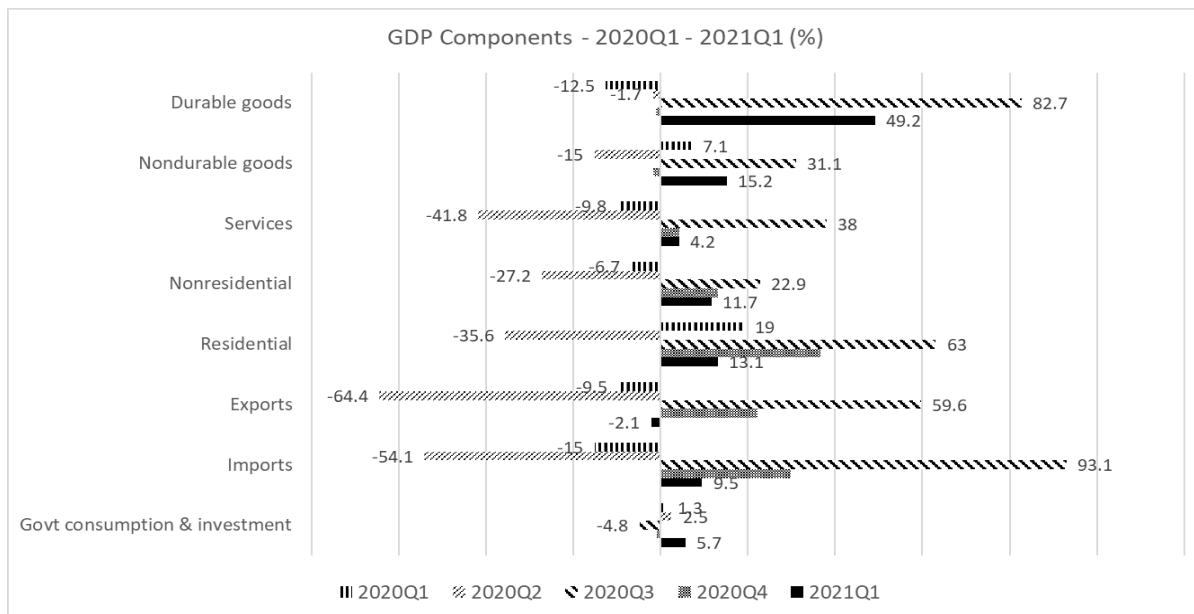
<sup>2</sup> <https://www.economist.com/graphic-detail/2021/06/23/after-a-stumbling-start-the-eu-is-vaccinating-at-a-fast-pace>

## The U.S. Economy – Peak Growth is Behind Us



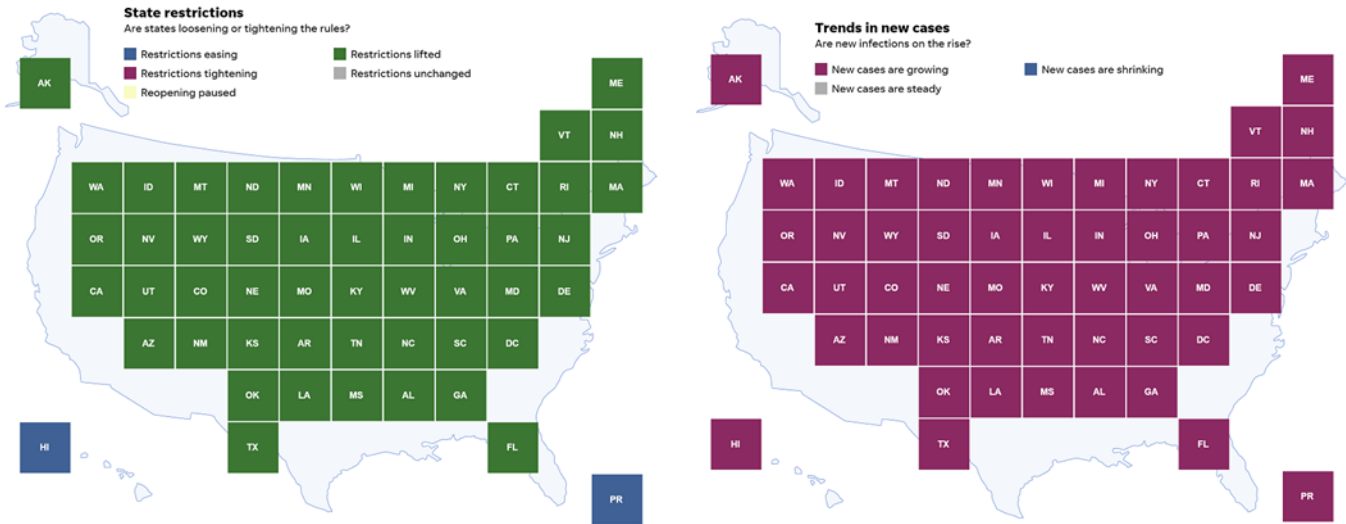
The short and sharp recession (back-to-back negative real GDP for two quarters) in the first two quarters in 2020 gave way to a recovery surge in the third quarter of 2020. This significant rebound was led by the gradual reopening of the economy which continued through the following two quarters with periodic regional economic closures. We certainly expect the real GDP for the second quarter to be even better than the first quarter, but we also expect

the second quarter to be the period of peak growth during this cycle.

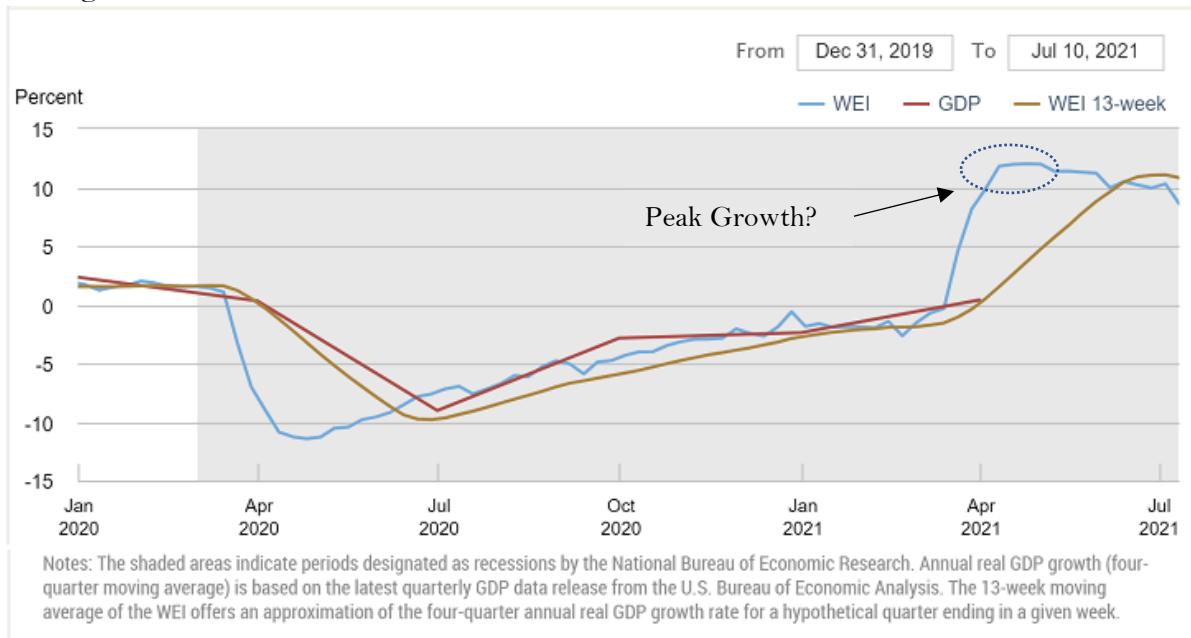


The above graph plots the growth rate of real GDP key components since the first quarter of 2020 through the first quarter of 2021 (the latest available annualized quarterly data). After the negative activities in the first half of 2020, durable goods and imports came soaring back in the third quarter. Residential investment also recovered. The first quarter shows that durable and non-durable goods sectors continue to recover along with expansion in government spending and investment. Services, after the initial rebound in the third quarter last year, remain behind in recovery, which is understandable. We expect the second quarter data will show the goods sector giving way to services with most of the economy completely reopened at the end of the second quarter.

All states are now “reopened<sup>3</sup>”, but this should not be viewed as the end of Covid or the pandemic. At the same time, new Covid cases are on the rise in every state and DC.



The New York Fed maintains the Weekly Economic Index<sup>4</sup> (WEI) which represents ten daily and weekly indicators of real economic activity, scaled to align with the four-quarter GDP growth rate.



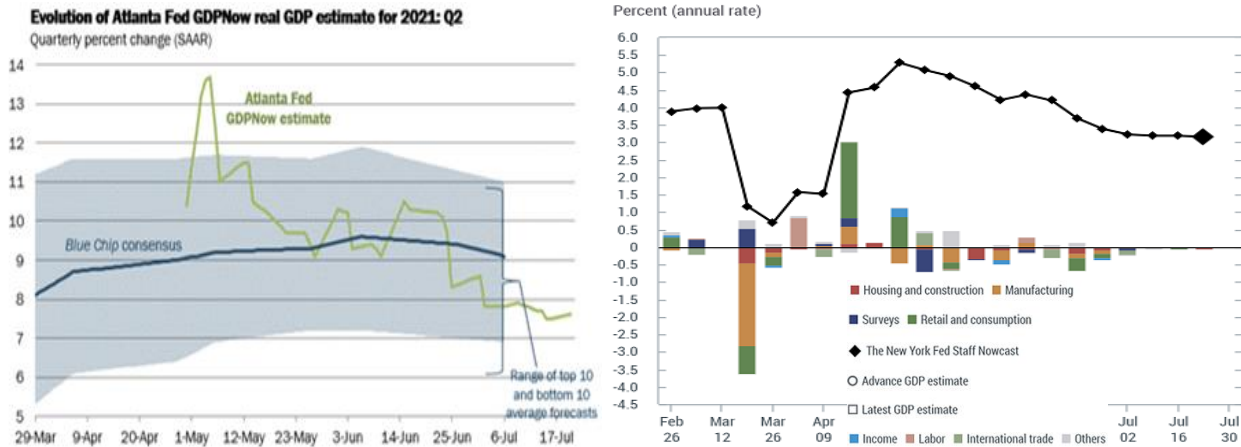
<sup>3</sup> <https://www.usatoday.com/storytelling/coronavirus-reopening-america-map/#restrictions>

<sup>4</sup> <https://www.newyorkfed.org/research/policy/weekly-economic-index#/interactive>

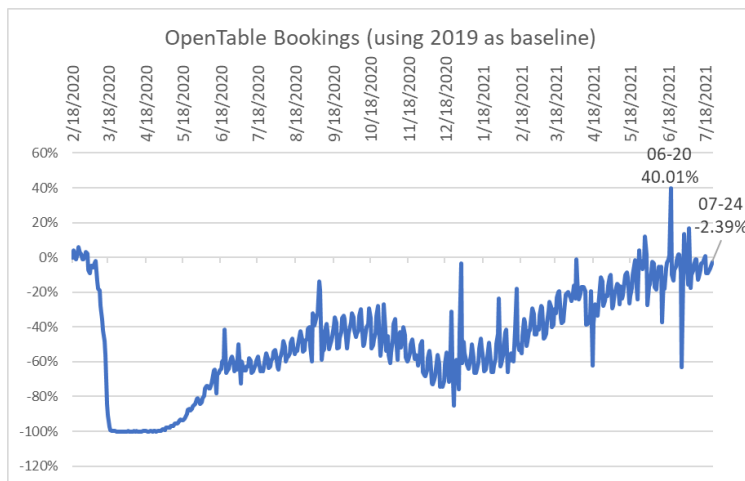
The ten indicators include:

Initial unemployment insurance claims	Continuing unemployment insurance claims
Federal taxes withheld	Redbook same-store sales
Rasmussen Consumer Index	The ASA Staffing Index
Raw steel production	U.S. railroad traffic
U.S. fuel sales to end users	U.S. electricity output

The Index suggests that the U.S. economy has passed its “peak growth” and activities are leveling and trending downwards on a weekly or 13-week trailing basis. The third quarter should continue this trend, assuming the Delta virus does not become an increasing meaningful burden on psychology and thus the economy.



On July 20<sup>th</sup>, the Atlanta Fed’s GDPNow<sup>5</sup> is projecting a 7.6% real GDP for the second quarter (upper left graph) whereas, on July 23<sup>rd</sup>, the New York Fed’s Nowcasting<sup>6</sup> is projecting a 3.16% real GDP. Despite the large differences between the two projections, based on incoming data, the trend for both is clear that the economy is expanding or growing at a much slower pace than in May.



High frequency data or close to real economic time data provide vital information regarding trends or directionality of economic activities. The left chart shows restaurant bookings on the OpenTable<sup>7</sup> app as of July 24<sup>th</sup>. It clearly shows the complete shutdown of dining out in March and April last year and the excitement of reopening towards the end of June this year. Since

<sup>5</sup> <https://www.atlantafed.org/cqer/research/gdpnow>

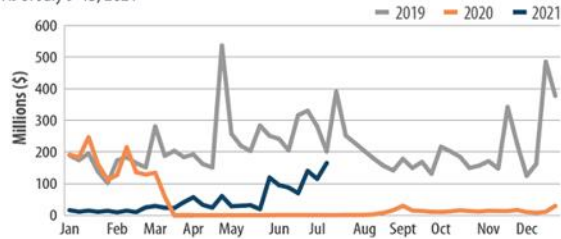
<sup>6</sup> <https://www.newyorkfed.org/research/policy/nowcast>

<sup>7</sup> <https://www.opentable.com/state-of-industry>

daily data is noisy, it is reasonable to suggest that, if restaurants are open, patrons are coming back to almost 2019 levels. This, however, does not tell us anything about the quality or abundance of services in restaurants or the menu selection and prices. A reasonable assumption is that the initial surge since lockdown continues, although at a less fevered pace. The following six graphs provided by First Trust show additional real time data that affirm improving economic activities. It is clear that we are traveling and using our cars (gasoline), railway and flying more this year (TSA Checkpoint) as we approach 2019 baseline activities. Of course, when we travel, we see hotel occupancy up as well, but it is also clear that, with many borders continuing to be closed or countries requiring a 7-to-14-day shelter-in-place, global travel is still weak. Finally, box office receipts are up but not yet at 2019 levels. Could the trend of new movies being released early via online venues be changing consumer behaviors a bit about “going to the movies”?

### BOX OFFICE RECEIPTS

As of July 9-15, 2021



Sources: Box Office Mojo, First Trust Advisors

### RAIL CAR TRAFFIC (CARS)

As of July 16, 2021



Sources: Bloomberg, Association of American Railroads, First Trust Advisors

### HOTEL OCCUPANCY

As of July 4-10, 2021



Sources: Hotel News Now, First Trust Advisors

### TSA CHECKPOINT DATA

As of July 21, 2021 (7-Day Moving Average)



Sources: Transportation Security Administration, First Trust Advisors

### SUPPLY OF MOTOR GASOLINE IN THE U.S. (MBBL/D)

As of July 16, 2021



Sources: Bloomberg, First Trust Advisors

### GLOBAL COMMERCIAL FLIGHTS

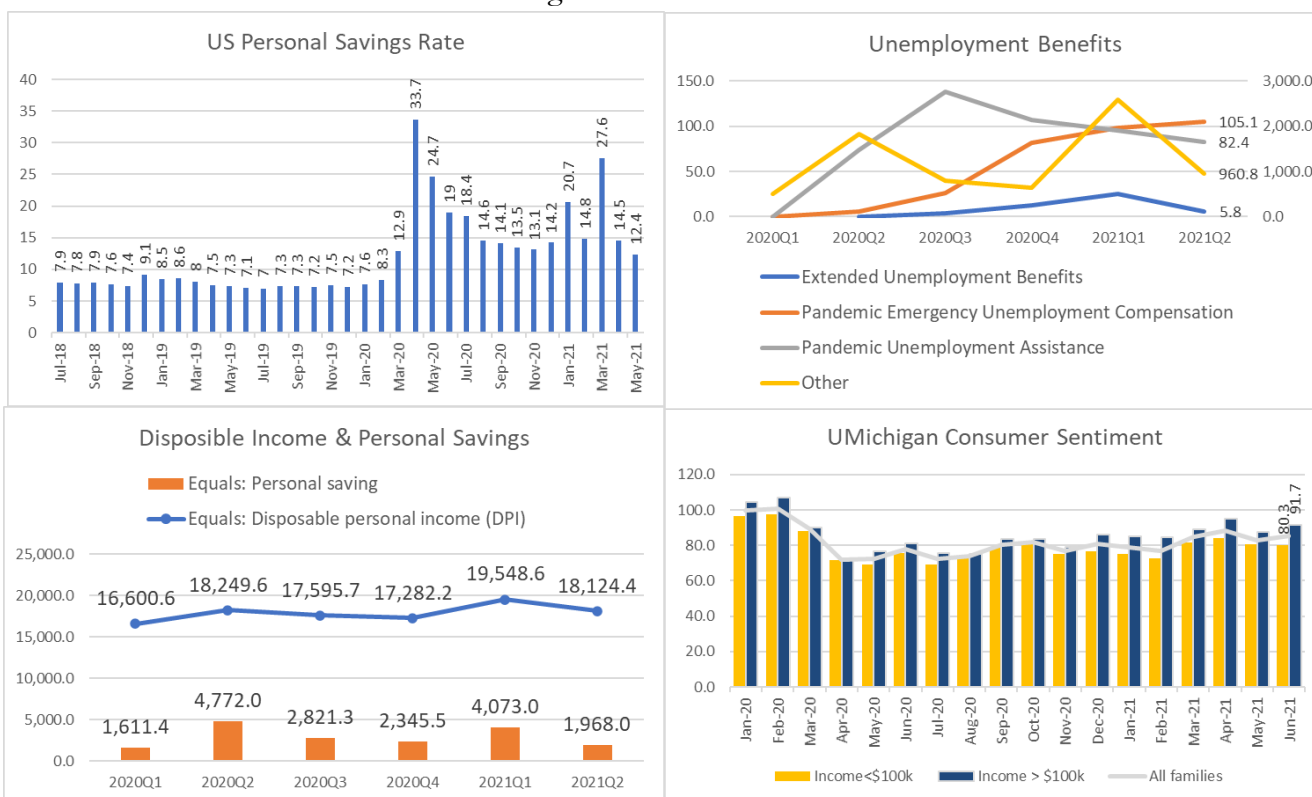
As of July 21, 2021 (7-Day Moving Average)



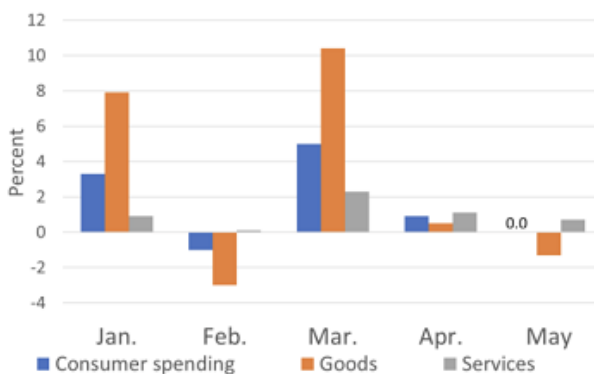
Sources: Flight Radar 24, First Trust Advisors



The economic data offers some mixed signals.



**Month-to-Month Change in Consumer Spending**



U.S. Bureau of Economic Analysis

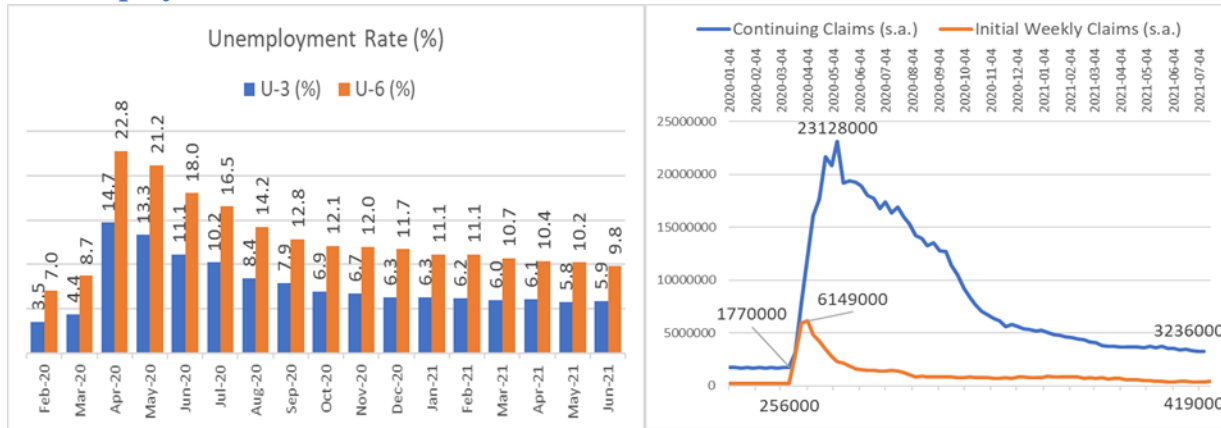
Seasonally adjusted

The U.S. Savings rate continues to come down as expected. The extraordinary savings rates of 33.7% in April and 20.7% in December last year as well as 27.6% in March this year were all due to the fiscal transfer payments that boosted savings. The special unemployment benefit programs, a large contributor to this excess savings, are all coming to an end, which also contributed to a drop in disposable personal income level. The

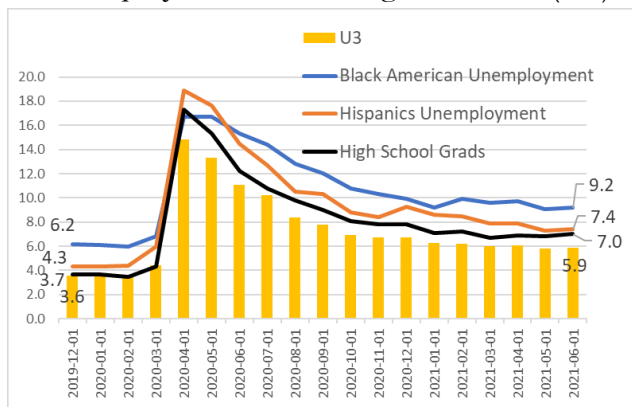
June University of Michigan survey of consumer sentiment shows that consumers remain very positive with people earning \$100,000 plus more positive, not a surprise. At the same time, the BEA May data shows a flat consumer spending, a drop in goods and a slight increase in services (due to reopening). What this shows is that not all cylinders are firing at the same time or rate. The end of fiscal transfer or stimulus (especially unemployment payments) should slow the general economic growth rate if employment does not pick up. We need to keep an eye on jobs, consumer spending and the savings rate.

The U.S. economy has likely passed peak growth, and the path forward (rate of slowing growth) will depend on the resurgence of Covid cases which could dampen economic activities and thus inflation pressure.

## Full Employment – Not so fast!

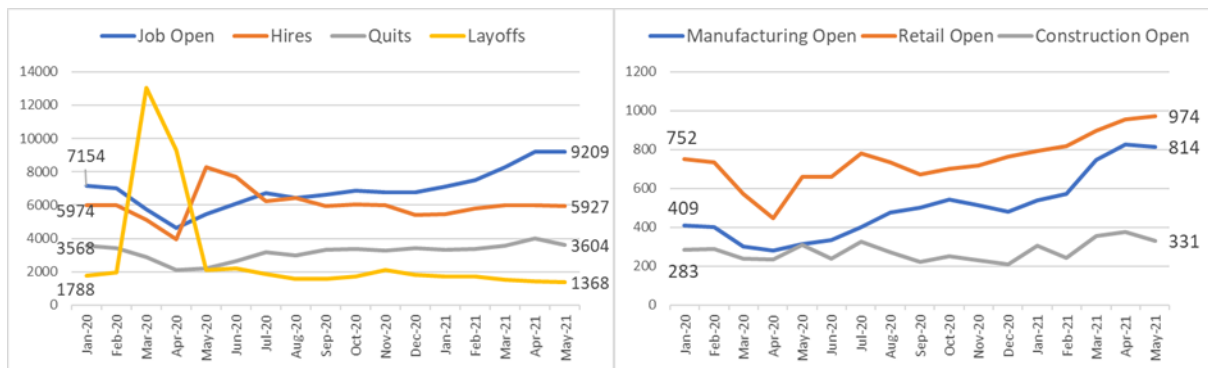


The headline (U3) unemployment rate is at 5.9% in June (0.1% above May and a sign that workers are back to looking for jobs). This is a fantastic improvement over 15 months from the high of 14.7%. The broader measure of unemployment which includes unemployed, underemployed and discouraged workers (U6) has also improved over the same period from 22.8% to 9.8%.



Compared to the Great Recession, which started at the end of 2007 where U3 was 5% and U6 was at 8.8%, it took eight and a half years for U3 to drop back to 5% and ten years for U6 to drop back to 8.8%. However, the speed for getting the rest of the unemployed, underemployed and discouraged workers back to work would likely be at a significantly reduced rate. In the case of Black and Hispanic Americans and workers

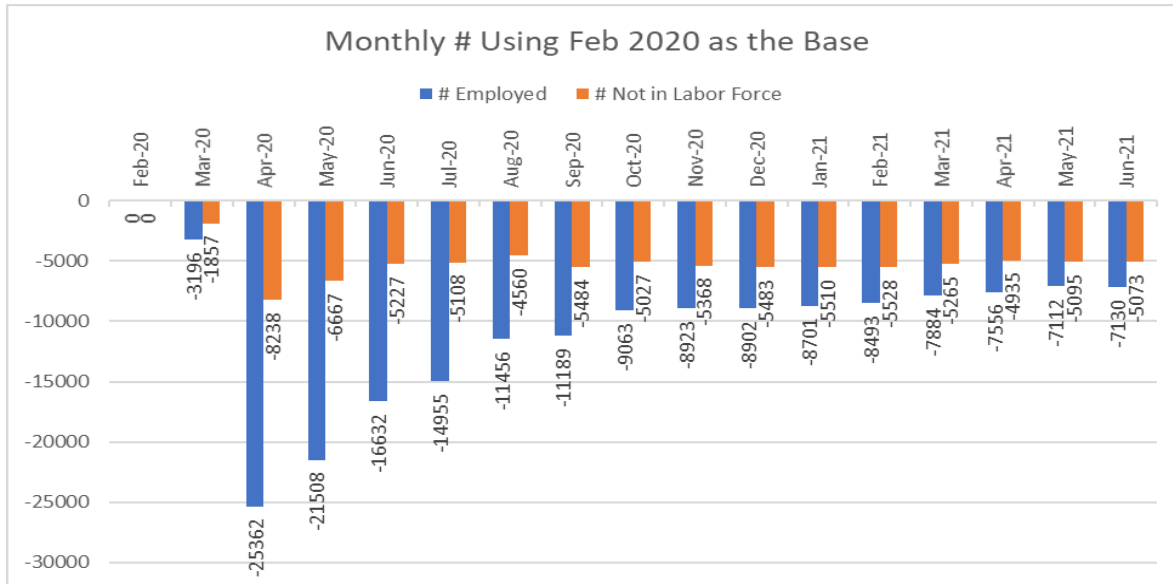
with high school education, unemployment rates are still high.



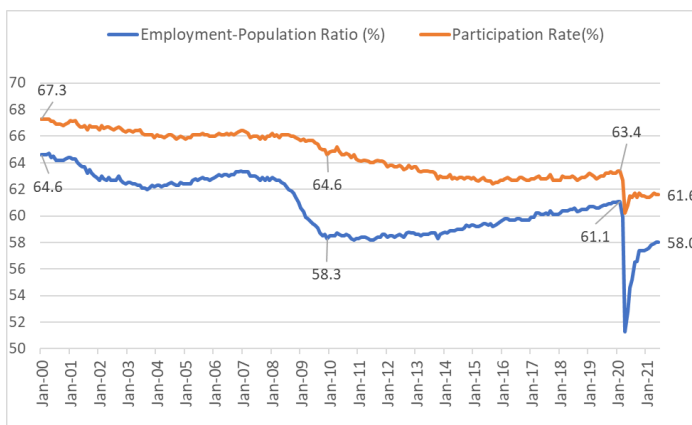
The May JOLTS report from the BLS, which is the most recent, shows hiring has returned to the pre-pandemic level and plateaued over the past few months even though job openings have surpassed the pre-pandemic level. This means there are more job openings than workers seeking jobs in May (qualified or otherwise). Layoffs have continued to trend lower, which is understandable since there are more job openings than available workers. At the

same time, quits have also returned to pre-pandemic levels. This means that, with many job openings, qualified workers are quitting with greater confidence that they could get a better paying job.

According to BLS, over the 12-months ending in May, hires totaled 73.0 million and separations totaled 64.8 million, yielding a net employment gain of 8.2 million. These totals include workers who may have been hired and separated more than once during the year.



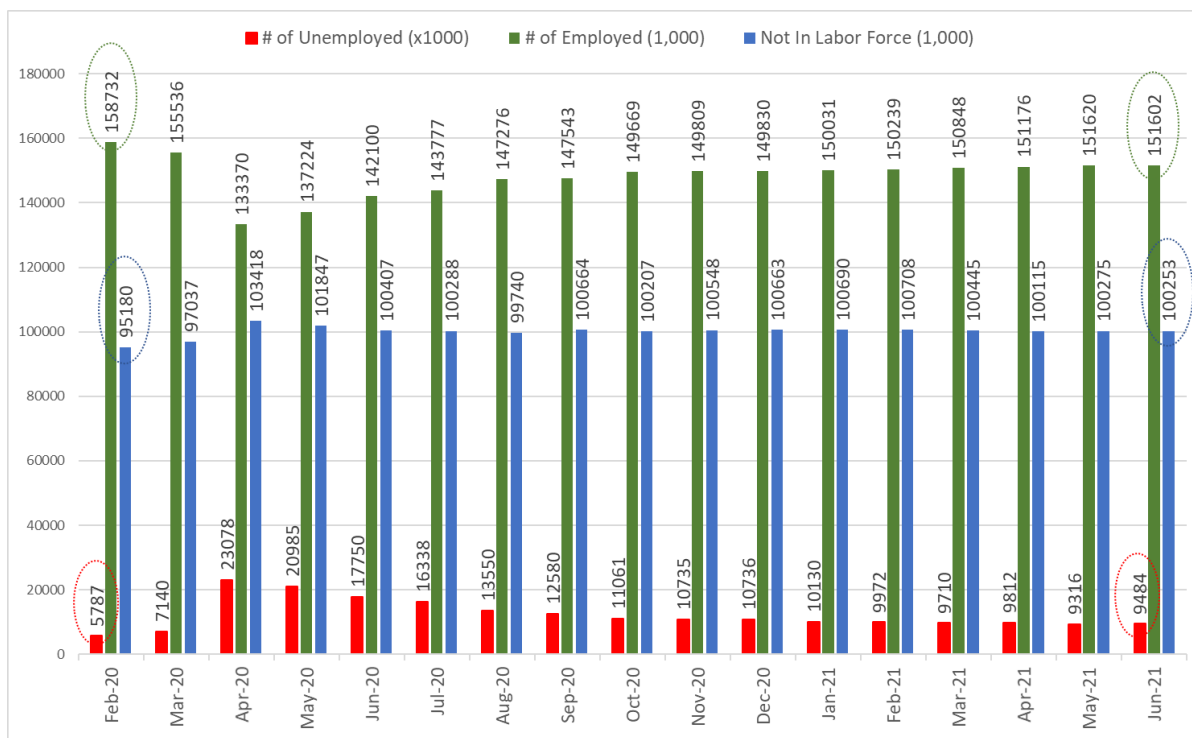
If we use the pre-pandemic February 2020 data as the baseline and compare the number of workers “employed” and the number of workers “not in the labor force”, both remain meaningfully below the corresponding baseline number. With the economy fully reopened and much of the extended unemployment payments and subsidies coming to an end in most states, the data should improve materially in the next quarter, barring a more severe infection resurgence.



The Federal Reserve (Fed), ever since the days of Chair Yellen, has focused on the labor market, which is one of its two core mandates. In Chair Powell’s July 14 Semiannual Monetary Policy Report to the Congress, he stated that “the unemployment rate remained elevated in June at 5.9 percent, and this figure understates the shortfall in employment, particularly as participation in the labor market has not moved up from the low rates that

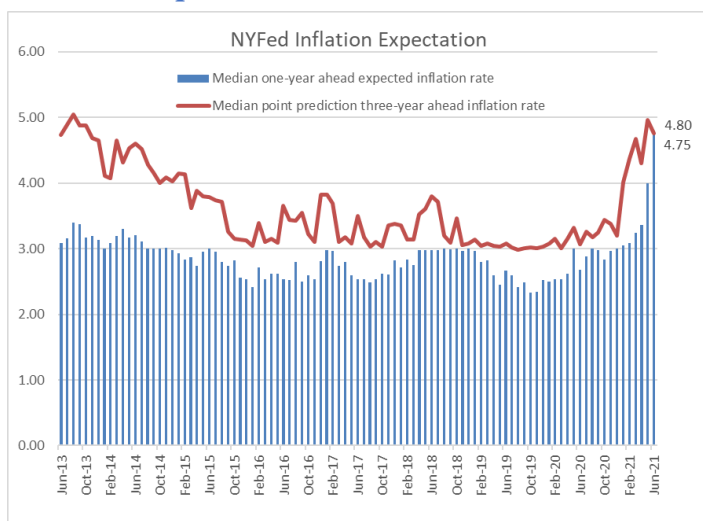
have prevailed for most of the past year.” He went on to say that “the pandemic-induced declines in employment last year were largest for workers with lower wages and for African Americans and Hispanics. Despite substantial improvements for all racial and ethnic groups,

the hardest-hit groups still have the most ground left to regain.” Based on the current reading of the labor economy, it is going to be a while before the Fed would be satisfied. This will likely be at the cost of higher inflation.



Speedy reduction of employment slack, especially in the lower income economic sectors, would support increasing aggregate demand which would contribute to higher inflation. Labor data, although speedily improved, has stalled, and the number of unemployed plus the number of workers not in the labor force remain high. The speed of labor market recovery, which is a focus of the Fed, will partially be dependent on the path of Covid/Delta resurgence.

### Inflation Expectations & Inflation



The Fed takes the view that inflation expectation is the single most important factor in determining future inflation. The idea being that, if the population believes prices will rise and get higher in the future, it would be “cheaper” to buy and spend now which in itself is pushing prices higher. The New York Fed’s June 2021 Survey of Consumer Expectations show a continuing rise in short-term expectations (1-year) since November 2020 while the medium-term expectations (3 year

forward) appear to be coming down a bit.

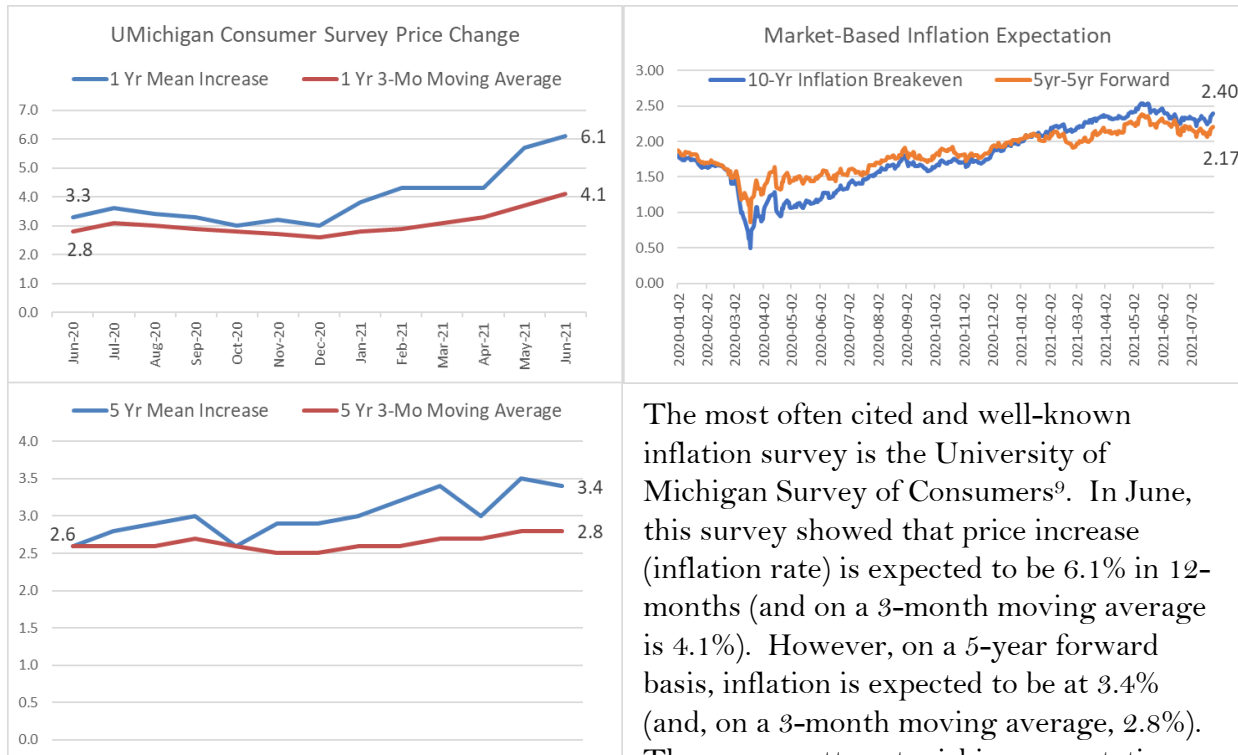
The Philadelphia Fed conducts a quarterly survey of professional forecasters<sup>8</sup>, and the survey data for CPI, Core CPI, PCE and Core PCE are as follows:

<b>CPI</b>	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2
2019Q4 Project	2.2	2.1	2.2	2.1						
2020Q1 Project	2.0	2.0	2.2	2.2	2.2					
2020Q2 Project		-2.6	1.5	1.9	2.0	2.0				
2020Q3 Project			2.3	1.6	1.8	1.6	2.1			
2020Q4 Project				2.0	2.0	2.0	2.1	2.2		
2021Q1 Project					2.5	2.1	2.1	2.2	2.2	
2021Q2 Project						3.2	2.6	2.4	2.3	2.2
<b>Core CPI</b>	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2
2019Q4 Project	2.3	2.2	2.2	2.2						
2020Q1 Project	2.1	2.1	2.1	2.2	2.2					
2020Q2 Project		0.7	1.5	1.6	1.7	1.8				
2020Q3 Project			1.6	1.5	1.6	1.8	1.8			
2020Q4 Project				2.1	1.8	2.0	1.9	1.9		
2021Q1 Project					1.8	2.1	2.1	2.1	2.1	
2021Q2 Project						2.5	2.5	2.3	2.1	2.2
<b>PCE</b>	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2
2019Q4 Project	2	2	1.9	1.9						
2020Q1 Project	1.7	1.8	1.9	2.0	2.0					
2020Q2 Project		-1.5	1.3	1.6	1.6	1.6				
2020Q3 Project			1.6	1.2	1.5	1.5	1.8			
2020Q4 Project				1.7	1.8	1.8	2.0	1.9		
2021Q1 Project					2.4	1.8	1.9	2.0	2.0	
2021Q2 Project						3.0	2.4	2.2	2.1	2.1
<b>Core PCE</b>	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2
2019Q4 Project	2.0	2.0	2.0	2.0						
2020Q1 Project	1.9	1.9	1.9	1.9	1.9					
2020Q2 Project		1.0	1.3	1.4	1.6	1.7				
2020Q3 Project			1.5	1.3	1.5	1.5	1.7			
2020Q4 Project				1.8	1.7	1.7	1.8	1.7		
2021Q1 Project					1.9	1.8	1.9	1.9	1.9	
2021Q2 Project						2.5	2.2	2.0	2.0	2.0

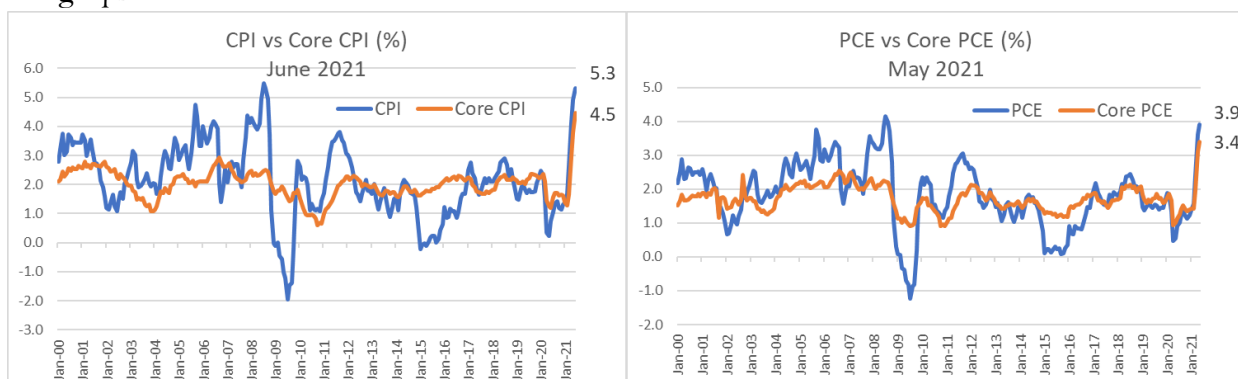
These tables show the forecast for each quarterly projection period (up and down) for the future quarters (top line across each quarter) on an annualized basis. The baseline projection rate is highlighted in boxes, and if in the following quarter, the projection for inflation is lowered, it would be highlighted in blue, and if higher, then highlighted in orange. There is no surprise that, beginning in 2020Q4 and going forward, all projections moved higher. CPI for 2021Q2 (the immediate past quarter) was the highest at 3.2% and trended down to 2.2% one year thereafter. This is the same trend for Core CPI from 2.5% to 2.2%, for PCE from 3% to 2.1%, and for Core PCE from 2.5% to 2%.

<sup>8</sup> <https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/spf-q2-2021>

transitory (or temporary) even though inflation is not projected to return to below 2% in the near future.



We do not have enough data or time series to suggest that consumer inflation expectation has moved in a structural and sustained way. However, we should be watching out for any permanency of change in inflation expectation which would require many more months of forward data to confirm. In the case of market-based inflation expectation, the upper right graph shows that market participants are expecting a 2.4% 10-year inflation rate which is higher than the Fed's target of 2% but much lower than the UMichigan survey in the upper left graph.



<sup>9</sup> <https://data.sca.isr.umich.edu/tables.php>

CPI and core CPI (ex. food and energy) show inflation to be running high in June at the annualized rate of 5.3% and 4.5%, respectively. The more favored inflation gauge for the Fed is PCE and core PCE. As of May, PCE was at 3.9% annualized and core PCE was at 3.4%. It is clear that these abnormally high rates can be attributed to base effect. This means the very low inflation readings in April, May and June 2020 gave exaggerated increases in the inflation rate 12 months hence. At the end of the second quarter, the base effect is over. We believe peak inflation is over and the annualized inflation rate should trend down from here. When the word transitory first was applied, I looked up the meaning of this word on the Merriam-Webster online dictionary. It defines it as “of brief duration” or TEMPORARY, or “tending to pass away” thus NOT PERSISTENT. This was not helpful. I was hoping for more of a quantitative definition of more than a week but less than 6 months. After speaking with many professional managers, analysts and economists, I was also disappointed. The only unifying conclusion is that it is short-lived but the “short” portion morphs over time. Now, I think of the transitory nature of inflation as an arc. The length of the arc is time, and the height of the arc is the severity of inflation. I do think we are near if not past the peak in inflation rate during this cycle. This is especially true in the aggregate if Delta’s impact on the U.S. (and to a lesser extent, to the rest of the world) is more severe and impactful. Nonetheless, the right tail of this inflation arc will likely be longer (i.e. higher and not runaway inflation for a longer period of time and it is not as TEMPORARY or NOT PERSISTENT as transitory would otherwise be defined).

One of the biggest reasons driving higher inflation beyond a transitory period is the dislocation of the supply chain<sup>10</sup>. COVID-19 originated in Wuhan, China, the manufacturing hub or factory floor to the world. It became an immediate supply shock. As the virus spread to the rest of the world, so did the spread of stoppage in global manufacturing and, ultimately, the food supplies and agriculture as well. Shipping and transportation also came to a halt. With great uncertainty, inventory was drawn down to critical levels during lockdown periods, and even as China manufacturing came back online, many other manufacturing hubs across the emerging economies were still wheeling from the pandemic. It is still trying to get back to “normal”. During the low point, manufacturers, shipping companies, docks, etc. were laying off workers. The fear of getting infected (and dying) and the lack of preparedness continue to act as bottlenecks to supplies, manufacturing, transportation, and delivery. A well-known case is the scarcity of chips for new cars. During lockdown, more chips were allocated for personal computers and all things mobile that require chips to fill working-from-home demands. This drove up prices for new cars (due to shortages) and especially used cars (as an alternative) as people wanted mobility and a “safe” alternative to public transportation. It is not only a shortage of chips, but shipping cargo across the world was challenged. After all, the global economy and the flow of goods and commodities cannot be turned on and off like a switch. The surge of demand from goods to services has also created a big challenge as the world reopens. The ability to find workers quickly and obtain the supplies needed to reopen businesses in the real (rather than the cyber) economy is not smooth and adds to pricing, thus inflation, pressure as well. The mismatch of

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<sup>10</sup> <https://www.clevelandfed.org/en/newsroom-and-events/publications/cfed-district-data-briefs/cfddb-20210226-covid-19-and-supply-chains.aspx>

recovering supply shock and the morphing demand shock have unforeseen impacts on inflation.

Nonetheless, the Fed has consistently advocated that the current bout of inflation is transitory. The Fed has made it clear that it will continue a loose monetary policy stance for as long as the labor economy does not fully recover (maximum employment mandate) and that battling disinflation or deflation would require witnessing a sustained above 2% inflation rate for some time (achieving price stability mandate). However, this does not mean we are going back to a sub-2% inflation environment any time soon. If the Fed is successful, we should see an above 2% inflation rate for some time. From Chair Powell's July 28<sup>th</sup> Press Conference: "Indicators of longer-term inflation expectations appear broadly consistent with our longer-run inflation goal of 2 percent. If we saw signs that the path of inflation or longer-term inflation expectations were moving materially and persistently beyond levels consistent with our goal, we'd be prepared to adjust the stance of policy."

Much of the inflation is transitory, but since transitory is not defined, we believe that peak inflation is likely behind us. However, there will be a longer tail of above 2% inflation for some time, and it is not just transitory.

### Interest Rate – So Strange, Right?



As vaccine efficacy and availability became a reality, 10-year U.S. treasury rates (a benchmark baseline for loans) began their rise. The upper left chart shows the treasury spread between 3-month and 10-year as well as 2- and 10-year treasuries. With the Fed Fund rates well anchored at the effective zero lower bound, the rise in longer dated (market-driven) treasuries made the yield curve more positive sloping. This is also a sign that supports the thesis that the economy is opening up, and with a wide adoption of vaccine, COVID-19 will soon be behind us. Something happened since mid-March that the spread reversed and the spread across the yield curve tightened. The upper right chart shows the yield on 3-months (now remaining near zero), 2 year and 10-year treasuries. On March 19<sup>th</sup>, the 10-year moved up to 1.74%. This is a 1.20% lift from the low reached on March 9, 2020. Since then, the 10-year



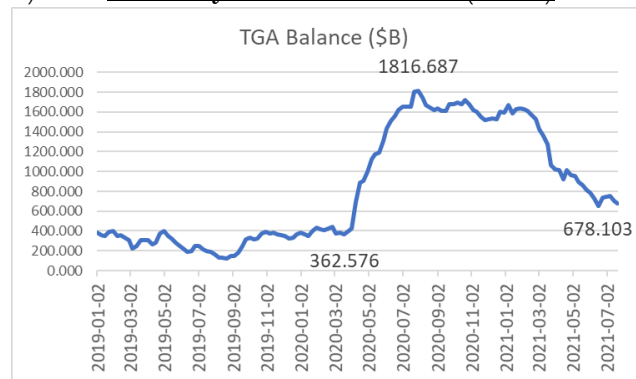
yield has gradually descended. As of July 27<sup>th</sup>, the yield is back down to 1.25% or a reduction of 49bp. In the meantime, the 2-year yield has moved higher from 0.16% on June 11<sup>th</sup> to 0.2% on July 27<sup>th</sup>. This is a reflection of the market incrementally anticipating a sooner rather than later Fed action on rates.

The 10-year yield reversal is caused from a blend of technical and fundamental drivers, although no one knows exactly all the factors and the weight of each factor influencing the move since mid-March. According to Jim Caron, Senior Portfolio Manager and Chief Strategist, Global Fixed Income Team at Morgan Stanley, there are three technical factors that have driven 10-year rates down:

1) Supplemental Leverage Ratio (SLR)

After the Financial Crisis, banks are required to meet various liquidity and leverage requirements. SLR measures a bank's ability to absorb losses. The total leverage exposure of a bank is a broad measure of the bank's risk weighted assets and includes its on- and off-balance sheet items in which bank reserves and Treasury securities are included. In April 2020, during the height of the pandemic, the Fed announced a temporary exclusion of U.S. treasuries and Fed deposits from its calculation of banks' SLR. This lowered banks total leverage exposure and increased banks' SLR and thus banks' abilities to take risk (a desired objective of the Fed during the crisis). On March 31, 2021, this exemption expired. This drove banks to buy and accumulate treasuries at the same time the Fed continued to buy treasuries monthly as a part of its \$120 billion monthly Quantitative Easing (QE) program. With more demand, treasury yield falls. This is a reversal phenomenon and not permanent.

2) Treasury General Account (TGA)



TGA, held at the New York Federal Reserve Bank, is the general checking account, which the Department of the Treasury uses and from which the U.S. government makes all of its official payments. At the height of the pandemic, the account, through issuance of treasury securities, went from \$362.576 billion to \$1.817 trillion. As of July 21<sup>st</sup>, the balance is down to \$678.103 billion. Since the

Treasury is not issuing any more debt (see Debt Ceiling below), the TGA is being spent down from its blotted days last year. This simply means that there will likely be no new supply of treasuries (only refinancing) for this fiscal year.

3) Debt Ceiling<sup>11</sup>

The debt limit is the total amount of money that the United States government is authorized to borrow to meet its existing legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds, and other payments. The debt limit does not authorize new spending commitments. It simply allows the government to finance existing legal obligations that Congresses and presidents of both parties have made in the past. This is a political football and each party out of power uses the debt ceiling to

<sup>11</sup> <https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/debt-limit>

threaten the party in power for leverage. The bottom line is that there is likely to be no more new treasury securities to be issued until the debt ceiling matter is behind us. This is a temporary supply shortage as market demand continues to grow.

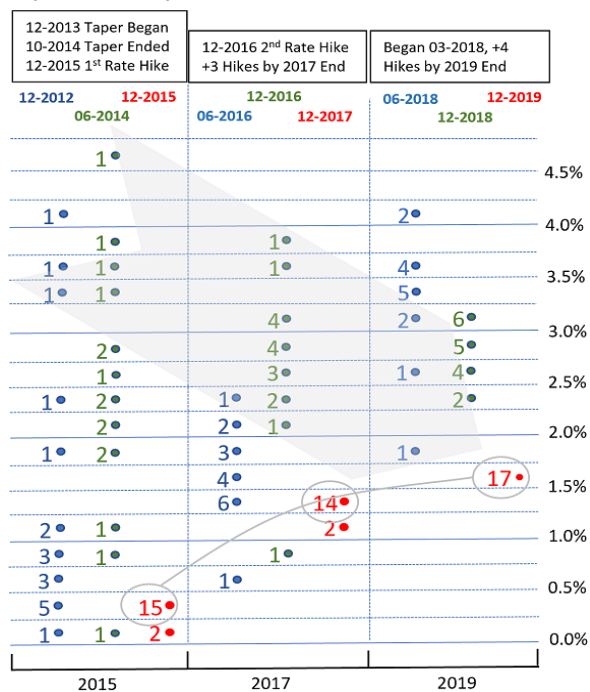
Additionally, foreign buying has come back now that, on a currency adjusted basis, U.S. treasury yields are more favorable than their domestic government bonds. The combination of these technical factors has contributed to a drop in 10-year treasury yields since mid-March. Fundamentally, the drop in yields may be attributable to the following market sentiments: 1) U.S. economy is slowing and not speeding up; 2) Delta may further impact the U.S. and global economic recovery and drag down growth prospects further; 3) inflation is largely transitory, and rates should reflect a normal low inflation environment; and 4) the Fed will remain low rates for longer.

If peak growth and peak inflation are behind us, the Fed will have more time to wait before taking action. The technical factors are pushing interest rates lower and are not structural. This should dissipate by the year-end, and we expect 10-year treasury to rise from closer to 1.75% to 2%.

### The Mighty Fed – Could FOMC have the cake and eat it too?

After the June 16<sup>th</sup> meeting and reading the dot plot, there was a momentary scare that the Federal Open Market Committee (FOMC) was to raise rates sooner and faster. Four times a year, the FOMC publishes its Summary of Economic Projections (SEP) where each member (voting and non-voting) anonymously offers his/her personal expectation for real GDP, unemployment, inflation and Fed Fund rate projection over the ensuing two-year period and

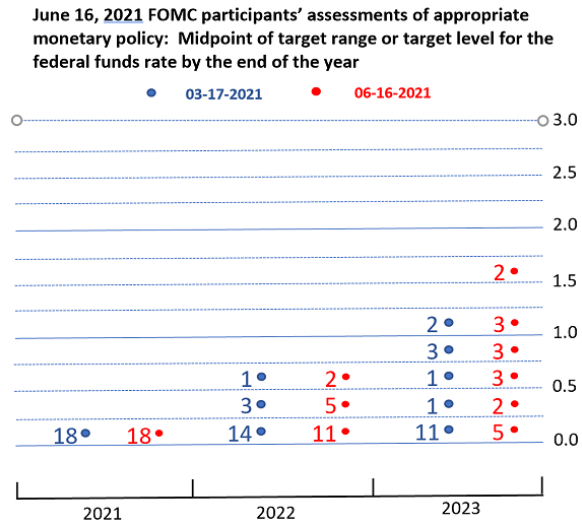
**FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate by the end of the year.**



for the longer run. These projections are often referred to as the dot plots and offer the public a view of where the members are related to each economic factor and their rate stance. However, the public gives way too much credibility to dot plots since the most important dots regarding Fed Funds rate are from the Chair, Vice-Chair and the New York Fed. Furthermore, the non-voting member's positions are immaterial to the final decision.

To examine the accuracy of the dot plot projections, I went back to look at the relevant meetings the last time the FOMC initiated tapering and rate hikes. The left graph illustrates the movement of dot plots from the various SEPs. I have divided this graph into three panel periods. The first period represents three meetings when the taper began at the 12-2013 meeting, taper ended on 10-2014 meeting and the first rate hike at the 12-2015. The dots represent the first two of the three meetings where the members were

expecting the rates to be at and the third meeting in 2015 when the rate decision was made. (They submit their dots prior to the meeting.) The dots pretty much all collapsed to around 0.25bp. That was exactly where the first rate in December 2015 hike was and did not resemble the more aggressive dot plots (individual projections) illustrated in the prior two SEPs. The second and third panels show exactly the same over-anticipation prior to the rate decisions, and the rates ended up much more contained.



This graph to the left shows the two meetings that provided the latest SEPs. Here the graph illustrates the dot plots for 2021, 2022 and 2023 for each of the two meetings. It is clear that no member projected any rate movement for 2021 and the majority (14 and 11) projected no increase in rates in 2022. But for 2023, the March SEP shows a majority (11) still projects no rate hike, but the June projection shows a wide dispersion of where the rate would be. If history is a guide, there is a lot of noise here and the reality is likely to be more muted and contained.

Based on this review, I suggest that even the FOMC members and regional bankers are acting on personal emotion. The final reality is more muted.

In the July 28<sup>th</sup> FOMC press release, the FOMC made a small change that suggested the members are continuing to discuss tapering their \$120 billion monthly purchases of U.S. treasury securities and mortgage securities. In December 2020, the FOMC stated that it would continue this Quantitative Easing policy until substantial further progress has been made toward its maximum employment and price stability goals. The following sentence was added: “Since then, the economy has made progress toward these goals, and the Committee will continue to assess progress in coming meetings.”

During the press conference and in Chair Powell’s prepared remarks he further emphasized the Committee’s position by saying:

“We also reviewed some considerations around how our asset purchases might be adjusted, including their pace and composition, once economic conditions warrant a change. Participants expect that the economy will continue to move toward our standard of substantial further progress. In coming meetings, the Committee will again assess the economy’s progress toward our goals, and the timing of any change in the pace of our asset purchases will depend on the incoming data. As we have said, we will provide advance notice before making any changes to our purchases.”

This is the beginning of forward guidance. The message is that we are now “thinking about thinking about” tapering or shrinking the amount of monthly purchases. Many Fed watchers

believe that the Fed should taper sooner rather than later to avoid policy mistakes. I don't disagree. The massive monthly \$120 billion in purchases of treasuries and mortgage securities was instituted to ease financial conditions, add significant liquidity, push interest rates lower to stimulate buying, borrowing and risk taking. This has fueled significant asset inflation and is probably no longer needed as the economy is at a significantly better position than last summer. But policy mistakes can be bifurcated. One such mistake is to curtail dovish policies too late with the Fed on its back foot and then have to raise rates faster and in larger chunks to fight inflation, causing a self-engineered economic slowdown by squeezing credit and significantly tightening financial conditions. On the other hand, a mistake can be made by being restrictive too soon and choke off the recovery unnecessarily.

The Fed has a new framework of abandoning an ex-ante approach of taking action in anticipation of a change in favor of an ex post approach of witnessing the data with a trend fully established and then take action. This approach, by definition, is reactionary and, as such, would likely be late. (A hotter economy leads to higher, more sustainable inflation above 2%.) The Fed's insistence that the current inflation is transitory and the desire to bring employment equity to all have been consistent and that means lower rates for longer...for now.

## Conclusion

We expect slowing growth and a more tempered inflation rate going forward. The wild card remains Covid, which is predicated on this country's and the world's ability to reach herd immunity (80% of the population fully vaccinated or has been infected) quickly. If not, mutation (because of transmission from host to host) will continue, and new and more lethal variants will result. This will continue to challenge us in economic recovery and in bringing our lives back to normalcy. Demand driven inflation will likely not be an issue if we do not control the spread of Delta, but supply chain challenges will likely persist for some time, which does add to inflation and increasing labor input costs due to mismatch of skills and labor. The next two quarters will likely be jagged for the stock market since it continues to reach higher highs and is priced for perfection. At this point, it is not too hard to be disappointed with the market taking a tumble. Similarly, bonds are very richly priced with the spread getting ever tighter (a result of the sustained dovish monetary policy). There is also very little room for error. We are concerned with the potential positive correlation between stocks and bonds going forward and the benefit of diversification vanishing, but for now, stocks still reign supreme since there remains the potential of upside whereas high-quality liquid bonds with little real yields to speak of have almost no upside and much downside.

Sincerely yours,

**EXPERIENTIAL WEALTH**

Philip Chao, Principal & CIO

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