March 23, 2021

The Economics of the Pandemic

We began this year with a lot of hope and optimism for the country to turn the corner on the pandemic. Hope that citizens would have access to vaccines and that life can begin to return to “normal.” This should translate to a stronger economy and a rebound from the dreadful slowdown of last year.

As optimism is spreading in the U.S. that Covid deaths are plummeting, and states begin to ease restrictions – across Europe – dread is setting in with another wave of infections closing schools and cafes and bringing new lock downs. Currently all of Italy and Poland is under lock down and many of the major cities including Paris and Brussels are following suit. Federal officials last week warn that the U.S. may be on track for another surge in Covid cases, trailing Europe by a few weeks in a pattern that has been seen throughout the pandemic. Who really knows?

The main question being asked on Wall Street since January of this year is **will inflation increase to the point of preventing any economic recovery?** The ingredients for inflation are certainly present; lots of fiscal and monetary stimulus (which includes the $1.9 trillion Covid bailout passed last month - not to mention a new $3 trillion stimulus package to address jobs and climate change that was announced just yesterday); Lots of pent-up demand from consumers who have deferred much of their normal spending during the past year; and a housing boom that has seen home prices rise above the highs reached during the great real estate bubble of 2008.

The Fed sees all this but isn’t worried. Fed Chair, Jerome Powell, is betting that inflation won’t get out of hand and reviving the economy is more important right now anyway. Janet Yellen, current Secretary of the Treasury, recently said the $1.9 trillion stimulus package is unlikely to cause inflation and higher interest rates and she expects that the economy will return to full employment in 2022.

What is the bond market telling us? Despite what Chairman Powell has said, long-term interest rates have been rising this year, which historically signals that the bond market is expecting inflation. That fact has been borne out over the last two months by observing the increases in the U.S. 10-year and 30-year Treasury yields. The rise in both of these bond rates of over 1% strongly indicate that the markets are anticipating inflation sooner rather than later.

110 Fort Couch Rd., Suite 108, Pittsburgh, PA 15241
Tel: 412.851.1400 | Fax: 412.851.1403 | Email: kfg@kapustafinancial.com

Kapusta Financial Group is a Registered Investment Advisor

What is the stock market telling us? Stock valuations continue at their lofty highs setting off alarm bells on Wall Street. By a variety of measures, equities have never been so expensive outside the dot com bubble years. The price to sales ratio of the S&P500 back in March 2000 (the previous peak of stock market valuation) was 2.1 and today, it is at an all-time record high ratio of 2.7. The other most important and revealing valuation metric is the total market cap to GDP ratio. The total market cap of the Wilshire 5000 to GDP was 1.4 at the March 2000 peak. However, it is now over 1.85.

Why is this a concern? Because we have continually stated over the last year that the action by the Federal Reserve to print historically large sums of stimulus money, as well as keeping interest rates locked at near zero interest rates, have been motivation for the current historical valuations of the bond and stock market. When the Fed is forced to raise interest rates due to inflation, the game of "propping up" Wall Street is over.

Again, to keep interest rates down and to prevent the stock and bond bubbles from bursting, *the Fed has no choice other than to continue to print massive amounts of money each month and purchase treasury securities.* The problem is that this form of artificial interest rate suppression, through the printing of large amounts of money, is highly inflationary. In the one year since the declaration of the national emergency on 3/13/20, the U.S. national debt has increased by $4.46 trillion. Thanks to massive and unprecedented Fed intervention, short-term interest rates are at all-time lows. This has translated that the interest expense on the $27 trillion National debt was just $522 billion in 2020. If interest rates were to return to the normal level of 7%, the interest expense would soar to $1.9 trillion per year! Something is going to give.

Recent statements by the Biden economics team have suggested that the private sector is going to be downgraded as the primary source of economic growth and the main driver will be "the reallocation of cash from the worker to corporations." They acknowledge that corporate growth and profits will be modest at best in the medium to long term and that higher corporate taxes will restrict dividend payments.

What are our current thoughts? Currently, most money managers on Wall Street and serious investors are mostly sitting still for the moment. Not in, nor out. Not chasing the latest fad. Nobody has an idea of what will happen or when, so if they feel good about their current investments, they are for the most part just sitting still until they see where the country and the market are really going. These sentiments strongly reflect our current philosophy and guidance at this time.

We continue to monitor these events daily. As always, we at Kapusta Financial Group, would like to thank you for the trust and confidence you place in our team. Please don't hesitate to contact us with any questions or concerns.

110 Fort Couch Rd., Suite 108, Pittsburgh, PA 15241
Tel: 412.851.1400 | Fax: 412.851.1403 | Email: kfg@kapustafinancial.com

Kapusta Financial Group is a Registered Investment Advisor