MEDALLION WEALTH MANAGEMENT

April 2021 Market Commentary

Godzilla

"History shows again and again
How nature points up the folly of man
Godzilla!"
by Blue Oyster Cult
https://www.youtube.com/watch?v=muUZjovOFRg

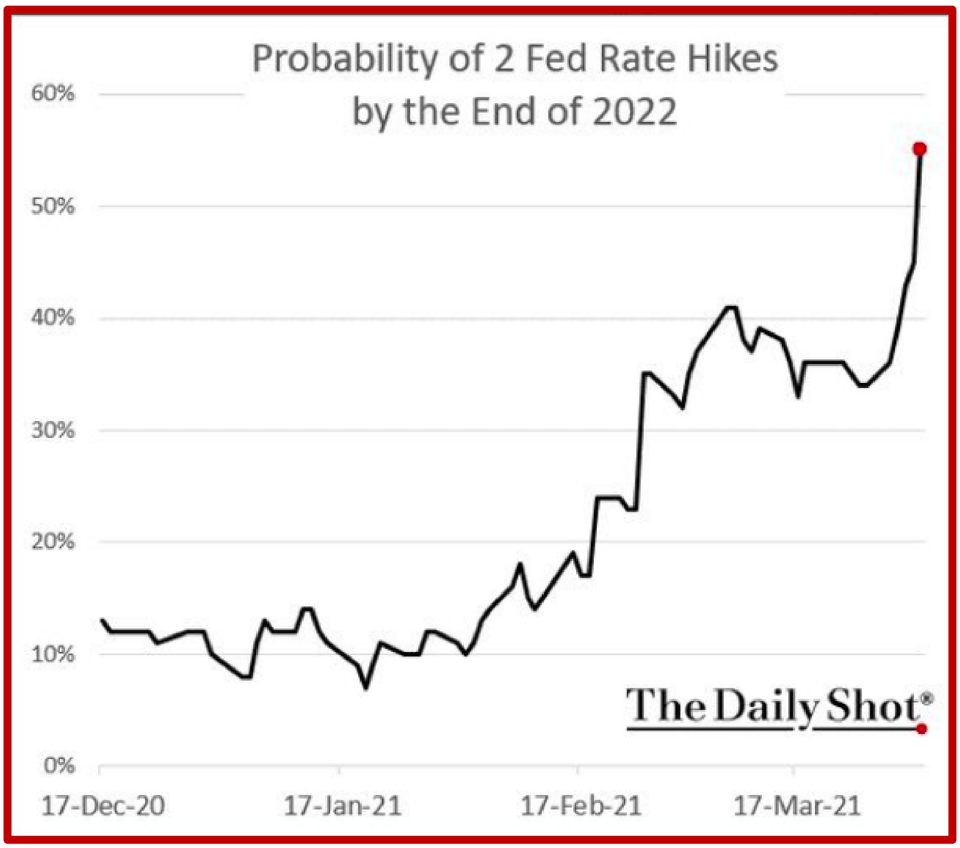
Godzilla is an enormous, destructive, prehistoric creature who has been awakened and powered by nuclear radiation. He made his first theatrical appearance in 1954, and has now appeared in at least 36 films, including his recent blockbuster movie *"Godzilla vs. Kong".*

With the nuclear bombings of Hiroshima and Nagasaki still fresh in the Japanese consciousness, Godzilla was conceived as a metaphor for nuclear weapons. Some also say it was created as a metaphor for the United States, a giant beast awoken from its slumber which then takes terrible nuclear vengeance against Japan. Whatever the case, Godzilla has been with us for nearly 70 years, and no matter what happens in the latest King Kong battle, he'll probably still be with us for a long time to come.

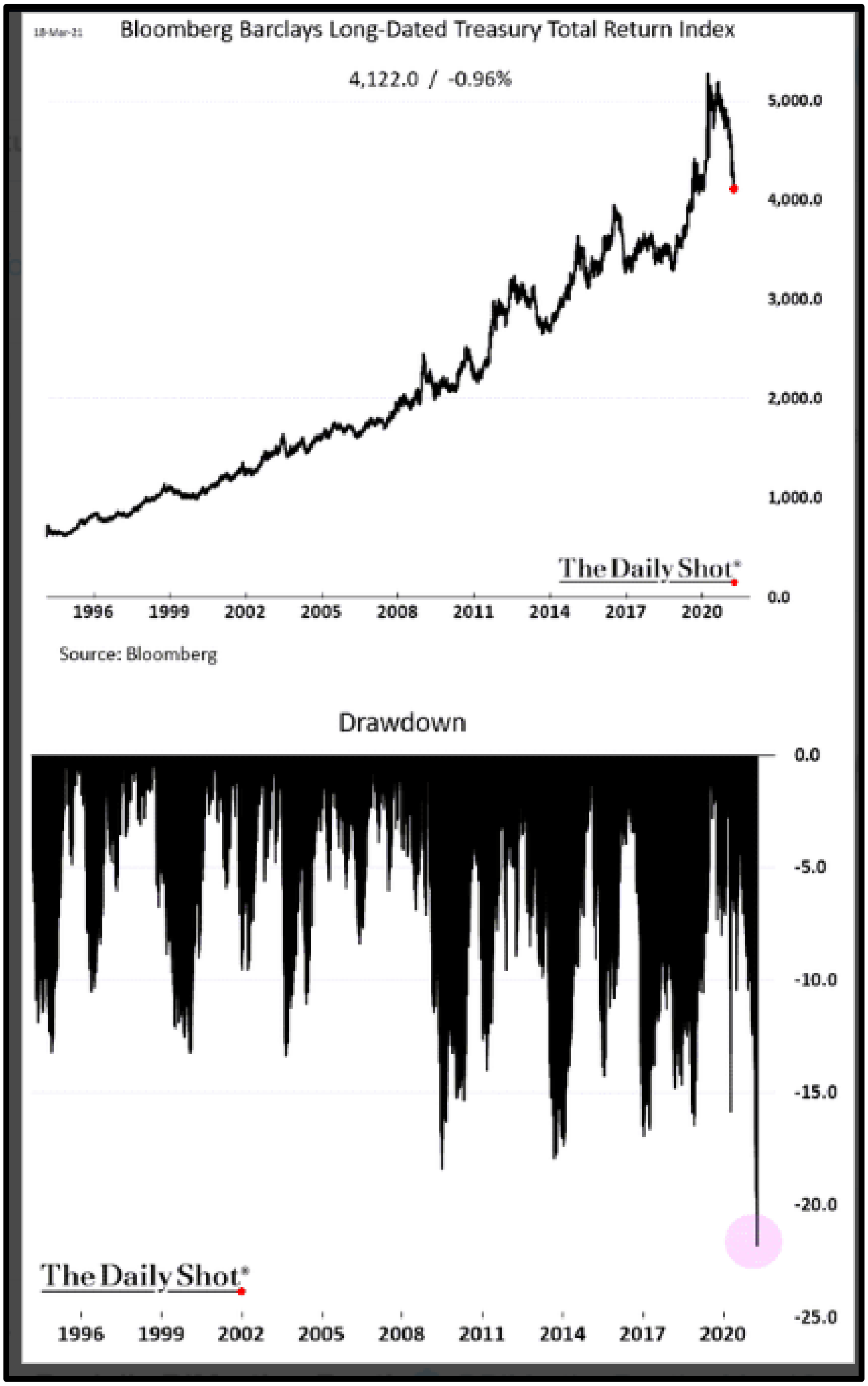
Is inflation the Godzilla of our financial markets? It has been in a deep slumber for years, and many in the financial community believe it is dead. The world's central bankers are so certain it is no longer an issue that they playfully taunt it by blasting it with nuclear levels of liquidity. Will they wake the beast, and if so what does that mean for our economy and investments?

Current central bank officials, from Fed Chair Jerome Powell on down, have taken pains to insist that their ultra-easy monetary policies are nothing to worry about. That inflation will not be a problem even with fed-funds rates pegged at 0%, plus $120 billion of monthly bond purchases. That they can continue these policies until the labor market reaches “maximum employment” and inflation runs “moderately above 2% for some time”. The FOMC consensus view was that the fed-funds target rate would remain near zero through 2023.

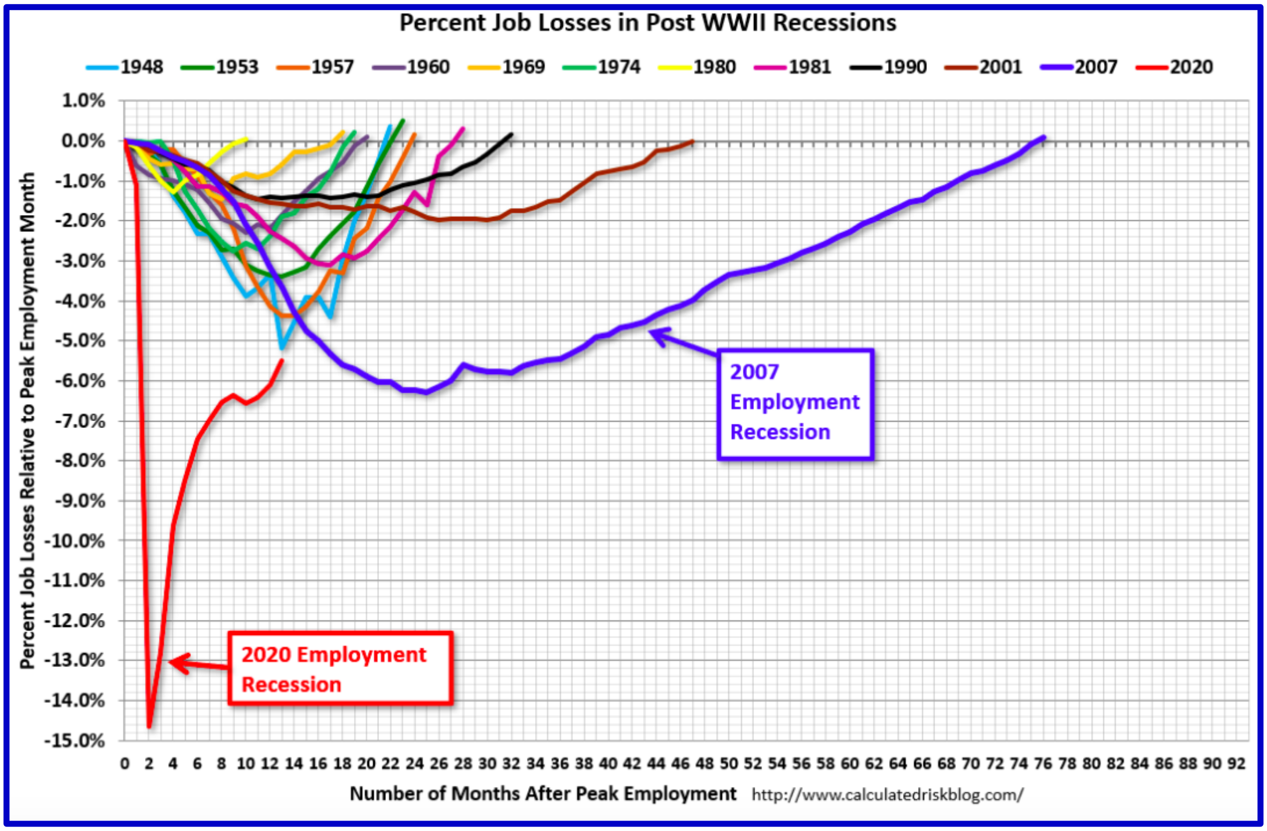
Of course, the financial markets are not so sure about that and are currently saying that there is greater than a 50% probability of two rate hikes by the end of next year.



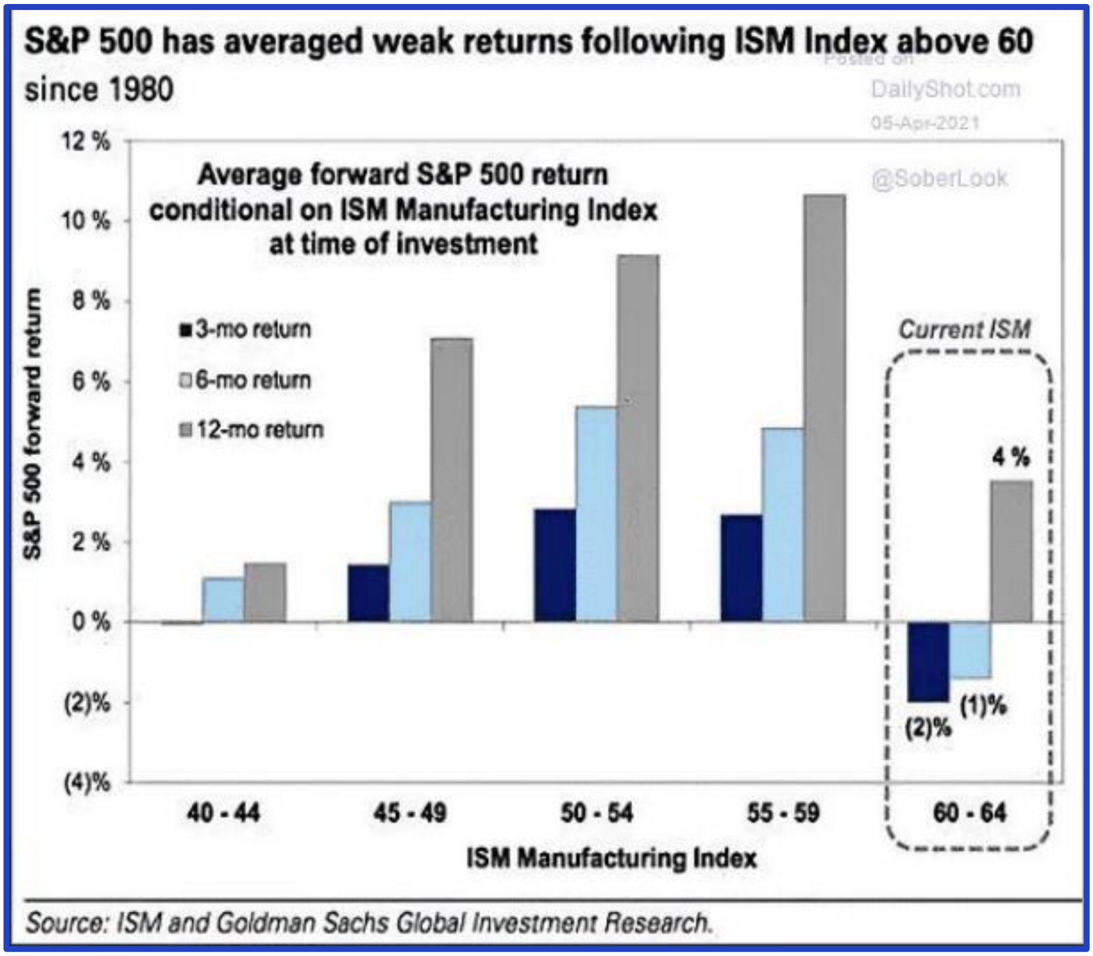
We have also seen yields on the ten-year Treasury bond rise from 0.93% at year-end to 1.74% currently. This has resulted in over a 20% drawdown in long-dated Treasuries for the first time since the early 1980’s. And on top of this the expected growth in gross-domestic-product (GDP) for 2021 is now forecasted to be in excess of 7%! Does an economy growing at a 7% clip sound like it needs 0% interest rates?



The Fed is right in their pursuit of full employment, it is one of their key mandates, and as the graphic below shows they still have a way to go. But will zero interest rates and massive liquidity injections lead to full employment before they awaken the sleeping inflation monster?



Another sign of an economy that is clicking on all cylinders is the recent ISM Purchasing Managers Index reading of 64.7. Also known as PMI, this is a survey of 400 purchasing managers on their current business and their near-term projections. Readings above 50 generally reflect a bullish outlook, while readings under 50 are perceived as bearish. The current reading of 64.7 is the highest since 1983's 64.1. While this is generally bullish, when readings are very high, those above 60, it appears that the good news is already priced into stocks and near-term returns can be lackluster.



If the stock market is a reflection of our current mood as well as our near-term economic prospects, then the first quarter was very telling, investors eagerly embraced risk. Meme stocks such as GameStock surged. Celebrities openly promoted blank-check SPACs. Christie's auctioned off a nonfungible token (NFT) attached to a digital image for $69 million. And just before quarter's end we witnessed the collapse of Archegos Capital Management due to excessive leverage.

The S&P 500 was up a respectable 6.35% in the quarter. What was even more telling is that those sectors that would benefit from a strong reopening were also up the most; Energy was up 30.8%, Financials were up 16%, and Industrials were up 11.5%. In the meantime, those sectors that benefitted most during the shutdown were the weakest; Health Care was up 3.3%, Technology was up 2.4%, and Consumer Staples were only up 1.8%.

As mentioned earlier, bonds had a tougher struggle; 20-year Treasuries had a negative total return of 13.92%. Near zero yields and now negative total returns on safe fixed income is leading to more and more investors willing to take on risk in search of higher returns.

Look around, and ask yourself: Are investors optimistic or pessimistic? Are the prices you pay for food, gas, housing increasing or decreasing? Are novel investment schemes (SPACS, Meme stocks, NFT's, cryptocurrencies) accepted or dismissed out of hand? Are securities offerings and fund openings being treated as opportunities to get rich or possible pitfalls? Has the credit cycle rendered capital readily available or impossible to obtain? Are price/earnings ratios high or low in a historic context, and are yield spreads tight or generous? All these things are important, and yet none of them entails forecasting. We can make excellent observations, with no need to make guesses about the future.

Has the Godzilla of inflation been awakened, or is this all just a ripple on the water's surface?

Oh no, they say he's got to go
Go go Godzilla, yeah
Oh no, there goes Tokyo
Go go Godzilla, yeah
History shows again and again
How nature points up the folly of man
Godzilla!

Be careful out there,

Chris Wiles, CFA

Where Trust is Earned