AN OUTRIGHT ECONOMIC BOOM

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Summary and Major Conclusions:

The ultimate issue for equity investors is the potential duration of the emerging business expansion cycle. History has clearly revealed that equity bull markets generate the highest returns during extended periods of economic growth, as occurred during the very long expansion cycles of the 1980s and 1990s and the decade following the Great Recession. Answers to this question will become apparent only when the economy begins to converge on full employment, which is not expected to occur until later next year.

- Developments involving the economy, government policy, and public health are unfolding at a frenetic pace, suggesting that the US economy may be approaching a major inflection point in terms of its growth trajectory over the next two years.
- The domestic economy has been in a holding pattern during the past six months, with growth stable around 4%. However, business conditions could change abruptly: Powerful forces currently underway have the potential to create a perfect storm that could spark explosive growth in GDP in coming quarters.
- Government data on household savings point to massive pent-up demand for future spending on consumer goods and services following a full reopening of the economy. Inventories are at very depressed levels, suggesting that businesses will need to rebuild stocks in response to a sharp revival in final demand.
- Economic growth will be augmented by additional fiscal stimulus. The $900 billion COVID relief package passed at the end of last year will supercharge the economy over the next three to six months, and another spending package is in the works.
- President Biden's American Rescue Plan could be legislated into law in March, boosting economic growth during the second half of this year. The primary focus of this fiscal package will be on making direct payments to individuals, expanding unemployment benefits, supporting small businesses, assisting state and local governments, and funding vaccination efforts.
- The probability of an overheating economy and sharp rise in inflation is directly proportionate to the ultimate size of the Biden fiscal relief package. Cumulative fiscal outlays over the past 12 months amounted to a record 15% of US GDP. Additional spending as proposed could lift this ratio to 20% to 25% of GDP.
- Monetary policy will likely remain accommodative throughout this year and well into 2022. The unique aspect about monetary policy in the current cycle is the Fed's determination to sustain an expansionary policy long after the economy has returned to normal and after inflation has exceeded its 2% target.

- There is compelling evidence that business-to-business (B2B) spending has strengthened considerably in recent months. According to Moody's Analytics, B2B spending increased by more than 12% in January versus the year-ago level.

- Unsurprisingly, the data reveal that B2B sales of larger companies (those with more than 500 employees) are increasing at a 18.5% rate, while small company sales are up less than 5%. Strongest growth is reported for online retailers, home improvement and electronic stores, homebuilders, and truckers.

- Although lingering questions remain, trends pertaining to COVID-19 continue to gradually improve. The number of confirmed daily infections has collapsed, as have hospitalizations. However, these very favorable trends could prove to be short-lived because of an imminent explosion in infections from the UK B.1.1.7 variant.

- Despite numerous short-term obstacles, vaccinations continue to increase at a steady pace, and now exceed 75 million nationwide. While the existing mRNA vaccines appear to be fully protective against the UK variant, preliminary evidence suggests that these vaccines provide only partial protection against the South African strain.

- The outlook can best be characterized as a race between vaccinations and the expected surge in B.1.1.7 infections in March and April. The Biden administration has indicated that 600 million doses of the vaccine will be available by July, which should allow the country to reach herd immunity before the end of the summer.

- The likelihood of an outright economic boom has investment implications in the following four areas: Corporate earnings, inflation, Federal Reserve policy, and long-term interest rates. Implications of an earnings boom are favorable for the corporate debt and equity markets.

- The greatest challenge for long-term investors will be anticipating in advance when the US economy might begin to overheat. If my boom scenario is correct, the odds of an overheating economy and aggressive tightening of monetary conditions by the Federal Reserve will increase over time.

- The ultimate issue for equity investors involves the potential sustainability and duration of the emerging business expansion cycle. History has clearly revealed that cumulative rates of return in equity bull markets are maximized during extended periods of economic growth.

Developments relating to the economy, government policy, and public health are unfolding at a frenetic pace, suggesting that the US economy may be approaching a major ***inflection point*** with respect to its growth trajectory over the next two years. This week's *Economic Perspective* provides a review of current economic trends along with an analysis of potential implications for financial markets.

Recent trends have been mixed, especially with respect to COVID-19 infections, new variants, and vaccine distribution. There is also a lack of clarity regarding the outlook for President Biden's American Rescue Plan. *Nonetheless, it seems reasonable to assume that favorable trends will soon dominate the economic landscape* and that business and consumer confidence will be on the upswing beginning in the second quarter of this year.

A PERFECT STORM

The US economy has been in a holding pattern during the past six months, with growth stabilizing at a 4% annual rate. However, *business conditions could change abruptly due to numerous underlying forces that have the potential to create a **perfect storm**, sparking a rapid acceleration in GDP growth in coming months*. There is already emerging evidence that the domestic economy could soon be entering a more rapid growth phase:

- **Vaccinations:** The current disappointing pace of COVID-19 vaccinations will soon give way to an increasingly rapid pace beginning in April and May. Whereas only 75 million doses of the Pfizer and Moderna vaccines were administered through the end of February, cumulative vaccinations could double to 150 million by May 1 and 300 million by July 4.

- **Pent-Up Demand:** Government data on consumer savings point to massive pent-up demand for future spending on consumer goods and services. There is currently an estimated $1.6 trillion in excess household savings, the equivalent of 7% of GDP. The current level of inventories is also depressed. Businesses will begin to rebuild stocks as confidence in the sustainability of the economic recovery improves.

- **Wealth Effect:** Household net worth has increased by an estimated $10 trillion over the past year — the equivalent of nearly 50% of GDP — stemming from rapid appreciation in stock portfolios and home values. Econometric models estimate that roughly 5% of increased wealth will be spent during the next 12 months.

- **Mortgage Refinance:** Homeowners have been on a refinance binge over the past six months. More than $180 billion in home equity was extracted during 2020, an average of $27,000 per household. Homeowners who refinanced without cash-out refinances effectively reduced their monthly mortgage payments by $200 per month, or $2400 annually.

- **Fiscal Policy:** Economic growth will be augmented this year by additional fiscal stimulus. The $900 billion COVID relief package passed at the end of last year will boost spending and output over the next three to six months. President Biden's American Rescue Plan could be legislated into law in March and provide incremental stimulus for the economy during the second half of this year and in early 2022.

- **Federal Reserve:** Monetary policy will likely remain accommodative throughout this year and well into 2022. ***What is unique about monetary policy in the current cycle is that the Fed appears determined to maintain an expansionary policy long after the economy has returned to normal and after inflation has broken out on the upside***.

The bottom line is that the cyclical forces needed to support a robust economic expansion are slowly falling into place and could culminate in an outright economic boom over the next four to six quarters.

BUSINESS TRENDS

There is compelling evidence that business-to-business (B2B) spending has strengthened considerably in recent months. According to Moody's Analytics, B2B spending increased by more than 12% in January versus the year-ago level. This compares with a whopping 14% year-over-year ***decline*** in May of last year during the period of peak lockdown. Raw data are provided by Cortera, a research firm that tracks commercial and credit trends within the business sector.

Large Versus Small Companies: Unsurprisingly, the data reveal that B2B sales of larger companies (those with more than 500 employees) are increasing at an 18.5% rate, while small company sales are up less than 5%. Strongest growth is reported for online retailers, home improvement and electronic stores, homebuilders, and truckers, while laggards include the hospitality and restaurant industries, airlines, traditional retailers, and entertainment.

THE CORONAVIRUS PANDEMIC

Although lingering questions persist, public health conditions continue to gradually improve, albeit at an uneven pace. The number of confirmed daily COVID-19 infections has collapsed, as have hospitalizations, each of which has declined by more than 50% from recent peaks. *However, these very favorable interim trends could prove to be short-lived because of an anticipated explosion in infections of the UK B.1.1.7 variant, which is expected to become the dominant strain in the US during March and April*.

Vaccinations Lagging: Vaccinations for the US population have lagged previously announced goals but continue to increase at a steady pace and are now currently in excess of 75 million nationwide. While the existing mRNA vaccines appear to be fully protective against the UK variant, preliminary evidence suggests that these vaccines provide only partial protection against the B.1.351 South African strain. The pharmaceutical industry continues to expand research on medicines that will protect against the new variants.

Vaccines Versus Variants: Conceptually, the public health outlook can be characterized as a race between vaccinations and the expected surge in infections during March and April. The Biden administration has indicated that 600 million doses from just Pfizer and Moderna will be available by July, which should allow the country to reach herd immunity before the end of summer. Single-dose vaccines from Johnson & Johnson will augment these supplies.

The bottom line is that the worst of the pandemic appears to be behind us, although health conditions could remain precarious for another several months, as infections accelerate once again and as the extent of vaccine protection against the new mutants remains unresolved. A combination of an escalating pace of vaccinations along with new vaccines and booster shots to effectively treat these various mutations to the SARS-CoV-2 virus should result in a reopening of the economy by Labor Day.

THE AMERICAN RESCUE PLAN

Economic growth later this year will be reinforced by additional fiscal stimulus. The $900 billion COVID relief package passed at the very end of last year will supercharge the economy over the next three to six months. In addition, President Biden's centerpiece American Rescue Plan should be legislated into law during March, boosting economic growth during the second half of this year.

Compromise Spending Bill: Although it is unlikely that Biden's entire $1.9 trillion spending program will be approved by Congress, federal outlays within the range of $1 to $1.5 trillion seem plausible. The primary focus of this fiscal spending package will be on making direct payments to individuals, expanding unemployment benefits, supporting for small businesses, assisting state and local governments, and funding for vaccinations. A phase two of government stimulus initiated later in the year — with an emphasis on infrastructure spending — is uncertain at this time.

Economists Debate: There is a lively debate among economists as to the size of the Biden plan and the risks to inflation. *The probability of an overheating economy and sharp rise in inflation is directly proportionate to the ultimate size of the Biden fiscal relief package*. Cumulative fiscal outlays currently amount to a record 15% of US GDP. Additional spending as proposed could lift this ratio to nearly 25% of GDP — an unprecedented amount of fiscal stimulus — which could easily overwhelm the economy and result in overheating.

INVESTMENT IMPLICATIONS

Pulling it all together, it appears that the US economy could be entering an economic boom beginning in the middle of this year and extending well into 2022. My forecast assumes real GDP growth of 6% to 8% for all of 2021, followed by growth of 4% to 6% in 2022, well in excess of consensus predictions. If so, these would be the two fastest GDP growth years since the mid-1980s.

The likelihood of an outright economic boom has investment implications for the following four areas: Corporate earnings, inflation, Federal Reserve policy, and long-term interest rates. This corporate earnings cycle could be the most spectacular in decades, with earnings rising by more than 30% this year and 20% in 2022. Implications of an earnings boom are favorable for both the corporate debt and equity markets.

Inflation is likely to remain under control over the medium term, but the probability of unacceptably high inflation beyond 2022 will begin to increase later next year. The path of monetary policy is unlikely to change this year but could become increasingly less accommodative over the course of 2022 and 2023. A new rate-tightening cycle is probable beginning later next year or in 2023.

The greatest challenge for long-term investors is anticipating in advance when the US economy might begin to overheat. *A related challenge is determining when rising inflation could trigger a new rate-tightening cycle by the Federal Reserve*. If my boom scenario is correct, an overheating economy accompanied by aggressive tightening of monetary conditions by the Federal Reserve will become increasingly likely over time and could become a reality in 2023.

The ultimate issue for equity investors is the potential duration of the emerging business expansion cycle. *History has clearly revealed that equity bull markets generate the highest returns during extended periods of economic growth*, as occurred during the very long expansion cycles of the 1980s and 1990s and the decade following the Great Recession. Answers to this question will become apparent only when the economy begins to converge on full employment, which is expected later next year.

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Bloomberg Barclays US Aggregate Bond Index: is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.