FREQUENTLY ASKED QUESTIONS

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Summary and Major Conclusions:

Negative yields on long-term US Treasury bonds are unprecedented and stand in contradiction with modern finance theory. The current real yield is a negative 0.9%, near the lowest levels in bond market history. Bond yields incorporate market expectations regarding the future path of economic growth, inflation, and monetary policy. My forecast assumes that negative real yields are unlikely to prove sustainable in the long term. However, bonds are unlikely to move into positive territory until the Federal Reserve shifts policy from expansionary to contractionary, expected later next year.

- Negative real yields on long-term government bonds are an anomaly and stand in contradiction with modern finance theory. The market yield on the ten-year US Treasury bond fell below the inflation rate in 2012 for the first time in the long history of the US government bond market.
- In theory, a negative real yield on government bonds is a manifestation of a sick economy, and reflective of three economic circumstances: (1) Anemic prospects for economic growth; (2) A high probability of deflation; and (3) Very low expected returns on invested capital for business firms.
- Each of these factors appears unrealistic and at odds with the facts: Real GDP is on track to expand at an average annual rate of 4% or greater over the next three years; the current inflation rate of 3.5% is more likely to move higher rather than lower; and return on investment in the private sector is the highest in many years.
- Bond yields also incorporate market expectations regarding the future path of monetary policy, which is currently the most accommodative in modern history. Excessive monetary ease should culminate in even faster GDP growth and/or higher inflation.
- My conclusion is that currently negative real yields are unlikely to prove sustainable and should move into positive territory as the Federal Reserve implements a progressively contractionary policy beginning later next year.
- It is crucial for investors to understand the Federal Reserve's assessment of the underlying health of the US economy. In principle, the Fed develops its strategy for monetary policy based upon its evaluation of the relative upside and downside risks to the economy.
- Since the 2008 world financial crisis, Federal Reserve officials have become more pessimistic, believing that the US economy is more susceptible to contractionary and deflationary pressures than it is to inflationary pressures.
- The practical relevance of the Fed's perception of the economy is that it has far greater confidence in its ability to cool an overheating economy than to revive a slumping economy. With a greater assurance of its ability to manage an outbreak of inflation, the Fed appears likely to err on the side of monetary ease.
- Company profit margins are not at risk to rising commodity prices in the short term because these costs comprise only a small percentage of the cost structure of American industry, assuming wage inflation remains relatively stable.
- Labor costs are far more relevant than material costs. For the overall business sector, labor compensation constitutes two-thirds of total operating expenses. Therefore, investors should focus on the relationship between wages and selling prices in projecting company profit margins.

- Profit margins should also benefit from operating leverage — the sensitivity of earnings to changes in top-line sales. Periods of rapid growth in company revenues are accompanied by widening margins simply because a significant portion of business expenses are fixed versus variable.

- Markets have become less confident regarding prospects for large fiscal spending programs before the end of this year. However, investors are too pessimistic, in my judgment: There is a high probability of further legislation this year, most likely in the form of traditional infrastructure projects.

- However, because passage will remain unclear until later in the year, government bonds, the US dollar, and technology stocks — as classic safe-haven assets — could benefit from the interim uncertainty, while cyclicals and value stocks could continue to lag.

- The economic impact of deficit spending will peak this year, and could decline sharply in 2022, despite passage of an infrastructure bill. Actual spending on key projects is unlikely to begin until 2023 but will then continue to build in 2024 and 2025.

- Investors should not exaggerate the significance of this irregular fiscal spending timeline since there remain numerous sources of stimulus within the private sector to support solid economic growth during 2022.

The financial markets continue to be buffeted by economic crosscurrents, which have resulted in sharp short-term moves in the equity, bond, and currency markets. This week's *Economic Perspective* provides answers to frequently asked questions regarding economic growth, financial markets, and fiscal and monetary policy.

ARE NEGATIVE YIELDS ON LONG-TERM GOVERNMENT BONDS SUSTAINABLE?

Negative real yields on long-term US government bonds are an anomaly and are contrary to modern finance theory. The market yield on the ten-year US Treasury bond fell below the inflation rate in 2012 for the first time in the long history of the US government bond market and has remained depressed since then. Over the past 200 years, government bond yields have exceeded inflation by an average 3.5%. Since its peak of 4.5% in 1999, the real yield on government bonds has steadily declined, with the most precipitous declines occurring between 2008 and 2012.

Real yields have remained depressed over the past decade: The differential between market yields on ten-year bonds and the consumer inflation rate has been less than one-quarter of one percent. The real yield reached a recent peak of 1% in early 2019 and has been in negative territory since the onset of the pandemic in early 2020. The current real yield is a ***negative 0.85%***, approximately in line with the average of the past year. For the ten years leading up to the 2008 financial crisis, the average real yield on long-term government bonds was a positive 2.85%.

In theory, a negative real yield on government bonds is a manifestation of a sick economy, and specifically reflective of three areas of economic dysfunction: (1) Prospects for an extremely weak economy; (2) A high probability of deflation; and (3) Very low expected returns on invested capital for business firms. *Each of these maladies appears unrealistic and at odds with actual circumstances*: Real GDP is on track to expand at an average annual rate of 4% or greater over the next three years; the current inflation rate of 3.5% is more likely to move higher rather than lower; and return on investment in the private sector is the highest in many years.

Bond yields also incorporate market expectations regarding the future path of monetary policy, which is currently the most accommodative in modern history. Excessive monetary ease should culminate in even faster GDP growth and/or higher inflation. ***The conclusion is that currently negative real yields are unlikely to prove sustainable*** — but are also unlikely to move into positive territory until there is a shift in Federal Reserve policy from expansionary to contractionary expected later next year.

HOW CAN INVESTORS BEST UNDERSTAND THE FUTURE DIRECTION OF MONETARY POLICY?

In principle, the Fed develops its strategy for monetary policy based upon its assessment of the relative upside and downside risks to the economy. Since the 2008 world financial crisis, Federal Reserve officials have adopted the mentality that the US economy is more vulnerable to contractionary and deflationary pressures than it is to inflationary pressures.

As such, its policy bias has been in the direction of excessive ease, choosing to err on the side of monetary accommodation. The practical relevance of the Fed's perception of the economy is that it has far greater confidence in its ability to cool an overheating economy than to revive a slumping economy.

Similarly, Federal Reserve officials are more fearful of deflationary, rather than inflationary, pressures. The implication for investors is clear: *With a greater assurance of its ability to counter an outbreak of inflation, the Federal Reserve is likely to maintain accommodative monetary conditions for longer than would seem appropriate based upon underlying economic trends*.

Because monetary policy affects consumer prices with long time lags, the risks of inflation will increase over the next several years. For investors, I believe that rising inflation in coming years is the greatest risk to the economic expansion, and therefore for long-term investment returns.

ARE CORPORATE PROFIT MARGINS VULNERABLE TO RISING INPUT COSTS?

It is important for investors to differentiate between commodity costs and labor costs. Because raw materials, commodities, and components comprise only a small percentage of the cost structure of American industry, the recent surge in input prices is less worrisome. As a generalization, I expect selling price increases to more than offset the rise in material costs, thereby allowing firms to maintain gross profit margins for the foreseeable future.

Labor costs differ markedly from material costs. Whereas the latter is a small component in the cost structure of most companies, the same is not true for labor costs. For the overall business sector, labor compensation constitutes ***two-thirds*** of total operating expenses. Therefore, investors must focus on ***the relationship between wages and selling prices*** in gauging the future path of company profit margins.

The issue of rapidly rising input costs and company profit margins must also be considered in the context of ***time horizon***. In principle, wages tend to be relatively sticky in comparison to selling prices. *Stated differently, in a classic wage/price inflation cycle, price inflation tends to lead wage inflation by more than one year*. The implication is that company margins could be protected in the early phases of a wage/price cycle until wage increases catch up to increases in selling prices, expected later next year and in 2023.

Another factor supporting my forecast of expanding profit margins over the next several quarters is ***operating leverage***, which is a measure of the sensitivity of changes in bottom-line net income to changes in top-line sales volume. In general, *periods of rapid growth in company revenues are accompanied by widening margins simply because a significant portion of business expenses are fixed versus variable*. For example, estimated revenue growth of 15% this year — the fastest pace in several decades — should easily outpace fixed costs, thereby pushing profit margins to an all-time high.

The final consideration is ***productivity***, which has the potential to systematically offset a rising trend in wage inflation. While prospects appear favorable, productivity is a notoriously difficult economic series to predict. My forecast assumes that productivity will rise at an above-average pace over the next two years — primarily a result of technology investments and company restructurings spurred by the pandemic — thereby supporting profit margins. On balance, I see no reason to alter my forecast for earnings growth of 45% and 8% for 2021 and 2022, respectively, but believe that the balance of risks is to the downside in the years beyond 2022.

WHAT SHOULD INVESTORS EXPECT FROM FISCAL POLICY OVER THE NEXT YEAR?

Fearful of growing animosity between the two political parties, markets have become less confident regarding prospects for congressional passage of large fiscal spending programs before the end of this year. In addition, it seems reasonable to assume that major fiscal policy initiatives during 2022 ahead of the mid-term elections are unlikely. However, investors are too pessimistic with respect to prospects for this year, in my judgment. *I continue to believe that there is a high probability of further legislation this year, most likely in the form of traditional infrastructure projects*.

While the odds of passage are high, it is unclear whether an infrastructure bill will be passed through a *bipartisan compromise* between the two parties or rather through a *partisan reconciliation* process. Another bill containing "social infrastructure" spending before yearend is also possible, but less likely to be enacted. However, because actual passage will remain unclear until later in the year, government bonds, the US dollar, and technology stocks — as classic safe-haven investments — will benefit from the interim uncertainty, while cyclicals and value stocks will continue to lag until a bill is passed.

Finally, there are also important nuances with respect to the effects of fiscal policy on economic growth over the next two years. *The economic impact of deficit spending will peak this year, and could decline sharply in 2022, despite passage of an infrastructure bill*. Because of the usual logistical factors, actual spending on key investment projects is unlikely to commence until 2023 but will then continue to build in 2024 and 2025. However, this spending pattern should not have ***significant*** economic consequences because there remain numerous sources of stimulus to support for solid economic growth during 2022.

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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.

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