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Risk Commentary: Human Hubris & the Wall of Worry (Aug 2021)

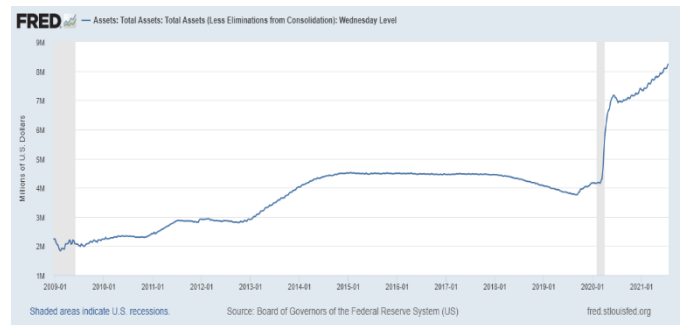
The Hubris

Despite the apparent success of the economic recovery since the emergence of COVID19, some skepticism is probably in order. Courtesy of the 2008 credit crisis, the developed countries' central banks have been granted immense power to intervene in the markets and intervene they have. As can be seen below, the FED's financial support programs and its balance sheet has exploded over the past several years. As reflected below, the FED's balance sheet has grown from \$2T in 2010 to over \$8T currently (given the \$20+T size of the US economy, the holdings are significant).

Figure I – FED Programs

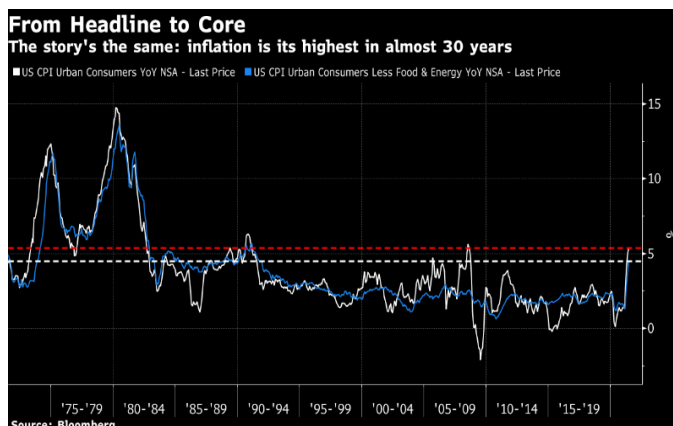
Commercial Paper Funding Facility
Primary Dealer Credit Facility
Money Market Mutual Fund Liquidity Facility
Primary Market Corporate Credit Facility
Secondary Market Corporate Credit Facility
Term Asset-Backed Securities Loan Facility
Paycheck Protection Program Liquidity Facility
Main Street Lending Program
Municipal Liquidity Facility

Figure II - FED's Asset Level



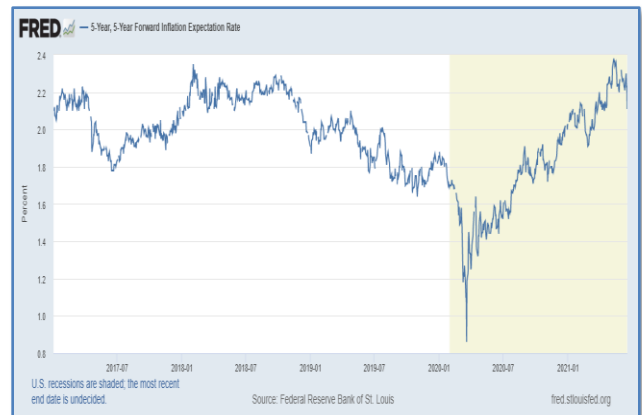
While a sound argument can be made for the need and efficacy of the programs, perhaps there is a cost to be born. (Thinking otherwise is where the hubris comes in.) Inflation is manifesting itself in various ways which are becoming increasingly difficult to avoid. Energy, housing, food and labor have all risen prompting a debate of whether the increases are temporary, or simply a reflection of the economy's re-opening from the COVID crisis. While the economic debate is hard enough, the reality is the discussion is as much political as economic. Simply put, in the short run, the benefits of government support programs outweigh the longer time costs. Hence, the FED is likely to wait perhaps longer than it should before taking any drastic action.

Figure III – Inflation



The Worry

Figure IV - 5 yr, 5 yr Forward Inflat. Expect.



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On to the worry side – and the long-establish maxim regarding the behavior of the markets is that it climbs a “Wall of Worry” meaning that many market participants worry about a variety of threats, but businesses and markets prosper over time. Perhaps the Dow’s reaching a record of 35,000 is the latest indication of this condition. (Another cut at the same condition is that many economists have predicted 15 of the last 3 recessions.) In terms of what this means for the average institutional investor, perhaps the best course is simply to stay the course, but to keep a few things in mind. One is that the government typically is set up to fight the last war and is less prepared for emerging battles. Hence, we believe the FED is more concerned about recessionary conditions than uncontrolled inflation. Additionally, the FED and other central banks are prepared to act if a recession threatens. An oddity that many market participants are struggling with is the relatively low rates on longer term Treasuries while inflation appears to be threatening. Our view is that Treasury rates are falsely depressed by the actions and threats of action by the central banks. Given the political benefits of funding government debts at low rates, this condition might not be reversed any time soon,

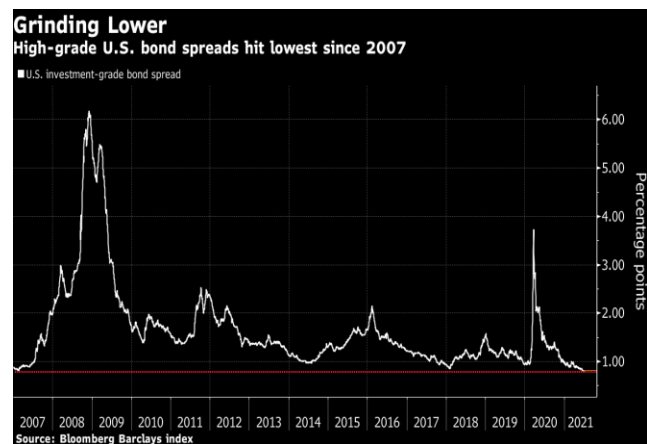
A Path Forward

While it might be interesting debating the best path for the FED, for most institutional investors a more profitable endeavor is to understand the current conditions and hopefully profit from them. Our view is the central banks will reduce their balance sheets over time but at a very slow rate. The reality is that many governments simply are not able to afford material increases in funding costs. Italy might have difficulty managing its debt levels, but the ECB and the EU appear willing to provide support. Japan might have outrageous debt to GDP levels (even before the costs of funding the Olympics are factored in), but the US and the EU need a sound Japan and will provide support if needed. In the meantime, businesses will prosper as will those which judiciously provide funding.

Figure V: 5 yr. Treasury Yields



Figure VI: High Grade Bond Spreads



Below is a summary of our expectations for the various economies:

Figure VII: EJR Normalized Economic Expectations (next 12 months)

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	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	2.0%	2%	4%	5%	6%
Stimulus Change	Moderating	Slight Rise	Moderating	Moderating	Little change
Earnings Trend	Slight Rise	Slight Rise	Slight Rise	Rise	Rise
Interest Rates	Negative	Negative	Low	Low	Varied
Asset Valuations	Slight Rise	Slight Rise	Rising	Slight Rise	Rising

Regarding trends, we had expected a slight rise in rates as economies recover but the market turmoil and central banks' money creation are depressing rates.

Figure VIII: Current and Expected Interest Rates

	5 year		10 year		30 year	
	Current (%)	Year End (%)	Current (%)	Year End (%)	Current (%)	Year End (%) *
United States	0.71	0.88	1.28	1.48	2.38	2.45
Germany	-0.71	-.5	-0.42	-0.30	0.06	0.20
Italy	-.04	0.02	0.63	0.75	1.63	1.75
United Kingdom	0.27	0.35	0.59	0.65	1.00	1.25
Japan	-0.15	-0.05	0.01	0.10	0.65	0.75

Source: <https://tradingeconomics.com/bonds>
<https://www.bloomberg.com/markets/rates-bonds/government-bonds/us>

*

Below are our expectations for major currencies:

Figure IX: Currency

	Current	EJR Est. Year End
USD-EUR	1.18	1.18
Yuan to Dollars	6.48 \$/RMB	6.45 \$/RMB
JPY-USD	110.55	109
USD-GBP	1.37	1.38

Source: <https://www.x-rates.com/table/?from=USD&amount=1>

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