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Vol. 45, No.1

QUARTERLY INVESTMENT OUTLOOK
JANUARY 2022

SUMMARY

- Rising deficits and debt will limit future growth. We reference two studies that show that countries encumbered by high debt/GDP experience lower growth. With federal debt/GDP exceeding 100% the U.S. is set to experience at least another decade of low growth.

- Money supply growth at 12.8% is historically high when viewed over the previous 60 years. Only in the 1970s did M2 growth exceed the current level, and that was a decade of high inflation.

- Included in this report is our technical view of the U.S. dollar and its impact on the reflation trade. A strong dollar coupled with rising oil prices and bond yields is creating a deflationary impulse into the global economy and financial markets. This is increasing volatility in both stocks and commodities. **With the stock/bond ratio at an extreme a cautious investment strategy is warranted**.

- Although we anticipate higher inflation over the next several years, prices may flatten out in 1H2022 as supply disruptions dissipate. This would enable the Fed to defer tightening credit conditions until after the 2022 mid-term election. Financial markets would benefit.

RISING DEFICITS/DEBT WILL LIMIT FUTURE GROWTH

In the post pandemic period fiscal thrust (increase in deficits) is waning. However, as detailed in the July 2021 Congressional Budget Office projection, budget deficits will keep the federal debt growing over the next 10 years. CBO projections show the fiscal deficit at $3.0 trillion in FY 2021, declining to $753 billion in FY 2024, then increasing steadily to $1.855 trillion in 2031. The cumulative impact on the Federal debt is significant! In FY2021 Federal debt is projected at $23.01 trillion, rising every year to $35.83 trillion in 2031, representing an increase of 56% over 10 years. As a percent of GDP, it increases from 103% in FY 2021 to 106% in FY2031.

Relative to the size of our economy, the increase in debt appears innocuous. However, professors Carmen Reinhart and Kenneth Rogoff published a 2010 study for the National Bureau of Economic Research entitled "Growth In a Time of Debt." Their primary conclusion showed that median growth rates in real GDP declined by 1% in countries having government debt above 90% of GDP. The CBO projection cited above assumes that real GDP averages 2.2% over the 2021-2031 forecast period, roughly in line with its growth rate in the 2011-2021 period. In fairness to CBO their forecast does reflect a slowdown in real GDP from 2.8% in 2021-2025, to 1.6% in the 2026-2031 years.

Dr Lacy Hunt of Hoisington Investment Management has studied the impact on highly indebted countries growth of increases in government spending. Specifically, Dr. Hunt shows the government spending multiplier is "sharply negative in countries where government debt exceeds 60% of GDP". Noteworthy is that this condition is currently met by most of the world's developed nations. The chart below, courtesy of <u>Hoisington Third Quarter 2021 Review and Outlook</u> shows the diminishing returns from debt, which Dr. Hunt describes as "the marginal revenue product of debt," or simply stated GDP per dollar of total debt. The chart depicts the MRPD for the U.S., Euro area and Japan. All three experienced declining economic returns from debt over the 2000-2021 period.

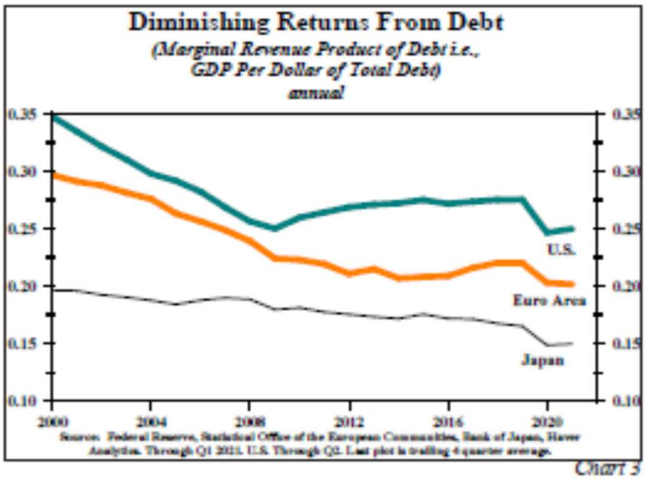
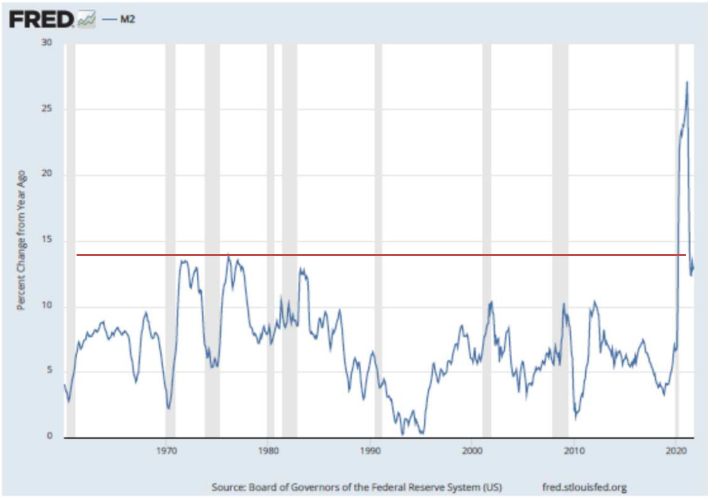


Chart 3

In our opinion the two studies referenced above offer strong evidence that the U.S. economy, being debt encumbered for the next 10 years, will have great difficulty achieving real GDP growth much above its rated potential (1.8% estimated by the Federal Reserve). However, the output gap (difference between actual and potential growth) will likely stay positive resulting in an inflationary bias, despite slower growth. This bias will be reinforced by policy makers willingness to use fiscal spending in conjunction with an accommodative monetary setting in order to increase economic growth. We can envision a period of sticky inflation (3-4 %) coupled with slow real growth (2-3%). <u>As such, real rates, which track real growth is projected to be around -1%.</u>

M2 GROWTH SLOWING BUT STILL ELEVATED HISTORICALLY

The chart to follow courtesy of the Federal Reserve, shows the annual rate of growth in M2 money supply since1960. The recent peak growth in the series was February 2021, when M2 grew at 27.1% yoy. The current reading for M2 growth is +12.8%. Prior to the post pandemic period, M2 grew in excess of 13% in July 1971, January 1976, and February 1977. The chart shows that the current period of M2 growth is at an elevated level when viewed over the past 60 years. While fiscal thrust is likely at its peak for this cycle, as the budget deficit declines to 2.9% of GDP in 2024, versus 13.4% of GDP in 2021, it is projected by CBO to average 4.2% of GDP over the next 10 years. Excluding the pandemic stimulus effect in 2021, the deficit is projected to average 3.4% of GDP over the decade.



Our analysis suggests that fiscal deficit finance will play an important part in determining macro trends over the current decade. Noteworthy is that the CBO analysis assumes that net interest on the debt averages 1.89% of GDP over the 10 years. This is a yellow flag! Historically interest has averaged 5% of GDP. At 5% interest would average $14.385 trillion, equal to a projected 22.7% of total outlays, and a whopping 84% of total discretionary expenditure, leaving little room to increase spending to "fight another recession or pandemic."

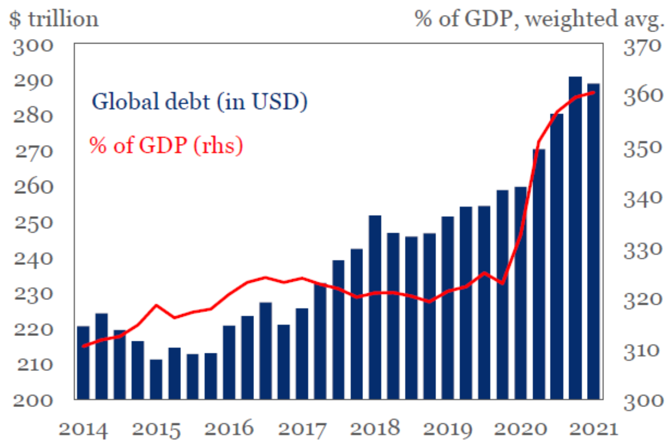
A TECHNICAL VIEW OF THE U.S. DOLLAR AND ITS IMPACT ON THE REFLATION TRADE

The chart to follow courtesy of stockcharts.com, shows the U.S. dollar has mostly traded within a range defined between 90 at the lower boundary, and 93 at the upper limit. A breakout of the range occurred on 9/27/2021. Presently, the dollar is trading above 96, which we had targeted as a minimum price objective, following the breakout. The move up from the June 2021 low at 90 was 6.6%, a gain which we view as too far, too fast!

TP Objective 96.00

The dollar broke out of the box on 9/27/21 and has reached its projected target price objective of 96.00

Our past analysis has shown that the U.S. dollar, along with oil prices and bond yields are three important sources of reflation. Sustained reflation occurs when all three decline together. For most of 2021 all three sources of potential reflation have been trending higher, thereby exerting a deflationary impact on the global economy. Moreover, recent tighter policy script from the Fed and other central banks have contributed to the rise in both the dollar and bond yields. With global debt at record levels (see chart below courtesy of Baird Private Wealth Management Research) it is likely to be very challenging for central banks to move towards more normal monetary policy settings without activating deflationary forces.

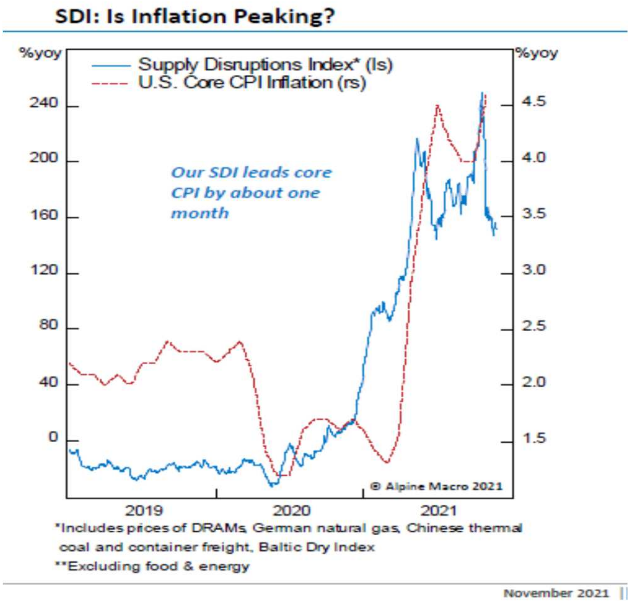


Source: IIF, BIS, IMF, National sources

Therefore, any stimulus withdrawal such as tapering the Fed's balance sheet will be at risk of increasing market volatility. Policy adjustments in favor of less accommodation will have to be tempered by market reaction.

INFLATION MAY FLATTEN OUT IN 1H2022

We have been cautioning investors to expect the current decade to feature a combination of slow real growth and higher inflation. The COVID-19 pandemic caused fiscal/monetary policy makers to "throw caution to the wind" by unleashing over $5 trillion of stimulus, amounting to roughly 23% of GDP. With the arrival of vaccines in 1Q2021 confidence in the ongoing economic recovery increased. Both wholesale and retail inventories have been depleted. Global supply chains were severely compromised with manufacturing centers in Germany and China locked down. As a result, severe material and component shortages still persist today. In view of these global bottlenecks, it is unsurprising that goods prices have spiked higher, feeding into core inflation



The bottom line is global supply problems are contributing to the inflationary cycle. The above chart, courtesy of Alpine Macro, plots the Supply Disruption Index (comprised of DRAMs, German Natural gas prices, Chinese thermal coal, the container freight index, and the Baltic Dry Index) against core consumer price inflation. The SDI leads core inflation by about one month. With the global economy on the mend the SDI, measured yoy, appears to be peaking. This would suggest that core inflation could level off in 1H2022.

Should inflation level off 1H2022 it would give the Fed more leeway to renormalize policy. At present the market is pricing in three rate increases beginning in March, 2022. Our bet is the Fed defers increasing rates until after the mid-term elections.

RISKS

- The Fed tightens policy into a slowing economy
- The dollar holds firm

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January 2022