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QUARTERLY INVESTMENT OUTLOOK
JULY 2021

SUMMARY

- At this juncture we would welcome a correction in risk assets i.e., equities, commodities, bitcoin etc. Momentum and sentiment are stretched. Risk assets need a reset in order to pave the way for a continuing cyclical advance in prices, which is our base case looking out twelve months.

- Equity valuations are also extended. Stock prices are far ahead of corporate earnings trends. A digestion phase would be beneficial. The cyclical advance in bond yields has raised investment risk! A slowdown in real growth (ISM manufacturing) could flatten bond yields over the intermediate term.

- Corporate bond spreads, both Baa and Junk, are trading near historic lows. Tight corporate spreads vis a vis treasuries are supportive of risk assets. Our macro strategists MRB Partners caution investors not to become too complacent regarding low corporate yields. As treasury yields gradually trend higher this is bound to exert upward pressure on corporate yields, having a potentially negative effect on equity valuations. On a positive note, this is unlikely to happen until central banks finally shift gears.

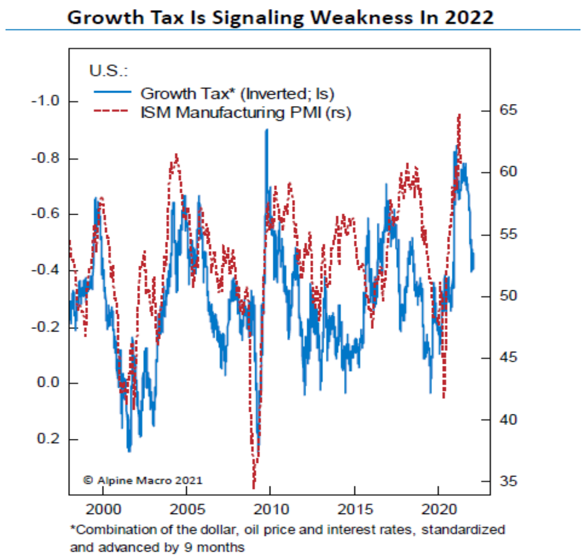
- We expect both real growth and real yields to remain low in the post-pandemic period. Inflation should gradually trend higher with both fiscal and monetary policies remaining accommodative. Our inflation barometer is trending higher. Avoid intermediate/longer dated Government bonds.

- Gradually increase exposure to global ex-U.S. equities. Foreign markets offer better value and should benefit from dollar weakness.

- Stuyvesan*T*rends Dividend Growth Payers: Introducing a value strategy with growth attributes.

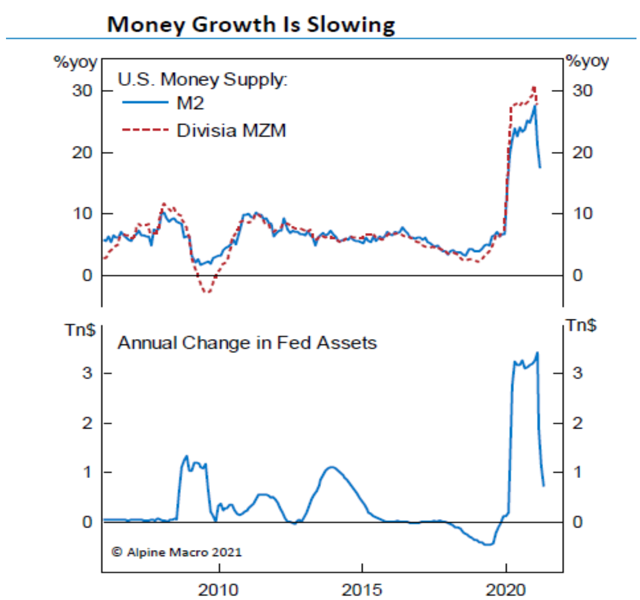
THE FED'S CONCERN THAT THE ECONOMY IS OVERHEATING MAY BE PREMATURE

The Growth Tax Indicator, developed by Chen Zhao of Alpine Macro, has an excellent track record of forecasting changes in the ISM Manufacturing Purchasing Managers Index. Last April, amid the pandemic, it was signaling a V-shaped recovery in the ISM Manufacturing Index, and by extension real GDP. Currently the Growth Tax Indicator, a combination of the dollar, oil prices and interest rates, advanced 9 months is signaling economic weakness into 2022 (see chart to follow).



Courtesy: Alpine Macro

A slowdown in money growth and the Fed Balance Sheet, shown in the chart below courtesy of Alpine Macro, is another piece of supporting evidence that indicates the U.S. economy is at risk of slowing.



Courtesy: Alpine Macro

Investors are concerned that the Fed is supercharging inflation by following a zero-interest rate policy while simultaneously purchasing $120 billion in mortgages and treasuries monthly. We believe they are unlikely to alter their policy until the unemployment rate reaches its pre pandemic level of 3.5% and the personal consumption expenditure deflator exceeds 2.5% for several months. We expect both these unemployment and inflation targets to be met within the 4Q21 and 1Q22 timeframe.

REAL GROWTH/REAL YIELDS SHOULD REMAIN LOW AS THE ECONOMY RECOVERS

Over the 2016 – 2019 pre pandemic period, we estimate non-farm U.S. productivity (real output per manhour) grew at an average rate of 1.26%, ranging between 1.9% and -0.20%. As the U.S. economy emerged from the pandemic induced recession, productivity climbed rapidly from 0.80% in 1Q2020 to 4.12% in 1Q21. The sharp recovery in output per manhour follows a normal post-recession outcome with companies slow to hire. This trend was exaggerated last year with the economy in lockdown; hence we are not surprised to see a strong rebound in productivity.

With business investment showing little growth over the past 10 years, we forecast productivity will eventually return to its pre-pandemic average growth of 1.26%. Add in .5% growth in the labor force results in a real growth estimate of 1.8%.

Treasury Inflation Protection Securities (TIPS) are a good proxy for real yields. Noteworthy, is that TIPS yields averaged 47bp between 2016-2019 (pre-pandemic). The real yield averaged 23bp in 2016 peaking at 83bp in 2018. In 2019 the real yield declined sharply to average 37bp. In the 2H2019 the inflation adjusted yield declined to average 11bp, before the pandemic struck, signaling a period of slow growth going into 2020.

Looking out into 2022 we see a period of lower growth accompanied by higher inflation. Our tentative estimate is growth of 1.5% cagr with 3% inflation. Should our forecast prove correct then we anticipate the real yield to rise from -.8% currently to +50bp. This assumes a gradual decline in the dollar. Should the dollar weakness develop at a faster pace, inflation will surprise on the upside. This could further depress real yields, perhaps keeping them in negative territory.

TIME FOR GOLD TO SHINE?

The gold price has been in a consolidation pennant since peaking last August at 2,067. Gold equities have been under pressure and are roughly 14% below their August highs. On a positive note, gold stocks, as measured by the GDX (35 largest miners) have risen 30% from their March 2020 lows, far outdistancing gold bullion which gained roughly 12%. Our base case remains intact i.e., gold is in a multi-year bull market. We view gold as the anti-dollar and should benefit from its forthcoming secular decline.

We acknowledge that gold also functions as a risk-off asset. With equities at close to all time highs, investors have little incentive to hold gold. Holding a 5-10% position in gold/gold equities is like buying insurance. You do not need it until you need it.! Many academic studies have shown holding gold in modest amounts can increase portfolio risk adjusted returns. We also see the benefit of owning it during the current period of historically low interest rates. As bond yields trend higher, the classic balanced 60% equities/40% bond portfolio allocation is going to be severely challenged with bonds losing their safehaven status. This last occurred in the 1970s which was characterized by rising inflation.

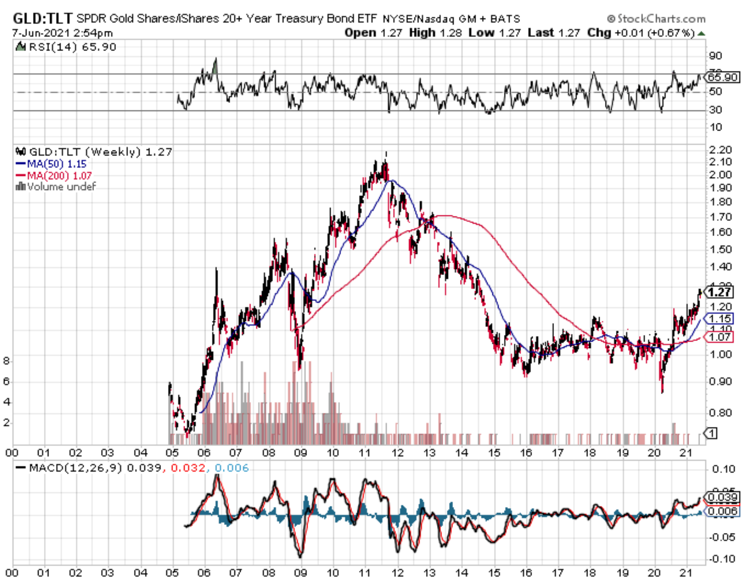
The recent correction in gold has also been aided by the increasing move into digital gold i.e., bitcoin. As shown in the chart below which plots the ratio of gold to bitcoin, investors have cycled back and forth between the two asset classes over the past five years. Since March 2020 investors have shunned gold in favor of bitcoin. However, since March 2021 there are encouraging signs that a move back into gold vis a vis bitcoin may be developing.

Courtesy: Stockcharts.com

J.P. Morgan’s analyst Nikolaos Panigirtzoglou noted in a May 20, 2021 WSJ article that the average capital flow into bitcoin funds, measured as a four-week rolling average, has been declining since late January when it peaked at $600 million. In May, those same funds experienced net outflows of roughly $100 million, the first downdraft since January 2020.

OUR INFLATION BAROMETER IS SIGNALING RECENT PRICE INCREASES ARE NOT TRANSITORY

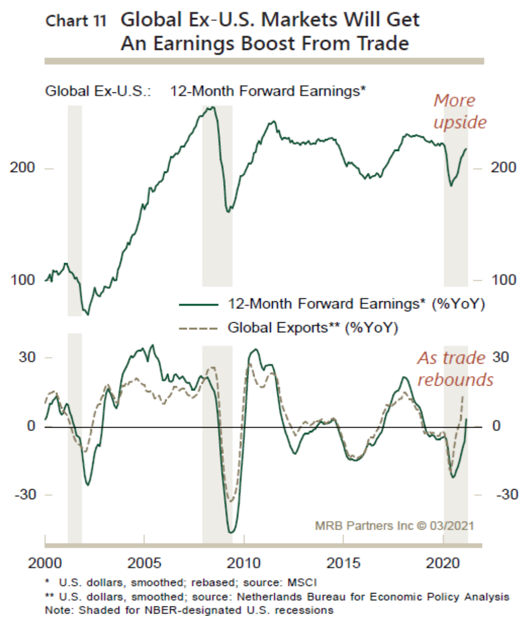
The chart below plots the ratio of the gold price/20-year U.S. treasury bond price. An increase in the ratio is a signal that inflationary forces are dominant. A decrease (2011-2016) signals deflationary forces are exerting downward pressure on the general price level. The indicator bottomed in 2016 and was gradually rising into 2020 when the economy was stricken by the COVID-19 pandemic. A second bottom was recorded in March, 2020. All three trend measures are rising i.e., the 20-week EMA, the 50-week MA and the 200-week MA confirming the technical strength and potential duration of the dominant trend of inflationary forces that are imbedded in the financial system. Also shown beneath the indicator is a macd (moving average convergence divergence) which is a traditional measure of momentum, suggesting the trend is durable. The behavior of the inflation barometer gives us high conviction in our incipient inflation thesis.



Courtesy: Stockcharts.com

WE REMAIN BULLISH ON GLOBAL-EX U.S. MARKETS

The key to an inflation cycle is the slowly emerging U.S. dollar bear market. During Q1 the U.S. dollar staged a countercyclical rebound of roughly 3%. Global exports are heating up. This should benefit the Euro and yen currencies in the second half of 2021, setting the stage for renewed dollar weakness. The U.S. benchmark S&P 500 is heavily weighted in Technology as compared with the Global ex-U.S. benchmark which is over weighted in Financials. Also, many non-U.S. markets i.e., Europe, Japan, Taiwan, and India are more dependent on global trade. With U.S. import demand poised to strengthen materially this should benefit these trade dependent markets.



Courtesy: MRB Partners

<u>CENTRAL BANK DIGITAL CURRENCIES (CBDC) CAN HASTEN A UNIVERSAL BASIC INCOME</u>

In an article dated 05/24/2021 written by Lael Brainard, President of the Federal Reserve Bank of Cleveland, titled "Private Money & Central Bank Money as Payments Go Digital" the author repeatedly mentions the phrase "financial inclusion." Is this a new Federal Reserve mandate? In previous Investment Outlooks we have quoted Ray Dalio's suggestion that the new paradigm, which is evolving as a solution to the problem of income inequality, necessitates a close working relationship between the Treasury and the Fed. In effect, the Fed becomes the funding source for future government expenditure. The Fed's stated goal is to raise the level of inflation above 2% with policies designed to promote income equality. Despite several rounds of QE and most recently roughly $4 trillion + of COVID relief, inflation as measured by the pce deflator is +1.6% yoy. Analysts point to the decline in M2 money velocity as the major reason inflation is stuck below 2%. We agree that M2 velocity GDP/M2 needs to increase to generate sustained inflation.

Mr. Dalio proposes a universal basic income as a possible solution to both inequality and weak velocity. His idea is to get money into the hands of those people that need it the most and are primed to spend it the fastest. While it makes sense economically, it would set up a political dog fight? However, what if we had a central bank digital currency (dollar)? Individuals/families with income below $50,000 could open deposit accounts directly with the Fed and those could be credited with digital dollars as needed. In this form a CBDC can be an effective means of distributing a universal basic income.

RISKS

- A rapid breakdown in the dollar
- The Fed initiates yield curve control creating financial system uncertainty
- The Fed tapers prematurely

INTRODUCING A VALUE STRATEGY WITH GROWTH ATTRIBUTES: *STUYVESANTrends* DIVIDEND GROWTH PAYERS

In the current cycle of low interest rates and high equity valuations investors need for income is paramount. We believe the Stuyvesna*T*rends Dividend Growth Payers Strategy, which focuses on companies with long histories of paying dividends is best suited for conservative investors seeking to enhance income. The strategy includes exposure to large, mid, and small cap companies represented in three ETFs selected by Pro Shares. It is a global strategy utilizing dividend growers in Europe, Australia, and the Far East (EFA) and in the major Emerging Markets (EM). In addition, the strategy offers investors the opportunity to enhance income through selected fixed investments in high grade corporate bonds while protecting against principal erosion common in an inflationary period, using a Pro Shares sponsored inverse treasury ETF. The strategy automatically defaults to a short-term treasury ETF if neither equity nor fixed investments mentioned above are deemed attractive.

Dividend Growth Payers allocates investments between domestic (all caps) and foreign dividend growers, fixed investments and cash using a rules-based market signaling system designed and developed by Stuyvesant Capital Management and Market Trends Global. It incorporates the fundamental research of Pro Shares dividend selection methodology with momentum/trend technical indicators in a strategy that optimizes asset allocation.

If you wish to learn more about our Dividend Growth Payer Strategy, do not hesitate to contact us at (914) 219-3010 or by emailing pdaly@stuyvesantcapital.com or vcatalano@stuyvesantcapital.com

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