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THE COUNTDOWN HAS BEGUN?

Outsized reaction to a slightly hawkish tilt

The epic equity bull market has continued unabated. As of the end of June, the S&P 500 Index has generated a total return of 15.2% YTD and appreciated 92% in the 321 trading sessions since the March 23, 2020 market trough, making it the fastest start of any U.S. bull markets since the Great Depression by a wide margin. The S&P 500 Index is also 27% higher than the pre-COVID-19 market peak reached on February 19, 2020 – an impressive feat which seems to imply that the world has emerged from the pandemic stronger and wealthier.

Beneath the surface of the epic bull market, however, there were some recent movements showing that investors might be getting concerned about the strength and duration of the stimulus and vaccine-induced boom. Various segments of the market that would benefit from the re-opening of the economy – e.g., airlines, leisure and hospitality, etc. – have peaked since March or April. Then in June, value and cyclical sectors such as financial services, basic materials and industrials declined as the market leadership rotated back to growth stocks led by FAANG. The narrowing market leadership and the rotation back to growth are not a vote of confidence for reflation.

Equity investors may have been taking cues from the U.S. Treasury market, where long bond yields dropped like a rock after the Federal Open Market Committee (FOMC) turned a bit more hawkish in its economic projections. It appeared that investors were finally embracing the Fed's "inflation-is-transitory" narrative, as U.S. breakeven rates (expected future inflations) have also come down. The FOMC's slightly hawkish tilt gave support to the U.S. dollar at the expense of precious metals. Base metal prices also weakened after China announced that it would sell industrial metals from its national reserves in order to drive down commodity prices.

These somewhat defensive rotations may also reflect a concern over the rise of the dreaded Delta variant. Having wreaked havoc in India, this COVID-19 strain is causing new lockdowns from Taiwan to Australia and postponing the U.K.'s full-scale re-opening. The U.S. is in a stronger position to deal with it as 67% of adults have gotten at least one vaccination jab. However, this also means that more than 30% of American adults are still at risk, and some will remain so due to their reluctance to get vaccinated. With COVID-19 having become endemic, the world has to adjust to live with these new strains and trust that the mRNA technology can develop effective booster shots. That is the new normal, and unfortunately, it also puts less developed countries at a disadvantage.

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DIVINE INTERVENTION?

People across this great nation were looking forward to celebrating this particular Independence Day. Some believed that the unique occasion might just inspire politicians to reflect on the ideals that bind us together and to tone down the bitter partisanship that had divided the country. It was in this spirit that the mayor of Washington D.C. sent invitations to all the living ex-Presidents and the signers of the Declaration of Independence – there were just a handful of them left by that time – to the Jubilee Celebration on July 4, 1826. To the disappointment of many Washington residents, John Adams, Thomas Jefferson, and Charles Carroll were too old and frail to make the journey, and James Madison and James Monroe had also graciously declined. However, their letters of declination, brimming with words of inspiration and remembrance, were widely circulated by newspapers on that Fourth of July.

Two days after the Independence Jubilee Celebration, President John Quincy Adams received the news that Thomas Jefferson had passed away at Monticello at ten minutes past one on the afternoon of July 4th. As noted in his diary, Adams found it a "strange, and very striking coincidence" that the author of the Declaration of Independence would pass away exactly fifty years after its pronouncement in Philadelphia.

On the morning of July 8th, President Adams received three letters from his relatives in Quincy, Massachusetts, informing him that his father, former President John Adams, was gravely ill. At 5 am the following morning, President Adams and his son John left Washington, D.C. in a carriage with four horses and sped north for Baltimore, where they would board a north-bound steamboat. Shortly before 11 am, the carriage had reached Waterloo, Maryland, about 35 miles northeast of the White House. There he learned from someone who was traveling from Baltimore that morning that his father had passed away at about five o'clock in the afternoon of the Fourth.

President Adams took the news in stride as his father was nearly 91 years old and had lived a life "illustrious in the Annals of his Country, and of the World." However, he was struck by the fact that Jefferson and Adams, two of the most influential Founding Fathers with a complex friendship and rivalry between them, had passed away just hours apart on the fiftieth anniversary of the creation of the country they had both sacrificed so much for. He concluded that the time, manner, and coincidence of their passing were a manifestation of "visible and palpable marks of divine favour" for which he would humble himself "in grateful and silent adoration before the Ruler of the Universe."

Many would like to believe that it was divine intervention that guided the two most influential figures in the creation of the Declaration of Independence to reunite up above on the 50th Anniversary of this great nation. It could also be a matter of mind over body. Jefferson's condition was deteriorating rapidly in the days leading up to the Fourth, but he willed himself to cross the finish line on a day of his choosing. He had slept through most of July 3rd and woke up in the evening asking, "Is it the Fourth?" His physician Robley Dunglison replied, "It soon will be." When Dunglison later offered to give him a dose of opiate to lessen the discomfort, Jefferson replied, "No, doctor, nothing more."

In Adams' case, his attending physician had estimated on July 3rd that he would not last more than two days. On the morning of the Fourth, Adams had remarked, "It is a great

Equity Markets Indices[1]	5/31/21 Price	6/30/21 Price	MTD Change	YTD Change
MSCI All Country World	711	720	1.2%	11.4%
S&P 500	4204	4298	2.2%	14.4%
MSCI EAFE	2334	2305	-1.2%	7.3%
Russell 2000®[2]	2269	2311	1.8%	17.0%
NASDAQ	13749	14504	5.5%	12.5%
TOPIX	1923	1944	1.1%	7.7%
KOSPI	3204	3297	2.9%	14.7%
Emerging Markets	1376	1375	-0.1%	6.5%
Fixed Income				
2-Year US Treasury Note	0.14%	0.25%	11	13
10-Year US Treasury Note	1.60%	1.47%	-13	55
BBG Barc US Agg Corp Sprd	0.84%	0.80%	-4	-16
BBG Barc US Corp HY Sprd	2.96%	2.68%	-28	-92
Currencies				
Chinese Renminbi (CNY/$)	6.37	6.46	1.4%	-1.1%
Brazilian Real (Real)	5.22	4.97	-4.8%	-4.4%
British Pound ($/GBP)	1.42	1.38	2.7%	-1.2%
Euro ($/Euro)	1.22	1.19	3.1%	3.0%
Japanese Yen (Yen/$)	109.58	111.11	1.4%	7.6%
Korean Won (KRW/$)	1110.65	1126.15	1.4%	3.7%
U.S. Dollar Index (DXY)	89.83	92.44	2.9%	2.8%
Commodities				
Gold	1907	1770	-7.2%	-6.8%
Oil	66.3	73.5	10.8%	51.4%
Natural Gas, Henry Hub	2.99	3.65	22.2%	43.8%
Copper (cents/lb)	468	430	-8.1%	22.1%
CRB Index	206	213	3.7%	27.2%
Baltic Dry Index	2596	3383	30.3%	147.7%

Source: Bloomberg

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day. It is a good day." His condition subsequently deteriorated. According to Louisa Smith, Adams' niece who was by his side, his lasts words were, not knowing that Jefferson had predeceased him by a few hours, "Thomas Jefferson survives" It remains a mystery if these last words were uttered out of resignation, bitterness, or nostalgia.

Lastly, James Monroe, a Founding Father and the Republic's fifth president, also passed away on the Fourth of July, but in the year 1831 – the nation's 55th birthday. Somehow the number 55 does not carry as much cachet as 50, but I am sure that Monroe was grateful for the extra five years.

LOSING MY RELIGION

For most politicians, becoming a head of state is the pinnacle of one's career. For Jefferson, however, being a two-term president was apparently not as significant as some of his other achievements. He had designed his own gravestone with the epitaph that read, "Author of the Declaration of Independence [and] of the Statute of Virginia for religious freedom and Father of the University of Virginia." Of these three accomplishments, the second is perhaps not as well-known as the other two. However, it was the driving force behind the religious clause of the First Amendment – "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof."

While religious freedom and the separation of church and state are taken for granted today, Jefferson was viewed as a radical in his era. During his presidential contest against John Adams in 1800, Jefferson was vilified as an atheist and libertine. It just goes to show how social norms and values are constantly evolving, and why our forefathers should be judged on the standards of their time.

Speaking of religion, the U.S. is becoming increasingly secular. A recent Gallup poll shows that, for the first time, the majority of American adults are not affiliated with a church, synagogue or mosque. Specifically, in 2020, just 47% of Americans belonged to a house of worship, down from 50% in 2018 and 70% in 1999. The decline in religious affiliation raises an interesting question regarding what would fill this religious void, as human beings seem to have an innate need to believe in something. Some attribute the rise of political extremism in the U.S. to the decline in religious beliefs. In place of religion, we may embrace various isms, theories or movements that foster a sense of judgmentalism, moral righteousness, and intolerance for dissention, which is akin to how some deal with heresy in the religious realm.

This need to fill the religious void may have even affected the financial market. Earlier this year, Joe Weisenthal, a columnist and editor at Bloomberg, penned an interesting article arguing that Bitcoin has evolved into the first new religion of the 21st century. Weisenthal observed that Bitcoin has a prophet in its enigmatic inventor, Satoshi Nakamoto, whose nine-page white paper on the subject is viewed by Bitcoin aficionados as sacred text. Bitcoin's first block was called The Genesis Block. Some of the earliest technologists in the cryptocurrency movement are involved in a subculture called the extropians, who believe in advancement, including eternal life, through technology. The late Hal Finney, who had conversed with Nakamoto and was on the receiving end of the first Bitcoin transaction, was a loyal disciple who was cryogenically frozen in the hopes of resurrection in the future. Some hardcore Bitcoin supporters preach the struggle between good (themselves) and evil (central bankers and the government) and promise riches for "true" believers who practice HODL (holding without selling). They even have a curse on non-believers who dare challenge their orthodoxy, "Have fun staying poor."

Of course, most Bitcoin investors these days are in it for the money rather than for the cause. However, some of them appear to have acquired a sense of smugness as evidenced in the "laser eyes" meme on social media. It was allegedly started as a campaign in February 2021 to convince more people to fork over their money in order to drive Bitcoin's price to $100,000. The movement had Bitcoin enthusiasts placing laser eyes over their profile pictures to signal they "get it" when it comes to Bitcoin. It has attracted people from all walks of life, including respected Wall Street strategists and members of Congress. One Bitcoin enthusiast crowed that the rapid adoption of the laser eyes meme demonstrated the power of Bitcoin's network effects, which, coupled with its scarcity, would lead to higher value – "To the moon!"

Call me old fashioned, uncool, or lacking a sense of humor, but this laser eyes meme feels cultish. It's a form of peer pressure to get on with the program. Unfortunately for those who may have been enticed by this clever campaign to put their hard-earned money into Bitcoin, many have suffered losses as the price of Bitcoin, having peaked on April 15th, has taken a round-trip to its early February levels. Adding insult to injury, some of the newbies who have sold at a loss were ridiculed as having "paper hands" and lacking the fortitude to tolerate volatility. It seems like the Bitcoin faithful are required to have "diamond hands" – the mettle to hold on to the coins come hell or high water.

As an outside observer, I believe this "diamond hands" meme is one of the worst advice to cryptocurrency investors, or to any investors. No investment should be so sacred as to warrant "diamond hands." Bitcoin is an object of speculation, and one should trade it accordingly. As for the "right time" to buy it, I guess one potential contrarian signal is when many of those in the laser eyes movement feel so embarrassed that they restore their profile pictures to display their beautiful God-given eyes.

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A SLIGHTLY HAWKISH TILT

Alternative currencies have been in existence for centuries. During the Free Banking era in the U.S. from 1837 to 1863, thousands of banks had issued their own banknotes, but none had stood the test of time. Over the last few decades, technology has enabled utopians and anarchists to design various digital currencies out of their distrust for the banking system, central banks, and fiat currencies. While some of these people have been ridiculed for their doomsday mentality, their concerns of fiat currency debasement and fiscal mismanagement are not unfounded. Indeed, the rapid buildup of our national debt and the unconventional monetary policies over the last 14 years are anything but normal.

Between 2000 and 2007, the federal government's gross debt-to-GDP had increased slightly from 59% to 63%, and the Federal Reserve's balance sheet had grown steadily at an annualized pace of 3.7% from $669 billion to $891 billion. Fourteen years and two black swan events later – the Great Financial Crisis and COVID-19 – our debt-to-GDP has ballooned to 128% and the Fed's balance sheet has shot up nine-fold to $8 trillion. The elevated debt-to-GDP has not created much fiscal burden since, with the Fed's active market intervention, interest rates have declined to the lowest levels in U.S. history. The Fed's loose monetary policies also did not create much inflationary pressure in the real economy as a result of weaker loan demand and tougher regulations over banks.

In the past few months, strong demand spurred by generous bailout checks from Uncle Sam and supply chain disruptions have pushed up inflation. The Consumer Price Index (CPI) in May was up 5% year-on-year, the highest rate of change in 13 years. However, members of the FOMC were uniform in delivering the message that the ultra-loose monetary policies will remain in place since the high levels of inflation are deemed transitory. Of course, to say otherwise would necessitate a policy shift. Former Fed officials, however, can be more forthcoming as they do not have the pressure to toll the party line. Several ex-Fed officials – Kevin Warsh, William Dudley, and Donald Kohn, to name but a few – were openly disagreeing with the Fed's dovish stance. Dudley cautioned that by staying too easy for too long, the Fed runs the risk of having to play catch up down the road to tame persistent inflation pressure, which would ironically cut the length of the economic expansion short.

On June 16th, the FOMC surprised the market by raising its projected year-end 2023 median Fed funds rate from 0.1% to 0.6%. It was as if several of the Fed's district presidents were revolting against Chairman Powell's uber-dovish stance. The dot plot showed that 13 of the 18 FOMC members forecasted at least one rate hike by the end of 2023, compared to 7 in March. There were also 7 members who projected at least one rate hike in 2022, compared to 4 in March. At the post-meeting press conference, Chairman Powell took pains to put a dovish spin by telling investors to take the dot plot "with a big grain of salt" on the ground that that "the dots are not a great forecaster of future rate moves."

The FOMC's hawkish tilt triggered violent market moves and rotations. Longer-maturity Treasury bond yields fell sharply, leading to a flattening of the yield curve. Equity investors took a cue from the flattening yield curve and rotated away from the so-called reflation trades back to growth stocks. It was as if a slightly hawkish tilt in the Fed's policy projection has suddenly convinced investors that the macro environment will soon decelerate significantly. Indeed, there is a growing narrative that the second quarter of 2021 has marked the peak for economic growth, year-over-year inflation, and long bond yields in the current cycle.

The peak economic growth and inflation thesis should not be a surprise, as it is a function of easy comparison. The second quarter of 2020 bore the brunt of the COVID-19 damage as nearly half of the global population was under some form of lockdown. On a year-over-year basis, the U.S. real GDP sank 9% during that quarter, and inflation, as measured by CPI, was up an anemic 0.1% in May 2020. In the coming months, the year-over-year change in CPI will likely head lower due to tougher comparisons but could still hover above 3% into early next year.

As for long bond yields, the *real* 10-year and 30-year Treasury yields closed at -0.88% and -0.19%, respectively, at the end of June. These are simply too low unless one expects an imminent return to disinflation and very anemic economic growth. With the 10-year and 30-year real yields having averaged about 0.5% and 1% from mid-2013 through 2018, a period that covered the Fed's initial signaling of tapering to the end of its hawkish stance, I would not be surprised if the 10-year and 30-year yields moved higher in the coming quarters.

There may have been another temporary factor that drove U.S. long bond yields lower in the second quarter – a much reduced supply of Treasuries to the market. During the first two months of the quarter, the U.S. government had run up a deficit of $358 billion, yet it only issued $35 billion of debt. Quarter to date through June 29th, the federal government's total debt has increased by only $199 billion, which was less than the Fed's $240 billion quarterly purchase of U.S. Treasuries. This decline in the net supply of Treasuries to private investors up to that point during the second quarter might have contributed to the downward pressure on long bond yields, which in turn scared some investors to cover their short positions.

The U.S. government was able to materially reduce Treasury issuance during the second quarter as a result of

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strong tax collection and a planned cash balance reduction in the Treasury General Account (TGA), which is akin to the Treasury Department's checking account at the Fed. It had built up a large cash balance due to aggressive Treasury issuance in 2020. During the second quarter, Uncle Sam drew down $270 billion from this account, bringing the balance from $1.12 Trillion to $852 billion. The Treasury Department may be able to keep a lid on debt issuance for another quarter or two by running down its TGA balance to its target of $500 billion. However, the pace of borrowing will pick up again after that if deficits remain elevated. It also begs the question on whether the Fed would dare to scale back its $240 billion per quarter of debt monetization.

STICKY OR TRANSITORY?

Despite the Fed's assurance that they have everything under control, we – policymakers, investors, corporate executives, etc. – are all sailing in uncharted waters and no one can be certain of how things will play out. The data that policymakers and investors rely on for analysis and forecasts have been distorted by a variety of factors – pandemic-induced lockdowns and the varying pace of reopening, temporary and permanent behavioral changes, unprecedented fiscal and monetary stimulus, not to mention trillions of dollars of additional stimulus and tax hikes being haggled over in Washington. It is also questionable how well the all-important inflation data reflects real life, as the Bureau of Labor Statistics has revised the methodology used to calculate the CPI numerous times over the years. According to economist John Williams at Shadowstats.com, the CPI calculation methodology from the early 1980s would peg the May 2021 CPI reading at 13% rather than the reported 5%. One glaring discrepancy between the real-world inflation and the CPI data is the cost of shelter, the biggest component of the index. According to the National Association of Realtors, the national median existing home price has risen to $350,000 in May, up 23.6% from a year ago. However, housing prices are no longer included in the CPI calculation, as housing units are treated as capital goods (or investments) rather than consumption items. Government statisticians use an imputed owner's equivalent rent to estimate the shelter cost, which went up only 2.1% in May. So, is there high inflation in housing or not?

The debate over the transitory nature of higher inflation will likely drag on for some time. There is no doubt that some components of the CPI are experiencing transitory pressure due to a supply-demand imbalance. The world's manufacturing capacity is calibrated for an environment of 2% U.S and 4% global GDP growth rather than their current run rate of 6% or higher. Beyond this transitory phase, however, inflation may still settle at levels above 2% due to several longer-term drivers. They include higher cost structure as a result of the West's gradual reduction of its over-reliance on Chinese manufacturing, and a more activist administration with higher fiscal impulse and pro-labor policies. Interestingly, climate change and ESG movements can also be inflationary. Extreme weather events and droughts have impacted crop prices. Environmental and social concerns have made it more difficult for miners to start new mines, which could lead to supply shortages and higher prices. The shift to alternative energy is also more costly for some companies – if not, they would have embraced it without pressure from activist investors and regulators.

The debate over inflation has also exposed an interesting intellectual inconsistency at the Fed. Chairman Powell has reiterated that the Fed's policymaking will be outcome-based rather than forecast-based. Yet when confronted with a CPI reading of 5%, he chose to stay the course based on the assumption that higher inflation reading is transitory, which is, of course, a forecast-based decision. He may be proven right after all, but he should acknowledge that his policies are still forecast-based.

STILL THE SHINING CITY UPON A HILL

The market's erratic reaction to the FOMC's slightly hawkish tilt is a warning that volatility could pick up materially when the Fed officially announces its tapering plan, which could happen as early as late August at the Fed's annual Jackson Hole Economic Symposium. As former Fed Chairman Bernanke had remarked, "monetary policy is 98% talk and only 2% action." It is not lost on Chairman Powell that Bernanke's tapering comment in 2013 had triggered a big market tantrum. However, investors can rest assured that this august body will, at the very least, use "bias-free language" to avoid triggering anyone. The Federal Reserve Board of Governors has reportedly issued communication guidelines to avoid words and phrases that may be considered offensive or pejorative. For example, terms such as "Founding Fathers" and "grandfathered" are to be avoided.

With the country having just celebrated its 245th Independence Day with a sense of renewal and hope, I find it amusing that some well-meaning bureaucrats would consider the term "Founding Fathers" offensive. I wonder how the data-driven, outcome-based Fed determined what terms and phrases ought to be censored. Has one of the Fed's many PhDs done an analysis on exactly what percent of Americans or their employees would be offended by the term "Founding Fathers?" It would also be interesting to find out what percent of Americans would feel offended when told to bite their tongue. As Benjamin Franklin, a Founding Father, had written at a tender age of sixteen, "In those wretched countries where a man cannot call his tongue his own, he can scarce call anything his own.

Whoever would overthrow the liberty of a nation must begin by subduing the freeness of speech." It's a powerfully prophetic observation considering how various totalitarian regimes managed to seize power in the 20th and even in the 21st century by first suppressing the freedom of expression. To wit, the Hong Kong authority, under the tutelage of China, has arrested Jimmy Lai, the 73-year-old founder of Hong Kong's pro-democracy newspaper Apple Daily, unceremoniously froze his assets, and shut down the newspaper. I suspect the people of Hong Kong have a deeper appreciation for the freedom of speech now more than ever. It also begs the question of whether our hypersensitivity about pronouns and various phrases may be distracting us from the larger challenges confronting America. Can a generation of Americans sheltered from "harsh" language and dissenting views compete against our geopolitical opponents who are focused on taking America down? Will a culture of conformity and self-censorship stifle the spirit of individualism and heterodoxy needed for innovation and creativity? These are serious issues that deserve more debate, as they could, in the long run, affect the direction of capital flow, America's standing in the world, and our way of life.

Let me wrap up this report with a few personal reflections. As an immigrant who came to the U.S. forty-five years ago – a few months after its Bicentennial – I am eternally grateful for this country's opportunities and generosity. Having lived outside the U.S., visited many countries, and analyzed various foreign systems as a part of my investment work, I remain in awe of our Founding Fathers' genius in creating this more perfect union. For those who tend to be reproachful of America's imperfections, just remember that people vote with their feet. So many around the world still long to come to this shining city upon a hill, and the world looks to us during times of crisis. We have overcome the challenges of COVID-19 by developing the most effective vaccines in record time, and we are now donating them directly to many countries in need. The innovation, generosity, and goodwill are just some of the attributes that make America the greatest nation in history. Let's keep it that way, please.

R.

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