"It's more important to ensure survival under negative outcomes then it is to guarantee maximum returns under favorable ones."

In financial markets as in life despite our preparations to deal with expected outcomes, once they actually occur it is difficult to maintain the rational arguments we were so sure made sense. As Mike Tyson said, "Everyone has a plan until they get punched in the mouth". The topic de jour, as we discussed in our last letter, is the increase in inflation rates tied to the reopening of the economy and the higher growth rates. Battlelines were already drawn in anticipation of the actual event but are even more entrenched now that the price increases are a reality. On one side the Federal Reserve and its apologists believe this high inflation will prove transitory once the economy returns to a more normal level. Others see it as more endemic which will cause interest rates, both market and regulated, to rise to the detriment of stock and bond markets. Each and every data point and economic release is parsed within an inch of its life despite the fact one statistic doesn't make a trend and these numbers are subject to great revision anyway. We were taught in Economics 101 that inflation is too much money chasing too few goods. A reasonable definition but that word "chasing" can be problematic. As we have witnessed after the "global financial crisis" of 2008, despite the massive injections of liquidity by the Fed inflation remained muted. Concerned consumers and corporations were in no mood to chase purchases (with the exception of financial markets). The old expression comes to mind that, "you can lead a horse to water but you can't make him drink". That reluctance was even more intensified during the pandemic resulting in huge increases in household savings and corporate cash balances. The answer to the inflation debate might well be found in how those funds will be spent. If the argument that we are about to experience a "roaring twenties" spending spree the possibility of a more negative outcome for markets increases. At the end of the day though the real danger from inflation happens when it becomes not just an economic and monetary phenomenon, but a psychological one. If the fear of missing out and of rising prices causes consumers to rush out and spend to beat those increases, much higher inflation can become self-fulfilling. We aren't there yet but there are anecdotal examples already appearing. (See used car prices in the absence of new car supply and of course Bitcoin.)

As more and more restrictions are being lifted the U.S. economy is showing solid growth and if the ISM Purchasing Managers Indices are any indication there is more growth to come. While readings in April were lower than in March, they were still much higher than the 50% that signals expansion. The Manufacturing Index was at 60.7%, Services at 62.7% and New Orders 63.2%. There have been a few negative surprises, in particular the April payrolls report that came in at 266,000 new jobs produced after 536,000 in February, 770,000 in March and estimates as high as 2,000,000. Explanations have included supply chain issues, COVID avoidance, or people making more money on stimulus checks than actually going to work. As I mentioned earlier, this isn't yet a trend, extensive revisions are likely and if the seasonal adjustments were removed the number would have been 1.1 million jobs. The strong economy is also reflected in impressive current corporate earnings reports and rising estimates for both 2021 and 2022. There is a caveat though, with such positive expectations the room for disappointment increases.

The recent minutes from the Federal Reserve Board April meeting caught investor's attention as for the first time in a long while the subject was raised of "tapering" the amount of bond buying the Board is making. It referenced only a few members and was characterized as only if it might be time to think about beginning such discussion. In any event chairman Powell remains strongly committed to continuing the current policy and that weak jobs reports came after the Fed meeting which would have muted such talk.

President Biden continues to be under pressure on many fronts. I mentioned in the last letter that China and Russia are testing his resolve and now the hostilities in Israel and Gaza will add to his challenges. The President has been a long term supporter

of Prime Minister Netanyahu going back at least as far as when Biden was Vice-President. That has become a less popular position both in the court of global opinion and perhaps more importantly within his own party as the progressive wing led by Saunders and Ocasio-Cortez is more supportive of the Palestinian position. The divisions within the Republican party are front page news but there are plenty of disagreements within the Democratic party as well. President Biden is faced with not only proposing legislation that can garner Republican support but also meet the differing demands of the moderate and progressive factions in his own party. The White House reduced the infrastructure package by $600 million but it was still $1 billion larger than the Republican proposal and was quickly rejected. A compromise is hard to imagine given the two parties have yet to agree on a definition of “infrastructure”.

I'm following several issues that probably have no near-term impact on markets but have the potential to be game changers. The energy industry, in particular the fossil fuel sector, has long argued that renewable sources like solar and wind are unable to provide power at times of peak demand. Developments in battery technology are expanding storage capacity and bringing down prices thus weakening, if not eventually nullifying, that argument.

The People's Bank of China is slowly introducing use of a digital Yuan. So far it is only being used as an internal replacement for cash, but there are plans to “internationalize” the currency. If it becomes used in cross border transactions it will provide competition for the U.S. dollar which currently dominates trade. As such it would affect the pre-eminence of the dollar and the control the dollar has as the world's reserve currency, which is a goal of the Chinese government.

Finally, there is lots of talk about DeFi (Decentralized Finance), a new method of executing one-on-one financial transactions using the blockchain technology behind cryptocurrencies and avoiding processing institutions like banks and brokers. I only understand the technology enough to be dangerous, but if you, like me, have experienced an ATM tell you your transaction will be processed after the weekend or had a teller say your cheque deposit will clear in about a week, the theory has appeal. There are many hurdles before there will be any widespread availability, but it could be transforming for the financial services industry.

I'll leave you with a quote from Howard Marks, one of the smartest and most reasoned market commentators: “It's more important to ensure survival under negative outcomes then it is to guarantee maximum returns under favorable ones.”

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