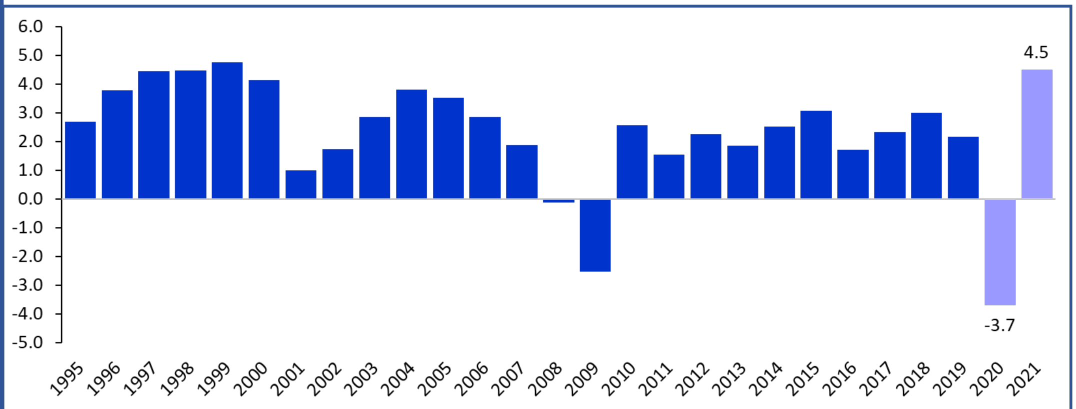
New Roaring Twenties?

Real GDP Growth - % change from previous year



(1) Source: Federal Reserve | December 2020
(2) Note: 2020 & 2021 are consensus estimates

Covington IA Research

The outlook now is all about a return to normal life in 2021. The baseline outlook as we head into the New Year is we have a coiled economy loaded with pent up demand being release by a vaccine rollout, full reopening, and additional $2,000 stimulus checks. Retail inventories are at an all-time low and a replenishment at these levels is likely to drive a manufacturing cycle that could last years. On the monetary side, central banks have been adamant about keeping policy loose even going so far as changing their framework on inflation targets. Many are characterizing the Post-Covid reopening as a euphoric economy akin to the "New Roaring Twenties". Take that as you will.

Although it seems there is light at the end of the tunnel, near and long-term risks cannot be ignored. The two largest downside risks to the economy in 2021 are an unsuccessful rollout of the vaccine, and/or runaway inflation causing the Federal Reserve to renege on the signal that rates will remain zero until 2023.

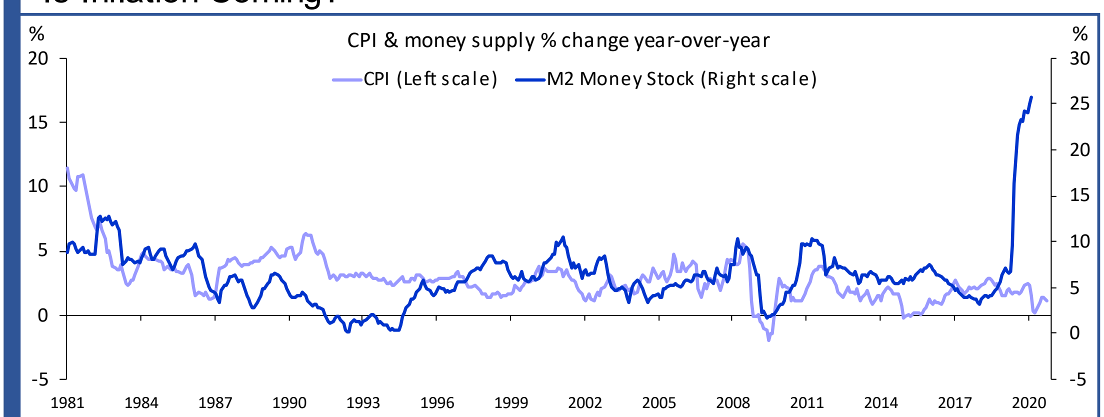
On the vaccine front 3 million shots were given in 2020, much less than the goal of 20 million by year end. Still, we think logistics will be hashed out enough in the coming weeks to vaccinate close to 1 million people per day starting in early 2021. To reach herd immunity by end of 2021, assuming 80% of the population need to be inoculated, the US will have to quickly ramp up the daily administered doses in the second half of 2021. The Covid-19 virus is also mutating which can complicate the vaccine rollout. Our vaccine development will have to evolve with it. This means developing advanced genome-sequencing capabilities to meet the needs of advanced detection capabilities.

The inflation question is more difficult to answer. The initial damage from COVID was a demand side shock that was overall deflationary. Interest rates fell, commodity prices plummeted (if you recall oil futures contracts in March traded at negative prices), and money velocity fell to its lowest ever reading. But subsequently central banks rushed to plug holes in the economy by lowering rates, enacting unlimited quantitative easing, and creating credit facilities to lend money to corporations. The Federal Reserve even went as far as purchasing high-yield corporate bonds through credit facilities which was an unprecedented action. Money supply in the US increased 26% in 2020. Of course, these actions start raising flags that runaway inflation will be the consequence.

What makes inflation difficult to forecast is that it is about more than just increasing money supply. If increasing money supply alone caused inflation, the last decade would have been characterized by rising prices as central banks expanded their balance sheets and M2 money supply[1] rose consistently more than GDP since the Global Financial Crisis. The opposite has taken place and inflation, as measured by CPI & PCE, has not sustainably eclipsed 2% in the last business cycle. This can mostly be attributed to structural factors of economic growth (population growth, productivity growth, technology) which have overwhelmed any central bank tool to spur lending and economic expansion. But at the same time, there is a limit on the amount of Fiscal and monetary support that can be taken before inflation takes place.

[1] M2 is a measure of the money supply that includes cash, checking deposits, and easily convertible near money.

Is Inflation Coming?



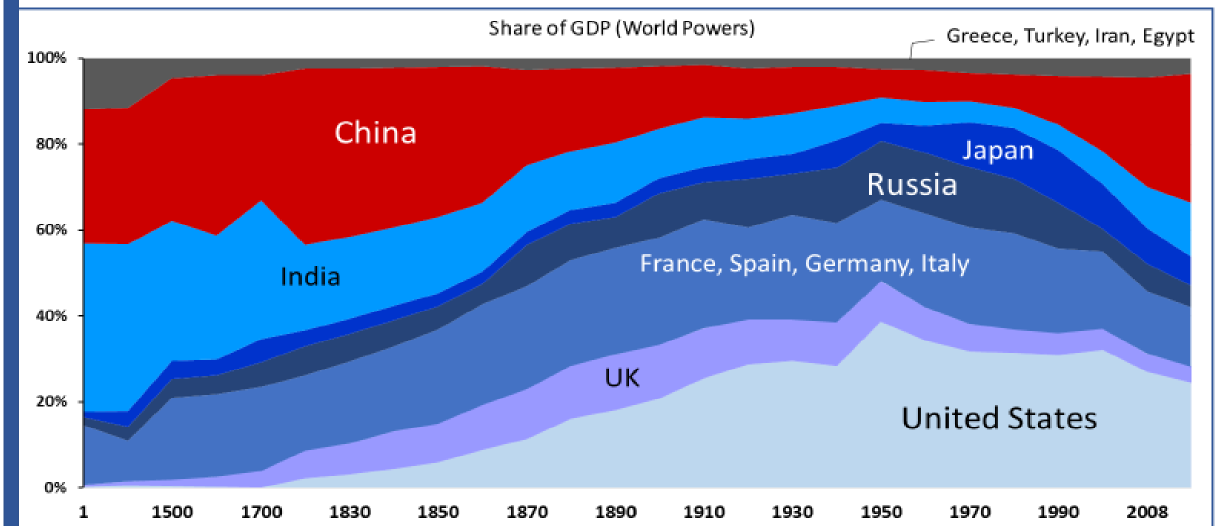
(1) Source: Federal Reserve January 2020
(2) Note: M2 includes a broader set of financial assets held principally by households.

Covington IA Research

In short, our view on inflation is that the unprecedented fiscal and monetary actions in 2020 will likely cause some uptick in inflation in the next 12-24 months as slack begins to pick up in the economy. This view coincides with the Federal Reserve's policy framework of keeping interest rates at zero until 2023. But eventually the structural factors of the economy and low rates abroad will keep a lid on rates.

Era of De-Globalization

Historical Share of Global GDP

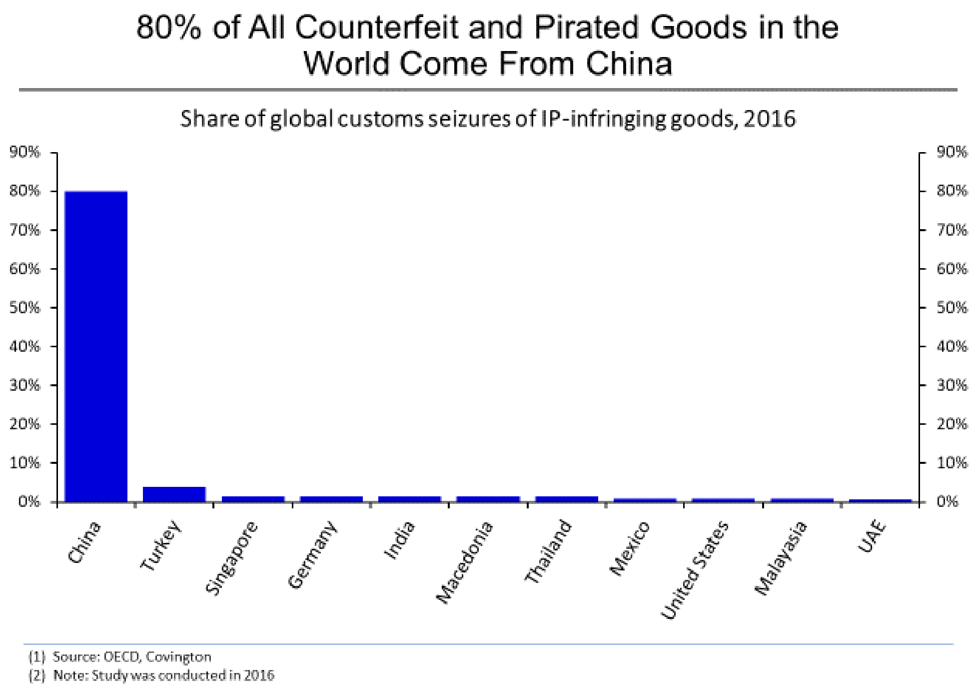


Source: Visual Capitalist, Maddison Database

Covington IA Research

International trade has taken a backseat in 2020 & 2021 due to obvious circumstances but looking ahead it may be important as ever. The last 25 years have been shaped by globalization, international trade, and the integration of the emerging/developing world. China in particular has seen its economic fortunes benefit as the assumption from the West has been as the country developed it would increasingly become more Western in its outlook, and fully integrate with the liberal world order. This has not been the case. The rise of China and decline of US & European manufacturing since the 1990s have led to a rise in nationalist, anti-globalization sentiment boiling over with the US & China Trade war in 2017. The COVID-19 pandemic has not helped to heal these tensions and likely will be a political wedge used by both the West and China to reverse the trend of Globalization.

Technology and intellectual property will be a sticking point. A 2016 study conducted by the OECD found that 80% of all pirated goods in the World come from China/Hong Kong. And on the other side, over 20% of these pirated goods was IP sourced from the US. This dynamic illustrates why closing the trade gap between the US and China is difficult. The Biden administration is perhaps seen as more dovish on China than the Trump administration, but there is enough bi-partisan support for action to be taken that it is not going to go away. The most likely scenario is that Biden will approach the issue in a more multi-lateral method rather than the uni-lateral strategy of the Trump administration.



As China moves to become the World's largest economy its relationship with the West will likely deteriorate into a bipolar standoff as the spheres will remain trading partners, but constantly be weary of integrating too far. One of the most significant legacies of COVID-19 could be a reshaping of the World supply chain in manufacturing, trade, tariffs, and technology.

New Presidential Administration

2021 will feature the integration of a new Presidential administration. In the past we have wrote extensively regarding our opinion that letting politics dictate significant investment decisions is a mistake. Instead, we try to focus on what we know, and when it comes to legislation, taxes are perhaps the most concrete information we have. In past notes we have written about Bidens policy as it pertains to corporate taxes, but now we have more information about his holistic tax policies including personal taxes. Below is a summary of his key policy initiatives:

Biden Tax Policy Summary

Personal Taxes	▪ Increase top individual tax rate for taxpayers with incomes above \$400K to 39.6% from 37% ▪ Tax long-term capital gains and qualified dividends at the ordinary income tax rate for incomes above \$1mn ▪ Impose payroll tax on wages earned above \$400K ▪ Cap the value of itemized deductions for high earners ▪ Phase out business income deduction above \$400K ▪ Increase 401(k)/IRA incentives ▪ Expand a number of tax credits including the Earned Income Tax Credit for childless workers aged 65+ and renewable-energy tax credits for individuals
Corporate Taxes	▪ Increase the corporate income tax rate from 21% to 28% ▪ Increase the tax rate on Global Intangible Low Tax Income (GILTI) earned by foreign subsidiaries of US firms from 10.5% to 21% ▪ Impose a minimum 15% tax on US-based corporations with a 'book profit' of \$100mn or higher ▪ Reduce real-estate tax preferences ▪ Offer a Manufacturing Communities Tax Credit to businesses that experience large workforce layoffs ▪ Expand the New Market Tax credit for investment in low income, distressed communities ▪ Provide tax credits to small businesses for adopting workplace retirement savings plans

(1) Source: Tax Foundation, Biden Campaign
(2) November 2020

Covington Investment Advisors

The likelihood that he will be able to implement all of these, even with the favorable outcomes in the January 5th runoff elections, is questionable. And the policies that he can pass will likely look different once put through the Washington legislative process.

While markets have been surprisingly immune to political headline risk, we still believe the presidential transition is likely to cause at least some volatility in 2021.

Bitcoin: Revolutionary Digital Asset? Or Sign of Excess & Mania?

Becoming more and more difficult to ignore, Bitcoins meteoric rise has filled the media in the last six months. The headline above might be a bit misleading because this is not so much about dissecting whether bitcoin is a savvy investment or not, but more about why we have reservations about the safety of cryptocurrency as an asset and its place in a portfolio.

The first issue with bitcoin is that no one seems to be able to decide whether cryptocurrency is a true currency, or a store of value/investment vehicle. If it is a storage of value it is not a very reliable one because its price fluctuations +/- 50% consistently within a calendar year.

And if bitcoin is a true currency then its volatility would make it virtually unusable. For example, imagine agreeing to pay a contractor to redo the roof of your house one month ago. If that service were paid for in bitcoin, the same service would cost 30% more one short month later. This could also go the other way and the service you paid for (or were paid to do) would have fallen by 30% depending on when this is being read (see the point).

But currency is also a unit to account for debt. Yet bitcoins wild price swings make it difficult to think about financing even a relatively small transaction such as the example above, let alone a large transaction such as purchasing a house or car with cryptocurrency debt. In 2017 and 2020 the price of bitcoin denominated debt would have risen more than ten-fold. However, because salaries are all paid in dollars, euros, or other currencies, they have not grown as rapidly. As a result, had bitcoin been widely used, these time frames would have been massively deflationary.

The counter argument to this is that price fluctuations would decrease if bitcoin were widely adopted *for all currency transactions*, but there are two main impediments to this:

1. Bitcoin is still very far from a frictionless payment medium and transactions take much longer than cash/debit conduits. In a report by the Federal Reserve, it was noted that wallet-to-wallet transactions are relatively frictionless but when the 'coin' enters other currency exchanges that changes. Transaction times for bitcoin have fallen significantly since its founding but have plateaued at roughly 10 minutes. This is compared to cash/debit which are virtually instant. New technology could change this.
2. No one seems to be able to describe how paying workers in bitcoin would realistically work. The purported plan by many crypto advocates is just "pay the workers their salary in bitcoin!" So, for example, a worker who makes a $50k/year salary would just be paid with $50k of US dollars automatically converted into bitcoin. *But this salary is still denominated in US dollars.* The worker gauges the purchasing power of their salary by knowing how much in dollars their salary will be, not how many bitcoins. So, in this example, for bitcoin to be the denomination currency, the same worker would instead receive 1.5 bitcoins per year going forward as their salary rather than $50,000 dollars. Is it realistic to think all businesses and workers will convert to this method any time soon? At this point it does not seem likely for an economy/world that has used the US dollar as the reserve currency for over 100 years.

So, all this creates a chicken/egg problem where if the price is not fluctuating/increasing by large amounts a year than people lose interest with it, but if its price is fluctuating so much than it renders it useless as its primary purpose as a currency. Bitcoin certainly has proved itself as a useful ***untraceable and untaxable*** payment system which has made it a favorite to be used in illicit activities. But once again this creates a paradox where governments understand this and will do everything they can to squash the payment.

Another hurdle for bitcoin becoming the “currency” of the world is being able to meet the needs of our monetary system. The foundation of our modern economy relies on a fractional reserve banking system to grow the economy. To summarize, this entails subsidiary banks being able to expand the money supply by lending out multiples more of their reserve deposits. Since Bitcoin is a finite asset with a fixed supply of 21 million coins, how would the economy expand credit during a downturn if no new coins can be created? This would theoretically constrain the ability for economies to grow and worsen the severity/length of recessions. It’s the same reason why we no longer adhere to the gold standard. In a way, it would be a step back in the money system, not advancement. Many gold and Bitcoin advocates would argue that being able to significantly fluctuate the money supply has negative consequences which would certainly have some merit, but its only one aspect of the equation. Imagine if when the economy undergoes a shock such as what was experienced in March of this year, and the money conditions were not able to be eased. This would have dramatically worsened the severity and length of the economic shock.

The final reason we struggle to find a place for bitcoin in a portfolio is there is no way to accurately value a bitcoin. Is bitcoin worth $1 or $1 million dollars? There really is no way to value it making it a speculation not an investment. When purchasing a share of a corporation that produces hard earnings or dividends in dollars it can theoretically be valued in said dollars. Bitcoin as an investment is bought with the pure hope that at some point the buyer will be able to sell it to another person at a higher price in the future. History has shown that purchasing an asset with this intention has almost always been a mistake.

Being Prepared for 2021

Although we try to forecast and plan for what the future will hold, 2020 proves that a new year almost always brings surprises in one form or another. Having a diversified portfolio, being prepared with a plan, and sticking to proven investment principles are keys to achieving long-term financial goals.