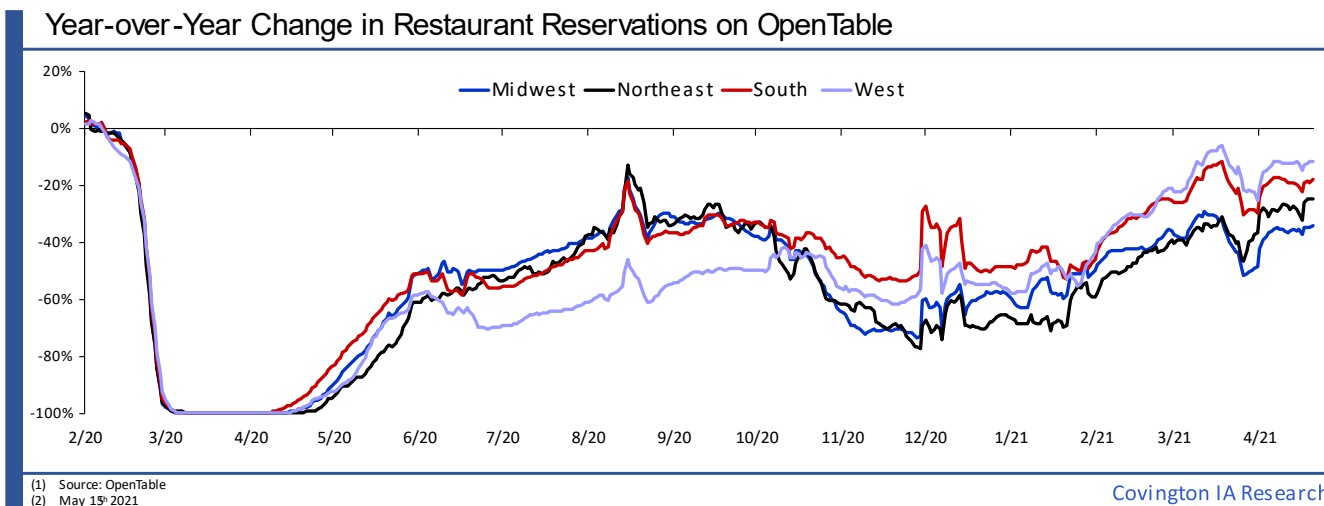




Tracking the Recovery



One year removed from the onset of Covid and economic activity continues to normalize, and the risk posed by Covid fades further. This has shown up in most measures of economic data surprising to the upside and equity earnings forecasts being revised higher as the year goes on. There is still a ways to go before a full recovery but the economy remains on track. Virus cases have continued to decline and deaths along with it. As of writing this the 7-day average of Covid deaths has fallen below 500 in the United States and the UK has even reported its first day with 0 Covid deaths.

The Covid vaccine rollout which we pegged as a key risk to the economy in our January outlook has so far been successful with over 60% of the US adult population receiving at least one dose. Vaccine doses administered are slowing, but this was to be expected to a point after crossing a certain percentage threshold of the population. Not only the volume but the effectiveness of the vaccines has given reason for optimism with Moderna publishing results from a study showing 100% effectiveness against the virus for ages 12-17 and >90% for other age groups.

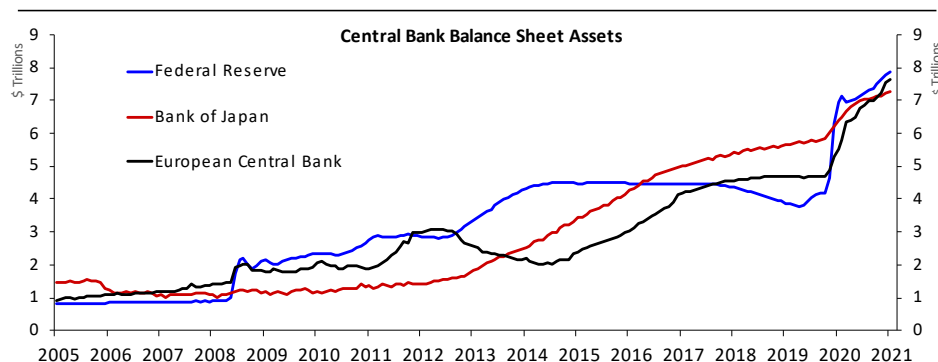
With the fade of Covid consumer activity has continued to steadily rebound. High frequency data such as OpenTable seating reservations (see graphic above) and Google mobility data is almost back to its pre-Covid peak. TSA passenger data remains below pre-Covid levels with TSA checkpoint throughput on May 31st, 2020, 24% lower than the same weekday two years ago. But a continued rebound in travel is expected to be a matter of when, not if.



The primary risk present in the economy now is a double-edged sword: The quick snapback in the economy is now at risk of overheating. In our January outlook we outlined inflation as a key risk for 2021 as the World emerges from Covid and inventories were at all-time low levels. Turbocharged stimulus has exacerbated supply chain bottlenecks and now signs of wage inflation are also beginning to pick up. This dynamic has sparked a debate in the economic world of whether this inflation is really going to be transitory, or a new paradigm lies ahead for the next decade. We discuss this at length in the next section.

And what comes along with rising inflation risk and an overheating economy? A tapering of the aggressive stimulus support which we have been talking about extensively over the last 15 months. So much so that most people would be perfectly fine if they never heard the word “unprecedented” ever again.

Central Banks Have Been Aggressive With Asset Purchases



(1) Source: Federal Reserve
(2) June 2021

Covington IA Research

In our view the Federal Reserve slowly ‘pulling away the punch bowl’ will be the next source of volatility in the second half of 2021. In response to mounting inflation pressures Fed officials have begun to discuss the prospect of tapering asset purchases and investors have brought forward their expectations for when the Fed will eventually begin to hike rates.

We view the premonition of hiking rates as premature, and the more likely scenario is for Fed Chairman Powell to publicly signal at the annual Jackson Hole conference in August that the Fed is contemplating winding down parts of the quantitative easing¹ program. After this signal it will likely take months until the Fed acts and then another stretch of time until rate hikes come into possibility. This will cause some volatility, but stock returns have historically remained strong until the latter parts of a fed hiking cycle when the yield curve inverts (signaling that bank’s propensity for lending is drying up). In the last 4 rate hiking cycles (1994,1999,2004,2015) the S&P 500 has gained an average of 9.5% in the twelve months prior to the first hike, and 26% over the subsequent 3 years.

¹ Quantitative easing—QE for short—is a monetary policy strategy used by central banks like the Federal Reserve. With QE, a central bank purchases securities in an attempt to reduce interest rates, increase the supply of money and drive more lending to consumers and businesses.

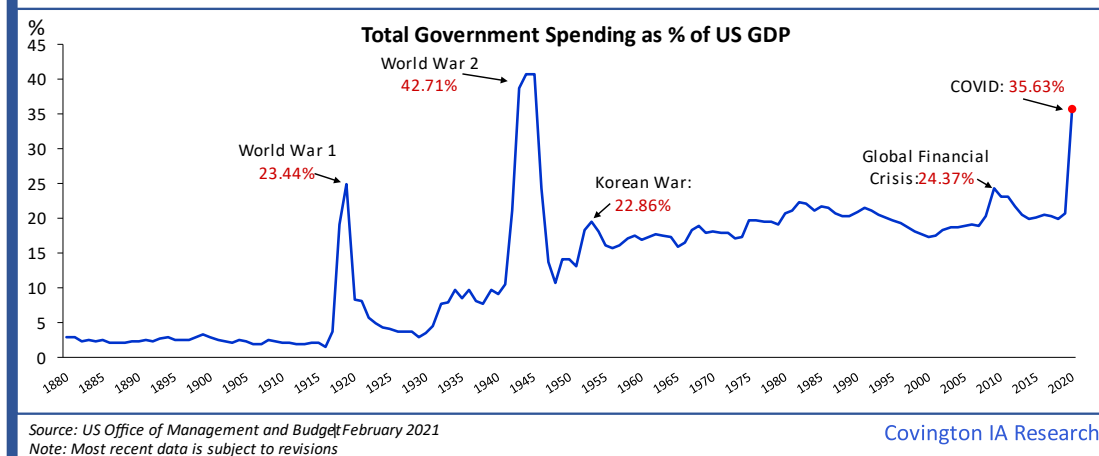


All About Inflation

Inflation has always been a polarizing topic, but fuel has certainly been poured on the fire with the advent of rising prices coming out of Covid. As we step into the new world, many are trying to figure out how much of what we understood about macroeconomics is still valid. And some are just asking, is it really a new economic world at all?

The Federal reserve has been adamant about communicating that they believe the inflation pressures will prove to be transitory as the bottlenecks relieve themselves and slack in the labor market gets picked up. In a recent note we outlined the perspective tentatively supporting this view but also hinted at there being merit to the other side of the argument: What if it's not transitory?

US Government Spending Highest Since WW2



The most immediate manifestation of the policy risk today is a shift in the fear of inflation, and of rising levels of government debt, that shaped a generation of policymakers is receding. This has boiled over with an economic response to Covid the likes of which have not been seen since World War 2. Since the 2008 recession economists have been scratching their heads because the traditional policy mechanics that have created inflation have seemingly broken.

Since the Financial Crisis central banks have cut interest rates to all-time lows (even negative in some cases), ballooned central bank balance sheets via large scale asset purchases, and governments have widened budget deficits to historical records.



All of these in the past would signal that currencies should weaken and inflation would skyrocket. In fact, many alarmed that these actions would cause hyperinflation similar to Weimar Germany in the 1920s well known by the infamous pictures of citizens using their currency, the Papiermark, as wallpaper or kindling. The more recent Zimbabwe instability has created a similar environment where a legitimate Zimbabwean 100 trillion-dollar bill can now be purchased as a novelty on the internet for a couple hundred US dollars. But in practice, the opposite has taken place. Developed economies around the world have instead been fighting deflation and nominal GDP growth among most developed economies have been below historical trend.

German Banknotes Being Used as Wallpaper, 1923



Source: Bloomberg | June 2021

Zimbabwe One Hundred Trillion Dollar Bill²



Source: Amazon | June 2021

² We actually have one of these notes in our office. Although now obsolete, they can still be purchased on Amazon for around \$250.

Central Banks have (*hopefully*) learned from institutions like Weimar and Zimbabwe and instead of using tools to print legal tender, what developed Central Banks have been doing for the last decade is more akin to printing debt. Meaning through the alchemy of quantitative easing ¹ and other tools, central banks essentially have just ensured subsidiary banks do not stop lending money into the economy and governments can finance their bloated budgets which will eventually need to be repaid through taxes.

The consequences of this have puzzled market observers over the last two decades especially when comparing this inflation regime to that of the inflationary period of the 1970s. But it is important to remember that the economic world of the 1970s was different from today's in several key areas. The first is that until 1971 the value of the dollar was pegged to gold whereas today almost all world currencies are free floating. Furthermore, technology and globalization have been massively deflationary pressures which were not present in the 1970s.

Additionally, central bank tools were still in their infant stage in the 1970s. Quantitative easing, which has been the tool of choice for Central Banks for the last two decades had yet to really be pioneered. For these reasons anchoring inflation beliefs to the 1970s has not been a useful mental model. Today really is uncharted waters.



To illustrate this the Federal Reserve conducts a quarterly survey where they ask economists at large financial institutions what their forward forecasts are on a handful of financial metrics including inflation and interest rates. One of these metrics is the 10-year treasury rate which is impacted by various factors, but primarily growth and inflation expectations. If the 10-year treasury rate is increasing it usually signals that inflation and growth are predicted to rise. The chart below plots the average of the annual forecasts made by the economists (dotted black lines) versus what the actual 10-year treasury rate has turned out to be (blue line). As can be seen the economists have been forecasting higher rates since 2003 meaning higher growth and inflation, which has just not materialized.

Once again, the consensus position today among these forecasters is that rates will trend higher from here (red dotted line) and along with it an inflection in growth and inflation. But the poor track record of accurately predicting this has led the Federal Reserve and many market observers to a 'show me' approach to the prospect of rising inflation.

Wall Street Has Been Forecasting Higher Rates Since 2003



Could this combination of a Fed policy shift tolerating higher inflation, an unprecedented amount of stimulus being injected into the economy, and a Presidential administration with ambitious social spending goals signal that the Fed will be behind the ball to curb potential inflation? That in a nutshell encapsulates the other side of the 'transitory inflation' argument which investors need to be prepared for.



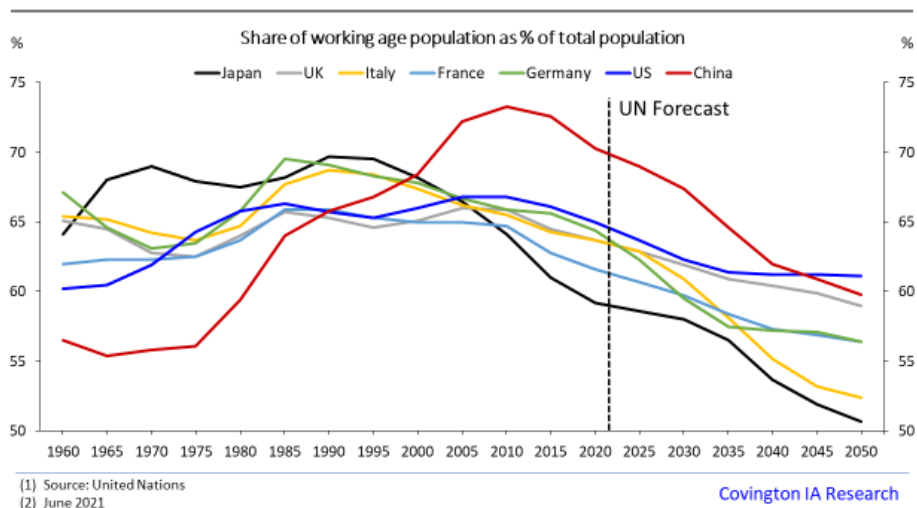
What do the Demographics Say?

The erratic track record of the professional forecasters also leads to the question, why have economists consistently overshot inflation and growth expectations for so long? One school of thought could be that too much emphasis has been put on the mechanical levers of inflation (interest rates, quantitative easing, deficits) and not enough on the structural drivers (population growth, technological deflation, globalization of supply chains, debt anchor, productivity decay).

Looking forward we have a scenario where the mechanics have been pushed to the extremes, but the structural outlook is no better than it was pre-Covid. Demographics among the developed world are projected to stagnate in the coming decade with some countries facing the risk of shrinking. Even the once booming population of China is projected to peak in 2030, partially attributed to the One-Child policy of the 1980s. In our view this stagnating population will serve as a headwind for long-term growth and inflation.

In this respect, Japan could be used as a roadmap for the rest of the developed world. Japan is an example of historically inflationary policy tools, even when used to the extreme, not being able to overwhelm a stagnant economy awash in debt

Stagnant Outlook For Developed World Demographics





Mid-Year Preparation

And ultimately what does all of this mean for an investment portfolio? For fixed income, inflation is not a welcomed pressure. We remain biased towards equities in this environment as rising rates will cause a selloff in bond prices. The 40-year bull bond market starting in the late 1970s which was defined by falling interest rates and rising bond prices may finally be over.

Inflation is also a threat to speculative growth companies which trade at sky-high multiples. This pocket of the market performed well in 2020 but have lagged so far in 2021 and continue to be at risk of multiple compression. We remain conscious of our multiples paid for investments and we think this cautious approach lends itself to a rising rate environment.

Treasury Inflation-Protected Securities, or TIPS, are another tool which historically have been added to portfolios to protect against inflation. But one part of the aggressive actions by the Fed since last March has been buying up a huge amount of the TIPS market to control inflation expectations. For example, the Fed has purchased almost all the new TIPS issued in the last year and now owns over \$300 billion in TIPS. So, most of the TIPS market is trading at prices where even if the US economy ran hot reaching inflation of 3-4% the nominal yield on a TIPS security would not offer much upside. And if the Fed were to begin tapering purchases soon as we think they will, it could create an air pocket in the TIPS market. We look at TIPS in today's environment as taking on risk with the prospect for not much reward.

In our view the investments which are best equipped to handle inflationary environments are dynamic firms which are in a strong competitive positioning allowing them to raise prices. These companies are ultimately the ones that would be facilitating the inflation. This strategy is an extension of our core philosophy we constantly abide by: Own shares of proven enterprises at reasonable prices, and then allow the business to compound its value over time.

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