Gerry's Journal

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This Too Shall Pass

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As the world slowly returns to normal, it's a good time to take a moment and reflect on the journey we have collectively travelled during the last year. In doing so, I'm reminded of the story of King Solomon and Benaiah ben Yehoyada.

Benaiah ben Yehoyada was the leader of King Solomon's army and one of the king's most trusted ministers. The king wished to humble Benaiah, so he gave him a seemingly impossible task: Solomon asked Benaiah to bring him a ring with magic powers that could make a happy man sad and a sad man happy. The king gave his minister six months to complete the task and off went Benaiah to scour the country in search of this ring.

The night before he was to deliver the ring to the king, and unsuccessful in his search, a despondent Benaiah wandered a poor section of Jerusalem and came across a merchant. He asked the merchant if he had ever heard of such a ring, but the merchant had not. The merchant's grandfather then appeared, selected a plain ring from the display case, and engraved something on it. When Benaiah saw the inscription, his face broke into a smile. The next day, he returned to King Solomon, who was smiling in anticipation of teaching his minister a lesson in humility. Benaiah handed Solomon the ring, and the king's smile turned to a frown as he read the inscription:

This too shall pass.

The story of King Solomon and Benaiah is an allegory for the impermanence of all things, a reminder of the value of humility in glory and optimism in hardship. It feels especially relevant as we look back on the past year. Millions of people were devastated by the pandemic: some lost their jobs, others lost loved ones, and still others lost their lives. Many of those fortunate enough to remain employed also struggled with socially-distanced work environments, separation from family and friends, a disrupted work-life balance, and the stress of navigating life during a global pandemic.

Since March of 2020, we have seen a significant recovery in the economy and equity markets in a very short period of time. Like in March of 2020, we again come back to the story of Solomon — this too shall pass — and we feel it is unlikely that the exceptional returns observed during the last year should be extrapolated into the future. While we are not projecting a dramatic decline in equity markets, it is important that we collectively manage our expectations for the future. To aid in our analysis, we have been following and will continue to follow a "dashboard" of market factors. The first six factors each have the potential to influence the direction of global investment markets, and the final factor is what we believe is the best way to navigate through these markets. Taken together, these factors form the acronym VERITAS.

- **V**accination program
- **E**conomy
- **R**ates
- **I**nfrastructure
- **T**axes
- **A**sset bubbles
- **S**trategic allocation

What follows is our perspective on each of these critical topics.

Vaccination program

Since the pandemic began, the ongoing rollout of the COVID-19 vaccination program has had the greatest impact by far on past and present market developments. When the pandemic first hit, many believed it would be years before a viable vaccine could be developed; after all, coronaviruses and rhinoviruses share a number of similarities, but no vaccine has ever been developed for the common cold. Fortunately, we saw a number of vaccines being developed and put into operation at the end of 2020. In January 2021, vaccination rates averaged around 350,000 people per day; by April, rates averaged over 3 million vaccinations per day. So far in May, the number has come down to a little more than 2 million per day[1], but overall the progress we have made is remarkable, and it portends a light at the end of the tunnel.

That said, however, the base case that has been incorporated into our economic recovery and our ability to resume some level of normalcy (e.g., going out to restaurants, visiting friends and family) is still predicated upon the assumption that we will maintain the rate of progress we have seen thus far. Achieving full vaccination — or as close to it as is reasonably possible — in the United States is the first priority, but we won't be able to fully put the pandemic behind us unless we can achieve the same success across the globe. Accordingly, it is vitally important for the U.S. to provide as much support and assistance as possible to not only its own citizens but to citizens of the globe. In the meantime, if new mutations or variants emerge that are more contagious or more lethal, then our base case assumptions will be disrupted, and the capital markets will respond accordingly.

Economy

The economy is recovering well, with Q1 data released on April 29th showing a quarterly GDP growth rate of 6.4%.[2] With the exception of the Q3 recovery of last year, which had a print of 33.4%[3], you would have to go all the way back to Q2 2003 to find a quarter that had a stronger period of growth in terms of GDP than the one that just concluded.[4] But remember: this too shall pass. There are still 8 million people

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[1] Our World In Data, *Coronavirus (COVID-19) Vaccinations.* (Link)

[2] CNBC, *Consumer-fueled economy pushes GDP to 6.4% first-quarter gain.* (Link)

[3] Associated Press, *Q3 GDP estimate gets a slight upgrade to 33.4% growth.* (Link)

[4] CNN Money, *U.S. economic growth revised up.* (Link)

who lost their jobs due to the pandemic and are still unemployed.[5] The economic recovery is continuing, but it will not just be smooth sailing as there will doubtless be some choppy seas to navigate.

Rates

Interest rates are another area of great importance. At the end of 2020, 10-year Treasuries were yielding less than 1%; during Q1 2021, Treasuries moved close to 1.75% before settling in the 1.55–1.65% range, where they remain today.[6] This may not sound significant, but for the bond market, this was a massive move. It is a great time to be a borrower, but opportunities for fixed income investors remain limited. And while the Federal Reserve has continued to express its commitment to maintaining accommodative monetary policy, it is only one player, albeit an important one, in determining where interest rates are and will be going forward. If the bond market anticipates that we will be entering a period of above average inflation, you can anticipate that interest rates will move higher. As mentioned in Barron's this week, "Reported inflation, even with its flaws, has started to rankle investors worried that the Fed might already be behind the curve. Consumer price index, or CPI, data from this past week show that prices rose 4.2% in April, or 3% without food and energy."[7] We will be closely watching rates — and inflation — in the coming months.

Infrastructure

Infrastructure has been a popular talking point in recent years, and it has been clear for decades that a refresh of U.S. infrastructure is badly needed. Our roads, railways, bridges, and airports have fallen into disrepair. This presents security issues (for example, the recent ransomware attack on our pipeline infrastructure) and safety issues; beyond that, without an efficient and robust infrastructure, the U.S. economy is operating at a competitive disadvantage.

There is bipartisan consensus on Capitol Hill and Pennsylvania Avenue that our infrastructure must be addressed, but as is often the case, the devil is in the details. Democrats have proposed the American Jobs Plan at a projected cost of $2.3 trillion[8], while the Republicans' plan would be less than one quarter of that amount ($568 billion).[9] Once upon a time, the "b-word" (billion) represented a significant government expenditure and got people's attention; these days, that seems to be reserved for the "t-words": trillions and taxes.

Taxes

The new tax initiatives proposed by progressive congressional Democrats and the White House give new meaning to the phrase "go big or go home." The tax proposals are remarkably ambitious, as are the initiatives that the tax revenue would fund: the $1.8 trillion American Families Plan would increase the corporate income tax rate and use the additional funds to address teacher shortages, provide comprehensive paid family and medical leave, expand nutrition assistance, invest in mental health

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5 Reuters, *With 8 mln Americans out of work, why are more companies not filling jobs?* (link)
6 U.S. Department of the Treasury, *Daily Treasury Yield Curve Rates*. (Link)
7 Barron's, *Inflation Is Here and Hotter Than It Looks. Why It's Time to Worry.* (Link)
8 Forbes, *Biden Aims to Create Millions Of Jobs With New $2 Trillion Economic Plan.* (Link)
9 NPR, *Countering Biden, Senate Republicans Unveil Smaller $568 Billion Infrastructure Plan.* (Link)

services, and expand tax credits for working families.[10] The aforementioned $2.3 trillion American Jobs Plan would fund infrastructure improvements primarily through an increase in the capital gains tax rate on those in higher income brackets.[11] And remember, these proposals are in addition to the $1.9 trillion American Rescue Plan that already passed earlier this year.[12] In all, this represents nearly $6 trillion in potential spending, with a variety of suggested ways to fund that cost.

The word “unprecedented” is often overused, but in this case, it is an apt characterization. While we are hopeful a reasonable compromise will be reached, if these plans were to be implemented as they are now, there would be some worrisome elements, including increasing capital gains tax rates from 23.8% to 43.4% (not including any state capital gains taxes). And there remains debate whether a significant rate increase would bolster tax revenue: according to research by the Tax Policy Center, the revenue from the long-term capital gains tax is maximized around 28%, after which revenue recognition may decline.[13]

It is unclear at this time what will be passed by Congress. Democrats need unanimous agreement on their proposals in the Senate, which is far from a foregone conclusion. If the majority of these initiatives do pass and lead to significant tax increases, it is very likely that Democrats will lose their slim Senate majority in the midterm elections. Is there room for compromise? Is there a way to focus on addressing the mission-critical elements of infrastructure that are necessary for national security and economic prosperity? It remains to be seen, but we remain cautiously optimistic.

Asset bubbles

Whether we are, in fact, in an asset bubble depends primarily upon your view of interest rates. If you believe interest rates will remain low for an extended period of time, you can justify *some* of the multiples that investors are willing to pay for certain companies. In our view, however, interest rates are unlikely to remain at these low levels for very long, and a gradual rise in rates in response to continued economic expansion is not necessarily the negative that is often portrayed.

First, an interest rate increase would create greater opportunity in fixed-income securities; as interest income comes off, or bonds mature, proceeds can be reinvested into higher-interest-earning bonds. Second, an interest rate increase would reintroduce some discipline into the borrowing process. We are seeing companies take advantage of low rates and add additional leverage, but as Warren Buffet famously said, “Only when the tide goes out do you discover who's been swimming naked.” When interest rates move up and the tide goes out, the companies that took on a lot of variable debt now will face additional stress on their income statements, and their valuations will be adjusted accordingly — assuming, of course, they can afford to service those debts.

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10 The White House, *American Families Plan*. (Link)

11 The White House, *American Jobs Plan*. (Link)

12 The White House, *American Rescue Plan*. (Link)

13 Tax Policy Center: *A New Study Suggests Congress Could Raise Money By Increasing Capital Gains Taxes To 47 Percent. But There Is A Catch.* (Link)

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Strategic allocation

All the factors mentioned above underscore the importance of having a strategic allocation that is disciplined and consistent with your short- and long-term financial objectives. We understand how challenging it can be to stick to a strategic allocation, especially when the markets sometimes seem to ignore risk. Our role is to provide a steady hand that can help you navigate through these challenging times. Remember, it is extremely difficult to be a successful long-term investor. It is next to impossible to be a successful speculator, especially a part-time one.

If you're anxious about the pandemic, this too shall pass. If you're enjoying the outsized returns from the last year, this too shall pass. If the partisan rancor and vitriol is making you feel uneasy, this too shall pass. And if you are experiencing FOMO from missing the latest meme stock, this too shall pass. In the meantime, our team will continue be here to provide guidance and support as you continue to move toward your financial goals — and this shall not pass.

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