Gerry's Journal

July 29, 2021

$64 Questions For The Second Half of 2021

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In the early 1940s, there was a radio game show called *Take It or Leave It*. The rules were simple yet proved to be a format quiz shows would follow to this day: contestants would be asked a series of questions, each more difficult than the last. If the contestant answered enough of these questions correctly, they would win the show's top prize of 64 silver dollars (roughly $1,200 in 2021, accounting for inflation).

The show was popular enough that the notion of the "$64 question" has entered the common lexicon, and today this phrase is used to describe any question that is complex, difficult to answer, and of material importance. You may have heard it phrased as the "$64,000 question," a reference to the 1950s TV game show that shared the same structure as *Take It or Leave It*, just with larger prizes. As we begin the second half of 2021, the market is wrestling with several $64 questions, each relating to distinct segments of the economy and each with the ability to materially impact investment markets.

In this edition of Gerry's Journal, we discuss several of these critical questions and share our perspective on the matter. Like last quarter, we will use an acronym — CREDIIT — to capture the salient topics to aid in a review of our analysis:

- **C**OVID-19
- **R**ates
- **E**conomy
- **D**ebt
- **I**nflation
- **I**nfrastructure
- **T**axes

As always, if you have questions about the information shared or how it may impact your wealth management strategy, we invite you to connect with your wealth advisor.

COVID-19

The collective efforts of scientists, drug companies, federal & local government, and healthcare providers resulted in an extraordinarily fast vaccine rollout in the United States. This was highlighted on April 10th, when more than 4.63 million Americans received a vaccine dose in one day— a pace that far exceeded vaccine distribution in other developed nations.[1] Since that peak, we've seen a steady decline in daily vaccinations, driven largely by declining demand. Several months ago, many observers opined that while a 50% vaccination rate in America wasn't ideal, it might be sufficient to stem the spread of COVID-19. The spread of the COVID-19 Delta variant in recent weeks has brought that assumption into question.

Right now 82% of all COVID-19 cases in the United States are the Delta variant, up from just 2% two months ago.[2] And since June, the 7-day average of new cases in the U.S. has risen from roughly 10,000 per day to over 50,000 per day.[3] For the unvaccinated portion of the population, this presents a significant problem, as the Delta variant is reported to have a viral load that is 1,000 times higher than the original strain of the virus.[4] In terms of the modeling, the most likely scenario puts the peak of this wave around mid-October in the U.S. with 60,000 infections and 850 deaths each day. However, the worst-case scenario is a much more dire picture, with potential for 240,000 daily infections and 4,000 daily deaths — approaching the peak of the U.S. surge last winter.[5] Clearly, the toll for individuals, families, and communities would be significant under either circumstance.

The virulence of the Delta variant likely means that some economic re-openings may be put on hold or even possibly incrementally reversed. As a result, we have started to ask the question once again: what investments are most attractive when economic activity slows down due to an outbreak? Back in March of 2020, we shifted our portfolios to an overweighting toward growth, large cap, and domestic equities. In November of 2020, based upon the development of effective vaccines and anticipated progress towards re-opening of the economy, we re-balanced the growth-value component of the portfolio and simultaneously introduced more international equities.

For the most part, those adjustments have worked reasonably well. The $64 question of whether the spread of the Delta variant shall serve as a trigger point for further allocation adjustments is one that our team is closely analyzing. With the qualification that there are several dynamic factors that are in flux including but not limited to 1) the pace of virus transmission; 2) the rate of vaccination (domestically and overseas); and 3) the rate of virus mutation producing other variants, for the time being the base case for the broader economy continuing to recover is still intact.

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[1] Bloomberg, *More Than 3.89 Billion Shots Given: Covid-19 Tracker* (Link)
[2] John Hopkins University & Medicine, *Demystifying The Delta Variant With Data* (Link)
[3] The New York Times, *Covid in the U.S* (Link)
[4] Scientific American, *How the Delta Variant Spreads So Quickly* (Link)
[5] NPR, *The Delta Variant Will Drive A Steep Rise In U.S. COVID Deaths, A New Model Shows* (Link)

Rates

If we go back to the end of 2020, the 10-Year Treasury was trading below 1.00%. Then, we saw a surge in rates, with Treasuries moving to 1.75% toward the end of the first quarter of 2021. Since then, rates have backed off, with the 10-Year Treasury now hovering around 1.30%.[6] These rates have significant implications in terms of market valuations, and our underlying investment thesis for equities and bonds.

Investors can justify higher valuations and multiples for equities when interest rates are low. If, alternatively, interest rates were to move aggressively and sustainably higher, that could be problematic. In saying this, it's important to acknowledge that the devil is in the details. If or perhaps when rates do rise, the way they rise will be critical. Thus, the $64 question is: "do we see rates rising uniformly, or do we see a steepening of the yield curve (where long-term rates move higher more rapidly than short-term rates)?" With the same caveat as to our position with respect to the direction of travel of the COVID virus, there are several variables that will impact changes to interest rates including but not limited to the following: 1) Inflation; 2) Federal Reserve policy response; & 3) Market reaction to both. With that in mind, we believe that rates will be somewhat rangebound in the near term. By way of example, while it is entirely possible and likely that the rate of interest will increase for the 10-year US Treasury (currently trading at a yield of 1.27%), it is unlikely to see the 2.25% level broached before 2022.

Economy

In the first quarter of 2021, U.S. GDP grew by 6.4%.[7] Yesterday, we got our first look at second quarter domestic growth. It was reported that during second quarter, U.S. GDP grew by 6.5%. Excluding the 3rd quarter of last year, we would need to look back to the second quarter of 2014 to find a print even close to this, when GDP growth was 5.5%.[8] In addition to robust economic growth, the unemployment rate continues to decline, reaching 5.9% in June.[9] These data points suggest the U.S. economy is continuing to make real progress, but how is this happening? Is this just an economic mirage, or are we seeing a real follow-through in economic activity as we begin to resolve the pandemic?

The case can be made that we are seeing real economic follow-through as millions of Americans have reevaluated how they live and spend their money. This same shift occurred following the global pandemic of 1918, and we might be seeing a similar phenomenon play out in 2021. This factor, in addition to pent-up demand that may still be lingering from the last 18 months, could be driving economic activity in a way that translates into GDP growth. So, the $64 question is whether these factors, combined with historically high personal saving rates[10], will provide a boost to the economy that has some staying power? Outside of a major exogenous shock to the global economy, we anticipate that we will continue to see some follow through on these recent gains and that the economy will continue to make positive strides forward.

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[6] CNBC, *U.S. 10 Year Treasury* (Link)
[7] AP, *US Economy grows 6.4% in Q1, and it's likely just the start* (Link)
[8] Statista, *Annualized growth of real GDP in the United States from 2011 to 2021, by quarter* (Link)
[9] Bureau of Labor Statistics, *The Employment Situation — June 2021* (Link)
[10] St. Louis Fed, *Personal Saving Rate* (Link)

Debt

While personal saving rates are at historic highs, so is the national deficit and cumulative debt. In the first quarter of 2021, the U.S. public debt was 127% of GDP. This compares to 105% of GDP prior to the COVID-19 pandemic, just 62% of GDP prior to the 2008 financial crisis, [11] and 113% at the end of World War II.

Most of us agree that if an individual runs up a tab there eventually comes a time when you need to "belly-up" to the proverbial bar and make good on that tab. Most of us can also agree that this principle holds true for families, businesses, states, and municipalities. However, there is a disagreement among economists as to whether this principle holds true for the U.S. federal government.

In the near term, the United States is in the enviable position that it has the power to print the world's premier reserve currency. Therefore there is little reason to believe that current levels of U.S. public debt is cause for an individual to deviate from a diversified investment strategy. However, is there is a tipping point when the U.S. (which represents less than 5% of the world's population[12]) will no longer get a "pass" as it relates to public debt? So, the next $64 question is: "Can the U.S. federal government accumulate debt in perpetuity?" Or will there come a time when the U.S. will be required to "belly-up" and meaningfully reduce public debt? The answer to this question necessitates a deep dive into subjects such as "modern monetary theory" and notions of intergenerational transfers of wealth (or debt) that would be best explored in a separate Gerry's Journal entry.

Inflation

In June, the Labor Department reported that the consumer price index (CPI) increased 5.4% when compared to this time last year — the fastest pace in 13 years. Even excluding food and energy from the CPI calculation (which tend to see more dramatic price changes) the so-called "core" inflation rate rose 4.5%.[13]

Is 5% inflation a fleeting remnant of the global pandemic, or indicative of something larger and longer lasting within the marketplace? It is still too early to tell, though there are certainly components of the CPI that are starting to increase in a manner that won't readily disappear. One noticeable example is the computer chip shortage, which has far reaching consequences for other sectors of the economy and is expected to cost the auto industry $110 billion in lost revenue.[14] And with the intensive process required to build computer chip production facilities, IBM estimates that the chip shortage could last for two more years.[15]

[11] St. Louis Fed, *Federal Debt: Total Public Debt as Percent of Gross Domestic Product* (Link)
[12] Worldomoter, *Countries in the world by population (2021)* (Link)
[13] Wall Street Journal, *Inflation Accelerates Again in June as Economic Recovery Continues* (Link)
[14] Forbes, *With Inflation At Highest Level Since 2008, Are Computer Chips The Only Supply-Chain Risk?* (Link)
[15] The Guardian, *Global shortage of computer chips could last year years, says IBM boss* (Link)

We aren't certain how much of inflation is specifically driven by food, energy, labor or supply bottlenecks, but there are enough factors in the mix that won't disappear anytime soon. It's hard to imagine that this recent round of inflation is 100% transitory in nature, and the $64 question in the market today is: is it inflation transitory, structural, or a combination of both? Like GDP, this is a dynamic situation and one we will be following closely in the coming weeks and months.

Infrastructure

So far, the debate in Washington D.C. has centered around one question: what is infrastructure? According to the New Oxford dictionary, infrastructure is defined as "*the basic physical and organizational structures and facilities (for example, buildings, roads, and power supplies) needed for the operation of society or enterprise.*" The $579 billion bipartisan initiative that is focused on transportation, broadband, and utility projects (in addition to what is already the baseline for annual infrastructure spending amounts of more than $1 trillion dollars)[16] looks and feels a lot more like this traditional definition than the broader $3.5 trillion proposal that includes many additional projects. While certainly laudable, many of the proposals fall beyond the scope of the New Oxford definition of infrastructure and are likely to stoke controversy on Capitol Hill.

It's not our place to weigh in on which programs are most needed, but we do feel it's important to collectively pause and consider the impact that another significant round of stimulus could have on the U.S. economy. We remain hopeful that some meaningful investment in infrastructure will be passed that is mindful of the prevailing macroeconomic environment, as investment in America's roads, airports, seaports, trains, subways, and broadband capabilities is sorely needed. Regardless of the form and extent an infrastructure bill ultimately takes, the $64 question remains as to the extent additional stimulus will further stoke inflation and GDP growth, and whether this phenomenon will be transient or longer lasting in nature.

Taxes

Even without new stimulus measures, the U.S. government needs to service the unprecedented public debt that was issued in response to the pandemic. This can be accomplished in four primary ways:

1. Higher tax revenue through population growth (more people paying the same tax rates),
2. Higher tax revenue through increased productivity (the same population paying the same tax rates on an increasing per-capita GDP),
3. Higher tax revenue through increased tax rates (the same amount of people generating the same per-capita GDP, but paying higher rates), or
4. Lower government expenditures (a net reduction in government spending).

Option 1 is unlikely, since the U.S. currently has a record low fertility rate (an estimate of how many children that a group of 1,000 women will average during her lifetime). A fertility rate of 2.1 children is defined as the "replacement rate," or the number of children required for a population to remain steady

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[16] CNBC, *Senators hope to forge ahead with bipartisan infrastructure bill this week* (Link)

over the long run. The U.S. hovered around replacement levels from 1971 to the mid-2000s but has been consistently below replacement levels since 2007, with a current rate of just 1.61 according to the CDC.[17] And while immigration has been a historic driver of population growth, we don't expect that to be a key factor in the decade to come.

Option 2 can take significant time, with growth in productivity typically taking years to materialize.

Option 4 is very difficult to manifest from a political perspective and austerity has been a historically ineffective remedy.

As a result of these issues, option 3 has received the most attention during the last year and is a likely course of action. We certainly aren't excited by the prospect of higher individual and corporate taxes, but we also are not overly concerned with that prospect. As we shared in Gerry's Journal in August 2020, *"Biden has proposed increasing the top income tax rate from 37% to 39.6% and the top corporate tax rate from 21% to 28%. By comparison, during past bull markets the average top personal and corporate tax rate was 63% and 40%, respectively. While there will likely be elevated levels of volatility in the coming months, we do not feel that Biden's tax policies represent the 'end of days' for the U.S. economy, individual companies, or investment markets."*[18]
To what degree taxes rise, and how effective tax increases are at raising revenue is our final $64 question. We will have to wait and see what our elected representatives decide in the coming weeks and months ahead and will adapt and adjust our approach as necessary.

Closing Thoughts

Today, the world remains a very dynamic place, and the sheer volume of information, data, and talking points can be difficult to digest. Alan Alda's concept of "the curse of knowledge" put it best: sometimes, too much information is no good. In reality, having too much information is never a problem. The challenge is how to effectively synthesize and ultimately share that information with others is where the really challenge exists.

Our job is to distill all these datapoints down into key themes that translate into investment guidance on behalf of our clients. We hope this journal has provided a look into the conversations and deliberations we are having internally. As always, if you have any questions about the ideas shared, we invite you to connect with your wealth advisor.

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[17] BBC, *US birth rate falls 4% to its lowest point ever* (Link)
[18] GYL Financial Synergies, *2020 Election Analysis: What Does a Biden-Harris Ticket Mean for November's Election and What are the Implications of Higher Taxes?* (Link)