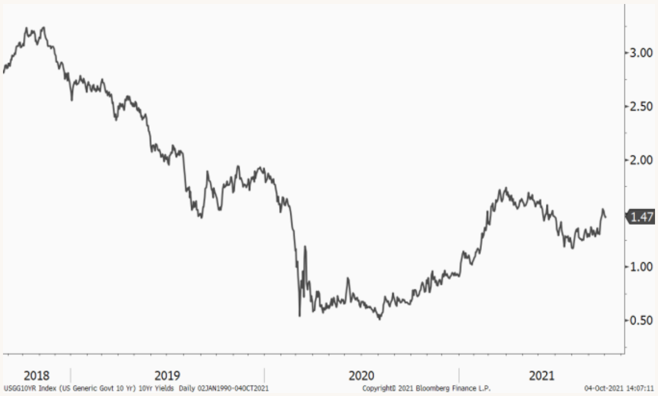
"common prosperity"

As the saying goes, we have a lot to unpack these days. The pandemic and its effect on the economy and society, the outlook for inflation, and Federal Reserve Board policies are three that come immediately to mind as having potentially meaningful repercussions on financial markets. Each is worthy of serious analysis to have an intelligent investment plan, but in my opinion the most critical question that needs to be addressed is where China is headed, as an economy and as a political entity. Obviously as the world's second largest economy and major trading partner of many countries, slower growth in China would have a significant negative impact on global growth. Already this year pandemic controls and government regulations have resulted in construction investment being down 3.2% as of the end of August and year over year retail sales in August came in at only 2.5% versus estimates of 7%. In addition, China's second largest property developer Evergrande Group is in default and facing bankruptcy which can't be good for the economy at large. If the Government or the Central Bank come to the rescue it will be a positive for markets not just locally but globally as well. President Xi Jinping might, however, see the bankruptcy as an opportunity to reduce risk taking by investors and to provide an excuse to consolidate his control over the country. Which brings us to a more significant and longer-term consideration; what is Xi's plan for the future of China. In 1972 President Richard Nixon made his famous trip to China to try and rekindle relations post the isolation that had resulted from events like the Korean War, the Vietnam War and Mao's cultural revolution. In the ensuing decades China gradually became more westernized, adopting a more democratic and capitalistic approach to government and the economy. Today there is a strong sense that is about to change. Xi has become much more authoritarian, has cracked down on companies and entrepreneurs like Alibaba and its founder Jack Ma, and is proposing what appears to be a return to a stronger socialist state under the heading "common prosperity". It is difficult to know where this will all lead, but such a path for China would add to an already deteriorating relationship with the U.S. and other Western countries and raise concerns about global economic growth.

On this side of the Pacific Ocean the questions of leadership are much more up in the air. Canada has elected another minority government and in the U.S. hope for stability in Congress has vanished despite the Democrats owning a narrow majority. President Biden finds himself fully aware of the number of Republican votes against his legislative proposals, but is forced to beg and cajole to find support within his own party. The debt ceiling will be raised, (the government can't go on without money) but it's almost a tradition for the party not in power to squeeze as much of its own agenda in to the legislation as possible. It is beyond strange that a politician can vote for spending that requires borrowing and the next day vote against that borrowing. The infrastructure bill is even more contentious, as both the size of the bill and how to pay for it are up for serious debate. The U.S. economy would benefit from the fiscal spending the bill will provide, but the increase in taxes will have a reverse effect. Everyone seems to forget taxes don't need to be increased; the government has the power to allocate the funds without needing to balance any budget.

Figure 1:
US 10 Year Yield
The "spike" in yields was a popular topic across financial markets in September. While yields did rise in the month they remain well below levels seen earlier this year.



Source: Bloomberg, Mulvihill Capital

Which brings us to the spectre of high inflation. There is a compelling argument that the Fed's easy monetary policy over the past decade, which involved injecting liquidity into the system by buying bonds, did not in fact increase the amount of money in the system since more cash but less bonds left the system flat overall and hence didn't precipitate inflation. Fiscal stimulus such as this infrastructure bill and the support payments made during the pandemic are a whole other kettle of fish. They definitely involve injecting new money into the system and heighten the inflation risk. The CFO of Costco summed up the current environment rather well: "inflationary factors abound, higher labour costs, higher freight costs, higher transportation demand, along with container shortage and port delays and higher commodity prices". Of course, he is rationalizing his own price increases but he's not wrong. I am still of the belief that there will be reversion to the mean as the pandemic forces ease, but the energy crisis developing in Europe is another example that this is no time to relax.

I found it interesting that, as John Mauldin points out, the three expansions in U.S. GDP of the last 20 years prior to the decline and subsequent rebound caused by the COVID pandemic look like this:

1991 – 2001	3.6%
2001 – 2007	2.8%
2009 – 2019	2.3%

It can be argued that once the economy normalizes, this longer-term trend of slower growth will reappear. Something I hadn't thought of, again from Mr. Mauldin, is the effect on the labour force participation rate in the U.S. of the large number of men incarcerated or with criminal records compared to the rest of the world. This group consists mostly of men, African American men, and men with low education and amount to 20 million persons who are largely precluded from joining the work force and are a wasted potential asset.

The Fed is doing a reasonable job of preparing us for a taper in quantitative easing and an eventual rise in regulated interest rates, but not causing a panic in the process. It remains to be seen if they actually have any idea what the future holds, and whether appropriate policies are in place. The risk of a policy error remains, and the Board's credibility is still in question. It boggles my mind that a group of economic experts were unaware that trading one's personal investment account while making monetary policy for the country might be cause for concern.

Fortunately stock markets continue to climb the proverbial "wall of worry", and if the pandemic continues to show signs of easing, more upside is in the offing.

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