Inflation, Margins, Earnings & Business Cycles

The Fed's Admission, Corporate Tax Pushback, It's Still Early for Tightening & Reflation and Profit Margins

The Fed's Admission

"Model- and survey-based estimates suggested that a significant portion of the increase in yields was associated with an increase in term premiums. Higher term premiums could reflect the outlook for more expansive fiscal policy and an associated upward revision in the expected path for Treasury debt outstanding."

Minutes of the Federal Open Market Committee March 16–17, 2021

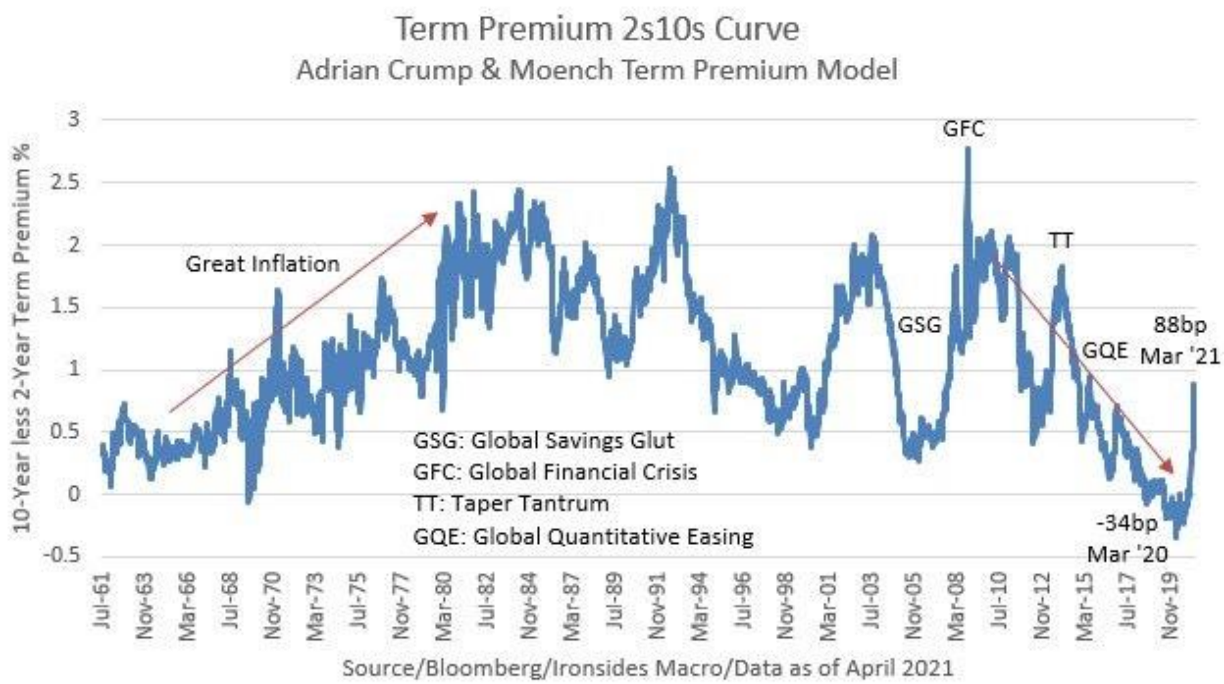

Figure 1: Treasury yields can be decomposed into two components: expectations of the future path of short-term Treasury yields and the Treasury term premium. The term premium is the compensation that investors require for bearing the risk that short-term Treasury yields do not evolve as they expected. Treasury Term Premia: 1961-Present, NY Federal Reserve Bank.

This is the explanation for the rally in rates we identified based on the steepening of the 2s30s real rate curve beginning with the Georgia Senate runoff elections that you will not hear from the Fed leadership or even regional bank presidents, certainly not in Congressional testimony but there it was in the staff analysis of market conditions. Nevertheless, despite an exceptionally strong employment report, an all-time high print for the ISM services index and the strongest ISM manufacturing report since December 1983 in the early stages of the recovery from the deep Volcker recession, rates have fallen as the American Jobs Plan runs into resistance. In other words, the standard explanation from policymakers, economists, equity strategists and market participants, that rates increased due to an improving growth outlook, is convenient, and inaccurate. Our longer-run forecast for higher Treasury yields is primarily a function of the recovery reflation evolving into inflation in a ‘60s analog scenario, however, in 2021, rising inflation expectations are the second most important factor, fiscal policy and Treasury supply will likely cause the high velocity moves, at least until the Fed begins talking about, talking about, tapering asset purchases. With that in mind, pushback from tax policy think tanks and the corporate sector (Business Roundtable, US Chamber of Commerce, National Association of Manufacturing) on the Biden Administration’s corporate tax plan is the primary catalyst for the breather in the rates rally. This dynamic could reverse over time if the Biden Administration scales back any of the three elements of the tax plan, but does not reduce spending, thereby increasing expectations of additional deficit financed outlays, which should restart the rates rally. The equity market reaction was also consistent with the apparent loss of fiscal spending momentum and related rates rally breather, the technology and communication services sector led the rally, homebuilders, FANG and software also rallied sharply. Additionally, the VIX is below its long-run median of 17.4% for the first time since the pandemic panic, skew continues to be elevated and the 1-month, 6-month term structure at 5.3% is significantly steeper than its longer-run median of 2.7%. Consequently, given our outlook for strong near term economic and earnings momentum and intermediate term risk of policy tightening, buying near-term near-the-money S&P 500 index calls and selling out of the money longer-term calls looks like an attractive set-up. In terms of what the decline in equity volatility implies about market sentiment, we expected implied volatility to cheapen this year, but it is not low and therefore should not be viewed as a sign of complacency, normalization is a better characterization.

Measures of Risk	Median	Standard Deviation	Max	Min	Current	Z-score	Implied Risk
S&P 500 Volatility Index (VIX)	17.40	8.13	82.69	9.14	16.82	-0.07	Average
S&P 500 Vol of Vol Index (VVIX)	89.17	15.98	207.59	59.74	100.92	0.74	Above Average
S&P 500 Term Structure (6m-1m)	2.65	4.17	10.85	-40.45	5.57	-0.70	Below Average
S&P 500 Skew Index	118.48	8.31	159.03	101.23	139.04	2.47	High
S&P 500 Implied Correlation Index	49.71	14.92	87.10	23.32	49.17	-0.04	Average
Treasury Vol (MOVE)	89.55	28.01	264.60	36.62	60.08	-1.05	Low
FX Vol (JPMVXYGL)	10.01	2.40	27.02	5.18	7.57	-1.02	Low
BB&D Policy Uncertainty	83.12	78.67	807.66	3.32	167.18	1.07	High
Lehman Corporate OAS	1.15	0.77	6.18	0.51	0.89	-0.34	Average
Lehman High Yield OAS	4.65	2.50	19.71	2.33	2.92	-0.69	Below Average
EEM Volatility Index	21.58	6.57	92.46	13.28	20.78	-0.12	Average
Post-GFC Median Across Asset Classes						***0.02***	***Average***
Source: Bloomberg/Ironsides Macro/Data as of April 9, 2021							

Figure 2: The equity volatility market still has lingering effects of the pandemic, skew and the vol of vol indices are elevated. Treasury and currency volatility are low, in addition to Fed volatility suppression through their mortgage purchases, crypto may be drawing volatility speculators from those markets.

So, You're Telling Me There's a Chance

We received an amusing notification on Thursday of a Politico story that the Biden Administration's 'secret weapon' in raising corporate taxes is its complexity. This characterization is naïve as evidenced by the tax policy think tank and largest business lobbying groups resistance to the headline rate, minimum tax, and international tax provisions. Treasury Secretary Yellen's assertion that the Tax Cuts & Jobs Act sparked a global 'race to the bottom' on tax rates is incorrect in its causation. The US fell to the bottom of global corporate tax rate competitiveness by essentially leaving the rate unchanged from the 1986 tax reform until TCJA, while the rest of the world battled for market share during the 1990-2010 globalization boom and early stages of deglobalization in the '10s. As we listened to Secretary Yellen pitch a 21% global minimum tax rate, we were reminded that during the European sovereign debt crisis the Germans attempted to tie EU support for Ireland's banking crisis to a higher corporate tax rate, and the Irish held firm. The Netherlands has a provision that makes it an attractive destination for intellectual property. As the world struggles to transition from just-in-time to just-in-case supply chain management we doubt that the Biden Administration will receive much cooperation in their quest for higher corporate tax rates. Consequently, the headline domestic corporate rate is uncompetitive, the international provisions are unrealistic, and the minimum domestic rate is counterproductive to tax incentives including the R&D tax credit, the Biden Made in America credit and the improved incentives for equity financed investment. My former colleague at Barclays, Maneesh Deshpande, estimates an 8% reduction in earnings while the tax policy think tanks concluded it would raise ~half of the Administration's estimated revenues and would reduce growth and capital spending by crowding out private investment. We expect the 'Jobs Plan' and to be announced healthcare plans to be combined and the majority of revenues to be raised from changes to the individual tax code. This of course makes sense given that corporate tax revenues are ~25% of individual receipts. One final point, the argument that corporate tax receipts fell after TCJA passed is misleading, total receipts as a percent of GDP were unchanged in 2018, growth accelerated from 2% to 3%, R&D and software investment boomed, real wage growth accelerated, and labor share of income increased.

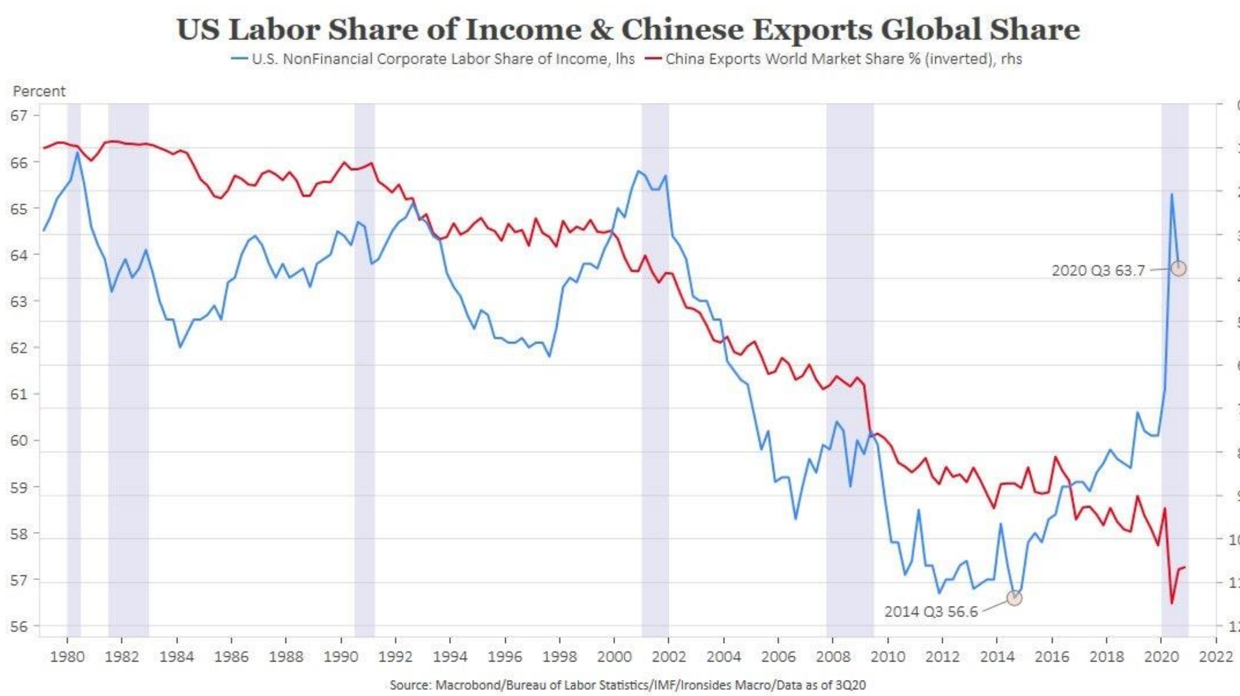

Figure 3: Labor is less mobile than capital, the costs of raising corporate taxes is likely to fall more heavily on employees than shareholders.

When Should We Worry About Policy Tightening?

The Treasury market bull flattened (rates declined led by longer maturities) in response to the fiscal policy debate and Fed speakers including leadership and the System Manager of the New York Fed Lori Logan, and while 'longer-duration', that is high multiple and earnings growth companies rallied. That notwithstanding, the question of when tax hikes and/or Fed policy normalization will slow the equity market rally persists. Thus far, our early cycle framework that 10%+ corrections are unlikely until fiscal or monetary policy tightening begins, has been effective. This approach worked last cycle when deleveraging slowed the pace of the recovery, this cycle's recovery is likely to be far more robust. As we detailed above, we expect significant modifications of the Biden corporates tax plan. Even with revisions, there is likely to be tax hikes on capital, individuals and corporations in 2021, though they will not be in effect until 2022. For guidance about when the markets are likely to discount higher taxes, we look to the first year of the Trump Administration. Their first legislative initiative was to repeal and replace Obamacare, that effort failed in late July. An effort to reform the corporate tax code was already underway, however when repeal and replace failed, the market implied probability of passage of the Tax Cuts & Jobs Act was exceptionally low as evidenced by relative sector performance (high average tax rate sectors relative to technology and healthcare that paid the least taxes) and equity market momentum. By November, as TCJA made its way through the legislative process, the market began to discount passage and the rally continued through the balance of the year and into January. The final agreement occurred over the holidays and the bill was signed very early in 2018. Given that passage of the next round of legislation in its final form is unlikely until late 3Q at the earliest, we do not expect the market to discount higher taxes until after Labor Day.

Inflation, Margins, Earnings & Business Cycles

With earnings season beginning this week, Friday's exceedingly strong producer price index report is likely to sharpen investors' focus on the effects of rising input costs on profit margins. Since we first showed this chart a month ago, prices paid and prices received in the five regional Federal Reserve Bank surveys increased further, though input costs continue to lead the advance. Based on consensus forecasts, only the industrials sector is expected to see weaker earnings than revenue growth. Analysis of prior cycles implies this is a business cycle timing issue, input prices increase first, then companies pass prices along closing the marginal cost gap and finally, positive operating leverage from increasing revenues relative to fixed costs, leads to a strong rebound in margins.

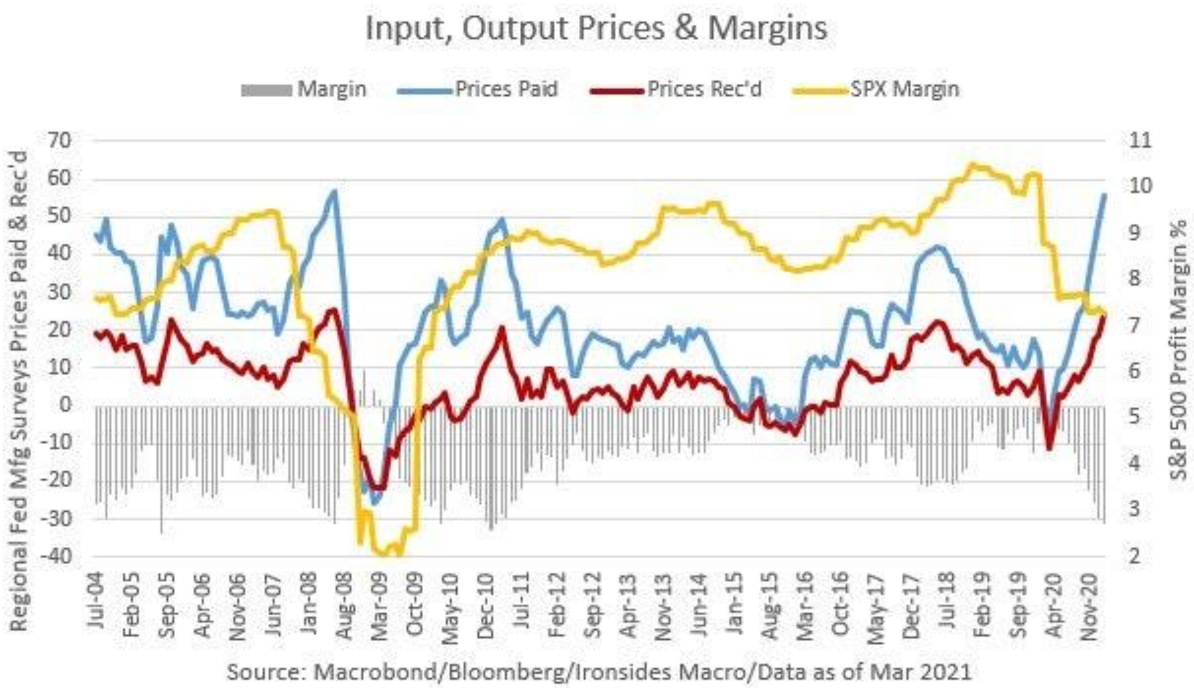

Figure 4: We expect a sharp recovery in profit margins in 2021

With this in mind, we were asked to summarize our view on inflation this week and thought it might be useful to restate our outlook ahead of next week's CPI and more importantly, import price index reports next week.

Rising Inflation is Not Transitory, it is both Cyclical & Secular

The Cyclical Case

The pandemic was not a financial crisis. At the 2010 Jackson Hole Conference Carmen & Vince Reinhart presented a paper titled "After the Fall" that analyzed 15 post-WWII financial crises. The most consistent economic effect was a decade of disinflation. Both the supply and demand for credit were impaired by the global financial crisis. Household and financial sector leverage were at record levels, this led to reduced credit supply as banks shed bad assets and reduced demand as households needed to repair their balance sheets. The financial sector regulatory policy response further reduced the supply of credit. The balance sheets of the household and financial sectors are the antithesis of 2009 and the demand for credit is likely to increase through the cycle as evidenced by record household formation and the boom in house prices. Chairman Powell described the increase in house prices as related to the pandemic and likely to fade, this discounts the household formation dynamic from Millennials.

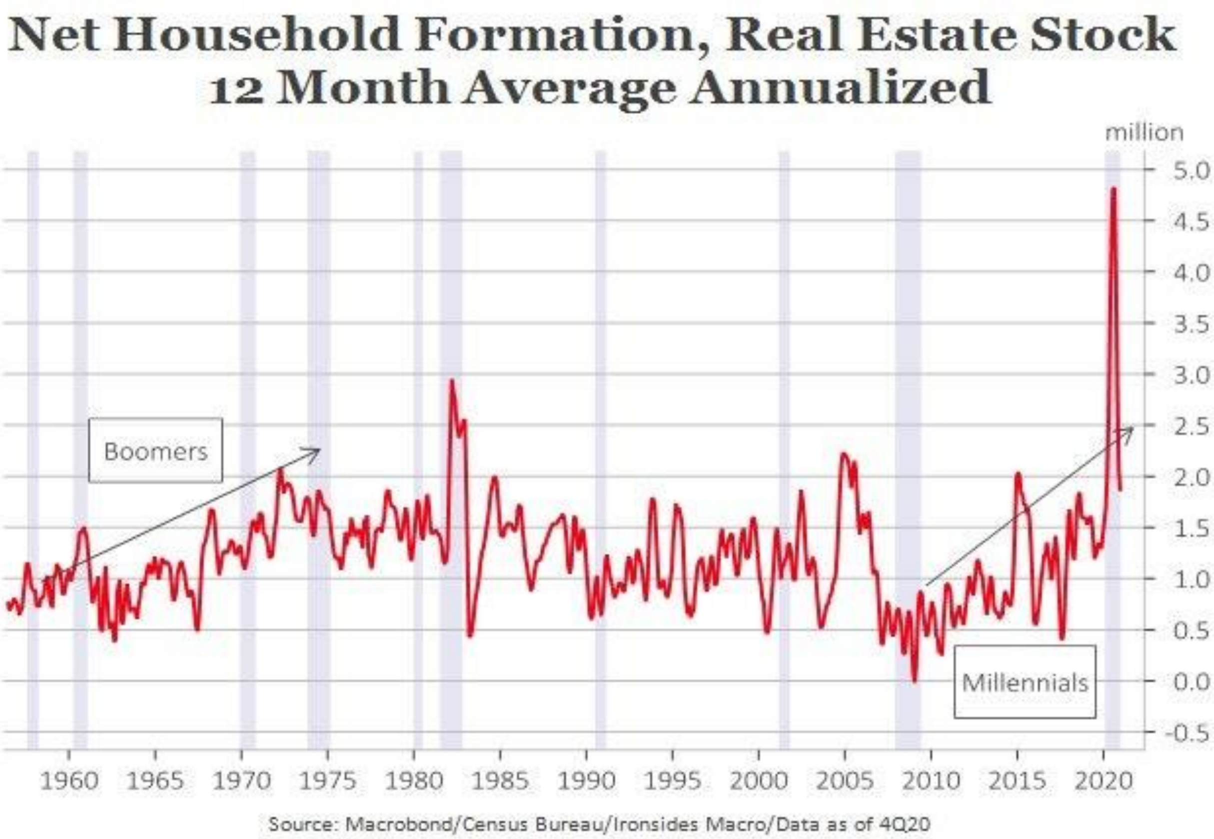

Figure 5: The implications of increasing Millennial household formation extends beyond housing to consumption and inflation. Boomers will begin drawing down savings and Millennials are in peak consumption years while the smaller GenX cohort is in the savings years. Notwithstanding slow population growth, demographic trends are shifting away from savings.

The recovery in global trade and manufacturing is from a double-dip recession, that is the trade war and the pandemic. While the Fed expected prices to rise, we doubt they expected ISM manufacturing at the highest level since the Volcker

Recession ended in December 1983. The inventory restocking cycle has not really begun as evidenced by customer inventories at record lows while prices paid are near record highs. The policy response is a lengthy topic but the order of magnitude of the fiscal and monetary ease, combined with less friction due to the leverage being concentrated in the government sector, implies that if the response does not generate inflation it really will be different this time.

Figure 6: Rent moratoriums are depressing CPI housing inflation, some measures show rents have stopped falling.

The Secular Case

Theories about technology related disinflation are not invalid, they did prevent service sector inflation from increasing faster than the 3-4% it averaged over the last several decades. The true source of disinflation for the last three decades has been goods prices because of the supply of industrialized labor increasing from 750 million workers in 1990 to 2 billion by 2010 as China and the Soviet Bloc were integrated into global supply chains. Globalization was already slowing in the ‘10s, growth of Chinese, Japanese, Taiwanese and South Korean exports slowed from 15% in the ‘00s to 5% in the ‘10s and is likely to slow further as supply chain management shifts from 'just-in-time' to 'just-in-case'. The economics of manufacturing in China to sell goods globally haven't worked since 2015, the Honeywell's CEO characterized their model as 'locally sourced' production. Productivity adjusted wage costs, increased transportation and energy costs, exchange rate risks and the final straw that broke the camel's neck, supply chain risks, are not likely to reverse anytime soon. This implies the decades of goods disinflation are over.

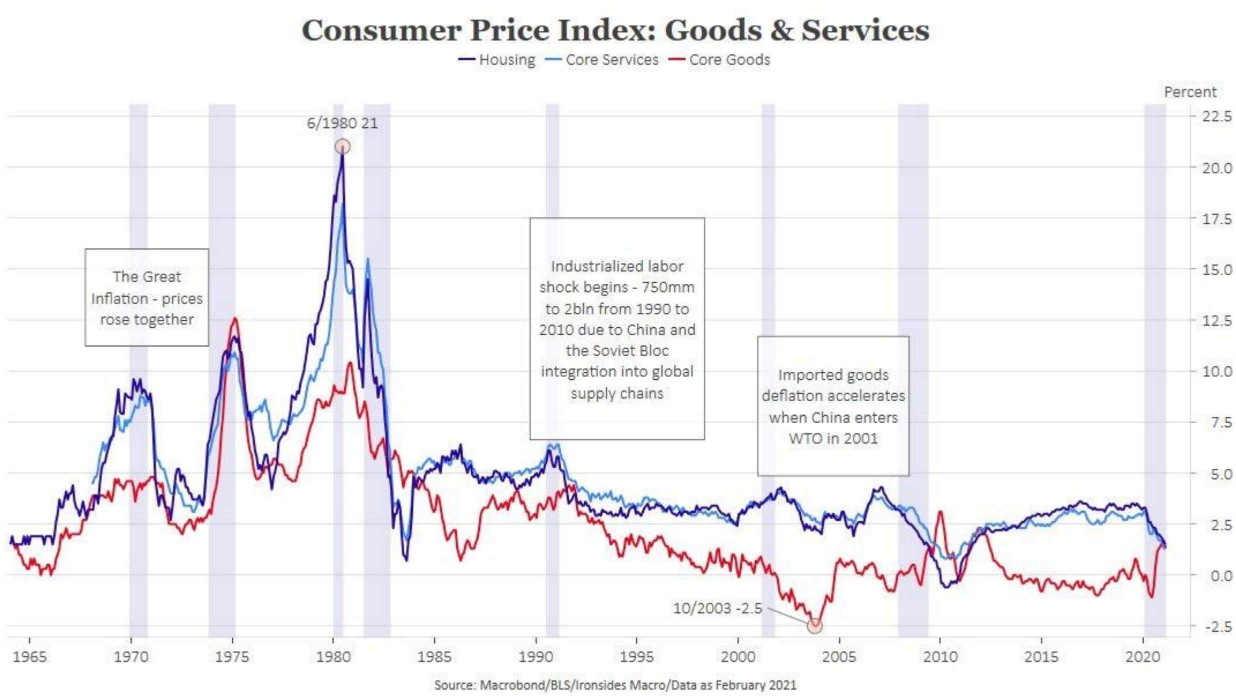

Figure 7: Services inflation was never below the Fed's target outside of recessions. Service prices are domestically determined, goods price disinflation is a global phenomenon. We will be watching next week's import price report more closely than CPI.

Investment Implications: Reflation and Inflation

Notwithstanding our outlook for higher inflation, it is important to understand the market implications of the early stages, or reflation, relative to inflation. We have been drawing on the '60s analog frequently. The '50s were like the '10s, growth was uneven (5 recessions from the end of WWII through '60), earnings growth was slow (~8%), capital investment was sluggish, but the equity market was strong as the S&P 500 PE increased from 7 at the end of the war to 20 by the time JFK was elected. The Kennedy Administration was elected on a 5% GDP platform, they pushed for looser monetary policy, changed the focus from inflation to employment, loosened fiscal policy, weakened their commitment to the dollar/gold standard and earnings growth accelerated to 15%. The PE multiple stayed at 20 due to faster earnings growth until reflation turned into inflation at the end of the Johnson Administration.

Figure 8: We turned the S&P PE into an earnings yield to make this chart easier to interpret. Omitted from this chart was Treasury yields, they rose consistently through the '60s. In other words, they were a poor risk diversifier.

Consequently, while investors often site inflation as the biggest market risk, because we are in the reflation stage of the cycle, rising inflation is a plus for equities, not a negative. It is clearly a negative for Treasuries, the stock/bond correlation that has been so persistent for the last two decades and turned the 60/40 model into the core framework for asset allocators, is failing. Your risk reducing diversifying asset should be cash against your equity portfolio, not Treasuries.

US Equity Market Valuation Index/Sector	PE	Fwd PE	P/S	P/B	EV / Sales	EV / EBITDA	Z-score	Ironsides Recommendation	ERP	ERP Z-score
SPX	33.35	23.58	3.08	4.49	3.45	20.42	2.82	Overweight	4.91%	-0.02
Discretionary	69.10	38.47	2.96	12.15	3.17	27.75	4.42	Market	3.27%	0.27
Financials	19.93	15.40	2.68	1.57	2.90	10.39	-0.01	Overweight	7.16%	-0.42
Technology	36.92	28.90	7.30	10.93	7.26	23.73	2.29	Market	4.13%	0.11
Comm Services	32.75	24.06	4.24	4.59	4.86	16.81	3.08	Market	4.82%	0.19
Industrials	56.14	28.40	2.55	5.89	2.90	25.38	4.20	Overweight	4.19%	0.22
Materials	31.65	20.15	2.63	3.31	3.21	18.05	2.43	Overweight	5.16%	-0.36
Energy	150.31	22.24	1.39	1.72	2.07	37.94	1.71	Overweight	5.16%	-0.04
Healthcare	23.25	16.63	1.93	4.85	2.16	18.43	0.40	Overweight	6.68%	-0.53
Staples	22.69	21.39	1.66	6.63	1.95	16.61	1.62	Underweight	5.34%	-0.65
Utilities	21.52	18.65	2.84	2.14	5.16	13.95	2.54	Underweight	6.03%	-0.41
Real Estate	69.75	53.92	7.81	7.81	10.71	25.42	2.99	Underweight	2.52%	0.22

Source: Bloomberg/Ironsides Macro/Data as of April 2021

Figure 9: The S&P 500 2021 estimate began the year at 163.50, it is now 174.25 and has increased each week in 2021. This is not the stage of the cycle to focus on valuation as analysts struggle to keep up with the pace of the recovery.

Key Investable Themes & Beneficiaries:

- *Global Manufacturing and Trade Recovery: Industrials, Materials, EM Equities*
- *Capital Spending Boom in 2021: Technology, Industrials, Healthcare, Software, Semis*
- *Reflation: Materials, Financials, Energy, Small Caps, Inflation Breakevens*

Barry C. Knapp

Managing Partner

Director of Research

Ironsides Macroeconomics LLC

908-821-7584

bckknapp@ironsidesmacro.com

https://ironsidesmacro.substack.com

https://www.linkedin.com/in/barry-c-knapp/

@barryknapp