John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday March 24, 2021

There was a warning last February. Demand for U.S. treasury securities was so low that the sale on Feb. 25 of seven-year notes almost was a failure. With the addition of the new Biden $1.9 trillion spending, the federal deficit for this fiscal year will likely be 18% of GDP. That is the highest since the wartime years of 1942-1945. And as the February note sale indicated, there are now a whole lot of treasury securities to sell and demand is uncertain. Historically U.S. investors have been able to finance deficits of about 4%-5% of GDP. This means we are now depending on strong foreign demand to finance the remaining 13%-14%. The appetite of foreign buyers will depend on relative interest rates, currency values and confidence in the U.S. economy.

The left wing of the Democratic party seems to believe they are in control and can enact radical changes in energy and tax policies without consequences. They have forgotten the global currency market. If they take a step too far and obstruct the now rosy forecasts for the economy, the dollar will come under pressure, and interest rates will likely have to rise to attract enough foreign buyers to sell all the new Treasury securities. The currency market likes conservative economic policies. It also detests socialist policies. Look at Venezuela - its currency is basically worthless. There are real world limits to what politicians can do as long as they need foreign support to finance their plans.

We are already seeing financial markets starting to react to the massive federal spending. The yield on a 10-year U.S. Treasury bonds is up 80 basis points since January. It reached a near term high of 1.74% last week. With bond market volatility, the yield

could reach 2% at any time. The rapid rise in interest rates is unsettling. Normally it would be seen as driven by rising inflation expectations and anticipating a Federal Reserve anti-inflation rate hike. But this time the Federal Reserve is signaling near zero interest rates this year, in 2022, and until we are back to full employment.

In their meeting a week ago the Federal Reserve Open Market Committee members raised their median growth estimate for 2021 to 6.5% from 4.2% in December. They also predict the current 6.2% unemployment rate will fall to 4.5% by year end. They see growth remaining robust at a 3.3% rate in 2022 with unemployment falling to 3.9%.

How can this be possible? Can we really enjoy a booming economy and interest rates near zero? The Fed says yes, because the boom is a V shaped recovery from a devastating pandemic. And after the economy has fully recovered continued growth at a 3% or slightly better rate is manageable. The Fed basically is saying they have all the tools they need to keep economic growth alive, inflation under control and interest rates low.

That all sounds good as long as there is sufficient demand for U.S. Treasury securities. The Fed will keep buying $120 billion a month of Treasuries and mortgage-backed securities. American investors can be expected to keep financing their 4%-5% of GDP share of the deficit. But that still leaves a huge gap that needs financing by foreign investors.

The U.S. Treasury market is historically the deepest and most liquid in the world. But lately demand for Treasuries has been rocky as the supply of new debt has risen fast to pay for the COVID-19 stimulus measures. And it turns out that bond traders are taking

full advantage of the situation. According to recent data from the U.S. commodity Futures Trading Commission, bond market speculators are significantly short longer-dated Treasury futures. Andrew Brenner, head of international fixed income at National Alliance says: “The momentum right now is in the hands of the shorts.”

The bottom line is the recent rise in Treasury yields has nothing to do with inflation expectations and everything to do with uncertainty about foreign demand for U.S. Treasuries. The uncertainty is not going away any time soon because the federal deficit is still rising fast. The need for massive stimulus spending will end as the economic recovery gains momentum. And then the bond market speculators will have had their fun. The shorts will get covered and the bond market will get back to fundamentals.

As far as the stock market is concerned, the good news on the economic outlook is and will remain the primary driving force. Speculators selling stocks short riled the stock market a couple of weeks ago. Some hedge funds got caught with large short positions and suffered heavy losses. But that speculator induced stock market volatility did not cause a major stock market decline. Likewise, the bond market short sellers are taking a big risk. They are essentially betting against the Federal Reserve. That will likely turn out to be a bad bet.

Lindsey Bell, chief Investment Strategist at Ally Invest, points out: “yields tend to rise early on in bull markets and in economic recoveries because the outlook is improving.”

He is right and recent interest rate increases confirm his point of view. During the worst of the pandemic the yield on a ten-year Treasury was 0.54% and the S&P 500 stock

index was at 2,237. Now the 10-year Treasury yield is up to 1.73% and the S&P 500 index is up to 3,915. Both stocks and interest rates have risen simultaneously.

And the yield on a 10-year Treasury was 1.92% before the pandemic. Prior to that, since 2012, the 10-year Treasury has traded roughly between 1.5% and just over 3%, all the while stocks kept rising to new highs.

What kills stocks is overly aggressive interest rate hikes to stop rising inflation. That may happen again sometime in the future but definitely not this year, next year, or even in 2023. The improving economy remains a fundamental positive for stocks.

I will have the next market review and update one week from today on Wednesday March 31, 2021.

All the best,

John Dessauer

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