



**PACIFICUS**  
CAPITAL MANAGEMENT

INVESTMENT OUTLOOK – MAY 2021

## The Inflation Trade Is Crowded

*"I do not like the raw sound of the human voice in unison unless it is under the discipline of music." - Flannery O'Connor*



**"WE MUST BE NEAR THE WATER BECAUSE I SEE  
A SEA GULL."**

CartoonStock.com

The inflation trade is a crowded trade and will ultimately fizzle out. Nonetheless, expectations for higher future inflation on the back of easy monetary policy, government stimulus, and supply chain disruptions have added to recent market volatility and increased uncertainty. I've seen this play out many times over the years and it has only ended up one way – a resumption of disinflationary forces and lower bond yields.

Professional investors, namely hedge funds and bank traders utilize leverage, can bet on both higher and lower prices, and if applying their craft properly, look for asymmetric

risk/reward opportunities. It is the asymmetric risk/reward potential in the short bond trade which has attracted many professionals to take a stab at betting against the almost forty-year decline in U.S. interest rates. For many, betting on U.S. 10-year treasury rates going higher (the rate currently stands around 1.65%) is too appealing to pass-up. From a risk/reward perspective, a trader might think 10-year rates can ultimately go down to either 0% from here, or up to 4%,6%,+. If the probability of interest rates going up or down is 50/50, one might believe the expected return on making a bearish bet is clearly superior. However, this has not played out as expected over the years (see Japanese Government Bonds).

I first started reading David Rosenberg's commentary back in 2005 while working as a bond/interest rate trader on Mizuho's proprietary trading desk in New York. At the time "Rosie" was the highly regarded Chief North American Economist at Merrill Lynch and known for his bearish views on the economy and particularly the housing market. Some found his conclusions a bit dogmatic, but I found clarity in his analysis back in those days.

Today he is sticking his neck out and going against the grain as usual. Please see the below piece written by Evan Simonoff in a recent issue of Financial Advisor Magazine.

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### **David Rosenberg Sees Reopening Trade Over By Year's End**

May 6, 2021

By Evan Simonoff

Mainstream investors, both retail and professional, are fixated on inflation and are likely to be caught off guard making the wrong bet, economist David Rosenberg told attendees at Mauldin Economics' Strategic Investment Conference.

Conference founder John Mauldin introduced Rosenberg as his "lead-off hitter" for the 13th consecutive year of the event, which was virtual. Rosenberg "has been consistently right, because he isn't consistent," Mauldin said. "He is willing to change his tune."

For his part, Rosenberg said he "unabashedly" finds himself in the same camp with Fed Chair Jay Powell. Prices for goods and services have been driven up by a combination of "fiscal juice and supply conditions associated with reopening," he said, but that's a transitory situation, in his view. That's why he sees growth stocks, Treasuries and other interest-rate-sensitive assets continuing to outperform others.

Investors are likely to be surprised when the conditions for modest deflation reassert themselves by year's end, Rosenberg argued. Many in the inflation camp fail to spell out in any detail why inflation should persist.

The supply chain disruptions currently being experienced by the global economy simply are likely to be short-lived. They certainly aren't powerful enough to override "a trend line that has been in place for decades."

Furthermore, the bearish view on inflation and interest rates "is already priced in" to asset prices, he said. "People will be surprised when supply catches up with demand going into the fourth quarter," he predicted.

One of the economic developments arising from the pandemic that has been overlooked is that the U.S. has seen its highest productivity growth in 10 years. Rosenberg noted that GDP fell 3.5% in 2020, while employment fell 5.5%, revealing that far fewer workers were needed to produce somewhat fewer goods and services.

In 2020, the worst year for the economy since 1946, business spending on software and IT was 6%. "Productivity is more powerful" than the CRB index, he maintained.

In addition, GDP currently stands only 1% below where it was before the recession began in February 2020, Rosenberg said. That was after an 11-year economic expansion.

The productivity boomlet may be good for businesses and investors, but it isn't helpful to the eight million Americans still unemployed after last year's sharp downturn. Rosenberg didn't deny that the economy has grown after lockdown-induced 2020's collapse but he asked, "How could we not have a recovery?"

As for the labor market, the statistic Rosenberg watches most closely is the U-6, which stands at 11%. "Once it gets to 8%, I could change my mind on inflation," he said.

The real story is the government sector, where the federal budget deficit swelled from \$1 trillion in 2019 to \$4 trillion last year. When it comes to government spending, "even LBJ would have blushed," he said.

"This is not an organic recovery," he continued. "We were in a modern-day depression. Checks in your bank accounts replaced soup lines."

Some well-informed observers like JPMorgan Chase CEO Jamie Dimon have said the economy is likely to enjoy a boom that could last into 2023. Rosenberg isn't one of them.

The government has produced an "illusory boom," in his opinion. Fully "80% of the economy is already reopen."

He concedes “we will see a boom” in pent-up demand in areas that were at the epicenter of the lockdown. But travel, casinos, theme parks and restaurants represent only about \$800 billion in GDP.

“We’re getting all excited about 4% of the economy,” Rosenberg said. “How many vacations, haircuts or dinners out will you be taking?”

Conversely, another side of the economy that boomed during the pandemic, consumer durables, is likely to take a hit. Consumer durables are double the size of consumer services.

“How many more times will you remodel your house or buy another dinner table?” he asked. That’s why there will be an offset to the reopening boom.

Rosenberg thinks there will be a relapse in sluggish growth in this year’s fourth quarter, as the economy returns to some sort of secular stagnation that characterized the previous decade. He noted that the consensus on Wall Street that GDP will expand at 5.0% in the final quarter diverges dramatically from the Fed’s prediction of 2.0% growth in those last months.

If the Fed is right, that “could threaten the risk-on trade,” he said. “If you are of an inflation view, you are in a crowded trade.”

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No major changes in client portfolio positioning. I started to modestly shed some of the smaller cap technology names that peaked back in February, but still maintain an overweight exposure to the large capitalization technology sector and housing/real estate sector/industries.

Early in the year, I mentioned it would not be smooth sailing. I think investors who are chasing today’s data or sector rotation fads could be caught off guard during the second half of the year. For the most part, less trading in most market environments, particularly today, is the way to go.

<b>ASSET CLASS &amp; SECTOR OPINIONS</b>		
<b>OVERWEIGHT</b>	<b>NEUTRAL</b>	<b>UNDERWEIGHT</b>
<b>U.S. Real Estate &amp; Related Equities</b>	<b>Communication Services Sector</b>	<b>Energy Related Equities</b>
<b>Large Capitalization Technology</b>	<b>Healthcare Biotech &amp; Pharmaceuticals</b>	<b>Financial Services Sector</b>
<b>Consumer Discretionary Sector</b>	<b>Healthcare Equipment</b>	<b>Consumer Staples</b>
<b>Small Capitalization Stocks</b>	<b>Mortgage Backed Securities</b>	<b>Materials Sector</b>
<b>Aerospace &amp; Defense</b>	<b>Local Currency EMG Bonds</b>	<b>Leverage Loans (Floating Rate Debt)</b>
<b>Leisure &amp; Hospitality</b>	<b>High Yield Corporate Bonds</b>	<b>Treasury Inflation Protection Securities</b>
<b>Emerging Markets Equities</b>	<b>Investment Grade Corporate Bonds</b>	<b>Gold &amp; Gold Miners</b>
<b>U.S. Treasury Notes &amp; Bonds</b>	<b>International Developed Market Equities</b>	

Sincerely,  
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