

# David's Goliath Cometh

## Waging Battle to Uphold the 'Transitory' Narrative

"Am I a dog, that you come to me with sticks?" So, the Bible tells us, sneered gigantic Goliath at the slight shepherd who appeared to be brandishing his staff as a weapon. As we know, the hubris was the giant's fatal flaw. He never saw the perfectly aimed rock coming. Such is the beauty of the original story of the underdog. History abounds with similar tales of heroism, when a seemingly lesser opponent somehow prevails.

On the night of May 9, 1945, Lachhiman Gurung single-handedly held off an estimated 200 Japanese soldiers retreating to the village of Taungdaw in northwestern Burma. Five years earlier, the British Indian Army had rejected him for service. Gurung had grown up in such abject poverty that, due to malnutrition, he stood a scant 4'11" tall. Sheer determination landed him a place as a rifleman in the 4th Battalion, 8th Gurkha Rifles. Surrounded by his dead fellow soldiers and friends, his right hand no more than pulp and half-blinded with injuries, using his left hand to operate his standard-issue bolt-action rifle designed for right-handed soldiers, he fired at point blank range, reloaded and repeated this action for four hours. Though he lost his right hand and left eye, the hero slayed 31 soldiers and was awarded the Victory Cross, Britain's highest award for valor.



A towering 6'4" tall, Abraham Lincoln was anything but lacking in stature. And yet, the odds that he could rise to be one of the most revered politicians in world history were nil to none. Born in 1809 to a poor family in Kentucky's backwoods, his mother died when Lincoln was all of nine years old. He received only about one year of formal schooling. His early career was a disaster. After moving with his family first to Indiana and then Illinois, he became a partner at a general store in New Salem that failed, leaving the young man buried in debts. He took it upon himself to learn the law, as in no law school, and still managed to achieve success in the field. Lincoln made such a name for himself he entered politics and went on to serve four terms in the Illinois Legislature and one in the U.S. House of Representatives. His loss to Stephen Douglas for the U.S. Senate might have marked the end to his public service. But Republicans had noted his outstanding oratory skills in the debate that preceded his defeat which earned Lincoln the nomination at the 1860 National Convention. A split Democratic Party then handed him the victory that forever changed a nation.

Dubbed "dead men walking" headed into a round robin game against the Soviet Union in 1980, the world of sports may never again see a more inspiring tale. That's saying something as sports is full of standard bearers in the underdog department. It's nonetheless likely that we will never one-up the inspiring journey of the 1980 men's USA Olympic hockey team. Though they played stellar hockey going into the matchup with the Soviets, the players were amateurs and college stars, veritable novices compared to their opponents who had played together for years and operated on the ice like a well-oiled machine. We know they went on to win the gold. We've never stopped believing in miracles.

After Wednesday's stunning Consumer Price Index (CPI) report, most think it will be a miracle if inflation proves to be "transitory" as Federal Reserve Chair Jerome Powell keeps insisting, hoping he can stave off tightening in any form until his term ends in January. It's no longer an open secret that the Fed is making policy to support the stock market. It's plain open, cut the feigned secret part.

Against this backdrop and rising odds that he could be wrong, QI's dear friend David Rosenberg is sticking to his similar call that the inflation scare will come and go. Making matters worse, he, like me, nearly always disagrees with the Fed's policies. And he agrees that policy is stoking unprecedented financial instability and that shattered credibility among monetary policymakers is becoming problematic. But that doesn't change his stance on his inflation outlook, at least for the moment.

Of course, there are always two sides to every story. And there's no sugar-coating the headlines with the 0.9% month-over-month (MoM) increase in the core CPI being the biggest increase since 1982. The tail risk is definitely out there -- a lasting inflation could emerge from what is likely ferocious but passing. At the opposite end of the distribution lies the risk of a policy error, Powell relenting and the mere whisper of tightening sending risky assets falling. Wednesday's trading likely reflected both tail risks which, more than anything, shows how tight of a box the Fed is in.

Absent rendering the Fed's liabilities legal tender, inflation becoming entrenched has but one requirement. Fiscal policy would need to continue to run off the rails which would solidify what should be a long-overdue, but nevertheless, unwelcome rise in wage pressures. The problem with this hypothesis is that such an outcome would be accompanied by a falling stock market, which would prompt C-Suite occupants to whip out their digital pink slips. The worst-case scenario would be companies not being able to temper wages if a good number of the 17 million able-bodied workers in the labor pool continue to collect supplemental unemployment benefits even as women pour back into the workforce when schools nationwide (presumably) re-open fully in the fall. That's called stagflation.



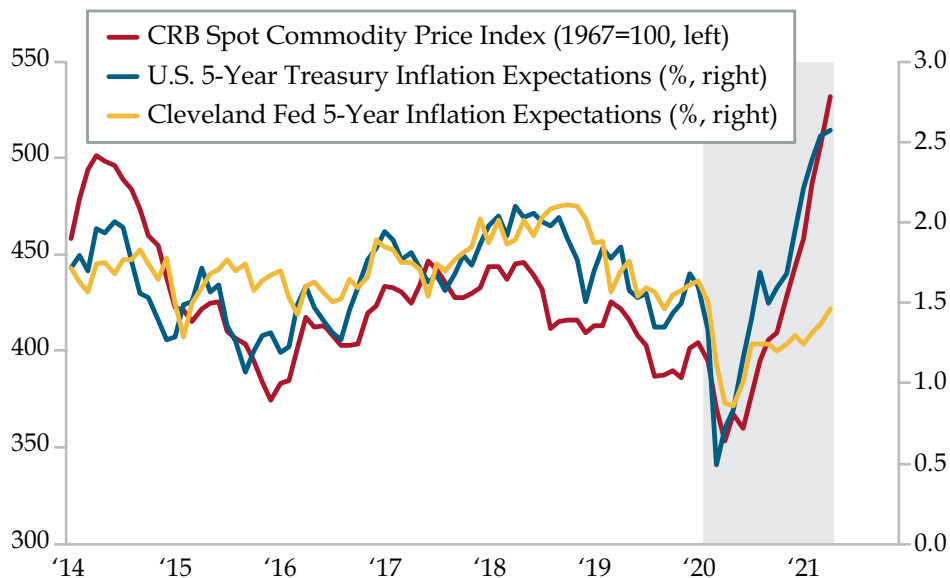
In the interim, it's well worth your while to check the hysteria against some hard data and bold assumptions. Consider the following Bloomberg headline that warned, "'Transitory' Inflation Could Last as Long as Two Years." The opinion piece posited that in the aftermath of the Great Financial Crisis (GFC), rising commodity prices were driven by China's massive infrastructure stimulus spending. "This time," the story suggested, "the U.S. may fill the role that China played more than a decade ago as the Biden administration proposes billions of dollars in spending."

The collapse of talks with Republicans who have drawn a "red line" on tax hikes suggests Democrats will pass the legislation containing infrastructure via reconciliation strictly along party lines. That will translate to \$157 billion earmarked for construction or improvement of bridges, highways, roads, ports, waterways and airports. Throw in upgrading wastewater and drinking water systems, expanding high-speed broadband, modernizing the electric grid and improving infrastructure resilience and you get to \$158 billion. That planned spending will be stretched over an eight-year span. Not only is the size too small to displace China as the world's primary consumer of commodities, the protracted period over which the funds are deployed, after months if not years of permitting concludes, will not support today's elevated prices.

Somehow, many investors have accepted as gospel that the politically charged push into climate-friendly initiatives plus the proposed infrastructure will indeed lead to the U.S. taking the helm as the world's driving force in the commodities space. Such narrow thinking takes us to one of Rosenberg's biggest pet peeves. In an hour-long interview with me last week, he lamented the avalanche of inflation expectation stories throughout the financial media. What the stories don't tell you is that the very inflation expectations referenced off the Treasury Inflation-Protected Securities (TIPS) are nearly a one-on-one reflection of the Commodity Research Bureau (CRB) Index. "For bond traders in the futures and options pits, their inflation model is a one variable model – the CRB Index."

Color him an economics sophisticate, but Rosenberg prefers a bit more elegance in his models. For that, he looks to the Cleveland Fed every month which dares to include labor as a variable in its inflation expectations formula. "How can you do any inflation forecast without 70% of the cost structure called labor in there?" he asked. "The Cleveland Fed model is actually a real model. It's not a one variable model, and the inflation expectations from their model are 100 hundred basis points lower than the one driven by the current bond market structure." The chart certainly corroborates.

## Will the True Inflation Expectations Model Please Stand Up?



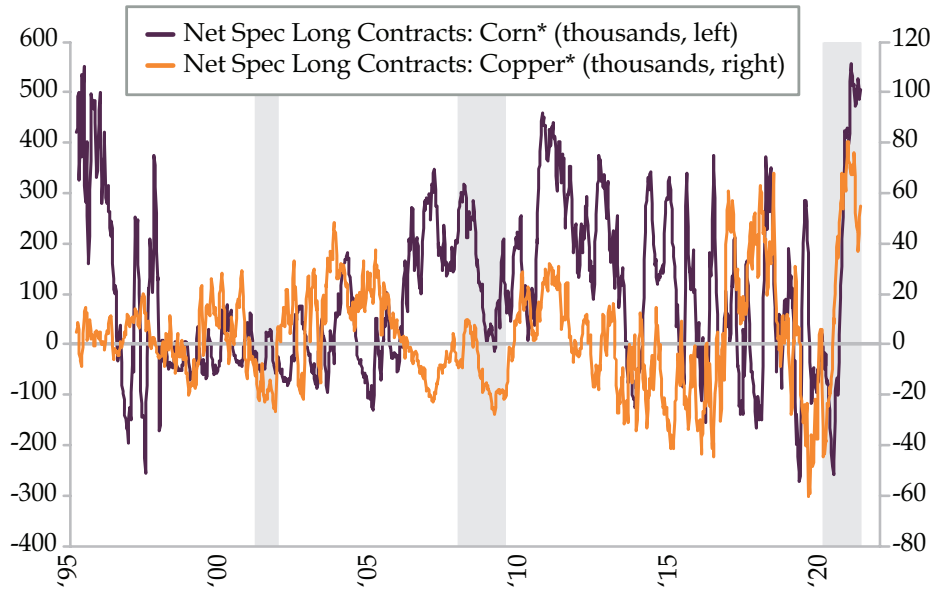
Source: Quill Intelligence, CRB, FRB-Cleveland, U.S. Treasury. Recession shaded.



Moreover, commodity prices today are dictated in no small way by spectators along for one helluva ride. Per Rosenberg, “The breadth and scope of the speculative positioning is unprecedented.” Zeroing in on two that have been among the hottest, you see that speculation in copper is off its recent peak but still on par with some of the highest readings in the past 25 years prior to the pandemic. Corn speculative positions remain in the stratosphere, within a whisper of their record highs. Surreally, on Wednesday of all days when the validating spike in CPI printed, the CRB closed up 0.2%. Both corn and copper closed down on the day as well as did the “it” girl of the whole universe, lumber. As fickle as today’s investors are, one can only imagine how small the size of the move need be to send the fast money fleeing.

### A Fast Money Flood Floats Copper and Corn

I would be remiss to move away from the subject of the CRB without sharing the following brilliant and brief analysis shared by HSBC’s FX guru and fishing buddy Brent Donnelly. Despite being on “Team Transitory,” as he self describes (he even has a t-shirt that says just that), with the inflation scare front and center, he was curious about how the dollar (USD) behaves when the CRB is up 0.5% or more in the face of rising



Source: Quill Intelligence, CBOT, COMEX. Recessions shaded.

Treasury yields and falling stock prices. He isolated weekly data back to 2000 that satisfied all three parameters. It would seem we’re in an exceedingly rare environment given there have only been nine weeks in the past 1,063 weeks in which the stars triple aligned.

“You can see in 2001 and 2002, the USD rallied, in 2005/2008, the USD sold off and now we are back to a regime where the USD rallied in that particular setup,” Donnelly concluded. “This makes sense. During 2001/2002 and again now, the USD is most sensitive to U.S. yields. In 2005/2008, the USD was more sensitive to stocks.”

### Yields Primary Determinant of Dollar

	CRB	SPX	10 Yr yield	CAD	EUR	JPY	CHF	AUD	NZD	GBP	NOK	SEK	KRW	TRY
2/16/2001	1.1%	-1.0%	0.08	-1.9%	-1.0%	1.5%	-1.0%	-1.4%	-1.6%	0.3%	-0.9%	-1.5%	1.6%	-0.7%
5/10/2002	1.1%	-1.7%	0.06	0.4%	-0.4%	-0.5%	-0.3%	1.0%	1.0%	-0.3%	-0.1%	-0.9%	0.3%	-1.0%
3/11/2005	1.7%	-1.8%	0.23	2.0%	1.7%	0.7%	1.6%	0.3%	0.9%	0.2%	2.4%	1.3%	0.5%	-1.4%
5/12/2006	2.4%	-2.6%	0.09	-0.4%	1.6%	2.3%	2.3%	0.1%	-2.1%	1.9%	2.2%	1.0%	-0.2%	-7.9%
2/8/2008	0.8%	-4.6%	0.05	-0.4%	-2.0%	-0.8%	-1.0%	-1.0%	-0.8%	-1.0%	-1.9%	-2.0%	-0.3%	-3.8%
3/28/2008	1.3%	-1.1%	0.11	0.1%	2.4%	0.4%	1.4%	1.7%	0.7%	0.6%	3.0%	2.5%	1.0%	-4.3%
8/16/2013	0.7%	-2.1%	0.25	-0.5%	-0.1%	-1.4%	-0.4%	-0.2%	0.8%	0.8%	-1.1%	-0.2%	-0.2%	-1.3%
2/2/2018	0.8%	-3.9%	0.18	-1.0%	0.3%	-1.5%	0.1%	-2.2%	-0.7%	-0.3%	-0.6%	-0.4%	-2.4%	-0.5%
2/26/2021	1.1%	-2.4%	0.07	-1.0%	-0.4%	-1.1%	-1.4%	-2.1%	-0.9%	-0.6%	-2.3%	-2.0%	-1.7%	-6.6%

Source: HSBC





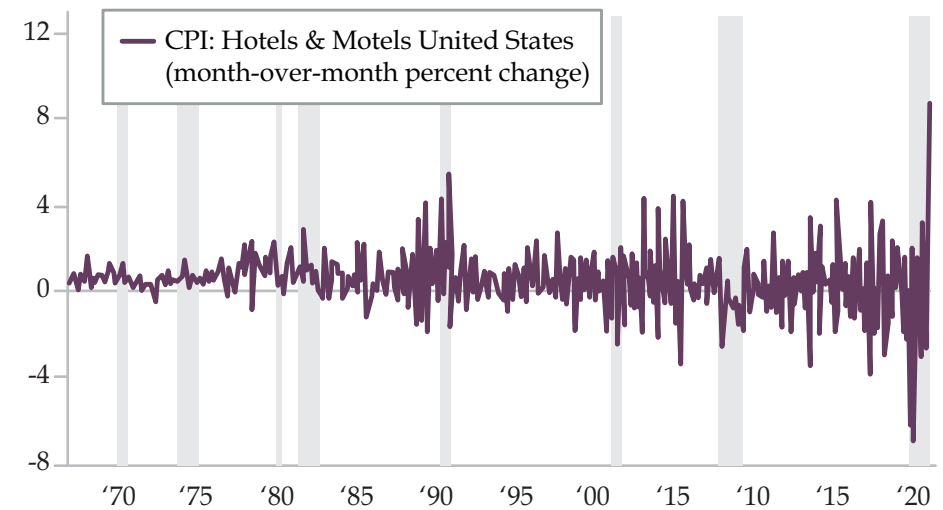
It was curious to see the inflationistas running victory laps Wednesday given the data had so many idiosyncrasies. While the monthly change was extraordinary, it also revealed some pockets of runaway prices that will correct. Used car prices rose 10% in April, the fastest pace since data were first collected in 1953. Aside from the Manheim Index being up more than 50% over the past 12 months, we knew this was coming for three reasons – the semiconductor shortage, stimulus checks and rental car firms dipping into the used car market to replenish their fleets given the supply of new cars is insufficient. Such was the spike, it accounted for more than a third of the 0.8% MoM increase in headline CPI.

Rosenberg is also not convinced the demand will persist. He poured over historic data to find other instances of car sales being as strong as they were in April, when the seasonally adjusted annualized rate hit 18.5 million units. Each of these instances was followed by precipitous declines over the next six months. The same goes for the history of new home sales coming in north of one million in any given month. Housing starts at 1.7 million also take us back to levels last seen in 2005 and 2006. “We’ve brought forward a lot of consumption, not just on housing and autos, but durable goods in general,” said Rosenberg.

As for the popular notion that the next step for U.S. consumers is venting their pent-up demand for services, Rosenberg points out the obvious – that we are not going to have six dinners out per weekend to make up for last year’s lost meals. We will only get one haircut at a time. We could only take one vacation during Spring Break. You get the idea. Moreover, services spending is \$800 billion per annum, or 4% of U.S. GDP. Will there be spikes as the Americans who have been cooped up stretch their arms for the first time? That’s clearly the case as we saw unprecedented monthly rises in sporting event prices, airlines and hotels. But ask yourself whether you will swallow months on end of those types of rises in these areas. Just in the last few days, I’ve received several emails from New York hotels announcing they’ve reopened and welcome my next visit.

### Hotels Enjoy Spike in Room Rates Upon Re-Opening

When Rosenberg put pencil to paper, he added up 7% of the core CPI that rose by roughly 10% in April, a degree of concentration that history has never witnessed. “Then again,” he quipped, “it’s been over a century since anyone had to endure a global pandemic.” The flip side of these one-month aberrations is that 93% of the core CPI came in at +0.3%, spot on with what the forecasters had been expecting.



Source: Bureau of Labor Statistics. Recessions Shaded.

The appreciably larger contributor to GDP is consumer durable goods, which account for \$2 trillion including all those new and used cars that have been driven off dealer lots. Over the past year, spending in this gargantuan sector has risen 44%, something that hasn’t been clocked since 1950.

“You would never know we had a recession by looking at the data on pleasure boats, furniture, appliances, electronics and home remodeling,” Rosenberg observed. “Normally goods spending goes down in a recession and it skyrocketed. So I would have to say that there is no pent-up demand for a huge share of consumer spending.”



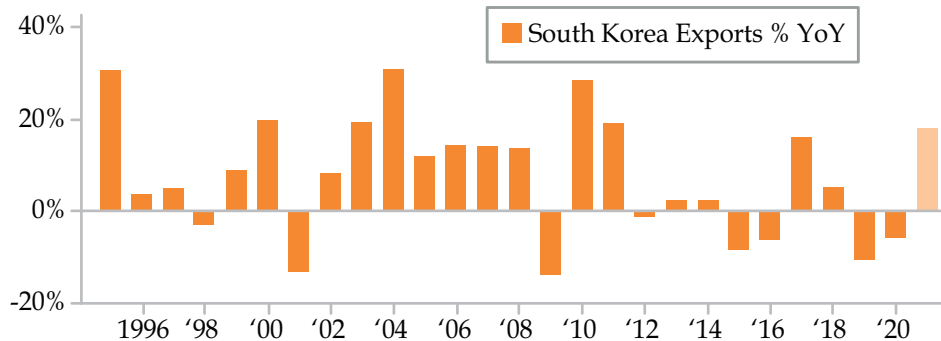
As for the supply side of the economy, there is no denying the acute shortages with which the U.S. factory sector is contending. That doesn't mean those who stand to profit the most from satisfying the unmet demand aren't feverishly working to ring the cash register at current prices. Rosenberg is also following the data out of the two biggest U.S. ports on the West Coast which he described as being "filled to the brim with merchandise."

That is anything but an exaggeration. In a report released Wednesday, the Port of Long Beach, the nation's second largest after that of Los Angeles, announced April was the 10th consecutive month that total volumes broke records for a particular month. That said, April's 44.8% increase over the prior year was down 11.2% from March's all-time high.

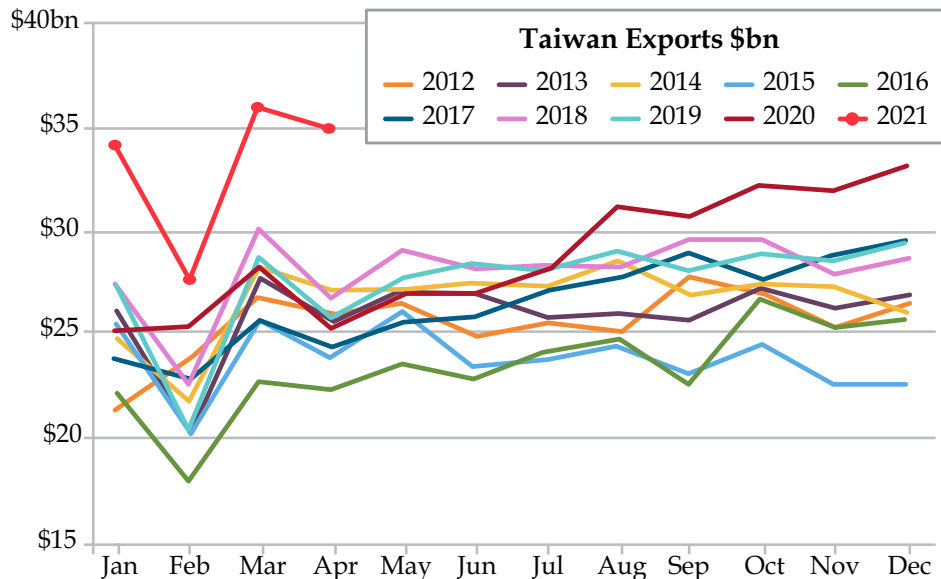
It would appear ships' wait times have also turned the corner. In February, 90% of the ships arriving at the Port of Los Angeles had to wait outside the breakwater in the 'parking lot' before being brought inside to anchor and unload. By the beginning of May, that percentage had fallen to about 65% despite ports operating 10-15% above normal capacity. Port officials met the challenge to improve cargo flow throughput and expect the surge in capacity to ebb by this summer.

As for the most talked about supply/demand mismatch, Rosenberg is not deaf to them, "I'm hearing all about semiconductor shortages. I'm also looking at the export and shipment numbers in Korea and Taiwan. They are through the roof. I'm looking at Canadian lumber production, which is also through the roof. To suggest that supply's not going to come back online with a lag to me is nonsensical." South Korea exports are expected to hit their highest since 2011 while those coming out of Taiwan need a higher scale.

### Korean and Taiwanese Exports "Through the Roof"



Source: Trade Ministry, Hyundai Research Institute. \*2021 estimate from HRI



Source: The Daily Shot



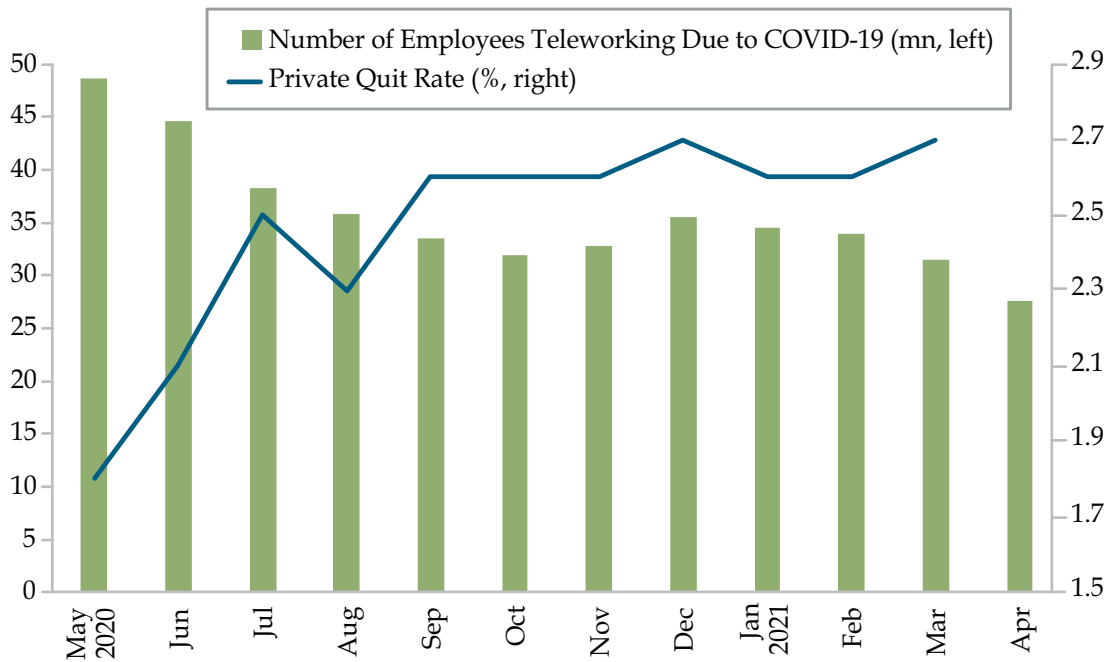
While a few in the economics community have begun to sniff out an abatement in the supply chain disruption, few see a light at the end of the tunnel when it comes to the other severe shortage, that of labor. There are a few hopeful signs. Just today, I heard that a school on the outskirts of Dallas was in its final week before letting out for the summer. The rest of Texas' schools will be out by May 28th, as in two weeks from now. Some of the vacant positions will be filled by high school students who can never qualify for unemployment benefits in time to take advantage of the supplemental unemployment benefits.

True relief, however, is unlikely to arrive until the start of the next school year which will unshackle millions of women who've been forced to leave the workforce. The best news is that all of two states have rising COVID-19 case counts suggesting that even as we witness the highest TSA throughput numbers since February 2020 and a visible loss of social distancing, we're not suffering a virus resurgence.

The linchpin will be arresting those supplemental unemployment benefits. As Rosenberg points out, some 16 million U.S. workers are in collecting mode. Prior to the pandemic, that number was two million. "Here we are the economy almost fully reopening, not totally, but largely reopening. We've got this gargantuan GDP growth on our hands. And yet, we have a situation where employment is lagging well behind for a variety of reasons," he said. "When you have eight times the number of people on at least one benefit program it does support the view that these people are getting paid not to go back to their old job because they are making more than they were making before. There's a big incentive to not go back to work."

While only time will tell, it is telling that banks and private equity firms are demanding their employees get back into the office. Financials are part of the driving force that's nearly halved the number of employees working remotely. There are sure to be other sectors that follow suit...or else. Once workers fully grasp what it means to have to go back to the office, they could shed some of the bravado that's helped push up the Quits Rate.

### Work from Home Waning Which Should Help Cap Quits Rate



Source: Quill Intelligence, BLS



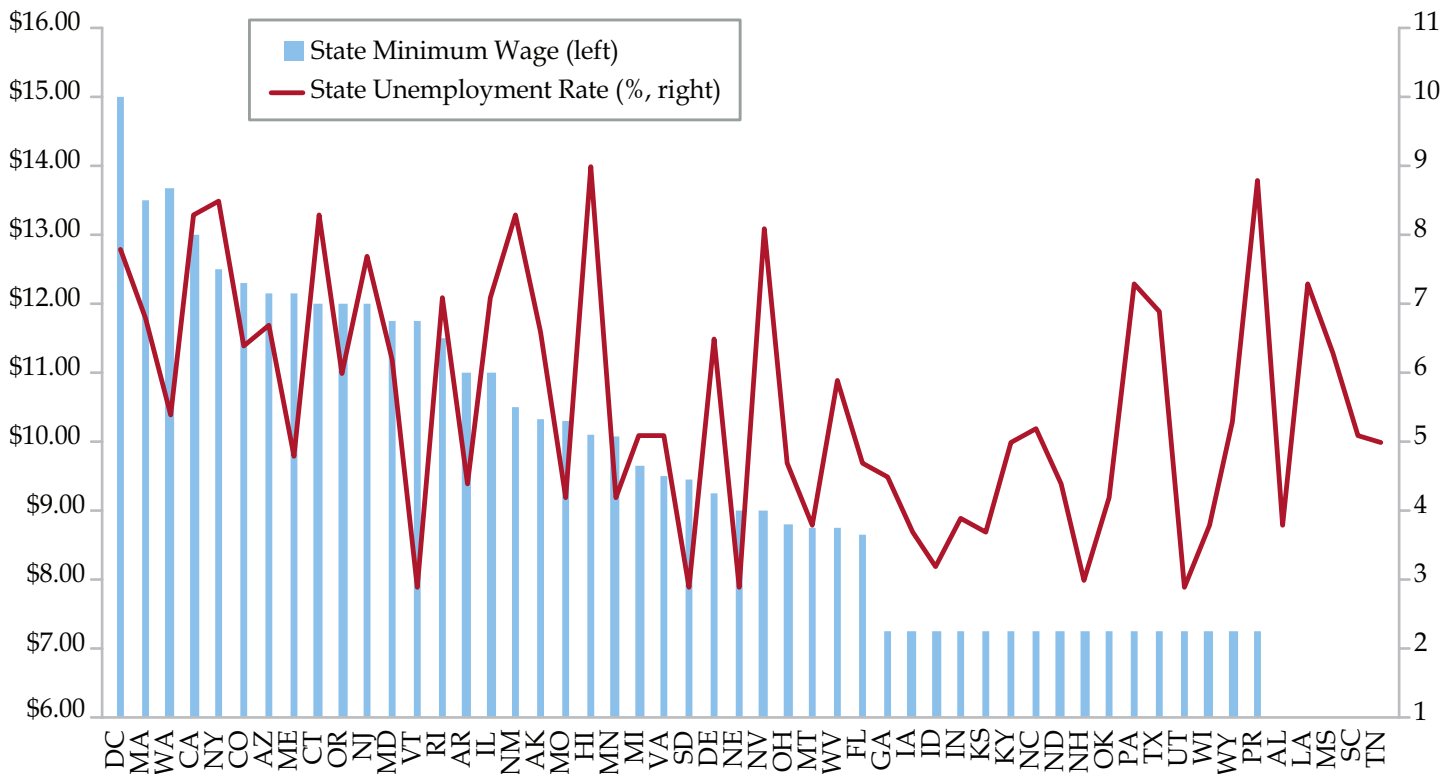
A normalization in the number of those collecting supplemental unemployment benefits will also temper the “take this job and shove it” factor. Actions being taken by individual states should also help relieve the shortage of workers. As of this writing, 12 states have announced they will be terminating their involvement in federal pandemic-related unemployment programs early. We will have real-time data to contrast the states that remain in the programs through September 6th with those that pull out this June.

Perhaps what’s most intriguing is that states that pay relatively high minimum wages do not have systematically lower unemployment rates. Washington D.C., which pays a minimum wage of \$15 an hour is contending with a 7.8% unemployment rate, well north of the national average of 6.1%. Meanwhile, Alabama, which is pulling out of the federal programs by June 19th, has a 3.8% unemployment rate. It’s little wonder the governor is tapping what few available workers are sidelined.

Another state that is stepping away from federal benefits on June 19th is Idaho, home to the hottest housing market in America. Flooded with Californians escaping the Golden State’s taxes, the Gem State’s unemployment rate is 3.2%, the fourth lowest in the nation despite its minimum wage of \$7.25.

Consider this math via Boise’s KTVB local news: “Someone working 40-hours a week at the minimum wage would take home a gross weekly pay of \$290 for a total of \$1,160 a month and just over \$15,000 annually. With the unemployment benefits, someone who made \$7.25 an hour could collect up to \$14.75 an hour, on the low-end of the spectrum. The maximum someone in Idaho can receive in unemployment benefits is \$463. To beat that, they would have to make more than \$11.57 an hour to bring that much home. With President Biden’s \$300 weekly bonus, some may receive a maximum of \$763 a week, which is nearly \$20 per hour. Idaho Governor Brad Little reinstated the requirement that people on unemployment must be actively searching for a job.”

### No Rhyme or Reason to Minimum Wages and State Unemployment Rates





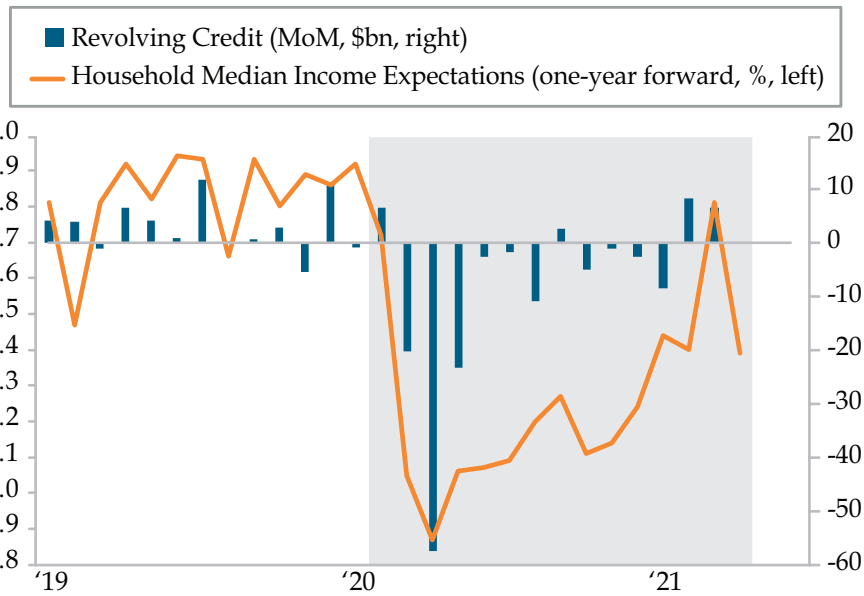


It should be pointed out that, per Bureau of Labor Statistics data, in 2020, there were 479,000 Idahoans being paid an hourly wage. Of those, 7,000, or 1.4% of them were paid minimum wage or less. While minimum wages have realistically risen due to the massive growth the state has experienced, it's doubtful many can compete with nearly \$20 an hour.

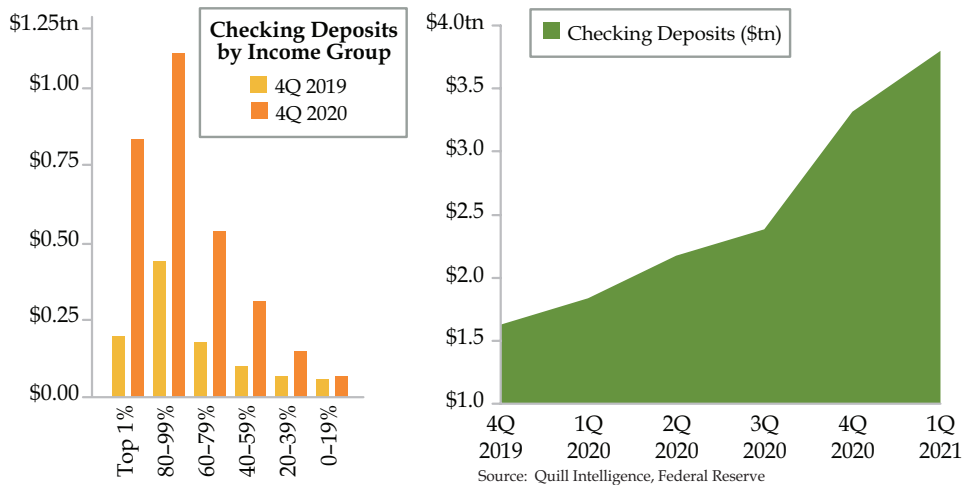
While a nascent trend, it's telling that households' income expectations have come off their post-pandemic highs. That conflicts with the back-to-back rises in credit card spending in February and March, which typically signal income earners are confident enough in their job security to splurge on debt-financed spending beyond their means. It's clear that conflicting political winds have some feeling more confident than others.

There's also the possibility that easing lending standards have households leaning on the plastic to offset what is, without a doubt, a spike in food and gas prices. Many households could be growing nervous about life after stimulus checks and supplemental unemployment benefits. As you can see in data from the *Wall Street Journal*, a good portion of the savings that's been built is in the hands of the highest income earners. Per the *WSJ*, "Of the \$2 trillion increase in checking deposits between the final three months of 2019 – the last quarter before the pandemic struck – and the final three months of 2020, roughly a third was accumulated by the richest 1% of households, and slightly more than a third by the remainder of the top 20%. While checking deposits held by the poorest 20% rose, that accounted for a very small share of the overall increase."

### Tapping the Plastic as Stimulus Runs Dry



Source: Quill Intelligence, Federal Reserve, FRB New York. Recession shaded.



Source: The Wall Street Journal

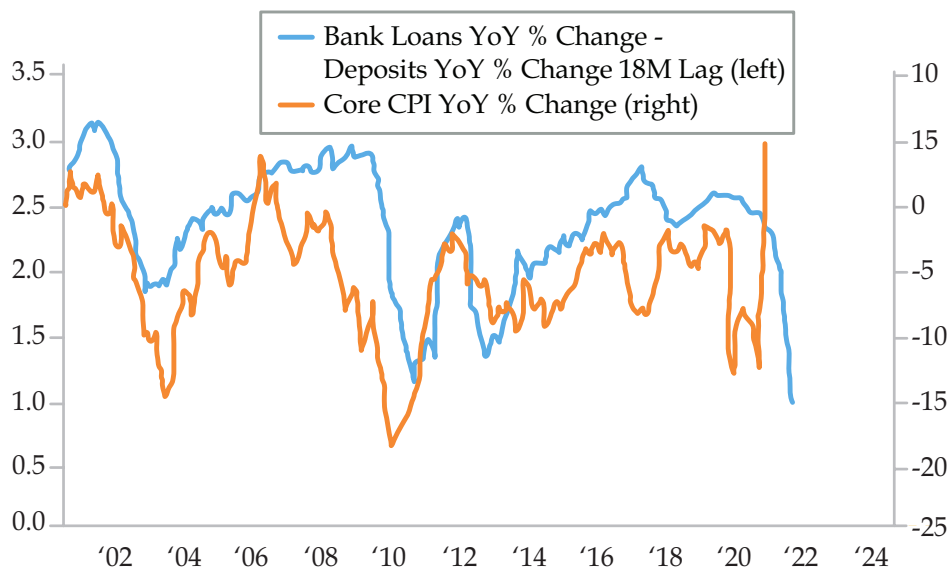


Rosenberg is also an adherent to the Lacy Hunt school of thought on velocity being the key to unleashing sustainable inflation. By the looks of this chart crafted by QI amigo Steve Blitz, we ain't there yet. Bear in mind that while not depicted, the relationship between the core CPI and bank lending is strong all the way back to the 1950s. According to Blitz, "One reason why an inflation process is not yet underway is that the process requires banking to be complicit -- financing the demand for funds to buy goods and services. Banks make loans, create deposits - we have been living in a world where the Fed creates reserves by way of buying Treasury securities. Hence, an inflationary process for asset markets has been unleashed, not for real goods."

To be sure, the banks are not complaining. Not only has the Fed reinstated their ability to buy back their shares, which pumps up their bonus pool, they've been the chief beneficiaries of the Fed's bailout of the U.S. corporate bond market. Investment banking fees, wealth management and hyperactive capital markets have all powered earnings since the pandemic first struck.

"I'm looking every week at the bank lending data and not just businesses, but households, and it's undergoing an epic contraction. People are actually paying down debt," said Rosenberg. Citing New York Fed data that showed only 25% of the stimulus checks flowed through to spending, he added that, "the rest is being split between paying down debt and investment, which is your Robinhood account. That's really the story here in the overall context of how gigantic the stimuluses and the impact they've temporarily had on personal income, which is without precedent, bigger than LBJ's Great Society. But what happens when the well runs dry, Danielle? People will be surprised at how high the saving rate is going to be for a prolonged period of time."

### Missing in Action: Bank Lending



Source: TS Lombard

Rosenberg is clear that he won't be married to the "transitory" narrative if May's and June's monthly rises are as meteoric as that of April. If that happens, he sees the Fed being forced to shift its dovish rhetoric or risk losing what little credibility they've still got. "At the same time, I fully expect the price data to settle back down once all the distortions have run their course," he added in his post-CPI print deep dive. "To be honest, I find it both amusing and just a tad disingenuous that the legion of 'pundits' and 'experts' out there are willing to extrapolate the CPI data after telling you to ignore Friday's weak jobs number as just a one-off aberration. The market in select thinking, but what is actually poor thinking, is in a bull phase of its own."



## One Month Does Not A Trend Make, Unless You're the Breathless Punditry

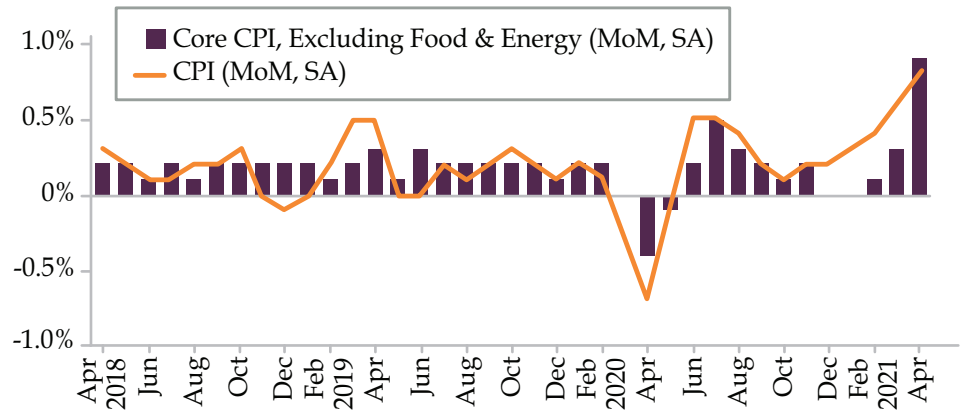
A personal note to round out this week's missive. I met David Rosenberg, who I call Rosie, in the fall of 2007 in New York. We were both attending the BCA's annual conference. I had joined the Fed the prior year and was relieved to be newly invisible after the unending torrent of hate mail I had received during my short stint as a columnist on the financial markets. Predicting the housing crisis did not win any popularity contests.

Rosie was at the opposite end of the limelight spectrum, vindicated at last for being the only bulge bracket economist to rightly call

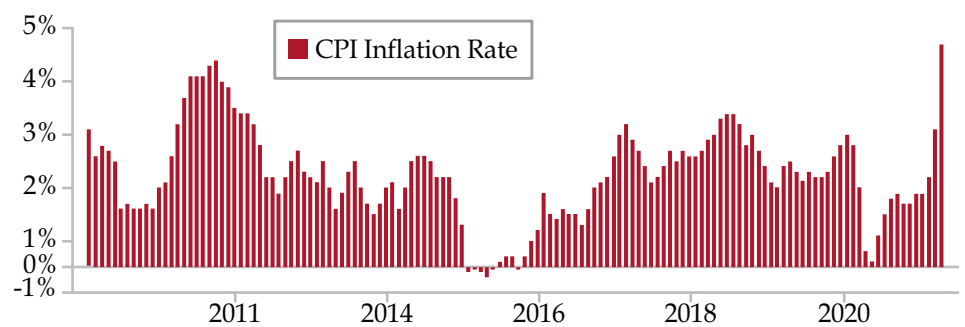
the housing bubble and stick to his call despite enormous pressure to stand down. Recall that Merrill Lynch was the firm to first put a price tag on its subprime book. It was 22-cents on the dollar, even worse than we had predicted. Aside from a being kindred economics spirit, Rosie is one of the best people I've had the privilege of meeting. That day at The Pierre Hotel, we commiserated on what it felt like to be ostracized as I was arguably even more reviled within the Fed for having rightly called the damage to be unleashed on the economy even as the bubble burst in real time before our very eyes.

Is it conceivable that we're at the precipice of a turn in the 40-year trend in inflation? Janet Yellen is Treasury Secretary. Anything is possible if the economy stumbles anew, and she finds herself in an environment open to re-writing the Federal Reserve Act to legalize socialism. It might not even take such extreme measures. If the Democrats find a way to keep stimulus monies pumping into the economy and extend supplemental jobless benefits with the two remaining pieces of legislation they've been green-lighted to pass via reconciliation this calendar year, wage pressures could persist for longer than what can be characterized as "transitory."

If these events manifest, the data will change. And if the data change, so too will Rosie's. Until that time, he's happy to be playing the role of David once again, the one who fooled the unbeatable Goliath with the ruse of a staff just as the original underdog took precise aim at his adversary's head with the rock that felled the giant.



Source: Bureau of Labor Statistics



Source: Bureau of Labor Statistics

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