

CONTINUED RECORD STIMULUS

US economic growth should exceed 5% in 2021, and record monetary and fiscal stimulus continue. If Congress passes half of the administration's infrastructure stimulus spending proposal, then total pandemic federal stimulus spending will be seven times greater than the 2007-2009 Financial Crisis fiscal stimulus.

Moreover, the Federal Reserve (the Fed) maintains monthly net purchases of \$80 billion of US Treasuries and \$40 billion of federal agency mortgage-backed securities (MBS). The Fed's monthly gross purchases of these bonds are greater as it includes the reinvestment of all proceeds from the Fed's holdings of maturing treasuries, agency bonds and MBS principal payments.

The Fed's recurring monthly MBS purchases have resulted in many of these bonds yielding less than 10-year US Treasury notes. This is likely the first time MBS or any type of collateral backed bond has yielded less than a US Treasury bond of similar duration or maturity.

While the Fed's US Treasury bond purchases have also depressed government bond yields, the supply of US Treasury bonds is about to surge. During the pandemic the US Treasury issued more bonds than needed in order to have excess cash available if needed. In recent months, the US Treasury used this cash on stimulus payments. Consequently, the federal government will ramp its debt issuance to fund its regular annual deficit spending as well as funding past stimulus acts and future stimulus bills. Even if increased taxes are expected to cover some future stimulus spending, those estimated revenues tend to be spread out over ten years, while the spending is typically front loaded. As a result, one should expect a record year of government bond issuance.

The Fed has two mandates, full employment and price stability. As rising inflation becomes more apparent, the Fed will be under increasing pressure to curtail its bond purchases (i.e. cut back on printing new money to buy bonds). In other words, the world's largest US Treasury bond purchaser will curtail buying

Key Dates

07/02	Unemployment Report
07/05	Independence Day – Stock Market Closed
07/13	June CPI
07/28	Federal Reserve FOMC Press Conference
07/29	GDP 2Q Advance Estimate
08/06	Unemployment Report
08/11	July CPI
08/26	GDP 2Q Second Estimate
09/03	Unemployment Report
09/06	Labor Day – Stock Market Closed
09/14	August CPI
09/22	FOMC Press Conference
09/30	GDP 2Q Third Estimate



(or taper) later this year while the world's largest debt issuer dramatically increases debt issuance. This combination should result in higher long-term interest rates and declining bond prices.

A RISING YIELD CURVE

The Fed controls money printing and overnight interest rates. Record monetary stimulus was achieved through doubling the Fed's balance sheet (i.e. printing record amounts of money to buy bonds) and lowering overnight interest rates to zero. As rising inflation pressures the Fed to cut back on monetary stimulus, it will curtail bond purchases before raising overnight interest rates. The result could be a material supply/demand in-balance in US Treasury bonds, creating higher interest rates. At the same time, the Fed is keeping overnight interest rates close to 0%. This will result in a steepening yield curve.

Economists interpret a steep yield curve as signaling a strong economy which may lead to overall inflation. The Fed typically squashes threats of inflation by raising overnight interest rates, which, in turn, flattens the yield curve. However, this time, the Fed must curtail or taper its bond purchases first since too much newly printed cash in a strong economy can lead to more immediate and even greater inflation.

This is an attractive time for homeowners to refinance their mortgage as longer-term interest rates may rise from greatly depressed levels. However, bank savings accounts and money market funds will continue to pay savers close to nothing as overnight interest rates remain stubbornly close to zero.

WHERE TO INVEST

Rising inflation and rising long-term interest rates are bad for bonds and bond-like investments. Investments purchased for their stable yields will be worth less when competing yields rise. Today, a 30-year US Treasury bond yields 2.1%. If its interest rate rises by 1% point (to 3.1%) then the market price of that 30-year US Treasury bond will fall by 19%.

Other investments purchased for yield include most types of bonds, preferred stocks, master limited partnerships (MLPs), utility stocks, mortgage REITS and even some energy stocks.

Meanwhile, large-capitalization stocks have surged in value over the last ten years, far outpacing the stock returns of many small and mid-size firms. Recently, just 20 stocks represented 36% of the S&P 500 index. Those same 20 companies were 22% of the MSCI World index. Thus, adding a large-cap global index fund might not diversify an investor portfolio as much as intended.

The average company has a hard time growing profits during periods of inflation. Rising labor, shipping, energy, raw materials, interest rates and possibly taxes can cut profits. Well informed customers, substitution and competition limit the ability of many companies to raise prices enough to preserve margins.

Investors can focus on overlooked areas of the stock market that have strong fundamentals during periods of inflation. Many dividend-paying, dividend growth, value, small-cap and mid-capitalization stocks were ignored during the last decade. Investors should focus on companies, industries and sectors that should experience accelerating earnings growth during this economic cycle.

Types of companies that might become more profitable include property REITs, patent holders, financials, media content owners, scalable automated-production lines, distributors and logistics-based firms.

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Timothy C. Call, CFA, President & CIO



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