Q&A-Markets may be under-pricing inflation; muni bonds trading at historically rich levels: Craig Brothers, Bel Air Investment Advisors

The combination of fiscal stimulus and loose monetary policy to combat the coronavirus pandemic along with reopened economies will drive a rise in inflation that bond markets may be mispricing, **Craig Brothers, Senior Portfolio Manager & Co-Head, Fixed Income at Bel Air Investment Advisors** told the Reuters Global Markets Forum on Thursday, January 28.

"I don't think the market is properly pricing in the inflation that is in the pipeline," Brothers said. "The commodity markets have moved up sharply the last 6 months … traditional indicators of inflation: gold and silver are waking up."

Following are edited excerpts from the conversation:

Q: To begin with the Fed - the statement yesterday was fairly uneventful, was there anything there that you found notable?

A: The Fed wants to convey to the market that commitment to accommodation. [There was] no change in their stance. Powell has been clear that he wants more rather than less fiscal help from Washington [D.C.], Yellen is in the same camp.

There is uniform support for Fiscal Stimulus from Fed, Treasury, White House, and Congress.

Q: At this point, what does the ideal stimulus package look like? More direct checks?

A: Direct checks in the hands of the worker is best but these packages have lots of special interest money, i.e. pork.

As everyone is seeing with GameStop much of the stimulus is finding it way into the market. I saw a survey of income groups below $100 thousand and the #3 place money was going was "speculation." These are not the people who are "in the market." As long as the economy remains closed, the savings rate will just build.

Q: On that note - do you think the craziness of the past few days in equities could prompt some investors to move back into bonds?

A: I think a larger selloff is needed to create a flight of quality move into bonds.

We manage high-net worth money, most in municipal bonds (munis). Our flows remain strong. The Muni Market is trading historically rich relative to U.S. Treasury bonds.

The supply has been impacted by the 2017 Tax Act that limits advanced refunding to taxable munis.

Q: Do you see that trend continuing?

A: Yes, the reduction in tax exempt supply and the demand for tax exempt paper has created this abnormally rich market. This month the 10 Muni Ratio (Muni/Treasury) reached a 20 year low of 65%. To put that in context, the 5yr average is 93%.

Q: What is your expectation for inflation this year?

A: We expect inflation to move up to 2%**.** The combination of record fiscal stimulus, monetary accommodation and a reopened economy will get us to [over] 2%. The vaccine is the final catalyst.

Most Wall Street economist are projecting 4% GDP with recent moves to 5% and greater by Bank of America and Goldman. A 5% GDP would be the highest GDP since 1984 so we expect inflation to come along for the ride

Q: Given that, are inflation expectations adequately priced in to bond markets at this point?

A: I don't think the market is properly pricing in the inflation that is in the pipeline. The commodity markets have moved up sharply the last 6 months. The CRB Raw Industrial Index is breaking above a 10yr downtrend. Traditional indicators of inflation: gold and silver are waking up.

The Biden Administration is not a friend of Big Oil. The move to prevent new drilling on Federal Land could have an impact on oil prices. Biden stopped the Keystone Pipeline and left the sanctions on Iran. These actions will allow oil prices to rise higher when the economy reopens.

Q: If there is a faster than expected jump in inflation, how do you see that impacting TIPS?

A: The move in TIPS has done a better job of pricing in the move inflation. Higher inflation numbers validate the move.

Q: Got that. As our last question, when would you expect the Fed to begin tapering?

A: The Fed wants to wait as long as possible to taper, they have seen what happens by tapering too soon. Powell has said the he is not even thinking about thinking about raising rates. [Richard] Clarida has said inflation needs to run over 2% for a year (Average Inflation Targeting). Inflation would need to run above 3% for at least 6 months to bring their target date for tightening into 2022.