INVESTMENT
UPDATE

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THEY SAY YOU CAN'T FIGHT THE FED… BUT WILL THE FED FIGHT?

Today (June 2nd), I walked maskless for the first time since pre-Covid into our local downtown Evanston Starbucks for my morning java. It was the most crowded I've seen throughout the pandemic. Restaurants are filling up, O'Hare is busier than ever, and road traffic is crowded. Anecdotally, at least signs of a return back to "normal" life are everywhere. Just ask my wife Natalie—I even shaved my Covid beard, two weeks of course after receiving my second shot!

From a government perspective at least, stimulus spending rages on to combat the situation. Just last week, President Biden announced a $6 trillion budget for the next year. Some contemplated offsets are an increase in the high marginal income tax bracket to 39.6%, a near doubling of the capital gains rate to 43.6% for high earners, a reduction of the estate tax exemption to $3.5 million per person, and probably of most interest to our clients, an elimination of the "step-up" in basis on an investor's portfolio, creating huge tax liabilities at the owner's death. Of course, none of this is final at this stage, so stay tuned for updates.

But what really seems to be financing this and future budgets (i.e. deficits) is a bet on interest rates. Treasury Secretary Janet Yellen defended the budget last Thursday by telling Congress it is fiscally responsible because the real interest rate burden is negative. That is, at 1.60% long term Treasury yields are less than the 2% inflation target.

In interest of remaining transparent and apolitical, former Clinton Administration Treasury Secretary Larry Summers stated that the spending plan risks are "overheating" the economy, which he sees returning to normal trend growth at the end of the summer. He warned that with existing monetary and fiscal stimulus programs, this could lead to inflation and price surges that are more than transitory, as Fed officials now insist. But the fear is that the only way this spending binge can be financed is if interest rates stay unusually low.

Historically, the Federal Reserve's biggest tool is its ability to set lending rates. If the economy is showing signs of running hot, the Fed can raise rates to pull dollars out of the economy and into savings, or vice versa. Some of those signs are starting to emerge in commodity prices for example as Nicole Kustok discusses inside. But signs are also appearing in the markets: think "meme" stock trading in Gamestop, the rise (and for the moment fall) in Bitcoin, the pullback in many high-flying stocks like Tesla, etc.

Rising rates are not only bad for financing government deficits, but also for equities. Similar to governments, corporations in many cases have become addicted to low rates. As rates rise so do their costs of financing increase and their profit margins fall. Additionally, bonds become more attractive fixed income plays relative to the uncertainty of stocks.

It's too soon to tell if any of this will play out, but our concern is that the Fed, and despite statements to the contrary, seems more than ever beholden to the rising markets and backed into the corner afraid to signal even modest increases in rates anytime soon, evoking parallels to an ostrich with its head in the sand or a game of Chicken. They say you can't fight the Fed, but will the Fed fight?

To us, investment opportunities are not abundant and our cash levels are generally at their highest historical levels. This is a tough stance in a rising market, but we are taking a measured approach and reviewing our asset allocations. We thank you for your patience but as we invest our money alongside yours, we must invest with conviction–or not at all. A pullback in equity prices would be healthy in our view and a welcome opportunity to put some sidelined money to work.

We thank you once again for your trust and confidence in us and wish you a rapid re-entry to "normal" daily life, albeit a new normal.

Sincerely,

Joe Romano,
PRESIDENT

INFLATION—HERE TO STAY OR GONE TOMORROW?

Over the past year, while you were likely worried about staying healthy and figuring out how to spend *a lot* more time at home, a curious phenomenon was happening to our Nation's money supply. *The M2 money stock,* a term used to include cash in circulation, checking and savings accounts and money market funds, rose by $6 trillion dollars, or more than 30%.

There are a few reasons the U.S. now has drastically more spending money than it did just over a year ago, and ultimately two different possible outcomes.

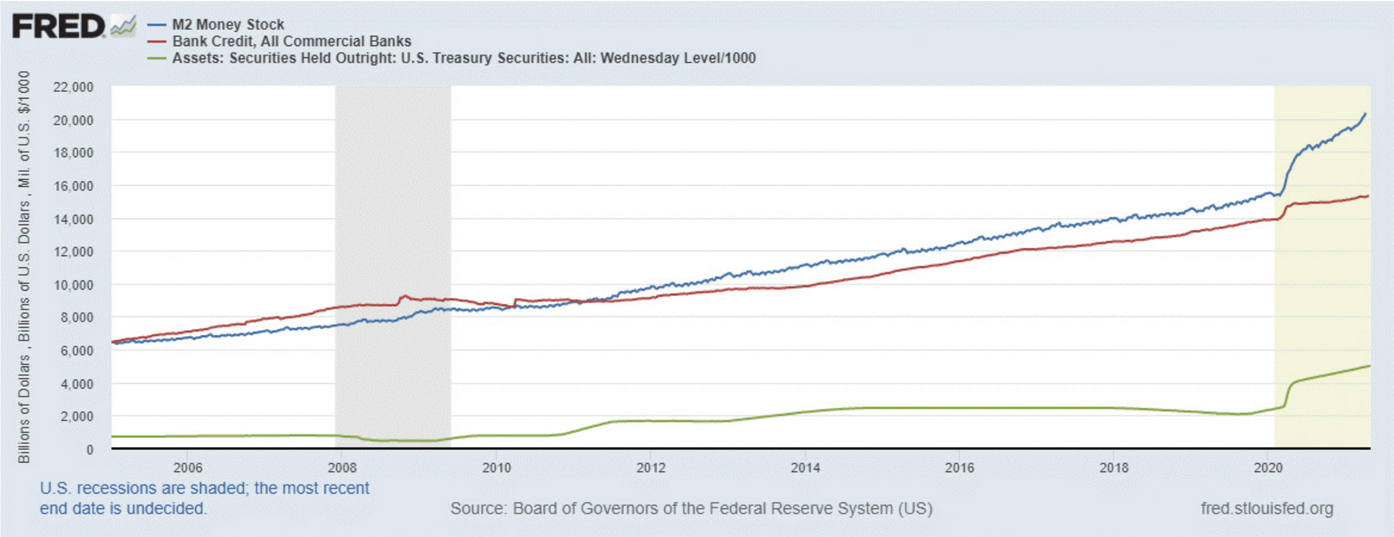
As the pandemic hit, the Fed began monetary expansion by enacting liquidity programs in hopes of staving off a longer-term recession. In the chart below, the steep increase in blue represents the Fed's purchases of Treasury bonds and mortgage-backed securities, to the tune of $4T. At the same time, U.S. companies drew down roughly $800 billion on their credit lines, adding the funds to deposit accounts in the event they needed quick cash for operations. Finally, commercial banks purchased short-term government debt securities, resulting in $1T credited back to the seller or borrower's account balance.

Throughout modern history, economists, and frankly my own college professors, taught us the recipe for inflation was simple - more money plus increased demand yields inflation. And, prior to the Fed's bond repurchase program, most money entered the economy through bank credit, via the *multiplier effect,* whereby when banks have additional money, they make exponentially more loans. This, in turn, helps drive business and grow the economy at a rapid rate.

However, given the global uncertainty and the shut-down, banks have been hesitant to assume additional credit risk, so we aren't seeing that same correlated surge in lending, or multiplier effect, this time around. Further, long-term unemployment benefits have made it harder for employers to fill positions, there-by stalling growth. While many will argue we have mostly recovered, we haven't yet seen full employment, or a growing economy backed by increased lending and business expansion. As a result, the Fed is telling us not to worry, any inflation is a fleeting problem. Namely, it isn't driven by how much money exists, but by *how much is spent.*

The final driver increasing the money supply is the stimulus programs passed by Congress to support businesses and consumers. Most of that money is stuck, too. Both the Federal Reserve Bank of New York and the Economist surveys reveal that only a quarter of the stimulus checks were spent, with the bulk of the payments being saved or used to pay down debt. This doesn't seem inflationary either—putting money in the bank or paying a bill doesn't result in any more demand for goods and services, at least not immediately.

Estimates for increased consumer savings during the pandemic range from $1.6–$2 trillion dollars. It's early to tell if this money is an increase in wealth or transitory income that will ultimately be spent. For example, as the world reopens, a family won't likely take multiple vacations or get extra haircuts to make up for lost time. They may however, renovate a room or replace the washing machine, both purchases that won't happen again



for some time—behaviors that reinforce Fed Chairman Jerome Powell's 'there's nothing to see here' rhetoric.

As convincing as the case above may be against inflation, both Wall Street and Main Street will tell you otherwise. Take a walk through the Home Depot lumber section or talk with someone trying to buy a vehicle and the shortages coupled with increased demand are readily apparent. Consumer Price Index data released in May show that prices for goods excluding food and energy rose more than 4%.

Commodity prices, from steel and corn to crude oil are all showing big gains over the past year, with some having doubled. Covid-induced supply chain issues, legacy tariffs and Biden administration infrastructure spending plans are all very real. We've witnessed a 17% jump in existing home sales pricing and housing supply shortages not seen in a decade. And everyone from pizza deliverymen to sanitation workers are being offered four-figure-sign-on bonuses by potential employers. All of this makes the immediate purchasing power of your dollar less and the good you want most harder to secure.

So then, when does temporary inflation turn into something more? Interestingly enough, the answer may come from behavioral psychologists rather than economists. We know we have an employee shortage, empty shelves and rapidly rising raw material costs, all things that may take months to resolve themselves. Things can change quickly once the worry starts to set in. History has shown us that once consumers start to rush large purchases and stock up on necessities because they fear higher prices tomorrow, inflation can be self-fulfilling.

At Romano, we are monitoring inflation data closely and adjusting our financial models when necessary. As for human behavior, time will tell if we learned anything at all from the great toilet paper shortage of 2020.

Nicole Kustok joined Romano in June of 2020 after spending more than fifteen years in the global macro hedge fund and trading space, holding roles in portfolio management, investor relations and business development.

Nicole Kustok

ROMANO NEWS

ROMANO IS GROWING

We are pleased to announce the June hire of Scott Mayer, who recently joined Romano after ten years in the marketing and advertising industry. Previously, Scott was focused on bringing digital marketing solutions to life for a variety of clients in the consumer goods, manufacturing and hospitality industries. Scott is a 2010 graduate of the University of Illinois at Urbana-Champaign and the grandson of Richard Romano. He will be aiding our operations department while he works toward completing his Series 7 and Series 66 licenses.

BRETT'S PERFECT GAME

Romano Portfolio Manager Brett Larson bowled a perfect 300 in April! A life-long bowler, Brett plays in a league every Monday night with his father, who grew up playing in the *same league* with *his father.* Prior to his brush with perfection, Brett had a high score of 279. He says he had nerves of steel going into the 10th frame, probably due in large part to his partner at the time—Romano Operations Specialist and Brett's wife, Valerie Romano.

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BUSINESS AS USUAL

When Romano Employees left work on Friday March 13th, 2020, few of us dreamed it would be 15 months before we were all together under one roof again. Technology and strong leadership enabled a seamless transition to remote work and continued service to you, our clients. Nonetheless, we are thrilled to report we have the whole gang back together again! After daily morning calls and lots of Zoom meetings, it is wonderful to be able to stop at a colleague's desk with a question and catch up on the months gone by. If you plan to stop by the office, we ask that you make an appointment and wear a mask, per building regulations. We are looking forward to seeing many of you soon.