the advisor

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Hope

Danger's Comforter [1]

"Doubt is not a pleasant condition, but certainty is absurd." Voltaire

Recently, estimates of American stock market valuations reached their most extreme in US financial history.

The Wilshire 5000-to-GDP ratio sits at around 200% — higher than the ratio preceding the 1929 stock market mania, the 2000 dot-com bubble as well as the 2007-2009 Global Financial Crisis.[2] At the same time, American households are loaded up on stocks. In fact, equities account for 40% of US households' total allocation of financial assets, which is more than at previous market peaks.

This does not mean stocks are going to fall next week or next month. The path of least resistance is still higher. What it does mean is that it will be challenging to earn above average returns from stocks over the medium term. And if there were a market 'event', historically normal valuations are a long way down from these levels.

As Jeremy Grantham, a legendary hedge fund manager, has warned: "We have totally full employment, totally wonderful profit margins. All the things you would *not* want to start a bull market from. This is where you start bear markets from. Great bull markets start with exactly the opposite."[3]

For the moment, let's assume that valuations are reasonably informative about likely future returns (and about potential losses) over the complete market cycle. Returns over shorter periods of the cycle are driven mainly by investor psychology – speculation versus risk-aversion. Speculation becomes somewhat of a self-fulfilling prophecy. Recency bias spurs investors to buy an asset believing that it will rise; that increased demand causes the price to rise, encouraging more investors to buy. Investors increasingly disregard valuations during speculative episodes to the point where they become blinded by hope while inside the bubble.

By the time this market cycle is complete, speculators may find that the expectation of ever-rising profit margins was a forlorn dream. The risk is if the prop of ever-expanding earnings gets knocked out, the valuations of large-cap stocks will be left with an expansive air pocket below.

This past month, the US Federal Reserve finally cut interest rates by 50 basis points despite record tax receipts, low unemployment and better than expected GDP growth. Investors responded by pushing "risk-on" groups higher. Financial assets were already priced for perfection and lower interest rates will only push prices higher, or so speculators assume with certainty.

As sceptics, we are not so sure. A Fed pivot is usually a signal that all is not well. Let us explore one glaring concern and a potential course of action.

Regardless of who gets elected in America, there is a shocking disregard for budget deficits, now 7% of GDP. Currently, America's national debt is US$35.3 *trillion*, about 125% of GDP. The Treasury Department's own forecasts indicate that it will rise by an additional $16 trillion over the next 10 years. Given past governments' spending, the rise will be far greater.

This year's interest bill on the debt will exceed $1.1 trillion (the US government is borrowing over $3 billion per day just to pay the interest). This expense is growing at an alarming rate.

Consider that, just before the pandemic in 2019, the annual interest expense was around $400 billion. Today it's almost three-fold larger. Government tax revenue has increased in the last five years as well but the interest expense is surging even faster. The more money the government has to pay in interest, the less money is left over to cover discretionary spending in areas such as defence, education, etc. This forces the government into a Red Queen situation: borrowing even more money just to make ends meet.

Lowering interest rates does not disguise America's enormous fiscal problems. The real reason why the Fed cut interest rates is that the government *cannot afford it*. The 10-year yield today is less than 4% but even that is too high, therefore interest rates must come down.

1401 - 675 West Hastings Street, Vancouver, BC V6B 1N2, Canada Phone: (604) 687-5884 Fax: (604) 681-9694 Email: admin@investwell.ca

Hope, Danger's Comforter (cont'd)

With the federal debt expanding at an accelerating rate, it will likely surpass $50 trillion within the next decade. If interest rates averaged 4% at that time, the government would be spending $2 trillion per year just to service the debt.

The Federal Reserve governors may appear certain in their stewardship of interest rate policy but they know the situation is unsustainable. They know the only way that the American government can continue to function is if interest rates are closer to zero. The government seems to be running out of easy options. It will never be able to repay its debts so the question is not whether they will default but how.

Ultimately a combination of lower interest rates and extreme deficits will create a lot more inflation (default in slow motion). Moreover, if the Fed has to choose between higher inflation and a bankrupt government, they will choose the expedient path every time.

How does one protect a portfolio from the loss of purchasing power that accompanies inflation?

Having exposure to real assets in your portfolio could help. Real assets are tangible, physical goods such as certain commodities and natural resources which have intrinsic value tied to real world uses. These include energy, foods, metals and fertile farmland.

Unlike financial assets and paper money, these assets cannot be conjured out of thin air by central banks or by governments, which is why they can protect one's wealth from inflation.

Investors typically consider an allocation to commodities in order to get three key benefits: diversification, return potential, and an inflation hedge. Diversification (to dampen volatility) and higher return potential would be reasons enough to own this asset class. Inflation is why it makes it critical to do so.

Commodity prices tend to move in large cycles relative to the stock market. There are times when commodity prices are inexpensive and it is prudent to invest, and times when they are expensive and it's better to avoid them (see Figure 1).

"Over the past 125 years, commodities have reached these points of extreme undervaluation relative to equities on four notable occasions: 1929, 1969, 1999, and most recently, 2020. After each of the first three lows, commodities… went on to dramatically outperform the broader market. We suspect history is poised to repeat itself…All signs point to the early stages of a prolonged commodity bull market, likely stretching into the 2030s."[4]

Some commodity prices are on the move. Leading the way with impressive increases this year has been gold prices (which is not a good thing). Rising gold prices suggest that central bankers and investors are losing confidence in the US dollar. The conditions present in this precious metals space is an example of finding an undervalued commodity relative to the probability of future debt monetisation.

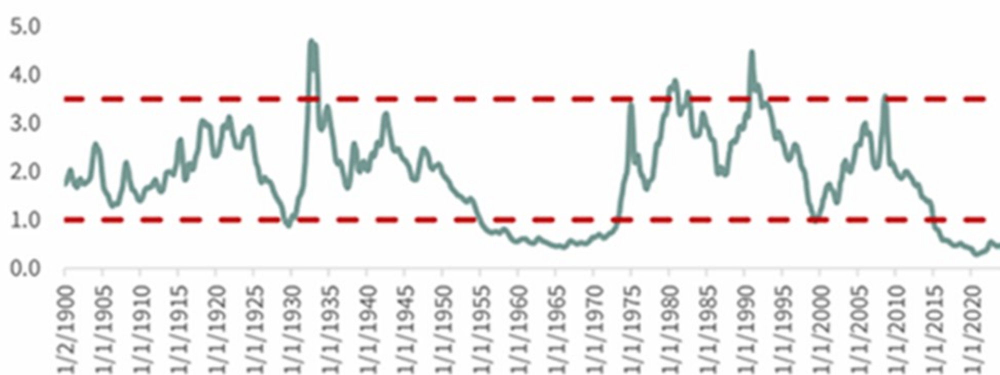
Other commodity prices currently on the march include energy assets such as oil and uranium.

But we are getting ahead of ourselves. Rather than trying to anticipate the future, a better approach is to first identify vulnerabilities lurking in one's portfolio. Specifically, those companies whose business models are not sustainable in an environment of higher inflation. Afterwards, gain exposure to assets that could provide resilience.

Investing in critical real assets at historic lows is an ideal way to capitalise on the situation. If inflation rises or if stock markets correct, those who invest carefully may be able to prosper.

Most investors seem to be overly certain about the stock market. As far back as the fifth century BC, Thucydides warned in his history of the Peloponnesian War that only those with abundant resources could afford hope; those without faced ruin.

Perhaps it is time for prudent investors to seek succour in commodities.



Sources:

1. Thucydides, "The Melian Dialogue", The Peloponnesian War
2. Buffett Indicator, GuruFocus, 25 September 2024
3. Jeremy Grantham, GMO, The Insightful Investor, 19 March 2024
4. Goehring & Rozencwajg Associates , "What is the cost of Being Early?", Market Commentary, 28 August 2024
5. Chart his page, Goehring & Rozencwajg Associates , "What is the cost of Being Early?", Market Commentary, 28 August 2024

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