TFP

the advisor

Winter 2020

Recovery & FAIT

"The tendency of an inconvertible paper money is to create fictitious wealth, bubbles, which by their bursting, produce inconvenience."

Robert Banks Jenkinson, Lord Liverpool
26 May 1818

Things are finally looking up as far as treating the covid-19 pandemic. The current economy, with countless businesses shuttered and millions of unemployed people, is another story but you wouldn't know it from looking at stock market valuations.

If the pandemic was the defining event of 2020, it wasn't the only factor affecting markets. These continue to be ultra-low interest rates and quantitative easing (printing money to buy bonds - and other assets). Central bankers appear to be blind to the relationship between monetary policies and yield-seeking speculation in riskier assets.

Central bankers' principle concerns are inflation and unemployment, so they think they can afford to ignore market valuations and the asset bubbles created by their monetary policies. As long as inflation remains below target, they do not see any risk. But risks there are aplenty.

The first risk is a potential banking and debt crisis. Banks borrow short and lend long, so when the slope of the yield curve (the difference between long and short-term interest rates) is steep, banks make a lot of profits; when the yield curve is artificially suppressed lower, their profit margins are squeezed and it becomes an existential challenge. Low interest rates encourage firms to take on debt, allow heavily indebted companies to stagger on, and incentivize businesses to shun productivity enhancing investments. Bad capital allocation today is bad for productivity and prosperity tomorrow. As borrowers' solvency and liquidity ratios weaken in a late business cycle, a rise in non-performing loans is inevitable. This build-up of debt becomes the banking crisis of the "hangover" years.

The second risk is emboldening investors to chase higher yielding assets, driving up their prices. Central bankers hubristically believe the risks of rising asset prices can be contained but we know from past experience that "manageable" risks are rarely managed at all. Furthermore, when the biggest bubble is in sovereign debt, citizens will bear the ultimate consequences: higher taxes as deficits rise and weaker purchasing power of savings and wages as central bankers adhere to policies that debase their currencies.

The third risk is ignoring inflationary pressures on the goods and services that citizens actually consume. For years, American education, healthcare, insurance and food prices have all been rising much faster than real wages. A study from Bloomberg Economics showed that the cost-of-living inflation suffered by the poor and middle-class is up to three times higher than the official CPI (consumer price index) followed by the Federal Reserve.[1]

If those are legitimate risks, why are the markets disregarding them? Market behaviour is a curious thing. The market responds predictably to the stimuli it receives But the market also sends signals that confound investors.

On the one hand, most bulls will say that the underlying stock market's strength is due to vaccine rollouts and the waning of the pandemic, to repressed consumer spending, and to the likelihood of ongoing global stimulus. Current momentum suggests stocks are only going higher.

On the other hand, most bears will quote from "Extraordinary Popular Delusions and the Madness of Crowds", and warn of the unsustainability of rising debt and the dangers of bubbles.

Most realists will subscribe to parts of both perspectives but point out the real issue is the distortion of asset prices caused by long-term, ultra-low rates and ongoing policy repercussions. Too much money chasing too few assets (the situation in stocks) will always push up prices. For many stocks, it will take years if not decades for the share price to grow into the current valuations placed on them (just as it took almost two decades for Microsoft, Cisco and Intel to grow into the stupendous expectations investors had for them during the 2000 dot.com bubble).

The reality is central bank policies are the dominant force driving stock prices higher. That might be difficult to accept, unless investors believe

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Recovery & FAIT (cont'd)

stocks represent fundamental value at these levels? Moreover, the belief markets cannot go down because central banks have investors' backs is now firmly rooted in their mindset.

The principles of finance - of risk, reward and valuation - are well known. There is an economic relationship between growth, global wealth and the value of stocks. Today, stock market valuations are badly out of sync with global growth prospects. Investors are being forced to accept ever greater risks for ever lower potential returns. Markets are not rational; they are the aggregation of beliefs driven by the hope of reward. Beliefs have consequences: investment bubbles are one.

In addition to central bank policies, there are a number of factors fuelling stock market speculation at present.

With zero-commission trading apps, such as Robinhood, it is now easy and costless to trade. So there has been a surge of new participants into the stock market and the options market.

Career risk and the paucity of yield-positive alternatives have also forced institutional investors into taking on more stock exposure, however frothy.

Not least is the belief that some companies are changing the narrative, goosing hopes of extraordinary future profits. Bubbles always thrive during times of innovation. (See chart this page.)

Bubbles becomes self-reinforcing, attracting more and more money the higher they inflate – right up to when they burst, which is followed by a period of "inconvenience". Market extremes then have a strong propensity to reverse, regardless of central bank manipulation. Reversion to the mean and bubble-symmetry indicate how far down markets may have to fall.

What will cause the current bubble to burst? We do not know. Potential sources may become apparent as the pandemic wanes and the debate about the debt hangover ratchets up. As economies recover, the fiscal stimulus will be cut back and government balance sheets will need repair, so tax increases are likely. It's also possible we might see signs of inflation, forcing central banks to "tighten" at which point the bond market will go to hell in a handcart with the stock market right behind.

Signs of rising inflation are appearing in America. We are beginning to see an uptick in the velocity of money, a key component for inflation expectations. If the velocity of money is rising, demand for money must be growing faster than the supply of money. This implies that the price of money - the interest rate - should rise. What would negate this logic would be the US Federal Reserve continuing to print money and to cap interest rates (in order to keep government debt under control). If this happens, the US dollar exchange rate could fall significantly.[2]

In the meantime, economic activity is probably going to be stronger in the front half of 2021 while inflation is probably going to accelerate in the latter half of the year. In the past, rising inflation would prompt central bankers' hands.

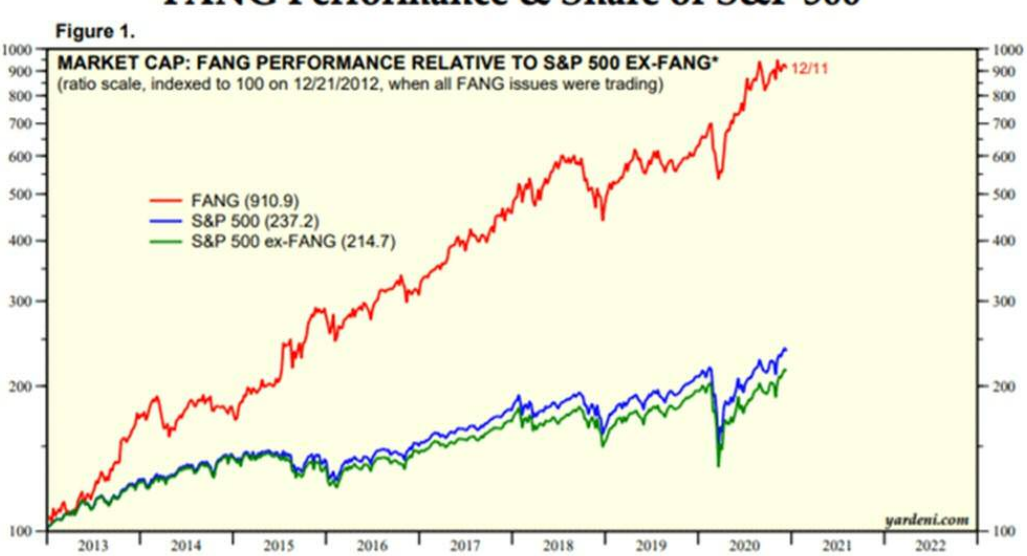
The Fed refuses to be bound by the past. Instead, the Fed is going to practise Flexible Average Inflation Targeting (FAIT). It wants to run inflation above it's 2% target of yore. FAIT is a significant paradigm shift and investors should pay attention.

If the US is purposely moving from a disinflationary environment to an inflationary one, prudent asset allocation will be essential. In past inflationary periods, the dollar fell so investors needed to own precious metals. Emerging markets tended to outperform the American stock market. Holding long-dated bonds in undervalued currencies was also profitable. Cash positions held in the same currencies helped retain purchasing power during those inflationary episodes.

In short, a recovery from the pandemic with a Fed that is complacent about excessive inflation is highly likely.

Inconvenience should be expected in 202X . . .

FANG Performance & Share of S&P 500



* FANG stocks include Facebook, Amazon, Netflix, and Google (Alphabet).
Market cap includes both classes of Alphabet.
Source: Standard & Poor's and Yardeni Research Inc.

Sources:

1. Simon Kennedy, "Low-Income American Households Suffer Inflation Shock", Bloomberg Economics, 3 July 2020
2. Charles Gave, "The Boom of 2021", Gavekal, 25 December 2020
3. Chart this page: Yardeni Research, www.yardeni.com