PCM
PEAK CAPITAL MANAGEMENT

A Lurking Monster

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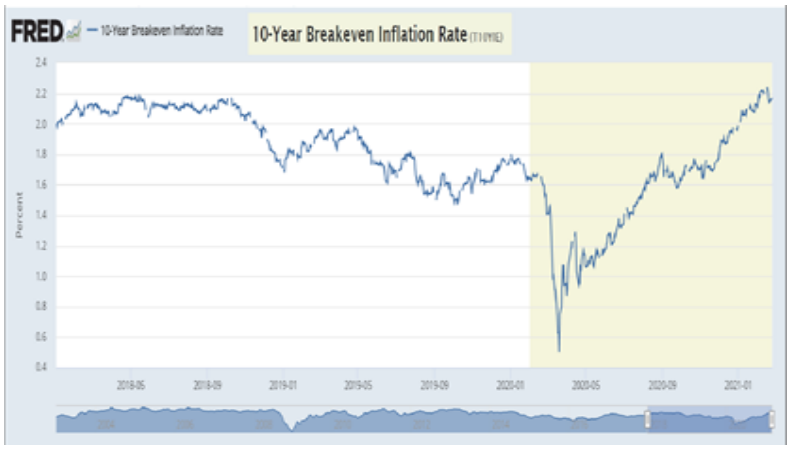
Brian Lockhart

Somewhere in the darkness lurks a menacing threat to our economic and financial well-being. It tends to be insidious in its silence, yet its impact can be seen almost daily if you know where to look. Fighting this monster has proven to be futile, and in many cases no war is even waged against it until it is too late. Who is this monster with the power to strip people's wealth from them while making it difficult for countless people to make ends meet? It is inflation.

Doctors have referred to high blood pressure as the "silent assassin" because of its ability to slowly but surely weaken key organs and nerves, leading to strokes and heart attacks that kill or debilitate. Inflation works in the same manner, slowly eroding people's purchasing power until their financial future looks bleak. Inflation perhaps represents the greatest threat to the financial markets and investors, as it will force the Federal Reserve to change tact and fight this monster just as Paul Volker did in the 1970's.



There are many data points suggesting inflation is rising, and rapidly. One of my favorites is the Shanghai shipping index, which measures the cost of shipping containers originating in China. Because shipping costs are highly correlated to supply and demand, you get a real-world data point of economic activity that can lead to higher inflation. The current chart shows freight costs have more than tripled since last May. The latest "Prices Paid" survey from the ISM Manufacturing Index is at a 10-year high right now. The chart shows the St. Louis Federal Reserve Bank 10-Year Breakeven Inflation Rate is the highest since 2018, and climbing rapidly.

The traditional way to fight the inflation monster is with higher interest rates, as that slows demand for goods and services by making them more expensive to finance. Higher interest rates are then able to compete with the stock market for total return, and many investors choose the relative safety of bonds instead of owning potentially over-priced stocks. The reduced demand for risk assets leads to falling stock prices and a cycle of selling begins.

Not everyone is convinced we are on the precipice of an economic boom. Notable economist David Rosenberg identifies several reasons why he believes economic growth is going to languish in the coming years. Rosenberg notes that government benefits, or transfer payments, now account for almost 20% of aggregate personal income. He shows that one in four households were unable to pay monthly bills over the last year, and nearly 7% of all homeowners are in some type of loan forbearance. His data indicates that nearly 75% of government stimulus payments were used to pay down debt or add to savings instead of spending that increases economic activity. Rosenberg and his team believe the economic slump is years from being over, and inflation and interest rates will continue lower in the coming years.

Fed Chair Powell in recent testimony called higher prices transitory and suggested it would not impact the Fed's accommodative stance towards monetary policy. The question portfolio managers and investors are forced to answer is, at what level of interest rates does fixed income compete for allocations? Just as important is to understand what has historically worked best in periods of high inflation, if that is your expectation.

When inflation rises it tends to benefit cyclical and economically sensitive stocks at the expense of utilities (very high debt levels) and consumer staples (reduced margins). Financial stocks have historically performed best during periods of rising inflation as long-term interest tends to climb faster than short-term rates and banks profit on the spread. Financials have outperformed so far this year, particularly in February, where the S&P Bank ETF is up around 20% compared to a 4% rise in the S&P 500. Energy prices tend to be responsive to upticks in inflation, causing the sector to also perform well as a hedge against rising inflation. Lastly, Industrials are typically the most economically sensitive sector and often outperform during inflationary periods.

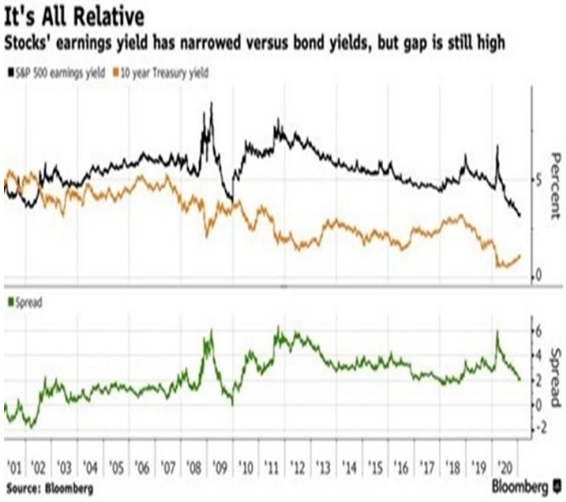
We will continue to dynamically allocate portfolios across equity sectors and factors and adjust our hedges for changes in market volatility. There are very smart people on both sides of the inflation debate, and our focus is to deliver consistent returns regardless of which camp prevails.

Can Bitcoin Go Mainstreet?

The cryptocurrency enthusiasm grew to new heights in February, jumping from $33,000 at the beginning of the month to almost $60,000 at one point. From the beginning of 2018 until October of 2020, Bitcoin traded in a relatively narrow range with no overall increase over the nearly three years. In the five months that followed, the digital currency has risen by 400% and currently trades just below $50,000 at the time this is being written. The chart is interesting in that it shows that between December 2019 and December 2020, FANG stocks (Facebook, Amazon, Netflix, Google) mostly outperformed the price of Bitcoin. Financial intermediaries are making it easier for regular investors to own Bitcoin, and there is talk of being able to use Bitcoin on everyday transactions in the near future.

- There are approximately 18,500,000 bitcoins in existence today with a renewed interest in mining new coins. Data from Statista indicates that seven new blocks per hour are being created at a value of $350,000 each block.
- Bitcoin has a total market capitalization has surged to around $925 billion, about 5X the size of its closest competitor, Ethereum, at $180 billion. No other cryptocurrency is valued about $40 billion at this time.
- For Bitcoin to become a true alternative to the U.S. dollar it has to become mainstream, which many see happening. Tesla recently announced it bought $1.5B of the coin, and Miami is considering allowing residents to pay their taxes in the cryptocurrency.

The Reflation Trade



Reflation is defined as an anticipated period of growth. Investors typically respond by rotating in to risk assets, namely equities. Recently, this is in response to relaxed Fed policy and the expected impact the vaccine has on economic recovery. Within equities, small caps and growth-oriented companies tend to do well. The rotation in to risk assets is occurring in coordination with a sell off in treasuries. The chart below shows the spread between the 10 year Treasury yield and S&P 500 earnings yield. A wide spread indicates investors are compensated for taking on the additional risk in holding stocks versus treasury bonds. The chart shows that the current spread continues to be greater than the long-term trend going back to 2000.

- The spread between the 10-year Treasury yield and S&P 500 earnings is about 2%, down from over 5% at the start of 2020 (Bloomberg).
- In addition to a rotation to risk assets, a sell off in Treasuries may be a result of inflation expectations.
- A reflationary trade coupled with improved economic expectations and risking rates may benefit the bank sector and commodities.
- The reflation trade is having an impact on sovereign bond yields globally. The 30 year Japanese Government Bond rose to .745% as of February 26th, the highest the yield has been in two years (Reuters).

Return Correlations

Year-to-Date Return Correlations (Source: Ycharts)

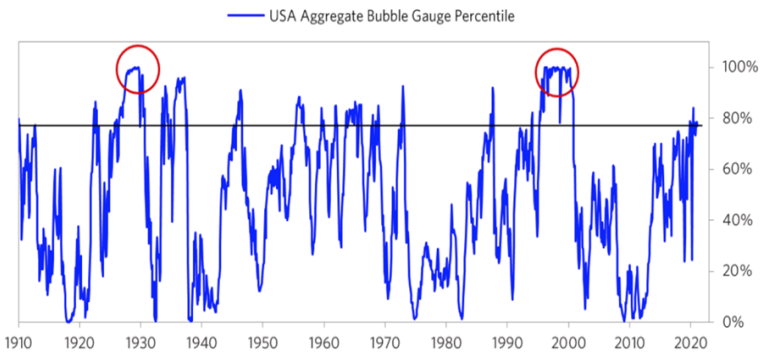
	(1)	(2)	(3)	(4)	(5)	(6)
Low Vol (1)	1.00					
Value (2)	0.66	1.00				
Momentum (3)	0.57	0.58	1.00			
Quality (4)	0.80	0.88	0.82	1.00		
Size (5)	0.46	0.83	0.53	0.70	1.00	
Treasuries (6)	0.17	-0.35	-0.01	-0.09	-0.34	1.00

At the height of the COVID-19 outbreak last year, markets were in turmoil as investors assessed the ensuing damage from the economic shutdown. Asset values in general fell in unison to the downside as investors assessed the economic fallout. From a portfolio construction standpoint, there was nowhere to hide unless you went to cash or shorted the market. Ultimately, however, the markets rebounded and finished the year with new highs. What we are seeing now is a diversified market in terms of return correlations. As the table shows, correlations across the five major equity factors and U.S. Treasuries are now far from one, which suggests that portfolio diversification is working again.

- In particular, the return correlation of momentum stocks to small caps (0.53), value (0.58), and low volatility (0.57) stocks is relatively low today. This suggests that investors are now beginning to rotate into factors that underperformed in 2020.
- The return correlation of Treasury returns across equity factors remains negative (except for low volatility stocks). However, these correlations have risen materially from the depths of the COVID-19 outbreak in March 2020.

Macro View – Bubble Watch

Central banks have made it clear that accommodative policy will continue through Covid and into the recovery. The challenge investors face is understanding when and under what circumstances central banks will finally remove the punch bowl. As liquidity seeks yield in the midst of historically low rates in fixed income, stocks become the home for liquidity. This leads to a pricing of stocks based on central bank policy versus fundamental valuations. Bubbles emerge. The risk boils down to companies falling short of earnings expectations coupled with expectations not being met around the Covid recovery. Bubbles are only a problem until they burst. Ray Dalio and Bridgewater have created a "bubble indicator," currently at about the 77th percentile, while hitting the 100th percentile in 1929 and 2000. Further, the stocks exhibiting extended valuations, or bubble territory, account for 5% of the top 1000 companies in the U.S.



Source: Ray Dalio

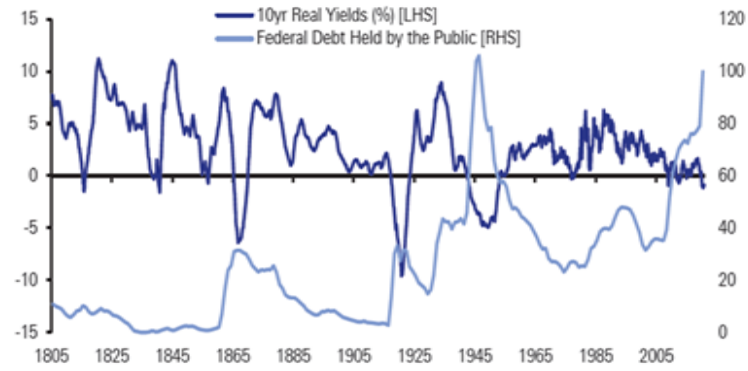
Taking Stock – Is It Time for Travel and Leisure?

361 Capital pointed out recently that technical analysis is beginning to look positive for travel and leisure stocks. World travel declined by approximately 60% in 2020, according to ICAO. The cruise lines were hit particularly hard during 2020. For example, Carnival's (CCL) share price had gone from over $32/share late February 2020, to $7.50 by the beginning of April 2020. As of February 24, 2021, the share price has returned to over $27/share (CNBC). Wynn Resorts (WYNN) has already surpassed price levels pre-pandemic, trading around $108 per share the end of February 2020, compared to closing at $134.21 on February 24, 2021 (CNBC). Airline companies, reflected through the U.S. Global Jets ETF, JETS, is recently approaching pre-pandemic share prices. The bullish case for travel and leisure to continue their climb is the pent-up demand with the assumption that the vaccine is effective in driving economic growth.

Source: 361 Capital

Fixed Income - Chasing Zeroes

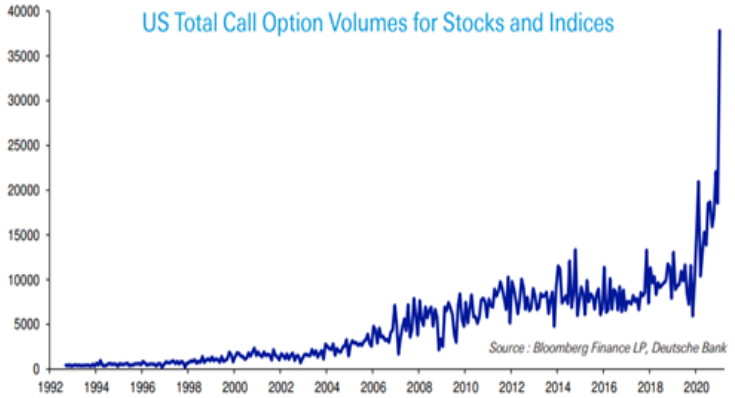
As Federal debt continues to climb to higher and higher levels, you have to wonder how far we are from the markets imposing consequences. Many have expecting the bond vigilantes to appear over the last 12 months as government spending skyrocketed, but these revered characters may be more myth than reality. The yield on the 10-Year U.S. Treasury Bond has surged to 1.50% in recent days for the first time since January 2020. However, what is surprising to many is that the inflation-adjusted yield, or real yield, is actually falling. This is because inflation expectations are rising faster than the yields, primarily being driven by the dramatic rise in Federal debt. Investors might be collecting higher interest payments on debt, but it is being more than offset by an increase in prices. Expect to see the dollar come under weakness if Federal spending does not decline soon.



Source : GFD, CBO, Deutsche Bank

Technical - Hockey Stick Speculation

If there was ever a chart as a precursor to a bubble or mania, it might be a chart of Call Options. The chart has been gradually trending higher for 30 years, but in 2020 we saw spikes in volume that were unprecedented. The latest data suggests demand for speculating in stocks is at historic levels as the chart would make even Bitcoin envious. When investors buy "Call" options, they are paying for the right to purchase a stock at a pre-determined price in the future. For example, a year ago you could buy Tesla calls giving you the right to purchase the stock at $150/share when it was trading at $133/share for the next year. You might have paid $20/share for the call option, giving you a profit of $530/share today even after the $50/share price decline today. This is clearly being driven by speculators, which tends to end poorly for those entering late in the game.



Treasury Yields

Clint Pekrul, CFA

The recent move in U.S. Treasury yields has garnered most of the investment headlines so far this year. After reaching a low of approximately 0.50% in March 2020 amid the depths of the COVID-19 outbreak, yields have begun to climb higher. By the end of February 2021, the benchmark 10-year yield sat at approximately 1.5%, which is roughly equal to the dividend yield on the S&P 500.

The recent uptick in Treasury yields has, so far, been more-or-less steady. Furthermore, the rise in rates has not seemed to have adversely impacted equity forecasts. Still, in a post-financial crisis world, any uptick in yields makes the headlines.

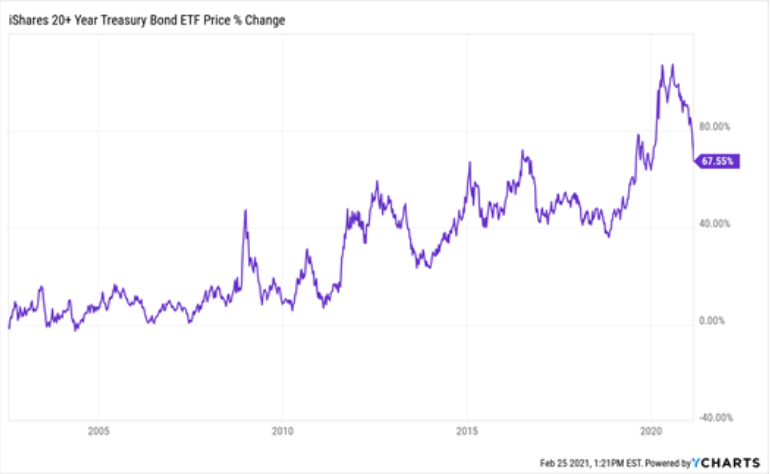
To maintain perspective, it is helpful to evaluate how the benchmark 10-year Treasury has behaved over time, particularly around major market events. The chart below plots the CBOE 10-year spot rate going back to June 2008 (just prior to the financial crisis):

Starting from the left, the first dip in yields – from roughly 4% to 2% – coincided with the financial crisis. Yields then rebounded as stocks rose in 2009. Move forward to the Flash Crash and Greek sovereign debt issues of 2010, and yields fell once again, rebounded, and then subsequently collapsed amid the Euro Crisis of 2011.

Then we move forward to the Taper Tantrum of 2013, when Fed chairman Ben Bernanke hinted that the central bank might not be so accommodative. Yields rose again only to fully reverse heading into the 2016 presidential election. At the time, massive infrastructure spending and tax cuts would prove inflationary. The Fed began to raise interest rates. By the end of 2018, as the S&P 500 fell 20%, the Fed reversed course and began to lower its target rate.

Yields fell throughout 2019, then COVID-19 hit in late February of 2020, and yields collapsed down to 0.50%. We have now since bounced off the COVID-19 lows.

In addition to evaluating the 10-year spot rate from the chart above, it is also useful to examine the historical trading pattern of the long-term U.S. Treasury index, which tracks a total return investment in a constant maturity Treasury bond. The Blackrock iShares 20+ Year Treasury Exchange Traded Fund (Ticker: TLT) tracks an investment in longer dated Treasuries. The chart below shows the percentage change of an investment in TLT going back to its inception in July 2002:



We show the growth in terms of percentage change to illustrate that historically, we have seen trading patterns similar to what we are seeing today. Typically – but not always – a major disruption event to the downside in equities occurs, Treasuries become overbought (i.e., yields decline as bond prices rise) and then eventually reverse course. This tendency played out in 2008, 2011, and more recently in 2020.

Is the reversal we are seeing today simply a repeat of the trading pattern we have experienced in the past? In other words, did bond prices simply overshoot to the upside during the pandemic and are now heading to some equilibrium (perhaps a yield closer to the S&P 500), or is there something more fundamental under the surface that will send interest rates materially higher? Interestingly, it was not that long ago that the dividend yield on the S&P 500 was roughly three times the benchmark 10-year Treasury rate.

If inflation is truly coming due to stimulus and the reopening of the economy from COVID-19, it is likely that the Federal Reserve will be forced into action. It could take the form of a new QE program to help keep longer-term rates under wraps. Increasing the discount rate would likely prove problematic for the equity markets.

From a portfolio construction standpoint, it would be prudent to consider both the volatility of U.S. Treasury returns and the correlation of these returns to the broader equity market. As market conditions change, rebalance your allocation accordingly. As history has shown, U.S. Treasuries can be an effective hedge to equity volatility. However, interest rates can move quickly, so be prepared.

Q: Should investors be concerned about data from the Buffet Indicator?

In the short term, probably yes, you should be concerned. For those unaware of what the Buffett Indicator is, it is an elegant and simple way of measuring if stocks are over or under valued using a rather common sense approach. It simply compares the market value of the entire stock market to the value of the economy. This intuitively makes sense because as GDP grows, corporate earnings should grow and stock prices should rise in tandem. When GDP shrinks, the same occurs with earnings and you would expect stocks to do the same. Measuring the ratio of stock market valuation to the economy over long periods of time is very useful to determine how stretched valuations might be.

The ratio is higher today than at any point in history, including the tech bubble in 2000 (the only other time valuations exceeded by more than 2 standard deviations). I understand the argument that we are still "normalizing" from the impact of COVID-19 that only caused a hiccup with stock prices, but we are still in uncharted territory with valuations and I expect we will see a sizable correction sooner rather than later.

It is noteworthy. The Buffett Indicator measures the ratio of the total capitalization of the U.S. equity market relative to gross domestic product (GDP). To estimate the market capitalization of equities, we would typically use a broad index like the Wilshire 5000. GDP is measured quarterly and reflects the recent economic output of the U.S. economy. While equity valuations are forward looking, GDP measures prior economic activity. By comparing the ratio of the two numbers – equity valuations to GDP – we can get a sense of how reasonably stocks are valued. Ultimately, economic productivity and output must support the forecasted valuations embedded in stock prices. If this support does not materialize, then equity valuations will likely fall.

The Buffett Indicator currently sits at an all-time high, which some would argue is a bearish signal for stocks (i.e., markets are overvalued). But remember, investors must have other options available before they begin a wholesale rotation out of equities. Thanks to central banks, cash has a negative real return and yields on bonds are often less than the dividend yields on stocks. Higher valuations could persist for longer this time around, but ultimately economic output has to support forward expectations. So, keep an eye on Buffett's indicator.

Q: How will the storms in February impact the move toward renewable energy?

I think a single storm, as devastating as it was in places like Texas where people are not equipped to deal with bursting pipes and snow, is unlikely to change opinions. Those who believe fossil fuels are the bane of our existence and support radical ideas like the Green New Deal have made that a political ideology and they will not be swayed by a storm, regardless of how many people are impacted. Saving the planet from destruction in the next 10 years is far more noble a cause than creating jobs or economic opportunity for the masses. What I have never understood about climate alarmists is how they reconcile the fact that the US is cutting greenhouse emissions while the rest of the world is increasing the same. According to EPA data, from 2005 to 2018 the US reduced emissions on power generation by 27% even as GDP grew 25%. The rest of the world, in contrast, increased emissions over the same period by more than 30%.

I am in no way opposed to renewable energy. We have replaced most lights in our homes to LED because it makes sense to do so. Technological advancements will continue to make renewable energy more sensible for the masses without forcing draconian changes to the economy. We all benefit if free markets determine the pace of change, rather than government mandates.

If there is one thing that we have learned over the past year or so, it is that the nation's power grids are woefully susceptible to failure during extreme weather. If it is extreme cold in Texas or extreme heat in California, it seems blackouts could become more common in the next decade. Part of the challenge we face is that utilities and power grids are regulated on a regional basis, rather than through a national infrastructure. The two largest states – Texas and California – manage their power systems quite differently. President Biden has pledged to modernize the nation's power infrastructure by moving to wind turbines, solar panels, and zero emission technologies by 2035. But I think this will be incredibly difficult to accomplish.

The fact is that issues involving renewable energy are extremely political, which makes accomplishing anything on a large-scale basis almost impossible. Texas governor Gregg Abbott cited the continued necessity of fossil fuels after power outages in February. Conservatives often point to California's rolling blackouts amid wildfires, despite the state's efforts to go green. Likewise, advocates of renewable energy point to the failures of Texas' largely deregulated "free market" system. The bottom line is that there is a lot of money – and political capital – at stake for any substantial move to renewable energy.

PCM

PEAK CAPITAL MANAGEMENT

9250 E. Costilla Avenue, Suite 430

Greenwood Village, CO 80112

Phone: 720.361.4019

Email: info@pcmstrategies.com

Website: www.pcmstrategies.com