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PEAK CAPITAL MANAGEMENT

A Taxing Matter

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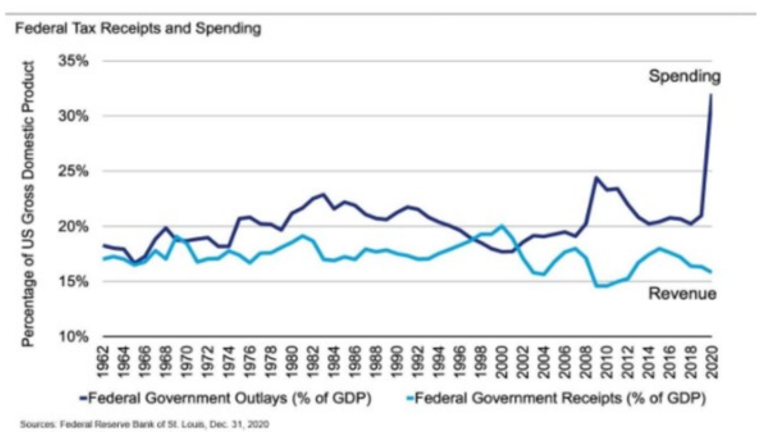
The Biden Administration has stated they would like to raise taxes by $2.1 trillion over the next 10 years according to the Tax Policy Center. This has been applauded by some and derided by others, claiming it will end the bull market in stocks. The “expert” opinions on how tax increases will impact the economy and markets are as wide ranging as opinions on global warming or the Affordable Care Act. Are higher taxes likely to be the culprit that sends stocks into a bear market? Ultimately it will depend on what type of tax increases are able to get passed.

There are generally four different types of taxes with very different economic impact for each. There are taxes on wages, taxes on corporate income, taxes on capital, and finally taxes on estates. Proposals to increase estate taxes are hotly debated but have virtually no economic or market impact. It has been estimated by the Brookings Institute that if you taxed the taxable estates at a rate of 100% it would only fund the government for a few weeks. The CBO estimates only 4,100 estate tax returns this year, so it would not move the needle for revenue or impact.

Taxes on the other three sources can impact markets far more. We are about to have a robust dialogue about the disparity between taxes on capital and income. It has been a long-held view that higher taxes on capital is counter-productive because it leads to less capital creation and fewer opportunities for the working class. The data is mixed and anything but certain, but you have to take into account that capital can be very mobile. When taxes rise above certain thresholds, it may look for a more friendly tax home.



Corporate income taxes are slated to go back to levels before the Tax Cuts and Jobs Act of 2017 reduced them to 21%, and this might ultimately be the more serious threat to the markets. It is undeniable that much of the stock market gains over the last 5 years have been the result of massive stock buybacks by corporations. Eliminate the buybacks and investors might experience a scenario where there are more sellers than buyers and prices plummet. Corporations, whose earnings have been flat in many cases, have increased earnings per share by simply repatriating cash at low rates and using it to reduce the amount of stock outstanding. This has been particularly effective for companies like Apple, Oracle, and Microsoft. Higher corporate taxes are likely to reduce the amount of buybacks and could become the pin that ultimately bursts the stock market bubble.

Not all tax increases will be negative for the economy or markets, especially if the increase in revenues result in productive spending like infrastructure. Eliminating tax loopholes that are exploited each year for billions in savings could generate much needed spending on roads, bridges, and water treatment plants.

Are higher taxes likely to be the culprit that sends stocks into a bear market? Ultimately it will depend on what type of tax increases are able to get passed.

The Administration has hinted at very large plans, but what is able to get passed seems likely to disappoint the Democratic party. I do not see any possibility of student debt forgiveness, a wealth tax, or taxes to support the Green New Deal getting through Congress. I will be watching closely the debate over ending the filibuster, as if that were to occur, I think the markets would implode with sellers rushing for the exits.

The national conversation about taxes must equally consider what are likely to be unintended consequences. Take private aviation for example. It is very possible generous tax breaks for corporate jets will be taken away under the guise it only benefits the ultra-wealthy. According to Forbes, more than 1 million people are employed in private aviation and the annual economic benefit is significant. There are over 5,000 airports in the U.S. and commercial airlines use just 500. A single corporate jet accounts for $2.5 million per year of economic impact where it is based. Teterboro in New Jersey employs 14,900 jobs with an economic impact of $2.3 billion each year, and Forbes states there are more than 15,000 business aircraft humanitarian flights each year.

Remember Newton’s Third Law -- for every action, there is an equal and opposite reaction. This tends to be very true with tax policy, as those who are the targets of higher taxes are often more nimble and quick to act than the governments trying to tax them. There is an entire industry devoted to helping the wealthy retain more of their income, and this is why tax increases often end up hurting the middle class they are intended to benefit.

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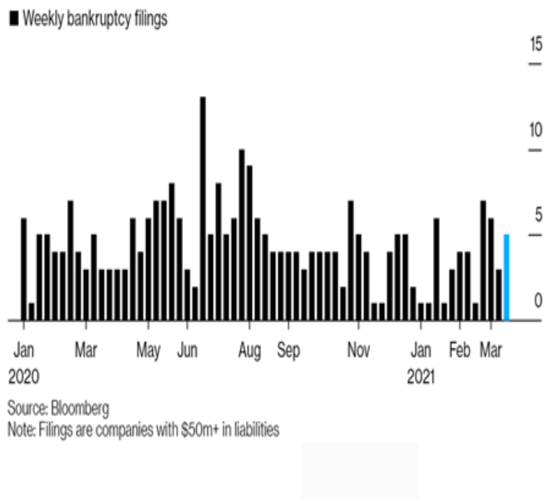
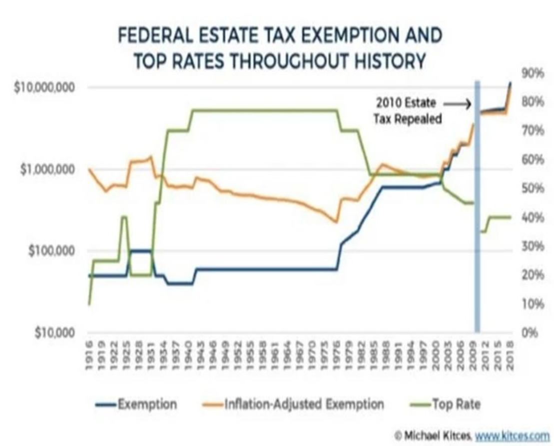
Broken and Bankrupt



March was a banner month for a group that nobody wants to succeed -- bankruptcy attorneys. We are on pace to double the number of large bankruptcy filings compared to the same period in 2020, with 41 large corporate filings through March 2021. Fifteen firms with $50 million or more in liabilities have already filed for protection this month, with energy and retail leading the way. Gas driller Nine Point Energy Holdings filed bankruptcy along with a plan to hand over operations to its lenders. Another driller, Highpoint Resources Corp, managed to enter and exit bankruptcy in March when its plan to be acquired by Bonanza Creek Energy, Inc. was approved by the courts. Brilliant Energy, LLC made a high profile filing after being decimated by the catastrophic storm that hit Texas.

- The pipeline for bankruptcy attorneys is robust based on data for distressed bonds. Bonds that have been downgraded to just above the category of bankrupt has continued to increase, and tops $93 billion according to Bloomberg data.
- It is likely the actual number of bankrupt companies is far greater than what is reported through the courts. This is due to the fact that many companies have engaged in debt for equity swaps, where lenders take over the company.
- Issuers of distressed debt are headlined by Diamond Sports Group ($8 billion) and Transocean ($4.2 billion), who represent approximately 15% of the entire distressed debt bond market.

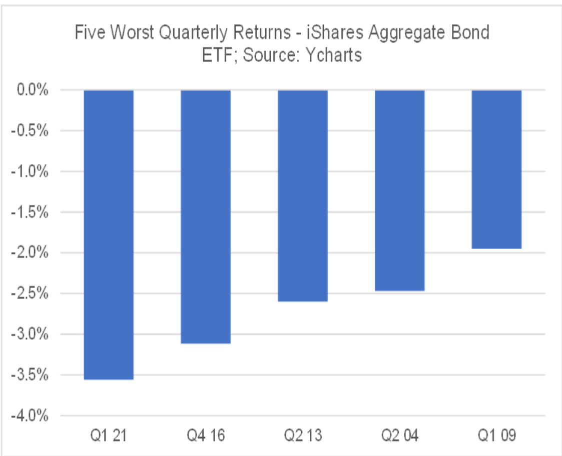
Estate Tax Update



There are estimates of trillions of dollars in assets that must transition from the baby boomer generation to heirs or beneficiaries. This creates tremendous opportunity to generate revenue through estate taxes, perhaps off-setting government spending on covid relief and infrastructure. The estate tax has flown under the radar for many as the tax takes effect at an estate valued at $23mm for married couples, taxed at 40% above that amount. President Biden appears to be gravitating toward returning to the estate tax levels under President Obama -- $7mm for a married couple taxed at 45% above that amount. Assets with significant gains such as equity positions held over years and residential properties passed to heirs and beneficiaries will be under a microscope on how to minimize estate and capital gains taxes.

- Perhaps even greater impact than the estate tax itself may be the potential removal of the step up in cost basis on inherited assets.
- Housing may be impacted as a result of gains potentially being taxed at the original cost basis of the home, rather than the stepped-up cost basis.
- Gifting of assets is a likely strategy to potentially mitigate changes in the estate tax.
- The potential removal of the stepped up cost basis may preclude beneficiaries from selling securities in order to avoid significant tax consequences.

Bond Market Headwinds



The first quarter of 2021 is not going to be a good one for the overall bond market. As the 10-year benchmark Treasury yield continues to rise from record low levels following the onset of the COVID pandemic, fixed income investments have come under pressure. The Barclay's Aggregate Bond Index, which measures the performance of the domestic investment-grade bond market, is on pace to have one of its worst quarters on record. The chart to the left illustrates the five worst quarters for the iShares Aggregate Bond Index ETF going back to its inception in 2003. (Note that performance for the first quarter of 2021 is through March 29th).

- Much of the losses in bonds have been concentrated in investment-grade credit and U.S. Treasuries. While still lower for the quarter, mortgage-backed bonds have held up relatively well. There are income producing assets, however, that have weathered the rise in rates.
- High-yield bonds, which have higher coupons, have produced modest gains for the year. Dividend-paying equities are also higher for the year, as are REITs. Interestingly, the asset classes that were penalized last year due to the COVID shutdown are in many cases outperforming the broader market in 2021.

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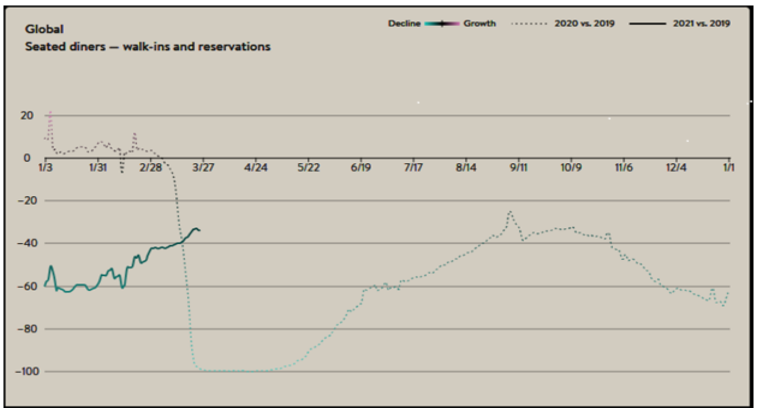
Macro View – Open Table

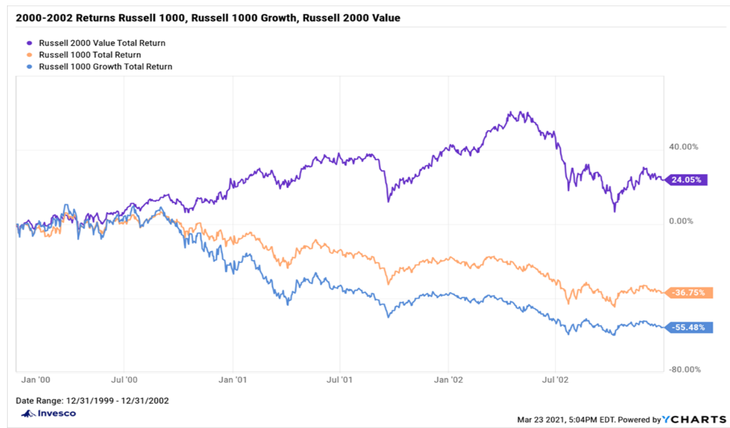
In March of 2020, Open Table introduced “State of the Industry” to communicate online, phone, and walk-in reservations at restaurants globally. It provides quantitative results on consumers’ willingness to exit the confines of their home as Covid risks subsides. The data goes back to 2019 based on a sample set of approximately 20,000 restaurants. The results indicate recovery in evaluating the trendline from 2019 through 2021. The chart below shows seated diners, including walk-ins and reservations, globally. The dotted line shows results comparing 2019 vs. 2020 from January 3, 2019 until January 1, 2020. Over the summer the economy was beginning to open back up, followed by a surge in the virus. The solid line indicates 2020 vs. 2021 results, also suggesting recovery. It is important to note that this does not take in to account restaurant closures over the time periods.



Source: www.opentable.com

Taking Stock – Post Covid Postulating

With technology retreating, analysts are evaluating asset classes expected to provide outperformance. Traditionally, outperformance comes from equities with opposing characteristics to large cap growth, namely small cap value. The chart from Invesco dating back to the popping of the tech bubble in 2000 to 2002 tells the story. For that two-year period, large cap growth was down over 55%, while small cap value was up 24.05%. Year to date, as of March 19th, the Russell 2000 value index was up 24.98%, while the Russell 1000 growth index was down .95%. Sector exposure for small cap value is overweight financials, healthcare, industrials, and consumer cyclicals. Consistent with sector exposure, top holdings in the Russell 2000 value index include Berkshire Hathaway, JP Morgan Chase, and Johnson and Johnson. The annualized return over 10 years for small cap value is 10.72% as of March 25th (ETF.com).

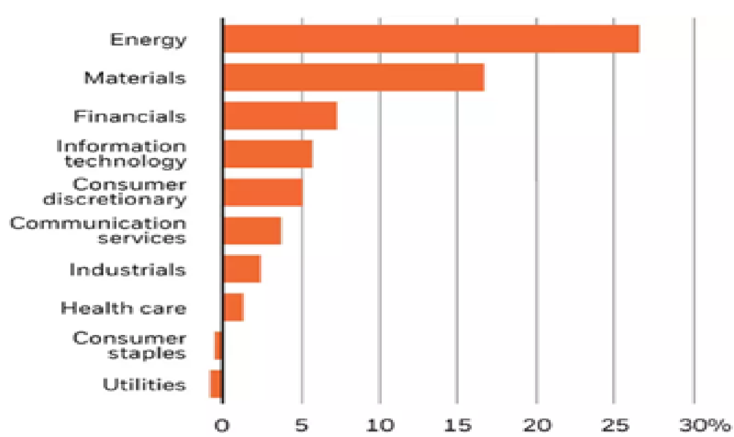


Fixed Income - Unsafe Haven

Investors in long-duration Treasury bonds have taken it on the chin through the first quarter of 2021, posting a loss of □12.8% through March 26th. This is compared to more than a 6% positive return for investors in stocks that many view as dramatically overpriced. There are several culprits for the sell-off in government-backed bonds, with higher forecasted inflation at the top of the list. It would be hard to argue to that the previous Administration was fiscally conservative, or any Administration in the last couple of decades, but the prospect of spending multiple trillions in changing the basic economic foundation of the country has some nearing panic mode. It is always difficult to forecast what the future holds, but higher rates typically result in a slowing economy that leads to recessions and lower interest rates. Rates bottomed in August 2020 at 0.5%, and today’s rates are still historically very low.

Technical - Proof of Rotation

A lot has been made of the supposed market rotation away from technology and growth and toward value so far in 2021. Many are now heralding the next decade as the “Decade of Value,” following a decade when growth and momentum trounced value and quality. Not everyone is a believer that value is here to stay, but the analysts at Blackrock are very confident regarding earnings in traditional value sectors. Energy has been one of the poorest performing sectors on both a trailing 1-year and trailing 3-year basis, but analysts’ 3-month change in earning forecast suggest energy may soon be leading the earnings parade. There is a long way for energy and materials to go before catching up to the returns of tech and consumer discretionary over the past few years.



Source: Blackrock

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Asset Classes for Inflation

Clint Pekrul, CFA

As we have mentioned in previous PCM reports, the prospect of an inflationary environment is dominating the headlines. The narrative is that with the economy reopening from the COVID shutdown combined with a massive stimulus from the government will send overall prices higher. This in turn will force the Federal Reserve's hand and move shorter-term interest rates higher. Longer-term bond yields will also rise given the prospect of stronger economic growth.

The scenario described above may indeed materialize, although it is far from certain. At any rate, investors should be prepared for the possibility of a more inflationary environment over the next several years. There are certain investments described below that could provide attractive risk-adjusted performance, should we see an uptick in inflation.

Inflation Defined

Simply put, inflation is the loss of purchasing power for a given currency. For example, in an inflationary environment, a U.S. dollar will be worth less in terms of purchasing power in the future. As prices rise, it will take more dollars in the future to buy the same amount of goods today.

Inflation is typically gauged by the Consumer Price Index (CPI), which measures the price level of a basket of goods and services. The Federal Reserve in the past has tried to target an inflation rate of 2%. The reason for this target is to achieve a balance of economic growth against a loss of purchasing power. In theory, a modest level of inflation will encourage investment that will generate sufficient returns to more than offset the loss of purchasing power. If there is no inflation, investors will more likely save, which can stifle economic growth.

Inflation has various causes. When aggregate demand for goods and services exceeds production capacity, prices tend to rise. Likewise, an expansion of the money supply can find its way into production costs, which can result in higher prices as well.

A modest level of inflation is considered desirable. However, if inflation overheats, the results can be detrimental to the economy. Investments may no longer generate sufficient returns to offset the loss of purchasing power. However, there are certain investments that might weather the inflationary storm.

Inflation Sensitive Assets

There are options available across the three major asset classes – fixed income, commodities, and equities.

Fixed Income

Treasury Inflation Protected Securities, or TIPs, are bonds issued by the U.S. Treasury with coupon payments that periodically adjust based on increases in CPI. As overall prices increase, the interest collected on TIPs increases as well. These step-up payments offset the loss of purchasing power that exist with traditional Treasuries. To be sure, however, TIPs do carry duration risk. Prior to maturity, the price of TIPs will fluctuate based on changes in interest rates (like a traditional Treasury).

Another option within fixed income are floating rate bonds. These include leveraged loans with coupon payments that are referenced to a floating rate such as LIBOR. While the adjustable coupon can help in a rising rate environment, leveraged loans typically carry greater credit risk than investment-grade bonds.

Commodities

Historically, gold has been a store of value during inflationary periods. Past relationships show that when the value of the dollar declines, the value of gold tends to increase. However, there can be a significant opportunity cost to holding gold over the long-term, as it generates no earnings and pays no interest. However, a broad basket of commodities could provide attractive returns if inflation picks up significantly. If aggregate demand increases, the cost of raw materials should rise.

Equities

Historically, equities have provided a return in excess of inflation going back several decades. The long-run compound rate of return on the S&P 500 going back to the 1920s is roughly 9% compared to an average inflation rate of 3%. In other words, stocks have delivered an excess return over inflation of approximately 6%.

Moreover, dividends have grown at an average rate of 5% over the long-term, which may surpass the long-run rate of inflation. A broad basket of stocks that have historically grown their dividends (so called “dividend achievers”) could help investors retain purchasing power in an inflationary environment.

Certain commodity sensitive sectors, such as basic materials and energy, could outperform the broader market if inflation becomes an issue. Specifically, precious metals and mining stocks might shine in a highly inflationary environment. Infrastructure exposure, which includes highly regulated utilities with price controls, could provide revenue streams that are largely shielded from inflation.

The bottom line is that there is no perfect inflation hedge. Investors must consider a range of investment opportunities as the sources of inflation are highly uncertain. The example given above could serve as the basis for a portfolio positioned to benefit from an inflationary environment.

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Q: What is driving Bitcoin's recent surge and where does it end?

The dramatic rise in Bitcoin has been attributed to everything from coming hyper-inflation, speculation about government bond defaults, and Elon Musk making the decision to invest billions in the cryptocurrency. The mainstay of the crypto world, Bitcoin was just $3,400 in December 2018 and only $6,000 in March 2020 when COVID-19 was spiraling out of control. Bitcoin had risen to $32,000 by January 1, 2021 and above $55,000 at the end of March after nearly touching $60,000 earlier in the month. I do see Bitcoin becoming much more mainstream as an investment tool, even prior to Musk's announcement. Catherine Wood of ARK has been bullish on crypto-related investments for some time and believes there is much further to go with both currencies and blockchain in general.

Bitcoin also becomes its own self-reinforcing mechanism as wealth is created from its rising price. Many of the people participating in Bitcoin mining and trading are not interested in traditional markets like stocks and bonds. The higher its price moves, the more attractive many will find the alternative currency. People who shunned it at $3,400 all of a sudden think it is a great idea north of $50,000. There is also a tremendous amount written in blogs about Bitcoin getting to $250,000 in the future, giving the impression to some that it has much further to climb.

Bitcoin certainly has been on a roller coaster ride lately. A year ago, Bitcoin was trading around $7000. Today it has surged to roughly $58,000, which translates into a gain of approximately 700%. The volatility of Bitcoin is pronounced with daily changes of +/- 5% not uncommon, so as an investment, Bitcoin is not for the faint hearted. It has been speculated that the recent surge in the crypto currency has been driven by fears of inflation. The line of reasoning is that if inflation becomes a real issue – which is far from certain – Bitcoin will retain its value due to its limited supply. It is the same reason that investors flock to gold when inflation concerns become elevated. After all, the government cannot print gold like it can print U.S. dollars. Moreover, the government cannot mint crypto currencies. It seems reasonable that if the inflation narrative continues, the value of Bitcoin can remain at elevated levels. However, at the end of the day, crypto currencies are simply commodities with no intrinsic value (there are no earnings or cash flows associated with Bitcoin). So, if the inflation narrative wanes, do not be surprised if the price of Bitcoin experiences a significant move downward.

Despite the above, there has been increased attention paid to efforts to incorporate cryptocurrencies, such as Bitcoin and Etherium, into conventional payment infrastructure. For example, Visa recently announced plans to settle transactions in "UDSC" cryptocurrency on the Etherium blockchain. As these efforts to "mainstream" cryptocurrencies advance, they may gain value as monetary units.

Q: Where should I be looking for protection against hyper-inflation ?

It is entirely reasonable to assume that inflation is going to trend higher, but it is a stretch to think we could get to a level of hyper-inflation unless the government were to openly pursue a path of implementing Modern Monetary Policy.

Hedging for a low probability, high impact outcome like hyper-inflation is difficult because the cost, actual and opportunity, is significant. It would not be prudent to allocate more than 1% or 2% to such an unlikely event, but if you did, here would be some options.

Gold is the most obvious because it has demonstrated an inverse relationship to the U.S. dollar for a long time. Inflation lowers currency value, so you want to own an asset that is inversely correlated. I still believe gold is probably the best inflation hedge and owning as much as 5% of your portfolio in gold is not unreasonable.

Bitcoin is an alternative currency as well but has no intrinsic value as exists with other alternatives to Central Bank controlled currencies. Gold and precious metals have intrinsic value and demand for jewelry and industrial uses. Bitcoin relies on the "greater fool theory," although you might not convince a 26-year old driving a Lambo of that.

Real estate and commodities also make sense to hold if you are concerned about rising inflation. Real estate has a component of 'replacement cost' that rises with inflation, and commodities are typically priced in dollars and go up when the value of the dollar falls.

We talked about this at length in the spotlight section of this month's report. There are a handful of liquid asset classes that could potentially hold up well in an inflationary environment. Commodity-based equities, such as gold miner stocks, energy manufacturers, and the basic materials factor could provide superior risk-adjusted performance should inflation become an issue. Investors could also hold commodities such as gold directly. Another viable option is publicly traded real estate investment trusts (REITs), which hold commercial real estate directly. These investment vehicles must pass through the income that the underlying properties generate through rent directly to shareholders. Typically, rent payments can rise over time to keep pace with inflation, which ultimately can help avoid the loss of purchasing power. Likewise, stocks that have a history of increasing their dividends over time can provide rising cash flows during inflationary periods. While fixed income investments pose a challenge for combating inflation, higher-yielding bonds offer some degree of protection in terms of absorbing an increase in yields. Likewise, Treasury Inflation Protected bonds, or TIPs, offer some hedge against an increase in the consumer price index with resetting coupons. For the investor, the primary focus should be to hold assets that have variable, rising cash flows with limited duration.

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