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Rogue Fed

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According to the Cambridge English Dictionary, a rogue organization is one that no longer behaves in the usual or acceptable manner. Some of the Federal Reserve's recent actions arguably fall within this definition. The Federal Reserve, as the most powerful financial institution on the planet, has a responsibility to act in a manner that is both rational and predictable if the financial markets are to maintain a level of stability and confidence. A growing number of the Fed's actions are neither, which raises the possibility of a crisis of confidence that would impact the world's financial markets.

The Fed was created by Congress in 1913 to establish economic stability in the U.S. by introducing a Central Bank to oversee monetary policy for the country. The policy was to be carried out by the 12 Federal Reserve Banks and a Board of Governors. For decades it has been understood that the Fed has a dual mandate: maintain price stability and maximum sustainable employment. These goals of monetary policy are transparent and allow the markets to intuitively know what the Fed is likely to do based on economic data. Today's Fed, in sharp contrast, is pursuing monetary policy that is opaque at best, forcing market participants to guess what their next step might be.

In an attempt to be more transparent following the actions taken in response to the 2008 financial crisis, the Fed implemented a 'dot plot' matrix in 2012 to communicate where voting members of the Fed expected interest rates to be in the future. We were told by the Fed that they would be 'data dependent' in making changes to policy accommodation and interest rates. Fed Chair Powell's most recent press conferences suggest the role of data in his decisions may have diminished.

The markets intuitively understand we are on an unsustainable path as yields rise. Interest rate policy likely has a greater bearing on the direction of the stock market than earnings do in today's environment.

As 10-year Treasury yields moved sharply higher in March to 1.75%, up from just 0.9% in January and more than three times higher than the .53% in July 2020, Powell was asked if the Fed was going to cap how high long duration yields would move higher. While refusing to answer the question, he stated ". . . accommodation would continue until 3 criteria were met: non-transitory inflation was above 2%, forecasted future inflation was at or above 2%, and the economy was experiencing full employment."

Nice sentiment for sure, but the problem is that the Fed has done trillions in quantitative easing since the financial crisis and those criteria have still never been met. The Fed's ability to track inflation somehow misses the fact that esoteric items like 2X4's have risen around 300% or the Bloomberg Ag Index is up 76% this year. The Fed is searching for a 2% inflation print while anyone who actually goes to a store recognizes prices are 10% higher, if not more.

The markets intuitively understand we are on an unsustainable path as yields rise. Interest rate policy likely has a greater bearing on the direction of the stock market than earnings do in today's environment. You see this particularly in the technology sector, which tends to be very interest rate sensitive due to the long time frame between investment and earnings for many tech companies. Higher yields mean a greater opportunity cost, causing many investors to move out of the tech sector. Value stocks, that trade at modest valuations, are seen as less risky in a rising rate environment as are energy stocks which also provide a hedge against inflation.

Financial repression, the Fed's intentional actions to artificially suppress interest rates, is creating greater and greater distortions in the markets. I wonder if Cathie Wood's popular ARK Fund would even exist without the Fed-created distortion? When Fed policy can no longer be attributed to its dual mandate what do we tether it to? We are forced to invest in a world where the search for yield and returns has led to unprecedented leverage in the financial markets. If Fed credibility was to be seriously questioned you could see bubbles in housing, stocks, junk bonds, collateralized loan obligations, and many others simultaneously bursting, creating chaos.

A recent E-Trade survey of brokerage accounts with over $1 million had interesting results. Over 90% of respondents stated they believe the market is "fully in a bubble," "somewhat of a bubble," or "approaching a bubble." Housing prices in many areas are rising so fast there is almost no inventory for buyers. People are receiving astronomical offers for their home which is not even on the market.

This current market environment is likely to end badly for most investors. Fortunately, there are early warning signals we are able to track to help us maneuver and reduce risk before the fan spreads foul air.

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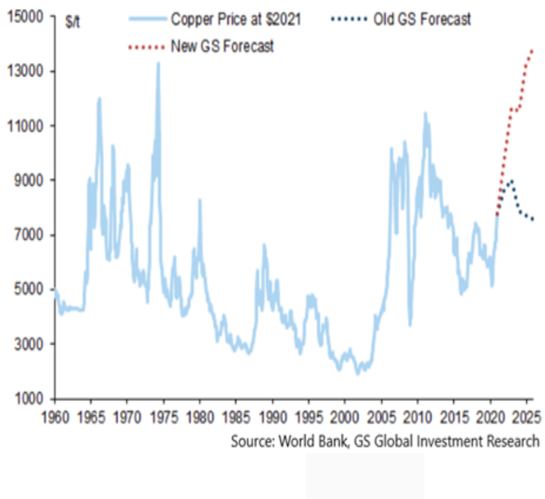
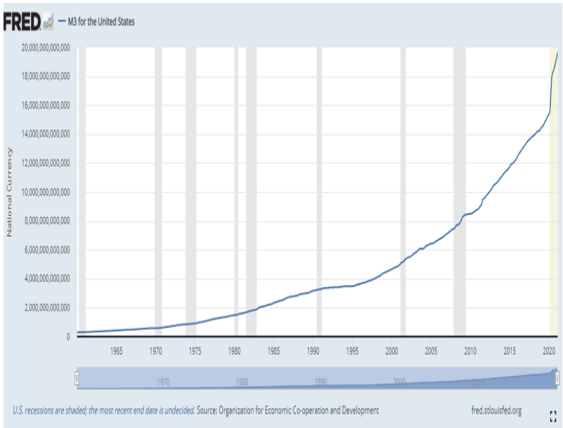
Green New Commodity Deal



We are all well acquainted with the Green New Deal proposed by AOC, the New York Congresswoman, and that climate goals from the Paris accord will demand attention in the current Administration. What markets might be missing is the opportunity this might bring for the metal that is affectionately known to have a Ph.D in Economics. As the world moves toward the goal of zero emissions, as the CEO of United Airlines discusses in a video on every flight, the demand for copper is likely to rise far above forecasted supply. Copper is the most cost effective of the conductive metals which include gold and silver. A pound of copper has risen sharply to $4.50 while a pound of gold is over $28,000 and a similar amount of silver is $450.

- As power generation shifts from hydrocarbons (oil and gas) to solar, wind, and geothermal the demand for copper is expected to rise more than 600% in a recent Goldman Sachs report.
- It takes approximately 8 years to permit and establish operations at a new copper mine, suggesting copper prices could have strong upward pressure if demand increases as some forecast.
- Copper is particularly valuable in the production of cables, batteries, transistors, and inverters because of its electrical and thermal conductivity properties and ability to resist corrosion.

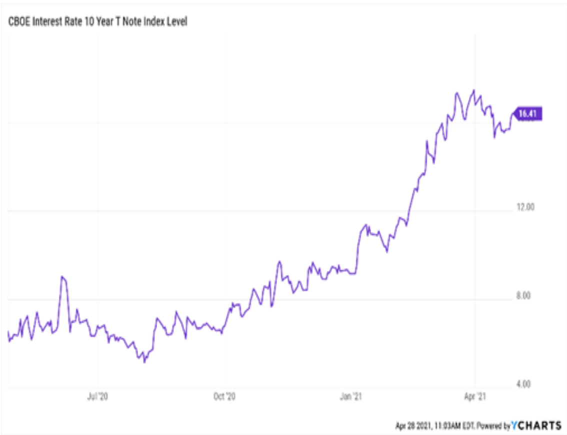
M3 Resurrected



M3 is the broadest definition of money supply. It is regarded as the total money supply including currency in circulation as well as liquid financial products such as CDs. The Federal Reserve has not tracked M3 since 2006, but the Federal Reserve Bank of St. Louis does publish M3. As the Federal Reserve stopped reporting M3, some economists ceased using it as an indicator of growth and demand. With nearly $20tt in circulation and bonds providing little to no yield, it is not surprising that equities and housing are attracting investors. The result in demand is driving prices up. The St Louis Fed also reports on the velocity of money for M2, being similar to M3. Despite record levels of M3, the velocity is showing that the currency is largely being saved rather than used to buy goods and services.

- As of February 2021, M3 was just under $20 trillion (St. Louis Federal Reserve Bank).
- The difference between M2 and M3 money supply is that M3 is M2 plus large deposits, institutional money market funds, or larger liquid assets.
- The velocity of money as report by the St Louis Fed is at all time lows, dating back to 1960.
- As of March 2021, currency in circulation jumped from 1.84 tt in March 2020 to 2.12 tt in March 2021 and reserve balances increased 1.96tt (Federal Reserve Bank)

Yields Pause



Fixed income investors have faced significant headwinds over the past few months. The benchmark 10-year Treasury yield jumped from a low of roughly 0.5% to its current level of approximately 1.6%. This sudden upward move sent bond prices tumbling, which resulted in the worst quarterly performance for the asset class since 1980. After the outbreak of COVID, investors piled into bonds which pushed yields lower. But as the economy reopens, investors have turned increasingly to equities in their overall asset allocation, which in turn has pushed yields higher. The chart to the left plots the 10-year Treasury yield over the past year.

- While yields are well off their lows from 2020, the 10-year Treasury has traded in a relatively flat range over the past month. In fact, the yield has receded a bit from its yearly high of roughly 1.75%. The prospect of a more inflationary environment over the coming years has been a catalyst for the rise in yields, but by now the market might have fully priced in this expectation.
- If inflationary pressures mount, the 10 -year yield could certainly move higher and surpass its pre-pandemic levels. On the flip side, however, rates could pull back in the intermediate term if COVID cases surge and threaten the reopening of the economy.

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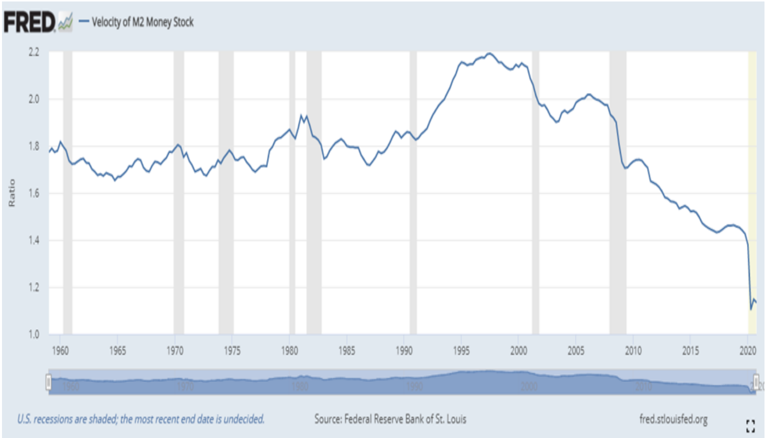
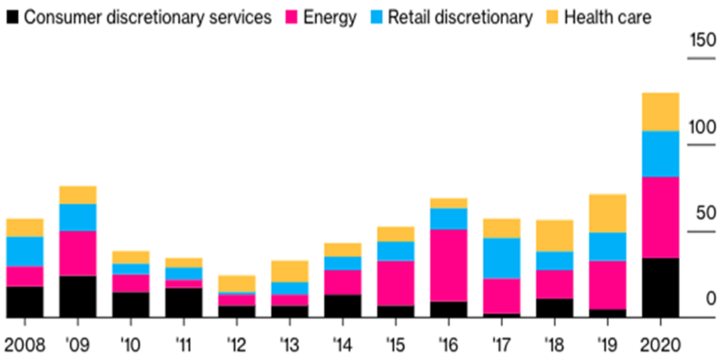
Macro View – Spending Slow Down

The St. Louis Fed chart on the velocity of money referenced in the Moving the Markets section was so dramatic, it is worth sharing in this section. The definition according to the Federal Reserve Bank of St. Louis is the frequency of at which one unit of currency is used to purchase domestically produced goods and services during a given time period, communicated as a ratio. As the velocity of money increases, more transactions are occurring within the economy. While money supply grew dramatically in 2020, GDP collapsed around covid, triggering the sharp decline in the velocity of money as depicted in the chart. While money is not being used for goods and services, demand for risk assets may indicate that the additional currency in the system may be going towards investment in equities, housing, and commodities.



Taking Stock – Zombie Apocalypse

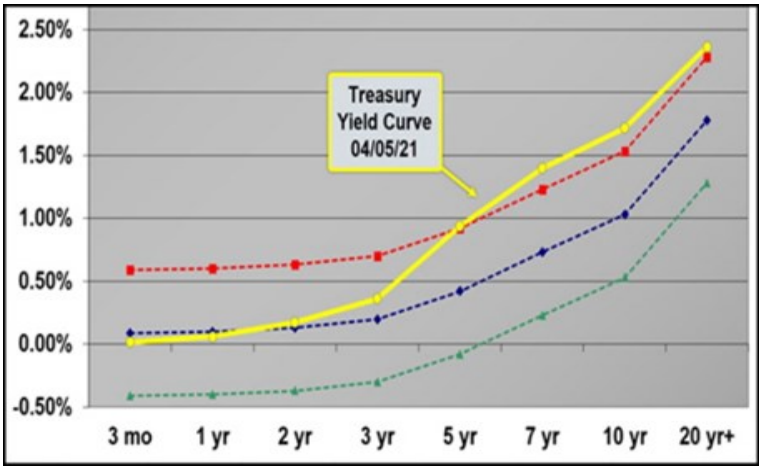
Zombie companies are defined as companies that have reached debt levels that require government bailout to survive. Further, the companies cannot afford to pay the interest on the debt that is on the books. According to Bloomberg, zombie companies' debt levels had eclipsed over $2tt by January 2021. The main lifeline is through the Fed purchasing corporate bonds, giving companies access to credit. Covid and government support greatly multiplied the number of zombie companies, leaving analysts speculating on the impact to the rate of economic recovery. The Bloomberg chart shows bankruptcy filings for public and private companies with liabilities greater than $50mm concentrated across the industries most impacted by covid: consumer discretionary services, energy, retail discretionary, and health care. There was a surge in bankruptcies among large companies, yet smaller company bankruptcies dropped in 2020 (Bloomberg) because of government aid to small businesses.



Source: Bloomberg
Note: Reflects Ch. 11, 7 filings for public and private companies with liabilities >$50M

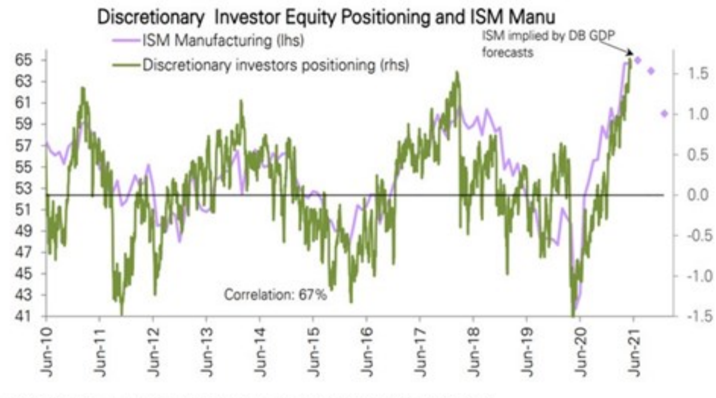
Fixed Income - Following the Rules

Our friends at Crestmont Research developed what they call their 6/50 Rule when analyzing the yield curve and making forecasts for where rates are headed. The 'rule' suggests that rates can be expected to change by more than 0.5% (50 basis points) during any subsequent six-month period somewhere on the yield curve. The blue line represents the yield curve on January 8, 2021, with the red and green lines showing 50 basis points above and below. It took only about 90 days for the rule to be corroborated by Crestmont, as it has been in 97% of weeks over the last 53 years, at the 5-year mark of the yield curve. As we look out to October, the 30-year Treasury could be headed toward 3% or possibly back down below 2%; will the short end remain low or will the curve flatten?



Technical - Trend Following Equity Investors

Evaluating the quality of technical indicators involves many factors including overall correlation, magnitude of highs and lows, and whether correlation is increasing or decreasing in the latest periods. The ISM survey has been a reliable indicator of economic growth in the U.S. for a very long time. The correlation between ISM and discretionary investor equity positioning has been 67% (strong) for the last 10 years, but even stronger over the last 5 years. ISM today is at a 37-year high and equity positioning is not surprisingly at an all-time. Given that forecasts for ISM show a decline over the next 3 and 6 months, it would not be surprising to see investors pull back on their equity exposure leading to a small market correction. We have already seen many large institutions and hedge funds reducing equity exposure and they tend to lead smaller investors by 3-6 months if history repeats.



*Wtd avg Z-score across indicators; weights based on explanatory power in regression w/equity perf
Source : ISM, EPFR, CFTC, Bloomberg Finance LP, Haver, Deutsche Bank Asset Allocation

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The Quotable Warren Buffett

Clint Pekrul, CFA

You are likely familiar with Warren Buffett – the so-called Oracle of Omaha, Nebraska. His long-term performance record at Berkshire Hathaway is the envy of most investors. He is known around the world for his down-to-earth approach to investing, which makes the complex seem simple. What follows are some of Warren's best quotes through the years.

"If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes."

This quote encapsulates Warren's long-term view on investing. You should have an ample time horizon to not only grow your wealth but to recover from inevitable losses.

"Do not take yearly results too seriously. Instead, focus on four or five-year averages."

Even Berkshire Hathaway – Warren Buffett's holding company – has had its share of disappointing years, particularly when value stocks were out of favor. But since 1965 through 2020, Berkshire's compound annual rate of return is roughly 20%, or approximately twice the return for the S&P 500 over the same period.

"It is a terrible mistake for investors with long-term horizons -- among them pension funds, college endowments, and savings -minded individuals -- to measure their investment 'risk' by their portfolio's ratio of bonds to stocks."

The risk that Warren is referring to here is the potential profit that you forego over extended periods by being underweight in equities. Carrying a large bond position in a portfolio when your time horizon is relatively long (e.g. 20 years) could prove costly, hence the risk.

"I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years."

If March 2020 taught us anything, it is the fact that liquidity, or the ability to buy and sell shares, is not guaranteed. There is no law that stipulates that the market must be open. When COVID hit last year, the markets were temporarily frozen. Trading was halted temporarily. The Fed provided a backstop. Nevertheless, the turmoil reminded us that markets can be fragile.

"The most important thing to do if you find yourself in a hole is to stop digging."

It is important to recognize that at some point, as an investor, you will inevitably make a mistake. Rather than accept a mistake and move on, some investors will stubbornly deny their error and expose their portfolios to additional losses.

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."

Your reputation can be your biggest asset or your biggest liability. A solid reputation, particularly when it comes to managing other people's money, is a highly valuable asset, and separates people like Warren Buffett from Bernard Madoff.

"You don't need to be a rocket scientist. Investing is not a game where the guy with the 160 IQ beats the guy with 130 IQ."

Investing does not have to be overly complex. One of the simplest strategies is to dollar-cost-average into a passive index fund over many years. This is essentially the strategy used by employees when they participate in their 401k plans.

"When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients."

As an investor you should always weigh the cost of advice and money management against the fees that you are paying. Over time, the true cost of investment fees can compound and take a bite out of your retirement savings.

"Predicting rain doesn't count, building the ark does."

There is no way to predict when market panics will materialize. They are an inevitable part of long-term investing. What you can do, however, is follow a sound and disciplined investment strategy to help get you through the turbulent times.

"The one thing I will tell you is the worst investment you can have is cash. Everybody is talking about cash being king and all that sort of thing. Cash is going to become worth less over time. But good businesses are going to become worth more over time."

Stashing away money in a checking account really is not an investment at all. Through inflation, cash loses its value over time, which means a negative real rate of return. However, thoughtful investments in good businesses are likely to deliver returns above and beyond the rate of inflation.

"In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."

It is probably ill advised to bet against stocks over the long haul. Equity returns over the long run – despite some periodic headwinds – have proven quite resilient.

"For 240 years it's been a terrible mistake to bet against America, and now is no time to start."

Despite all the turmoil we have experienced over the past few decades, an investment in American business via the equity markets has generally paid off handsomely.

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Q: How impactful would an increase in capital gains taxes be?

The answer depends heavily on whether you are evaluating from a political or economic perspective. Few would doubt that it is a smart political move by Biden and is consistent with the "rich need to pay their fair share" theme of his campaign. The data is somewhat mixed on the economic impact or the impact it is likely to have on the markets. The tax increases are substantial for many taxpayers, with gains being taxes at 43.4% versus 23.8% today. If you live in a high tax state like California, your combined taxes on capital gains is over 55%.

I believe any negative impact is more likely to be felt in the economy than the stock market. Any impact on the stock market is likely to be transitory as wealthy investors sell positions with large gains so they are taxed at current levels instead of proposed levels. A UBS report suggests there is little relationship between changes in capital gains rates and stock market performance. One reason for this is that almost 75% of stocks are held in non-taxable accounts like IRAs and 401ks, according to Bloomberg data.

What politicians often neglect to take into account is that capital has no borders -- just ask California and New York who are seeing residents flee high tax states. Tesla to Texas and Goldman Sachs to Florida are just two examples of high profile companies choosing low-tax venues to operate out of. A tax system that favors consumption over savings and investment creates fewer opportunities for people, especially those not already wealthy.

The Biden administration is pushing for a meaningful change in the capital gains tax rate. The tax on long-term capital gains would increase from the current rate of 20% to 39.6%. I am not sure how they came up with their number, but let us just call it 40%. Essentially, the Biden administration is doubling the tax rate on long-term capital gains. In my opinion, this change could be disruptive. Consider the gains we have had across asset classes over the past decade. Equity indexes like the S&P 500 have more than doubled. Interest rates have plummeted, so bond prices have appreciated. Investors in general are sitting on an enormous pile of capital gains, helped in large part by the Federal Reserve's monetary policies over the past decade.

Now, the federal government wants to swoop in and tax these gains away. Meanwhile, we are still printing money and will do so in response to any disruptive market event. It seems like a bad cycle. Ultimately investors will find ways around paying the full tax through various loopholes. I understand the motivation behind the capital gains tax hike proposal, but at the end of the day it will likely fall short of raising the revenue that politicians expect. Meanwhile, the prospect of a higher capital gains tax rate down the road might motivate some investors to sell today. Biden unveiled his tax plan during his campaign, so his actions should not be a surprise. But now that prospect might become a reality.

Q: Are Travel and Hospitality stocks poised for a comeback?

My guess is that winners and losers will be more company specific than industry specific with economies around the world reopening. You can come to radically different conclusions depending on the time frame you are using for analysis. Let's take 3 proxies for Travel and Hospitality -- Disney, Carnival Cruise Line, and Invesco's Dynamic Leisure and Entertainment ETF, and compare against what the S&P 500 has done. On a YTD basis, everyone but DIS has outperformed the S&P with CCL more than double the return this year. On a trailing 1-year basis, accounting for early in the pandemic, all 3 proxies handily beat the S&P, with CCL again leading the way with 110% gains. However, if you look at the trailing 2-year period it is a very different story. None of the proxies have outperformed the last 24 months with PEJ gaining 4%, DIS up 31%, CCL at -49% while the S&P was up 42%.

Carnival has either outperformed by 100% or underperformed by the same depending on which time period you consider. I do believe there is a lot of pent-up demand for travel and returning to favorite restaurants and entertainment. Large crowd venues will likely lag other forms of entertainment for quite a bit longer. I would guess Carnival's target audience is likely to already be vaccinated, so they should not be hurt by any restrictions on travel for those who have not received the COVID vaccine.

The recovery from COVID sure makes the case for a rebound in travel and hospitality. After a full shut down a year ago, we are starting to see the business and economic activity pick up. A good measure of the travel and hospitality sectors is an index created by S&P. Year-to-date the S&P Travel and Leisure Index is up approximately 17% compared to a gain of roughly 12% for the S&P 500. It is no surprise that the stocks in this group rebounded from their lows in March of 2020. The stocks that got beaten up due to the shutdown are now benefiting from the reopening of the economy.

However, some of the biggest holdings in the leisure and hospitality index are trading at valuations well above historical measures. The price-to-book valuations on some of these companies are north of 30 times. I think the question for investors is to what degree the has the market accounted for the reopening trade? Much of the rally in the travel and hospitality names already reflects the positives of the reopening trade. From a portfolio positioning standpoint, you might want to consider some names in the travel and hospitality sectors to further benefit from the reopening economy but be mindful of valuations.

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