PCM
PEAK CAPITAL MANAGEMENT

Hedging History

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Milton Friedman famously stated, “Inflation is always and everywhere a monetary phenomenon” and this has remained a bedrock of economic theory for almost 60 years. That was then. In an era of Fiscal Stimulus, when over $5 trillion has been spent by the government in response to the pandemic, economic theory is being forced to evolve.

Inflation is on every investor’s mind and the hedges that have been effective in the past to combat the silent assassin may not be effective in the current environment. Government transfer payments as a percentage of household income are at all-time highs according to WSJ data. As economies and businesses try to reopen, they are hindered by government policies making it more financially attractive to stay home rather than return to work. I have read of Domino’s Pizza franchises paying $1,000 bonuses and $25/hour to get drivers to deliver pizzas.

Commodity price increases today would make the 1970’s blush. The cost of shipping a container from overseas has risen from $3,500 in January to over $10,000 today for a furniture mart in Nebraska. The inflation print for April was influenced by massive gains in hotel and lodging (+7.6%) and airlines (+10.2%), as the percentage of vaccinated people increases and travel resumes. If the current trend continues, we are at risk of seeing a return to a dangerous psychology that was present in the 1970s -- buy before prices go up.

The Federal Reserve has historically used interest rates to tamp inflation, but that may not work considering today’s causes of inflation. Higher interest rates are likely to lead to credit scarcity and higher cost of capital, but may do nothing to force prices lower. Even the recession that would be almost certainly created by higher interest rates may not bring prices down to the 2% threshold the Fed targets if transfer payments continue.

Gold has historically been seen as an effective hedge against inflation as it is an alternative currency to the dollar. Don’t count on that in this environment. TIPS might reduce the pain of traditional Treasury bonds but may still generate disappointing results. Investors are going to have to find new, creative ways to mitigate the damaging effects of inflation on their portfolios and income streams.

Energy has historically been a strong inflation hedge in the past and should help protect portfolios today. When oil prices were in the $30s and storage facilities were at capacity much of the shale production was taken off-line, reducing supply. With prices now in the $60s that supply will start to come back online, but it will take a while to catch up with increasing demand. The world is consuming around 94.5 mb/d (million barrels per day) today, but this is expected to rise to 99 mb/d by the end of September, according to IEA forecasts. Energy stocks should fare well with strong pricing for E&P companies, pipelines, and oilfield services.

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Industrial real estate is another sector that could provide shelter in an inflationary storm. Real assets tend to appreciate with inflation, and I expect demand for industrial land, particularly in areas with favorable regulatory policies, to see strong demand as manufacturing and supply chains are relocated closer to home. Warehousing is a very attractive space, especially as shipping costs are rising sharply.

There is a very interesting debate happening right now about the use of cryptocurrency as an inflation hedge. While there is no intrinsic value or industrial use with crypto as there is with gold or industrial metals, it is growing more mainstream on a daily basis. Those in the camp that the dollar’s best days are behind it are turning to bitcoin and other cryptocurrencies as a hedge. I personally believe this is premature as a hedge as there is simply insufficient evidence that negative correlations exist between crypto and traditional currencies or between crypto and inflation. There are some interesting opportunities with companies like Square (SQ), Tesla (TSLA), and MicroStrategy (MSTR) who are industry leaders but also carry large amounts of cryptocurrency on their balance sheets.

The cause of inflation today is different than in the past and the strategies that prove effective to hedge the impact may be different as well. The velocity of money has not yet turned higher but seems likely given the excessive demand for services as the economy reopens. Governments are using fiscal policy to create social stability but ironically may be only compounding the inequality gap as asset inflation continues. Portfolios will need to be tactical and opportunistic to avoid getting steamrolled when yields begin to rise above consensus estimates.

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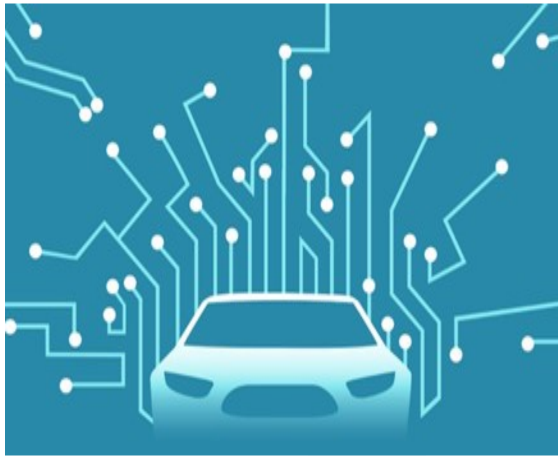
Pass the Chips



Thinking about getting a set of those high-tech headphones with noise cancelling and all the new features? Think again. The small microchips that go into the headphones are in such short supply there is a 12 month wait time to get the chips. Chipsets that run power management devices are backlogged 6 months, and ordinary sensor chips like what cars use have a wait time today of 17 weeks. When Covid first began to decimate the landscape, many companies canceled orders because of the uncertainty causing many manufacturers to reduce output. Instead of falling, demand for electronics skyrocketed and companies have not been able to keep up with demand ever since supply chains were interrupted. Analysts expect it to take between 12-18 months before supply keeps up with demand in a best case scenario.

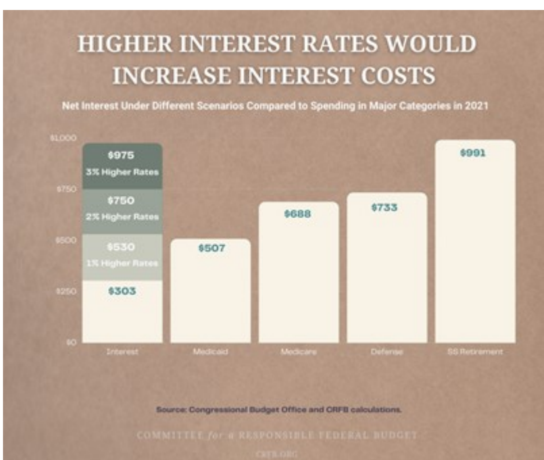
- It is forecasted the automobile industry will lose as much as $10 billion in lost revenue in 2021 because of delays caused by the lack of computer chips. Many features are being left off cars rather than wait for parts.
- Almost 75% of all computer chips are manufactured in Asia, led by Taiwan Semiconductor. The recent Covid outbreak there is forecasted to further reduce the supply of critical components in electronics.
- The U.S. is considering $50 billion in government funding to create more chip manufacturing capacity domestically to mitigate the impact of the shortage, but expectations are that it will take two years to bring new plants online.

Nonfungible Tokens (NFT)

Just when you thought you could not absorb one more financial industry acronym, the industry delivers the Nonfungible Token (NFT). NFTs are a cryptoassets where each asset is assigned a token. A fungible asset would be defined by a value that is defined across the asset class, similar to how a commodity or currency is valued. The NFT is used to authenticate digital assets such as domain names, collateral on investments, artwork, collector's items, or real estate. Owners of the NFT do not necessarily receive the asset reflecting the token, rather, the owner receives a token demonstrating that the owner of the asset is the "real" owner. An NFT, then, is like a certificate of authenticity. Sale of the NFT occurs peer to peer versus through an intermediary.

- In 2021, Christie's auctioned a collection of digital artwork of Mike Winkelmann resulting in a sales price of $69mm (Coinbase)
- NFTs are currently used to sell virtual sports trading cards, music clips, video art, memes, tweets, and virtual real estate
- NFTs are stored on blockchain technology such as Ethereum
- NFTs also have the ability to generate royalties paid out to the creator of the NFT
- There have been notable scandals involving the sale or transfer of fraudulent NFTs, so they are not without inherent risk, in addition to the background of rising asset prices generally.

Interest and the Budget



There is a growing concern among economists that we are on an unsustainable path with respect to the debt and the associated interest costs. The narrative has been told countless times since the financial crisis of 2008. When the COVID-19 pandemic hit, the yield on the 10-year Treasury bond more -or-less hit the zero bound. Since then, interest rates have gone one direction – up. Now, higher inflation expectations are part of the reopening narrative. In particular, how high would yields have to rise to attract investment in the bond market under an inflationary scenario? The chart to the left illustrates the current "base" scenario for interest expense using today's rates and debt levels.

- As the chart illustrates, a 3% jump in yields would send the debt service from $303 billion to $975 billion. We would spend more on debt service than defense and would approach the cost of funding social security. The Federal Reserve knows how tenuous the situation can become if yields were to surge higher.
- Consequently, they are prepared to provide as much liquidity as possible through direct purchases of Treasuries to keep yields in check (i.e., the Fed will print money). Of course, we do not fully understand how this would end, or if it would end. If there comes a time where the dollar is no longer the world's reserve currency, there could be dire ramifications.

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Macro View – Central Banks Go Digital

The word "crypto" carries a mysterious stigma that raises more questions than answers. Analysts alongside central banks are becoming more comfortable with "digital currency" versus "crypto." Central Bank Digital Currencies (CBDCs) add efficiency to payment and settlement. Likely, the CBDC becomes a substitute for bank deposits. Security and regulation immediately come into question on CBDCs with unique token identity via blockchain technology offering a possible solution. The immediate application already exists through Google Pay and Apple Pay. The Federal Reserve has communicated the introduction of FedNow, a retail instant payment system that allows for digital service and 24/7 clearing and settlement. Not surprising, China is moving swiftly towards a digital currency. Alibaba introduced digital pay in 2004. In 2019, total Chinese mobile transactions equaled $35 trillion and 1.2 billion users (St. Louis Federal Reserve Bank). The Chinese Central Bank is expected to bring the e-CNY, the digital Yuan in 2022 or 2023.

Source: Bank of England

Taking Stock – Electric Vehicle Opportunities and Threats

Analysts and investors are weighing the opportunity provided surrounding the global commitment to electric vehicles. Front and center has been lithium and the lithium mining companies in the U.S. and abroad. Reuters reported that President Biden has communicated a commitment to look outside the U.S. for lithium. Biden justified the move by supporting job creation specific to jobs specific to semiconductors, chip production, and batteries versus mining itself. Certainly, a nod to environmentalists likely also played into Biden's comments. Livent Corporation (LTHM) may be a company that benefits. Livent is based in Philadelphia with mines in North America, Latin America, Europe, the Middle East, Africa, and Asia. Livent is well recognized as being the lithium provider to Tesla. The chart below shows a one-year return on LTHM of 200% from May 25, 2020 to May 25, 2021.

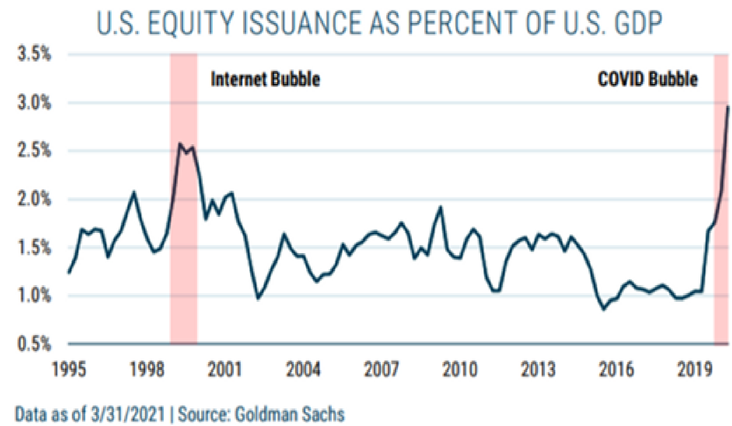
Source: Seeking Alpha

Fixed Income - Keeping the TIPS

Considering rising inflation has been the dominant narrative in the bond market for the better part of a year, it is not surprising to see how much inflation-protected bonds are outperforming their non-hedged counterparts. This chart shows the trailing 12-month performance of the iShares TIP and their 7-10 year Treasury ETF. With the move higher in yields, the Treasury ETF has lost almost 6% over the last year, while the inflation-hedged bonds have added over 5% in positive returns. This is about as stark a contrast as there has been between these two funds. If the latest inflation readings showing almost 6% annualized readings persist, expect TIPS to continue to outperform by a wide margin. Whatever is lost in yield by hedging your fixed income allocation may be more than compensated for in lower draw downs as yields continue to rise.

Technical - Float Much?

Who can forget the insanity of the late 1990's? IPOs were so hot prices would double or triple on the first day of trading, creating a frenzy of demand. The period saw new stock issuance as a percent of GDP double in less than 2 years, one of many signs that what was happening was unsustainable. It is hard to believe this last year has seen something even more remarkable -- a tripling of new issuance as a percentage of GDP while economies have been in lockdown and earnings suppressed. SPACs are a large part of the new issuance, with Goldman Sachs estimating they could reach $200 billion in 2021, staggering when you consider they were under $1 billion just 5 years ago. Those promoting the new issuance are doing so because they know there is demand today, but all that can change quickly when reversion to the mean occurs.



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Review of Factor Performance

Clint Pekrul, CFA

The returns across equity factors year-to-date look quite different than the returns we experienced in 2020. As we have mentioned in previous reports, the momentum trade has lost a bit of steam as investors bid on value and dividend-paying stocks. Nevertheless, we are still sitting at record-high valuations across most of the equity market.

We examined the returns across the following six indexes – S&P 500 Momentum, S&P 500 Value, S&P 600 Small Cap, S&P 500 High Quality, S&P 500 Low Volatility, and the S&P Dividend Aristocrats. We compared the returns for each index against the benchmark S&P 500 and illustrated relative performance over the past year.

Momentum Factor

Momentum has been in favor since the onset of the pandemic. In particular, the S&P 500 Momentum Index gained roughly 23% in the second half of 2020, which more-or-less matched the return of the S&P 500 Index (which is dominated by large-cap growth stocks).

However, for the year, the momentum trade has slowed somewhat. The S&P 500 Momentum Index is higher by only 4% compared to a gain of roughly 12% for the broader S&P 500 Index. However, valuations for high momentum growth stocks remain quite elevated. The price-to-earnings ratio for the S&P 500 Momentum Index is currently 44 times, which is well above the historical long-run price-to-earnings ratio of 16 for the broader market.

Value Factor

In general, value stocks broadly underperformed the S&P 500 Index coming out of the pandemic lows of 2020. The S&P 500 Index was dominated by momentum stocks, which caused value stocks to lag. In the second half of 2020, the S&P 500 Index advanced roughly 23% with dividends, compared to a gain of approximately 18% for the S&P 500 Value Index.

However, year-to-date, value stocks have caught up to the broader market. The S&P 500 Value Index has advanced roughly 17% compared to a gain of 12% for the S&P 500 Index. Despite the outperformance for the year, the price-to-earnings ratio for value stocks is approximately 25 versus 44 for the S&P 500 Index.

Size Factor

Small cap stocks have weathered the pandemic fairly well. In the back half of 2020, the S&P 600 Index soared 35%, well ahead of the broader S&P 500 Index. Likewise, for the year, the S&P 600 Index has advanced a further 21% compared to a gain of 12% for the large-cap S&P 500 Index.

Perhaps part of the reason for small cap outperformance is that these companies are not as capital intensive as large-cap equities. Still, from a valuation standpoint, the price-to-earnings ratio on the S&P 600 Index sits at 22 times, which is well below the same measure for the S&P 500 Index.

Quality Factor

In the second half of 2020, the S&P 500 Quality Index advanced roughly 20%, which was slightly below the broader S&P 500. With strong underlying fundamentals, high quality stocks performed relatively well coming out of the March 2020 lows. Likewise, so far this year, the S&P 500 Quality Index is higher by 11%, outpacing the broader market.

From a valuation standpoint, the price-to-earnings ratio for high quality stocks is roughly 30 times, which is below the broader S&P 500 Index but above the long-term historical average.

Low Volatility Factor

The low volatility factor has underperformed the broader market over the past year. Given its weighting methodology and defensive positioning, the S&P 500 Low Volatility Index avoided many of the high-flying momentum names that led the markets higher in 2020. For the second half of 2020, the S&P 500 Low Volatility Index advanced 14%, which was about 9% below the return of the S&P 500 Index over the same period.

Likewise, for the year, the S&P 500 Low Volatility Index has advanced roughly 10%, which is lower than the overall S&P 500 Index return. However, from a valuation standpoint, low volatility stocks are generally trading at a price-to-earnings multiple of 22, or about half that of the S&P 500.

Dividend Factor

In general, dividend stocks underperformed the broader market in 2020. The S&P Dividend Aristocrats Index, which is more heavily weighted to financials and energy than the broader S&P 500 Index, advanced 20% in the second half of 2020. However, year-to-date the Index is higher by approximately 16%, which has outpaced the S&P 500 Index.

With an above average price-to-earnings multiple of approximately 18, the yield on the S&P Dividend Aristocrats Index is a mere 2.8%.

In summary, returns across factors have been quite varied over the past twelve months as the economy reopens and investors reposition their portfolios. Indeed, from a valuation standpoint, some areas of the market remain quite expensive.

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Q: Is there a bubble in clean energy stocks today?

I believe so, and I say that even after many of the stocks have been cut in half. The majority of the companies in this category will never reach a commercialization that allows them to be even remotely profitable. These companies survive on a mixture of ESG mandates and quasi-government funding because they are not commercially viable, but that does not stop them from attracting capital. You are just beginning to see similarities to the internet bubble when it burst with high profile companies being forced to restate their earnings reports. Plug Power just recently stated they are going to restate every quarter going back to 2019. This will be disastrous for the stock and they are not alone. Another blue chip in the clean energy space is Fuel Cell, who recently reported their latest earnings. The company lost $.15/share or $47 million in the latest quarter on sales of just $4.9 million. I will admit it is impressive to be able to lose almost $50 million in less than $5 million in revenue, but their revenues are falling double-digits quarter after quarter.

I have no doubt that some companies will find commercial viability and be part of the long-term transition to more renewable power. Picking those companies in today's landscape is particularly difficult and may lead to very poor returns as a category.

Like with most risky assets today, you could make the argument that valuations are elevated for clean energy stocks. If you look at the S&P Global Clean Energy Index, which tracks the performance of clean energy related businesses in both developed and emerging markets, the current price-to-earnings multiple is just under 30. Compared to the historical price-to-earnings multiple of roughly 16 for the S&P 500 Index, valuations in the clean energy sector seem a bit frothy. Companies like Nio and Nikola traded at astronomical multiples in January. Green energy companies like Vestas and Seimens traded at multiples of 100 times earnings. All this momentum sent the S&P Global Clean Energy Index higher by roughly 300% off the March 2020 lows.

Indeed, the sector has now pulled back about -20% from its January highs as the momentum trade from 2020 has waned. I do not think the underlying fundamentals in this sector remotely justified the valuations we experienced. There is likely more risk to the downside despite the recent pullback, based solely on rich valuations. However, the clean energy trade is not just a passing fad. We are not reverting to fossil fuels. There are overriding political and cultural forces at play with this trade. You just have to be mindful of the price you pay to invest.

Q: Will there be a bipartisan infrastructure bill?

This question would be a slam dunk in my opinion except for the little phrase "bipartisan." I do expect an infrastructure bill to be passed this summer, and it would not be difficult to find several hundred billions of projects that really do need funding, given the deterioration of our country's roads, bridges, water treatment plants, and such. However, Congress appears to splintered and it is hard to see both sides of the aisle coming together to agree on legislation everyone can agree is best for the country.

Politics used to involve the hard work of compromise and negotiation, but has devolved into press conferences, demonizing the other side, and tweets. Those on the fringes are often given the largest megaphones even though their ideas have very little mainstream support. The media prefers to report on every movement and conversation from Reps Greene or Cortez when in reality those two are unlikely to be responsible for any meaningful legislation.

I will be rooting for the passage of an infrastructure bill for the sole reason that with over $5 trillion already spent in fiscal stimulus responding to the pandemic we have little or nothing to show for it. The additional debt will reduce future growth, but at least we will have better infrastructure for the next generation. Let's hold out the smallest level of hope rational sides on both sides of the aisle will come together and surprise me.

The White House set a deadline of Memorial Day – May 31st – for Congress to present an infrastructure bill for President Biden to sign. I doubt that is going to happen. While there was bipartisan progress, talks have seemed to break down recently amid disagreements around issues that have nothing to do with infrastructure. Both parties I believe want genuine progress on infrastructure. Rebuilding roads, bridges, airports, etc., is not where the contention lies. The Democrats, who control both chambers of Congress by narrow margins, want to push their agenda forward. Included in the bill are agenda items for police reform, tighter gun laws, and voting issues. Not surprisingly, these are issues on which the Republicans disagree. As a result, talks have stalled, and the bill is stuck in deliberations. I think Joe Biden wants both parties to come together, and he might be willing to make a deal on his own to avoid a path down partisan reconciliation. However, the president is feeling pressure from the far left progressive faction of the Democratic party to push through their agenda.

Interestingly, according to Fortune magazine, only about $157 billion, or 7%, of the bill's total cost has anything to do with traditional infrastructure. Unfortunately, this is how the legislative process works. It is no wonder bipartisan efforts are stalling.

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