Sitka Pacific
Capital Management, LLC

July/August 2017

Dear Investor,

Ten years ago, during the summer of 2007, the first major tremors of the looming credit crisis spread through the financial markets. In July, two hedge funds that invested in mortgage bonds suddenly failed, and shortly thereafter the stock prices of banks and mortgage companies began to fall. However, despite the turbulence, the broader market held up through the wild gyrations, and the S&P 500 began to rebound as summer came to an end. By the fall, the market had erased all the losses from the summer volatility, and investors optimistically pushed stock prices to a new high for the year; from a traditional technical perspective, the turmoil of the summer turned into water under the bridge. Fed Chairman Ben Bernanke had said earlier in the year that he thought the troubles in the sub-prime mortgage market would be contained, and the market seemed to agree.

With the hindsight we have today, we can look at such moments with a very different perspective. In the fall of 2007, the market, in all its wisdom, was sending the message to investors to stay calm, stay invested, and most of all, disregard any arguments that a looming housing bust would eventually impact stock prices. Looking back at that moment today, however, it's safe to say the market was giving investors truly terrible advice at a truly critical moment.

Yet the real mystery is why investors tend believe the market's advice when valuations are at an extreme. Instead of being led toward the rocks by the siren song of an intact uptrend, valuations today suggest we should be allocated as conservatively as ultimately proved prudent in 2007, the late 1990s and 1929. These are the only periods comparable to today's valuation, and the years following each of these peaks form a short list of the most tumultuous periods in market history. The surefire way to have avoided those perilous periods was to have plugged our ears to the soothing message sung by the market's trend leading up to the peak, and instead focused entirely on the ominous outlook suggested by the market's valuation.

The market today is again giving investors terrible advice, as prices this year have drifted higher, with valuations above the peaks of 1929 and 2007, and within a stone's throw of the tech bubble peak. It is in this market environment that the Fed has been slowly raising interest rates and discussing a plan to shrink its balance sheet. In this month's letter, we'll review this plan in the context of what happened during the only other times the Fed has shrunk its monetary base.

In this month's letter:

- The Fed Has Only Shrunk Its Balance Sheet Twice in Its History, and It Wasn't Pretty
- Everyone Seems to Be Waiting for the Perfect Bubble Peak

The Fed Has Only Shrunk Its Balance Sheet Twice in Its History, and It Wasn't Pretty

> *If your ambition is to maximize short-term gains without regard to the long-term cost, you are better off not knowing those costs. If you want to preserve your personal immunity to the hard problems, it's better never to really understand those problems. There is a downside to knowledge. It makes life messier.*
>
> \- Michael Lewis, author of *The Big Short*

Summertime is generally (but not always!) a rather slow time in the financial markets, and this usually allows some time for reflection. In contrast to the tremors that reverberated through the markets a decade ago in 2007, this summer has been remarkably calm . . . at least thus far. Although there have been a few significant trend changes this year, such as the rollover of the U.S. dollar, even these events have evolved in a relatively peaceful manner. As we keep watch on equity market prices moving a few tenths of a percent day after day, it's almost possible to forget we are standing on top of one of the largest financial bubbles in our history.

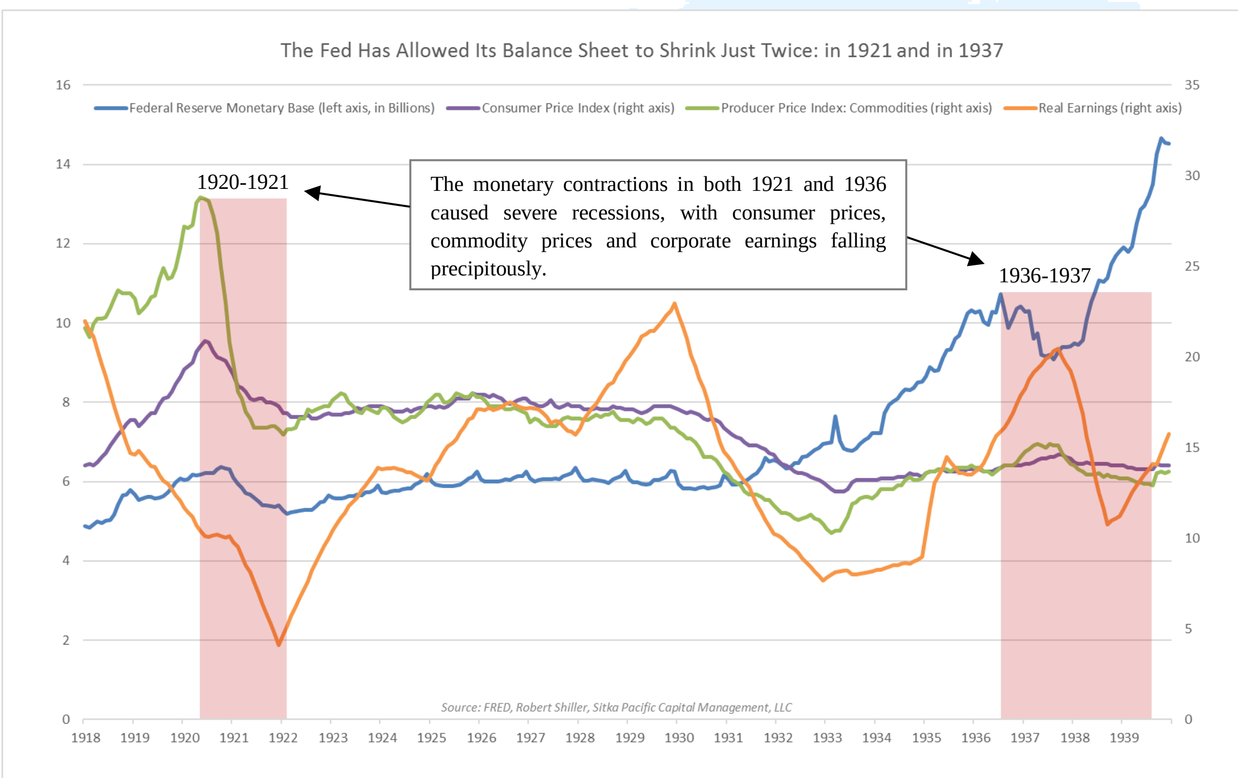
Almost. If we use the Wilshire 5000 Index as a proxy for the value of public equities in the U.S., the market has now reached up to within 5% of the high-water valuation mark set at the peak of the tech bubble. That valuations have risen back near the heights seen during the largest bubble in U.S. history is truly astonishing. If you think back to the tech bubble years for a moment, you can probably remember many of the seemingly rational justifications that were thrown around for those record prices and valuations. Yet after the bubble fever had passed, those arguments were in tatters, and there was nothing left but a classic bubble narrative. And over the decade that followed, the real price of the S&P 500, a proxy for the spending power of a portfolio of large-cap stocks, fell by two-thirds — 66%. Such declines have always followed extremely high valuations, but a new list of justifications being passed around today, many of which sound just as rational as the ones circulating during the tech bubble, are convincing investors that *this time* will be different. Unfortunately, it won't. When this bubble ends, the market will begin falling back to more reasonable valuations, as it always has. It is not a question of *if* this will happen, only how.

It is in this precariously overvalued market environment that the Fed is, for the third time in twenty years, attempting to thread the needle by tightening monetary policy without popping a financial bubble. And for those of us aware of the history of the Fed and financial bubbles, the last few years have been filled with déjà vu after déjà vu. Before the current episode, there had been three large financial bubbles during the Fed era — the 1920s bubble, the 1990s tech bubble and the housing bubble — and monetary policy had been instrumental in *both* inflating these bubbles and popping them. The interesting aspect of these prior episodes is that although they were all unique in terms of the specific circumstances of the times, they all resulted in very similar outcomes.

During the 1920s, the New York Fed, under Benjamin Strong, held interest rates low throughout the middle of the decade, and this helped set the market on a strong upward trajectory. This low interest rate policy was carried out for a number of reasons, among them Strong's desire to aid Britain's effort to return the pound to its pre-WWI exchange rate versus gold. However, this policy was also partially a *response* to what had transpired earlier in the decade — when the Fed had induced the first monetary contraction in the central bank's brief history.

Immediately following World War I, the Fed faced an existential question: after it had been pressed into service to aid in the financing of the government's huge war expenditures, what should be done with its bloated balance sheet? It is a question that should strike us all as familiar ground, given the similarity of the debate within the Fed today. But in 1920, the U.S. was still officially on the gold standard, and central bankers in Europe and the U.S. still held firm ideas about the role of sound money and the importance of maintaining exchange rates. While the Fed today emphasizes the importance of a consistent rate of devaluation (i.e. its goal of 2% inflation), the early Fed considered it vital to maintain truly stable prices (i.e. no monetary-policy-induced inflation). In this intellectual framework, Benjamin Strong and other Fed governors thought the wartime monetary inflation, and the vast increase in prices, must be corrected back to pre-war levels. Thus, in 1921, the Fed began selling securities to shrink its balance sheet back toward its pre-war level.

This policy had the predictable effect on the economy: prices began to fall, a severe recession began, and corporate profits sank dramatically. Although real corporate profits had already fallen by half from their wartime highs, the recession cut them in half again, and the stock market sank to the lowest valuation it would see in the 20th century — a 10-year P/E of just 5. Being as it was a decade before the Great Depression, many thought this was the worst economic downturn they had ever seen. However, Governor Strong and others considered this policy to be "strong medicine" that was necessary to put the U.S. economy, and the global monetary system, back on a proper track.



The price of commodities across the board fell by nearly half in 1921, and this remains the largest annual fall on record for commodities (green line in the chart above). The price of wheat in 1919 had been $2.12 a bushel, but by 1922 it had fallen all the way down to just $0.88 — and wheat did not fall alone during this monetary contraction. This decline had a severe impact on farm income and employment, and the Midwest suffered particularly. Although the Fed's policy was not solely responsible for this decline (the end of wartime procurement was also a factor), the monetary contraction in 1921 accelerated the declines. By 1922, the Fed, realizing the severity of the economic downturn, decided to change course early even though the Fed's balance sheet remained above its pre-war level, and prices immediately stabilized. However, between its peak in October 1920 and its trough in February 1922, the Fed's monetary base still had contracted by 18.7%.

The monetary contraction of 1921 turned out to be strong medicine indeed. In fact, it was so strong that it was the last time the Fed intentionally shrank its balance sheet with the goal of maintaining stable prices. The Depression of 1920–1921, as it is now known, was the second worst economic downturn of the 20th century, and the severity of the downturn planted itself into the institutional memory of the Fed. In the years that followed 1922, the Fed held interest rates low even as the economy recovered and the stock market started a dramatic ascent. However, having been stung by the severity of the 1920–1921 contraction, the Fed remained hesitant to actively tighten monetary policy until six years later, in 1928. But by then, it was too late: the 1920s bubble had fully inflated, with all the malinvestment, speculation and bad debt that comes with a period of over-exuberance. The Fed's tightening in 1928 and 1929 popped the bubble, and the Great Depression began.

The second time the Fed's base money supply shrank was in 1937. Having gone through the bursting of the bubble in 1929 through 1933, and the partial recovery from 1933 through 1936, which was powered largely by government stimulus, the Fed in 1936 was concerned about the potential for future inflation. Not only had the federal government massively expanded its expenditures with the New Deal programs, and funded those expenditures with debt, but gold began to flow into the U.S. from abroad in large quantities from 1933 onward. This gold inflow had expanded the base money supply by 50% in just three years' time, and along with the government's rapidly expanding debt, inflation alarms were going off at the Fed.

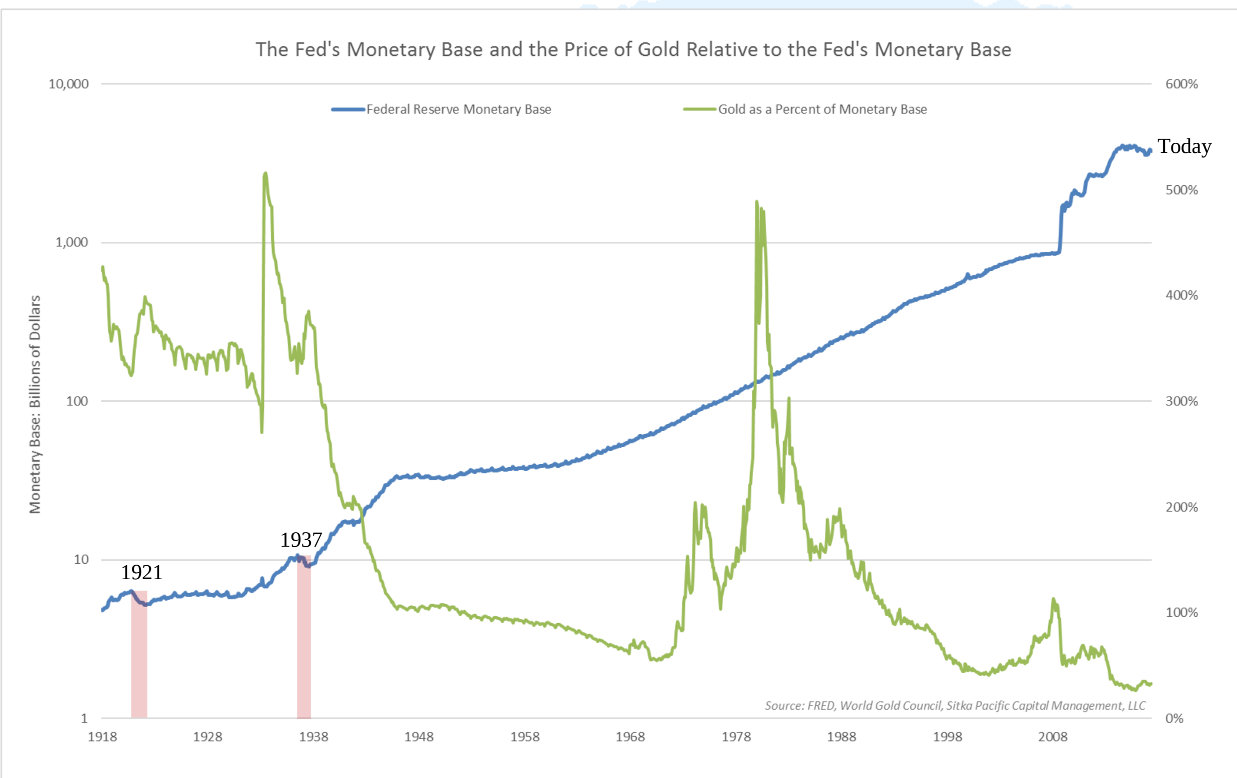
Since the U.S. remained on the gold standard in the 1930s, every ounce of gold that flowed into U.S. banks quickly turned into new base money in the banking system, which had the potential to increase credit in the economy. Between the large increase in government spending and the expanding supply of gold, the Fed and the U.S. Treasury Department decided monetary policy needed to be tightened to prevent prices from spiraling upward. While the Fed raised bank reserve requirements in 1936, the Treasury Department began to "sterilize" new inflows of gold — which would, in theory, inoculate the economy from any further increase in the money supply.

Instead, between these two policies, the base money supply did not just stabilize — it began to contract. Between July 1936 and July 1937, the base money supply contracted by 14.3%, and this was enough to kick off the third worst economic contraction of the 20th century. Within just a year's time, real GDP fell 10%, unemployment rose back up to 20%, and industrial production fell by an astonishing 32%. At the same time, corporate profits fell by nearly half, the stock market fell by 45%, and commodity prices began a slide that would take them down 15% by 1939.

The recession that began in 1937 was such a rapid unraveling of the economic gains from the lows in 1933 that the Fed and the Treasury Department quickly reversed course, and in the years that followed, the base money supply soared. The upward spiral in prices never happened, largely because the private economy was deleveraging, and like the lessons learned after the 1921 Depression, the experience of the 1937 recession firmly planted themselves into the institutional memory of the Fed; the response to the credit crisis in 2008 came right out of lessons learned from this period.

* * *

These two formative experiences, 1920–1921 and 1936–1938, are the only times the Fed has overseen a contraction in the base money supply, and besides the economic contraction during 1929–1933, they represent the two most severe economic contractions of the 20th century. There are volumes and volumes of work in the economic literature on what these periods represent, and the consensus that has been reached is that both periods represent serious policy mistakes. And by mistake, it is meant that shrinking the money supply ended up being a "bad" idea.



That is why, in the eight decades since 1937, there has not been another attempt to deliberately shrink the base money supply. Apart from the two periods highlighted above, the Fed has never attempted it, and it certainly has not attempted such a contraction since the U.S. abandoned the gold standard in 1971. The last 80 years has been a one-way trip of monetary expansion, and this monetary expansion has facilitated the huge expansion of debt in the post-WWII era.

However, the Fed now apparently feels that the time is right to wind down its emergency response to the credit crisis with yet another experiment — the first base money supply contraction of the modern monetary era. Just as they were in 1936, Fed officials today appear to be worried about the potential for future inflation from the large increase in the base money supply since 2008, and they are determined to preempt such an upward spiral in prices.

According to statements from Fed officials and various press releases, the Fed intends to embark on the first such attempt to shrink its balance sheet, perhaps as soon as later this year. Although we do not yet have an officially announced plan, as of June we do have a general outline. The working plan would have the Fed steadily and gradually begin reducing the size of its balance sheet month by month, by amounts that would shrink the base money supply by a total of around 33% over the course of five years.

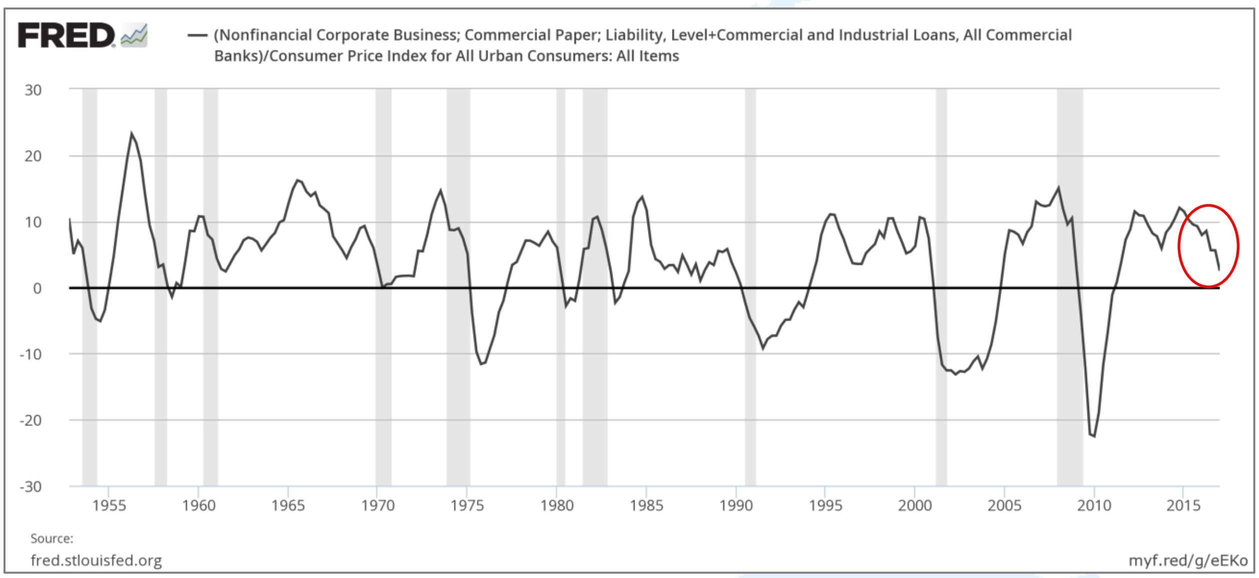
At first brush, this could sound to some like a reasonable plan. After all, it would slowly and gradually take the Fed's balance sheet down over a period of many years, in contrast to the quick and rapid actions in 1921 and 1937. And the end point of this contraction would still have the Fed's monetary base far above its pre-crisis level near $800 million, which would theoretically leave much of the post-crisis stimulus in place. These aspects of the plan show the institutional memory of the Fed from the 1930s remains an influence on current policy.

However, set within the context of the experiences of 1921 and 1937, and the fact that the private economy is currently deleveraging for the first time since the 1930s and 40s, it appears that the Fed's institutional memory perhaps isn't as strong a force as it once was — *if*, in fact, the Fed really intends to go through with such a plan. It must be remembered the expansion of the Fed's balance sheet has always been presented as a "temporary" response to the credit crisis, and that talk of eventually returning the Fed's balance sheet to pre-crisis levels began almost immediately after the first QE program began. As part of the policy to maintain the public's confidence in the Fed and the dollar, this talk has been essential.

Yet if it has now become more than just talk, the Fed's proposed balance sheet contraction is probably the single largest threat to the post-recession recovery to come along since 2009. A shrinking money supply has always been associated with economic busts, and this was the case during the century before the Fed's creation. And since the Fed's creation, that relationship has continued — as was experienced in the busts of 1921 and 1937. Perhaps only because the vast majority of people today have never actually experienced how an economy functions on a shrinking base money supply does the idea sound even remotely plausible within the context of the Fed's dual mandate. After all, it has been 80 years since the last time.

During the entire post-war era leading up to the credit crisis, credit creation in the private economy expanded broad aggregates of money supply, and this occurred without any strong impetus from the Fed. During these periods of leveraging, the Fed acts as a *restraining* force on credit creation, and it raises interest rates to slow the process down before it drives prices too high too fast.

However, during periods of deleveraging, the Fed is not a restraining force in credit creation — it is a *driving* force. When the private economy is not propelling credit growth, and credit growth is largely being driving by the Fed's monetary policy, it's natural to see credit growth slow when the Fed scales back its monetary stimulus — and that's just what we have seen over the past two years. Although the Fed funds rate remains negative on a real, inflation-adjusted basis, which is by itself extremely accommodative, the pace of new credit growth by many measures peaked in late 2014 — just when the Fed ended its most recent QE program. The chart below shows one such measure — the year-over-year rate of new bank loans. Since 2014, as the Fed has slowly taken the Fed Funds rate into shallower negative territory, on a real basis, this measure of credit growth has slowed dramatically (red circle).



In light of all this, we wonder whether those at the Fed honestly believe that they can shrink the Fed's balance sheet in the years ahead, or whether they are just trying to take this cautious tightening cycle as far as they can until the next downturn forces them to reverse course. It's hard to tell, but two things are relatively clear. First, a balance sheet contraction similar to the plan circulated by the Fed in June would be the largest base money contraction in the Fed era — larger than in 1921 and 1937, if not as quickly implemented. Second, the next economic downturn will likely unmask much unsound credit and debt created during this monetary-induced bubble. Although all bubbles ultimately exhaust themselves and eventually begin to unwind on their own, a base money contraction would probably greatly accelerate that process — just as it did in 1937.

Everyone Seems to Be Waiting for the Perfect Bubble Peak

> *The market value of the world's negative-yielding bonds has jumped almost 25 percent over the past month to $8.6 trillion amid slower-than-forecast inflation data and as investors piled into the safest securities as perceptions of geopolitical risk increased. That's happened even after Federal Reserve officials started raising benchmark borrowing costs and said they would begin running off their $4.5 trillion balance sheet "relatively soon."*
>
> \- Bloomberg, August 14, 2017

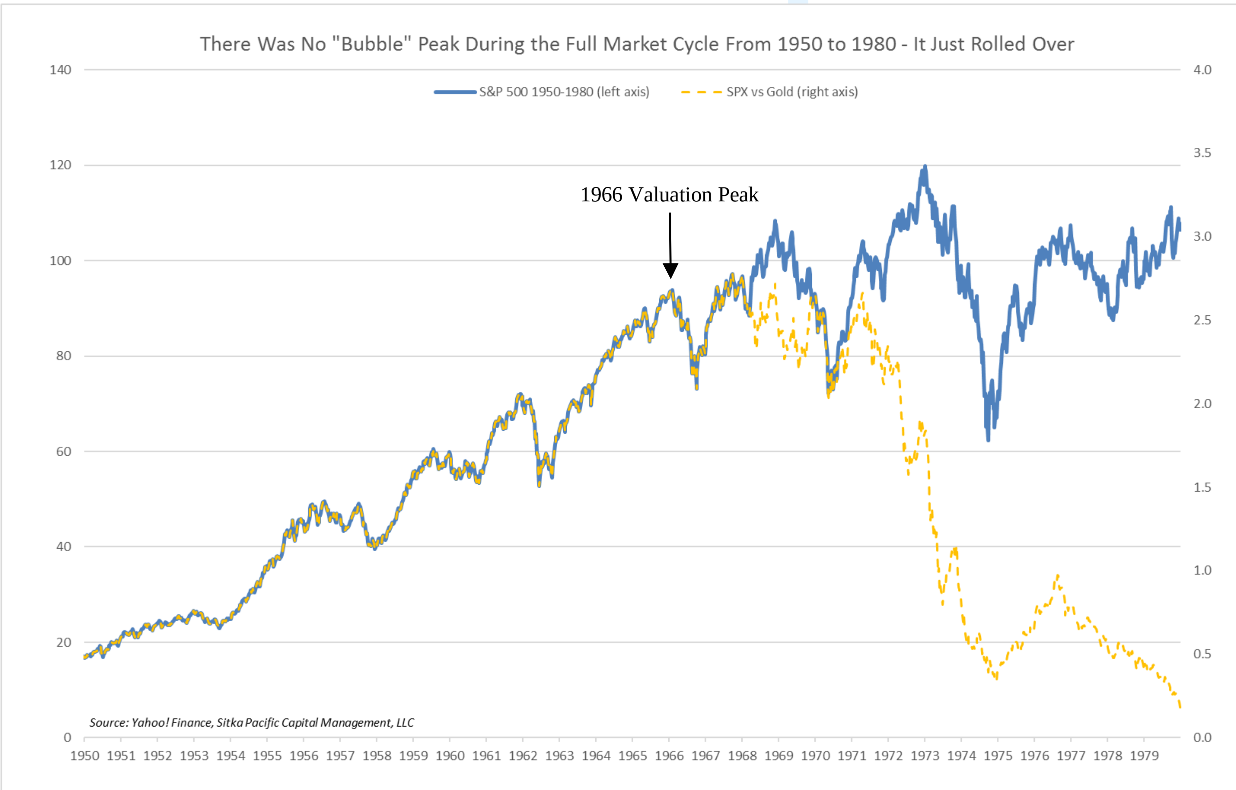
In our letter in June, we highlighted the divergence between the Fed's policy of incrementally raising short-term interest rates, and the message the bond market and the dollar were sending with their declines. Both long-term Treasury yields and the dollar have been falling this year, and it's important to understand the implications of these trends: they suggest the Fed is near the end of its monetary tightening cycle, whether those who sit on the FOMC know it or not. If so, the next monetary easing cycle may be not far off, which is something the global bond market appears to be anticipating with so much debt still trading with a negative yield.

Amid this late-cycle market action in the bond market and the dollar, we've noticed a curious theme among professional investment managers. Although many acknowledge that equity valuations are extremely high, they cite a distinct lack of euphoria among investors as reason to expect this bubble has further to run. In other words, since the market action is not yet like the euphoric, parabolic peaks of past bubbles, this one isn't done yet. So, for the time being anyway, they remain invested.

We've used "bubble" to characterize the market in recent years because it's a label that befits prices and valuations that are unsustainable and will result in negative returns over a reasonably long time horizon. Such high valuations are a relatively rare occurrence in market history — only a handful of short periods have seen such high valuations over the past century that a negative 10-year return has followed. However, it is a label that began to fit the market in late 2013, and it fits the market even more so today.

What our bubble label *doesn't* mean is that some kind of explosive, euphoria-filled crescendo is required to mark its end. The tech bubble certainly had such a parabolic ending: in the year and half between 1998 and early 2000, the Nasdaq 100 Index almost quintupled. No one can argue with that ending — it was a speculative peak that can stand alongside Dutch tulips in terms of form. In contrast, the top in 2007 was much more subdued, with the S&P 500 climbing to a state of exhaustion more than anything that can be described as euphoric. The most dramatic crescendos were seen elsewhere during this market top: China's stock market doubled in the months leading up to October 2007. However, even with the less dramatic ending, the S&P 500 fell more after the top in 2007 than it did after the top in 2000.

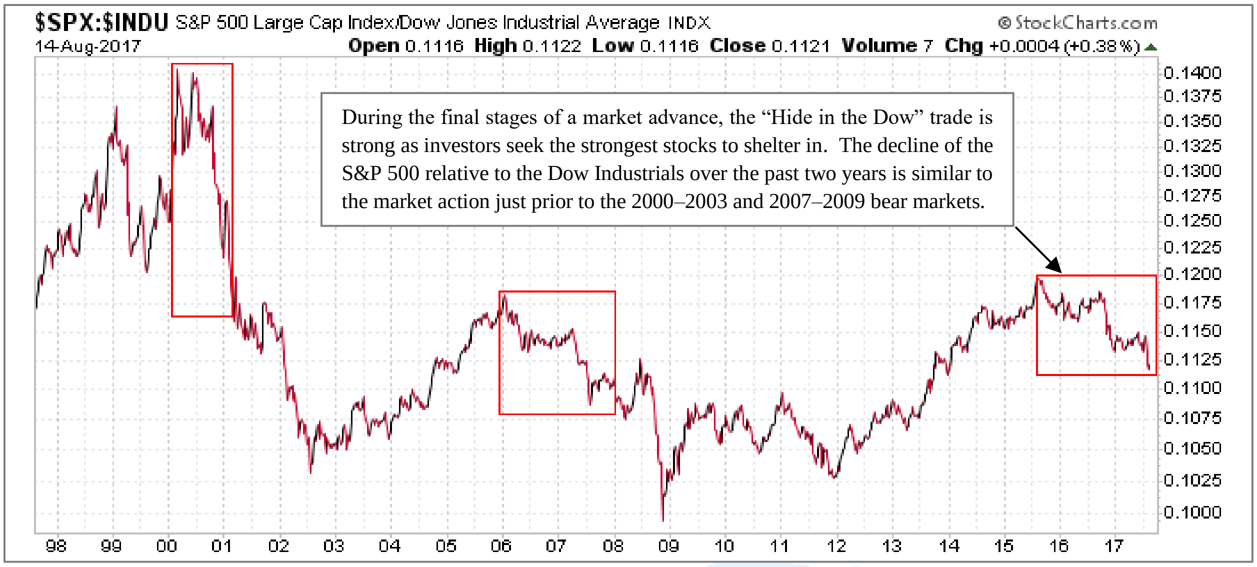
If there were a sneaky way for the market to lure investors into remaining invested during the final stage of the current bubble, being the third bubble in two decades, it would probably be to make it come to an end with a whimper rather than a bang — perhaps like it ended in January 1966. In that month, the market did indeed top out and begin declining, but not in a way that was dramatically different from other short-term peaks and corrections over the prior decade. And not only that, the market fully recovered from the decline by the following year, in 1967. On the surface, you could hardly call it a top of any significance — it was more like a "healthy pause." Yet this relatively inconspicuous moment in 1966 marked the peak valuation seen in the bull market from 1949, and from that point on the tide began to go out.



In the fifteen years after the peak in 1966, the market would lose more of its real value than it did in the fifteen years after 1929. However, the peak in 1966, and the erosion of value in the years that followed, came in an entirely different form than during the Great Depression. In contrast to the peak in 1929, which was a classic speculative peak, the peak in 1966 was subdued and sleepy. And in contrast to the losses in the 1930s and 40s, which saw the largest nominal declines in market history, the losses in the 1960s and 70s were entirely via inflation. Both periods eroded away most of the real value of an equity portfolio, but each did so in entirely different ways.

This is a long-winded way of saying that those looking for a classic, textbook parabolic ending to this bubble may never find one. Those looking for such a peak in the 1960s and 70s never found one. Instead, those holding out for such an ending found themselves years into a value-corrosive long-term bear market before they realized what was happening.

We aren't looking for any particular ending to the current bubble, but we are always looking for the type of market action that usually precedes significant trend changes. With the valuation of the market in its second highest phase in history, any underlying weakness should be cause for concern, and there have been numerous causes for concern over the past few years. Here is just one example:



The fact that these technical red flags have not *yet* translated into a significant bear market speaks mainly to the scale of this bubble. Current market valuations imply very low forward returns — negative returns, in fact. This isn't a problem by itself, except that the majority of investors holding stocks today clearly expect a different result than negative returns, and when this discrepancy becomes apparent to them they will sell. This discrepancy is part of the reason why markets cycle, and why sky-high valuations never stay sky-high for very long — because they are based on a fundamental miscalculation. Investors are making the same miscalculation today.

Even though the price action of the market today is quite different from the price action in 2000, over the past two years we've seen many of the same trends between sectors and between markets that were present at the peak of the tech bubble. The chart above highlights one relationship with the stock market itself that has been a consistent marker, regardless of the price action at the peak. The rollover of the dollar this year, which was preceded by a pickup in precious metals last year, is an almost identical progression to that which unfolded in 2000 and 2001. These red flags have been quite visible for some time, and taken together they suggest this bubble is in its terminal stage.

* * *

One dynamic that has been consistent throughout the Fed era, and even during the century before the Fed era, is that the value of money rises during severe market and economic downturns. As the Fed tightened monetary policy in 1921 and 1937, the value of (gold-backed) dollars rose dramatically relative to risk assets like stocks, and many other prices throughout the economy. Under the gold standard, with each $20 bill exchangeable for an ounce of gold, falling prices was equivalent to a rising value of gold.

The increase in the value of gold also occurred over the long period of the Great Depression, during the 1960s and 1970s (chart above), and in the decade following the peak of the tech bubble. Regardless of whether the downturn was strongly deflationary (1921, 1929, & 1937), or strongly inflationary (1966–1982), or something in between (2000–2009), the value of gold ended up much higher relative to risk assets and other assets, such as commodities. This increase in the value of money during downturns is one of the few things we can bank on during the long fallout following a market bubble.

Markets sometimes look beyond the conditions of the present and begin pricing in long-term trends before clear evidence of those trends is visible in the monthly or quarterly economic data. Gold has been rising over the past year and a half while the Fed has continued to modestly raise interest rates, and in case you have been wondering why gold would do this when, according to conventional wisdom, it should be falling as the Fed tightens monetary policy, it is likely because the market is again looking out beyond the immediate horizon.

When the Fed tightens monetary policy during a market bubble, tighter monetary conditions hasten the onset of the next cyclical downturn, which brings forward the next monetary easing cycle and the next round of dollar devaluation. This is the progression that has played out every time market valuations have been as high as they are today, and given the debt, deleveraging and demographic issues the markets are reckoning with, the value of money has a good chance of increasing in value versus risk assets again.

As we said at the beginning of this letter, the markets have been quiet this summer, but we don't believe anyone should be lulled into complacency by these valuations. We don't have any special insight into precisely how markets will revalue themselves after this bubble finally bursts, but we do feel that money will again gain value during that process — and our portfolios are positioned to do well as that increase in value unfolds.

As always, if you would like to discuss investments in your account, or topics discussed in this letter, feel free to contact us — we would be happy to talk with you.

Sincerely,

Brian McAuley
Chief Investment Officer
Sitka Pacific Capital Management, LLC