February 2021

Dear Investor,

One year ago, in the span of a few trading days last February, it became clear that monetary policy had suddenly fallen dramatically behind the curve. Within the span of just a week, the futures market went from assuming the Fed Funds rate would remain stable in its 1.5%–1.75% range, to a 95% chance of a 50-basis-point rate cut at the next policy meeting, only three weeks away. For those of us who witnessed the credit crisis unfold in 2008, it was the first time since then there had been such a rapid phase shift in the outlook for monetary policy. Over the same few days, the yield of the 10-Year Treasury note plunged to a new all-time low below 1.5%, a level which had proven to be a floor of support for eight years. It was obvious then that the markets had crossed over a significant threshold, though it was not yet clear what was about to emerge on the other side.

Exactly one year later, almost to the day, the bond market endured another shock, but this time it came in the form of the first real test of the environment which emerged in the wake of the turmoil last February. Amid rising expectations for future inflation, long-term Treasury yields have been moving higher since last summer, and it culminated in a bond market rout on February 25th. However, instead of plunging through 1.5% from above, as it did a year before, the yield on the 10-Year Treasury note briefly surged through 1.5% from below, before settling back.

The market action in stocks, bonds, and commodities so far this year has revolved around the expectation of rising inflation in the years ahead. After reaching a low of just 0.14% last March, the market's assumption of inflation over the next five years rose as high as 2.38% this past month — the highest estimate in nine years.

One impression this year's annual letter intended to convey was that the threshold crossed in 2020 likely represented only the beginning of a much larger process — a process which will undoubtedly be accompanied by significant volatility. The combined impact of the pandemic, the recession, and the shift in monetary policy toward fueling higher inflation over the long term represents a major pivot. The impetus to devalue is now tremendous, and the financial markets have only just begun reckoning with what that will ultimately mean for prices and valuations. The bond market action this year appears to represent an early test of those waters, which we'll discuss in the pages below.

In this month's letter:

- Amid Fears of a Taper Tantrum, Half of the Dual Mandate Is Securely on the Shelf
- The First Bond Market Revolt Reaches the First Line in the Sand

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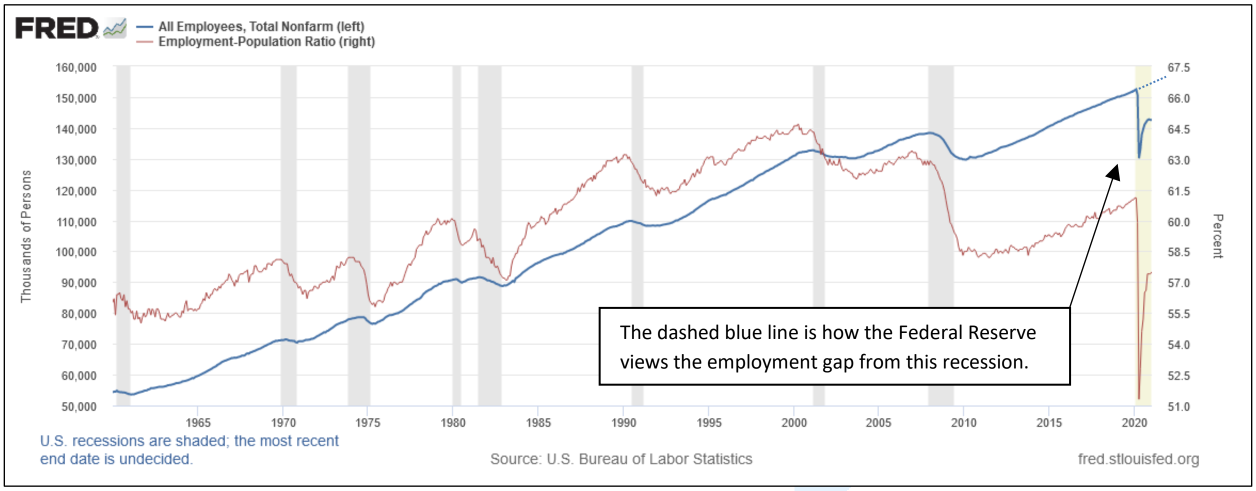
Amid Fears of a Taper Tantrum, Half of the Dual Mandate Is Securely on the Shelf

> *Seventy-five years ago, in the wake of WWII, the United States faced the challenge of reemploying millions amid a major restructuring of the economy toward peacetime ends. Part of Congress's response was the Employment Act of 1946, which states that "it is the continuing policy and responsibility of the federal government to use all practicable means . . . to promote maximum employment." As later amended in the Humphrey-Hawkins Act, this provision formed the basis of the employment side of the Fed's dual mandate. My colleagues and I are strongly committed to doing all we can to promote this employment goal.*
>
> *Given the number of people who have lost their jobs and the likelihood that some will struggle to find work in the post-pandemic economy, achieving and sustaining maximum employment will require more than supportive monetary policy. It will require a society-wide commitment, with contributions from across government and the private sector. The potential benefits of investing in our nation's workforce are immense. Steady employment provides more than a regular paycheck. It also bestows a sense of purpose, improves mental health, increases lifespans, and benefits workers and their families. I am confident that with our collective efforts across the government and the private sector, our nation will make sustained progress toward our national goal of maximum employment.*
>
> \- Fed Chairman Jerome Powell, February 10, 2021

In our last three annual letters, the core of our discussion has revolved around the imbalances that arose in the 1960s, and the consequences of those imbalances which were visited upon investors throughout the 1970s. In our 2019 annual letter, we looked at the growing conflict between Fed Chairman McChesney Martin and President Johnson, and the resulting pivot of real interest rates in 1965. In our 2020 annual letter, we looked at the events leading up to the end of the Bretton Woods system of fixed exchange rates, including the conflicts resulting from the Employment Act of 1946. And in our annual letter this year, we focused in more detail on the impact all those imbalances ultimately had on investors, once markets began the long process of pricing them in.

Discussions of risks and imbalances like those can seem esoteric, until — all at once — they become exceedingly relevant. The economic downturn over the past year was an event that brought many simmering risks and imbalances above the surface all at once, and it resulted in a punctuated equilibrium shift into an entirely new paradigm. Just before the downturn, trends in economic growth, employment, the federal budget, monetary policy, and the independence of the Federal Reserve all seemed to be slowly, but surely, returning to the norms which were familiar before the credit crisis. Yet within just a few weeks last year, those trends toward normalcy were completely upended, and the imbalances which had been quietly building below the surface were suddenly thrust into the driver's seat. Such is the nature of growing imbalances, and risks — you never know just when or how they will emerge, but they quickly dominate when they do.

The economic impact from the pandemic and the recession will prove to be long and lasting. As you can see in the chart below, although employment has partially recovered from the sharp decline during the national lockdown last spring, it remains far below its level prior to the recession. There are currently 9.9 million fewer people employed than a year ago, which is a larger employment deficit than was seen at the trough of the Great Recession in 2009. And there are 13.3 million fewer people working today relative to the pre-recession growth trajectory of employment.



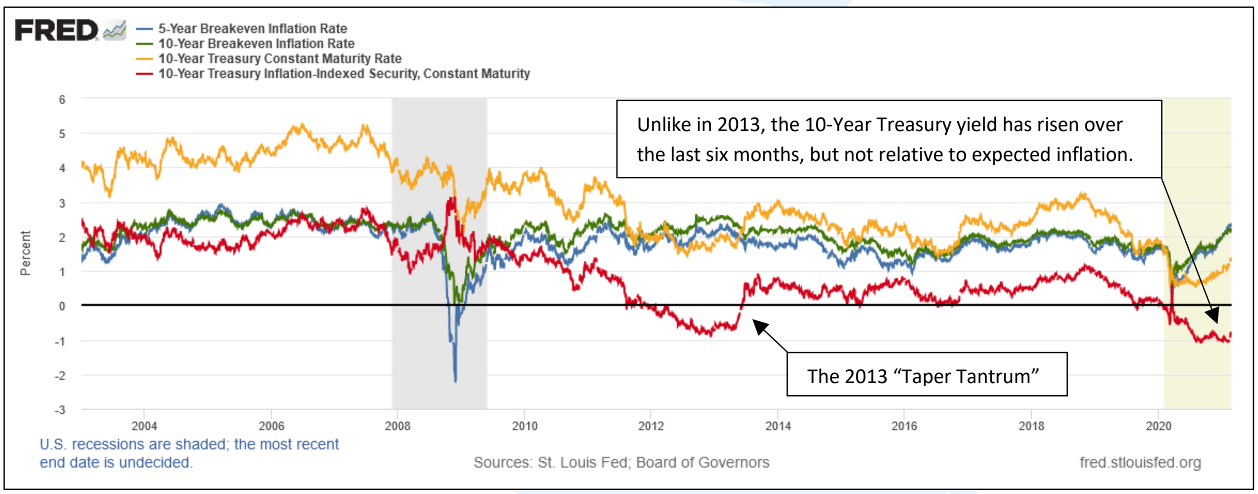
This is the largest employment disruption since the recession immediately following World War II, and the Chairman of the Federal Reserve harkened back to those days in a revealing speech a few weeks ago. The speech was revealing in that it showed the Federal Reserve considers the challenges of the current downturn to be far more serious than those of a typical cyclical recession, or even a financial crisis, and as a result it will require a policy response of a scale and caliber not seen in several generations. This has been the consistent message from Chairman Powell and other Federal Reserve officials over the past year. When the Chairman of the Federal Reserve pointedly references the economic challenges of 1940s and the responsibility of the government to promote maximum employment, and takes such pains to emphasize that *my colleagues and I are strongly committed to doing all we can to promote this employment goal*, investors should take those statements at face value.

It is important to remember that during the 1940s, the Fed willingly ceded control of monetary policy to the Treasury, and agreed to fix short-term and long-term interest rates until six years after the war ended. This ensured the federal government could cheaply fund its vast wartime expenditures without risking a debt crisis, and it also ensured that short-term and long-term interest rates remained well below the inflation rates in the years that followed. Maintaining negative real interest rates was the primary tool used to stimulate GDP growth in excess of the growth in debt, and the inflation during those years played a key role in delivering nominal economic growth.

The lessons from the 1940s, and the 1960s, are particularly relevant today because when we hear in such strong language that the Federal Reserve will do all it can to promote a return to full employment, and hear references to the challenges of the postwar years, it is an unambiguous signal that the other half of the Fed's dual mandate — price stability — has effectively been shelved for the foreseeable future. It is also a sign that investors should not overweigh the more recent experience of the last decade when looking for guidance as to what may unfold in the years ahead.

Over the last six months, the yield on the 10-Year Treasury note has risen from 0.5% to 1.5%, and this rise has triggered fears of what happened during the *Taper Tantrum* in 2013. At that time, with the economy four years into a recovery from the financial crisis, and employment approaching its pre-recession level, Fed Chairman Ben Bernanke signaled the beginning of the end of quantitative easing by stating, at a Congressional hearing, that the Fed would begin to taper the rate of its bond purchases if conditions continued to improve. The response in the market following that testimony was swift: after spending two years in negative territory, the real, inflation-adjusted 10-Year Treasury yield rapidly shot up into positive territory. This handed steep losses to bond investors, and the return of positive real long-term rates also sparked a precipitous decline in precious metals.

As the rise in long-term Treasury yields accelerated in recent weeks, there has been a palpable fear in the air of a repeat of the experience of 2013. However, it is clear the current rise in Treasury yields is quite distinct from the what unfolded in 2013. While the Taper Tantrum represented the reemergence of positive inflation-adjusted long-term Treasury yields, the rise in yields over the past six months has been, unlike 2013, accompanied by an equally strong rise in inflation expectations. As a result, the expected real 10-Year Treasury yield (red line in chart below) remains just as negative today as it was six months ago, when the nominal 10-Year Treasury yield was at 0.5%.



The rise in long-term inflation expectations over the past year has been swift, and it makes the current environment quite distinct from the market environment in 2013. We are also still in the middle of the fiscal and monetary policy response to this recession — not near its end. As we discussed in this year's annual letter, Chairman Powell and others at the Federal Reserve are now operating in a starkly different policy framework than in the years following the financial crisis. They now see rising inflation expectations as part of the solution to the below-trend inflation of the past decade, and they are committed to making up for lost inflation. In their view, rising inflation expectations is an emerging trend to be nurtured, not something to guard against, or prematurely snuff out.

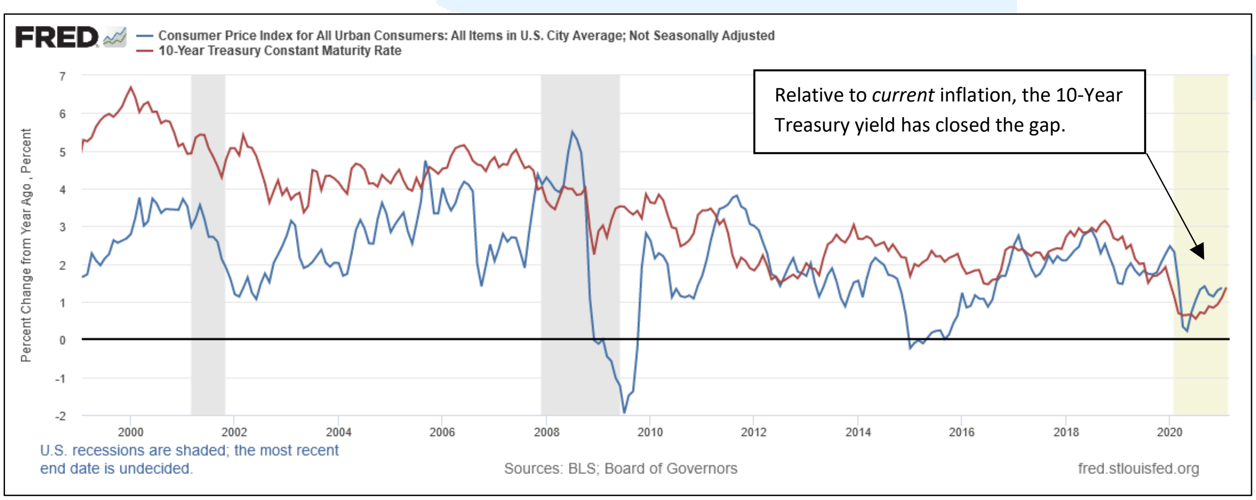
A full recovery from this recession will likely take at least as long as the recovery from the Great Recession, and for the Federal Reserve, the lessons learned from the past decade include an acute awareness of just how long it can take for the economy to recover from a deep decline in employment. They are also aware of the undertow that deleveraging exerts on prices, and they are resolved to counter it with a more forceful response this time. It was four years after the end of the last recession in 2009 before there was open talk of winding down the pace of quantitative easing. Within the new policy framework, which emphasizes a return to full employment and an extended period of higher-than-average inflation to make up for more than a decade of perceived inflation shortfalls, the fears of tapering appear rooted more in the lingering shock of 2013's tantrum than in today's reality.

The First Bond Market Revolt Reaches the First Line in the Sand

> *A breakneck selloff in the bond market left one of the biggest Treasury exchange-traded funds bleeding. The $14 billion iShares 20+ Year Treasury Bond ETF (ticker TLT) has plunged 11% this year as long-dated Treasury yields climbed, fueled by building wagers on a rebound in inflation.*
>
> *Covid-19 vaccine rollouts combined with the prospect of further fiscal aid from the Biden administration has forced a reckoning of sorts for the Treasury market, where long-dated yields were hovering near historic lows entering 2021. Breakeven inflation rates have soared to multi-year highs, dragging benchmark 10-year yields to the highest in over a year, as the economic outlook brightens. That point was reinforced by Federal Reserve Chairman Jerome Powell this week as he said the recent run-up in bond yields is "a statement of confidence" in the economy, while downplaying the risk of a sustained pickup in price pressures.*
>
> \- Bloomberg, February 24, 2021

Looking back at the Great Inflation, we can date the moment of liftoff for long-term Treasury yields to August 1965. The month before, the 10-Year Treasury yield had ended at 4.20%. It had been higher for a short time at the end of the 1950s, but after then it had settled down to a relatively narrow trading range, centered below 4%. In August 1965, however, the 10-Year Treasury yield ticked up to 4.25%, and by the end of the year, just after President Johnson had berated Fed Chairman Martin over raising interest rates without his consent, it had risen further to 4.62%. Unbeknownst to investors at the time, it would be another thirty-seven years before the 10-Year Treasury yield would again trade as low as it did in the summer of '65.

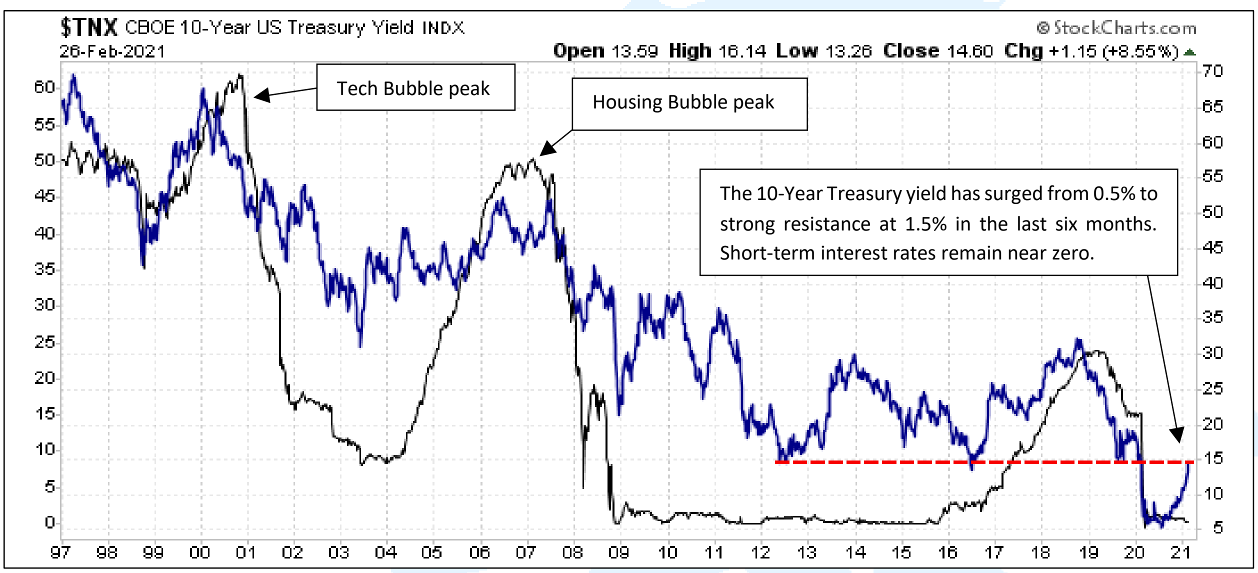
That initial rise in the 10-Year Treasury yield tightened financial conditions, because inflation was tepid at the time. Between the end of 1964 and the end of 1965, the Consumer Price Index had risen just 1.92%. This inflation reading was a couple tenths of a percent higher than the typical inflation rate over the prior few years, but it was well within the range of the previous decade. After ending 1965 at 4.62%, the yield on the 10-Year Treasury note continued to rise in early 1966, reaching 4.8% in



February, and then proceeding to rise above 5% in July. By that time, consumer price inflation had begun to tick up as well, to a year-over-year change of 2.85%. This was a steep enough rise in long-term yields and inflation to be noticed by the stock market. The cyclically adjusted valuation of the S&P 500 began falling that spring, and unbeknownst to investors at the time, it would be twenty-six years before the market rose above the real, inflation-adjusted high-water mark established in early 1966.

While the rise of long-term Treasury yields over the last six months has mirrored the rise in long-term inflation expectations, leaving the *expected* real 10-Year Treasury yield near negative 1%, the increase in yields has tightened financial conditions, as current inflation is tepid; over the past year, the Consumer Price Index has risen a mere 1.37%. As the yield on the 10-Year Treasury note rose this past month, then dramatically spiked as high as 1.61% on February 25th, after a disappointing auction of 7-Year Treasuries, it also rose into positive territory relative to current inflation. This was immediately noticed by the rest of the market. At that moment, stocks, bonds, commodities, and precious metals all declined in lockstep.

Yet there was another reason risk assets began falling when long-term rates spiked higher in the last few days of February: the 1.5% level is a key technical line in the sand for the 10-Year Treasury yield. It defined the lower bound of the decade after the financial crisis, and the plunge below that level a year ago marked the beginning of the era of ultra-low long-term yields. If the 10-Year Treasury yield were to rise above 1.5%, and remain there, it would mark a sudden and unexpected end to that era, and the main justification for the incredible rise in risk asset valuations would vanish along with it.



For risk assets trading at sky-high valuations, rising interest rates and rising inflation rates represent threats, for the reasons we discussed in our annual letter. When the *bountiful triple dip* reverses, as it did in early 1966, real returns from risk assets like stocks turn negative. The threat inflation poses to bonds is more readily apparent, as the decline in bond prices so far this year clearly demonstrates; when the fixed yield from bonds is ultra-low, as has been the case over the past year, it only takes a slight increase in inflation expectations to deliver losses greater than the nominal yield. For assets like stocks, which do not come with a fixed, known yield over the unknown duration of the company, the threat of rising interest and inflation rates is not as clear upfront, but it is just as real.

For assets like commodities and precious metals, however, rising inflation represents a long-term tailwind, but it is a tailwind which can be buffeted along the way by the turmoil it creates in stocks and bonds. When financial conditions tighten from a steep rise in bond yields, all financial assets can be negatively impacted, in the short term. During the Taper Tantrum, the yield on the 10-Year Treasury note doubled, from 1.5% to 3%, and when viewed in those terms, the rise of long-term Treasury rates over the past six months has been steeper than in 2013: the 10-Year Treasury yield has more than tripled from its low last summer.

We will have to wait and see how the bond market responds to the line in the sand for the 10-Year Treasury yield. If 1.5% proves to be a ceiling, then the fireworks on February 25th will be recorded as the capitulatory end to the bond market's first revolt against the new inflation paradigm. If 1.5% is durably breached and yields continue higher, it would probably result in a resumed sell-off in financial assets, along with slowdown in the recovery.

It would also likely draw a policy response. Although the yield on the benchmark German 10-Year Bund remains negative, the head of the European Central Bank has already served notice to the markets that they are watching the rise in yields closely, and the head of the Federal Reserve made it clear he views the current challenges as the most daunting since the 1940s. Back then, the Fed was willing to fix short-term *and* long-term rates in order to maintain stability, and the Fed is perfectly capable of enacting a similar policy today, if it is deemed necessary. The recovery from this downturn has barely begun, and the new policy framework promoting higher inflation is just six months old. When we look back at the market action over the past six months, it may end up appearing similar to the first rumblings in 1965 and 1966 — just the earliest adjustments to a new monetary regime.

We appreciate you taking the time to read this letter. 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
Founder and Portfolio Manager
Sitka Pacific Capital Management, LLC