Sitka Pacific
Capital Management, LLC

July/August 2020

Dear Investor,

In our last two annual letters, we spent a fair number of pages discussing monetary events in the 1960s and early 1970s. We first detailed the political pressure McChesney Martin and the Fed felt from the Johnson administration in 1965, which was intended to force monetary policy into a more accommodative stance amid widening federal budget deficits. The net result of this political pressure was a pivot lower in real interest rates, which marked the beginning of a new, inflationary monetary era. Then, we discussed the domestic and international pressures which eventually brought about the final collapse of the Bretton Woods system in 1971.

If it seemed odd that we have spent so much time in recent years discussing monetary events from the past, including the policy coordination between the U.S. Treasury and the Fed during World War II, hopefully it has resulted in a more grounded understanding of events this year. Sometimes, what seems like the distant past can suddenly look a whole lot like the present. The Covid-19 pandemic, and the recession that is now unfolding in its wake, has ushered in another era of rapidly rising government deficits and monetary policy captivity; along with rapidly expanding its balance sheet, the Fed has pledged to keep nominal short-term interest rates at zero more or less indefinitely. As a result, real Treasury yields, which remained modestly above zero at the beginning of the year, have now moved decisively into negative territory all the way out to the long end of the yield curve. Not since the 1940s, when the Fed pursued an explicit policy of capping nominal rates throughout the Treasury yield curve, have rates been so uniformly negative relative to the estimated rate of inflation.

This combination of monetary expansion and negative real interest rates began to impact the value of the dollar over the past few months, and it also seems to have sparked the first serious reassessment of the bond market's long-term value as an investment allocation by the larger investment management community. This reassessment appears to have been prompted by the near-zero level of long-term yields like the 10-Year Treasury, which remains pinned near 0.6%, while the market's estimate of inflation over the next decade has steadily risen since March, and currently resides near 1.6%. This budding awareness has also brought the value of gold into the fringes of the mainstream discussion for the first time in many years, and by the recent price action, it appears the first flight into real assets has begun.

In this month's letter:

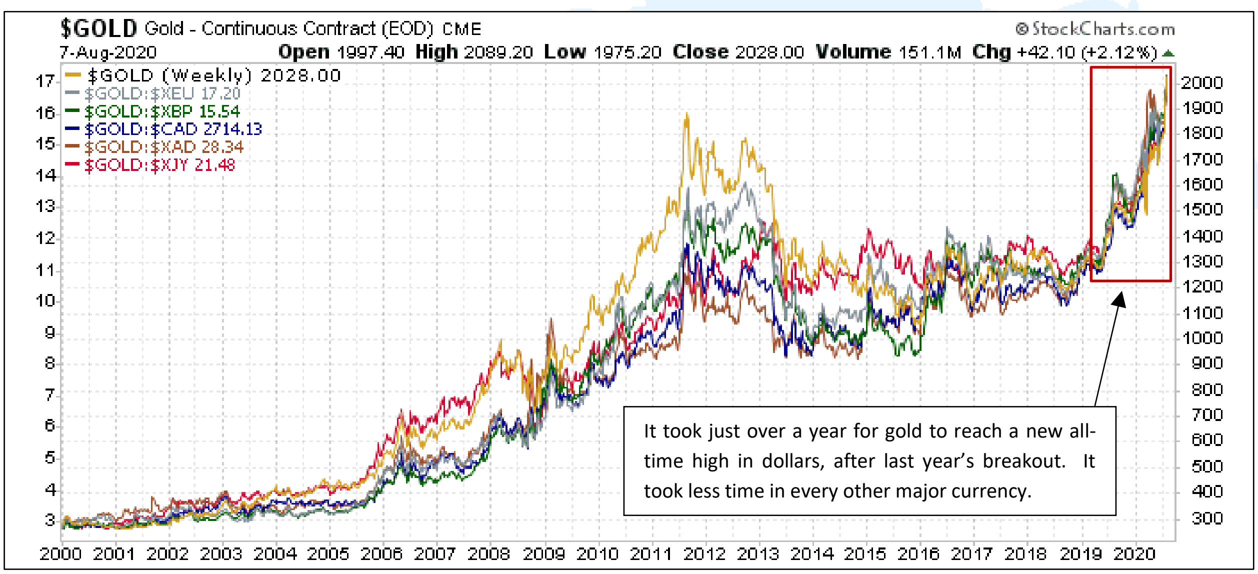
- Gold Walks Through Its 2011 Peak as Awareness Grows and Real Rates Sink
- The Real Outlook for the Typical 60/40 Portfolio of Stocks and Bonds

Gold Walks Through Its 2011 Peak as Awareness Grows and Real Rates Sink

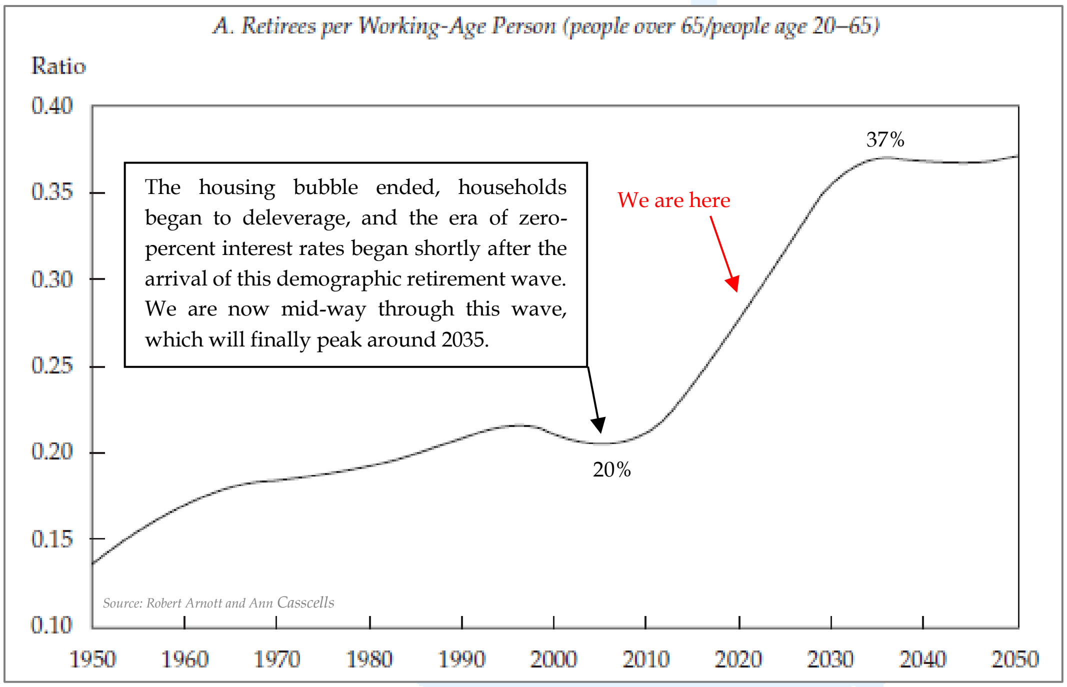
> *Gold is the currency of last resort, particularly in an environment like the current one where governments are debasing their fiat currencies and pushing real interest rates to all-time lows... The resulting expanded balance sheets and vast money creation spurs debasement fears,* [and this leads to] *a greater likelihood that at some time in the future, after economic activity has normalized, there will be incentives for central banks and governments to allow inflation to drift higher to reduce the accumulated debt burden*.
>
> \- Goldman Sachs, July 2020

On the last day of July, the credit ratings company Fitch released a statement which announced they had revised their outlook for their rating of U.S. Treasury debt from *stable* to *negative*. Their rating of U.S. sovereign debt remained Triple-A, the highest rating possible, and they still considered the U.S. to be exceptional even among Triple-A rated borrowers, due to the dollar's status as the global reserve currency. However, amid the "ongoing deterioration in U.S. public finances and the absence of a credible fiscal consolidation plan," Fitch believes "there is a growing risk that U.S. policymakers will not consolidate public finances sufficiently to stabilize public debt after the pandemic shock has passed." In their estimation, public debt is now set to soar to 130% of GDP in 2021, after annual deficits of 20% of GDP in 2020 and 11% of GDP in 2021. In the years that follow, they project the national debt will continue growing faster than the economy, as it had been prior to the pandemic.

The statement then went on to mention the evolving outlook for inflation, and, importantly, the increasing potential for conflict between the U.S. Treasury and the Federal Reserve in the years ahead. Although they expect inflation to remain subdued over the next few years, the pandemic has "accelerated a number of trends that could bring about higher inflation over the medium to long-term," which could eventually bring "the goals of the Fed and the government into conflict." They noted that the economic cost of allowing the average interest rate on the national debt to rise is already steep: while the effective interest rate on the national debt has now fallen to just 1.75%, each 1% rise in the debt's effective interest rate would result in 1.2% of GDP of additional interest cost, *every year*.



While Fitch seems to think the goals of an independent Fed and the Treasury are at risk of coming into conflict at some point in the future, the market appears to think that day may have already arrived. We have discussed past examples of this fiscal-monetary conflict at length in these letters, particularly the forced coordination of policy during World War II and the erosion of independence during the late 1960s and 1970s, because the seeds for the loss of Fed independence have been planted for some time. The first seed was the arrival of the demographic retirement wave, shown below. The second seed was the pivot into private sector deleveraging in 2008. And the third seed was the resulting trend higher in federal debt relative to economic growth, which began in 2009.



As these seeds of potential conflict began to grow, federal debt nearly doubled relative to the size of the economy between 2009 and 2019, yet the underlying trends behind that rise in indebtedness had not yet run their course — they were set to remain factors throughout the decade ahead. Under those mounting conditions, it seemed only a matter of time before the weight of the Treasury's obligations began to press down on the Federal Reserve's policy decisions, the way it had in the late 1930s and the late 1960s, just before monetary policy became completely subservient to political and economic forces outside the Fed's sphere of influence. Then, amid these trends, the pandemic arrived.

While 2020 has been chock-full of changes none of us thought we would go through this year, the pivot inside the Federal Reserve appears to be just as significant. While the era of zero-percent interest rates and quantitative easing could be characterized as having partially enabled the rise in federal debt in the decade following the Great Recession, the Fed pursued those policies during those years while continuing to publicly warn about the risks associated with failing to rein in the growing budget deficits. These warnings came from a relatively independent Federal Reserve, which was still sounding the alarm about the risks to the public from a government budget (and monetary policy) increasingly beholden to debt service.

That was then. Now, the message emanating from the Fed has turned around 180°. Over the past few months, in media appearances which are always carefully coordinated, several Fed officials have publicly welcomed a closer coordination of monetary and fiscal policy by openly advocating for more stimulus spending from the federal government — *much* more stimulus spending. The presidents of regional Fed branches in Minneapolis, Chicago, Boston and Richmond have all made it clear in recent speeches and interviews that the Fed thinks the federal government should spend more than it already has. Richmond Fed President Charles Evans was the most explicit when he was interviewed on August 9th: *Fiscal policy has been unbelievably important in supporting the economy during the downturn that we've been experiencing … and another support package is really incredibly important.*

It is extremely rare for Fed officials to directly comment on specific actions that should or should not be taken by Congress as it exercises its constitutional authority over the federal budget. In the days before the financial crisis, Chairman Greenspan was notoriously evasive when asked by members of Congress about specific tax or spending proposals, and regional Fed presidents did not comment on those issues at all. That hard border between monetary policy and fiscal policy softened during and after the financial crisis, as comments from Fed officials usually remained focused on monetary policy's role in supporting the economy, but at times strayed into generally mentioning the benefits of deficit spending in times of recession.

This time, however, we have Fed officials explicitly stating that the federal government needs to spend far more than it has so far in order to support the economy. This amounts to the supposedly independent stewards of monetary policy telling the supposedly independent stewards of fiscal policy what to do, but there no longer seems to be any objection, on either side, to this kind of policy cajoling. Just a couple of weeks ago, the Fed chairman echoed the comments of the regional Fed presidents on the need for more federal spending to support the economy, and he has publicly pledged to do whatever it takes to enable that fiscal support. In his prepared comments during the press conference following the July meeting of the FOMC, Chairman Powell had this to say:

> *The fiscal policy actions that have been taken thus far have made a critical difference to families, businesses, and communities across the country. Even so, the current economic downturn is the most severe in our lifetimes. It will take a while to get back to the levels of economic activity and employment that prevailed at the beginning of the year, and it will take continued support from both monetary and fiscal policy to achieve that*.

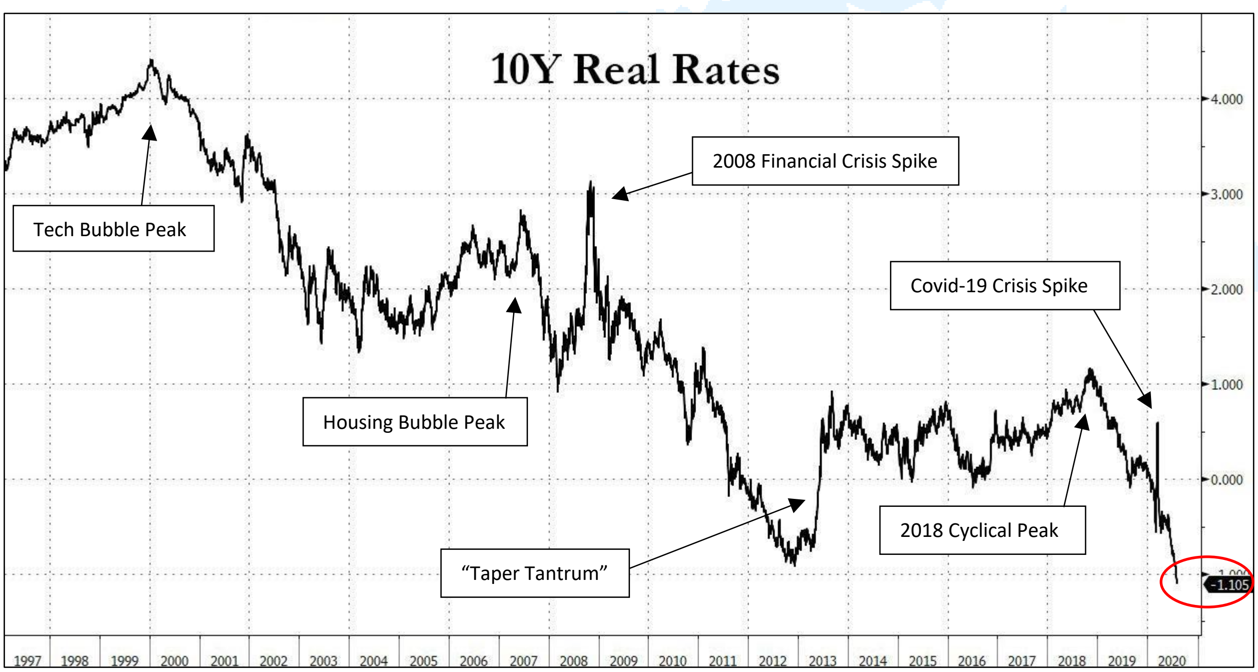
And later during the press conference, in response to a reporter's question about when the Fed might consider raising rates again, he had this to say:

> *We're not even thinking about – thinking about raising rates. We're totally focused on providing the economy the support that it will need. We think that the economy will need highly accommodative monetary policy and the use of our tools for an extended period. And we're absolutely committed to staying in this until – until we're very confident that that is no longer needed. So I wouldn't look for us to be sending signals about cutting back on facilities or anything like that for a very long time. We're – we're in this until – until we're well through it.*

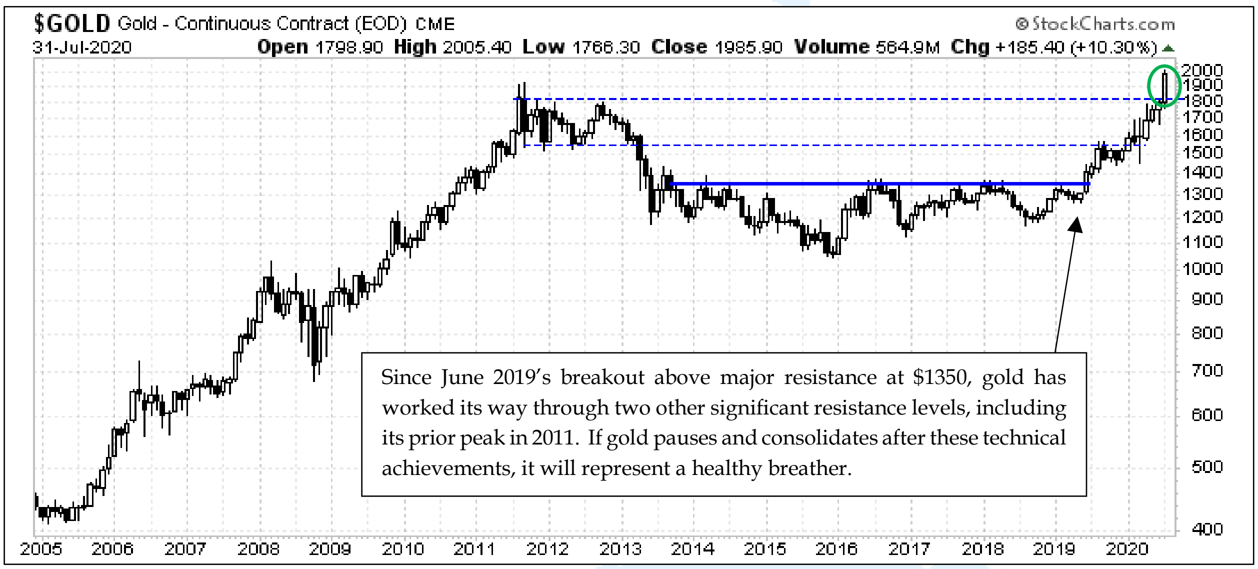
The true extent of the erosion of independence between monetary policy and fiscal policy this year will only be known when the history of this period is written with more complete knowledge of the behind-the-scenes communications between the Fed and other parts of the government. By then, we will also have a better understanding of the impact that all of the monetary and fiscal actions taken during this downturn had on the value of the dollar. For now, all we have are public statements, the data from publicly disclosed programs, and … the market's unfolding reaction. And by the reaction thus far, it seems the markets have taken another step into an era of negative real returns.

The yield on long-term Treasury securities usually contains the market's estimate of the average level of short-term interest rates over the duration of the note or bond, and a premium based on the assumption of the average rate of inflation over that time. However, this year that relationship has been turned upside down. During the market collapse in March, the yield on the 10-Year Treasury Note traded as low as 0.4% and as high as 1.2%, and since then it has settled into a relatively tight trading range around 0.6%; in July and early August, it traded between a low of 0.5% and a high of 0.7%. However, the bond market's expectation for inflation over the next 10 years, derived from comparing the yield on Inflation-Protected Treasury Notes to regular Treasury Notes, has been steadily rising since March, and was recently estimated near 1.6%. Thus, today's 10-Year Treasury Notes, with a recent nominal yield of just 0.6%, are trading with an expected *negative* 1% real, inflation-adjusted yield.

As you can see on the chart below, the market's estimated real yield on the 10-Year Treasury Note has now sunk to levels not seen any other time over the past 23 years; in fact, the real 10-year yield has not been this negative since 1980, at the tail end of the inflationary 1970s. This is the bond market's way of saying that the guaranteed safety of nominal principle is now worth *paying* 1.1% in real value a year for, which amounts to a cumulative 10.5% real loss over 10 years. A real yield on an investment above negative 1% today can now be assumed to have some degree of risk attached to it.



Understanding the price changes in precious metals in recent months begins with understanding the seismic shift into negative territory which has unfolded in real Treasury yields this year, but, of course, it is also about much more than that. Gold rallied to a new record high in July, rising above its 2011 peak at $1923, and it did so while real Treasury yields sank below negative 1% for the first time in 40 years. However, gold did not begin its current trend higher a couple months ago — it began rising two years ago, just prior to the cyclical high in real yields in late 2018. Since then, the real yield on the 10-Year Treasury Note has fallen from positive 1.2% to negative 1.1%, and gold has risen from $1200 to above $2000. Although much of the attention gold has received in recent months has focused on the Fed's actions in response to the pandemic, the drivers of this trend run deeper than the Fed's actions this year.

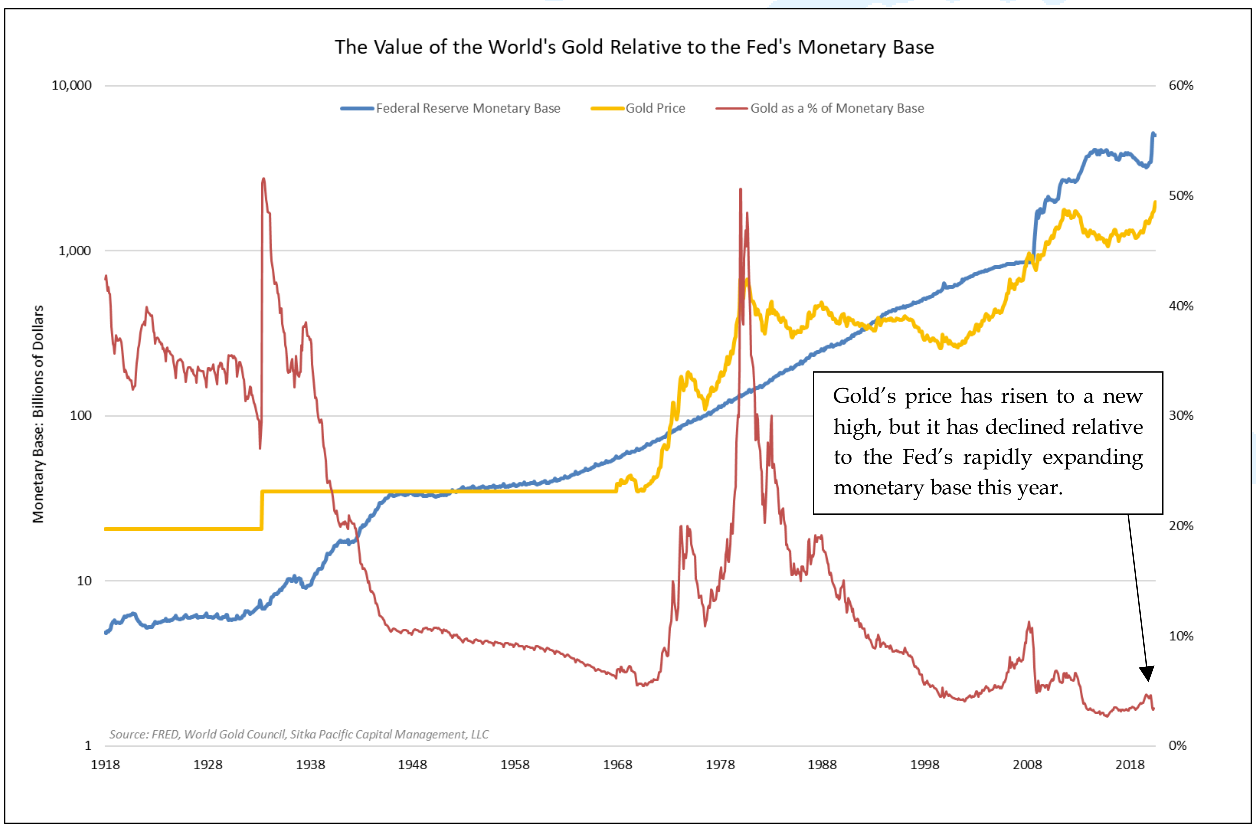


The intimate, cyclical relationship between real Treasury yields and gold has unfolded three times over the past 20 years. In the chart of real 10-Year Treasury yields on the previous page, there are three cyclical peaks noted: the tech bubble peak in 2000, the housing bubble peak in 2007, and the 2018 cyclical peak. After the tech bubble peak and the housing bubble peak, the real 10-Year Treasury yield fell 3% and 4%, respectively, over the subsequent five years. This was part of the lasting fallout from those two bubbles, and while yields fell and remained low for several years following the end of the recessions, gold rallied strongly.

Each of these prior cycles has unique aspects, some of which favored gold more than others. At the end of the tech bubble, for instance, real Treasury yields were relatively high; the peak of the real 10-Year Treasury yield in 2000 was positive 4.5%. The price of gold rose as that yield fell from 4.5% down to 1.5%, but real yields remained positive throughout that cycle — and positive real interest rates are an inhibiting factor for gold. During the next cycle, however, the real 10-Year Treasury rate fell from positive 2.8% down into negative territory for the first time since the 1980s. When real rates turned negative, it removed one of the most often cited mainstream arguments against holding gold — that it pays no interest. When safe Treasury securities effectively began *charging* investors to hold them, holding an asset that pays no interest suddenly looked much better.

As the Fed's zero percent interest rate policy and quantitative easing continued for years after the end of the Great Recession in 2009, the dip into negative real territory out on the long end of the Treasury yield curve in 2011 prompted a rush into gold — a rush which then came to a sudden end in 2013, during the market's "Taper Tantrum." During that tantrum, the real 10-Year Treasury yield quickly rose to positive 1% from negative 1% in just a few months, and gold fell alongside bond prices. Yet as sudden as the shift back to positive real rates was, the positive 1% level remained a ceiling for the real 10-Year Treasury rate while the bubble cycle in risk assets repeated a third time. It remained below that level until its brief peek above it in late 2018. That brief rise above 1% was enough to cause the steep selloff in risk assets into the end of 2018 and bring a premature end to the Fed's campaign to raise short-term interest rates.

The current downturn began with the lowest peak in the real 10-Year yield thus far, just 1.2%, and it was followed by the quickest crossover into negative territory. The fallout from the tech bubble never saw negative real interest rates, and it took four years for negative interest rates to appear after the housing bubble peak. This time, the real 10-Year Treasury yield dipped below zero within months after the cyclical peak, and the crossover into negative territory was cemented only a little more than year after the peak. This progression of lower real rates since the year 2000 has been increasingly favorable for gold, fueling increasingly strong rallies. Yet despite the recent attention surrounding gold's new nominal high, there are few signs today of any speculative fervor. Gold calmly walked through its 2011 high over the past few months, and it remains near the lowest value relative to the Fed's expanding monetary base in its history, far below previous peaks in 1980 and 1933.



The Real Outlook for the Typical 60/40 Portfolio of Stocks and Bonds

The performance pressures most investors feel drives them into an absurdly short-term orientation. If your results are going to be evaluated in the near-term, if you run a mutual fund and your performance is going to be in the newspaper every day, if your track record is going to be considered by investment committees and their consultants every quarter, if you might lose clients and possibly your job because of poor short-term performance, then the long term becomes almost completely irrelevant.

But if Mr. Market and his emotions are to be taken advantage of, it can only be in the long term. You must ignore the market and go against the grain in the short term to win in the long term.

- Seth Klarman, 2013

Surreal doesn't even begin to describe this moment… Investors are being infantilized by the relentless Federal Reserve activity. It's as if the Fed considers them foolish children, unable to rationally set the prices of securities, so it must intervene. When the market has a tantrum, the benevolent Fed has a soothing yet enabling response.

As with the 30-year-olds still living in their parents' basements, we can only wonder whether the markets will ever be expected to make it on their own.

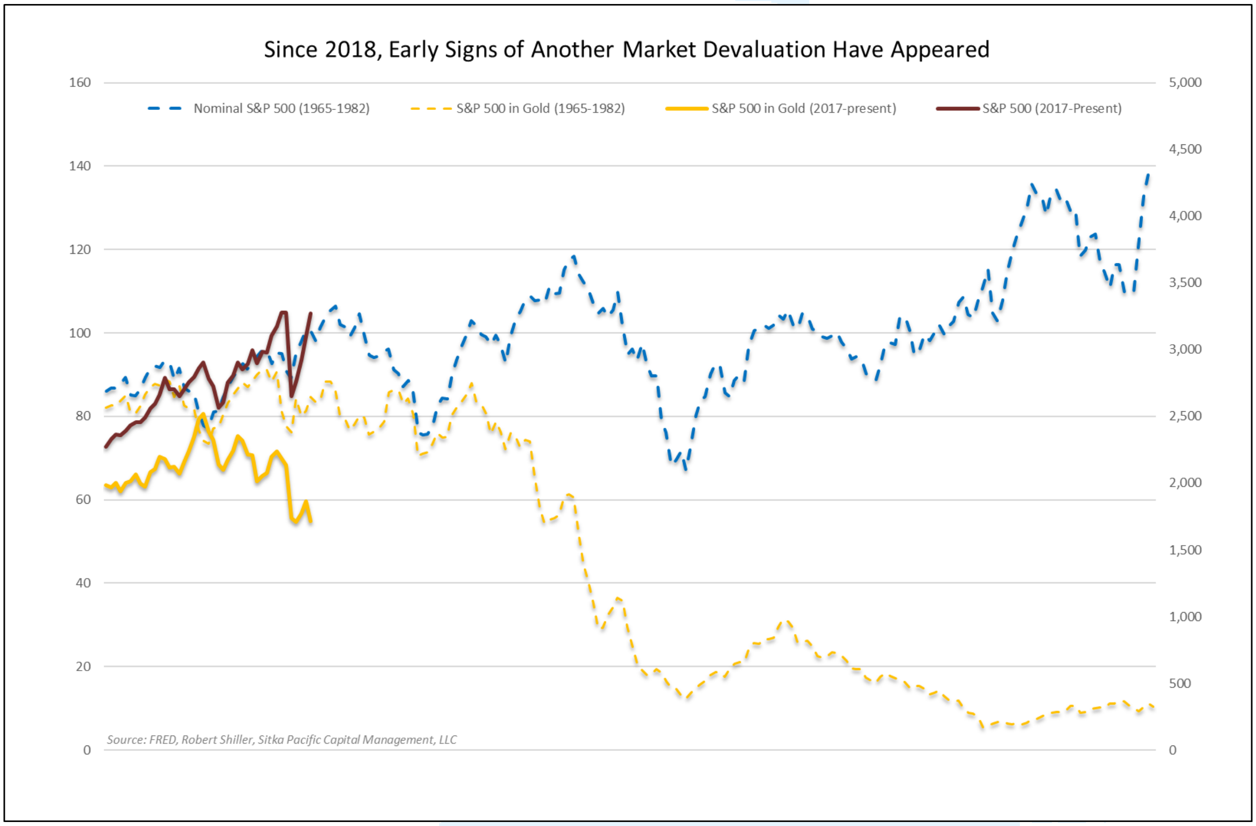
- Seth Klarman, July 2020

Even among veteran investors with many decades of experience under their belt, there has been a palpable sense of something having become unmoored in the markets this year. Even as the global economy suffers through the largest disruption since the 1930s, risk asset prices have in many cases drifted back close to where they began the year, as if nothing economically significant has happened. And, in some areas, the markets appear downright optimistic. For example, the yield on BBB-rated bonds, which peaked above 10% during the financial crisis in 2008 and 2009, declined to a new all-time low of just 2.29% last month. The spread between junk bonds and Treasury bonds is also near historic lows. Apparently, the Fed's backstop has erased the risk of any significant defaults in corporate junk bonds in the coming year, as would be expected during a typical recession.

One of the main themes of our recent discussions of the 1960s and 1970s was the extent to which monetary policy progressed as if it was captive to the political and economic circumstances of the times. Again, and again, when the Fed faced the choice of preserving the long-term value of the dollar, or easing policy to buoy short-term economic and financial conditions, it chose to alleviate current conditions. Over time, there were two results of this captivity: a long-term trend lower in real, inflation-adjusted interest rates, and a massive devaluation of the dollar.

The devaluation of the dollar during the 1970s became the single largest factor affecting not only the market prices of financial assets, but the real returns investors received for holding those assets. Early on, as real interest rates began to trend lower in the late 1960s, risk asset markets were buoyed by the stimulus that lower interest rates provided; when real interest rates fall, the returns of other financial assets become all the more attractive if their rates of return do not fall as much or stay the same. These were the market conditions which spawned the speculative fervor over the Nifty Fifty, which were a group of growth stocks whose long-term outlook was considered so stable that they were known as "one decision" investments — i.e. the only decision anyone had to make was to buy them.

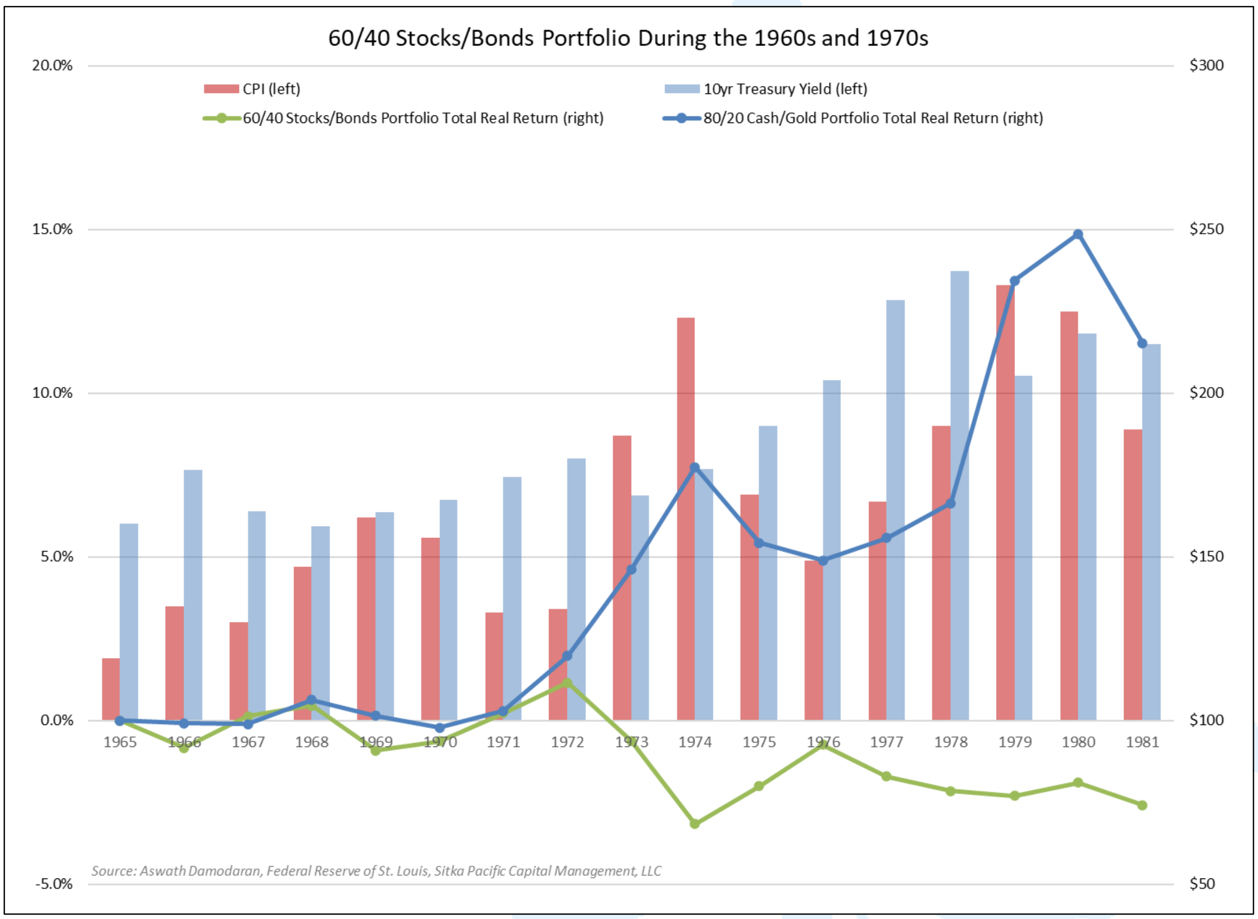
The growing exuberance among investors during those years resulted in a series of marginally higher nominal highs in the equity market in 1968, 1972 and 1973 as real interest rates fell, but underneath those higher highs was a growing disconnect between nominal prices and the real value they represented. This can be seen in the chart below, which shows the S&P 500's nominal price (dashed blue line) and the S&P 500's price in terms of gold (dashed gold line). These two prices of the S&P 500 began to diverge from one another once gold began trading higher in international markets than its statutory price in the late 1960s, and then they completely parted ways after 1971, when gold began to trade freely following the collapse of Bretton Woods. As you can also see in the chart below, the early signs of another divergence between the nominal price of the market and its price in freely trading gold have unfolded over the past two years, with the gap widening significantly this year.



It was difficult, during the early years of the 1965–1982 long-term bear market, for investors to get a sense of what was really going on, for several reasons. First, for the country's entire history up until that moment, the value of the dollar had been fixed to a specific price in gold. As a result, few people could imagine untying the dollar from a stable moorage, let alone imagine the consequences that would follow such an act. Second, since the dollar remained fixed to gold and all other major world currencies remained fixed to the dollar until 1971, there were few reliable market signals available to investors that hinted a vastly different market environment lay ahead. All investors could see was that the rate of inflation had picked up a bit, and that nominal interest rates had not kept pace — i.e. real interest rates had fallen, and they kept falling. Thus, profitable stocks with dependable growth outlooks — like those in the Nifty Fifty — were the clear choice over lower and lower real interest rates, which eventually turned negative. It felt like there was no alternative.

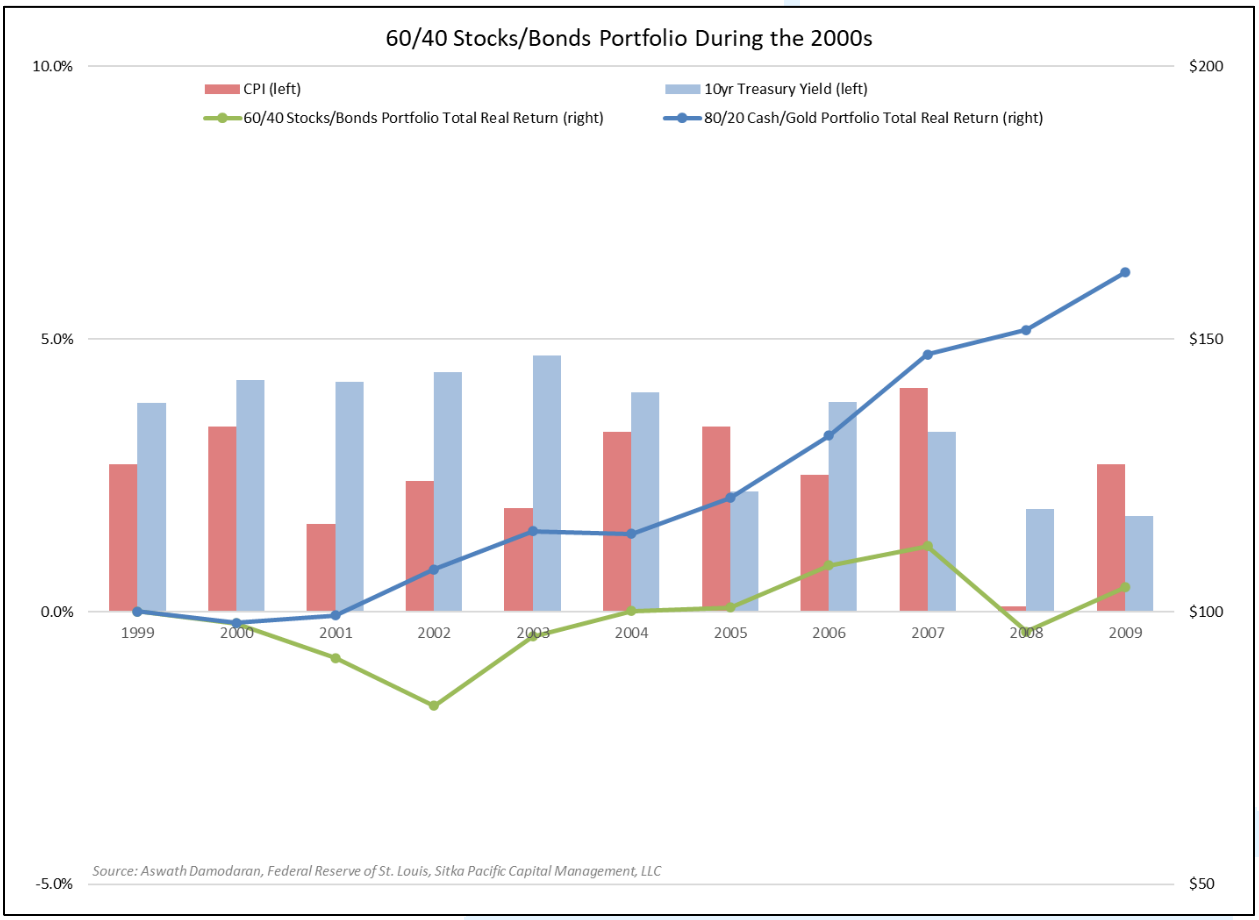
The Nifty Fifty era ended the same way every other era in which a willingness to pay exorbitant valuations has ended. After the rush into that small group of popular growth stocks pushed the broader market to yet another new marginal high to begin 1973, it looked as if stocks were finally ready to burst higher in a new bull market after years of hesitation. Alan Greenspan, the future Fed chairman, reflected the prevailing mood when he confidently told the New York Times that month that "it is very rare that you can be unqualifiedly bullish as you can be now."

Instead of a burst higher, however, what began that very month was a rapid unwinding of the exuberance surrounding the Nifty Fifty, and the beginning of the equity market's reckoning with the price inflation resulting from years of monetary expansion. Although lower real interest rates initially offered investors a justification for chasing stocks regardless of their valuation, the subsequent inflationary consequences of those lower real rates thoroughly eroded that justification after January 1973. A little less than a decade later, the broader market had sunk to its lowest cyclically adjusted valuation in 50 years.



The chart above highlights the cumulative toll taken by rising rates of inflation and the decline in the equity market's valuation during the 1970s. The standard, diversified, 60/40 portfolio of stocks and bonds, which continues to be the foundation of modern portfolio management to this day, was not diversified enough to provide shelter from the storm. By 1981, as the equity market approached its lowest valuation in decades, and just after nominal interest rates and the rate of inflation registered their highest rates in U.S. history, a standard 60/40 portfolio had fallen to three-quarters of its real, inflation-adjusted value.

When President Johnson successfully nudged the Fed onto a path of enabling ever-expanding Federal deficits in 1965, the economy and the markets turned down a road which would ultimately claim a quarter of a diversified portfolio's value; it was not until 1984, 20 years later, that a diversified 60/40 portfolio reclaimed its 1965 real value. The Great Inflation, as it is known today, was an extreme market environment, and we may never see those conditions again. But it is not only under such extreme conditions that a standard, diversified portfolio of stocks and bonds can fall far short of the returns most investors expect. As illustrated by the decade following the tech bubble, in which the real value of a standard 60/40 portfolio of stocks and bonds rose a total of 4.5% between 1999 and 2009, high valuations alone can be followed by returns far below long-term averages.



The 0.44% annualized real return in the decade following the tech bubble and the negative 1.73% annualized real return over the 17 years after 1965 illustrate the risks associated with high market valuations and large-scale monetary expansions, and it appears the 60/40 portfolio will face both of those risks in the decade ahead. While many seem to feel *there is no alternative* to chasing after overvalued stocks just because interest rates have now fallen into negative territory, there *is* an alternative, though it is a departure from the traditional, conventional portfolio of stocks and bonds.

It has recently been estimated that there are currently $88 trillion of equity market assets globally, and $108 trillion of bond market assets. In contrast, there is $2.8 trillion worth of privately held gold today, which represents just 1.4% of the combined value of equity and bond markets worldwide. This gives some sense of the scale of real assets to paper assets today, and why real asset prices can rise fast and furiously at times; it takes only a slight shift in investor preferences to overwhelm the available supply of real assets. If holders representing just 1% of global debt assets decided to flee negative real rates in favor of assets which hold their value through the course of large monetary expansions, the calm upwardly walk of gold would probably become more volatile than it has been up to now.

With the S&P 500's 10-year P/E currently at 31, and with more than a decade of the retirement wave left to traverse, it appears we are only two years into what will eventually be a much larger market rebalancing. The emergence of negative real rates is a significant threshold to have crossed, and there will undoubtedly be additional thresholds in the years ahead. Just when the U.S. equity market will reach its own "January 1973" moment of reckoning is anyone's guess, but it is clear the equity market's devaluation against gold is ongoing. In light of the clear coordination of monetary and fiscal policy, we are a long way away from the markets having priced in of all the downstream effects of the monetary and debt expansion underway this year, let alone additional expansions in the years ahead. Most of that process remains ahead of us.

We appreciate your 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