July/August 2021

Dear Investor,

This past winter, the federal government crossed over a financial threshold that provides a poignant symbol of these times: the average interest expense on the national debt fell below 2% for the first time since the 1940s. In the fourth quarter of 2020, the interest expense declined to a rate of 1.94%, down from 2.03% the prior quarter, and it fell further in the first quarter of this year, to 1.88%. Despite the tremendous surge in borrowing over the past year, and despite a tripling of the national debt over the past decade, the government is financing its debt at the lowest rate in almost eighty years.

That the interest rate on the national debt has returned to the ultra-low rates of the 1940s is significant, because the 1940s was the last time the Federal Reserve had officially surrendered its independence. At that time, the Fed did so voluntarily just after the attack on Pearl Harbor, to help finance the looming war effort at low rates and ensure minimal disruption from the financial markets. While we don't know if there is any formal agreement with the U.S. Treasury today, as there was in the 1940s, monetary policy in the U.S. is now hemmed into the tightest corner since that time.

One of the enduring lessons learned in the aftermath of the financial crisis was that when monetary policy acts largely on its own, the benefits of quantitative easing flow mainly to the banking system and holders of financial assets. With that lesson on the minds of policy makers, the response to the downturn in 2020 was to vastly expand the fiscal response, so that more of the Fed's monetary expansion would flow into the real economy. Yet while the monumental fiscal response has been shaped, in part, to address some of the policy dilemmas of the last decade, it has also effectively removed control of monetary policy from the Federal Reserve for the first time since the Treasury-Fed Accord of 1951. This has had, and will likely have, a profound impact on the markets.

The discomfort of this new confinement could be seen in the conflicting comments by Federal Reserve officials in the past few months, and the discomfort it places on investors has also been visible this year, especially in the bond market. Rising inflation rates which cannot be met by an adequate policy response is not an environment most investors today are familiar with, and with the standard portfolio of U.S. stocks and bonds now offering the lowest effective yield on record, the effects of this uncomfortable position are becoming real. We'll discuss this further in the pages below, as we look at prospective market returns amid the return of this market environment from a bygone era.

In this month's letter:

- A Look at Prospective Market Returns Amid a New Era of Negative Real Rates
- Allocating as the Fed and Other Central Banks Begin to Tolerate Higher Inflation

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A Look at Prospective Market Returns Amid a New Era of Negative Real Rates

> *When I look out at what's been going on the last six months, I see financial mania... The Fed, having pumped asset prices to historically high levels, doesn't make me feel comfortable. I feel as anxious today as I've ever felt about the financial world because of my belief that the Fed has been pumping up asset prices in a way that is creating a bit of an illusion. I think the odds are now sort of one in three—very high—that we will look at this as an epic mistake and one of the great financial calamities of all time.*
>
> \- Peter Fisher, Federal Reserve Bank of New York, 1985–2001

> *The Third Great Mistake means there is no longer an alternative to higher inflation, and there is also no pain-free way for monetary policy prevent inflation from spiraling higher than intended. It is reminiscent of the circumstances in the late 1960s, and it is fitting that financial markets appear to be in a similar position as well: interest rates are low, risk asset valuations are high, and there is a speculative fervor which has apparently concluded that the entire equity market is now a one decision investment.*
>
> \- 2021 Annual Letter

One theme we have focused on in these letters over the past three years is what a transition into a regime of negative real interest rates looks and feels like, and the long-term consequences such a regime brings for the markets, and for investors. Since it has been fifty-five years since the last extended period of negative real interest rates began, and forty years since that period of negative interest rates ended, few investors today have any experience navigating such a market environment. For those who do, the memories are distant.

Most investors active in the markets today have only known a market environment defined by positive real rates of return on bonds and stocks, and over the past forty years this environment has been further defined by inflation rates that continuously trended lower. These are trends which supported ever higher valuations for risk assets, and ever longer effective durations for bonds, in a repeat of Warren Buffett's *Bountiful Triple Dip* — one of the topics in this year's annual letter. This regime had been firmly in place since the early 1980s, but it appears increasingly likely we may be witnessing its end. Evidence of the emergence of a new regime has been popping up all around the market landscape over the last year, and it can clearly be seen in the wake of the pivotal June meeting of the Federal Reserve's rate-setting committee, the FOMC.

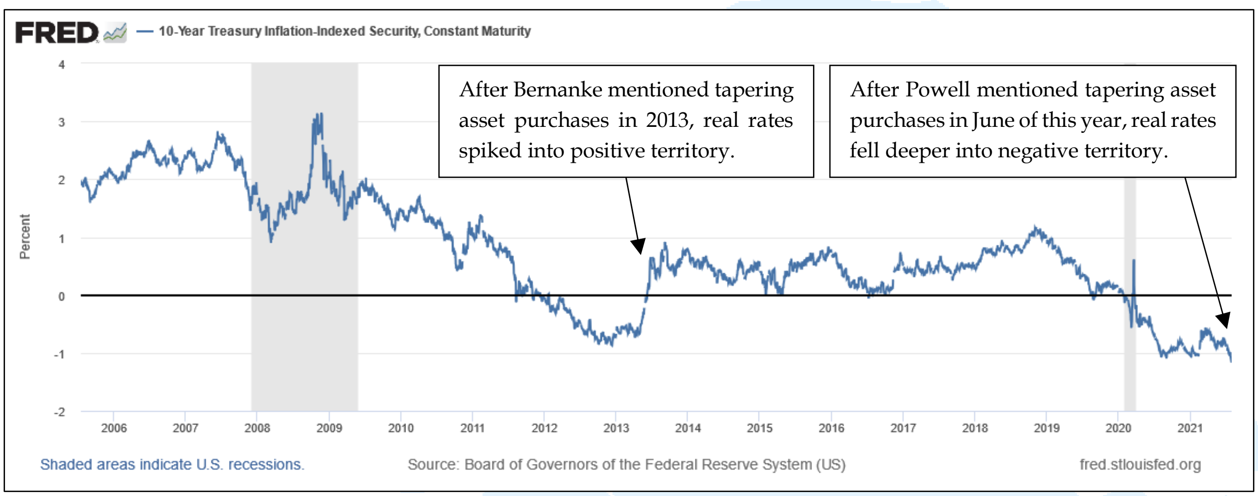
In the weeks after Fed Chair Jerome Powell confirmed that the FOMC had begun discussing at its June meeting when it might be appropriate to begin scaling back the pace of its extraordinary balance sheet expansion, yields on long-term Treasury yields continued a slide that had begun in May, when the first rumblings of a policy shift discussion were heard. At the same time Treasury yields fell, the market's estimates of long-term inflation bucked the trend in yields and remained elevated, with the result being that expected real, inflation-adjusted yields on long-term Treasury securities declined to the lowest rates seen over the past year: the yield on the 10-Year Treasury Inflation-Protected security fell to a new low of -1.19%.

This reaction in the bond market was notable because it was the opposite of the reaction during the Taper Tantrum of 2013, when Treasury yields immediately shot higher when the possibility of tapering the pace of QE was first mentioned. This time, long-term Treasury yields tumbled, with the yield on the 30-Year Treasury bond falling as low as 1.78% in July.

As the entire Treasury yield curve descended below the Federal Reserve's long-term inflation target of 2% in reaction to the tapering discussion, one conclusion the bond market appeared to reach was that any tapering of asset purchases would result in the Fed Funds rate remaining at zero for a longer period of time. With short-term interest rates at zero, and with the Fed's $8.2 trillion balance sheet still expanding at a rate of $1.4 trillion a year, this is an extraordinary reaction. A nominal 10-Year Treasury yield trading near 1.2%, below the lowest levels seen in the last decade, suggests there may now be a new working definition of what tightening monetary policy effectively means.

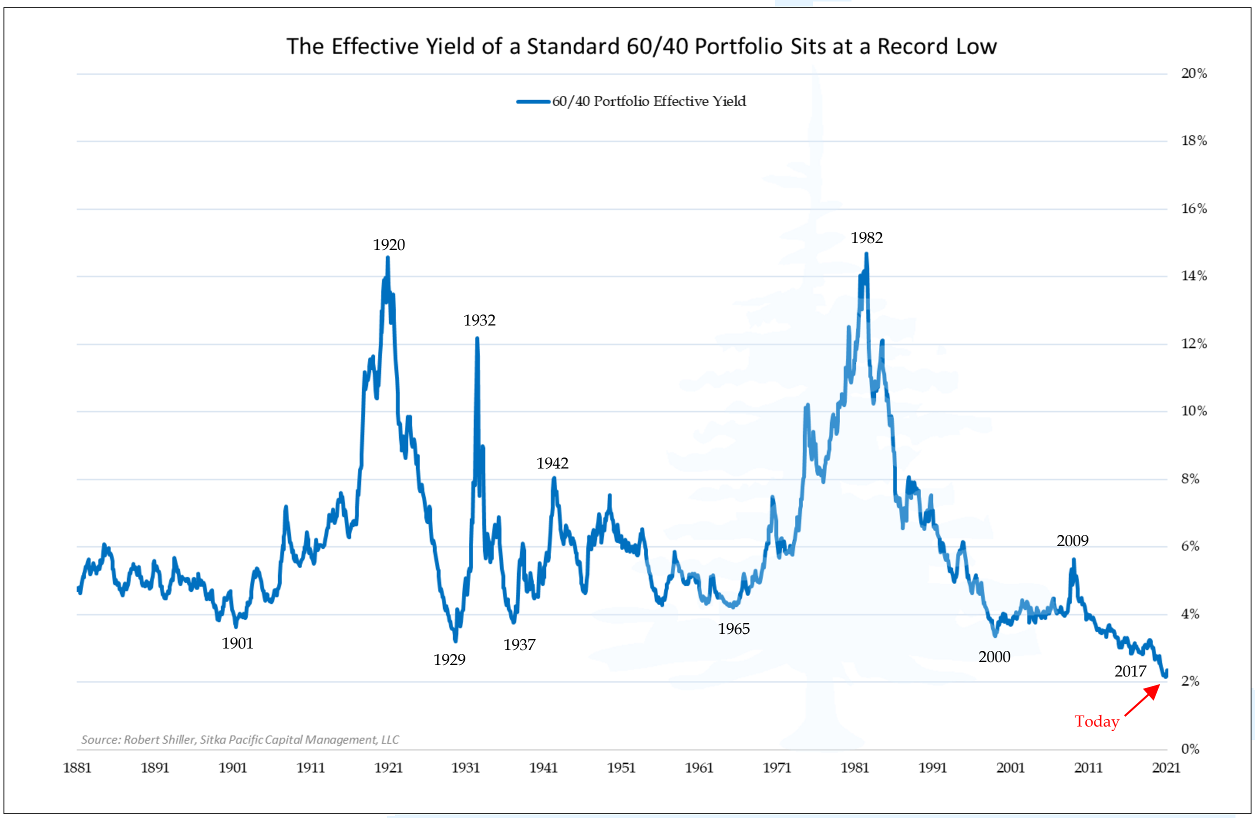
Whereas before private sector deleveraging commenced it took an increase in real interest rates well above zero to cool the economy enough for inflation to subside (at the peak of the tech bubble, short-term interest rates peaked above 6%, which was 2.7% above the inflation rate at the time), the message from the bond market in recent months suggests that today's modestly negative real interest rates alone will not be enough fuel for the Fed's preferred inflation indexes to keep rising at a pace that meets the long-term inflation target of 2%. Ongoing quantitative easing may be needed as well.

In such a policy framework, tightening monetary policy would involve slowing the pace of QE until inflation rates and inflation expectations subside, then increasing the pace of QE to raise inflation rates and expectations when they fall too low, all while keeping short-term interest rates at zero — well below the inflation rate. While this prospect of perpetual quantitative easing coupled with negative real short-term interest rates may sound like a far-fetched scenario, it is just the outcome implied by the bond market in June and July, as the entire Treasury yield curve fell deeper into negative real territory when the prospect of tapering asset purchases appeared on the horizon.



The initial market reactions to the emergence of this new monetary regime — zero percent interest rates along with perpetual quantitative easing — have resulted in a long list of never-before-seen events and milestones over the past year, which have left many investors, even those with legendary careers spanning decades, scratching their heads. For just one example, in recent months the yield of some corporate bonds rated below investment grade has declined below the expected inflation rates over the bonds' duration. While the idea of receiving a negative inflation-adjusted yield on the safest bonds came to be seen as somewhat rational after the chaos of the credit crisis, the desire to invest in risky corporate bonds with a negative expected real yield is more difficult for many experienced investors to fathom. Yet as bewildering as they seem, there is a common theme running through many of these incongruous events and milestones, and it is what we have focused on discussing in recent years: the transition to a negative real rate environment.

While the conversation amongst economists since June has been dominated by a high-frequency debate about when the Federal Reserve will begin tapering the rate of its asset purchases, and the subsequent timing of when short-term rates will cyclically *lift off* from zero, the market has been sending a different message which is far more consequential for investors. The core of this message is that in order to make meaningful progress toward achieving the goals of its dual mandate in the years ahead, the Federal Reserve is now in the awkward position of having to maintain short-term interest rates below the rate of inflation. And the primary reason the yields of the 10-Year Inflation-Indexed note (shown above) as well as the 30-Year Inflation-Indexed bond are trading in negative territory is that the market is expecting the Fed will remain in this awkward position for an extended period of time. A regime of negative inflation-adjusted interest rates and bond yields has arrived, and the effects of this phase shift have been propagating through the financial markets this year.

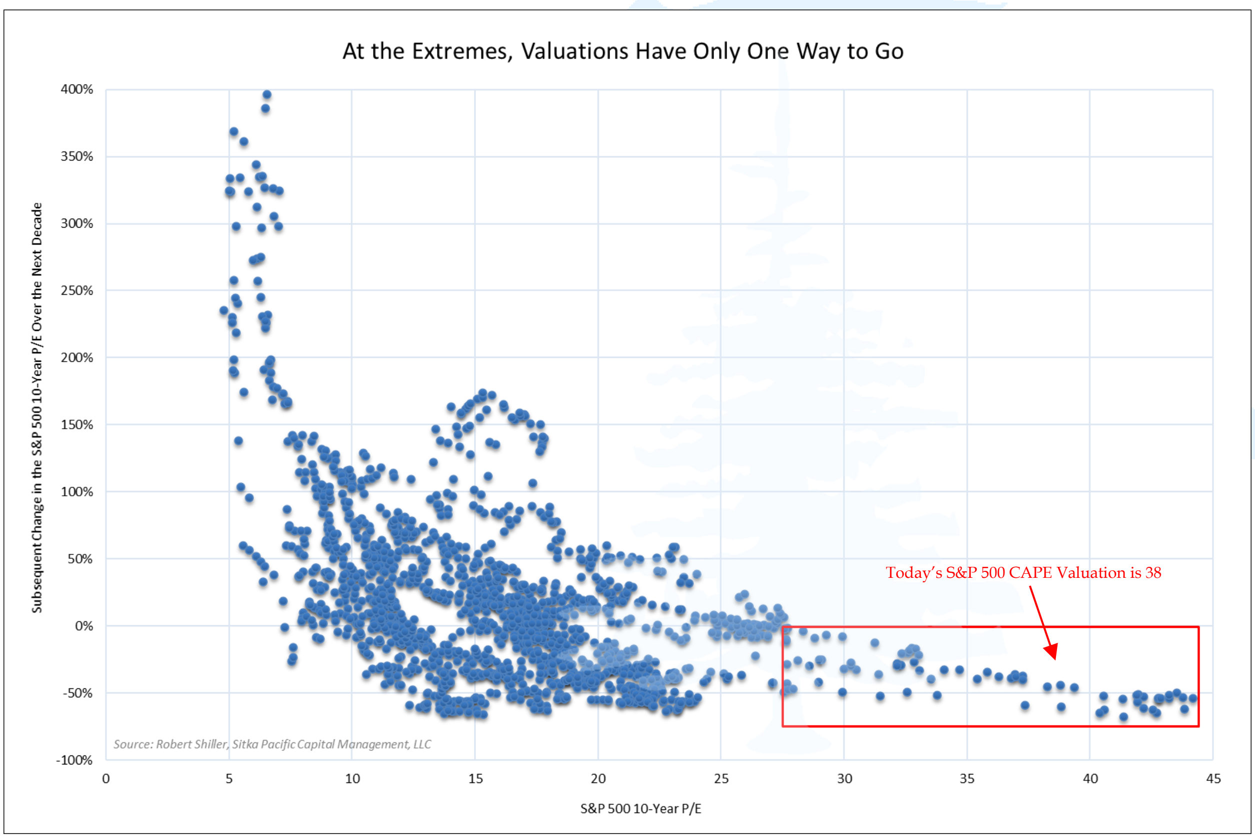


With Treasury bonds and more risky corporate bonds now offering a yield below the expected rate of inflation, investors have been scrambling for investments with a positive real yield. Yet as the equity market has climbed over the past year, its effective yield — the underlying cyclically adjusted earnings yield — has declined along with it, and this has left the standard 60/40 portfolio of stocks and bonds with a combined effective yield of just 2.1%. Not only is this combined effective yield of stocks and bonds the lowest in market history (chart above), it is also below the market's current expected inflation rate of 2.4% over the next decade.

With the effective yield of a 60/40 portfolio of stocks and bonds having declined below the expected inflation rate, it suggests that not only has an era of negative real interest rates arrived, an era of negative real effective yield for investors has arrived as well. The chart above amounts to a *summary statistic* of current equity market and bond market valuations, and with data going back 140 years, stocks and bonds have never offered a combined effective yield — cyclically adjusted earnings from stocks, along with coupon payments from bonds — less than they are offering now. If the market's expected inflation rate of 2.4% over the next decade proves accurate, a balanced portfolio of stocks and bonds currently offers investors a real effective yield of *negative* 0.3%.

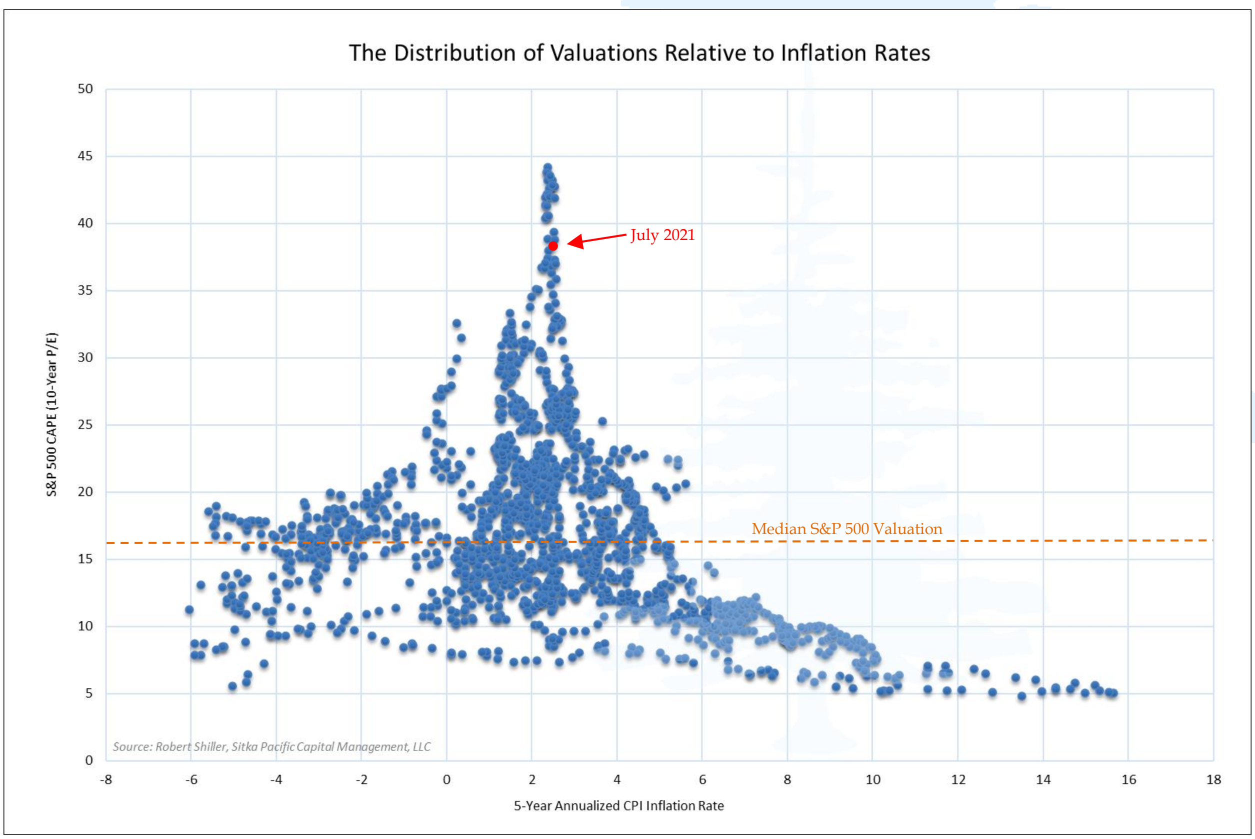
The underlying effective yield of 2.1%, or a negative 0.3% real yield, would equal the total return investors receive from stocks and bonds if two specific conditions are met in the years ahead: 1) bonds held in the portfolio are held to maturity; and 2) the valuation of the broader equity market remains at today's elevated level. If either of those conditions is not met, the total return of a portfolio of stocks and bonds over the next decade will be different than its effective yield.

A higher return from a 60/40 portfolio would result from bond yields declining further, *and* bond holdings being sold to capture the gains in bond prices as yields fell. A higher portfolio return would also result from an equity market valuation that is higher a decade from now. These higher-than-expected portfolio returns would require bond yields to decline meaningfully below the record-low 0.4% yield on the 10-Year Treasury note seen in 2020, and it would also require the equity market to do something it has never been able to achieve: maintain itself on a permanently high plateau. As the chart below highlights, valuations have never remained at today's lofty levels over time.



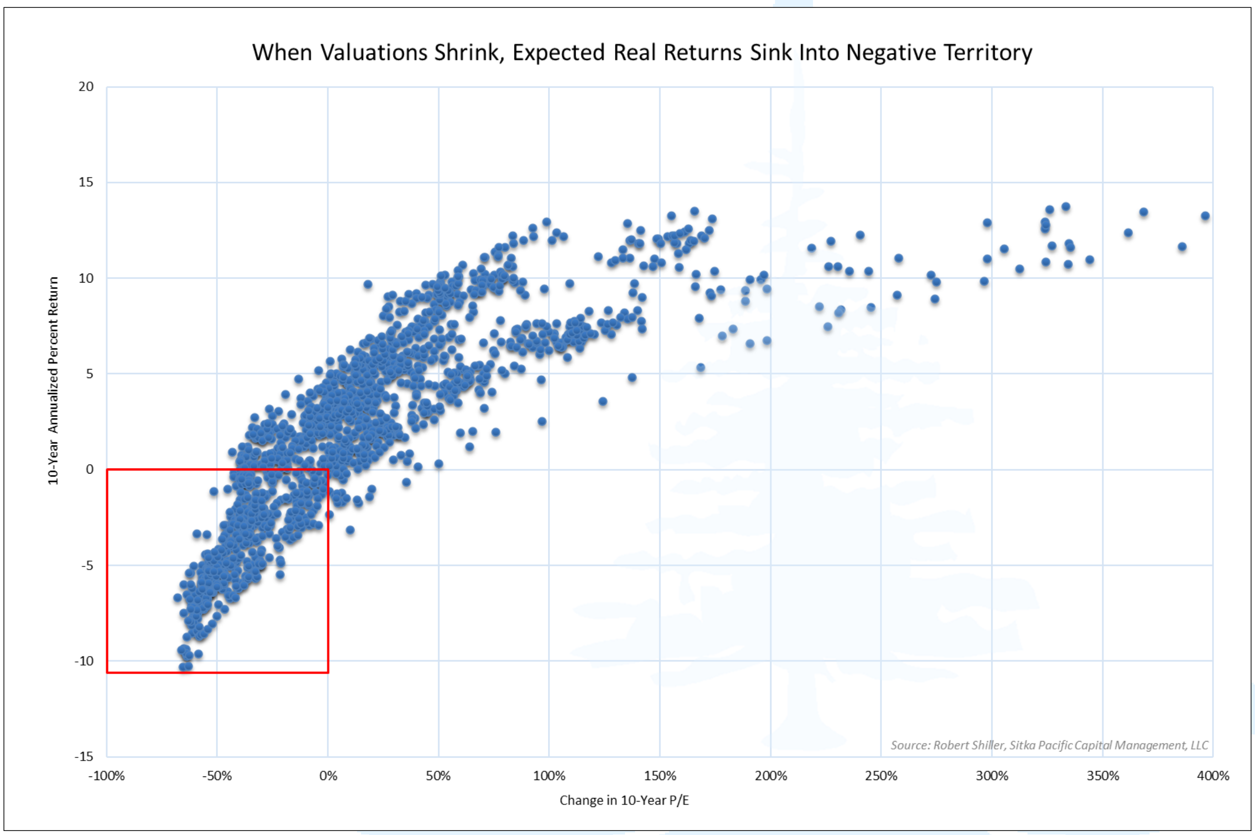
In recent years, it has become almost commonplace to expect market events which "have defied all market history," and this has especially been the case in the wake of the monetary and fiscal response to the pandemic. The downturn that began in February 2020 progressed at a speed which had not occurred before, and the policy response was on a scale that harkened back to before the post-war era. The Federal Reserve responded by buying as much debt in three months last year as it did in the entire decade after the financial crisis in 2008, and it also provided a backstop to corporate bonds for the first time in its history; for the pioneering Federal Reserve governors of a century ago, all of whom subscribed to the real bills doctrine and firmly believed a central bank had no business taking credit risk onto its balance sheet, the actions of the Fed over the past year would have seemed utterly alien. At the same time, the federal government provided a fiscal response equivalent to the deficit spending seen during World War II.

These actions flooded the economy and financial markets with trillions of dollars over the past year, and it was no coincidence that such an unprecedented flood of new money produced market outcomes which were also unprecedented. The most consequential has been the decline in long-term yields, which are tied to the market's expectation that the Fed will end up keeping short-term interest rates near zero far longer than it did after the financial crisis — regardless of other factors, including inflation. Zero percent interest rates, ultra-low long-term bond yields, quantitative easing *and* subdued inflation rates near 2% have propelled risk asset valuations into rarefied air. This rarefied air is highlighted in the chart above, which shows how far off in the "tail" of the distribution of historical valuations the market is today. It is also highlighted in the distribution below, which shows that the market's valuation today has only been seen under idyllically benign inflation conditions.



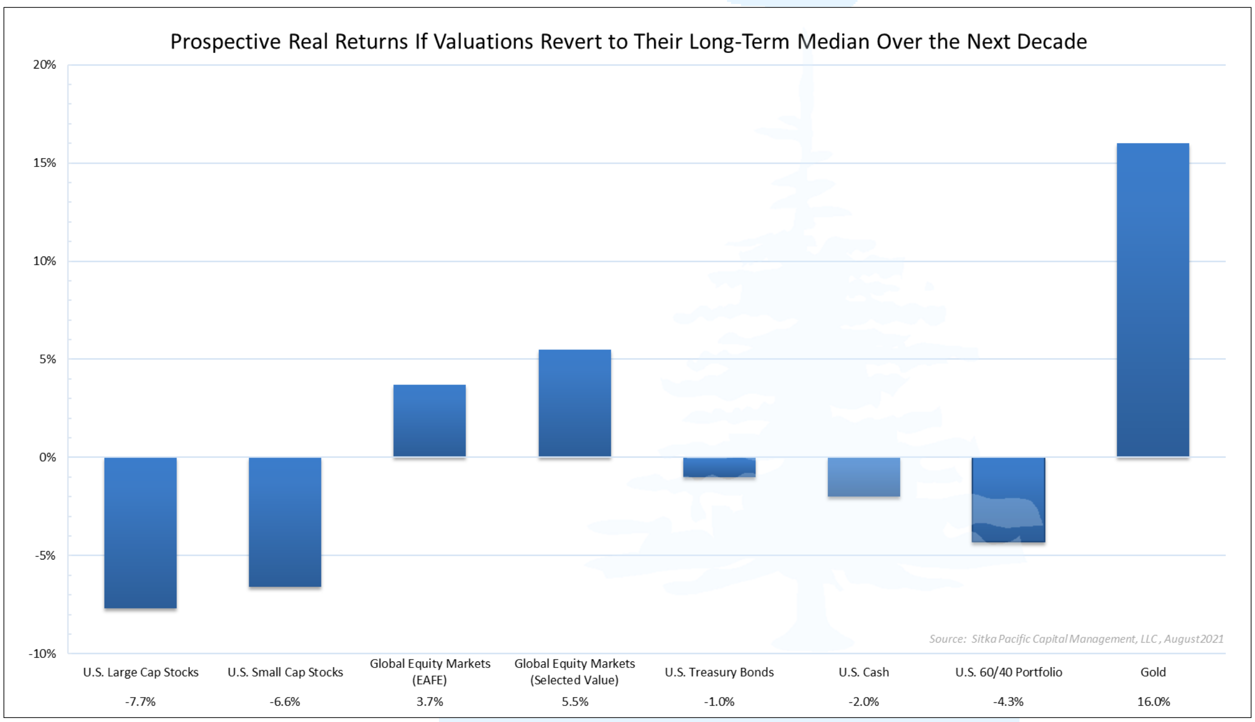
The chart above gives a visual sense of just how fragile these circumstances are. In recent months, year-over-year increases in the Consumer Price Index (CPI) have been close to 5%, and these few elevated readings have been enough to increase the rise in the CPI over the past 5 years from an annualized rate of 1.66% to an annualized rate of 2.39%. Although it appears likely these recent elevated CPI readings will moderate at some point, as they have been driven by large increases in sub-components of the CPI which probably won't last, the chart above highlights how little inflation it would take to upset the ideal conditions supporting the market's current valuation.

The question most relevant to investors, that of prospective *future* market returns, is a question that appears to have no satisfactory answer. Now that long-term bond yields have descended to record lows, and stocks have risen to valuations only seen during a bubble, the standard 60/40 portfolio of stocks and bonds is offering zero effective real yield. And earning a zero percent real return depends on the fragile conditions prevailing today remaining intact more or less indefinitely. If they do not remain intact, and yields begin to rise and/or valuations begin to fall, real returns from a standard portfolio of stocks and bonds will quickly sink deeply into negative territory.



After such a long period of rising valuations, it may be hard to remember how difficult it is to earn a positive return in stocks when valuations begin to shrink over an extended period of time. When the market began the last such period of shrinking valuations, following the tech bubble, safe-haven long-term Treasury bonds offered investors a yield near 6%. Not only was such a yield high relative to the 1% nominal yields of today, it was also high relative to inflation: the CPI advanced at a 2.4% annualized rate in the ten years after the tech bubble peak. This provided investors with a 3.6% real yield on their bond holdings, and this return from bonds cushioned the negative real return from stocks in the decade after the tech bubble. However, with yields throughout the bond market already below the likely rate of inflation in the years ahead, the standard portfolio has no such refuge.

This all adds up to a market environment that currently offers the lowest prospective return for a diversified portfolio of stocks and bonds in market history, in line with the lowest portfolio yield highlighted earlier. One of the most pervasive arguments today is that investors have no alternative than to remain invested in stocks, because they now represent the last positive real return available. This argument is true, up to a point. While the earnings yield of the broader U.S. equity market does remain marginally above the likely inflation rate, in order for investors to receive a positive real return from stocks, valuations will have to remain high or keep climbing. If valuations instead revert to their historical norms over the next decade, returns from stocks will be closer to those shown below, and the real return of a 60/40 portfolio will likely be well below zero.



Although the returns shown above may not seem possible amid the exuberant sentiment today, they would simply be the result of the *Bountiful Triple Dip* of recent years unwinding itself and the market returning to historical norms. That unwinding process has been the end result of every overvalued market in the past. It would be a typical outcome, not an exceptional one.

When investors (and investment managers) restrict themselves to U.S. stocks and bonds, today's market environment presents a particularly difficult dilemma, one which has twisted relative value arguments almost beyond recognition. However, the end result will likely be quite simple: the new era of negative real interest rates will eventually be joined by an era of negative real returns for the standard 60/40 portfolio of U.S. stocks and bonds.

Allocating as the Fed and Other Central Banks Begin to Tolerate Higher Inflation

> *The European Central Bank raised its goal for inflation and may let it overshoot the target for a while, giving officials more discretion in how to bolster the economy after years of lackluster performance. In the culmination of an 18-month review published Thursday, policy makers agreed to seek consumer-price growth of 2% over the medium-term with a "symmetric" aim. The ECB said that when interest rates are near their effective lower bound, as now, the economy will need "especially forceful" monetary stimulus that could "imply a transitory period in which inflation is moderately above target."*
>
> *The new wording is a significant change from the previous "below, but close to, 2% over the medium-term," which some monetary officials felt was too vague and led to calls for tighter policy too soon. "The new formulation removes any possible ambiguity and resolutely conveys that 2% is not a ceiling," President Christine Lagarde told reporters in a press conference, adding that the strategy review was agreed unanimously.*
>
> \- Bloomberg, July 8, 2021

The market news over the past few months has been dominated by headlines of inflation, and how (or *if*) the Federal Reserve and other major central banks will respond to the increases in prices over the past year. The tug-of-war at the core of the debate has centered on how much of the recent rise in prices is due to the effects of the pandemic. Since price increases stemming from the pandemic would be expected to fade as the U.S. and the global economies get back on their feet, such *transitory* price increases do not require a response from monetary policy, at least in the opinion of many at the Federal Reserve. Yet since the pandemic-related price increases have been larger and more persistent than many expected, outside pressure has been growing on the Fed to respond.

In the press conference following the most recent meeting of the FOMC on July 28, Chair Jerome Powell began by summarizing the state of the economy by saying that the number of people working remained many millions below the level of employment before the pandemic, and that it will likely take some time before *substantial further progress* is made on reaching the Fed's goal of full employment. He also conceded that while inflation measures had recently risen more than expected, and that elevated measures of inflation appeared likely in the months ahead, long-term inflation expectations remained well-anchored and consistent with the Fed's inflation goal within its new policy framework — that prices rise 2%, on average, over time. He re-emphasized that if long-term inflation expectations were to become unanchored and rise significantly above 2%, the Federal Reserve is prepared to adjust monetary policy to dampen inflation.

As the question-and-answer portion of the press conference began, however, the growing tension between recently rising prices and employment that remains millions below the Fed's target was palpable, and the discussion eventually zeroed in on the precise meaning of the words Powell has been using over the past year to define the Fed's outlook and policy goals, including the word *transitory* in the context of recent elevated inflation measures. In the public debate surrounding inflation in recent months, there has been no doubt that many pundits and politicians have considered the word *transitory* to mean something that is *temporary*. Yet in response to a question which asked for a specific definition of what transitory meant in terms of inflation and monetary policy, Powell gave an illuminating answer that harkened back to the days of the Great Inflation of the 1970s, when Arthur Burns often cited reasons for price increases which were one-time in nature, and not directly connected to monetary policy or inflation, as it is defined at the Fed:

> Chair Powell: The concept of transitory is really this: It is that the increases will happen. We're not saying they will reverse. That's not what transitory means. It means that the increases in prices will happen, so there will be inflation but that the process of inflation will stop so that -- so that there won't be further [price increases] -- when we think of inflation, we really think of inflation going up year upon year upon year upon year. That's inflation. When you have inflation for 12 months or whatever it might be -- I'm just taking an example. I'm not making an estimate -- then you have a price increase, but you don't have an inflation process.

What Powell sought to distinguish in his answer is the difference between *price increases* that prove to be durable, and an *inflationary process* that is part of an ongoing, exponential growth of prices. For the average citizen, price increases which prove durable but not part of an exponential inflationary process may be a distinction without a difference, but for Jerome Powell and those at the Fed, this distinction has a very practical policy impact: price increases which *are not* part of an ongoing inflationary process need not be responded to, whereas price increases which *are* part of an inflationary process need to be dampened. For investors, this is a critical distinction.

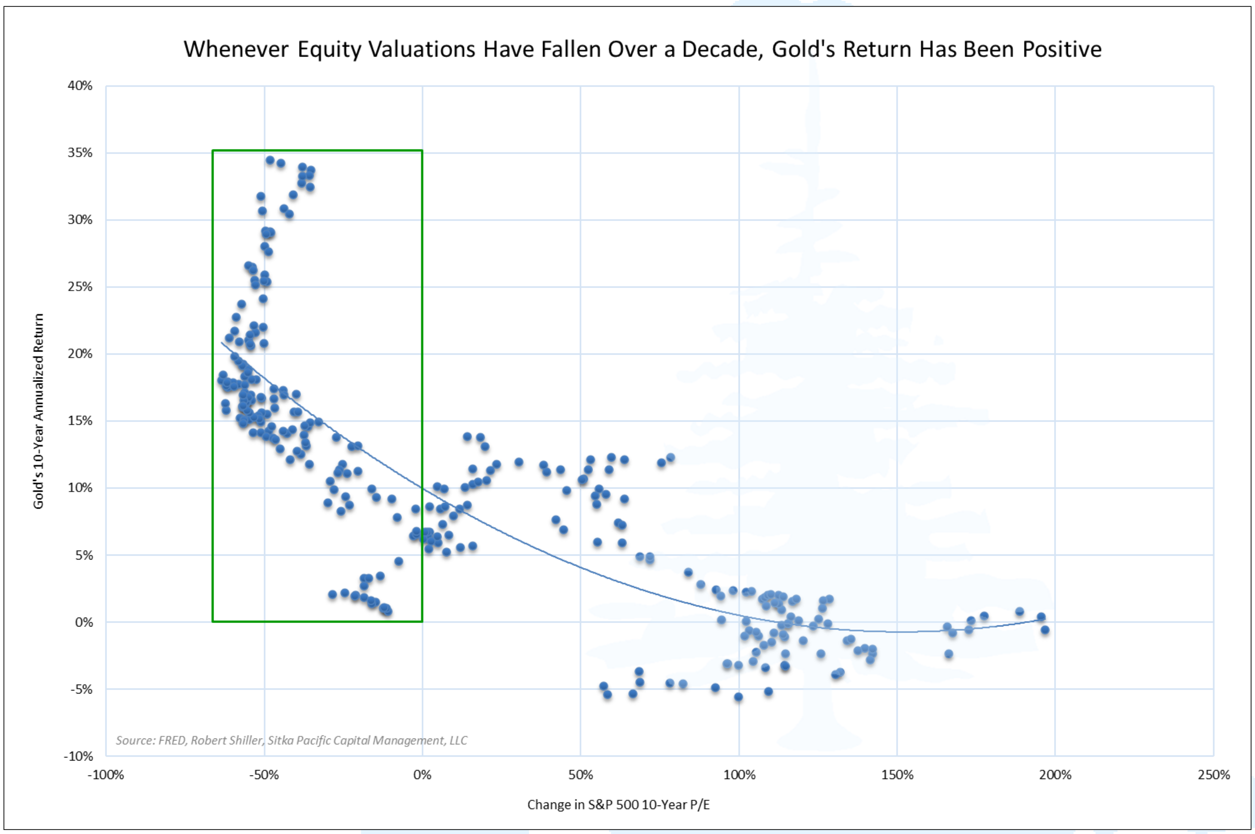
In the eyes of Jerome Powell, what has been seen in the economy and in the financial markets over the past year is not considered inflation, at least in terms of how the Fed narrowly defines it. The price of residential real estate has risen dramatically over the past year, with affordability indexes comparing home prices to incomes now more stretched than at the peak of the housing bubble fifteen years ago. Risk assets like stocks along with bonds throughout the risk spectrum have reached previously unseen highs in valuations, with effective yields reaching all-time lows. And the federal government has borrowed over $5 trillion in the past 18 months, much of it injected directly into the economy to counter the impact of the pandemic, while enjoying the lowest average interest rate since the 1940s. However, because there has not been a significant increase in the market's expectation for the ongoing rate of price increases, which would signal the emergence of an unwelcome inflationary process, the Fed believes current monetary policy is not fueling inflation it needs to worry about.

Yet when we consider the dire consequences for housing, risk assets and the government's interest expense were the Fed to actually raise interest rates, you can probably see why we've called the current circumstances the Fed's *Third Great Mistake*. The bond market appears to understand the nature of this mistake, but the Fed does not yet seem to fully appreciate the bond market's message. Here is what Powell had to say when asked about the decline in bond yields in recent months:

> Chair Powell: Well, so in terms of what's been happening in bond markets, I don't think there's a real consensus on what explains the moves between the last meeting and this meeting. We've seen the long-term yields go down significantly. Some of it is a fall in real yields, which may have been connected to, some speculate -- connected to sentiment around the spread of the Delta variant and concern about growth. There was also some decline in inflation and compensation, which is significantly reversed. And there are also so-called technical factors, which is where you put things that you can't quite explain. So, I don't see in any of that, that there is really anything that challenges the credibility of our framework. We are committed to achieving 2 percent average inflation over time.

What the bond market appears to understand, but Powell and others at the Fed have not yet (publicly) acknowledged, is that the Federal Reserve has already effectively lost control of monetary policy. Although Powell is probably correct to expect the high readings of inflation indexes like the Consumer Price Index to settle down as the economy heals from the pandemic shutdown last year, the bond market understands that the Fed probably could not raise interest rates even if it wanted to, because the economy and markets are now too leveraged and dependent on ultra-low rates.

Which brings us to real assets. Among the prospective market returns outlined earlier, the one obvious standout is the prospective return for gold. While an era of negative real interest rates and bond yields is a supportive environment for real assets, the 16% prospective real return shown for gold, should risk assets revert to their median valuations in the coming years, is not an estimate based on real rates, or monetary policy — it is simply an estimate based on the historical correlation between gold and changes in risk asset valuations.



As an asset class, gold is one of the least understood by the investing public. While conventional thinking considers gold simply an inflation hedge, being a long-term inflation hedge does not explain gold's performance in each decade since the inflationary 1970s. For example, in the decade after the end of the tech bubble in 2000, gold rose at a 13% annualized rate despite the most deflationary events since the Great Depression: the tech bust, the housing bust and the 2008 credit crisis. A deeper look at the performance of gold over the last fifty years shows it has depended on a more complicated set of factors than simply being an inflation hedge. A more pragmatic characterization of its performance may be summarized this way: gold tends to rise in price when economic growth is being fueled by excess monetary and/or fiscal stimulus, *and* major risk asset classes are suffering as a result. When those conditions are not met, gold's price tends to stagnate or decline. Whether excess monetary and fiscal stimulus surfaces in the form of price inflation (as in the late 1940s and the 1970s) or in the form of asset bubbles (as in the 2000s and today) is less relevant to gold's performance than its attractiveness as a reliable store of value when the consequences of excess stimulus begin to negatively impact risk assets. Gold is what made cash a reliable store of value in earlier eras.

In a recent memo, renowned bond investor Howard Marks asked whether it was all too good to be true — whether the Fed can keep markets aloft, eliminate or at least minimize recessions, and enable the Treasury to borrow as much as it needs at ultra-low rates, all without consequences. He suspected there must be a catch, though he wrote that he didn't know exactly what it is. There most certainly is a catch, and when we look back at this time, the ultra-low interest rates and bond yields will likely be recognized as an important signal that traditional cyclical monetary policy had been relegated to the sidelines. Being unable or unwilling to increase interest rates due to the negative repercussions it would have for the economy and the markets was a hallmark of the inflationary 1940s and 1970s, and excessive monetary stimulus in reaction to debt-induced fragility has been the hallmark of the boom-and-bust cycles over the last twenty years. Although it is not possible to know in advance the precise nature of the catch this time, we do know it is a matter of *when* we will find out, not *if*.

Investors face a clear choice in allocating their portfolio in these circumstances: either ride U.S. stocks and bonds further into unprecedented territory, hoping higher valuations will add returns on top of the lowest effective portfolio yield in history, or invest for the market environment which unfolds when asset bubbles fomented by fiscal and monetary policy inevitably begin to deflate. We remain committed to the latter approach and are focused on the sectors and markets highlighted earlier that appear to have a positive prospective absolute return. It is fortunate that these same sectors and markets will also likely feel a strong tailwind from U.S. monetary policy in the years ahead. We are just one year into this new era of negative real rates and the effort of major central banks to pursue higher rates of inflation, and there is a long, volatile road ahead before they achieve their goals.

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