June 2020

Dear Investor,

The first half of 2020 will probably be looked back on as a pivot of enormous consequence, a pivot where the economy and markets veered onto a path quite different from the one that appeared to stretch out ahead at the beginning of the year. After the market volatility in 2018 and the first half of 2019 unfolded as the Federal Reserve tightened monetary policy, sentiment returned to exuberance in late 2019 after the Fed ended its campaign to shrink its balance sheet. That exuberance continued early this year, until everything changed in late February.

Although the Covid-19 pandemic seems to have relegated the lead-up to February's dramatic market shift to pre-history, it is important to understand that pre-history if there is any hope of anticipating what lies ahead. Over the past four years, an attempt was made to gradually unwind the expansive monetary policies that began during the financial crisis more than a decade ago, and as that effort to unwind those policies progressed, the markets eventually began to price in the end of the post-financial-crisis boom: the stock market's cyclically adjusted valuation peaked in early 2018, real assets began to outperform risk assets in late 2018, and the Treasury yield curve inverted in 2019. By the time the Fed halted its campaign to normalize monetary policy in late 2019, the bond market was already signaling a recession was on the horizon. The seemingly clear road which appeared to stretch out in front of risk assets at the start of the year was mostly a mirage of a late-stage bubble.

While we will never know how that oncoming recession would have unfolded absent a pandemic, we do know what a long-term market peak looks like, and the past two and a half years has been a textbook example. We also know how assets have tended to devalue since the end of Bretton-Woods, and the 40% decline in stocks versus gold over the past two years is also a textbook example of the early stage of a long-term devaluation. The fact is, risk assets have always devalued against gold, but the difference today is that the dollar is no longer fixed to gold the way it was in earlier eras.

While the short-term market action has been dominated by the massive monetary expansion over the past three months and the near-term outlook for the pandemic, the long-term outlook for various asset classes has been impacted little by Covid-19. We'll review that outlook in the pages below, after we first highlight some of the early economic and monetary data of this downturn.

In this month's letter:

- Early Signs Suggest the Monetary Earthquake of 2020 Is Unlike Any Other in the Post-War Era
- The U.S. Equity Market Now Stands Alone in Overvaluation

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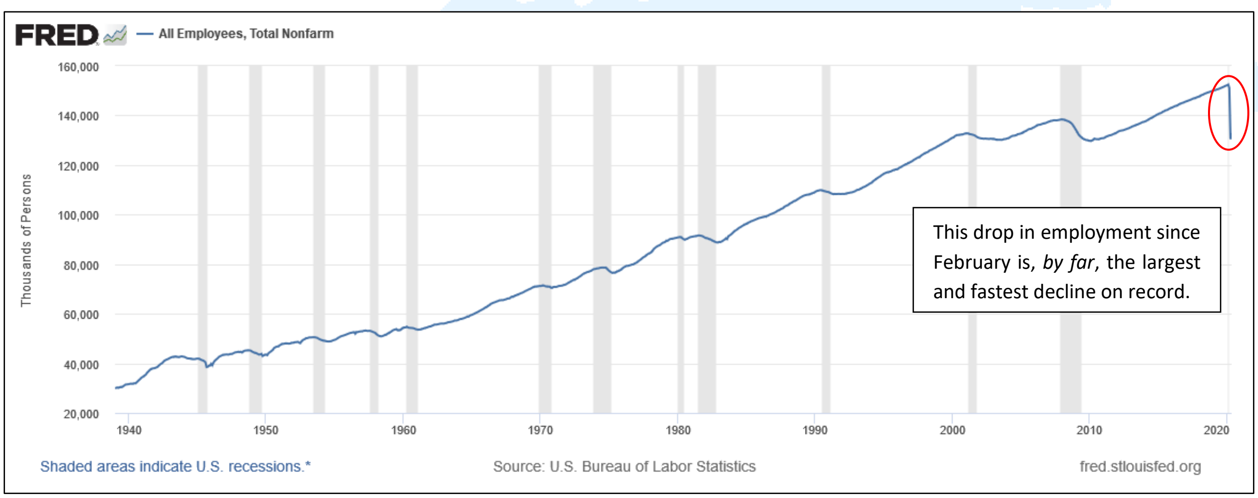
Early Signs Suggest the Monetary Earthquake of 2020 Is Unlike Any Other in the Post-War Era

> *The hardest lesson from both the Great Depression and the Great Recession is that it took a decade to dig out. A decade for the economy to fully recover and for the benefits of growth to reach all of those displaced by the shock. The Great Depression began in 1929. And in 1939, overall employment was still below its pre-depression peak, leaving many workers and families stranded and struggling 10 years later. The employment recovery following the Great Recession was faster, but the gains were uneven. What do we learn from this? A decade is too long. We can't wait 10 years for an economic recovery to reach everyone...*
>
> *We have to commit—now—to not letting this happen. Any plan for long-term economic recovery has to include the people we welcomed into employment during the expansion. This must be the measuring stick we hold ourselves to.*
>
> - Mary Daly, President of the Federal Reserve Bank of San Francisco, June 2020

It has been three months since the markets began reacting to the Covid-19 pandemic, and it seems clear at this point that the current downturn will turn out to be the most severe global economic contraction since the Great Depression. It is also equally clear that the vast majority of the public, including the investing public, do not yet appreciate the magnitude of what is unfolding.

The worst economic contraction most of us alive today have experienced was the Great Recession a decade ago, and for some that downturn was matched in severity by the recession in 1982; both of those recessions resulted in a 10% peak unemployment rate in the U.S. Yet as severe as those downturns were in the U.S., they were relatively mild on a global basis. The global economy never suffered an outright contraction in the early 1980s, and during the Great Recession, global economic output contracted a mere 0.1% in 2009, after growing 3% in 2008.

Most people in the U.S. would agree that the twin recessions of the early 1980s and the Great Recession were severe, but those contractions are not in the same league with the global contraction of 2020. This past month the International Monetary Fund estimated global economic output will contract by 4.9% in 2020, a stunning figure that is 1.9% lower than what the IMF estimated only two months prior. Such a contraction would be, by far, the most severe economic downturn since the Great Depression, when global economic output declined a total of 10% between 1929 and 1932.

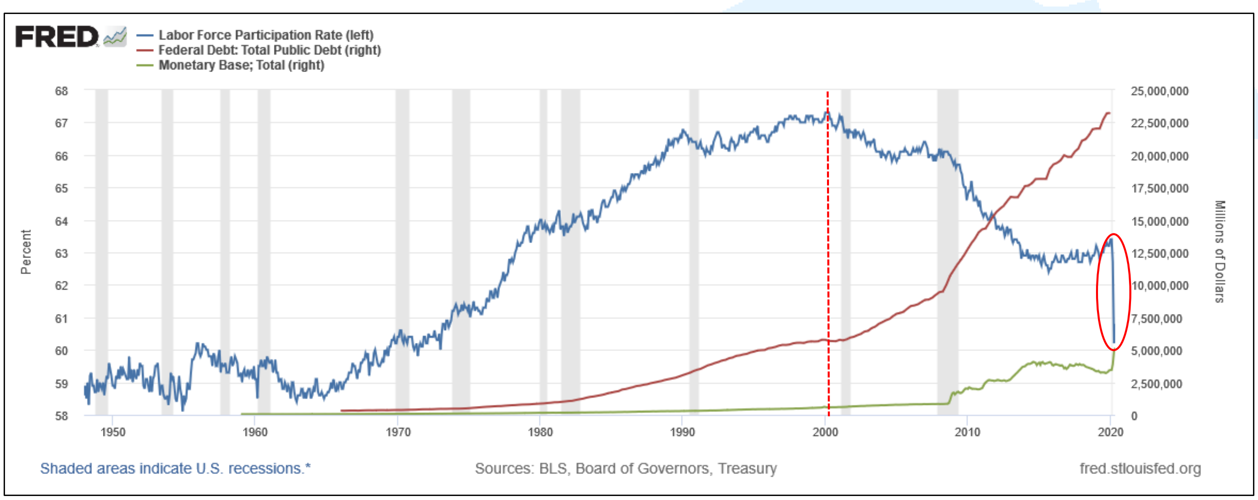


There are few alive today who lived through the Great Depression, and one would be hard-pressed to find anyone active in the markets today who managed themselves as adults through that chaotic time. Even Warren Buffett, whose caution we highlighted last month, distilled his investing lessons from that period indirectly from his mentor, Benjamin Graham. Given that few alive today have any direct experience managing through a significant decline in global economic output, it is no wonder there is a large disconnect between the reality of the economic situation and overall public sentiment. A similar disconnect was pervasive in 1930.

Among those steeped in history, however, there has been less of a disconnect — along with a general sense of shock at some of the early data. The two monthly employment reports since February have been plagued by classifications which have misrepresented some of the facts on the ground, but even with those problems it is clear that the drop in employment this year is unlike anything seen since the 1930s (see chart above). Although the steepness of the employment drop has undoubtably been influenced both by government-mandated shutdowns and by stimulus payments, there will be lasting social changes brought on by the pandemic which will continue to impact employment, along with spreading ripple effects as private and public balance sheets continue to deteriorate.

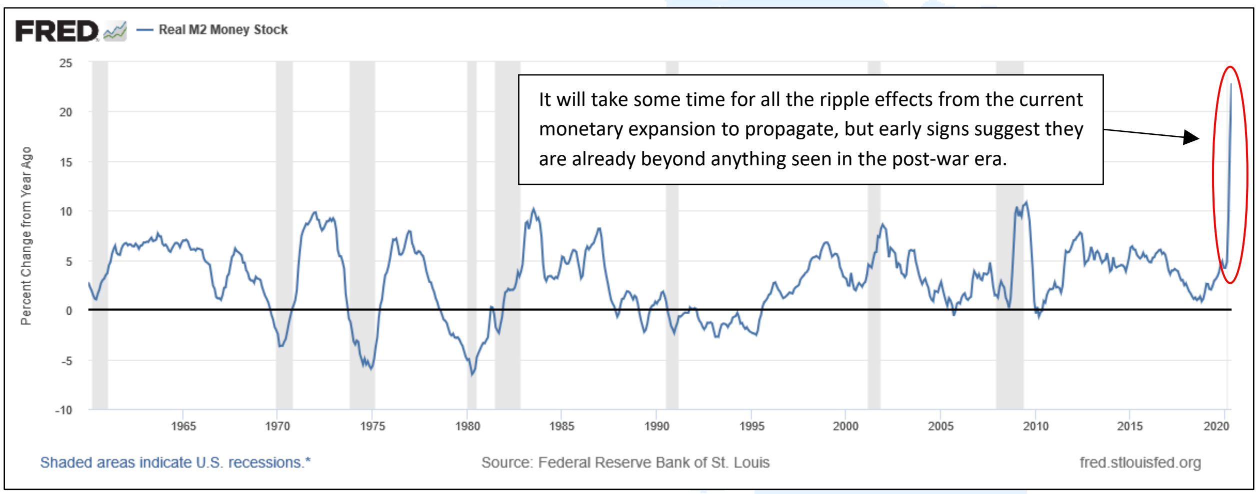
While there has been no shortage of forecasts for economic recovery in 2021 and beyond, the second and third order effects of such an employment shock amid a *global* economic contraction are in no way predictable, so all such forecasts should be treated with caution. This downturn is anything but a standard, post-war recession, one where a loosening of monetary policy eventually stimulates enough demand to spark the next growth cycle. Instead, monetary policy was loose for most of the past decade, and the moment it was tightened, recessionary clouds appeared on the horizon. This represents a major paradigm shift in the short-term economic cycle from the post-war era.

The underlying reasons for this shift are tied to private sector deleveraging, which began with the financial crisis, and deleveraging is intimately related to the demographic shift associated with the retirement of the baby boom generation. The current recession, as influenced as it is by the pandemic, is embedded in these long-term trends. An example of this can be seen when we look at employment relative to the total U.S. population, which has been trending lower for two decades.



The rise and subsequent fall of the Labor Force Participation Rate over the past 60 years approximates the rise and fall of the baby boom generation in the labor force, and it's no coincidence the economy began deleveraging not long after the ratio of workers to retirees began falling after the 2000–2001 recession. These are demographically spawned and induced trends which have been seen in similar circumstances outside the U.S. The sudden collapse of the Participation Rate due to the job losses this year takes the rate all the way back down to levels last seen in the late 1960s and early 1970s, a level it would have probably settled at over the course of the next decade. However, the pandemic has accelerated the shift, and that has brought forward and compressed a staggering economic headwind which otherwise would have been spread over many years.

In response, the Federal Reserve has been very quick to act in order to counter that headwind. Between late February and late June, the Fed purchased $3 trillion worth of financial assets, a staggering 72% expansion of its balance sheet in just four months' time. Not coincidentally, this also represents the rough amount of economic stimulus the federal government has enacted since February, and the monetary expansion along with the new deficit spending has resulted in surging rates of change in measures of money supply beyond all prior post-war experience — even beyond the peak rates seen during the inflationary 1970s.



While the underlying circumstances today are very different from the 1970s (the economy was then riding a rising demographic tide, and in the process of increasing leverage, not deleveraging), money supply growth rates above 20%, as shown in the chart above of M2 growth, represent a monetary earthquake unlike any other in the post-war era. In fact, there have been only two other times during the last century when M2 growth rose above 15%, which were during the peak levels of military spending during World Wars I & II. High rates of money supply growth do not necessarily mean that inflation, like what was experienced during those earlier periods, is right around the corner; price inflation is a complex dynamic between money supply, velocity and economic output, and increasing money supply is only one part of that dynamic. However, it is certainly a sign that the value of the dollar is at greater risk in the coming years, especially considering we are only four months into addressing the effects of this economic downturn.

As Mary Daly, the president of the Federal Reserve Bank of San Francisco, said this past month, the Fed will not likely rest until all the employment lost during this downturn is restored. That will be a very tall order given the staggering employment losses to date, and the demographic headwind, but we have no doubt the Fed will do what it thinks is necessary — regardless of its ultimate impact on the dollar. This has been the consistent pattern over the last century.

The most remarkable aspect of the Fed's endeavor so far, aside from the scale of the expansion itself, is how quickly and thoroughly public sentiment has shifted in favor of monetizing of assets of all kinds in order to ease the economic pain of this downturn. It caused hardly a stir this past month when a press release announced the Fed had directly purchased bonds of AT&T, Boeing, Ford Motor Company, Walmart and many other familiar names as part of its emergency lending program; up to that point, the Fed had only been purchasing corporate bonds indirectly via exchange-traded funds. When the history of this period is written, the decision to veer down this monetization road will perhaps be revealed as one of the more fateful moments of this downturn.

The U.S. Equity Market Now Stands Alone in Overvaluation

The Fed can change how things look; it cannot change what things are.

- Jim Grant, of *Grant's Interest Rate Observer*

After the shock of the market plunge in February and March, it is safe to say that, for most investors, the extent of the rebound in the stock market since then has been one of the most surprising, and perhaps mystifying, events of this year. And since the stock market is widely assumed to be an accurate barometer for how the economy will fare, the rebound in the market seems to have had the effect of a large dose of tranquilizer having been infused into the investing public at large. The panic which completely paralyzed the markets in March has subsided.

Of course, the cost of that single dose of tranquilizer has been immense, and it has only partially, and most likely temporarily, eased the impact of the downturn. The most visible cost includes a $3 trillion expansion of the Fed's balance sheet. Although this will most likely serve only as a down-payment on the monetary stimulus to counter this recession, what has already happened will ultimately have a lasting, and significant, long-term impact on prices throughout the economy. That will be part of the direct legacy of the Fed's actions thus far, but there will be indirect impacts as well.

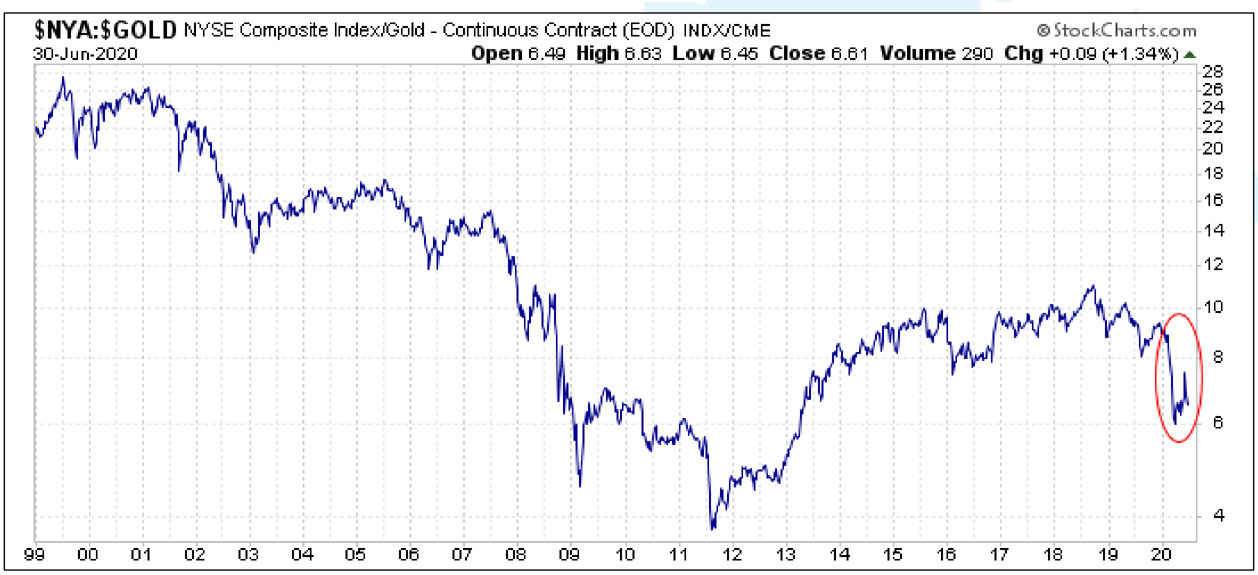
For example, when the Fed first announced in March that it would, for the first time, begin purchasing corporate bonds as part of its effort to ease monetary policy, it had an immediate and dramatic effect on the markets which went far beyond the actual dollar amounts of the initial Fed purchases. It shifted market sentiment to such an extent that many public companies, some of which had been completely shut out of the credit markets only the week before, were subsequently able to borrow billions of dollars. By early June, the amount of corporate borrowing in the U.S. had risen above $1.1

trillion for the year — twice the pace of borrowing seen in 2019. It is now almost certain 2020 will mark the largest annual issuance of U.S. corporate debt on record.

The immediate impact of this corporate borrowing binge has been a tremendous sense of relief among investors, as it has increased available liquidity on corporate balance sheets, but rising debt levels (with corporate-debt-to-GDP having already started the year near a record level), coupled with declining sales (a collective inevitability when global GDP contracts) is a recipe for a significant erosion of equity value over time, to say nothing of the short-term hit to earnings. The partial recovery from the March market low is a partial reflection of this reality. As exuberant as the rebound has felt, the NYSE Composite declined 15% in the first half of 2020, and the Russell 2000 small cap index fell 14%.

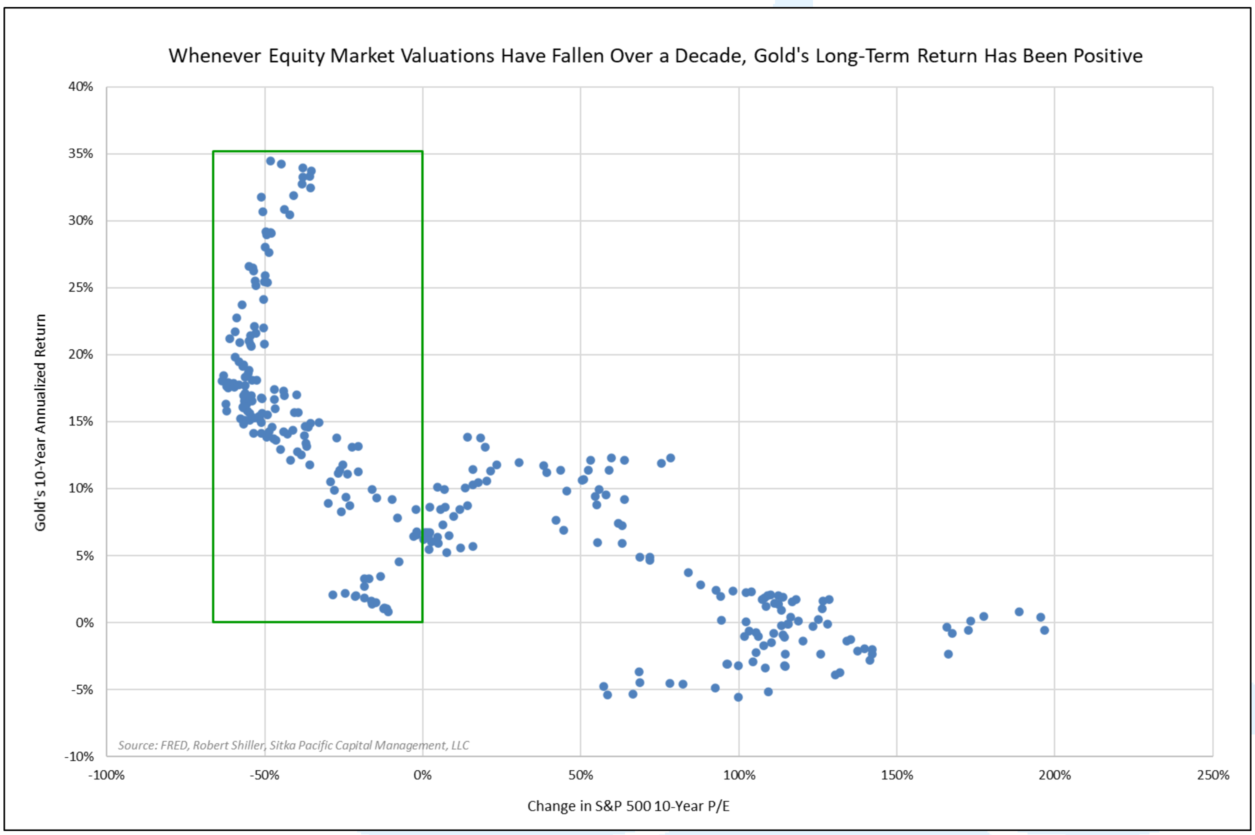
Of course, the real loss of equity value this year is far greater than the nominal declines in those main indexes, but the Fed's actions have altered how things look. Equity value in any company is simply the discounted present value of all future earnings, but the market's current price of that equity value depends on what investors are willing to pay for it *and* what those dollars used in the transaction are worth. Those who have been surprised by the apparent strength of the equity market rebound from the March low probably have not taken into account how much that latter factor, the dollar's value, has changed this year.

Monetary expansions can take a long time to percolate into prices in every nook and cranny in the economy, but one of the first responders to significant changes in the dollar's value has always been gold, and looking at stocks in terms of their gold price gives a different impression than the market's 15% nominal decline. Not only has the NYSE Composite in gold-terms been trending lower over the past two years, but it fell 28% in the first half of this year, and the rebound in the second quarter was meager. Although this is not a perfect measure by any means, as gold is subject to swings in sentiment just like any other market price, the drop on the far right of the chart below is probably a more accurate reflection of the real decline in the equity market's value in the first half of 2020.



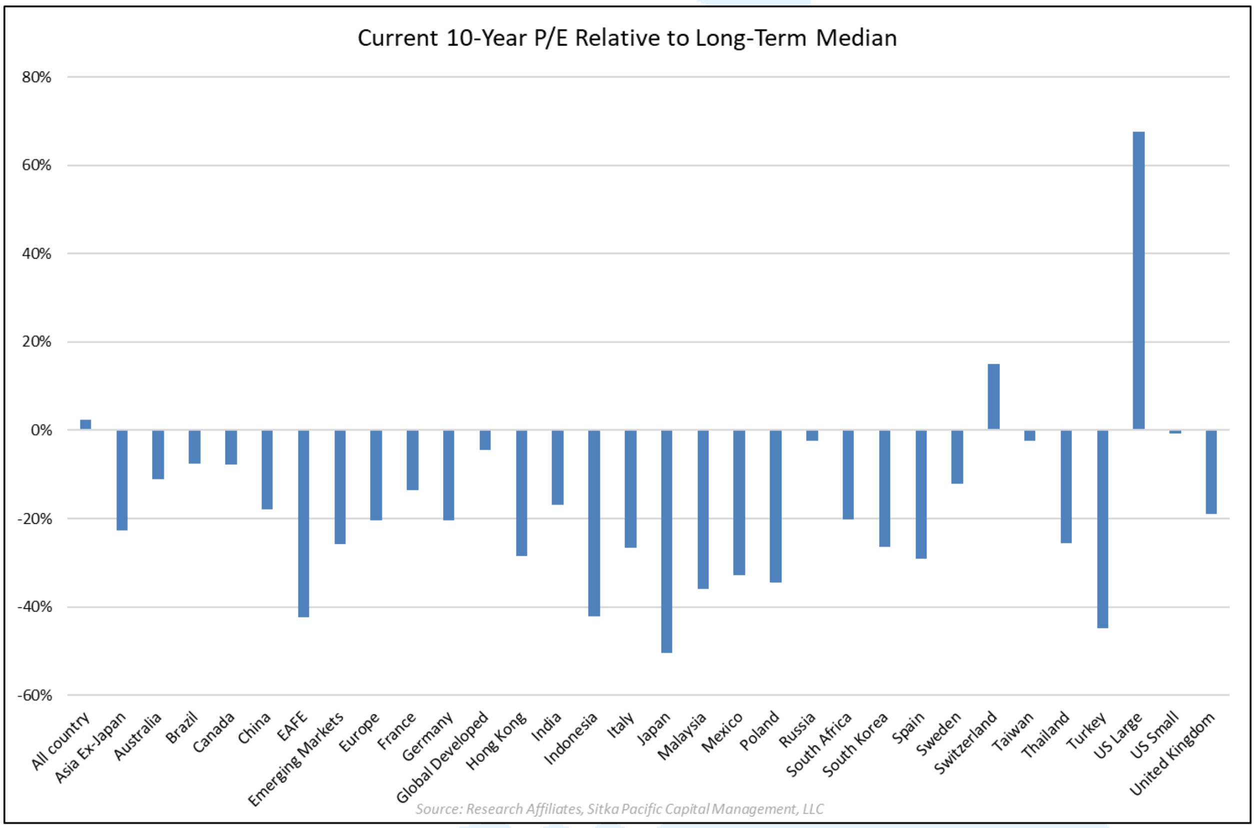
To say it politely, an ongoing focus on gold has not been something which has necessarily endeared an investment manager to the mainstream in recent years. When most firms publish forecasts of their expectations for how various asset classes will perform, gold is rarely even included in the list, let alone given an expected return. The focus is usually on assets which represent more than 90% of financial assets available to investors in the public financial markets — stocks and bonds.

What people tend to forget is that risk assets have *always* devalued against gold, it is just that prior to 1971, the dollar was tied to gold, so when risk assets devalued, the entire devaluation was there for all to see in nominal dollar terms. However, the two long-term bear markets since the dollar has been decoupled from gold have seen risk assets and the dollar devalued together as monetary policy, untethered to anything tangible, was aggressively employed to cushion the impact of each downturn. The only way to avoid those simultaneous devaluations has been to hold gold directly. This is what an investment in gold today is intended to be — a holding which will gain value relative to risk assets as they devalue over an extended period of time. It is the utility interest-yielding cash equivalents used to provide, in earlier eras.



The most difficult aspect of long-term devaluations in risk assets is that they take time. A lot of time. In previous long-term devaluations from high valuations, the market spent many years bobbing up and down while it devalued. It did so during the entire decade of the 1910s, and also the 1940s. It did so for 17 years between 1966 and 1982, and more recently, the market took 13 years to durably rise above the nominal peak established by the tech bubble. During each of these devaluations, the equity market ultimately lost significant value against gold, but for most of those who remained focused on what the market did in this month, or that month, as it endlessly bobbed up and down, the process went largely unnoticed until it was almost over.

The current devaluation is merely two and a half years old, having likely begun with the peak in the market's cyclically adjusted valuation in early 2018, so there are many years ahead to navigate. The S&P 500 ended June with a 10-year P/E of 29, which is down slightly from its peak value of 33 in January 2018, but still in what we consider bubble territory — a designation which the U.S. equity market now stands alone with. As you can see from the chart below, which shows cyclically adjusted valuations for equity markets around the world relative to their own long-term medians, large-cap U.S. stocks are the only equity market trading significantly above historic valuations.



As investors remain utterly transfixed on large-cap U.S. stocks, and particularly on just a handful of the largest tech firms within that large-cap universe that have been driving the main large-cap indexes, the rest of the world's equity markets are undervalued, having trod water in the same nominal price range for 14 years. This gaping disparity in valuation between the U.S. equity market and the rest of the world will likely result in an equally gaping disparity in returns over the next decade between those who focus on global equity markets and those who don't. However, between now and then, these markets have some precarious-looking bridges to cross.

Global equity markets, and especially emerging markets, are facing the most severe contraction in demand, supply and trade in the modern era, and unlike the U.S. and other major economic zones, many do not have access to unlimited credit in their own currencies. Carmen Reinhart, the co-author of the seminal book on sovereign defaults, *This Time Is Different*, made a point this past month of highlighting the default risk looming in many emerging markets, given the magnitude of this economic downturn. In these circumstances, many of these markets *should* be significantly undervalued, perhaps more than they are today. Over the course of the decade ahead, however, global equity markets appear poised to vastly outperform large-cap U.S. stocks.

The portfolio which will deliver real returns in the years ahead will likely be structured differently from the standard 60/40 portfolio of U.S. stocks and bonds — it will be heavily weighted in real assets and, eventually, in select risk assets in markets outside the dollar. Real assets began outperforming two years ago, and risk assets outside the dollar will likely begin outperforming cash and U.S. risk assets following the current downturn. We are already well allocated in real assets, and this bear market, which appears to be in its early stages, looks like it will eventually provide an ideal opportunity to substantially increase our allocation to undervalued equity markets outside the U.S.

There is a pervasive sentiment of surprise at how strongly the stock market has recovered from the selloff in February and March, but given the Fed's actions, along with the history of rebounds following sharp selloffs, this is not surprising. Against gold, however, stocks have recovered less than the nominal rally suggests, and this dynamic likely offers a template for what to expect in the years ahead — an oscillating market being devalued by real assets. Investors who continue to focus solely on nominal price changes while the Fed expands the money supply by leaps and bounds are missing the most important messages the markets are sending.

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
Chief Investment Officer
Sitka Pacific Capital Management, LLC