Sitka Pacific
Capital Management, LLC

June 2021

Dear Investor,

In contrast to the first half of 2020, which witnessed the largest monetary expansion in history over the course of just a few months, along with a decline to near zero in long-term bond yields, the first half of 2021 witnessed a modest tightening of market conditions. It began the first week of the year, when long-term Treasury bond yields began moving higher, and it continued through this past month, when the Federal Reserve disclosed that most voting members of the Open Market Committee had brought forward the timing of when they anticipated hiking interest rates, to the end of 2023. In addition, in referring to the possibility of tapering the pace of its monthly asset purchases, Fed Chair Powell summarized the June meeting's discussion this way at his press conference: *You can think of this meeting as the talking-about-talking-about meeting, if you like.*

Although the end of 2023 is more than two years away, and the Fed continues to purchase $120 billion in Treasury and mortgage-backed bonds every month, the meeting in June represented the most hawkish shift in rhetoric coming out of the Fed since the pandemic hit the markets last February. We will discuss this shift further in the pages below, but it is clear the recent headline inflation numbers have had an impact on sentiment within the Federal Reserve. It is also clear from the early bond market reaction to Powell's *talking-about-talking-about* announcement that the aftermath of this recession is already quite different for the markets than the aftermath of the credit crisis.

The evidence of the stark difference between the current market environment and that of the recovery a decade ago has become glaringly obvious outside the bond market as well. Households added $13.5T of wealth in 2020, the year of the deepest recession since the Great Depression, and this was due in large part to home prices and risk asset prices, quite literally, going off the charts. In data released this past month, home prices increased at a year-over-year pace which surpassed the peak rates seen during the housing bubble. And as can be seen in the chart at the end of this letter, the stock market has gone far beyond all prior bounds to heights which have never been seen before.

While most of the asset management industry remains fixated on guessing just how high the market will go in the wake of this recession, the years ahead will clearly separate those who were investing during this time, from those who were gambling. As we will discuss, it is an important distinction that only becomes clear in the aftermath of periods like this one.

In this month's letter:

- Feeling Cold Feet, the Fed Releases a Tapering Trial Balloon
- An Update on the U.S. Equity Market, in Two Remarkable Charts

Feeling Cold Feet, the Fed Releases a Tapering Trial Balloon

> *Investors have been struggling to interpret signals from the Federal Reserve about how hot it is willing to let inflation run before it begins unwinding pandemic-era monetary stimulus. Measures of markets' U.S. inflation expectations hit multi-year highs in mid-May, but fell after comments from some Fed speakers and minutes from the committee's April meeting sounded more hawkish. Some investors interpreted that as policymakers having a lower tolerance for an inflation overshoot than previously estimated.*
>
> *The fall in inflation expectations was exacerbated by the central bank's policymaking meeting on June 15-16, when the Fed pulled forward projections for its first two rate hikes into 2023. Since then, bets on inflation have nudged back up, likely helped by Fed Chair Jerome Powell's insistence on Tuesday that the bank would not preemptively raise rates because of the "fear" that inflation may be coming. The choppiness suggests investors are struggling to make sense of the sometimes conflicting signals from Fed officials, who are facing their first inflation test under a new flexible average inflation framework adopted in 2020.*
>
> \- Reuters, June 2021

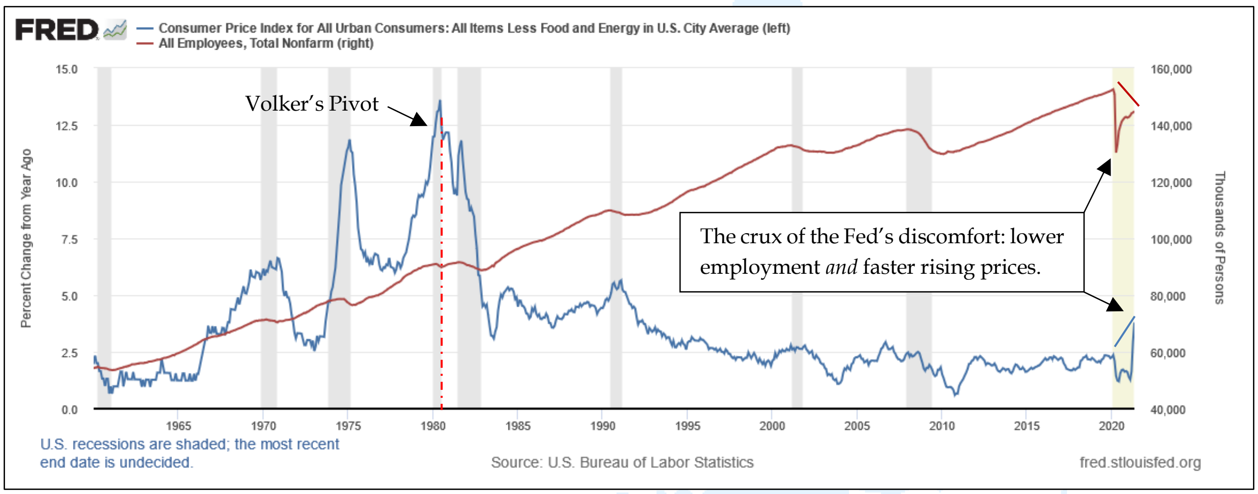
Amid the chaos of the pandemic last year, there were two seismic shifts in monetary policy which are not yet fully appreciated, in terms of the impact they will have on the markets and the economy in the years ahead. The first of these shifts was the conscription of monetary policy to support a truly massive expansion in federal spending in response to the pandemic. This brought the Fed's attempt to normalize monetary policy after the financial crisis to a sudden end, and it ushered in a new era of interest rate and yield management, the likes of which have not been seen since the 1940s. The impact of this first shift will last far beyond the pandemic. The second shift came later in the year, when the Fed released the results of a review it had been conducting of its response to the financial crisis.

The results of this review effectively announced the Fed was moving on from the lingering fear of its *Second Great Mistake*, the inflation of the 1970s, a fear which had haunted monetary policy decisions for the last forty years. The review concluded that despite holding interest rates near zero after the Great Recession, and despite a fivefold expansion of its balance sheet, inflation had remained below the Fed's preferred 2% target, in large part due to *preemptive* tightening of monetary policy. In other words, the Fed's actions in anticipation of (or, one might say, in fear of) higher inflation in the decade after the financial crisis turned out to be premature, and it resulted in a seven-year undershoot of price increases relative to its goal.

Together, these two shifts represent the most significant pivot in monetary policy since the Volker era, and they carry profound implications for the markets. When Paul Volker decided to end the Fed's role in fueling the inflation of the 1970s, he did it by giving up control of interest rates and the market's reaction to Treasury debt sales, and instead the Fed turned its focus to controlling the main driver of inflation — the expanding money supply. When Volker did this, interest rates spiked higher as market forces were released from the Fed's suppression, and this resulted in the highest bond yields of the 20th century. At the same time, money supply growth rates were successfully brought down by this policy pivot, with inflation rates subsiding soon thereafter, and this paved the way for a broad-based expansion of asset valuations that continues to this day.

The pivot in 1980–81 marked a dramatic shift in emphasis toward restraining inflation, and restraining inflation continued as the primary goal of monetary policy for the next four decades. However, the impact of the recession over the past year, along with the review of the decade after the credit crisis, effectively amounted to an end of the Fed's focus on controlling the money supply. This represents a return to what the Fed focused on prior to the Volker pivot — controlling interest rates and managing bond yields, while allowing measures of money supply to grow as they will.

Between the first quarter of 2020 and the first quarter of 2021, the federal government borrowed $4.9 trillion to support the economy amid the pandemic, and this brought its total debt above $28 trillion. At the same time, the Federal Reserve purchased $3.3 trillion in assets as it sought to keep the bond market as calm as possible. These vast fiscal and monetary expansions fueled the highest money supply growth rates in the postwar era, and if we set aside the debate over the minutia of recent inflation reports, it is no coincidence that a little more than a year after these new policies took hold, the initial impact began showing up in the form of faster rising prices.



Until this past month, Fed Chair Powell had succeeded in conveying a consistent message about the new goals of U.S. monetary policy. With the long, slow recovery after the financial crisis freshly in their minds, Powell and his colleagues at the Fed repeatedly emphasized how the pandemic had resulted in such a deep drop in employment that the focus of monetary policy in the years ahead would be to support a return of the economy to a state of full employment as quickly as possible. The underlying message in their comments, which we discussed earlier this year, was that the employment side of the Fed's dual mandate was now the preeminent focus, and while employment remained the priority, the other half of the Fed's dual mandate, price stability, would have to remain on the shelf.

However, while the exclusive focus on the employment deficit from this recession was relatively easy to maintain when the Fed's preferred measures of inflation also were low, over the past few months, prices began to rise at a pace that was clearly beyond the comfort zone of many Fed officials — and this growing discomfort culminated in a fracturing of the messaging that emanated from the Fed in June.

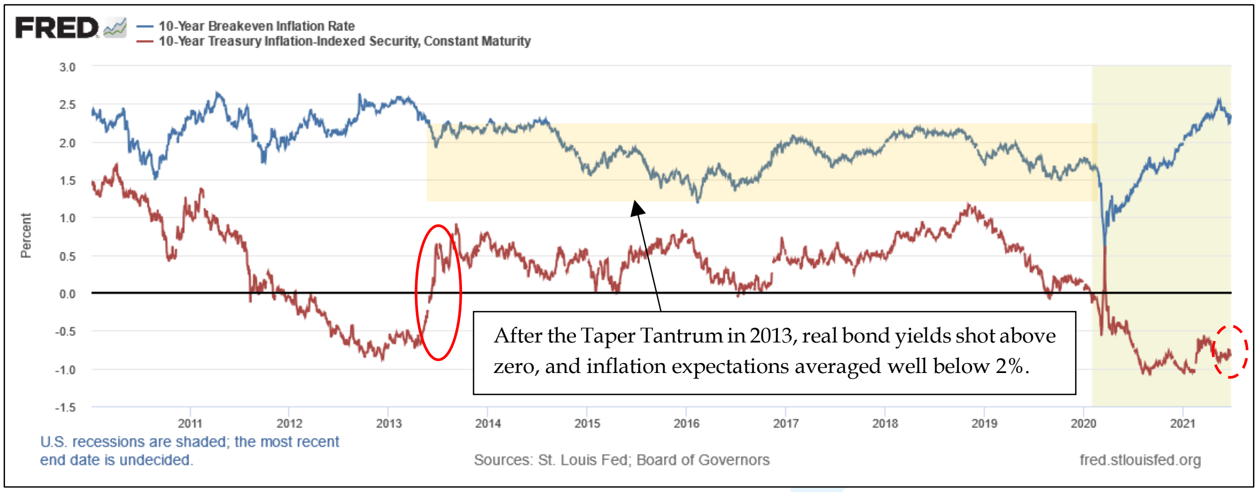
In the chart above you can see that the most recent rates of increase in the Consumer Price Index have been the highest since the early 1990s. This was before most current voting members of the Open Market Committee entered the Federal Reserve system, so many of them have not experienced inflation rates this high as members of the Fed. Although there are many reasons to believe some of the factors behind recent price increases will indeed prove transitory, as Powell has repeatedly emphasized, the rates of inflation were high enough to provoke a shift in the "dot plots" the Fed releases, which represents a poll of the interest rates Open Market Committee Members expect in the years ahead. It also was enough to mark a shift in the rhetoric following the meeting.

In fact, it is difficult to recall another Fed meeting that was followed by so many interviews of Fed officials, many of them expressing opinions quite contrary to one another; in the week after the meeting, it seemed two or three interviews were being published every day.

There were those at the Fed, such as Minneapolis Fed President Neel Kashkari, who voiced skepticism that recent high inflation readings will last, and remained committed to helping the 7–10 million workers who left the workforce regain their jobs before tightening monetary policy. Then there were others, such as Federal Reserve Bank of Dallas President Robert Kaplan, who favored starting to taper the Fed's asset purchases "soon," because asset purchases were helping create excess demand in the economy — demand which is exacerbating the supply issues which appear to underly the higher inflation readings.

Investors tend to forget that the Fed considers its communication with the public to be one of the main tools of monetary policy, which makes the public airing of differences of opinion amongst Fed officials over the last month notable. They know how important the public's perceptions and expectations are, and how much those perceptions and expectations can feed into and affect the data they care about, and most of their communication is carefully calibrated and coordinated to shape those public narratives. And when there is little room to maneuver, policy-wise, as is the case today, shaping the public narrative with communication becomes all the more important. This is part of the reason the public airing of such differences of opinion about the direction of monetary policy was so notable — and it probably represents the difficulty of the choices ahead.

Amid the rousing public debate about the Fed's asset purchases this past month, it was also notable that the bond market reaction was calm and quiet. In 2013, the first mention of tapering the pace of quantitative easing sparked a violent reaction in the bond market, which became known as the Taper Tantrum (highlighted by the red circle in the chart below). This time, however, there has been almost no reaction in the bond market. Nominal Treasury yields declined modestly as the taper debate played out this past month, with the 10-Year Treasury yield remaining below the critical 1.5% level and falling as low as 1.44%. At the same time, real long-term Treasury yields remained just as negative as they were before the debate began (dashed circle in the chart below).



The lack of reaction in the bond market as the tapering debate erupted this past month is revealing, and it indicates much has been learned over the past decade. What the bond market appears to understand is that without asset purchases, headline inflation rates will likely decline below the Fed's long-term target — which would be in conflict with the Fed's new goal of "making up" for the low inflation rates over the past eight years. An uncomfortable decline in inflation rates is what happened after the Fed wound down its quantitative easing purchases after the financial crisis, and the Fed's policy review has made it a priority that a similar disinflationary outcome in the years ahead needs to be avoided.

The lack of reaction to the tapering debate this past month reveals the bond market understands the dilemma the Fed finds itself in: in order to achieve its goals for inflation in the years ahead, the Fed is going to have to maintain a regime of negative real, inflation-adjusted interest rates and bond yields. If the Fed allows interest rates and bond yields to rise into positive territory, as it did between 2013 and 2020, inflation rates will likely decline enough to elicit a policy response under the Fed's new long-term guidelines. This is likely the reason why the yield on the 10-Year Treasury inflation-indexed security, shown above in red, has remained firmly in negative territory.

One of the main themes we have discussed in recent years is the progression of events that unfold as real interest rates and bond yields descend into negative territory for an extended period of time. Negative real interest rates and bond yields profoundly impact all other financial assets, and we have seen that impact spread far and wide over the past year — just as happened in the early years of the Great Inflation. The rush into assets with any prospective positive real yield was the main driving force that powered the speculative boom in the Nifty Fifty era in the early 1970s, which lasted until the realization dawned that a positive earnings yield was no guarantee of a positive overall return once valuations begin to decline.

* * *

An Update on the U.S. Equity Market, in Two Remarkable Charts

> *The last 12 months have been a classic finale to an 11-year bull market. Peak overvaluation across each decile by price to sales, so that the most expensive 10% is worse than it was in the 2000 tech bubble and the remaining nine deciles are much more expensive. All measures of debt and margin are at peaks. Speculative measures such as call option volumes, volume of individual trading and quantities of over-the-counter or penny stocks are all at records…*
>
> *Checking all the necessary boxes of a speculative peak, the U.S. market was entitled historically to start unraveling any time after January this year. One odd characteristic of the three biggest bubbles in the U.S. -- 1929, 1972 and 2000 -- is that the very end was preceded by blue chips outperforming more aggressive, higher beta stocks. In 2000, for five months from March, tech-related stocks crashed by 50% as the S&P 500 was unchanged, and the balance of the market was up over 15%. In 1972, before the biggest bear market since the Depression, the S&P outperformed the average stock by 35%. And in 1929, the effect was even more extreme, with the racy S&P low-priced index down nearly 30% before the broad market crashed…*
>
> *For the great bubbles by scale and significance, we also noticed that they all accelerated late in the game and had psychological measures that could not be missed by ordinary investors. (Economists are a different matter.) The data, like today, is always clear, just uncommercial and inconvenient for the investment industry and often psychologically impossible to see for many individuals.*
>
> \- Jeremy Grantham, June 2021

Despite the lack of reaction in the bond market following Powell's *talking-about-talking-about* tapering announcement this past month, other markets were not as quiet. Relative to other major currencies, the U.S. dollar rose significantly in the days following the Fed meeting; over the course of just three days, it rose nearly as much as it did in the month of March. This helped the dollar record its largest monthly gain since 2016 in June, rising 2.6%.

At the same time, the rapid gain in the dollar weighed on the price of gold and commodities. Gold recorded its largest monthly decline since 2016, and the price of silver, copper and other metals fell in June as well. However, these declines did not alter the state of their larger trends. For industrials metals like copper, the gains over the past year have been substantial, and the modest decline from its high-water mark in May has been coincident with a decline in the market's inflation expectations, both of which appear to be settling down in light of the Fed's discomfort with recent inflation readings. For precious metals, they remained within the trading ranges in place since last summer; June's decline followed a similar advance toward the top of that range in May.

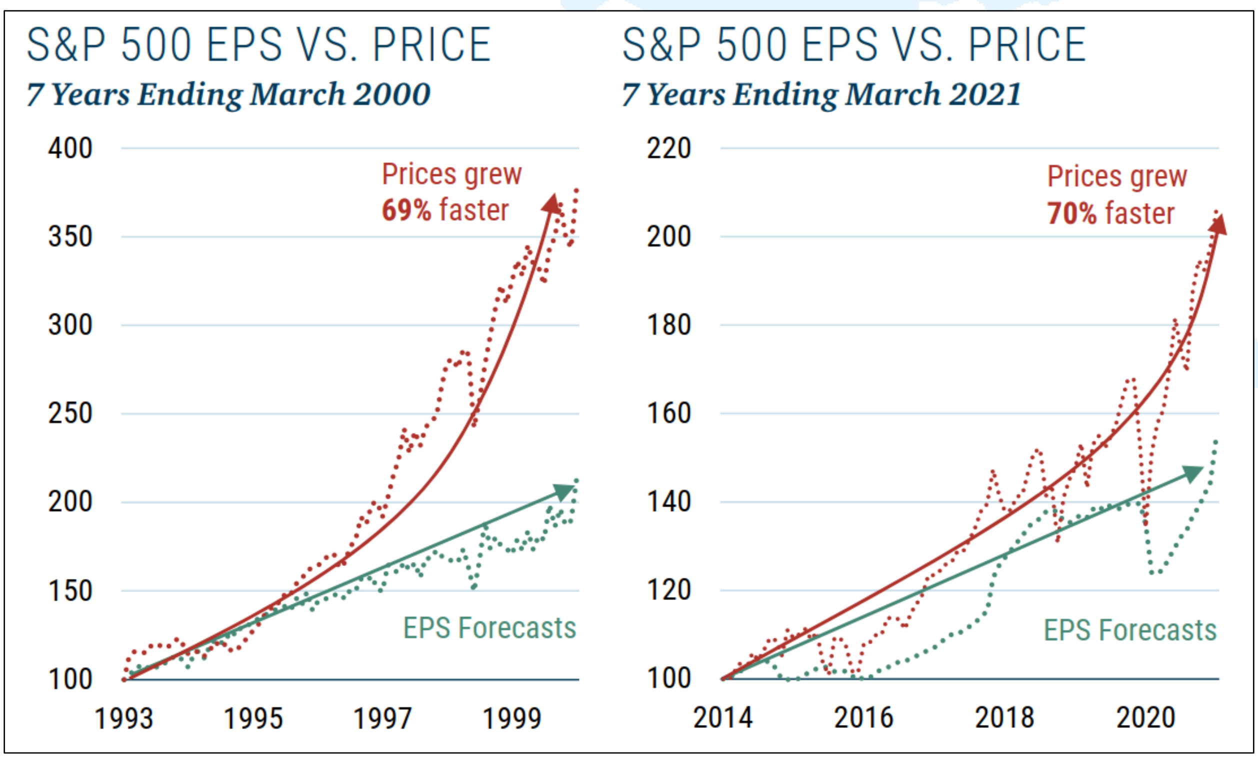
With all the focus on rising inflation rates in recent months, you may be wondering why the prices of gold and other precious metals have remained rangebound since last summer. There are two likely reasons for this. First, one of the most powerful *cyclical* drivers of the price of gold is a significant change in real interest rates and real long-term bond yields, and after reaching a cyclical peak in late 2018, real long-term yields hit their lowest levels last summer. Since then, they have remained just above their lows, but have not declined further. The cyclical trend in long-term real yields from 2018 correlates strongly with the overall trend in precious metals during that time.

The second reason precious metals have remained rangebound since last summer can be found in the chart below, and also the chart on the following page. These also highlight the primary reason we remain invested in precious metals for the long term, beyond shorter-term cyclical factors.

We have not spent a lot of space in these letters recently discussing the bubble in the U.S. market, in part because, at this point, there is little new ground to cover. As we discussed in March, investors and investment managers who are largely confined to stocks and bonds, and who look at the equity market from a *relative* value perspective, have watched Treasury bond yields decline toward zero over the past five years, and more recently, with the help of the Federal Reserve, have watched yields on corporate and municipal bonds reach new all-time lows this year, and these ultra-low bond yields have maintained the equity market's relative attractiveness as prices have continued to climb. As we discussed in this year's annual letter, this is part of Buffett's *bountiful triple dip*.

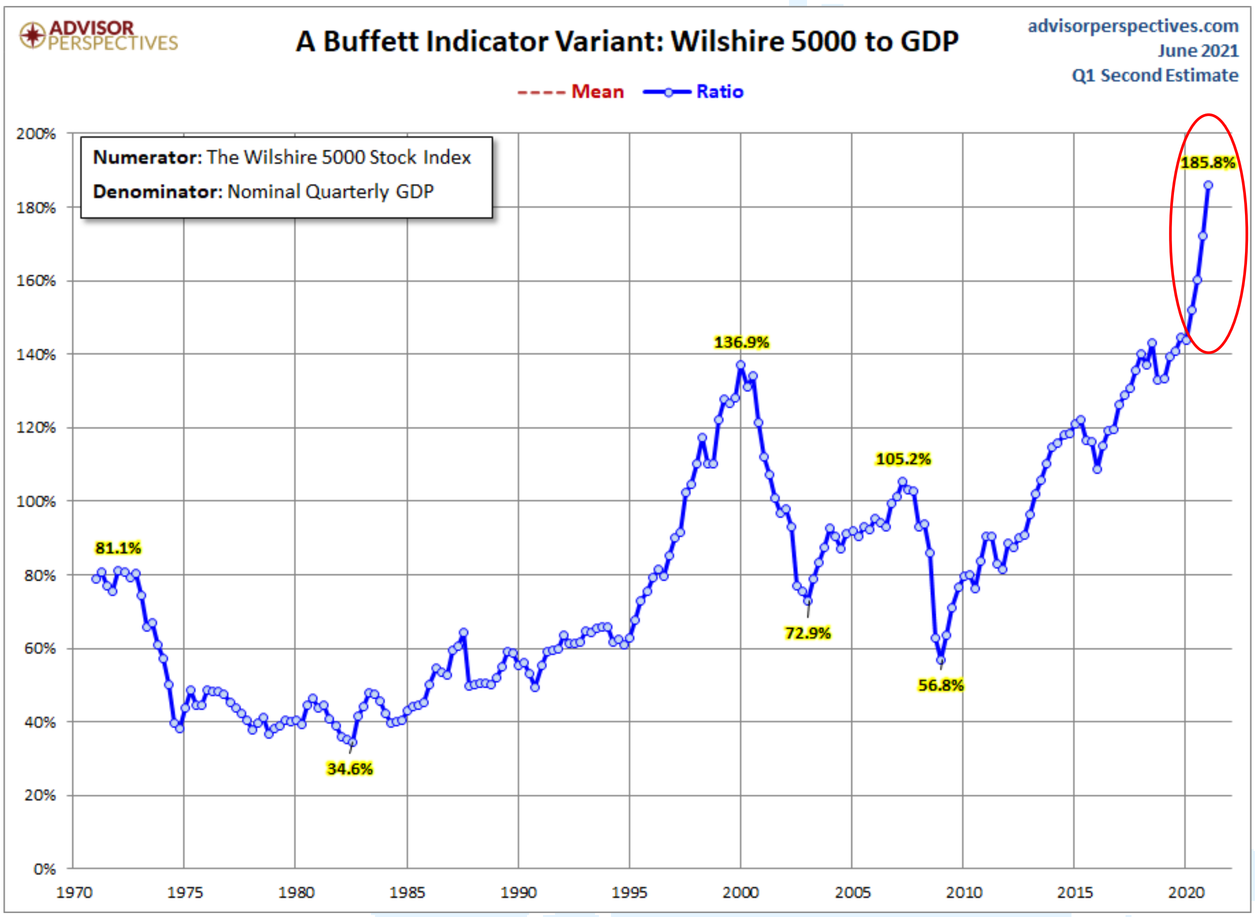
For investors and investment managers who look at the market from an absolute value perspective however, the continued rise in the market has steadily eroded its attractiveness. With so much attention focused on the market's rapid recovery from the decline at the beginning of the pandemic, little attention has been paid to just how far prices have outpaced earnings in recent years. The chart below, from the asset management firm GMO, gives some perspective.

It shows that the price of the S&P 500 has risen 70% more than earnings since 2014, which is the same magnitude of price-versus-earnings outperformance seen at the peak of the tech bubble two decades ago. For those who view the market from absolute value perspective, the reason for this trend is less important than the end result: an investment in the S&P 500 today receives an earnings yield of just 3%, and that is *if* the projected earnings recovery unfolds as forecasted.



The rise in the market's price far above and beyond corporate earnings should be reason alone to reflect on what has unfolded in recent years, and this is clearly seen in any measure of the market's value relative to earnings. A yield against projected corporate earnings of 3% equates to a current P/E ratio of 33, which is well above a more typical P/E of 20, and the cyclically adjusted P/E of the S&P 500 currently sits at 38 — just 14% shy of the all-time peak of 44 seen in 2000.

However, other measures show that the current bubble has gone well beyond the tech bubble. When the value of the U.S. equity market is viewed relative to gross domestic product, a relatively simple valuation method that nonetheless accurately highlights periods of extreme exuberance, it is easy to see how the current market has, quite literally, gone far beyond all prior bounds to heights which have never been seen before. Or, put simply, the market has gone "off the charts."



We would encourage taking a few moments to let the meaning of the message in this chart sink in. The quote above from Jeremy Grantham was excerpted from an interview he gave with Bloomberg this past month, and as he notes, over the past year the market has checked all the boxes of a major speculative peak. As a self-described student of market bubbles, he views this bubble as the most consequential event of his investing career. The chart above, which shows a blowoff that is unparalleled in post-war market history, agrees with that assessment.

Yet, amid these circumstances, the majority of the asset management industry remains narrowly focused on predicting just how high the market will go in the wake of this pandemic recession, or which sectors of the market are best positioned to outperform in the years ahead. From an absolute value perspective, this is a classic example of industry-wide cognitive dissonance. As Grantham stated so succinctly in his interview, discussing the incredible circumstances beyond that narrow cyclical focus is *uncommercial* and *inconvenient* at the least, and at worst, the circumstances are *psychologically invisible* due to their severity. For the majority of the asset management industry, the consequences of this period are better left not thought about, let alone discussed.

When the magnitude of the consequences of this period is thought about, however, it brings us back to those few asset classes which have proven to be consistently negatively correlated to risk assets, and that brings us back to precious metals. Gold can decline for a myriad of reasons in the short term, and when the stock market booms as it has over the past year, gold often stagnates as money chases risk assets. This is part of the negative correlation precious metals have with risk assets. However, it appears clear that precious metals will likely prove to be one of the few asset classes that thrive in the market environment following this bubble in risk assets, as it will likely be defined by an extended era of negative real interest rates.

Beyond the cyclical discussion of tapering the rate of asset purchases, and beyond any thoughts of increasing interest rates years down the road, the Fed will eventually have to respond to the end of this bubble in risk assets — and this is the primary reason we remain focused on gold and real assets. Precious metals historically have had positive returns during periods of declining risk asset valuations, and instead of gambling on how high U.S. stocks will stretch before their off-the-charts valuations begin to decline, we are maintaining investments which have a positive absolute outlook through that inevitable reversion. In the years ahead, these investments will likely distinguish themselves from the gambling prevalent in the market today.

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