Sitka Pacific
Capital Management, LLC

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Dear Investor,

It has now been a year since the global economy entered the deepest contraction since the 1930s, and it was also a year ago this month that the fiscal and monetary response to the pandemic began. Since last March, there has been $5 trillion of supplemental spending enacted by Congress, which amounts to 23% of pre-pandemic U.S. GDP. This is a stunning infusion of economic support in such a short timeframe, and it includes the $1.9 trillion relief bill passed this past month, which is now flooding into the economy. In addition, the Federal Reserve expanded its balance sheet by 16% of GDP over the past year, by purchasing $3.4 trillion of Treasury, mortgage, and corporate bonds. This amount nearly equals the $3.6 trillion it purchased in the seven years after the financial crisis in 2008.

Although the labor force remains far below its pre-pandemic peak, optimism has been increasing lately that the year ahead will see significant progress toward recovery. As deep as the contraction has been, it is clear the massive fiscal and monetary response over the past year has prevented a far more dire economic outcome from unfolding in the wake of this recession.

It is also clear that while the most significant economic risks may be starting to fade, the markets have only just begun to reckon with the impact this recession will have on monetary policy and inflation in the years ahead. Beyond the sugar-high from injecting such a massive amount of stimulus into the economy and the markets in such a short amount of time, the legacy of this recession will be measured in years, not months. After the financial crisis, the Federal Reserve was able to slowly bring quantitative easing to an end after seven years, and it was able to begin slowly increasing short-term interest rates after eight years. It took a full decade before real interest rates turned positive after the Great Recession, and circumstances today suggest negative real rates will be around for longer.

So far in 2021, we have seen just how interest-rate sensitive stocks are. As the 10-Year Treasury yield rose as high as 1.75% in March, sectors of the market with the longest effective duration — namely technology stocks whose profitability is far off in the future — were quickly impacted. This illustrated how sensitive risk assets are to even a modest (< 1%) increase in nominal yields, and this fragility is at the heart of the illusion of value created by ultra-low bond yields over the past year. This illusion has been the subject of much public debate in recent months, and we will distill some of the practical implications of that debate in the pages below.

In this month's letter:

- Shiller's ECY Makes Relative Sense, but the Market's Absolute Return May Be Another Story
- The Federal Reserve Is No Longer Acting on Expectations and Assumptions

Shiller's ECY Makes Relative Sense, but the Market's Absolute Return May Be Another Story

> *We cannot know how the COVID-19 pandemic will end, and it may well end soon with the advent of effective vaccines. But a key takeaway of the ECY indicator is that it confirms the relative attractiveness of equities, particularly given a potentially protracted period of low interest rates. It may justify the FOMO narrative and go some way toward explaining the strong investor preference for equities since March.*
>
> *Eventually, down the line, bond yields may just rise, and equity valuations may also have to reset alongside yields. But, at this point, despite the risks and the high CAPE ratios, stock-market valuations may not be as absurd as some people think.*
>
> - Robert Shiller, *Making Sense of Sky-High Stock Prices*, November 2020

It often happens that associations which end up leaving an indelible mark on our collective memory of certain market events are the result of sheer happenstance. One instance of this is our association of the phrase *irrational exuberance* with the peak of the tech bubble twenty-one years ago. The phrase is most widely associated with Yale professor Robert Shiller, whose book titled *Irrational Exuberance* happened to be published in March 2000 — the very month that marked the peak of the tech bubble. If there was a single moment in the last few decades which defined irrational exuberance in the stock market more than any other, it was the frenzied buying in those last weeks leading up to the March 2000 peak. From that moment, *irrational exuberance* entered our cultural lexicon as the definition of the bubble experience, and it has been there ever since.

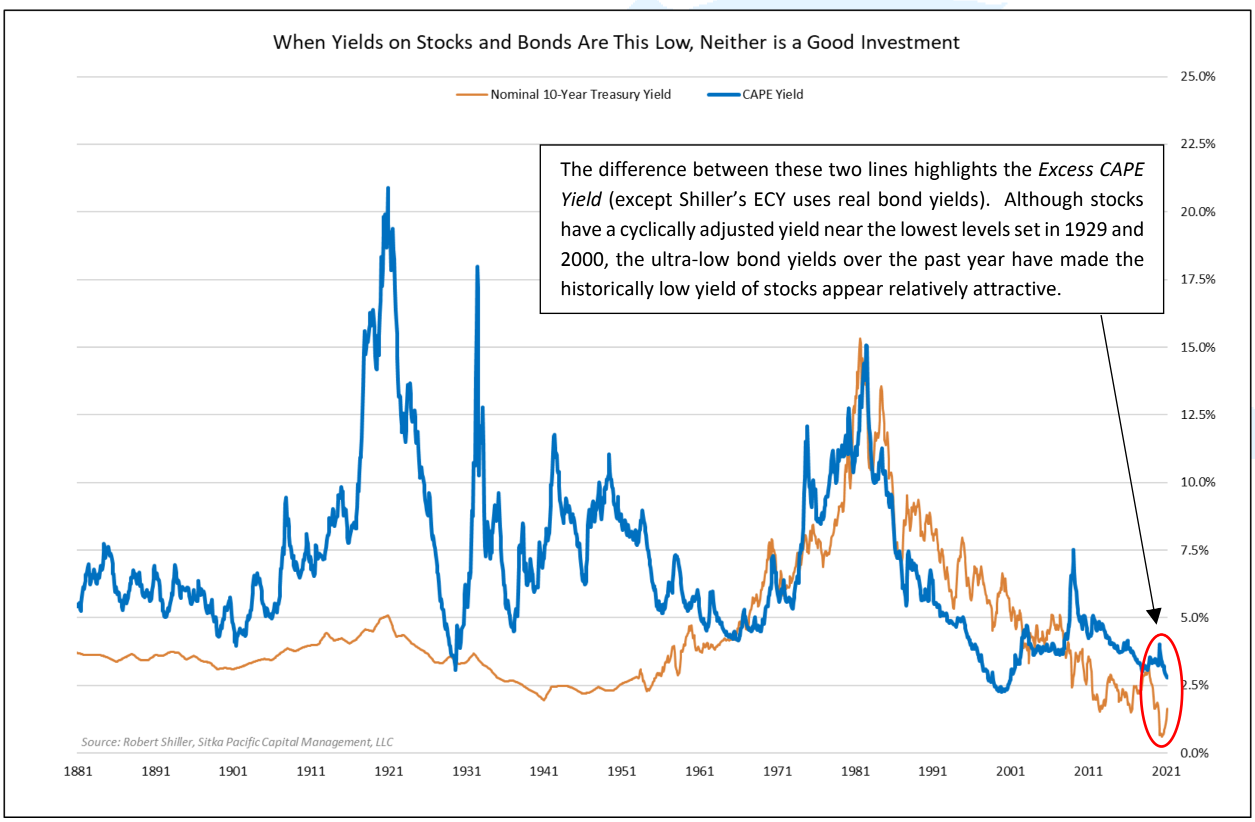
If the book *Irrational Exuberance* had been published a year earlier, or a year later, the phrase probably would not have the same legacy, as Shiller was not the first person to publicly cite irrational exuberance during that period. Fed Chairman Alan Greenspan used it in congressional testimony to describe the conundrum facing policy makers in judging the value of the stock market in 1996. In hindsight, 1996 happened to be the year which marked the beginning of the tech bubble's speculative frenzy, and if not for Shiller's book, *irrational exuberance* may have had a different legacy; perhaps a phrase marking the beginning of a bubble, not the end. As it happens, Greenspan's use of *irrational exuberance* marked the moment of liftoff of the tech bubble, while Shiller's book marked the moment it came to a crashing end. Those two uses of the same phrase neatly bookended the most speculative period in stock market history.

While the precise timing of the publication of *Irrational Exuberance* in March of 2000 may have been random chance, Shiller proved in subsequent years that his analysis was not the result of happenstance. The appearance of the first edition of *Irrational Exuberance* marked the peak of the tech bubble within a month, and the second edition of the book was published in 2005 — and it included a detailed discussion of the housing bubble. Within a year of the publication of the second edition, home prices in the U.S. reached their peak, and in the years that followed, investors endured the bursting of the second major market bubble within a decade.

It is not an extremely complicated task to look at a market's valuation and assess whether it is likely overvalued, but it is nearly impossible to know just when an overvalued market will stop becoming even more overvalued, and begin to deflate. Yet with the first two editions of *Irrational Exuberance*, Robert Shiller managed to do the nearly impossible — twice. As a point of fact, however, Chairman Greenspan's assessment of the market's overvaluation in 1996 proved not entirely off the mark. While Shiller's book marked the precise moment the bubble popped, Greenspan's assessment happened to be made early in what turned out to be the largest market bubble since 1929. In the end, all the of gains made subsequent to his testimony proved to be temporary, which showed that his basic assessment was correct; the S&P 500 traded at the same level in 2003, and again 2009, as it did when he testified before Congress in December 1996. The ephemeral nature of gains is a hallmark of an overvalued market, as is the difficulty in precisely timing the deflation of those short-lived gains.

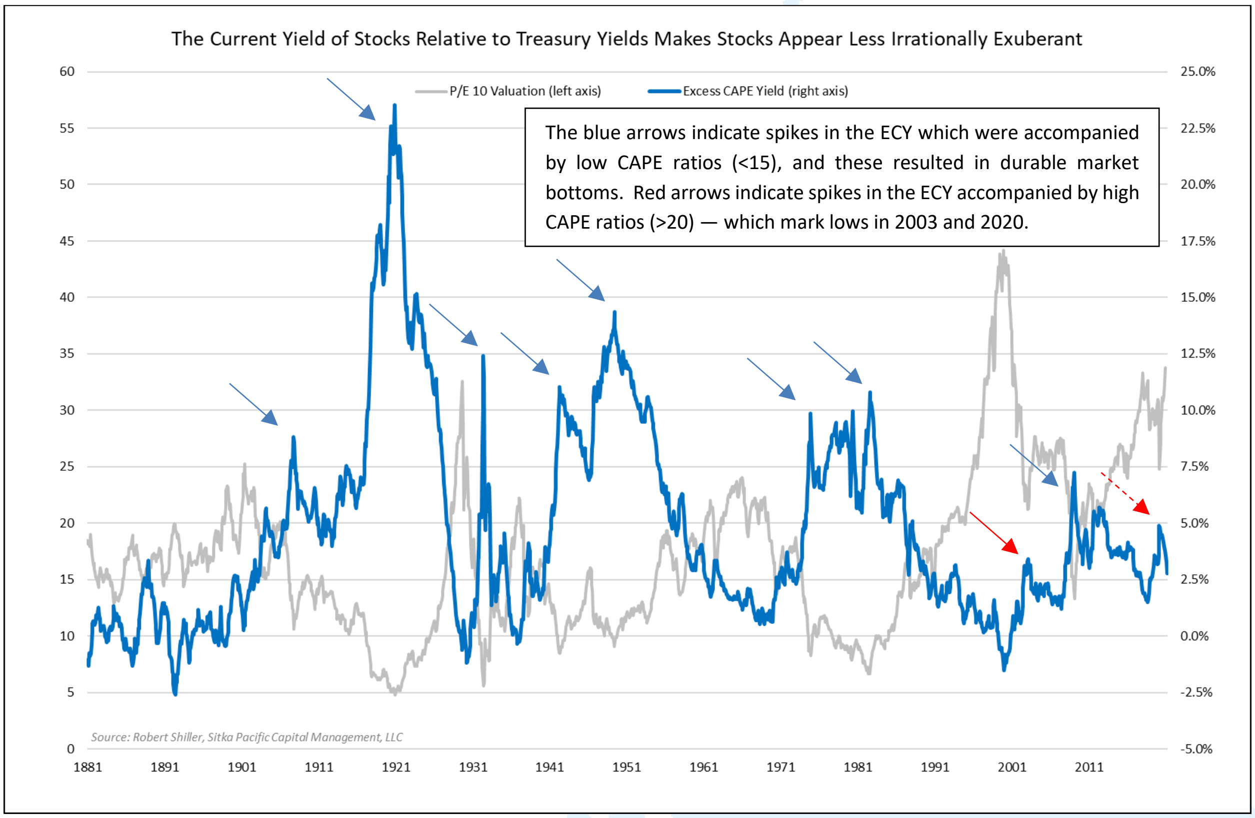
The third edition of *Irrational Exuberance*, however, showed that even Robert Shiller was not immune from the inherent difficulty of timing an overvalued market. Published in 2015, in the third edition Shiller turned his attention to bonds, commenting that holding bonds at the low rates which existed at the time was not likely to end well for investors. Although he did not call it a speculative bubble, and thought bond yields could well remain low for a while longer, he also thought having long-term bond yields near the long-term rate of inflation — or below — was clearly unsustainable.

Six years later, we now know that not only can long-term bond yields remain low, they can sink to levels which were nearly unimaginable just a few years ago. At the time of the publication of the third edition of *Irrational Exuberance*, the 10-Year Treasury yield was fluctuating between 2% and 2.5%. Since then, the 10-Year Treasury yield has sunk to as low as 0.4%, and major benchmark yields outside the U.S., such as in Japan and Germany, have fallen below zero.



It is difficult to understate the impact the continued trend lower in long-term interest rates since 2015 has had on risk asset valuations, especially over the past year. When long-term "risk-free" rates fall to near zero, as in the case of the U.S. in 2020, or *below* zero, as continues to be the case in Japan and Germany, the higher yield received from other assets becomes all the more sought after. And when those long-term rates are below the expected rate of inflation, yields which remain above the rate of inflation are highly valued.

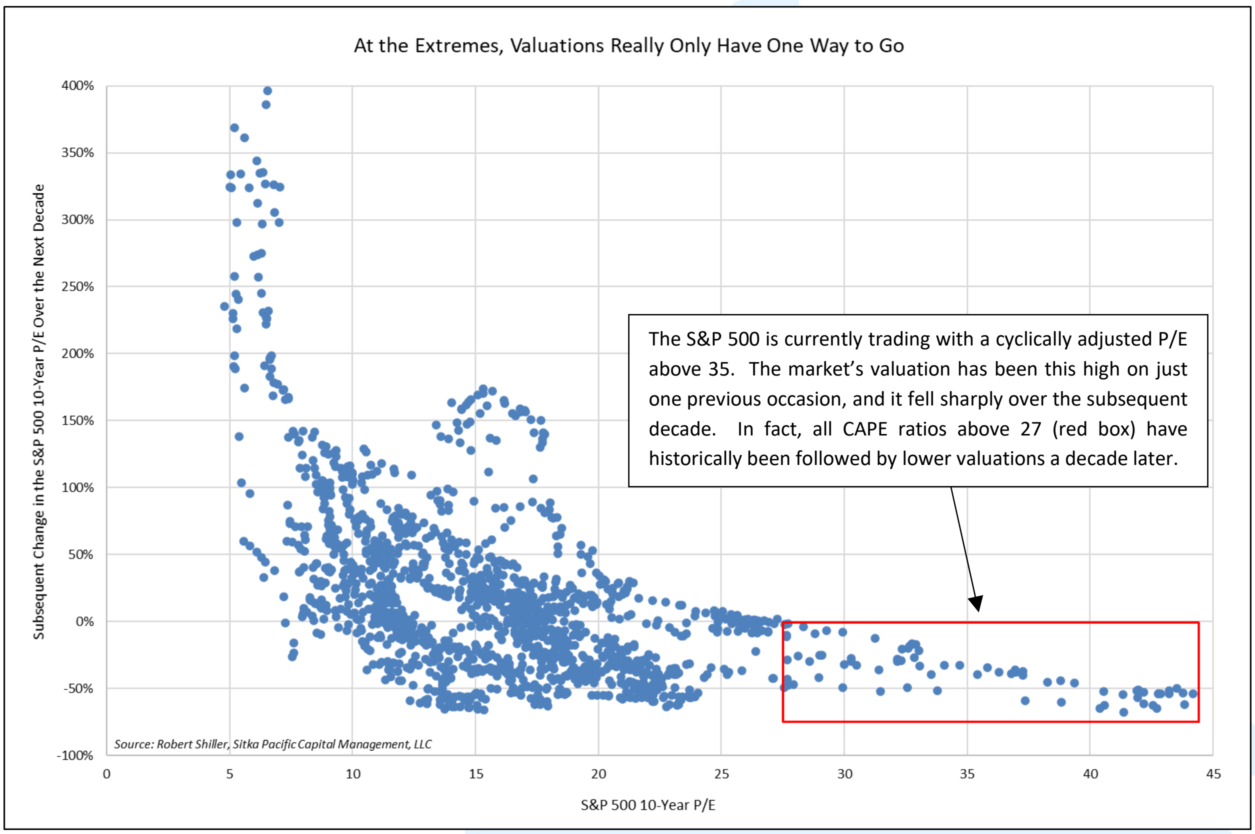
To better visualize this dynamic between low risk-free yields and the valuation of the stock market, Shiller released a new indicator last fall: the ECY, or the *Excess CAPE Yield*. The value of the ECY for the S&P 500 is calculated by taking the cyclically adjusted earnings yield (using the average earnings over the last ten years) and subtracting the real, inflation-adjusted 10-Year Treasury yield. The result is the excess real yield investors receive by owning the S&P 500 instead of 10-Year Treasury notes.



Within the realm of institutional asset management, which is largely confined to assessing the relative attractiveness of stocks, bonds and cash equivalents, the blue line in the chart above showing the Excess CAPE Yield represents the best option among the three. With interest rates at zero, cash equivalents represent a near-certain inflation-adjusted loss in the years ahead. Long-term Treasury yields are also below the expected rate of inflation, and the rise in long-term rates this year highlights the added risk of these supposedly risk-free securities in the face of rising inflation expectations. Investment grade corporate bonds have also had a negative return this year. Amidst these poor cash and bond options, the positive excess earnings yield received by owning stocks seems to be the only real alternative when investment options are restricted to U.S. stocks, bonds, and cash.

Yet choosing the "least bad" investment option does not guarantee it will lead to a positive absolute return. The overall return investors receive from publicly traded stocks is not simply the earnings of the underlying corporations — it is also a function of the value at which those earnings trade.

The earnings yield of the S&P 500 is a combined measure of the earnings of the underlying companies *and* the valuation at which investors are currently willing to trade partial claims to those earnings. The absolute return that investors realize from owning stocks depends significantly on how the valuation of underlying corporate earnings changes, especially over the time horizons relevant to most investors — i.e., holding periods less than 15–20 years. If the market's valuation of earnings rises, investors in stocks will receive a return greater than the underlying corporate earnings yield. If the market's valuation of those earnings declines, however, investors will receive a return less than the underlying corporate earnings yield. And, importantly, if the valuation of those earnings declines by a greater amount than the earnings yield, the overall return investors realize will be negative — regardless of how much earnings rise, or how much the economy grows.

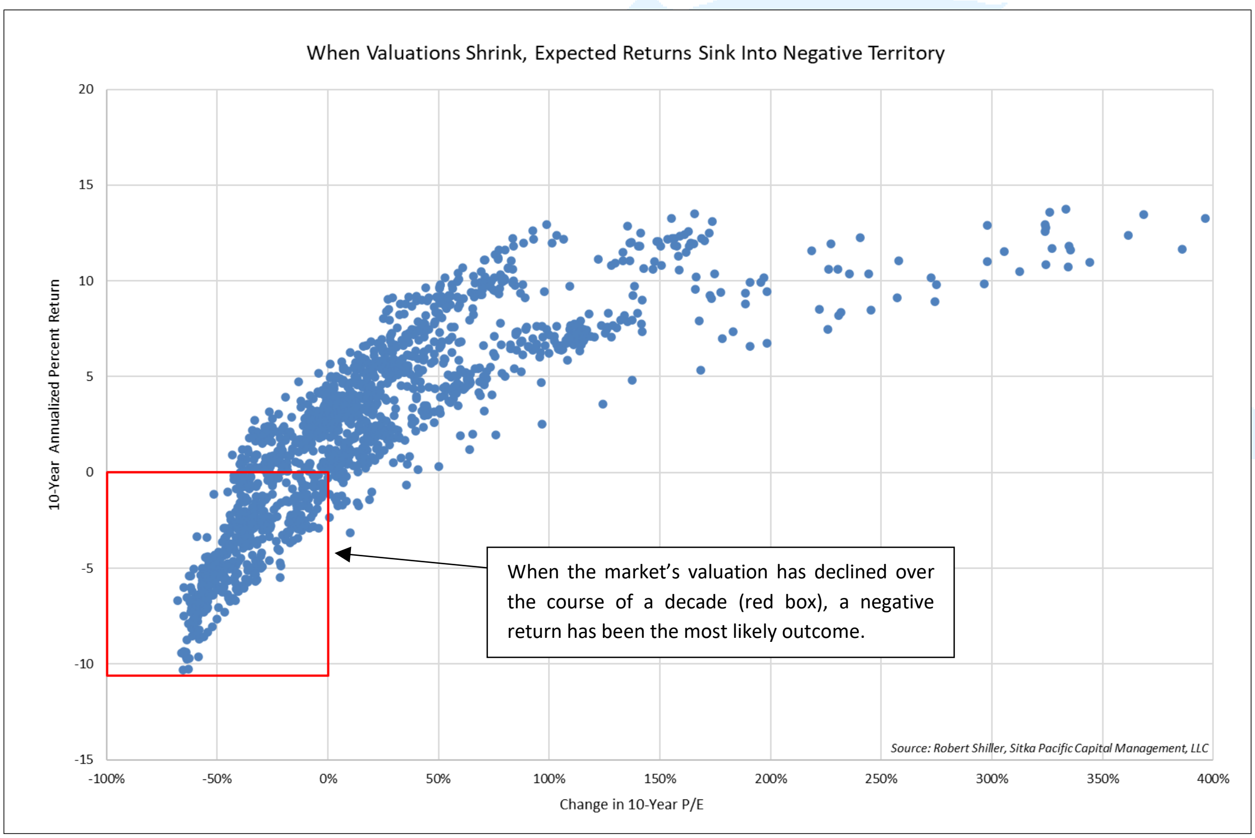


Investors in bonds learned this lesson during the first three months of this year, as the price of long-term bonds declined far more than the coupon yield, and investors in stocks learned this lesson thoroughly during the 1970s. Corporate earnings tripled between 1970 and 1980, as gross domestic product more than doubled, but investors in stocks suffered a negative return due to falling valuations. The trend in the market's valuation alone can determine whether stocks end up providing a positive or negative absolute return, and that is particularly the case when valuations are at extremes, as they are today.

Over the past forty years, the rate of inflation and interest rates have gone from one extreme (high) to the other (low), and the decline in both of those rates fueled the dramatic rise in the stock market's valuation over that timeframe. But investors today should be asking themselves whether or not there is room for those trends to continue, in light of the extreme lows in long-term yields reached last year and the Federal Reserve's new commitment to higher inflation. If the lowest levels in interest rates and inflation rates have been seen, then the two strongest tailwinds powering the forty-year-long expansion in risk asset valuations have just turned into headwinds.

In some of his commentary since he released this new indicator last fall, Shiller has emphasized the dual nature of the market's valuation at the moment — it is both expensive and reasonably priced. In his view, it is *expensive* based on its valuation relative to earnings, but it is *reasonably priced* given that cash and bonds offer negative real returns. Yet when the analysis stops there, it leaves out what is arguably the most important factor for equity investors: whether valuations will rise, fall or stay the same in the years ahead.

If valuations stay at these record levels, or rise, investors can expect to earn the current 2.8% earnings yield underlying stocks today, plus any rise in valuation. However, if valuations do not stay the same or rise further, it will only take a modest 2.8% average annual decline from valuation for stocks to join bonds and cash with a negative return from today's prices. The chart on the previous page suggests this outcome is quite likely, and the chart below highlights annualized returns realized when valuations have declined. While the Excess CAPE Yield may succinctly illustrate the rationale behind the surge in stocks over the past year, it offers investors no assurance of a positive absolute return.



The Federal Reserve Is No Longer Acting on Expectations and Assumptions

> *It has taken four decades, but the Federal Reserve has finally shaken off its fear of inflation. The markets are only just waking up to the implications of the shift.*
>
> *The outlines of the turnaround have been developing for a while as the Fed's focus has moved from its inflation mandate to a constant emphasis on its goal of full employment. Meanwhile, its measure of rising prices has moved to an average target, allowing inflation to overshoot a 2% goal to make up for past misses.*
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> *Last week, Fed Chairman Jerome Powell underlined the final two steps: looking at where inflation actually is, rather than worrying about where it is forecast to be, and making clear that neither the current wild excess in the stock market nor the recent run-up in bond yields bothers him.*
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> \- The Wall Street Journal, March 21, 2021

It was remarkable to watch Federal Reserve Chairman Jerome Powell this past month reiterate the same message he has been consistently delivering since last year, but to do so in the midst of a surge in Treasury bond yields. Investors in Treasury bonds recorded their worst quarterly loss since 1980 over the past three months, as the 10-Year Treasury yield rose from 0.92% at the end of 2020 to 1.75% in March. This represents a 90% increase in yield, and, for the moment at least, it also represents a return to the pre-pandemic range of long-term yields.

Amidst the surge in long-term yields, there was a palpable eagerness among market forecasters to hear what Fed Chairman Powell would offer as a response at the March FOMC meeting. During the long recovery after the financial crisis, the Fed closely monitored conditions in the bond market, and eventually revived a policy from the 1960s — Operation Twist — to tailor its quantitative easing purchases and micromanage the long end of the Treasury yield curve. Given the recent rise in long-term yields, there was an expectation the Fed would follow in its own post-2008 footsteps.

The European Central Bank appeared to open the door to such a response in early March. European Central Bank President Christine Lagarde made it clear the ECB viewed the rise in yields as a threat to the recovery, saying at the press conference following the ECB's March meeting: *If sizeable and persistent, increases in these market interest rates, when left unchecked, could translate into a premature tightening of financing conditions for all sectors of the economy*. And later in the month, when asked about what the ECB would do should investors push rates higher, she added: *They can test us as much as they want. We have exceptional circumstances to deal with at the moment and we have exceptional tools to use at the moment, and a battery of those. We will use them as and when needed in order to deliver on our mandate and deliver on our pledge to the economy.* These comments are remarkable given that the main long-term benchmark yields in Europe remain negative.

In contrast, during the press conference following the FOMC's March meeting, Chairman Powell took the opportunity to again make it clear that U.S. monetary policy is now being guided by a very different framework — one that is less concerned with micromanaging market expectations, and more concerned with actually achieving its long-term goals. He repeatedly emphasized that the U.S. economy remains a long way from getting back to a state of "full employment," and then reminded his audience that even at very low levels of unemployment in the years leading up to the pandemic, the Fed's goal of 2% inflation had not been achieved. In a telling remark, he said: *There was a time when there was a tight connection between unemployment and inflation. That time is long gone. We had low unemployment in 2018 and '19 and the beginning of '20, without having troubling inflation at all.*

Powell repeatedly emphasized the Fed was no longer conducting monetary policy on the assumption inflation will inevitably return as the economy recovers, as it did following the financial crisis. When asked about how high he would let inflation rise in the years ahead, this was his response: *I would say the fundamental change in our framework is that we're not going to act preemptively based on forecast, for the most part, and we're going to wait to see actual data. And I think it will take people time to adjust to that and to adjust to that new practice and the only way we can really build the credibility of that, is by doing it.*

The contrast between these remarks and the inflationary fears which permeated decision-making at the Federal Reserve in the years after the financial crisis could hardly be clearer. The Fed has more or less lost its fear of inflation, and in the years ahead, monetary policy will not likely be restricted by the same hesitancy which underpinned decisions in the years after the financial crisis — a hesitancy which reacted to expectations instead of outcomes and resulted in a decade of undershooting its 2% inflation target. As the Wall Street Journal succinctly summarized in the quote above, it appears the markets have only just begun waking up to the long-term implications of this new monetary regime.

The last four decades has seen inflation rates steadily trend lower, but the goal of the Federal Reserve's new framework is to upend that trend and generate higher inflation. When we look at the investment value of U.S. stocks and bonds in that context, the relative value debate ignores the risk that yields of both stocks and bonds will rise over time with higher inflation. In that case, absolute value will prove more relevant to the returns investors actually receive than relative value, and both stocks and bonds are vulnerable to a valuation reset. This is just one reason we remain focused on investments and markets with attractive absolute valuations.

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