May 2020

Dear Investor,

After the market turbulence in February and March, the relative calm in April and May seemed to allow room for investors to begin assessing what exactly had happened over the past few months, and what all of it means going forward. The decline in the equity market in February and March was the steepest decline of more than 30% on record, and the seizure of the credit markets was paralyzing enough to induce the largest monetary response on record. In the two months since then, some of the underlying economic reasons for the market volatility have begun to come into view, as over thirty-six million people have filed initial unemployment claims. Although measuring the real extent of such a sudden surge in unemployment is problematic, given the frequency and methodology of the monthly employment report, it seems clear that the real unemployment rate is now higher than at any other time in the post-war period.

For many, this downturn will be the most traumatic economic event of their lifetimes; and if it has not risen to that level already, it will likely rise to that level in the months and years ahead. One way to think about the current situation is as a water pipe that has burst during a sudden deep freeze. The pipe is broken, but with the line frozen there is no flooding in the basement … yet. There are now many such frozen pipes throughout the economy, but so far, the damage appears to be limited, in part, by the policy response: the Federal Reserve's purchase of $3 trillion of financial assets, even junk-rated bonds; the federal government's swift enactment of trillions of dollars of new spending; and the implementation of mortgage forbearance programs. As a result, the visible flooding in the financial markets has been limited. However, when the financial thaw begins, so to speak, and the extent of the damage and the repair costs begin to come into view, there will likely be a greater impact on real asset prices than we have seen thus far. That process remains ahead of us.

It is not easy to maintain a longer-term perspective during a crisis, but the process unfolding over the past few years — the peak in the market's valuation in 2018, the failed attempt to normalize monetary policy in 2019, and the return of real asset outperformance — has been an almost textbook long-term turning point. In that context, in this month's letter we'll discuss what appears to be the emergence of an agreement between the U.S. Treasury and the Federal Reserve to coordinate monetary and fiscal policy, and the long-term implications of such policy coordination.

In this month's letter:

- A Decade into Deleveraging, It Feels Like Another Treasury–Fed Agreement Is Now in Place
- Warren Buffett Senses Something He Doesn't Like

Sitka Pacific Capital Management, LLC
Phone: 425.967.5533 • Fax: 888.877.1314 • Email: investing@sitkapacific.com
www.sitkapacific.com

A Decade into Deleveraging, It Feels Like Another Treasury–Fed Agreement Is Now in Place

> *On April 30, 1942, the Federal Reserve Announced its commitment to purchase all ninety-day Treasury Bills offered "on a discount basis at the rate no higher than 0.375 percent per annum." It did not fix rates on other government securities explicitly, but it established a pattern of rates that it maintained throughout the war and beyond. It held one-year rates at 0.875 percent. At the longest end, it held the rate on bonds with twenty-five years or more to initial maturity to a maximum of 2.5 percent…*
>
> *By the end of the war, short-term government securities had become the Federal Reserve's principal asset. The pre-World War I problem of a portfolio insufficient to offset a gold inflow or, in the 1930s, excess reserves greater than the portfolio, would not return. Financing World War II left the Federal Reserve balance sheet and the monetary base dominated by the open market portfolio. This result was different from the founders' plan; the System had become an indirect source of government finance.*
>
> \- *A History of the Federal Reserve*, by Allan Meltzer

> *A few participants also noted that the balance sheet could be used to reinforce the committee's forward guidance regarding the path of the federal funds rate through Federal Reserve purchases of Treasury securities on a scale necessary to keep Treasury yields at short- to medium-term maturities capped at specified levels for a period of time.*
>
> \- FOMC Meeting Minutes, April 28–29, 2020

The past few months has been a time which few alive today can draw any close parallels to, in terms of their personal experience. When a society-wide shock comes along, and we have to blow the dust off albums filled with sepia-colored photos and read news reports from a century ago in order to get a feel for what it was like to live under a pandemic lockdown, then you know you're dealing with something that current investors have no direct experience with.

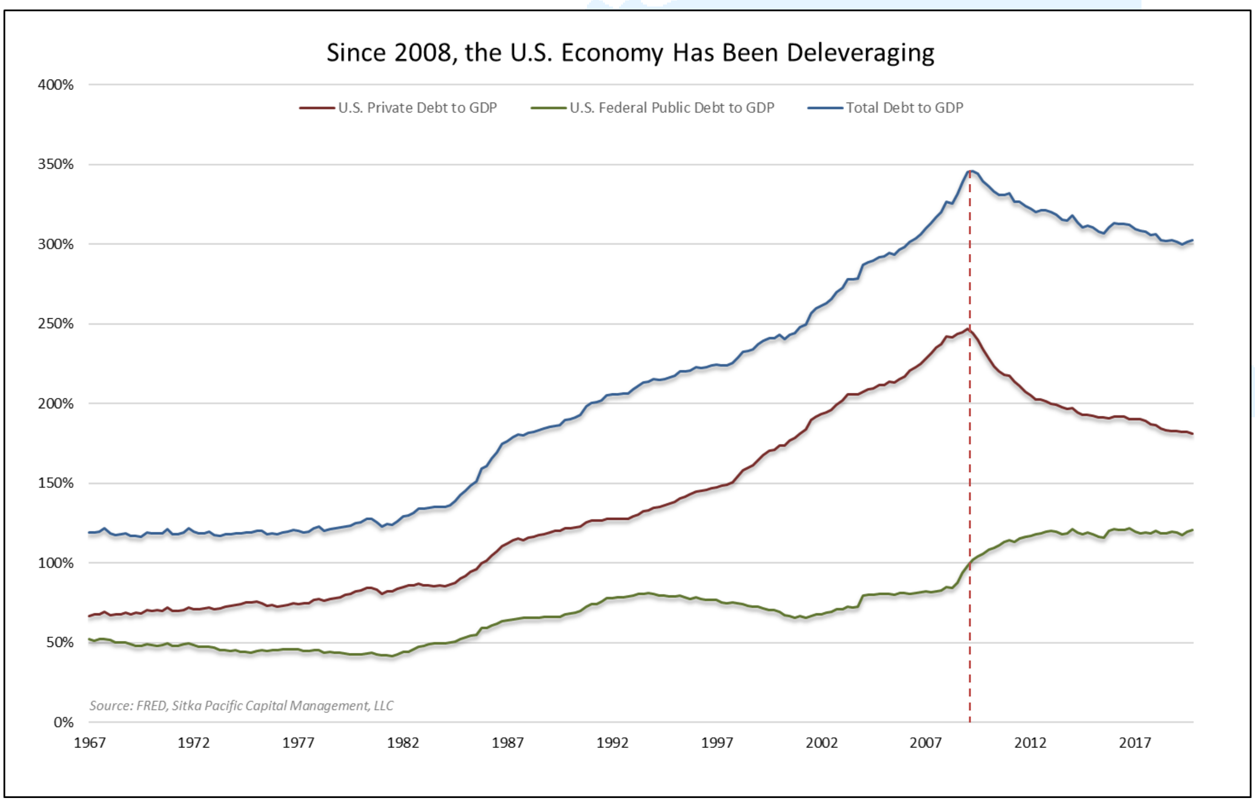
The immediate temptation in circumstances like these is to think that something like this has never happened before, or that it came from so far out of left field as to be a *Black Swan*, but such reactions say more about that lack of direct experience than historical reality. In fact, the example of a pandemic was used in the book by Nassim Taleb to illustrate a rare event that is, unlike a true Black Swan event, entirely predictable. There have been four near-pandemic viruses just in the past twenty years, but none of them rose to a level which significantly impacted the U.S. economy; a list of pandemics throughout history that were large enough to have a significant economic impact was included in last month's letter. And there have been those like Taleb, and others like Bill Gates, who have been warning in recent years that it was only a matter of time before a virus came along which *would* have a significantly greater impact. Yet the problem with risks such as these is that they are, by their very nature, rare — rare enough to relegate warnings from those like Gates to background noise, or dismiss them entirely.

These themes, that of current investors having no direct experience with key issues facing the markets and the economy today, and risks that are rare but also near certain to affect the markets in significant ways when they do occur, have permeated our discussion in these letters for some time. There have been several reasons for this, all of which center on fragility and the tendency of investors to focus myopically on recent experience.

Many of the assumptions underlying financial markets and asset prices these days grew up entirely in the post-war era. In fact, it was not until after World War II that most economic data began to be published more frequently than an annual basis. Before then, investors took their cues almost entirely from individual companies themselves, but even that company-specific information was often opaque and difficult to obtain.

It was not until the 1960s that a *portfolio theory* culture took root on the foundation of more reliable and accessible economic and market data, and this spawned the asset management industry as we know it, along with many of the popular investing mantras we are familiar with today. For example, the idea that a portfolio's overall risk could be reduced by owning a mix of asset types with various correlations appeared in 1952 in a paper published by Harry Markowitz, and the Black-Scholes model, which underlies most derivative prices, was introduced in 1968. More than any others, these two ideas have shaped the modern investing world, and today's asset management industry is a product of these post-war theories and data.

It represents a significant problem, then, that in many ways the post-war era came to an end with the credit crisis. It was a shock when previously uncorrelated or negatively correlated asset classes all fell together in 2008, and leveraged portfolios built on the assumptions of the reduced risk of owning a broad range of assets suddenly collapsed; Modern Portfolio Theory and Black-Scholes said that wasn't supposed to happen, or at least it wasn't expected to happen but once in a thousand years or so. It is also possible, however, that the models being used to make those estimates were not including enough data to give results which approximate the real world — the world outside the confines of the post-war era.



The years immediately following the end of World War II marked the end of the private-sector deleveraging that had begun with the onset of the Great Depression, twenty years before. From that time in the late 1940s, up until the credit crisis in 2008, private sector debt levels steadily rose. The earliest quarterly data available suggests private sector debt was only around 38% of GDP in 1951, but by 2008 it had risen to 245% of GDP — a rise of more than five-fold. The market turmoil in 2008, which resulted in financial market correlations and price movements which were not supposed to happen, was really the onset of an economic paradigm — private sector deleveraging — that hadn't been seen since before the post-war era data boom began.

Since the credit crisis, there has been a growing list of issues which defy post-war market and economic logic, including persistent slow growth, low inflation, and ultra-low bond yields, including negative interest rates. And all of this despite what appeared to be extremely stimulative monetary policy: i.e. zero percent interest rates and quantitative easing. This outcome does in fact defy post-war economic logic, but the apparent conflicts dissolve when the time period considered is expanded beyond the post-war era. The 1930s and 1940s encompassed a period of private sector deleveraging, and after the trough in 1933 there was a period of economic growth which was similar in many ways to the experience after 2009. And then a decade into the private-sector deleveraging during the Great Depression, there was a shock that prompted a complete transformation of the government's role in that long recovery. These are lessons which reside just outside the post-war experience that underlies so many market assumptions, but they will likely prove quite relevant in the years ahead.

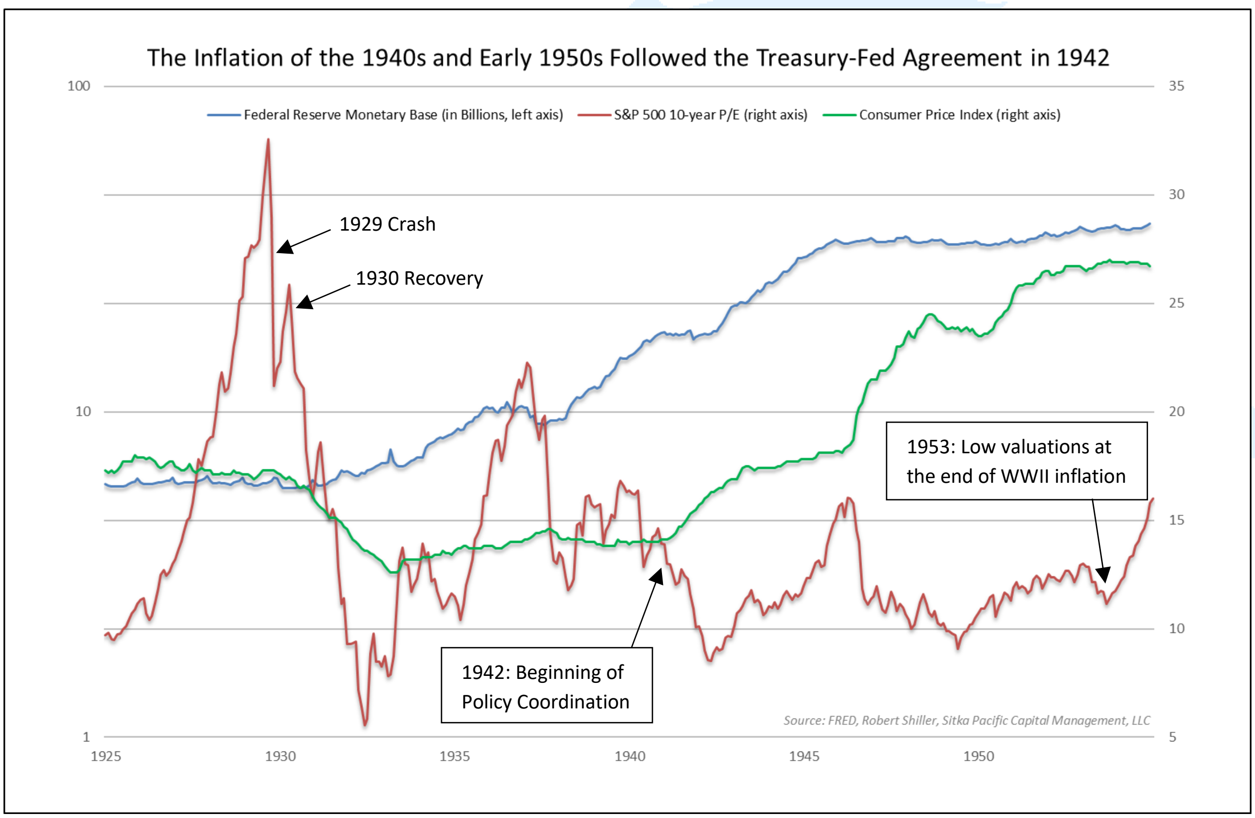
In 1942, the Federal Reserve was suddenly faced with a set of problems not too dissimilar from what it has been faced with in the last few months. With the U.S. suddenly plunged into World War II following the attack on Pearl Harbor the previous December, the staff within the Federal Reserve estimated that the federal government would have to borrow upwards of $200 billion over the next few years to finance the war effort. Since the federal debt in 1941 was only $58 billion, this represented an astronomical amount of borrowing.

Partially as a result of the inflationary experience during and after World War I, the spending for which was financed largely by monetary expansion, the Roosevelt Administration, spearheaded by Secretary of the Treasury Henry Morgenthau, favored financing as much as possible of the WWII wartime spending directly by taxation. Morgenthau correctly understood that inflation was a form of taxation, but he preferred to levy taxes directly so the tax burden could be targeted and specific. In the first months of the war, significant tax increases were passed through Congress, and new taxes ended up paying for a significant portion of the cost of the war — close to 50%. But even with those tax increases, the Fed anticipated there would still be a need to borrow at least $200 billion by the end of 1944.

The Fed felt that its primary duty during the war was "the financing of military requirements and of production for war purposes," which was a far cry from the goal before the war of maintaining price stability. In practice, this meant the Fed would do what it could to enable the federal government to finance the war at the lowest cost possible. This was primarily achieved by expanding available bank reserves on buying up Treasury securities from the open market (i.e. quantitative easing), which enabled the banking system to absorb new debt issued by the government, and by capping the yields of new bills and bonds sold by the Treasury, ensuring the government would borrow at low rates.

The Chairman of the Federal Reserve at the time, Marriner Eccles, whose name still adorns the building where the Board of Governors meets in Washington D.C., later recalled that "the Federal Reserve merely executed Treasury decisions" during the war. The Fed and the Treasury were closely coordinated during those years, and it was Treasury Secretary Henry Morgenthau and other Treasury officials who often directly told the Fed what to do. When the Treasury needed to sell bonds, it often told the Fed at what yield it wanted to sell them, and the Fed then worked with the banks to have the bonds placed at the yield the Treasury wanted. If there was not enough demand to absorb the entire sale, the Fed bought the excess to make sure yields did not rise. Even before the war, Morgenthau often pushed on the Fed to facilitate the sale of bonds at the lowest yields possible, but after the war began, the Treasury explicitly directed the Fed to do so.

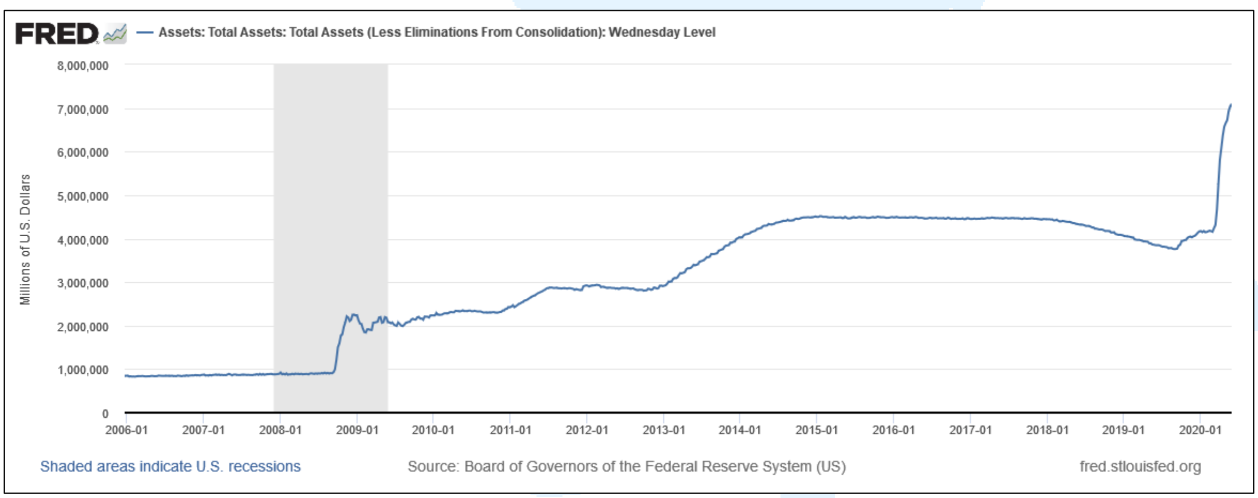
In order to stimulate investor demand for the Treasury's debt sales, in early 1942 the Fed began an explicit policy of not only facilitating new Treasury debt sales at low rates, but capping the rates at which Treasury bonds traded in the market. The thinking at the time was that if the public knew rates would not rise, banks and citizens would not wait for higher rates to buy Treasuries — they would buy today, instead of waiting for tomorrow. And if it were known that the Fed would prevent a rise in rates, those buyers, especially the banks, would not have to fear the significant loss of capital that always comes to holders of long-term debt when rates rise. By effectively fixing rates in 1942, the Fed helped create a virtuous cycle of debt sales and investor demand to fund the war effort.



The cost of these efforts was borne by the Fed's monetary base, which doubled between 1941 and 1945, and by the inflation which followed over the following decade. During the war years, there were severe restrictions in place on the production of consumer goods, as well as price controls and credit controls on consumer goods and commodities. All of these actions distorted the effect of the monetary expansion during the war. Over time, however, as price controls were lifted in fits and starts, and credit controls were relaxed, prices throughout the economy eventually adjusted to the vast monetary expansion. By the mid-1950s, the Consumer Price Index was double what it had been in 1941, just before the U.S. entered the war.

Chairman Eccles and others within the Fed during the 1940s agreed that the war was a national effort, and that the cost of winning the war belonged to the entire country. As such, the Fed in the 1940s did what it could to enable the government to fund the war effort, with the inflationary cost unfolding over the subsequent decade and a half. By the 1950s, when most of the widely available data series used in our present-day, post-war financial models begin, the turmoil of the Great Depression and the inflationary aftermath of the war years had passed.

The sentiments and actions of the Fed in the 1940s should ring familiar today, as Chairman Powell and the Fed have embarked on another vast monetary expansion in response to the economic cost of fighting the Covid-19 pandemic. Although there has been no formal announcement by the Fed that yields on long-term Treasury securities will be capped, the minutes from the most recent meeting of the policy-setting Open Market Committee made it clear that Fed officials were already thinking along those lines. And the actions of the Fed since March have made it clear that its balance sheet is already being used to keep the market for Treasury, mortgage and corporate debt functioning smoothly, *and at low rates*. As of this past month, the Fed's balance sheet has risen above $7 trillion for the first time in this effort, which is almost double its level of just a year ago.



It is rare for the Fed to comment on fiscal policy, other than to make general hints about the possible implications of tax and spending proposals, but this past month also saw Fed officials specifically, publicly recommend that the federal government enact more deficit spending measures, in addition to what has already been passed by Congress. For those who are familiar with the history of the

Federal Reserve, these were dramatic statements. They clearly reflect a deep fear within the Fed that the current economic downturn will result in significant long-term damage unless the federal government takes additional steps to help households and businesses stay afloat for the duration of the pandemic.

It will be some time before we know more about all the discussions which have taken place behind closed doors between the Treasury and the Fed in recent months, as well as any formal or informal agreements that have been made. Those involved will hopefully take the time to reflect on and eventually publicly record their experiences. However, from what has been seen so far, it appears the Treasury and the Federal Reserve are now working together in ways which are reminiscent of the agreement between the Treasury and the Fed in the 1940s. The Fed recognizes that the economic effects of the pandemic will last years, and that the federal government will, in the end, likely need to borrow an enormous amount in the years ahead — borrowing that the Fed appears more than willing to monetize. The fight is a national effort, and the Fed's actions so far make it clear that the cost of winning the war will belong to the entire country.

Warren Buffett Senses Something He Doesn't Like

Well, nobody knows how much of this money printing we can do. And, of course, we have politicians who like— and are in both parties, who like to believe that it doesn't matter how much you do. That we can ignore the whole subject and just print money as convenient. Well, that's the way the Roman Empire behaved, then it was ruined. And that's the way the Weimar Republic was ruined. And— it's— there is a point where it's dangerous. You know, and of course, my attitude when something is big and dangerous is to stay a long way away from it. Other people want to come as close as possible without going in. That's too tricky for me. I don't like it.

- Charlie Munger, February 2019

And we'll know the consequences of swelling the Fed's balance sheet. You can look at the Fed's balance sheet. They put it out every Thursday. It's kind of interesting reading if you're sort of a nut like me. But it's up there on the Internet every Thursday. And you'll see some extraordinary changes there in the last six or seven weeks. And like I say, we don't know what the consequences of that, and nobody does exactly. And we don't know what the consequences of what they undoubtedly will have to do. But we do know the consequences of doing nothing. And that would've been the tendency of the Fed in many years past, not doing nothing, but doing something inadequate.

- Warren Buffett, April 2020

Not long after writing last month's letter, in which we discussed how the market felt in the year following the 1929 crash, the transcript of Berkshire Hathaway's annual meeting, which was held virtually for the first time, was published. There had been a considerable amount of discussion in the press in the days following the meeting about what Buffett had said, and also a fair amount of controversy among Berkshire shareholders. The expectation ahead of the virtual *Woodstock for Capitalists* was that Buffett would use the opportunity to disclose all the ways in which Berkshire had taken advantage of the equity market selloff in March, given that he had accumulated over $120 billion in cash within the company in recent years, seemingly waiting for just in such an occasion to put it to work. Instead, however, Buffett struck an unexpected tone from the outset.

Warren Buffett has, for decades, been America's perennial equity market optimist. In his public comments, whether in an interview, an op-ed piece, or in Berkshire's annual meetings, he has always sought to emphasize the long-term benefits of betting on the continued success of the American economic system through the stock market. In the market turmoil following the 9/11 attacks, he said in an interview that his long-term outlook remained bullish. And in the darkest days of the credit crisis in 2008, he penned a New York Times article in which he told everyone he was buying stocks amid the market freefall: *In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary. So … I've been buying American stocks*, he wrote. This is the Warren Buffett who had, time and time again, offered reassurance that the market turmoil of today would inevitably be followed by a brighter and wealthier tomorrow for investors.

Although his optimism about the ability of the American economic system to create wealth and raise living standards over the long-term was still evident in this year's meeting, he spent an unusual amount of time discussing periods in which the upward trajectory of the country was interrupted by "very serious bumps in the road." He first discussed slavery and the Civil War, and then he spent a long time talking about the Great Depression, the lasting impact it had on the psyche of the country, and as a result, the lasting impact it had on the markets. He repeatedly emphasized that it took until the 1950s for the stock market to fully recover to the level it had reached in 1929, even though by the 1950s the economy had been doing better for quite some time. Being born in 1930 himself, he noted that he had graduated from college before the market rose above the level it had traded at on the day of his birth.

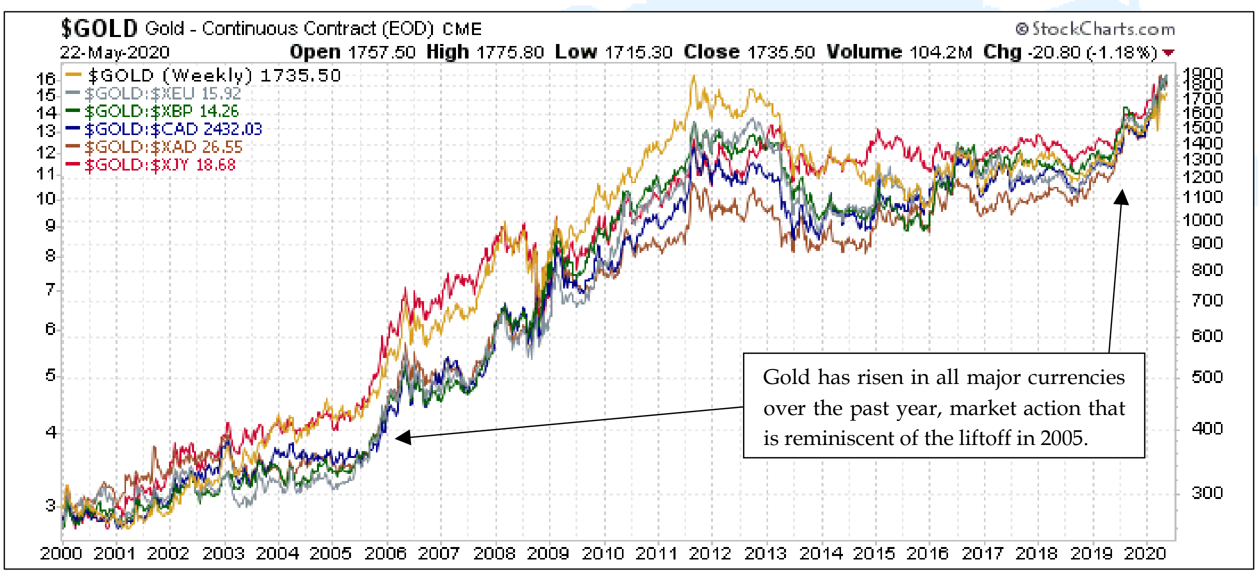
Later in his presentation, he disclosed, to the apparent disbelief of many, that Berkshire had *not* bought stocks in the March selloff, but instead had been a net seller; he had disposed of Berkshire's entire position in the four largest airlines. This was coming from the same man who once said: *Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold. When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons*. This time, however, he had not rushed outdoors with his washtub to collect bargain stocks, but had become increasingly cautious and increased Berkshire's cash position. He offered this partial explanation during the lengthy question and answer period following his presentation, in which he emphasized again that it took 25 years for the market to get back to even during the Great Depression:

> Berkshire will never get it in a position where it needs money. And we factor in, like I said, we factor in some things that are not ridiculously unlikely. And I'm not going to spell out scenarios because I, to some extent, you start spelling out scenarios, you may increase the chance of them happening. So it's not something that we really want to talk about a lot, but our position will be to stay a Fort Knox…
>
> We don't need … 130 or 35 billion, but we need a lot of money that's always available. And that means we own nothing but treasury bills. I mean, we've never owned, we never buy commercial paper. We don't count on bank lines and a few of our subsidiaries have them, but we basically want to be in a position to get through anything. And we hope that doesn't happen but you can't rule out the possibility any more than in 1929 you could rule out the possibility that you know you would be waiting until 1955, or the end of 1954, to get even. Anything can happen and we want to be prepared for anything…

To those who have followed Warren Buffett for a long time, the meeting was striking in its overall tone. Buffett has always been a relatively cautious investor, but he also has always been one to emphasize that the long-term investor has everything to gain by remaining invested in stocks through short-term market turmoil. This time, however, he chose to emphasize periods when investors had to wait decades to get back to breakeven, periods that we have termed *long-term bear markets* in these letters. It was clear, not only from his words, but especially from his actions, that he thought things may get significantly worse in the markets before they get better, and he's choosing to preserve Berkshire's cash on hand in case that happens. This is perhaps the most cautious he has acted since shuttering his investment partnerships in 1969.

It was also notable that Buffett spent more time than usual emphasizing that he didn't know what would happen to the economy as it worked through the pandemic, or what would happen in the wake of the Federal Reserve's response to the economic downturn. Buffett's usual optimism about the economy's inevitable bounce-back from recessions and other short-term setbacks was largely replaced by discussions of past recoveries that are measured in decades, not years. He also made it clear that there will be consequences down the road from the Federal Reserve's monetary response, though hopefully those consequences will be better than *the consequences of doing nothing*.

In the early 1960s, Buffett's mentor, the legendary Benjamin Graham, had become quite anxious about the high valuation of the broader market, and he expressed some of that caution in a lecture at a town hall meeting in San Francisco in November 1963, entitled *Securities in an Insecure World.* The lecture is a historical gem, as it captures the Father of Value Investing wrestling with the implications of an overvalued market. It is also a cautionary tale, in part because although the market was indeed overvalued at that time, and although investor caution was subsequently shown to have been warranted, by the time the market was undervalued again the entire monetary system that had existed in 1963 had broken down, and the inflationary path to market undervaluation could hardly have been conceived of when Graham spoke in 1963. Gold, as an investable asset, was still unlawful at the time, though it would prove to be the principal asset stocks recorded their devaluation against.



It was too bad that the Vice-Chairman of Berkshire, Charlie Munger, was not in attendance at Berkshire's annual meeting, because the onstage discussion of the consequences of the Fed's recent actions would probably have been animated. The quote above is from an interview Munger gave last year, and he was referring to what the Fed and other major central banks had done in the years after the credit crisis up until 2019. It is anyone's guess how his views have evolved over the last few months, as the Fed has expanded its balance sheet in a few months what took years to do following the credit crisis. It's probably safe to say, however, that at least some of Buffett's current caution stems from recent discussions with his closest business partner.

Over-valuation and over-indebtedness are sources of fragility, and the market action and monetary response over the past few months have placed the immediate consequences of that fragility on display for all to see. However, what Buffett perhaps senses is that the longer-term consequences of issues such as record corporate indebtedness have only begun to be felt, and that the upward spiraling double-helix of the federal government's debt and the Federal Reserve's balance sheet will eventually have consequences which come to bear heavily on market valuations, just as they have in prior long-term bear markets.

In the early 1950s, when Buffet was just starting his investing career, and the inflation stemming from the policy coordination between the Treasury and the Fed was coming to an end, the 10-year P/E of the S&P 500 was only a third of its 1929 peak. This decline in the market's valuation was the primary reason it took 25 years for the market to reclaim its 1929 peak, and, as Buffett knows, there is no reason such a long-term valuation decline cannot happen again. Based on the market action of the past few years, it appears such a process is already unfolding, and it is a process which we remain cognizant of and invested for.

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