May 2021

Dear Investor,

In last month's letter, our discussion focused on two demographic factors which will likely contribute to a more inflationary environment than unfolded in the decade after the financial crisis. Of all the influences on the markets and the economy, demographic trends are among the *longest* of the long-term influences. Population and demographic trends have little, if any, bearing on month-to-month or year-to-year measurements of inflation, such as is reported in the monthly release of the consumer price index (CPI).

As it happened, the CPI report just after that discussion caused a stir, as it showed a 4.15% increase in the headline number over the same month a year before, and a 2.96% increase in the "core" CPI, which does not include food and energy prices. These were the highest readings of year-over-year changes in the consumer price index in more than a decade, and the data release set off a vigorous debate over what it means. At the heart of this debate has been a simple question: how much of these price increases are due to factors which will fade once the effects of last year's historic economic shutdown fade? It is a debate which will undoubtably carry on in the months ahead, as more data is released comparing prices today with prices measured in the heart of the shutdown a year ago.

Fortunately, the raging debate over inflation this year has little, if any, significance for our current portfolio allocations. The shifts in the market environment over the past year, including the peak in the trade-weighted value of the dollar, and the emergence of a new era of negative real interest rates, are likely still in the early stages of impacting market prices and valuations. Long after the debate over the year-over-year CPI reports from 2021 has run its course, attention will eventually turn to the full impact of the tight corner U.S. monetary policy is now situated in. And it is this tight corner, more than current year-over-year inflation numbers, which will likely have the greatest long-term impact on investment opportunities in the years ahead.

One major impact from the shift in market environment over the last year has been the awakening of commodity prices. While real assets like gold have been trending higher for almost two years now, more economically sensitive commodities are now clearly rising out of trading ranges that have defined the past twelve years. We will highlight the recent rise of commodities in the pages below, and then offer few comments on the market's assumptions of the future of interest rates.

In this month's letter:

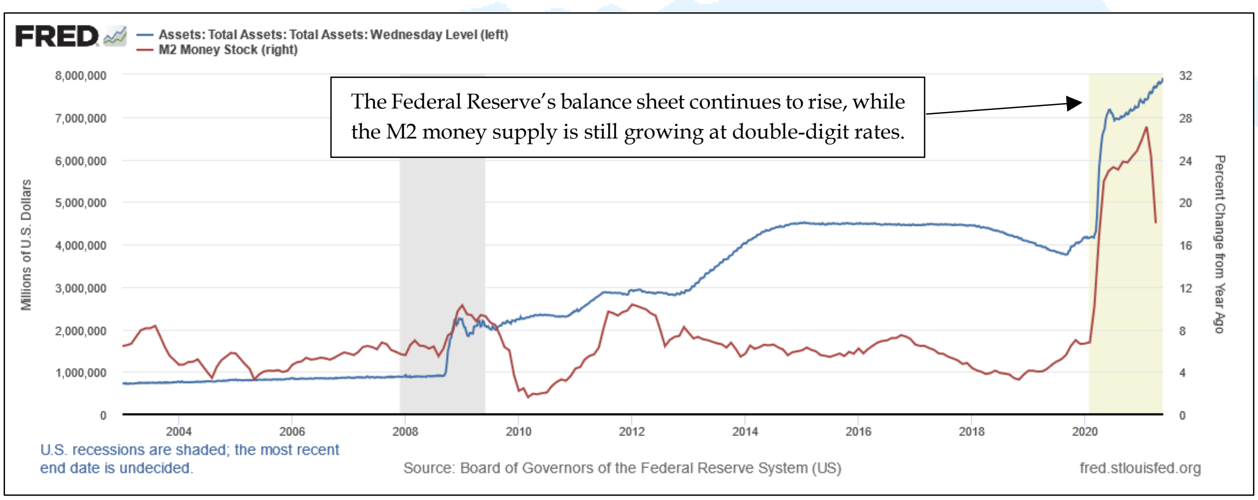
- Beyond Recent Gains, Commodities Likely Represent a Long-Term Opportunity
- The Current Tapering Debate Appears to be Missing the Forest for the Trees

Beyond Recent Gains, Commodities Likely Represent a Long-Term Opportunity

> *One of the biggest commodities booms in decades is looking for a fresh reason to power higher. Markets from copper to oil to corn surged recently as monetary stimulus and a recovery from the pandemic tightened supplies, fueling a debate about whether raw materials are in a new supercycle. But the rally is now wavering on worries about faster inflation, Federal Reserve hints at easing stimulus and China's warning over measures to cool price spikes.*
>
> *Yet many reasons for higher prices -- from a stronger global economy to a coming wave of green spending -- are still intact. Plus, a big shift in monetary policy may be unlikely with economies in an uncertain stage of recovery.*
>
> \- Bloomberg, May 2021

Before the pandemic, and even before the inverted Treasury yield curve in 2019 signaled the preceding tightening of monetary policy had gone too far, it was fairly clear that fiscal and monetary trends in the U.S. would come to have a dominating impact on financial markets over the course of time. This is the primary reason we have, in recent years, thoroughly discussed the last time monetary policy became subservient to forces outside the Federal Reserve's direct control, in the 1960s and 1970s. The Great Inflation, which witnessed a tripling of consumer prices over the course of fifteen years, was not something which happened intentionally, or by design – it was an era which unfolded more or less as a series of critical mistakes and unfortunate events, and it resulted in the effective loss of control over monetary policy and prices. It also happened despite the best intentions of most officials at the Federal Reserve at the time.

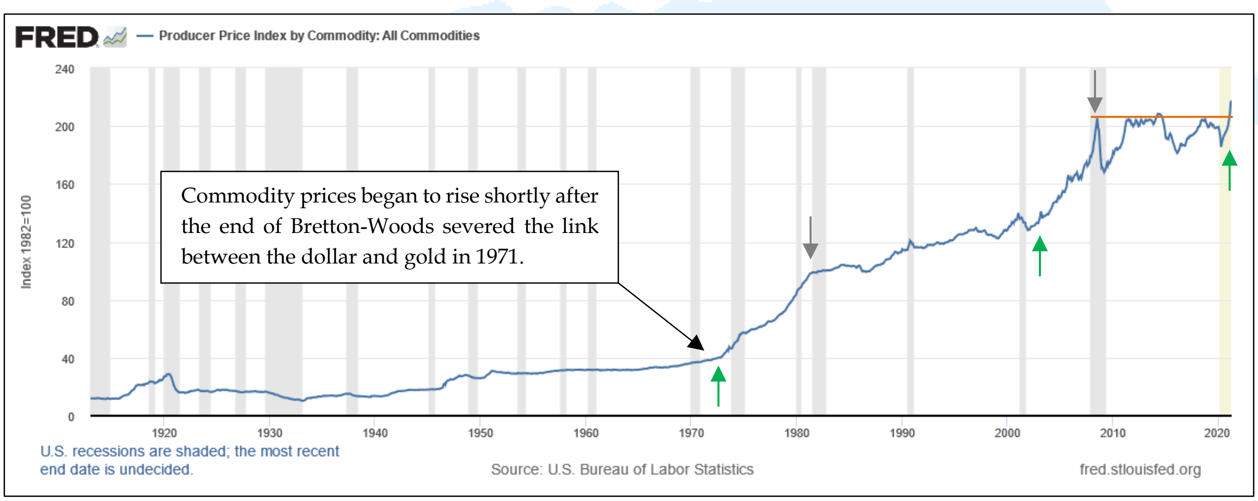
Fiscal and monetary trends leading up to the downturn in 2020 were concerning because they represented the potential for another loss of control over monetary policy, and in light of the events over the past year, we have not been alone in thinking of the early days of Great Inflation. The economist Stephen Roach published a short but illuminating article this past month about his time at the Federal Reserve fifty years ago, entitled *The Ghost of Arthur Burns*. At that time, Mr. Roach was just beginning his career as an economist, and it turns out he happened to be at the right place at just the right time to have an insider's view of beginning of the Great Inflation, from its birthplace. And as he relates in the article, the events of the past year have been giving him strong flashbacks.



As the title suggests, Mr. Roach spends much of the article relating his experience with the Chairman of the Federal Reserve at the time, Arthur Burns, and the impact his personality had on decisions made within the Fed at the time. He recounts, for example, that Burns "ruled the Fed with an iron fist," and tended to be unreceptive to input from his staff. And in Mr. Roach's opinion, despite being a "data junkie," Burns "lacked an analytical framework to assess the interplay between the real economy and inflation, and how that relationship was connected to monetary policy." In place of a more analytical framework, Burns "believed price trends were heavily influenced by idiosyncratic, or exogenous, factors – 'noise' that had nothing to do with monetary policy."

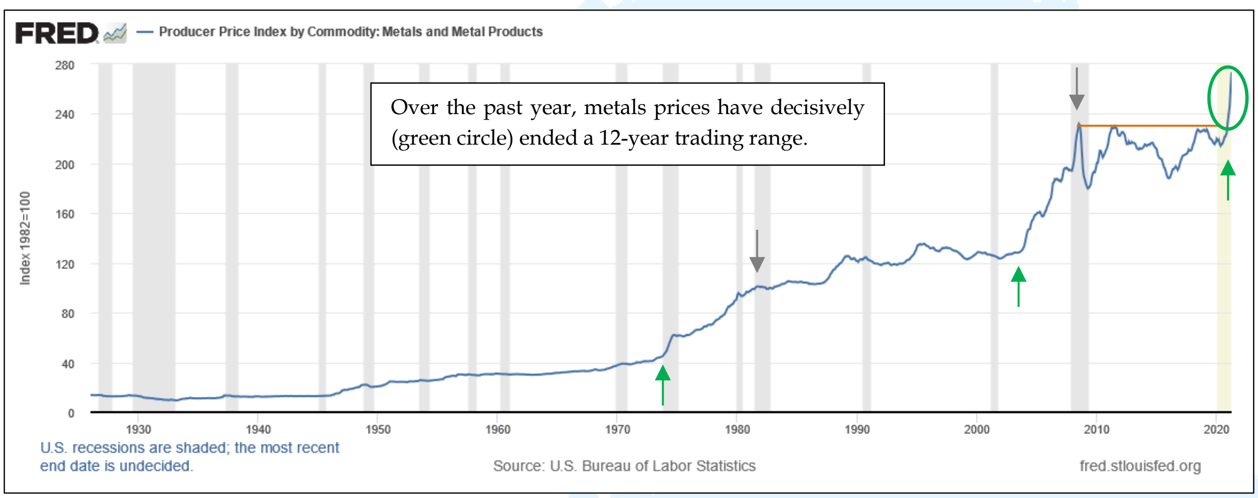
As Mr. Roach recounts, the belief that sustained price increases were largely due to factors outside the influence of monetary policy led to, among other things, a systematic purging of prices included in the consumer price index (CPI). When oil prices quadrupled following the OPEC embargo of 1973, Burns argued that the price of oil and all other energy-related prices should be excluded from the CPI, since the rise seemingly had nothing to do with monetary policy. As Mr. Roach witnessed, the staff at the Fed pushed back on such a move, as energy represented 11% of the CPI at the time, but Burns threatened to have the revised index calculated by staff at another agency if the change wasn't made. That same year, he insisted that the El Nino weather event of 1972, which had decimated the Peruvian anchovy harvest that winter, was the reason food prices were rising so dramatically in 1973; anchovies were a key ingredient in fertilizer. He subsequently ordered his staff to remove food prices from the CPI, which at the time accounted for 25% of the index. These changes are the origin of the "core" CPI still in use today – the index of consumer prices without food and energy.

In the years that followed, the rising prices for many other items were similarly purged from the CPI, including jewelry prices (because of the rising price of gold), and home prices (which represented 16% of the index), so that by 1975 only 35% of the original consumer price index remained in the headline CPI. Yet, as Mr. Roach recounts, that remaining measure of consumer prices was still rising at double-digit year-over-year rates in 1975, and it was only then that Chairman Burns conceded that monetary policy may be playing a part in the inflation problem in the U.S. This was a full decade after real interest rates had pivoted onto a path below zero, and by that time the Fed's monetary base had more than doubled. It would double yet again in the decade that followed.



For Mr. Roach, the haunting memories of that era ring all too familiar today. As officials from the Federal Reserve and other agencies have attempted to explain some of the dramatic price increases over the past year as being caused by factors unrelated to monetary policy, the underlying fact of the matter is that without an expansion of the money supply relative to economic output, there can be no broad-based, *sustained* rise in prices. There are always non-monetary factors which impact prices over the short-term, such as the weather, embargoes or wars, or even major labor strikes. Recessions also exert strong pressure on prices. These exogenous factors all carry significant influence for prices, in the short-term, but over time they are part of the "noise" in the long-term path of prices. They are not the underlying source of a sustained rise in prices over the long-term – as is shown by the rising trend since 1971 in the chart above of commodity prices.

Despite the non-monetary reasons put forward to explain some of the dramatic rises in prices in recent months, and the reasons why those price increases will ultimately prove temporary, it appears what we have seen over the past year is the birth of the third trend of strongly rising commodity prices since 1971. As investors, it matters less whether the headline consumer price index reports eventually show that recent CPI increases begin to moderate, because we do not invest in the consumer price index. However, as investors we *do* seek to invest in major trends like a sustainable rise in commodity prices, and the rise over the past year has all the tell-tale signs of being a major, sustainable trend for commodities in the broadest sense, as well as for some specific commodity sectors – such as metals, shown below.



In the broad-based exuberance of the past nine months, there have been price increases in some commodities which may have risen too far, too fast. As an example, the parabolic rise in lumber prices over the past year may prove to be a case where a number of short-term factors – both supply and demand related – conspired to create just the type of temporary price increase Federal Reserve officials have cited as being emblematic of the broader issues the economy faces as it moves through the bottlenecks exacerbated by the pandemic. There are a number of specific cases of such pandemic-induced imbalances in the economy today. At the same time, however, it would be a mistake to attribute *all* of the price increases we are seeing to issues related to the pandemic. This would be committing the same error that Arthur Burns did in the 1970s.

Specific, dramatic cases like the parabolic price rise of lumber appear to be part of a much broader rise in commodity prices brought on, not by temporary pandemic-related supply and demand issues, but by the extraordinary monetary policy actions over the past year, coupled with the global fiscal response. These are monetary and fiscal conditions which have spawned bull markets in commodities in the past. Unlike the consumer price index, in it all its various formulations since the time of Chairman Burns, the overall trend of rising commodity prices, with its ebbs and floods, has been a feature of the investment landscape since 1971 – and it appears we may have witnessed the birth of another flooding phase of that long-term trend over the past year.

The Current Tapering Debate Appears to be Missing the Forest for the Trees

> *The White House on unveiled a $6 trillion budget proposal that would ramp up spending on infrastructure, education and combating climate change, arguing it makes good fiscal sense to invest now, when the cost of borrowing is cheap, and reduce deficits later.*
>
> *Biden's plan for fiscal year 2022 calls for $6.01 trillion in spending and $4.17 trillion in revenues, a 36.6% increase from 2019 outlays, before the coronavirus pandemic bumped up spending. It projects a $1.84 trillion deficit, a sharp decrease from the past two years because of the COVID-19 pandemic, but up from 2019's $984 billion.*
>
> \- Reuters, May 2021

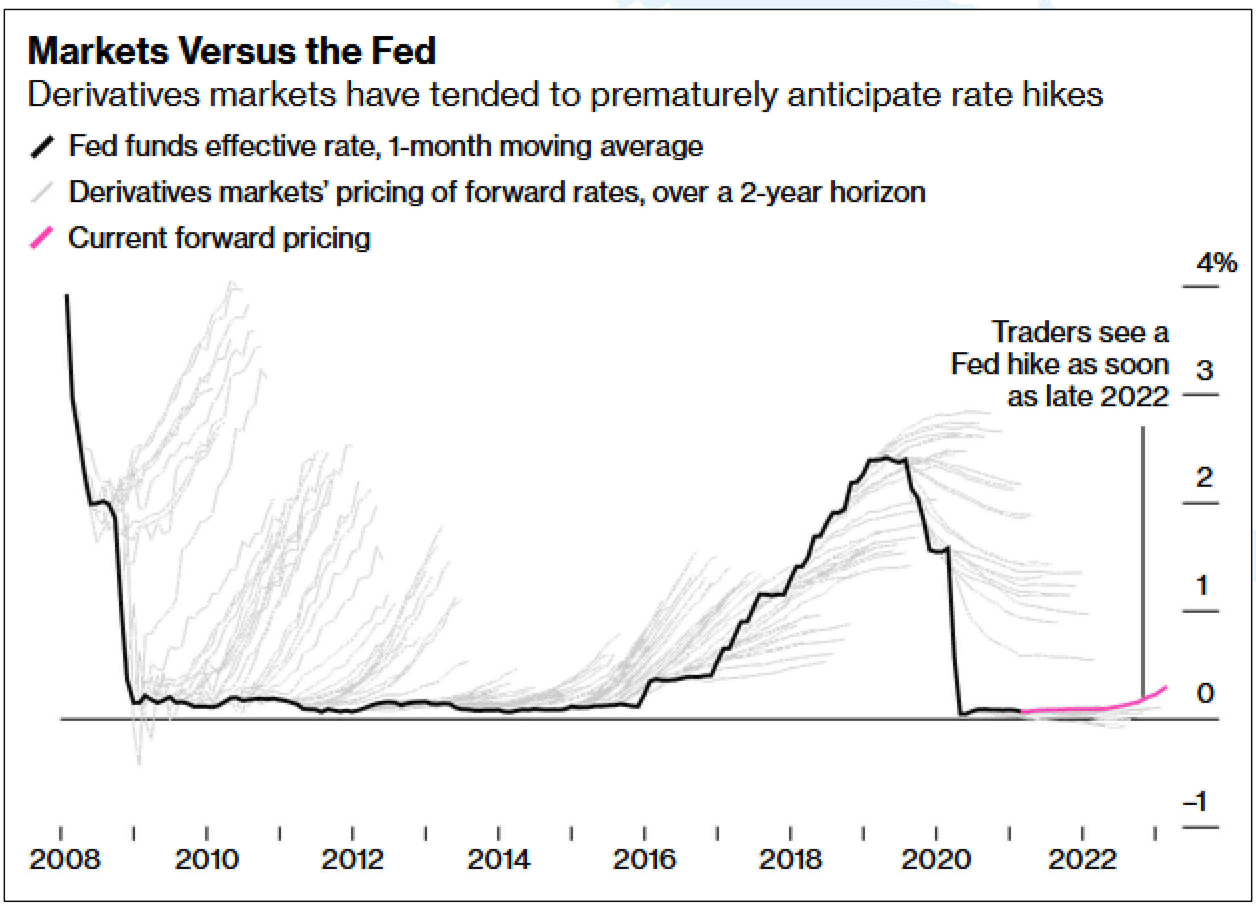
> *Treasury investors fretting about when the Federal Reserve will scale back its bond purchases may be missing the bigger picture: Its more than $5 trillion stockpile will make it a major force for years to come. The prospect of a pullback in buying edged a little nearer when minutes of the Federal Open Market Committee's April meeting showed that a number of officials were willing to discuss it if the economy keeps improving.*
>
> *But bond bulls say the Fed's virtually inextricable presence in the world's largest bond market means it will provide crucial support long after any price blips come and go when it brings the buying spree to a close. The central bank's Treasury holdings have doubled since March 2020, accounting for nearly one-quarter of the total outstanding, a bigger share than it held even after the 2008 credit crisis. It's a result of aggressive moves to keep the market functioning and hold down rates on everything from mortgages and car loans to corporate and municipal bonds.*
>
> \- Bloomberg, May 2021

In February, in a section titled *The First Bond Market Revolt Reaches the First Line in the Sand*, we discussed the rise in Treasury bond yields that had brought the 10-year Treasury yield up to 1.5% from last year's record low near 0.4%. It was a relatively dramatic market move at the time, one which seemed to upend a number of key assumptions about the future of interest rates, and monetary policy. The main message from the rise in yields appeared to be that the market was moving up the timeline of future policy tightening by the Federal Reserve; whereas before the market believed Fed officials when they said monetary would remain ultra-accommodative more or less indefinitely, doubts appeared to be creeping in.

Since then, although the yield on the 10-year Treasury note briefly rose as high at 1.76% in March, it has settled into a narrow trading range between 1.5% and 1.7%. Only time will tell whether long-term Treasury yields remain below the long-term support/resistance we highlighted near 1.5%. As we discussed in February, the 10-year Treasury yield found this area to be support in the decade following the financial crisis, before it plunged below 1.5% in 2020 and ushered in a new era of ultra-low yields in the U.S.

Though the Treasury market has calmed down over the past two months, the debate over how soon the Federal Reserve will move away from its ultra-accommodative stance has not. While Chairman Powell has continued to stress the Fed's commitment to support the economy until it returns to a state of full employment, the markets have lately been sensitive to any hint that monetary conditions could tighten sooner than planned.

However, this debate, and this market sensitively, is nothing new. In the years after the financial crisis, the market remained similarly sensitive for years while the Fed pursued its zero-interest rate policy and quantitative easing purchases. The chart below is visual representation of just how sensitive – and wrong – the futures markets were in anticipating how long the Fed would remain accommodative. While the black line represents the actual Fed Funds rate, each grey line represents the market's assumption of the path of the Fed Funds rate as time went on. In short, it took many years after the financial crisis for the market to accept that interest rates were going to remain near zero for a very long time.



As the note in the chart above indicates, the futures market currently anticipates the Fed will begin hiking interest rates in late 2022. This represents an earlier time than what the market assumed at the start of this year, but such market assumptions should be viewed in the context of their full history. They should also be viewed within the broader context of the circumstances we find ourselves in today.

The ongoing debate over how soon the Fed will begin tightening monetary policy seems to forget that the Fed attempted to re-introduce positive real interest rates in 2018, and it led to an substantial increase in market volatility and an inverted yield curve in 2019 (indicating a recession was on the horizon). If the Fed attempted to do the same any time soon, given conditions today, it would probably make the market volatility of 2019 appear quaint in comparison. The same likely applies to the possibility of tapering the pace of its $120 billion monthly bond purchases. With the Federal Government now on pace to cross the $30 Trillion debt line later this year, and the likelihood of running deficits well above a trillion dollars a year in the years ahead, the Fed may already be in the position of perpetual quantitative easing.

This is all part of the *Third Great Mistake* we discussed in this year's annual letter, and the rise of commodity prices over the past year appears to represent the beginning of a rational market response to these monetary conditions. When the dollar is being actively devalued by negative real interest rates and monetary expansion, the value of real assets increase. And as the market gradually comes to terms with just how long the Fed will remain accommodative, the market prices of real assets will likely rise over time with that growing recognition. While there will undoubtably be volatility along the way, in this market environment the emerging trend in commodities represents a long-term opportunity we will likely remain focused on for some time.

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