October 2020

Dear Investor,

Over the past month, evidence emerged that another wave of the pandemic is underway in the northern hemisphere, along with the arrival of autumn. When we discussed the flu pandemic of 1918 earlier this year, along with other pandemics throughout history, it was clear that the health and economic effects of prior pandemics are measured in years, not months or quarters, and it certainly seems clear at this point that the fallout from the Covid-19 pandemic will be no exception.

The markets, however, have been trading with a far more near-sighted focus in recent weeks. The issue which dominated the daily market action in October was the outlook for the passage of another federal stimulus bill. On days when the outlook for additional stimulus darkened, financial market conditions tightened, with the U.S. dollar rising and risk asset prices falling. On days when the outlook for additional stimulus brightened, market conditions relaxed, the dollar fell, and risk asset prices rose. This alternating dynamic dominated August and September, but recently the markets appeared to begin reckoning with the prospect of another virus-induced economic downturn.

Beyond the outlook for additional stimulus, it remains the case that this year the global economy will shrink for the first time since the 1930s, and it seems to remain the case that the long-term implications of an outright decline in global GDP are not yet widely appreciated. As it stands today, although the economic free fall from the lockdown in the spring has now been partially recouped, weekly initial unemployment claims remain at a rate above the peak levels seen in 2009, and U.S. GDP may decline by as much as 4%–5% in 2020. And since GDP will likely remain dampened until people no longer have reason to fear the coronavirus, the cumulative economic impact of this downturn will be far beyond what was endured in the decade following the Great Recession. In other words, we are just seven months into a process which will be measured in many years.

If it seems odd that the financial markets appear so sanguine in light of the scale of this economic downturn, it is a tribute to the power of monetary policy to alter prices and perceptions. Monetary policy has been the central narrative underlying major market trends over the last decade, and with fiscal and monetary policy now more closely aligned than at any other time since the 1940s, it will likely be an even stronger force in the years ahead. The latest evidence of this alignment has been the recent sentiment shift surrounding debt, which we begin our discussion with below.

In this month's letter:

- Sentiment Surrounding Debt Crossed a Major Threshold This Year
- Two Years into the Reversion, and It Has Hardly Begun

Sentiment Surrounding Debt Crossed a Major Threshold This Year

The world's largest economy just posted its largest fiscal deficit on record. The U.S. budget shortfall more than tripled to $3.1 trillion in the government's fiscal year ended in September, swelling the national debt to exceed the economy's size, after lawmakers opened the spending spigots to soften the blow from the coronavirus pandemic. The deficit as a share of the economy surged to 16%, the largest since 1945.

- Bloomberg, October 16, 2020

The US federal budget is on an unsustainable path, [and] has been for some time. This is not the time to give priority to those concerns.

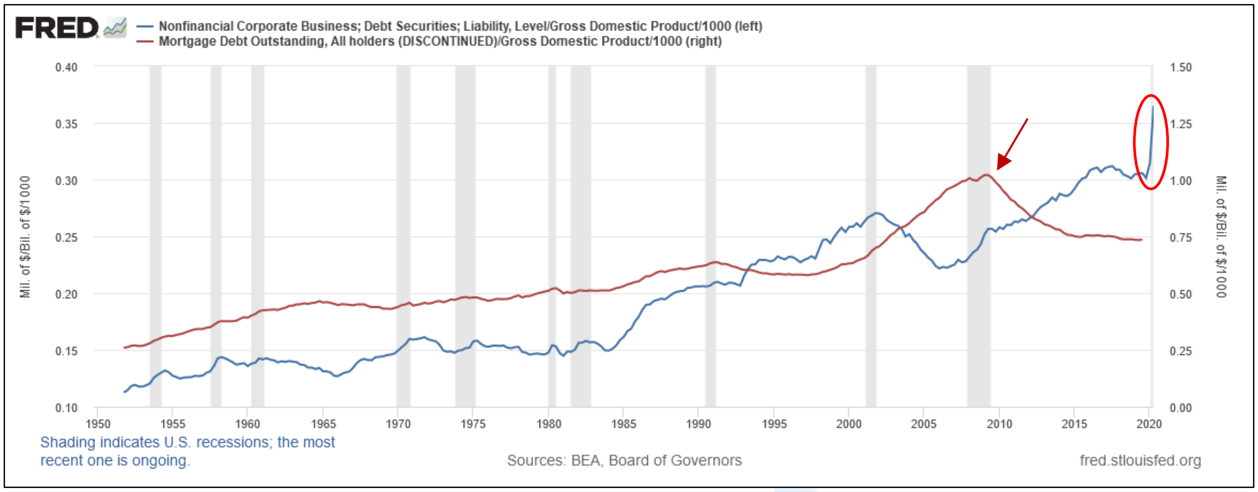
- Fed Chairman Jerome Powell, October 2020

When you begin a conversation about debt, especially the national debt, it is difficult to start with a clean slate. Most people have well-formed opinions already. Within the pragmatic realm of the financial markets, however, debt is one of those issues that remains comfortably tucked below the surface, at least most of the time. For equity investors, debt can act as a fantastic accelerant, multiplying returns on equity and investment, and can enable development and ventures which would not be feasible otherwise. It can also act as stabilizer, as being able to increase indebtedness can sometimes be the difference between staving off, or succumbing to, bankruptcy — as entire sectors of the economy have demonstrated this year. There is a utilitarian side to debt in the capitalist system which has enabled progress on a grand scale, and it can also perform a useful function in helping to preserve temporarily struggling enterprises — and their current ownership — for a more profitable future.

Yet, there is also a certain allure to debt, an allure in which the use of debt transforms from utilitarian and strategic to something entirely different, something which distorts economic motives, increases fragility, and introduces risks which are not present otherwise. While debt can dramatically increase growth rates while it is being accumulated, it also stifles and inhibits growth after it has been amassed in excess — *especially* if it was not used to acquire productive assets. The academic research on this is quite clear. The allure of debt is the increased growth that can occur while it is being accumulated. The resulting fragility comes afterwards, and it can prove to be a trap which warps every economic incentive it comes into contact with.

We do not have to venture far to find cut-and-dried examples of this fragility dynamic and how it can warp economic incentives . . . and policy. For the first time in its history, the Federal Reserve began buying corporate bonds this year in an effort to keep the entire bond market functioning properly — i.e. continuing to supply ample credit to corporations during the pandemic, *at rock-bottom interest rates*. It is no coincidence that these unprecedented actions came during a downturn which corporations entered with a record level of debt on their books, both nominally and relative to GDP.

Thirty-five years ago, non-financial corporations in the U.S. had outstanding debt of $700 billion, which was equal to 15% of GDP at the time. However, in the final quarter of 2019, non-financial corporate debt stood at $6.55 trillion, a nominal amount which had doubled since the start of the last recession. Relative to GDP, non-financial corporate debt entered the recession at 30% (blue line in the chart below), just under the record indebtedness achieved two years prior, and double the level of thirty-five years ago. And with corporations having taken on another $571 billion in debt just in the first half of this year, while GDP has contracted, U.S. non-financial corporations are now far more indebted than ever before.



The Federal Reserve's corporate bond purchases are held in its *Secondary Market Corporate Credit Facility*, and it releases detailed summaries of this program's holdings every month here. In the summary spreadsheets, you will find bonds from many household names throughout corporate America. Through September, the Fed had purchased a little over $13 billion of corporate bonds and exchange-traded bond funds, which may seem like a relatively small amount. But while the purchases represent one small step for the Fed amid the trillions of bond purchases since March, they represent a giant leap for the corporate bond market. When the Fed announced it would start purchasing corporate bonds, it was a signal by the largest central bank in the world that corporate bond prices would not be allowed to fully re-price during this downturn.

Since the financial crisis in 2008, we have witnessed the end of price discovery in an ever-larger share of the bond market. Along with lowering interest rates to near zero, the Fed began buying Treasury bonds and mortgage-backed bonds in 2008, after mortgage debt had risen to 100% of GDP during the housing bubble (red arrow and red line in the chart above). Today, more than a decade later, the Fed continues buying them — at a rate of $120 billion per month. With interest rates near zero and the yields in the safest realms of the bond market suppressed by the Fed, the ripple effects spread to nearly every corner of the economy and markets over the last decade. Such a statement may sound esoteric and abstract, but it had enormous consequences which only now, during the first downturn since the Fed initiated quantitative easing, are beginning to be felt. A recent article on Bloomberg, published on October 26, offered a snapshot into one slice of the emerging fallout:

> Bankruptcy filings are surging due to the economic fallout of Covid-19, and many lenders are coming to the realization that their claims are almost completely worthless. Instead of recouping, say, 40 cents for every dollar owed, as has been the norm for years, unsecured creditors now face the unenviable prospect of walking away with just pennies — if that. While few could have foreseen the pandemic's toll on the economy, the depth of investors' pain from corporate distress was all too predictable. Desperate to generate higher returns during a decade of rock-bottom interest rates, money managers bargained away legal protections, accepted ever-widening

> loopholes, and turned a blind eye to questionable earnings projections. Corporations, for their part, took full advantage and gorged on astronomical amounts of debt that many now cannot repay or refinance.
>
> It's a stark reminder of the long-lasting repercussions of the Federal Reserve's unprecedented easy-money policies. Ultralow rates helped risky companies sell bonds with fewer safeguards, which creditors seeking higher returns were happy to accept. Now, amid a new bout of economic pain, the effects of those policies are coming to bear.
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> Debt issued by the owner of Men's Wearhouse, which filed for court protection in August, traded this month for less than 2 cents on the dollar. When J.C. Penney Co. went bankrupt, an auction held for holders of default protection found the retailer's lowest-priced debt was worth just 0.125 cents on the dollar. For Neiman Marcus Group Inc., that figure was 3 cents…
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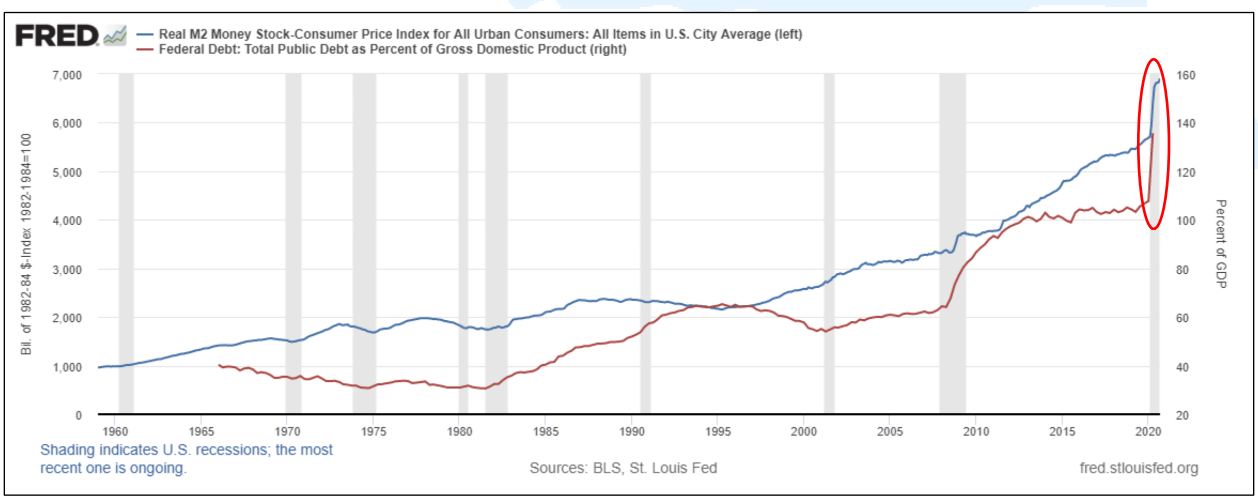
> While creditors always do worse in economic downturns than in better times, in previous downturns, lenders had more power to press companies into bankruptcy sooner, stemming some of their losses. The pandemic is upending industries like retail and energy, making it unclear how much assets like stores and oil wells will be worth in the future. The underlying problem for many companies, though, is that they have astronomical levels of debt after borrowing with abandon over the previous decade, then topping up with more to get them through the pandemic.

By directly subsidizing Treasury and mortgage bonds in the decade following the Great Recession, the Fed encouraged a rebound in mortgage lending and helped mask the real cost of the growing federal debt as it rose from $9 trillion to $23 trillion; the real cost was masked not only by artificially low rates, but also by remitting excess interest on Treasury debt to the Treasury. However, the Fed also indirectly encouraged debt growth outside the mortgage and Treasury markets, and it is only now beginning to be revealed how those Treasury and mortgage bond purchases warped economic incentives over the past decade.

It is also just now beginning to be revealed how much all this debt growth has warped monetary policy, as the Fed now finds itself inhibiting price discovery in Treasury, mortgage, *and* corporate bonds. This collectively represents $45 trillion of debt, or an amount greater than 200% of U.S. GDP. With the economic and financial consequences of letting market forces alone settle interest rates and bond prices deemed too painful to bear, the Fed now finds itself expanding the money supply at ever greater rates just to maintain some semblance of order in the financial markets.



In this context, it is ironic that Chairman Powell and other vocal members of the Fed have been so direct and forceful in their statements encouraging the federal government to commit to enacting more economic stimulus. Of course, in the short term, such a desire for more stimulus is understandable. In fearing a repeat of the deflationary spiral which took hold during the early years of the Great Depression, the Fed understands how critical it is to prevent nominal GDP from entering a sustained decline. Standing on the sidelines while just such a nominal decline unfolded between 1930 and 1932 is considered the Fed's *First Great Mistake*, and Fed officials are only too aware of the risks of allowing aggregate economic activity to contract on a nominal basis.

Yet, if you get the feeling that monetary policy is already trapped, it's because it is already trapped. And it appears Chairman Powell and other members of the Fed are not only well aware of this, they are determined to dig monetary policy out of its trap by doing everything possible to encourage higher inflation in the years ahead — including embracing the rising national debt as a vehicle to achieve that inflationary goal. So, while the rising national debt prior to 2020 was viewed as an unsustainable problem, which would eventually, someday, need to be addressed, it has suddenly become a significant part of the Fed's solution going forward. At a speech in early October, Chairman Powell again emphasized the importance of additional fiscal support, beyond what has already been enacted:

> At this early stage, I would argue that the risks of policy intervention are still asymmetric. Too little support would lead to a weak recovery, creating unnecessary hardship for households and businesses. Over time, household insolvencies and business bankruptcies would rise, harming the productive capacity of the economy, and holding back wage growth. By contrast, the risks of overdoing it seem, for now, to be smaller. Even if policy actions ultimately prove to be greater than needed, they will not go to waste. The recovery will be stronger and move faster if monetary policy and fiscal policy continue to work side by side to provide support to the economy until it is clearly out of the woods.

In speeches and interviews, Fed officials have continued calling for more fiscal support for the economy, which stands in stark contrast to the sentiment surrounding the debt prior to the pandemic. After adding $3 trillion over the past year to bring the total national debt to over $26 trillion, Fed officials appear to have now accepted the one-way nature of this path. Long after Covid-19 ceases to impact the global economy, crossing this sentiment threshold in 2020 will likely mark a significant long-term pivot for U.S. monetary policy.

Lastly, it must be noted that this sentiment shift has not been limited to the U.S. With France, Germany and most recently England re-entering various stages of lockdown, European Central Bank President Christine Lagarde signaled during the last week of October that the ECB was already preparing to increase monetary stimulus before the year is out. A recent Bloomberg article headline summed up the situation in Europe rather succinctly: *The ECB Keeps Bond Yields Low, Allowing Governments to Spend*. This has more or less been the case since the financial crisis, but it has now become firmly established policy in Europe and the U.S.

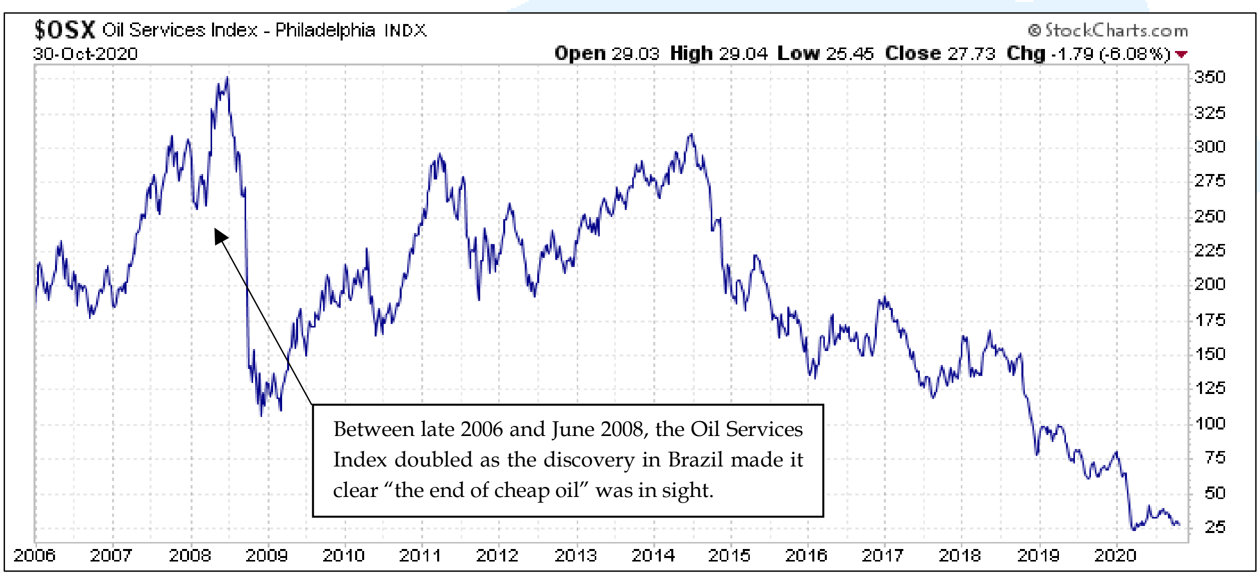
Two Years into the Reversion, and It Has Hardly Begun

> *It's waiting that helps you as an investor, and a lot of people just can't stand to wait. If you didn't get the deferred-gratification gene, you've got to work very hard to overcome that.*
>
> \- Charlie Munger

In the spring of 2008, investor sentiment had stabilized after the Fed had cut interest rates by a larger-than-expected 0.75% early in the year, and the markets began regaining some of the ground lost from the peak in late 2007. As the market recovery gained steam in April and May, hope began to rise that the credit market turmoil during the summer of 2007 and early 2008 had passed, and attention turned to the possibility of economies and markets outside the U.S. "decoupling" from the troubles in the U.S. Equity markets such as those in Canada and elsewhere proceeded to rally to new highs.

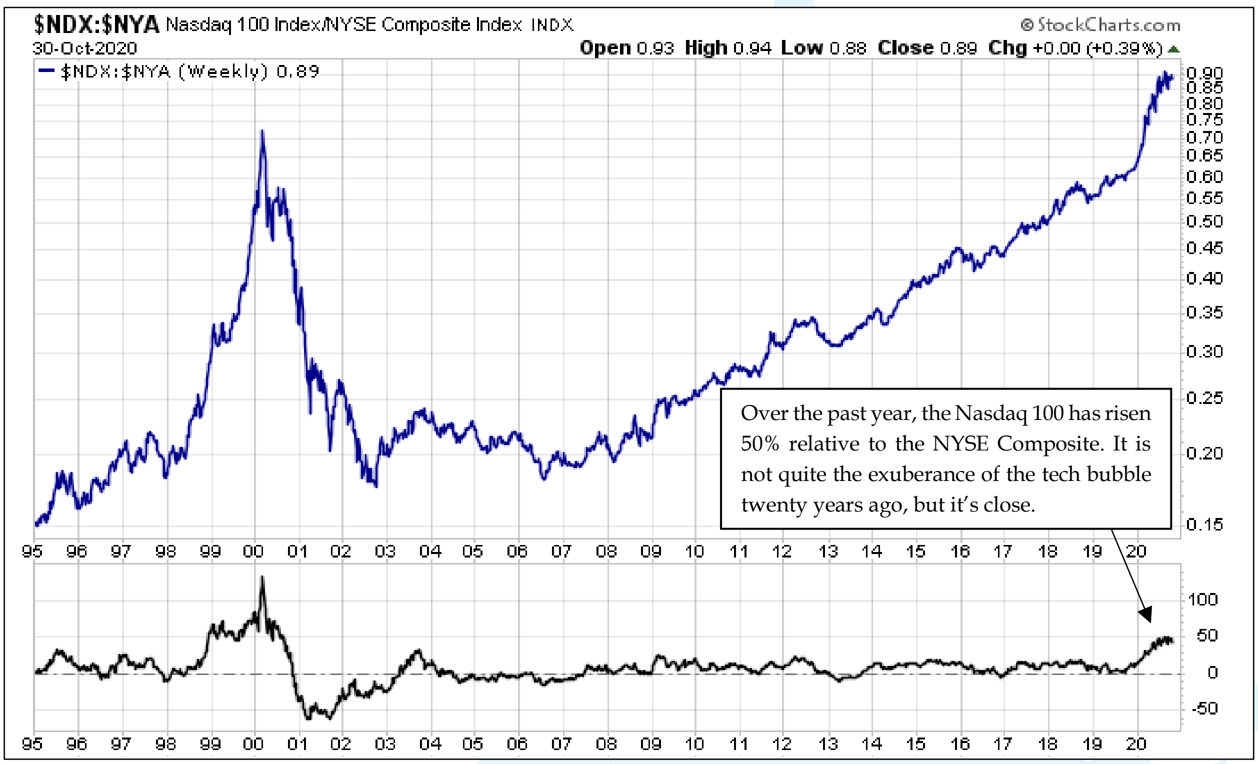
A year after credit markets had seized up and forced the seemingly overnight liquidation of two large mortgage-focused hedge funds, and two years after the peak in home prices, investors' hope morphed into a potent speculative fervor, focused on some of the last remaining intact bullish trends. And at the time, the narrative for oil was particularly compelling. The Fed was cutting interest rates in response to the slowdown in housing, which was clearly a domestic issue confined to the U.S. However, the impact of lower interest rates on the world's reserve currency would be powerful. The U.S. dollar would probably begin to fall against the rest of the world's currencies, as growth in the rest of the world would not be impacted the slowdown in the U.S. housing market. And, in fact, growth outside the U.S. would probably accelerate, fueled by cheaper borrowing costs in dollars.

Such a scenario would probably result in strong growth in the demand for oil, and that was not all. At the same time, it was rumored "the end of cheap oil" was in sight. In late 2006, the largest western hemisphere oil field discovery in decades was made off the coast of Brazil, but there was a catch — it was estimated that it would cost around $100 per barrel to extract the oil. All of a sudden, it seemed the era of cheap Saudi oil was about to yield to an era of $100+ oil, and investors concluded that no price was too high to pay for companies positioned to extract that expensive new-era oil.



As is plainly shown in the chart above, it didn't quite work out that way. Shortly after the market recovery in April and May, cracks began to appear in the idea that global growth would decouple and accelerate while the U.S. economy slowed down. And as we know today, the global economy and financial markets would prove to be far more connected than most investors thought possible at the time; not only would there be no economic decoupling, but positive correlations in financial markets around the world would reach new heights. In addition, the "end of cheap oil" didn't arrive either. In the years that followed, hydraulic fracking in the U.S. ushered in a new era of domestic oil output well below the $100 level. Long story short, as the key assumptions underlying the desire to *pay any price* eroded, investors were left holding the bag over the next twelve years, and counting.

The story of energy stocks over the last twelve years likely has lessens for investors today, as today's narrative for some technology stocks appears just as compelling as the narrative for energy was in 2008. Whenever a narrative takes over to such an extent that it compels investors into a *pay any price* frenzy, it is likely the case that a few reasonable conclusions have been warped into justifying the kind of exuberance that usually accompanies long-term market peaks.



In the case of the Nasdaq 100, six large technology companies with a combined $6 trillion market value now represent 45% of the entire index, and investors appear to feel that the impact of the pandemic justifies a complete decoupling from the rest of the market not unlike early 2008, when investors felt markets outside the U.S. would decouple and ultimately benefit from the slowdown in the U.S. However, even if the pandemic has accelerated the trends on which the technology narrative rests, the current exuberance in the share prices of some of these companies can lead to a very different outcome than investors at these prices envision. It has happened many times before.

In the case of energy, the reversion which began twelve years ago could be approaching its end. At the height of the *pay any price* fever in mid-2008, energy stocks represented 25% of the S&P 500's market capitalization. Today, they represent a mere 2%. And while investors then thought the end of cheap oil was in sight, today the narrative is that the end of all oil demand is in sight, with alternative energy and electric vehicles on the rise. While there are usually kernels of truth in every compelling market narrative, when assets are priced extremely, driven by either exuberance or despondency, there is usually a big gap between valuation and reality.

It is no surprise that the largest sector weighting in the S&P 500 is now information technology, which currently represents 27% of the index's market capitalization. This is below the 33% of the index it represented at the height of the tech bubble in 2000, but not by much. The current bubble in stocks is a big one, and like all such bubbles the peak is marked by a rolling transition measured in years, not in months. The earliest signs of transition during the tech bubble appeared as early as 1998, and though it took another three years for the transition to complete, it established a high-water mark which lasted for more than a decade.

While the market appears to be two years into a similar transition, it is important to remember that the real reversion has hardly begun; the S&P 500's valuation remains near its peak, and investors' attention remains firmly fixed on the asset classes which defined the inflation of the bubble. Amazingly, but perhaps fittingly, the assets we remain concentrated in are still being largely ignored, even though they have been outperforming for over two years. As the old saying goes, the market is at times a Voting Machine and at other times Weighing Machine. While there may certainly be short-term volatility for our holdings at times when traders vote to exit, monetary policy in the years ahead will likely be a powerful force, and the markets have only just begun weighing the impact.

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