October 2021

Dear Investor,

When the pandemic hit the economy in the spring of 2020, it was clear within a short period of time that the markets were crossing over a significant threshold. Even for those of us who had watched the credit crisis unfold, and anticipated the depth of its impact, the speed at which the markets seized up was truly breathtaking. Equally breathtaking was the policy response, which unleashed a flood of monetary and fiscal stimulus that was unprecedented in the post-war era. By the end of 2020, with long-term yields having reached record lows, and measures of money supply rising at the fastest rate since World War II, it was clear that the recovery from the pandemic would likely be quite different from any other post-war economic recovery.

Almost a year later, the burst of stimulus-fueled growth appears to be slowing, even though employment remains millions below its pre-recession peak. At the same time, prices throughout the economy have risen more than policymakers expected, and in recent months inflation expectations for the years ahead have continued to increase. The rise in prices has prompted the Federal Reserve to give clear signals that it intends to begin tapering the pace of asset purchases earlier than planned, before the employment recovery is complete.

A policy tug-of-war between employment and prices like we are seeing today has not been seen since the 1970s, and over the past number of months the haunting phrase *stagflation* has seen a resurgence in use. It is natural to look back and find the last period from which comparisons can be drawn, both in the financial markets and in life, and we have certainly spent a fair amount of time in these letters discussing the 1960s and 70s. Yet while there are many lessons to be drawn from the 1970s, it's important to recognize that there are also major differences between circumstances then and now. These differences will undoubtedly see markets follow a unique path in the years ahead.

One of the major differences between the 1970s and today is another topic we have focused on for years — debt. High indebtedness has had a meaningful impact on interest rates, long-term yields, and asset prices in the wake of the Federal Reserve's anticipated tapering of asset purchases, but that impact appears to be widely misunderstood. We will discuss this misunderstanding in the pages below, including forgotten parallels with an earlier era, the 1940s.

In this month's letter:

- The Policy Repercussions of the *Third Great Mistake* Are Slowly Becoming More Apparent
- The Trifecta That Will Impact a Generation of Investors and Advisors

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The Policy Repercussions of the *Third Great Mistake* Are Slowly Becoming More Apparent

> *Federal Reserve Chair Jerome Powell said on Friday the U.S. central bank should begin reducing its asset purchases soon, but should not yet raise interest rates because employment is still too low and high inflation will likely abate next year as pressures from the COVID-19 pandemic fade.*
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> *"I do think it's time to taper; I don't think it's time to raise rates," Powell said in a virtual appearance before a conference. "We think we can be patient and allow the labor market to heal." That outlook, Powell emphasized, is only the most likely case, adding that if inflation – already higher and lasting longer than earlier expected – moves persistently upward, the Fed would act.*
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> *The central bank, however, is facing a delicate balancing act in its dual mandate to seek full employment and stable prices. Consumer prices have been rising at more than twice the Fed's 2% target, but employment is still well below the pre-pandemic level.*
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> \- Reuters, October 22, 2021

As much as last year centered around the Covid-19 pandemic and its impact on the economy, the major topic of discussion in the financial markets this year has been centered around inflation, and its prospective impact on monetary policy. During the first half of this year, Chair Jerome Powell and other Federal Reserve officials were consistently adamant that the increase in prices rippling through the economy was the result of *transitory* factors stemming from the pandemic itself and its direct impact on the economy's ability to deliver goods and services efficiently. Since the rise in prices was attributed to causes which would dissipate over time as the economic impact of the pandemic waned, the Fed felt justified in more or less ignoring prices while focusing exclusively on the employment half of its dual mandate. And since there remained millions fewer people working than before the pandemic, the exclusive focus on employment seemed justified.

This approach was also in line with the Federal Reserve's new policy framework, which was announced in August of last year. This new framework was the result of a critical assessment of the decade following the financial crisis, and the persistence of below-target inflation despite low interest rates and the first use of quantitative easing in seventy years. The assessment concluded that monetary policy had begun tightening prematurely under the assumption that inflation would revert to 2% over time as the effects of the financial crisis faded, when in fact inflation subsequently remained below 2%. This not only resulted in low inflation rates and low long-term Treasury yields later in the decade, it also severely limited the Federal Reserve's room to maneuver in the event of another downturn in the economy, since short-term interest rates remained low. The new policy framework aimed to alleviate these circumstances by reframing the inflation half of the Fed's dual mandate to aim for an *average* 2% inflation rate over time, instead of maintaining a 2% ceiling. This new framework would enable the Fed to pursue its long-term inflation goal by providing more flexibility in how short-term inflation readings were reacted to.

Since the perceived "inflation deficit" from the decade after the financial crisis was over 8% at the end of 2020, which was highlighted in January's annual letter, the rise in prices earlier this year was viewed favorably by Powell and most other Fed officials. After a decade of persistently below-target inflation, seeing prices rise at a rate above 2% for a time was a welcome sight within the halls of the Eccles building — even if it was caused by base-effects from last year's shutdowns, and pandemicinduced bottlenecks in the economy that would presumably resolve themselves as time went on. Thus, as the year-over-year change in the headline Consumer Price Index rose above 2% in March, and above 4% in April, and then close to 5% in May, the dramatic policy response to the pandemic seemed not only to be providing extraordinary support to the economy, it was also creating significant progress toward alleviating the main policy dilemma of the last decade — persistently low inflation rates.

In the months since May, however, sentiment surrounding the rise in prices inside and outside the Federal Reserve has shifted markedly. Along with providing new flexibility to achieve its goal of 2% inflation over time, the new policy framework also represented an institutional effort by the Fed to put the ghosts of the 1970s behind it. The *Second Great Mistake* in Federal Reserve history was rooted in how monetary policy enabled the rising inflation of that era by succumbing to outside political pressure, and by letting the desire for short-term market stability override longer term goals. In the decades since then, falling rates of inflation made it much easier for the Fed to focus on its long-term goals — the Fed was generally not forced to choose between dampening rising inflation or attempting to stimulate the economy to increase employment.

Over the last six months, however, prices have defied the Fed's expectations and continued to rise at rates well above the 2% inflation target, and market estimates for inflation in the years ahead have recently risen to new highs (blue line above). Earlier this year, Fed officials expected prices to be moderating by the latter half of this year, and they certainly didn't expect long-term inflation expectations to continue climbing further above 2% while employment remains lower than before the downturn, and well below what the Fed currently estimates would represent "full employment."

This unwelcome combination of uncomfortably increasing inflation coupled with lower employment has been enough to reawaken the ghosts of the 1970s for many at the Fed. These fears are not often explicitly expressed by Fed officials in speeches and press conferences that represent the views of the rate-setting committee, but they can be clearly discerned from the change in tone in more informal settings. And over the past month, Chair Powell sent clear signals in his formal remarks that, in light of the stronger than anticipated rise in prices this year, it was time to act and begin reducing the $120 billion per month pace of the current quantitative easing program. This represents a fairly swift pivot for the Federal Reserve.

One of the conundrums amid these rapidly shifting inflation circumstances has been the persistence of ultra-low long-term bond yields. While inflation expectations have continued to rise in recent months, long-term Treasury bond yields have remained subdued. The entire Treasury yield curve remains below the Fed's long-term inflation target of 2%, which means that the entire Treasury yield curve has a negative real yield relative to the rise in prices over the past year. The red line in the chart above highlights the 10-Year Inflation-Indexed Treasury yield, which remains near negative 1%. And the nominal 30-Year Treasury bond yield remains modestly below 2%, after trading as high as 2.5% earlier this year.

For many, the persistence of low long-term Treasury bond yields is a clear sign the market is anticipating the current inflation surge to eventually fade. Yet it may also be the case that long-term Treasury yields may not be reflecting the market's expectations for inflation as much as assumed. As the past few years have clearly demonstrated, monetary policy is not solely focused on responding to inflation. A number of other factors have influenced short-term interest rate policy over the past decade, and some of those factors are now exerting a stronger influence than ever before. In a recent interview, a former markets desk trader at the New York Federal Reserve highlighted some of these factors, and his succinct and frank characterization of the dilemma facing monetary policy is worth reading in its entirety:

> I think the Fed is really worried about inflation after telling everyone it was transitory – you no longer hear that word anymore. And I think it's a really hard question for the Fed right now because a lot of this inflation, it appears to be driven by supply side effects. You have, you read about the energy crunch. We have congestion at ports. There is also a big demand burst as well. You know, we kind of printed and spent a lot of money and that increases demand. A lot of the supply constraints will be changed by interest rate hikes, but interest rate hikes do dampen demand. So if you hike rates, you can really hurt demand. And reducing demand, that lowers inflation. However, it costs your other mandate, which is full employment.
>
> **So, it's a very, very difficult time for the Fed to choose right now. And I would also add that just mechanically speaking, looking at the financial system, it's really hard for the Fed to hike rates without having a tremendous financial impact. And the reason for that is when you have a very high level of debt in the system, your interest rate hikes are magnified in their effect**. So there's interest rate risks in let's say fixed income debt. And when you hike rates, you kind of basically destroy some of that value. And when you are thinking about Treasuries, you're basically kind of pulling away money out of the system. If you think about Treasuries as a form of money, what we've been doing the past, let's say decade, when we reduce rates, all those high-duration assets, their market price rises, they become enriched.
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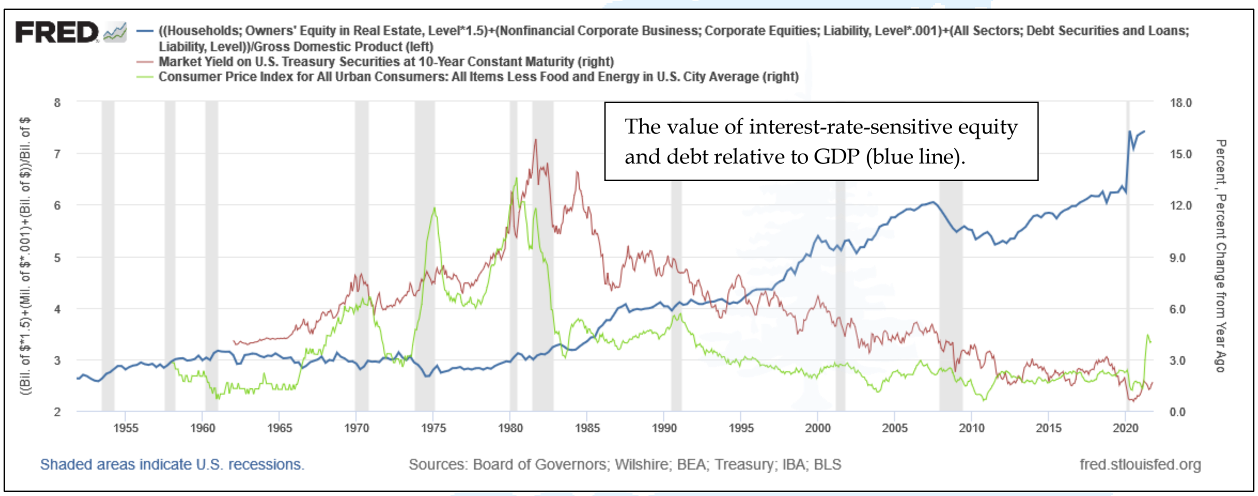
> People have more money through that, which they can repo or sell, and then they can buy other stuff. Or if you're, let's say a 60/40 portfolio manager and your bonds appreciate, you will have to buy more equities to balance. Then that makes equity markets go higher. **But when you're hiking rates, you're doing the reverse. And because the level of debt is so much higher, I think there's some very long, non-linear impacts. So that collateral channel through which monetary policy is transmitted, that I think really sets a constraint on the Fed as to whether or not they can just hike rates like they did in the seventies, because you could have very, very large impacts on the financial markets.**
>
> - *Joseph Wang, October 2021, Former Senior Markets Desk Trader at the New York Fed*

When inflation rates rose in the late 1960s and 1970s, the Federal Reserve responded by increasing interest rates, but the increases were not enough to stem the rising tide of prices. The reasons the Fed failed to respond adequately are well documented, and we have discussed some of them in letters over the past few years — from the pressure Lyndon Johnson exerted on Fed Chair McChesney Martin to keep rates low amid the war in Vietnam, to Richard Nixon's pressure on Fed Chair Arthur Burns to keep unemployment low in the run-up to the 1972 election, to the global imbalances which brought about an end to the Bretton Woods system of fixed exchange rates. Monetary policy in the 1960s and 1970s was pressured by a number of forces outside the single issue of inflation, and the result was a more dramatic and lasting rise in prices than anyone anticipated when it began.

There are similarly strong forces outside inflation influencing monetary policy today. As Joseph Wang highlighted at the end of the passage above, the channel through which monetary policy is transmitted and magnified through the financial markets now represents a significant constraint on monetary policy. This can be seen in the chart below, where the blue line represents an estimate of the value of interest-rate-sensitive financial assets — including real estate, equity and debt — relative to the size of the economy. The value of these assets is now over 2.5 times what it was when the Fed attempted to raise rates in the 1960s and 1970s, and 25% higher than at the peak of the housing bubble fifteen years ago. This represents a powerful economic disincentive for higher interest rates.



The entrapment of monetary policy by debt and other factors that make responding to rising inflation problematic is part of what we have referred to in these letters as the Fed's *Third Great Mistake*. And it may be the case that today's low long-term bond yields are more of a reflection of this entrapment than a rational anticipation that the current high inflation readings will return to the low levels of the past decade. If so, many are misunderstanding the bond market's signal.

As the 1940s clearly demonstrated, long-term interest rates can remain low if the market understands that the Fed will not raise short-term interest rates, despite high inflation. At that time, the Fed had an official agreement with the Treasury Department to keep short-term and long-term yields low while the federal government borrowed heavily for the war effort. There may not be such an explicit agreement today, but long-term bond yields may partially reflect a conclusion that the Fed will not be able to significantly increase interest rates for a long time — regardless of inflation.

The Trifecta That Will Impact a Generation of Investors and Advisors

> *The prices of stocks, bonds and real estate, the three major asset classes in the United States, are all extremely high. In fact, the three have never been this overpriced simultaneously in modern history.*
>
> *What we are experiencing isn't caused by any single objective factor. It may be best explained as a result of a confluence of popular narratives that have together led to higher prices. Whether these markets will continue to rise over the short run is impossible to say. Clearly, this is a time for investors to be cautious. Beyond that, it is largely beyond our powers to predict.*
>
> \- Robert Shiller, October 2021

While one lesson from the 1940s is that long-term bond yields can remain low despite high inflation, there is another important lesson from that era that appears to have been all but forgotten by investors today. In the late 1940s, as inflation rates rose to as high as 18% year over year, and in the early 1950s, when inflation rates again rose to 10%, risk assets traded at very low valuation levels. The S&P 500 remained at a cyclically adjusted price-to-earnings ratio near 10 throughout those years. Importantly, the low valuations of that period were prevalent despite interest rates and bond yields remaining low, with the 10-Year Treasury yield never rising above 3%.

Inflation devalues the present value of future earnings regardless if interest rates are also high, and when the value of future earnings is lowered by rising inflation, the market naturally trades at a lower valuation to compensate. This is one of the key lessons from the 1940s that is lost in the more recent experience of the 1970s, when both inflation and interest rates relentlessly climbed.

More recently, Robert Shiller, the Nobel-prize winning economist, published an article in the New York Times in early October which detailed what he called a *trifecta of high prices.* In the article he described how stocks, bonds and real estate are all currently priced at very high valuations. This is notable because, as the quote from the article above highlights, there has never been an instance in modern U.S. history when all three major asset classes were severely overvalued at the same time. He then asked his readers to *consider this trifecta of high prices*:

> • Stocks: Prices in the American market have been elevated for years, yet despite periodic interruptions, they have kept rising. A valuation measure that I helped create — the cyclically adjusted price earnings (CAPE) ratio — today is 37.1, the second highest it has been since my data begin in 1881. The average CAPE since 1881 is only 17.2. The ratio (defined as the real share price divided by the 10-year average of real earnings per share) peaked at 44.2 in December 1999, just before the collapse of the millennium stock market boom.
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> • Bonds: The 10-year Treasury yield has been on a downtrend for 40 years, hitting a low of 0.52 percent in August 2020. Because bond prices and yields move in opposite directions, that implies a record high for bond prices as well. The yield is still low, and prices, on a historical basis, remain quite high.
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> • Real Estate: The S&P/CoreLogic/Case-Shiller National Home Price Index, which I helped develop, rose 17.7 percent, after correcting for inflation, in the year that ended in July. That's the highest 12-month increase since these data begin in 1975. By this measure, real home prices nationally have gone up 71 percent since February 2012. Prices this high provide a strong incentive to build more houses — which could be expected eventually to bring prices down. The price-to-construction cost ratio (using the Engineering News Record Building Cost Index) is only slightly below the high reached at the peak of the housing bubble, just before the Great Recession of 2007-9.

What Mr. Shiller describes in his summary of stocks, bonds and real estate is a valuation breakout of the interest-rate-sensitive equity and debt assets highlighted earlier. One of the reasons there is now a far greater amount of interest-rate-sensitive assets relative to GDP than ever before is because all three major asset classes in the U.S. are severely overvalued at the same time. If we take time to recall the impact of the bursting of the tech bubble twenty years ago, or the subsequent housing bust, we have to remember that those tumultuous periods involved only *one* major asset class undergoing a significant devaluation.

If we think about the consequences of more than one of those major asset classes enduring a devaluation simultaneously, it becomes easier to appreciate just how much pressure is now on monetary policy to remain accommodative, and perhaps why long-term bond yields remain at ultra-low levels. It also becomes easier to appreciate just how much inflation risk there is in the years ahead. If the Federal Reserve finds itself unable to adequately respond to prices that rise more than anticipated, as has been the case this past year, the real value of assets whose valuation currently depends on inflation remaining low is extremely vulnerable. If the S&P 500 were trading at its median historical valuation, which is 70% higher than its valuation during the high inflation of the 1940s and 1970s, the index would be trading near 1920, which is 58% below its current level.

Due to the impact of the *Third Great Mistake*, the Federal Reserve will likely be forced to respond in ways it finds both uncomfortable and unnerving in the years ahead — just as it has been forced to respond beyond its comfort zone over the past few years. The overvaluation of asset prices today is sowing the seeds of more obligatory policy responses tomorrow, and market history is quite clear how circumstances like these ultimately resolve themselves: risk assets and debt are eventually devalued, and real assets are eventually re-priced. A real devaluation of bonds appears to be well underway, yet we are still in the earliest stages of a process which will ultimately impact every investor and advisor who passively relies on stocks, bonds and real estate to generate positive returns. By the time the process is complete, the *trifecta of high prices* will be a distant memory.

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