September 2020

Dear Investor,

Leading up to this year, it had long seemed clear that the next recession, whenever it began, would usher in a market environment that would feel utterly new to most investors. The Credit Crisis had felt that way, as investors suddenly grappled with correlations and losses that were not supposed to happen in a diversified portfolio. The recovery following the Great Recession unfolded in unexpected ways as well, as interest rates remained near zero for years while early inflation fears never materialized in consumer prices, despite the Fed's expanding balance sheet. The three pillars of low interest rates, low inflation and monetary expansion then fueled a rise of risk assets beyond the valuations reached at the peak of the narrowly focused tech bubble; this past month, the broad Wilshire 5000 Index traded at 152% of GDP, well above the high-water mark of 137% in early 2000.

Yet, despite the market's exuberance in recent years, the Fed found itself unable to easily extricate itself from the tight corner it found itself in. Not quite two years ago, the markets signaled that monetary policy had tightened too much when the Fed Funds rate was increased to 2.2% while the Fed's balance sheet slowly shrank. Then, one year ago, after the Fed had paused its campaign to increase interest rates but had continued to shrink its balance sheet, credit markets began to seize up as some overnight lending rates soared to 10%. It was crystal clear then that there would be no "normalization" of monetary policy, even a decade after the end of the Great Recession. The question then became — what would the Fed find itself doing during the next recession, and its aftermath?

This past month we received another part of the answer, and it was not really a surprise, as monetary policy has long been headed in this direction. The new policy of targeting an *average* 2% inflation rate over time effectively ensures that the modestly negative real interest rates seen this year will eventually deepen to at least negative 2%–3% before monetary policy is tightened again. This is what the Fed has planned, and although it is anyone's guess what unplanned actions will arise from this new policy of deliberately higher inflation, one thing is clear: U.S. monetary policy has now officially moved on from its lingering fear of the Great Inflation. Instead, just as in the 1970s, and the 1940s, the Fed has embraced negative real interest rates, debt monetization and inflation as the way out of its tight corner. We'll discuss some of the implications of this policy shift in the pages below, along with a notable endorsement for markets outside the U.S.

In this month's letter:

- The Fed Emerges Out of the Shadow of Its Second Great Mistake
- Undervalued Equity Markets Outside the U.S. Begin to Attract More Attention

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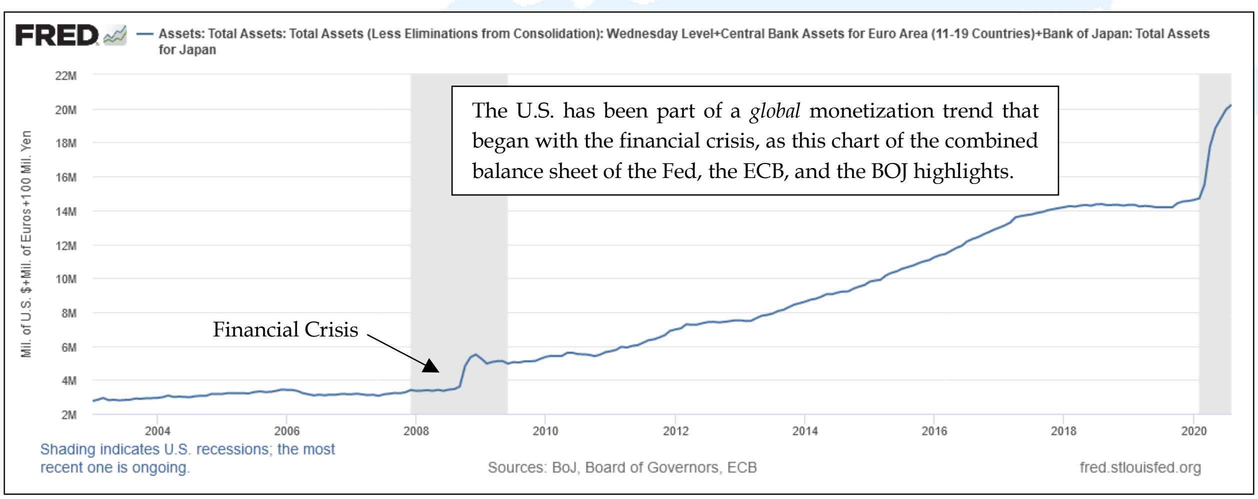
The Fed Emerges Out of the Shadow of Its Second Great Mistake

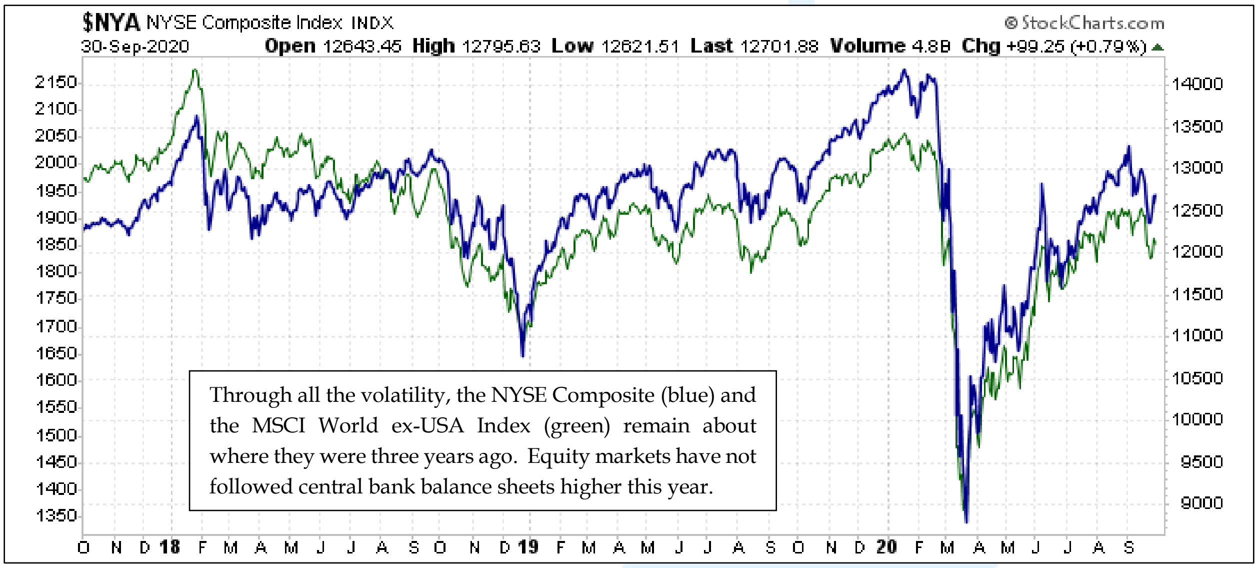
> *Global central bankers are discovering that monetary policies they once viewed as unconventional and temporary are now proving to be conventional and long-lasting. Forced to think outside the box by the 2008 financial crisis and then again this year by the coronavirus pandemic, the Federal Reserve, European Central Bank and most of their international counterparts have become more aggressive and innovative than ever in defending their economies from recession and the threat of deflation.*
>
> *With the global recovery still uncertain and the virus set to leave scars on employers and employees, the likelihood is that monetary policy will stay ultra-loose for years to come — even if that means central banks artificially propping up markets or sparking a run-up in prices. Such an outlook was underscored by the Fed's recent decision to say it will allow inflation to run above its 2% target in the future if needed to make up earlier undershoots.*
>
> \- Bloomberg, September 2020

Over the past decade, investors have experienced a rare set of circumstances, the special nature of which does not appear to be generally appreciated. In the wake of the credit crisis, the Federal Reserve and other major central banks engaged in the largest monetary expansion since the 1930s, but because a large part of the U.S. economy was deleveraging at the same time, there was less than expected inflation of consumer prices. Instead of finding its way into the hands of deleveraging households, the inflating money supply largely remained in the financial system — and inflated assets instead. This was a perfect trifecta for financial assets of all stripes: as the Fed and other major central banks continued to soak up government and mortgage-backed bonds from the market, the newly created money it exchanged for those bonds, with fewer places to go in the hands of consumers, ended up flooding into real estate, stocks, bonds and other financial assets. By the end of the decade after the financial crisis, the U.S. equity market had risen to its highest cyclically adjusted valuation since 1929, and risk spreads in the bond market had reached record lows.

A popular correlation which circulated as this financial inflation unfolded showed the expanding Fed balance sheet overlaid with the rising stock market. It seemed every dip in the market coincided with a slowdown in monetary expansion, and as soon as the monetary expansion resumed, the market resumed its march higher. The implication many took away was that as long as central banks continued to print, investors in stocks would be spared any downside.



While the belief in the strong correlation between risk assets and monetary expansion appears to remain firmly embedded, it was inevitable that the correlation would eventually break down at some point, as circumstances changed. In that context, it is notable that although the balance sheets of the largest central banks, shown above, have exploded higher this year, equity markets in the U.S. and around the world, particularly absent the influence of just six large technology companies, remain within their trading ranges of the past three years. Without much fanfare, the close association has quietly evaporated over the past few years, as equity markets have not followed the dramatic expansion of central bank balance sheets this year.

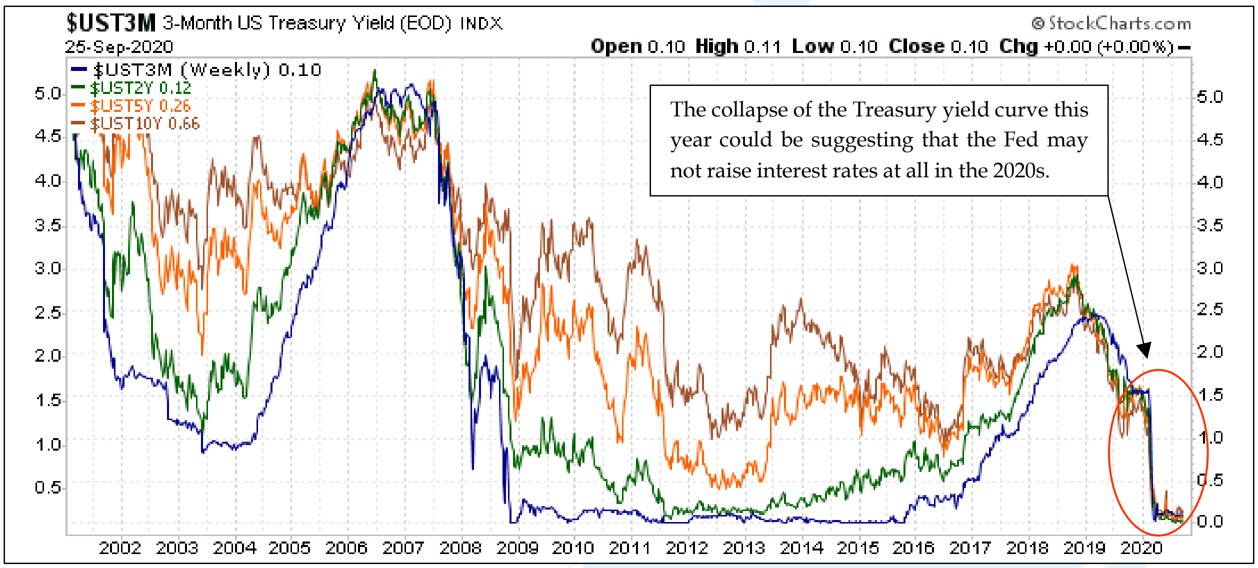


Through all the volatility, the NYSE Composite (blue) and the MSCI World ex-USA Index (green) remain about where they were three years ago. Equity markets have not followed central bank balance sheets higher this year.

Beneath moving lines on charts, the correlation of risk assets to the monetary expansion in the years after the financial crisis rested upon two conditions remaining firmly in place: low interest rates, and a low rate of consumer (and producer) price inflation. While both of these factors have a strong influence on risk asset valuations, investors tend to focus solely on the former, and ignore the latter, even though the experience during the Treasury-Fed Accord of the 1940s clearly demonstrated that higher inflation, without correspondingly higher interest rates, dampens risk asset valuations nearly as much as higher interest rates do.

However, there is no doubt that investors' focus on interest rates this year has provided plenty of fuel for the markets. Though interest rates and Treasury bond yields trended lower throughout 2019, the entire Treasury yield curve out to beyond ten years completely collapsed in March, and since then has remained near zero. Over the past six months, Fed officials have repeatedly emphasized that interest rates will remain low until the economy fully recovers, which they have said could take a number of years. The bond market, however, seems to have a slightly different opinion. With the Ten-Year Treasury yield remaining pinned near 0.6%, the bond market appears to think short-term interest rates will remain firmly near zero for longer than just a few years.

The collapse of the yield curve this year, highlighted by the red circle in the chart below, is unlike anything seen in the post-war era. Although the Fed lowered the Fed Funds rate to near zero during the credit crisis, the bond market remained sensitive and watchful for the day when interest rates would lift off the effective lower bound; this ongoing vigilance is reflected in the continuously fluctuating lines of the Two-, Five- and Ten-Year Treasury yields between 2008 and 2018 in the chart below. Although assessments continuously shifted as successive quantitative easing programs began and ended, and although Fed purchases had an impact on bond prices to some extent, it is clear that the decade after the credit crisis featured a functioning bond market doing what it usually does — estimating and reacting to likely future trends of interest rates and inflation. Since March of this year, however, that functioning has more or less halted. The lack of movement since then feels like the first six months of market action of a freshly fixed Treasury yield curve.



With short-term interest rates back to near zero, and with a record-low 10-Year Treasury yield of just 0.6%, there has been a lot of interest-rate fuel during the strong market rebound from the sell-off in February and March. However, the broader question remains: with the Fed and other central banks having so dramatically expanded their balance sheets this year, and with interest rates having dropped to record lows, why have equity indexes not soared beyond their highs over the past few years? The answer may well prove to be found in the pillar underlying the past decade that investors usually ignore — the market's long-term estimate of future inflation.

In our discussions of the 1960s and 1970s, a major theme has been highlighting the quiet, almost imperceptible transition from a stable, low-inflation market environment, to an environment where the market's long-term estimates of inflation begin to rise. Although it was not until well into the 1970s that inflation became a widespread concern among investors and the public at large, the markets began reacting to rising rates of inflation well before then. For stocks, the peak cyclically adjusted valuation during this period occurred in January 1966, just one month after President Johnson confronted Fed Chairman McChesney Martin at his ranch in Texas about the Fed's recent rate hike — which had been done against the president's wishes. From that high-water mark, the stock market's valuation and real interest rates began a long descent, which began so slowly at first that it was hardly perceptible except to the most astute observers. In retrospect, however, it was a pivot of enormous consequences for investors, because it marked the moment at which the real value of investments in bonds and stocks bumped up against a glass ceiling that would remain in place until the 1980s for the standard portfolio of stocks and bonds.

There were many hallmarks of that inflationary era, but one of the key drivers was a rapidly expanding federal budget deficit, and a central bank that ended up enabling those deficits with monetary expansion. The fact that the Fed ended up playing the role of enabler, despite the reluctance of many Fed officials nearly every step of the way, is one of the reasons why that era of Fed history is known as the Second Great Mistake (the First Great Mistake being the Fed's inaction during the early 1930s). This second mistake has haunted the halls of the Eccles building in Washington, D.C., for the past forty years, and throughout that time Fed officials have gone to great lengths to emphasize their constant vigilance to any possible threat of higher inflation.

As of this past month, however, it appears the Fed has decidedly put the lingering fears over the Second Great Mistake behind it. Instead, it has now apparently embraced higher inflation as its stated goal going forward. After a yearlong review of monetary policy, which aimed to understand why inflation remained well below its 2% target throughout the decade following the financial crisis, Chairman Powell announced in an August speech that the Fed's monetary policy would no longer aim for inflation to simply reach 2% — it would aim for inflation to *average* 2% over the long term. The difference would effectively result in periods where the Fed would pursue policies that would result in inflation rates over 2%, in order to compensate for early periods during which inflation ran below 2%. Following the regularly scheduled meeting of the FOMC this past month, Chairman Powell elaborated on the new policy during his press conference:

> **Hence, as we say in our statement, with inflation running persistently below 2 percent, we will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent.** We expect to maintain an accommodative stance of monetary policy until these outcomes, including maximum employment, are achieved. With regard to interest rates, we now indicate that **we expect it will be appropriate to maintain the current 0 to 1/4 percent target range for the federal funds rate until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time**.
>
> **In addition, over coming months we will continue to increase our holdings of Treasury securities and agency mortgage-backed securities at least at the current pace**. These asset purchases are intended to sustain smooth market functioning and help foster accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

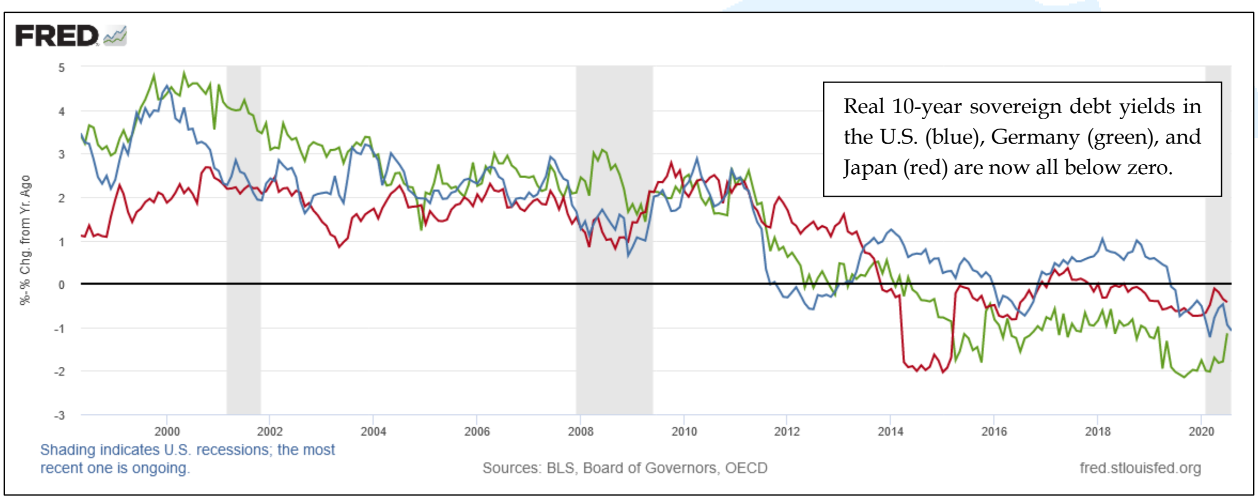
For those of us who have followed the Federal Reserve for many years, and who understand the historical context in which the above announcement was made, it is incredible to witness this pivot from a deep institutional fear over the prospect of inflation rearing its ugly head, to embracing inflation as the primary solution needed to get monetary policy out from the tight corner the Fed finds itself in. After watching its preferred gauge of price changes linger below its 2% target while large sectors of the economy deleveraged over the past decade, the Fed has apparently decided that a more active approach — even more active than the zero percent interest rates and quantitative easing over the past decade — is now required to accelerate price increases in the economy. The primary, if unstated, goal of such an acceleration of prices is to allow monetary policy to get up off the mat, so to speak, and give the Fed back the ability to raise and lower interest rates as it sees fit.

There is no way to know, of course, how successful the Fed will ultimately be in stoking the inflation it now seeks. When there are strong demographic and/or deleveraging drags on economic growth, sustained inflation can prove elusive. Japan's central bank has tried for decades to ignite a sustainable rise in prices, to no avail. And in Europe, even negative short-term interest rates and negative long-term bond yields have not prevented the Eurozone's main inflation gauge from falling back to below zero this year, for the third time in the last decade. Economic prices are a complex interplay among many significant factors, and monetary policy is only one part of that dynamic.

What we do know is that the Fed is now intent on deliberately pursuing a more aggressive inflationary policy than it has up to this point. And we also know that this pivot in monetary policy toward higher inflation comes just when the federal government's budget outlook over the coming decade will require nothing less than full cooperation from the Federal Reserve, just as it did in the late 1960s and 1970s. This time, however, as we have discussed recently, the Fed appears to be welcoming policy coordination while it encourages more federal fiscal support for the economy. Along with additional calls for more fiscal stimulus over the past month, Federal Reserve Vice Chairman Richard Clarida had this to say regarding interest rates in a recent interview:

> We're not going to even begin to think about lifting off, we expect, until we actually get observed inflation — and we measure it on a year-over-year basis, equal to 2%. That's at least — we could actually keep rates at this level even beyond that. We now think that to anchor inflation expectations at 2%, we need, coming out of recessions, to spend some time above 2% to balance off those times that we've been below.

By waiting until an inflation rate of 2%–3% has become firmly entrenched before considering interest rate increases, the Fed is effectively assuring that the transition to modestly negative real rates in the U.S. over the past year is just the beginning of a new era. If so, the reason the 10-Year Treasury yield now sits firmly at just 0.6% may be because an increase in the Fed Funds rate above zero is now nowhere in sight.



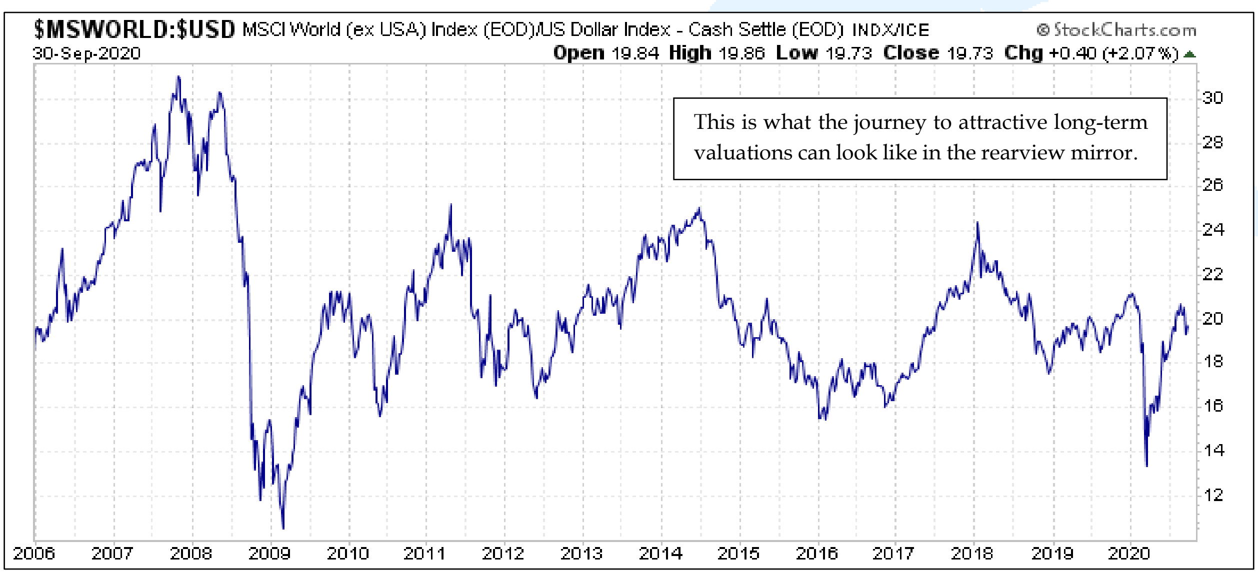
Undervalued Equity Markets Outside the U.S. Begin to Attract More Attention

> *Berkshire Hathaway Inc's $6.2 billion foray into Japan's five largest trading houses may signal billionaire Warren Buffett's expectation that inflation and a falling U.S. dollar may make international equities more attractive when economies worldwide recover from the coronavirus pandemic. The trading houses, known as sogo shosha with their diversified business lines including commodity exploration, fit the legendary investor's taste for classic value stocks, which have lost investor favor.*
>
> \- Reuters, September 2020

There were two notable sets of headlines that generated attention over the summer, both concerning Berkshire Hathaway and Warren Buffett. The first set, in August, revealed Berkshire Hathaway had recently purchased a 21-million-share position in Barrick Gold, one of the largest gold mining companies. The headlines which swirled around following this revelation mostly took some form of "Buffett Buys Gold," even though it is highly unlikely Buffett himself had anything to do with the decision to invest in Barrick; it is more likely one of Buffett's deputies, who more or less operate independently, purchased those shares. Nevertheless, since Buffett has long questioned the value of investing in gold, and has also long been reluctant to invest in mining businesses, Berkshire's departure from those long-held views made news.

The second headline likely *was* directly connected to an investment decision by Buffett himself. On Buffett's 90th birthday, Berkshire Hathaway announced that it had invested more than $6 billion in five Japanese conglomerates. In the press release, Buffett was quoted as saying, "I am delighted to have Berkshire Hathaway participate in the future of Japan," and the statement went on to say that "Berkshire Hathaway's intention is to hold its Japanese investments for the long term."

While so much attention is focused on the U.S. equity market, and on the six large technology stocks which have been responsible for so much of the S&P 500's levity this year, markets outside the U.S. have languished for fifteen long years. For dollar-based investors, the MSCI World (ex-USA) Index today trades 34% below its peak in 2007, at the same price it ended at in 2005.



Whether undervalued markets appear attractive or not tends to depend on how an investor reacts to the view in the rearview mirror. Some investors tend to look at a view like in the chart above and quickly recoil, thinking that such a prospective investment with a history like that could not possibly be anything but a trap. After all, they think, if there was anything worthwhile there as an investment, it would have performed better. Other investors, however, look at the same view and become curious. They begin to look into what brought about the performance in the rearview mirror, and investigate whether there is now any value there that others are not paying attention to. If there is value there, a view in the rearview mirror like in the chart above can be cause for great excitement.

Over the course of multiple business and market cycles, investment success comes with the ability to buy and hold investments which represent a good long-term value, and shun those which are overvalued, even when they are popular. It is not easy to do, but the current market environment represents such a stark contrast between markets which are undervalued and ignored, and those which are tremendously overvalued and popular, that there is no mistaking one for the other.

In that context, it was welcome to learn Berkshire Hathaway had invested in the markets which represent two of our largest allocations, as it seems traditional value investors are now apparently beginning to see the value which we have seen for some time. While our current allocation to Japan and other markets outside the U.S. is only a fraction of what it will likely be coming out of the current recession, our allocations to those markets and to precious metals remain primarily long-term investments. These are allocations which will likely feel a strong valuation- and currency-fueled tailwind as real interest rates sink deeper into negative territory in the U.S., and that tailwind has likely only just begun to be felt.

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