



September 2021

Dear Investor,

On the third trading day in January, the U.S. Dollar Index fell to a new low, continuing a downtrend that began shortly after the market panic in March 2020. However, since that day in January, the dollar has spent the past nine months rebounding, and in the last week of September the dollar traded at the highest level of the year against other major currencies — up 6% from January’s low.

As much as the decline in the dollar underpinned the major market themes in 2020, the rebound of the dollar has done the same in 2021. The rally in the dollar this year has coincided with a rise in long-term Treasury yields, a trend which took on new vigor on the very first trading day of the year. The yield on the 10-Year Treasury Note ended 2020 at 0.917%, up from its lowest levels near 0.4%, but it rose dramatically during the first quarter, to as high as 1.765%. And after cooling off during the summer, Treasury yields have recently been on the rise again — which fueled additional dollar strength in September.

The rise in the dollar and Treasury yields have been accompanied by a relatively hawkish shift in tone from Federal Reserve officials in recent months regarding the future path of monetary policy. While the Fed continues to buy \$120 billion per month of Treasury and mortgage-backed securities, Fed officials have been gently preparing the financial markets for a shift in that policy since June. That preparation continued in September with Fed Chair Jerome Powell saying it will likely be time to start tapering the pace of asset purchases “soon.” Powell also said that while the economy has progressed enough to consider tapering the pace of asset purchases, the criteria for raising interest rates off the zero-bound are stricter and have not been met.

We’ll discuss the markets in the pages below, in light of the shifting sentiment regarding the path of monetary policy in the year ahead. The consensus appears to feel that the economic recovery from the pandemic will enable the Federal Reserve to wind down monetary stimulus over the next year, and then begin raising interest rates in 2023. However, with stocks, real estate and the government now more leveraged to ultra-low interest rates than ever, the response to an increased possibility of higher rates may prove to be a major impediment to tightening monetary policy. These conflicting forces are part of the *Third Great Mistake*, and the inability of monetary policy to sufficiently tighten amid these pressures will likely be the hallmark of this era.

In this month’s letter:

- ▲ Investing in Undervalued Markets Amid a Monetary Bubble
- ▲ As the Fed Considers Tapering, the Phase Shift in the Bond Market Is Clear

Investing in Undervalued Markets Amid a Monetary Bubble

If you go back some years, I think we—people who were working at the Fed in 2013 and '14—took away the lesson that the markets could be very sensitive to news about the size of the balance sheet, the pace of asset purchases, the pace of runoff, and things like that. So we thought carefully about this, on how to normalize policy, and came to the view that we would effectively have the balance sheet runoff on automatic pilot and use monetary policy, rate policy, to adjust to incoming data.

- Fed Chair Jerome Powell, December 19, 2018
(Federal Reserve Balance Sheet: \$4.08 trillion)

Corporate defaults are very low in the United States right now. Corporate leverage built up over the course of the long expansion that ended with the pandemic. We were concerned in the last year or so, and then I'd say very concerned at the beginning of the pandemic that, if you've got a highly leveraged company and your revenue stops for an uncertain period, as things happened at the beginning of the crisis, we were very concerned that there would be a wave of defaults. It didn't happen to a significant extent because of the Cares Act and the response that we undertook and all that. It was a much stronger response than we've ever had. And I think for whatever reason now you have very, very low default rates now among corporate debt.

- Fed Chair Jerome Powell, September 22, 2021
(Federal Reserve Balance Sheet: \$8.49 trillion)

In a sign of the times, this past month marked a telling milestone for the S&P 500. Although long-term Treasury yields remain near the lowest levels in history, the dividend yield of the S&P 500 fell below those ultra-low yields in September. At just 1.3%, the dividend yield from large-cap U.S. stocks was lower than the 10-Year Treasury yield of 1.5%. The dividend yield of the S&P 500 has been lower than it was in September during one other brief period, between December 1999 and February 2001. During those fourteen months at the very peak of the tech bubble, it fell as low as 1.1%. That remains the lowest yield on record, and it was just two tenths of a percent below the yield this past month.

At the same time as the S&P 500 reached its lowest dividend yield on record, when the tech bubble had reached its zenith, the demand for U.S. financial assets had grown so strong that the U.S. dollar was trading at the highest level in more than a decade. The inflation of the tech bubble during the 1990s had inflated the attractiveness of the dollar along with it, and this resulted in a 40% rise in the U.S. Dollar Index between 1995 and 2000. As the dividend yield of the S&P 500 reached a record low in August 2000, it marked a singular moment of overvaluation of U.S. financial assets, and the currency they are based in.

For investors, the peak in 2000 presented a stark contrast between overvalued U.S. financial assets, including the U.S. dollar, and undervalued markets, currencies and asset classes outside the dollar. Yet as glaring as that value-divergence was, it also represented a difficult short-term allocation dilemma. The bursting of an equity market bubble in a major economy like the U.S. is an event which inevitably impacts markets around the world, and undervalued markets can be just as volatile as overvalued markets in the short term. In fact, investor sentiment surrounding severely undervalued markets can be so fragile that the smallest spark can ignite panic selling.

As the tech bubble in the U.S. began to deflate, global equity markets entered a particularly volatile period alongside U.S. stocks. Although equity markets outside the U.S. were relatively undervalued

and had lagged the U.S. market for years, global stocks declined just as much as the S&P 500 did between 2000 and 2002. And for dollar-based investors, the relatively undervalued currencies of these markets did not cushion the losses during those years. The blue line in the chart below represents the U.S. dollar-adjusted MSCI World (ex-USA) Index, and as you can see by the left axis, a dollar-based allocation to global stocks fell more than 50% from its peak in late 1999 to its low in 2003. This was a similar magnitude of loss to that suffered by the overvalued S&P 500 during those years.



One enduring lesson from the market action following the peak in 2000 is that while undervaluation leads to higher returns over time, it does not protect a market or asset class from extreme short-term volatility. The tech bubble was centered in the U.S., but the volatility stemming from the bust propagated throughout global equity markets – regardless of valuation.

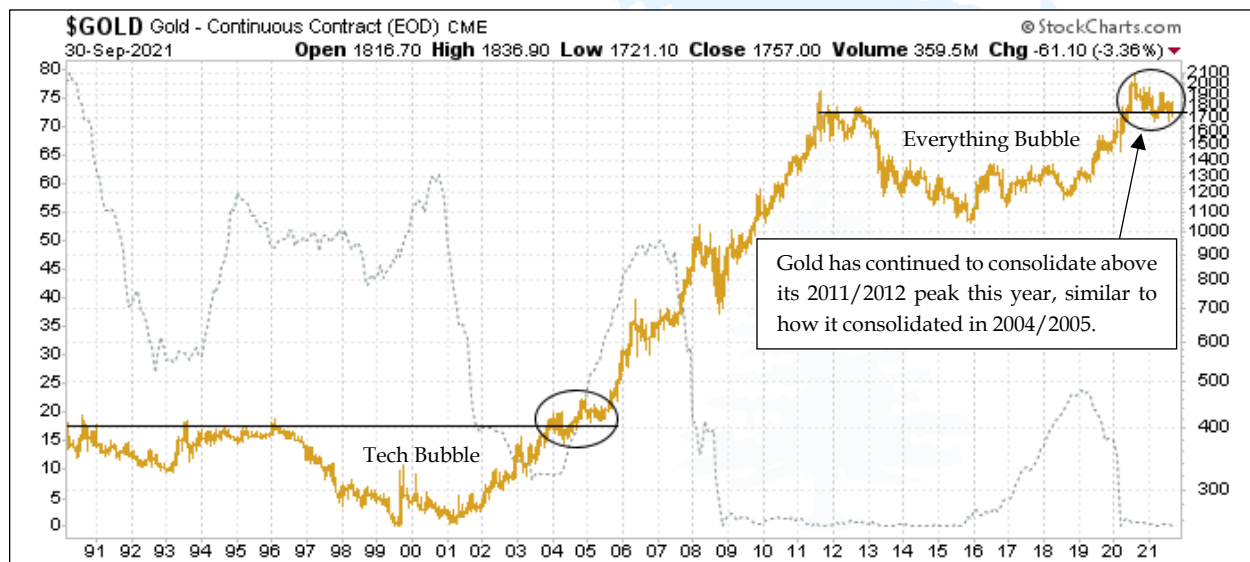
Yet while undervaluation does not offer investors protection from short-term volatility, it does lead to much stronger returns as the volatility subsides, and that dynamic was on display in the years following the tech bust. After 2002, undervalued global equity markets led the way during the recovery, quickly exceeding their peak in 2000. Returns to dollar-based investors were further propelled by rising currencies outside the U.S. dollar after 2002. By the peak of the next cycle in 2007, an investment in undervalued global equity markets had doubled relative to the S&P 500, rewarding investors who maintained their focus on value through all the volatility.

Today, the value disparity in global equity markets is more extreme than it was at the peak of the tech bubble, not only because the U.S. market is more overvalued that it was in 2000, but also because global equity markets have trailed behind the U.S. market by a far larger degree in recent years than during the 1990s. For dollar-based investors, global equity markets have lost 60% of their value relative to the S&P 500 since 2007 (shown by the grey dashed line in the chart above), and they remain below the nominal peak value reached in 2007 (blue line). This is a similar, but more extreme than, value divergence at the peak of the tech bubble. In these circumstances, global equity markets represent a more attractive long-term opportunity than existed twenty years ago, but it is a long-term

opportunity which remains vulnerable to short-term shocks of potentially greater magnitude that could emanate from any downturn in the U.S. market.

Similar short-term risks are embedded in markets which benefit directly from the end of a major equity market bubble. While undervalued equity markets eventually attract capital from overvalued equity markets, the end of the tech bubble twenty years ago created a global downturn that negatively impacted all equity markets between 2000 and 2003. However, the easing of monetary policy by central banks around the world directly benefited real assets like precious metals right from the beginning of the bear market. In contrast to undervalued global equity markets, which suffered through an additional erosion of value during the recession in 2001, the tech bust was a source of increasing value for precious metals from the start.

The tremendous market volatility between 2000 and 2003 impacted nearly all asset classes, but its impact on assets like gold and silver represented a set of risks and opportunities quite distinct from equity markets. When a bubble begins to burst, a new era of monetary easing is quickly ushered in which fuels a tremendous increase in the underlying value of real assets. Amid this increasing value, volatility stemming from deleveraging equity markets can weigh on precious metals in the short term, but the rising tide of value represents a resilient undercurrent which ultimately leads to higher prices, even as equity markets trend lower.



The market peak in 2000 was not the peak of a bubble fueled primarily by monetary policy – it marked the end of a speculative mania surrounding new technologies. Yet its demise ushered in an era of monetary easing that resulted in a reversal of the relative outperformance of U.S. financial assets, including the U.S. dollar, and marked the beginning of an eleven-year rise in the price of gold.

The rise in gold began only a few months after the dividend yield of the S&P 500 reached its record low in August 2000, and the short-term volatility stemming from the 2000–2003 bear market, while at times negatively impacting gold, also accelerated the increase in its underlying value. The dashed grey line in the chart above shows how the 3-Month Treasury yield ultimately fell from 6 percent in

2000 to zero percent beginning in 2008, and gold anticipated this long trend of monetary easing – which was unimaginable amid the unbridled optimism at the peak of the tech bubble – by strongly rising throughout the decade.

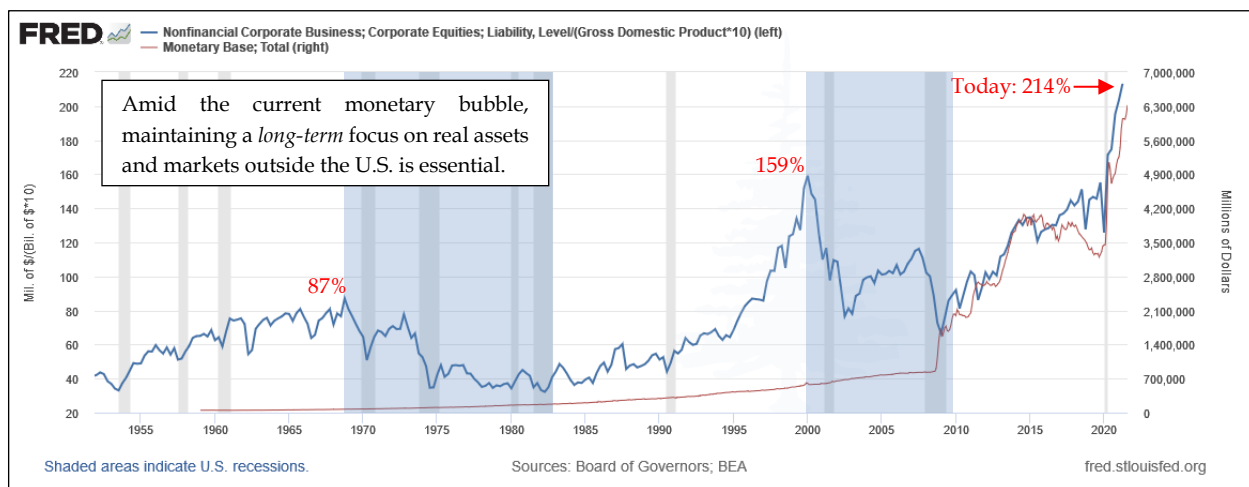
While precious metals themselves endured periodic corrections in the decade after the tech bubble, the share prices of stocks related to precious metals were far more volatile – especially during the fragile sentiment early in the trend. While the S&P 500 had a negative return between 2000 and 2011, stocks related to precious metals advanced at a 14% annualized rate. However, there were significant corrections along the way, and the underlying sources of this volatility were diverse. At times, mining stocks fell amid a steep selloff in the broader stock market, as was the case with the 38% decline in the Philadelphia Gold and Silver Index in the summer of 2002. At other times, investor sentiment turned strongly pessimistic on gold, such as when the Federal Reserve began to tighten monetary policy in 2004. Many of the declines in gold and silver mining stocks in the years after the peak of the tech bubble were particularly harrowing, but they all represented corrections within an ongoing bull market.



Investments in precious metals, and precious metals-related stocks, were one of the few allocations an investor could maintain to earn a positive return while the broader market devalued after the peak of the tech bubble. Yet precious metals were also one of the more difficult allocations to maintain committed to through the volatility along the way. It was important to understand the strength of underlying trend through the volatility, and it was important to have a thorough understanding of how and why real assets increase in value as a bubble bursts and risk assets begin to devalue.

This understanding of what drives returns in real assets is more important today than it was twenty years ago, because the market environment today is not characterized by a typical speculative mania in risk assets – it is a fully fledged *monetary* bubble that has inflated stocks, bonds and real estate values simultaneously. What we have dubbed the *Third Great Mistake* in these letters is the small, confined corner the Federal Reserve now finds itself in, where it cannot tighten monetary policy without negatively impacting the price and value of nearly all U.S. financial assets. The implication

this has for monetary policy in the years ahead is substantial, and it will likely prove particularly relevant for the strength of trend in real assets when the current bubble begins to deflate – a process which has not yet begun.



If we take a moment to remember back to the fall of 2018, the Federal Reserve believed at the time that it was finally on a clear path to normalizing monetary policy, after years of zero-percent interest rates and the extraordinary monetary expansion in the decade following the financial crisis. Although volatility in the financial markets had increased markedly as the Fed’s balance sheet began to shrink and interest rates steadily increased above 2%, Fed Chair Powell was confident enough with the path ahead to say in December 2018 that the balance sheet reduction would continue in 2019 as if on *automatic pilot*. As the first quote above from Powell in 2018 notes, the Fed’s balance sheet was then just over \$4 trillion.

Less than three years later, the Fed’s balance sheet has more than doubled, and as the chart above attests, this has sparked a rise in risk asset prices that is unprecedented in the post-war era. As Powell acknowledged after the Fed meeting this past month, part of which is highlighted in the second quote above, the actions of the federal government and the Federal Reserve had an enormous impact on the financial markets over the past year and a half. They did indeed, and the guarantee the Federal Reserve provided to the corporate bond market last year set a precedent that won’t be easy to back away from in the future.

The Fed’s actions have also created conditions which have the potential to spawn one of the strongest bull markets in real assets on record in the years ahead, once risk asset valuations reach their zenith and begin to fall. Long trends lower in risk asset valuations, shown by the blue shaded areas in the chart above, have been accompanied by strong bull markets in real assets, and it is in this context which we view current volatility and corrections in precious metals, as we have seen in recent months. Long-term bull markets in real assets tend to begin slowly, with significant corrections in mining shares early on. However, amid the fragile investor sentiment prevalent in this sector as risk assets trade at unprecedented valuations, the long-term potential return is the highest.

As the Fed Considers Tapering, the Phase Shift in the Bond Market Is Clear

The Federal Reserve on Wednesday cleared the way to reduce its monthly bond purchases “soon” and signaled interest rate increases may follow more quickly than expected, with nine of 18 U.S. central bank policymakers projecting borrowing costs will need to rise in 2022. The moves, which were included in the Fed’s latest policy statement and separate economic projections, represent a hawkish tilt by a central bank that sees inflation running this year at 4.2%, more than double its target rate, and is positioning itself to act against it.

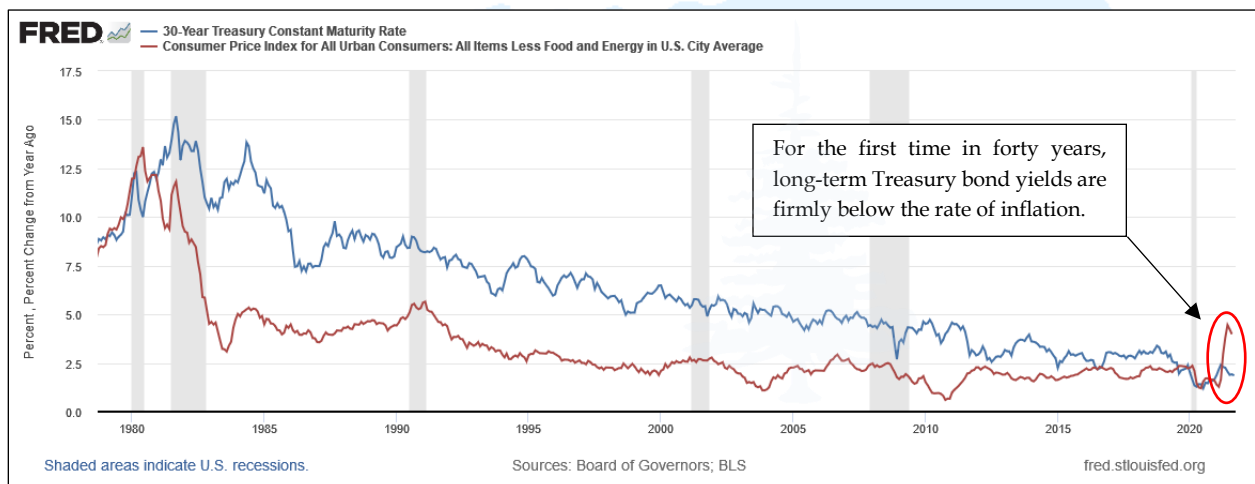
- Reuters, September 22, 2021

Resolving “tension” between high inflation and still-elevated unemployment is the most urgent issue facing the Federal Reserve right now, Fed Chair Jerome Powell said Wednesday, acknowledging the central bank’s two goals are in potential conflict. “This is not the situation that we have faced for a very long time, and it is one in which there is a tension between our two objectives...Inflation is high and well above target and yet there appears to be slack in the labor market,” Powell said at a European Central Bank forum, an apparent reference to the 1970s bout of U.S. “stagflation” that combined high unemployment and fast-rising prices.

- Reuters, September 29, 2021

This past month represented a challenging market environment — for stocks, bonds, commodities, and precious metals. The Federal Reserve held a meeting during the third week of September, and during the press conference following the meeting, Chair Jerome Powell gave the strongest signal to date that the time was drawing near to begin tapering the pace of the current monetary expansion. The Fed has continued to purchase \$120 billion of Treasury and mortgage-backed bonds every month this year, but Powell said that the time to begin tapering that pace would likely be *soon*.

In our June letter, we looked at a chart highlighting the crux of the Fed’s current discomfort: lower employment *and* faster rising prices. This uncomfortable dilemma has been the source of a vigorous debate inside the rate-setting committee in recent months, as Fed members more sensitive to rising prices have argued for an early end to the current monetary expansion, while members more sensitive to the employment gap argued for a continuation. This conflict between the two goals of the Fed’s dual mandate mirrors a similar conflict for investors, as inflation rates above 4% mean real earnings and interest yields from stocks and bonds (respectively) are both firmly negative.



In the early 1980s, the bond market was slow to accept that inflation rates had peaked. Treasury bond yields remained elevated while the inflation rate plummeted after 1982, and yields did not begin the process of accepting the endurance of lower inflation rates until after 1985. And for the next thirty years, the fear of higher inflation rates remained in the background.

Investors may be just as slow this time around to come to terms with the Fed's *Third Great Mistake* — that the Fed cannot allow interest rates or bond yields to meaningfully rise, due to the amount of public and private debt, and the elevated level of asset prices. The Fed can control interest rates or the monetary supply, but it cannot control both, and just as in the 1960s and 1970s, controlling interest rates is more important to today. This means that all of the assets valued off those ultra-low yields are priced courtesy of the Federal Reserve, and it also means that uncomfortably high inflation rates may not be as transient as expected in the years ahead.

Yet in this environment of record valuations in risk assets, the price of gold has firmly consolidated above its 2011/2012 peak during the past year, and appears to be preparing for another advance. Gold began to rise in 2018 when the consensus view was that monetary policy was set to tighten further in 2019 and beyond, but it is often in those circumstances, when the consensus view is fully priced into a market, when markets can begin to move the other way. If precious metals and commodities were to begin another advance over the next year, the pessimism reflected in mining shares in recent months may reverse as quickly as it did after 2018.

The consensus today views the tightening of monetary policy over the next two years in nearly the same certain terms as it did in 2019, and yet the continued strength in gold suggests the anticipated tapering and interest rate increases may not arrive as planned. One can only guess at what may transpire to derail those plans, but with stocks, real estate and the government now more leveraged to ultra-low interest rates than ever, it doesn't take much imagination to understand how high the odds are.

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

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