January 2021

Dear Investor,

This past year was a truly remarkable year in the markets, and not only because we faced the first global pandemic in nearly a century, or witnessed spectacular events such as a 0.4% yield on the 10-Year Treasury note and a negative price of oil. Although it may seem like ancient history, you may recall that one year ago, before the pandemic hit, the economy was on the cusp of a recession. With monetary policy having been tightened in 2017 and 2018, the Treasury yield curve had strongly inverted in 2019, signaling a recession was likely on the horizon. In that context, a recession over the past year was not a surprise. What made this past year remarkable was how the recession, with the added weight of the pandemic, evolved into a truly threshold-crossing event for the markets.

When the history of this period is written, the past year may be remembered as the moment when market prices began to be influenced more by monetary policy than by underlying economic fundamentals. Our last few annual letters have focused on the events leading up to another such erosion of economic influence, as there have been strong indications another such threshold was approaching. That a disconnect suddenly arrived due to the pandemic, which resulted in the steepest global economic contraction since the 1930s, was unpredictable. That it arrived at all, however, was not so surprising.

Since last March, investors the world over have been attempting to assess the implications of receiving almost no return from risk-free assets. In the years following the Great Recession, short-term interest rates were pinned near zero, but investors could still receive a modest nominal return from longer-term risk-free assets: the yield on the 10-Year Treasury note fluctuated around a central range of 2%–2.5% between 2009 and 2019; in hindsight, this reflected the market's assessment that the era of zero-percent short-term interest rates following the financial crisis would eventually come to an end, and eventually it did. A 10-Year Treasury yield near 2.5% also allowed conventional risk asset valuation assessments to continue, however stretched the conclusions became. As stocks and other risk assets climbed ever higher, continued low Treasury yields provided the justification.

This past year, however, the 10-Year Treasury yield traded in a range far below any other range in history, including the lowest yields seen during the Great Depression. After hitting a record low of 0.398% during the panic in March, the 10-Year Treasury continued to fluctuate between 0.5% and 0.9% through the rest of 2020. Unlike the years following the financial crisis, such a low yield on the 10-Year Treasury may suggest zero-percent short-term interest rates are here to stay, even if inflation rates rise above the Federal Reserve's target. The absence of any return from risk-free assets has prompted deeper questions that venture beyond the confines of conventional value assessments.

The reaction to the phase-shift in Treasury yields had a dramatic impact on risk assets in the latter half of 2020. Spurred on by the lure of value relative to a sub-1% nominal risk-free yield, the U.S. equity market rose to the highest valuation in history by some measures. Adding fuel to the speculative fire were the actions of the Federal Reserve beyond lowering short-term interest rates. In just three months, between March and June, the Fed expanded its balance sheet as much as it did over six years following the financial crisis. This astounding monetary expansion, coupled with the $2.2 trillion pandemic relief bill passed by Congress, resulted in the highest growth rates of broad money supply measures since World War II. As it stands, the Federal Reserve's balance sheet has now swelled eight-fold since the financial crisis in 2008.

Yet as dramatic as the monetary expansion in the U.S. has been over the past year, it may prove to be just the beginning. Central banks from New Zealand to Sweden joined the Fed by initiating their own quantitative easing programs in 2020, and there is a growing realization that the era of influencing the economy solely with interest-rate adjustments may now have been supplanted by a new era of waxing and waning levels of quantitative easing, coupled with fiscal stimulus. This transformation of monetary policy from growth and inflation management via interest rates to an era of ongoing adjustments to the pace of central bank balance-sheet expansions is an historic threshold to have crossed, and it appears markets have only just begun assessing its long-term implications.

To understand how important these issues were to market prices in 2020, we can imagine the likely progression of events had the Federal Reserve and other central banks *not* stepped in as they did. The volatility early in the year, when the equity market suffered its quickest decline of 30% on record, would, in all probability, not have been followed by a complete recovery. In addition, many of the large companies which were temporarily frozen out of the credit markets would have likely been forced into a much more dramatic belt-tightening, resulting in more job losses on top of the tens of millions seen early in the year. There would also have likely been at least a few large bankruptcies, and instead of new record lows in junk bond yields, investors probably would have endured record losses in corporate credit, which would have likely sparked a violent, forced deleveraging throughout the financial markets. The policy response in 2020 successfully prevented such a dire outcome, but in the process it also further entrenched the very dynamic which made that outcome possible. In the long run, this entrenchment will likely be recognized as part of the Fed's *Third Great Mistake*.

Our discussion in this letter will focus on the impact of having crossed the threshold into this new era. Beyond the pandemic, and the noise of the high-frequency economic and market data, this transit may prove to be a truly pivotal event for the markets. For context, we will begin our discussion with another return to the last pivotal time the markets begin to detach from the economy, which confounded value investors then just as much as the markets have in recent years.

In this year's annual letter:

- How an Inflationary Long-Term Bear Market Swindled Equity Investors
- This Era May Come to Be Remembered as the Federal Reserve's *Third Great Mistake*
- A Summary of Our Market Outlook
- In the Years Ahead, Real Returns May Be Confined to Unconventional Portfolios

How an Inflationary Long-Term Bear Market Swindled Equity Investors

> *The continuation of some degree of inflation is certainly probable in the future, and that is the chief reason why most intelligent investors now recognize that some common stocks must be included in their portfolio. However, that is only part of the question of the effect of inflation on investment policy...*
>
> *[T]he argument that common stocks are and always will be attractive, including the present time, because of their excellent record since 1949 – involves in those terms a very fundamental and important fallacy. This is the idea that the better the past record of the stock market as such, the more certain it is that common stocks are sound investments for the future… But you cannot say that the fact that the stock market has risen continuously (or slightly irregularly) over a long period in the past is a guarantee that it will continue to act that way in the future. As I see it, the real truth is exactly the opposite, for the higher the stock market advances the more reason there is to mistrust its future action…*
>
> \- Benjamin Graham, November 15, 1963

The year 1963, not unlike the year we just experienced, was a period of growing turbulence in the United States. Both at home and abroad, seeds were being sown for changes which would come to define the era ahead, in ways few could then imagine. At the time, those changes were still beyond the horizon. For most of the country, and especially for the financial markets, 1963 seemed like it was the best of times.

The stock market was a potent symbol of that *best of times* feeling. Over the past fourteen years, stocks had been rising almost without interruption, and the market had quadrupled since the dust had settled after the Second World War. Interest rates were comfortably low as 1963 began, as was inflation. Consumer prices had risen just 1.3% over the past year, and the rationing, price controls and inflation during and after the war were a distant memory. So was the debilitating unemployment during the Great Depression. The torch had recently been passed to John F. Kennedy, and his cadre of the best and the brightest seemed to embody a new era of optimism. Just the prior summer Kennedy had announced the U.S. would land on the moon before the end of the decade, and the Mercury missions were already carrying Americans into space. And although the Cold War with the Soviet Union hung overhead, Kennedy had just convinced Khrushchev to remove the nuclear missiles that had been installed in Cuba. By the end of 1962, having faced down the Soviet Union, and with the stock market fully recovering — yet again — from another selloff, it seemed Kennedy and the U.S. were poised to continue on a firmly upward trajectory.

As 1963 began, however, events would unfold which would prove to be harbingers of things to come. On the second day of January, five helicopters were shot down in the Mekong Delta region of southern Vietnam. In the battle that followed, three U.S. military advisors were lost alongside eighty-three South Vietnamese soldiers. The U.S. had maintained a limited involvement in Vietnam since sending thirty-five advisors along with the first shipment of military aid in 1950. However, 1963 would prove to be a pivotal year in the United States' involvement in the region. Originally sent to oversee the distribution of military equipment, then later to help train South Vietnamese soldiers, by 1963 there were sixteen thousand U.S. advisors and special forces in Vietnam, and by then they were accompanying the South Vietnamese army on combat missions. The situation in South Vietnam had been deteriorating for years, and the U.S. involvement had been growing, but most people in the U.S. were not yet paying much attention. More battles followed in the spring and summer, resulting in more U.S. casualties. By the end of 1963, 122 U.S. personnel would be lost, more than the 78 who had been lost throughout the entire involvement in Vietnam up to that point.

At home, 1963 also proved to be a pivotal year. In April, twenty civil rights demonstrators were arrested in Alabama for sit-in protests in downtown Birmingham, and the following month, Dr. Marin Luther King was arrested as he led demonstrators on a march through the downtown. In the months that followed, civil rights demonstrators faced police dogs and fire hoses as the number of protests grew. On June 14, protestors marched in Washington D.C. after Alabama's governor George Wallace had stood in the doorway of the administration building of the University of Alabama in Tuscaloosa, in an effort to block the registration of two African American students. The Alabama National Guard was federalized, and Federal troops were deployed to enforce the law and restore order. Civil rights protests and confrontations continued through the summer, culminating in the March on Washington in August, where 250,000 people gathered on the National Mall watched Dr. King deliver his *I Have a Dream* speech.

As civil rights protests grew in strength at home, and the turmoil engulfing South Vietnam steadily worsened, 1963 ended with the most shocking event of the year: the assassination of President Kennedy on November 22nd, as he drove through Dallas. Two hours after the assassination, with Jacqueline Kennedy standing at his side aboard Air Force One, Lyndon Johnson was sworn in as the 37th President of the United States. Although the passage of the Civil Rights Act Kennedy had championed earlier that year followed in 1964, so did a dramatic escalation of U.S. involvement in Vietnam. Two years later, there would be ten times more U.S. personnel in Southeast Asia. In time, the budgetary pressure resulting from the escalation of the war in Vietnam, coupled with Johnson's Great Society programs, would steadily increase political pressure on U.S. monetary policy. The inflationary consequences stemming from that political pressure would eventually impact the value of nearly all financial assets.

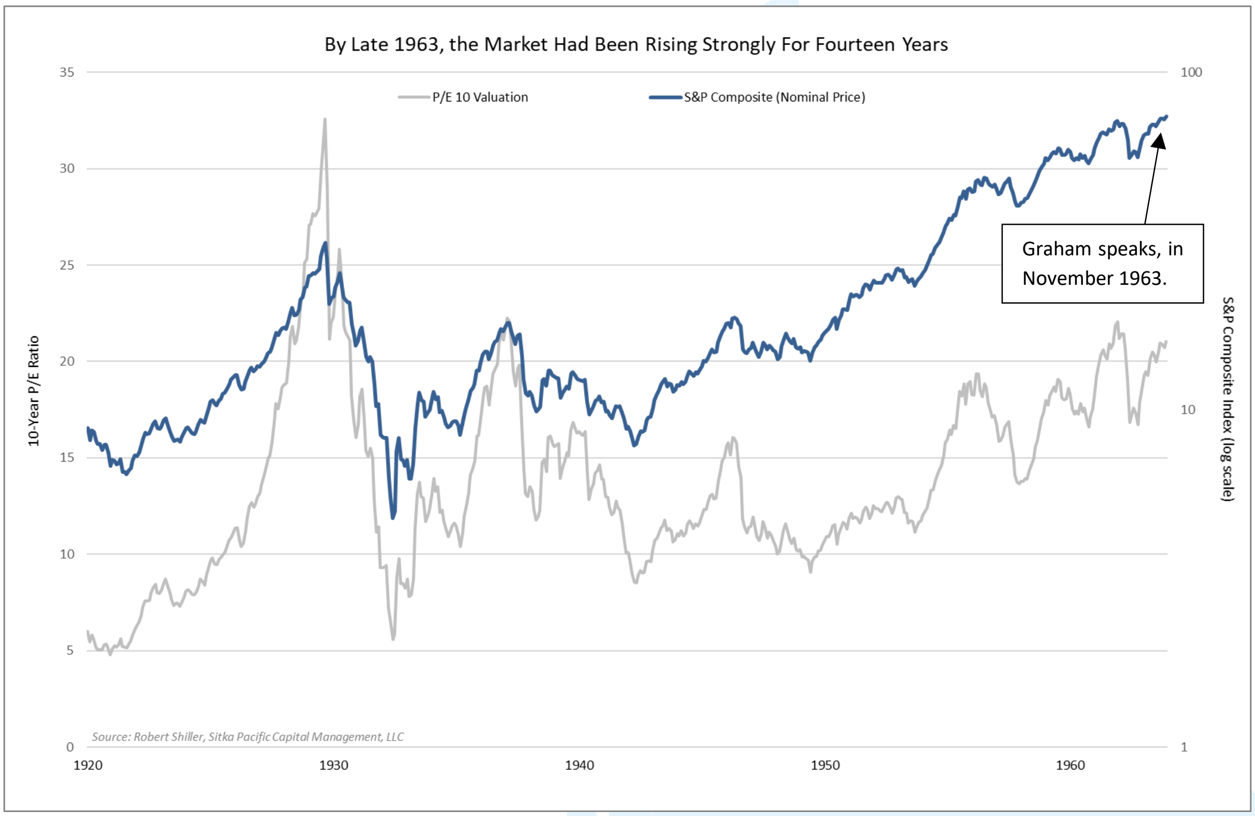
In November 1963, however, the *Great Inflation* was still beyond the horizon. Even so, inflation was not completely absent from the minds of those who remained focused on risks after stock prices had risen so far, for so many years. One week before that fateful day in Dallas, Benjamin Graham, the author of *Security Analysis* and *The Intelligent Investor*, delivered a lecture in downtown San Francisco, at the St. Francis Hotel. The lecture covered many topics, including the risk of nuclear war with the Soviet Union, but the main issue he focused on was the nature of the seemingly unstoppable stock market rise, and the assumptions which seemed to be driving it. What makes the discussion particularly interesting for investors today is that it represents the open ruminations of one of the greatest investing minds of the 20th century, the father of value investing, wrestling with the early signs of a monetary phase-shift that would fundamentally alter so many of the assumptions long used in assessing investment value.

Although the full implications of this phase shift would not become apparent for another decade, Graham spoke to the audience that November during one of the few genuine "it's different this time" moments in U.S. economic history. Up to World War II, every major war had been accompanied by significant inflation throughout the economy. This happened during the revolutionary war, when the Continental Congress authorized the printing of new currency to pay and provision the Continental Army; by 1778, amid widespread food riots, the annual inflation rate in the colonies rose as high as at 29%. Inflation also happened during the War of 1812, when prices rose 21% over three years. During the Civil War, prices rose 58% in dollars, but rose far more in confederate currency (which ultimately ended up worthless). And during World War I, prices rose 49% between 1915 and 1920. Yet despite periods of intense inflation during the wars in the 19th and early 20th centuries, there had been no lasting inflation of prices over the long term. The Federal Reserve Bank of Minneapolis estimates that in 1940, the purchasing value of the U.S. dollar was nearly the same as it was in 1800. Wartime inflations had inevitably been followed by periods of *de*flation when peace returned, and over the course of time this resulted in relatively stable prices.

The period during and after World War II, however, proved to be different. Wary of the potential for a deflationary economic downturn following the war, such as happened after World War I, and with memories of the deflationary spiral which ushered in the Great Depression still raw, the Federal Reserve and the Treasury Department agreed to maintain the vast wartime monetary expansion after 1945. Prices had risen 69% during the war, as price controls and rationing were instituted, but as price controls were lifted after 1945, the inflation continued: consumer prices rose another 186% in the decade that followed. For the first time in U.S. history, wartime inflation was not followed by a post-war deflation. The lack of post-war deflation was unfortunate for savers, as the real value of cash savings declined precipitously as the Federal Reserve suppressed interest rates below inflation rates during the war, in the interest of funding wartime expenditures at affordable interest rates. The lack of post-war deflation meant that loss of value was permanent.

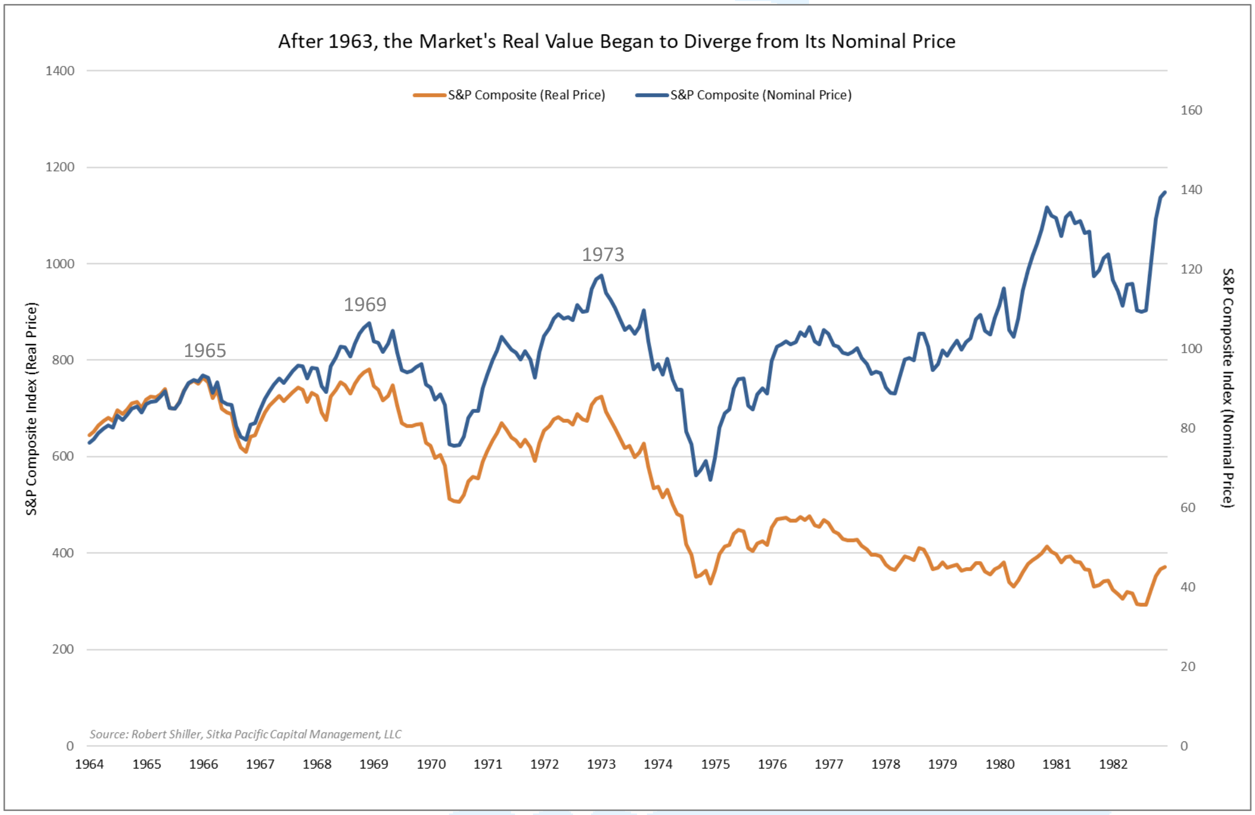
For Graham, expectations of future inflation resulting from the recent post-war experience appeared to be one of the main justifications investors were using to continue bidding up stock prices in the early 1960s, as stocks then seemed to be a far safer place to protect savings from inflation than bonds or interest-bearing cash. Yet by 1963 he was openly questioning whether inflation justified the *pay any price* mentality which was pervasive at the time. As he spoke that November, the market had been rising for a very long time, and for an investor like Graham, who had navigated the boom years of the 1920s, along with the ruinous market collapse during the Great Depression, remaining cognizant of the market's underlying value was one of the keys to long-term survival. It had taken twenty-five years for the market to return to the speculative peak of 1929, and it had only been a few years earlier, in 1958, that the market had risen above its inflation-adjusted price from 1929. Twenty-nine years was a painfully long period of time for the market's real value to remain below a speculative peak. Regardless of how much inflation was in the future, Graham continued to believe that paying too high a valuation introduced risks which eclipsed many of the long-term benefits of an allocation to equities in lieu of bonds or cash, no matter how low interest rates were.

At the same time, Graham attempted to find an adequate explanation for the ongoing strength in the market. As you can see in the chart below, every minor dip the market in the years leading up to 1963 had been followed by a quick and full recovery, despite valuations being at the highest levels in nearly thirty years. Given the novel post-war inflationary outcome, Graham very astutely observed that there was an apparent irony in using inflation as a justification for paying high prices for stocks, because a careful look at the actual history of the market's performance seemed to indicate that stocks actually disliked higher inflation. When inflation had been roaring just after the war in the late 1940s, stock prices had fallen, and valuations were low. Yet in more recent years, when there had been hardly any observable inflation (the Consumer Price Index had risen at a 1.2% annualized rate over the prior five years), stock prices had risen dramatically. This apparent negative correlation with actual price inflation over shorter periods of time seemed at odds with the main justification being used to justify the high market valuations. Graham concluded that investors were reading too much into the market's performance — i.e., they were taking the continued strength of the market to be evidence of inflation to come, instead of inflation actually driving stock prices higher. In other words, investors were assuming the cart was driving the horse.



As the years ahead would show, there would be elements of truth to the inflationary assumptions held by investors at the time, which seemed to be underpinning the strong stock market. Yet Graham's caution regarding high valuations and the apparent negative relationship between stocks and inflation would also prove enormously consequential for investors — though not in the ways he or anyone else could have foreseen at the time.

In his speech, Graham conceded it was possible that stocks should perhaps be valued more liberally than in the past (his words), due to the federal government's apparent commitment to prevent economic depressions. He cited the Employment Act of 1946, which we discussed in last year's annual letter, and he (once again) astutely observed that one of the effects would be a reduced likelihood of a depression-like decline in corporate earnings. Such a reduced downside tail-risk for earnings may justify a permanently higher fair value for the stock market, but in his estimation the market in 1963 had long since risen above his upwardly revised fair value estimate. While it was clear that the lack of postwar deflation and the reduced likelihood of a catastrophic decline in corporate earnings could result in a sustainable higher market valuation, it was also clear to Graham that investors had taken those rational conclusions and irrationally turned them into justifications for buying stocks at any price. As would be shown in the years ahead, while investors seemed to believe the result of the Employment Act was an overall reduction in risk, it was actually a swap of one set of risks for another.

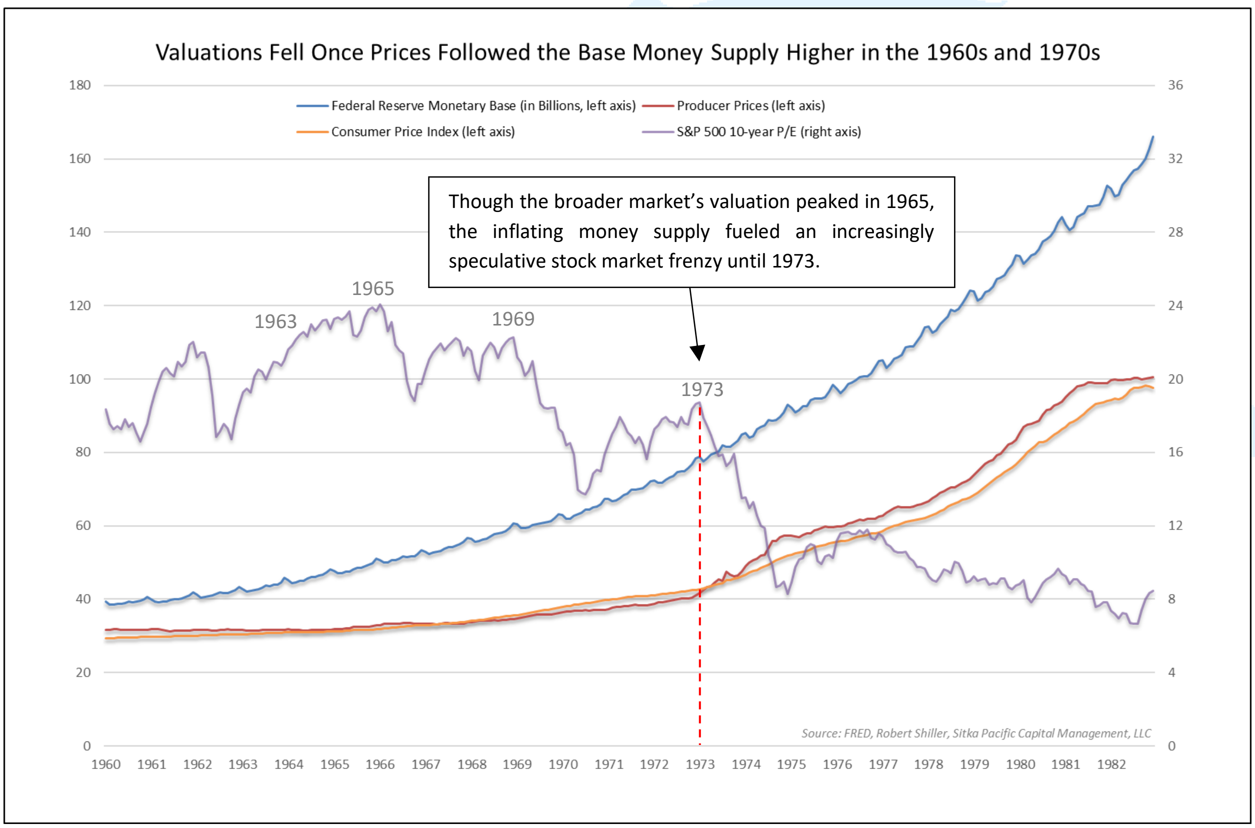


As we discussed in our last two annual letters, by 1963 events were already unfolding which would, in due time, bring those new risks to the surface. When Graham spoke in San Francisco, the monetary trends which would eventually bring down the Bretton Woods system of fixed exchange rates were already causing tremors. Between 1960 and 1965, dollar liabilities to foreigners increased substantially, while at the same time, the amount of gold the U.S. government held in reserve declined. As a result, by 1965 the U.S. had less than half the gold it needed to settle foreign liabilities, should those foreigners (mainly other central banks) request payment. By 1970, that gold coverage ratio of foreign liabilities would decline further to just 26%.

The year 1965 also marked a pivotal moment for interest rates. In what proved to be just the beginning of a fifteen-year-long trend, real short-term interest rates began declining, ultimately falling into negative territory, and this decline unfolded even though the Federal Reserve was increasing the Fed Funds rate throughout that time.

One of the principal misconceptions that turned the economic downturn in 1929 into a deflationary conflagration was a lack of awareness within the Federal Reserve of real, inflation-adjusted interest rates. By 1931, short-term interest rates had fallen below 1%, and Federal Reserve officials at the time believed that they had done all they could to ease monetary policy; in fact, they believed monetary policy was more accommodative than at any other time up to that point. What they missed, or were genuinely unconcerned about since prices had remained stable over the long term, was that with prices falling at an annualized rate of 10%, the real, inflation-adjusted short-term interest rate had risen to over 10%. While those at the Fed thought monetary policy was extremely loose, it was, in fact, ruinously tight. Thus began the *Great Depression*.

The Federal Reserve made a similar mistake in the 1960s and 70s, but in the opposite direction. We have discussed the progressive loss of independence of the Fed in those years, including Fed Chairman McChesney Martin's infamous run-in with Lyndon Johnson at his Texas ranch, after the Fed had raised rates in December 1965 without first informing the president. It was a significant event because it so poignantly marked the beginning of the loss of Federal Reserve independence during that era. Believing they were tightening monetary policy by increasing the Fed Funds rate in 1965 and in the years that followed, monetary policy was instead becoming progressively looser as the Fed found itself unwilling to accept the economic and political consequences of tighter monetary policy in the face of ever-expanding federal budget deficits. Thus began the *Great Inflation*.



The markets immediately took notice of the inflationary pivot in 1965. Ironically, however, some of the market's initial reactions served to reinforce beliefs among investors about the attractiveness of stocks amid rising rates of inflation.

When a central bank expands the money supply, the newly created money inevitably percolates into the economy unevenly, and the specific manner in which it does so depends on the specific conditions prevailing at the time. Its impact on the financial markets is equally specific to those prevailing conditions, though in the equity market, large monetary expansions have initially ignited animal spirits time and time again. This was certainly the case in the late 1960s and early 1970s. While the broader market's valuation quite rationally began to decline as inflation expectations increased, the expanding money supply fomented an increasingly intense search for investments which seemed able to maintain a positive real return. As bond yields began to move higher after 1965, rising inflation's deleterious effect on a long-term bond's price became clear. And as real interest rates declined, and then turned negative in 1970, the eroding value of cash also became increasingly clear. As inflation increased and bonds and cash became less and less attractive, and as investors desperately searched for a positive real return, shares of companies which seemed capable of growing their earnings even as consumer prices rose became highly sought after. This was the era of the Nifty Fifty, stocks which were considered such sure-thing long-term investments amid rising prices that no price was too high to warrant selling them. Price-to-earnings ratios of these stocks rose to incredible heights, which was justified by their unusually bright and stable outlook for real growth. They were known at the time as "one decision" stocks — the only decision anyone had to make was to buy them.

By the early 1970s, a decade after the Federal Reserve's balance sheet had lifted off from its stable postwar level, the speculative fervor surrounding the Nifty Fifty had concentrated and intensified. Yet even as the market made a series of new nominal highs off investors' hunger for a positive real return, it was steadily losing inflation-adjusted value. In a way, the increasingly desperate search for shrinking islands of perceived safety was an understandable reaction to the deteriorating market environment. However, Graham's observations in 1963 proved prescient in the end: after the speculative fever finally broke in early 1973, the Nifty Fifty's value plummeted along with the rest of the market. Paying a sky-high valuation for an equity share in a company, even one which seemed able to indefinitely maintain its real earnings, offered little protection from rising inflation.

A few years later, one of Graham's former students, Warren Buffett, penned an article in *Forbes* outlining his thoughts on why stocks did not hold their real value in the way investors had expected as inflation continued to rise. By the time the article was published in May 1977, the S&P 500 had lost 31% of its real, inflation-adjusted value since Graham had spoken in 1963, even though its nominal price had actually risen 36%. This divergence between the index's nominal price, which kept reaching marginal new highs, and its real value, which kept sinking, was part of how investors had been swindled by inflation. But it was only part. In the article, entitled *How Inflation Swindles the Equity Investor*, Buffett detailed the mechanics of the inflationary swindle Graham had feared back in 1963, when the market's valuation had been twice as high as it was in 1977. It is worthwhile to read his explanation in his own words (bold has been added):

It is no longer a secret that stocks, like bonds, do poorly in an inflationary environment. We have been in such an environment for most of the past decade, and it has indeed been a time of troubles for stocks. But the reasons for the stock market's problems in this period are still imperfectly understood...

For many years, the conventional wisdom insisted that stocks were a hedge against inflation. The proposition was rooted in the fact that stocks are not claims against dollars, as bonds are, but represent ownership of companies with productive facilities. These, investors believed, would retain their value in real terms, let the politicians print money as they might.

And why didn't it turn out that way? The main reason, I believe, is that stocks, in economic substance, are really very similar to bonds…

Looking back, stock investors can think of themselves in the 1946-66 period as having been ladled a truly bountiful triple dip. *First, they were the beneficiaries of an underlying corporate return on equity that was far above prevailing interest rates. Second, a significant portion of that return was reinvested for them at rates that were otherwise unattainable. And third, they were afforded an escalating appraisal of underlying equity capital as the first two benefits became widely recognized.* ***This third dip meant that, on top of the basic 12% or so earned by corporations on their equity capital, investors were receiving a bonus as the Dow Jones industrials increased in price from 133% of book value in 1946 to 220% in 1966. Such a marking-up process temporarily allowed investors to achieve a return that exceeded the inherent earning power of the enterprises in which they had invested.***

This heaven-on-earth situation finally was "discovered" in the mid-1960s by many major investing institutions. ***But just as these financial elephants began trampling on one another in their rush to equities, we entered an era of accelerating inflation and higher interest rates. Quite logically, the marking-up process began to reverse itself.*** *Rising interest rates ruthlessly reduced the value of all existing fixed-coupon investments.* ***And as long-term corporate bond rates began moving up (eventually reaching the 10% area), both the equity return of 12% and the reinvestment "privilege" began to look different.***

Stocks are quite properly thought of as riskier than bonds. While that equity coupon is more or less fixed over periods of time, it does fluctuate somewhat from year to year. Investors' attitudes about the future can be affected substantially, although frequently erroneously, by those yearly changes. Stocks are also riskier because they come equipped with infinite maturities. (Even your friendly broker wouldn't have the nerve to peddle a 100-year bond, if he had any available, as "safe.") Because of the additional risk, the natural reaction of investors is to expect an equity return that is comfortably above the bond return -- and 12% on equity versus, say, 10% on bonds issued by the same corporate universe does not seem to qualify as comfortable. ***As the spread narrows, equity investors start looking for the exits.***

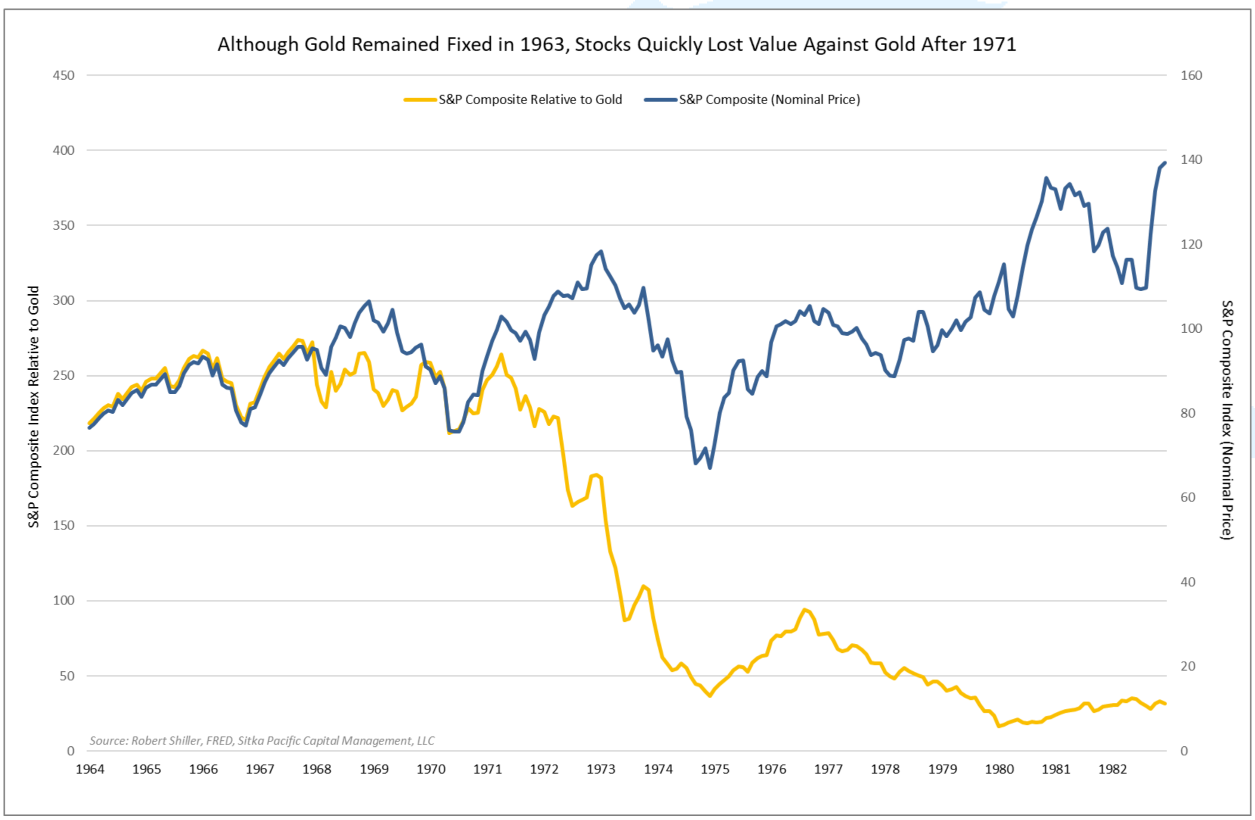
But, of course, as a group they can't get out. All they can achieve is a lot of movement, substantial frictional costs, and a new, much lower level of valuation, reflecting the lessened attractiveness of the 12% equity coupon under inflationary conditions. *Bond investors have had a succession of shocks over the past decade in the course of discovering that there is no magic attached to any given coupon level: at 6%, or 8%, or 10%, bonds can still collapse in price.* ***Stock investors, who are in general not aware that they too have a "coupon," are still receiving their education on this point.***

When he spoke, Graham had no inkling of the events that would lead to inflation rising as it did. He did not know that one week later, Lyndon Johnson would become president. He also did not know that five years later there would be more than half a million U.S. soldiers in Vietnam. And in all likelihood, he could not have conceived that a mere eight years later the U.S. would be forced off the gold standard for good, and for the first time the developed world would settle on a regime of floating fiat currencies. On November 15, 1963, all of these events lay in the future.

What Graham intuitively understood, however, is that in an environment of low interest rates, low inflation, and high equity market valuations, there is a significant underlying risk embedded in stock prices. He also understood, based on the inflationary postwar experience, that the dual mandate of the Employment Act of 1946 may have fundamentally tilted the economic landscape toward higher inflation over time. Yet while investors in the early 1960s seemed to have sensed this tilt toward higher inflation, they also seemed to have concluded that stocks were more attractive in the long run, even at the high valuations present when interest rates were near cyclical lows. Therein lies the key fallacy that Graham pointed to in 1963, and which Buffett later offered a more detailed explanation of in 1977: the "marking up" process as inflation rates and interest rates fall creates a tremendous tailwind for stocks, but when the process reverses, the resulting headwind is equally powerful.

Between Graham's lecture at the St. Francis Hotel and Buffett's published thoughts on the inflationary swindle in *Fortune*, the S&P 500 had lost real, inflation-adjusted value at an average rate of 2.7% per year. There is no doubt a long-term decline in real value was not the result investors in 1963 were anticipating. In the equivalent amount of time leading up to 1963, the S&P 500 had risen at a real annualized rate of 8.6%, the result of Buffett's *bountiful triple dip*, and investors in 1963 almost certainly expected the positive returns to continue.

Yet the inflation-adjusted decline still did not represent the entirety of the swindle of equity investors after 1963: stocks declined far more against real assets. Between 1963 and 1977, the S&P 500 fell at an annualized rate of more than 15% against gold, for a cumulative loss of 89%. Not coincidentally, this loss was similar in magnitude to the value lost at the depths of the Great Depression.



This Era May Come to Be Remembered as the Federal Reserve's *Third Great Mistake*

> *The success of the Federal Reserve System is apparent today…These [recent] events are deplorable, but they were of course inevitable and could not have been avoided.*
>
> - Charles Hamlin, Federal Reserve Board Governor, November 8, 1929

> *While the Federal Reserve would always accommodate the Treasury up to a point, the charge could be made – and was being made – that the System had accommodated the Treasury to an excessive degree. Although [Chairman Burns] was not a monetarist, he found a basic and inescapable truth in the monetarist position that inflation could not have persisted over a long period of time without a highly accommodative monetary policy.*
>
> - FOMC Meeting Minutes, March 9, 1974

> *The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation… In order to anchor longer-term inflation expectations at this [2%] level, the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.*
>
> - *Statement on Longer-Run Goals and Monetary Policy Strategy*, FOMC, August 27, 2020

The *Great Inflation* of the 1960s and 70s, the earliest stages of which were already underway when Graham spoke at the St. Francis Hotel, eventually produced some of the most astonishing economic dislocations in U.S. history. After 1963, there would be a parabolic increase in consumer prices, leaving the Consumer Price Index at three times its former level. Commodity prices would also triple. Near the end of the most rapid phase of that increase in prices, interest rates would reach the highest levels in U.S. history, and risk assets would sink to the lowest valuations in fifty years.

Yet as the earliest stages of the monetary expansion were underway in late 1963, none of the oncoming inflation of prices was reflected in the markets. Interest rates were low and stable, and valuations of risk assets were high and still rising. Though the impacts of rising inflation represented *risks* which were embedded in the prices and valuations at the time, the long process of pricing in those risks lay ahead.

Within the Federal Reserve System, the inflation which plagued the U.S. in the 1970s is known as the *Second Great Mistake*. The primary reason it is known as a mistake is because many of those within the Fed at the time understood the inflationary implications of the policies which were being enacted, but monetary policy traveled down that road anyway. It remains a case study of an institution that lost sight of its long-term goals while reacting to short-term problems. At every step along the road to higher inflation, the costs of prioritizing long-term price stability over the economic and market conditions at the time were, again and again, deemed too high.

It also represents another example, in a long history of examples, of what happens when political pressures are allowed to railroad monetary policy decisions. That many at the Fed were aware of how heavily monetary policy was being influenced by political considerations, while at the same time allowing that influence to continue, is another reason the inflation of that era is known as a mistake.

As the quote above from the Federal Open Market Committee meeting minutes in March 1974 attests, the Fed was well aware that *it* was the main source of the inflation problem, and that its delayed interest rate hikes and accommodation of ever-expanding debt sales by the Treasury had resulted in higher money supply growth rates and rising inflation (known as the "even keel" policy, the Fed would steady the markets by flooding the banking system with reserves during large Treasury debt sales, but would repeatedly fail to recall all of the additional reserves when the debt sales were complete). Yet it would be another six long, inflationary years after 1974 before decisive action would be taken to reassert the Fed's focus on long-term goals.

Underlying the many decisions that led to the inflation of the 1970s, however, were the haunting institutional memories of the Fed's *First Great Mistake* — the Great Depression. The deflationary spiral which took root after 1929 was not the first depression the U.S. had endured, as there had been downturns severe enough to be labeled depressions in the 1800s. However, it was the first depression after the Federal Reserve had been created, and the economic cataclysm that followed was seen as a failure of the System which had been established, in part, to ensure that panics and depressions were relics of the past.

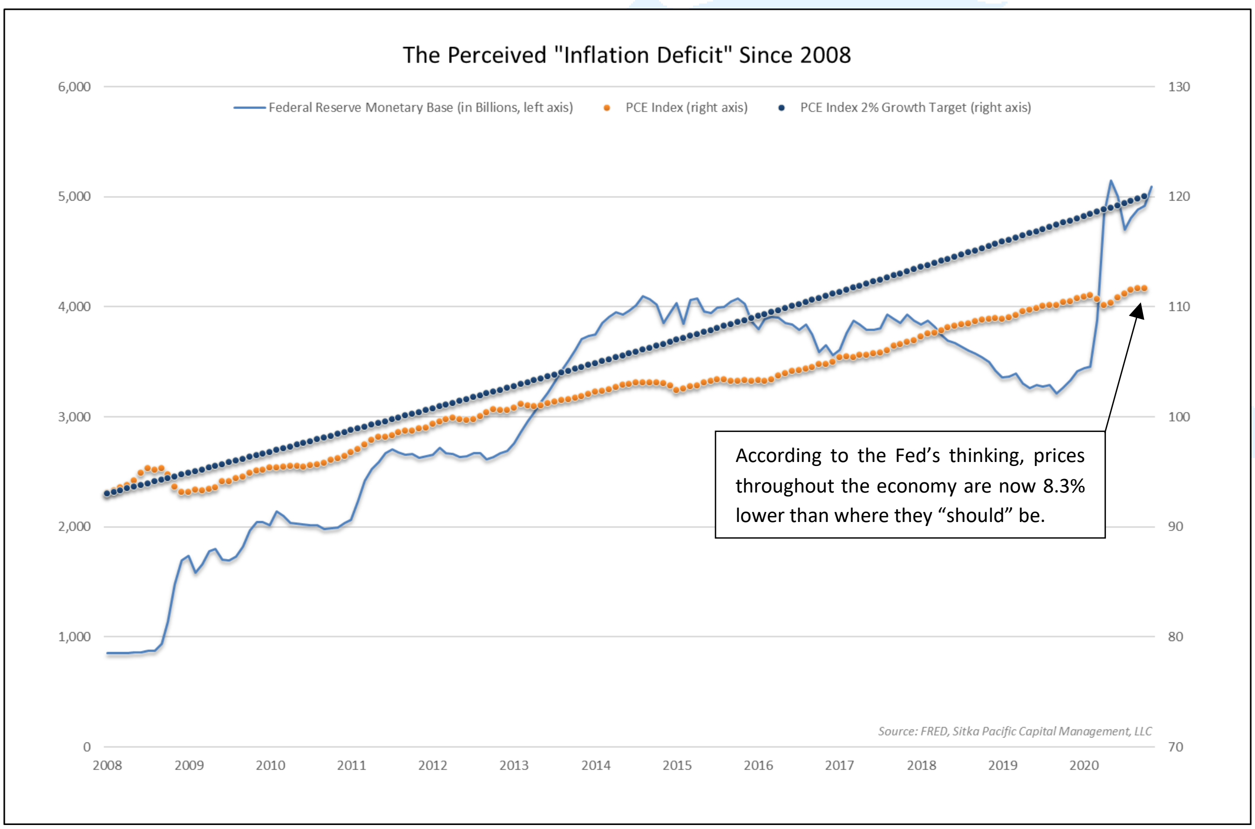
At the heart of the *First Great Mistake* was monetary policy's role in fomenting the speculative boom in the late 1920s, followed by the failure of the Fed to understand how restrictive monetary policy had become during the early 1930s. As was mentioned earlier, between 1929 and 1933 real interest rates soared above 10%, and consumer prices in the U.S. fell 27% as banks failed and credit contracted. The primary driver of the bank failures was a real estate bust — in this case, a farmland bust. As prices for wheat and other cash crops plummeted, farmers across the Midwest found themselves unable to meet their obligations to their local banks. And as local and regional banks found themselves with a soaring inventory of seized property that was no longer generating income, they began folding in increasing numbers. Credit contracted as more banks failed, and the deflationary spiral worsened.

Yet during those early years of the Great Depression, many within the Fed considered the downturn to be a healthy, restorative correction of the excesses of the preceding boom. The quote above of Charles Hamlin, who had been a member of the Federal Reserve Board of Governors since the Fed's founding in 1914, and was its first chairman, exemplified this sentiment. For many at the Fed, the speculative excesses in the stock market in 1928 and 1929 had been partly the result of monetary policy's overreaction to the mild recession in 1926–1927. As a result of that experience of overreacting to a mild recession and triggering a speculative bubble, the economy seemed long overdue for a more substantial recession, and many at the Fed felt the economy would be best served if they did not overreact again by easing monetary policy too much in 1930.

The actions of the Federal Reserve in the nine decades since that moment have been haunted by the misjudgment of the severity of the downturn after 1929, and the long road to recovery that followed. In addition, the Fed learned during those years that not only is the economy at stake when it fails to respond aggressively enough, but its independence is at stake as well. As Roosevelt took the initiative and devalued gold in 1933, in a desperate effort to expand the money supply, it marked the beginning of the Treasury's takeover of monetary policy. The Fed would not regain its independent footing until after the Treasury-Fed Accord of 1951.

The year 2020 marked an almost cosmic confluence of the lessons which have been seared into the institutional memory of the Federal Reserve since its founding, and it is difficult to understate the impact these lessons had on the policy actions over the past year. An important lesson the Fed learned during the *First Great Mistake* was fairly straightforward: a failure to ease monetary policy enough during a severe downturn risks a complete loss of institutional independence. And a key lesson learned during both the *First Great Mistake* and the *Second Great Mistake* was that losing control of long-term price stability, in either direction, risks complete loss of control over interest rates in the short term. Over the last forty years, the Fed has done everything it could to avoid making these same mistakes, and risk losing independence or control, and in doing so, it has perhaps unwittingly stumbled into its *Third Great Mistake*.

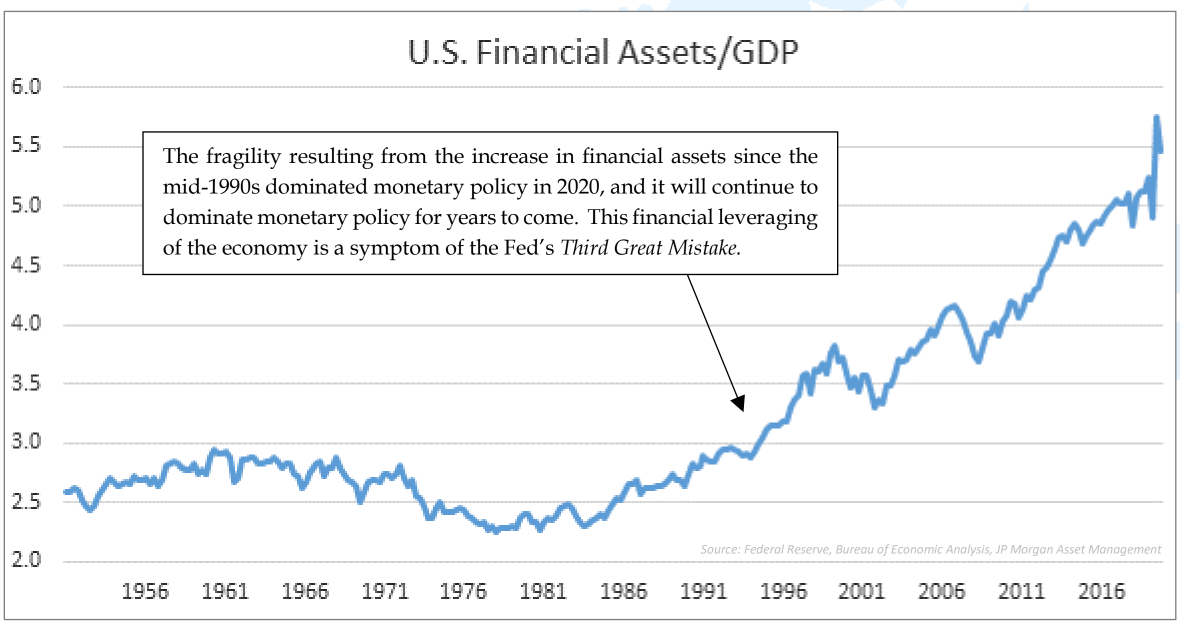
Before the pandemic arrived, the Federal Reserve had long sought to understand why inflation had consistently trended below its target since the financial crisis in 2008. Despite holding short-term interest rates near zero, and despite expanding its balance sheet by more than it had during the 1930s, the Fed's preferred method of measuring inflation — the PCE Price Index — had never really picked up as the economy continued to recover. Contrary to the typical postwar experience, the economic recovery progressed with little inflation. As the decade wore on and the Fed felt compelled to begin normalizing monetary policy, PCE-measured inflation slowed further. By 2020, prices throughout the economy were well below where they would be had the Fed's inflation target been achieved.



As recently as 2019, the Fed sounded an optimistic note about inflation to eventually returning to its 2% target as the economy continued to recover from the financial crisis. In its 2019 *Statement on Longer-Run Goals and Monetary Policy Strategy*, there was no hint in the statement that indicated otherwise. But as with so many other aspects of life over the past year, the pandemic prompted a strategic reassessment, and the 2020 *Statement on Longer-Run Goals and Monetary Policy Strategy* outlined a major shift in the Fed's approach going forward: no longer content with the inflation rate merely reaching its 2% goal in any given year, monetary policy would now aim for inflation *averaging* 2% over time, so prices would more closely follow the Fed's intended long-term path.

Aside from the policy reactions to blunt the economic impact of the pandemic, this revision of the Fed's approach to achieving its long-term goal for inflation is the most significant policy event of the past year. It effectively means the Fed now intends to "make up for lost inflation" by keeping monetary policy looser for longer than it would have in prior cycles. Going forward, the Fed does not intend to repeat the post-financial-crisis experience of inflation stubbornly remaining below its 2% target — it wants inflation to have recovered its recessionary trend deficit before monetary stimulus recedes. This shift in the Fed's approach also means that the past year effectively marked the beginning of a new era of negative real interest rates.

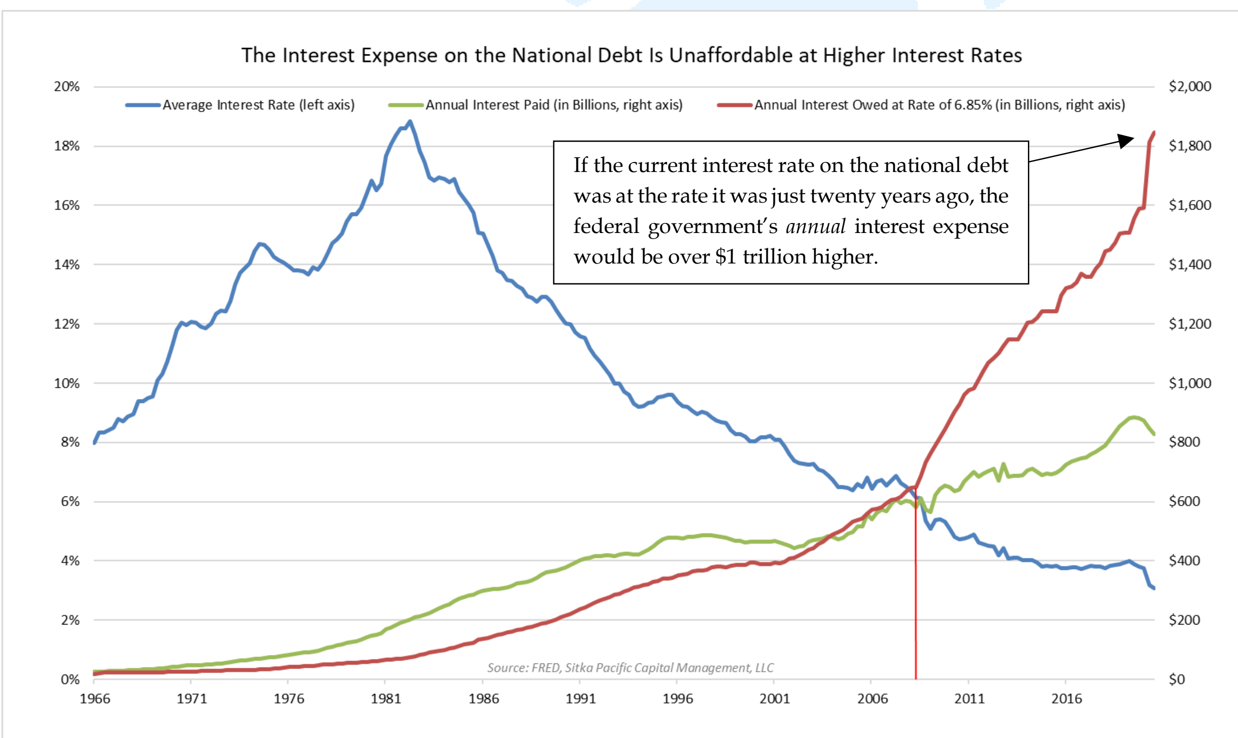
What seems to have been lost amid the fiscal and monetary policy reactions to the pandemic is that the Fed may have already lost control over short-term monetary policy, due to the imbalances built up over the past several decades. The past year also showed that monetary policy in the U.S. has already suffered a significant loss of independence to the Treasury. The early stages of the first two Great Mistakes in Fed history were defined by a similar loss of control and independence, and both were followed by inflationary episodes that defied the Fed's goal of long-term price stability. In a twist of irony, however, this time a more inflationary outcome appears to be just what official Fed policy is now seeking.



With short-term interest rates having been pinned back down to the zero-bound by the recession, which so quickly unwound a years-long campaign to increase its room to maneuver leading up to 2019, the Federal Reserve now recognizes that its policy response to the credit crisis was inadequate. Instead of fearing a return of inflation, the Fed made it clear this past year that its primary goal going forward is to avoid a return to the low-inflation environment of the past decade. In the Fed's reassessment, the fear of inflation in the years following the financial crisis resulted in an approach that was too tentative, and Fed officials have made it clear that monetary policy will not be so tentative in the years following this recession.

It appears, however, that the Fed has already lost the ability to raise interest rates, even if it wanted to. As a result of its efforts over the past four decades to avoid a return of 1970s-like inflation, and its efforts over the past two decades to avoid a return of 1930s-like deflation, the economy, the financial markets and the government are now so leveraged that higher interest rates are untenable. The chart above highlights the value of all financial assets relative to the size of the economy, and all of those assets are interest-rate sensitive. With so much asset value now at stake relative to the economy, raising interest rates is most likely no longer a realistic option.

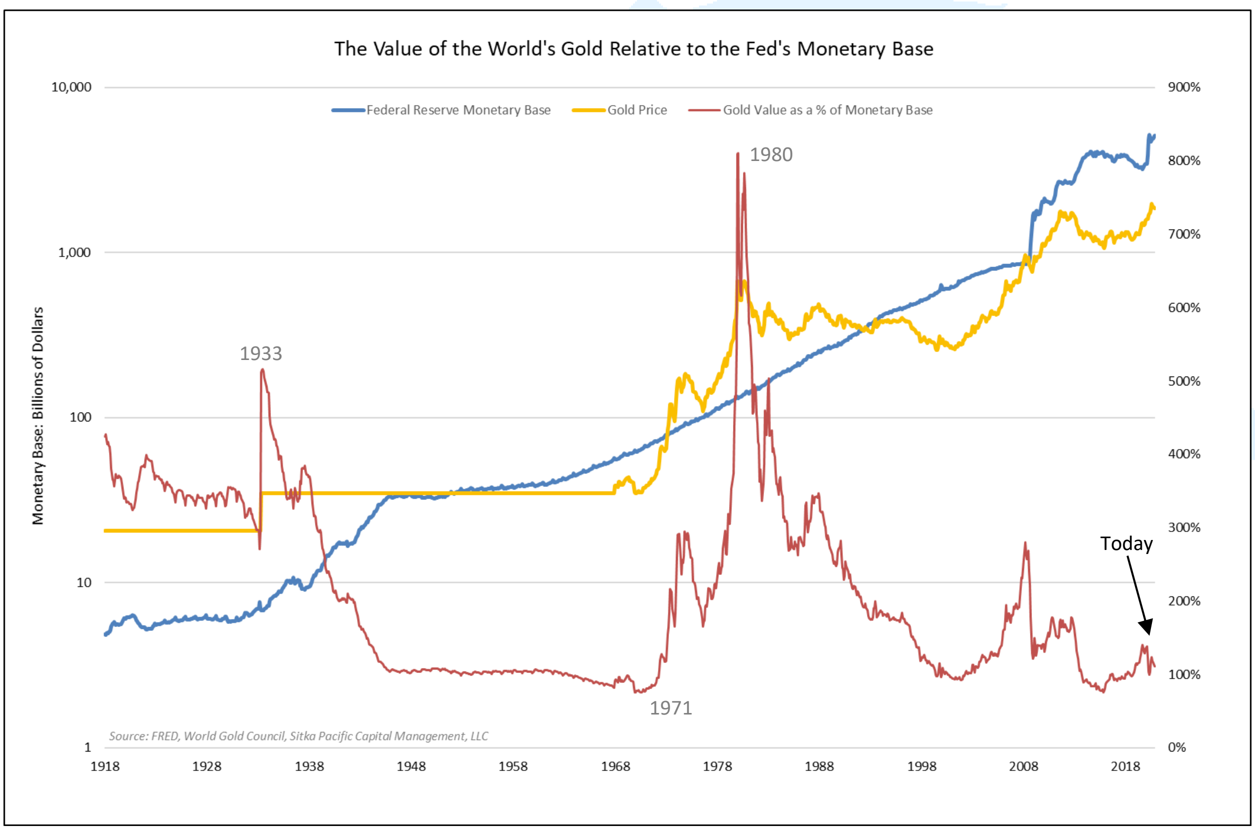
At the same time, the federal government is no longer in a position to afford higher interest rates. With the increase in the federal government's debt over the past twenty years, there is now more political incentive for continued low interest rates than at any other time since the Treasury took over monetary policy during World War II. Since the interest payments the Federal Reserve receives on its Treasury holdings are returned to the Treasury, the actual net interest expense is lower than is shown by the green line below. However, the red line shows what the annual interest expense would be if the interest rate on the national debt returned to the level it was just twenty years ago.



In what may serve as a poignant symbol of this era, Janet Yellen was recently confirmed as the 78th Secretary of the Treasury. This appointment effectively places both fiscal and monetary policy in the hands of those who deeply understand the need for inflation, and are committed to enacting policies which will avoid a repeat of the low-inflation environment of the post-credit-crisis period.

At her confirmation hearing, Yellen addressed the growing national debt in her opening statement: *Neither the president-elect, nor I, propose this* [latest] *relief package without an appreciation for the country's debt burden. But right now, with interest rates at historic lows, the smartest thing we can do is act big.* Later, she referred to the lack of increase in debt service in recent years: *In a very low interest-rate environment like we're in, what we're seeing is that even though the amount of debt relative to the economy has gone up, the interest burden hasn't.* While it is certainly true the interest burden has not risen in recent years, that will only remain the case if interest rates remain low until the debt burden relative to the economy is far lower than it is today. So it appears the major stakeholders are now all aligned on the desirability for higher inflation, and the need for interest rates to remain low.

The *Third Great Mistake* means there is no longer an alternative to higher inflation, and there is also no pain-free way for monetary policy prevent inflation from spiraling higher than intended. It is reminiscent of the circumstances in the late 1960s, and it is fitting that financial markets appear to be in a similar position as well: interest rates are low, risk asset valuations are high, and there is a speculative fervor which has apparently concluded that the entire equity market is now a *one decision* investment. Meanwhile, though we do not know how successful the efforts to induce higher inflation will ultimately be in the years ahead, real assets are quietly trading as if inflation is nowhere in sight.



A Summary of Our Market Outlook

- Despite an estimated 4.9% contraction in global GDP, the steepest contraction since the 1930s, investor exuberance inflated the U.S. equity market bubble further in 2020. Valuations suggest this bubble is now on par with the tech bubble, but with overvaluation far more pervasive than it was twenty years ago. Valuations also suggest that the peak, when it occurs, will establish a real, inflation-adjusted high-water mark that will remain in place for 15–25 years. As happened during prior cycles, in the decade after the peak a portfolio of large-cap stocks will likely lose real, inflation-adjusted value at an average annual rate of 3%–4%, with a maximum drawdown of 50%–67% at cyclical lows.

- U.S. equities remain extremely stretched versus global markets, though there were signs in the latter half of 2020 that the trend of outperformance by U.S. risk assets was weakening. The trend of U.S. outperformance over the past decade will likely conclude with the end of the bubble in the U.S. market, after which global equity markets appear poised to outperform for an extended period.

- Equity markets outside the U.S. are generally below their long-term median cyclically adjusted valuations, with some markets significantly undervalued. Yet while equity markets outside the U.S. represent relative value, the end of the U.S. equity market bubble will likely be a global event, creating volatility throughout global equity markets. Thus, while many global equity markets appear attractive, with positive prospective long-term returns for dollar-based investors, the end of the U.S. market bubble will likely provide additional buying opportunities.

- The U.S. dollar likely completed a cyclical top during the market volatility in early 2020. In mid-2020, the trade-weighted Dollar Index broke the uptrend which had been in place since 2011, likely signaling a new long-term downtrend is underway. As in previous cycles, a bearish trend in the dollar will likely unfold until U.S. financial assets represent a relative value versus global markets.

- Following the rapid policy reversal in 2019, monetary policy in the U.S. crossed an historic threshold in 2020. After failing to sustain positive real interest rates during the last tightening cycle, members of the Fed have made it clear that negative real interest rates will be maintained for the foreseeable future, in an effort to encourage higher rates of inflation than were seen following the financial crisis in 2008.

- Long-term Treasury yields fell to all-time record lows in 2020. The 10-Year Treasury note yield traded as low as 0.398%, and the 30-Year Treasury bond yield traded as low as 0.837%. Yields on long-term Treasuries rose modestly after the lowest levels reached in March, with the 10-Year Treasury ending the year at 0.917%, and the 30-Year Treasury yield ended the year at 1.646%. However, the entire Treasury yield curve ended 2020 below the market's expected inflation rate of 1.99% over the next ten years.

- U.S. corporate credit spreads had been the lowest on record in the years leading up to 2020, but they rose rapidly in February and March until the Federal Reserve announced it would begin buying corporate bonds, including junk-rated bonds. In the months following the announcement, corporate bond yields fell to record lows, and credit spreads returned to their pre-recession levels, despite U.S. non-financial corporate debt rising to a record above 50% of GDP in 2020. Moody's Seasoned Corporate Aaa index ended 2020 trading at 2.53%, while Moody's Seasoned Corporate Baa index ended 2020 at 3.11%. These represent minimal real yields of 0.54% and 1.12%, respectively, relative to the market's expected inflation over the next ten years.

- As of December 31, there was $17.8 trillion of debt trading worldwide with a negative nominal yield, which represents roughly 6.5% of the estimated $272 trillion of global debt at the end of 2020. Global indebtedness reached an estimated 365% of global GDP in 2020, a record level. The yield on the German government 10-year bund ended 2020 with a yield of -0.587%, and the Japanese government 10-year bond ended the year with a yield of 0.02%. The combined balance sheets of the Federal Reserve, the European Central Bank and the Bank of Japan expanded from $14.6 trillion to $21.4 trillion in 2020, a 47% increase. At the end of 2007, just prior to the credit crisis, the combined balance sheets of the three largest central banks stood at $3.4 trillion.

- Commodities and other economically sensitive real assets are trading near their lowest inflation-adjusted prices in a decade, after reaching new lows in 2020. Commodities will likely feel a tailwind from a new downtrend in the U.S. dollar, and the ongoing policy response to the recession in the years ahead, but the end of the U.S. equity market bubble could carry risks in the short term. However, the cyclical low in commodity prices during this downturn may prove to be a durable long-term opportunity.

- Precious metals rose significantly in 2020, with gold priced in U.S. dollars reaching a new high, following new highs reached in all other major currencies in 2019. The cyclical peak in the U.S. dollar in 2020 likely represents a pivotal new tailwind for real assets. In addition, the global monetary response to the pandemic and the recession has also begun to provide a strong policy tailwind for precious metals, and continued negative real interest rates in the years ahead, as the Federal Reserve has pledged, will likely maintain that support for some time. In this context, the strength in precious metals over the past two years appears to be the early stage of a longer-term trend.

- With nominal short-term interest rates at zero, and with real short-term interest rates likely to remain negative for the foreseeable future, the value of cash is now mainly in the opportunity it provides to purchase discounted value during the next significant market downturn. With the U.S. equity market significantly overvalued, the reserve purchasing power which cash represents remains a critical part of a risk-averse portfolio.

In the Years Ahead, Real Returns May Be Confined to Unconventional Portfolios

> *The long, long bull market since 2009 has finally matured into a fully-fledged epic bubble. Featuring extreme overvaluation, explosive price increases, frenzied issuance, and hysterically speculative investor behavior, I believe this event will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929, and 2000.*
>
> *These great bubbles are where fortunes are made and lost – and where investors truly prove their mettle. For positioning a portfolio to avoid the worst pain of a major bubble breaking is likely the most difficult part. Every career incentive in the industry and every fault of individual human psychology will work toward sucking investors in.*
>
> *But this bubble will burst in due time, no matter how hard the Fed tries to support it, with consequent damaging effects on the economy and on portfolios. Make no mistake – for the majority of investors today, this could very well be the most important event of your investing lives. Speaking as an old student and historian of markets, it is intellectually exciting and terrifying at the same time.*
>
> \- Jeremy Grantham, January 2021

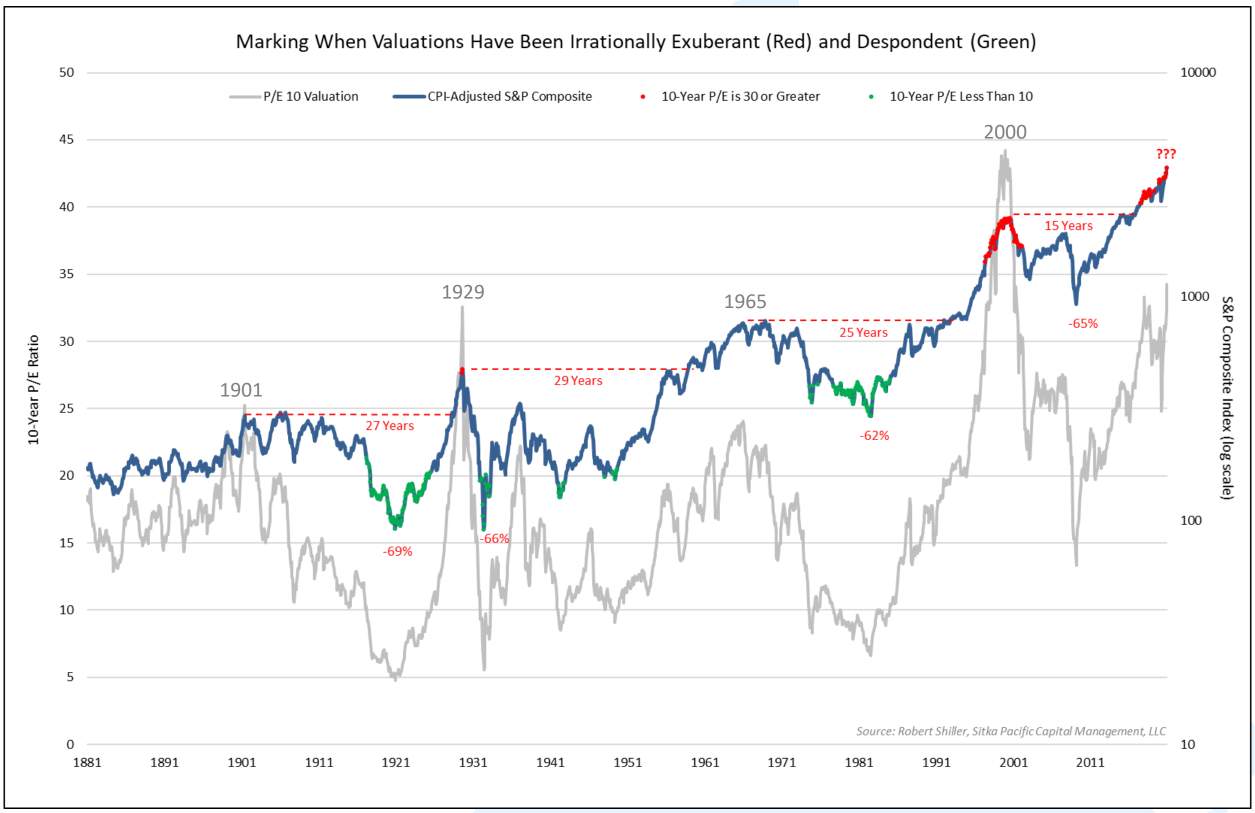
When we look back at overvalued markets throughout history, they were all driven by convincing lines of reasoning which induced irrational behavior from supposedly rational investors. Yet, in time it eventually became clear those seductive lines of reasoning also contained fatal fallacies, but by that time, the markets had already reverted to more a rational value.

In 1963, Benjamin Graham addressed what he thought was an important fallacy that was irrationally motivating investors at the time — the idea that the better the past record of the market had been, the more sound of an investment stocks represented for the future. To his way of thinking, the opposite was actually true, as the more overvalued the market became, the higher the *risk* was, not the potential return. He also addressed another assumption which seemed to underlie investors' willingness to continue buying stocks at such elevated valuations, but which to him seemed suspect — that is, that the prospect of future inflation made stocks attractive, even at high valuations. In his limited experience with the novel postwar inflation in the late 1940s and early 1950s, Graham had noticed the market's valuation seemed to correlate negatively with high rates of inflation.

This letter has focused on these issues because investors in recent years have relied on many of the same justifications for the market's high valuation and perpetual strength that investors in the early 1960s irrationally relied upon, yet those justifications contain the same fatal fallacies today as they

did back then. These lessons have been learned before. The laws of valuation have not changed over the last sixty years, and apparently neither has the madness of crowds. In fact, the sentiment surrounding the market in recent years is evidence that many of the same forces which governed valuation and fueled investor sentiment in the 1960s are in full operation today — only the actors and the audience have changed.

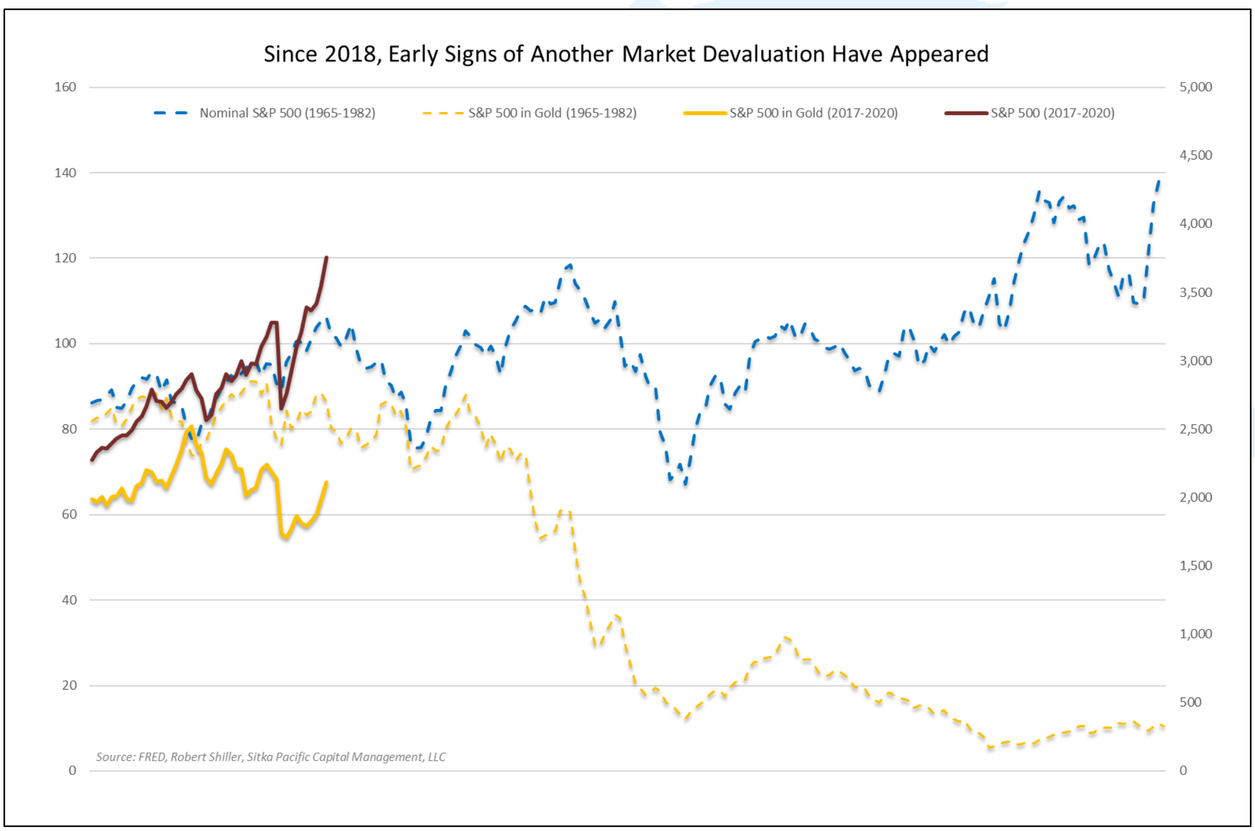
The main force propelling investors in recent years has gone under the acronym TINA — i.e. *There Is No Alternative* to remaining invested in stocks. Although it did not have such a catchy name at the time, this is the same sentiment which motivated investors in the 1960s and early 1970s. The fatal fallacy embedded in this sentiment is that the very conditions which have propelled valuations higher over the past decade — in another of Buffett's *bountiful triple dips* — are again being taken as perpetual, when in fact they are not. The marking-up of risk assets as interest rates and inflation rates fall to rock-bottom levels lasts only as long as interest rates and inflation rates continue falling. When those rates are near their lows, the risk embedded in equities is at its highest.



This high-risk moment is where the U.S. equity market is today. The cyclically adjusted price-to-earnings ratio of the S&P 500 ended last year at 34.2, which is higher than at any other time in history, except for 36 months surrounding the peak of the tech bubble. Over the past year, the prospect of *indefinitely* low interest rates in the wake of the pandemic has fueled a frenzy that now places the current bubble firmly among the most speculative market environments in history. The frenzy has been fueled by monetary forces similar to those which propelled the frenzy during the Nifty Fifty era, and investors today are at risk of falling for the same swindle investors fell for back then. In thinking bonds and cash are now unacceptably poor investments in light of their negative real yields, the seemingly positive real yield earned by corporations appears to be the only viable alternative.

However, the marking-up process during the *bountiful triple dip* over the past decade will eventually reverse, and it will do so even if the Federal Reserve and other major central banks succeed in keeping interest rates low. What Buffett understood in 1977 was that not only do stocks do poorly when there is increased competition from higher interest rates and higher bond yields, equity valuations decline when inflation consumes a greater share of what a corporation earns simply to maintain its current real earnings. With inflation rates low, corporations can devote the vast majority of what they earn to growth, not just earnings maintenance. But when inflation rates rise, so does the share of earnings which must be devoted simply to maintaining current real earnings. And as the share of earnings devoted to future growth falls, this lower real growth rationally results in a lower market valuation.

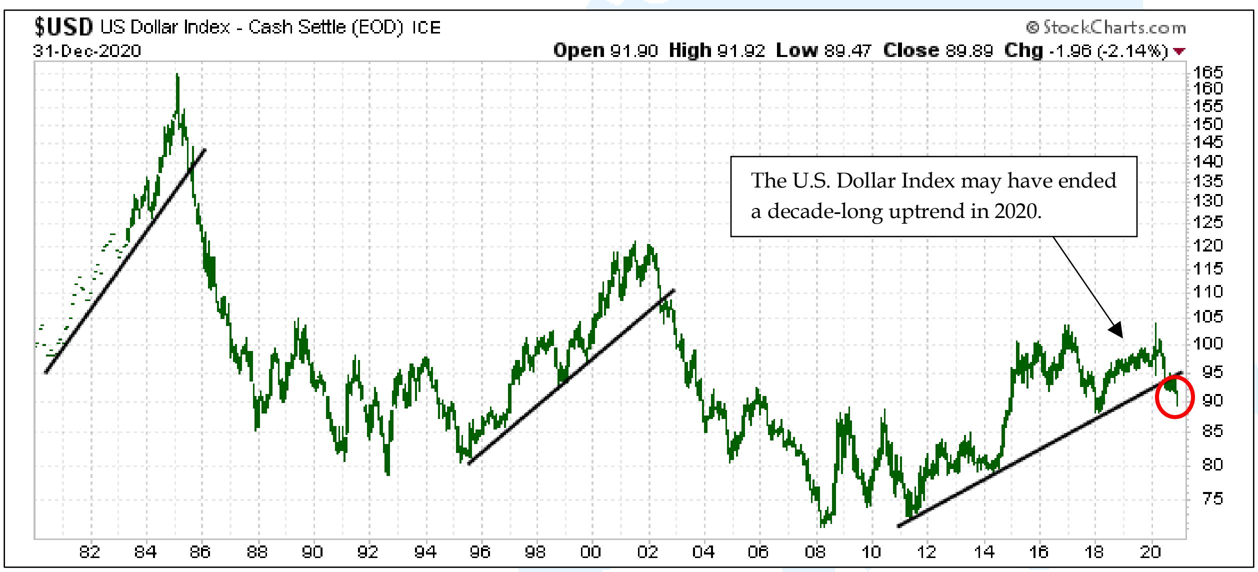
Buffett understood that rising inflation swindles the equity investor as it lowers the future real growth of corporate earnings, which lowers the present value of that equity investment. This devaluation happens regardless of whether interest rates move higher with inflation, as experienced by Buffett in the 1970s, or are held artificially low by the Federal Reserve, as experienced by Graham in the 1940s and early 1950s. This is the fatal fallacy embedded in today's TINA narrative: the *bountiful triple dip* will eventually end even if the Fed keeps interest rates low, as its goal of inducing higher inflation will eventually result in lower valuations. The return on corporate equity for public companies remains in the range it was in the 1970s, and higher inflation would inevitably lower future real earnings growth.



Part of how inflation swindles equity investors is in the long delay between the beginning of major expansions of the money supply and the subsequent rise in prices. Over the last century in the U.S., it has taken a decade or more for prices to begin rising after a significant monetary expansion began, a delay which seems to leave many wondering if there is any connection between the two at all. Investors today appear to have thoroughly internalized the experience of the last decade, which saw interest rates fall and inflation remain subdued while households deleveraged. The lesson investors learned from that experience seems to be that expansions of the money supply can only benefit risk assets. However, this holds true only until inflation rates begin to rise, which is why the new Fed approach represents such a pivotal shift for the markets.

The new consensus among Fed officials is that monetary policy was too conservative in the decade after the financial crisis, and that a far more aggressive approach is called for in the wake of the current recession. The Fed now *intends* to induce higher inflation, and the federal fiscal deficits over the coming decade — which will be substantial — will likely provide the means to achieve that goal.

In this context, it is notable that as intense as the speculative frenzy in stocks has been, the broader market declined in value relative to gold over the past year and a half (chart above). The disconnect between the market's higher nominal price and its lower value in gold likely represents early evidence of devaluation, and it is not the only evidence of the Fed's newfound determination to emerge over the past year: after nearly a decade, the U.S. dollar's trend higher against the currencies of its main trading partners appears to have ended in 2020. The dollar spiked higher during the market panic last March, but subsequently dropped 13.5% from its peak to end near its lowest level of the year.



The dollar's decline unfolded as Chairman Powell and other Fed officials made it clear throughout the year that they would not repeat what are now considered policy mistakes made in the wake of the financial crisis a decade ago. As we discussed at the beginning of the beginning of Quantitative Tightening, the Fed had never before downsized its balance sheet without destabilizing financial markets and subsequently reversing itself soon after, which was why it had been roughly eighty years since the last attempt to do so. These actions contributed greatly to the rise of the dollar after 2013, played a major role in the decline in real assets between 2013 and 2016, and greatly destabilized the equity market beginning in 2018. The preemptive tightening also played a major role in the Fed losing control over interest rates again this past year, so it appears the balance-sheet lessons last learned during the gold sterilization in 1938 have now been learned again.

In his most recent press conference on January 27, Chairman Powell reiterated the Fed's commitment to ushering in a new inflation regime, and he took pains to emphasize that the Fed is thinking well beyond the pandemic. When asked whether or not the Fed would act to restrain prices if inflation were to rise when the restrictions from the pandemic ease and people begin to return to their normal lives, he had this to say:

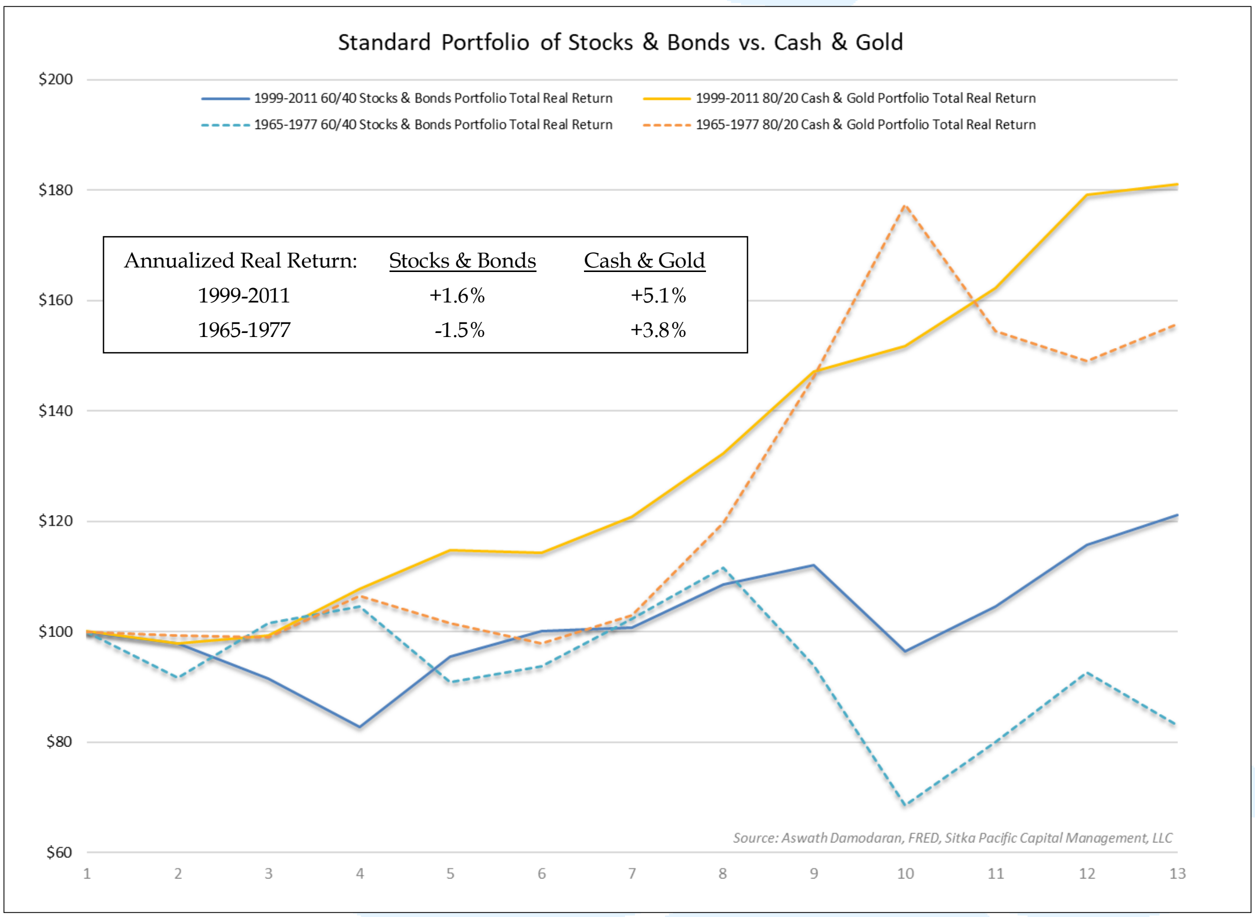
> ***I think it helps to look back at the inflation dynamics that the United States has had now for some decades and notice that there has been significant disinflationary pressure for some time, for a couple of decades. Inflation has averaged less than 2% for a quarter of a century****, and the inflation dynamics with the flat Phillips curve and low persistence of inflation is very much intact. Those things, they change over time. We understand that inflation dynamics evolve constantly over time, but they don't change rapidly. So we think it's very unlikely that anything we see now would result in troubling inflation. Of course, if we did get sustained inflation at a level that was uncomfortable, we have tools for that****. It's far harder to deal with too low inflation. We know what to do with higher inflation, which is, should the need arise, we would have those tools. And we don't expect to see that at all.***
>
> *In terms of how much, what we've said is we'd like to see, because inflation has been running persistently below 2%, we'd like to see it run moderately above 2% for some time. We have not adopted a formula. We're not going to adopt a formula. We use policy rules and formulas in everything we do, consult them constantly, but we don't set policy by them. We don't do that. And so we are going to preserve an element of judgment, and again,* ***we'll seek inflation moderately above 2% for some time, and we'll show what that means when we get inflation above 2%. The way to achieve credibility on that is to actually do it, and so that's what we're planning on doing****.*

It is remarkable to hear those words spoken by the Chairman of the Federal Reserve, in light of the events of the past century. While it is certainly the case that the Fed has the tools to dampen inflation, it is also the case that the will to use them when they are truly needed has repeatedly been lacking. And when the will was not lacking, and the Fed attempted to tighten monetary policy amid an inflationary surge in government spending, it has thrice resulted in the annexation of monetary policy by political forces. Similar political forces will likely be strong over the next decade, as retirement demographics and private sector deleveraging continue.

In October of 1955, Fed Chairman McChesney Martin famously described the job of the Federal Reserve as that of a "chaperone who has ordered the punch bowl removed just when the party was really warming up." Yet just a decade later, as much as he valued price stability, he would preside over the politically driven pivot into the *Great Inflation*. The lesson from these past episodes is this: possessing tools which can easily tame inflation does not guarantee they will be deployed in the face of stiff political opposition.

The dilemma facing U.S. investors today is one which they have faced before, but not for a long time. With the U.S. equity market trading at such high valuations, and with Treasury yields lower than they have ever been, the markets are completely unprepared to deliver a positive real return in the face of the Federal Reserve's new goals.

The last time the U.S. equity market was in a position similar to today's speculative frenzy, investors could obtain a 6% nominal yield by investing in 10-Year Treasury notes, but such a safe-haven yield now seems like a relic of a bygone era. And the last time the markets entered a period of rising inflation, in the mid-1960s, the stock market's valuation was far below the stratospheric levels of today. Yet despite the 6% yield from long-term Treasuries at the peak of the tech bubble, and the much more modest valuation of the S&P 500 in 1966 (a cyclically adjusted P/E 30% below the present level, and a market cap only one-third today's level relative to GDP), the average real return of a balanced portfolio of stocks and bonds in the years following these two market pivots was near zero.

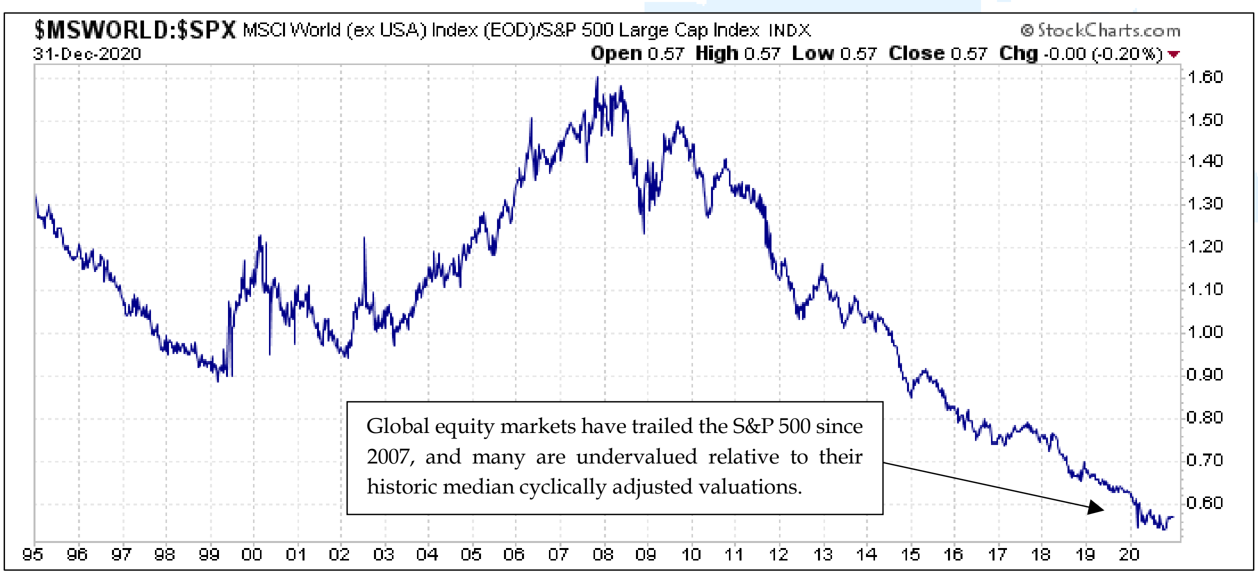


Like investors in the 1960s, today's investors seem to expect the experience following the financial crisis to continue after the current recession, especially with the Fed resuming its aggressive monetary stimulus. Yet not only are the Fed's inflation goals likely to work against investors in the years ahead, the market environment was quite different when the monetary response to the financial crisis began in the fall of 2008. At that time, the yield on the 10-Year Treasury note was near 3.8%. In the decade that followed, the Consumer Price Index rose at a 1.4% annualized rate, which left investors holding a 10-Year Treasury note to maturity with a positive real return. And after falling 37% from its high a year earlier, the S&P 500 traded at a 10-year P/E of 16 in the fall of 2008. Although stocks were not undervalued when the Fed launched its first quantitative easing program, the broader market was not overvalued either. The S&P 500 was then trading near its long-term median valuation of 15.7, and an expectation of a positive long-term real return from stocks was a reasonable assumption from such a middle-of-the-road valuation.

Today, however, an assumption of a positive long-term real return is not reasonable for a standard, balanced portfolio of stocks and bonds. The yields of reasonably safe corporate bonds and long-term Treasuries are at or below the level of inflation the Fed is now pursuing, and the valuation of the broader U.S. equity market makes a positive return, nominal or real, unlikely. As a result, real returns in the years ahead may be confined to portfolios which may appear unconventional, but which in fact have a long history of delivering positive real returns in the face of both rising inflation and reverting risk asset valuations.

The performance of a portfolio consisting solely of cash and gold is shown in the chart above to highlight the divergence in value between risk assets and real assets when high market valuations revert to more moderate levels. The era of the 1960s and 1970s witnessed a devaluation resulting from rising inflation, and the era after 1999 was defined by the deflationary bursting of two bubbles. Yet both eras witnessed a significant rise in the value of real assets. This performance reflects the modern-day, post–Bretton Woods rise in value of what an allocation to interest-bearing cash equivalents used to achieve when Graham originally described value investing as a discipline.

Given the market environment, our allocation to real assets remains long term in nature, as will our focus on equity markets outside the dollar. Global equity markets fell further relative to the U.S. market in 2020, but they remain undervalued and will benefit from a trend lower in the U.S. dollar. As risks from the current recession recede, a number of undervalued equity markets outside the U.S. appear poised to deliver positive real returns to dollar-based investors in the years ahead.



Final Thoughts

The *Third Great Mistake* is embedded in how the reactive policies of the Federal Reserve over the last few decades have resulted in another loss of control over short-term interest rates and the base money supply. Due to the dramatic increase in financial leverage, conditions have now become too fragile to allow positive real interest rates. Such fragile conditions have been seen before, and the result was an increase in consumer and producer prices until debt burdens were more manageable. This likely means monetary policy will remain unable to restrict price increases for some time, with the result likely being a devaluation of the dollar to a greater extent than the intended goal of 2% per year, on average, in the years ahead. This pivot toward higher inflation will likely prove to be the longest-lasting impact from the pandemic-fueled recession over the past year.

As the legendary Jeremy Grantham wrote this past month, the current bubble in U.S. financial assets will likely prove be the most important event in the lives of most investors today. For investors who have navigated the fallout from the tech bubble and the housing bubble, this is an astounding claim at first blush, but it is one which is not without supporting evidence: there has not been a time before today when U.S. stocks *and* bonds were so overvalued, at the same time. The speculative excesses in recent months may just be just a hint of the volatility in the post-bubble market environment to come.

Fortunately, there are attractive alternatives available for those investors willing to look beyond dollar-based stocks and bonds. Though the end of the current bubble will no doubt create short-term volatility in all financial assets, we remain focused on investments which have proven durable through past cycles of valuation reversion in risk assets. This has been our focus for some time, and given the market conditions at the beginning of this new year, it will likely remain our focus for years to come.

We appreciate you taking the time to read this letter, and for being our client. 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
Chief Investment Officer
Sitka Pacific Capital Management, LLC