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THE IMPACT OF THE GOVERNMENT'S PANDEMIC ACTIONS ON THE MARKETS

THE BIG PICTURE

What does the future hold for investors? Since early March 2020, we have seen unprecedented government monetary and fiscal actions impacting our economy and financial markets. What those actions mean for our future is uncertain, with a wide array of views being presented by market commentators. Economic expansion or slowing? Inflation or deflation? Many "experts" forecast a continually sunny future, but experience tells us that forecasting is difficult and can be wildly wrong. Both the Fed and Wall Street seem to consistently overestimate economic growth.

The Fed's balance sheet had been growing significantly since late 2008 when it was below $1 trillion, but since March 2020 it exploded from $4.2 trillion to $8.0 trillion. The Fed continues its efforts to support everyone's pursuit of happiness by spending $120 billion every month ($4 billion every day) to purchase an amazing $40 billion of mortgages along with $80 billion of U.S. Treasury securities. Congress added $5 trillion of Covid stimulus relief, spent a total of $9.1 trillion over the period, and has generated record budget deficits. Financial markets have loved all of it, surging to all-time highs, generating a new record for securities issuances, and creating a level of retail investor involvement not seen since the tech bubble at the turn of the century. Similarly, the housing market looks like something we haven't seen since just before the Great Financial Crisis of 2008. What a ride it has been since March 2020. But where is this all going? Who knows? But it certainly pays to be prepared for change as the future unfolds.

Many believe we are entering a long-term strong growth environment with sustained economic expansion, stronger employment, and rising inflation. Others believe that our massive debts suggest a future more along the lines of weak economic growth, weak job growth, and weak inflation, creating concern about a rotation in investor psychology from risk indifference to risk aversion, from thinking about how much they might make to how much they might lose.

Our current judgment is that we likely have seen the best of the post-pandemic reopening growth. We believe we have already seen what looks like a range of peak prices in investments such as Bitcoin, Tesla, SPACs (Special Purpose Acquisition Companies), and ARKK funds (ETFs invested in aggressive growth companies like Tesla). All of this implies a logical progression to a slower growth economy, similar to what we saw pre-pandemic, and a more difficult road ahead for equities.

THE ECONOMY AND INVESTMENT MARKETS

There seems to be fairly broad agreement that we are currently seeing a lot of peak growth numbers off the pandemic lows, such as GDP growth, earnings growth, and money supply growth — the source of liquidity for both the economy and the markets. The federal stimulus payments and extra unemployment benefits that have been a material part of recent consumer spending are beginning to disappear. Labor Day weekend will see the extra unemployment benefits dropping off a cliff for about 9 million Americans. As stimulus fades, will economic growth be able not only to replace the government supports, but also to provide even more economic expansion?

Since March 2020, the Fed's low interest rates and injection of trillions of dollars into the financial markets through its Quantitative Easing asset purchases are obviously material factors in investor psychology tilting toward risk indifference. Can the Fed ever change its course without serious economic and political fallout? At the June 2021 meeting of the FOMC (Federal Open Market Committee) the Fed suggested that they may start to consider raising interest rates and tapering asset purchases in a year or so. The market reaction was a drop in long-term U.S. Treasury yields, a drop in some commodity prices, and a drop in most stock indices, with Nasdaq holding up the best.

Those responses suggest that the market is pessimistic about the future of our economy without endless Fed and Congressional support. Higher rates would strain the federal budget, strain corporate and consumer debt costs, and dramatically impact the housing market. Can we ever return to a real growth economy without continued low rates, Quantitative Easing, and trillions in stimulus every year? If not, will continuing such actions increase our already massive debt load and increase the risk of worrisome inflation that would negatively impact both businesses and consumers? These are immensely difficult questions.

The Fed sends conflicting messages on their answers to these questions. As soon as the market expressed concerns about QE tapering or increasing rates, multiple Fed speakers assured investors that their market supports will remain for the indefinite future. So, the Fed's trial balloon about tightening financial conditions was reversed and the Fed once again made it clear that investors can continue to rely on the prolonged availability of easy money. The Fed continues to fear the economic and political consequences of upsetting Wall Street. And so, Nasdaq hit another new high — just as the Fed's balance sheet continues to hit new highs.

But under the surface, markets may be changing. The combination of fiscal (Congressional) and monetary (Fed) interventions is unprecedented. The resulting liquidity has led to unprecedented stock valuations, particularly in tech, and the firm belief that the market's continuing ascent is assured because the government has our back. But the reality is that we are now at never-before-seen stock valuation levels. To us, that says be careful. Every new Nasdaq high comes with fewer index stocks hitting individual new highs. The Nasdaq February new high had 600 stocks reaching new highs. In April it was 250. In late June it was 125. At this point, we are back to relying on the monopoly tech stocks (Apple, Amazon, Google, Microsoft and Facebook) generating most of the Nasdaq gains. For the rest, like Tesla, it is becoming harder for the happy stories to prop up their stock prices (TSLA down 23% from its January peak and down 7% YTD, with a current P/E of 680). The message is, be careful buying at these prices and valuations. It is not guaranteed that the current market calm will last.

Our job is to navigate market conditions as they change. Stock prices are determined by a combination of macroeconomic data, individual company fundamentals, and investor psychology. We pay attention to all and believe that current stock market prices are not prepared for any disappointments.

Today, the ratio of total stock market capitalization to total corporate revenue, often referred to as the price/sales (P/S) ratio, is at its highest level ever. That should give investors pause as to how much risk they wish to assume, and it should make us attentive to looking for clouds on the horizon.

Printing money by the Fed to buy financial assets or giving away stimulus money by Congress does not cause sustainable economic growth. It does not create permanent jobs and thereby a better standard of living. What those government actions mostly create is more debt and cheap money used to speculate in financial markets. Despite more than a decade of various Fed and Congressional interventions and supports, economic growth continues to trace a declining trend line.

Inflation concerns have been receiving increasing attention due to government deficit spending, Fed increases in the money supply, supply chain disruptions and labor availability issues. We certainly have seen evidence of inflation in food, housing and other prices. The big question is whether inflation will continue to rise. Wage pressures are starting to increase due to a shortage of skills sought by employers, which tends to put pressure on corporate profit margins. Weaker profit margins can cause credit defaults, even if interest rates do not rise. The overall result is a range of economic frictions resulting in weak economic growth similar to what we saw pre-pandemic. Weak economies generally suggest weak inflation.

Dollars have been falling from the sky since 2009, and speculation in financial assets has become a popular activity during the pandemic lockdowns. Investors keep taking on more risk, and risk indifference has beaten margin-of-safety investing hands down. The bottom line is that markets still believe that if we have a downturn, the Fed will fold on any plans for tightening financial conditions, and resume supporting markets with whatever it takes. We must gauge the range of what the Fed may do and adjust portfolios accordingly.

INVESTMENT STRATEGIES AND PORTFOLIO MANAGEMENT

Investor psychology has a lot to do with the PRICE of a stock. In the short-term, investors love the popular stocks, regardless of price. In the long term, investors benefit from a stock's revenue, cash flow, and earnings. Sustainable top-line revenues, cash flows and bottom-line earnings have a lot to do with the VALUE of a stock. And balance sheet structure (manageable debt that can be covered by cash flow even if economic circumstances deteriorate) has a lot to do with the quality, or safety, of a stock. Neither economic growth nor earnings growth has come close to stock price growth over the past decade.

How much does our "cautious" approach really matter in today's government supported markets? Is this a fragile market, or are concerns about possible risks misdirected? With our country's growing debts and deficits, our uncertain economy dependent on government supports, and our historically high stock prices, we believe being prudent is the proper path forward to build and protect wealth. We have been in a "bull" market for a long time, and stock prices continue to rise far faster than has economic growth or corporate profits. We are more concerned about a 20% downturn than a 5% upturn.

The result is that we are always looking for investment choices that offer a good risk/reward balance, where we can get rewarded if we're right, but not hurt too badly if something unexpected happens. In general, we are looking for high quality names with businesses that don't change too quickly. We may not make a fortune, but, more important, we also should not be exposed to excessive downside risk. We believe there are a number of stocks that can fit that bill, starting with selected drug companies, consumer defensives (e.g., food), utilities, and some opportunistic stocks in other sectors, including tech. We try to buy them when they're out of favor and hold them unless conditions change. While that approach may not be very exciting, it keeps us in the game while we wait to see what the next attractive pitch is for us to take a swing at.

Even Warren Buffett has been written-off more than once for his cautious approach to investing and the belief of others that the world has passed him by. But history has suggested that Buffett's unwillingness to invest in most of the popular, supernova stocks has eventually enabled him to come out on top time after time.

There are two additional areas that some may view as more exciting and that also fit the bill for our portfolios — precious metals miners and cannabis stocks. Like everything else, the pricing for precious metals stocks isn't as good as it was a year ago, but historically and over time they benefit from monetary expansion, and that seems like a fair bet. In addition, we believe they have the best cash flow prospects they've had in decades. They appear to be a pretty rare deal where downside, particularly over time, seems limited, while potential upside seems great.

The cannabis stocks are evidence that we don't try to slot our holdings to any specific style box. We want to be opportunistic and find the best available risk/reward, whether value, growth, or any other category. The cannabis stocks are typically classified as growth. We would call them sensible, reasonably priced growth. We think that is ideal - to look for sensible opportunities at sensible prices, wherever they may be.

CONCLUSION

With all the Fed interventions suppressing evidence of risk in financial markets, it takes intellectual independence and patience to manage portfolios without getting sucked into the belief that the Fed can protect us from all serious economic and market downturns. How do we avoid getting sucked into that popular outlook? One answer is to have both conviction in our investment ideas and be patient with those ideas. Neither conviction nor patience is easy. They require both intellectual independence and emotional strength to take a differentiated path. That ability is based on having a broad, disciplined portfolio management process, while recognizing that we cannot control the changing, uncertain market environment in which we work. We believe we have built an investment process that enables us to have conviction in and patience with our investment selections in the current market circumstances.

This process of conviction, patience and disciplined macro and fundamental research is central to our Intelligent Risk Management mindset. We want to make money, to increase wealth. To do that we believe we have to manage risk and seek to avoid going over a cliff, like the broad stock market declines that occurred in 2000 and 2008 — as investors focused on reward and dismissed risk concerns. Popular stocks and consensus market views often harbor unforeseen risks. Our differentiated approach tilts toward seeking quality stocks that are out of favor and being patient with them. It means being willing to be different from the indexes. It means being disciplined, not overpaying for a stock, and being willing to hold some cash if sensible investments are in limited supply.

As a boutique portfolio manager, we do not need to be part of the herd mentality. We can be consistent in looking for quality stocks at prices that provide a margin of safety as we seek to build durable wealth. Our goal is not to beat a benchmark that, particularly today, in our judgment requires taking on too much risk. Our goal is to protect and increase the purchasing power of our wealth as safely as possible. We want both wealth preservation when risks are significant and wealth appreciation when attractive opportunities appear.

Yours sincerely,

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