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VIEWPOINTS

As we move beyond the one-year anniversary of last year's dramatic Covid crash, price behavior in every corner of global securities markets continues to be dictated and distorted by unprecedented levels of monetary and fiscal stimulus, and the longer-term structural impact from this new era of "bubble-finance" remains the key debate behind every investment decision. Governments and central banks have signaled there is no limit to the support they're willing to provide in order to ensure price stability and avoid a dangerous deflationary spiral, which they are ill-equipped to combat. In response to the extraordinary levels of accomodation, the inflation narrative has firmly taken hold, and large swaths of market participants have reduced, or downright eliminated their need to guard against downside risk. Meanwhile, rising expectations for consumer spending and capital investment as economies open back up have shifted market leadership away from sectors which tend to benefit in a low-growth, low-interest rate environment towards more speculative, lower-quality, economically-sensitive assets. Once the initial wave of pent-up consumer demand passes, we suspect the speculative fervor will subside and a rotation back into quality will ensue.

The recent high-profile blow-up of a relatively unknown family office, Archegos Capital Management, was emblematic of the interconnectedness and excesses of today's marketactivity. Through the use of esoteric derivative contracts with a variety of prime brokers, Archegos was able to gain massive exposure to a group of stocks without technically owning any shares. The negotiated swap contracts allowed the firm to put on huge trades with relatively small upfront payments. In an egregious failure of risk management, the prime brokers were unaware Archegos was making the same leveraged bet with numerous other brokers, or perhaps chose to turn a blind eye to the risks because of the large commissions earned in such trades. Making matters worse, because the banking partners had purchased the shares on behalf of Archegos, the rest of the market had no way of discovering that a single firm effectively owned ~40% of Viacom's stock. The strategy backfired for Archegos when the shares declined in value, and once it became clear Archegos was

unable to meet its obligations the prime brokers were forced to take giant write-offs. In the case of Credit Suisse, over $5 billion in market cap was wiped out in a single day.

Eerily reminiscent of the collapse of Long-Term Capital Management in 1998 and the Bear Stearns High-Grade Structured Credit Fund in 2007, which marked the onset of the Great Financial Crisis, the Archegos story reveals the fact that easy money and high leverage inevitably bring about unintended, and potentially widespread consequences. Furthermore, it highlights the potential systemic risks created by an ever-growing shadow banking system, where derivatives and credit trade freely outside of regulatory oversight.

This sort of behavior has not been unique to family offices and hedge funds. Over the past year, retail and institutional investors alike have chased higher returns and increased their use of margin loans and options by historic levels. The rise in leverage and derivatives trading has undeniably supercharged an already hot market, leading to outsized moves up relative to units of invested capital. History has revealed time and again that this behavior results in phenomenal returns as market's rise, but wreaks havoc in market reversals. In the words of Warren Buffet: "It's only when the tide goes out that you learn who has been swimming naked."

Later this year, as economic indicators no longer benefit from the base effect (favorable year-over-year comparisons to ugly 2020 figures), the market may be forced to reconsider the nature of the current recovery and confront the hangover from the massive dislocations created by the protracted economic shutdown. Since the start of the pandemic, the household savings rate has surged to north of 20% from ~7% at the end of 2019. Looking at it from another angle, 70% of stimulus funds to date have gone into savings and debt reduction, according to the New York Fed. On a micro level, increased savings is a great thing for families who have not put away enough money for the future, but on a macro level higher savings presents a severe drag to GDP growth given our consumption-oriented economy.

Today's consensus GDP expectations suggest a sharp reversal in the savings rate to pre-pandemic levels. There will undoubtedly be a huge initial rush of service spending, but our research reveals that a significant portion of households have made investments in the homestead, most of which are one-time expenditures, as well as lifestyle changes that will make many less willing to spend on discretionary services such as gyms and restaurants. Going forward, we expect continued saving, not wild spending.

In our view, deflationary factors such as aging demographics, growing protectionism/de-globalization, rising tensions between the US and China, historically high leverage, declining labor force participation, and likely tax reform addressing wealth and income inequality will return to focus once Covid is no longer a front page story. For now, massive inflationary and deflationary forces are smashing together throughout the developed world to a degree that would make the engineers of CERN's particle collider blush.

Although we've been tactically adding positions to take advantage of what we had anticipated to be a growing consensus around inflation accelerating, we don't believe money-printing alone is capable of redeploying labor and capital to the extent needed for a sustainable and robust upcycle to occur. To whatever degree the proposed Biden administration infrastructure plan successfully mobilizes aggregate demand, restructuring the energy complex is a Herculean task and it will take many years for benefits to be realized.

One of our core beliefs is that over the long-run, returns tend to favor higher quality companies. Quality's outperformance tends to come with slowing rates of change in inflation, personal income, PMIs, and GDP - areas we think it is reasonable to expect a slowdown as the year progresses. Furthermore, as economies reopen and consumer demand returns, companies will surely face temporary supply disruptions, higher costs, or even missed sales altogether. Some of this will be passed through to consumers by way of higher prices, but we suspect cost inflation will be largely absorbed by companies who will struggle to materially raise prices and remain competitive. In the end, profits are the main driver of performance, and we continue to believe that a focus on companies which pay dividends and provide goods & services people *need*, in contrast to what people *want*, will lead to superior risk-adjusted returns against a backdrop of low-growth and higher volatility.

That said, because of the uncertainty around the structural changes that our increasingly planned economy will produce, portfolio diversification remains paramount. Unlike the talking heads on TV who are incentivized to describe their outlook with utmost confidence, now is not the time to construct portfolios in a way that reflects absolute conviction about one macroeconomic outcome or another. Indeed, our bias leans towards securities which will benefit from the low-growth, deflationary scenario we've described ad nauseam, but we also recognize that we must be prepared for the unexpected, and so we continue to push forward with one foot on the gas and one foot on the break.

Finally, in compliance with Rule 204-3 (c) of the Investment Advisers Act of 1940, we are enclosing a copy of the material changes to our current brochure and making our annual offer to send the full brochure which is also located on our website.

-Peter Hatfield, CFA®