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VIEWPOINTS

In the zero interest rate world we've been living in since the Great Financial Crisis there has never been a more challenging time for investors to practice risk aversion. As the gap between asset prices and economic fundamentals continues to widen, there's perhaps also never been a more *important* time for investors to practice risk aversion. This conundrum is confronting nearly everyone in the investment world: retirees, pensions, insurance companies, endowments, and the like, all of which are increasingly dependent on returns that can no longer be achieved with traditional safe-havens like Treasuries and corporate bonds. This cohort of investors has been forced to target investments further out on the risk spectrum than they'd otherwise be comfortable with to achieve required yields. To date, most have been rewarded by this strategy. With the Fed showing no signs of slowing the printing press, the paramount question becomes how to calibrate portfolios in this situation. Should one tilt towards offense to wrangle high returns from a low-return environment, or shift towards defense in light of heightened uncertainty and thereby accept lower returns going forward? Our bias remains toward the latter.

Unaware of the dramatic events soon to come, we entered 2020 with a message of caution based primarily on deteriorating economic indicators and our subdued outlook for earnings growth. Record high indebtedness, negative earnings growth, and rising populist movements were just a few of the reasons we felt the market was vulnerable to an exogenous shock. That message remains intact as we begin 2021, albeit with a very different economic backdrop. Three of the most important prices in the world economy are the 10-year Treasury yield, crude oil, and the Dollar. A year ago, the 10-year yield and oil were trending downward and the Dollar was moving higher. Today, Treasury yields and oil are going up, and the Dollar is going down.

Consequently, nearly every brokerage house on Wall Street is now pushing the narrative that we're rapidly entering a new inflationary paradigm whereby the US dollar will weaken, yields will move higher, commodities will surge, emerging markets will outperform developed markets, small caps will outperform large caps, and value will overtake growth. As we've described in recent publications, we too believe the stage is set for a return to a broad-based inflation, but with the important caveat that we are not yet out of the woods with respect to the deflationary scar tissue from the pandemic that will become increasingly apparent as the threat of the virus fades. The market has decided to look across the valley of the near-term economic and political challenges towards a new spending cycle ahead.

The argument that inflation has returned in full force stems largely from the fact that the Federal Reserve increased the money supply by an astounding 21% in 2020, significantly more than the increase in any other major currency, and thus with more dollars sloshing around the system the value of the dollar should fall. There are a number of related factors, however, that suggest a sustainable, synchronized growth-driven inflation has not yet arrived and that we're in a more transitory, dollar-driven inflation that's revealing itself in a more limited fashion with higher commodity prices.

The most important of these factors is the velocity (turnover) of money, which has declined steadily since 1999 and fell precipitously in 2020. No matter how fast the supply of money grows, if the speed at which money changes hands falls at a faster rate, deflation will persist. Much of the growth in the money supply in 2020 can be attributed to US corporations which tapped their lines of credit from banks en masse in response to the economic shutdown. If C-suites lack the confidence to invest in new plant, property, and equipment as they look ahead, many companies will decide to use their built-up cash to simply pay down their lines of credit. Similarly, deflation will remain the prevailing force if individuals decide to use the new round of stimulus funds to pay down credit card loans or pad their savings accounts in lieu of new purchases. Consumer confidence surveys indicate optimism has been declining steadily since the second wave of the virus gained steam in the fall.

Another factor that suggests the inflation narrative has gotten ahead of itself is that the lockdown has significantly pulled forward demand for finished goods and commodities. Consumers have shifted spending patterns away from hotels and restaurants in favor of home improvement projects which generally involve purchasing imported goods. One can see this clearly by observing the US trade deficit with China, which skyrocketed in 2020. As the economy opens back up and households return to spending on domestic services this trend will likely lose some legs.

One of the most important deflationary forces in the past three decades was the incredible rise of Chinese manufacturing. Nearly every company in the world was compelled to outsource whatever they could to China at the lowest cost possible. Today, US tensions with

China are escalating and the hope many had for an integrated global economy is fading, driven largely by populist anger about the unfortunate byproduct of globalization: the decimation of domestic manufacturing. In time we expect a series of policies and sanctions to emerge from Washington and Beijing that will force US companies that are straddling both worlds, particularly those in the technology sphere, to shift their end-markets and supply chains away from China.

On the topic of tech, it must be noted that the top five contributing stocks in the S&P 500 accounted for 57% of the index's gain in 2020 (Apple, Amazon, Microsoft, Nvidia, and

Google). It took Apple 42 years to get to a $1 trillion valuation, and a mere five months to reach $2 trillion. Broadly speaking, and aside from the accelerated demand for tech brought about by the work-from-home economy, we think the strength and potential of today's tech leaders derives principally from their dominant market shares and market power. This same element creates one of their greatest vulnerabilities: potential exposure to anti-trust action. For now, investors continue to operate as speculators in a momentum-driven market - the most dangerous type of market - which we believe will eventually face a moment where the best stocks to own will quickly become the worst stocks to own.

Warren Buffett has famously said "the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs" and to us, this statement has never been more relevant. It is indeed difficult for owners of defensive portfolios to watch speculative investments soar to extraordinary levels on the back of printed money and government bailouts, which show no signs of slowing.

We remain in the late innings of what is now the longest upcycle in history, and until we see debt issuance going toward productive capital investment instead of filling holes in lost revenue, economic growth will remain stagnant. New cycles begin when optimism is improving and demand outstrips productive capacity, and in turn corporations shift their focus to expansion and consumers eschew saving for spending.

We continue to focus our allocations on recession-resistant, domestically-oriented stalwart companies that will persevere through what will surely be a rocky economic and geopolitical landscape for years to come. Although our preference will always lean towards lower-beta, dividend-paying equities, we have no inherent bias towards growth or value stocks. It must also be noted that as cycles unfold, stocks will oscillate between growth and value, and the distinction between the two categories has become increasingly blurry. As asset managers, our portfolio allocation decisions, both within equities and across asset classes, reflect our perception of risk in the market and where we see macroeconomic cycles trending. For now, risk remains skewed towards the downside and we will continue to emphasize capital preservation in our investment decisions.

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