Slocum, Gordon & Co. LLP
INVESTMENT COUNSEL • EST 1978
OCTOBER 1, 2021

VIEWPOINTS

One of the great mysteries since 2008 is that we've seen successive waves of liquidity pumped into the global economy, and throughout these seemingly endless rounds of quantitative easing, rather than inflation, as economic theory suggests should happen, the problem policymakers have had to combat has actually been lowflation, or in some cases deflation. The prospect of the global economy contracting and prices falling, like they did spectacularly in the global oil market last April when the price of oil actually went negative for a day, is a scenario that central bankers are ill-equipped to combat.

The Fed, Treasury, and Congress - well aware of this post-Great Financial Crisis dynamic - responded powerfully to the Covid-19 shock by setting up a firehose of money to support businesses, workers, and owners of financial assets. Through direct payments, loans, grants, enhanced unemployment insurance, and large-scale bond buying, trillions of dollars were injected into the economy in a matter of months. Once confidence rose around the efficacy of vaccines and the potential for a robust economic recovery, concerns around higher inflation quickly became a topic of elevated discussion.

Today, the debate rages on as empirical evidence has become supportive of the inflation narrative: used cars, residential real estate, and materials like copper, semiconductors, and lumber have all surged in price. The bond market, on the other hand, continues to signal that the outlook for inflation is benign,

which seems to be supported by softening month-over-month inflation data.

As we've described ad nauseum in recent issues of *Viewpoints*, there is a tremendous amount riding on the question of whether the inflation we're seeing is transitory or permanent. Sustained inflation would surely lead to higher interest rates, which likely would result in lower asset prices, or worse, full-blown calamities in certain high multiple and over-leveraged pockets of the market. This logic has played out in recent weeks as equity markets softened in response to the Fed articulating its plans to begin tapering its asset purchases later on this year, and possibly pull forward the timing of its first rate hike to next year.

While our portfolios are indeed skewed towards securities that should outperform in a low-growth world, we are not banking on a purely inflationary or purely deflationary environment as we look ahead. There are intelligent economists, strategists, pundits and the like who sit firmly on either side of the debate and present compelling and high-conviction arguments for specific macroeconomic scenarios to unfold. Our view, unlike those of most public figures who are incentivized to make headlines with bold predictions, is that inflation is not a monolithic experience, and the longer-term effects of the incredible levels of monetary and fiscal stimulus on price levels in the abstract are simply not knowable with any degree of confidence. The reality is that the situation we're in is opaque and unprecedented. What we can discern, though, is that central bank policy has effectively been underwriting speculation for more than

a decade, and that debt-financed spending, as opposed to production, has been the engine of economic growth in the real economy, while P/E multiple expansion and share buybacks have been the drivers of gains in the stock market.

As risk managers with an emphasis on capital preservation, we aim to steer clear of both manias and panics and to chart a course that leads to the kind of consistent returns that impress over full market cycles. And when

the future looks especially cloudy, as it does today, we think it's helpful to turn to history in order to see patterns that might otherwise be invisible. With that, let's take a brief digression and consider one relatively obscure period of mania in American history that we think warrants a comparison to the big-tech-driven world we've been operating in.

In the early 1800's, as industrialization pushed farmers to specialize in their most profitable crops and to grow them for distant markets, an age-old cycle that returned nitrogen and other essential nutrients to the soil was unknowingly broken. As crop yields began declining throughout the country against a backdrop of a rapidly expanding population, a national crisis emerged. After decades of experimentation with different substances, it ultimately became clear to agricultural scientists and farmers which worked far better than the rest as a fertilizer. It was, of all things, bird droppings, also known as guano. In an 1840 address, President Fillmore sparked what would become a multi-decade mania by declaring that the US must use all means necessary to secure cheap guano in the interest of food security.

Armed with the knowledge that uninhabited islands serve as ideal rookeries for birds and their coveted droppings, speculators turned their attention to the South Pacific, where whalers and explorers had described encountering uninhabited remote islands covered entirely with thick layers of guano. In 1850, one group of entrepreneurs formed the American Guano Company with a capitalization of $10 million (a figure that looks a bit more substantial when compared to the federal budget that year of $45 million). And with the support of the Guano Islands Act of 1856, a new industry exploded over the following decades: vast infrastructure was constructed, entrepreneurs became wildly wealthy, and by the turn of century the US had annexed nearly ninety-four guano islands.

In the end, however, guano proved to be less essential and entrenched than most had believed. In a single stroke, the German chemist Fritz Haber was able to bring the entire industry down with the announcement of the invention of ammonia synthesis. With the discovery, the world was bestowed with a better alternative

to guano: a cheap source of nitrogen that was infinitely expandable.

The mismanagement of money and credit has led to countless financial explosions over the centuries. One of the greatest challenges for investors is to see and navigate potential crises as they unfold. In many ways, and most notably in valuations, it appears as though today's digital platform giants are invincible. After all, lawmakers' appeals to big-tech CEOs to address a laundry list of questionable business practices have felt akin to begging Godzilla to quit stomping on Tokyo. Yet as these behemoths continue to grow more powerful than most nation-states, we believe the risk of some form of disruption will increase as well. Time will tell whether a boiling point will come from legislation, social backlash, or something currently beyond our collective imagination. As we know from experience, technology companies, and in particular those in the social media space, do not often age gracefully. And while these businesses have indeed changed the way we communicate, shop, and consume entertainment, we remind ourselves of the old adage that "tall trees do not grow to the sky."

Peter C. Hatfield, CFA®, CFP®

Slocum, Gordon & Co. LLP was founded in 1978 to provide its clients with individualized asset management, advice, and counsel. We are an SEC registered investment advisor in Newport, Rhode Island. *Viewpoints* and *Our View From Mill Street* are informational only and not intended as advice on individual securities or investments. Our opinions are based on our current analysis and may change without notice. All investments have some risk associated with them and may lose some or all value. Past performance is not necessarily indicative of future results, and future performance cannot be guaranteed.