Quarterly Market Outlook & Strategy

Stocks & Bondage

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Executive Summary

- Central banks are trying desperately to manage the financial monster they created. As Fed Chairman Jay Powell acknowledged in a recent *60 Minutes* interview, our monetary authority is now digitally "printing" money in order to purchase securities, and sees no limit on how far it can or should go in that endeavor.

- The Fed is encouraging further accumulation of debt by firms that are, for all practical purposes, already insolvent. Unfortunately, each time our leaders kick the debt can down the road, they intensify the adverse impact of these liabilities on growth, and raise the threat level of the next crisis. What makes the current situation unique in history is policymakers' success in fostering a speculative frenzy amid the worst economic and social conditions since 1932.

- Those who have been tracking this policy folly to its logical conclusion apprehend that the only way the Fed can avoid a catastrophic outcome is by assuming broad control over financial markets—with terrible consequences for capitalism and democracy.

- It's difficult to imagine a happy scenario in which investors can exit from the dangerous corner into which the Fed has painted them. We think three unhappy—and mutually reinforcing—outcomes are plausible. Under the first (and most likely) scenario, the Fed is pressured to extend its monetary largesse to the general public, producing an eventual inflation surprise. Stagflation is the worst macro environment for asset prices, although commodities, real estate and emerging market assets typically outperform.

- A second scenario is that financial markets are destabilized by rising volatility. Due to heavy leverage and illiquidity in many markets, asset prices can easily be destabilized by a *rise or fall* in interest rates. The Fed will, of course, intervene to try to stabilize things, but it may not succeed given the vast size and interconnectedness of levered markets.

- A third scenario involves a destabilizing decline in the value of the US dollar as a result of the Fed's money-printing spree, which would reinforce the negative consequences of scenarios one and two.

- Paladin portfolios are designed to be robust to these risk cases. For now, we are waiting and watching the intense tug of war between the forces of deflation (debt and collapsing demand) vs. inflation (a monetary & fiscal escalation combined with ongoing supply shocks). The reflationary scenario looks to us as the most likely one *over the longer-term*, but we expect a bumpy road on the path toward stagflation.

Stocks and Bondage was the title of the Princeton Triangle Club's 1981 musical revue—staged in the fall of my freshman year—which presciently marked the beginning of the longest bull market in US history. I thought it was a great show (even though I had no interest in finance) so I consider it a fitting title for this quarterly letter. I believe we are at the end of an era.

We are now living though one of the most extraordinary periods in US history. Our society is grappling simultaneously with a pandemic on the scale of 1918, an economic shock more severe than any since the Great Depression, a social protest that ranks among the largest in US history, and a general breakdown in political and civil leadership. Tensions with our primary trading partner and geopolitical rival are escalating, with potentially serious consequences for the US economy and financial markets. Global output is on track to shrink by 5% in 2020. That's a drop of 10 percentage points relative to the norm of recent years, making this the worst economic contraction in modern history, by far.

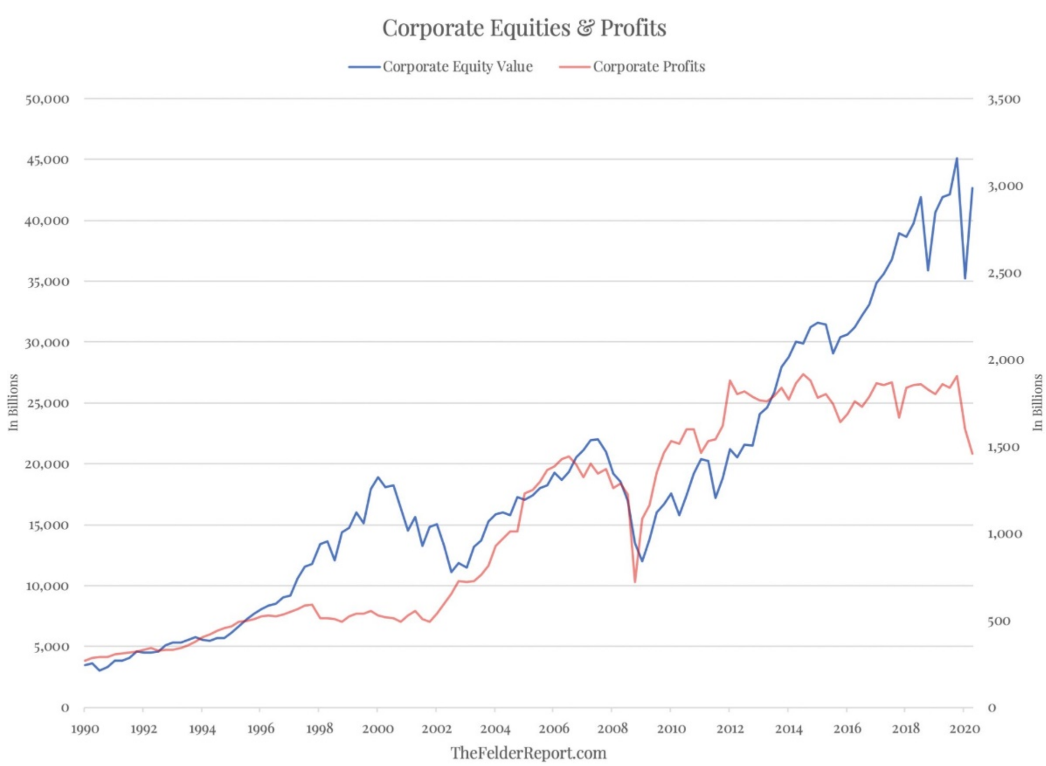
All of this is occurring against the backdrop of stock and bond markets that have never been more highly valued or more heavily leveraged. Investment returns have been sustained in recent years not by fundamental improvements in corporate profitability, but rather through the assumption of debt, as central banks drove institutional borrowing costs toward zero. These monetary operations have fomented a culture of financial engineering, greed, and moral hazard of epic proportions. America's appallingly unequal distribution of wealth can be attributed in no small part to the actions of our Federal Reserve which—with support from political leaders—have underwritten asset inflation, corporate concentration, endemic corruption and an erosion of democratic accountability.

Central banks are trying desperately to manage the financial monster they created. As Fed Chairman Jay Powell acknowledged in a recent *60 Minutes* interview, our monetary authority is now digitally "printing" money in order to purchase securities, and sees no limit on how far it can or should go in that endeavor. These "large scale asset purchases" extend well beyond the government bond markets to include mortgage bonds, municipal bonds, corporate bonds, junk bonds and—by extension, given how indebted are most corporations—stocks. Their purpose is to prevent global financial markets from collapsing under the weight of excessive leverage, because a re-pricing of assets toward fair value would result in a tidal wave of corporate and investor bankruptcies. That's the path we were headed down in March, before the Fed intervened in markets to "rescue" investors once again.

A financial crisis caused by unpayable private debts cannot be resolved via more borrowing; it can only be addressed through restructuring and/or write-offs. Our leaders, in their infinite wisdom, have chosen yet again to defer the kind of resolution that would rekindle competition and growth. Instead, they are bailing out poorly-performing management teams and their shareholders. The Fed is encouraging further accumulation of debt by firms that are, for all practical purposes, already insolvent. The insolvency did not begin with the coronavirus; the International Monetary Fund estimated last year that ~40% of corporations could not survive a typical recession. 20% were already broke when the pandemic hit.

Why did these improvident managers, while paying themselves huge bonuses, not save anything for a rainy day? Did they think the Fed had outlawed recession? No. They knowingly dug their firms into a debt hole, because the Fed made it cheap and easy for them to do so—and impossible for investors to profit from safer alternatives. Analysts, auditors, shareholders, banks, and financial regulators have come to accept corporate accounting practices that give new meaning to the phrase "wishful thinking." Everyone, it seems, has been trained to "extend and pretend" that these obligations will someday be repaid. Why? Because there is an avalanche of passive investment money looking for a home, with no questions asked.

Who are these necessary optimists? They are America's mutual funds, pension funds, insurance companies, hedge funds and, yes, retail investors. All have been bullied by the Federal Reserve's zero-interest rate policies into assuming more investment risk than they might otherwise be comfortable taking. No one can achieve a decent return on a portfolio invested in US Treasury bonds, or any other asset that can reasonably be considered safe. Many investors have chosen to believe the Fed's bedtime story about the security of financial markets, because they have no other choice.



Unfortunately, each time our leaders kick the debt can down the road, they intensify the adverse impact of these liabilities on growth, and raise the threat level of the next crisis. Thus has the economy lurched from 2000 to 2008 to 2020, with each "recovery" producing fewer jobs, weaker income trends, increased financial fragility, and greater social dysfunction. What makes the current situation unique in history is policymakers' success in fostering a speculative frenzy amid the worst economic and social conditions since 1932. That's the kind of thing you used to see only in developing countries.

It ought to be self-evident that printing money in order to inflate the prices of financial assets is not a sure path to prosperity. If it were, such policies would have succeeded everywhere by now. Invariably they have failed—albeit at different rates and in different ways. The most notorious example (and one that bears more than a passing resemblance to our current situation) was the rise and fall of the Mississippi Company and its illustrious leader, John Law. After founding the Banque Générale de France in 1716 with a mandate to issue fiat money, Law executed a leveraged buy-out of the Mississippi Company and expanded its reach in global trade. He progressively increased the issuance of paper currency, which drove down interest rates and eased the burden of government debt. Low rates also made it easier for investors to acquire equity in Law's company, in part by exchanging sovereign bonds for shares. His monetary largesse produced one of the most spectacular bubbles in financial history.

Eventually, liquidity found its way out of the financial system and into the economy, as investors sought to convert their profitable investments into real goods. The resulting surge in money growth produced a sudden and dramatic rise in prices, prompting widespread social unrest. When Law reined in the supply of currency in order to quell inflation, the Mississippi bubble collapsed, and he was hounded out of the country. All in the span of five years.

Following in John Law's footsteps, former Federal Reserve Chairman Ben Bernanke postulated a "wealth effect" from rising asset prices that would make people more inclined to spend. Rather than save for retirement out of income, the markets would, in effect, do the saving for them. Bernanke was right in his conjecture: by driving down interest rates, the Fed succeeded in elevating house prices to an historical extreme and encouraging families to refinance their mortgages. Millions of Americans extracted equity from their homes and used those funds for current spending. Unfortunately, the experiment ended in tears, as thin equity cushions pushed many homeowners into foreclosure when house prices fell. First-time home buyers were quickly priced out of the market, as institutional investors scooped up available inventory to create rental units. The result was a significant decline in home ownership, along with a large chunk of Americans' retirement savings. Fast-forward to 2020: the housing market is back in bubble territory—very near the peak of 2006.

Winston Churchill defined success as the ability to go from failure to failure with no loss of enthusiasm. Undeterred by the housing debacle—which could, of course, be blamed on others—the Fed turned its attention to the stock and bond markets. Unlike homes, these assets are owned primarily by the wealthiest Americans; 85% of stocks are held by 10% of the public. Here again, the Fed succeeded in inflating asset prices, which have risen more or less steadily since 2009. The result is debt and equity valuations in the top 1% of their historical distributions. Leverage magnifies price movements upward *and* downward, turning investors into forced sellers if the value of the collateral underpinning their loans declines. Those who have been tracking this policy folly to its logical conclusion apprehend that the only way the Fed can avoid a catastrophic outcome is by assuming broad control over financial markets.

"Hello, young man.
I'm with the Federal Reserve.
Today, we're buying baseball cards."

They say that all happy families are alike, whereas each unhappy family is unique in its dysfunction. It's difficult to imagine a happy scenario in which investors can exit from the dangerous corner into which the Fed has painted them. However, at least three unhappy—and mutually reinforcing—outcomes seem plausible to us.

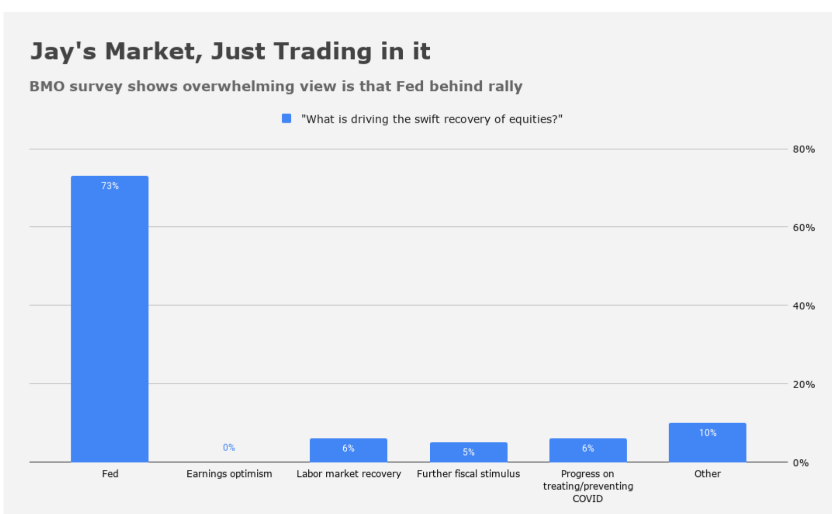
The first and most likely scenario (it's already happening) is that the Fed will be induced to share its monetary largesse with the public. Although Chairman Powell insists that the Fed has not contributed to rising inequality, few believe him. It's a silly assertion, since the "wealth effect" was designed to operate through financial markets that are owned primarily by the most affluent Americans.

Now that Powell has acknowledged there's no limit to the Fed's ability to digitally print money, ordinary citizens might well ask: Why can't the government afford to extend unemployment benefits? How about providing a universal basic income? Medicare for all? Free public college? Such questions are to be expected, now that the Fed has so conspicuously crossed the Rubicon.

The legislation supporting the CARES Act solidified a Fed-Treasury partnership that envisions a massive expansion in the government's borrowing program, which will move us rapidly along the path advocated by modern monetary theorists. The Federal deficit is slated to rise from 5% to 15% of GDP this year. The Fed has already increased the money supply by 15% in three months—that's *seven times* faster than usual. Most of those funds are now sitting in bank accounts, as precautionary savings. When they are spent, we may see higher inflation at last. The University of Michigan's consumer survey reported an uptick in inflation expectations, which is unusual during recession; households are experiencing sticker shock from rising food prices. Businesses are also reporting pipeline price pressures in purchasing manager surveys, as a result of dislocations in supply chains and increased costs of doing business. They expect to be able to pass these costs on to consumers.

A little inflation would be seen as a good thing—certainly by the Fed—if it greases the wheels of macroeconomic adjustment and lowers the real burden of our massive debts. It becomes a problem when it develops suddenly, disrupting bond markets. As we saw in 2018, it doesn't take much of a rise in interest rates to destabilize an economy that is fully loaded with debt.

A *fall* in bond yields could create a different (and equally serious) problem, which brings us to our second unhappy scenario. As long-term interest rates decline toward zero, bonds offer less return and more volatility, reducing their value as a portfolio hedge. Strategies that are predicated on leveraging "risk free" assets to balance the risk of a portfolio's equity holdings would become dysfunctional, resulting in a liquidation of both asset types. This is the one of the dynamics we saw in March, when the US 10-year yield collapsed from 1.5% to 0.5% in the span of two weeks; the stock market's decline quickly ensued. Because so much capital is tied up in passive strategies that are fully-invested and price-insensitive, forced equity sellers can find few willing buyers near the current market level. The result is huge downward price gaps, as occurred in March, and again in June. Lofty valuations for both bonds and stocks make the likelihood of a cascading market decline worryingly high—*whether interest rates rise or fall*.



BMO Survey of Institutional Fixed Income Investors, June 2020.

The third unhappy scenario involves a sudden decline in the value of the US dollar vs. foreign currencies. Remember that the United States is a net debtor to the rest of the world. We rely on the kindness of strangers to buy our stocks and bonds; that's how we finance our large trade deficit. It's true that the dollar has long served as the global reserve currency, and is the primary instrument for foreign trade and capital flows. However, foreign investors may reconsider its suitability as a store of value when the Fed is printing it in large quantities.

Like inflation, some US dollar weakness would undoubtedly be welcome, as that would ease the burden on dollar-denominated debtors abroad. However, if the currency's weakness were to accelerate, foreign investors could lose confidence in US assets, resulting in higher interest rates and/or lower stock prices. A weaker dollar would also contribute to inflationary momentum, by raising the cost of imported goods, especially commodities. Eventually bond yields and/or the Fed would have to respond, bringing us back to unhappy scenario one.

A final possibility is that—in recognition of the risks described above—the Fed backs quietly and carefully away from its market interventions, allowing asset prices to adjust toward fair value. Although such a scenario would be less painful than the alternatives, at least in the long run, we consider it the least likely. The Fed has gotten deep into the market's business, and is worried about any disruption to financial stability—or its reputation. They will feel compelled to carry on their Wizard of Oz act, for as long as it continues to work. Heaven help them.

Paladin Strategy

At a minimum, Paladin seeks to preserve our clients' portfolio purchasing power (to keep up with inflation) *without* subjecting them to the risk of catastrophic financial loss. This exercise is becoming more challenging against the backdrop described above: equity markets that offer very little return compensation for the risks incurred, and "safe" assets that offer almost no return at all—and policymakers who are determined to keep it that way! Overwhelmed by the market momentum that has been created by the Fed's backstop, many investors have given up on fundamental analysis and joined the game of roulette known as "don't fight the Fed."

It should be clear by now that this is not the path Paladin has chosen. History and common sense indicate that governments cannot print their way to prosperity. A debt problem cannot be solved via the issuance of more debt, and passive investment strategies that ignore fundamentals eventually come to tears. The challenge lies in determining *when* and *how* these unsustainable dynamics might unravel. We do not have a crystal ball (obviously!) but believe that the Fed's attempt to force stability upon the markets will either fail (or eventually be abandoned) via one of the scenarios described in this letter:

(1) An abrupt surge in inflation caused by aggressive monetary easing, the escalation in government spending and/or US dollar weakness; (2) A failure of market infrastructure (á la March) caused by rising interest rate volatility and illiquidity in context of passive & algorithmic trading; and/or (3) a normalization of asset prices engendered by a philosophical policy shift (i.e., a return to fiscal and monetary sanity) amid a public and/or professional unease.

Each of these scenarios has different implications for financial markets. The first could result in continued asset price appreciation, at least on a nominal basis, with particularly strong performance by foreign currency-denominated assets, commodities, and real estate. Scenarios (2) and (3) could entail abrupt stock market declines – likely across regions and sectors – similar to what occurred in February and March of this year. There's a good chance we will see a combination of all three, amid heightened market volatility, as policymakers struggle to come to terms with the financial monster they've created.

Defensive income equity and covered calls, high-quality bonds & cash, and opportunistic portfolio hedges are the cornerstones of our current strategy; one that is robust to scenarios (2) and (3). This posture acknowledges ongoing market risks from the present combination of extreme market valuations, excessive leverage, and continued downside risks to the US economy. These risks include a resurgence in Covid-19, record-high unemployment, and escalating bankruptcies. We're not sure whether the extension of stimulus measures will be targeted at those households most likely to benefit, creating an uncertain impact on growth. Even so, markets are already flirting with the reflationary scenario, as indicted by the dollar's recent weakness, rising commodity prices, and a surge in foreign equity markets.

Our goal is to build portfolios that are robust to an uncertain—but certainly changing—economic and market environment. For now, we are waiting and watching the intense tug of war between the forces of deflation (debt and collapsing demand) vs. inflation (a monetary & fiscal escalation combined with ongoing supply shocks). The reflationary scenario looks to us as the most likely one *over the longer-term*, but we expect a bumpy road on the path toward stagflation. It goes without saying that slow growth and rising inflation has not, historically, been favorable for most asset markets. Our plan is to use the opportunities created by market volatility to layer in investments that will help Paladin clients protect the purchasing power of their assets. These include, in rough order of implementation:

- Asia-focused international bonds and income equity
- Global inflation-protected securities
- Raw materials (energy and metals), renewable energy, and international real estate
- Opportunistic country- and sector-specific equity investments