Quarterly Market Outlook & Strategy

Opening Pandora's Box

Third Quarter of 2020

Jeffrey Egizi & Karen Parker Feld

October 2020

Executive Summary

- The bedrock of most Americans' retirement strategies is the so-called 60/40 portfolio—a mix of 60% stocks and 40% bonds, mostly US assets. Fueled by decades of benign inflation trends, falling interest rates, and rising corporate profits, this stalwart allocation has served US retirees extremely well over the years, producing an average annual return of over 10% since 1980.

- The downside of this strategy's exceptional success is that the assets that comprise the 60/40 portfolio are more expensive than ever—just as the Fed undertakes a major policy shift in a desperate attempt to generate higher inflation. We think a baton pass is coming, one that will again favor international markets, value stocks and commodities. These asset classes benefit from environments of rising inflation and US dollar depreciation.

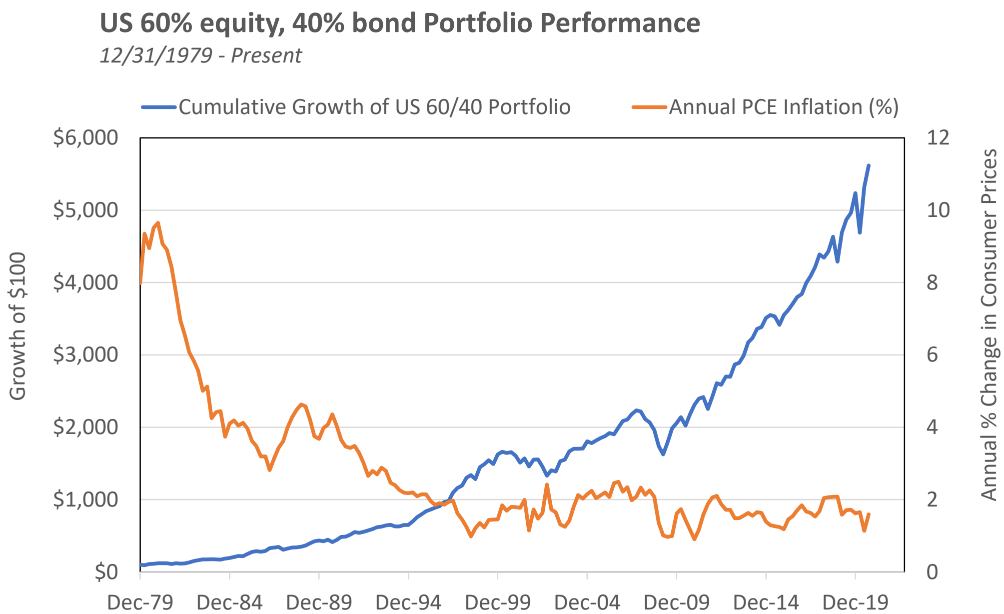
- Paladin's medium-term signals for foreign currencies and commodities suggest such a shift may begin within the next couple of years, driven by rapidly-expanding US deficits, greater fiscal spending in China, and contracting supplies of oil and other commodities. Given the relative illiquidity in commodity markets, these sectors could see large gains if the inflationary thesis gains traction.

- On the other hand, reversing a 40-year policy paradigm—associated with the longest bull markets in US stocks & bonds—won't happen overnight. We expect the transition to be unpredictable and potentially turbulent, given the ongoing tug-of-war between the forces of deflation vs. inflation. This is especially true given massive debt burdens, aging demographics and challenging political dynamics in the US. Deep divisions will linger and make consensus on economic policy—and many other issues—difficult to achieve.

- The macro signals and policy analysis described here *raise the likelihood* of a bout of dollar weakness and rising inflation over the next several years, but do not assure such an outcome. Therefore, rather than try to map out the precise trajectory of interest rates, inflation and asset prices, we are building diversified portfolios that can perform reasonably well under a range of possible outcomes—with a balance of assets that do well in deflationary and inflationary regimes. We are also keeping enough cash on hand to take advantage of opportunities as they arise. In the meantime, we are proceeding with care, and using bouts of market volatility to build exposure to non-US dollar assets, such as foreign bonds, commodities, and international equity.

A Forty-Year Success Story

The bedrock of most Americans' retirement strategies is the so-called 60/40 portfolio—a mix of 60% stocks and 40% bonds, mostly US assets. There are many variations on the theme, including target-date retirement funds, pre-set 401k allocations, and liability-matched pension plans. This stalwart allocation has served US retirees extremely well over the years, producing an average annual return of over 10% since 1980, across a variety of economic environments. Returns have been exceptionally good over the past year, despite evident problems in the US and global economies.[1]



These results coincided with a significant decline in the rate of consumer price inflation from 1980 – 1997, and a stabilization of inflation at very low levels from 1997 – 2020. *All else equal*, low and stable rates of inflation are supportive of financial asset prices; particularly those that provide fixed payment streams. For example, bond coupons are able to hold their purchasing power relatively well amid low inflation, increasing the appeal of fixed income investments. The most immediate result of this logic is rising bond prices and falling interest rates.

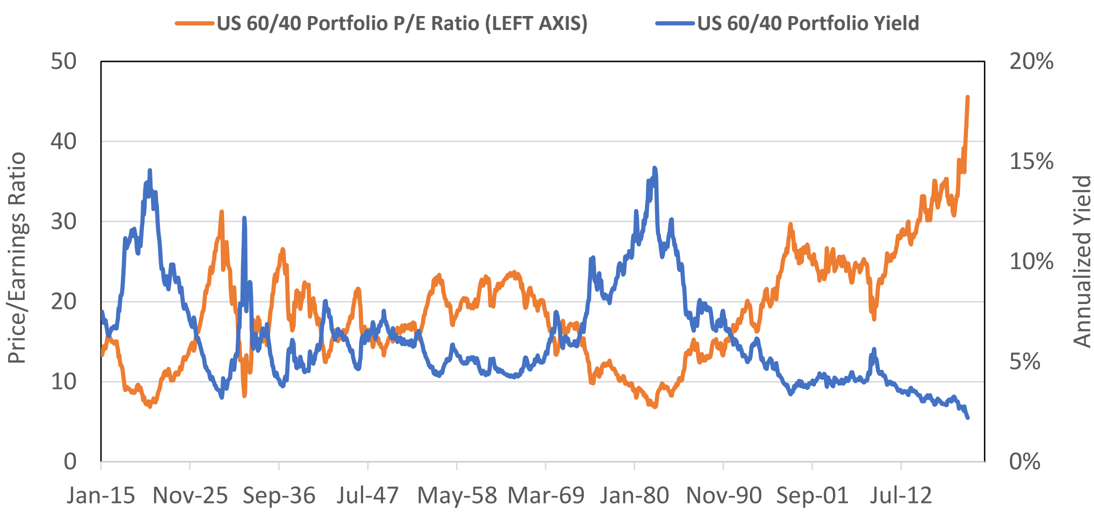
Low/falling inflation and interest rates carry a range of benefits for equity investments as well. Cheaper borrowing costs facilitate credit growth and therefore economic expansion, reduced interest expenses and input costs support corporate profit margins, and low/falling bond yields encourage return-seeking investors to pay higher valuations for a range of cash flow-producing assets (including equities and real estate).

[1] Unless otherwise noted, all charts are constructed by Paladin using data sourced from Bloomberg

This four-decade trend of benign inflation, falling interest rates, and rising corporate profits has made the assets that comprise the 60/40 portfolio more expensive than ever. Figure I below shows the strategy's yield (a weighted average of the S&P 500 earnings yield and the US 10-year Treasury bond yield) alongside its mirror image—the portfolio's current valuation.[2] Equity and bond yields are now so low that the 60/40 portfolio no longer represents a viable strategy for those seeking income (or safety) from their investments. The question is: is there a better alternative?

Figure I. Starting Yield and Valuation of US 60/40 Allocation

1915 - Present



Source: Robert Shiller, Paladin Advisors

Investments outside the US stock & bond markets are more attractively priced, but—not surprisingly—come with a certain amount of baggage, whether that be diminished credit quality, weak and/or inconsistent corporate earnings, policy risks, or poor liquidity. There is no longer such thing as a risk-free lunch! That said, attractive valuations can compensate for many of these risks, just as overpriced "safe" assets can expose investors to meaningful downside.

Financial markets are characterized by long cycles of divergent asset class performance, as certain industries, sectors or countries fall into and out of favor (Figure II). The current period harkens back to 1999, when US markets—led by technology stocks— seemed invincible. As we all know, that bubble came crashing down, and was followed by a decade in which large cap US stocks delivered *zero* returns, including dividends. Fortunately, bond yields were still relatively high, allowing investors to earn income while stock markets adjusted—keeping portfolio returns ahead of inflation.

[2] The S&P 500 earnings yield is calculated using average earnings over the trailing 10-year period

Now, all US yields are extremely low, reducing the attractiveness of the 60/40 portfolio in a world in which central banks are now hell-bent on *raising* inflation.

Figure II. Asset Class Performance Trends

Annualized Returns Through September 30th, 2020

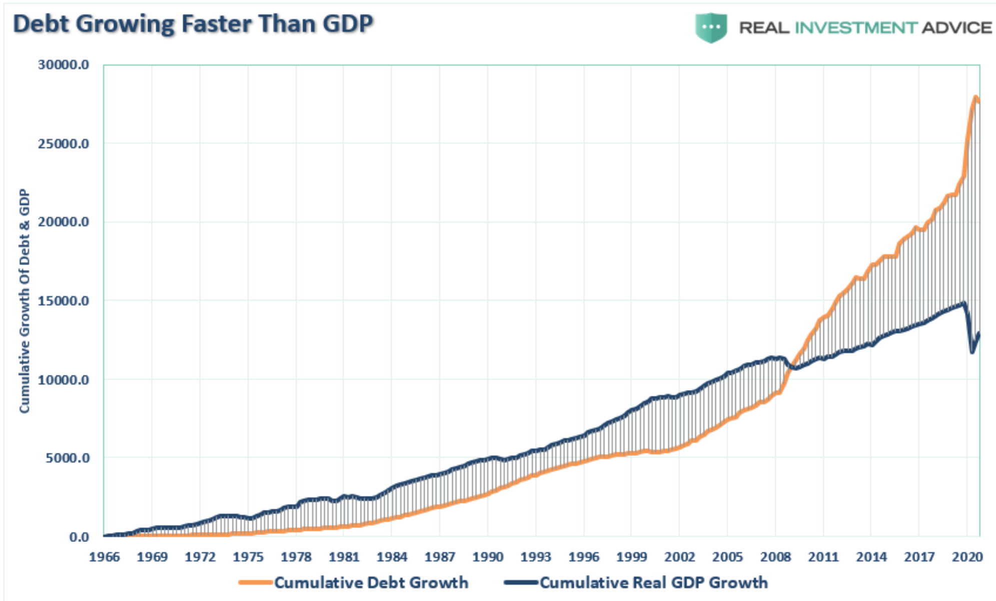
Asset Class	Trailing 12-month	2010 - 2020	2000 - 2010
US Large Cap Equity	**15.1%**	**13.7%**	**-0.4%**
US Small Cap Equity	0.4%	9.8%	4.0%
International Equity	3.4%	4.4%	4.7%
Global Value Equity	-7.3%	6.0%	3.5%
Long-Term Treasuries	**9.9%**	**4.2%**	**7.3%**
Intermediate-Term Treasuries	6.9%	2.7%	6.4%
Short-Term Treasuries	3.5%	1.2%	4.2%
Commodities	-8.9%	-6.6%	3.7%
Natural Resource Equities	-9.5%	0.2%	17.0%
Real Estate	-12.2%	9.2%	7.9%

From Deflation to...?

We think another baton pass is coming, one that will again favor international markets, value stocks and commodities. These asset classes benefit from environments of accelerating growth and rising inflation, when the US dollar typically depreciates. However, unlike 1999, we believe the coming transition portends a larger and more difficult paradigm shift—one that will bring back inflation, but without as much growth. In other words: *stagflation*. The global backdrop is quite different than it was at the turn of the century. We now confront rapidly-aging demographics, under-funded private and public sector pensions, and very high levels of corporate, government and household debt. These realities have inhibited private sector spending, as have the monetary policies pursued by the world's central banks.

The latter statement might come as a surprise, given central banks' stated objective of supporting consumption and investment through low interest rates and the purchase of private financial assets. This strategy worked for a while, but has become quite counterproductive. Monetary policy brought forward—and has now largely exhausted—*years* of future consumption growth, while fostering unsustainable debt burdens among households, corporations and the federal government (Figure III). That's why central banks are so keen to create inflation—to erode the real burden of private and public sector debts.

Figure III. US Debt Growth vs. GDP Growth



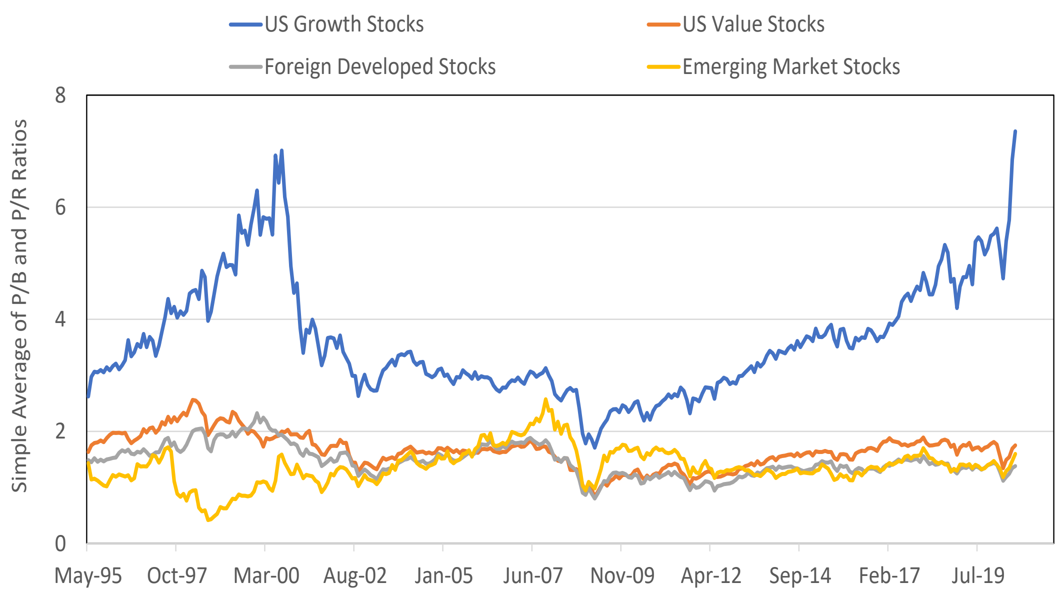
Source: Lance Roberts

Meanwhile, low interest rates and central bank bond purchases have driven the price of US assets, including homes, into the stratosphere. That has raised the fortunes of those who already own such assets, while pricing others out of the market. As a result, the majority of American families are utterly unprepared for retirement, despite extraordinary market returns. Wealthy households have greater capacity to spend, but a higher tendency to save their gains, resulting in slower growth than would occur under a more equal distribution of income.

On the corporate side, bank lending has been channeled primarily to large businesses and those owned by private equity firms—who have directed the funds back to their shareholders, rather than to productive capital investment and/or employment. As a result, the number of "zombie" companies, whose debt service exceeds their earnings, has increased sharply, even as small firms have been driven out of business. These trends, along with automation and diminished competition across increasingly monopolized industries, have curbed real income growth.

In sum, monetary policy has contributed to a debt-deflation cycle in the *real* economy, even as *financial* markets have been inflated by excess liquidity. These dynamics have generally favored large companies over small, bonds over stocks, and intangible capital (i.e., technology and other sectors with a preponderance of IP) over real assets. And, because the United States is the leader (or at least the most liquid market) in each of these segments, US assets—and thus the classic 60/40 portfolio—have generally outperformed foreign ones (Figure IV).

Figure IV. Valuation Comparison: Average of Price/Book and Price/Revenue Ratios



Granted, international and value stocks have always traded at a discount to US technology stocks, but the gap has never been wider. The rise of passive investing has further contributed to a self-reinforcing pattern of rising asset prices and increasing flows into the 60/40 strategy. These trends are now so entrenched, it's hard to imagine they could ever change.

A New Monetary Policy Paradigm

But change they will. As Herb Stein famously said, if something cannot go on forever, it eventually will stop. Extreme inequality, political dysfunction and popular unrest have brought our economy and society to the breaking point. The Federal Reserve's trickle-down strategy of supporting the economy via debt creation and asset inflation has failed. Nor have budgetary support measures been effective, given our intractable, and frankly corrupt, legislative process. The original CARES act provided emergency resources to small business and households, but a large majority of the funds went to large corporations and investors who didn't need the support. Fed Chairman Powell has for months been imploring Congress to renew these stimulus programs, warning of dire economic consequences of inaction—to no avail.

Under mounting public pressure, and stung by criticism that it has been driving inequality higher, the Fed (rightly) fears that it will lose its independence. In response, the central bank has taken some dramatic policy steps.

First, it is winding down its much-criticized corporate bond buying program at the end of this year. Second, it has announced a new approach to inflation targeting, in which it will treat risks around the 2% level as symmetric. In other words, it will let inflation run "hot" above that level in order to get prices closer to where they might have been had the economy not experienced a decade-long economic slump.

A new inflation-targeting regime would be meaningless without a credible strategy to raise prices. The third step in the Fed's plan is to create digital currency that will be transferred directly to US households, via accounts set up at central bank. These will be credited with digital dollars (via a bookkeeping entry) which can be spent, invested or used to pay down debt—just like other forms of electronic payment. So as not to usurp Congressional authority, the Fed has said it will issue digital currency only in a recession, and only with congressional approval. The European Central Bank and Bank of Japan are developing similar plans (known collectively as central bank digital currencies, or CBDC) and are working with credit card processors to create a technology platform that will allow wide-scale testing. Cleveland Fed President Loretta Mester has said the new system could be in place as early as 2023.

Distributing money directly to households, rather than via the financial system, represents a major shift in monetary policy, one that is far more likely to produce inflation than low interest rates or asset purchases. Until now, the only inflation central bank policies created is asset price inflation. Most US households are likely to spend their windfall—resulting in higher prices of goods and services. A good portion of the increased spending will show up in higher imports (since most consumer goods are produced outside the United States) but there will also be higher spending on services such as housing, education, and health care.

This policy shift is an implicit acknowledgement that the Fed's "quantitative easing" strategy has failed to support the real economy, while producing adverse effects in the form of asset bubbles and rising inequality. It also suggests the Fed is reluctant to follow the path of other central banks toward negative interest rates. These are a tax on savings, corrosive to bank profitability and—if the experience of other countries is any indication—deflationary. Fed officials recognize that the US Treasury market, the anchor of the global financial system, would collapse under a negative interest rate regime. By contrast, distributing digital currency directly to US households (including those that are unbanked) is more equitable, and more likely to produce a stimulative effect on the economy, than the tools the Fed has used to date.

That said, creating inflation via the "printing" of digital currency poses considerable risks. For starters, it does nothing to address the structural problems of adverse demographics, monopolistic business practices, diminished productivity gains and stagnant wages. Stronger demand without a productive supply response will produce higher prices, but not a higher standard of living. On the contrary, hourly employees, small savers, and those living on fixed incomes will almost certainly experience a loss of purchasing power, as wages and interest rates will (by design) not keep up with rising prices. By contrast, wealthy households invariably find ways to hedge against inflation (more on that below). Second, there's a good chance that higher inflation will become entrenched, with adverse consequences for everyone. In theory, the Fed should find it easy to restrain "excess" inflation by withdrawing digital currency from circulation. In practice, the central bank has found it difficult to end *any* of the unconventional tools it has adopted since 2009. In the absence of reforms to support productivity, employment and broadly-distributed income growth, these "emergency" measures could become a permanent fixture of the policy landscape.

There are other risks as well. Central bank-sponsored digital currencies will lead many households to bypass commercial banks, especially smaller community banks that offer a narrower range of services. The result will be further industry concentration among too-big-to-fail financial behemoths. There are also serious privacy issues; a seamless global payments system will allow governments to monitor, track and/or tax *every single financial transaction*—and block or tax those that do not meet some preapproved criteria. Finally, as with any electronic transaction, there are ongoing risks associated with malicious hacking, interruption of internet service and/or power failures—which are increasing in frequency and severity.

Several other developments point toward higher future inflation. The Fed has pledged to finance a surging budget deficit, and that's just the tip of the iceberg. Unfunded Medicare and Social Security entitlements will prevent the deficit from falling, even when the economy recovers. Given the massive US "twin deficits" all this money printing will take its toll on the US dollar (Figure V) and a weaker dollar means rising import prices—which is inflationary. Our US dollar model (Figure VI) continues to point toward currency depreciation.

Figure V. US Twin Deficit vs. US Dollar

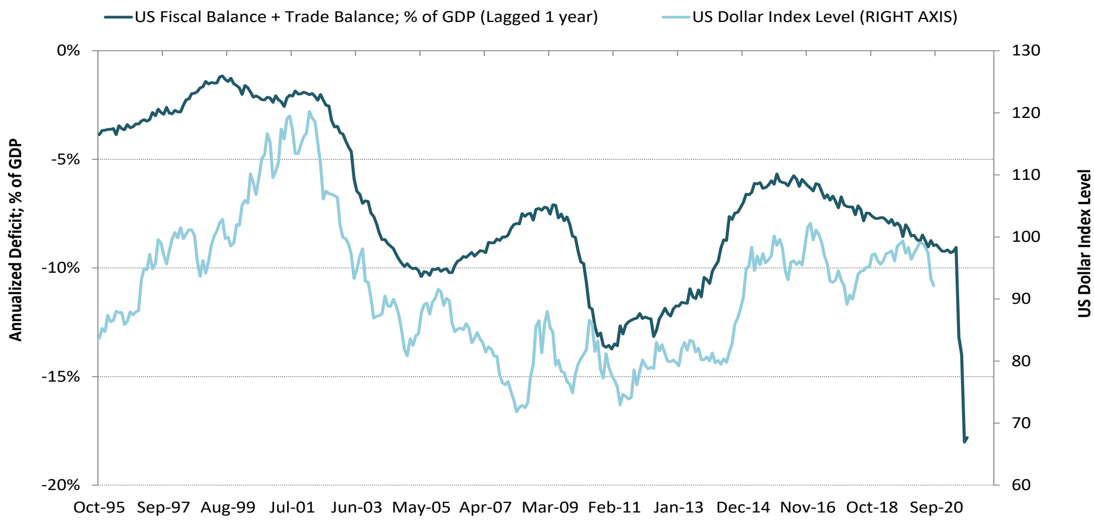
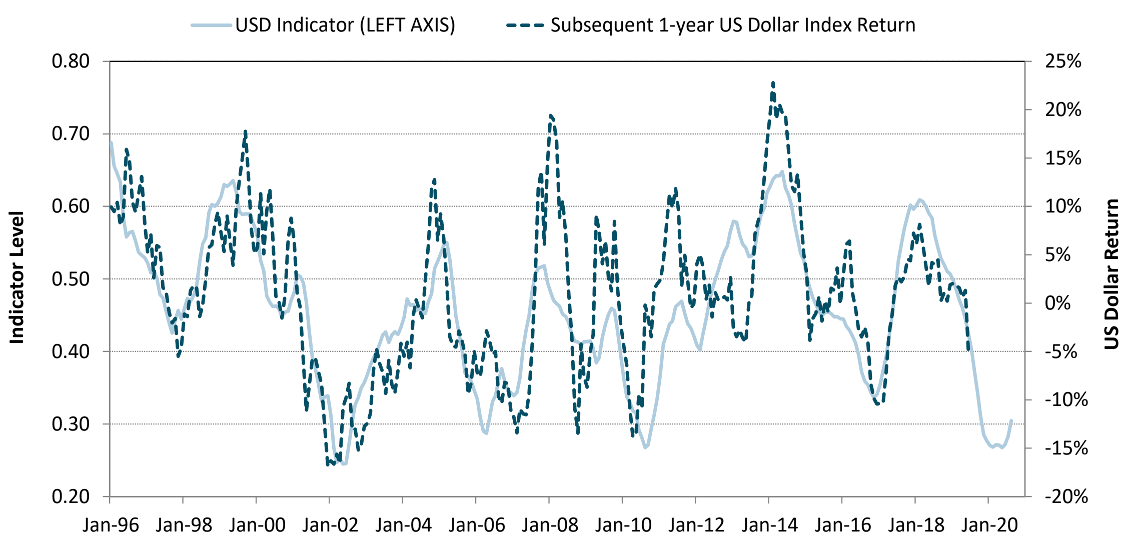


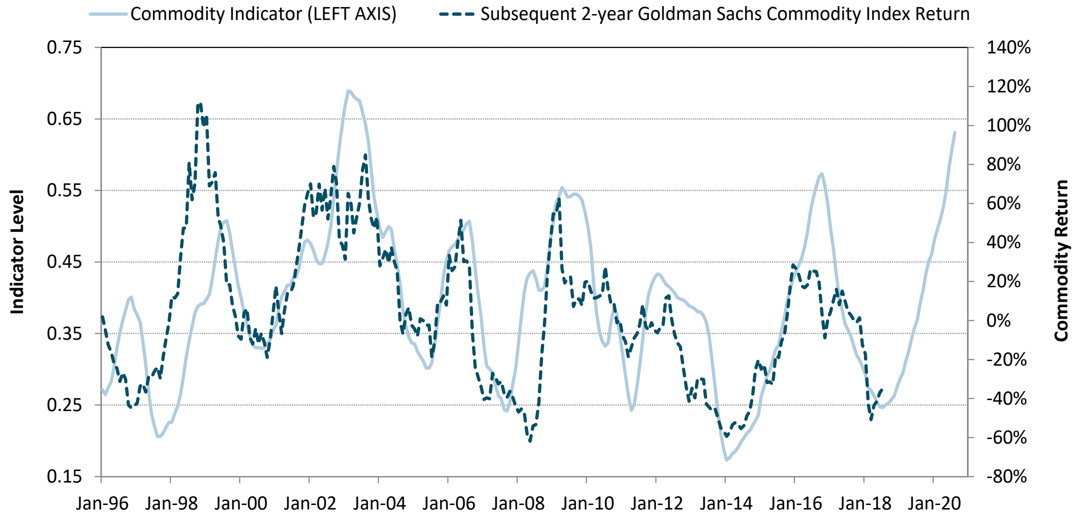
Figure VI. Paladin Advisors Currency Signal
Jan 1996 - Aug 2020



Developments related to the Chinese economy also point to higher inflation in the years ahead. Faster wage growth in China over the past two decades has alleviated the downward pressure on US prices from cheap imported goods. The breakdown in global trade relations has also resulted in rising tariffs and fracturing supply chains, contributing to higher prices for imports. China confronts many of the same policy challenges as countries in the western world, and is also providing significant budgetary stimulus, including through the Belt-and-Road initiative.

Fiscal expansion, in an environment of increasingly scarce natural resources, will lead to higher commodity prices in future, as our commodity model indicates (Figure VII). This too, will contribute to inflationary pressures.

Figure VII. Paladin Advisors Commodity Signal
Jan 1996 - Aug 2020



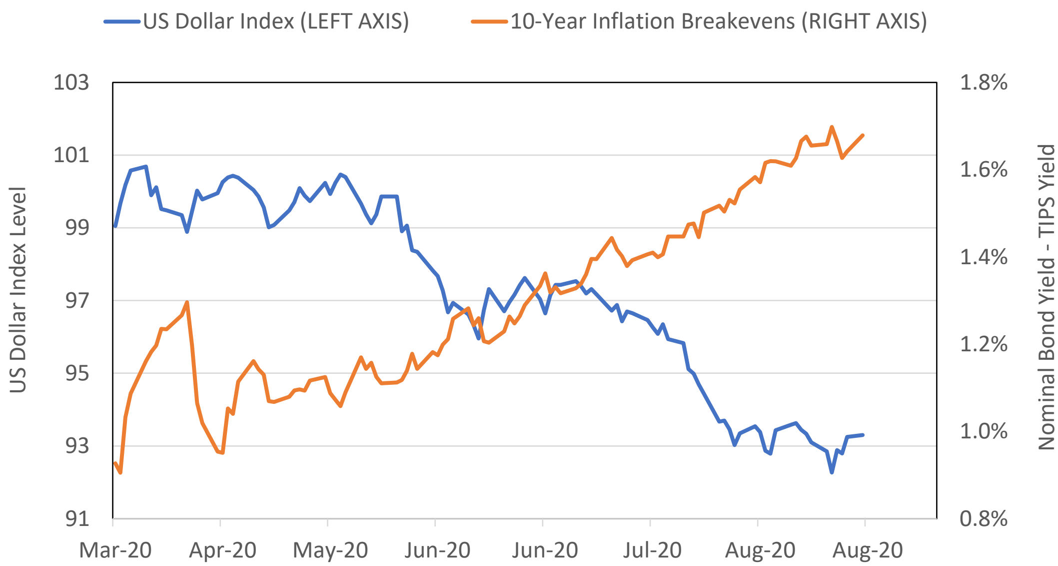
Paladin's US dollar and commodity models are mutually reinforcing; since almost all commodities are priced in US$, their prices rise (fall) when the dollar is falling (rising). However, our models rely on separate input variables, to generate independent signals for these two markets. There's already some evidence that inflation expectations (as measured by TIPS breakevens) are rising, as the US dollar declines (Figure VIII).

Reversing a 40-year policy (and market) paradigm won't occur overnight. We expect the transition to be unpredictable and potentially turbulent, given the ongoing tug-of-war between the forces of deflation vs. inflation. Investors are increasingly conscious of inflation risk, but deflation dynamics continue to dominate, since:

- Although it's experimenting with new tools, the Fed continues to rely on a strategy of debt creation, supported by very low interest rates
- Private spending remains hamstrung by heavy household and corporate debt burdens, along with high rates of joblessness. Spare capacity remains too elevated—and wage growth too subdued—to generate a *sustained* rise in inflation
- Another round of stimulus is needed, but may not be forthcoming (or appropriately targeted) due to legislative gridlock and the influence of big money in politics

There are doubts about the viability of natural resource investments (and the emerging markets in which they are produced) given the existential threat posed by climate change—and potential regulatory responses to those threats. Commodity markets are notoriously illiquid and volatile, discouraging participation by large market players. On the other hand, it means these sectors could see large gains if they are perceived as a viable inflation hedge.

Figure VIII. US Dollar Index Level vs. Inflation Expectations
3/31/2020 - Present



Paladin Investment Strategy

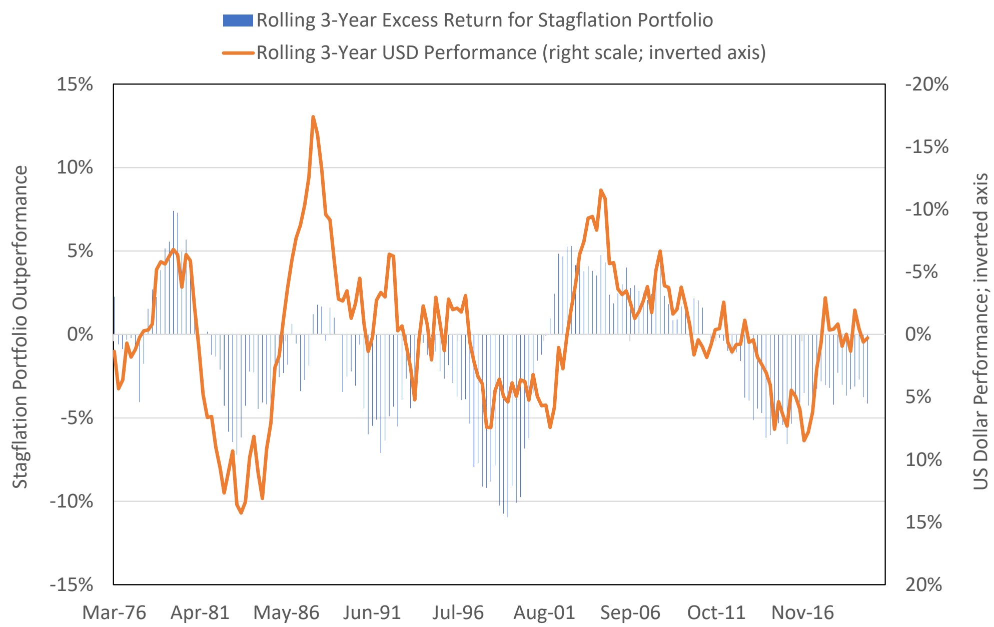
Figure IX compares a US-focused 60/40 portfolio to a hypothetical portfolio constructed for a stagflation scenario. This Stagflation Portfolio attempts to approximate the risk profile (equity/bond mix) of the 60/40, and keeps the asset list relatively short for simplicity and data availability purposes. Nonetheless, it's a reasonable approximation of what a more diversified alternative might look like.

Figure IX. Asset Allocation - US 60/40 vs. Stagflation Portfolio

	US 60/40 Portfolio	Stagflation Portfolio
US Equity	60%	20%
International Equity	0%	15%
Fixed Income	40%	40%
Real Estate	0%	10%
Commodities	0%	10%
Gold	0%	5%

Essentially, the Stagflation Portfolio swaps out the majority of the US equity exposure for other equity and equity-like assets which add protection against a rising inflation and falling US dollar scenario. In Figure X, we show the relative performance of the Stagflation Portfolio versus the US 60/40 over time, graphed against the performance of the US dollar versus a basket of international currencies. The key takeaway is that the path of the US dollar is a significant driver of the relative performance of the Stagflation Portfolio. A weaker USD supports the Stagflation Portfolio's international equity and real asset exposures, while a stronger USD benefits the US-focused portfolio.

Figure X. Annual Return Spread - US 60/40 vs. Stagflation Portfolio



It's important to underscore that the macro signals and policy analysis we've discussed in this paper *raise the likelihood* of a bout of dollar weakness and rising inflation within the next several years, but do not assure such an outcome. Therefore, rather than try to map out the precise trajectory of interest rates, inflation and asset prices, we are building diversified portfolios that can perform reasonably well under a range of possible outcomes—with a balance of assets that do well in deflationary and inflationary regimes. We are also keeping enough cash on hand to take advantage of opportunities as they arise.

We're monitoring the following developments that might accelerate the transition toward a more inflationary economic regime: a) the development of COVID-19 herd immunity and/or progress toward a vaccine, which would release pent-up demand; b) a clear election victor and orderly transition of power, which would bring renewed budgetary stimulus; and c) clarity on climate policy and strategies for using fossil fuels more efficiently and safely.

In the meantime, we are proceeding with care, and using bouts of market volatility to build exposure to non-US dollar assets, such as foreign bonds, commodities, and international equity (in that order). We are building a diverse and climate-sensitive natural resources allocation, including copper and renewables. We are retaining exposure to precious metals and miners, which serve as a hedge against potentially disruptive market scenarios. We continue to rely on signals from our global business cycle indicators to dictate our overall risk profile.