Knightsbridge
WEALTH MANAGEMENT

July 14th, 2021

Summer Quarterly Commentary

"I continue to believe that the American people have a love-hate relationship with inflation. They hate inflation but love everything that causes it."

William E. Simon (1927 – 2000)
Secretary of the U.S. Treasury
Businessman, Philanthropist

Last October, we wrote that virus-wise, we would be 90% back to normal by the third quarter of 2021. We are happy to report that seems to have been a decent prediction. Unfortunately, this only applies to the U.S. When it comes to the rest of the world, only 7% of the population has been vaccinated. This pandemic will linger for years, especially in developing countries[1]. Yet, we continue to believe that, for Americans, COVID will remain a public health issue, not a society-altering economic one.

From an investment standpoint, the global economy cannot thrive without a strong U.S. economy. Fortunately, the converse isn't quite so true. Unlike in early 2020 when we took evasive action and subsequently repositioned the investment portfolio for an economic reopening, this year we are investing steadily through the virus news.

[1] At present, COVID is by no means a developing world-only problem. As we write, Sydney, Australia is in strict lockdown to protect its largely unvaccinated population from the Delta variant and the now unpopular Tokyo Olympics are set to go forward without spectators.

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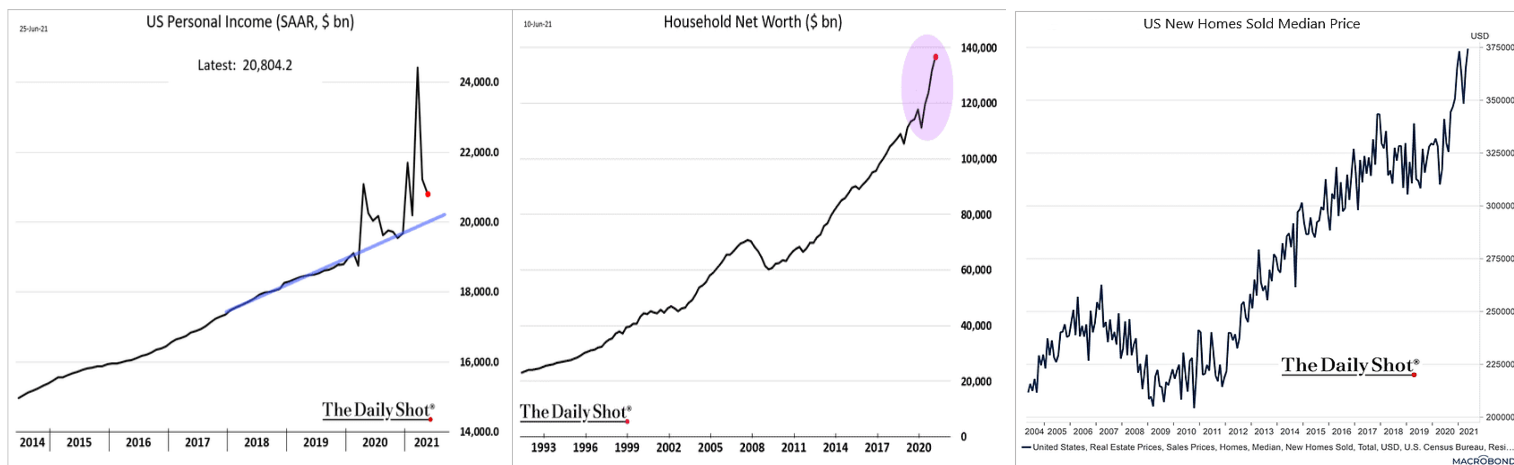
It's a good thing we have been fully invested – asset prices are soaring and the stock market is no exception. This is due in large part to all the liquidity created by the Federal Reserve to buy assets. Meanwhile, a river of money is also flowing into the real economy as the government spends (or gives away) much more than it takes in.



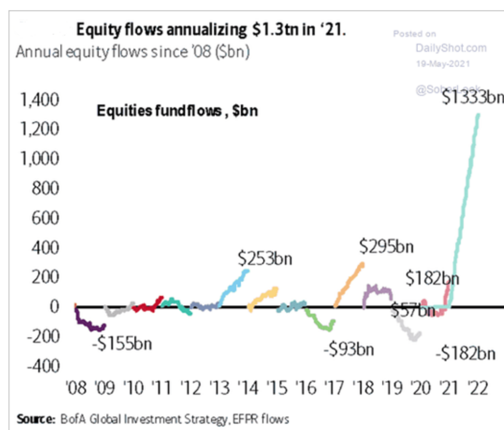
This combination of monetary forces helped add $13.5 *trillion* to U.S. household wealth over the last year. This same period saw median home prices leap 17%. Today's real estate prices are breathtaking. They serve as a prime example of the "illusion of prosperity" we referenced in our Winter commentary. You still live in the same home, just with a higher accounting value. Surging home values will eventually be resolved one way or another: a crash, reduced future appreciation or the price of everything else rising to catch up (inflation), though perhaps not for a long time.

The rise in stock and home prices is passé, however, compared to the sheer madness going on in the world of cryptocurrency. Dogecoin is minting millionaires. What is Dogecoin? A decade ago, funny little pictures of a Shiba Inu pup nicknamed "Doge" began floating around the internet (a "meme"). In 2013, a few coders got together and created a cryptocurrency based on this dog meme and called it Dogecoin, primarily as a satirical joke to show how easy it is to create a cryptocurrency. Dogecoin is a parody of cryptocurrency based on an internet joke. And this year, when people started sending out Dogecoin memes purporting that the cryptocurrency would figuratively "go to the moon" in price terms, it rocketed up 4,300 percent. Think about that for a moment.

<u>Original Doge Meme</u> **<u>Dogecoin Meme</u>**

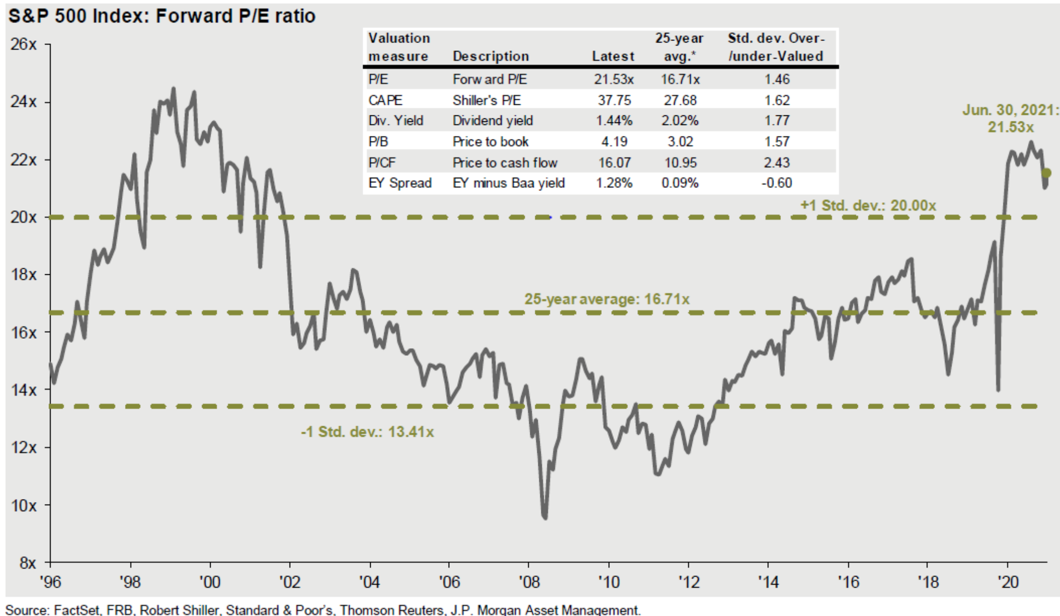
Most cryptocurrencies have lofty goals but do not actually *do* anything just yet. Dogecoin is different in that it does not even *pretend* to do anything. It's funny; it's cute; it's valuable; that's it. Think of it as a suddenly popular electronic beanie baby. Get rich quick stories abound, like that of the gentleman who spent (invested?) $60k on Dogecoin that is now worth $3 million. Dogecoin started as satire, but now the "currency" is collectively worth $28 billion... with a "b"[2]. It gets even crazier. While Dogecoin is a parody of a cryptocurrency, there now is a parody of Dogecoin called Shiba Inu Coin which was recently worth $13 billion (today down to a mere $3 billion). People getting rich plowing their money into a parody of a parody will eventually become a very expensive joke. Unfortunately, just as with the "meme stonk" stocks such as GameStop[3], a lot of people are going to lose a lot of money. In the end, prices for these "assets" will return to earth and the net result will be a wealth transfer from those who bought late to those who bought early and managed to sell. Fortunes will be lost and that isn't so funny.

Meanwhile, back in the world of assets possessing intrinsic value, the bull market continues, with stocks hitting all-time highs. Inflows to equity funds have been enormous and valuations appear increasingly stretched.



[2] Even this value is well off its high, with the price dropping 31% in a single day (June 21st). While the value of Dogecoin defies logic, not all cryptocurrencies will necessarily go to $0. One or two could become long-term stores of value. Others could serve a different useful function, though we're not aware of any that do so today.

[3] Now the largest valued company in the small cap index.

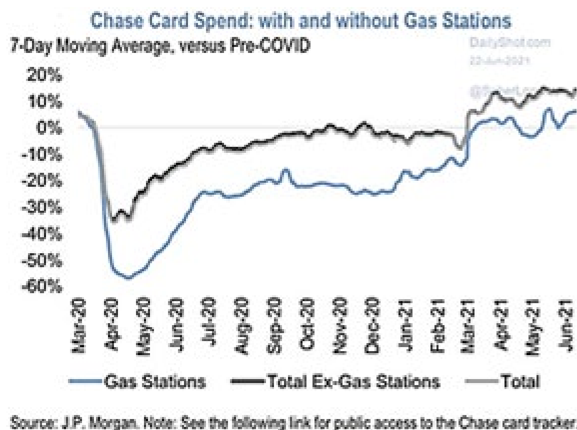


Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.53x	16.71x	1.46
CAPE	Shiller's P/E	37.75	27.68	1.62
Div. Yield	Dividend yield	1.44%	2.02%	1.77
P/B	Price to book	4.19	3.02	1.57
P/CF	Price to cash flow	16.07	10.95	2.43
EY Spread	EY minus Baa yield	1.28%	0.09%	-0.60

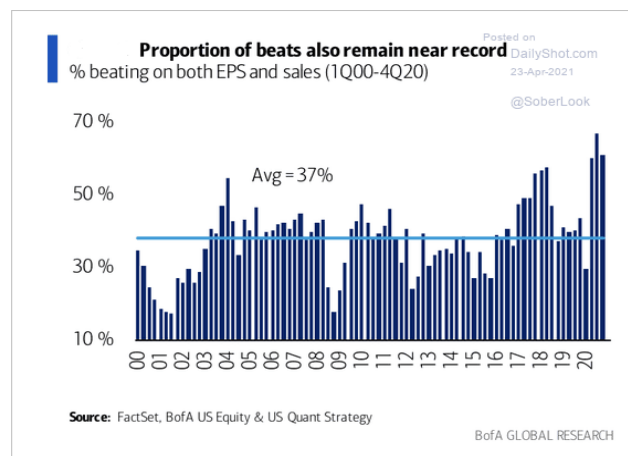
Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

We fear many are buying stocks for the same reasons they buy cryptocurrencies... because they are going up. If that was the *only* prevailing rationale, we might say stocks are in a bubble. We hold off on that label because there is another potential reason people are buying: stocks offer the opportunity for positive returns by their nature of being productive assets. For now, we are riding a rising tide which is lifting all boats, including ours, while doing our level best to avoid the most extreme corners of the market.

Perhaps it is understandable that we are in a bull market. The U.S. economy is running red-hot with consumer spending back above pre-COVID levels. As a result, corporate earnings are beating estimates by historic proportions.



Source: J.P. Morgan. Note: See the following link for public access to the Chase card tracker.



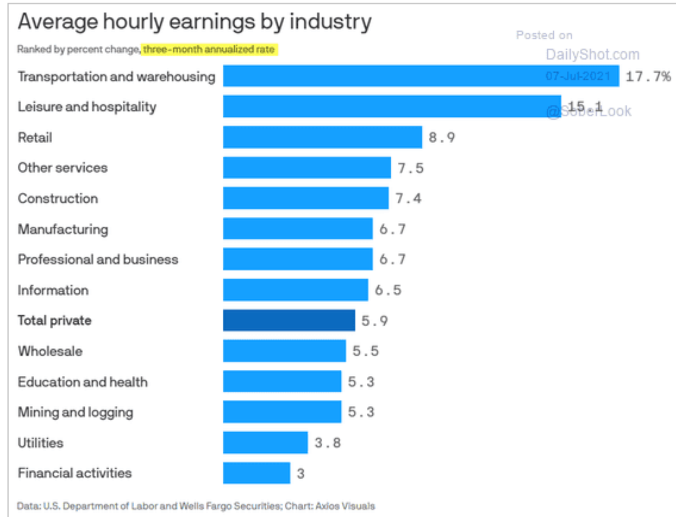
Source: FactSet, BofA US Equity & US Quant Strategy

With the economy booming, businesses are hiring. Everywhere you turn there is a story about production delays or a higher priced something. Rising wages are the most concerning (to capitalists) because they go

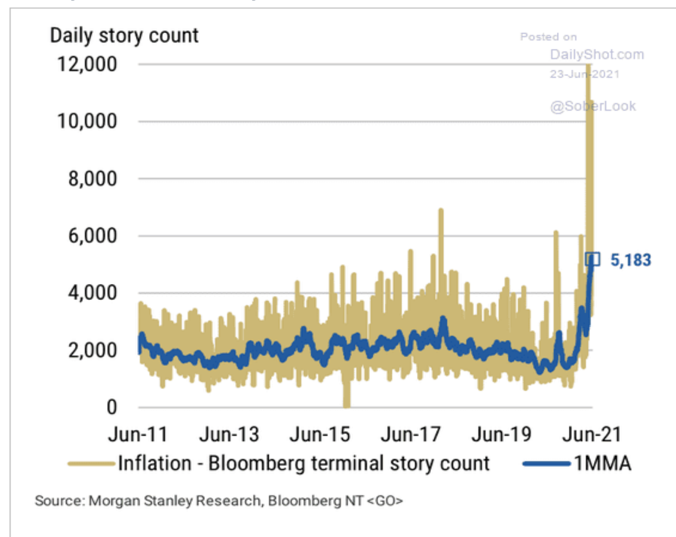
into *everything*. The question on everyone's mind is, "will inflation ruin the party?"

New and Used Vehicle Prices

Recent Wage Gains by Industry



Daily Inflation Story Count

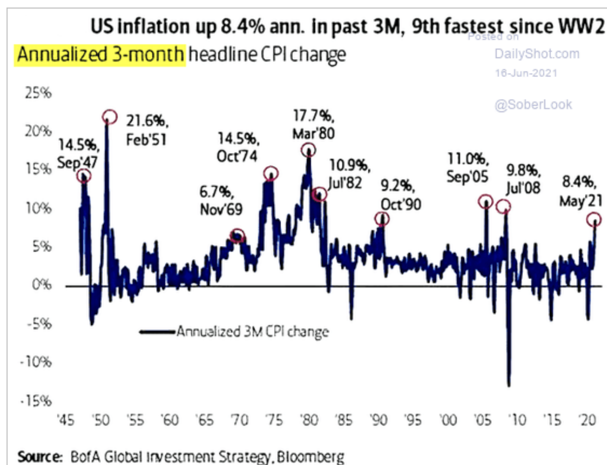


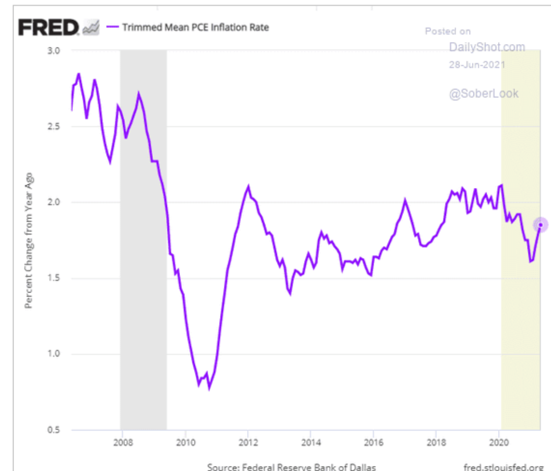
So far, despite some sensational reporting and "chart crime"[4], most measures show overall inflation is rising, but hardly running away. Take the below headline which shouts, "U.S. Inflation up 8.4%". This chart is annualizing the three-month headline Consumer Price Index (CPI) change, which is a rather noisy measure based on a very short time period. A better, more stable indicator of inflation is the "trimmed mean Personal Consumption Expenditures (PCE) index"[5], which remains

[4] The term applies to any misleading or unnecessarily sensationalistic chart or graph. Common chart crime charges include cherry-picked time frames, truncated Y axes and different X axes overlayed on the same chart.

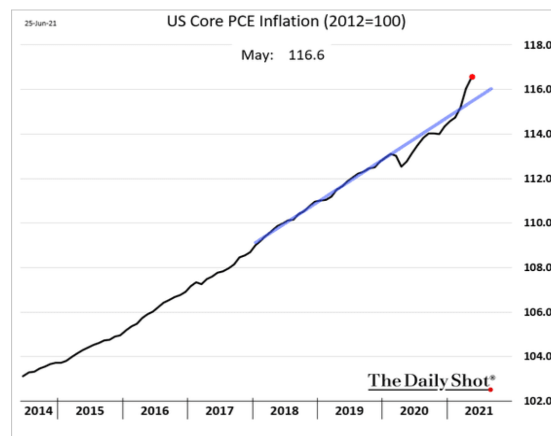
[5] The "trimmed" mean discards the highest and lowest price changes among the basket of observed items in order to avoid distorting outliers. In the recent

stubbornly below 2%. In an age of viral information where "clicks" are paramount, which measure is more likely to show up in your newsfeed?





Annual inflation measures comparing the price levels of today vs. a year ago suffer from another problem. A year ago, large swaths of the economy were shut down and prices had cratered. Thus, today's annual measure of inflation (i.e. the June 5.4% headline CPI[6]) captures both the higher prices of today *and* the lower prices a year ago. Compared to two years ago, prices only rose 3% in June. A visual representation of this phenomenon can be seen in the continuous graph of U.S. Core PCE inflation at right (see last year when it dipped below trend).



You may wonder how measured inflation can possibly be tepid given the 17% rise in house prices over the past year. One explanation is that rising home prices will eventually show up in the numbers, just with a lag. Another aspect is that lower mortgage rates have rendered the monthly expense of owning a home relatively stable despite higher prices. If you own a home, perhaps you refinanced your mortgage and should ask yourself, "Did I experience housing inflation or deflation over the past year?". Also, CPI and the Fed-preferred PCE measure prices of items consumed by the typical person. These baskets do not include investment assets... which most certainly have experienced substantial inflation. These inflation measures also exclude items not consumed by the average

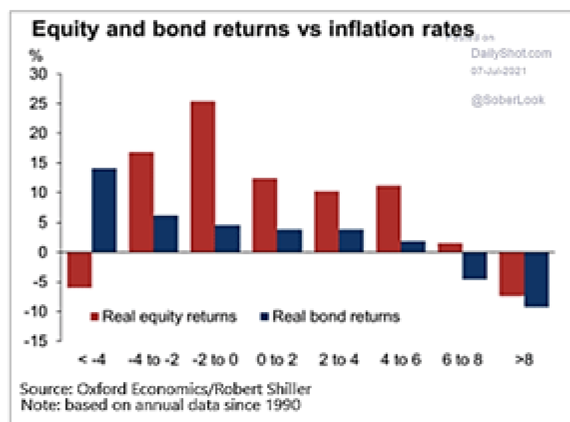
case, the quickly advancing cost of used vehicles was probably excluded. This might make sense because the increasing cost of vehicles is likely driven more by the global chip shortage as opposed to underlying inflationary pressures.

[6] Core CPI, which excludes the volatile categories of food (down) and energy (up big), was 4.5%.

citizen such as luxury yachts or trophy homes, and thus it is possible for certain classes of goods to experience large price increases without affecting CPI.

We are skeptical that inflation will increase significantly and sustainably. Yet, even if we were certain inflation would spike, the investment playbook would not be straightforward. Let's consider the potential implications for the primary asset classes of bonds, stocks, real estate, and cash.

Bonds, particularly long-term, fixed-rate instruments, are clear losers in any inflationary scenario. Bonds, as nominal assets, represent a promise to receive a certain number of dollars in the future. If those dollars are worth less when payoff arrives, well then tough cookie. Where we employ fixed income in portfolios, we have made a concerted effort to avoid the longest terms (though this risk cannot be completely avoided... and so far, investors have been rewarded for bearing inflationary risk.)

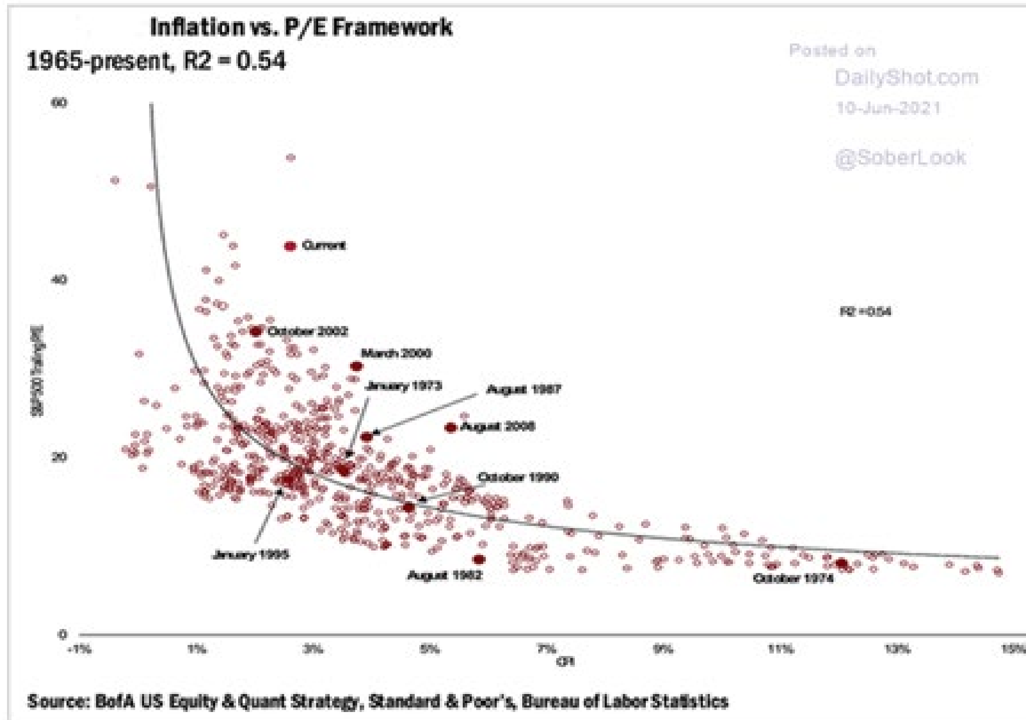


Source: Oxford Economics/Robert Shiller
Note: based on annual data since 1990

In principle, stocks represent ownership in businesses, which are real assets and should hold up during inflationary periods. Companies can theoretically raise prices to make sure revenues (and ultimately profits) rise to keep pace with expenses[7]. In practice, stock values were significantly impaired by inflation in the 1970s. The valuation multiples investors were willing to pay seriously contracted, resulting in stagnant or falling stock prices.

Investment literature features myriad graphs like the chart atop the next page, which compares equity multiples (P/E on the vertical axis) to inflationary environment (CPI on the horizontal axis). You see a strong correlation. Unfortunately, despite the numerous dots, when it comes to high inflation you are seeing an empirical study with a sample size of one (1). The high CPI readings arose from a single decade-long episode. If you ignore that period, the relationship between stocks and inflation is not quite so clear. We simply do not have that many high inflationary historical periods to study... and each experience is different anyway.

[7] What you really want is a business which has already paid all its expenses and will collect its revenues in the future. Inflationary disaster is receiving revenues up front but then having to pay expenses later. You also want companies with "pricing power" that can raise prices without losing customers.



REITs (i.e., real estate) performed well during prior inflations. This makes sense. The cost of land and buildings is in the past and future rents can be increased. But will this necessarily ensure a good investment outcome the next time around? Today, real estate values have risen because interest rates have fallen. Interest rates were not this low when REITs fared well in previous inflationary episodes. Rising inflation would raise interest rates, which might cause property prices to fall, even while cash flows are steady or increasing. We worry that stocks and real estate, even those with the ability to raise prices, might find themselves in the same boat[8].

Paradoxically, if inflation comes to pass, cash might not be such a bad place to hide. In the inflationary 1970s, even though the value of "cash" was eroding, you were not really in (physical) cash, earning nothing. Your savings account or money market fund was receiving interest at an increasing rate. If inflation truly arrives, undoubtedly bringing higher interest rates with it, we wonder if there will be almost nowhere to hide, except cash.

We contemplate what an inflationary investment environment might look like because we are frequently asked about it these days and of course, the prospect is always on our minds. But the real question is *will* we see inflation? We read the steady drumbeat of stories about "Help Wanted" signs and wage increases, but it is helpful to remember there are still a ton of people not working. Unemployment claims have dropped nine

[8] If you really believe inflation is headed your way, the best thing you can do is effectively *short* debt by borrowing a *lot* of fixed-rate, long-term debt. Say, buy five houses that generate positive cash flow.

percentage points faster in states which have already eliminated enhanced unemployment benefits (which often paid more than recipients' prior jobs). When the remaining states end these extra payments in September, we might then expect a rush of people returning to work, suppressing wage pressures. Government stimulus payments, which push up prices, are also waning. Recent inflationary headlines and anecdotes may indeed be "transitory" as the Fed has suggested.

The markets are certainly expressing this viewpoint. Long-term interest rates and inflation expectations always head in the same direction. After a spike in Q1, the 10-year bond yield mostly headed south in Q2. There are derivatives which explicitly reflect investors' collective forecast regarding annual inflation over the next decade. This forecast has come down over the past quarter and currently stands at only 2.36%.

The point we make is that financial markets are telling you they are not worried about accelerating inflation[9]. In a democracy, it is one person one vote. In markets, it's one dollar one vote. Apparently, the investors with the deepest pockets believe inflation will be transitory. You can count our neighbor PIMCO in this group. Their official forecast has core inflation peaking at 4%, ending this year at 3.5% and moderating to 2.3% in 2022. Their one voice counts more in markets (and in our book) than a thousand breathless commentators. One body we don't pay much heed is the Federal Reserve. The Fed had no idea the inflation of the 70's was coming and allowed inflationary momentum to build for far too long.

This is all to say that we are not explicitly positioning investment portfolios for an inflationary environment right now. Long-term, we are indeed worried about inflation given the spending dynamics at play in Congress[10]. But that does not necessarily equate to inflation or trouble for the markets today, or perhaps ever. Consider Japan, which has managed through high debt levels for many years. Currently, the country's debt stands at 260% of GDP vs. 130% for the U.S. The problem Japan has is not high inflation, but low growth.

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[9] The flipside of this means you will currently make a lot of money if you bet on inflation and are correct.

[10] U.S. Government debt increased by $5 trillion to $28 trillion in 2020.

There are always reasons to worry when investing. Even absent inflation, interest rates may rise, equity valuation is extended, taxes are probably going up, and labor may see a larger share of GDP. That said, we are in a bull market until proven otherwise and we are doing our best not to be shaken out too early (even if the market is overvalued). It is this mindset which has enabled the substantial gains in our investment portfolio year-to-date. The stock market is showing signs of exuberance. While we do not forecast a crash, we stand ready to address whatever the second half of the year has in store for us, as we invest alongside you.

Sincerely,

John G. Prichard

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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