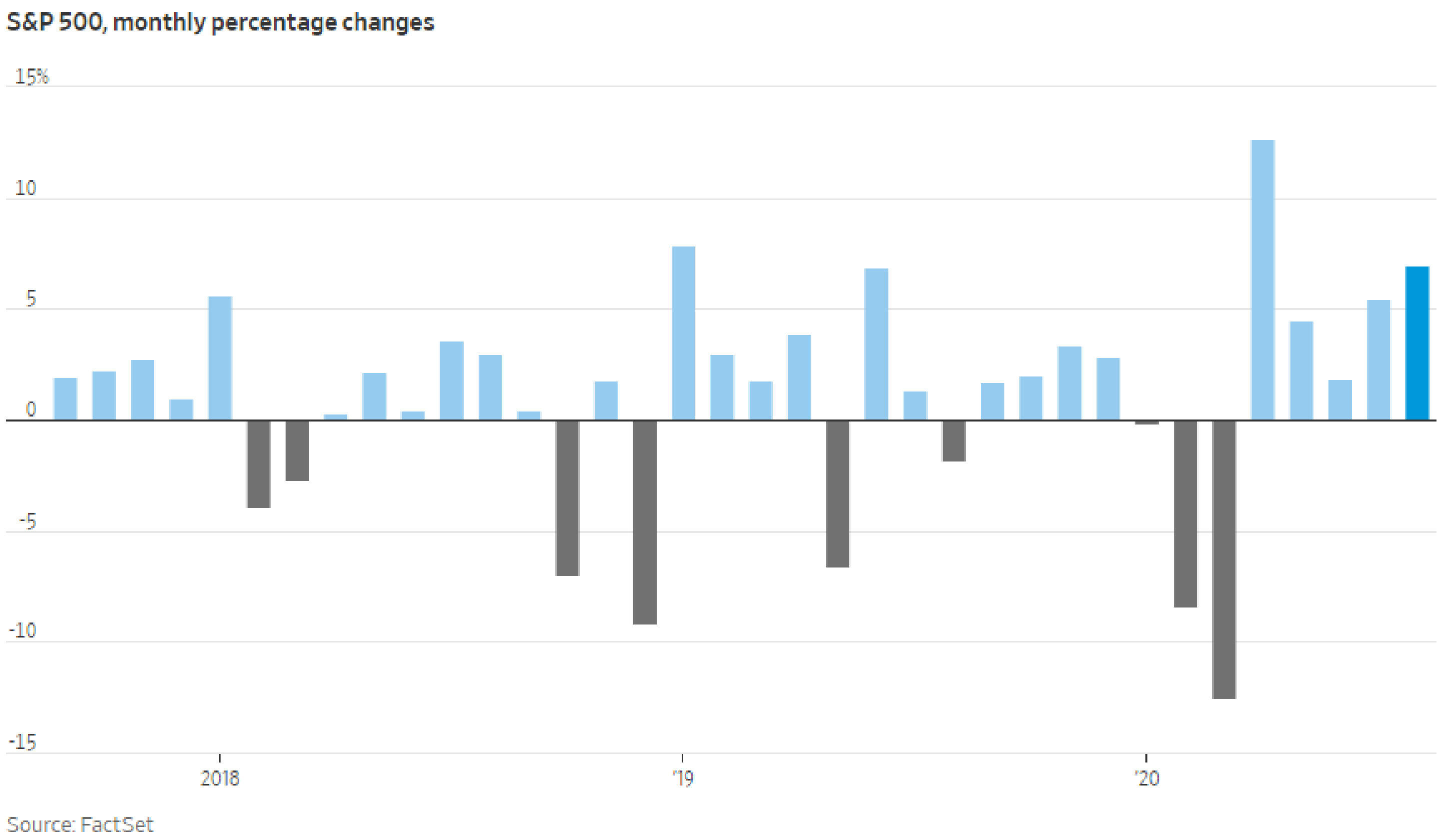
August 2020

On August 18 the S&P 500 closed at a record high, bringing an end to the shortest bear market in U.S. history. From the front page of Tuesday's WSJ:

Stocks Log Five Straight Months Of Gains

S&P 500 had its best August since 1986; low rates and stimulus spur market rebound

By Alexander Osipovich And Anna Isaac



U.S. stocks wrapped up their best month since April, continuing an extraordinary rally fueled by stimulus from Washington, signs of economic revival and progress toward a coronavirus vaccine.

All three major U.S. stock indexes have climbed for five consecutive months after a brutal February and March that ended the longest bull market on record. The benchmark S&P 500 (up 7% for the month) has surged 35% over that period, its largest five-month percentage gain since 1938. (Small Caps continue to lag, with the S&P 600 being up only 3.9% in August, and down 11.1% YTD, while the Nasdaq 100, lead by Tech, was up 10.9% for the month, and 39.2% YTD.) ...

The S&P 500 set records last week after the Federal Reserve signaled that it was likely to keep U.S. borrowing costs low for an extended period. Meanwhile, recent economic data, including July's orders for durable goods, have surpassed economists' expectations. The index is up 8.3% in 2020.

A longer term concern from the front page of the WSJ on August 28th:

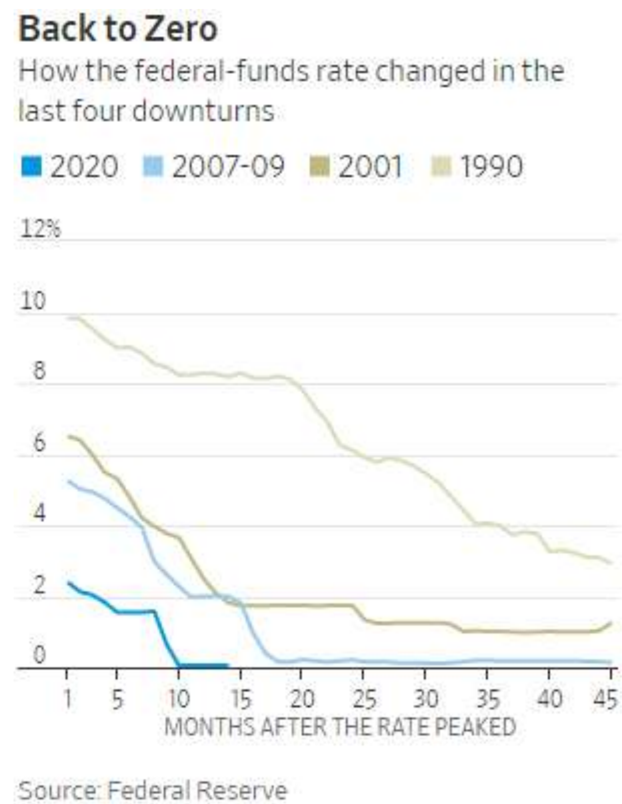
Fed Eases Inflation Target in Landmark Decision

By Nick Timiraos

The Federal Reserve approved a major shift in how it sets interest rates by dropping its longstanding practice of preemptively lifting them to head off higher inflation, a move likely to leave U.S. borrowing costs very low for a long time.

It won't lead to a significant change in how the Fed is currently conducting policy because it had already incorporated the changes it formally codified Thursday.

But the shift marked a milestone. Had the strategy been adopted five years ago, the Fed would have likely delayed rate increases that began in late 2015, following seven years of short-term rates pinned near zero. It amounted to the most ambitious revamp of the central bank's policy-setting framework since the Fed first approved a formal 2% inflation goal in 2012.



By signaling Thursday it wanted inflation to rise modestly above its 2% target, the Fed revealed how the global central-bank principle of inflation targeting, widely adopted over the last quarter century, might have outlived its usefulness in a world of lower interest rates.

The revamp is designed to address the "reality of a quite difficult macroeconomic context of low interest rates, low inflation, relatively low productivity, slow growth and those kinds of things," said Fed Chairman Jerome Powell during a conference broadcast online. "We've really got to work to find every scrap of leverage in helping stabilize the economy."

... Government bonds sold off, with the yield on the 10-year U.S. Treasury rising to 0.744% from 0.686% the day before, to a two-month high. Bond yields rise when prices fall.

Mr. Powell initiated a policy-setting strategy review in late 2018, motivated by the sobering probability that central banks around the world would face greater difficulty than in the past to spur growth due to low levels of interest rates.

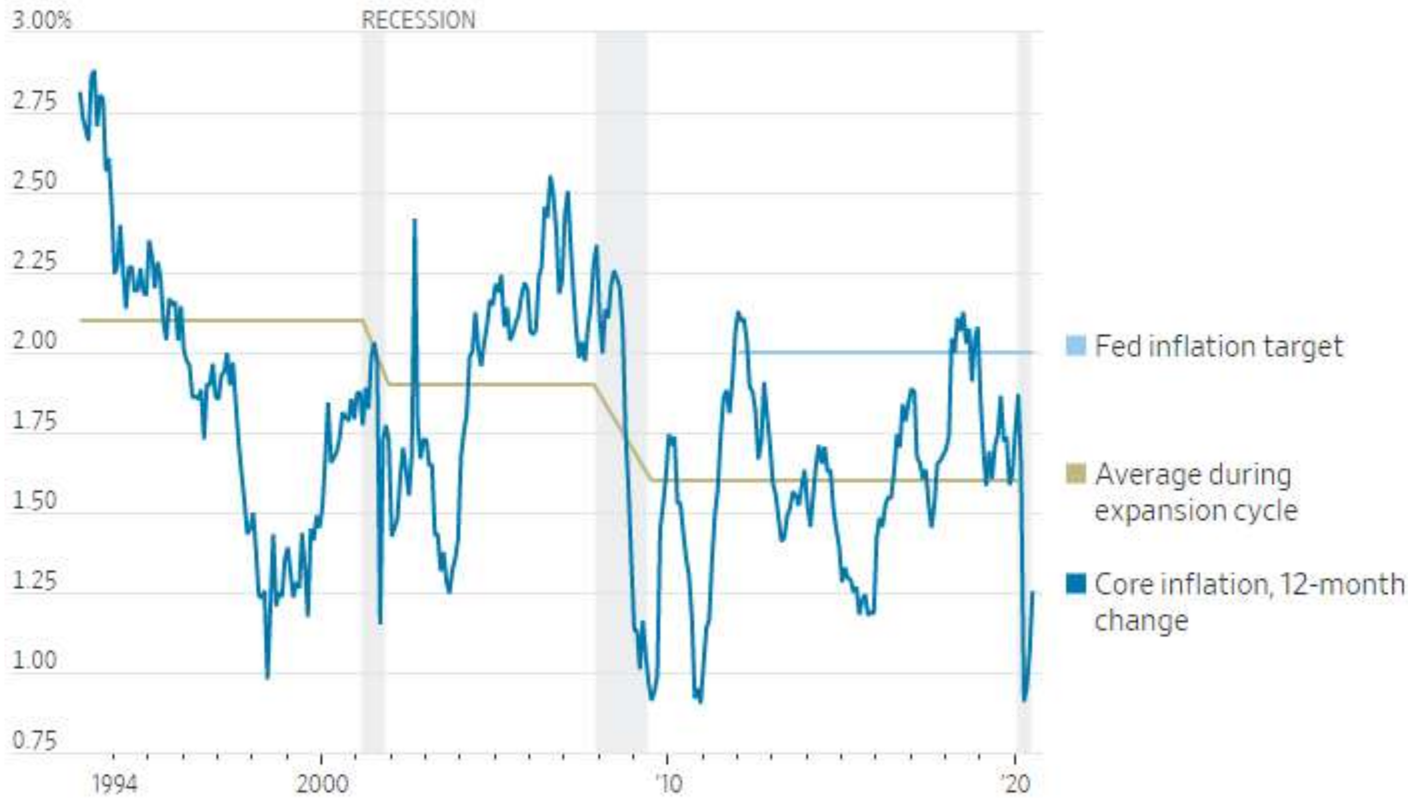
The pandemic-induced recession brought those challenges into stark relief. The Fed cut its benchmark rate twice in March to near zero from a range between 1.5% and 1.75%, and it has bought trillions of dollars of government assets to stabilize markets.

If investors believe the Fed's words are credible, the changes announced Thursday "will increase the accommodative power of policy," said former Fed Chairman Ben Bernanke. "When you go into a recession, markets will expect a longer period of easier policy and that will, in turn, increase the amount of effective stimulus."

For years, the Fed justified plans to withdraw stimulus as the economy recovered by warning that waiting too long to do so could provoke an acceleration of price pressures, particularly as joblessness fell below a level expected to push prices higher, sometimes referred to as the natural rate of unemployment.

Price Puzzle

Inflation during the expansion phase of the business cycle has trended lower, on average



Note: Core inflation excludes food and energy
Source: Commerce Department

The Fed said Thursday that decisions to raise interest rates would be guided by a desire to avoid shortfalls of employment from its maximum level, rather than all deviations above or below the maximum level.

"They believe, and I agree, that there are substantial social benefits from a strong labor market," said Mr. Bernanke. "Under this strategy, they will not take any steps to cool the labor market unless there is clear evidence of inflationary pressure."

The change "reflects our view that a robust job market can be sustained without causing an outbreak of inflation," said Mr. Powell.

The revamp also set the table for the Fed to provide more specifics about how long it expects to keep interest rates low as soon as its Sept. 15-16 meeting. It could do that by putting forward an inflation threshold and a qualitative description of labor market conditions that would warrant higher rates.

While the Fed didn't change its 2% target on Thursday, it said it would seek periods of above-target inflation if inflation runs below 2% following economic downturns to prevent expectations of future prices from sliding lower.

The Fed didn't specify exactly how high or how long it would allow inflation to rise above 2%.

Mr. Powell secured agreement from all 17 officials who participate in the Fed's rate-setting deliberations on a new policy statement enshrining the conclusions of the strategy review. ...

While it might be counterintuitive for the Fed to desire more inflation, particularly given rising costs for certain items such as housing, Mr. Powell said the Fed needed to avoid "an adverse cycle of ever-lower inflation and inflation expectations."

The dynamic is particularly troubling because expected inflation feeds directly into the general level of interest rates, he said. Lower inflation deprives central banks with already-low interest rates of tools to counteract downturns.

"We have seen this adverse dynamic play out in other major economies around the world and have learned that once it sets in, it can be very difficult to overcome," said Mr. Powell. "We want to do what we can to prevent such a dynamic from happening here."

From the WP:

Don't forget about inflation

Robert J. Samuelson

August 30, 2020

We spent a good part of the late 1960s to the early 1980s grappling with the scourge of rising inflation. Consumer prices rose from less than 2 percent in 1960 to 13 percent in 1980. There was a widespread fear it would go higher. Various presidents tried different approaches, including mandatory wage and price controls. We need to be careful that we don't accidentally fall into the same trap.

On its face, this is an absurd statement. The double-digit inflation of the early 1980s was crushed by a deep recession engineered by then-Federal Reserve Chair Paul A. Volcker, with the crucial backing of newly elected President Ronald Reagan. Peak monthly unemployment reached almost 11 percent. Today, inflation is an afterthought. The crying need now is to reduce the huge pool of jobless workers receiving unemployment benefits — about 14.5 million, or roughly a 10 percent unemployment rate.

We believe we've won the battle against high inflation. It's one economic problem not worth worrying about. The staggering number of unemployed people will keep wages from exploding. Federal Reserve Chair Jerome H. Powell and others have argued that the Phillips curve, which describes the relationship between wages and inflation, has flattened. Wage gains have a much weaker impact. Popular expectations of annual inflation over the next decade average a mere 1.34 percent, reports the Federal Reserve Bank of Cleveland.

All that is true — and it's wildly misleading.

The Fed last week announced new guidelines for policing inflation and unemployment. The old policy established an inflation target of 2 percent. If inflation exceeded this level, the Fed would presumably raise interest rates to relieve upward pressures on wages and prices. Under the new policy, the Fed would tolerate slightly higher inflation levels temporarily rather than risk triggering a recession or economic slowdown.

Superficially, this seems a pragmatic response to balancing the risks of inflation and unemployment. But history — such as the previous run-up of inflation — sounds an alarm.

No one favored the inflation breakout; no one wanted it. The increases occurred in short and powerful bursts that fed on each other. What people did want was "full employment," defined in the early 1960s as about a 4 percent unemployment rate. People were willing to suffer slightly higher inflation to keep wages high and unemployment low.

What seems remarkable now is that many, possibly most, economists blessed this arrangement. Their argument was that just a little bit more inflation was a small price to pay for sustaining "full employment." The trouble was that "just a little more inflation" was repeated countless times until it was a lot more inflation — and, as a practical matter, was out of control. Only the harsh Volcker-Reagan recession convinced companies and workers that high inflation would no longer be accommodated.

The Fed's new inflation policy bears a striking resemblance to the flawed approach of the past. The Fed would tolerate breaking the 2 percent inflation barrier to the extent that actual inflation had been below the 2 percent target for some specified period. But would the Fed then automatically raise interest rates to quell inflation? How would periods of undesirably low inflation be calculated? Would the Fed wait too long before raising rates and, thereby, worsen inflation?

Even before the coronavirus pandemic, Powell had been eager to promote a tight labor market that would provide jobs for many low-skilled and low-paid workers, who traditionally have struggled to find employment. That goal was (and is) commendable, but for the time being, it's unrealistic.

We ought to remember that high inflation, when it raged in the 1970s and 1980s, was enormously unpopular. People didn't know whether wages and salaries would keep up or fall behind rising prices. High inflation made planning for retirement harder for the same reason. In general, the future seemed more unpredictable and precarious. Sadly, the Fed has made many errors in forecasting inflation and interest rates.

We don't want to revisit this failure, which was political and social, as well as economic. None of this detracts from the Fed's constructive role in stabilizing the economy after the global financial crisis of 2008-2009 and the pandemic. Since mid-March, the Fed has pumped $3 trillion into the economy, arguably preventing crippling insolvencies.

But the Fed is not all powerful. The whole exercise of hitting a rate of inflation of 2 percent assumes the Fed can control inflation and job creation with an exactitude that doesn't exist. The best the Fed can do is to aim at a range of inflation — say, zero to 2 percent — and, when prices are moving undesirably in one direction or the other, respond vigorously to reverse course. It's unheroic but feasible.

From High Dividend Opportunities on Aug. 30th:

The Fed's New Inflation Goals: What it Means to You

The Federal Reserve announced on Thursday August 27 that is has adopted a new strategy for monetary policy that will be more tolerant of temporary increases in inflation.

Basically, the new approach will allow inflation to overshoot the US central bank's 2% target to compensate for persistently low inflation, which has been weighing on the US and other economies in recent years.

Following periods when inflation has been running below 2 per cent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 per cent for some time," Mr Powell said.

He said such a low inflation scenario would be "costly" in slowing the recovery from the pandemic, and "risky" because "a longer phase of even lower inflation might become entrenched and contribute to a downward drift in inflation expectations".

As we all know, the Federal Reserve has full control over short-term interest rates, and the interest rates the banks can borrow overnight, but long-term interest rates are determined by Mr. Market, or by investors. This means that if inflation starts ticking up, then the yield curve will start to widen more significantly than previous cycles because the Fed will allow some flexibility before intervening.

With his statement Chairman Powell effectively means that: **The Fed will keep interest rates at ultra-low levels for years to come.**

What Lower For Longer Interest Rates Mean

There are several ramifications of keeping interest rates lower for longer. I will list some of them:

1- Higher Stock Prices

Stock will be one of the biggest beneficiaries as a result to lower interest rates. There are many reasons for this:

- Interest rates on CDs and shorter-term treasuries will remain near zero. This will cause more savers and retirees to allocate a larger part of their portfolio to equities.
- Leverage and margin costs will remain very low, allowing investors to leverage their investment funds to boost their returns. This means that more money will be chasing equities.
- One of the best ways to value the stock markets is to compare its valuations relative to interest rates. One such valuation method would compare the dividend yield of the S&P 500 index to the 10-year treasury rates. Using this method, the current stock valuations are not all excessive. While technology stocks would look high, this leaves a vast majority of stocks that did not participate much in this rally grossly undervalued relative to technology.

2- A New Housing Boom Is Around the Corner

Low interest rates and low mortgage rates can be very bullish to real estate prices, and especially residential Real Estate. Not only can families afford to own more expensive homes, but those that are renting can save money by purchasing a home. If you add to this that a whole new generation of millennials will be wanting to live independently, this is a big boost in demand for residential housing, whether it is in a form of rent or purchase.

Today, despite the virus situation, the housing market is booming. US existing home sales surged a record 24.7% in July. The jump marks the 2nd consecutive month of record sales gains.

The housing market is well past the recovery phase and is now booming with higher home sales compared to the pre-pandemic days," said Lawrence Yun, NAR's chief economist.

This comes at a time when real estate inventory is short. The [supply of existing homes] plummeted 21.1% annually. The July supply number is the lowest on record.

All of the above is resulting in a surge of US home prices. The median existing-home price was $304,100 in July, up 8.5% from a year ago. In fact, it is the 101st month where home prices have increased on the year. This also marks the first time ever that median home prices in the United States have exceeded $300,000.

The housing market today sits in a perfect storm. All the above factors combined would mean that house prices will continue to go higher, and soar to unprecedented levels.

3- The Chase for Yield Will Continue for Years to Come

Investors and retirees need to stretch their savings to the maximum to allow for a more comfortable life. With low yields, both on the short-end and the long-end of the curve, returns are just not the same as they used to be. If you started planning to retire 15 or 20 years ago, you would most likely have assumed that the 10-year treasury yields would pay you at least 4% to 5%. Unfortunately today it is closer to 0.7%. Take a look at the 54-year chart for the 10-year Treasury Yield.

Source: [MacroTrends]

Investors and retirees who need to keep the same level of income that they earned a few years ago will have to allocate some of their funds to dividend stocks or higher-yield bonds. The good news today is that most high-dividend stocks have been out of favor for many years, and offer very attractive valuations in a market where indices such as the S&P 500 (SPY) and the Nasdaq (QQQ) are at all time highs. That is right. Remember that the S&P and Nasdaq only represent a few large cap stocks in a huge pool of stocks. So saying that the equity markets are expensive just because these indices are at all-time-highs is not a correct assumption. In fact, some high dividend stocks are trading today at their lowest valuations in years relative to treasury yields, and this is where investors should be focused.

The Bottom Line: My Predictions for the Next 3 to 5 Years

1. The stock markets are set to continue to rally, fueled by low interest rates and very few other investment opportunities. While the leadership today is the high-flying technology stocks, this leadership will change, and value stocks will get their fair share of demand by investors.
2. Residential real estate prices are set to soar. If you are an investor, you could either buy a rental property or a new home, or otherwise invest in residential REIT stocks. Today, almost all residential REIT stocks are trading near their 52 week lows, and at very cheap valuations. They have not recovered from the COVID-19 sell-off seen in February despite solid fundamentals. You can easily earn 3% to 5% dividend yield by investing in these REITs while banking on future higher prices.
3. Demand for high dividend stocks is set to increase significantly. Here, investors should note that not all dividend stocks are alike. While sometimes higher yields can mean higher risk, you can still achieve high yields by investing in preferred stocks for example, or in the common shares of stocks with strong balance sheets. Here you are probably taking a much lower risk than investing in the high-flying tech stocks and still collecting a high level of income.

... Before I conclude this article, I would like to also share my last prediction which is set to happen starting two years from now: higher inflation. As noted in several of my previous reports, the excess liquidity and money printing will come at a cost, and it will be in the form of higher inflation. Investors need to plan ahead, and we have been doing so as part of our service to our members. Remember, the markets are forward looking, and you don't want to wait until the last minute to hedge against inflation. If you do, you might be too late, as assets that hedge against inflation will have already become expensive. It would be similar to buying a car insurance policy after you have been in an accident.

From WSJ on August 24th:

STREETWISE | By James Mackintosh

In This Tech Market, Beware Rising Bond Yields

There has been a lot of concern recently about the stock market being top-heavy, dominated by just a handful of companies, and that this might spell trouble for future returns. But really, what we should worry about isn’t that the market is reliant on a *few* stocks. It’s that the market is reliant on a few *very similar* stocks.

The five biggest companies today— **Apple,** which passed $2 trillion in market value last week, **Amazon, Microsoft , Alphabet** and **Facebook —** make up 25% of the market value of the S& P 500. That is the most since 1970, but stocks managed a stellar performance during the 1960s despite being even more top-heavy. The difference is that in 1970 the biggest companies did quite different things: computers (IBM), telephony (AT& T), car making (General Motors), oil (Exxon) and cameras (Kodak).

The danger now is that the market is overly reliant on a group of companies that are all a bet on disruptive innovation— the big five and a wider circle including other fast-expanding growth companies such as **Netflix** and **Nvidia .** They have thrived since the pandemic began because so much of their lifetime profits lie far in the future, meaning their valuations benefit from low rates while short-term pandemic-related hits matter less. Anything that hurts this group could drag down the wider market, even if other stocks are fine. And because this group has done so well from low bond yields, it should be especially susceptible to pain if those yields were to rise.

Earlier last week highlighted how two types of rising yields could be a risk for the broader market.

The first risk is that yields go up because the economy is healing. The opposite happened on Tuesday, when bond yields fell as investors became more cautious about economic recovery. Twice as many stocks fell as rose, and the average stock fell. Yet the S& P 500 passed its February high because the ones that did rise were far bigger: the 168 gainers on the day averaged a market value of $103 billion, while the 332 losers were valued at an average $40 billion.

Reverse this position, and it is easy to see how improving economic optimism could result in the market as a whole falling. The average stock should still go up, but the top-heavy nature of the market will leave more big stocks exposed, and so could drag down the S&P.

The second risk is that yields go up because the Federal Reserve becomes more hawkish. Earlier last week we had a dry run when the Fed minutes disappointed many hoping for explicit guidance on rates soon. Investors changed their view on how the Fed will react in future, and stocks dropped— with the biggest falling by more than the rest. Growth stocks underperformed, but the mass of the rest did badly too, with again twice as many losers as winners.

I don’t think the Fed is likely to abandon its super- dovish stance any time soon, despite Wednesday’s minor disappointment.

And while I would love to see a V-shaped economic recovery lift bond yields, the obstacles are huge. My reason for raising this issue now is that the price moves of the big stocks and the rest have begun to diverge much as they did in advance of several prior corrections—as the relationship between stocks and bonds has begun to shift.

The simplest way to compare the moves of the big stocks and the rest of the market is to look at the correlation between daily rises and falls in the ordinary capitalization- weighted S& P and the equal-weighted version. When the market is working normally the two are closely linked, but when the biggest stocks move differently from the rest they have more effect on the ordinary S& P than the equal-weighted version, so the correlation falls.

The correlation fell sharply in the late stages of the dot-com bubble in 1999 and 2000, the housing bubble in 2006, the volatility bubble of 2017 and the excesses before the recession fears of late 2018, and it has fallen sharply again. When the biggest and most fashionable stocks start behaving differently from the rest, it is often an early warning that things are getting out of kilter, although it may be months before trouble becomes obvious.

The stock-bond correlation hasn't moved as much, but suggests that the big tech stocks and growth stocks are becoming much more sensitive to bond yields than the rest of the market. Short-term correlations are volatile, so this could quickly return to normal. But if the trend continues it would threaten a pattern of higher yields typically being good for stocks that has been in place since the early 2000s.

It's too early to say that things are going wrong, and certainly this isn't evidence of a bubble. But it wouldn't be a surprise that a market reliant on central bank and government support should be threatened by rising yields, even when they start out so low.

Follow-ups

From High Dividend Opportunities on Aug. 12:

... Today we are taking a look at ESG investing. This type of investing focuses on the environmental, social and governance side of companies. It often highly favors technology and renewable energy securities. While we do not actively endorse or follow its practices, we felt that its impacts warranted a discussion and a closer look at it for our members.

They Took A Shot Across the Bow of ESG Investing

Summary

- *ESG investing is not new, it is an outgrowth of SRI*
- *The results of ESG funds are a point of contention*
- *The Department of Labor is putting its foot down on Fiduciaries regarding ESG.*

What is ESG investing anyway?

ESG investing (environmental, social and governance) is an outgrowth of SRI, or socially responsible investing. SRI decided it would eschew any investment that was believed to have a net negative impact on humanity. So these investors would refuse to invest in alcohol, tobacco, and often firearm companies. We recognize that some of you ... refused to invest in ... **Imperial Brands** (OTCQX:IMBBY) due to their disagreements with tobacco companies. You may not realize you are falling into this group of investors partially. We have decided a long time ago that we will highlight opportunities as we see them and allow our members to make the decision if they morally object to investing in that company.

So where does ESG differ? It largely takes SRI one step further. ESG considers additional impacts on the environment and society, as well as the governance of the company.

> ESG investing provides a way to invest in strategies using a disciplined evaluation of one or all of these considerations:

- Environmental themes, such as investing in companies that are responding to consumer demand for sustainable practices
- Social themes, such as investing in companies committed to a diverse and inclusive workplace
- Governance themes, such as investing in companies committed to diverse board composition, strong oversight, and shareholder friendly policies

Source: Fidelity

As an example, **AY** generates power through renewable sources, takes great care to not negatively impact the environment, and has an easily trackable corporate structure. This makes it a very positive company from an ESG mindset. Energy firms largely are viewed negatively for their impact on the environment from an ESG viewpoint.

ESG has reached a larger critical mass among investors. Large brokerages have ESG-only mutual funds aimed at matching the more socially-minded investor with firms that meet their mindset. Often it is viewed that you vote with your dollars, and as such ESG-minded investors are trying to better the world by prompting companies to adopt ESG-positive policies to attract those investors dollars.

Performance of ESG Funds – A point of Contention

ESG funds are promoted to have more strength due to their strict limitations. Companies with ESG policies are less likely to garner strong negative sentiment and have sustainable practices.

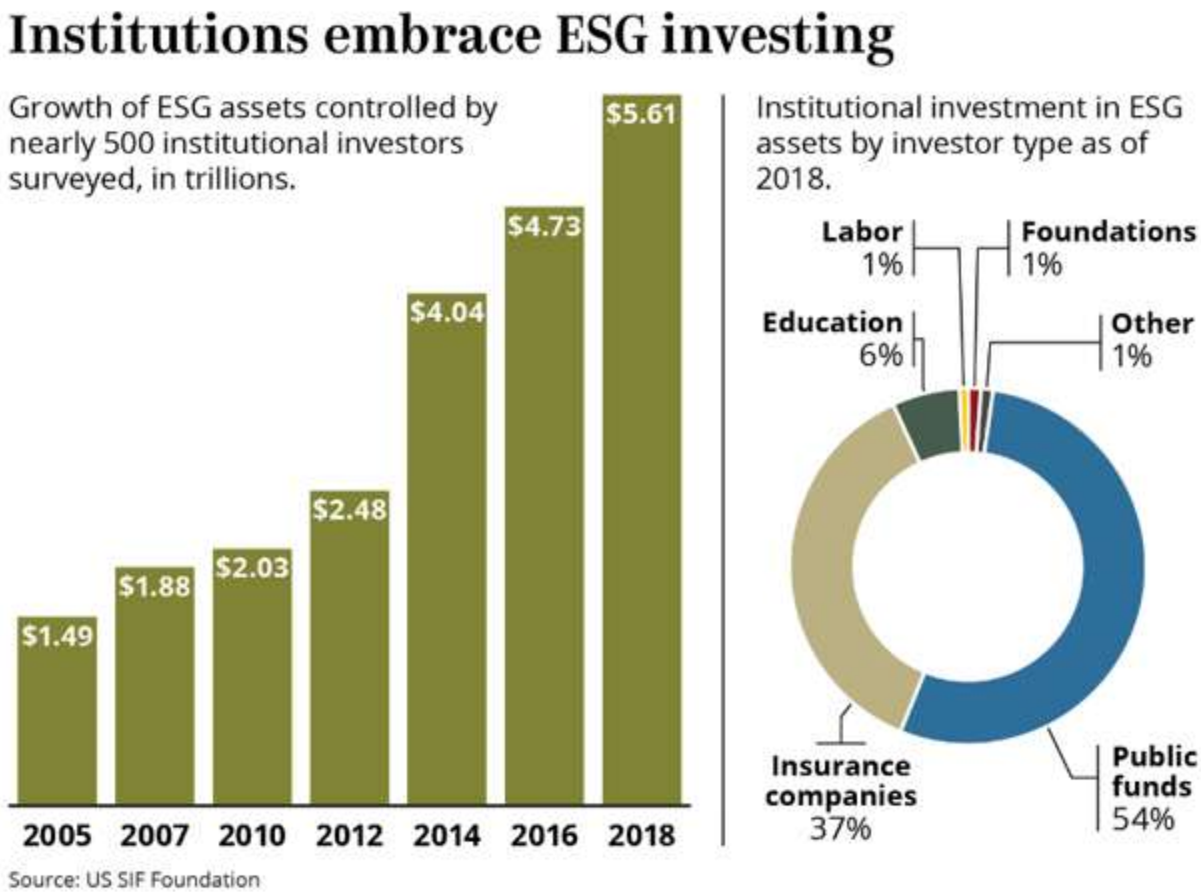
Recent reviews of ESG funds or ESG-tilted funds found that they largely outperformed their conventional counterparts during the beginning of this year. However, this review was looking into only 2020 Q1 or Q2 performance and not a longer-term look.

> a recent study by Wayne Winegarden, an economist and senior fellow with the Pacific Research Institute ('PRI'). Winegarden looked at 30 ESG funds, 18 of which have a 10-year track record and the remaining 12 of which outperformed the S&P 500 over the recent past.
>
> Only 1 of the 18 outperformed the S&P 500 over a five-year investment horizon, and only 2 beat the S&P 500 over a 10-year horizon. The results were no more encouraging for the 12 recent outperformers.
>
> Source: Advisor Perspectives

The expectation that these more selective funds should outperform the general market and/or the matching mutual funds has not come true. Part of this issue may be their expense costs. ESG funds often have almost 1% higher fees that go directly into the portfolio manager's pocket. You're paying more, to have fewer options and it is showing. ...

This underperformance would not be an issue for an individual investor who truly believed in this type of investing. They could readily accept lower returns to have a calmed conscience.

The issue comes when someone who oversees another person's investments puts that money into ESG investments.



As you can see above, large public funds are being poured into ESG investments. What are these public funds? Pension funds mostly. Essentially the retirement of thousands of public civic servants are being put into funds that underperform. They often don't get a say either. Pensions are operated by trustees – overseers who have a Fiduciary responsibility.

In a nut shell, a Fiduciary (like HCM) is required by law to put your best interests first. They must do so by investing your funds in the best route to get the best returns. ESG ideals are secondary considerations, and a Fiduciary shouldn't put their environmental ideals before the financial returns of their clients.

> A **fiduciary duty** is an obligation to act in the best interest of another party.
>
> Source: US Legal

A Rule Change that Would Affect ESG Investments

This ongoing shift has caught the attention of The Department of Labor. On June 23rd the DOL proposed a formal rule that would make it illegal for a fiduciary to invest in ESG funds if an equivalent conventional fund out-performed it. This also would mean a 401(k) plan couldn't default to an ESG fund if the plan holder did not select a fund to invest in. Most 401(k) plans use retirement term-funds to ensure the best returns for a projected retirement date.

How would this rule impact ESG investing? Well for starters, 54% if the $5.6 trillion invested in ESG funds would potentially be forced to reallocate to non-ESG funds. **This would benefit energy names such as (XLE) and hurt technology stocks (QQQ) that are often ESG favorites.**

This DOL proposal is a clear shot across the bow of ESG-minded Fiduciaries. They can invest with that mindset themselves but when controlling vast sums of others' capital they must put aside their political and environmental views. Charges to remove investment dollars in coal, oil, weapons and "controversial" companies has been popular among new funds being created, however their returns have not been stellar in the long run. As income investors, we also find ourselves seeing extreme value-investment opportunities in sectors that ESG funds purposefully avoid. However if this proposed rule comes into full force, a wave of styling and buying is likely to occur in the largest pension funds within the United States.

This also helps us understand why some sectors have reached extremely overbought prices and others trend the opposite direction. Changing the world through one's money isn't a new idea, but Fiduciaries trying to effect change with someone else's money is a risky proposition that the government is choosing to not ignore or allow to continue.

Conclusion

... we must be aware of the shifting sands of investment philosophy. ... For all of us, this massive influx of money into ESG investments can often be the reason why many less "popular" companies have struggled to keep up with the general market indexes.

It is important to be aware of what is going on around you while not letting it control how you choose to invest. The ESG S&P 500 index refuses to invest in **Home Depot** (HD) or **Berkshire Hathaway** (BRK.A)(BRK.B) due to low ESG scoring, yet **Amazon** (AMZN) that treats its employees poorly makes the cut. No system is perfect, but knowing what $5.6 trillion of invested dollars is doing is important!

Two from Morningstar:

What If Inflation Isn’t Dead?

Forgotten does not necessarily mean expired.

John Rekenthaler

Aug 11, 2020

A Long Silence
The last time that inflation was this dormant, Neville Chamberlain began the year as the United Kingdom’s prime minister and three cans of Campbell’s Tomato Soup cost $0.25. The year was 1940, and not only had inflation not reached 4% during any calendar year of the previous two decades, but eight of those 20 occasions also suffered *deflation*.

Although recent years haven’t featured deflation, save for 2009, today’s low-inflation streak is even longer. Not since 1991 has calendar-year inflation surpassed 4%. Consequently, the market’s inflation expectations, as implied by Treasury yields, are an all-time low. In the early '40s, payouts on 10-year Treasuries bottomed at just below 2%. That note’s yield is now 0.56%.

That investors have become nonchalant about inflation may be witnessed by the distinctly muted reaction to the federal government’s recent stimulus efforts. In 2009, an $800 billion recovery bill prompted widespread unease about growth in the federal debt. In contrast, this year's $2 trillion CARES Act, accompanied by the suggestion of an additional stimulus bill, has elicited few complaints.

Another perspective: The Congressional Budget Office forecasts that the United States will run a $3.7 trillion budget deficit in fiscal 2020, which represents 18% of expected gross domestic product. That will almost double 2009's shortfall, as measured by that same ratio of deficit/GDP. That 18% percentage has been exceeded in modern U.S. history only by the World War II years of 1943, 1944, and 1945, and barely at that.

Rising national debt no longer seems to trouble bond-fund managers. Those who fussed about such things have been chased out of the business, replaced by pragmatists who cannot explain exactly why what they learned in their macroeconomics classes no longer applies but who know what happens to investment managers who habitually underperform their peers. Let economists sort out the theories; fund managers have a job to do and shareholders to satisfy.

This approach may continue to succeed. If investment professionals struggle to understand why inflation remains so quiet, far be it for me to provide the answer. Nor am I terribly concerned that the marketplace has become so complacent. While the popularity of bonds triggers my contrarian impulses, I have learned the hard way that sometimes the crowd is correct. For example, 10 years ago critics disparaged the development of a "bond bubble" based largely on the premise that all those individual investors couldn't be right. So far, they have been.

Wartime Economies

Perhaps 2020 will later be recognized as the turning point, the year when inflation was finally rekindled. So far, that has been anything but the case. The bond markets have been delighted by the worldwide slowdown created by the appearance of the coronavirus. That reaction certainly makes sense for the near term. With spending depressed and global economies shrinking, inflation is currently but a concept. It will be a while before prices can increase.

However, warns my friend Bill Bernstein, when the coronavirus is finally subdued, danger may await. The analogy is of a war economy. While the battle against COVID-19 is metaphorical, as it is waged with social distancing and ventilators rather than tanks, bullets, and drone strikes, it resembles a wartime activity in that resources have been diverted. Consumer spending is depressed, and, for those who have retained their jobs, assets are accumulating. Eventually, per the wartime thesis, this pent-up demand will explode, thereby sparking inflation.

That certainly has occurred in the past. Inflation in the United States exploded after World War I, then again after WWII, and then again after Vietnam. (The latter, admittedly, was greatly exacerbated by the Oil Crisis, which was a separate and distinct problem.) The lone exception among the past century's four major conflicts was the Korean War, although inflation briefly spiked a couple of years after its conclusion, before once again subsiding.

The analogy, to be sure, is imperfect. While wartime economies typically bring increased employment, the COVID-19 pandemic has sidelined workers. Global economies are slack, as opposed to stretched by the addition of wartime projects. Nor, for the most part, could the world's COVID-19 response be classified as a figurative version of total war. Only a small portion of the global economy is being employed against the pandemic.

Nonetheless, the resemblance is sufficiently strong to merit concern. Also worth considering is that eventually global developed governments may decide to inflate their way out of their national debts. They did not make that choice after the 2009 financial crisis, but debt levels were lower then. For example, in 2010, the United States had a debt/GDP ratio of 54%, as opposed to 101% currently.

Practical Implications
As a reminder--this being familiar territory--the best assets for an inflationary environment are cash, inflation-adjusted bonds, and commodities. Equities aren't as attractive but neither are they terrible, because over time corporate earnings tend to rise with inflation. Then come junk bonds and finally, at the bottom of the list, the high-quality bonds that have performed so well in 2020.

Three modifications can improve a portfolio's inflation resistance: 1) moving high-quality bonds for cash and/or Treasury Inflation-Protected Securities; 2) shifting some assets from equities to commodities, and 3) swapping high-growth stocks for value stocks. (Inflation hurts growth stocks more than their cheaper rivals because the cash flows that accrue to growth companies tend to occur further in the future. That is, growth stocks have longer durations.)

I do not necessarily advocate these transactions. Doing so would overstate my confidence that inflation will indeed resurface. (To paraphrase Warren Buffett, when a highly credible investment source--such as Bill Bernstein--attempts the perilous task of predicting macroeconomic events, it is usually the reputation for peril that remains intact.) However, they are worth considering, particularly if the trades align with other reasons for adjusting one's portfolio.

Value Investing: When History May Not Be Enough

Might this time be different?

John Rekenthaler

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The Long View
Finance professors are historians. Because their research must withstand tests of statistical significance, it typically is conducted over prolonged time periods. Consequently, they also tend to distrust growth stocks. The broad view informs them that today's champions become tomorrow's also-rans. Competitors arise, while winners grow complacent.

Management consultants have a different perspective, as they are paid to identify ongoing corporate advantages. When Tom Peters and Robert Waterman Jr. penned the 1982 best-seller, *In Search of Excellence*, it was to highlight "eight basic principles of management" that, in their view, enabled companies to succeed. Unfortunately, the businesses that they profiled were less remarkable after the book was published. For the most part, their financial health declined.

Five years later, a cynic named Michelle Clayman wrote a rebuttal, "In Search of Excellence: The Investor's Viewpoint." Using Peters and Waterman's methodology, Clayman compiled a list of the worst-scoring firms at the time of the book's launch. Over the ensuing five years, she found, the businesses of those "unexcellent companies" consistently improved, even as those of the allegedly excellent companies slipped.

Their stock prices behaved even more dramatically. As fundamental fortunes shifted, the leaders no longer were so alluring, nor the doormats so contemptible. Accordingly, the price multiples that investors paid for the two stock groups converged. That movement gave the unexcellent companies a double boost. Not only did their earnings increase but so did their price/earnings ratios. As a result, the group outgained the S&P 500 by an average of 12 percentage points per year.

Value Investor, Ph.D.

The knowledge of such experiences turns most finance professors into value investors. Money-management firms founded by finance Ph.D.s typically follow value strategies. Dimensional Fund Advisors does, as do AQR Capital Management, LSV Asset Management, and Fuller & Thaler. The organizations diverge in their details but not in their underlying principles: Assume that most investors overreact, and take the other side of the trade.

The drawback to that mindset is that, on rare occasions, the underlying pattern does indeed change. Finance professors are unparalleled at amassing and analyzing investment data, but they do not excel at identifying turning points. In 1990, nothing in the history suggested that U.S. inflation could remain steadily low for three decades. (Not that many economists predicted the event, either, but they at least stood a chance.)

Small Problems

I write this after reading a striking passage in "Public to Private Equity in the United States: A Long-Term Look." Authored by Morgan Stanley's Michael Mauboussin and Dan Callahan, the paper--a wonderful reference for those of you who seek such things--broadly examines the state of the U.S. equity marketplace. Among its topics is the shrinkage of publicly listed companies, which numbered over 7,000 in the mid-1990s but only 3,600 today. (As of year-end 2019, the Wilshire 5000 Index contained but 3,473 members.)

Several reasons underlie this decline, including higher listing fees, greater regulatory requirements, and improved funding from private equity sources, should companies seek capital without going public. But the biggest explanation is fundamental. From a business perspective, as opposed to investor sentiment, large companies are leaving small companies far behind. Write the authors, "The difference between the median return on assets for large and small companies was 15 percentage points in the 1990s and is now in the range of 30-35 points."

Small businesses by nature are less profitable than larger firms, both because they lack scale and because they tend to be younger, which makes them likelier to reinvest in their businesses. But 30 to 35 percentage points is massive! Also worthy of exclamation is that that the change occurred over a single generation, with the difference between small- and large-company margins doubling within 25 years.

The growing disparity owes partially to smaller firms' struggles. Back in the day, not only did more companies go public, but when they did so they were likelier to survive. In the 1970s, report the authors, 92% of initial public offerings were still listed five years later. By the decade of the 2000s, that figure had dropped to 63%. Bankruptcies among the newly listed had increased, as had buyouts from larger firms.

Big Victories

Which leads to the second half of the story: "The strong," as the authors write, "are getting stronger." Not only have large companies pulled away from smaller entities, but inequity has risen among the giants themselves. Mauboussin and Callahan continue, "The gap in return on invested capital between a U.S. company in the top

10% and the median has risen sharply in recent decades. Consolidation explains a large part of this. Measures of concentration … have shown a substantial increase for many industries since the mid-1990s."

Today's behemoths are eating the competition. More than ever, their assets are intangible, created from buying other companies at a premium to their book values. Acquisitions have long been derided by finance professors as "empire building"--flubs by corporate managers who judge success by their companies' revenues rather than by shareholder value. In recent years, however, such deals have frequently worked, enabling the leviathans to "exhibit increasing returns, which include very high market shares and economic profits."

I do not know if this process will continue. It may be that large-company margins have peaked, or that after a long hiatus the Department of Justice will begin to prosecute antitrust statutes vigorously, or that the gap in valuations between the market's glamour stocks and its huddled masses has become so great that value investing will rebound, regardless of such companies' fundamental performances.

However, I must pose the question because it is too important to ignore. Value investors assume that history will repeat--and in this instance, changing fundamental conditions challenge that assumption.

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Positions

JCAP - Agreed to be purchased for 7.30 per share. We sold for a client when it moved above that level @ 17.40 on 8/3.

STAG - We sold this fully valued Industrial REIT for a client @ 33.445 on 8/6.

XPER - We purchased this Infrastructure Software IVA System pick on 8/31 for 4 clients @ 12.765, and another @ 12.785.