May 2021

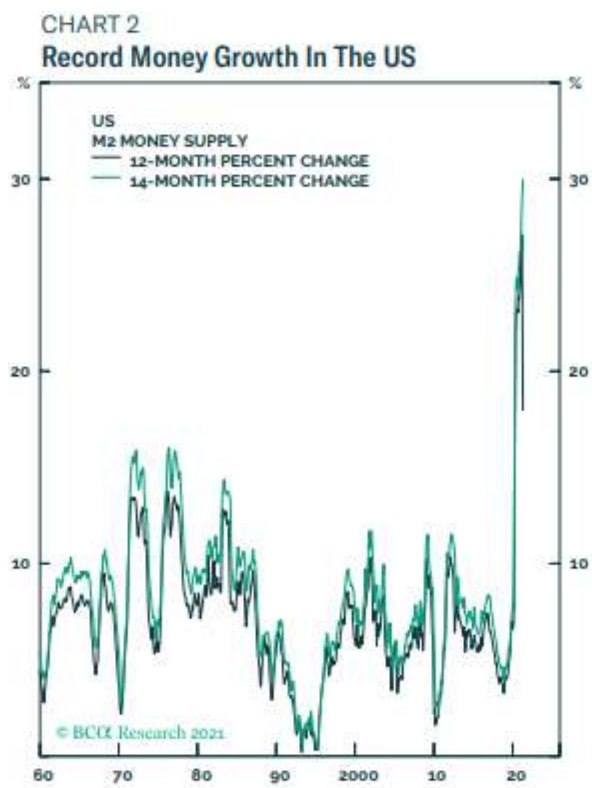
Friday saw both the S&P 500 & Dow close less than 1% below their May 7th all time highs, while the Tech dominated NASDAQ finished the month 3% below its April 26th high, and the Small-Cap Russell 2000 4% below its March 15th high.

Inflation has been dominating the economic news, with "stimmies" enabling pent-up demand from the unwinding pandemic to slam into residual supply chain constraints, and labor shortages resulting from excessive Federal unemployment benefits. It is the very definition of Demand-pull inflation, "**too much money chasing too few goods**". From Friday's Global Investment Strategy, **Mo' Money Madness**:

Cranking Up The Printing Press

Money growth has exploded in the US and to a lesser degree, in the other major developed economies. ...

US M2 growth peaked at 27% on a year-over-year basis in February 2021. As of April, M2 was 30% higher than in February 2020, the biggest 14-month increase on record (**Chart 2**).



A Fiscally-Driven, Fed-Abetted Monetary Expansion

What explains the surge in M2? To a large extent, the answer is "fiscal policy." The US budget deficit ballooned from 5.7% of GDP in 2019 to 15.9% of GDP in 2020 and is set to clock in at 15.0% in 2021.

Direct government spending on goods and services contributed very little to the increase in the budget deficit. Real federal government consumption and investment increased by only 5.8% between Q4 of 2019 and Q1 of 2021, while direct spending at the state and local level actually contracted. Rather, it was the surge in transfer payments to households, and to a lesser extent, businesses, that caused the budget deficit to soar. ...

Over the course of the pandemic, not only did the Fed scoop up almost all newly-issued debt, but it bought the debt that the government had issued prior to the pandemic, along with other assets such as mortgage-backed securities. It was the combination of these asset purchases and decreased spending during the pandemic that pushed bank deposits up to record high levels.

Bank Credit: The Dog That Didn't Bark

What did commercial banks do with all the deposits they received? For the most part, the answer is nothing. They just parked the money at the Fed. Bank credit rose briefly at the outset of the pandemic as companies drew down their credit lines and obtained government-backed loans through the Paycheck Protection Program. However, credit outstanding then began to shrink as businesses shelved capex projects and households paid down their debts.

In recent months, consumer credit has shown signs of stabilization, partly due to a rebound in auto lending. Our expectation is that overall US bank credit growth will turn positive later this year but will remain well below its pre-GFC pace.

The subdued expansion in bank lending should help keep inflationary pressures in check. However, inflation could eventually rise significantly once the output gap disappears and the US economy begins to overheat. While this is not a major risk (To what, the economy or Stocks? It is important to remember that investors attempt to divine what is heading toward them around the next bend, which is especially nerve racking with elevated valuations, and doubts about whether the guard rails, if any, will hold.) for the next 12-to-18 months, it is more of a concern over a 2-to-4 year horizon. ...

Follow-ups

We have repeatedly shared our concerns about future inflation. The following lead article from the front page of May 24th's WSJ contains an interesting study on returns from Treasurys, Stocks, TIPS, and Commodities "by type of inflation environment." For the record, we do not recommend Treasurys, TIPS, or Commodities.

Signs of Inflation Threaten Investors' Portfolios

Fears blunt market rally as old standbys falter, sparking wider search for alternative plays

BY SAM GOLDFARB

Signs that inflation is picking up momentum are adding a new dimension to the post-lockdown market rally, forcing investors to make difficult decisions about how to protect their portfolios from the emerging threat.

Investors have a variety of options at their disposal but face near-record prices for old standbys like gold, sending some searching for alternatives that might be even more imperfect. Inflation fears have buffeted stocks, pulling major indexes back from records. Some have even talked up bitcoin as an inflation bet, but it fell as much as 30% during a trading session last week.

The challenge facing investors was apparent this month when new data showed a surprisingly large jump in consumer prices. Rather than rise, a collection of assets generally thought to safeguard investors against inflation fell after the report.

The price of the benchmark 10-year Treasury inflation-protected security logged its biggest one-day decline in a month. Shares of real-estate investment trusts slid the most since January. Commodities were generally flat but dropped the following day.

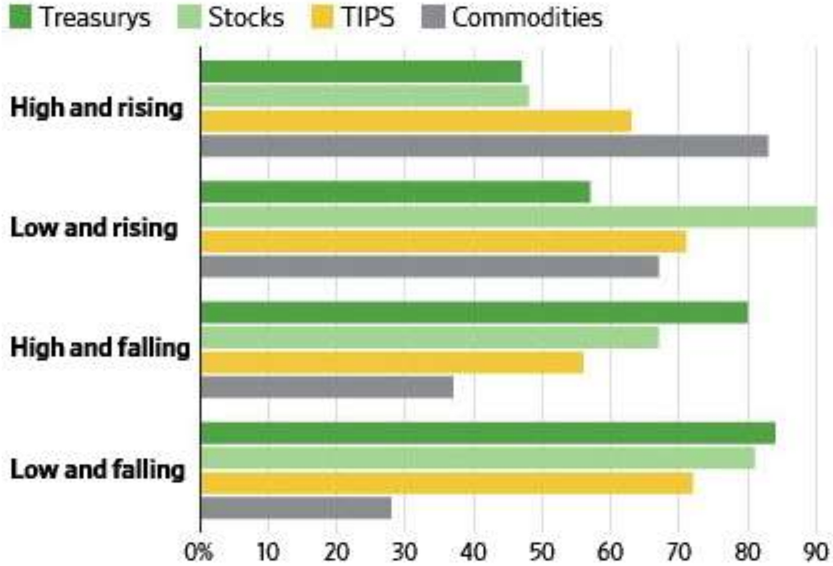
The three asset classes have vacillated since, but their initial moves showed the unexpected ways that markets can behave when inflation is rising, especially when many are already expensive by historical measures.

This week, investors will gain greater insight into the inflation picture when the Commerce Department updates the Federal Reserve's preferred inflation gauge, the personal-consumption-expenditures price index. ...

The stakes are high for investors. Inflation dents the value of traditional government and corporate bonds because it reduces the purchasing power of their fixed interest payments. But it can also hurt stocks, some analysts said, by pushing up interest rates and increasing input costs for companies.

From early 1973 through last December, stocks have delivered positive inflation-adjusted returns in 90% of rolling 12 month periods that occurred when inflation—as measured by the consumer-price index—was below 3% and rising, according to research by Sean Markowicz, a strategist at Schroders, the U.K. asset-management firm. But that fell to only 48% of the periods when inflation was above 3% and rising.

Percentage of rolling 12-month periods in which returns exceeded inflation, 1973-2020, by type of inflation environment



Note: High and low inflation defined as CPI above or below 3% over the preceding 12-month period.
Sources: Schroders; ICE BAML 7-10 Year US Treasury Index (Treasurys); MSCI USA Index (stocks); Bloomberg Barclays US TIPS Index (TIPS); S&P GSCI Commodity Total Return Index (commodities)

A recent report from the Labor Department showed that the consumer-price index jumped 4.2% in April from a year earlier, up from 2.6% in March. Even excluding volatile food and energy prices, it was up 3% from a year earlier, blowing past analysts' expectations for a 2.3% gain.

Analysts said there are plenty of reasons why inflation won't be able to maintain that pace for long. The latest year-over year numbers were inflated by comparisons to deeply depressed prices from the early days of the pandemic. They were also supported by supply bottlenecks that many view as fixable and robust consumer demand that could dissipate once households have spent government stimulus checks.

Before the pandemic, inflation spent years struggling to climb above the Fed's 2% annual target due in part to structural factors like aging populations in developed countries. Analysts said those forces remain, though many won't rule out sustained higher inflation and said investors might prepare accordingly.

Protecting against inflation is tricky, however. Treasury inflation- protected securities, or TIPS, offer the most straightforward option, as their interest payments and principal automatically increase when the CPI rises. When investors buy TIPS, the yields on the securities are lower than nominal Treasurys of the same maturity, but investors can ultimately earn a better return depending on the rate of inflation over the life of the bond.

As of Friday, the yield on 10year TIPS was minus -0.826% — meaning investors would incur losses absent any inflation — compared with 1.629% for the nominal 10-year Treasury note. That means CPI growth would need to average at least 2.45% over the next 10 years for the inflation-protected security to pay as much or more than the nominal Treasury.

To some, this makes TIPS the safest and best inflation hedge. Investors are nearly guaranteed to get their principal back if they hold the bonds to maturity. At current yield differentials, they can earn significantly more than regular Treasurys if inflation fears are realized.

Still, TIPS returns are likely to be paltry under almost any scenario, particularly if inflation comes below expectations. TIPS prices can also fall along with regular Treasurys—as they did after the CPI report— when investors think rising inflation will push the Fed to raise short-term interest rates.

History suggests there might be better hedges than TIPS when inflation is especially high. According to the research by Mr. Markowicz, TIPS returns exceeded inflation in 71% of the periods when inflation was below 3% and rising, but only 63% of periods when it was above 3% and climbing.

By comparison, the S& P GSCI Commodity Total Return Index delivered positive inflation-adjusted returns in 83% of the high and rising inflation periods. “Commodities are a source of input costs for companies and they’re also a key component of the inflation index, which by definition you’re trying to hedge,” Mr. Markowicz said.

At the same time, commodities are among the most volatile of all asset classes and can be influenced by an array of idiosyncratic factors. ...

The cycle may have turned on another speculative vehicle that we have repeatedly warned about. From May 20th's WSJ:

SPAC Selloff Bruises Investors

BY AMRITH RAMKUMAR

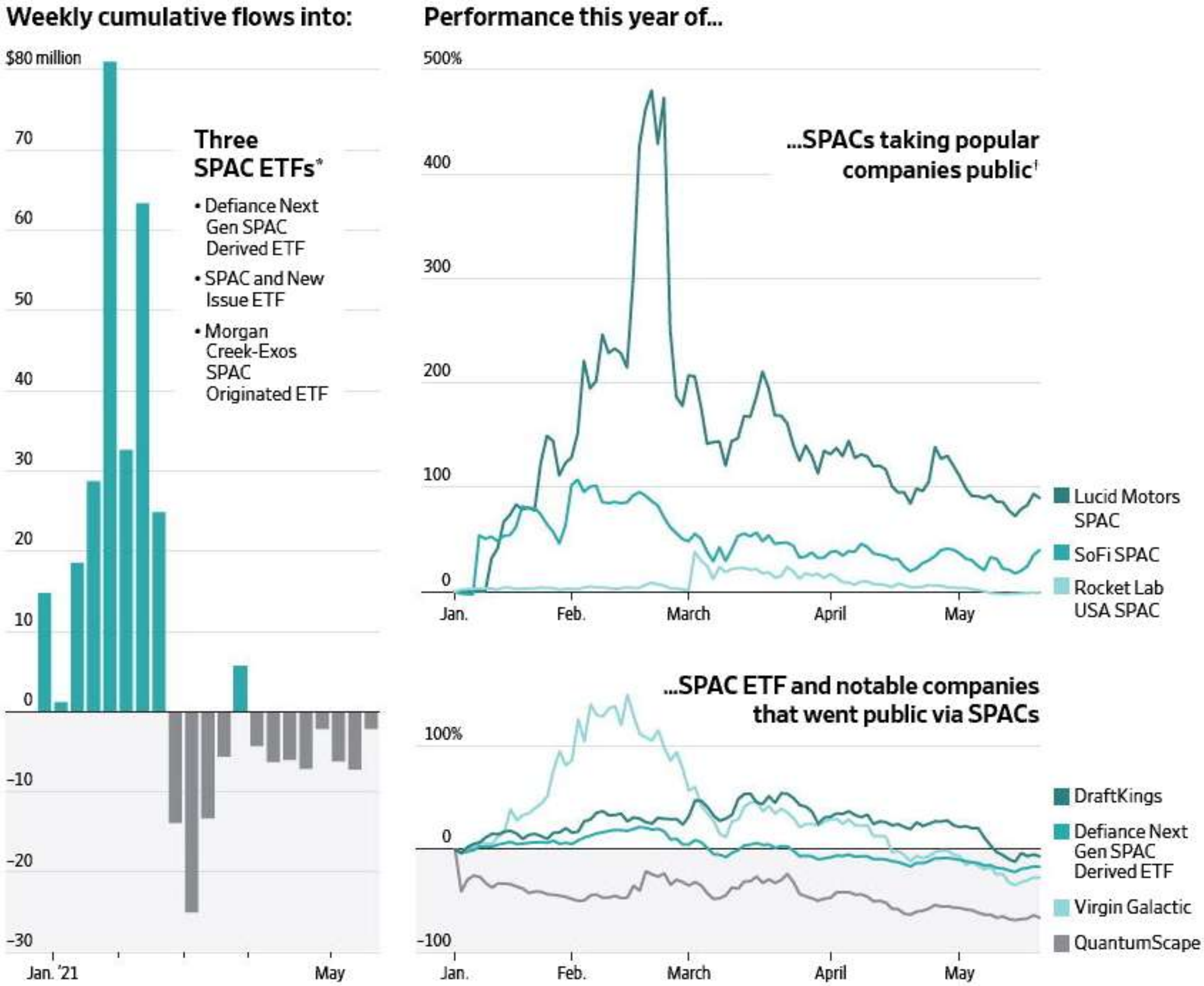
Shares of special-purpose acquisition companies and firms they have taken public are tumbling, punishing individual investors who piled into the once-hot sector.

The Defiance Next Gen SPAC Derived Exchange-Traded Fund, which tracks companies that have gone public through SPACs along with SPACs that have yet to do any deals, has fallen about 30% in the past three months and recently hit a six-month low. Popular firms tied to the sector such as electric-car-battery company **Quantum-Scape** and space-tourism firm **Virgin Galactic Holdings** are down 50% or more during that span. SPACs listing splashy firms such as electric-car startup **Lucid Motors** and personal-finance company **Social Finance** are also taking a beating.

The reversal shows the risks that come with popular speculative trades. It is occurring as investors retreat from technology stocks amid fears that rising inflation will force the Federal Reserve to end its easy-money policies more quickly than anticipated. Those concerns make wagers on rapidly growing companies less appealing. Those related to SPACs have been among the worst hit by the selloff and have been battered by signals that regulators are increasing scrutiny of blank-check firms. The swift change in momentum for what was one of the winter’s hottest investments shows how quickly volatile assets from startups to cryptocurrencies can inflict pain on traders. Early this year, nearly all SPACs were rising, even when there was little fundamental reason behind the gains.

Former athletes and celebrities from Alex Rodriguez to the singer Ciara are involved with SPACs, which made stars out of prolific deal makers such as venture capitalist Chamath Palihapitiya.

Now, nearly all companies tied to the sector are in a uniform free fall, engulfing names backed by even the most popular SPAC creators.



*Data as of Tuesday †Lucid Motors SPAC is Churchill Capital IV; SoFi SPAC is Social Capital Hedosophia V; Rocket Lab USA SPAC is Vector Acquisition
Sources: FactSet via Dow Jones Market Data (flows); FactSet (performance)

"It's nothing short of a slaughter," said Garrick Tong, a 42-year-old physician in Southern California who has more than half of his six-figure portfolio tied to SPACs. Its value has fallen about 30% from a February peak. Some of his biggest holdings include blank-check companies that are taking Lucid, SoFi and Rocket Lab USA public.

SPACs are shell companies that list on an exchange with the sole purpose of acquiring a private firm to take it public. The private company, often a startup, then gets the SPAC's place in the stock market. Many individuals view SPACs as a way to get in early with exciting companies of the future—and companies that go public through a SPAC are allowed to make rosy projections that aren't allowed in a traditional initial public offering. Blank-check firms have raised a record $103 billion this year, according to data provider SPAC Research. ...

Several SPAC-related companies were among the most heavily traded stocks on brokerages such as Robinhood Markets earlier this year. The outsize trading activity coincided with gains in shares of videogame company GameStop and other popular stocks but has now turned into a rout for some investors who didn't sell.

The losses lend credence to the idea that SPAC mergers enrich insiders through unique incentives while often sticking individual investors with losses if shares struggle, skeptics say. SPAC creators are typically protected by the right to buy a chunk of shares at a steep discount, while savvy professional investors often quickly sell their SPAC shares before deals are completed to minimize losses.

Still, even SPAC insiders have seen their paper profits slashed in recent weeks. The selloff could also complicate valuations for SPAC mergers that have been announced but not yet completed.

One reason for the volatility is that many investors such as Mr. Tong have used options and warrants to amplify their SPAC wagers. Both options and warrants are much more volatile than underlying shares, and frenzied trading in them can exacerbate stock moves in either direction. Heavy options activity in SPACs such as **Churchill Capital Corp. IV,** the blank-check firm taking Lucid public, helped fuel the sector's rise but is now likely contributing to its retreat, analysts say.

The declines in shares tied to SPACs since mid-February coincide with outflows from ETFs tied to the sector and a drop in stock-market and options-trading activity by individual investors in March and April after such activity boomed to start the year, according to data compiled by JPMorgan Chase.

Some investors seem to have moved on from stocks related to the SPAC sector to cryptocurrencies, analysts say ... with the millions of younger traders who have been at home during the Covid-19 pandemic and increasing their investing activity in search of quick fortunes. ...

Except for pre-pandemic India, HCM has avoided direct exposure to Emerging Markets. China, which is compared to Japan in Verdad's May 10th analysis below, has the largest allocation in EM indexes, and their ETFs. For example, the largest such ETF at $80.7 billion is iShares Core MSCI Emerging Markets ETF with a 20.5% allocation.

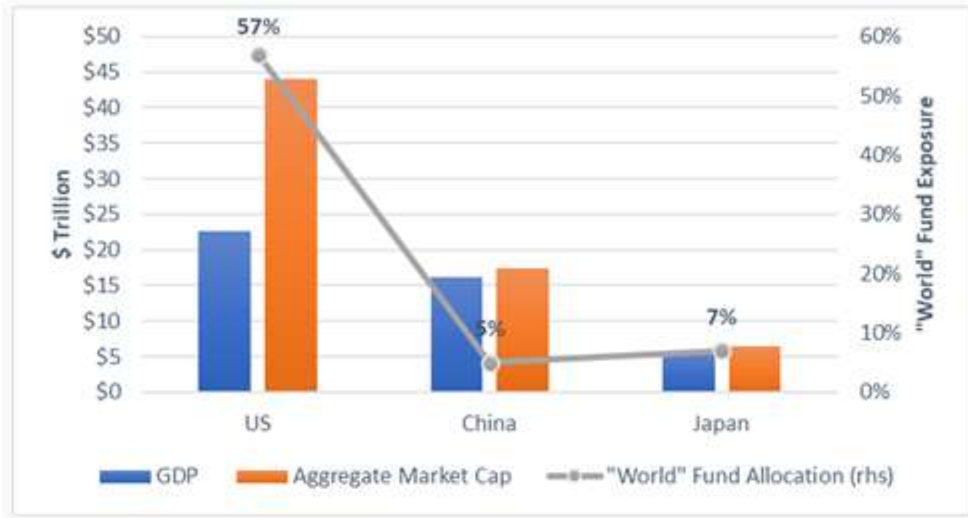
Weighting on China

Growth and Scale Suggest China Stocks Are Hot and under Bought. Here's Why Not.

By: Nick Schmitz

The three largest economies by GDP are the US, China, and Japan. These are also the largest country stock markets by aggregate market cap. By our count, US-headquartered stocks add up to $44T in equity value, Chinese (and Hong Kong) stocks add up to $17.3T, and Japanese stocks add up to $6.5T. Meanwhile, Vanguard's Total World Stock ETF allocates 57% to US stocks, 5% to Chinese stocks, and 7% to Japanese stocks.

Figure 1: GDP, Aggregate Market Size, and Vanguard (VT) Fund Weighing



Source: IMF for 2021 nominal GDP estimates. Capital IQ for aggregate market cap of all country-headquartered public listings on country exchanges, excluding REITS and capital markets; China includes Hong Kong. Vanguard (VT) for country exposure weights.

Relative to GDP or total market capitalization, global equity indices, and by proxy most investors, are massively underweight Chinese stocks. The case for upping exposure to China looks even stronger when we look at the selection opportunity, liquidity and growth, especially relative to China's Asian competitor, Japan. China has 2x the number of listed stocks as Japan, and those stocks have 3x the median market cap of Japan.

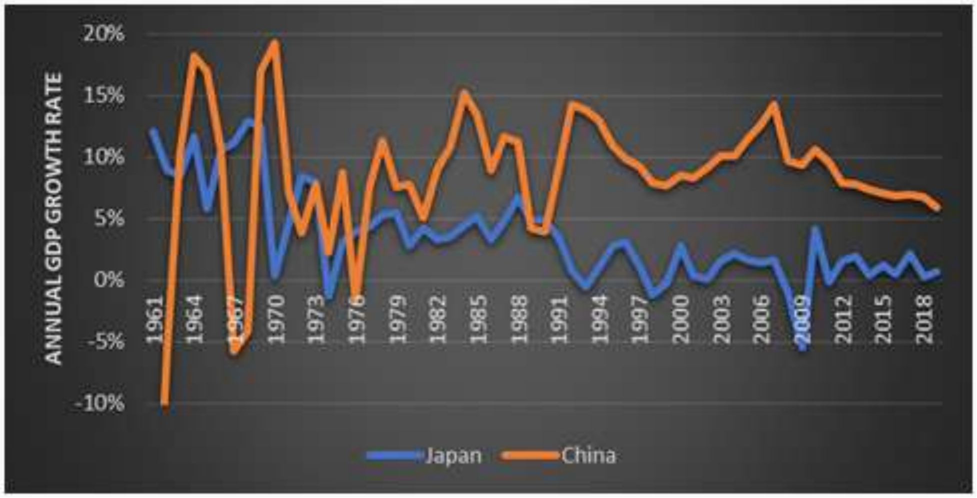
Figure 2: Stocks, Stock Size, and Growth for the Big Three Countries

	US	China	Japan
Stocks	3702	6276	3788
Median Market Cap ($M)	$1,197	$609	$165
5Yr Rev Growth	4.8%	9.0%	0.5%
1Yr Fwd Rev Growth	10.7%	22.9%	2.1%

Source: Capital IQ, 27 April 2021

Perhaps most notably, China's median firm growth rates are >5x Japan's. And China's exceptional growth rates aren't just figments of equity analysts' imaginations: Chinese corporate profits have been growing faster than Japan's for decades.

Figure 3: Chinese vs Japanese GDP Growth Rates



Source: IMF

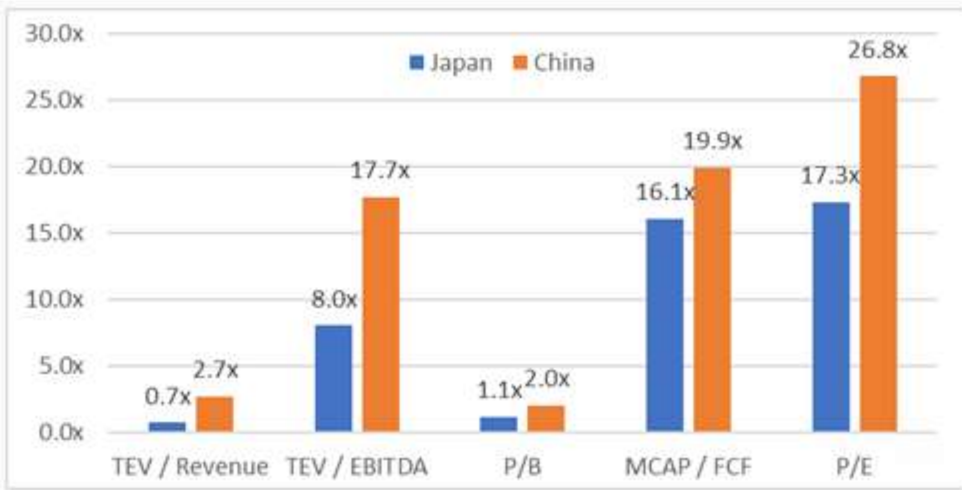
It’s puzzling, therefore, to note that China’s equity market hasn’t dramatically outperformed the Japanese market for 10 years now. Despite a massive difference in historic growth rates, the MSCI Japan index returned the exact same amount as the MSCI China index over the past decade, and with way less heartburn along the way.

Figure 4: MSCI Japan vs MSCI China Index (2011–2021)

Source: Capital IQ. Net Total Returns, USD.

This is in large part because investors paid a hefty premium to own Chinese stocks throughout the decade. The growth differential, it appears, was more than priced in. The picture today is little changed from a decade ago: the price differential between the two is still one of the biggest for countries outside of US markets, a concerning data point for China bulls.

Figure 5: Chinese vs Japanese Median Stock Trading Multiples Today



Source: Capital IQ. All listed stocks, excluding REITS and capital markets.

Chinese stocks are around 25% to 200% more expensive than Japanese stocks, depending on how you measure them.

But this simple analysis assumes a Chinese public equity is the same thing in kind as other developed-market public equities like a Japanese stock. There is a relevant quote, often misattributed to Stalin: "I consider it completely unimportant who in the party will vote, or how; but what is extraordinarily important is this—who will count the votes, and how." For minority voting shareholders of Chinese "public equities," we think both may be extremely important. This is because Chinese public equities are neither "public" nor "equitable" to the extent we can measure.

As shown below, Chinese equities have a public float of 45% on average, making them technically not public. Despite China's maintenance, until recently, of the democratic-sounding "one share, one vote" law, in practice, this means that state-owned or quasi-state-owned institutions will often maintain full control according to academics and Pulitzer Prize winning journalism. This is a system of collective equity that might be thought of as having less of the nuance of James Madison and more of the nuance of Mao's 1949 concept of The People's Democratic Dictatorship. This "democracy for the people and dictatorship over the reactionaries," is most likely why the reactionary practice of shareholder activism is "quite uncommon" in China, according to legal experts.

But why rely on the opinions of experts and academics in their ivory towers? As shown below, when you ask Chinese people themselves, they routinely rank themselves alongside Bhutan, the Kyrgyz Republic, and Colombia on most every metric related to the equitable treatment of shareholders, again making them not technically "equities" to the extent we can measure this.

Figure 6: Public Float and Indicators of Equitable Treatment for "Public Equities"

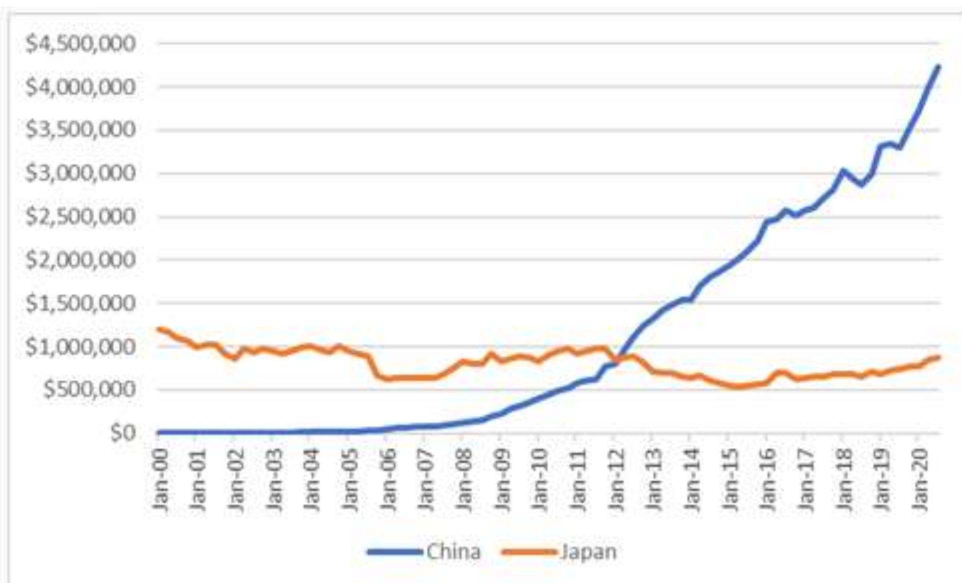
	US	Japan	China	Adjacent ranked
Public Float	79%	63%	45%	
Minority Shareholder Rights	#8	#14	#38	Bhutan
Accounting Quality	#16	#18	#71	Nicaragua
Efficacy of Corporate Boards	#15	#18	#126	Kyrgyz Republic
Strength of Investor Protections	#31	#51	#102	Tunisia
Soundness of Banks	#24	#21	#82	Senegal
Regulation of Securities Exchanges	#18	#12	#60	Colombia

Source: Capital IQ for float. All publicly listed stocks, excluding REITs and capital markets. Survey rankings from the latest World Bank's and World Economic Forum's Global Competitiveness Ranks.

Finally, in comparing Chinese to Japanese equities, it may be useful to consider not just the valuation and transparency risks but also the debt markets these equities are subordinated to.

Below is the aggregate amount of corporate ex-financial debt in China and Japan over the last 20 years. The financial statement growth that makes Chinese equities so attractive compared to Japanese equities has come at the cost of skyrocketing debt.

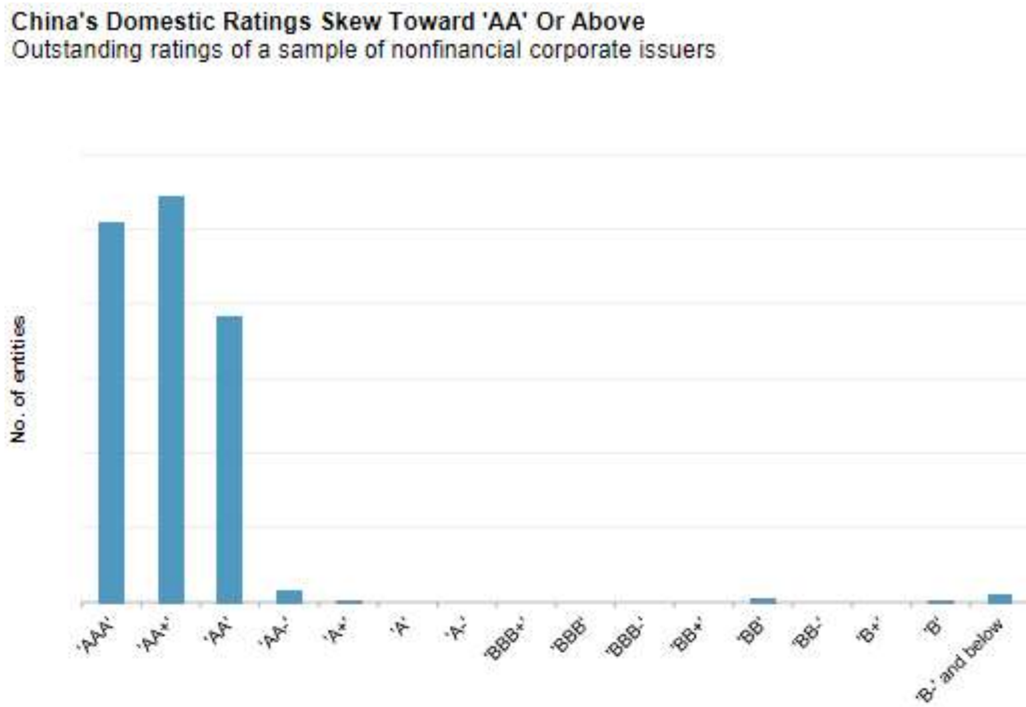
Figure 7: Total Corporate Ex-Financial Debt ($M)

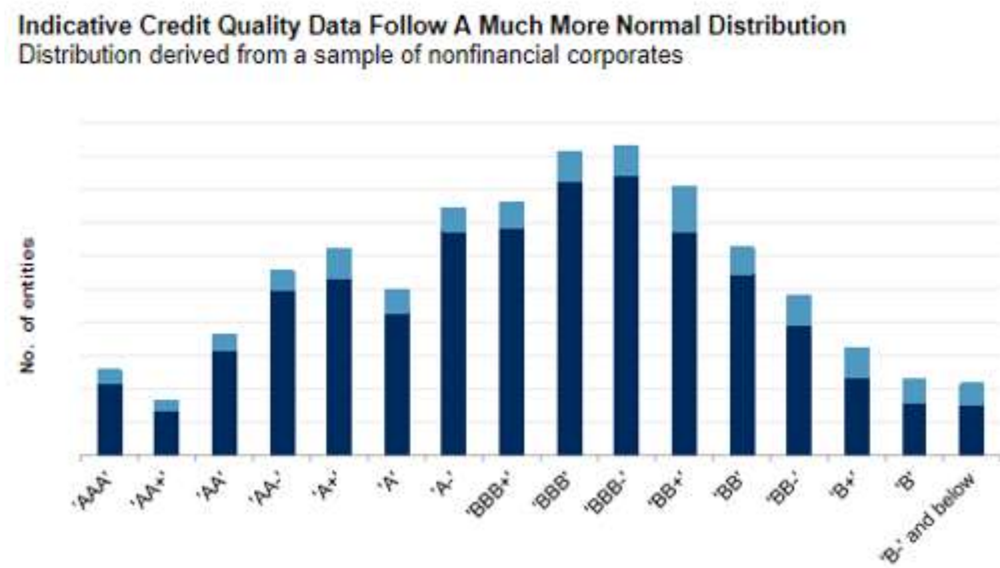


Source: Fred

And while the Chinese ratings agencies have ranked most all issued domestic bonds in the AAA to AA investment grade range, when the imperialist swine at S&P Credit Ratings applied their independent analysis on the publicly available Chinese accounting data, this resulted in a downgrade of the same sample of Chinese issuers from exclusively investment grade to largely speculative and junk grade.

Figure 8: Chinese Domestic Credit Ratings vs S&P Indicative Ratings





Source: S&P Global

China is a unique market. We can think of only one historical analogue to a country like China today. A country whose capital markets rose at breakneck speed from the ashes of war and economic catastrophe. A country with a market that emerged as nearly dominant globally after prolonged sustained growth, at massive scale, with high valuations and extremely accommodative corporate lending. A country that adopted many capitalist standards to get there while allowing the government and complex webs of corporate crossholdings to play a heavy-handed role in directing national industrial and technological efforts before hitting peak population and a non-performing loan crisis. That country is Japan in the 1980s, before the asset bubble burst.

But China is quite different from the historical example of Japan for many reasons, including that China is one of the very few officially Marxist-Leninist countries surviving today. North Korea, Laos, and Cuba don't really have markets, let alone stock markets. As such, this extreme survivorship bias makes it difficult to estimate your long-term probability of realizing a return on (or return of) your capital in Marxist-Leninist states. We are left with only rough comparable examples like the Ho Chi Minh City Stock Exchange in Vietnam and Venezuela's Caracas Stock Exchange. We can't say much empirically on such a limited sample, but for what it's worth, all three markets joined the UN's Sustainable Stock Exchanges Initiative, giving your capital what some would argue is two layers of communist oversite.

It may be tempting to assume that when you put your money in a foreign country, no matter which one, you will get it back a decade later, as has occurred quite regularly since the '70s. Capital controls were really something that only our grandparents had to worry about. But foreign investors thinking about Chinese exposure over the next decade have neither the assurance of constrained law nor credible deterrence. Meanwhile, in Japan, investors enjoy the backdrop of a close ally with a pluralistic liberal democratic constitution and the geopolitical insurance policy that only a division of US Marines in Okinawa can provide.

For these reasons, we think of allocation decisions to the largest countries outside of the US as more complicated than a weighting of fully interchangeable financial instruments.

Our conclusion is that, compared to Japanese public equities today, Chinese public equities are not technically public or equitable to the extent we can measure. They are massively more expensive and are probably subordinated to much more dubious lending practices than the government-approved ratings agencies would let on, according to S&P's mathematical standards. But we must admit that the trailing and one year forward growth is red-hot in the market that's marked-to-Marxist.

From May 8th's WSJ:

The Great Cash Splash

Stocks are in a frenzy. Cryptocurrencies now equal the value of U.S. dollars in circulation. Real estate is booming. And the Federal Reserve is still pumping stimulus into the economy.

BY GREG IP

To veterans of financial bubbles, there is plenty familiar about the present. Stock valuations are their richest since the dot-com bubble in 2000. Home prices are back to their pre-financial-crisis peak. Risky companies can borrow at the lowest rates on record.

Individual investors are pouring money into green energy and cryptocurrency.

This boom has some legitimate explanations, from the advances in digital commerce to fiscally greased growth that will likely be the strongest since 1983.

But there is one driver above all: the Federal Reserve. Easy monetary policy has regularly fueled financial booms, and it is exceptionally easy now. The Fed has kept interest rates near zero for the past year and signaled rates won't change for at least two more years. It is buying hundreds of billions of dollars of bonds. As a result, the 10-year Treasury bond yield is well below inflation—that is, real yields are deeply negative—for only the second time in 40 years.

There are good reasons why rates are so low. The Fed acted in response to a pandemic that at its most intense threatened even more damage than the 2007-09 financial crisis. Yet in great part thanks to the Fed and Congress, which has passed some $5 trillion in fiscal stimulus, this recovery looks much healthier than the last. That could undermine the reasons for such low rates, threatening the underpinnings of market valuations.

"Equity markets at a minimum are priced to perfection on the assumption rates will be low for a long time," said Harvard University economist Jeremy Stein, who served as a Fed governor alongside now-Chairman Jerome Powell. "And certainly you get the sense the Fed is trying really hard to say, 'Everything is fine, we're in no rush to raise rates.' But while I don't think we're headed for sustained high inflation it's completely possible we'll have several quarters of hot readings on inflation."

Since stocks' valuations are justified only if interest rates stay extremely low, how do they reprice if the Fed has to tighten monetary policy to combat inflation and bond yields rise 1 to 1.5 percentage points, he asked. "You could get a serious correction in asset prices."

'A bit frothy'

The Fed has been here before. In the late 1990s its willingness to cut rates in response to the Asian financial crisis and near collapse of the hedge fund Long-Term Capital Management was seen by some as an implicit market backstop, inflating the ensuing dot-com bubble. Its low-rate policy in the wake of that collapsed bubble was then blamed for driving up housing prices. Both times Fed officials defended their policy, arguing that to raise rates (or not cut them) simply to prevent bubbles would compromise their main goals of low unemployment and inflation, and do more harm than letting the bubble deflate on its own.

As for this year, in a report this week the central bank warned asset "valuations are generally high" and "vulnerable to significant declines should investor risk appetite fall, progress on containing the virus disappoint, or the recovery stall." On April 28 Mr. Powell acknowledged markets look "a bit frothy" and the Fed might be

one of the reasons: "I won't say it has nothing to do with monetary policy, but it has a tremendous amount to do with vaccination and reopening of the economy." But he gave no hint the Fed was about to dial back its stimulus: "The economy is a long way from our goals." A Labor Department report Friday showing that far fewer jobs were created in April than Wall Street expected underlined that. The Fed's choices are heavily influenced by the financial crisis.

While the Fed cut rates to near zero and bought bonds then as well, it was battling powerful headwinds as households, banks, and governments sought to pay down debts. That held back spending and pushed inflation below the Fed's 2% target. Deeper-seated forces such as aging populations also held down growth and interest rates, a combination some dubbed "secular stagnation."

The pandemic shutdown a year ago triggered a hit to economic output that was initially worse than the financial crisis. But after two months, economic activity began to recover as restrictions eased and businesses adapted to social distancing. The Fed initiated new lending programs and Congress passed the $2.2 trillion Cares Act. Vaccines arrived sooner than expected. The U.S. economy is likely to hit its pre-pandemic size in the current quarter, two years faster than after the financial crisis.

And yet even as the outlook has improved, the fiscal and monetary taps remain wide open. Democrats first proposed an additional $3 trillion in stimulus last May when output was expected to fall 6% last year. It actually fell less than half that, but Democrats, after winning both the White House and Congress, pressed ahead with the same size stimulus.

The Fed began buying bonds in March 2020 to counter chaotic conditions in markets. In late summer, with markets functioning normally, it extended the program while tilting the rationale toward keeping bond yields low.

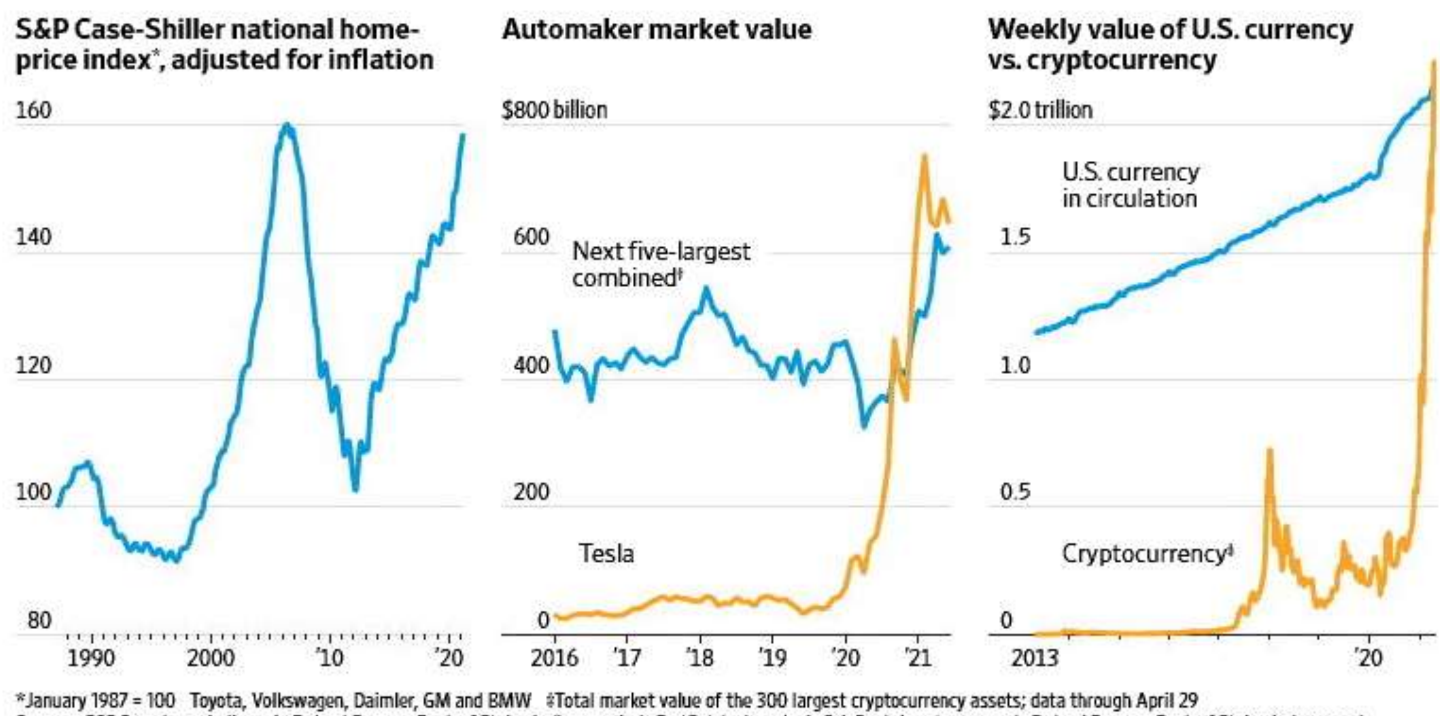
At the same time it unveiled a new framework: After years of inflation running below 2%, it would aim to push inflation not just back to 2% but higher, so that over time average and expected inflation would both stabilize at 2%. To that end, it promised not to raise rates until full employment had been restored and inflation was 2% and headed higher. Officials predicted that would not happen before 2024 and have since stuck to that guidance despite a significantly improving outlook.

Running of the bulls

This injection of unprecedented monetary and fiscal stimulus into an economy already rebounding thanks to vaccinations is why Wall Street strategists are their most bullish on stocks since before the last financial crisis, according to a survey by Bank of America. While profit forecasts have risen briskly, stocks have risen more. The S& P 500 stock index now trades at about 22 times the coming year’s profits, according to FactSet, a level exceeded only at the peak of the dot-com boom in 2000.

Other asset markets are similarly stretched. Investors are willing to buy the bonds of junk-rated companies at the lowest yields since at least 1995, and the narrowest spread above safe Treasurys since 2007, according to Bloomberg Barclays data. Residential and commercial property prices, adjusted for inflation, are around the peak reached in 2006.

Stock and property valuations are more justifiable today than in 2000 or in 2006 because the returns on riskless Treasury bonds are so much lower. In that sense, the Fed’s policies are working precisely as intended: improving both the economic outlook, which is good for profits, housing demand, and corporate



*January 1987 = 100 Toyota, Volkswagen, Daimler, GM and BMW ‡Total market value of the 300 largest cryptocurrency assets; data through April 29
Sources: S&P Dow Jones Indices via Federal Reserve Bank of St. Louis (home price); FactSet (automaker); CoinDesk (cryptocurrency); Federal Reserve Bank of St. Louis (currency)

creditworthiness; and the appetite for risk.

Nonetheless, low rates are no longer sufficient to justify some asset valuations. Instead, bulls invoke alternative metrics.

Bank of America recently noted companies with relatively low carbon emissions and higher water efficiency earn higher valuations. These valuations aren't the result of superior cash flow or profit prospects, but a tidal wave of funds invested according to environmental, social and governance, or ESG, criteria.

Conventional valuation is also useless for cryptocurrencies which earn no interest, rent or dividends. Instead, advocates claim digital currencies will displace the fiat currencies issued by central banks as a transaction medium and store of value. "Crypto has the potential to be as revolutionary and widely adopted as the internet," claims the prospectus of the initial public offering of crypto exchange Coinbase Global, in language reminiscent of internet-related IPOs more than two decades earlier. Cryptocurrencies as of April 29 were worth more than $2 trillion, according to CoinDesk, an information service, roughly equivalent to all U.S. dollars in circulation.

Financial innovation is also at work, as it has been in past financial booms. Portfolio insurance, a strategy designed to hedge against market losses, amplified selling during the 1987 stock-market crash. In the 1990s, internet stockbrokers fueled tech stocks and in the 2000s, subprime mortgage derivatives helped finance housing. The equivalent today are zero commission brokers such as Robinhood Markets, fractional ownership and social media, all of which have empowered individual investors.

Such investors increasingly influence the overall market's direction, according to a recent report by the Bank for International Settlements, a consortium of the world's central banks. It found, for example, that since 2017 trading volume in exchange-traded funds that track the S&P 500, a favorite of institutional investors, has flattened while the volume in its component stocks, which individual investors prefer, has climbed. Individuals, it noted, are more likely to buy a company's shares for reasons unrelated to its underlying business—because, for example, its name is similar to another stock that is on the rise.

While such speculation is often blamed on the Fed, drawing a direct line is difficult. Not so with fiscal stimulus. Jim Bianco, the head of financial research firm Bianco Research, said flows into exchange-traded funds and mutual funds jumped in March as the Treasury distributed $1,400 stimulus checks. "The first thing you do with your check is deposit it in your account and in 2021 that's your brokerage account," said Mr. Bianco.

Facing the future

It's impossible to predict how, or even whether, this all ends. High-priced stocks could eventually earn the profits necessary to justify today's valuations, especially with the economy's current head of steam. In the meantime, more extreme pockets of speculation may collapse under their own weight as profits disappoint or competition emerges.

Bitcoin once threatened to displace the dollar; now numerous competitors purport to do the same. Tesla was once about the only stock you could buy to bet on electric vehicles; now there is China's NIO, Nikola, and Fisker, not to mention established manufacturers such as Volkswagen AG and General Motors that are rolling out ever more electric models.

But for assets across the board to fall would likely involve some sort of macroeconomic event, such as a recession, financial crisis, or inflation.

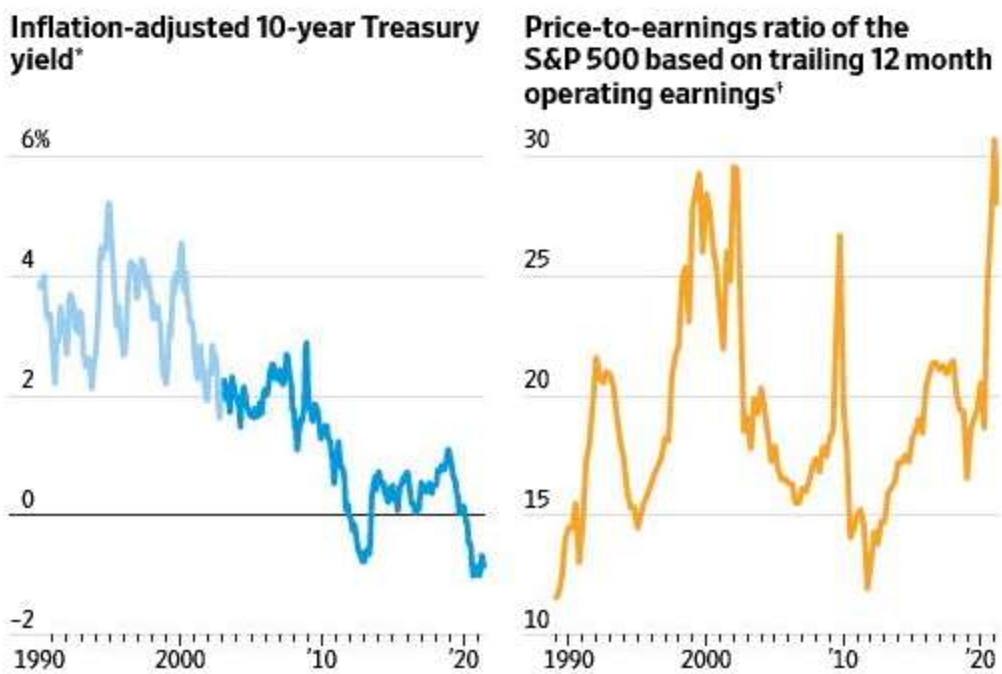
The Fed report this past week said the virus remains the biggest threat to the economy and thus the financial system. April's jobs disappointment was a reminder of how unsettled the economic outlook remains. Still, with the virus in retreat, a recession seems unlikely now. A financial crisis linked to some hidden fragility can't be ruled out. Still, banks have so much capital and mortgage underwriting is so tight that something similar to the 2007-09 financial crisis, which began with defaulting mortgages, seems remote. If junk bonds, cryptocoins or tech stocks are bought primarily with borrowed money, a plunge in their values could precipitate a wave of forced selling, bankruptcies and potentially a crisis. But that doesn't seem to have happened. The recent collapse of Archegos Capital Management from reversals on derivatives-based stock investments inflicted losses on its lenders. But it didn't threaten their survival or trigger contagion to similarly situated firms.

"Where's the second Archegos?" said Mr. Bianco. "There hasn't been one yet."

That leaves inflation. Fear of inflation is widespread now with shortages of semiconductors, lumber, and workers all putting upward pressure on prices and costs. Most forecasters, and the Fed, think those pressures will ease once the economy has reopened and normal spending patterns resume. Nonetheless, the difference between yields on regular and inflation-indexed bond yields suggest investors are expecting inflation in coming years to average about 2.5%. That is hardly a repeat of the 1970s, and compatible with the Fed's new goal of average 2% inflation over the long term. Nonetheless, it would be a clear break from the sub-2% range of the last decade.

Slightly higher inflation would result in the Fed setting short-term interest rates also slightly higher, which need not hurt stock valuations. More worrisome: Long-term bond yields, which are critical to stock values, might rise significantly more. Since the late 1990s, bond and stock prices have tended to move in opposite directions. That's because when inflation isn't a concern, economic shocks tend to drive both bond yields (which move in the opposite direction to prices) and stock prices down. Bonds thus act as an insurance policy against losses on stocks, for which investors are willing to accept lower yields. If inflation becomes a problem again, then bonds lose that insurance value and their yields will rise. In recent months that stock-bond correlation, in place for most of the last few decades, began to disappear, said Brian Sack, a former Fed economist who is now with hedge fund D.E. Shaw & Co. He attributes that, in part, to inflation concerns.

The many years since inflation dominated the financial landscape have led investors to price assets as if inflation never will have that sway again. They may be right. But if the unprecedented combination of monetary and fiscal stimulus succeeds in jolting the economy out of the last decade's pattern, that complacency could prove quite costly.



*10-year Treasury yield minus 12-month change in consumer price index excluding food and energy before 2003, 10 year inflation-indexed Treasury yield thereafter †Quarterly data through Dec. 2020, last datapoint May 5, 2021
Sources: Federal Reserve Bank of St. Louis (Treasury yield); S&P Global (price/earnings ratio)

From Verdad on May 3rd:

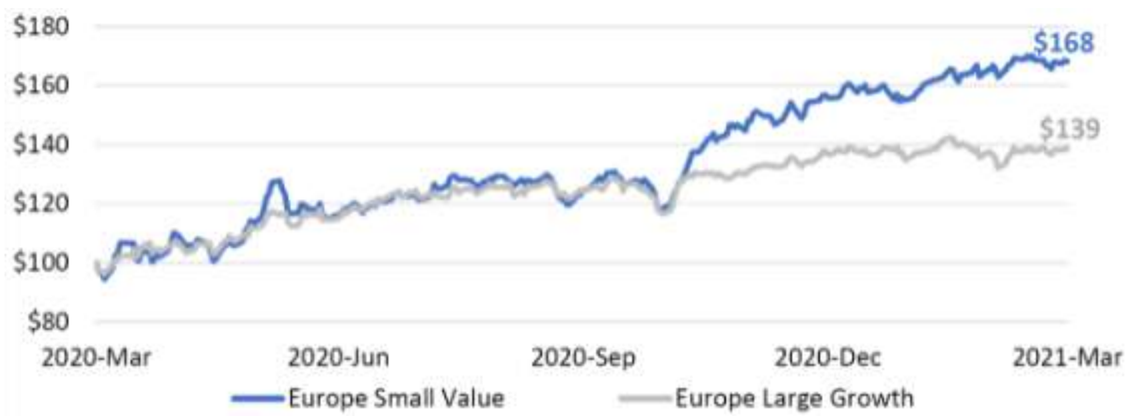
The Next Decade in European Value

Europe appears to be priced for significant value outperformance over the next decade. To fully capture this value premium, we believe investors should also have some exposure to developing economies in Eastern Europe (we don't).

By: Brian Chingono

European small value stocks have had an impressive run over the past year, up 68% over the 12 months ending March 31, 2021, compared to a 39% return among European large growth stocks.

Figure 1: One-Year MSCI Index Performance (March 31, 2021)



Source: MSCI

With small value having outperformed large growth by 29 percentage points over the past year, some investors without a European small value allocation may be wondering, “Did I miss it?”

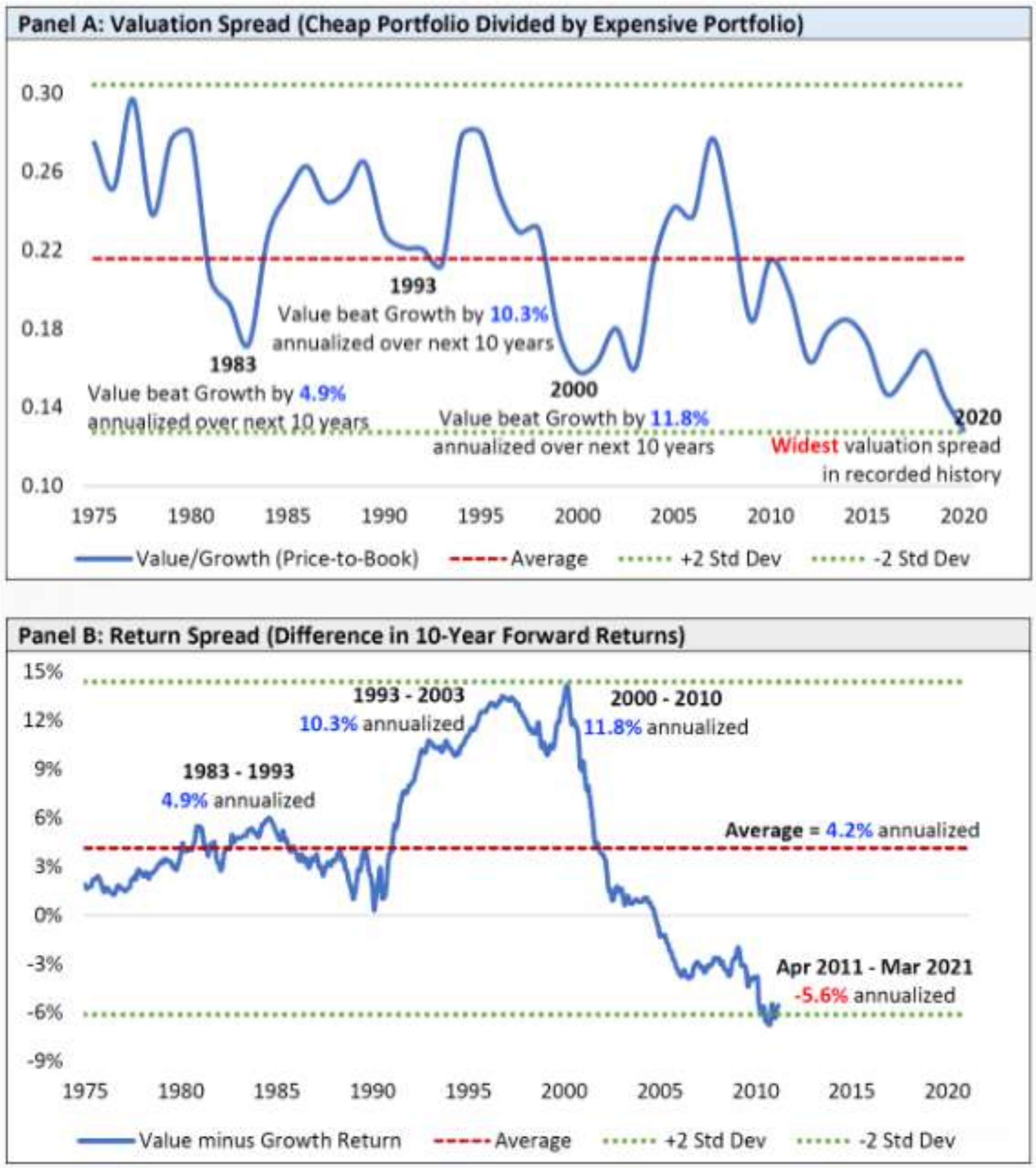
Based on the long-term evidence, we think the answer is an emphatic “No.” After a decade of drought, we believe value companies are currently priced at such extremely low levels that the next decade could potentially be the mother of all reversals in favor of value.

We believe there are a couple of things working in Europe’s favor today. First, Europe trades at a 25% discount to the US, based on P/E ratios. Second, Europe offers diversification benefits through a mix of mature economies in Western Europe and the Nordics, alongside developing economies in Eastern Europe that trade at a significant discount to their peers.

Figure 2 below sets the stage with historical context in Europe over the past 45 years, covering the full period of available data from Ken French’s library since 1975. Panel A shows the annual spread in valuations between cheap stocks and expensive stocks, defined as the price/book ratio of the value portfolio divided by the price/book ratio of the growth portfolio. For context, the average level of this spread is shown in the red horizontal line, and the green lines denote two standard deviations from the mean (i.e., extreme distances from the average). And Panel B below shows the spread in forward 10-year returns at each point in time since 1975, defined as the 10-year forward return of value stocks minus the 10-year forward return of growth stocks.

We can see evidence of mean reversion in Panel A, as value stocks have often delivered their strongest outperformance following periods when relative prices have dropped below their historical average. The troughs in relative prices in 1983, 1993, and 2000 were followed by annualized value outperformance of 4.9%, 10.3%, and 11.8% respectively over the next 10 years.

Figure 2: Valuation Spreads and Return Spreads (Jan 1975 to Mar 2021)



Source: Ken French website

Notice that the endpoints of the above charts are related. In 2020, value stocks in Europe reached their cheapest level of relative valuation in recorded history. And this opportunity exists because value stocks are now digging out from their worst decade of relative performance on record since 1975. Evidently, there is a lot of room for value stocks to run over the next decade as today’s extreme spreads revert toward their historical averages.

So how should investors position their Europe portfolio to maximize exposure to this value opportunity? As shown in the figure below, there is significant variation in valuations across countries within Europe. In the analysis below, we took the European countries with investment-grade sovereign ratings and we ranked those countries by their median equity valuations using a combination of price/book and EV/EBITDA ratios.

The countries on our list are based on a broad definition of Europe that combines Continental Europe (which has 40% of its landmass in Russia) with the island nations of the UK and Ireland. Perhaps the surest indication that these countries belong to the same "family" can be seen in their history of economic cooperation and sporadic family feuds.

Figure 3 clearly shows that developing economies in Eastern Europe are a necessary component of a deep value strategy in Europe. Four of the five cheapest countries are in Eastern Europe. Overall, Eastern Europe trades at a 29% discount to Western Europe in terms of price/book and a 41% discount in terms of EV/EBITDA. These Eastern European discounts increase to 54% and 43%, respectively, when compared against the Nordic region.

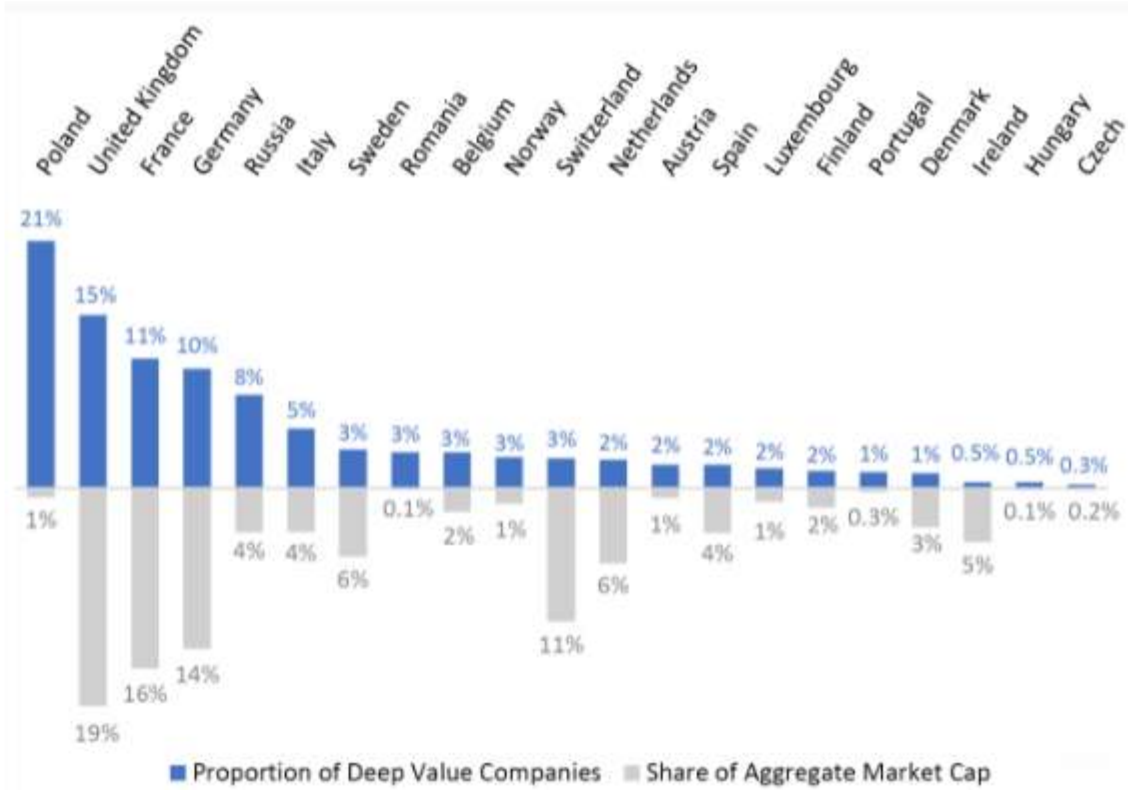
Figure 3: Valuations by Country in Europe (April 2021)

Country	Region	Govt. Debt	Price/Book	EV/EBITDA	Value Rank
Romania	Eastern	BBB-	0.86x	6.1x	1
Russia	Eastern	BBB-	1.24x	5.8x	2
Portugal	Western	BBB-	0.79x	7.4x	3
Poland	Eastern	A	1.54x	6.6x	4
Czech Republic	Eastern	AA-	1.41x	7.3x	5
Austria	Western	AA+	1.23x	8.3x	6
Luxembourg	Western	AAA	1.36x	9.3x	7
France	Western	AA	1.66x	8.4x	8
Italy	Western	BBB-	1.64x	9.2x	9
Belgium	Western	AA-	1.38x	10.4x	10
United Kingdom	Western	AA-	1.63x	10.2x	11
Ireland	Western	A	2.04x	9.1x	12
Norway	Nordic	AAA	1.62x	11.3x	13
Germany	Western	AAA	2.00x	10.2x	14
Spain	Western	BBB+	1.99x	10.8x	15
Hungary	Eastern	BBB-	2.09x	10.6x	16
Denmark	Nordic	AAA	2.08x	12.0x	17
Netherlands	Western	AAA	2.33x	11.6x	18
Finland	Nordic	AA+	2.74x	11.2x	19
Switzerland	Western	AAA	1.97x	14.4x	20
Sweden	Nordic	AAA	3.59x	9.8x	21
	Eastern		**1.30x**	**6.1x**	
	Western		**1.82x**	**10.4x**	
	Nordic		**2.84x**	**10.8x**	

Sources: Capital IQ, Moody's Investors Service

As with many of the best opportunities in the market, European deep value is capacity constrained. The chart below shows the same list of countries ranked by their representation in Europe's deep value universe (defined as the proportion of deep value companies located in each country). Below these blue bars, we show the depth of each market, measured in terms of each country's share of Europe's aggregate market capitalization.

Figure 4: Deep Value Representation and Market Depth by Country (April 2021)



Source: Capital IQ. The deep value universe is defined as the cheapest quartile of companies in Europe based on a combination of price/book and EV/EBITDA.

We believe two key points are demonstrated in Figure 4. First, although Eastern European countries like Poland, Russia (a kleptocracy we wouldn't touch), and Romania represent a small share of aggregate market capitalization, they contain a disproportionately large share of deep value companies. Overall, Eastern Europe represents 5% of the continent's market cap, but this region contains 33% of Europe's deep value companies. The upshot is that meaningful deep value exposure simply cannot be achieved through market cap–weighted indices.

Second, a deep value approach in Europe must be capacity constrained to maximize exposure to the cheapest opportunities across the continent.

With the flexibility to achieve broad diversification by country, and the ability to access cheap opportunities that are priced at historically low levels, we believe that a deep value strategy focused on Europe could be poised for significant outperformance over the next decade, as valuation spreads revert to their long-term average.

Warren Buffett at Berkshire Hathaway's May 1st Annual Meeting:

"We're seeing very substantial inflation - it's very interesting. I mean, we're raising prices. People are raising prices to us. And it's being accepted.....The costs are just up, up, up. Steel costs, you know, just every day, they're going up.....But there's more inflation going on than-- quite a bit more inflation going on than people would have anticipated just six months ago or thereabouts."

Positions

NEWT - We sold this BDC on 5/24 for 5 clients @ 33.06 in order to purchase TUP.

While High Dividend Opportunities rates NEWT as a Buy Under 36 as of June 1st, this from BDC Buzz on the 25th: "... NEWT continues to outperform due to increasing its 2021 dividend forecast of $3.00 to $3.30 (previously $2.40 to $2.90). Please be careful at these price levels that will likely remain elevated until the company provides guidance for its 2022 dividends in October or November and will be discussed in the updated NEWT Projections & Pricing report. NEWT's earnings are expected to drop by around 31% (from $3.01 in 2021 to $2.09 in 2022) which would imply dividends paid will drop back to previous levels. ..."

The chart to the right is BDC Buzz's listing of the Best-Priced BDCs from the 24th:

	Current Price	LT Target	Difference		Current RSI
SUNS	15.12	16.50	-8.4%	SUNS	42.91
TSLX	22.05	24.00	-8.1%	AINV	43.47
ORCC	14.41	15.50	-7.0%	GSBD	44.66
GSBD	19.26	20.50	-6.0%	PNNT	49.18
GBDC	15.58	16.50	-5.6%	TPVG	49.93
HTGC	17.03	18.00	-5.4%	PFLT	49.98
OCSL	6.69	7.00	-4.4%	MAIN	50.32
ARCC	19.24	20.00	-3.8%	HTGC	50.71
TPVG	15.10	15.65	-3.5%	TSLX	52.51
CGBD	13.61	14.00	-2.8%	CGBD	52.53
FDUS	17.08	17.50	-2.4%	ARCC	53.67
PFLT	12.45	12.50	-0.4%	GAIN	54.35
PNNT	6.35	6.35	0.0%	OCSL	55.56
AINV	14.07	14.05	0.1%	FDUS	55.72
NMFC	13.15	13.00	1.2%	TCPC	56.48
FSK	21.65	21.00	3.1%	GLAD	56.53
GAIN	13.74	13.00	5.7%	ORCC	56.63
TCPC	14.64	13.50	8.4%	GBDC	57.03
GLAD	10.92	10.00	9.2%	NMFC	57.17
CSWC	24.92	22.50	10.8%	MRCC	59.03
MAIN	41.02	37.00	10.9%	PSEC	59.74
MRCC	10.76	9.50	13.3%	CSWC	63.91
PSEC	8.29	7.00	18.4%	FSK	66.28
NEWT	32.88	26.50	24.1%	NEWT	74.87

OPCH - We purchased this Infusion & Home Care Management IVA System pick on 5/17 for 4 clients @ 17.09, and 1 @ 17.12.

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
05/11/2021	2	Rademacher John, Shapiro...		12,500
05/10/2021	1	Pate R Carter		855

TUP - We purchased this Housewares IVA System pick on 5/24 for 4 clients @ 26.08, and 1 @ 26.33.

Insider purchases:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
05/10/2021	1	Sheehan Karen		2,000
05/07/2021	2	Minges Timothy, Cuesta Pa...		8,885

VER - On 4/29 it was announced that VEREIT was being bought for stock by Realty Income (O), the largest and widely considered best managed Net Lease REIT. On 5/24 we sold VER for 4 clients @ 46.89. O closed that day at 68.14. As of the May issue, Forbes Real Estate Investor rated O a Hold with a Buy Under 61.75.