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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JANUARY 11, 2021

A Real Humdinger

"I am doubling down, because as prices move further away from trend, at accelerating speed and with growing speculative fervor, of course my confidence as a market historian increases that this is indeed the late stage of a bubble… A bubble that is beginning to look like a real humdinger." – Jeremy Grantham, co-founder of GMO

Legendary value investor Jeremy Grantham is credited with predicting the 2000 and 2008 downturns. He argues that today's bull market, born in 2009, "has finally matured into a fully-fledged epic bubble" that can be considered one of the great bubbles of financial history, akin to the South Sea bubble and those of 1929 and 2000. Grantham goes on to say "These great bubbles are where fortunes are made and lost — and where investors truly prove their mettle."

I believe (and have for some time) this is a financial bubble of epic proportions and they are everywhere: equities, corporate credit, cryptocurrencies, residential real estate. Maybe the bubbles grow larger. Maybe there's another year (feel lucky?). Or maybe not. Undoubtedly, bubbles are fun, and they make us all feel like financial geniuses. But remember that bubbles always pop they 'take the elevator down' creating a world of hurt. Finally, the thing about investor psychology (hubris) is that everyone seems to think they'll get out in time… but they don't.

THIS WEEK

- AS THE BUBBLE GROWS
- A BLUE PEACH
- DEBT CANCELLATION?

PORTFOLIO STRATEGY

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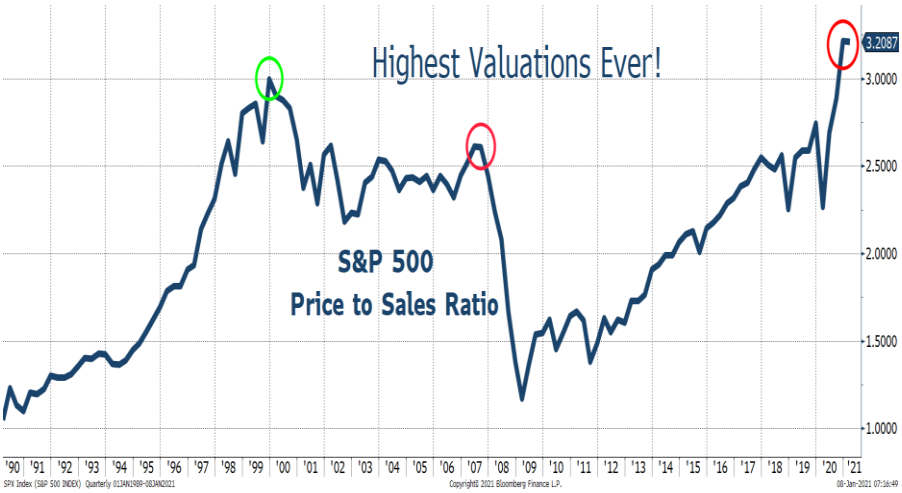
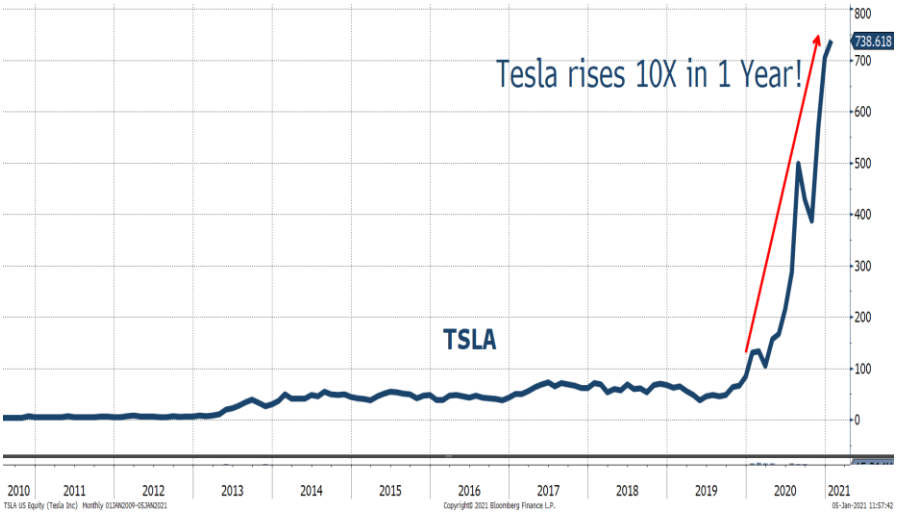
As displayed above, the S&P 500 price/earnings ratio at 29.85 has exceeded the level reached during the dot-com bubble with the economy in tatters. This is completely without precedent.

Likewise, the price/sales ratio confirms that stocks are priced to more than perfection. As shown below, the price/sales ratio – which, by the way, cannot be manipulated by accounting tricks or stock buybacks – is at the highest level ever!



Undoubtedly, there are many disruptive high-profile companies that have a good story to tell about new technology and major shifts in consumption. But don't confuse companies with their stock prices, which have experienced unsustainably extreme moves. Tesla is the posterchild. Tesla, which only recently generated any free cash flow, has a price/earnings ratio of 1223 and is now the sixth largest stock in the S&P 500. In 2020, Tesla delivered 500,000 cars. Seems like a big number but the auto industry as a whole delivered over 73 million cars last year.

This is the reality. Tesla remains a very small player in the auto space with a miniscule 0.7% market share. Yet, Tesla's market cap of $750 billion is higher than the combined market cap of of Toyota, Volkswagen, Daimler, GM, BMW, Honda, Ford and Fiat Chrysler. The graph below tells the story.



Yes, yes, electric cars are here to stay, but there will be intense competition in the electric vehicle (EV) space with no barriers to entry. The traditional automakers are now investing billions of dollars in EVs. Volkswagen alone has

earmarked $86 billion over the next five years to the EV cause. Enter Apple. Apple's EV project, codenamed "Titan," is expected to start electric vehicle production in 2024. Yet the world rewards Tesla with a $750 billion market cap. This amounts to over $1.5 million per car sold each year versus $9,000 per car for GM. I have been told Tesla makes a fine EV, but seriously? All I can say is irrational exuberance is on steroids and Wall Street has gone berserk!

Tesla Auto Deliveries vs. All Global Automakers

Source: Wolf Richter

Moving on. The single most dependable feature of the late stages of the great bubbles of history has been really crazy investor behavior, especially on the part of individuals. Today, investors' psychology is euphoric, and valuations are simply a representation of the psychology – and it's the same psychology that actually drives the bubble.

IPOs are on fire as investors look for the next "get rich quick" trade. One need not look further than Airbnb, which now has a market cap of $90 billion – larger than Marriott, Hilton and Hyatt. Yet, Airbnb has lost money every year, and the company's cumulative losses total $2.8 billion since 2008. Or how about DraftKings, up 340%. It's all the same story — liquidity, speculation and momentum-chasers.

There are now approximately 250 special purpose acquisition companies (SPACs) – "blank-check companies" for IPOs – have raised a record $82.1 billion in 2020, up from $13.5 billion in 2019. Now that is what I call speculation!

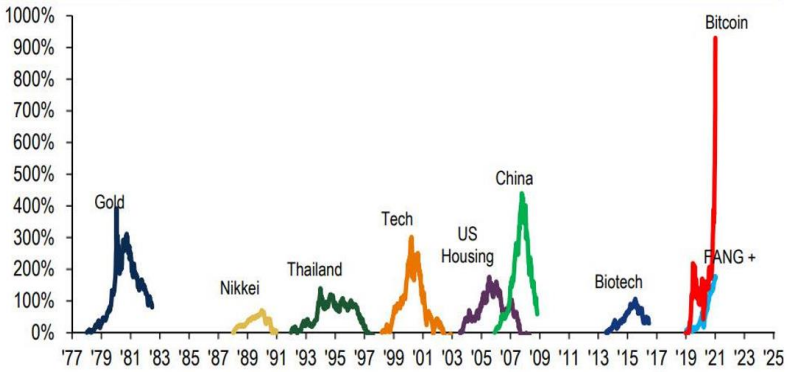
Then look at the disconnect between the giddy investors and the misery for the broad population. Last year, individual investors opened up more than 10 million new brokerage accounts when there were over 20,000,000 unemployed

Americans and 357,000 deaths – more than doubling all the U.S. fatalities in World War I (116,000) and more than World War II (nearly 292,000). Yet, the stock market rose. Not just a rebound. A surge.

With the first pandemic in 100 years and the economy in tatters, it took little more than six months for the S&P 500 to rise 65%. (see graph above) What do you think a Martian would say if he landed on planet Earth to see how many people made a killing? Then again, the market is not a moral compass. But just remember what happened to Gordon Gekko at the end of *Wall Street*. Regardless, this has been very good news for the top 10% of the income strata that own 84% of the equities and top 1% who account for half of all equity holdings.

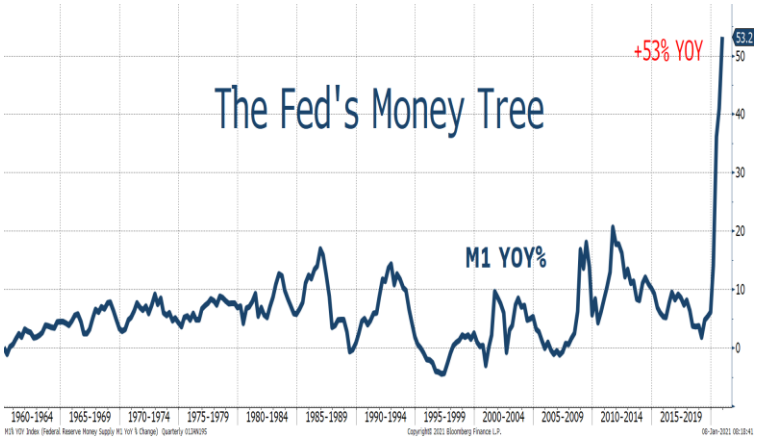
Another poster child for the "everything bubble" is Bitcoin, which shot above $40,000 last week. Do you think it's normal for Bitcoin to have doubled in a three-week span? Yet, as was the case with the dot-com bubble, if you tell anyone that cryptocurrency is in a bubble, you'll hear a mouthful about how you don't know anything about anything. Another sign of a bubble: denial.

BitCoin: The Mother of All Bubbles



Source: Bank of America

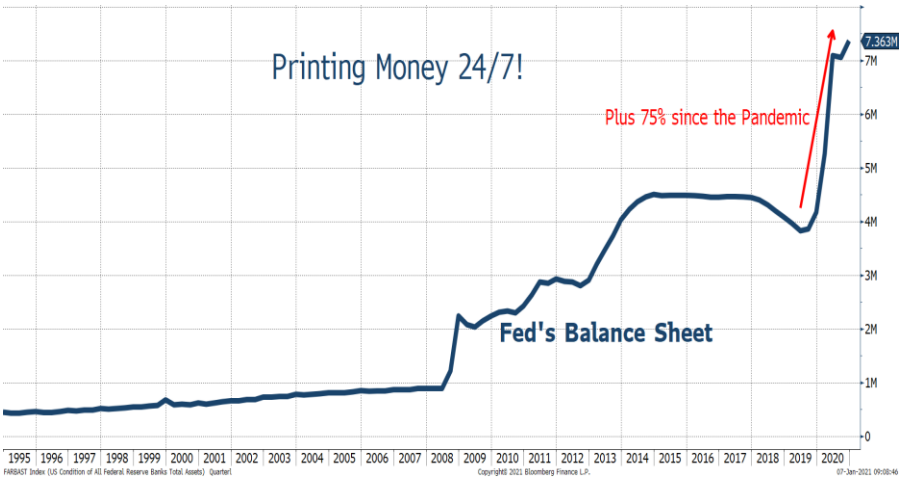
But, then again, how can assets not be in a bubble, when M1 is running at a red-hot 53% year-over-year pace. In the 1970s and 1980s, M1 never exceeded 10%. Back then, most of the inflation was in goods and services. Today, most of the inflation is in assets, financial and real alike.



This is the crux of the matter. For the capital markets and asset prices in general, the only thing that matters is stimulus. The Fed's balance sheet, as shown below, remains in overdrive with the printing presses running 24/7. The most recent Federal Open Market Committee (FOMC) minutes showed that the $120 billion per month of asset purchases aren't

going away any time soon. As it stands, the Fed has already boxed itself in, stating that it will not touch rates for three more years, even if inflation crosses above 2% and the jobless rate drops below 4%.

Meanwhile, as the printing presses are running nonstop, fiscal stimulus is being pushed to the metal. Frankly, never in my life would I have believed that investors would be cheering a Pelosi-Schumer tag team. But as I said, it's all about stimulus, and we are about to get a lot more of it. Remember that President-elect Joe Biden called the $900 billion package that just passed a "down payment." Now he can make good on that promise. So look for an additional $1-2 trillion or so, with $2,000 checks per person (with incomes $75,000 or less) instead of $600.



The high probability of more fiscal largesse may mean more "oomph" for risk-on assets, valuations be damned. Recall what the "red wave" did to market psychology and "animal spirits" following the November 2016 election. Of course, with the "blue wave" there are many differences, but there is much more certainty now around the policy outlook.

Here is the paradox. Asset valuations and sentiment can only be justified by the super low bond yields and more and more liquidity engineered by central banks! But you need to also understand that that while zero or negative interest rates are a boon for risk assets, the reason interest rates are so low is due to stagnant economic growth. It shouldn't be lost on anyone that without the government training wheels, real GDP would be contracting again. Good grief.

While the markets are totally disconnected from fundamentals and economic reality, it is important to understand, as Bob Farrell would say, "exponentially rising markets can go further than you think." That is indeed the case. But also remember, bubbles "do not correct by going sideways."

So the $20 trillion something question is when will the "everything" burst? And what will be the catalyst? I have not a clue, but Mr. Grantham believes that time is running out.

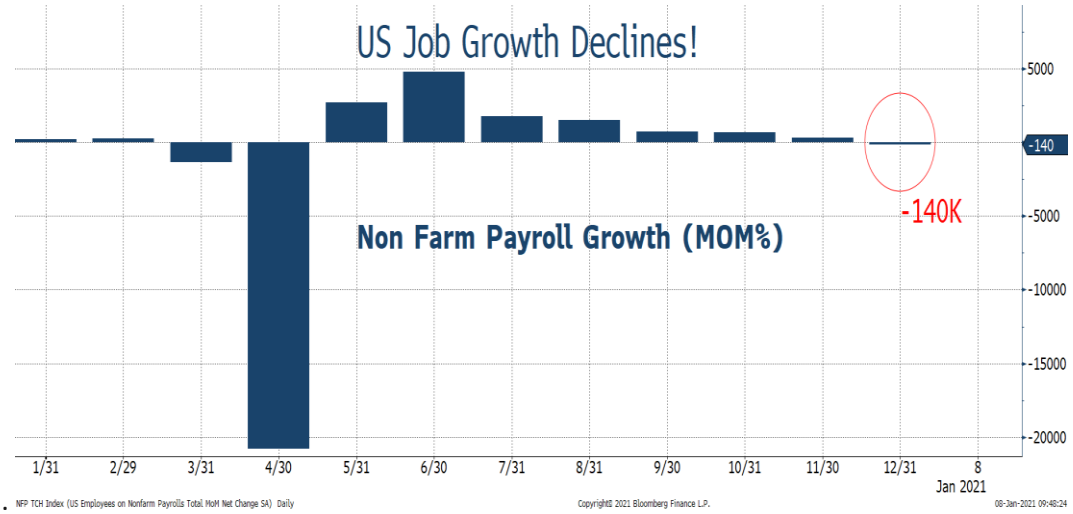
"My best guess as to the longest this bubble might survive is the late spring or early summer, coinciding with the broad rollout of the COVID vaccine." – Jeremy Grantham

So, in this epic financial bubble, invest wisely, because this is a market made for speculators, not investors. Investors focus on fundamentals and valuation, and they matter not today. Speculators focus on liquidity, leverage and momentum, and these have been the primary influences on market pricing and this process is ongoing.

AS THE BUBBLE GROWS

Clearly economic data matters not in a liquidity driven mania. In fact bad data is good for asset prices because it ensures more liquidity and uber easy fiscal and monetary policy. To wit: last week, the ADP Report (private payrolls only) and the non-farm payroll report showed job declines in December. The headline non-farm payroll report came in at -140,000 with private payrolls down 95,000. This was the first setback since April and surprised a consensus that was looking for a modest 50,000 increase. The unemployment rate held at 6.7%, halting a string of seven straight drops. Not surprsingly, the weakness was concentrated in restaurants, bars and other businesses hit hard by fresh pandemic restrictions. Nevertheless, I don't think I've ever seen a day when non-farm payrolls plunged and missed the consensus by a wide margin while equity prices soared to record highs! But again… Stimulus. Stimulus. Stimulus.

Even so, President-elect Joe Biden will inherit an economy that's down almost 10 million jobs compared with before the pandemic. The pace of hiring will be hard-pressed to accelerate until a meaningful portion of the general population is vaccinated, with distribution in the U.S. running slower than planned and potentially holding back the recovery.



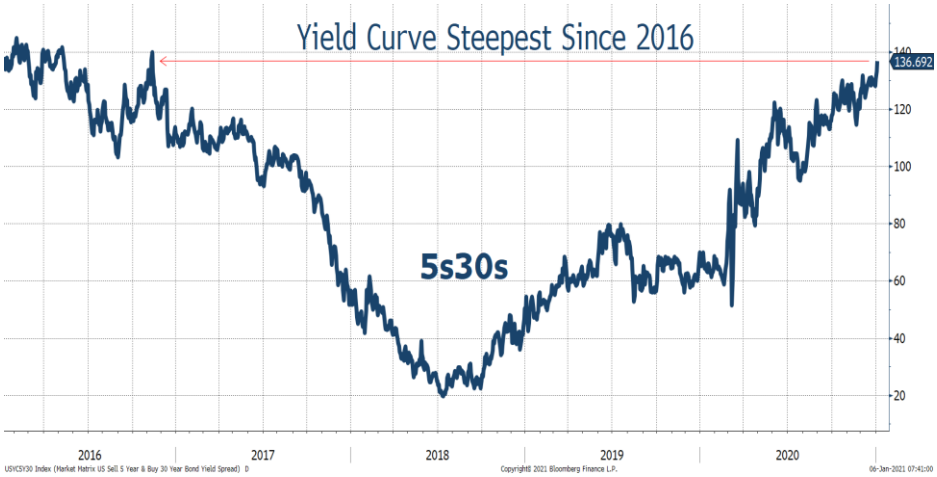
A BLUE PEACH

Georgia, once a hotbed of conservatism, elected two self-proclaimed leftists last week. This leaves the Democrats in controlling the House, Senate and White House. Amazingly, in only four years, the country has done a complete 360-degree turn, from a GOP sweep in 2016 to a Democratic sweep in 2021. As such, the Biden initiatives will have a much

greater chance of being implemented. This could mean a sea-change from the right (tax cuts, deregulation) to the left (spending boom, reregulation).

The markets have reacted quite predictably. Bonds have reacted to the prospect of much more fiscal relief, with the 10-year Treasury yields soaring 20 basis points to 1.11% — breaking above the 1.0% threshold for the first time since March. The long bond has risen 24 basis points to 1.88%.

With the long end selling off and the front end anchored to the Fed, the yield curve has steepened sharply.



As we move forward, further coronavirus stimulus will no doubt be passed and will be a welcome development for individuals grappling with job losses and furloughs. That said, I believe the markets are way ahead of themselves on the Senate flip meaning endless fiscal stimulus ahead. Not everyone in the Democratic Party in the House and the Senate is that far left of center. In fact, the Democrats only have a 10-seat majority in the House and the Senate is tied 50-50 with Vice President-elect Kamala Harris as the tie-breaking vote. This is the weakest majority a government has ever had — at least back to 1900.

Here's the point. Nothing big can really happen without 60 votes in the Senate and even getting 50+ may be tougher than assumed given that there are two or three moderate Democrats in the Senate who are unlikely to sign onto endless fiscal stimulus.

DEBT CANCELLATION?

For years I have argued that for yields to rise in a sustained manner, debt needs to be reduced via debt moratorium, debt jubilee (if you are religious) or restructuring. Apparently, I am not the only one with those thoughts. Take a look at the excerpt from an article in the Financial Times titled, *"We Need to Think About Debt Cancellation,"* penned by bond fund CIO Mark Dowding at BlueBay Asset Management.

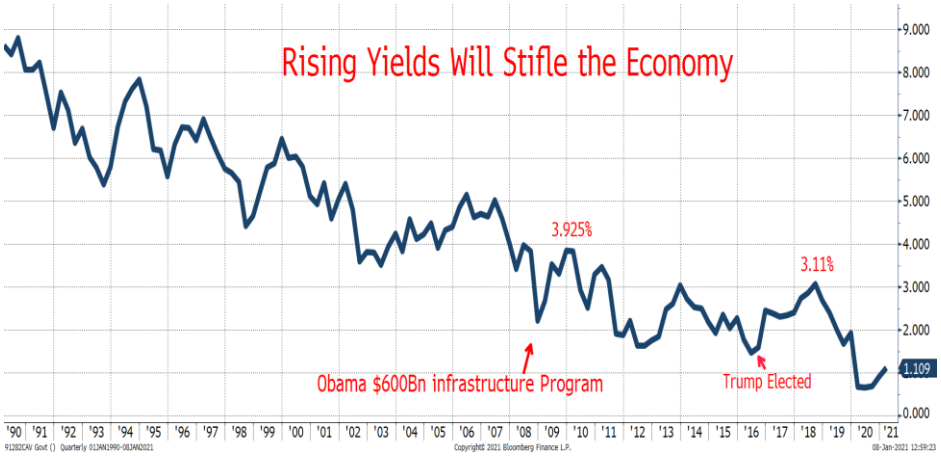
> *"When a fixed income asset manager like me is saying there is too much debt in the world, there must be something seriously wrong. Many EU countries have already breached the bloc's fiscal rules on debt levels and there is little room for maneuver. Debt cancellation needs to be an option in the toolkit."*

Wow.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

I have been bullish on bonds for a long time. Last week the benchmark 10-year Treasury yield pierced 1% and there could be more upside pressure. But to me, this is nothing more than short-term noise. Yes, we will get a bigger fiscal boost for the first quarter (Q1) but that is most likely now in the price.

Let's take a step back and look at the big picture. The big reason why rates cannot rise in a "sustained" manner is debt. The economy-wide debt-to-GDP ratio in the U.S. has soared 40 percentage points this year to a record 366% — adding as much in three quarters to this ratio as in the prior 18 years combined. The government debt-to-GDP ratio is now up to 128%. The fiscal deficit in 2020 will exceeded $3 trillion. All the debt that has been accumulated this past year is deflationary, not inflationary. In fact, every time that rates have risen in the past, these market yield spasms are ultimately snuffed out by the debt-servicing pain in a massively overindebted economy.



Let's take a look at a couple of periods over the past decade when rates did rise.

The Obama administration's $600 billion infrastructure package in February 2009 pressured the 10-year Treasury yield higher from 2.7% to 4.0% by April 2010. But then the downward pull from the fundamentals of structurally weak growth and excessive debt took the yield back down to 1.4% by July 2016.

Then, in November 2016 Trump's election win drove yields up to 2.6%. By April 2017, the 10-year was back down below 2.2%.

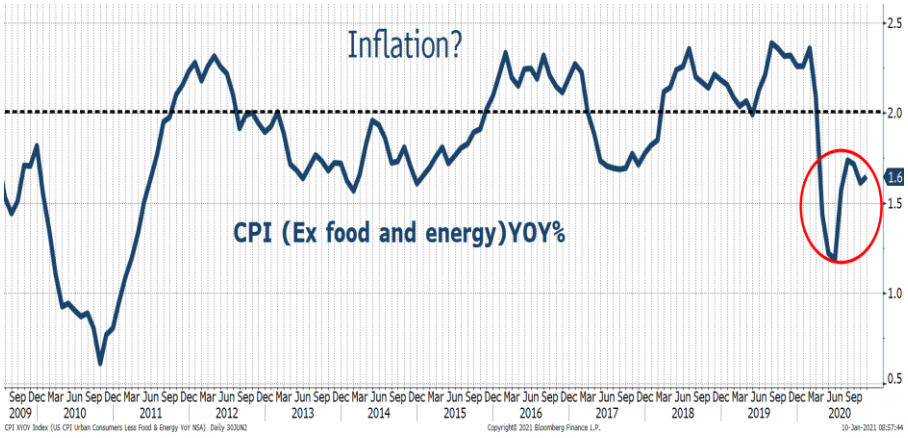
Then came the tax cuts and the yield was back to 3.2% by October 2018. By the end of 2019, the yield had sunk to 1.9% and that was before the pandemic. The 10-year Treasury yield reached an all-time low of 0.6% on April 21 of this year. Now we are a smidge above 1.0%.

This is the point. If you add up all the sell-off days for the 10-year Treasury yield from the end of the Great Recession (June 2009), to the end of the expansion (February 2020), the cumulative yield increase has been 5,000 basis points. Yet, over the entire period, the 10-year Treasury yield fell from 3.53% to 1.65%. Yes indeed, buying the dips has been a very wise trade.

It should also be emphatically highlighted that over this period we had a flat-to-negative fed funds policy rate, a five-fold surge in the Fed balance sheet, massive tax cuts, unemployment falling to a 50-year low, the stock market quintupling, and yet, core inflation could barely top 2% at the peak. Get this. The yield on the 10-year Treasury over the entire period managed to decline nearly 190 basis points. The ability for inflation and interest rates to rise speaks to the secular deflationary headwinds from aging demographics, accelerating technological change, labor insecurity, extreme income and wealth inequalities and excessive debt levels. Think about this.

As we move further into Q1, the consensus is that the economy will boom with added stimulus. Undoubtedly, if the Biden administration adds another $1-2 trillion, the economy will pop with some forecasting 5-7% growth in 2021. So welcome to a government- and debt-fueled economic boomlet. But remember, government assistance is a one-quarter wonder and without stimulus, the economy is still in the sick bay. What happens when the stimulus ends again? What happens if we get with a reversal in investor risk appetite (the bubble bursts)?

Over the past week, the bond markets have become concerned that the endless fiscal largesse and money printing moving into overdrive will drive prices higher. Yet, as discussed above, the Fed has been trying to manufacture inflation for the past decade to no avail. So, while the fear of higher inflation is ever present, there is no evidence yet. Further, I think any near-term or even intermediate-term inflation risk is minimal. To wit: rents account for over 30% of the Consumer Price Index (CPI) and are rapidly disinflating, now running below 2% on a year-over-year basis (was 3.4% a year ago). While oil prices have risen, energy is only 6% of the CPI.



Moving forward, from my perch there is much more room for disappointment over the expected V-shaped recovery than there is upside potential. From a portfolio perspective, I think there is a cap on Treasury yields, with no Fed risk, the extremely steep yield curve and the gigantic interest rate spread between the U.S. and other sovereigns around the

world. As such, credit unions should continue to systematically invest excess cash reserves while maintaining a duration-appropriate, diversified ladder strategy. Sell-offs should be capitalized upon.

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