MEDALLION WEALTH MANAGEMENT

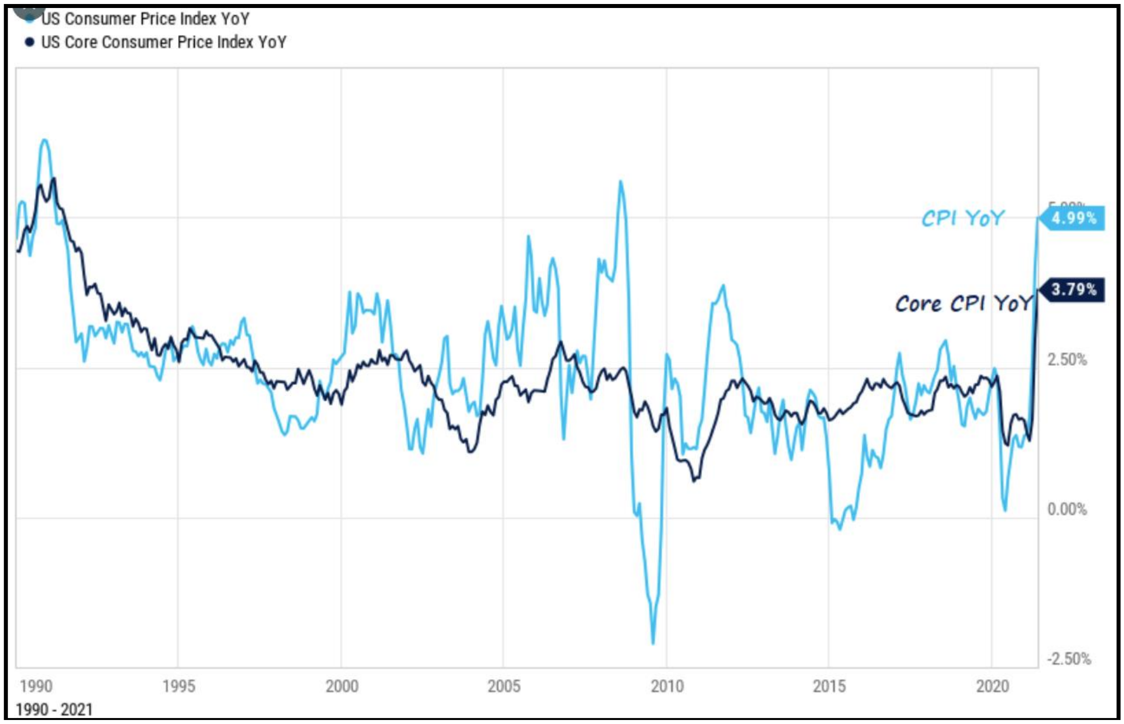
June 2021 Market Commentary

"Man, It's a Hot One
Like seven inches from the midday sun"

Smooth by Santana & Rob Thomas
https://www.youtube.com/watch?v=6Whgn_iE5uc

Hot and Cool, best describes our current economy and the performance of Carlos Santana and Rob Thomas. IMHO, one of the best summertime music videos ever.

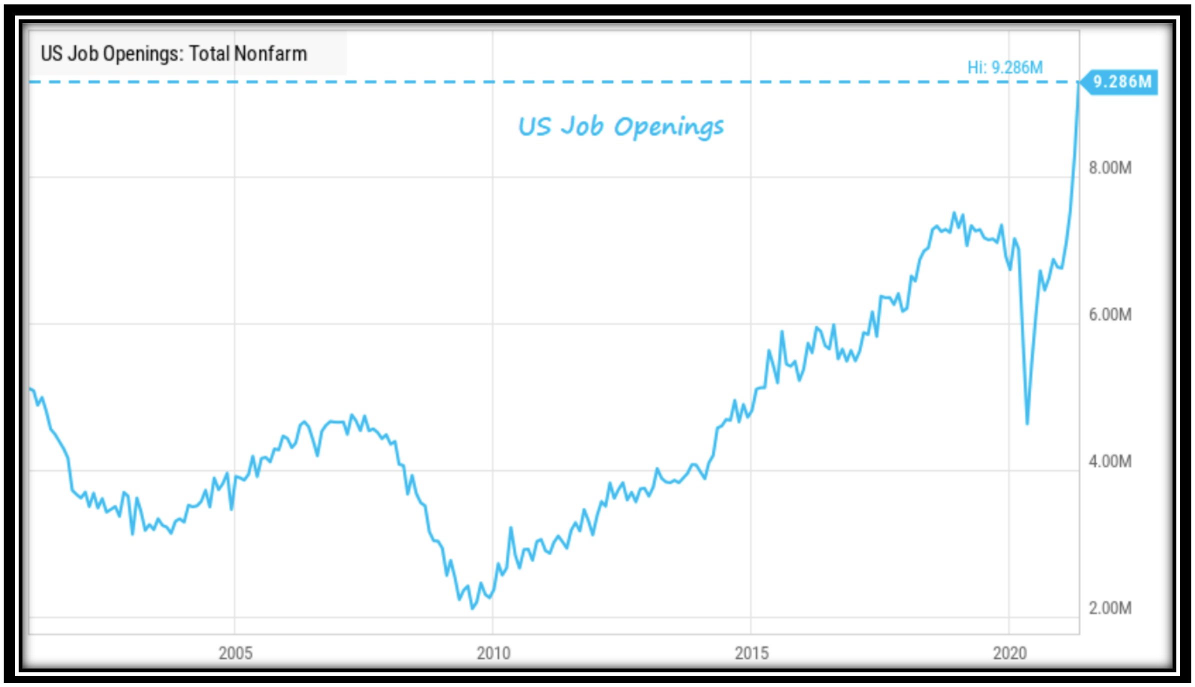
First, the Hot. Last week we found out what many of us already knew, that inflation is running hot. The Consumer Price Index (CPI) is running at a 5% annual rate, while Core CPI (ex volatile food and energy) rose at an equally robust 3.8%. That's the highest Core rate in 29 years!



Now the Fed will tell you not to worry your silly little head, this inflation is **"transitory"** and is absolutely nothing to be worried about. Considering that the economy was shut down last year, it's totally normal that year-over-year inflation readings would be elevated, but as the months roll forward we'll see many of these price spikes reverse.

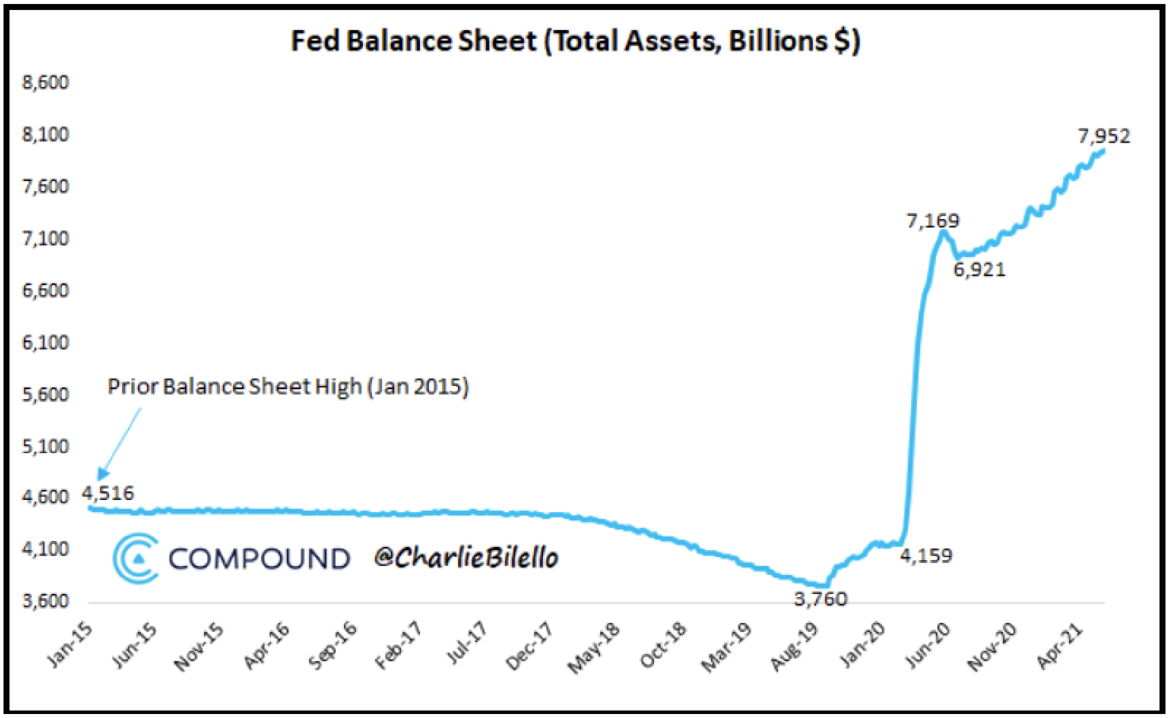
I tend to agree with most of the transitory line of reasoning. Shortages in chips will be addressed and we'll eventually see supplies catch up to demand. Also, the cure for high prices is often high prices, and we are already starting to see demand wane. Auto sales dropped 8% in May, and in April existing home sales fell for the third straight month, while new housing starts slid by 9.5%.

But, I don't believe one of the most important inflation components is transitory. That would be wages. Wages are up 8.8% over the last two years, or 4.3% annualized. With the push for $15 minimum wages, and the record number of job openings, it is hard to believe that wage increases are transitory and will reverse.



If inflation is "transitory" does that mean that inflation in financial assets is also transitory? That is the trillion-dollar question. The Fed has rescued us from the economic collapse of Covid-19 by blowing up their balance sheet buying assets of all types, especially Treasuries. On the strength of both home and stock market appreciation, household net worth has reached a high of $136.9 trillion.

In the annals of history we have rarely seen a governments balance sheet explode like this. Usually a government only resorts to this type of balance sheet expansion in times of war, and this time we had the war against Covid.

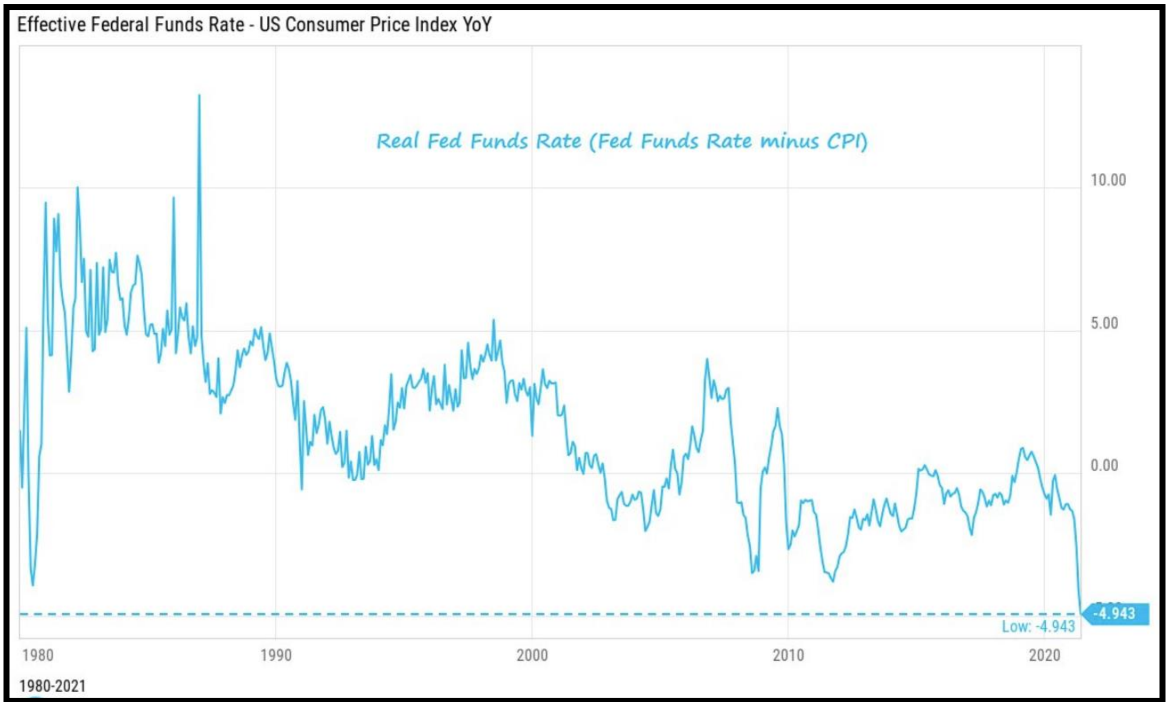


Where did the money go? Not guns and tanks, but certainly financial assets. Let's look at what happens to financial assets when the Fed goes on a buying spree. Here are the five year annualized total returns on some common assets (I'm excluding crypto-currencies, MEME stocks, and SPACS). Stocks and corporate bonds are at all-time highs, but remember; don't confuse a bull market with intelligence.

<u>Five-Year Annualized Total Returns:</u>
S&P 500 **17.28%**
NASDAQ QQQ **26.72%**
High-Yield Bonds **6.12%**
Aggregate Bond Index **3.12%**
Gold **7.62%**

Now for the cool. Generally when we have inflation you would expect interest rates to rise. This was certainly the case earlier this year as the 10-year Treasury rose from 2020's low of 0.54% to this years high of 1.74%. But of late yields have been falling, and surprisingly fell to 1.45% when the high CPI numbers were released.

Maybe the market believes that inflation is transitory, or maybe the market is sniffing out slower economic growth later this year, or maybe it believes that the Fed can't possibly let rates rise because individuals and the government could never repay their debts at higher rates. Who knows? What we do know is that we currently have the lowest Real Fed Funds Rate (Fed Funds minus CPI) in history at a minus 4.9% (tied with 1975's -4.9%). That means any money you have sitting around in cash is losing 4.9% after inflation.



The Fed and other global central banks are playing a game that is certainly unprecedented. We have never seen central banks so keen to court inflation. Inflation is simply the devaluing of a currency, as prices rise the value of your currency declines. The Fed's stated goal is to devalue the U.S. dollar by 2% per year, but they are currently willing to let the pace of devaluation accelerate substantially above that 2% rate. Debasing a currency is a risky game, and it doesn't just manifest itself in higher prices, it also tears at the fabric of society.

I know that history doesn't repeat, but as they say, it sometimes rhymes.

Entering WWI in 1914, the Germans expected a short war and speedy victory, which fully justified them taking on enormous sums of debt to finance the war effort. Unfortunately for them it didn't quite work out that way. The end of WWI led to one of the greatest hyperinflations of all time as the Weimar Republic collapsed under the weight of 41% **daily** inflation. Lest we forget…

Some excerpts from Thomas Mann in "Culture and Inflation in Weimar Germany". *"A straight line runs from the madness of the German inflation to the madness of the Third Reich...In those days the market woman who, without batting an eyelash, demanded a hundred million for an egg, lost the capacity for surprise. And nothing that has happened since has been insane or cruel enough to surprise her. It was during the Inflation that the Germans forgot how to rely on themselves as individuals and learned to expect everything from "politics", from the "state", from "destiny". They learned to look on life as a wild adventure, the outcome of which depended not on their* *own effort but on sinister, mysterious forces. The millions who were then robbed of their wages and savings became the "masses" with whom Dr. Goebbles was to operate. Inflation is a tragedy that makes a whole people cynical, hardhearted and indifferent. Having been robbed the Germans became a nation of robbers."*

Or as Klaus Mann wrote in 1923, *"The bloody war is over: let's enjoy the carnival of the inflation. It's loads of fun and paper, printed paper, flimsy stuff – do they still call it money? For five billion of it, you can get a one dollar. What a joke! The Yankees are coming but as peaceful tourists this time. They purchase a Rembrandt for a sandwich and our souls for a glass of whiskey. Krupp and Stines get rid of their debts, we of our savings. The profiteers dance in the palace hotels."*

And as John Maynard Keynes wrote, *"Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continued process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become "profiteers," who are subject to the hatred of the bourgeoisie, whom the inflationism has impoverished. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors become so utterly disordered as to be almost meaningless; and* ***the process of wealth-getting degenerates into a gamble and a lottery."***

When I look at our society today there appears to be a casino mentality towards investing. There is an increasing reliance on the government, and an increasing call to confiscate wealth and break-up successful corporations. I hope I'm wrong.

In the meantime, what's an investor to do? Enjoy the good times, be thankful for your record high net worth, but don't get greedy. Morgan Stanley's Market Timing Indicator is ringing a bell. It is based on valuation, fundamentals (econometrics), sentiment/liquidity, and momentum/breadth. Remember that all models are wrong, but some are useful.

S&P 500 vs Morgan Stanley's Market Timing Indicator

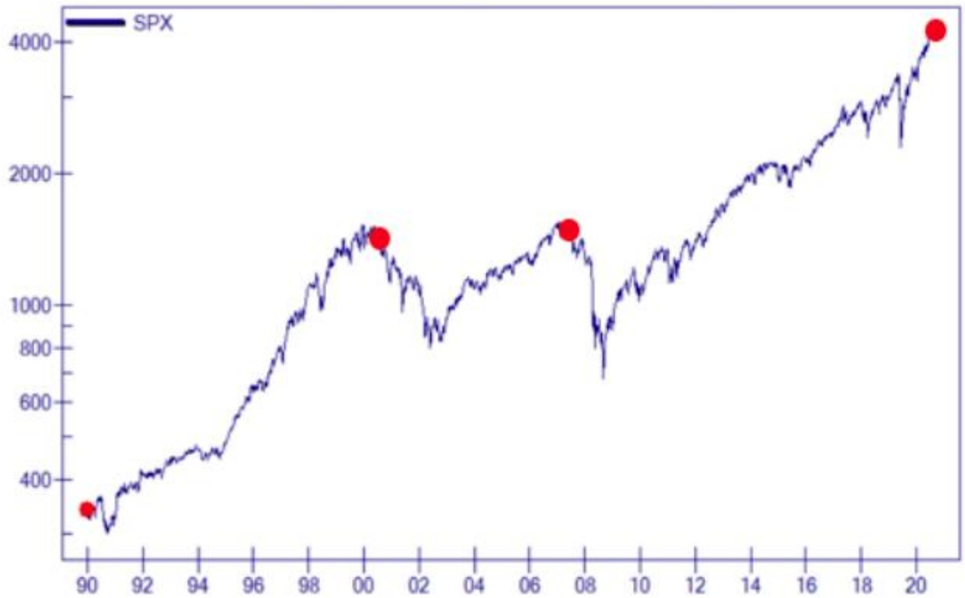
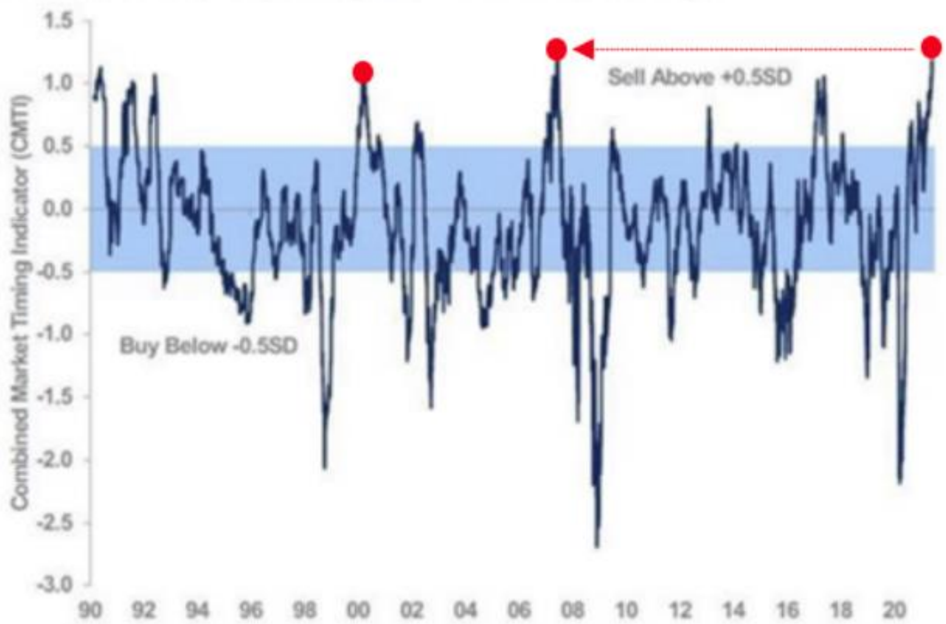


Exhibit 1: Our Combined Market Timing Indicator is in-line with its all-time high...



Source: MSCI, Morgan Stanley Research.

I know Fed Chair Jay Powell and his contemporaries are trying to maintain the U.S. dollar's global reserve currency status, I just don't know if the rest of the world will continue to play along. In the meantime make sure your own house is in order, realize some gains, pay down some debt, crank up some Santana and enjoy summer.

As always, be careful out there,

Chris Wiles, CFA

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