MEDALLION WEALTH MANAGEMENT

July 2021 Market Commentary

Hold My Beer

https://www.youtube.com/watch?v=Q-BXEF1CkKg

Yep, we've now entered the ***"hold my beer"*** phase of the market cycle, the absence of risk aversion.

If you're not familiar with the phrase "hold my beer", it's an expression used to describe someone's last words before they do something really crazy, generally while under the influence. If you've watched the video above, we can all probably relate to a period in our lives when we've done something that in hindsight was ill advised. Maybe it was just ordering the Atomic Wings, or maybe it was something we'd rather not mention.

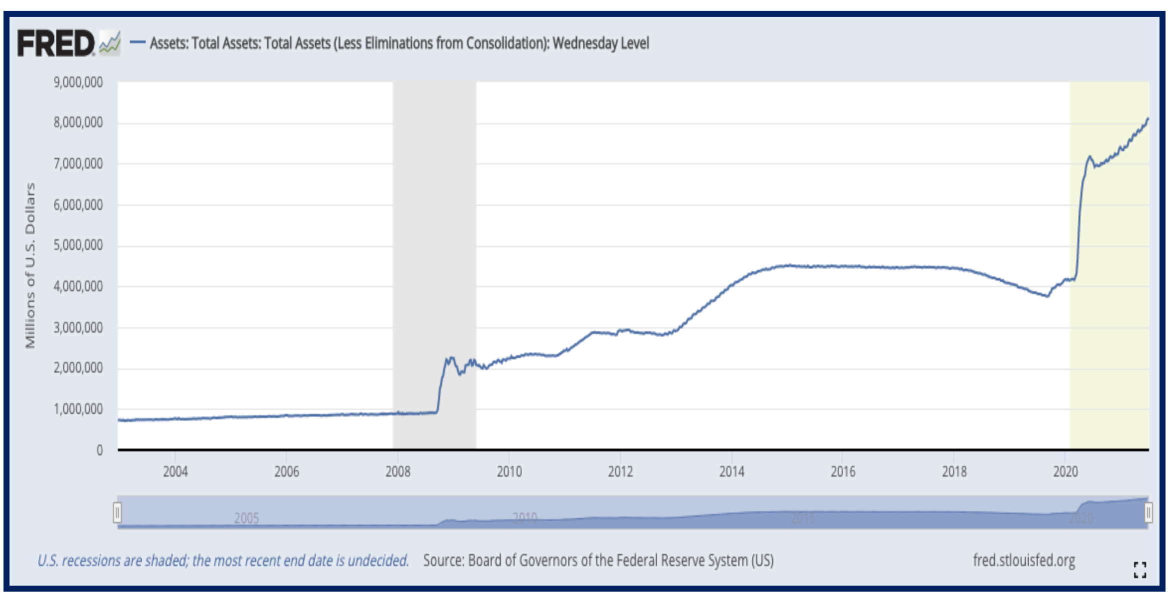
This is not new human behavior; it has probably been with us since the first cavemen discovered the miracle of fermentation (hold my grog while I ride this woolly mammoth). What is a bit new today is that we are now seeing organizations that were originally conceived to help rein in our proclivity towards excess, actually spurring us on to increased risk taking. Namely the Federal Reserve.

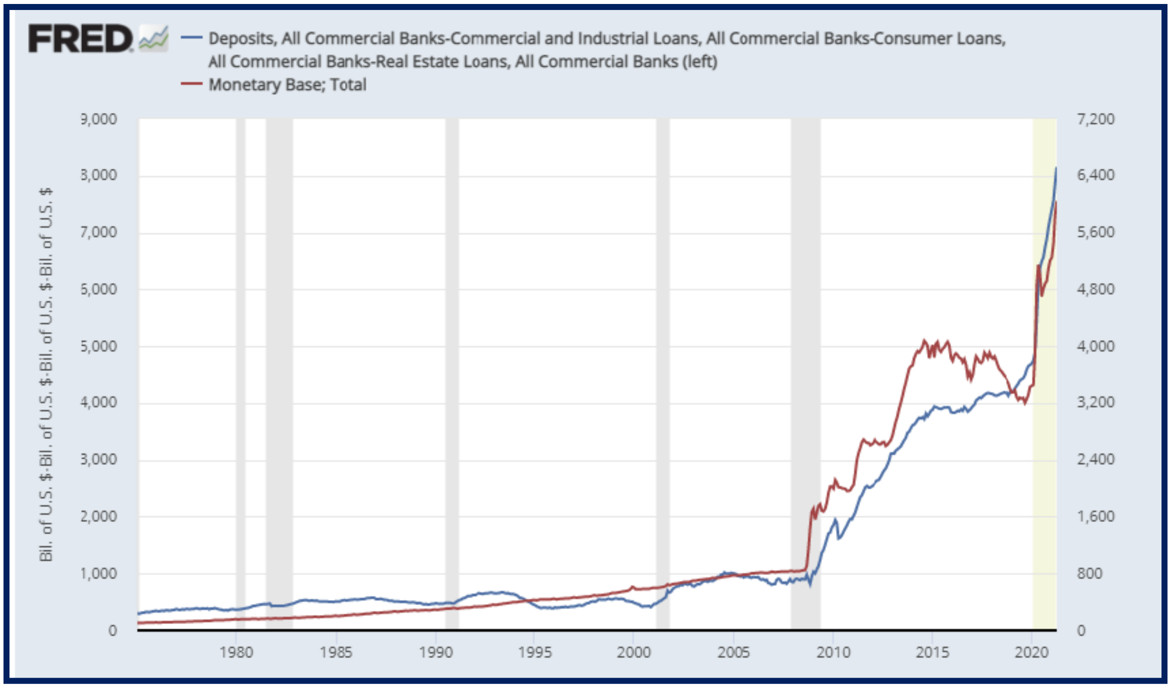
The Federal Reserve was established in 1913 to address the boom-bust financial panics that had become widespread around the turn of the century. Initially the Fed was designed to supervise and regulate the banks, and promote financial system stability. Over time their main function has broadened to include maximum employment and stable prices.

They were the adults in the room, there to bring order when we mere humans let our emotions get the best of us. In October 1955, Fed Chair William McChesney Martin, Jr. delivered a speech where he described the Fed's role of being a chaperone and removing the punchbowl before the party gets out of hand. He said, *"In the field of monetary and credit policy, precautionary action to prevent inflationary excesses is bound to have some onerous effects…Those who have the task of making such policy don't expect you to applaud. The Federal Reserve…is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up."*

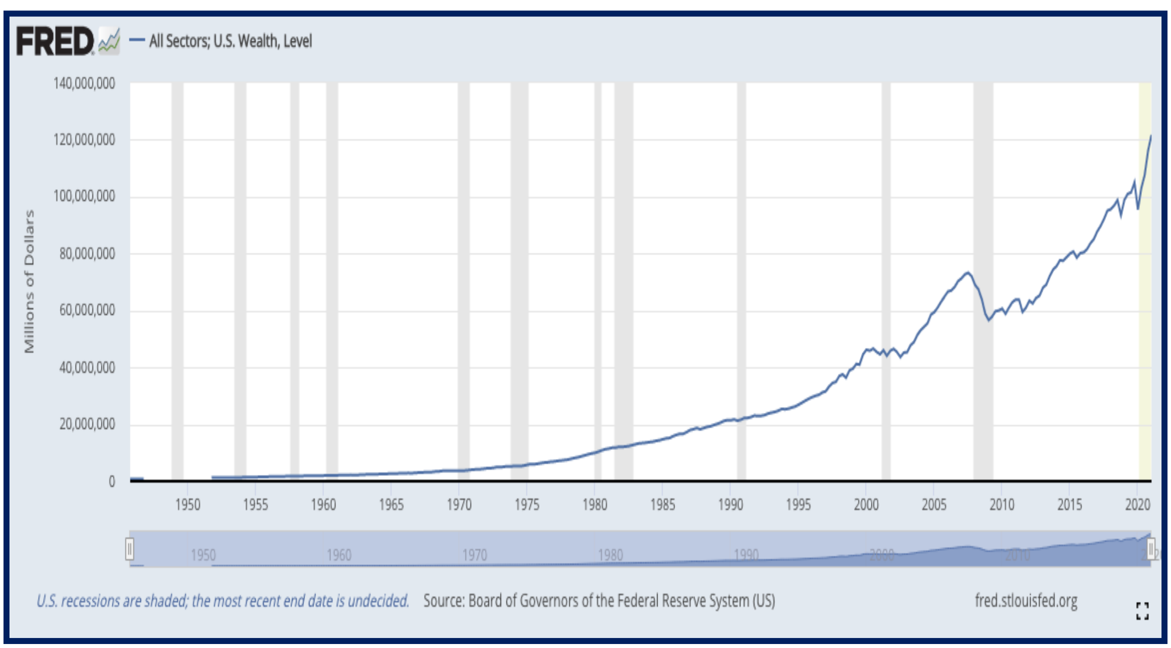
How quaint and how times have changed. Today's Fed is not only NOT removing the punchbowl, they are actually spiking it with equal doses of Red Bull and Vodka, and making sure that everyone checks their inhibitions and better judgment at the door. Ever since the Great Financial Crisis, which the Fed failed to prevent, the Fed has adopted a risk-on approach. You see, while individuals tend to sober up (I'm never going to drink like that again) and get more risk-adverse after a crisis, the Fed believes we need to increase our risk-taking in order to spur economic growth and employment. They want to prevent the hangover by keeping us intoxicated.

We all lived through this in 2008-09, when the Fed cut interest rates to 0% and instituted quantitative easing (the purchasing of longer-dated securities). The problem is that even after the economy recovered the Fed never fully reversed their ultra-easy monetary policy. So when the Covid pandemic hit last March, the Fed simply doubled down and flooded the system with enormous amounts of liquidity.

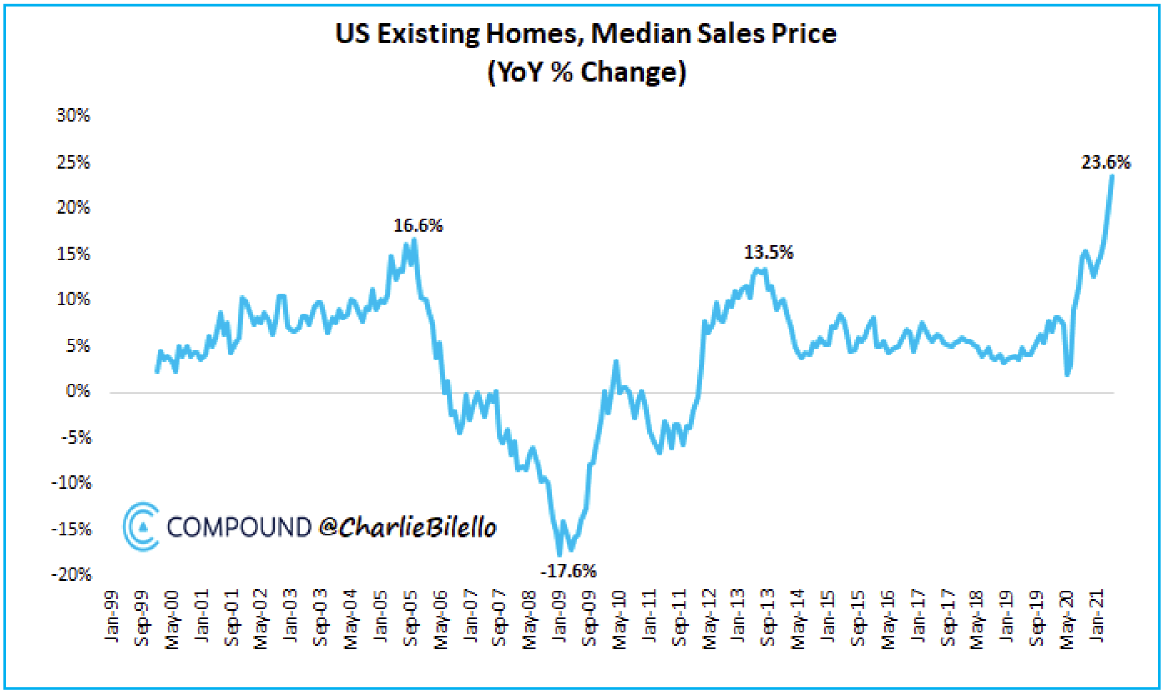




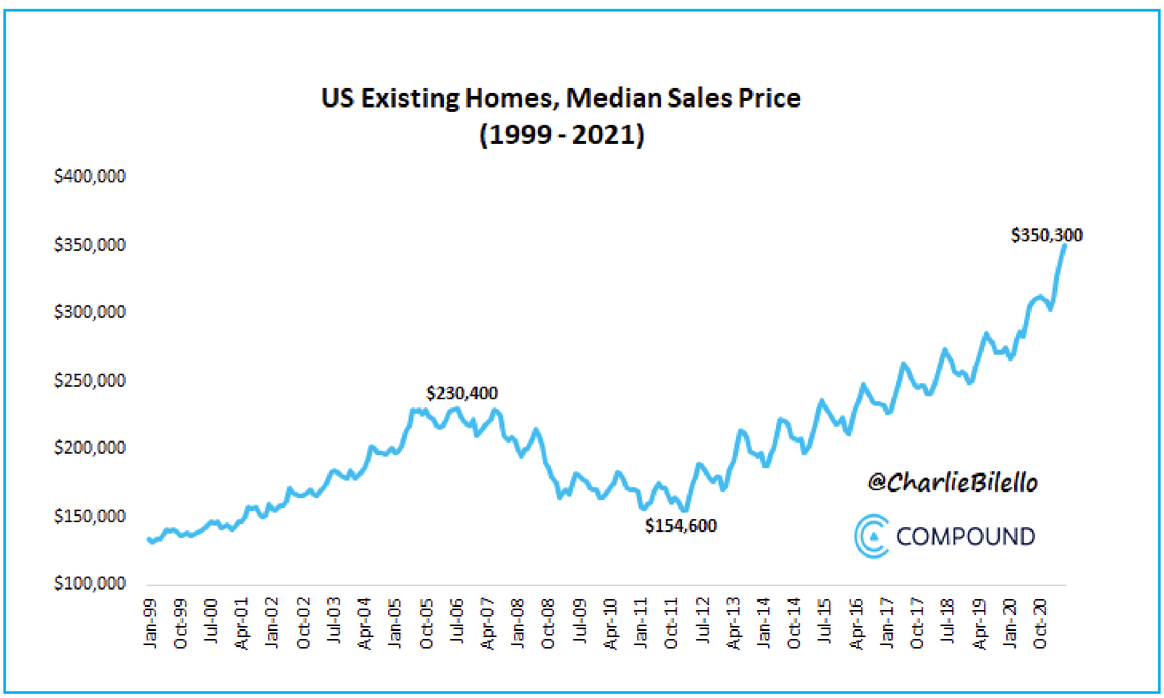
And it worked; we were able to shut down the economy until we developed a vaccine while keeping American's wealth growing. In fact, for the first time in history wealth did not decline during a recession, we actually had the greatest wealth growth ever.



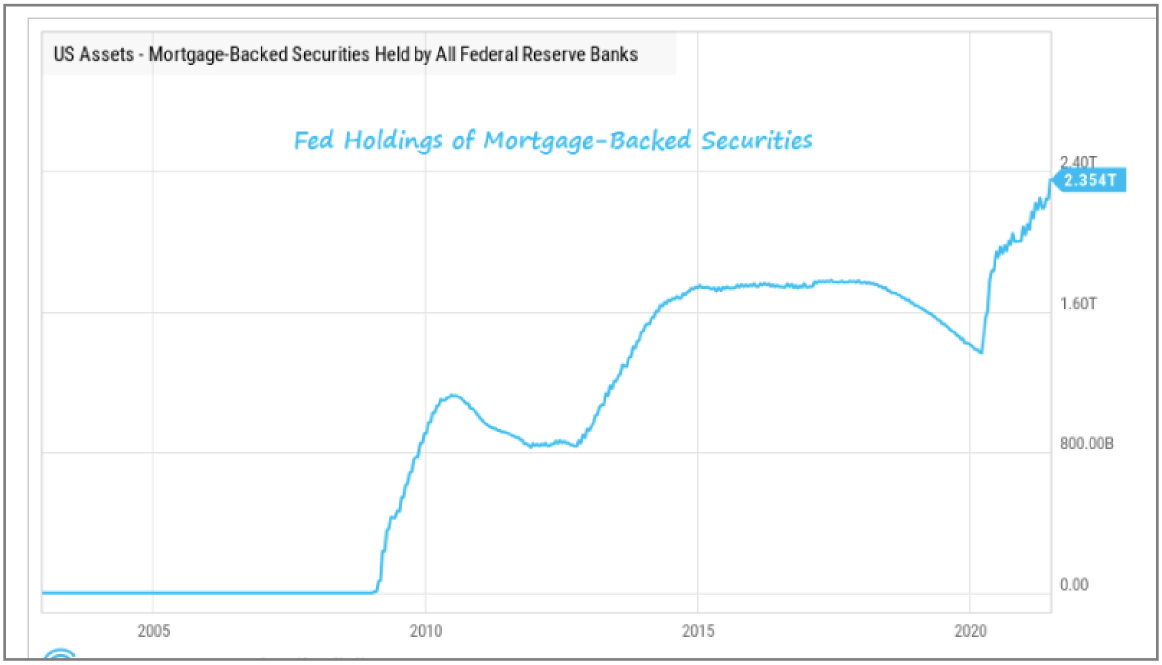
Those of us fortunate to have assets (houses, stocks, bonds, etc) are now probably sitting with our highest net worth ever. If you didn't know better, you'd probably think that pandemics were a good thing.



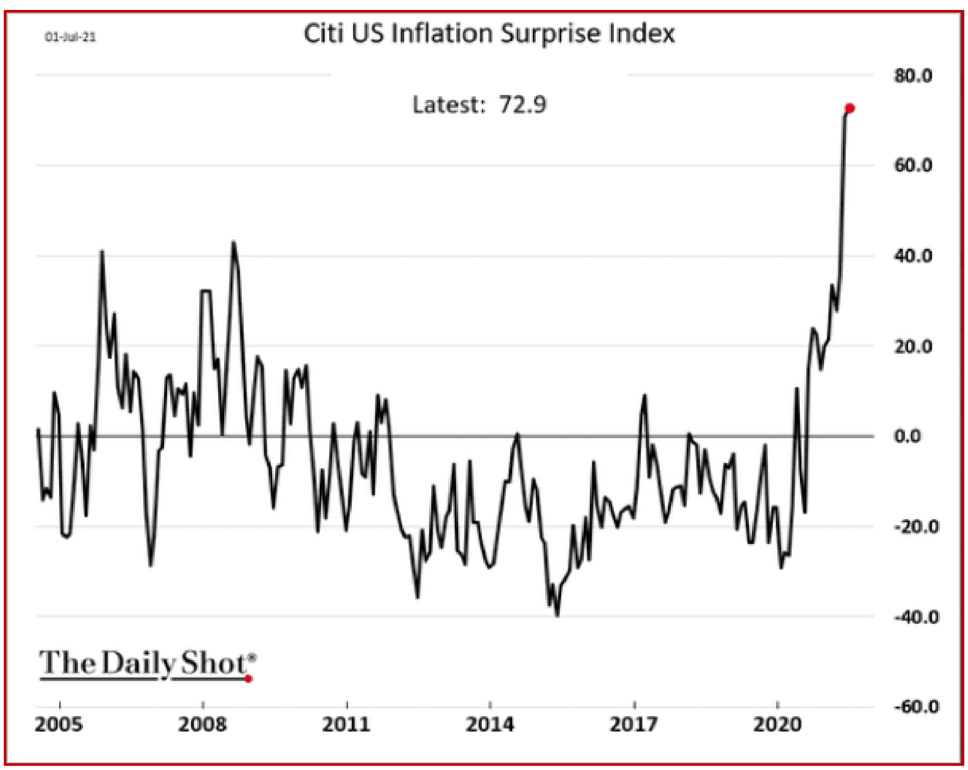
Over the last ten years we have seen home prices rise by over 100% from $169,000 to over $350,000. That's 10-year annualized appreciation/inflation of 7.5%.



Even though home prices are at record highs, and home affordability is at a record low, for some reason the Fed is continuing to purchase $40 billion of mortgage backed securities per month.



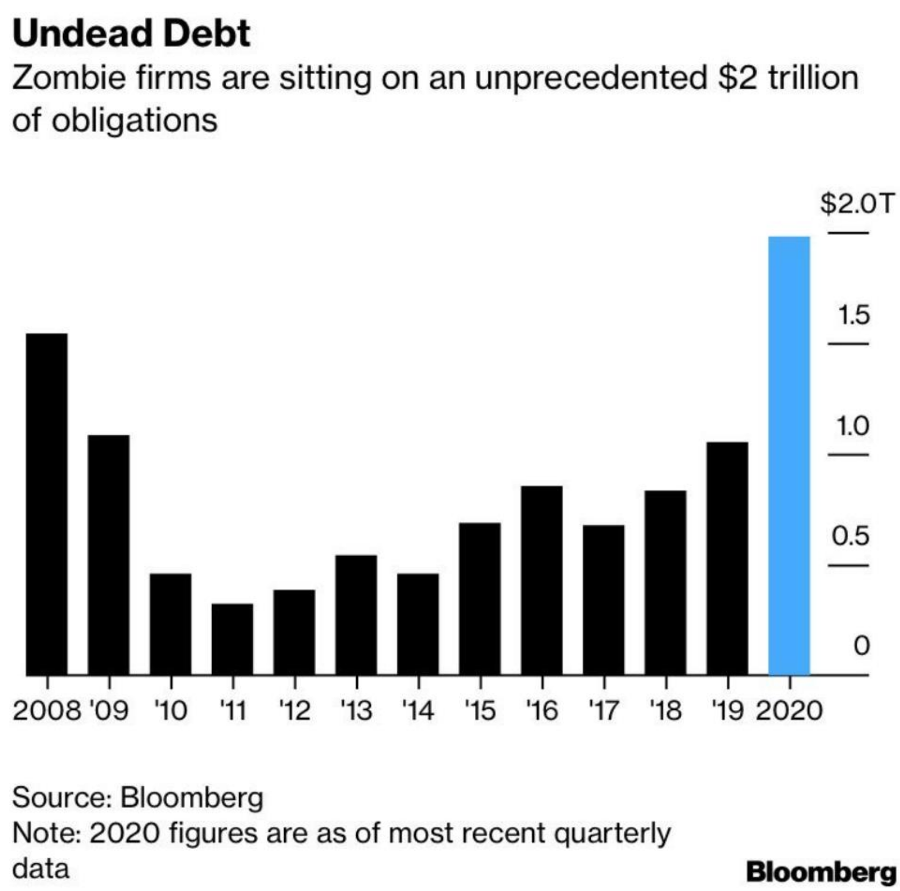
I know those crazy party boys at the Fed continue to tell us not to worry, that inflation is just "transitory", but they fail to define just how long transitory is. The other thing that worries me is that if inflation really is transitory, doesn't that mean that the value of my home and my other financial assets that have inflated will eventually deflate, or is there another definition for transitory that I don't understand?



What's an investor to do? You know this party has gone on much longer than is prudent, there are signs of excessive craziness everywhere you turn, and the chaperones may just be the craziest ones here. But you also know that these chaperones are extremely powerful and even though you'd like to leave and sober up, maybe just maybe they can slow the roll without a crash. It's the grandest economic experiment of all time, and you're a part of it whether you choose to or not.

Fixed Income:

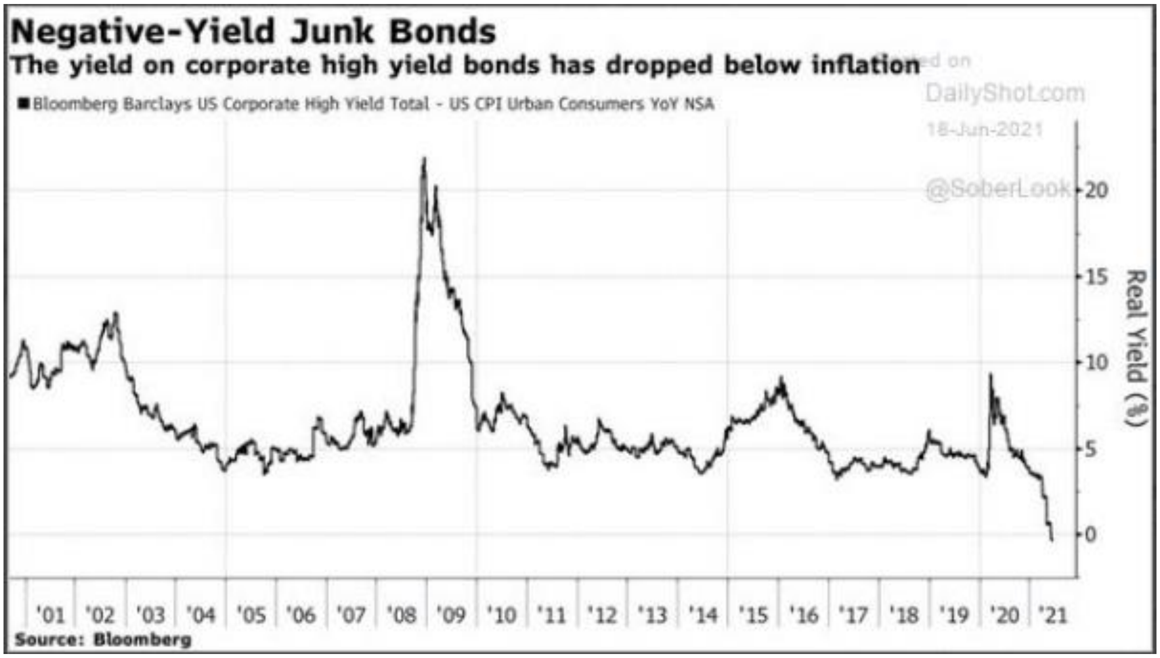
We all know that interest rates are low and that we get 0% on our cash, so from an investor perspective fixed-income isn't very attractive. But from a borrowers perspective it has never been a better time to be a debtor. Even zombie firms that don't make enough to service their debt are still finding "hold-my-beer" investors willing to keep them afloat.



The nice thing about fixed-income is that it is mostly about math, and math doesn't lie. Your return in fixed-income is very close to the yield-to-maturity on the security when you purchase it. If you buy a 10-year Treasury note at 1.50% you're going to get 1.50% over the next 10 years, before inflation.

The same is true for corporate bonds and high-yield, except you have the added risk that you may have some defaults that significantly lower your expected return. That's why investors have historically required a risk premium for owning Junk. Today that risk premium is at a record low 2.78%.

Not only are the yields on high-yield at record lows, after inflation they are actually negative. All the risk, no return. Or as Jim Grant said, "return free risk".



So as a fixed-income investor I think the math couldn't be much clearer, lower your risk. Even though cash after inflation gives you a negative return, it's much better than the potential very negative return you might experience holding high-yield.

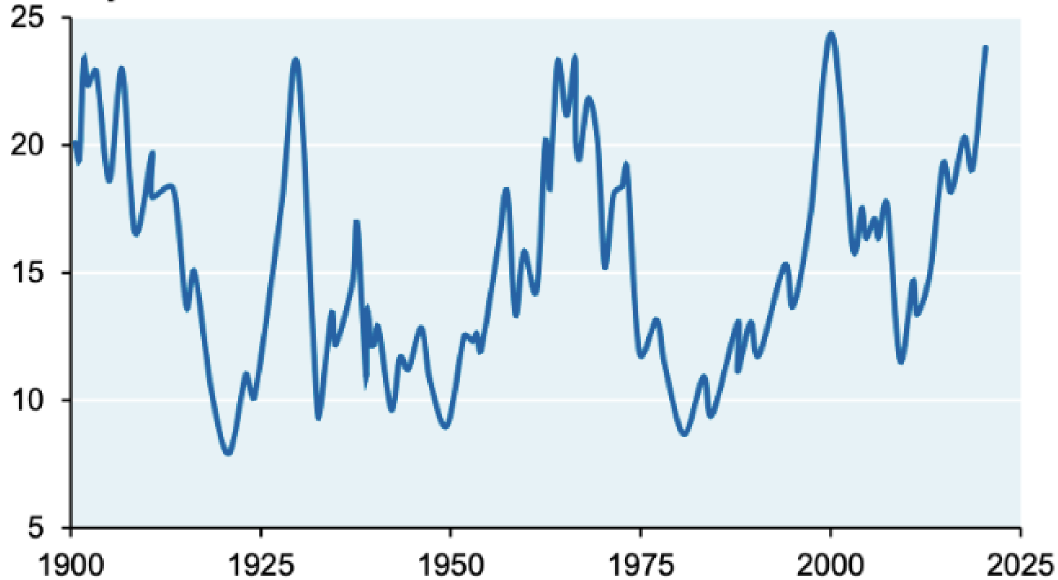
<u>Equities:</u>

Unlike fixed-income, equities are a bit more complex. Of course there is a heavy dose of math (earnings, dividends, cash flows, etc), but there is also an equally heavy dose of conjecture (growth, competition, and valuation). That's where equity valuation becomes more like art, it can be very different depending on who's looking at it. One thing we do know is that when you pay a lot for future growth you generally experience lower future returns.

I'm not going to get into the many myriads of ways to value stocks, I'll just say that pretty much every valuation model created is sitting near record highs, implying that future returns in equities will be lower. Ray Dalio of Bridgewater recently published the chart below, that shows based on current valuations and cash flows, how long it would take for an investor to recoup their investment. A 24-year payback equates to about a 3.0% annual return.

This is much different from the returns expected by the average investor. As Jason Zweig recently reported in the WSJ the average equity investor expects to earn 17.5% annually after inflation. Since the S&P 500 returned 18.4% during the pandemic of 2020, and is already up 15.5% this year, you can see why they're so optimistic.

Number of years for US corporate debt and equity holders to be paid back



Source: Bridgewater. March 2021.

I honestly don't know what the future holds. Maybe the Fed can keep this party going much longer than expected; maybe they can keep the partygoers from crashing. All I know is that I don't want to be the last guy saying, ***"Hold My Beer, Watch This"!***

There's nothing wrong with reducing your risk profile. Take some gains, pay down any debt, and be thankful that you were able to participate in the greatest wealth creation of all time. No party lasts forever.

As always, be careful out there,

Chris Wiles, CFA

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