

## Beeple and the Blinking Fed

Building on strong year-end momentum, the stock market delivered another stellar quarter with the S&P 500, Dow Jones Industrial Average and NASDAQ Composite up 5.77%, 7.76% and 2.78% respectively for the first three months of 2021. The performance disparity between the Dow and NASDAQ accentuates the ongoing rotation from growth to value stocks. Indeed, the NASDAQ became the first major index to suffer a 2021 correction with an 11% month-long decline through March 9th that quickly welcomed technology investors to buy the dip. Stuningly and testament to the severity of the 2020 coronavirus crash, these important market barometers are now up 53.71%, 50.48% and 72.04% year over year through March.

In our Outlook 2021 newsletter issued in January, we referenced many signs of bubble-like excess in markets including valuation of momentum stocks, trading activity in stocks and options by novice investors, Bitcoin, proliferation of SPACs and IPOs, record net-long exposure by hedge funds and rampant bullishness among investors. Just when we thought we have seen it all, an artist named Mike Winkelmann, known as Beeple, sold a purely digital piece of art for a remarkable \$69.3 million at a Christie's online auction. In the month through March 12<sup>th</sup>, so-called nonfungible tokens (NFTs) exchanged from seller to buyer on a cryptocurrency blockchain generated more than \$366 million in profits.

The explosion in value of the NFT market is yet another telltale sign of a bubble in the making. With the net worth of U.S. households now north of \$130 trillion, investors and consumers awash in cash estimated to be \$5 trillion or more, short-term interest rates pegged at zero with seemingly endless Fed accommodation, \$1.9 trillion in COVID relief helicopter money and plans for \$2 trillion or more in "infrastructure" spending, expedited vaccine rollout and end to the pandemic within our sights, booming equity and housing markets, consumer confidence on the rise, corporate earnings strong and GDP growth accelerating, what could possibly go wrong?

For starters, interest rates are finally rising, with the ten-year Treasury piercing through the 1% threshold in the latest quarter before peaking at 1.75%. The yield on this important benchmark has settled back to 1.65%. Indeed, the Treasury market just posted its worst quarterly performance in more than 40 years. The overall Treasury market lost 4.6% in the first three months of 2021, while long-term Treasuries with maturities over twenty years lost 14% during the quarter. In the wake of massive multi-trillion-dollar monetary and fiscal stimulus, inflation expectations are on the rise and bond vigilantes are voting with their wallets. The market gauge 5-year breakeven inflation rate has climbed to 2.6% from 2% at the start of the year. Yet Fed Chairman Powell is steadfast in his prediction that any spike in inflation will be transitory. At least so far, the market seems to believe him as the 10-year and 30-year breakeven inflation rates hover at 2.4% and 2.3% respectively. Remember, the Fed is targeting 2% for overall core

inflation and is increasingly comfortable with inflation running hot for some yet-to-be-known extended period.

The Federal Reserve recently increased their median GDP estimate for 2021 to 6.55% from 4.2% in December. They further predict that unemployment will drop from the current 6.2% to 4.5% by year-end, down from their 5% estimate in December. With such a rosy outlook, it is surprising that this same Federal Reserve predicts that it will continue its QE campaign and keep short-term interest rates pegged at zero at least through the end of 2023. In a very recent 60 Minutes interview, Fed Chair Powell stated that "we're at a place where the economy's about to start growing much more quickly and job creation coming much more quickly" with the economy producing close to one million jobs a month for "a string of months." Yet, when asked whether a rate increase might happen this year, Powell reasserted that it is "highly unlikely." Perhaps the trillion-dollar question is whether and when rising interest rates finally force the Fed's hand.

It is estimated that the cost to service the U.S. debt load even 1% higher than the Congressional Budget Office's (CBO) baseline estimates would add \$9.7 trillion to the deficit through 2030. For perspective, this is more than 10 times the annual U.S. defense budget. Even before the recently enacted \$1.9 trillion COVID relief package and President Biden's anticipated \$2+ trillion infrastructure bill, the International Monetary Fund predicted that total U.S. government debt would reach 133% of GDP by the end of 2021. With so much debt, rising interest rates and the subsequent escalating cost required to service our debt squeezes out otherwise (more) productive means of spending and stunts economic growth, leaving us seemingly destined for slow growth over the long-term and interest rates required to remain low.

There is an increasing number of analysts who believe it possible that the Fed may have to peg longer-term rates just as it has pegged overnight rates. This would essentially require the Fed to expand quantitative easing so that it absorbs all excess sales that would otherwise drive rates higher than the Fed's pegged rate. Not without precedent, the Reserve Bank of Australia has pegged its three-year bond rate to 0.10% and is aggressively purchasing bonds to prevent any higher uptick in yield. There is also precedent here in the U.S. when the Fed pegged the long-term Treasury at 2.5% to assist in funding the war effort during WWII.

When and how will the Fed blink? Do they keep the party rolling with more QE or a peg on long-term rates as suggested above, potentially inflating the mother of all bubbles? Do they let interest rates rise unabated and risk a clear disconnect between market forces and Fed policy? Or do they finally heed the siren call of the bond vigilantes by hiking rates? With asset prices at all-time highs and valuations increasingly stretched, much is riding on how the Fed ultimately handles the inevitable next phase of monetary policy. We are closely monitoring inflation expectations and the pace of change in long-term rates to give us potential clues in answering these important questions.

If interest rates were not enough of a concern, we would be remiss if we did not mention the potential for higher taxes to our list of what could go wrong. President Biden has proposed corporate tax increases of more than \$1.5 trillion over ten years and another \$1.5 trillion tax increase expected on individual income and investment. This equates to approximately \$300 billion per year or 1.36% of the \$22 trillion U.S. GDP and would amount to the largest tax increase since 1968. We suspect that the ongoing economic boom will mask any negative implications of such tax hikes over the very short term. That said, the velocity of the current boom will eventually slow. When the tide of the current V-shaped recovery finally goes out, we will still be left with ballooning debt and higher taxes required to pay for the debt. Longer-term, an environment of high debt and higher taxes implies slower growth, and interest rates that must remain lower for longer than we might otherwise expect.

Another concern is the rapid use of leverage amongst investors. According to FINRA, total margin debt recently surpassed \$814 billion, a new record and 49% higher than year-ago levels. This is the fastest annual increase in portfolio borrowing since 2007. While the data does not break down the proportion of margin debt held by individuals versus institutions, institutions such as hedge funds often use derivatives to amplify their bets. During periods of market stress, the unwinding of these levered bets exacerbates an already weak market as funds are forced to sell to meet margin calls and investor demand for liquidity.

Just this past month, hedge-fund veteran Bill Hwang ran his family office Archegos Capital out of business with eye-popping losses of \$20 billion. While Fed rules require investors to have at least 50 cents of collateral in their brokerage account for every \$1 dollar of securities on margin, Archegos somehow managed to put up as little as 15 cents for \$1 invested. When Hwang's bet on Viacom went south, so went his entire fund. The cockroach theory suggests there may be additional funds exposed to such leverage. Ed Yardeni, President of Yardeni Research, warns that the "further this stock market goes, the higher that margin debt will go, and when something blows up that will be one of the factors for why stocks are going down."

Valuations in the technology sector have rarely been so high. A recent report by Toni Sacconaghi of Sanford Bernstein counts 366 technology stocks trading higher than 15x sales, up from only 27 in 2017. It is the highest number since 2000 when a staggering 1,540 tech stocks traded above 15x sales. Further, the Bernstein analyst points out that 38% of technology companies are unprofitable today, slightly higher than the 36% level reached at the tech bubble peak in March of 2000.

Finally, the most recent AAI Investment Sentiment Survey shows the highest percentage of bullish sentiment since January 2018 at 56.9% and the lowest percentage of bearish sentiment since April 2019 at 20.4%. Such sentiment readings tend to be important contrary indicators where excessive optimism may signal a short-term top in the market.

With current S&P 500 earnings estimates for 2021 and 2022 at \$175 and \$202 respectively, the S&P 500 now trades at 23.6x this year's estimates and a more reasonable 20.47x forward estimates. At 4,135 on the S&P 500, we are now only 4% away from the high end of our predicted target range for the full year and very tempted to take some chips off the table. However, with an overabundance of monetary and fiscal stimulus even as the economy booms and the pandemic wanes, we would not be surprised if these earnings estimates prove too conservative. While difficult to be cautious in the wake of such wonderful economic and pandemic-related news, we are increasingly concerned for the potential of higher interest rates, higher taxes, rapidly growing margin debt, valuation excess in technology and rampant optimism to throw a monkey wrench into the heightened aspirations of traders and would-be NFT artists alike.

While we are not predicting a market crash nor an end to the bull market in stocks, we cannot help but think that the stock market needs a corrective phase to wring out some of the excess. Even though the most bubble-like signs of speculation seem to be segregated in specific areas, corrections tend to have unintended consequences that ultimately impact a broader swath of the overall market.

Of course, we have no way of knowing the timing or magnitude for any corrective phase with any precision. Further, we readily admit that growing cash balances will appear foolish in the wake of a continued surge in stock prices. We find ourselves in the difficult position of being a reluctant buyer as bargains become more scarce and a reluctant seller given the dearth of alternatives. We are confident that your portfolio is well-positioned for whatever volatility may come and also well-positioned to participate should stock market momentum continue unabated.