WOODWARD
DIVERSIFIED CAPITAL

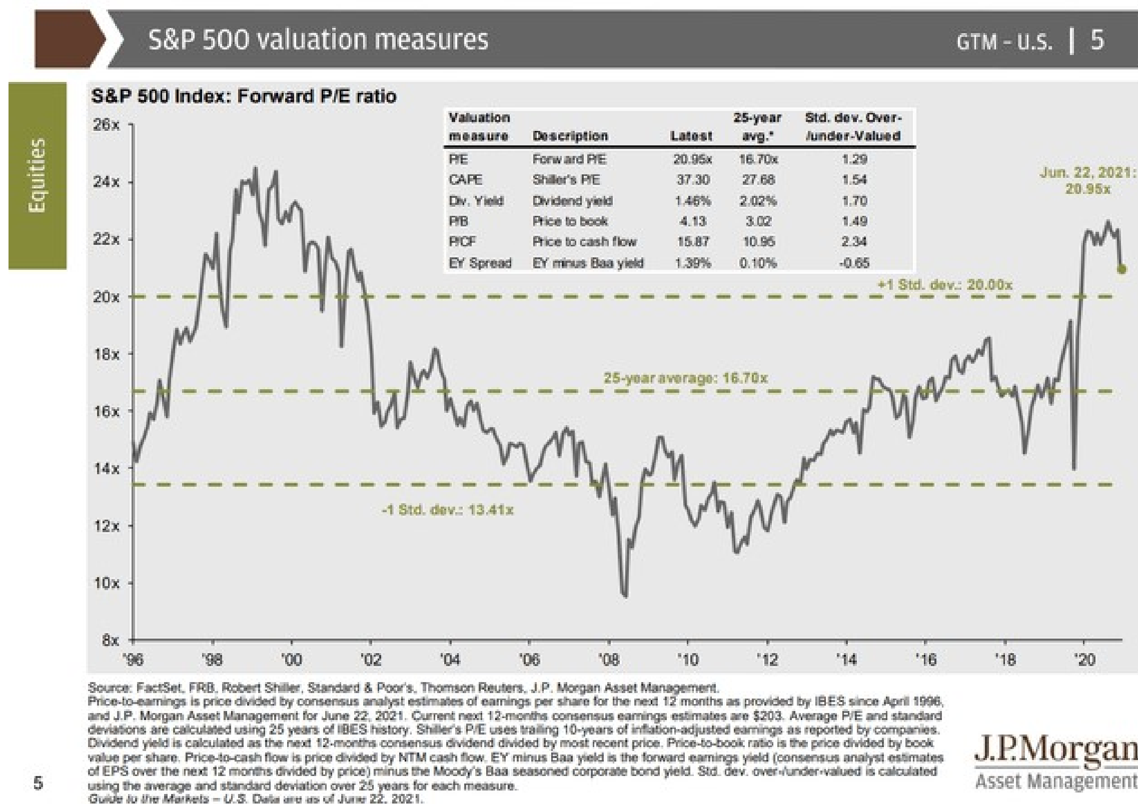
Capital Markets Brief – "Strange Trails"

7/24/21

"I came back from the edge
Where you go when you die
I fell back down to Earth
Through a hole in the sky
I crashed into the Sea
And somehow I survived
Don't know what to believe
But I know I'm alive… back from the Edge" – Lord Huron

"Back from the Edge" is actually on Lord Huron's Vide Noir album… while Strange Trails is definitely my favorite album from Lord Huron, Vide Noir is also fantastic.

"*Looking forward into 2021, it appears we are headed into a full tilt equity bubble… With an absolute avalanche of stimulus, and more seemingly on it's way, it is difficult to see investors wanting to sell stocks…"* – from our 1/11/21 capital markets brief entitled "***It's All About the Dollars***."

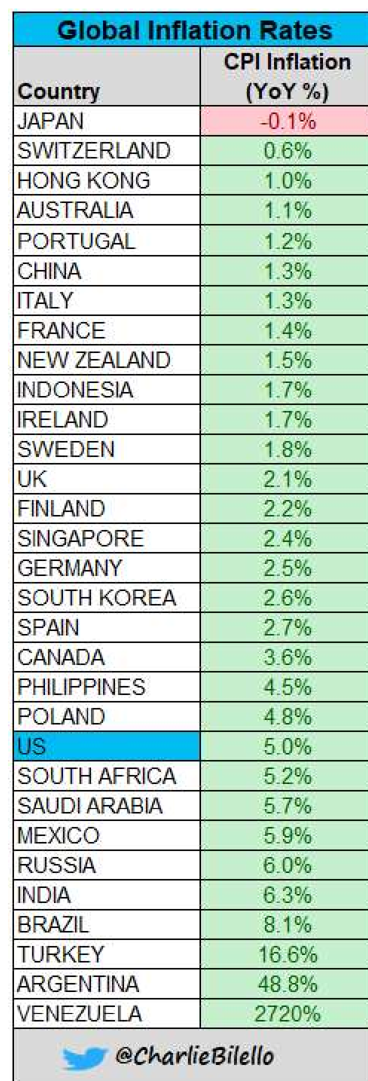


Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	20.95x	16.70x	1.29
CAPE	Shiller's P/E	37.30	27.68	1.54
Div. Yield	Dividend yield	1.46%	2.02%	1.70
P/B	Price to book	4.13	3.02	1.49
P/CF	Price to cash flow	15.87	10.95	2.34
EY Spread	EY minus Baa yield	1.39%	0.10%	-0.65

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since April 1996, and J.P. Morgan Asset Management for June 22, 2021. Current next 12-months consensus earnings estimates are $203. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
Guide to the Markets – U.S. Data are as of June 22, 2021.

It's official… by almost any measurement… after a violent collapse in 2020, US economic growth as well as the commensurate earnings of the S&P 500 have completely recovered back to their respective all-time highs from 2019… we "***fell back down to Earth through a hole in the sky (and) crashed into the Sea and somehow (we) survived.***" The market however, is considerably higher than it was back then, and that is a reflection of three things:

1. Several rounds of domestic and foreign stimulus
2. Corporate fiscal planning, translating into better earnings expectations
3. Broad economic participation in the recovery and expansion as a direct result of the stimulus.



Global Inflation Rates	
Country	CPI Inflation (YoY %)
JAPAN	-0.1%
SWITZERLAND	0.6%
HONG KONG	1.0%
AUSTRALIA	1.1%
PORTUGAL	1.2%
CHINA	1.3%
ITALY	1.3%
FRANCE	1.4%
NEW ZEALAND	1.5%
INDONESIA	1.7%
IRELAND	1.7%
SWEDEN	1.8%
UK	2.1%
FINLAND	2.2%
SINGAPORE	2.4%
GERMANY	2.5%
SOUTH KOREA	2.6%
SPAIN	2.7%
CANADA	3.6%
PHILIPPINES	4.5%
POLAND	4.8%
US	5.0%
SOUTH AFRICA	5.2%
SAUDI ARABIA	5.7%
MEXICO	5.9%
RUSSIA	6.0%
INDIA	6.3%
BRAZIL	8.1%
TURKEY	16.6%
ARGENTINA	48.8%
VENEZUELA	2720%

@CharlieBilello

Facing an unprecedented economic collapse last March, the US government along with several countries around the world passed massive stimulus plans designed to mitigate the downturn and subsequently stimulate a recovery. Several rounds of trillion-dollar stimulus plans have been passed over the last 15 months, with the current US administration working on a $1.2 Trillion dollar infrastructure bill they hope to pass in the next few weeks.

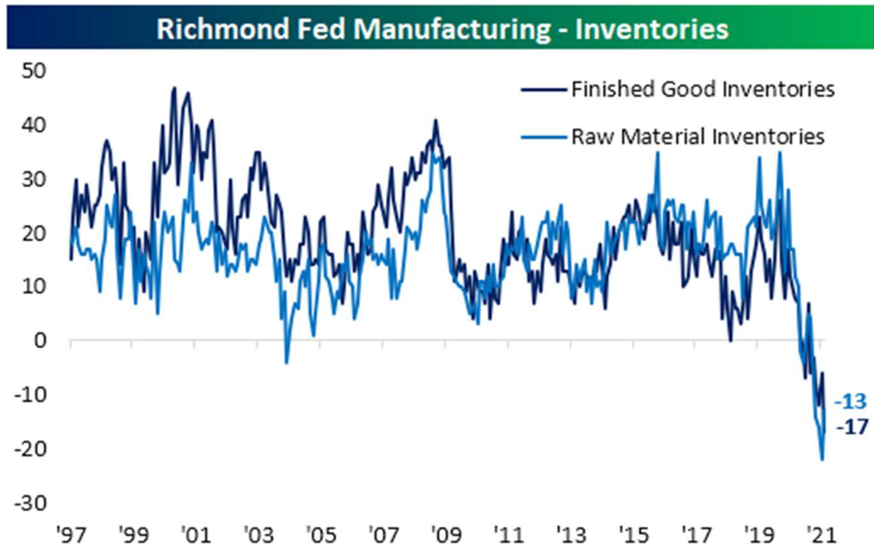
At the same time, and to some extent due to the structure of some of the 2020 stimulus, corporate executives in the US were able to plan their way through the pandemic collapse and recovery in a way that previous recessions have not afforded. Balance sheets at the consumer as well as corporate level, in large part, have been repaired. And earnings growth looks sustainable over the intermediate term.

US equity indices, when compared across several valuation metrics, appear historically stretched, but that really is a function of markets looking ahead into the next year of stimulus fueled earnings growth. Several questions come to mind:

1. Will earnings grow faster than broad market indices, thereby bringing valuations back towards their historical premiums?
2. …or will accommodative fiscal and monetary policy push markets further into bubble territory magnifying downside risks?
3. Could stimulus fueled inflation pressures and slowing economic growth create a stagflationary environment that erodes earning power, profit margins, and equity risk premiums?

These are observations we will absolutely be making over the coming quarters and good questions to be chewing on as the markets move around. Over the immediate future, we think domestic equity markets will struggle to advance and see a multi-month consolidation as the most likely outcome, with year-end rally to close out the year. Tax hikes proposed by the current administration are a likely culprit for causing some indigestion in equities, but there are other issues the markets may need to wrestle with. As we look ahead economic activity will have to fall back towards its organic pace and investors will have to ask themselves if it is worth paying the present premium for 2-3% annualized economic growth… particularly with what looks to be elevated inflation levels persistently threatening profit margins and corporate earnings.

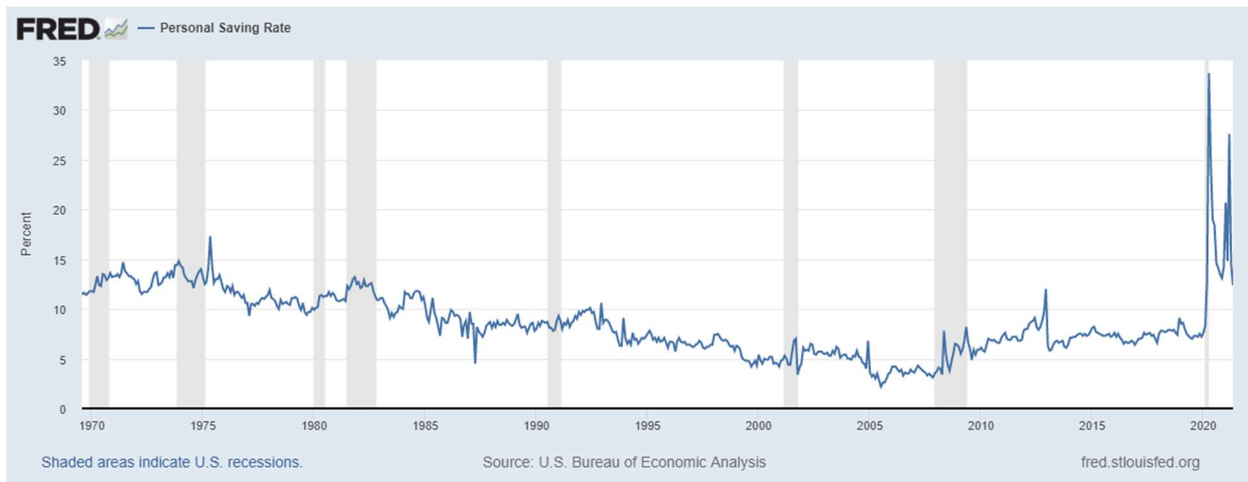
One unexpected positive we observed in 2Q was a massive drawdown in inventories across a broad swath of industries. As consumers came out of covid with beefed-up stimulus fueled savings accounts and the commensurate appetites to splurge, corporations have found supply lines strained by covid resurgences in various geographies around the world.



Nowhere is this phenomenon more observable to the average individual than in the housing market… as inventories have dwindled and lumber prices have risen, prices have pushed higher at record rates!

The increase in home values is undoubtedly adding confidence to consumers who were the beneficiaries of unprecedented government stimulus and saw their savings rates spike to levels not seen in several decades. The combined wealth effect of rising equity markets, rising home prices, and stimulus checks likely means we will see strong consumer spending through 2022… quite possibly even longer.

To get some perspective on just how much savings jumped for consumers, you need to see the data going back several decades… The last time we saw a spike like this was post WWII, and consumer spending accelerated dramatically over the next 24 months.



Inflation:

I recently read an article by one of the analysts we use, Josh Steiner, who I'd like to borrow from. His article mentioned a paper written in 1730, called *Essai sur la Nature du Commerce en General*, or *Essay on the Nature of Trade in General*, by Richard Cantillon. Cantillon was a merchant banker and his paper was the first reputable assessment observing how the printing of money circulated in and through the economy. Most Americans are familiar with the "trickle down" theory popularized by the Reagan administration in the 80's… but the Cantillon Effect seems to be a slightly better way of thinking about or explaining the phenomenon.

While the trickle-down theory espouses thoughts of water, Cantillon used the metaphor of honey. While water poured into a glass or bowl instantly distributes evenly, honey pours into a bit of a rounded pyramid in the center of the bowl before eventually dispersing towards the perimeter. Cantillon went on to theorize and observe in practice that when money is printed, the first thing to benefit is asset prices as the freshly minted money is first accessed by the wealthy who own land, homes, and businesses. Those with broad access and exposure to capital instigate the process of the new money slowly working its way through the economy, and as they use the capital, asset prices begin to rise meaningfully, and the capital gets gradually dispersed at an accelerating rate. The further the dispersion works into the economy the more broadly asset price inflation gives way to accelerating broad based inflation and eventually trickles down into rising wages and incomes for laborers. You can see this clearly in home prices rising and subsequently, realtors' incomes spiking. Both theories or metaphors are functionally accurate, but I find the Cantillon Effect more helpful as it accounts for why inflation accompanies money printing.

M2 money growth was 27% year-over-year in February of 2021 but has decelerated to (a still rapid rate) 13% as of the end of May. While we have likely seen the near-term peak in inflation rates, inflation is a sticky phenomenon and we expect CPI to remain at or above 3% for the foreseeable future. This means commodity prices are likely to remain fairly strong for at least the next year, and any infrastructure spending will only lengthen their bull run. Indeed, the more data that comes out, the more it looks like Goldman Sachs call for a multi-year commodity super-cycle appears valid.

Looking ahead:

As we look into the back half of the year, the markets have had a fairly strong advance ytd, and an incredibly strong run over the last 12 months. As nothing goes straight up, valuations appear stretched,

growth appears to be moderating and inflation remains stubborn, we see a recipe for a consolidation in equities. Add to this cocktail the threat of what could end up to be the largest tax hike in history, and you begin to understand why we think it is better to be positioned slightly more defensively for the next few months. While we are still at the very beginning of what will likely be a multi-year expansion for the US economy and equity markets, we see the strong potential for "the pause that refreshes" or a multi-month consolidation with equities moving sideways for 4-5 months before beginning another leg higher. A lot of good news and positive catalysts have been priced in over the last 12 months and earnings could use some time to "catch-up." Economic activity should be just fine as inventories are rebuilt and consumers are in good shape (thanks mostly to all the government stimulus, but still…).

Europe exited quarantine 4-6 months after the US, and as such, their equity markets look like a great place to be between now and year-end. While we do not love Europe long term, Germany and Switzerland, in particular, look like they have several months of strong acceleration in economic activity.

In the commodity space, both oil and natural gas look very strong with demand likely to persistently outstrip supply for what could end up to be the next 2 years. We still like Rare Earths (REMX or MP) as the US infrastructure bill currently floating around Congress focuses on alternative energy development. Gold too has been firming up nicely and we recently added to our gold exposure for the first time since last Fall.

While home prices have jumped a lot and are already showing signs of crimping affordability, we think real estate remains relatively strong and REIT's are a great place to have exposure.

Interest rates appear to have achieved a near term peak after a significant advance for most of the year. Additionally, our expectations for the economic environment in the back half of the year imply some moderate downward pressure on rates between now and year end.

We recently shorted Japan in most portfolios as we think the environment for equities in Japan is definitively bearish over the short term. Financials and small caps in the US look exposed to us as well though there are a number of very attractive companies in the asset class when looking more intermediate to long term.

Overall by raising some extra cash, adding to our gold exposure, and shorting Japan and financials, the risk in our portfolios has been dropping over the last few weeks. Looking ahead we remain fairly bullish over the intermediate to long term and as such would be buyers of any dip that occurs between now and late October. If pressed, a 10-15% pullback is probably our most likely scenario between now and then… though a boring sideways consolidation would be our preferred price action, setting equities up for another meaningful leg higher in the December through April period. You never know… but we will remain vigilant in our daily and weekly reviews of the economy and capital markets.

We thank you for your friendship and trust, and for the opportunity to serve you and your families.

-BTW and team