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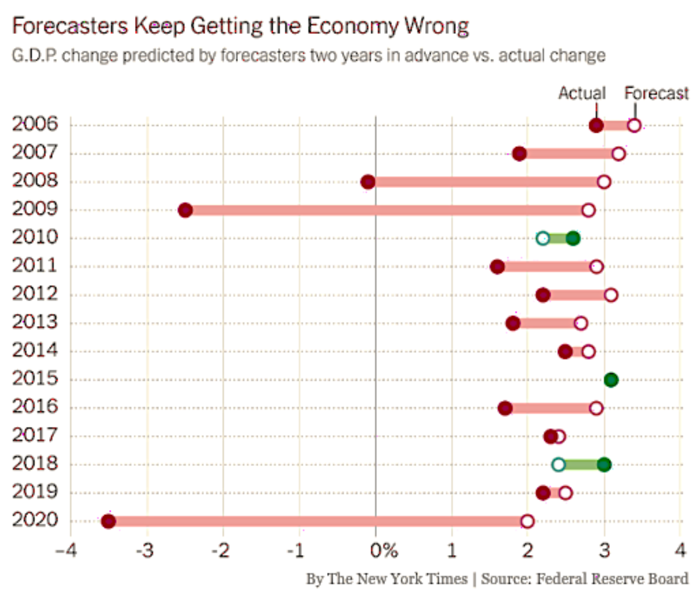
An Absence of Trust

Dear friends,

In my last letter I talked about fear and fatigue—how the constantly changing and often contradictory narratives by "the experts" stoke fear, and how the onslaught of government directives leaves us fatigued. Today I want to talk about the trust we once had in our institutions and their operatives, trust that has been on the decline for years, but has entirely evaporated since the advent of the pandemic.



On the surface that appears to be a good thing. As experts of almost any stripe and colour expose themselves as no more than a source of one specific opinion, it becomes imperative that we strip ourselves of our confirmation bias, study opposing viewpoints, and take responsibility. Consider the health theatrics of the past week. Do we trust the German, French, Italian or Dutch health authorities who feel an Astra Zeneca jab may constitute a serious health risk or do we listen to the European Union oracles or the World Health Organization, who keep promoting it? Do we rely on the Federal Reserve's exuberant 6.5% forecast for 2021 GDP growth, or should we pay more attention to some of the far more cautious private sector predictions. Can we believe Treasury Secretary Yellen's judgments, knowing that she's received $7 million in speaking fees during her time "away" from government? Can we trust the heads of academia on educational matters, our governments on law-inspired and law-abiding enforcement? Personally, I'd answer with an emphatic no to all of the above.

Yet, while that appears to be a liberating dynamic, we can't ignore the societal implications. Many of us understand that institutions of a certain size become, with few exceptions, corrupted. Consider the United Nations, the Vatican, the International Olympic Committee—even the most superficial analysis will detect rot in any of them. The same is true if we take a magnifying glass to the ethics of countless large corporate entities. A few days ago, Pfizer's CFO Frank D'Amelio gleefully noted that his company could raise vaccine prices "when the virus becomes endemic" (*note when, not if*), before declaring that, "we believe it's becoming increasingly likely that an annual revaccination is going to take place."

Other corporatist actors operate with far greater subtlety. The armaments manufacturers, for decades now self-styled as "defense" contractors, simply buy their legislators and let them do the explaining. The same is true of the financial conglomerates who routinely promote candidates for the presidency or various cabinet positions with lucrative consulting or speaking contracts (back to Janet Yellen).

Rebellion Ahead

So, what happens if we all lose faith in our private and public institutions? I'm pretty certain the answer is chaos. I would argue that the preconditions for rebellion have not been as vibrant as they are today since the 1930s. Unlike the unrest of the 1970s or more recent manifestations like Occupy Now, today's discontent transcends age groups and social classes. The middle class is as disenchanted with the status quo as are the poor; the millennials are as dissatisfied as are the elderly. The breakdown of the social contract, the unsustainability of every policy construct imaginable, the pursuit of the forever war at the expense of social justice—they all point to the same problem: the status quo doesn't serve us.

How to rebel against an abstraction like the status quo? All we need to do is to ask ourselves who it is that upholds and desperately clings to the current system. Follow the money! In other words, those who oppose the dismantling of the countless structural inadequacies that collectively make up the status quo—in politics, in the corporate world, in our institutional constructs and in academia—they are the enemy. I think we're finally on the verge of understanding that.

To be sure, there are many questions on how the pushback will proceed. Will there be open rebellion, as in broad social uprisings, or will discontent manifest itself more subtly, as in civil disobedience? Will alienated citizens burn and loot, or will they force the collapse of the law and order state by quietly defying it? Make no mistake, the latter can be a more powerful a disruptor to the status quo than all-out mayhem. The bottom line: we're in for turbulent times. The era of docile compliance that was facilitated by decades of debt-fueled consumerism is at an end. The only thing we don't know is whether the transition will be rapid or take time; whether it will be violent or muted.

Masking Everywhere

For the moment, massive monetary manipulation coupled with unprecedented fiscal relief is masking the precariousness of our situation. The Wall Street consensus, that the economy will soon experience a robust bounce, may well prove correct—after all, liquidity injections that used to be expressed in segments of billions are now produced in the trillions.

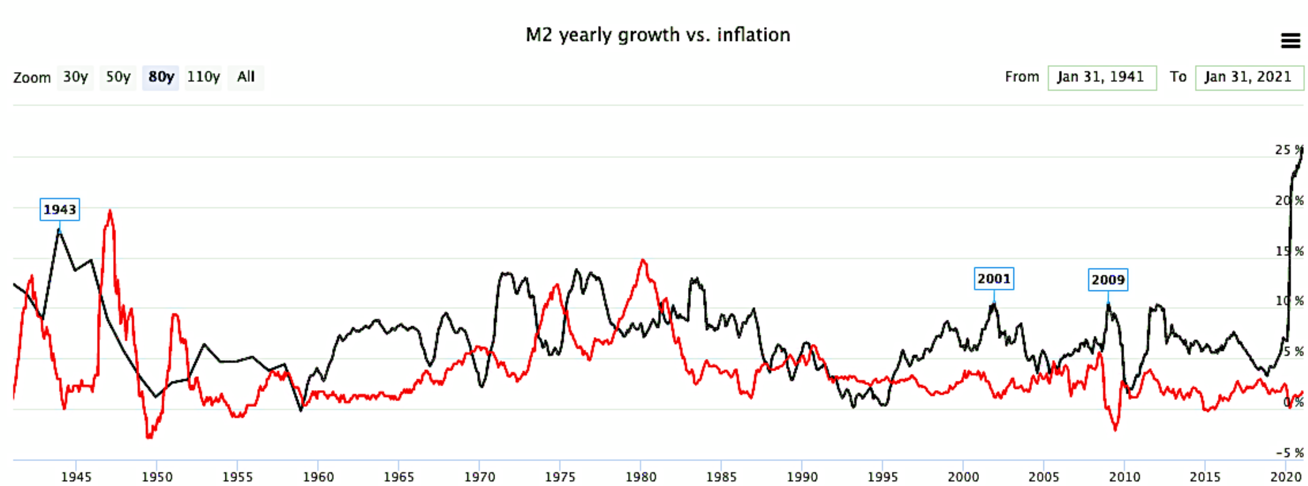
Still, anyone with a dose of common sense will look beyond the one or two recovery quarters that may lie ahead. “Helicopter money” in the form of relief cheques will cease, most likely at a time of high unemployment and rising taxes; tens of millions of developed world citizens will find themselves acutely pressured. Central banks, meanwhile, will have to find a way to counter inflationary pressures, while governments will be forced to cut back on spending. In short, as social pressures rise the standard of living will fall, creating an inescapable feedback loop.

Monetary and fiscal authorities are not the only ones desperately trying to mask systemic dysfunction. The politicians are hard at work too. Donald Trump’s MAGA efforts were a highly effective attempt to distract from domestic failures by creating an external enemy: China. Joe Biden is taking the show to the next logical level, evoking confrontations with both China and Russia. Will he succeed in diverting attention? That depends on whether a sufficient number of Americans are starting to understand that the system they once believed in isn’t working. Their European, Japanese and Canadian counterparts are on a similar journey: many of them are recognizing that the post-war American system they adopted has morphed into something they never wanted.

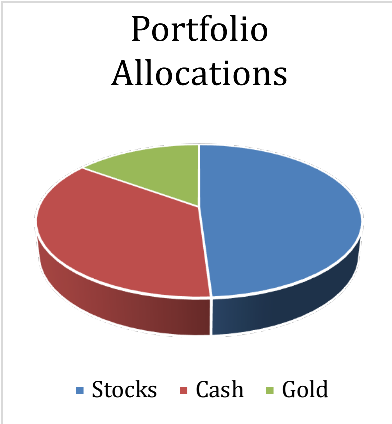
The Need for a Strategy

Preparing for such an inherently unstable environment makes for a huge challenge. Yet, a surprising number of people have taken bold actions. Nowhere is that more manifest than in the property sector, where strategic thinking has dramatically changed. Upscale urban properties, not long ago the stated preference of the wealthy, are losing out to mountain retreats, cottages and farms, as well-heeled city dwellers reconsider their circumstance. The stock market is another go-to place. Despite fundamentally unjustifiable valuations, the key indices keep gaining, largely because equities represent ownership and, unlike bonds, are not just someone else’s liability. Still, how long the stock market mirage can last is anyone’s guess.

M2 Money Supply vs. Inflation



In my last letter I confessed to being agnostic about the future of the economy and markets. I still am, but that doesn’t take away from the need to have a strategy. In 2020, we handily beat the equity indices, mainly because of our significant exposure to gold, last year’s best performer. So far this year, the yellow metal hasn’t helped us, but our stock holdings have appreciated handsomely. We entered 2021 with a 40% weight in equities, which, thanks to our emphasis on stock selection, now makes up close to 50%.



Going forward, we continue to feel very comfortable with this admittedly defensive portfolio balance. Even though the overall stock market is excessively valued, we feel this is not the case with our commodities-oriented selections and the value stocks we hold, which provide us with balance sheet strength and attractive dividend support. During the past weeks, we've also increased exposure to emerging markets, where lower valuations and better growth prospects prevail.

Meanwhile, we continue to stay away from bonds, an asset class we have avoided for some time. Even though the recent sharp rise in yields vindicates our cautious stance, the bond market's risk-reward profile is still unattractive.

What about our massive 35% cash hoard? Cash, at best, is a convenient parking spot—at worst it's an asset that is certain to become increasingly worthless. The cash dilemma is partly why we continue to maintain a robust 15% exposure to gold. The yellow metal is our hedge against inflation and, more generally, financial market volatility. Gold has lagged in recent months, but the fundamental backdrop remains strong, especially in the face of unprecedented monetary largesse. Take a good look at our chart on the previous page, tracing the past 75 years of correlation between money supply growth and inflation.

All the best!

Peter Cavelti