The Conservative Strategist

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The other regime change

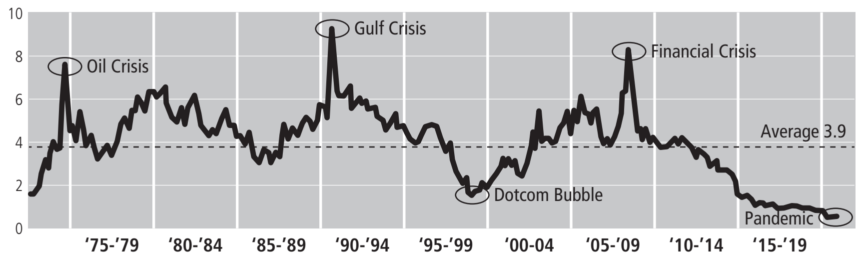
With this past season's 180-degree turnaround in the political sphere, we have witnessed a similar about-face in the investment world. This one started slowly during the fourth quarter, and has accelerated in the opening months of 2021.

Until roughly mid-September, investors were focused on the pandemic-induced lockdown, and seemingly unconcerned about the implications of an eventually reopening economy. In this regime, interest rates were driven toward zero by bond-hungry traders. As rates vanished, investors placed a premium on growth stocks, particularly the tech stocks thriving in the lockdown, like *Amazon, Netflix,* and *Zoom.* Meanwhile, economically-sensitive sectors were punished harshly. The stocks of a number of brand-name companies were driven down to levels that implied they would take many years to recover, if ever.

But by late September and early fourth quarter, the winds of change were already blowing. The tech sector topped out in mid-September, and at the same time, the polar-opposite energy sector made a significant bottom and began rallying strongly. This relative strength has carried through in Q1, with energy outperforming tech by nearly 30 points in a single quarter. And the energy sectors climbing the furthest in Q1 were not the renewable stocks (they had run too far on anticipation of a Biden administration and have now succumbed to profit-taking), but the traditional energy stocks that most investors thought would be punished in the new administration. A tripling of the price of oil has helped those stocks, as did the ultra-low valuations they sold off to in the heart of the lockdown.

Cheap stuff

S&P Goldman Sachs Commodity Index (GSCI) vs. S&P 500 Stock Index, 1972-2020 (10/22/20)



In normal periods, the GSCI trades at nearly 4 times the S&P. During commodity and financial crises (which drive commodities higher and stocks down), the ratio has approached 8 to 9 times. Today it trades at less than one-half the S&P. *Source: Bloomberg, US Global Investors*

Where do we go from here? As for relative valuations, inflation expectations and interest rates will call the tune. On days that rates rise, value stocks have done well relative to growth stocks. On days interest rates fall, growth has come to the fore, particularly tech.

As for absolute valuations, US stocks remain absurdly expensive, especially relative to real assets *(see graph).* It's a function in part of trillions of dollars pumped into the system in the past 12 months, much of it not finding its way to the real economy, but to financial speculation. Ironically, if the recovery continues, we should see much of that spending shift back toward the real economy and away from stocks. The paradox of stocks rising with a record weak economy may be matched by the paradox of stocks falling amidst a robust recovery. ■

The Markets March 31, 2021	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	3972.89	6.15%	6.15%
International Stocks (Vanguard Index)	20.12	3.94%	3.94%
Emerging Markets Stocks (Vanguard Index)	32.85	3.55%	3.55%
Real Estate Stocks (Vanguard REIT Index)	30.50	8.64%	8.64%
Bonds (30 year US Treasury/Vanguard Index)	2.41%	-13.22%	-13.22%
Dollar (US Dollar Index)	93.23	3.67%	3.67%
Gold (London Afternoon Fix)	$1691.05	-10.41%	-10.41%
Money Market Funds (Vanguard Cash Reserves Fed)	0.00%	0.00%	0.00%*

*change in yield

Portfolio Planning

Inflation not rising yet. Powell/Yellen not concerned. The bond market is.

One of the most prominent killers of bull markets is rapidly rising inflation and the surging interest rates that accompany it.

The bond market is spooked. (When inflation is forecast, lenders raise their rates, in response to the anticipated erosion of the dollars with which they will be repaid. Higher rates, lower bond prices.) As of March 20, high-quality bonds have seen the third-worst start to the year since 1830.

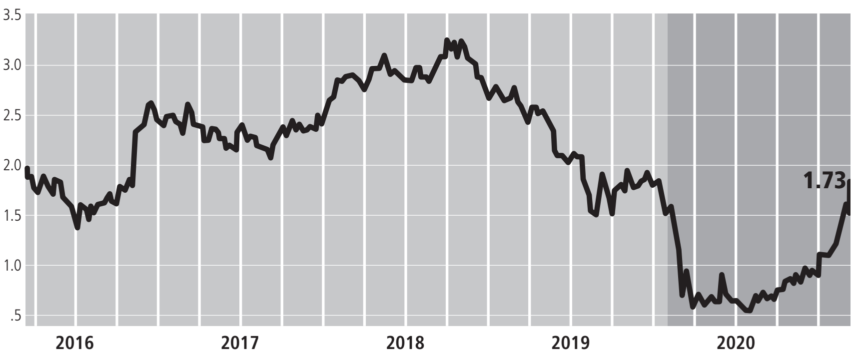
Reopening concerns

As the reopening accelerates, there is ample cause for concern. Nine reasons, at least, as outlined by former NY Fed President Bill Dudley across two *Bloomberg* columns in December and February. (Summary by John Mauldin, *Forbes.*)

1. The way prices fell abruptly last April and May will change the year-over-year comparisons this spring, making annual inflation figures jump.
2. As normal spending returns later this year, the leisure and hospitality industry will regain pricing power. Sharp price increases may be needed to balance demand with diminished supply.
3. Companies won't be able to meet increased demand by simply producing more. Many expansion projects and investments were suspended in the last year, and some businesses have simply disappeared.
4. The Fed recently revised its policy guidelines to allow higher inflation. The target is now 2% *average* inflation over some undefined period. And some Fed economists and academics think it can run significantly higher, with 3% or even 4% not scaring them.
5. Shifts in both political control and fiscal thinking mean the government is now more likely to spend aggressively, and less likely to remove stimulus quickly.
6. Economic slumps brought on by pandemics tend to end faster than those caused by financial crises.
7. Household finances are in far better shape now than they were after the 2008 crisis.
8. Companies have plenty of cash to spend, and access to more at low interest rates.
9. Inflation expectations are rising, which can lead to actual inflation.

A quick turnaround on inflation fears

US 10-Year Treasury yield, 2016-2021, as of 3/19/21



After reaching an all-time low of 0.53% last July, 10-year yields have more than tripled on concerns of a coming economic overheating. But there's still considerable room for them to rise — they're not even back to the current inflation rate.

Complacent officials?

The recent remarks of Fed Chair Powell and Treasury Secretary Yellen however, display complacency about a resurgence of inflation. Powell remarked that a rise in inflation from re-opening is likely to be "only temporary", and that without evidence of more durable inflation, he was unlikely to raise interest rates for the foreseeable future. Meanwhile, Yellen said fears that inflation will be triggered by the $1.9 trillion virus relief bill are "misplaced". She added that if inflation should become a problem, "there are tools to address that."

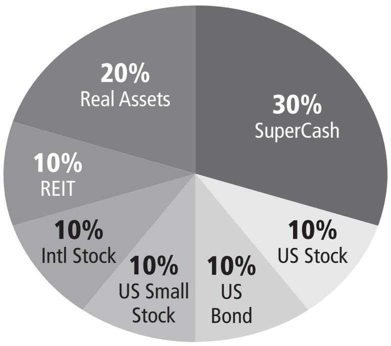
But in the past, when the economy has overheated and inflation has reared up, it has proven somewhat late for government action. In these instances, the bond market itself takes matters into its hands; traders pre-emptively sell bonds until rates are high enough to cool the economy and quell inflation. We may be seeing such an incipient move today, and the $64 trillion question is: *How far does it go?*

Our fiscal and monetary authorities will not put on the brakes. Only a resurgence of the virus, and an interruption of the economic recovery (which already seems to be occurring in Europe, with the rise of COVID variants) may cool inflation. Not exactly something to wish for. ■

SuperDiversified Portfolios (SDPs)

Stuff makes a comeback

SDP1 ***Conservative***

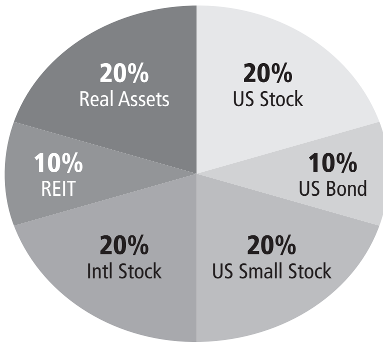


1st Quarter **3.49%**

Last 12 Months **32.10%**

In March of last year, the value of commodities reached an all-time low relative to the value of financial assets, at about one-tenth its normal ratio in the last 50 years. Since then, commodities have rallied steadily and substantially. But they remain near an all-time low valuation *relative to stocks.*

SDP2 ***Moderate***



1st Quarter **5.30%**

Last 12 Months **49.98%**

In the past four quarters, commodities (as measured by the performance of *PIMCO Commodity Real Return Strategy I,* PCRIX), have gained 11.71%, 11.47%, 12.57%, and 9.71% (through March 19), for a total gain of 54.55%. A continued resurgence will put a tailwind behind the SDP portfolios.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Will rising bond yields break the back of stocks?

Asset Class	Mutual Fund	Performance 1st Quarter '21	Performance Last 12 Months	
SuperCash	PIMCO Instl Low Duration	0.00%	3.49%	Best
	Merger	0.86%	8.36%	Worst
	Calamos Market Neutral	1.28%	10.79%	
US Stock	Vanguard Index Trust 500	6.15%	56.19%	
US Bond	Vanguard Long-Treasury	-13.22%	-15.11%	
US Small Stock	Vanguard Small-Cap Index	10.19%	87.53%	
Intl Stock	Vanguard Intl Index	3.94%	52.71%	
REIT	Vanguard REIT Index	8.64%	36.31%	
Real Assets	PIMCO Commodity Real Return	8.52%	52.12%	

The 10-Year Treasury bond has now tripled in yield since its all-time low last July. The question arises: When do higher rates begin to impact the values of companies and the prices of their stocks? The answer is that it's already happening in the mentioned rotation from growth stocks to value stocks.

But will this rotation give way to a general decline, and when? An initial move in rates off the bottom is often greeted positively by stock investors as indication the economy may be improving. But an extended move — say to the 3% area on the 10-year Treasury — should spook stock investors.

PIMCO All Asset

PIMCO All Asset (PAAIX) is a go-anywhere absolute return fund run by Research Affiliates chief Rob Arnott. It emphasizes what Arnott calls *Third Pillar* assets — inflation-friendly assets that are not highly correlated with mainstream stocks and bonds. Thusly, PAAIX offers a dose of inflation protection *and* portfolio diversification.

Arnott's lofty absolute return goal has been a long-term real return (return above inflation) of 5% annualized. How's he done? For the five years ending March 19, 2021, he's up 8.78% per year, or 6.75% per year more than inflation (2.03%). For the ten years until now, he's up 5.49% per year, or 3.82% per year more than inflation (1.67%). And since our earliest data on 11/6/2002, the fund has risen 6.96% per year — 4.91% per year better than the 2.05% inflation rate.

If the coming environment features rising inflation, it should play right into *PIMCO All Asset's* wheelhouse. As of year-end, 69% of the fund was invested in *Third Pillar* assets.

SEASONAL STRATEGY

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Building an inflation-friendly portfolio

If we face an era of rising inflation and rising interest rates, clearly some assets will fare better than others. Let's do a rundown based on our target asset classes.

Value over growth

Among our US Stock, US Small Stock, and International Stock allocations, value stocks will likely outperform growth stocks (as they have been doing rather steadily since mid-September). This is because interest rates play an outsized role in the way investors respond to growth stocks. When rates are low, investors attribute very high values to the earnings streams of growth stocks, giving them higher price/earnings (P/E) ratios and thus higher prices. As rates rise, that discount factor diminishes, P/E ratios drop, and so do prices. You can trace the recent underperformance in tech stocks, for instance, to the bottoming out in bond yields last summer.

Value stocks, which are assessed based not so much on earnings power as on the value of their assets, grow more valuable as inflation pushes up the worth of their physical assets. That's why inflation expectations, and the very real rise in the oil price, have made energy stocks the big winners of the first quarter. Bank stocks, too, are faring well, for a different reason: As rates rise, banks can make more money on the spread they obtain between their own investments and the rate they pay depositors, padding their profits.

Floating over fixed

In Bonds, we want to favor low-duration over high-duration, floating rate securities over fixed-rate, and high-yield over high-quality, since the kind of robust economic growth that brings the higher-inflation, higher rates regime will boost the credit quality of the lower-grade companies that issue high-yield debt. High-grade bonds, on the other hand, like Treasuries, may actually be an excellent short sale in a rising inflation phase. The *ProShares Short 20-Year US Treasury* ETF (TBF) has gained 16% year-to-date.

REOC over REIT

In Real Estate, we are biased toward real estate operating companies (REOCs) versus REITs, since the higher income payout of REITs is more vulnerable to rising rates, whereas REOCs depend more on the underlying value of their assets.

Let's get Real

The category we want to overweight is Real Assets, as a rising inflation scenario will boost the value of real assets versus financial assets, and the value of goods versus services. All subclasses in this category, including industrial commodities, precious metals, infrastructure, energy infrastructure, farmland, and timber should benefit from rising inflation.

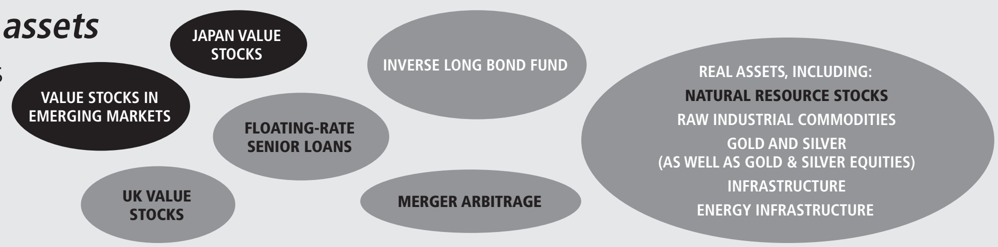
Arbies: We have the beats

Finally, in SuperCash, most of our arbitrage strategies will fare better once rates have reset higher, and are at least neutral with respect to rising versus steady or falling rates. Merger arbitrage spreads, for instance, tend to widen when short-term rates move higher. That may be a painful transition to the tune of a few percent, but once rates reset at a higher level, returns to merger arbitrage, so skimpy during the zero-interest-rate years, should reset higher likewise.

Of course, the aim is to position in anticipation of higher inflation, and not to wait too long until it's clear to all that inflation is a huge threat, as asset prices may have fully adjusted by then. ■

Inflation-friendly assets

We think these categories of assets will do well in a rising-inflation environment, and they are not yet expensive.



Two of the global asset allocation firms that we follow especially recommend the highlighted assets, with Research Affiliates *(RA) touting those shown in the black ovals, and* Grantham Mayo van Otterloo *(GMO) making the case for those in black type.*