

the Connection

A Quarterly Review

3rd Quarter 2021

CHICKEN OR THE EGG

Moving past the challenges of the pandemic, the third quarter shifted investor focus back to the basics; Inflation, interest rates, oil prices and valuations. It's 2000 again, again. Up until September, everything was going along as we expected. Interest rates remained low. Valuations were elevated because of low rates. Companies that had a decent growth rate with expanding margins were doing well. Then China had a shiver of their own 2008 catastrophe with Evergrande. The 10-yr treasury spiked. Demand swamped Covid-ravaged supply chains. Three years of inflation arguments all came rushing in at once, and the markets pulled back significantly.

Burning oil and coal has been a staple of industrial society for two hundred years. The fossil fuels market is dominated by low-cost suppliers that don't have common laws regarding property rights and trade. Oil producers don't have control over the price of their product. The entities that do have control over price are either antagonistic or ambivalent towards capitalism and property rights. This is reminiscent of investing in Chinese technology over the last decade. It looks sound until the ruling party pulls the rug out from under everyone. As soon as the United States and other free markets start ramping production back up in oil and natural gas, expect OPEC and Russia to flood the market. Our answer to this is oil itself and the companies that rely on that commodity are almost un-investable.

OPEC countries are now investing heavily in power and energy technology to support their economies after the end of oil. That coincides with the U.S. investing heavily in technology to wean off oil. This is taking place while China cracks down on their own technology companies becoming too powerful. Congress should pass a skinny version of the Build Back Better bill along with the infrastructure bill. This will cause increased demand in alternative energy technology. Secondly there will be significant inflationary pressures as countries and companies rush to meet incoming demand. (There is a longer explanation for why we think this is great for the U.S. and bad for China, but that may be a phone call for anyone interested in listening to us lecture).

Another aspect of inflation that has not been fully digested has been increased unemployment benefits. If people are

allowed to sit at home and consume without working, that is inflationary. Demand increases and supply decreases. As our current unemployment benefits and other subsidies roll off, people will go back to work. Work will increase supply more than demand. This should alleviate some of this Covid specific inflation, while leaving much of wage inflation intact.

Real inflation, heavy investment in new technologies and rising interest rates have everyone worried about a 2000-2002 type market crash. The global economy and valuations in capital markets are very different then the factors that set up the 2000 crash. First, Tech stocks are the cheapest they have been relative to other sectors since December of 2018 (the Nasdaq bear market in the 4th quarter of 2018). Second, interest rates are wholly supportive of current valuations. In 2000, short term rates were at 5%, today they are 0%. Not only that, the 2000-2002 market crash was coming off forward multiples in the high 20's, and the S&P forward actually got above 30 times forward earnings (we are at 20x right now). Lastly, the assumptions were bad in 2000. (Cisco was supposed to supply every house with a network switch.) The situation today is much different. The biggest problem technology (substitute car, toilet, flooring, furniture) companies have today is they cannot make products fast enough to meet demand. That is the opposite of what happened in 2000, when inventories ran up and demand died.

The only honest comparison between today and the early 2000's is that we are in a tech renaissance with increasing interest rates. Everything that was promised to us in 2000; like a talking toaster or a computer that plays songs on demand; took 15 years to finally get into our homes. Now that Covid has forced technology onto everyone at a breakneck adoption rate, people will not be able to live without the changes that technology products have made in their lives. We have inflation because we have pent up demand. The world was put on hold; and now in the reopening, supply chains need to be reexamined. There will be sufficient investment over the next decade to diversify supply chains and localize production. Slight over-supply should offset any painful inflation over the mid to long term. Short term nobody can control inflation.

Even with higher inflation caused by excess investment, we expect portfolios to do well. If the ten-year treasury goes up 2% over the next 18 months, like everyone is afraid of, we still expect portfolios to do well. The only way the world can stomach a U.S. ten-year rate of above 3.0% is if we are in an economic boom. That boom will coincide with earnings expansion, supporting equity market levels that we see today.

THE ACT OF GIVING

Below is an updated list of some organizations our clients are helping today.

All Local Food Banks
www.sfmfoodbank.org
www.shfb.org
www.foodbankccs.org
www.refb.org

Bloom Marin
www.bloom.org

Maya's Music Therapy
www.mayasmusic.org

Friends of the Urban Forest
www.fuf.net

Guide Dogs for the Blind
www.guidedogs.com

Doctors without Borders
www.doctorswithoutborders.org

The Nature Conservancy
www.nature.org

National Kidney Foundation
www.kidney.org

Guide Dogs of America
www.guidedogsofamerica.com

Golden Gate National Parks Conservancy
www.parkconservancy.org

Fine Arts Museums of San Francisco
www.famsf.org

Canine Companions for Independence
www.cci.org

Alzheimer's Association
www.alz.org

The Foundation for Rotary International
www.therotaryfoundation.org

Wildcare
www.wildcarebayarea.org

Homeward Bound of Marin
www.hbofm.org

Whistlestop
www.whistlestop.org

FINCA
www.finca.org

Sonoma Land Trust
www.sonomalandtrust.org

Friends of the Earth
www.foe.org

The American Friends Service Committee
www.afsc.org

Amnesty International
www.amnestyusa.org

Eastside College Prep
www.eastside.org

Northern Sierra Partnership
www.northersierrapartnership.org

American Bird Conservancy
www.abcbirds.org

The Cornell Lab of Ornithology
www.birds.cornell.edu

Mono Lake Committee
www.monolake.org

California Trout
www.caltrout.org

Tahoe Rim Trail
www.tahoerimtrail.org

Ocean Conservancy
www.oceanconservancy.org

Global Fund for Women
www.globalfundforwomen.org

Marin Agricultural Land Trust
www.malt.org

Walk to End Alzheimer's – San Francisco, CA
www.act.alz.org/sanfrancisco2019



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