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Q1 Review and Continued 2021 Outlook

Executive Summary and Introduction

- Global markets generally moved higher so far in 2021, but faced several emerging challenges. We saw three key themes emerge in Q1 and expect these themes to persist for some time.
- Government largesse is the first theme. Globally, governments are pushing into unprecedented extremes with both fiscal and monetary policy. While many of these government policies attempt to cure inequality, others have likely exacerbated it. Rising and extreme inequality is thus our second major theme. Finally, mounting tensions between the two dominant superpowers – the US and China – is our third major theme.
- These three themes are interconnected, their confluence is largely unprecedented and they will likely guide the shape of the markets for many years to come.

Cash

Cash was flat in nominal terms (before inflation and taxes) and we remain near neutral to the asset class. Signs of government largesse are fully on display here with global money supply up nearly 30% over the last year. In the US, nearly a third of all money in circulation was created in the last year. The average American household has never been in better financial shape with record low debt service ratios and nearly $2 trillion in excess savings. This, however, belies the inequality hidden beneath. Poverty rates rose over the last year, job losses have disproportionately impacted low-income workers, and one-third of small businesses remain closed. These disparities in pandemic and recovery outcomes have led the Federal Reserve to all but guarantee that our cash will earn no more than 0.25% per year until the end of 2023.

Cash is thus burning a hole in the consumer's pocket with negative yields after taxes and inflation. While the retail investor mania seems to be slowing for now, documentaries about the extraordinary events in Q1 have already been released. Vacation home prices soared, GameStop's stock rallied 900%, a mint condition Super Mario Brothers game sold for $660,000, and Beeple sold an electronic work of art certified with a non-fungible token (NFT) for $63 million. Average NFT prices have since collapsed by a remarkable 70%. While we don't expect to spend cash on any of these items any time soon, we do think that, despite its negative real yield, cash can be used opportunistically as we confront the major themes mentioned above.

The US Economy and Bond Markets

Perhaps the fading retail investor mania has something to do with an American economy that appears to be firing on all cylinders. The US added 916,000 jobs in March, with 280,000 coming from the hard hit but rebounding travel and leisure sectors. Despite the record cold snap in February, the initially released job creation numbers were also revised higher. Corporate purchasing managers are ready to spend, as indicated by their indexes reaching 20-year highs. Economists are predicting the US economy could grow from 6-10% this year after inflation, a growth rate we have not seen in 70 years.

Despite this anticipated level of growth, the US and many developed countries show no signs of pausing on unprecedented fiscal and monetary policy. This extraordinary accommodation should be a cause for concern for most bond investors. The Federal Reserve has not only anchored short-term rates to zero for another two years, but it continues to flood the market with cash by purchasing $80 billion of Treasuries and $40 billion of mortgages each month. Fed Chairman Jerome Powell has repeatedly insisted he is more concerned with the 8.5 million Americans out of work and the pandemic's exacerbation of inequality, than threats of inflation or asset price inflation. For now, this interest rate policy has given cover for the President and Congress to run record debts and deficits with potentially more on the way.

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Thus, US Treasury bonds, an asset class that we are considerably underweight, experienced their worst quarter in four decades. We noted in February that a 1% yield on a 10-year loan to the US was unattractive with the Federal Reserve targeting 2% inflation. Our view remains firm even with yields recently rising to 1.7%, but still below anticipated inflation. While Treasuries experienced a 40-year flood, tax-free municipal bonds, where we are closer to neutral, outpaced Treasuries by the widest margin since 2009. The asset class still experienced a narrow loss in Q1. However, we think by focusing on high-grade, tax-free bonds just beyond the Fed's 2023 interest rate lift off date, we can earn returns in excess of cash without undue risk.

Consistent with our letter earlier this year, we are still even more optimistic on high-yield municipals, which gained close to 2% in Q1. We see tailwinds intact with the recent stimulus package supporting state and local municipalities, and the threat of higher taxes on affluent investors driving more flows to the space. Despite the concerns in the Treasury market, the high-yield corporate market and thus, underlying financial conditions, have remained stable. On the topic of inequality, emerging market debt where we have near zero exposure, fell even further than Treasuries in Q1. Emerging economies are suffering more from the pandemic, with fewer vaccines, and are often even more susceptible to rising inflation for basic needs.

Public Equities

We also remain near neutral to public equities, which have largely been beneficiaries of both the economic recovery and government largesse year-to-date. While investors are increasingly concerned about an overheated economy, rising Treasury yields have not yet derailed financial conditions nor the current bull market. In the US, stocks gained just over 6% in Q1, but actually became cheaper on some metrics due to strong expected future earnings growth. Based on expected 2022 earnings, US stocks yield close to 5%, well above cash and bond yields. Such relative yields, coupled with an "easy" Federal Reserve, have generally rewarded stock investors for staying invested. We are mindful that bond yields can certainly move higher still and that future earnings could also be revised lower, especially in the face of higher taxes. The bull market since 2009 has disproportionately benefitted those who own significant financial assets and the call to raise capital gains taxes is clearly on the rise. For the time being, we are aware of these risks, but continue to believe in holding US stocks given the strong relative yields.

Outside of the US, international stocks gained roughly 4% in US dollar terms. Japanese markets were particularly strong and experienced inflows of net capital for the first time in many years. Relatively cheaper valuations, improving corporate governance, and a recent uptick in return on equity have all been tailwinds. Interestingly, Japan's Nikkei stock index is approaching price levels it last touched in 1990 when the Japanese economy and markets were world beaters. We don't expect a similar fate for today's world beater – the US – but do believe in some international diversification against this risk in countries like Japan.

It is often said that Europe will be forged in crisis and while European stock markets chugged along in Q1, they were certainly tested. Germany was in and out of lockdown, France faced lockdowns with 75% of new COVID cases stemming from mutant strains, and Credit Suisse took a $4.7 billion hit following the collapse of Archegos. While European vaccination efforts have significantly trailed behind US trends, we think investors are rightfully focused on the eventual light at the end of the tunnel and we remain slightly overweight international developed markets versus their ex-China emerging market peers.

Within emerging markets and despite the rising tensions between the US and China, we remain overweight China as we expect its share of the global economy to continue to grow. Cold War 2.0 news headlines certainly dominated in Q1. We saw the initial Biden-China summit largely fail, the 5G and semiconductor war heat up, increased naval activity in the South China Seas, and an almost overnight ban of H&M from China after it criticized China's treatment of the Uyghur Muslims. China also appeared to crack down on its own tech industry (and Alibaba, in particular) on the pro-democracy movement in Hong Kong and is one of the few global powers that appears to be tightening its fiscal and monetary policy. These factors led

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to subpar but positive returns to China in Q1, but we remain convicted on our overweight for several reasons. Despite the headlines, China generally continues to open its financial markets. Short selling is much more common today than just six years ago when the tactic could lead to prison. The Chinese STAR market is attracting some of the world's largest IPOs via a NASDAQ-like registration process. Hainan Island is set to become a free trade zone in four years. Charlie Munger, who serves as chairman of Daily Journal, which recently purchased Alibaba stock, is fond of saying that our country has all the reasons in the world to get along with China. In the last 20 years, US exports to China have grown 550% versus just 84% to the rest of the world. While we expect tensions with China to rise, we remain overweight and optimistic.

Alternative Assets

In Q1, many hedge funds had a difficult time staying out of the news and delivering excess returns. On an asset weighted average, hedge funds gained just over 2% for the quarter, but experienced extremely wide dispersion. Hedge funds that were heavily short GameStop or close to Archegos experienced existential losses. We continue to move our hedge fund allocation closer to neutral while improving liquidity and fees, and are concentrating on a smaller group of specialized managers. We generally require these managers to be humble, and to have a well-defined circle of competence and a focus on risk management.

Given the rising concerns around inflation, most real assets performed strongly in Q1. Real estate, after a difficult 2021, jumped nearly 6% in the first quarter. After positioning our real estate platform on the defensive side for most of last year, we grew more aggressive in Q4. We now see many of the reopening trade themes – largely hotels and office space – as stretched, and began to reposition back toward some of our long-term secular winners like industrial warehouses and single-family homes for rent. Front month oil prices here in Texas rose from $47/bbl to nearly $60/bbl by quarter-end. We turned net buyers of energy equities in Q4 and benefitted as the sector jumped over 30% in Q1. Finally, although gold struggled in the first quarter with a 10% loss, we began adding to the asset more recently and still believe it is a useful hedge against the continued theme of government largesse.

Finally, in private equity, we are working hard to roll out our next vintage of vehicles, while keeping a close eye on our existing managers, the markets and the opportunity set. We have been beneficiaries of both the white-hot IPO and SPAC markets, and early results suggest that private equity as an asset class kept pace with and often outpaced the strong public market returns in 2020. We continue to cast a wide net in looking for new opportunities while also maintaining our carefully cultivated legacy relationships.

Conclusion

In conclusion, we are facing a market environment that one former Federal Reserve governor described as "a great experiment." The confluence of government largesse, global inequity and rising tensions between the US and China are unprecedented and will likely to lead to continued volatility ahead. We are focused on these risks and have worked hard over the last quarter to be good stewards of your wealth. We generally are remaining close to fully invested while choosing our investing partners very carefully. We have worked hard to improve our liquidity and reduce our complexity so that we can be nimble as we head into largely uncharted waters. As always, we greatly appreciate your trust in us and are happy to speak at any time about your portfolio and the markets.

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