CLIFFORD SWAN

THE Investment Counselor

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WISDOM *for* GENERATIONS

LONG DAY'S JOURNEY INTO NIGHT

By Kevin J. Cavanaugh

Two features define the current economic and financial market backdrop. The first and most obvious is the significant increase in government involvement in both areas. Second, and as a direct result of the first, the world is awash in liquidity. By liquidity we mean

> "...the world is awash in liquidity...cheap money is available to almost anyone..."

that cheap money is available to almost anyone who seeks it, whether governments funding budget deficits, old-line businesses padding their balance sheets or newer businesses raising money to grow (IPOs). Businesses that might not otherwise be able to raise capital due to the risky nature of the enterprise have relatively easy access to cheap capital (junk bonds). Shell companies with no definitive business plans (SPACs – special purpose acquisition companies) are garnering funds at a breakneck pace. Margin debt is setting records and hedge fund managers are finding unique methods to invest on borrowed capital. Private equity managers are sitting on massive sums of potentially leverageable funds. Individual investors have again embraced leverage (options) to goose returns. Consumer credit is growing again as new fintech companies and the payments industry find innovative ways to encourage borrowing.

For now, complacency reigns in the financial markets as investors feel as if they may have dodged a bullet. History shows us that investors have a strong tendency to extrapolate current trends, and more critically, that this has proven to be an unreliable methodology for investment, especially at market extremes. Economic and corporate earnings growth are very strong as we bounce back from last year's weakness. In addition, investors are confident the Federal Reserve will keep easy money policies in place for some time—meaning interest rates will remain low. Strong earnings and low interest rates are usually a good combination for equity investment.

While change is sometimes imperceptible, we know that economic and investment cycles are as natural as night following day. The poet Johann Wolfgang von Goethe observed, "Sometimes our

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fate resembles a fruit tree in winter. Who would think that those branches would turn green again and blossom, but we hope it, we know it." At Clifford Swan, our investment process and our experience help us to mediate the risks associated with extrapolating trends. In a sense, extrapolation is a method which ignores the uncertain (change). In uncertain times, like today, we believe our investment process helps us raise the right questions. Successful investors have developed processes that embrace the uncertainty inherent to our practice, but never stop questioning.

Life is about trade-offs. In this article we point to a few of the trade-offs taking place related to heightened government intervention and the flood of liquidity. What might be the costs associated with the speculative trading activity and current elevated high stock prices? What are historically low bond rates telling us? Are rapidly rising single-family home prices, as well as consumer goods prices, evidence of successful Federal Reserve policies? While we will focus on the U.S., it is interesting to note that many of the same fiscal and monetary policies are being followed by countries around the globe. Easy money, low interest rates, heightened sovereign debt levels, and immense budget deficits are commonplace today. Furthermore, global central banks are as active as ever in the financial markets.

Given the heightened level of intervention taking place now, we ask

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whether activist governments will have the ability (or desire) to extricate themselves from aggressive fiscal stimuli and ultra-easy monetary policies. Since the Great Financial Crisis of 2008-2009, central banks have played a larger and larger role in the financial markets, especially through asset purchase programs (buying both distressed and secure assets). Last year, to remedy the economic and financial market disruptions caused by Covid lockdown policies, central banks ramped up their market activity to almost unprecedented levels, comparable only to wartime periods of the past. As a result, government debt levels, which have been growing for years, exploded higher over the last 18 months. And, as mentioned, this high level of intervention continues today. Even as economies are recovering from the lockdown conditions, governments continue to plan for aggressive fiscal stimulus while running high and persistent budget deficits. These policies now seem to have become legitimized around the world. Investors wonder whether central banks might be held hostage to governments that are simply not willing or able to curb the high levels of deficit spending. For now, it appears that the "independent" central banks have accepted the risks associated with these trade-offs: higher asset prices and potential market bubbles (bonds and stocks) versus funding budget deficits.

The quiet flood of liquidity has engendered a disconcerting level of complacency, especially as it relates to investors seeking yield. Investors have become increasingly emboldened to take on risk as they surmise that the central banks may not be able to tighten monetary conditions. Higher interest rates on government debt would result in yet larger budget deficits, which have the potential to spiral out of control. In the U.S., besides higher prices and lower yields, there is evidence that the flood of liquidity is causing "plumbing" problems in the financial system as incentive structures evolve. The personal savings rate is running at around 10%, which is higher than levels seen before Covid lockdowns. Accordingly, bank balance sheets are bloated with deposits. Banks' deposit-to-loan ratios are hitting record levels and money velocity (the rate of turnover of money in the system) has diminished considerably. In recent months, the U.S. Federal Reserve has stepped in to relieve congestion in the banking system by soaking up excess liquidity. Of course, that is one of the jobs of the Federal Reserve, but the level of intervention has been alarmingly high. In addition, large company (mainly big tech) balance sheets are bloated with cash, as borrowing incurred during the lockdowns turned out to be superfluous.

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Another responsibility of the Federal Reserve is to manage the money supply. The Fed does not control the creation of all money but does manage the reserves in the banking system, which then influence the creation of money in the financial system. The U.S. Federal Reserve has two mandates: to manage for full employment and procure stable prices in the economy. Accordingly, as outlined in the Federal Reserve Act of 1913, the Fed: "shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production." As you can see in the chart below, the money supply has been growing at a rapid pace as compared to before the lockdowns. M2, a measure of money, is up +30% over the last 18 months and is still growing at a high-teens pace. This level of money growth in the U.S. is almost unprecedented.

What is the trade-off for the implied benefits (increased production) of rapid money growth? Obviously, as more money is created the supply of U.S. Dollars becomes less scarce. The technical term for this occurrence is money

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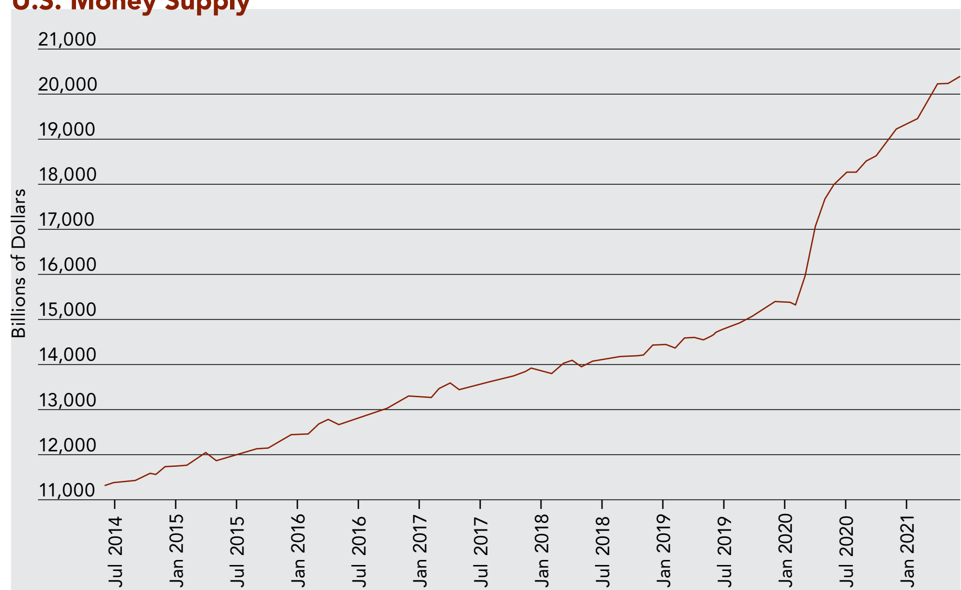
U.S. Money Supply



Source: Board of Governors of the Federal Reserve System. M2 Money Stock Monthly Average, Billions of Dollars, Not Seasonally Adjusted.

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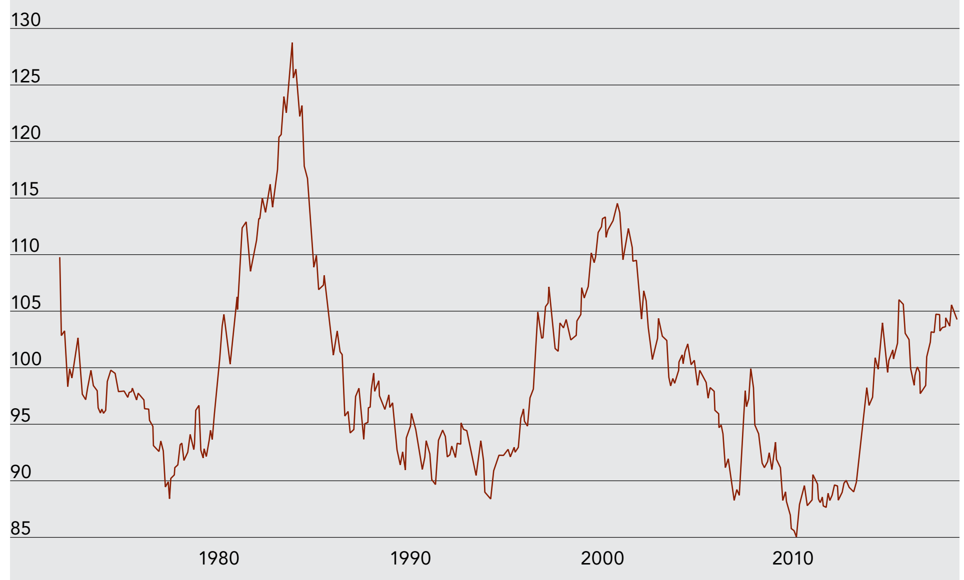
U.S. Dollar Index



Sources: Federal Reserve, www.macrotrends.net

debasement or devaluation. Ideally, this newly created money would cycle through the banking system wherein loans (credit aggregates) are generated for productive investment (creating jobs as well as more goods and services). But, as we mentioned, the flood of new money and congestion in the banking system indicates that the mechanisms for productive growth are not working properly. Instead, it appears that the money/liquidity is being siphoned off into other investing activities, pushing up prices in stocks, bonds, precious metals, commodities, real estate, and even cryptocurrencies. As the supply of U.S. Dollars appears to be unconstrained, it makes sense for investors to look elsewhere for relative scarcity and value.

By comparison, the supply of goods and services are relatively constrained. And because of the lockdowns, production of some goods has been curtailed. In this case, there are more U.S. Dollars chasing fewer goods, resulting in higher prices. The lockdown-induced global supply chain issues are contributing to a higher level of general price inflation. However, the supply chain issues are not

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the only reason for higher prices and investors are trying to understand the other factors at play.

The Federal Reserve has stated that they believe the current level of higher inflation (CPI +5%) should be transitory; this is an adequate justification for maintaining easy money policies. For now, investors seem to be accepting the Fed's forecasts, and bond yields consequently remain subdued. If, however, inflation pressures prove to be intransigent and investors lose confidence in the Fed's ability to control inflation, investors might call the Fed's bluff and interest rates will move higher, especially longer-term maturities. As we mentioned earlier, this places the central banks in a difficult position as they must balance the need to fund budget deficits with the desire to keep interest rates relatively low.

If confidence in the success of this high stakes juggling act wanes, the evidence will likely show up in the relative weakness of the U.S. Dollar against other currencies and hard assets. Please see the chart above which represents the value of the U.S. Dollar relative to the currencies of our major trading partners. As you see here, going back to the 1970's, there have been periods of U.S. Dollar strength as well as weakness and these trends can persist for many years.

What drives these trends and why is this important? In the past, when investors (including business managers) believed a government had adopted a policy of currency debasement, they sought refuge in other currencies or other assets. Rapid money growth (less scarcity) used to fund budget deficits is the warning signal of debasement. Interestingly, as mentioned, these high stakes juggling acts are a global phenomenon today. Investors seeking refuge from currency debasement policies have few safe havens. This is likely one reason for the current popularity of cryptocurrencies, a few of which may possess some scarcity value. This global phenomenon also provides a reason for the relative stability of the U.S. Dollar over the last year (the cleanest dirty shirt). The U.S. Dollar has been quite strong since the Great Financial Crisis, attracting capital to domestic financial markets. The chart on the following page shows the steady increase in foreign investors in U.S. stock markets.

Typically, when a currency is being debased, the offending country attempts to defend the currency by raising interest rates. In today's world with immense budget deficits and already bloated government debt levels, raising rates will not be an easy task. Periods of currency weakness are particularly difficult to manage through. During the 1970s and early 2000s, timely and effective asset allocation decisions made all the difference for investment returns. In both periods, stock markets entered as overvalued and then, while experiencing more difficult economic conditions, the major stock markets indices stagnated for years (1968-1982, 2000-2014). For much of the 1970s higher trending inflation forced interest rates up, which also pulled down

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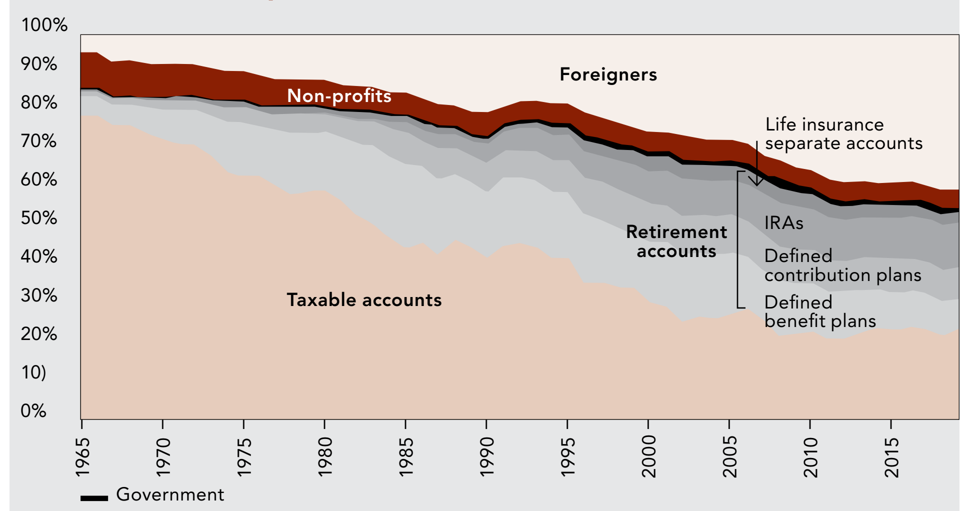
portfolio returns. However, with careful stock selection and timely deployment of liquidity into undervalued assets, positive returns after inflation were attainable.

> "For now, the flood of liquidity is floating all boats..."

Consistently building the purchasing power of our clients' assets is the primary objective of our investment style. Our client portfolios are carefully constructed to be resilient through periods of inflation or disinflation. We believe our style's primary advantages are derived from our long-term investment time horizon, a focus on high quality investments, and a disciplined approach to security selection and valuation.

For now, the flood of liquidity is floating all boats and investors are acting as if the waters shall not recede. However, while we admit the timing is uncertain, the flood will prove transitory—like Goethe, we know it. ◆

U.S. Stock Ownership 1965-2019



Sources: Board of Governors of the Federal Reserve System, Tax Policy Center Calculations (Oct. 2020), New York Life Investments, Visual Capitalist

MESSAGE FROM THE CEO

By Peter J. Boyle
CFA, CIC

Looking back on my first year serving as CEO, the theme of the year has been resiliency. Covid has presented so many individual and collective challenges. I am extremely proud of the Clifford Swan team for their adaptability, support of one another, and unwavering commitment to our clients. There was (and still is) a true sense of being in this together.

Although we aren't fully out of the woods, it has been wonderful to carefully and thoughtfully reopen our offices and start to see colleagues and clients in person. I'm thankful that the Clifford Swan team and our families were recently able to gather in my backyard where we all enjoyed burgers, fries, and, of course, pie from local favorite, Pie 'N Burger.

We welcomed new colleagues Murcy Huang and Sophia Sose this year. Sophia joins our exceptional team of client service specialists, working closely with Executive Director of Planned Giving Services, Ken Dike, to support our institutional clients with their planned giving programs. Murcy's significant experience in fixed income research and portfolio management make her an important addition to our fixed income portfolio team. Beyond adding investment and client service capabilities to our firm, these individuals exemplify Clifford Swan's culture through their energy, commitment, and collegiality. We look forward to having you get to know Murcy and Sophia, too. ◆

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DOES CRYPTOCURRENCY BELONG IN YOUR PORTFOLIO?

By George E. Hasbun
CFP®

Cryptocurrencies have entered the mainstream. What began as a white paper written by the mysterious Satoshi Nakamoto in 2008, titled "Bitcoin: A Peer-to-Peer Electronic Cash System," has morphed into several cryptocurrencies currently valued at approximately $2 trillion dollars. Bitcoin is the first and most well-known cryptocurrency and is gaining momentum worldwide. In fact, The President of El Salvador recently announced that Bitcoin will be accepted as legal tender—a first for a nation.

The foundation behind cryptocurrency's rise is its ability to be used across borders without government or central bank influence. It may be argued that there are strong benefits to a decentralized currency. Just imagine if on your next trip overseas you weren't concerned with converting dollars into foreign currency and you could use your digital wallet wherever you travel. And yet, recent ransoms paid in cryptocurrency to cybercriminals reflect the "Wild West" nature of this space which largely avoids detection by regulators and legal authorities.

One of the most interesting attributes of Bitcoin is the use of blockchain technology, which enables every transaction to be stored in a database operated by individuals all over the globe and is inherently transparent. To conceptualize blockchain technology, imagine the blockchain as a global bank vault with rows of glass boxes. Anyone in the vault can see inside the box, but the contents are only accessible to the keyholder. This technology has many uses beyond digital currencies including securely sharing medical data, serving as marketplaces for NFTs (non-fungible tokens), as well as providing supply chain, logistics, and data monitoring. For example, more than

> "This technology has many uses beyond digital currencies..."

450 airlines can now use IBM's blockchain-based vaccine passport to quickly clear international travelers to fly.

Beyond blockchain technology applications, Bitcoin is also a scarce "resource." The number of Bitcoins that can be mined is set in the code; its growth is predetermined and not subject to central bank policies. As such, does it serve as a good store of value? A store of value is a commodity or asset that will retain purchasing power into the future—a particularly useful thing in an inflationary environment—and can be saved, retrieved, and exchanged in the future. Gold is a good example because its physical properties and limited supply contribute to its relatively consistent value and use over time. While Bitcoin is theoretically scarce, its price is unstable, making it a poor store of value for now.

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So, does cryptocurrency belong in your investment portfolio? At Clifford Swan, our investment approach centers on valuing businesses by the cash flows they generate. In his legendary book, *Security Analysis*, Benjamin Graham said, "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative." When we invest your money for you it is only done after careful analysis by our team of research analysts. Our primary focus is to preserve and growth wealth. Importantly, we want to understand the businesses we are investing your money in, the cash flows they generate, and management's focus on deploying that cash so that it can benefit shareholders. Bitcoin and other cryptocurrencies do not possess the qualities we look for when investing a client's capital. Here are a few of the risks we see with an investment in Bitcoin or other cryptocurrencies:

1. REGULATION AND TAX:

One of the lures of cryptocurrency is anonymity, but recently the IRS determined that cryptocurrencies like Bitcoin are "property" that is reported on and taxed the same way as owning stocks. Over the past 10 years, Bitcoin has returned an astronomical 200,000%. The U.S. government certainly wants to tax those gains like they do all other property. Since the cryptocurrency market has surged, governments throughout the world have the regulation of this market in their crosshairs. Increased regulation, taxation, and the possibility of abolishment are all possible outcomes for cryptocurrencies. In fact, it's likely that governments will issue their own Central Bank Digital Currencies (CBDCs) in the coming months and years; China and the EU are already testing the viability of digital currencies. It is quite possible that privately created cryptocurrencies could be displaced.

2. VOLATILITY RISK:

The ride to 200,000% gains has been extremely rocky. Since 2012, Bitcoin has endured 14 selloffs of more than 30%, six of more than 50%, and three of more than 80%. If, like the U.S. dollar, Bitcoin or other cryptos are ever going to be a standard medium of exchange for goods and services, the volatility must decrease. Otherwise, if you were running a restaurant that accepted Bitcoin, the

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funds you received could be down 10% by the time you open the restaurant the next morning. To gain widespread adoption, the instability will need to subside, and businesses be willing to accept payment. For now, volatility persists.

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3. EXCHANGE SECURITY RISK:
Bitcoin and other cryptocurrencies can't be purchased directly in a brokerage account. For example, Schwab and Fidelity don't allow the direct purchase of Bitcoin. Investors are only able to indirectly purchase cryptocurrency at custodians like Schwab and Fidelity via managed funds, and these funds typically charge high fees. The direct purchase of cryptocurrencies is done through digital wallets and exchanges. Many of these exchanges have been hacked in the past and millions of dollars of digital currencies stolen. It remains to be seen if cryptocurrency exchanges can prevent the loss of client assets from determined hackers. Bitcoin has also gone missing when individuals lose passwords to digital wallets. Without a worldwide regulatory body in place to protect investors, the possibility of your cryptocurrency funds being stolen is high. The decentralized nature of cryptocurrency is part of the bull story, but it is also a hindrance as there is very little regulatory framework in case of hacking or exchange failure. Much of the U.S. financial market is regulated by the government. Many banks and brokerage firms protect client assets through FDIC and SIPC insurance, so if a bank or a brokerage firm were to fail, U.S. government insurance will be there to protect some portion of investor assets. Bitcoin and other cryptocurrencies currently lack these guardrails.

Clifford Swan continues to evaluate cryptocurrencies as an alternative asset class. However, given the characteristics described above, we do not view crypto as a viable investment at this point. If the risks don't deter you from putting some funds into cryptocurrencies, then perhaps the most sensible approach is to view cryptocurrency as Graham's "speculative" portion of your portfolio. As with any such investment, we recommend keeping a close eye on your position size and suggest a limit of 5% of your portfolio for this particular asset class. In any case, only use funds to speculate that you could afford to lose entirely, without affecting your long-term financial wellbeing. One way to consider the appropriateness of cryptocurrencies in your portfolio is to imagine your reaction if one of the several drawdowns that have occurred in the past were to happen again. Would you purchase more Bitcoin if it declined 50% from your original purchase price, or would you sell? If the answer is "buy more," then you may have the fortitude to invest in Bitcoin or other cryptocurrencies.

If you decide to buy cryptocurrency directly (versus indirectly via a managed fund) you might consider the following channels:

ROBINHOOD ACCOUNT. The app can be downloaded on your phone and cryptocurrency assets like Bitcoin can be purchased in the account. Robinhood only allows taxable accounts to be opened on their platform. No IRAs of any kind (Roth, SEP, Traditional) are allowed to be opened on the platform.

COINBASE. Coinbase is the most well know digital wallet. The company recently went public on the New York Stock Exchange. An individual can open an account on Coinbase through an app on a smartphone or on the website. Once you verify some personal financial information, you can fund the account and purchase cryptocurrency.

OTHER DIGITAL WALLETS. Some larger tech companies have embraced the cryptocurrency market and have made it easy to purchase cryptocurrency on their platforms. If you have a PayPal or Venmo account, you can purchase cryptocurrencies on their platform and hold it in a digital wallet.

If you are considering participating in this emerging asset class, your investment counselor can articulate the risks and guide you on the appropriate position size for your portfolio. ◆

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