# FROM THE DESK OF ERIK OROS

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It is said that markets climb a "wall of worry." Bears capitulate, new narratives emerge, and investors gravitate towards risk assets fueling a self-fulfilling feedback loop. In 1936, Keynes penned what is called the "Castle-in-the-Air" theory, or what many would call the "greater fool" style of investing; positing that markets are behavior institutions, driven not by intrinsic value but by investors expectations of what the crowd is likely to think in the future. We can think of no better explanation of the past month's exponential move higher in equity markets. There is no shortage of worry that markets have overcome, from a resurgence to the virus, escalating trade tensions, to increasing uncertainty in Washington. There is no shortage of new and recycled narratives either. From TINA (There is no Alternative), FOMO (Fear of missing out), and a triumphant return of "buy the dip," liquidity fueled markets have reached levels of "Irrational Exuberance" not seen since the 2000 dot-com bubble. In such markets, our outlook focuses on capital preservation and opportunity in assets whose performance is driven by sustainable risk adjusted returns, intrinsic value, and never the madness of crowds.

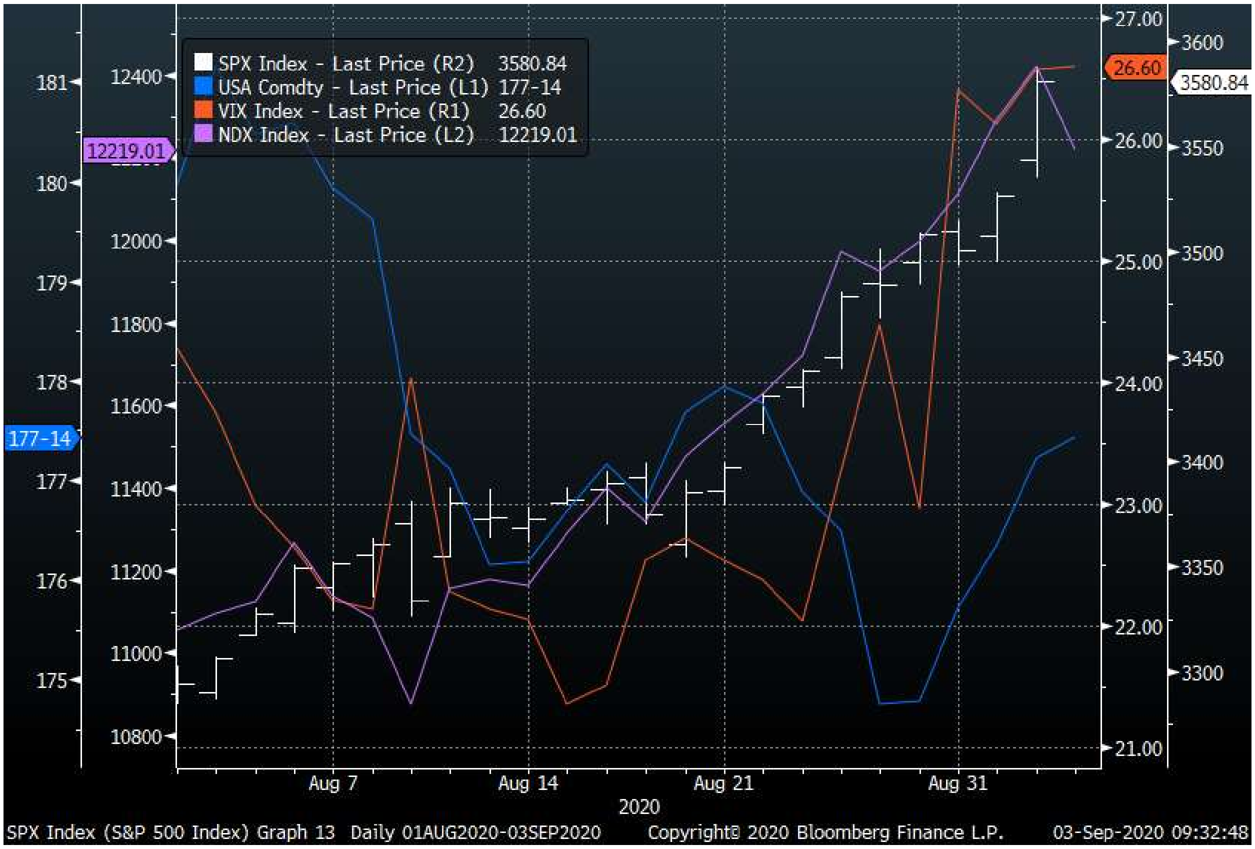
Perhaps the most pervasive narrative fueling the market's zeal for risk assets has been the conviction in a V shaped economic recovery. Economic data continued to improve over the course of August, particularly in the manufacturing sector. However, these gains slowed as the month drew to a close, as persistent labor market pressure and the expiration of fiscal support beginning to take hold.

**Citi Economic Surprise Index US, Eurozone, and Global**


***Past performance does not guarantee future results.**

Chairman Powell of the Federal Reserve gave a keynote speech at this year's virtual Jackson Hole Symposium, updating the Federal Reserves Monetary Policy framework. The action effectively ended the bank's policy of preemptively lifting interest rates to head off higher inflation. The bank has essentially committed to its strategy of infinite zero interest rates and unprecedented asset purchases until PCE inflation moves meaningfully above 2%. This proposal to allow inflation to overshoot and continue to fuel endless monetary support for markets sent equities higher as investors looked to stocks to provide the inflation hedge and yield nascent in the fixed income markets. Notably, August's equity rally, fueled by the continued narrative of lower for longer, did not coincide with a further compression in treasury yields or volatility measures. In fact just the opposite was curiously the case.

**S&P 500, Nasdaq Composite, VIX Index, and the 30 Treasury Bond**

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There are countless examples of excess in today's equity markets. Apple and Tesla saw their stocks add over $600bn and $220bn respectively on the back of economically irrelevant split announcements. Apple's market cap eclipsed that of the entire Russell 2000. Special purpose acquisition companies (SPACs) have raised $24bn this year for blank cheque endeavors, exceeding the 2019 record by 70 percent. Software companies whose business models have benefited from the work from home dynamics have risen to multiples north of 50x sales. Perhaps most notably, the so-called Buffet Indicator, total market capitalization to nominal GDP has eclipsed the highs of 2000. As Buffet famously wrote in a 2001 Forbes article, "For me, the message of that chart is this: If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200%--as it did in 1999 and a part of 2000—you are playing with fire"

**Wilshire5000 Market Cap to Nominal US GDP**


***Past performance does not guarantee future results.**

There is no shortage of analogies for today's market to speculative excesses of the past, whether it be the tech bubble of 2000 or Tulip-Mania of the late 1500s. We find many similarities to the "Nifty-Fifty" craze of the 1970s. Today, large capitalization growth stocks have been viewed as a haven for capital due to their durable earnings growth and endless liquidity. Like the "Nifty Fifty" these stocks moved higher on the back of endless multiple expansion rather than an acceleration in earnings growth. As chronicled by Burton Malkiel in *A Random Walk Down Wall Street*, "So what if you paid a price that was temporarily too high? These stocks were proven growers, and sooner or later the price would be justified." Today's large-cap technology stocks are reminiscent of the speculative excess in these blue chips of the 1970s. Needless to say, this speculative craze did not end well for investors.

**Large Cap Tech P/E Multiples**


**The Nifty Fifty**

| Security | Price-Earnings Multiple 1972 | Price-Earnings Multiple 1980 |
|---|---|---|
| Sony | 92 | 17 |
| Polaroid | 90 | 16 |
| McDonald’s | 83 | 9 |
| Int. Flavors | 81 | 12 |
| Walt Disney | 76 | 11 |
| Hewlett-Packard | 65 | 18 |

Without "playing with fire" the question of where to safely invest for both income and growth becomes exceedingly difficult in today's backdrop. The traditional hedge of fixed income against equity portfolios has become distorted due to central bank intervention. Valuations suggest an exceedingly poor risk/reward even for the most long-term investors. Therefore, our focus remains on identifying managers and strategies whose returns are tied to identifying durable dislocations in their respective markets. These strategies are increasingly found in private markets where retail speculation has yet to meaningfully distort prices. Finally, we remind our clients that investing is, as Buffet says, a game with "no called strikes." We can wait for our pitch and for risk/reward to improve and face no penalty. A focus on capital preservation and deliberate allocation remains paramount in such an environment, as ever.

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