Investor's Outlook

Quarterly edition of investment ideas from the research experts at Francis Investment Counsel

January 2021

Welcome to the inaugural issue of Investor's Outlook

The research team at Francis Investment Counsel is a busy group of investment professionals. Our clients witness the results of our labor in our quarterly meetings and reporting, which advise the investment decisions made in their retirement plans. The depth of our investment research, however, goes far beyond what is seen in quarterly reports alone.

For this reason, we are pleased to present the inaugural issue of Investor's Outlook. The vision of this quarterly newsletter is to climb up, zoom out, and provide a higher level view of investing trends, philosophies, and practices. It's our way of giving you a deeper understanding of our capital markets research and hopefully some good resources to find new ideas.

In this issue, you'll read:

- **King of the Hill**
  The dollar remains the world's reserve currency affording the United States the near-term ability to print and spend money at a torrid pace.

- **Research Review**
  "How great does inflation have to be before a government can no longer control it?" A book review of Adam Fergusson's *When Money Dies (1975)* explores this question by focusing on the German hyperinflation in the 1920's.

- **Idea Generation for the Future**
  How do you find 'smart money' moves? Take a look at Gurufocus.com

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King of the Hill

Conventional thinking is that 2020 has collectively been the worst year of everyone’s lives. I’ll spare you what usually comes next: the obligatory three-points supporting that contention. Are any really necessary? Maybe you are different and turned off the news at the end of 2019 or you possess the mental toughness of a championship golfer or Super Bowl winning quarterback, able to stay focused by defying all distractions and marching on. I’m envious if that’s you, especially the golfer.

In any event, investors face a perplexing outlook amidst record U.S. stock prices juxtaposed with an economy that’s still in early recovery. It’s not unusual to see strong stock returns coming out of a recession, but it is momentous to set new records so quickly in the midst of and shortly after a recession. Neither U.S. economic ingenuity nor some radically new economic model can be linked to the resilience in equity prices, but rather the U.S. Federal Reserve acting on its “exorbitant privilege” via the U.S. dollar. The Fed officially set into place this past August the “average inflation target” policy guaranteeing that the domestic money stock will hasten at levels greater than hitherto. In light of this regime change in Fed policy investors are left asking, “How long can the U.S. print money like this?”

Creating, controlling, and distributing money is the most authoritative lever government enacts on its citizens. Changes in the money supply undeniably define the purchasing power of notes in domestic and global trade but it also generates second order effects that influence societal ethos that encompasses morality. While connecting an inflating money supply with the moral choices of the citizenry may seem too far afield, the German hyperinflation of the 1920’s and the more recent economic collapse of Zimbabwe tell of this reality.[1] Unfortunately, the impact to society of runaway inflation is far more burdensome than merely paying for a loaf of bread with a wheelbarrow full of paper money.

Fortunately, a hyperinflation scenario in the United States is generally ruled-out in the near-term given two contributing factors: the reserve currency status of the dollar and the capacity of the U.S. military particularly the Navy and of course, the nukes. Economists and pundits stereotypically limit their focus of global economics to balance sheets describing terms of trade and an analysis of the political amphitheater to consider economic potential. When looking at the world in this way, some of those analysts conclude that currencies of other nations are on the cusp to take over the dollar’s reserve status. As the U.S. debases its currency, so goes the argument, it results in the increasing likelihood the dollar loses its dominance as trading partners rebel and embrace another currency or a basket of currencies. On paper, this may look practical but the reality is that the nation with the most sophisticated armaments in terms of guns, tanks and helicopter gunships is able to provide better backing for a currency than even hard assets like silver and gold. This leads to one of the key contrasts from Germany in the 1920’s to the United States today. Unlike Germany, the U.S. is not facing demands for reparations in the aftermath of a lost world war, unable to produce goods due to its most valuable lands and ports being confiscated, or stripped of its military apparatus to stop foreigners from doing as they please.

Think about this: with millions unemployed and an economy in tatters, the German central bank was able to keep the printing press and a dysfunctional economy going for nearly 5-years following the end of WWI in 1918. King dollar, in contrast, stands tall in the world with few worthy competitors.

Nevertheless, before you breathe a sigh of relief that the “inflation monster”[2] isn’t yet at on your front stoop, there are some shared attributes of life today with those economies that later blew-up into hyperinflation. For one, the U.S. government is paying citizens to stay home and a considerable amount of society remains unproductive. Many workers could not transition from “off-line” to “on-line” during the pandemic. The combo of reduced real economic growth simultaneous to increases in money supply via stimulus checks is inflationary.

King of the Hill Continued

Two, the stock market is roaring despite higher unemployment. Of late, this has led some concerned investors to wonder, "How can the stock market be so disconnected from the economy?" The answer to this enigma is that central bank monetary policy dominates far greater than what most perceive. Then there are those that are delighted by the 'wealth effect.' Stable prices for things like popcorn and soda tempt them to think, "We are getting ahead." Yet, the preponderance of negative real interest rates across the U.S. Treasury yield curve tells us that even with these tepid levels of inflation expectations for long-term economic growth are subdued. Eventually, prices will adjust upward so don't spend all of those extra shekels that seem like part of a windfall surplus.

Three, hoarding takes place for essentials such as food, fuel, and hard currency plus there is even a proliferation of alternative currencies. Cryptocurrencies like Bitcoin, Ethereum, and Litecoin etc. are increasingly sought after as a response by some to the governmental debasement of fiat currency. Quarters, dimes, and nickels have even been harder to come by of late.

So, what to do as an investor? Your savings and investment strategy necessarily need to incorporate the regime changes in U.S. monetary policy. In the early 1980's when inflation breached 15%, you could buy long-term U.S. government bonds as a hedge which yielded just over 15% thus preserving your purchasing power. Today, the yield on U.S. government debt maturing in 10-years is just below 1% but you have areas of expenses that are growing by multiples higher than that current yield for sure. For now, your best play is to favor equity securities and especially those with high returns on invested capital, arguably the best measure of how valuable a business brand is to its customers. Apart from equities, the traditional inflation fighting toolkit needs to be altered.

Commodities and real estate can still be considered but the days of expecting higher yields on cash can rightfully be labeled as wishful thinking. It is indeed time to ponder alternative inflation strategies that specifically hedge outsized household expenditures. You can identify these by observing where your pocket book is getting hit the hardest. For example, take a look at your medical bills and insurance premium costs and then pull-up some stock charts of the largest health insurers. You will notice a high correlation between your rising costs and their rising profits. Could a strategy include buying the equities of the company's to which you are giving the most money?

In the end, inflation is still something with which you must cope. All signs point to higher inflationary pressures across the board but that won't likely be realized until global output gaps are closed and trend positive for a few years. There is too much slack in the economy for an inflationary surge even with the Fed's balance sheet currently at 34% of US GDP. That's nearly 6x what it was prior to the Great Financial Crisis in 2008.

The prudent investor knows that even as the money stock is rising sharply, there is often a multi-year time delay before the second order effects appear on prices for goods and services of all kinds. For now, the U.S. dollar remains King of the Hill affording the United States the ability to print money big time. I encourage you to not underestimate the duration of the money printing exercise or the resolve of the Federal Reserve in its new policy regime. For how long this all goes on is hard to tie a timeframe, but if history is any guide the U.S. can likely go on inflating for much, much, longer than what most of us can fathom.

Summary and Action Steps

- *The Federal Reserve's monetary policy initiatives stand as the top reason why stock market returns soared to new highs in 2020.*
- *Muted inflation in the near-term will likely prevail until capacity utilization improves coincident with declines in unemployment (closing the output gap).*
- *Investors should overweight equities in this environment and look increasingly to commodities and real estate as hedges to unexpected inflation shocks in the future.*
- *For specific asset class weightings and portfolio positioning, stay tuned for our Independent View slated to be published later in January 2021.*

[1] The former is discussed at greater length in the following pages of the "Research Review" section in summary of: "When Money Dies, The Nightmare of Deficit Spending, Devaluation, and Hyperinflation in Weimar Germany" and next quarter the focus will be the economic plight of Zimbabwe.

[2] A term utilized by George Cooper in "The Origin of Financial Crises: Central Banks, Credit Bubbles, and the Efficient Market Fallacy." Highly recommended reading.

When Money Dies

The Nightmare of Deficit Spending, Devaluation, and Hyperinflation in Weimar Germany

By Adam Fergusson (1975)
Former member of European Parliament; adviser to Margaret Thatcher
Summary by Edward McIlveen, CFA

"How great does inflation have to be before a government can no longer control it?"

Adam Fergusson's 1975 look back in economic history to the German hyperinflation isn't what some might expect. Following its demise in WWI, Germany's economic rebound was greatly hindered by sanctions and lost access to significant hubs of industrial shipping via key seaports. Millions were displaced while tens of thousands of soldiers returned home and needed to be put to work or just paid by the state to await work. The Rhineland was noted as being a "domain of lawlessness, anarchy and the unrestrained terrorism of armed separatist bands, occupying the town halls and, with French support, defying the police." The scourge of inflation followed the scourge of losing WWI. No matter, the Allies demanded reparations irrespective.

With 2020 fresh in our minds, the reader will be surprised to the degree which some of the social unrest of today looks similar to that of 100-years ago. According to Fergusson, a lack of political will by the leaders of the day and moral decay accelerated inflationary trends that ultimately resulted in the infamous scenes of German citizens purchasing daily essentials with wheelbarrows overflowing with marks. Hyperinflation in Germany - and elsewhere as the stories of Austria and Hungary are briefly touched upon - forced citizens into extremes. Value was ascribed by desperation to avoid a worse experience leading to the provocative observation by Fergusson that, "A prostitute in the family was better than an infant corpse; theft was preferable to starvation; warmth was finer than honour, clothing more essential than democracy, food more needed than freedom." Inflation destroyed confidence in the governmental system, led to a mushrooming of alternative currencies, individual states seeking autonomy, and a clash of political ideologies like communism, socialism, and fascism.

Hyperinflation reached its breaking point in 1923, some 5-years after the conclusion of WWI, as German farmers refused to sell their food to the cities exacerbating the misery as this culmination occurred at the onset of winter.

Fergusson maintains that Germany did not inflate its currency to explicitly avoid WWI reparations; inflation and the momentum behind it existed prior to the printing press going berserk. The economic incentives for the industrialists were quite attractive in supporting this policy as it encouraged devaluation bringing forth an inundation of foreigners purchasing manufactured goods and commodities. Tourism also spiked along the borders during these money printing years as foreign currencies bought a lot more than normal for the visitors and gave German citizens money that actually had real value.

The question lurking for all to consider is, "How great does inflation have to be before a government can no longer control it?" For those seeking a precise answer in the book to that inquiry, you might be left frustrated. However, a matter containing this amount of complexity can be filtered to perceive when a major problem exists. From this book, the reader can see when the "inflation monster" approaches serving as a function of the following appearing with simultaneous ferocity:

- Inflation develops a powerful lobby that has no interest in rational arguments with policymakers watching currency depreciate into oblivion but still adding to the money supply.
- Attempting to avoid unemployment and insolvency by printing more money does the opposite by bringing on more unemployment raising the risks of insolvency to new heights.

Research Review Continued

- Fear, greed, immorality, demoralization, and dishonour are ever present, but the burden on society is dominated by those forces.
- Society's attitude about government and politics sours dramatically. Fergusson noted, "Contempt for the Republic and its servants now became almost universal" and "...in German minds democracy and Republicanism[3] had become so associated with financial, social and political disorder as to render any alternatives preferable when disorder threatened again."

The turnaround for Germany involved foreign intervention in supplying loans, the creation of another federal bank which was more of a psychological move to invoke confidence, and food returned to the cities as the farmers regained confidence that the currency they accepted could be converted into something of value.

The reclaimed normalcy of life, however, quickly led to the moral mobilization that brought the Nazi party to power and an all-out quest to avenge the Treaty of Versailles via a revitalized war machine.

Fergusson also asserts that inflation is the ally of political extremism and the antithesis of order believing that inflation was used in Russia and Hungary to destroy social order and spark revolution. While hyperinflation hasn't hit a major economy in years, the reader of *When Money Dies* can see parallels from 100-years ago that lead to thought-provoking if not frightening realities to consider for today.

Summary

- *Following its demise in WWI,* Germany's *economic rebound was rocked by sanctions and demands of reparations by the victorious Allies.*
- *Mass unemployment and economic stagnation brought about a colossal amount of money printing.*
- *Hyperinflation in Germany reached its breaking point in 1923, some 5-years after the conclusion of WWI.*
- *The turnaround for Germany centered on foreign loan assistance, but the reclaimed normalcy of life quickly led the Nazi party claiming power amidst the quest to avenge the Treaty of Versailles by revitalizing the German war machine.*

[3] Republicanism refers to a form of government and not a political party.

WHERE TO FIND SMART MONEY MOVES

What interests you and what you know are remarkably reliable rules of thumb for taking an initial look at a new idea. What you eventually select for stocks to invest requires far more scrutiny if you plan to make a regular habit of investing your own money rather than turning the keys over to an investment manager who charges a fee.

Taking into account how much time you can spend in the research and monitoring of your portfolio will clearly dictate how many stocks you can manage yourself. If you think you can take on 30 or more and you work a full time job, plan on spending lots of nights pouring over data and listening to earnings calls. For most, constraining your individual stock assets to no more than 10% of everything you own and owning 5-7 securities is a wise starting point.

With the stage set for discussing stocks, a resource that is particularly handy for identifying what the "Smart Money" is doing is Gurufocus.com.[4] Not all of the techniques are captured in a resource like this, such as trading, but what is provided at no charge (and there are other services for which you can pay) is excellent. For instance, hedge fund manager David Tepper of Appaloosa is one of my favorite investors to monitor. All I have to do is go to Gurufocus.com and enter Tepper's name at the top of the site to get intel on what he's buying and selling, at least as of the latest filings with the SEC. Though this is not real-time information (the website offers a service tied to real time data for a fee), you can still gain a good idea of what the pros are interested in.

Your favorite investor may be Warren Buffett and there is even a "Buffett Watch" tab at this website that aggregates all things related to the Oracle of Omaha. How wonderful is it that Gurufocus.com saves you an enormous amount of time from looking at tedious disclosures and assembling it into an easy to view format inclusive of graphics?

But it gets better – say you are interested in what all of the gurus think about a stock. That's easy. Just type in the name of the company or the ticker and then find the "Guru Trades" tab. Not only are the buys and sells combined for you in a picture format, you can see all of the gurus invested and what their estimated profit is on their trades. For example, shares of Tesla have surged in 2020 and while lots of people have opinions about it right now, you might find it interesting to know which guru tracked made the most money. In this case, it's Ron Baron. There's also a "Consensus Picks" tab that shows some of the more popular names being purchased by the gurus.

The serious investor will appreciate Gurufocus.com because it saves valuable time gathering administrative information that would ordinarily take hours thus freeing-up the time to do more thinking about building a portfolio. The gurus aren't always right, but knowing what they are doing is worthwhile as they in all likelihood have been able to do far more in researching a stock than you.

All the best for a profitable 2021!

[4] Francis Investment Counsel receives no remuneration from Gurufocus.com.

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Ed leads the Firm's research efforts at Francis Investment Counsel and has been on staff since 2005. Ed graduated from Marquette University with a Masters of Business Administration specializing in finance and attended Gustavus Adolphus College where he earned a Bachelor of Arts Degree in History (graduated cum laude). Ed holds the Chartered Financial Analyst (CFA) designation.