BAYSHORE CAPITAL

Issue 06.2022

Deflating the Everything Bubble

Bayshore's Chief Investment Officer shares his thoughts on current events and topics.

In this issue of *Views From the Top*, we provide an overview on what's driving the current market correction and how we expect matters to unfold.

Key take-aways:

- The last decade was marked by strong returns across risk assets, fueled by a combination of falling interest rates and an absence of inflationary pressures.
- The US government's significantly larger and consumer-directed economic stimulus policy in 2020 and 2021, in combination with a variety of supply-side problems, has inevitably caused the current high inflation.
- The Federal Reserve is in the midst of an aggressive maneuver to tighten financial conditions in its attempts to curb inflation, while simultaneously trying to avoid a recession.
- Inflation readings are likely to be slow to adjust, and we believe that structural factors, such as deglobalization and decarbonization, will keep it substantially above 2% over the next several years.
- We anticipate that the Fed will soon scale back their hawkish tone and action in order to minimize stress in the equity and bond markets.
- The best investments are made in the 12-18 months around peak market stress, and we are gearing up for a busy time to take advantage of dislocations in the market.

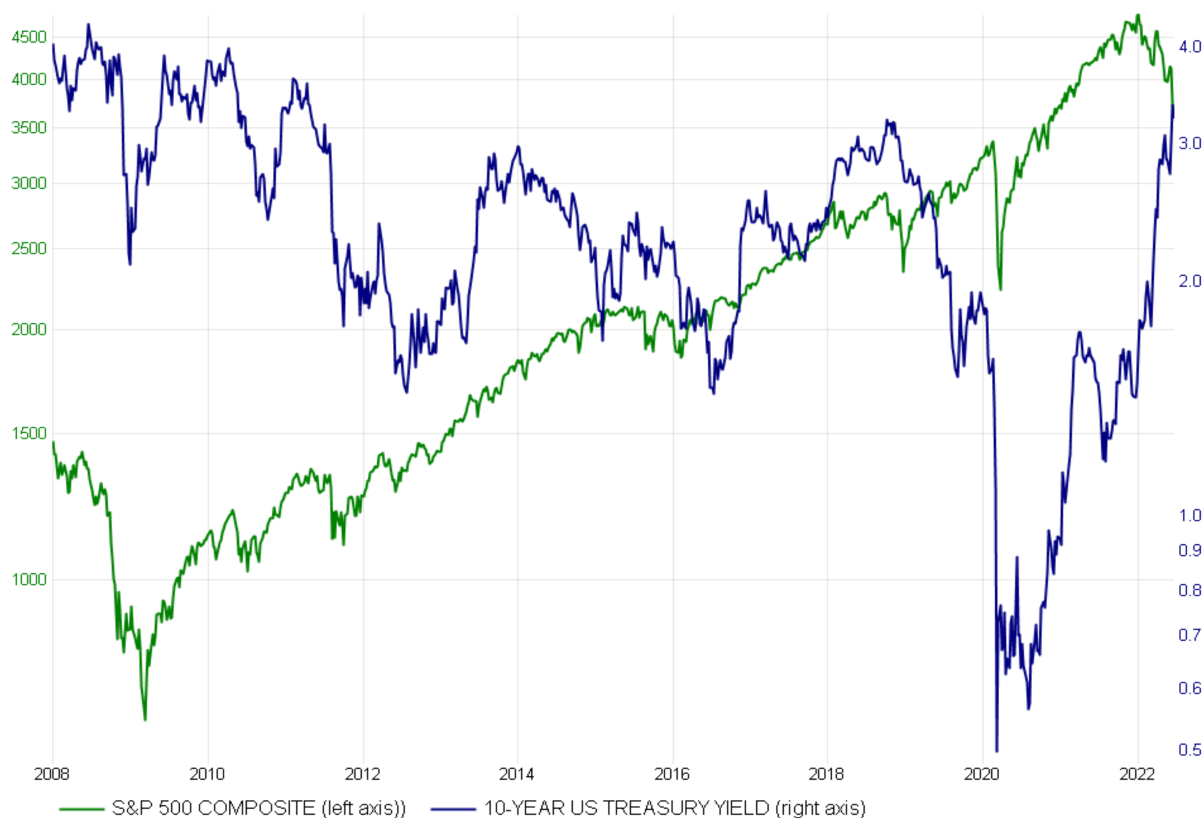
The end of the "everything bubble": We have just ended a challenging first half of the year for investors, not coincidentally following a decade of outstanding returns across most risk assets. That said, we are clearly entering a new chapter for markets. Following the 2008 financial crisis nearly fifteen years ago, investors and policymakers fought a sticky deflationary headwind with "unprecedented" stimuli, famously zero-to-negative interest rates and gigantic asset purchases by central banks. These measures created the uneven recovery of the 2010s with strong performances for equities and fixed income that seemed somewhat disconnected from the lackluster performance of the real economy (see Figure A). The 2010s will go down in history as the "everything bubble" created by cheap money and investors' needs and desires to go out on the risk curve. At the beginning of the decade, the warnings about imminent inflationary hell were plentiful, but consumer prices remained anchored; inflation occurred in asset markets but not in the real economy (i.e., prices of goods/services and wages).

Overstimulated and undersupplied: This all changed with the onset of the COVID-19 pandemic and the economic stimulus deployed to fight what would certainly have been an economic depression without government support. The stimulus used to fight COVID was many multiples the size of its GFC[1] predecessor. This time, it was not just the asset markets that responded, but the excess liquidity entered the real economy via direct payments to citizens and government-guaranteed bank lending programs.

[1] Great Financial Crisis (2008)

Combine this with a near-breakdown of globalized supply chains and a sizable shift in consumption patterns (from services to goods), and the result is excess demand meeting suppressed supply; the inflationary response is economics 101. The war in Ukraine makes things even worse, further suppressing supplies in critical commodities.

Figure A. S&P 500 and 10-year US interest rates (2008-2022)



Slowing down the economy – hard: Inflation has not been a topic to worry about since the 1970s, but it is now, and the Federal Reserve has signaled that fighting inflation by tightening financial conditions is now the top priority. The full Fed tightening package consists of higher rates (to increase the cost of credit and reduce demand), a shrinking balance sheet (to mop up excess liquidity), and a stronger USD (to lower the price of imported goods and tighten financial conditions for the rest of the world trading in USD). The exercise the Fed must undertake now is to slow down the economy enough to contain inflation but not enough to skid into the recessionary trench. No braking maneuver is best initiated by a hard hit on the pedals, but that is exactly what the Fed just did with its massive 75-basis-point interest rate hike. Smooth driving feels different, and the abrupt nature of the Fed's actions do not bode well for the eventual outcome.

Financial markets reprice to reflect higher rates: The final stage of the asset bubble ignited during the pandemic is now deflating. Rising interest rates are creating the most damage to growth companies because their sky-high valuations were based on assumptions of massive growth discounted back to today at low discount rates. Anyone who has ever played around with a discounted cash flow ("DCF") model knows how sensitive the outcome is to a change in the discount rate. Value stocks have fared

better but will be more vulnerable than growth stocks in a recession scenario. Year-to-date, US technology equities have shed 29% (and more so from the 2021 peak), see Figure B[2], while the broad S&P 500 Index is down 20% year-to-date. Both technology stocks and the S&P 500 would have to fall another 11-12% to retrace to pre-COVID levels. US investment-grade bonds are in their largest drawdown in decades (-11% year-to-date), a result of rising rates. This rare simultaneous sell-off of stocks and bonds results in the worst period in decades for the traditional 60/40 portfolio, as bonds have been unable to play their role as a safe-haven asset. Other risk assets sold off in a risk-adjusted manner, except for commodities. After having been the punching bag for the last ten years, energy, metals, and agricultural commodity prices are rising, due to the previously mentioned supply/demand imbalances, contributing substantially to the high inflation readings.

Figure B. Year-to-date performance[2]

Asset	Change (%)
US Equities	-20
US Technology Equities	-29
US Bonds	-11
US High Yield	-15
Commodities	32
Gold	-1
Bitcoin	-59
US Dollar	10

Who bears the cost of inflation?

The fact is that this inflationary bout has largely been created by the pandemic rescue. The program was funded (once again) with money created out of thin air, and at some point, there is a cost to spending money that does not exist. The question of who will bear the cost is based on the following two dilemmas:

1. **Companies vs. stakeholders:** Any company management will have to decide whether it has the power to fend off higher input costs (pushing back against suppliers and employees) or at least pass on the additional input costs to their customers. If management is successful, profits can be defended, and the stakeholders bear the cost of inflation; otherwise, company profit suffers, and the market will render its judgement.

2. **Stock market vs. consumers:** At some point, the Fed will have to decide whether to protect the consumer or the stock market. If the Fed is hell-bent on raising rates until inflation breaks (to protect the consumer), then the equity market will continue to face downward pressure, as the recession scenario becomes more probable. Inflation has long been a political issue, and the days when the Fed could make decisions in a vacuum are long gone. So, there is a clear risk that the Fed will overshoot, unless the monied interests in DC can successfully pressure for a stock market bailout once things fall apart. This will be an interesting conflict to watch.

Where does this leave us now?

Monitoring opinion leaders is part of our process, and never have we seen such a wide dispersion of opinions on how this will evolve over the next 6-12 months.

Inflation normalization will take a long time: Inflation readings are likely to remain high for months to come, due to lag effects in some of the core components, such as owners' equivalent rent ("OER"), so

[2] Price performance of the following reflective ETFs, in order: SPY, QQQ, AGG, HYG, DBC, GLD. US Dollar represented via DXY index. Data through 6/29/2022. Source: Refinitiv

we do not expect any material reprieve on that front. Further, supply-side stress from key energy and agricultural commodities may worsen going into winter. As we mentioned in previous letters, we expect inflation to remain substantially higher than the Fed's 2% target rate for years to come, also due to structural reasons (including deglobalization and decarbonization).

Fed will pivot to ease the upcoming financial market stress: However, in our view, the most likely scenario is that deteriorating economic data over the next few months will provide the Fed with enough evidence to talk down and eventually dial back its ambitious rate-hike program (which is exactly the scenario we predicted here last December); elevated stress in the equity and credit markets will give them additional ammunition to justify their pivot. At that stage, long-term interest rates will be well off their recent highs, and the equity market will be bottoming. The amount of additional downside depends on the Fed's next step and on how fast economic fundamentals deteriorate. Growth stocks may be closer to their bottom than value stocks.

"Be greedy when others are fearful": It's a sure crowd-pleaser to end a letter with a Warren Buffet quote, but we could not agree more. As I have seen throughout my professional life, the best investments are made in the 12-18 months around peak market stress. This time will be no different. At Bayshore, we just concluded an internal review of our existing exposures and feel that we are entering this crucial period in good shape and ready to play offense.

REQUIRED DISCLOSURES

This document has been prepared by Bayshore Capital Advisors, LLC ("Bayshore"), a SEC registered investment adviser. This document is provided for information purposes only and does not constitute an offer or a recommendation to purchase or sell any security or service. It is not intended for distribution, publication, or use in any jurisdiction where such distribution, publication, or use would be unlawful. This document does not contain personalized recommendations or advice and is not intended to substitute any professional advice on investment in financial products. Before entering into any transaction, an investor should consider carefully the suitability of a transaction to his/her particular circumstances and, where necessary, obtain independent professional advice in respect of risks, as well as any legal, regulatory, credit, tax, and accounting consequences. This document is the property of Bayshore and is addressed to its recipient exclusively for their personal use. It may not be reproduced (in whole or in part), transmitted, modified, or used for any other purpose without the prior written permission of Bayshore. This document contains the opinions of Bayshore as at the date of issue. The information and analysis contained herein are based on sources believed to be reliable. However, Bayshore does not guarantee the timeliness, accuracy, or completeness of the information contained in this document, nor does it accept any liability for any loss or damage resulting from its use. All information and opinions as well as the prices indicated may change without notice.

This material expresses our general views only and is not intended to describe or offer any investment solution or investment product, which will only be made upon additional presentations and definitive offering documents. This material (i) is not, nor is it intended to be, marketing material or advertising within the meaning of the Investment Advisers Act of 1940, the rules and guidance of the Securities and Exchange Commission ("SEC") or the Conduct Rules of the Financial Industry Regulatory Authority ("FINRA"), (ii) is for informational use only by the receiving party for general informational purposes, and (iii) is not intended to be an offer to invest in any security.