April 15, 2021

Just making an NFT does not give it any value. There's going to be a moment where we realize we got a little crazy and assigned insane value to crap.

Mike Winkelmann, aka Beeple, Artist/seller of a $69 million Non-Fungible Token (NFT)
New York Times' "Sway" podcast: What the Heck are NFTs? Let's Ask Beeple, 3.22.21

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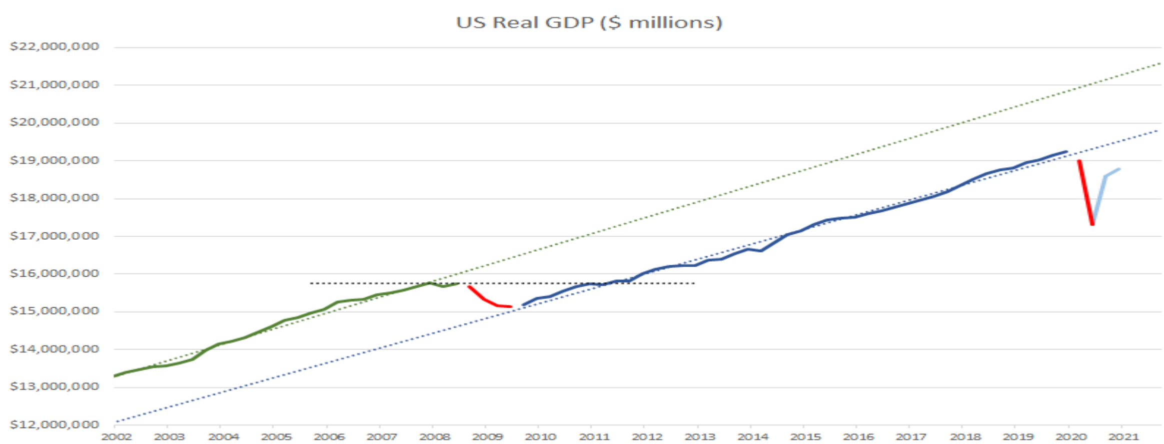
COVID-19 Update: In the United States, the COVID-19 vaccination ramp-up is in full swing. Certainly, the race against the virus cannot be run fast enough, but the speed of developing an effective vaccine and beginning mass vaccinations is really a major historical accomplishment. Today I read that at the current pace, 70% of the U.S. could be fully vaccinated by mid-June. While the current surges and virus mutations in the U.S. and around the world, along with the very uneven pace of vaccinations globally, mean we will all be working to manage the threat of COVID-19 for some time to come, I also remain hopeful that the pharmaceutical industry will come up with a simple, inexpensive treatment to manage the virus in the future. In the meantime, I am looking forward to my second vaccination on April 21st.

The Economy: In 2020, the economic output of the U.S. as measured by real Gross Domestic Product (GDP) dropped (-3.5%). It may sound like a relatively small contraction, but it is the largest calendar year drop since 1946 when the economy shrank a self-imposed (-11.9%) coming out of military budget cuts post World War II. The chart below tracks the quarterly level of U.S. GDP from 2002 – 2020. At the beginning of 2002, the U.S. economy was just emerging from the 2001 recession.



In the chart, the expansion of real U.S. GDP from 2002 through 2007 is represented as a solid green line, the expansion from the 3rd quarter of 2009 through 2019 as a solid blue line, and the current expansion, which began in the 3rd quarter last year, as a solid light blue line. The two recessions are charted as solid red lines. Trendline growth of the 2002 through 2007 expansion (or the growth rate for that period projected over time) is represented as a dotted green line. Trendline growth of the Q3 2009 through 2019 expansion is the dotted blue line. A trillion dollars is a million dollars X a million (i.e., a lot of zeros).

As illustrated in the chart, after the U.S. economy contracted in the Great Recession, from the end of the 2nd quarter 2008 through the 2nd quarter of 2009, it took until the 2nd quarter of 2011 for our economic output to move above the 2008 high. Along with the loss of jobs and homes and other economic dislocations during that period, it also put the U.S. on a lower economic growth trajectory. From where I sit, it is evident that policy makers, from both the Federal Reserve (the Fed) and the federal government, as demonstrated through the historic size and persistence of their stimulus programs, are committed to helping the economy avoid ratcheting down to a lower economic growth trajectory coming out of the pandemic recession. If you look to the top right portion of the chart, to recover back to 2019's GDP level, the economy needs to grow 3.63% this year. To recover to recent trend line growth, the economy needs to grow 6% this year. Based on current stimulus combined with the pent-up demand for getting out and about as the economy "reopens," most economists, including at the Fed, believe the economy will get there. To me, the real test will come in the 4th quarter of this year and the 1st quarter of 2022, after direct consumer stimulus wanes, additional unemployment support has ended, the mortgage and eviction deferrals have expired, and the reopening has had some time to establish some trends of its own. Then we should begin to have a clearer view of what the underlying strength and sustainability of this economic expansion is.

Stocks and Bonds: With the S&P 500 stock market index adding a 6.17% gain (with dividends) in the 1st quarter, on top of the all-time high at the end of 2020, it is evident that stock market investors have already priced in the U.S. economy getting back to trendline growth this year – if not higher. On the bond side, even as interest rates remain historically low, pinned down on the short-end by the 0% - 0.25% overnight Fed Funds lending rate, intermediate-term and longer interest rates did move up from their historic lows set in 2020. For example, the 10-year U.S. treasury ended the quarter with a relatively whopping 1.74% yield, up from 0.91% at the beginning of this year. As interest rates rise, bond values go down and, accordingly, in the 1st quarter the Bloomberg Barclays U.S. Aggregate Bond Index Total Return closed down (-3.37%). Neither stocks nor bonds are cheap, but the Fed remains committed to supporting the financial markets until employment has recovered from the pandemic collapse. The caveat is that long-term inflation expectations must remain low as well. Or, as Fed Chair Jerome Powell has repeatedly emphasized, "If we do see what we believe is likely a transitory increase in inflation, where longer-term inflation expectations are broadly stable, I expect that we will be patient." Either slower growth or more enduring inflation than currently anticipated will cause the stock and bond markets to adjust accordingly.

Speculation: There was plenty of strange speculative activity afoot in the first quarter.

- The GameStop short squeeze propelled the stock's price over 2400% higher between January 11th and January 28th. The stock price proceeded to drop (-89%) in the following 5 days, and then rally 280% into the end of the quarter. With elements of David vs. Goliath, or small investors vs. hedge funds, for a fuller recap see: https://en.wikipedia.org/wiki/GameStop_short_squeeze.
- The Archegos family office fund imploded through forced liquidation of its over-levered stock portfolio to cover under-collateralized margin loans and swaps, leading to large losses at a number of investment banks, including a $4.5 billion loss at Credit Suisse (which is now looking for a replacement for the head of its "risk management" division).
- SPAC offerings hit a one quarter record of $172 billion. A SPAC, or a Special Acquisition Company, is created to raise money through an initial public offering of its stock and then buy/merge with a private operating business (with at least some of the money that it raised). The purchase/merger effectively brings that private company public. When a SPAC first goes public investors don't know what company the SPAC will purchase; they used to be called "blind pools."
- As referenced in the quote that opened this letter, Non-Fungible Tokens (NFTs) are the latest mania. Beeple got paid $69 million for a unique cryptographic token that exists on a blockchain and cannot be replicated. The related digital art piece is titled "Everydays: The First 5000 Days." His quote is a rather clear-eyed definition of speculation – and I highly recommend listening to or reading the interview: www.nytimes.com/2021/03/22/opinion/sway-kara-swisher-beeple.

In all, these examples are a timely reminder that speculation is great when the money is flowing your way, but otherwise not so great.

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We hope this letter finds you and your family well. We appreciate your business and we continue to work hard to earn the trust that you have placed in us. Please let us know if you have a friend or a family member that could use our assistance.

John McCorvie, CFA