What the Heck Happened in 1971-74? What about 2008-9?

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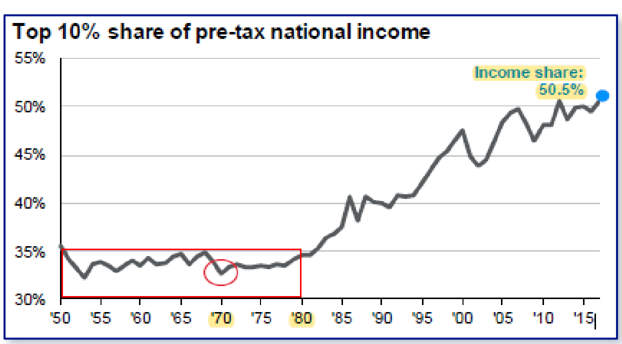
Wait. What? Did you receive the wrong commentary? Did we slip on ice and bump our head? No. We know its January 2022, and we're going to talk a lot about 2021, but before we do, we want to stroll down the memory lane of the early-mid 1970's and the late 00's. Why? Because those were "crossroad" points in time that spawned significant changes for both the American economy and the American social fabric, and we think that in 5-10 years, we may very well look back on 2020-2021 with similar significance.

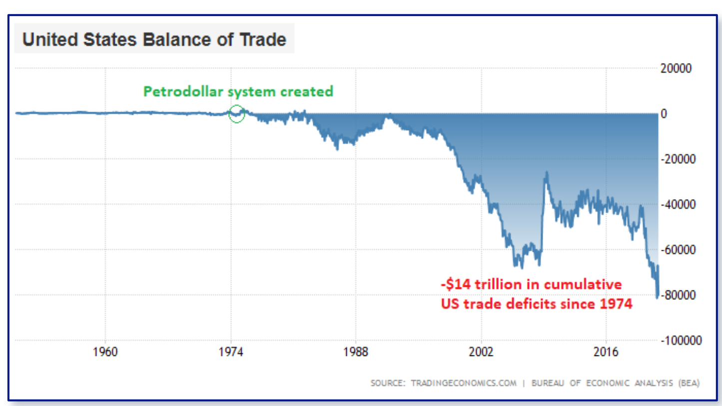
If you're over the age of 60 or grew up watching shows like *Happy Days*, or if you are simply a student of history, you can likely shake your head in agreement that both the American way of life and economy were much different between 1945 – 1970, after which something seemed to suddenly "switch". What changed so much?

- Economically, worker Productivity had steadily increased throughout American history, with wages tracking alongside. Beginning in the 1970's, worker compensation began to grow much more slowly relative to productivity growth, leading to a boom in corporate profits. **Income inequality** skyrocketed as those at the top garnered an increasingly large portion of the pie. This chart speaks volumes to the timing and magnitude of change in econonmic inequality in our country as the top 10%'s share of income has risen to 50.5% in the last 40 years after being no higher than 35% for the 30 years prior.



- As many of us remember, **inflation** took off in the 70's and rose to double digit levels. It wasn't contained and reversed until Paul Volcker raised interest rates well into the double digits in the early 1980's. And while headline inflation metrics such as the Consumer Price Index (CPI) were fairly benign from the early 1980s until 2021, those government calculated metrics like CPI belie the reality that we all live in. For example, the cost of a house, relative to average income, has been rising for 50 years. In 1970, it took 2.4 years of savings for an average American to buy an average house. Today it is 6.9 years.

- The **U.S. Trade Balance** was usually neutral or even positive until the early 1970s. Now our Trade Deficit is routinely 4% or more of GDP. This chart illustrates the enormity of our trade imbalance, how it began in the mid 70's, and how it really started accelerating around 2000.



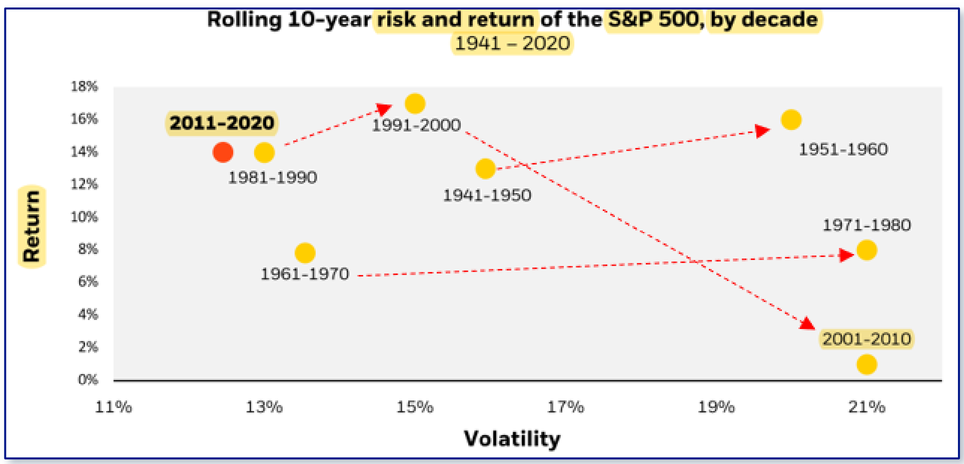
Since 1974, we've imported over $14 Trillion more than we've exported!

- Socially, our fabric and our way of life started to change dramatically in the 70's. Woman began participating much more in the workforce leading to a huge increase in the percentage of dual-income households. In 1970, 31% of 18-29 year-olds were living with a parent. In July 2020 that was 52%. Men got married at an average age of 23 in the early 70's. Now it's 30. Divorce rates have skyrocketed. The number of children born per woman has declined. The number born to single parent households has skyrocketed. Obesity is up. Not quite the "Happy Days" of the '50's and '60's.

Did something significant happen in the first half of the 70's that was the catalyst for such change? Yes. For centuries, nearly all currencies had been backed by **Gold**. In 1971 President Nixon removed the U.S. Dollar from the Gold standard. Since then, our currency, and others, became what's known as a "Fiat" currency – not backed by anything except the taxing power of their governments. Some say the U.S. Dollar is backed by our Aircraft Carriers. So, it became a lot easier to create money and in hindsight, it's no surprise that things changed a lot since then. And the switch from the Gold standard wasn't the only major global economic policy change - In the mid-1970's, the U.S., Saudi Arabia and OPEC created the Petrodollar protocol, requiring oil trade to be transacted in U.S. Dollars. Look at the previous chart for when the Petrodollar system was created (1974) and how our trade deficit changed afterwards.

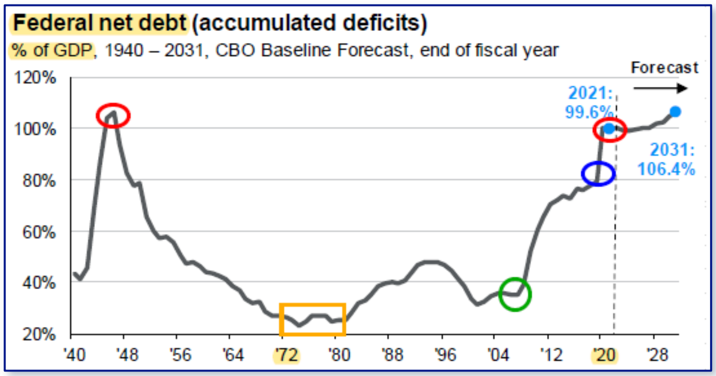
Over the next few decades, the status of the American "worker" continued to weaken. Unions gradually lost power. The demise of traditional pension plans began in earnest in the early 1980's, "replaced" by the 401k. Swapping a safe and defined pension for a variable and voluntary saving plan has likely hurt a lot more American households than it helped. Of course, the Personal Computer (PC) was born in the 1980s and then the internet took off in the 90's, further reducing the leverage of "labor". When China joined the World Trade Organization (WTO) in 2001, globalization and the hallowing out of our domestic manufacturing economy accelerated even more.

Yet, besides the bursting of the Tech stock bubble in 2000-2002 (which was accompanied by a relatively minor recession), things were going pretty well. Until 2008 – 2009. The popping of the Real Estate bubble and the near freeze of the global financial system. This is when the seeds of the last 10-12 years were sown. Global Central Banks, including the Federal Reserve, launched "Emergency" relief measures, flooding the markets with a then controversial $1.4 trillion to stave off a financial catastrophe. While it worked, it was a defining and world-changing moment. Surprising many, inflation remained low. At least the inflation of "things" remained low. The inflation of financial assets did not, as the S&P 500 gained 12 of 13 years from 2009-2021, with the only down year being a not-painful-at-all 4.4% decline in 2018. In fact, as this chart[1] illustrates with low volatility on the left and high returns at the top, that **red dot** in the top left shows that we just lived through arguably the "best" decade for stocks since the post-WWII period. Not only did the S&P500 return about 14% annualized - but it was also relatively pain free as it was the least volatile decade since the 1940s.



The world had grown accustomed to a low inflation, low growth, low interest rate environment with few ups and downs. This phenomenon was coined the "Great Moderation" where the business cycle smoothed out. Fewer highs and fewer lows. The big winners were U.S. Tech stocks that generated strong profit and revenue growth in the face of low economic growth. It seemed like it would go on forever. What could stop it? Then the Covid-19 pandemic hit. The global economy froze for the second time in 15 years.

As a direct result of the pandemic, things happened in 2020-2021 that, like 1971-1974 and 2008-2009, potentially changed the arc of the global economy and investing for the foreseeable future. For one, the Federal Reserve and the U.S. Government returned to their familiar playbook – they **printed money**. Lots of money. The numbers are so large, over 4 trillion Dollars – that they defy comprehension and make the 2009 stimulus look paltry. Now is a good time to look at the U.S. debt as a % of GDP (the black line) for the past 80 years.



As you can see, **U.S. debt to GDP** was pretty low in the mid 1970's when this little discussion began (the orange box). Then it went nearly vertical in 2008 (the green circle). Then it went nearly vertical again in 2020 (the blue circle), rising to a level of nearly 100% of GDP (red circle on the right), a level not seen since WW II (red circle on the left). Coincident with all this money printing, other inflationary forces surfaced. To name a few:

1) Global supply chains broke down.

2) American consumers, stranded in their homes, spent much less money going out and much more money buying "stuff" (which happened to be in short-supply due to the global supply chain problems).

3) A lot more people retired in the last two years than normally would have, resulting in a labor shortage that has pushed up wages significantly.

4) A large number of U.S. oil rigs went offline, and the energy industry has been slow to turn them back on.

The combination of trillions of stimulus and these other factors pushed inflation over 7%, a level not seen since…. the 1970's! Much like the 70's, things have changed socially too. Remote work is no longer a rare privilege. The price of residential real estate has leapt to new heights – leaving "have's" feeling rich and "have nots" behind. Younger professionals are (finally) moving out of their parent's basements. We have gender and pronoun choice. Now, Big Tech is investing in the "Metaverse" – a virtual world where we all sit home wearing virtual reality goggles and buying virtual stuff in virtual places. I will personally take a "hard pass" on the Metaverse, but Facebook thinks it's the future and has gone so far as to change the company's name to Meta. Back on planet earth, in the U.S. and around the world, hostility toward fossil fuels is gaining newfound momentum.

Last year also saw some significant developments in the capital markets. For one, it was a year of **massive speculation** – in non-profitable companies, SPACs, Crypto, the use of margin and options, and in "meme" stocks like Gamestop and AMC. To many, myself included, it felt a LOT like 1999. The U.S. bond market had only its fourth down year since the 1970s – declining 1.5%. While the Chinese stock market sold off in the face of slow growth and increased regulation, the value of U.S. Large Cap stocks gained 27%. But as has been the case for at least the last five years, much of the gains were concentrated in the largest, most popular stocks – Apple, Microsoft, Google (Alphabet), Amazon and Tesla. JP Morgan calculated that the top ten stocks in the S&P500 accounted for 17% of the S&P 500's gain, with the remaining 490 stocks accounting for only 10%. As you can see on this chart below, the U.S. stock market is now far more concentrated in the top 5 or even 20 stocks than it was at the height of the Tech bubble in 2000. We know what happened then.

Source: Bloomberg, JPMAM. December 29, 2021.

With inflation resurfacing, speculation peaking, and the large indices extremely top heavy, 2021 marked what we think is the beginning of an extended period of the **importance of Alternative Strategies and Asset Classes**. Real Estate and Real Assets performed well last year. So did Private Equity. Several hedge fund strategies provided attractive single digit returns with low correlation to stock and bond markets. Late last year we increased our allocation to Alternative strategies by trimming our Core Bond exposure further and allocating to a "Managed Futures" strategy that is a non-discretionary, rules-based trend follower. It doesn't attempt to make heads or tails of the craziness in the world and markets today as the strategy simply seeks to go "long" markets in an uptrend and "short" markets or securities in a downtrend. We think the time is right for such a mechanical approach.

Looking forward - we are expecting a **very different** year in 2022. Over the next few months, market pundits will be talking a lot about the Fed trying to "thread the needle" by "taking away the punchbowl" while trying to engineer a "soft landing". The last time the Fed attempted such maneuvers was 2018 – which happened to be the only calendar year in the last 12 which saw an S&P 500 decline. Longer term…Take another look at the chart of S&P500 returns by decade on page 2. The red arrows show how decades of low to moderate volatility like the 40's, 60's and 90's were each followed by a decade of very **high volatility**. Yeah, we think there's good reason to expect the next ten years should be very different than the last ten.

This essay may have you feeling anxious about the investing future. If so, please remember three things. One – Inflation. A hypothetical investor who started last year with $100,000 under her mattress still had $100,000 at the end of the year. But after a year of 7% inflation, it's now worth only $93,000. Challenges abound, but "safe" is sometimes not really "safe". Two – Throughout time, there has always been something to worry about. In the face of endless negativity, the best investors over the long-term are **cautious optimists**, not eternal pessimists. Third – Our hands are not tied, and our opportunity set is not small. Earlier this year we moved some exposure from aggressive stocks to defensive stocks. Late last year we upgraded some equity exposures to higher quality stocks. Currently, our portfolios are significantly underweight Core Bonds, and most have about 30% allocated to what we think are exciting Alternative investments. You won't see us wearing bell bottoms anytime soon, but that doesn't mean we can't still enjoy the ride and allocate to some groovy investment opportunities along the way.