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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Pick Your Poison

By Casey Clarke

We typically operate day to day within the guardrails of precedent, making decisions and evaluating outcomes based on what we've observed and those things that have played out in the past. Certain rhythms repeat for certain reasons which is why more times than not, this modus operandi not only makes sense, but is wise. There's a reason we should respect and learn from our elders. There's also a reason why as we age, we tend to become a little jaded about certain things – we often see the same mistakes being made over and over again. The boom/bust cycle is a tale as old as time and is a good example of this. Five years ago, we warned clients that the boom part of the current cycle was getting very long in the tooth, was very extreme, and based on historical precedent, was creating a very dangerous situation for investors when the "bust" eventually shows up. Well, since then we've learned that there are almost no lengths to which policy-makers (humans) aren't willing to go to extend the natural rhythm of the boom/bust cycle, and so far, those actions have worked in keeping what is now the biggest bubble in history not only from deflating, but inflating ever further. There is no precedent for what we've witnessed in recent years. That doesn't mean however that we've discovered a new happy equilibrium where everybody wins indefinitely. Quite the contrary actually. The situation we find ourselves in now is more binary than had we let markets sort themselves out more naturally along the way. Every day that goes by, our options are a more extreme choice between a cost of living that is increasingly unaffordable to most, or a massive deflation of asset prices that brings the world back into a more sustainable balance.

Most are aware that prices for things, whether home appliances or food at the supermarket, have gone up measurably over the last 18-24 months. What's interesting about how we've gotten to this point though is that many are attributing these price increases almost entirely to Covid, rather than the combination of monetary stimulus from the Federal Reserve and government spending out of Washington. Although Covid (mostly the world's reaction to it) has certainly played a role in supply disruption, which in turn has played a role in price increases, chalking inflation up to Covid alone misses the bigger picture. Over time, supply disruptions are normal and will happen. Our ability to take natural resources from the Earth, turn them into finished goods, and sell them on demand to whomever wants them actually does have limits. When the demand side of the equation via monetary policy and government spending is constantly and relentlessly being throttled, eventually you get what we've gotten over the last few quarters: rapid and broad price increases. For those who've been paying attention, this "Covid inflation" is nothing new, but more a confirmation of what's been happening for years underneath the veneer of the carefully curated government inflation numbers. Food prices have gone up little by little while packaging has gotten smaller and smaller. Like watching a child grow day by day; it's hard to notice, but it's happening. Paying a reasonably steady price for an appliance, but having to replace it twice as quickly because the quality isn't what it used to be. Health care costs rising by more than 10% each year. All of these things represent higher costs of living that existed prior to Covid but weren't as broad-based and obvious as the acute rises we've seen recently. Nonetheless, they are persistent, real, and the result of manipulating the demand side of the economic equation in order to perpetuate the status quo. A question to ponder: If prices fell by half, would it be the end of the world if 401ks fell by half? A pure hypothetical of course; situations are never this tidy and neat, but we'd venture to say that the vast majority of planet Earth's population would benefit greatly by this. It's really only those relative few with the bulk of the money in financial assets such as 401k plans that seem to have a problem with it - those whose lives aren't as greatly impacted by inflation. Of course we don't want 401k plans to fall by half, but we raise the question to illustrate the rock and the hard place we find ourselves between.

And so, we're in a situation where the pernicious effects of inflation are undeniable and can no longer be massaged, obfuscated, or discounted. This seems a reasonable crossroads for our policy-makers to arrive at where the decision to perpetuate the cycle now has real and obvious consequences – the end of the line if you will. Do they continue to inflate markets and keep money in people's pockets while letting inflation rise further? Or, do they recognize that inflation hurts far more people over time than falling asset markets do? It's a classic pick your poison scenario and it seems we're very close to finding out which poison our trusted and partially-elected financial wizards choose. One point we want to make is this: it's the actions of the Federal Reserve and government over many years that have led to this extreme binary scenario, not Covid 19. Don't think for a minute that this situation would have been avoided had Covid not arrived on our shores. Delayed maybe, but not avoided. The biggest bubble of all time doesn't get puffed routinely bigger without a reckoning at some point.

Rather than being happily ignorant to all of this in recent years, we've chosen to embrace it as reality, shun the notion that acknowledgment is cynicism, and focus on making the best of it. So, how does one prepare for either of the potential outcomes? Well, if our best and brightest in and around Washington decide to let inflation fully out of the bottle in fear of falling asset markets, then we need to own those things that will inflate in price as well or at least benefit from inflation. We currently have a good allocation to these categories within our managed client accounts. On the other hand, if they decide to battle inflation at the expense of asset markets, then we need to own the things that are least egregiously priced. If markets deflate, it's most likely going to be the things that are most expensive (usually the things that were most speculative – see our next piece on Tesla for more on this) that fall the furthest while those things that are viewed as relatively cheap or fairly priced tend to perform the best. Ironically, the asset classes that seem the most fairly priced right now are also some of the same ones that would perform well in the inflationary outcome. This simplifies things immensely. In the end, the investing principle that is most instructive here is "The long-term return you get is all about the price you pay". This is the worst time in history to overpay for anything.

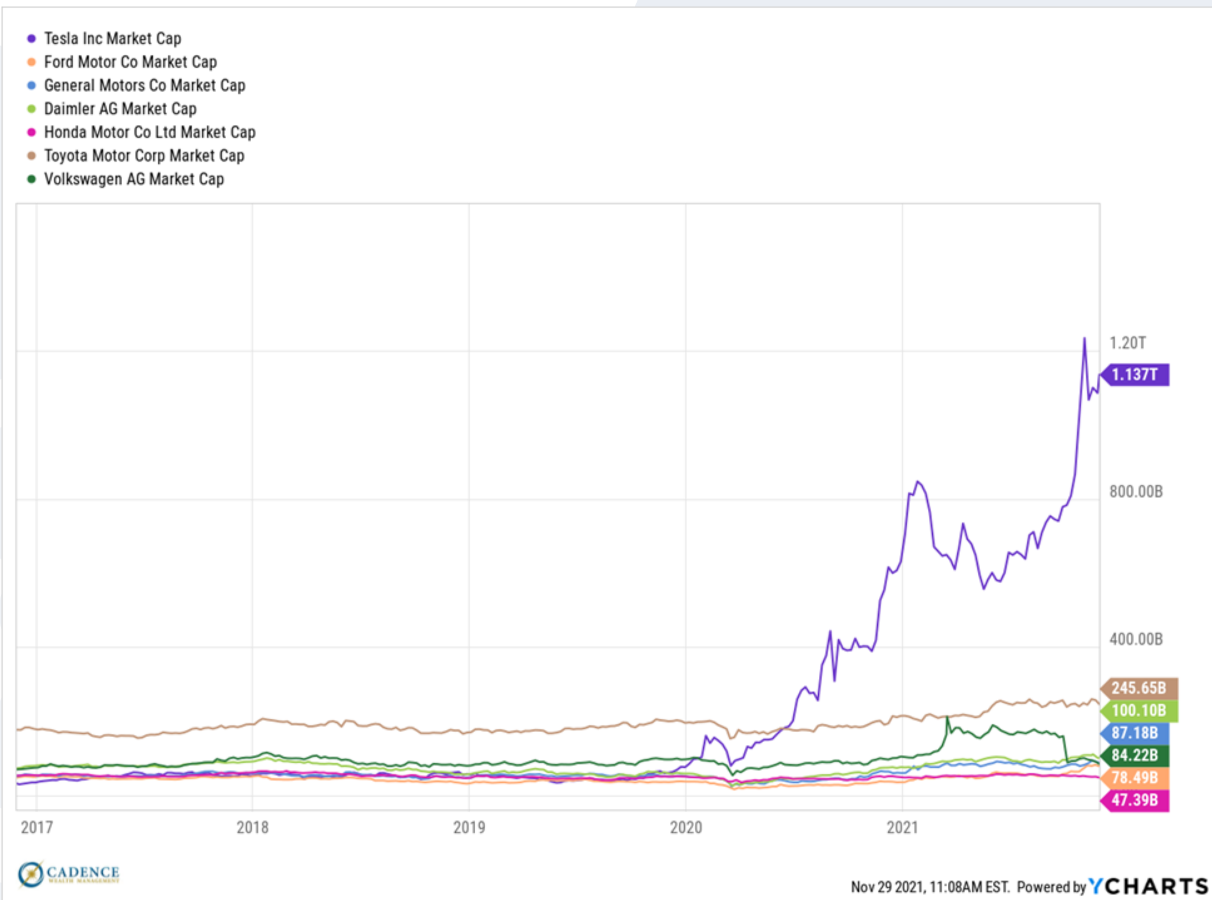
So, in the spirit of living with our heads up and full of awareness, it's important to recognize the crossroads we're fast approaching, if not already upon as a society. We either continue to marginalize the masses who aren't fortunate enough to have large nest eggs by allowing inflation to run freely, or begin to move back toward greater balance and equilibrium and accept the financial market events that come with that. We can't have it both ways, so if this is the reality we're facing, the question becomes "what do we do about it?" A piece of wisdom that's always resonated with me is "10% of life is what happens to you, 90% is how you react to it". It's possible that this saying has never been more relevant than it is today.

Tesla: An Emblem of Madness

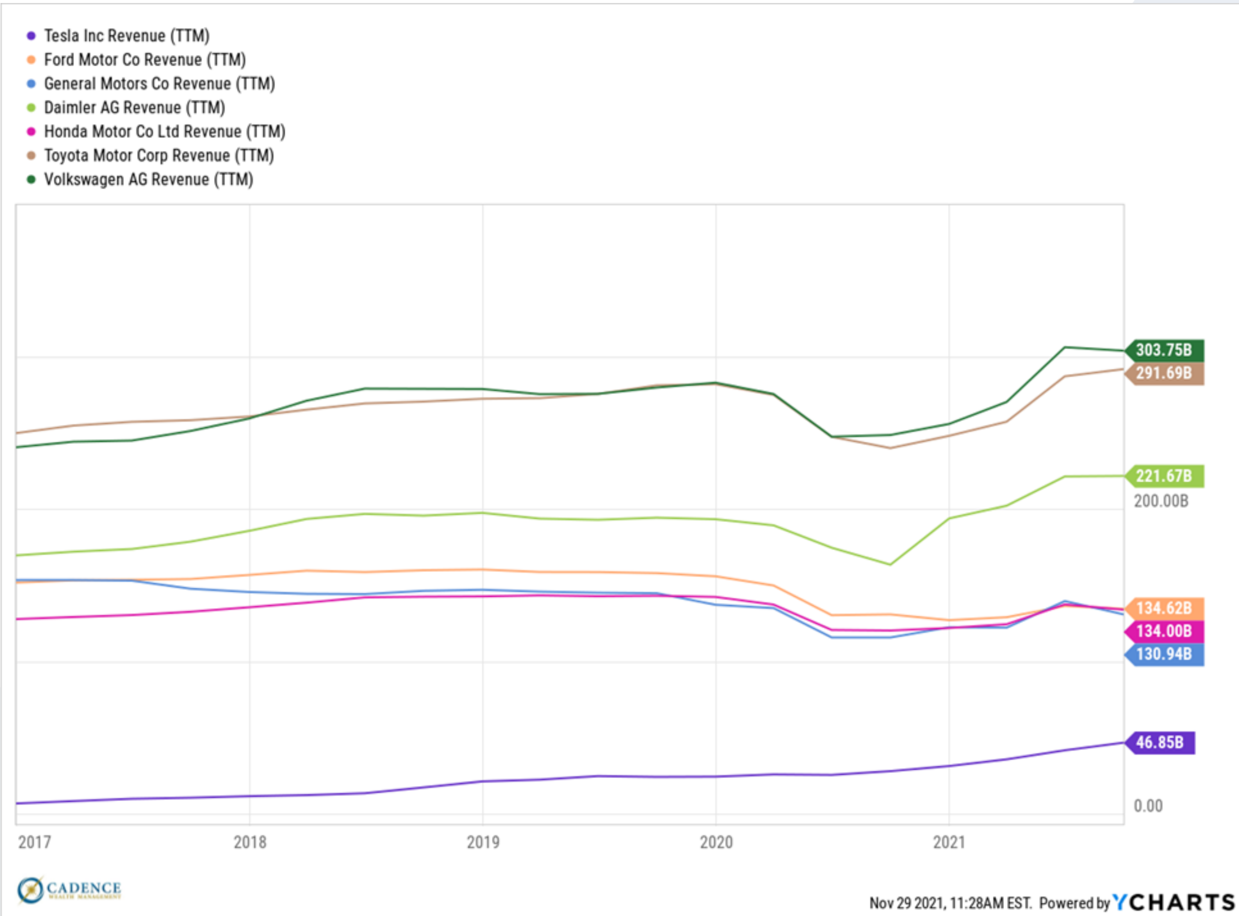
By Casey Clarke

Every mania has its focal point, where speculation is most heavily concentrated. In the late 1990's it was technology stocks and dot coms in particular, in the mid 2000's it was housing. Now, well, it's a lot of things as this particular episode is so big and broad, but one of the most ubiquitous emblems of the speculative mania is Tesla. Heard of it? We'll bet you have given the popularity of Tesla as a stock investment. The cars are also fairly popular, but we'd argue, and as you'll see in a moment, to a much lesser extent. In addition to being familiar with the Tesla brand, you likely also know those cars are electric. You probably also heard that they're on the cutting edge of technology. From there, it probably starts getting a little fuzzy and more about a story of what could be coming next. Self-driving capability, a super smart and omniscient iPad glued to the console, space flight, and possibly even space colonization? We kid, but the point is, there's actually money-making stuff and then there's the hype. In every mania, investors discount the money-making stuff (reality) and focus almost all their attention on the sexy what-ifs, regardless of how unlikely they may be to materialize. Sometimes this involves extrapolation where a positive trend is assumed to continue way out into the future and other times it's a desire to anchor on something more exciting that has yet to come to fruition. Regardless, whenever a stock price gets too far from the underlying reality of the fundamentals – the money-making aspects of the company that determines its value – it's usually just a matter of time before investors realize that the hype they've bought into may never materialize. So how far from the fundamentals is Tesla's stock price right now?

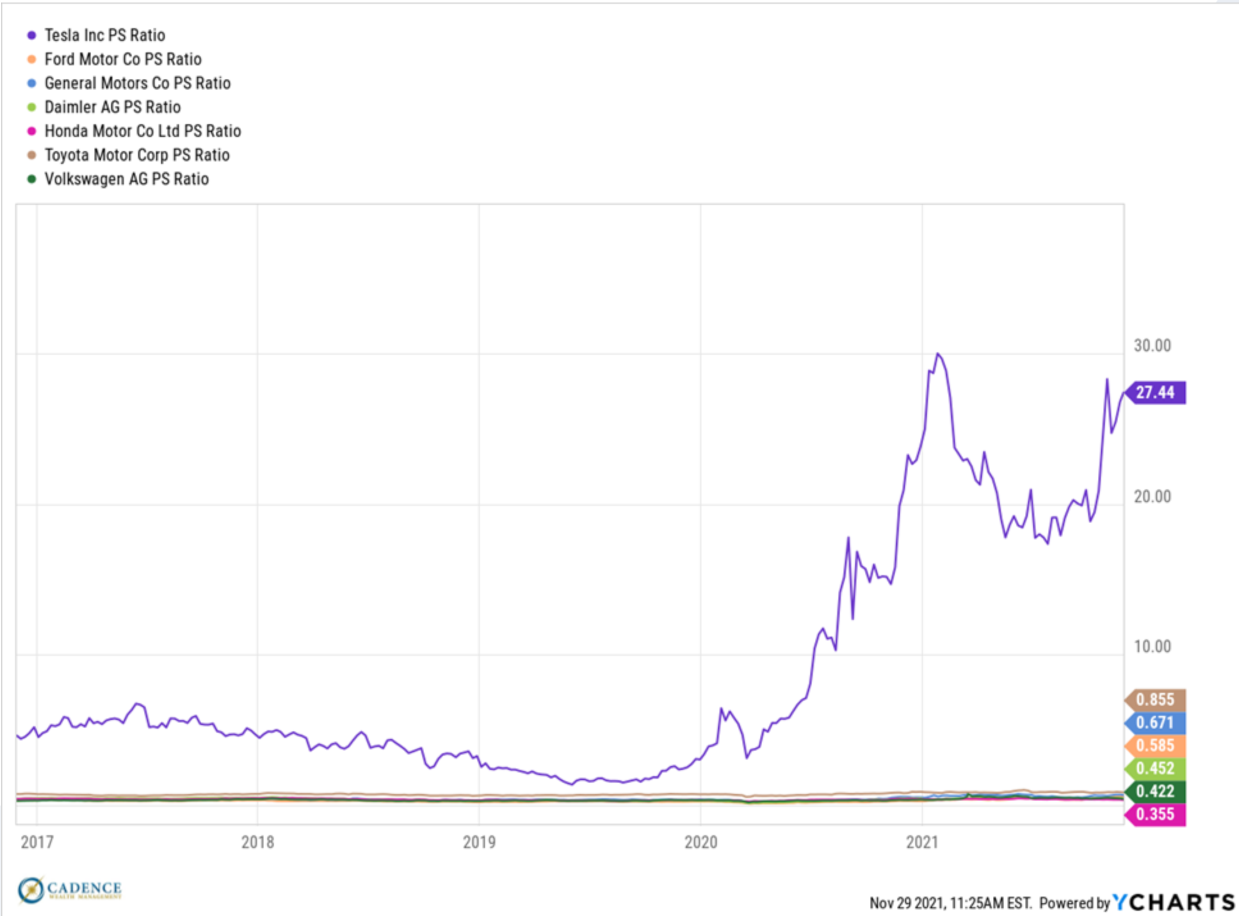
First, let's look at what the company is worth based on its share price and the number of shares outstanding. This is referred to as market capitalization, and since Tesla's a public company, it is up to investors and the stock market to decide what the whole operation is worth. As you can see from the chart to the right, Tesla has a market capitalization of $1.13 trillion. To put that into perspective, the six major auto manufacturers, Ford, GM, Volkswagen, Daimler, Toyota, and Honda, have a combined market cap of ~$650 billion.



Now, you may be thinking that if Tesla sells way more cars than the rest, then a valuation of nearly twice as much as all the other major competition combined might be justified. Maybe, but we probably all intuitively know they can't possibly be selling that many cars. As we can see below, not only are they not selling way more cars, they're actually in last place in total sales revenue over the last twelve months with Volkswagen and Toyota both bringing in approximately 6 times more annual revenue than Tesla. It's really not even close.



What this suggests is that virtually all of Tesla's market cap is based on the hype; the exciting stuff that has yet to play out. The price to sales ratio is very good at helping us determine what a company's stock should be trading at when investors are basing that price on money-making stuff. What we can see on the next page is that the six competitors we're measuring Tesla against all have a price to sales ratio somewhere below 1; let's say they average 0.55. For context, every industry is different in this respect. High profit margin industries tend to have higher price to sales ratios while low margin, high expense industries tend to have lower ones. Think of it this way, if a company keeps most of its revenue after expenses, investors are willing to pay more for each dollar of revenue because they'll end up pocketing more of it. If very little of that revenue ends up making it to the bottom line as profit, investors will pay less for those sales since they'll see very little of them in the form of profit that could be used for dividends or reinvestment. So, for cars, since margins are very low and costs high, the price to sales ratio is typically very low. Not for Tesla however. Tesla's PS ratio is over 27! Here's what this means. If revenues stayed steady from here and investors decided to value Tesla purely based on the fundamentals of selling cars, the market capitalization instead of being $1.13 trillion would be somewhere around $26 billion. That's a -97% reduction in value, which assuming no change in the number of outstanding shares, would equate to a similar drop in the share price. There are lots of what-ifs here, but investing is all about placing all those what-ifs on a scale and seeing which side has more of them. In this case, 97% of Tesla's value appears to be based on hyped-up future possibilities and 3% on the current business model. Even if some of those possibilities actually do come to fruition, 97% is a massive gap to close.



A critical thing to remember is that the stock price doesn't always move in the same direction as the company's fundamentals (sales and profits). Tesla could have a very successful future, but that doesn't necessarily mean the stock price will go up. It's all about how much of that foreseeable future is already priced into the shares. In this case, we'd venture to say all of it and then some. This story is not unique to Tesla. There are countless investments out there today that fall into this speculative category in addition to others that wouldn't be considered speculative, but have also been pushed to extreme prices relative to the underlying fundamentals. The theme across most major asset classes is consistent. Speculation and systematic buying have garnered all the attention while fundamentals have received little of it. If and when investors realize that a large vacuum lies between the current prices of their assets and the foundation of fundamentals that typically supports them, this cycle will be over.

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