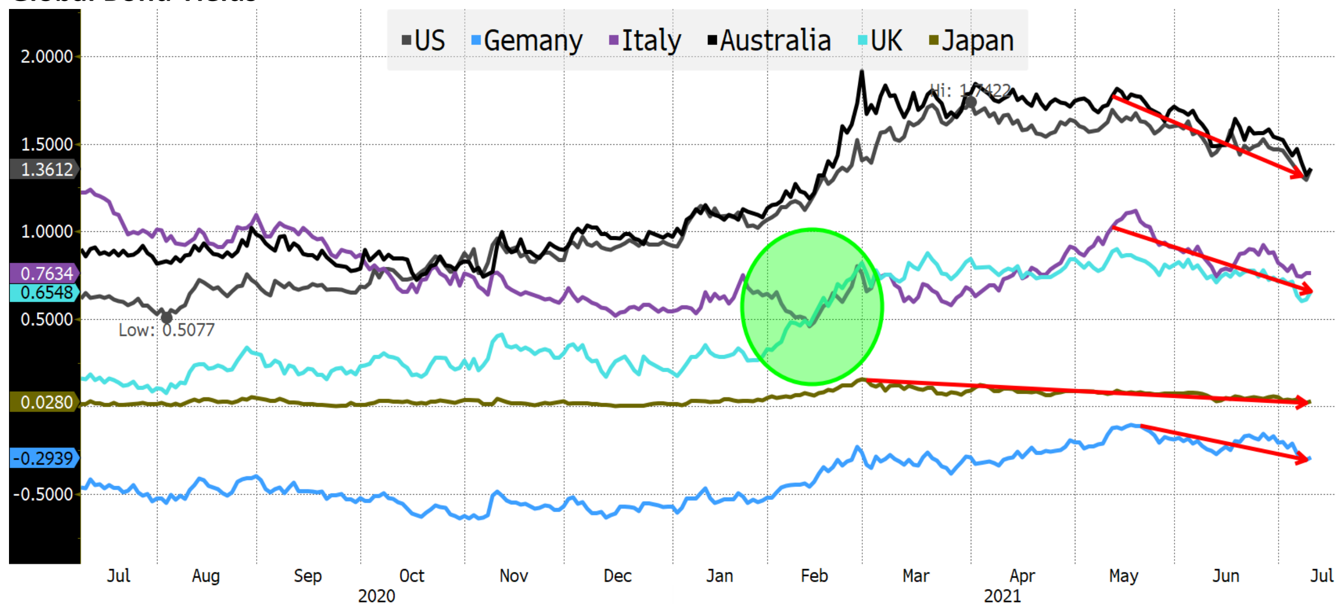
Voldemort and Things That Must Not Be Named

There is a strange undercurrent in the market. There are some subjects, while not taboo, that seem to be suppressed. I would put the **delta variant** at the top of the list of things not to be named. Yes, it is mentioned and it is even occasionally blamed for market moves, but probably not to the extent it deserves. Whether it is more interesting to complain (for many) about reduced WFH or quite simply that at some level we are all scared to open up that can of worms for fear that we might be closer to February 2020 than we want to admit remains to be seen. COVID isn't the only such topic, and we will hit on others, including **stimulus, China decoupling, meme ETFs, faux liquidity, and more**. One thing that many of these topics have in common (in addition to being under-discussed) is that they have had a lot of impact on yields.

Yields and Curves

Yields are lower across the globe. We often fixate on everything the Fed is saying and doing, but this rally in bonds is occurring across the globe! It is happening to varying degrees in different countries, but it is universal. It probably helps that all central banks seem to be adopting similar policies, but it also indicates that we should be searching for **commonalities beyond just "technicals" and "Fed policy"**.

Global Bond Yields



I highlighted in green the period where UK bond yields were rising even with the reality of Brexit. Bond yields in virtually every country have been declining since the late spring. It didn't matter whether you were a commodity country (Australia), a "credit" story (Italy), or the safest of the safe (Germany), yields were still declining. The only "surprise" is that Japanese 10-year yields are still positive, despite Japan's decision to prohibit spectators at the Olympics.

Last week might have been one of the more 'bizarre' sentiment weeks I've experienced in a long time. We had gradually accepted increased inflation, then doubt slowly crept in, but that doubt suddenly transformed itself into a "**growth scare"**. Technically a "lack of growth scare", but a scare nonetheless.

I am not sure what turned the growth scare into a crescendo. Maybe because it was easier to talk about than admitting we are really getting concerned about COVID and all its variants? Maybe it was just a relatively quiet news week (with a lot of people on vacation), which made it easy for a fear story to take hold? The story "dissipated" almost as quickly as it came, but it felt both strange and manufactured.

Too Flat or Not Flat Enough?

The yield curve has been flattening dramatically. I highlighted where we were in the summer of 2020. I cannot imagine a scenario where we have as much fear and uncertainty as we did in the summer of 2020. Deaths were still high. Vaccines were more of a goal than a reality. While the government was spending money, it was more of a "band-aid" than a producer of growth and quite frankly, the news was much more about ongoing closures than re-openings. Not to mention that the U.S. had an election looming. In any case, I find it extremely difficult to believe that we can get back to those levels.

The red line indicates where we were as we ushered in 2021. Could we get back to those levels? That seems like a more reasonable question.

- We didn't know how **readily available the vaccine would be** (positive), but we also weren't as focused on variants (negative).
- We were **expecting more band-aid stimulus to be followed up with infrastructure spending**. We got the additional stimulus (good), but it took longer than many expected (negative) and many more are questioning what the money was spent on (a fair point that I agree with, but that is a slight negative as it is impacting future spending). While infrastructure spending is still likely, it is probably going to be much smaller in total and spread over a longer time than was initially projected (**a big negative**).
- The **Fed was viewed as extremely accommodative and committed to not hiking** (positive). The market is now pricing in a Fed that is keeping an eye on inflation. I just don't think that is true at all. They will say any inflation is transitory. If it turns out not to be transitory (ignoring the

crazy swings in front month commodity futures contracts which are almost always transitory in both directions), the Fed will talk about longer run averages (which the ECB just implemented as official policy). **The Fed cares far more about jobs, unemployment, and underemployment, especially where inequality may exist, than they do about inflation.** Thinking the Fed will be anything but accommodative at the front end is where I have my biggest disagreement with what seems to be a consensus view. Currently a negative for growth, but one that I think is being mispriced and the market will start to reverse its view on this.

I must admit that I haven't seen any "**yield curve predicting a recession" reports**, but a 50 bp move in a quarter certainly isn't auspicious. I expect curves to steepen (and think it is in every central bank's interest to steepen the yield curve as it helps banks and also because steeper yield curves signal confidence in growth, and we need that back). Ultimately, central banks can only do so much to steepen the yield curve, but look for steps in that direction.

Why We Can't Say COVID

Yes, there are some headlines, but even in the section above, I minimized my discussion on COVID. It really is an uncomfortable topic (or at least it seems uncomfortable to me). Certainly, virtually every company I talk to (small and large), is discussing how their offices will re-open. I have not found anyone preparing for a severe pullback or renewed risk of lockdowns. There is data to support thinking that way, but **I'm increasingly worried the data is providing reason for concern that the bond market is picking up on, but no one else is.**

Why we can be sanguine:

- Cases are heavily concentrated on non-vaccinated people.
- Even accounting for lag effects, hospitalizations and deaths are not rising quickly. **It is very common for variants to be more contagious but less lethal.** Lethality can slow the spread (one reason that Ebola for example, as scary as it is, has never reached global pandemic levels is that it is so quick to kill).
- In many countries, those most at risk have not only been vaccinated, but are able to be more cautious as warranted by their own specific risks.
- Modern medicine is working furiously to help fight this variant/other possible variants, and our ability to treat patients continues to improve.

Why we need to be cautious:

- The spread of this variant, even if it turns out to be less lethal, shows that we are a long way from eradicating COVID. It also leaves the unspoken question of "what version is next?"
- Talk about booster shots as early as this fall is starting from health officials and drug companies. While both of those groups might have incentives to be extra cautious, it is worth paying attention to it.
- **If another wave hits hard,** which is hopefully unlikely, it seems clear that it will be more difficult for governments and communities to respond. There are so many question marks surrounding the last rounds of stimulus payments that it might be difficult to come to any meaningful

political agreement. Emotionally, the damage of moving back towards lockdowns would be difficult to deal with. The risk to commercial real estate in big cities would return as well. There is already some reluctance to get back to the daily grind of commuting, so anything that highlights health risks associated with that would result in even more risk to the return to office viewpoint.

On a scale of 1 to 10, I'd put the risk of the delta variant at about a 4, but the mainstream media seems to be labelling it a 2, and the bond market may well be pricing it at a 5 or 6.

Maybe it is just my perception that people aren't giving it the attention it deserves (away from the bond market), but it does seem to be an uncomfortable topic to discuss.

Why We Can't Say De-Globalization

We have been discussing the risk that China is less interested in being the global supplier of cheap goods and is more interested in focusing on their domestic economy and becoming the top superpower in the world. The Alaska Summit resonated, in that respect, with our entire Geopolitical Intelligence Group.

Virtually every economist will tell you that globalization is good, therefore it is in the interest of China, and they will pursue globalization. This is the same thinking that has led to policy mistake after policy mistake with China. We take our views, our priorities, and our perspectives and assume they translate reasonably well to China when analyzing what policies they will pursue.

This decoupling is certainly part of my inflationary view because we will find out that many of the price increases we face right now (that are deemed as temporary as China normalizes), will not be so temporary. There are a few things that are top of mind on this subject:

- We need to continue to protect our **high tech and medical/pharmaceutical** interests from a national security standpoint. While it is exciting to see entrepreneurs lead the rush to space, we need to maintain focus (a great opportunity to listen to Academy's 21st Century Space Race podcast with Navy Captain and Astronaut Wendy Lawrence and Air Force General David Deptula). One thing the delta variant should do, if nothing else, is to continue to encourage politicians to make sure we have domestic or closely allied sources of materials and equipment to prevent and fight viruses.
- **Competition for rare earths and critical minerals will define this decade.** Every major economy is focusing on a more sustainable future, but that will require many elements and resources. Competing for those and securing their availability will be crucial to the achievement of those goals. **I remain extremely concerned that the risk is simply creating policy (that is admirable), but isn't accompanied by a realistic plan to achieve that policy.** There is some evidence that is why energy prices have skyrocketed. We have to make sure we have "goal based" rather than "dream-based" policies. This is achievable and can get us where we want to go, but it will include fierce global competition for these resources.
- **China, Iran, and Russia.** It has been so long since geopolitical events have caused a rapid, large market move that we almost forget that they can. Getting the geopolitics right on China and other areas has been crucial over time for companies and markets, but it has moved slowly.

Similarly, while the battle for rare earths is crucial, it is even slower moving. While there is nothing definitive, **there is heightened awareness amongst our Geopolitical Intelligence Group surrounding the ongoing actions of China (particularly with Taiwan), Russia (with Ukraine and beyond), and Iran.**

- **Shifting from bitcoin to digital yuan**. Not sure what to make of this, but it isn't happening by accident.

I think the bond market may be ahead in pricing in not only the risk of China being more internally focused, but also in pricing in increased geopolitical risk. I generally agree, but I think China shifting its focus will be inflationary, even if it causes the global economy to slow. Rather than focusing on the slower global economy, I'm focused on China's voracious appetite for raw materials and the fact that is will be less willing to sell us goods cheaply. I expect their currency to resume strengthening and head back towards 6, which was where it was in early 2014.

Stimulus

I won't belabor the point anymore, but I'm increasingly nervous that we won't get as much money as hoped for and it won't be as well targeted as I'd like. There is still talk of infrastructure banks and truly aggressive deals, so I haven't given up all hope, but the bond market sniffed this out earlier than I did (rarely am I accused of having too rosy of an outlook, but that was the case here, at least as of now).

Faux Liquidity

Multiple times a day I have conversations not about the direction of the move, but the magnitude of the move. Traders, investors, corporate treasurers, and those who have been right and wrong all seem more able to understand which way things have been moving, but are having much more difficulty justifying the size of those moves.

That to me is indicative of 'faux' liquidity. Things look liquid, but there is no depth. Rotations are fast and powerful and often reverse quickly (like the "growth is over trade" reverting to the "low rates are good" trade and flip flopping every 24 hours). On an almost daily basis there is some stock that trades at such a high volume, that it isn't humanly possible (well, it isn't humans driving the trading).

When asked why I remain in "batten down the hatches" mode, it is because this sort of fake liquidity seems incredibly dangerous, especially as positioning isn't bullish.

Meme ETFs

It was somewhat interesting when David Portnoy and Barstool Sports became hot topics in the investing world, but there was an ETF launched last week that I cannot help but watch. From my perspective, the manager doesn't have the resources or experience (unlike ARK investments) and it is much more a function of media and social media in particular. Things like that and a bunch of other recent ETF launches are worth keeping an eye on, as ETF launches often signal way too extreme positioning (like when some high yield bond funds were launched that excluded energy bonds, within about a week of the lows in energy bonds).

This feels like a good time to point out that GBTC (Grayscale Bitcoin Trust), which has been trading at a discount to NAV, may reduce shares soon, which could impact bitcoin prices. While I knew how

profitable this ETF was ($19 billion of AUM with a 2% fee), I hadn't thought about it relative to some other fund families. The amount of money this single ETF is generating is larger than the entire revenue stream (let alone profits) of some household names (no wonder there are about 15 crypto ETFs filed with the SEC).

Bottom Line

I think we have become too pessimistic on growth, but we also need to really acknowledge all the reasons we are priced where we are, even if some of those subjects are uncomfortable and we all wish they would just go away and be a distant memory.

While I'm optimistic on growth, I find it difficult to get excited about adding risk here as equities probably need to think about what the bond market is pricing in (it isn't as simple as growth as we've discussed) and this lack of depth in any liquidity is troubling.

Credit spreads should remain "dull" as supply grinds to a halt this summer. Also, so far, even with reduced expectations from stimulus, nothing should impact credit in a material way because there is a massive equity buffer for most of the credit universe.

Not believing in doom and gloom for the economy is easy for me, but figuring out where to express that is more difficult.

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