REAMS ASSET MANAGEMENT
A Division of Scout Investments

January 4, 2022

Dear Clients and Friends:

Like many, I am happy to say goodbye to 2021, a year that plodded along in a largely desultory fashion before lurching to a close, leaving most feeling apprehensive and, in general, more uncertain about the future than usual. It feels as though we are living in a time that future generations will deem significant, yet how they will judge us is still unknown. The truly interesting discussions about this time are largely in the social and political realms, and sadly, these are not within the scope of this letter. Unfortunately, we must limit ourselves to the economic and financial sphere; yet I believe there are parallels between these areas of interest that could help inform how we might wish to position ourselves in the years to come. Yes, I said years and not months and not quarters, as we find ourselves in an era that will be studied and discussed at length for a long time to come.

I am routinely asked to forecast variables such as the yield on the ten-year Treasury or the rate of inflation, GDP growth, etc. And while I have opinions on just about everything, I recognize they are simply that and not really a basis for making investment decisions. First of all, it is likely that any given forecast will be well off the mark, but more importantly, even if you get it right, you may not get the reaction you expected. As an example, if on December 31, 2020 a genie had given you the inflation rate for 2021 at 6.8%, it is doubtful you would have then forecast the yield on the 30-year bond rising only 26 bps and stocks rising nearly 27% (as measured by the S&P 500). Even the forecaster in chief, the man with an army of the best and brightest, was exposed as merely guessing or more likely hoping. Federal Reserve Chair Jerome Powell famously dismissed inflation as transitory and nothing to worry about. In doing so, he was simply following the playbook of his predecessors and using the appeal to authority that comes with his office. He did not know that it would be transitory and clung to this narrative for far too long. The Fed Chair may be guilty of saying questionable things; yet he is not an ignorant man, not by a long shot. So why the dissembling, why not just say what everyone knew, that inflation was a problem and its future trajectory was highly uncertain? It is likely he is afraid.

A crystal ball is not required to be a great investor. Warren Buffett does not give forecasts. He simply repeats platitudes, such as “the economy will be bigger in ten years than it is today.” Yet he is considered perhaps the greatest investor in history. How is it possible without an ability to guess the future? He looks at data; he is dispassionate; and he is not afraid to be considered wrong for a time, even if some say being early is the same as being wrong. In 2007, the ratio of stock market value to GDP hit 1 for the first time in history before crashing to 0.5 during the Global Financial Crisis. It returned to 1 in 2013 and ascended to 1.5 in early 2020. Today it stands at 2. Is it a surprise that Buffett holds record levels of cash? He has no fear of missing out, and he scoffs at the “you only live once” crowd. He does not need a forecast to know there is, what we believe to be, a massive overvaluation in the equity markets. It is this valuation problem, a problem largely of the Fed’s making, that has Chair Powell afraid. It is why he used the appeal to authority on inflation. For if in fact inflation is not transitory, the ultimate denouement of this decades-long play of serial asset price inflation is at hand.

So where does this leave us as investors? Let us look at the environment dispassionately, as all good investors should, but which I understand is very hard to do. We see the stock market at historic valuations inflated by reckless central bank policy. We see inflation stoked by irresponsible fiscal policy, which was bizarrely cheered on by Chair Powell. Yet we have policy rates at zero and the ten-year Treasury yield at the second lowest year-end close since 1960. Inflation expectations are up a bit but

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still modest at 2.38% for the next 30 years vs. the 6.8% we have just experienced, the highest it has been since 1982. So risk assets are priced arguably as richly as they have ever been. Monetary and fiscal policy have unleashed, at least for now, inflation not seen in almost 40 years. Treasurys offer a negative real or inflation-adjusted return and a nominal return barely above zero. When looked at this way, it is not really difficult at all. We believe only a fool would take excessive risk and that a defensive posture is where prudent investors should be. Plan to protect your assets, understand why we are here, and acknowledge the risks an eventual adjustment could entail. Understand the risk/return ratio is skewed wildly to the expensive side in virtually all assets. We may very well be in the midst of a generational shift in the investment landscape, and I believe Chair Powell is right to be afraid. However, fear is not really an investment strategy.

We remain focused on our mission, which is to help safeguard and grow your assets over time. For now, the emphasis will be on the safety aspect for the reasons I hope are apparent. There will come a time when significant growth is back on the table, but between then and now, things may get a little dicey. I can't wait.

Sincerely,

Mark M. Egan, CFA
Managing Director