Licensed by the California Department of Corporations as an Investment Advisor

Investment Newsletter – June 2020

The March newsletter listed 4 problems and what needs to happen. So far, the only solution implemented was the Federal Reserve's bond market liquidity actions.

I cannot recall a time when there has been so much uncertainty about the future path of the economy, the investment markets, and how our society will be organized going forward. The disconnect between the stock market and the economy is astounding. In this newsletter I'll put recent events in context and highlight the potential I see for a new era of rising inflation in the U.S. Then we'll cover investing implications of the current environment and the heighted probability of inflation rising in future years. Finally, we wrap up with a review of our Short Term Income portfolio performance.

Current Market Environment

We have been in an extremely incongruous situation since March. The economy is in the worst recession since the 1930's, yet the stock market gained 25% to the recent high on June 8th. As of June 26, the Atlanta Federal Reserve Bank's 2nd quarter Gross Domestic Product (GDP) estimate using the most recent data shows an annualized drop in real GDP of 39.5% - which equates to an actual decline of 11.8% in the quarter. I estimate that government stimulus spending will amount to approximately 26% of GDP in the 2nd quarter. This implies that the contraction in the economy would have been 3 times as bad without the government spending. A significant portion of this spending was tied to hiring people back regardless of whether they had any work that could be done. This can account for the surge in payrolls for May - which seems to have fooled stock investors into believing the economy is already snapping back to its pre-pandemic state.

Unfortunately non-government financed spending will not recover so quickly. Without a new stimulus package I expect the currently enacted stimulus spending to drop to 19% of GDP in the 3rd quarter and below 10% in the 4th quarter. It seems likely that market participants will be surprised by dampening effect of the drop off in government support – if we don't get another stimulus bill.

For the calendar year to 6/22/20 new federal government borrowing was $3.05 trillion which is 5 times the run rate of last fiscal year. The Federal Reserve Bank has essentially bought all this debt by creating new money – a process called monetization. There are many examples from history where such large scale

monetization has led to rapid price inflation, but then there is the counter example of Japan. We'll get a bit deeper into the inflation question later in this newsletter. For now I'll just point out that, given the level of debt and increasing demands for the government to spend more and more, it seems likely that we will have a de-facto policy of financial repression similar to what was used to reduce government debt relative to GDP after World War II. By this I mean very low interest rates on government debt coupled with a goal of higher inflation. This policy combination can reduce government debt as a percentage of GDP by reducing the real value (after inflation) of savings invested in government bonds. In other words, it will be a stealth tax on foreigners holding our debt (China, Japan, Germany, etc.) and on conservative investors (and pension plans).

Day Trader Déjà vu – Its 1999 Again

One of the more surprising effects of the coronavirus lockdown is the re-emergence of a huge new generation of day traders. The narrative is that people at home have lots of time on their hands, they have stimulus money, and official gambling is closed down – so they're opening brokerage accounts and trading like mad because there are no commission costs. The vast majority seem to know nothing about stocks – and they are proud of that fact. It's a game for them to guess what the others are thinking and they love volatility.

In case you have not heard, Hertz Car Rental filed for bankruptcy May 22nd. This means that the creditors will sell its assets to recover their money. Stockholders get any residual but, by the time a company files bankruptcy, it usually means there is not enough money to pay creditors. Although Hertz stock dropped to $0.55/share the next day, it subsequently became popular with day traders and went as high as $5.53/share on June 8th. This highly unusual situation prompted the company to try to sell 247 million shares – to collect donations for the creditors. Surprisingly, a judge approved it, but the Securities Exchange Commission stepped in to fulfill its anti-fraud role, stopping the sale. Despite this clear signal that the stock is worthless, it continues to trade above $1 per share[1].

It will take some time for this new cohort of uninformed traders to lose their capital so I expect they will continue to be a contributing factor to the current disconnect between the stock market and the likely path of the economy. If you recall it took quite a while for the dot-com bubble to deflate.

The Potential for Inflation

While the federal government was borrowing $3 trillion this year, the Federal Reserve Bank was busy increasing the money supply by - $3 trillion. Yes, all federal borrowing this year was monetized by the Fed and now resides in bank accounts as savings to be spent later. The personal savings rate went from 7.7% in December to 32.2% in April. It was just not possible to spend all that money at once as the supply of goods and services contracted at the same time.

[1] The day after the judge ruled for the stock sale, I attempted to borrow shares to short the stock but they cannot be borrowed – so it is not easy to make money on the pricing error in this case.

What the government has done here is very different from 2008-2009. Most of the spending at that time was used to replace money (at the banks) that had already been spent by consumers when they took out mortgage they could not repay. Thus the federal money used to recapitalize banks did not feed directly into new demand at a time of contracting supply, but rather, it supported a less severe contraction in lending by banks. The Federal Reserve did vastly increase the money supply during the financial crisis, but that money went straight into bank reserves, and so, was not the so-called "helicopter money[2]" dropped to the population to be spent – as is the approach today.

A recent article in the Wall Street Journal points out that the more the government gets involved in supporting demand by loaning or gifting money directly to consumers and businesses, the more pressure there will be to avoid re-imposing budget discipline. We are rapidly reaching the point where government debt cannot be repaid in dollars with the same purchasing power. Inflation will eventually be necessary to avoid outright default. Here's a quote from the article:

> *"Inflation is both the result of out-of-control private money-creation financing consumption, and the easiest cure for excessive debt".*

As I explained in the March newsletter, because a large part of the economy was shut down, there has been a supply shock – the amount of goods and services available for purchase has been significantly reduced. As the economy opens back up, supply will increase. But, given the new precautions necessary for safety, it will take at least a year to return to 2019 levels.

Compounding this supply shock is a movement towards reconfiguring industrial supply chains away from China. Some of this will be accomplished by moving factories to other low cost (but less adversarial) countries such as Vietnam and India. But there will also be a "reshoring" component, meaning certain key products will need to be produced here in the U.S. In particular that will include key medical goods, semi-conductors, and materials and technology crucial for national security.

These changes in sourcing of products will increase costs, sometimes significantly. We will need to wean ourselves from the subsidies we've taken from the Chinese Communist Party – indirectly through their products. The adjustment process could be the trigger that starts the increase in U.S. inflation. Tariffs and trade protectionism are becoming popular and these policies will tend to increase costs and inflation.

In this election year it seems that free spending by government, protectionist trade policies, and massive money creation for the purpose of financing consumption are very popular. Most voters today do not remember the high inflation period of the 1970's and thus they are unfamiliar with the downside of inflation. That downside is lower real incomes and lower economic growth. In fact, these negative factors may be deemed a fair price to pay for the benefits. High inflation may help the large part of the population that has more debt than savings

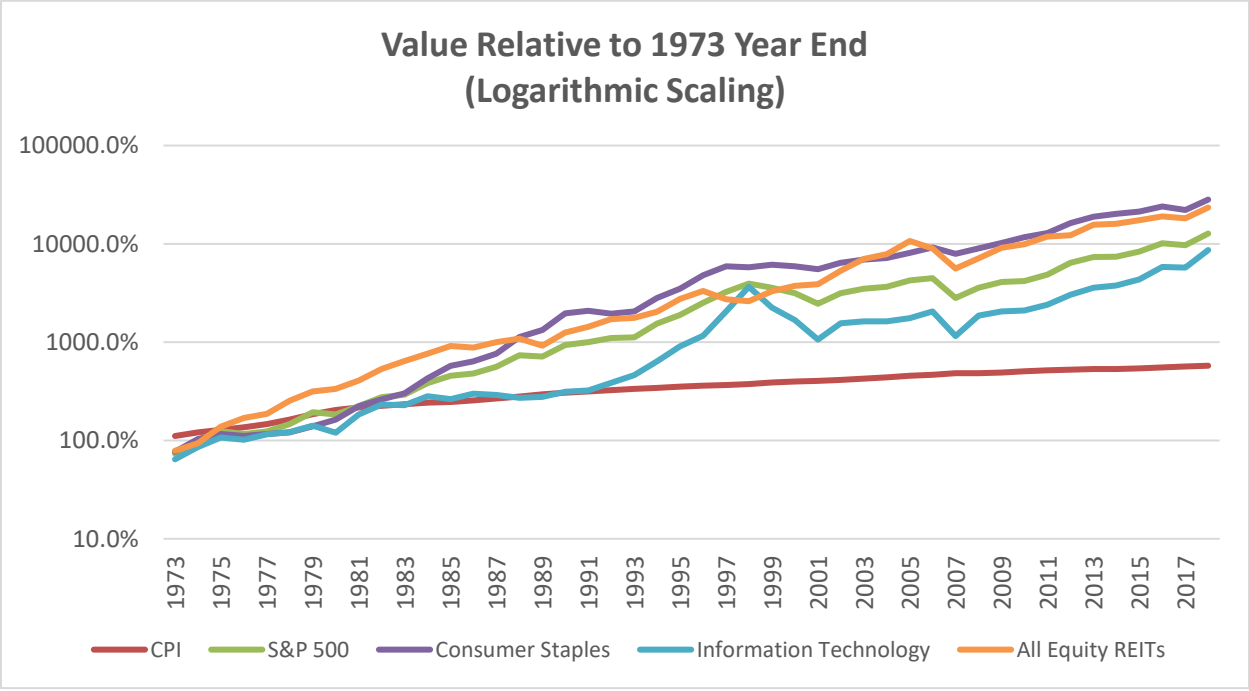
[2] Milton Friedman coined the term in his book "The Optimum Quantity of Money" in 1969. Former chairman of the Federal Reserve, Ben Bernanke got the nickname "Helicopter Ben" when he mentioned the idea in a speech on combatting deflation.

by reducing the real value of their debt; it will also reduce the real value of our government's debt to foreign holders. Conversely, the pain of inflation will be felt by owners of the debt – mostly foreigners and retirees. You could interpret this political momentum towards inflationary spending as a chance for the younger generation to even things out a bit - to get their share of the American Dream.

None of this guarantees that we will see inflation at the level we had in the 1970's. Consumer psychology plays a role. If the population expects accelerating prices, that expectation may become self-fulfilling in the absence of contractionary counter measures by policy makers. On the other hand if everyone believes the dollar (or Yen in Japan) can keep its value and they continue to build up savings in the currency as before, then the day of reckoning may be put off for quite some time. Japan has followed this course for many years. Of course, Japan as a country is a net saver, whereas the U.S. is not. Our dollar value crisis may not come until the day when foreigners no longer believe in the dollar as a suitable store of value. In any case, given the rising possibility of inflation, we need to be prepared.

Implications for Investing

Given the state of the economy and the disconnect of stock prices from the underlying reality, it is prudent to be defensive, at least in the near term until we reach more appropriate valuation levels as described in the March 2020 newsletter. In the equity market that means favoring stocks with lower than average volatility in earnings and cash flows. The consumer staples sector can limit downside risk while providing good returns in most environments. Here's a graph of the performance of consumer staples compared to the Equity Real Estate Investment Trusts (REITs), the S&P 500 index, and the much more historically cyclical information technology sector for 1974 to 2019.



Here are the key summary statistics for 1974 to 2019

Index:	Consumer Staples	S&P 500	Information Technology	All Equity REITs
Cumulative Return	28,096%	12,631%	8,549%	23,308%
Annualized Return	13.0%	11.1%	10.2%	12.6%
Worst Calendar Year	-23.1%	-37.0%	-43.7%	-37.7%

Note that because we are using calendar year returns, this data does not show maximum drawdowns as would be experienced within a year (or across several years) – such as the recent large drop in March that was recovered in the subsequent 2 months. For example the S&P 500 dropped approximately 50% at its bottom in 2009.

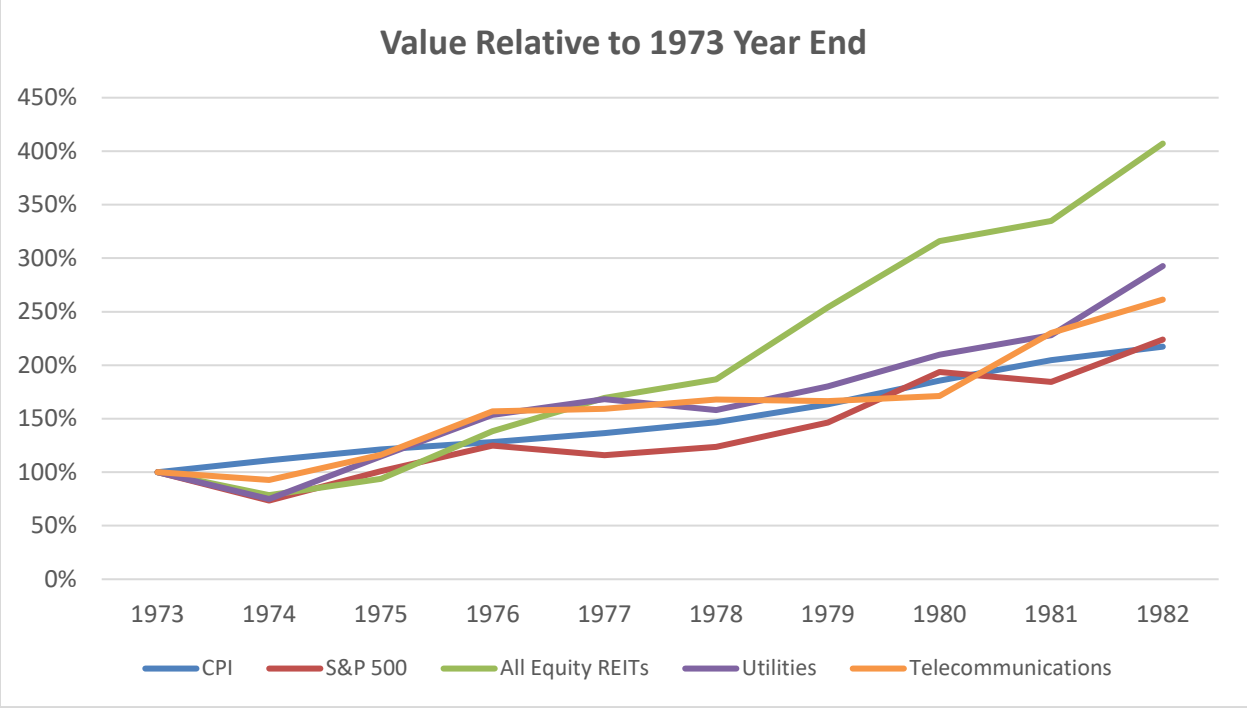
There are a couple of interesting points shown in this graph and the summary data. The technology sector has been historically very cyclical – meaning it tends to drop further than the overall market in downturns. So far this year that pattern has reversed! The boring consumer staples sector is the best performing sector of the market over this 46-year period, followed closely by REITs. If we look closely at the period up to 1982 when inflation was very high, we see that, except for REITs, the other assets barely kept up with inflation.

In my September 2011 newsletter I presented the returns for various investments relative to inflation. In that newsletter we looked at the performance of REITs as a single category even though many REITs specialize in particular types of property. We found that they outperformed all other asset classes over the period 1972 to 2010. Separately we looked at apartment buildings from 1984 to 2010 and found that real returns adjusted for inflation increased as inflation increased. The only other asset with this characteristic in that study was gold.

Now let's narrow things down to focus on returns in what I call the high inflation regime of 1974 to the end of 1982. Although 1973 was also a high inflation year, I don't have sector returns back that far so I'll start at the end of that year. Besides REITs, only two other sectors had returns in excess of inflation greater than 2% annually during this period: Utilities, and Telecom Services (now Communications Services). The table below summarizes what happened over the 9 year period.

Index:	Consumer Price Index	S&P 500	All Equity REITs	Utilities Sector	Telecommunications Sector
Cumulative Change	117%	124%	307%	193%	161%
Annualized Change/Return	9.0%	9.4%	16.9%	12.7%	11.3%

On the next page is a graph of returns versus inflation:



Now that we've seen that REITs can offer protection from a highly inflationary environment, let's take a look at some property types that REITs might specialize in so as to refine our selections of inflation hedging REITs. Unfortunately, REIT returns data broken out by property type only goes back to 1994. Inflation has never exceeded 4% in this period so we cannot directly see what works best with inflation. However, we can think of property leases like the maturity of bonds. The shorter the maturity, the more quickly the landlord can respond to inflation by raising the rents. On the other hand, certain properties are more sensitive to economic downturns. The following table summarizes key characteristics of the property sectors of interest and calendar year returns for 1994-2019.

Property Type	Typical Lease term	Economic Sensitivity	Avg. Return	Worst Year
Residential	1 year	Low	13.7%	-25.2%
Self-Storage	Monthly	Low/Inverse	16.7%	-24.8%
Lodging	Daily	High	10.2%	-59.7%
Office	5-10 years	Medium	12.9%	-41.1%
Industrial	10+ years	High	14.1%	-67.5%
Retail	5-10 years	High	12.0%	-48.4%
Health Care	10+ years	Low	13.4%	-24.8%

The current pandemic induced recession is a bit different than past recessions. It has hit retail and lodging extremely hard but the usually cyclical Industrial sector is doing very well because of the increase in ecommerce. Counter-intuitively health care properties are likely to be hurt because health care providers are losing a lot of money as lucrative elective treatments are postponed indefinitely.

Berkeley Investment Advisors intends to create a new REIT focused strategy portfolio designed for the possibility of inflation and as a defensive equity holding for the volatile markets ahead. The above table points the way – we will emphasize residential and self-storage while making opportunistic allocations to other property types depending on current market conditions.

Short Term Income Portfolio Strategy and Performance

Because of the length of the March Newsletter, this review for performance up to February was pushed back to this newsletter. Berkeley Investment Advisors uses several different strategy portfolios to manage client assets. The Short Term Income portfolio is a fixed income portfolio that focuses on short to intermediate term rate maturity loans and bonds. Typically shorter maturity bonds offer lower interest rates (yields) than longer maturity bonds and are less sensitive to changes in interest rates. This category of fixed income includes securities with floating interest rates that can reset periodically depending on market conditions. For example the rate paid could be set based on the 3-month London Interbank Offer Rate (3-month LIBOR). This rate, in turn, changes as the Federal Reserve Bank raises (or lowers) it's "Fed Funds Rate".

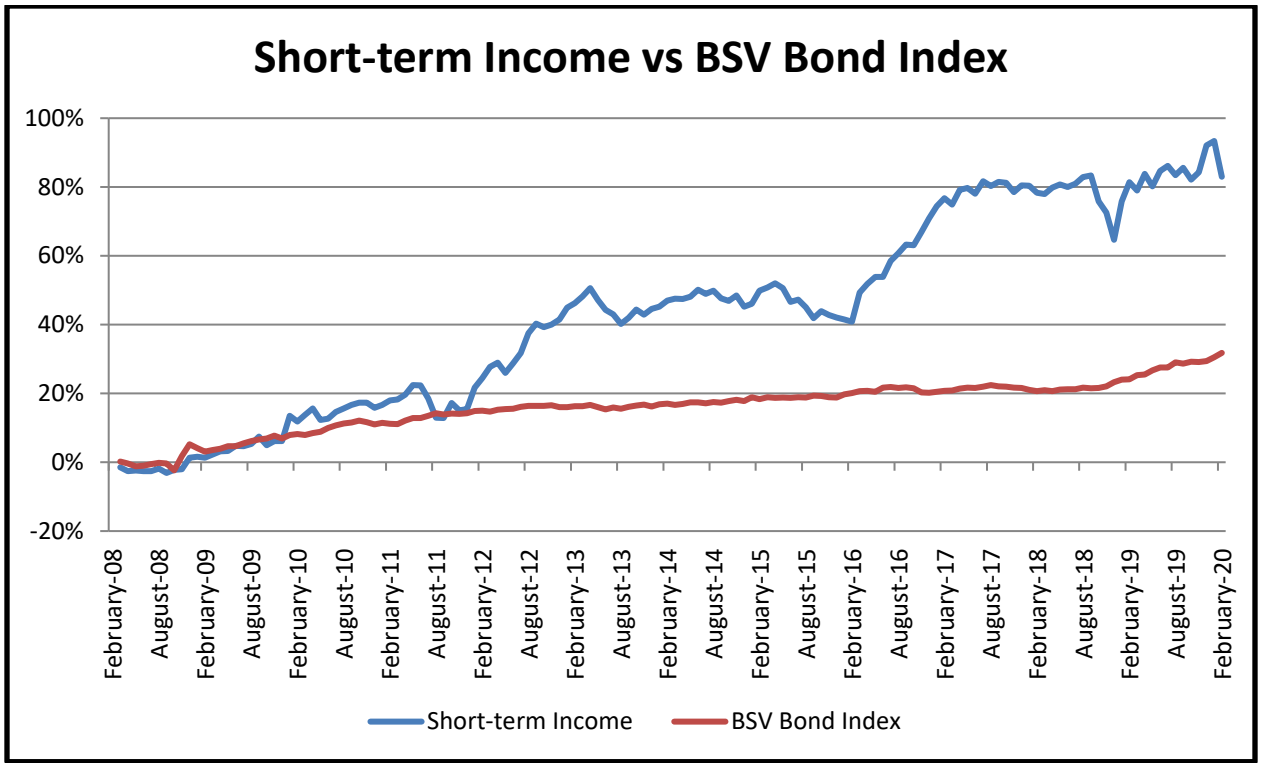
The interest rate risk sensitivity of the portfolio is measured by its duration. Typically a short term bond fund strategy would own bonds with durations below 3. If we held a bond with duration of 3 when rates went up 1%, we would expect the bond's price to decline by 3%. In the current environment where interest rates are historically low, we have chosen to keep portfolio duration to an even lower level – currently 0.6.

There is also credit risk in our portfolio –borrowers may default and not pay all that is due. High yield bonds have a higher probability of default than investment grade rated bonds but these lower rated bonds compensate by paying higher interest rates. It is this spread compensation that fluctuates depending on the market's current risk pricing attitude (mood). This pricing risk is related to equity market risk and it is also correlated with the performance of the economy. We manage individual credit risk by diversifying across a large number of issuers. This ensures that the extra premiums earned will not get wiped out by a few companies defaulting. Our strategy is to accept credit risks to earn the extra returns associated with those risks.

The portfolio also earns incremental yield by holding closed-end funds (CEFs). For a detailed explanation of the advantages of closed-end funds see the March 2017 newsletter. In holding these securities we must endure more price volatility in down markets as retail investors tend to want to sell more at lows. Current market conditions are providing about 1.3% higher yield on our portfolio than if we held the underlying bonds directly.

The portfolio is diversified across virtually all sectors of the fixed income market. The best comparison index is the "Barclays U.S. 1-5 year Government /Credit Float Adjusted Bond Index" as represented by the Vanguard Short-Term Bond exchange traded fund (ticker BSV). This is meant to represent the total short maturity U.S. bond market. It is not a perfect comparison to our strategy but there is nothing closer that has been in existence for the life of our portfolio.

At least some clients have had money invested in this portfolio since it was created in February 2008. The graph below and the table on the next page show total returns including price and interest payments in comparison to the bond index mentioned above as implemented in the exchange traded fund (ticker BSV). Our portfolio returns calculated here are based on a particular client's account and have been reduced by annual fees of 1.25% which would apply to new accounts above $500,000 but below $1 million.



The cumulative return for the strategy from 2/29/2008 to 2/28/2020 is 83.0%. **Thus the annualized compounded rate of return since inception (12 years ago) has been 5.16%.**

The graph above shows moderate volatility for the strategy's returns. Although this strategy did incur a minor loss in its 8th year, generally there is much lower risk of principal loss over a year's time than in other strategies - such as stocks or long term bonds. Relatively large allocations to this strategy should serve to reduce risk for clients when other asset classes have elevated risks. The stock market looks particularly risky using

historical norms. We want to avoid large losses and have funds available to buy when the market returns to a lower level.

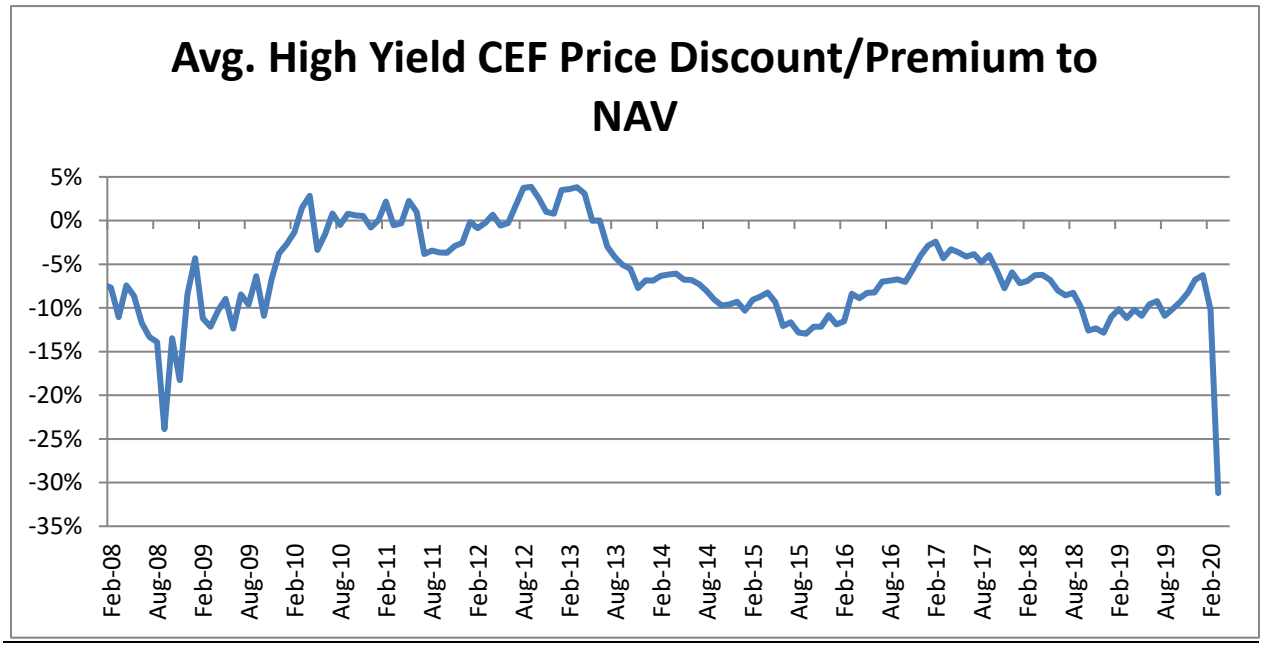
The table below breaks down the portfolio returns by year since inception. Over the last year, the strategy returned just .9% which was below the 6.2% return earned by the Vanguard Bond Index Fund. Although, the last year was not a good one for this strategy, as we will discuss, we have good reason to expect improved returns going forward.

		Returns by Year		
Year	Year Ended	Short term Income	BSV Bond Index	Difference
1	2/28/2009	1.4%	3.1%	-1.7%
2	2/28/2010	10.3%	5.0%	5.4%
3	2/28/2011	5.5%	2.7%	2.8%
4	2/29/2012	5.5%	3.4%	2.1%
5	2/28/2013	17.5%	1.1%	16.3%
6	2/28/2014	0.5%	0.6%	-0.2%
7	2/28/2015	2.0%	1.2%	0.8%
8	2/29/2016	-6.0%	1.5%	-7.4%
9	2/28/2017	25.5%	0.6%	24.9%
10	2/28/2018	0.9%	-0.1%	1.0%
11	2/28/2019	1.7%	2.9%	-1.1%
12	2/29/2020	0.9%	6.2%	-5.3%
	Compounded Total	83.0%	31.8%	51.2%

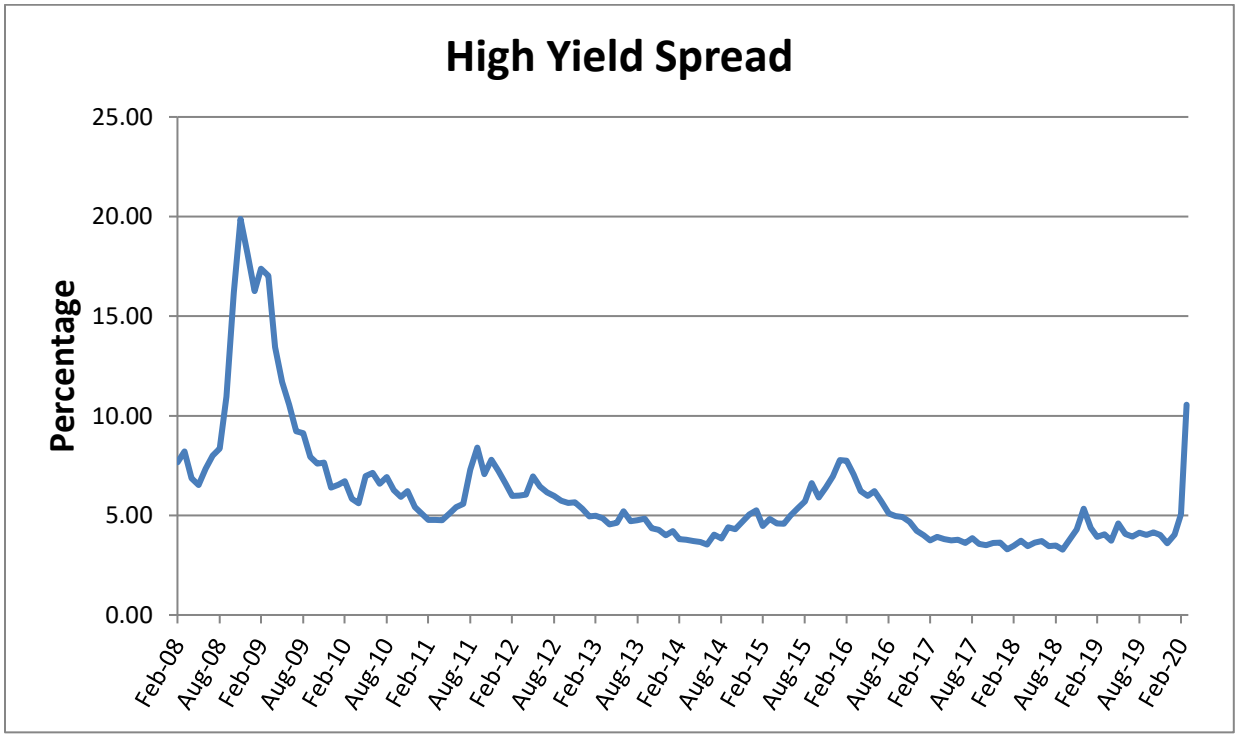
Up until April 2013 returns were quite good but then market conditions pulled returns below normal for the next 3 years. By February 2016 the market for these securities was extremely undervalued based on several indicators. One of these indicators is the level of closed end fund discounts. On the next page is an update of the usual chart showing the time series of an average of 7 CEFs we've tracked since 2008.

The median level since 2008 for average discounts for CEFs as shown in the chart on the next page is 6.68%. For these CEFs, discounts had mostly turned to premiums by April 2013 and then descended back to very wide discount levels by February 2016. Subsequently discounts moved back toward their central tendency, boosting returns for us to over 25% in the year ended February 2017. Since then discounts have been widening the last 2 years. Discounts are now much wider than the median of the last 11 year. They hit 12.9% at the end of December, prompting me to send out an email to clients highlighting the buying opportunity of such an extreme discount level. The portfolio returned 9.8% from then to the end of February.
The average discount is now 13.6% as of 6/26/20.

Over the year ended 2/28/20 the average CEF discount in the chart below increased from 6.9% to 10.1%. This is the second year in a row where discounts increased more than 3%. The weighted average discount for CEFs currently in the Short-Term Income portfolio is 9.3%.



Spreads on high yield bonds also fluctuate depending on the economic outlook and investors' attitudes towards default risk. The chart below shows the Bank of America High Yield Spread index over the last 5 years.



In the chart on the previous page, higher spreads indicate lower bond prices (and higher forward yields). Thus the spike up to a spread of 8.87% in February 2016 implies a decline in market values of high yield bonds. This combined with the widening of CEF discounts to produce a negative return for the strategy that year. This spike was somewhat usual and represented a buying opportunity. The median spread over this past 5 years has been 4.05%. Spreads are currently at 6.30%.

The portfolio positions change throughout the year; overall the weighted average net asset values of our positions declined. These decreases offset most of the interest collected for the year, leaving us just a very slight net return. Currently credit spreads are wider than the historical median and closed end fund discounts are close to the bottom of their range, which provide a boost to future returns. Offsetting these positives are short term interest rates and a higher probability of credit losses during the current recession. Overall the current portfolio yield before fees is 5.8%, compared to 6.5% last year. The portfolio currently contains risk reduction hedges. In the near term returns should be acceptable; longer run there is a good chance for above average returns.

Contact Information: RayMeadows@BerkeleyInvestment.com 510-367-3280

