Ivory's Economic Outlook

FALL 2021 • IVORY JOHNSON; CFP®, CHFC; FOUNDER; DELANCEY WEALTH MANAGEMENT, LLC

"Doctors think a lot of patients are cured who have simply quit in disgust".
Herbert Hoover, 31st United States President

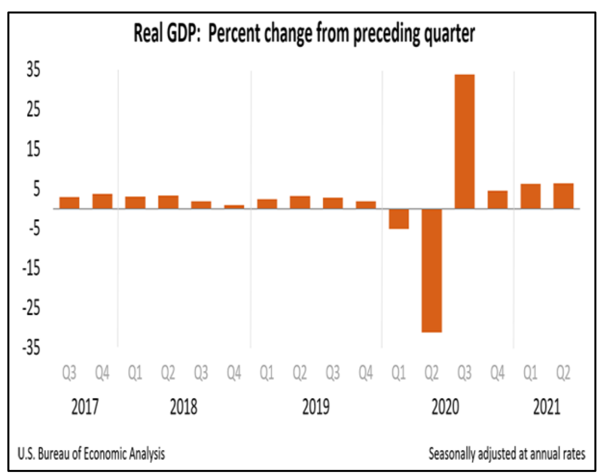
The United States of America is more than a republic, but a shining example of how individuals can prosper from a democratic political system that allows its law-abiding citizens to choose their own government representatives and participate in a meritocracy. In this environment, the best and the brightest can flourish without the burden of a single voice demanding compliance. There was no such arrangement at 455 FDR Drive in the Lower East Side of New York City. My parents called the shots. All of them.

My sister had not received the memo in 1979 despite the 15 years she had spent on this earth and cursed at my father during a disagreement. The words floated around the air looking for somewhere to lay down in. This would not end well. Much to our surprise there was no immediate response and my sister and I thought a power shift had occurred – we could finally exercise more control over our own lives.

What we didn't know was that our father had called Bellevue Hospital to make them aware that his daughter was having a mental breakdown and the psych ward needed to retrieve her for her own good, to somehow protect her against herself. Within an hour's time two men in white coats gripping a stretcher the way one would hold a baseball bat rang the doorbell at apartment 1905, and when my sister cursed at them too, my father had all the evidence he needed, raised his eyebrows and said "see what I mean? She done lost her damn mind".

My sister never cursed at my father again.

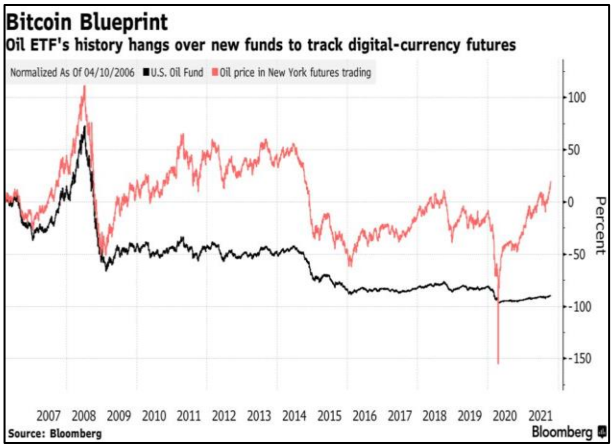
The free markets supported by the Federal Reserve and government's orchestrated apparatus are not so free either and from time to time require a divine intervention. A teenager learns the importance of an emergency fund in the first hour of a high school literacy class, yet multinational multibillion dollar multi a lot of things couldn't pay their bills during the early stages of the pandemic. The central bank, whose mandate changed from a worthy set of ideals to something that accommodates the will of the politicians (elected to represent the will of the people) came to the rescue, flooded the economy with liquidity and Wall Street made out like a bandit who didn't even have to rob a bank.



This is great news from an investor's perspective because the ensuing inflation, be it from supply chain disruptions or the central bank, means companies have more customers who can pay higher prices. That's why everybody from CEOs to 401(k) contributors have seemingly been a winner at the country fair. As a golfer might opine, it's been a stress-free round. What remains to be seen is what transpires when the Federal Reserve and Congress allows the markets to sort themselves out on their own during future crises. After all, you can't keep calling the markets free when you expand the Fed balance sheet to $8.2 trillion[i].

James Grant explains in "The Forgotten Depression" that the United States found itself in a deflationary death spiral after WWI. It seems the war efforts increased both wages and cost of inventory, and with so much available capital from low interest rates, the lending standards became loosey goosey. Five years before the war in 1914 American exports averaged $2.1 billion; by 1919 they reached nearly $8 billion[ii]. Consumer prices followed, increasing by 11%, 17%, 18.6% and 13.8% from 1916 to 1919 respectively[iii].

Once the demand subsided after the war U.S. companies were left with overleveraged inventory at prices they couldn't recoup. The nation's output in 1920-1921 declined by 23.9%, producer prices fell by 40.8%, industrial production by 31.6%, stock prices by 46.6%, corporate profits by 92% and the jobless rate was 19%[iv]. And then a funny thing happened: plunging prices made American exports and investments more competitive. The price of goods and what consumers would (or could) pay came into equilibrium. Wages came down and made industries profitable again.



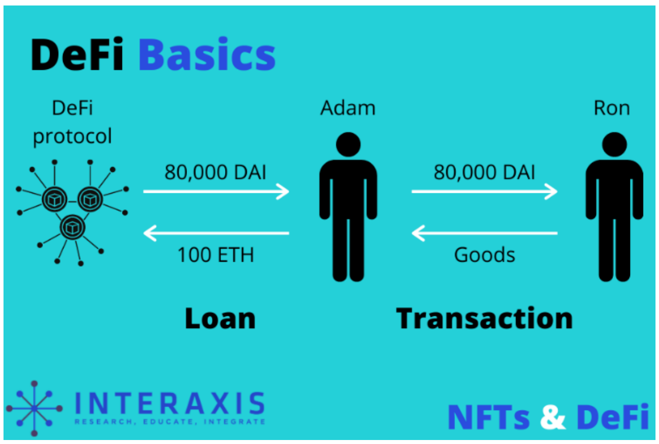
In 1920 Americans imported $3.6 billion more than they exported, but the following year it flipped in our favor by $2.1 billion[v]. Foreigners had to send something in return as the world was on the gold standard and many sent gold. Jackpot! The law required the Federal Reserve note to be supported by a certain amount of gold and in 1920 we were at the bare minimum of 40%. By May 1921 a staggering 100% was collateralized[vi] and that allowed the banks to begin lending again which ushered in the roaring 20's.

The United States exited a depression with minimal response by the government. Instead, nature took its course, allowed bad businesses to fail, workers to reconsider their market value and the country to recover without training wheels. In today's economy we have a shopping list of intermediaries and central banking activities. Some believe this is antiquated and now digital assets are waging a rebellion.

Digital assets do not have an intermediary – I can sell you my bitcoin in exchange for your dollars and it all happens on a blockchain where the transaction is validated by what are called miners. These are essentially computers known as nodes that solve complex math equations, and whoever solves the problem first not only validates the new block, or cell on the spreadsheet, but gets paid in bitcoin to perform the service. Needless to say, some trains are never late to the station and now Wall Street wants it's cut while Uncle Sam is all set to regulate something he knows absolutely nothing about.

A traditional ETF tracks the price of the underlying security because when you buy the ETF they purchase more shares of the underlying securities, i.e. S&P 500 stocks, and redeem the underlying securities when you sell the ETF. There is no lag on the ETF price relative to what it represents. The bitcoin ETF doesn't buy bitcoin but instead buys bitcoin futures which are contracts to buy bitcoin at a certain price and expire at a certain date. Usually the more time before expiration, very much like a parking meter, the more valuable the futures contract.

Unfortunately, the bitcoin ETF must sell the futures contracts when they get close to expiration and buy the contracts that expire later to maintain the bitcoin position, known as rolling over. And since the near-term expiration futures that the bitcoin ETF must sell will usually be worth less than the longer expiration contracts that they will correspondingly buy, there is likely a drag on performance. This is what has happened with oil ETFs based on futures contracts – sometimes the oil prices went up and the oil ETF did not.

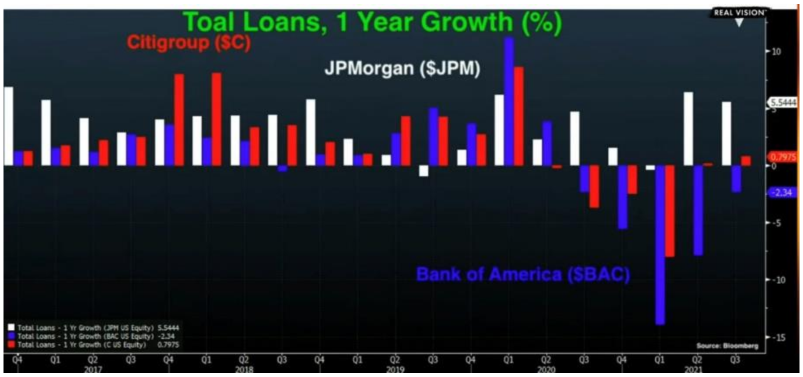


This sounds inefficient until you realize that a futures-based ETF, as opposed to one that would own actual bitcoin, will generate revenue for the commodities exchange, the traders and lawyers who benefit from a vehicle that's more complicated and has more moving parts than necessary. Hedge funds will in turn profit from the price discrepancy, betting that the ETF will go down and buying the actual bitcoin when the ETF is worth more than the coin – gangsta's gonna gangsta.

Nevertheless, blockchain and digital assets are themselves revolutionary. The book "Defi and the Future of Finance" explains how a commercial real estate interest can be used as collateral to borrow money with no middleman and minimal fees. That can be accomplished when a commercial interest represented by a Non-Fungible Token (NFT) is deposited to an online vault that enforces the terms of a contract with an algorithm and lends digital money to the owner of the NFT that they can spend as they please. If the collateral declines in value, there is a complex network that will immediately liquidate enough collateral to satisfy the (for lack of a better word) margin call.

Don't feel bad, I too had a mental hernia when I first read about this stuff, but what I just described is a cash-out refi with an illiquid asset that has no middlemen, delays, or excessive fees. When you hear the term decentralized finance, this is what they're talking about. Call me a dreamer, but something tells me there's money in something like this and I'm desperately trying to learn as much as I can before my competitors do, even if I'm still unsure how I would monetize the opportunity.

In the meantime, we have the aforementioned liquidity and residual supply chain disruptions causing inflation. The stimulus bill and government bailouts prompted economic growth that's still going strong, at least for now. During times like these, and sooner or later these times will change, technology, commodities and crypto currencies have historically done well. At some point the winds will change and what looked to be a perfect golf shot will end up in the woods.



After all, inflation is good for sales revenue and high wages put more money in the pockets of consumers, but it is a double-edged sword when inflation grows at 5.4% on a year over year basis[vii]. We have seen this movie before, and the critics won't appreciate labor costs eating into corporate profits. The supply chain also goes both ways, affecting the expenses of employers who now face potentially negative earnings surprises. Banks looked to have posted record profits until you notice the canary flapping around the coal mine with decelerating commercial and industrial loan growth[viii], the oil of economic growth.

The government wouldn't mimic the 1920 response and let things sort themselves out, or at least I doubt it. My guess is they'll likely find an excuse (and the money) to set a floor for the market. For our purposes that still invites volatility and warrants a process to select asset classes based on the direction of inflation and GDP growth. If it ain't broke, buy more of it.

My sister ultimately graduated from college, had great jobs and saw her own daughter graduate from both Harvard and Yale, schools that would have sued me if I applied for admission. It turns out intervention isn't all that bad if you learn from it. My son never cursed at me, but there was this one time we had a disagreement, and I could tell those magic words were on the tip of his tongue. Fortunately, I had told him the story about my sister and the time his grandfather called the men wearing white coats carrying a stretcher and I guess he didn't want history to repeat itself.

Boy will he be disappointed.

[i] Fed's $8 Trillion Balance Sheet Will Only Grow; Bloomberg; 8/10/21
[ii] Adolph C Miller speech to the American Association of the Banking Industry; 9/24/1919
[iii] The History of the Federal Reserve; Allan Meltzer
[iv] National Bureau of Economic Research, 1929
[v] Historical Statistics of the United States
[vi] Historical Statistics of the United States
[vii] Inflation rises at 5.4% yearly pace in September, CPI shows, and stays at 30-year high; MarketWatch; 10/13/21
[viii] Board of Governors of the Federal Reserve System