Seven Summits Capital

Markets

Tomfoolery and Market Mirage

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Investing should not be looked at as a game of chance. However, markets in the age of an activist Federal Reserve are increasingly difficult for anyone to quantify and forecast. The broad equity markets have rallied significantly following a sharp and quick 25% plus drop from the end of February through late

March. No one could have forecast this sharp sell-off and no one forecasted the strong rally off the bottom that continued through the end of May. I do not pretend to be able to explain why the broad equity indices behave as they do. Those who do pretend to be able to read the tea leaves of market technicals or discern patterns based on history are practicing what I would call a tomfoolery created mirage. All markets can do is provide a reflection of investor sentiment, which has proven time and time again to be more contrary than trendsetting. Thus, what can market behavior truly tell us about the future? There really is no clear-cut answer to this question because the capital markets are no longer free from non-market distortion as they once were.

Truly free markets should do a reasonably good job at discounting future risks and opportunities. The concept of the cumulative message of free-market risk-takers when it comes to discounting the future is well known and has many parallels in outside the financial markets. For instance, crowdsourcing websites that tabulate using ratings for contractors or restaurants do a reasonably good job of forecasting a consumer's future experience. Gambling bookmakers use cumulative betting to generate odds of a horse winning a race or the point spread of a football game.

The bookmaker example is one of the purest forms of discounting the outcome of a future event. In contrast, crowdsourcing consumer ratings to predict the quality of a planned service is subject to fraudulent ratings for the sole purpose of driving down ratings or inflating them. Unlike a cost-free consumer rating system, when money is risked, such as a bet or the purchase of an investment, the resulting cumulative results of such bets or investment will produce a reasonably accurate discount of the future. But what if the Federal Reserve got involved in placing bets when bets became too lopsided using its multi-trillion-dollar balance sheet? Those large bets by the Federal Reserve would dramatically change the calculated odds produced by the oddsmakers based upon the dispersions of bets. If this were to happen, the distortion of the "artificial gambling" would end up being magnified as less sophisticated gamblers would see the odds shifting and assume that big money gamblers know something that they do not they would start betting along with the Federal Reserve.

Today we are experiencing in real-time the most confounding short-circuiting of the discounting function of the capital markets due to extreme distortion in the form of central bank liquidity pumping and fiscal policy-driven "helicopter money" being infused into the economy. There is no historical model which can parse the market's correct discounting function from the distortion of non-market forces. The latest crisis moved the Federal Reserve to take more extreme and unprecedented actions such as broadly buying corporate debt, including "junk" bond ETFs at any price in order to stabilize price of those securities. This move not only stabilized and ultimately bolstered the market price of these fixed income securities, it also allowed the effected companies to refinance existing debt and/or take on additional debt, which staved off liquidity driven scenarios which would have pushed down the price of their stocks.

In August 2007, the Federal Reserve balance sheet stood at $807 billion. After the actions taken to stem to devastating effects of the 2008-09 financial crisis, which threaten to destroy the modern global banking system, the balance sheet ballooned to $4.5 trillion. In August 2019, after four years of attempting to unwind and normalize the size of the Federal Reserve balance sheet, the size of that balance sheet dropped to $3.7 trillion. Beginning last fall, political pressure and slowing economic growth seemingly caused the Federal Reserve to reverse its attempt to shrink its balance sheet. By the end of February 2020, the Federal Reserve's balance sheet once again exceeded $4 trillion. At this point, the impact of protecting populations here and around the world from the COVID-19 pandemic began to impact the economy, employment, and capital markets adversely. Now, three months later, the Federal Reserve's balance sheet exceeds $7 trillion. Between the Federal Reserve and economic assistance legislation, fiscal and monetary stimulus has totaled more than $6 trillion to bolster capital market price levels, cushion a significant spike in unemployment, and help private businesses survive.

With such significant stimulus and market support, I now see very pronounced pricing distortions in both the equity and fixed income markets. These pricing distortions have denied many opportunistic investors the opportunity to allocate capital to under distressed conditions. One of those famous opportunistic investors who was denied such opportunity by the unprecedented market support was Warren Buffett. Unlike previous periods of financial stress and market dislocation, Warren Buffett, and his company Berkshire Hathaway, has not made any material acquisitions or extended preferential financing arrangements to distressed companies over the last two months. Buffett told CNBC on May 4, 2020, "We haven't seen anything attractive. ... The Federal Reserve did the right thing, and they did it very promptly, which they should have, and I salute them. We have not done anything because we don't see anything that attractive to do. That could change very quickly, or it may not change." I share Buffett's sentiment about the Federal Reserve taking bold swift action in March and April in response to the pandemic caused economic 'shut down." However, I feel that the Federal Reserve and the U.S. Treasury have sacrificed precision and calibration in favor of expediency and this shotgun approach saved businesses that should have been saved, but also provided a substantial lifeline to those businesses which should have been forced to sell or liquidate.

On the same day, Warren Buffett spoke to CNBC, Mohamad El-Erian, Chief Economic Advisor of Allianz, was quoted by CNBC saying, "My sense is the Fed went too far in going to the high-yield market. But I understand why they did it, and time will tell what the consequences are, The Fed opened up the high-yield market for almost everybody, and that raises the specter of zombie companies. We've got to be careful about this because that eats away at what makes America special." Experienced investors know that market prices are distorted and attempt to manage this risk. Inexperienced investors get caught-up in stimulus-driven markets and confuse rising prices with improving fundamentals as the lure of "easy" obscure prudent investing principles.

Seven Summits Capital has demonstrated the prowess of our active management process through this period. The success of our process is driven by placing our entire effort on identifying, evaluating, and managing individual securities as opposed to attempting to guess what the broad markets are going to do. I usually go through the entire trading day without thinking about the pricing and direction of the market. I am typically so engrossed in the news and price action of our individual company stocks that market price action simply becomes background noise.

In no way would I have bet that the market averages would have bounced back so strongly before we know the extent and duration of the economic damage that has been done over the last several months. However, not being able to factor such a strong rebound into portfolio decisions has not in any way hampered our performance. We are able to control the entry price of our individual securities, monitor catalysts that we expect will move those prices higher, and apply a sell discipline based upon price levels that are fundamentally derived, but dynamic. Market pricing is increasingly a mirage. Without the ability to see value through the optic illusion of a stimulus-induced market, investors run a significant risk of losing sight of reality in favor of a hoped-for, self-reinforcing delusion.

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