INVESTMENT PERSPECTIVE 2Q 2021

WE’RE OFF TO SEE THE WIZARD

America’s first truly home-grown fairy tale, *The Wonderful Wizard of Oz*, was published in 1900 by L. Frank Baum. Although the 1939 MGM movie production won Academy Awards for Best Original Song and Best Score, it was mostly overshadowed by *Gone with the Wind*. It only became a cultural touchstone with the 1956 CBS television broadcast premiere. It went on to become an annual ritual. Incredibly it took 60 years in the public domain until someone recognized that beneath the fantasy storytelling lay an insightful allegory of populist era politics. Once you understand the meaning of the poppy field and the winged monkeys, you’ll never watch Dorothy and her friends the same way again.

The historical backdrop for Baum’s tale was the chasm of diverging economic fortunes between the agricultural Midwest and the eastern financial interests. The United States returned to the gold standard in 1879. From 1880 to 1896, the price level fell 23%. Farm product price declines were even steeper. The persistent deflation represented a windfall for eastern banks and giant headwind for farmers in the west who needed to make fixed mortgage payments out of steadily falling revenues. The solution to the plight of the indebted farmers was to create inflation. The Free Silver movement proposed adding silver as a monetary base alongside gold. The movement rallied behind Democratic Presidential candidate William Jennings Bryan. His Republican opponent in the 1896 election was William McKinley who stood for ‘sound money.’ McKinley won, and Congress passed the Gold Standard Act in his first term. But the Free Silver Movement got the inflation they wanted all the same. New gold discoveries in South Africa, Australia and Alaska were made around the turn of the century. Moreover, the cyanide extraction process led to a dramatic fall in the production costs. From 1896 to 1910, the price level rebounded 36%.

Baum’s story sets Dorothy as the embodiment of traditional American virtues. She joins with the Scarecrow (the farmer), the Tin Man (the factory worker) and the Cowardly Lion (William Jennings Bryan). Together they make their way to Oz (Washington) down the treacherous Yellow Brick Road (the Gold Standard). Everyone in the Emerald City sees the world through green lenses (money). As a loyalty test, the heroes must defeat the Wicked Witch of the West (cruel hardships of nature). Of course, they dispatch her with water (irrigation). Unfortunately, the Wizard (President McKinley) turns out to be an impostor. The Wizard cannot grant her friends the gifts they sought. They had possessed a heart, a brain and courage all along. Nor can the charlatan return Dorothy home to Kansas. However, Dorothy learns that her *silver* (MGM made them ruby for better visual effect) slippers had the power to get her back to Kansas. Simply stated, with adequate prices, the midwestern farmers could fend for themselves.

Politics is always linked in some way to a distribution of spoils – between regions, rural versus urban or capital versus labor. What is fascinating about this era is how the equitable allocation of wealth became linked to such an arcane issue (the Gold Standard vs. bimetallism). Mainstream media portrayed the Populists as economic simpletons. So Baum’s story lent some dignity and moral standing to their outsider cause. It’s also an interesting case study for the divisions in our current political landscape.

For my entire investing career, socio-political trends have been a tailwind for shareholder capitalism. From the Reagan-era deregulation, through the fall of the Soviet Union to China’s entry into the World Trade Organization, the world has become a more hospitable place for equity. For the past few years, in contrast, a few voices in the wilderness have been coalescing into a countermovement. One of those representative voices was French economist Thomas Piketty’s. In his 2013 *Capitalism in the 21st Century,* he postulated that when the return on capital exceeds growth of the economy, the distribution of wealth in society becomes more unbalanced. The increasing concentration of wealth has become the central argument behind calls for universal basic income financed by Modern Monetary Theory or MMT. MMT is the theory that governments that issue their own currency can print as much as they need. In other words, countries like the U.S. do not face pressures when it comes to financing and therefore can act in a manner that defies financial constraints. Increasingly, as in the Gilded Age, there is a movement to enlist monetary policy to address distributional consequences.

I suspect that wealth inequality in the late 19th century was a much more complex issue than just a story of overly tight monetary policy. Equally, I figure that the distribution of wealth today is a multifaceted phenomenon. Surely, the network economics of today’s digital plaforms is contributing to skewed outcomes. Nevertheless, the Federal Reserve is running a high-pressure economy to address inequality in labor force outcomes. There is a great danger, it seems to me, in pursuing purposive solutions to problems that are only vaguely understood. As if maintaining price stability and full employment aren’t difficult enough, the Fed is tasked with solving for economic disparity?

In several recent webcasts discussing inflation, we have noted that the balance of evidence favored the Fed's 'transitory' narrative. That is, the recent extreme observations in the price level seemed to be confined to pockets of observable re-opening pressures or known supply chain bottlenecks. Prices for new and used cars, hotel stays and airfares all fit that mold. We noted that expectations for inflation seemed to be contained. Above all, we observed that the excess supply of labor would serve to anchor wage costs. Despite continuing high prints for both producer and consumer inflation, those arguments still hold.

But the 'transitory' case is getting more precarious. First, the longer we accept higher inflation, the more those price increases get embedded into wage contracts. Similarly, consumers and businesses start to make purchase decisions and set prices in anticipation of rising prices. We are now experiencing the downside of the extended lockdowns. Namely, re-opening after a long idle period involves a lot of coordination problems. The stimulus that we're continuing to apply - both fiscal and monetary - risks flooding an engine that is only haltingly turning over.

If inflation is the clear and present danger to our positive outlook, the strength of corporate profits has been a steady following wind. The current earnings season - like the prior two - has been a tour de force. On average S&P 500 companies are beating expectations by 19% for Q2 2021. Full year 2021 earnings expectations for the S&P 500 are up 20% since the start of the year. In the valuation equation, we have benefited from a spectacular numerator that has thus far been only modestly dragged down by a rising denominator. Our expectation is for it to be a somewhat closer race for the second half of the year. In that environment, relying on skilled managers in both public and private markets to identify risk/reward opportunities is the best course.

The incantation that returns Dorothy to her own bed is 'There's no place like home.' For the Populists of the 1890's that was an admonition to self-reliance, and a warning to not expect deliverance from Central Banks. Well said, Dorothy.

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