CIO Commentary
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The election, inauguration and impeachment tensions have now passed, and headlines have shifted to the classics such as monetary/fiscal policy, increasing taxes, vaccine management, post-lockdown economic bounces and the timing of rotation from growth-styled equity approaches to economic/pro-cyclical themes. New headlines grabbing investor attention include SPACs, the "gamification" of the stock market, and the Reddit community of retail investors that "punt" and drive speculation on overly shorted equities. It is beyond the scope of a short CIO perspective to comment on all of these macro headlines but the one perennial issue material to the capital markets is the notion of rising interest rates, economic recovery and its impact on asset allocation and investment strategy.

The surge in rates

We had a spike in rates last week, then a quick retreat and then another flare up in rates as I write. These days provide good insight into the reactions of the capital markets on different types of instruments and serve useful purposes of bringing sobriety back to areas of the markets where speculative excess builds up. For the most part, a rise in rates affects longer duration assets more than shorter duration assets, (because the discount rates have a more significant impact on longer duration earnings streams) so growth stocks are punished more than value stocks and long bonds obviously punished more than shorter duration bonds. Essentially it becomes a "risk off" mentality for investors when this happens. It is important to "unpack" the rising rate question as this has been a latent fear/issue episodically brought into focus over the last several decades. Each time there is a spike in rates, it shakes the confidence of investors and leads to either a mild correction or a deep one and sometimes it leads to a forced unwinding of an over-leveraged investor and this can in turn create the potential for a contagion or serial unwinding (forced liquidations). Hence the "fear" and temporary reaction towards rising rates is perhaps as old as any other issue because it has an impact on just about every financial asset.

Recent investors will recall the 2013 "taper tantrum" which ultimately was not much more than a tantrum (shallow pause) by the markets and others will remember the period from 1994 to 1995 when rates rose from circa 3% to then one year later, they rose to around 5.5%. 10-year bond rates went from 5.26% to about 8%. Rates rose at this time because of improving economic strength and this rate spiking stalled "long duration asset" appreciation (growth stocks) for about a year from 1994-95 but it did not stop their powerful ascendance later on. This temporary stalling in 1994 only led to a subsequent 5x explosion in technology/growth stocks and the famous "internet bubble" from 1995-2000. At this time, the theme that later drove the NASDAQ upwards, was dominated by internet investment models. Many loss-making companies saw expanding speculative optimism and new valuations (# of eyeballs) justifying excessive pricing of these "new" business models. What followed after this 5x upside in internet stocks from 1995-2000 was a longer and deeper correction that followed from 2000-2003, which reset overly optimistic expectations and washed out all weak or failed business models. It also set a great stage for the survivors to ascend to domination later on from 2002 onward. Companies like Amazon and Google were in their adolescent phase at the time and later grew to become monster cash-generating leaders well known today. The year of 2003 went on to become a stellar

year for equities which on average appreciated over 25% with small cap stocks and technology-oriented growth stocks being up significantly higher.

Interest rates and technological innovation, adaptation and transformation

At the moment it is fair to say that we have witnessed a "pause" in the stock prices of "big tech" driven by rising rates and fears of the Biden Administration's aggression towards the oligopolistic pricing power that large-cap tech names are exerting in the world. To us, this is a healthy pause, especially for private equity strategies that focus on emerging growth in smaller-capitalized private companies that are betting on the enablement of technology to transform and digitalize a wide range of industries. Our approach to investing is that technology is a tool to unlock and enable growth. It is not an investment in technology stock per se, but a use of technology by a company applicable to a wider set of industries so they become more efficient and effective. We build our clients' portfolios in a way to achieve significant industry diversification across financials, health care, consumer, biopharmaceutical, media, agriculture, manufacturing etc. with the common denominator being the use of technology and innovation to accelerate and transform an industry. Think of Amazon. It is as much a retailer and consumer-oriented company as it is a financial services platform, and logistics or transportation company, too. It has used its technology and software to modernize all lines of its business and make it grow faster and more competitive relative to the slow adopters of technology.

The recent Biden Administration's threats of "clamping down" and potentially regulating/busting up big tech is to be expected because the reality is that many of these companies have become too powerful to be able to operate without incurring punishing regulatory consequences. As stated above we think this is a development that will not adversely affect smaller private equity backed tech enabling companies but will in fact *level the playing field* and should provide an environment of fairness to sell their value propositions across a wide range of customers.

Students of longer-term economic history will know that interest rates have been on a long decline over the last seven centuries (yes I said seven centuries), with interruptions driven by periodic flare ups, corresponding to moments of distress in the credit markets or a by-product of wars, or inflationary pressure, brought on by supply shortages of energy (as we saw in the 1970's). Along the way technology and innovation has been a driving force bringing down real costs for a broad basket of goods that have superior performance at effectively lower and lower real prices. The result of course is that the quality of human life has improved continuously over the longer term and innovations have kept prices and inflation under control. What does this have to do with interest rates you might ask?

Interest rates are basically "rent" that the user of capital pays for the right to use/borrow that capital. As in any demand supply situation, the greater the supply of something relative to the demand the lower the price on that supplied good/capital. The situation with capital right now is that there is absolutely no shortage of it. It has been created in large amounts by Central Banks around the world through repetitive quantitative easing "QE". Furthermore many Central Banks are beginning to adopt a new philosophy around Monetary policy called MMT (Modern Monetary Theory). Advocates of MMT assert that monetary policy should be more aggressively expansive to the point where inflation is evident. Once inflation becomes prevalent it can be contained by suppressing spending through increasing taxes on the private sector. Global central banks are thus

becoming more relaxed towards inflationary risk and have moved more towards a print and spend mentality because despite repetitive quantitative easing in the USA and elsewhere (think of Japan which is on almost perpetual QE) price inflation has been stubbornly difficult to create. So at the margin we see the supply of capital being mostly biased towards more of it not less of it. Central Bankers are addicted to the easier approach or “print your way-out” strategy. Furthermore it has become evident to all developed nations that technological superiority is the key to power and economic productivity. Nations are now competing for all types of specialized talent and trying to create epicenters for innovation and creative start-ups. This in turn is contributing to the acceleration of innovation across many industries and this movement, in our opinion is a structural constraint on longer term pricing increases (inflation).

There are a few reasons why, at the moment, there are near term indicators of inflationary pressure and hence a healthy back up in rates. One is that the supply chain was shut down in many areas due to manufacturing lockdowns during the last twelve months. Availability of goods that go into the housing sector, for example, are in short supply. Housing demand is expanding due to low interest rates, WFH shifts in demand and millennials coming of age to start families. So, in a nutshell, demand is strong (especially in the USA) and the V-shaped economic revival over the next 6 months is likely. We see this back up in rates therefore as a “good reason” (i.e. not a credit crisis spike) but as an economic strength spike, similar to the back up in rates that occurred in 1994-1995. As was the case then, the earnings improvement ultimately led to stock prices stabilizing and then rising again as the economic momentum accelerated. When rising rates correspond to economic improvement, equities are a much better risk reward ratio worth playing relative to safety-oriented bonds/fixed income. Longer-term, we see the power of innovation and technology being a source of containment in inflation as it has always been.

ALP’s new offices

As a firm we are pleased to announce that we have now established an office in New York City as an additional hub to support investment and capital deployment but also to serve our clients. Stay tuned for details on the specifics of this new office for Alpha Leonis Partners AG.

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