BARRACK YARD ADVISORS

Current Anchors

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Mother of All Bubbles?

We are 4-years into a concerted Central Bank effort designed to stave off a depression. Money is cheap and many assets are priced at artificially high levels.

Bonds, certain types of real estate, utility stocks, highly indebted companies, and precious metals are examples of assets that fall into this category.

The Fed intends on keeping rates low for at least another 3-years and possibly longer. This liquidity pumping might lead to unintended consequences as some fear, or it could result in success: an economy where interest rates no longer need to be at zero.

As value investors we note that interest rates have never been lower than they are today. That is, at least since 1545 when King Henry VIII of England legalized money-lending.

Another way of viewing this: *bonds have never been more expensive*. Ever! This is significant, akin to the stock market's rise to unprecedented heights in the late 1990s.

We contend that extrapolations of the recent past and Central Bank pronouncements have given fixed-income investors a false sense of security. Betting on a continued bull market in bonds is not unlike the late-1990s bet that earnings-multiples don't matter for stocks; or the mid-2000s bet that residential real estate prices always go up. Epically expensive markets can't defy gravity forever.

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The Election—or, Genesis of a Coming Bull Market in US Stocks!

Stock market cycles and economic cycles tend to be independent of the political cycle. As investors, we aren't convinced it matters who wins the Election.

Two data points: the stock market has nearly doubled during the current President's tenure, but fell by a third during his predecessor's term. Our conclusion is simply that one fellow took office at the bottom of a cycle; and the other took over at the top.

All year long I've heard people use the excuse of 'waiting until after the election' before making investment commitments. Like you'll stop brushing your teeth, or washing your hair, or driving your car depending upon who wins!

More interesting than the Election is an Investment Thesis making the rounds because it explains a path to the next American Boom—and it has nothing to do with the political cycle.

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The reason for our caution is common sense: even if the US economy falls into an extended period of 19th Century-style deflation—the most positive environment imaginable for quality fixed-income—bond prices now are already more expensive than they were in the 1800s.

Therefore, deflation would have to be much worse than the experience of the 1800s for bonds to turn out to be a good deal for investors. Accordingly, we think the best today's bond investors can hope for is that they won't lose money in the years ahead.

Whether one adopts our cautious stance or not, investors need to be mindful *there is always the possibility of a steepening of the yield curve.*

> ***"We think the best today's bond investors can hope for is they won't lose money..."***

A steepening of the yield curve means longer-term interest rates will rise faster than short-term rates. That means money market interest rates could remain essentially at zero even as bond prices decline (as long-term yields rise).

During the financial crisis in 2009, when there was a distinct possibility that the economy could free-fall into depression, thereby adding to the attractive-ness of US Government Securities, the 10-year yield was twice as high as it is today (~3.25% vs. ~1.60%).

Any steepening of the curve can happen quickly and without much warning. It is not inconceivable that an improvement in the US economy, combined with a non-melt-down in Europe and resumption in high Asian growth rates would provide the catalyst.

So, we're squarely in the camp of those who say "riskless" assets are in a bubble.

Apart from the valuation case, "interest rate risk" seems to have left the investment lexicon; and we point to recent policy papers by the IMF and others warning of coming shortages of risk-free assets.

In our experience, shortage warnings by experts often coincide with secular tops in markets.

Finally, there is a dichotomy in the bond market:

An old rule-of-thumb says 10-year T-bonds should be priced at 1% above the expected average rate for money markets over the next decade. Therefore, at 1.6%, the Treasury market now indicates the prospect of a decade of no growth in the economy.

Conversely, the high yield market is priced as if we're back in boom times. At roughly 5 ½%, high yield credit spreads are at low late-1990 levels. (By contrast, during the '08-'09 credit crisis, spreads exceeded 15 %.) Hence our advice: bond buyers beware!

Barrack Yard Core Portfolio
Comments/Review

Since the last *Current Anchors* we haven't added any names. Allocation is: 80% stocks, 20% cash.

We're a year into one heck-of-a-rally in risk-assets. Major markets are up 30% in the US and 5-20% elsewhere. America has regained its safe-haven status for now.

A year ago, it looked like the world was ending.

At the time we said, *"We advise caution when things look good and optimism when they look bleak. And things look bleak. Accordingly, we are moving portfolios to a more fully invested position."*

Now complacency rules and starting in August we decided to raise some cash.

We don't predict the future, we just aren't finding many great companies selling at good prices; or many good ones selling at great prices.

We know not-being-optimistic-enough can be a vice, but we are wary.

Deleveraging will continue in the developed world for many more years to come, European banks are not only too big to fail, it's been noted they're too big to save!

China's growth is not only slowing but it's negative in some areas and geo-political risks have heightened: sanctions are destroying the Iranian economy. Who knows how the mullahs will respond?

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The bullish narrative goes like this:

Histories of the 19th century generally contend America's manufacturing-based prosperity was built on a 3-legged stool—first, the rule-of-law; second, a decent infrastructure with a good workforce; third, abundant and relatively cheap natural resources.

Starting about 40 years ago, the third leg of this proverbial stool—cheap resources—fell off and US manufacturing jobs fled to cheaper climes, as we no longer had a competitive cost advantage.

And so things remained until literally a few years ago when the world changed in a big way and that third leg of the proverbial stool was restored.

Driven by a technological revolution in drilling processes, we're now in the early stages of a new American era of abundant and relatively cheap Oil & Gas. This will be transformative.

Citibank predicts the US will surpass Saudi Arabia as the world's largest producer of Oil & Gas within 8 years; and that the boom will create something like 3 million middle-class jobs and generate hundreds of billions in tax revenues.

It will greatly benefit the manufacturing base, as *American companies will enjoy a sustained and relatively permanent energy cost-advantage versus Europe and Asia.*

Among others, energy-intensive manufacturers and firms that use Oil & Gas as part of their feedstock are great beneficiaries of this trend.

Let the good times roll!

END

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Given stock prices are not particularly cheap, for the most part, we're happy to wait for better entry points.

So we're spending our days thinking through the implications of two great trends:

- *A billion people entering the global consuming classes in the next ~decade and a half*
- *America's structural cost-advantage in energy*

The global trend means hundreds of million people will enter the middle-classes in the next decade. This presents great opportunities for companies that cater to their needs.

We focus on 3-areas: the 'staples-of-a-better life,' the infrastructure to support it, and, the potential for scarcity values assigned to some assets (due certain things having limited availability).

One industry where both trends overlap is fertilizer. Fertilizer is an integral part of the global agricultural value chain—think about a billion people potentially adding protein to their diet—and it's energy-intensive.

No wonder it was recently announced an Egyptian company will invest $1.4 billion to build a fertilizer plant in Iowa. Simple math: if 40-50% of a product's cost is natural gas, and you have a cost advantage of some 70%, that's a 28-35 percentage point profit-margin advantage over European and Asian manufacturers.

Bottom line: the world doesn't lack for exciting investment stories. In fact, we call the migration of a billion the "Greatest Investment Show on Earth!"

And there's no shortage of great companies generating good cash flow. It's simply that in a de-levering world, we're willing to be patient and buy on our terms. And that means not following this Fed-induced sugar high, but rather keeping to our principles and hopefully not ending up over-paying for investments.

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