Issue #7

FULL FAITH AND CREDIT

JUNE, 2020

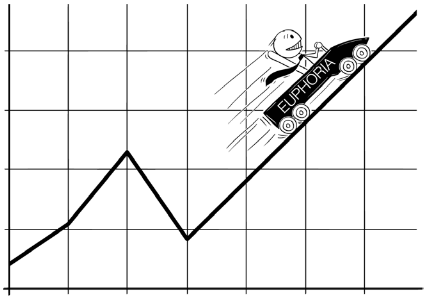
EUPHORIA, INFLATION & WHY I LOVE SILVER

Adam Baratta

Despair and Euphoria sit at opposite ends of the investment pendulum. For every "blood in the streets" bust there is a "euphoric" boom. The common trait between the two is that neither make sense. "How can valuations go lower when they're already dramatically below their historic average?" "How can stocks possibly go higher when they're so overvalued and the forecasts so abysmal?" These confusing questions are what makes the bottom of despair so painful and the peaks of euphoria so incredible, *neither* seem rational as they are occurring.

There are few things more exciting than the ebullient joy of riding the wave as stocks surge ever higher. During these moments the high becomes addictive. Investors everywhere hit the refresh button on their online accounts, hoping to see new and higher dollar amounts *scream in green* across the screen. The word euphoria is often used to describe the feeling for investors riding such a wave.

After more than eleven years of the Federal Reserve's managed market the masses no longer have a healthy fear of loss. What's to fear? The Fed has proven they have our back. Any time stocks drop the Fed intervenes, and markets recoup. These actions have spurred a strategy to *always* buy the dip. It leads to a lack of fear that then allows the euphoria side of the emotional pendulum to swing further higher.



The market has rarely looked this crazy.

In the 21st century, **euphoria** is generally **defined** as a state of great happiness, well-being and excitement, which may be normal, or abnormal and inappropriate. That it is irrational doesn't matter. *Because* it's irrational we look for other excuses to justify the moves higher. We kid ourselves into believing our story is sound and based on justifiable underlying fundamentals.

Astute investors can use this information on emotion to win. Historically panic is a sign for the smart money to buy, and buy big. Euphoria on the other hand presents an ominous signal to the professional investor. In March our markets panicked. Today they are euphoric. The move from bull to bear to bull has been more rapid than at any time in history. Until one emotion has been fully reached a true top or bottom cannot be called. We have had both in a matter or weeks. It's been one heck of an emotional roller coaster. Now we are faced with the question of what to do now? This essay ventures to provide an answer.

Perhaps you've been wondering, how on earth can equities continue to rise while a *projected* 40-48 million Americans have lost their jobs? The P in the P/E Multiple is rising sharply, while the E in earnings is falling off a cliff. The market has rarely looked this crazy or disconnected from reality. This overvaluation and disconnect can be summarized in one word, *euphoria*. Simply take a look at the explosion in forward looking valuations. The widening distance between what's *coming* and how stocks are *currently priced* signals danger ahead. What is causing this equity boom in the face of the ominous?

The CNBC cheerleaders come up with all kinds of reasons to justify the incredible rebound of stocks in April and May. My personal favorite being tossed around right now is that the stock market has the *ability* to to look through the short term and is focused on what will happen down the road next year and years from now. This, according to many financial prognosticators, is why stocks are going higher.

***Because* it's irrational we look for other excuses to justify the moves higher.**

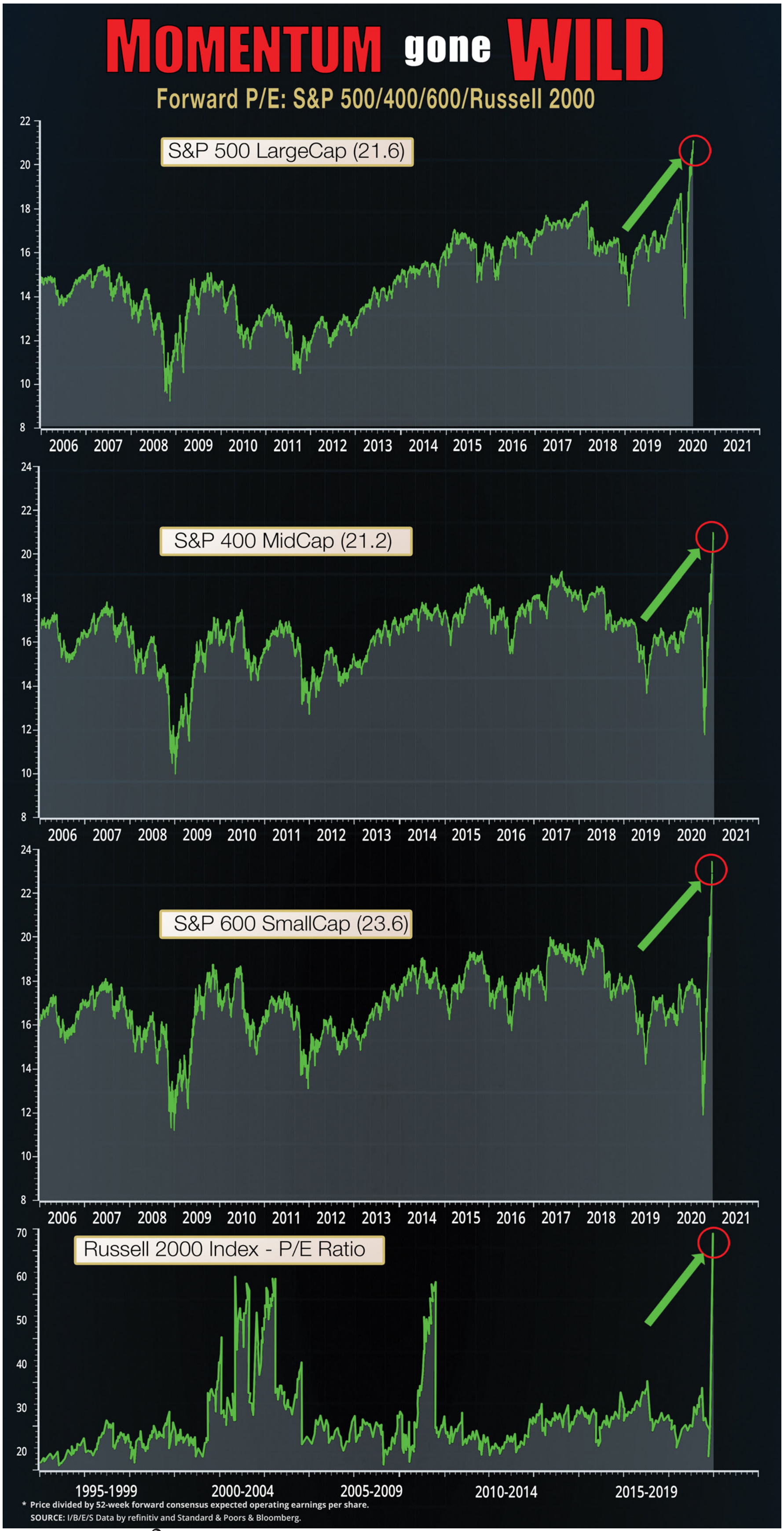
Does this sound right to you? My suggestion if you are buying this story is to turn off CNBC altogether lest you become infected with these ridiculous notions. Our markets are terrible long term indicators and have been for many years. There's been a transition over the last decade from "real" people trading fundamentals and actual price signals that has given way to flash boy computer algorithms focused only on trading momentum. This transfer and flow is the perfect confirmation that the opposite is true. Our markets aren't forward *looking through* anything, our markets are feasting on momentum. It's been a momentum that has only gone in one direction for over a decade. Higher. That direction now has two sides, up *and* down. If you don't like roller coasters, it may be time to get off this ride because this market is about to do a reverse loopty loop.

FROM THE EDITOR

The stock market is now a giant *momentum machine* which provides very little information for the long term investor other than what's happening in the *moment*. This is a trend Trump understands as he uses his Twitter account with the timely tweets designed to manipulate the algo's into buying. Trump has managed the stock market like an impresario conductor - always getting the orchestra to strike the right note. Anytime markets have turned down Trump is among the first to ramp them higher with a sweet tweet.

Wall Street has created a special measure, called the **"Volfefe Index"** is a reference to the great covfefe debacle of 2017, when the president in the middle of the night took to Twitter to complain about the media. Instead of tweeting about "constant negative press coverage," he tweeted about "negative press covfefe." While that was silly — and the Volfefe Index a weird Wall Street attempt at a joke — what JPMorgan analysts found in their look at Trump's tweets was not. According to the analysts, Trump tweets using the words "China," "billion," "products," "democrats," and "great" were the biggest market movers. Specifically, they're having an effect on two-year and five-year Treasury bonds and the volatility in their interest rates.

The Federal Reserve has also done wonders for the psyches of investors. When they buy, stocks rise. And they've been on a shopping spree of herculean proportions. Their $3 trillion expansion of the balance sheet is akin to taking 3/4th of the world's oceans and dumping it *on top of* the world ocean. That's a lot of liquidity and the speed at which it's arrived has created a new momentum. The Russell 2000 now sits at P/E multiples above 70 times earnings!



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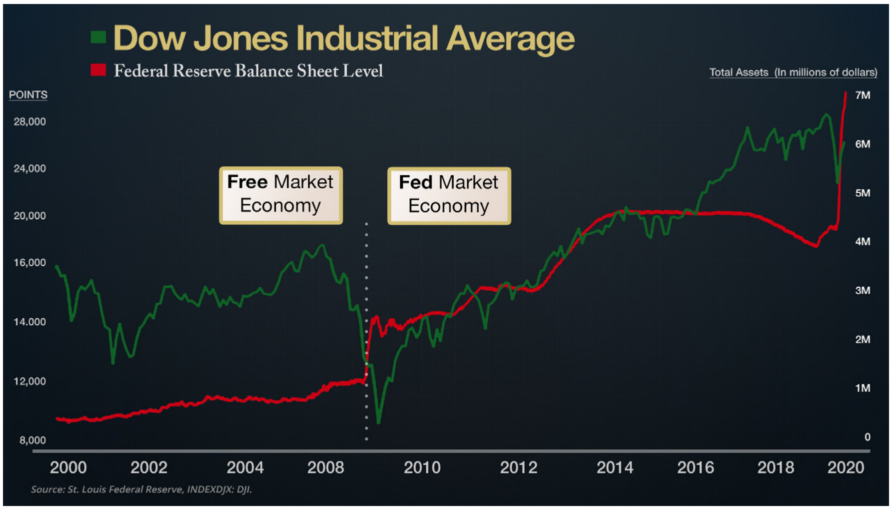
Why are markets soaring? Stocks are going higher because people are buying them. Why are people buying them? Because they are going higher, don't you see? Momentum. It's why the stock market is sending the wrong message if you are a long term investor. "In the moment", and "for the long term" are at opposite ends of the strategy pendulum. Unfortunately too many long term investors are not aware of this underlying reality of momentum, they have become complacent and will simply continue to hold because "markets always come back", especially when they know the Fed is on the case, right?

If *Momentum* was the title of a magazine, it's Person of the Year would have to go to none other than Jerome Powell, the Fed chairman who is receiving his best reviews yet from the Wall Street crowd. Powell has been universally celebrated for the moves the central bank has taken to fight the crisis. In a matter of weeks Powell has taken the balance sheet of the Federal Reserve from $4 trillion to over $7 trillion, an annualized increase of 600%. The easy money addicts have cheered the free money dealer who has nearly just doubled the supply of the narcotic. Markets have gotten high on all the new supply.

Powell has also gotten really good at *talking* to create momentum. Initially he wasn't the best speaker. When he first started opening his mouth at his press conferences he told the truth a lot more and the market didn't like it. Anytime Powell tried to suggest tightening or negative conditions were coming in the markets, Donald Trump would slap him around, and stocks would drop. The last time Powell spoke of anything remotely related to tightening was in December of 2018 after stocks had dropped 19% and Trump had made him the target of his vicious daily Twitter assaults. Trump called Powell lots of names, including a "moron", an "idiot", and a "bonehead." Trump even called Powell his "biggest enemy", and "the number one threat to the economy."

Powell has since been chastened. For the last 18 months Powell has only been dovish. The Fed Funds rate sat at over 2% in the 4th quarter of 2018. Since then rates have been moved lower, first to 1.75%, then lower to 1.25% then lower to .75% and most recently to the bottom where rates now sit at 0%. Not to worry, because what comes next after zero percent isn't negative interest rates, its massive balance sheet expansion. Since hitting ZIRP, Powell has added over $3 trillion to the balance sheet. Not coincidentally, since Powell was pushed from hawk to dove, the price of gold has steadily risen, from $1250 per ounce back then to $1731 per ounce as of May 29th.



A peek at the balance sheet of the Fed tells the true real story. Anytime Powell took a more sober approach in the first year of his role as chairman, the markets plummeted. Since then Powell has expanded the balance sheet and markets have roared. Towards the end of 2019 Powell started getting the hang of it all and began outright lying. He claimed the additions to the balance sheet were "Not QE", even though they clearly were. This was when Powell learned the impact of ***forward guidance***. It was a strategy that his predecessor Janet Yellen espoused. She understood the magic power of the Fed's voice. "If you speak it, they'll believe it" was her motto. Yellen was quoted as saying one of the biggest tools the Federal Reserve has is it's forward guidance. She was right. Never before have markets been more a slave to the words of the Federal Reserve.

According to the Financial Times, only a fraction of the multi trillion dollar emergency lending facilities unveiled by the Federal Reserve has been deployed. This is nearly two months since the Federal Reserve announced the programs. Of the 11 emergency facilities announced in March and April, which promised to make more than $2.6 trillion available, only five are fully or partially operational. Talk about having a great

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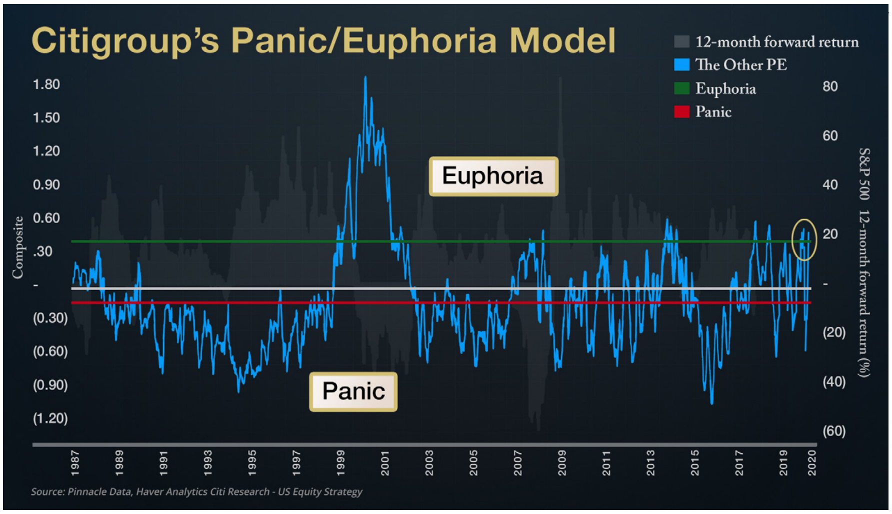
singing voice! The Fed now just hums a tune and stokes a rebound in the financial markets. The Fed no longer has to *do* anything. Just the promise of more free money gets the markets fired up.

When stocks paused mid-month and dropped 5% on the week of May 8th-14th. Captain Powell put on his superhero cape, showed up on the Fed's favorite hype show, *60 Minutes*, and did his best Warren Buffett, *never bet against America* talk it up routine. ***"In the long run, and even in the medium run, you wouldn't want to bet against the American economy. This economy will recover. And that means people will go back to work. Unemployment will get back down."*** Powell's verbal pump up sent stocks soaring, raising them a mouth watering up 8% in the two weeks since Powell's appearance. Talk about forward guidance!

In that episode which aired on May 17th he discussed why now was not the time to worry about debt and deficits. He argued that the Fed had an unlimited piggy bank and would do everything in their power to support the economy. Powell's was a literal call for the *moment* versus the *long term*. *"The Congress has done a great deal and done it very quickly. There is no precedent in post-World War II American history that's even close to what Congress has done. They have passed $3 trillion in stimulus, which is 14% of GDP. It is vastly larger than anything they've ever done. And also very, very quick. So a lot of that money is just starting to flow through the economy. And it's going to help households and businesses in coming months. The thing is that the coronavirus shock is also the biggest shock that the economy's had in living memory. And the question is, will it be enough? And I don't think we know the answer to that. It may well be that the Fed has to do more. It may be*



that Congress has to do more. And the reason we've got to do more is to avoid longer run damage to the economy. If we let people be out of work for long periods of time, if we let businesses fail unnecessarily, waves of them, there'll be longer term damage to the economy. The recovery will be slower. The good news is we can avoid that by providing more support now."

Powell is openly stating that with interest rates at these all-time lows, now is not the time to hold back, now is the time to *ramp up* our debt even further. And there you have it. If you are looking for an answer to the recent market euphoria, look no further. Our markets *love* debt, especially when it's bought by the trillions the central bank. Powell just told us the debt bazooka has been locked, loaded, and firing like a rapid-fire machine gun and that he is prepared to pull the trigger and rattle off trillions of dollars of new money at a clip.

The term "20/20 Vision" refers to the perfect eyesight and vision. I find it ironic that the year 2020 offers the least amount of clarity into the future than at any time in our lives. We've been programmed to distrust everything because everything is fake news. We simply do not know what to believe. The United States is faring the worst in the health crisis than any other country in the world in large part because the information coming from the leadership is inconsistent. The words are different when they come from the President, the scientists, the governors, the mayors and the philanthropists. Each is saying different things. The lack of leadership and unified voice is one of the main risks to getting to a new normal. Who should we believe? For me, this lack of unified voice will make a booming reopening of the economy all the more unlikely. We simply won't resume previous economic activity levels until we are certain that it is safe to do so. There will be no V-shaped recovery. The data point toward much more pain ahead.

A peek at the balance sheet of the Fed tells the true real story.

The data is so bad that it's now no longer being shared. The U.S Labor Department is ending its long standing system of allowing news reporters to review government economic data. At a time when talk is the rage, nobody wants to discuss the real numbers. This data includes high profile reports on unemployment, retail

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sales and inflation. The information has historically been made available to reporters in "lock up rooms" where news organizations were given 30 minutes to review the data, question government officials and ensure that the articles written were complete and accurate.

In May, William Beach, commissioner of the department's Bureau of Labor Statistics, decided that media lock-ups were to be suspended. "The recent COVID-19 experience demonstrates that DOL can eliminate the overhead and risk of lock-up rooms altogether without degrading the quality or timeliness of media coverage."

We find it more than a little bit interesting that a curtain is now being raised around future looking economic data. It would seem that COVID-19 has become a great excuse to avoid sharing numbers that signal the worst economy in U.S history. How much of this do you suppose has to do with an election cycle and the administration wanting to downplay the carnage? Data is a lot harder to overcome than the lies we are being told, therefore the data won't be shared and we will continue to be told how great everything is.

The Teddy Roosevelt days of "speak softly but carry a big stick" are over. Now because we have no big stick to swing, the game is "if at first you don't succeed, talk, talk, and talk some more." The problem is that all this chatter is sending the wrong message. The feedback loop Regular Joe investors have been receiving is that everything is great, that our challenges are behind us and that we are storming back towards a V shaped recovery. The feedback loop coming from the "pump it up at all times" cheerleaders only further enhances the "buy the dip" herd mentality that has taken hold of the stock market regardless of the true reality.

As for the *actual* unemployment numbers, at this point we can only guess. NBC predicts 41 million unemployed, Fox has 42 million as their guess and CNBC has projections of the total number unemployed closer to 47 million people. Even the most optimistic math can't hide that one in every four Americans is now without a job. This equals a 25% unemployment rate and exceeds the unemployment rates during The Great Depression.

So what should we pay attention to? The words of the Pep Squad led by cheerleading Captain Powell, or the unemployment numbers, "projections" may they only be? Should we see the stock markets rise as an all clear sign to a V-shaped recovery, or should we look at the explosion in forward P/E multiples and run for the hills?

To find our answer we must not pay attention to the near term momentum signals coming from the euphoric stock market, but the actual actions coming from the best investors of our time.

"The risk-reward for equity is maybe as bad as I've seen it in my career."

Warren Buffett has long been considered a "perma-bull" on stocks. When asked his investment strategy he has famously said, ***"my time horizon is forever."*** Well forever seems to be over for the Oracle of Omaha because Buffett has been doing the opposite of buying and holding. Buffett is selling. He recently sold all of his shares in the major airlines and several banking institutions. Mr. "buy and hold forever" *doing* the opposite.

Buffet isn't alone. The list of top investors who have lined up to sell is literally a Best Of list from the *Investor Hall Of Fame.* Over the past month, Stanley Druckenmiller has said, ***"The risk-reward for equity is maybe as bad as I've seen it in my career."*** Paul Singer has said, ***"global stocks could tumble more, ultimately losing half of their value from February's high".***

WHAT BUFFETT HAS SOLD SO FAR:

- On April 1 and 2, Berkshire sold about 13 million shares of Delta Air Lines (NYSE:DAL), raising $314 million in cash and taking his stake in Delta down from more than 11% to about 9.24%.
- Berkshire also sold shares of Southwest Airlines (NYSE:LUV) in that time period, with a smaller sale of 2.3 million shares raising about $74 million and leaving the insurance giant with a 9.92% stake in the Dallas-based airline.
- Later in April, Buffett sold 860,000 shares of Bank of New York Mellon (NYSE:BK), raising $30 million and leaving Berkshire with a 9.96% stake in the banking institution.

FROM THE EDITOR

According to Bloomberg, Blackrock CEO Larry Fink sees mass bankruptcies, empty planes, cautious consumers and an increase in the corporate tax rate to as high as 29%. Billionaire real estate developer Sam Zell said, ***"Too many people are anticipating a kind of V-shaped recovery. We're all going to be permanently scarred by having lived through this."*** Billionaire David Tepper has called this market, ***"the second most overvalued market I have ever seen."*** Jeffery Gundlach perhaps summed it up best when he said, ***"I'm certainly in the camp that we are not out of the woods. I think a retest of the low is very plausible,"*** Gundlach said on CNBC's "Halftime Report." ***"I think we'd take out the low. People don't understand the magnitude of ... the social unease at least that's going to happen when 26 million-plus people have lost their job. We've lost every single job that we created since the bottom in 2009."***

Gundlach spoke these words before the most recent job numbers which now have projections over 40 million Americans who've lost their jobs.

The unified melancholy chorus from these great investment minds demands a question. If the best investors of all-time are selling, who is it that's buying? For our answer look no further than what happened this past week with Hertz, the rental car company that has just filed for bankruptcy. Billionaire investor Carl Icahn had been building a large equity position over the past six years. It turned out to be a bad bet that put a $1.6 billion dollar ding in his net-worth this past week. Icahn has since completely sold out of Hertz Global Holdings Inc (HTZ), and sold his 55.3 million shares at a net price of 72 cents per share. And who you may ask did Icahn sell all of this stock to? On Wednesday May 27th, Hertz became the most heavily traded U.S stock with shares posting their largest gain on record. The volume hit 264 million shares traded on the day and witnessed the stock rise to highs of $1.49, a record 168% increase from their 59 cents per share starting price. Where did this surge in interest in a bankrupt company who will have to unload 500,000 cars on the used car market? The retail investor, otherwise known as the "dumb money." As the Mom and Pop's poured in, Icahn poured out.The Batmen of investing are selling and Robinhood is buying. What is it that the smart money sees that the little guy is missing? Mr. Buffett would say, ***"be fearful when others are greedy."*** We call it euphoria. The smart money always seems to buy exactly when the last of the retail investors is selling. The same smart money also seems to sell just as the last of the retail investors is piling in. Yesterday these Mom and Pop investors traded on platforms called Etrade and TD Ameritrade platforms. Today these platforms are called Robin Hood and Stash. What's the lure? Fractional shares. According to Robinhood website. ***"Our mission is to democratize financial services, and our Fractional Shares feature provides unique investing opportunities to people who might not otherwise be able to participate in the stock market. With fractional shares, you can invest in stocks and ETFs that cost hundreds or thousands of dollars for a single share with as little as $1. This gives you the flexibility to invest as much as you want in the companies or ETFs you believe in, or get your toes wet without committing to an entire share. Fractional shares can also help investors manage risk more conveniently. Since you're not locked into purchasing full shares, you can diversify your portfolio with smaller amounts of money."***

Few young investors can afford Amazon at $2000 per share. But what if Amazon were broken up into micro shares that at $20 and each, with full shares equalling 1000 micro-shares? When that happens investing becomes affordable for the masses. Robinhood has discovered how to get the young millennial into the "investing" game and it's one that everyone can afford to play. The idea is so good, and the millennial market so big that the big boys are getting in on the act. Discount brokerage Charles Schwab on Tuesday May 5th announced that it will offer trading in fractional shares of individual stocks as soon as June. TD Ameritarde also has plans for micro-shares. The big banks are getting into the fractional game and

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will be providing competition for micro brokerages like Robinhood and Stash who have drawn large market share from an increasingly younger demographic.

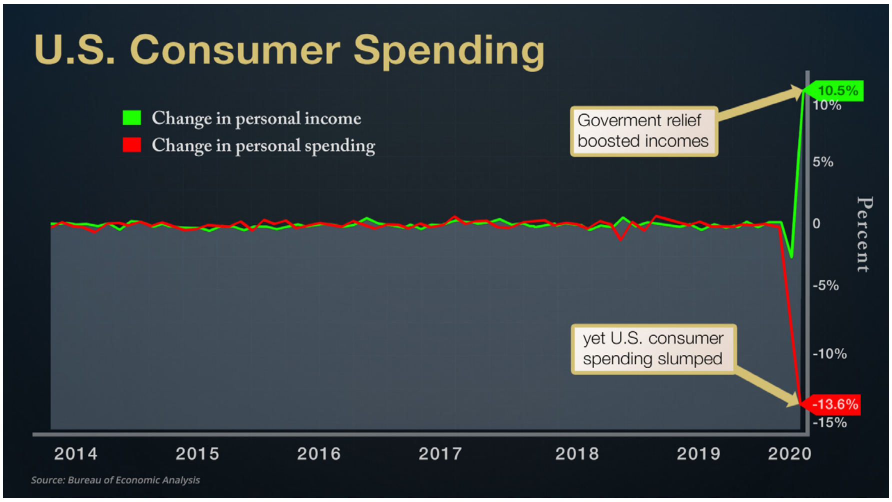
Millennials can gamble with little bits of money and play the game that the big boys have been playing for so long. The problem is that the big boy investors understand how the game is played. They have been lying in wait to unload their overvalued shares on the unsuspecting little guy.

The tail and the dog analogy continues. The analogy refers to the "smart money" as the dog and the "dumb money" as the tail. The dog is always the first one in and the first one out. The recent dead cat bounce that's seen by the market up 35% is providing the smart money a "get out of jail free" card.

The dog is always the *first one* in and the *first one* out.

Whew, Robinhood to the rescue!. Isn't it ironic that character Robin Hood stole from the rich to give to the poor? The Robinhood of today is doing the opposite and bailing out the rich with the fractional buying power of the poor. No wonder Powell is getting rave reviews from Wall Street. His chatter fooled the little guys into buying.

But aren't one in four American now unemployed? Where are the poor getting all of this new money coming from if 25% of the workforce is unemployed? Don't millennials make up a large portion of the out of work crowd? Where are they getting all of this money? The answer lies in the government stimulus package. While it is true that one in four Americans is now without work, it's not true is that incomes have fallen. In fact, incomes



have risen, and mostly from the lower end of wage earners. The $1200 stimuluschecks, coupled with the expansion of unemployment benefits to $600 per week has most of the formerly employed receiving more income than they were when working full time. The new surge in investment has come from micro-investmentor crew and is made up of lower income individuals with more time, and more money to play with.

The money currently plowing into the equity markets from the small retail investors is reminiscent of the Dot-Com bubble. Back then the boom was fueled by young people who loved the idea of becoming rich through day trading. The period was a time of market mania in which plumbers and mechanics were becoming millionaire day traders, tech IPOs would multiply on their first days of trading, and vanity metrics such as "eyeballs" or "mind-share" were becoming serious valuation metrics for analysts of technology companies. The dotcom bubble spawned many spectacular failures like Pets.com and Webvan.

We are right where we were then. Stocks are dancing on the deck of the Titanic. When prices are this disconnected from earnings it's an ominous sign of euphoria. It signals that markets are disconnected from reality. These are times that require the long term investor to be on high alert, especially when the unemployment benefits for all of the newly employed run out at the end of July. Of course we must also remember that markets can stay crazy longer than many can stay solvent. Momentum in the short term could push stocks even higher. This reality may keep the retail investor buying stocks against poor underlying fundamentals. The smart money is buying gold and silver, and in *large* quanties.

Where is it now?

Warren Buffett Indicator

As of 06/01/20

Significantly Overvalued

142.84%

Ratio = Total Market Cap/GDP	Valuation
50% < Ratio < 75%	Modestly Undervalued
75% < Ratio <90%	Fair Valued
90% < Ratio <115%	Modestly Overvalued
Ratio >115%	Significantly Overvalued

FROM THE EDITOR

WHY I LOVE SILVER

I often get asked, Adam, you wrote a book called *Gold Is A Better Way*, but what do you think about silver? For the longest time my answer has been that silver is an inflationary asset and gold is a monetary asset. While the two have tended to trend together over time, over the last several years I've believed that silver would lag well behind gold, who's safe haven status would see it do well in the deflationary environment in which we've been living while silver lags under the same conditions.

This answer has not been well received by the silver bugs. They'd argue that the silver to gold ratio used to be 16 to 1, then it grew to 35 to 1, and then rose to 75 to 1. How could I not like silver with the ratio that out of whack? All along the way I'd reply that ratios don't matter, silver is an inflationary asset, and until we could anticipate inflation on the horizon I didn't expect to see silver do too much.

Today the gold to silver ratio stands at 94 to 1. This is still not a reason to buy silver. But I now believe that inflation is on the way. This combination makes silver a *screaming* buy and why I believe we will likely see silver outperform gold in the coming years.

This is not a popular opinion. The general consensus has been that massive unemployment is deflationary and will lead to lower and lower interest rates, even negative rates. It's why silver has lagged behind gold and fell to lows of under $12 just two months ago. At the beginning of May, when silver was under $15, I began to take an extremely aggressive position in silver. Here is the thought process on why I believe inflation is coming. It's a step by step evaluation that leads me to conclude the opposite of what Wall Street is predicting. Inflation is coming.

Let's begin by looking at the recent past. Gold has risen 50% in the last 20 months while at the same time silver has traded sideways priced on average around $15.50. Gold has risen because of it's *safe haven* status and the monetary looseness of the Federal Reserve, not because of any inflationary impulses. This is a major input I now see changing.

A longer view of history is very useful when thinking through what's coming next. Remember that in 2008, as the Housing crisis hit in earnest the price of gold traded at about $750 per ounce. It would soar to highs of $1925 per ounce just a few years later for an increase of 2.5X in just three years. Silver during that same span of time would rise from $10 to highs of nearly $50 for an increase of 5X. Silver nearly doubled the performance of gold after the housing bubble collapsed. Why?

Back then in 2010 most investors believed that with all of the new money printing and the creation of QE, that we would see an inflation surge. It made sense. We were adding massive amounts to the money supply. Naturally investors expected this to come with higher prices. Silver exploded on the idea that inflation was coming. But inflation never showed up.

In fact, the opposite occurred. QE wasn't the inflationary bazooka many predicted for anything other than stocks. What we should have learned from this experience is that it's all about *where* the money flows. Interest rates at 0% and trillions of dollars of free money *didn't flow* into the hands of the masses, it flowed into the hands of the major corporations. These corporations in turn did not take the free money and hire new workers and build new plants which would have been inflationary, instead they took the road less challenging and bought back their stocks. This is evident in the data and a topic which has been covered by *Full Faith and Credit* in multiple previous issues. In summary, while stocks rose four times higher over the last decade, real wages have barely budged. This *flow* means that all of the newly created money went to one place, the investor class.

The question we need to ask ourselves is will *where* will all of this new money flow?

Well here we are once again. The Fed is back at it. Only this time they are not increasing their balance sheet in smaller steps over years of time, this time they've leaped nearly twice as high in a matter of months. The Fed has added over $3 trillion in liquidity in superheroic fashion. The Pavlovian response from the stock market thus far has been a surge higher of 35%. The Fed rang the bell - and the market salivated. We've learned our lesson. When the Fed prints money stocks go higher, right? In the short term that has been true. However that correlation will not work out in the long run the same way this time around. I believe most people have learned the wrong lesson. At least it appears retail investors have. We never find the right answer by asking the wrong questions. The question we need to ask ourselves is will where will all of this *new money* flow?

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The stock buyback days are over. The pushback against corporate America from Main Street is coming. It's why smart money is selling. We already know from the first stimulus package that Congress is now onto the Wall Street act. Any corporations taking bail outs will be forbidden to buy back shares until one year after paying back any bailout loans taken. This is a big deal and why some CEO's from the airlines and other battered down industries are trying to hold off taking the bailout money. But the problem runs much deeper than that.

The 2020 election will be a referendum on income inequality. The higher stocks go relative to the real economy the bigger the pushback from Main Street will be. Markets are surging higher because the Fed bailed out Wall Street. They've done this in the face of a health crisis where demand is getting crushed. It's now happening against a backdrop of social protest where small businesses are facing looting and rioting in the streets. Main street and Wall Street have never been this disconnected.

Larry Fink sees it. He and his firm Blackrock have been charged with helping the Fed with their bailout programs. Fink is predicting widespread corporate defaults. He also believes that the corporate tax rate will increase to 29% *next year*. He is suggesting this will be the case regardless of who wins the election. The corporate borrowing bubble is hitting it's peak at the worst time.

What history teaches us is that money will be funneled from the wealthy to the poor.

All of the Trumpian profits corporations have received through his 2017 corporate tax cut, which slashed the corporate tax rate to 21%, are about to be washed away by a wave of higher corporate taxes. This pinch in profits will occur at the exact same time that demand for buybacks falls off a cliff. Higher taxes and less buybacks are a bad one-two punch. The third punch will be the knockout blow. Inflation.

The Great Devaluation, which comes out in August tells the tale of how the 2020's will look like a combination of the 1930's and the 1970's, and will witness the greatest transfer of wealth in human history. What history teaches us is that money will be funneled from the wealthy to the poor. As that occurs inflation will rise. Monetary policy when loosened is good for the wealthy, fiscal policies when spending far outweigh revenues is good for the masses. It's also inflationary.

One need only gander at the United States economy through the looking glass of the restaurant industry. The american restaurant and food service industry makes up a total of 4% GDP of the economy and employs over 10% of the american workforce. By contrast, the manufacturing industry accounts for 8.5% of the overall workforce. While the restaurant industry employs 1/10th of the workforce, it's impact is far greater still since it's tied to agriculture, trucking, and warehousing as well. In short, the american economy may best be defined by its restaurant and hospitality industry. While the overall unemployment rate is likely 25%, the unemployment rate in this sector is closer to 40% according to government data. In short, the biggest pain is being felt the hardest in our restaurants and hotels.

It's an industry I have particular personal insight into. I am an investor in a restaurant, have friends and family that own dozens of restaurants, and am deeply connected on the commercial real estate side of the restaurant and hotel business as well. I've recently been fascinated by what will happen in this space, especially since the COVID-19 crisis has put a pause in the economy.

Over the past month I have been gathering inside intelligence from some of the most influential people in this space. My information is based on relationships rather than actual data and charts. As such it's my personal opinion based on a small survey sample. That said, I expect the logic will resonate for most. Here are five of the main challenges facing the industry over the coming months:

FROM THE EDITOR

Challenge #1 - Rent

Restaurant owners are faced with the daunting challenge of how to survive at 50% capacity. Health requirements and social distancing guidelines require that tables be moved further apart. Seats at the bar must now be limited, and restaurants that can re-open will likely, at best, be forced to operate with far less capacity. Keep in mind large seating chain restaurants like *The Olive Garden, Buffalo Wild Wings, IHOP, Red Lobster, Applebees, Sizzler* are working at margins close to 10%. These established chains are mostly in their second, third, and fourth lease options.

These addendum options are typically much shorter than first term leases which can be as long as 15 years. Second, third and fourth options are typically 3-5 year extensions. According to an inside source, whose firm represents many of these types of clients, the big seat chains could see that 30-40% of their stores simply hand back the keys to landlords rather than re-open. In the best of cases these restaurants will attempt to negotiate lease buyouts. Many unfortunately will outright default.

These widespread commercial real estate defaults will come with little re course. The restaurant owners leverage is the knowledge that landlords won't be able to afford to come after them legally. The costs will be too great, especially with no new lessors lining up to take on the space. As this reality set's in over the coming year I expect we will see widespread default on rents. Landlords will be left holding the bag. This then will spider web into the banking sectors as leverage tied to falling estate prices will be reigned in.

Challenge #2 - Product

Since the products that restaurants sell are mostly perishable, the costs that come with restocking their food supplies are a major upfront challenge that the cash starved industry is ill equipped to deal with. Restaurants are a high turnover business and require a lot of cash to re-supply inventories. With near zero business for two months, and with available cash being used to stay alive, many of the restaurants who don't have access to the capital markets will be unable to afford inventory necessary to re-open. Restaurants that do re-open we will witness limited menus that allow owners to limit their costs.

Prices for meat and chicken have risen dramatically.

The one area of potential good news in this regard is that invoices for liquor can be postponed for a maximum of 30 days in states like California and food invoices for as much as 60 days. Long standing restaurants with relationships with their suppliers and with access to customer credit will be in better position than restaurants with less access. The new restaurant owners are therefore facing the biggest challenges when considering how to pay for re-opening inventory costs.

Challenge #3 - Food Costs

Massive disruption within the agriculture and meat processing food chains have witnessed rising food costs. Immigrant workers who mine the fields are among the most vulnerable to the COVID-19 virus. They are often crammed into buses and living spaces where the virus can spread more readily. Farm laborers and meat processing plants have witnessed increases in virus cases. According to Blomberg in an article published on May 29th, one farm in Tennessee distributed Covid-19 tests to all of their workers after one employee came down sick to find that every single worker of it's nearly 200 employees had been infected with the virus. In New Jersey, more than fifty workers had the virus at a farm in Gloucester County, an agricultural area that produces apples, cherries, pears and most of the nation's hops. Unlike grains, which can be farmed using heavy machinery, meat, fruit and vegetables require manual labor and their supply chains have been impacted, leading to higher prices.

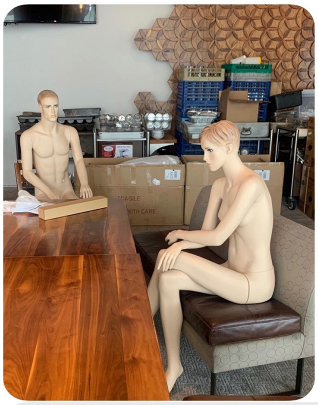
Virus outbreaks within agriculture are drawing comparisons to the meat industry crisis that has transpired over the last two months. Prices for meat and chicken have risen dramatically. Anecdotally, the restaurant across the street from my office has fantastic burgers. They've recently reopened for take out with a limited menu. Unfortunately for me they have taken my favorite hamburger off the menu because beef costs have skyrocketed. Even more unfortunate

THE BIG IDEA

is that they are operating at 10% capacity, with a dramatically reduced menu and skeleton staff.

Challenge #4 - Changing Habits

Americans who have become accustomed to dining out two or three times a week are now finding themselves cooking from home. A big worry for the restaurant industry is that even the most loyal patrons will scale back on their dining out as they cook from home, as new food delivery options make everything more convenient, and as expense accounts and budgets become pinched. One executive I've spoken with was joking that while his business was down 30%, his personal food and beverage costs were down more than 50%. Americans looking to tighten their belts often tighten in this area first. Habits that re-accustom us to cooking from home provide competition to market share.



Hi! I just have to share this with you.

We are reopening soon and the owners are planning on putting these mannequins at every other table to help with social distancing

SALARY INCREASE

Challenge #5 - Rising Wages

By far the number one concern for restaurants is the increasing costs associated with hiring and training employees, and paying a competitive wage. The estimate is that the big seat restaurants will need an average of $75,000 per store to rehire and retrain their employees. An even bigger challenge still is that many of the workers they formerly employed do not want to come back to work. I spoke to the owner of one of the most successful and hot restaurant chains in the world, with locations in Los Angeles, Phoenix, Philadelphia, Chicago and Hawaii who told me he is having a hard time hiring back workers because he cannot compete with the unemployment benefits his former employees now receive. Unemployed workers are making more money staying at home than they were while working. My owner friend estimates that due to the stimulus package the average restaurant employee is making $1000 per week in benefits. These are wages he cannot compete with.

According to the Bureau of Economic Analysis, 68% of unemployed workers eligible to collect unemployment will get benefits that top what they previously earned at work, University of Chicago economists Peter Ganong, Pascal Noel and Joseph Vavra covered this trend in a recent paper. While that pattern is visible nationwide, it's especially common in Alabama, Georgia, Mississippi and Montana.

FROM THE EDITOR

This short anecdotal case study of the restaurant industry should highlight a few very important takeaways applicable to the economy at large. The first is that the production (supply) side of the economy is going to continue to be pressured. Costs are rising. This pressure will be seen in the prices we pay for food, travel, lodging, health clubs. Even oil, once the supply side evens out, will become more expensive. While commodities and food prices could explode higher, we expect to see widespread defaults across the corporate real-estate. These defaults will grow as this reality becomes even more real.

None of the above, of course, considers the demand side of the equation. We have taken it for granted that a vaccine will change everything and we will go back to normal and that pent up demand will return once a vaccine is available.

Stocks exploded higher on positive news regarding the start of trials. This is a momentum trap. Most people who have been swayed by this argument haven't thought through the challenges a vaccine, when one or more become available, will face. According to an Associated Press-NORC poll only about half of Americans say they would get a Covid-19 vaccine if available, Vaccines have been labeled unsafe over the last twenty years. Many parents won't vaccinate their children for fear that vaccines are responsible for autism and other disorders. With only a 50% adoption rate a vaccine will not be the magic bullet for demand.

Less supply plus less demand as many consumers' habits change is likely to drive pricing higher on many of the things we have become accustomed to.

The costs to fly, to travel, to eat, to take public transportation, to insure our businesses are just a few of the costs of goods and services all likely to go higher. The margins can only be maintained by higher prices. Costs of labor are going to increase to draw the low-income worker back back to the workforce. As this plays out the conglomerates will become more powerful, the small business will be forced out of the marketplace. As it stands today, six individual stocks are carrying the entirety of the index. One fith of the entire S&P 500 market cap is accounted for by five big tech companies marking the highest level concentration for the index since the 2000 tech bubble.

THE BIG IDEA

A LONG HOT SUMMER PROTESTS AND RIOTS

One of the worries with massive unemployment is that the disheartened will take to the streets, riots will occur, and that martial law may be declared. One main reason we've managed to avoid that so far is the massive stimulus packages that have been passed. While the unemployed are hurting spiritually, the financial impact hasn't hit most workers yet. Should Congress fail to act and extend these benefits before the end of July we could witness a tremendous sea change in mood.

Politically things have never been this volatile. As I write this I am heartbroken at the riots happening around the country over the police killing of George Floyd. The anger that is boiling over is a result of a multitude of factors; the long standing racism that has been felt from the black minority dating all the way back to slavery, and the frustrations brought about by the massive income inequality, the pent up energy of people who have been locked up in quarantine over the past couple of months. The catalyst for the protests was the killing of George Floyd. The wide scale and national response from the young and disenfranchised is about far more than protesting an individual's death at the hands of the police, this is about a deep seeded frustration. The momentum is fueled by anger. The young and the poor lack control of their destiny. The protests happening nationwide should be a wake up call to the wealthy that the system is broken and forecasts dramatic change lies ahead.

There is zero excuse for the rioting and looting taking place across the country. I never believed I'd see a time where lawlessness abounded in this country the way it has in the past few days. The police have been emasculated. Any normal response to the behavior of anarchists has been tempered by the catalyst. So rather than take a heavy handed approach they've tried to take a more tempered one. As is true with all movements, there are those committed to standing up for change through peace, and those hiding within the movement seeking a personal non altruistic agenda.

These protests offer a glimpse at the anarchy we could expect as these voices grow louder. Our police forces are already overwhelmed. The numbers of protestors versus police and military personnel available to ensure the laws of the country are upheld are likely to become more lopsided as more and more of the unappreciated stand up. One thing keeping a lid on the outcries has been the swift stimulus and additional unemployment benefits. Should incomes drop dramatically due to lack of government action, the anger will boil over into much larger swaths of the population.

This challenge becomes more difficult heading into the election. The current position from Republicans, led by Mitch McConnell, argues that the federal government is not there to bail out the states. McConnell Instead of more federal aid, argues that states should cut their spending by declaring bankruptcy: ***I would certainly be in favor of allowing states to use the bankruptcy route. It saves some cities. And there's no good reason for it not to be available. My guess is their first choice would be for the federal government to borrow money from future generations to send it down to them now so they don't have to do that. That's not something I'm going to be in favor of."***

We are already witnessing state pensions for firefighters and police going bankrupt. Imagine what would happen if the states were forced to cut these essential public servants at a time like this. What happens if the police and firefighters stop wanting to serve? That image is disconcerting and reminiscent of what occurred at the end of the Roman Empire when the military refused to fight because the silver in the coinage had been reduced below .01%.

We need our public servants now more than ever and can ill afford to stop paying them. Imagine how bad the anarchy would become if they stopped showing up to protect us and the laws of this country.

The anger felt within the forgotten lower incomes is one that could explode during a long hot summer. We have the set up for a massive and total breakdown of society. It's all manifesting under a deafening silence from the leadership on both sides. I believe for these reasons that Congress will be forced to take additional action. The unemployment benefits will need to be extended. Any dropoff in incomes under the current scenario could set off unrest across the country. Heavy handedness with regards to extending help to the states is politically unfeasible at a time this. The image of Americans watching as our cities burn down while law enforcement stands by, is a sight I never believed I'd see in this country. The anger is now too great. The only solution is a massive short term influx of more and more money. This is the only viable political solution available until after the election. Anything less could lead to more and more uprisings and violence. The upper hand is held by the Democrats who are pushing Republicans to act. Failure to do so could cost the Republican party the election across the board, and why we will see more and more stimulus in the short term. This is why I believe we will see an inflation surge. This inflation will not likely be seen in financial assets as it has for the last decade.

The flow of money is headed towards the masses, not the wealthy. The top one percent can expect lower profits due to higher costs of labor and product in the short term, and higher taxes and lower growth in the long term. For these reasons, expect to witness tangible real assets and commodities soar. I believe we will see gold above it's all time high's before the end of the year and silver could hit $25 as this occurs. The big unknown in the short term is how much money will continue to flow to stocks. Should the euphoria continue, it could keep a lid on precious metals prices.

The long term reality of it all is that we are headed for stagflation. An extended time of low growth coupled with higher inflation and higher costs. The new direction will look a lot like the late 1970's where growth ground to a halt and prices continued to surge higher. Back then we watched gold prices soar 8X from $100 to $800 per ounce as financial markets struggled. Silver rose from under $2 per ounce to highs of nearly $50 by the end of the decade.

In 1975, the debt to GDP ratio of the country was 32%. This low ratio allowed for a massive surge in debt with negligible long term implications. Last year the debt to GDP ratio was 105%. This is why the current situation is so dire. Due to the onset of Covid-19, economists now predict a 10% dropoff in annual GDP. Which means our GDP for 2020 would drop from $21.3 trillion down to about $19 trillion. That drop in GDP will coincide with an increase in our debt from $23 trillion to an expected $27 trillion.

The flow of money is headed towards the masses, not the wealthy.

The debt to GDP ratio for 2020 could hit 145%, a level not seen since World War II. This likely means the end of the current economic system. The impending stagnant growth, coupled with rising interest costs, make this debt crisis one we will not be able to overcome. At this stage of the game there is only one move left, devaluation.

- Adam Baratta