Prerequisite CAPITAL

See page 12 for Portfolio Results

11th Apr 2021 // Quarterly Client BRIEFING

Dear Valued Client,

A wise or foolish builder?

A builder can build a fantastic looking house in a rapid amount of time, but if the foundations be poor, and the materials & methods of construction are inferior, then the house is unlikely to stand for very long.

"Always pay; for first or last, you must pay your entire debt. Persons and events may stand for a time between you and justice, but it is only a postponement. You must pay at last your own debt. If you are wise, you will dread a prosperity which only loads you with more."
...Ralph Waldo Emerson (1803-1882)

This simple analogy essentially summarises the situation that the majority of economies around the world are in.

As at January 2020 the Australian Government had circa $584 billion of outstanding net liabilities (i.e. public indebtedness), by March 2021 it stands at circa $879 billion, a greater than 50% increase in the space of a little more than a year. Most countries around the world have had similar experiences to that of the USA & Australia.

Many are praising the abilities of policy makers at re-stoking growth & reflationary dynamics in the global economy. This looks great superficially, but looking beneath the surface in most areas of the global economic system, you can see such growth is being built on poor foundations (see our *PCS Reports 011, 012 & 027* and the like for a full explanation)… as a result, such growth is likely to prove transitory.

"Today, I would say the government expenditure multiplier after three years is negative 0.2. In other words, if you engage in a dollar of debt financed fiscal activity, that will boost the GDP by dollar but at the end of three years you will reduce private GDP by about $1.20. In other words, there is no magic Keynesian multiplier."
…Dr. Lacy Hunt, Hoisington Asset Management (interviewed on Real Vision TV, 29th March 2021)

Modern Monetary Theory (MMT) is a dream come true for politicians as it provides for them an excuse to pursue effectively unlimited fiscal & monetary policy (with the insincere conceit that they will be able/willing to reign in excess inflation if and when it eventually appears).

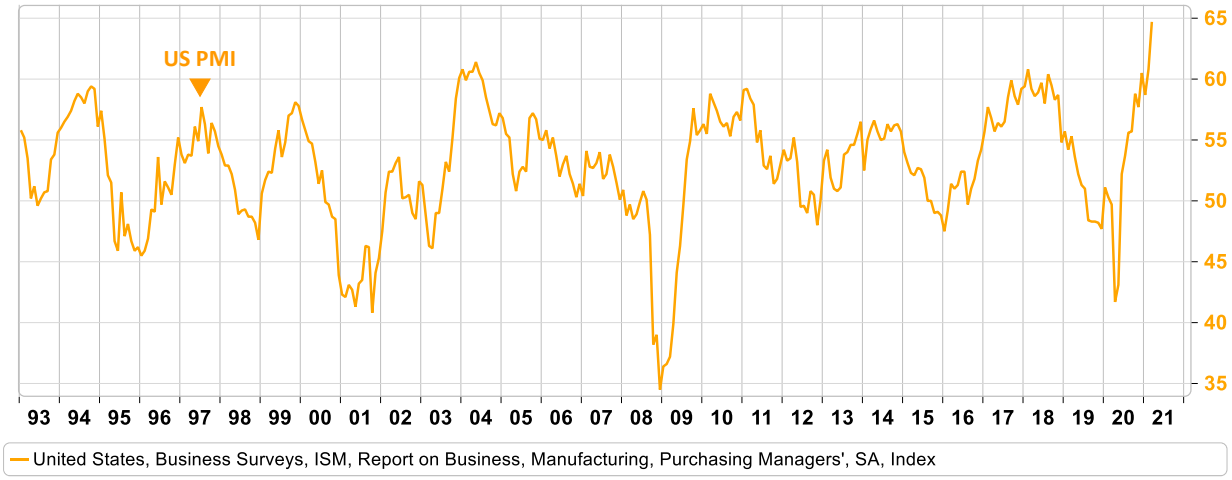
In the short term MMT may boost growth & inflationary pressures temporarily, but really all it is doing is misallocating resources, sustaining under-productive structures within an economy (and perpetuating the existence of securities which otherwise should have been written-off or significantly marked-down), such is medium term disinflationary (with deflationary risks building) as an increasingly zombified economic system ensues… yet in the long-term it is significantly inflationary as it inevitably leads to a loss of confidence in the underlying currency (and the public institutions that steward it), causing capital flight away from the currency in addition to the velocity of money increasing exponentially within that currency system. When these longer-term issues start to gather pace, our Portfolios will be rebalancing towards things like Precious Metals, Natural Resources, and other 'anti-USD' type exposures.

MMT also rests on the conceit that politicians & bureaucrats are more effective allocators of resources within a system than market-mechanisms founded upon a just & effective legal system (something you would have thought the experiences of the previous century would have disproven once & for all).

Many of these issues mentioned above we have explored in our Quarterly Letters in 2020 (all can be found here: https://www.prerequisite.com.au/managed-portfolios) and in our Subscription-only PCS Reports.

▶ Global Growth:

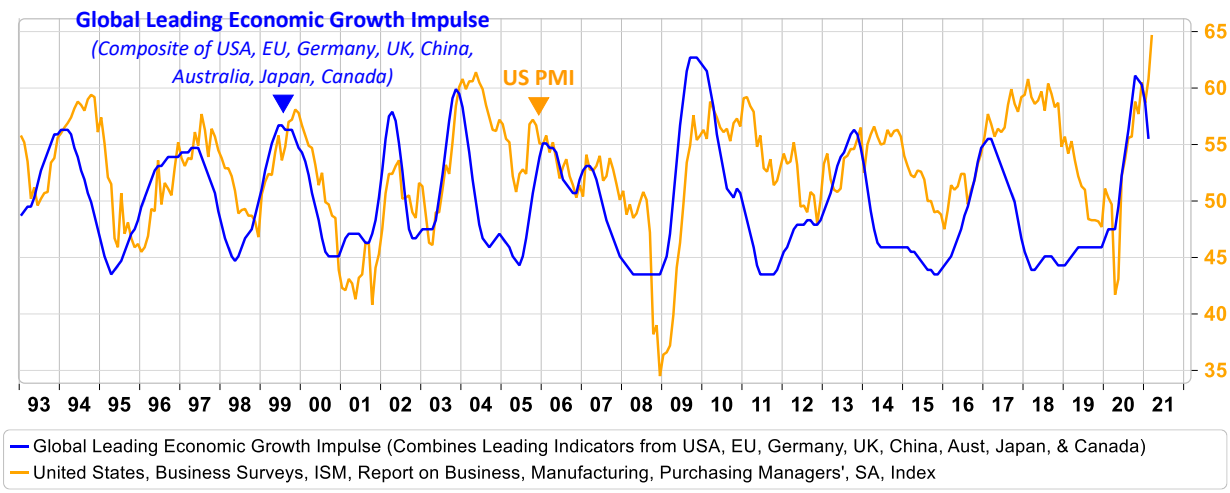
Presently the optimism around global growth can be seen in many different forms & measures, one such measure that seems to be fairly representative of the broad swath of datasets is the US PMI (Purchasing Manager's Index)…



What people forget with most of these type of measures, is that they are coincident, not leading, indicators. They are simply telling us what is happening now.

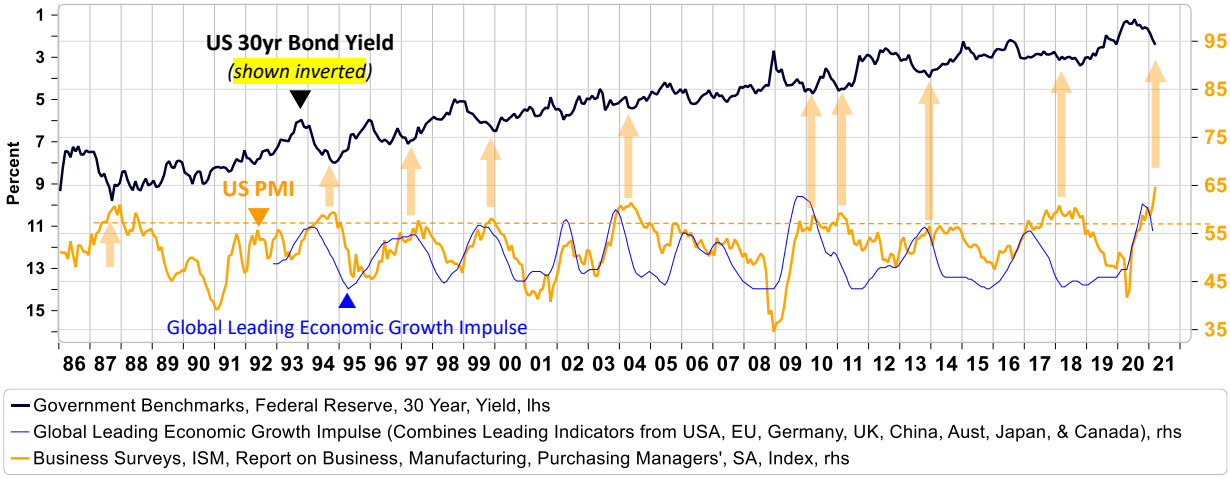
Furthermore, such indicators tell us nothing of the *'quality' of such growth*.

On the next page we overlay a fairly typical but effective 'leading indicator' of global growth…

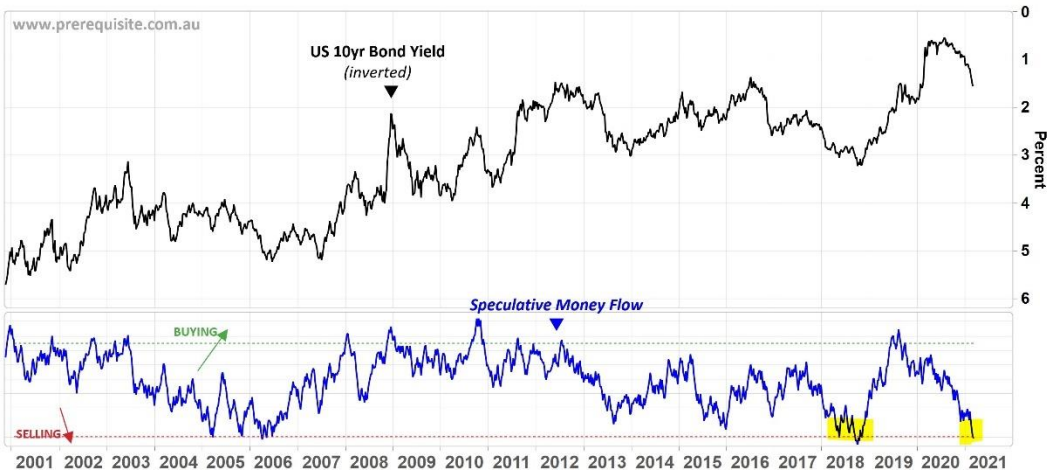


...obviously it shows that the previous impulse of economic growth in the world is already rolling over decisively (peaking early Q4 2020), such has led historically to weakening conditions within 6-12 months, suggesting a weakening trajectory for growth for the remainder of 2021.

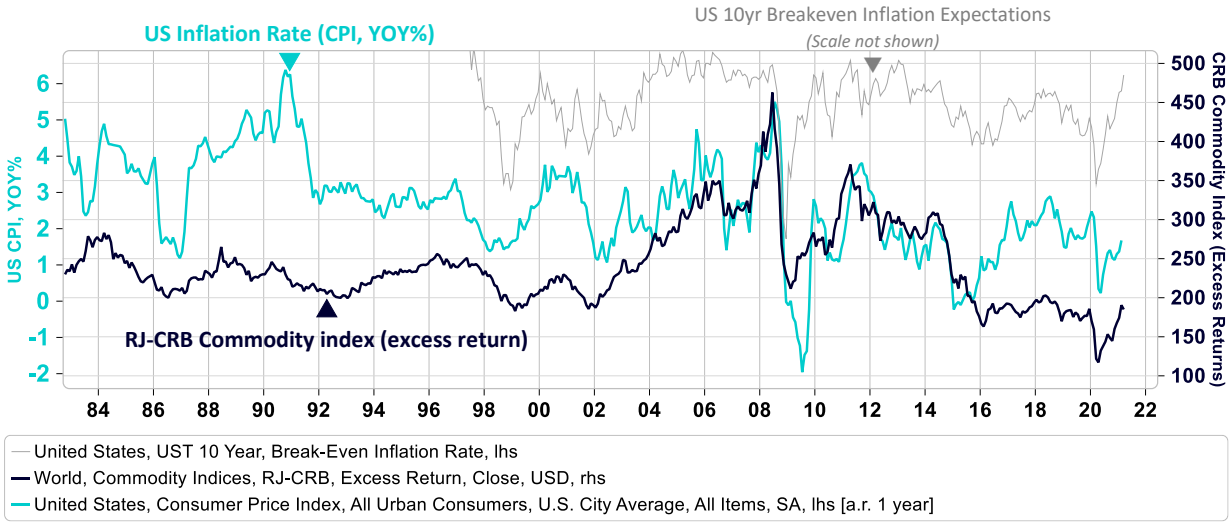
Furthermore, these sorts of peaks in coincident growth datasets, such as the US PMI series above, typically have marked the best times to own large quantities of long duration US Treasury Bonds in our Portfolios, as you can see in the following chart:



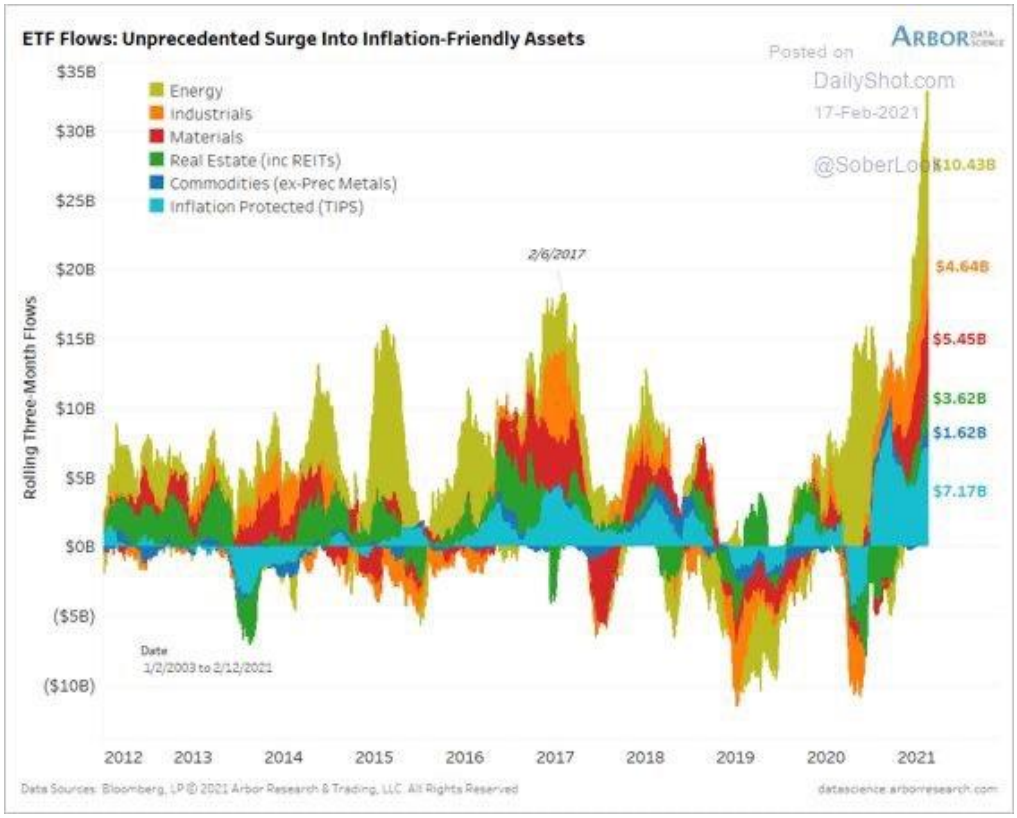
The speculative pessimism towards Treasuries is once again at levels that have typically coincided with major buying opportunities. We simultaneously are observing significant accumulation of Treasuries by larger more 'Patient' type participants.



▶ Inflation:



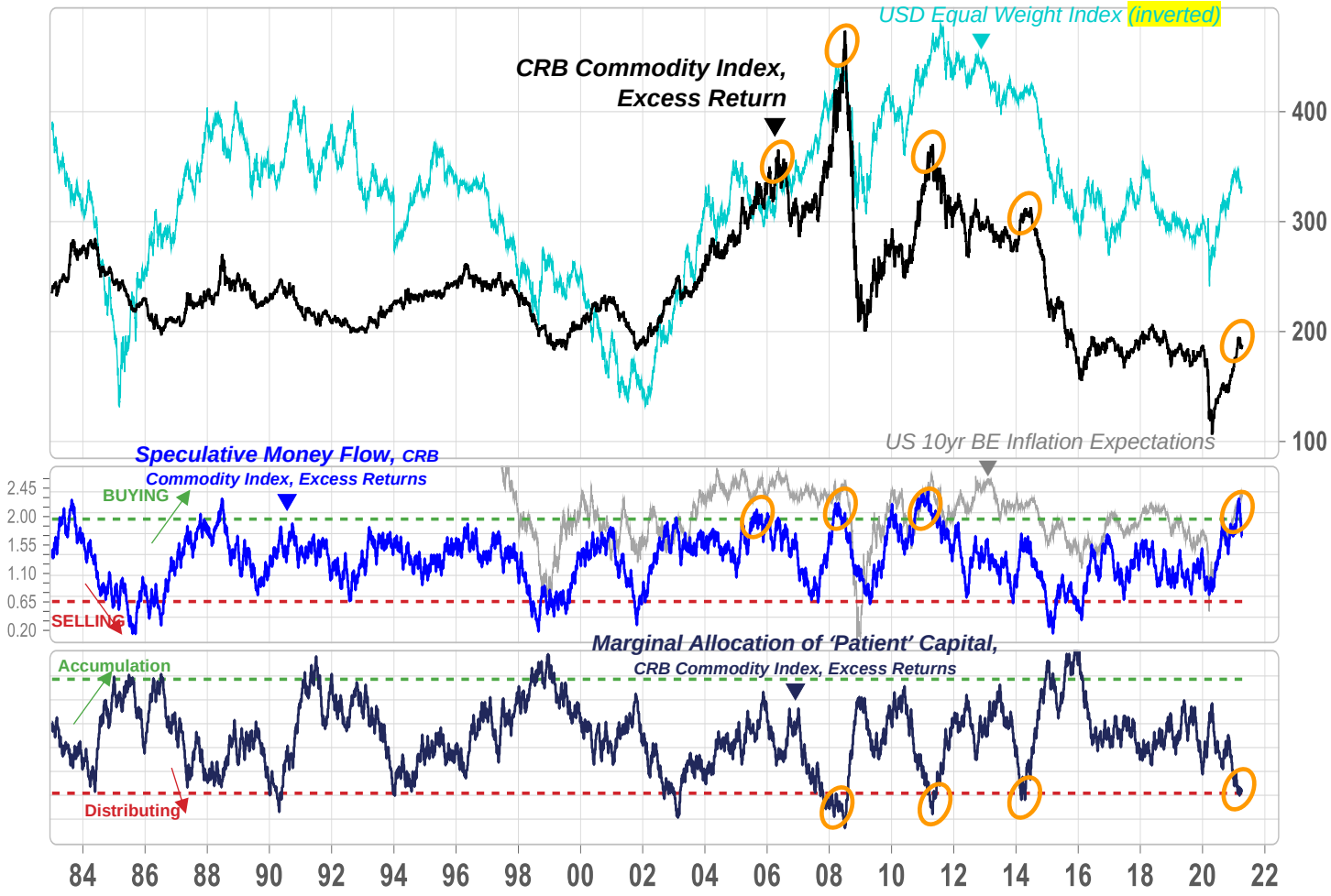
The concerns about inflation both in the USA & around the world are at an extreme, as evidenced by the stampede of investors into 'inflation sensitive' portfolio exposures over the last 12 months…



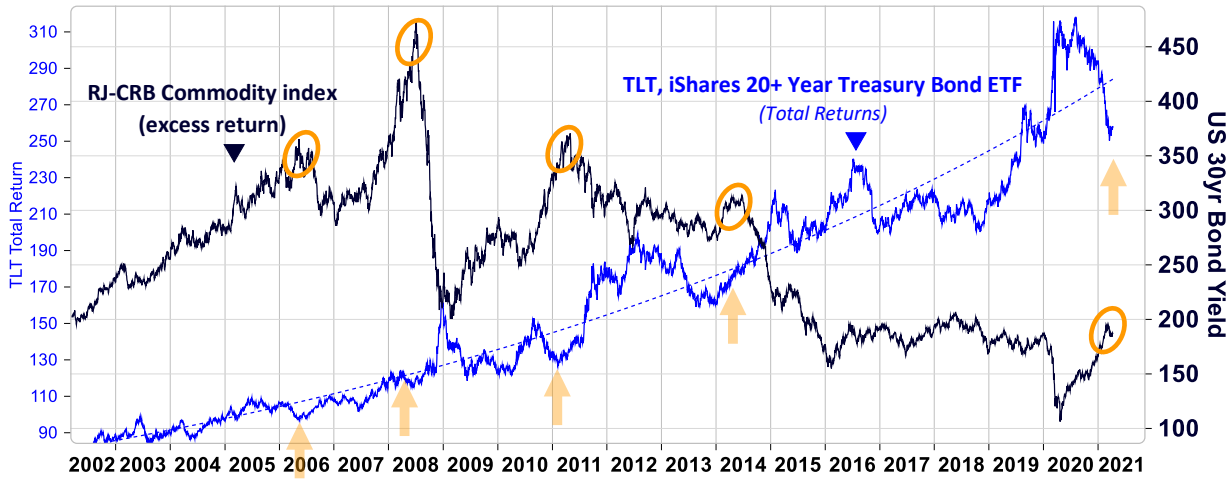
Yet most of the concerns about short/medium-term inflation are poorly founded (as explained extensively in our *PCS 027* and more recent PCS Reports, such as PCS 056).

For example, the chart on the next page effectively summarises much of what we're seeing – with the picture suggesting that inflation expectations are likely peaking presently (with CPI rates of change peaking soon after).

(See chart at the top of previous page for the correlation between Global Commodity prices and the US CPI & Breakeven inflation expectations.)



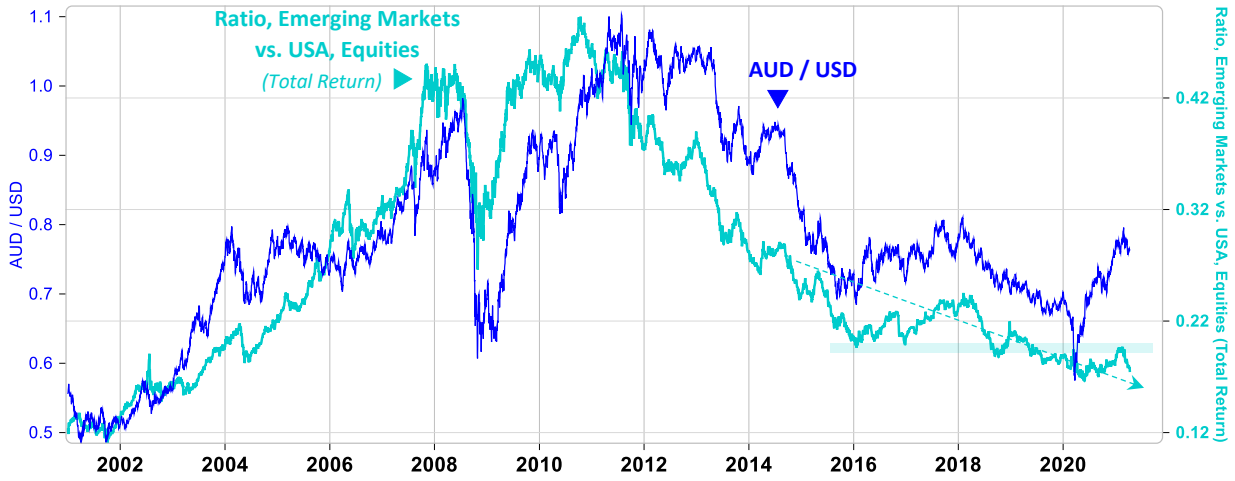
With global growth and inflation peaking presently, our strategic holdings of longer-duration bonds in our Portfolios are likely to do very well in the seasons to come, rewarding the patience we've maintained through the tactical pull-back in prices amidst the broader strategic bull-market in bonds (that is still intact).

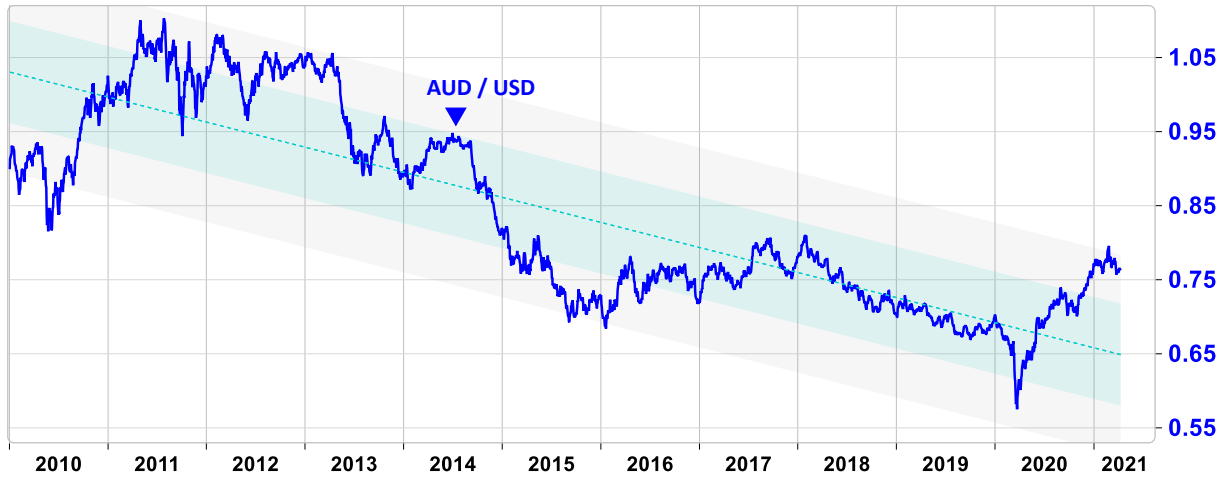


▶ The Australian & US Dollars:

Obviously the setups explained previously are generally bullish for the USD, and bearish for the AUD.

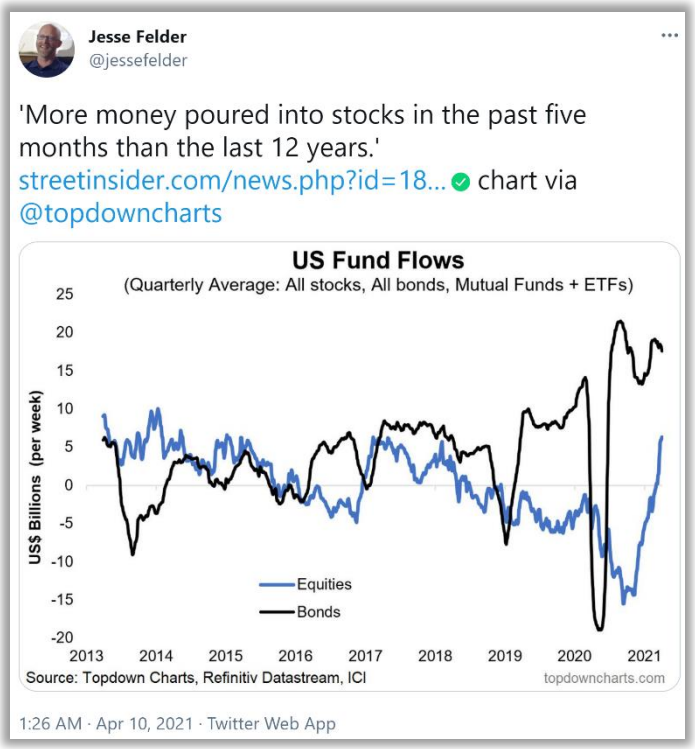
The majority of our frameworks suggest the multi-year strategic bear market in the AUD is still intact… summarised by the following two overly simplistic perspectives:



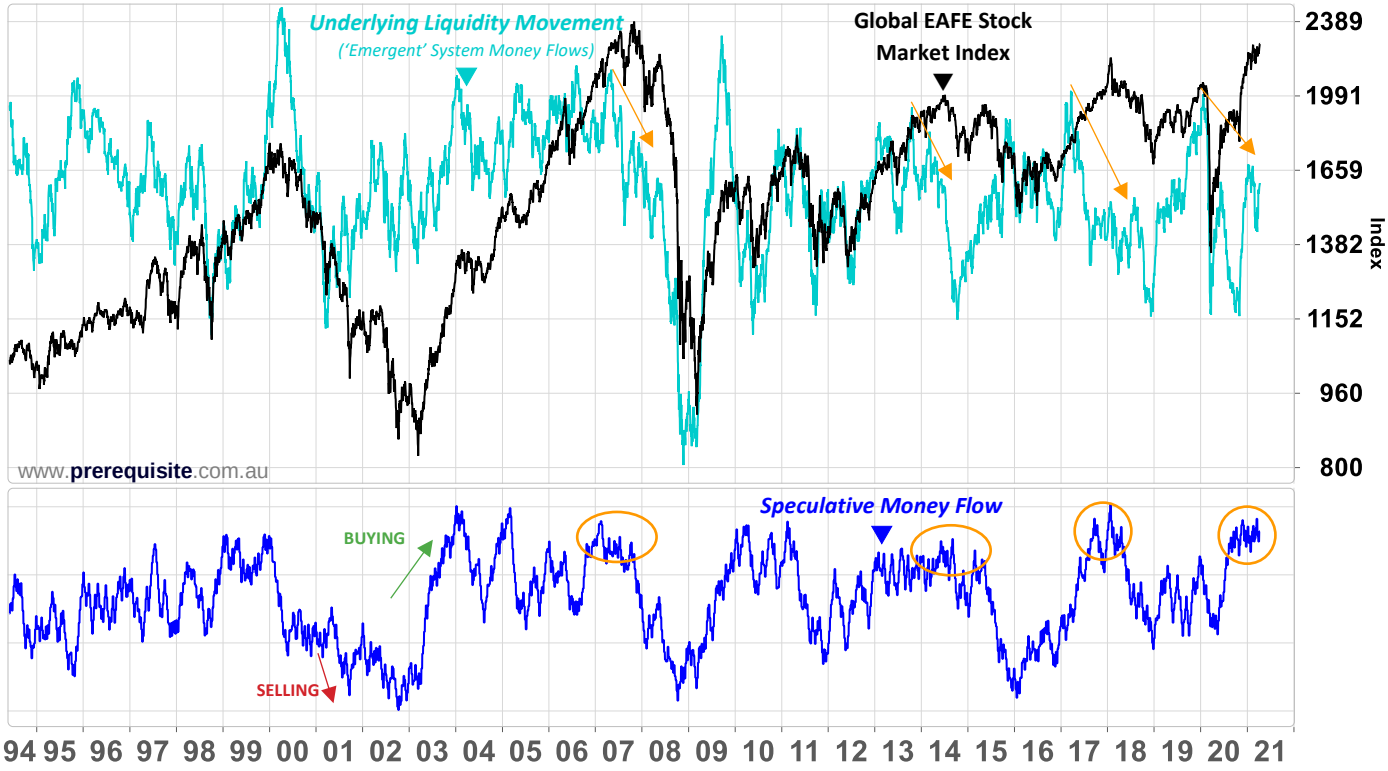


▶ Global Risk Assets:

Somewhat in keeping with the theme of the abundant explosion of public debt & money 'creation' (sort of) over the last 12 months, we found the following intriguing *(see Tweet to the right)*…



Updating our own measures of liquidity & flows, we can see the resurgence being almost entirely Speculative in nature, with underlying liquidity not confirming the new highs in the sharemarket. *(Please refer to our Q3 2020 Quarterly Letter for more information on our underlying liquidity measures.)*



This is an interesting setup given that we have global growth conditions appearing to be peaking presently. It is important to note, however, that we view US Equities as being likely to be far more resilient than non-US equities in the world (for reasons explained in PCS Reports over the last several years).

▶ PCM Portfolios & Broader Economic Issues:

Although the multi-year strategic backdrop of how the world is unfolding has changed little (in terms of the broader system structure unfolding over the last 10-20 years), ***it has been surprising to see the magnitude of the animal spirits that have risen over the last 12 months*** – with many markets rising in a Speculative bonanza, some with substance underpinning their moves, but many without. The reflationary growth pricing structures in global capital markets progressed much further than we would have anticipated, and we've had to be content with maintaining our positions in USD assets and bonds despite the counter-swing, but the way conditions are unfolding we believe we will be well-rewarded for our patience.

It has been staggering to see the willingness of the financial system to leverage itself further, storing for itself even greater issues as the dominos continue to fall towards a more challenging few years ahead as suggested by a raft of leading indicators & forward-looking market frameworks (see *PCS 056 Report*).

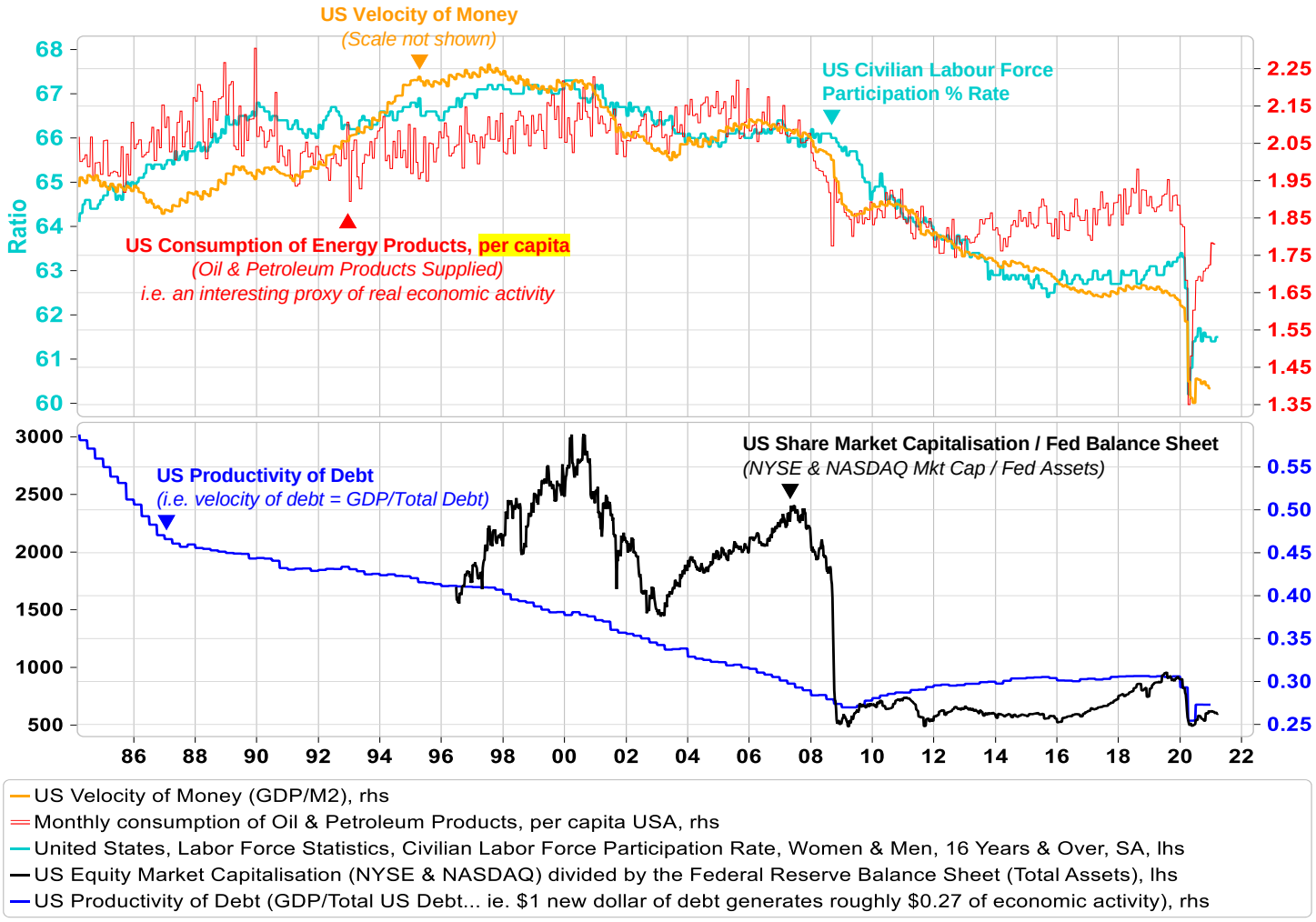
"Price is what you pay, value is what you get."

…Warren Buffet

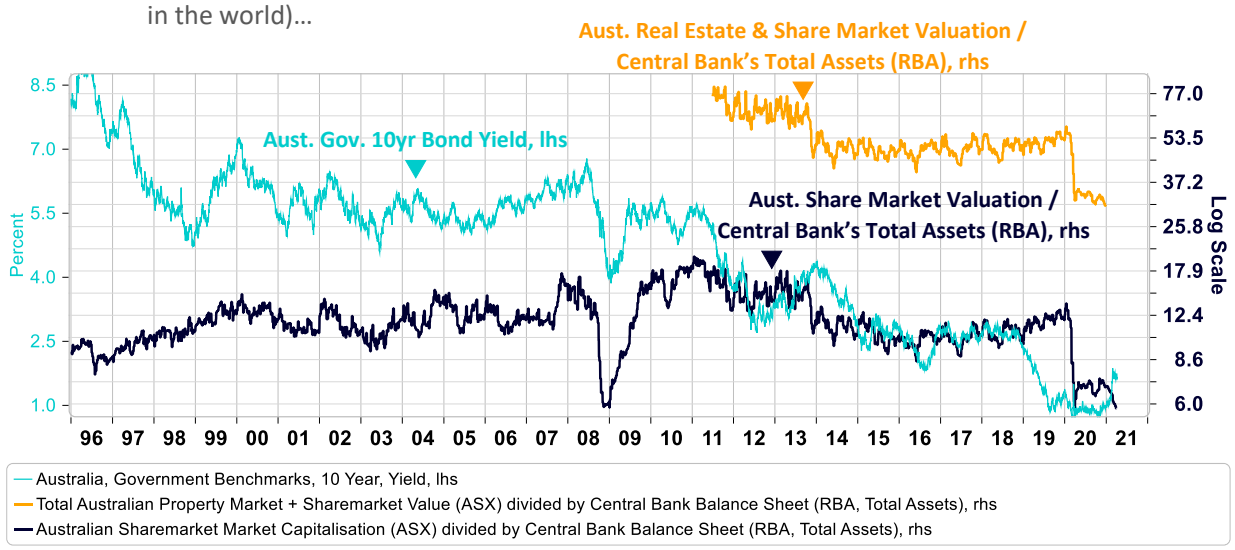
The price of money is effectively zero. The price of leverage seems to be approaching zero. The flow of credit however, is increasingly dependent upon how politically connected you are – all others must post meaningful collateral. The value the system is getting for all of this extra incentivised debt is likely to also be zero (negative actually). There is an old adage that when you buy cheap, you inevitably have to pay twice. Taking on cheap leverage, within a reckless propensity to assume risk exposures amidst unsustainable dynamics, rarely ends well.

For decades now our policy makers have been deliberately hindering or disengaging market mechanisms. Now that they've got to the point of sustaining the cost of capital near or below zero, and creating illusory capital through various central bank machinations, much of the global system is becoming increasingly under-productive and unsustainable absent further interventions – with such a backdrop, deteriorating pricing power (outside of supply shocks/squeezes) and falling returns on capital is likely to be the norm – such is a disinflationary/deflationary biased dynamic overall. But the day will come when confidence is more meaningfully lost in the public sector and the currencies issued by it, at that point the USA in particular will become highly inflationary. Until then, the remaining stock of higher quality productive capital will naturally acquire higher and higher valuation multiples as its relative scarcity becomes more pronounced, but whilst illusory capital is created and leverage supported by central bank activities, much 'lesser quality' unproductive capital structures will be maintained and bid up alongside the good productive assets. Caveat emptor.

At risk of getting a little too complicated for this type of Letter, when you deflate the market valuation of the entire US share market by the Central Bank's balance sheet, you see that **the deflated value of the share market has basically gone nowhere (see bottom panel of chart over page). The deterioration of real economic activity, real labour market conditions, and the falling productivity of both money & debt in the USA are all related.** The larger the policy (fiscal & monetary) footprint in the USA, the more sluggish real economic activity will ultimately become. The only way this will end is either significant civil unrest or collapsing confidence in the currency (could take a while yet) or both. It is unlikely the 'powers that be' in the US Government will change their trajectory anytime soon, we are paying the price for decades of moral compromise that has eroded the integrity of the legal system & market-mechanisms.



Realistically, at minimum, we should also include the market capitalisation of real estate and some other assets in the USA in the bottom panel of the above chart (where we redenominate by the Fed's balance sheet). For Australia it looks like this (it's a similar picture for most countries in the world)…



This all amounts to a deterioration in the quality of economic activity which ultimately causes living standards to deteriorate and the overall debt burdens & resource misallocations to become greater. If carried to its logical/likely conclusion, the currency starts to devalue drastically past a point (in the short to medium terms, AUD is at greater risk than USD, but as we move into medium to long terms, the USD is at greater risk).

Central Banks (& Governments) are reactive, any sign of instability causes them to attempt to fill the hole or stop the pain with 'liquidity' & forced fiscal spending, but this is illusory, only an increasing abundance of 'useful' goods and services within an economic system will cause living standards to rise. The only way to ensure that such production of an increasing abundance of 'useful' goods and services can be *maintained on a sustainable basis*, is to let market mechanisms work (assuming they're founded upon 'just' and efficient legal systems) to properly allocate resources and balance supply with demand in a complex and endlessly changing world. Government & Central Bank Policy directly seeks to suspend such market mechanisms creating a negative feedback loop where any form of economic instability causes governments to act to fill the void short-term, but in so doing they are increasing the malady long term, ensuring that their 'solutions' are only temporary because system instability increases (guaranteeing a bigger problem next time).

It is also worth noting, that in the Australian example above (see chart at the bottom of the previous page) we included the Australian Government 10yr Bond Yield. When economic activity deteriorates, and the general rate of return on capital within a system deteriorates, so to do the yields deteriorate to reflect the lower rate of return available in the economy and also a generally tighter financial environment (lower yields are required to induce further demand for credit generally, but this is not a stable relationship).

"...the interest on money is regulated in the long run by the profit on capital, which in its turn is determined by the productivity and relative abundance of real capital, or, in the terms of modern political economy, by its marginal productivity.
"In good times, when trade is brisk, the rate of profit is high, and, what is of great consequence, is generally expected to remain high; in periods of depression it is low, and expected to remain low. The rate of interest on money follows, no doubt, the same course…"

...Knut Wicksell (1851-1926)

"Low interest rates are generally a sign that money has been tight, as in Japan; high interest rates, that money has been easy.
"After the U.S. experience during the Great Depression, and after inflation and rising interest rates in the 1970s and disinflation and falling interest rates in the 1980s, I thought the fallacy of identifying tight money with high interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die."

...Milton Friedman (1912-2006)

Within this sort of environment, wherein the economic system although appearing okay on the surface, is becoming increasingly fragile and problematic beneath the surface, a resilient/defensive approach to Portfolio Management is necessary. In choosing to sit through the reflationary growth counter swing over the last 12 months (albeit we did not foresee the magnitude of this counter swing which has caused some discomfort to say the least), we are comfortable with the unfolding data that we will be well rewarded for our patience. We are increasingly moving into environments wherein caution will be necessary, as the economic house that has been built has poor foundations, with inferior materials & methods used in its construction – its ability to endure is compromised.

"I know what is to come by the principle on which it is built."

…Howard Roark in "The Fountainhead" (1949)

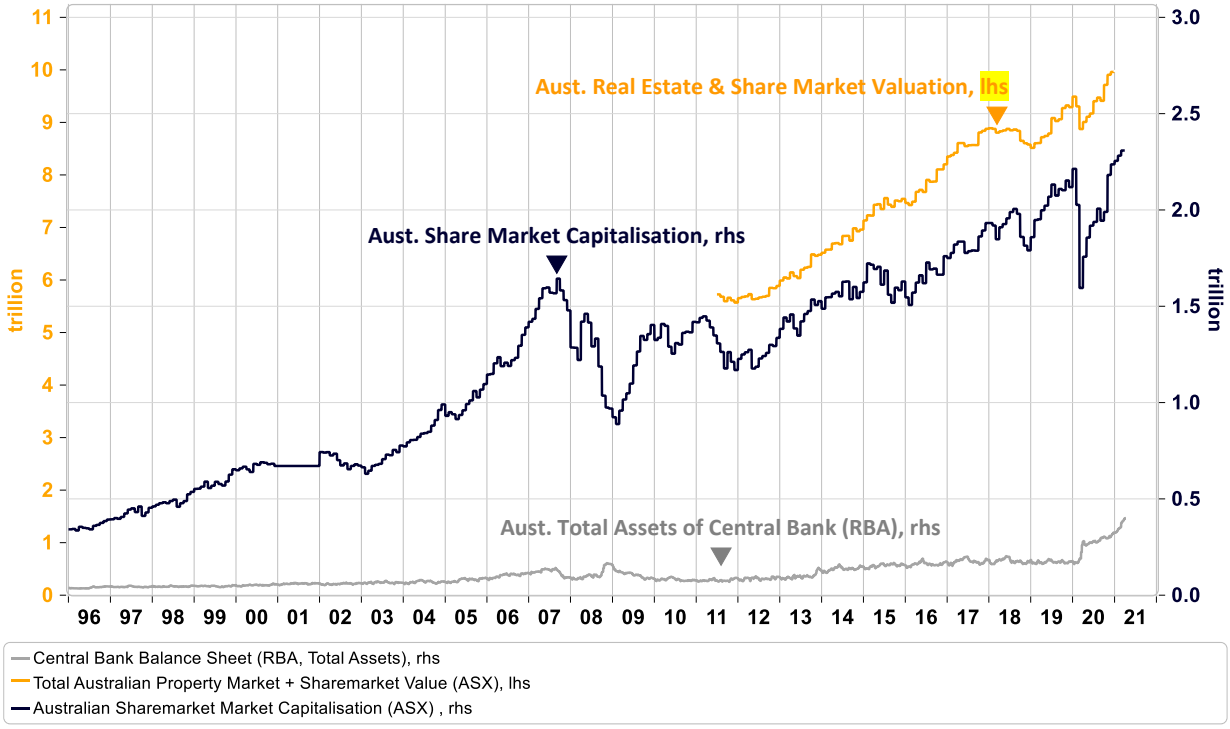
We hope this has been a helpful Letter. As always, please feel free to contact us should you have any questions about your portfolios or the conditions unfolding in the world.

Kind regards,

Daniel, Darren & Andrew

▶ Appendix:

The totals for Australia are shown here (i.e. without being deflated by the Central Bank's balance sheet as shown at the bottom of page 9) – for reference purposes, Australia's GDP is circa AUD $2 trillion p.a. in 2020 (about $1.5t in 2011):



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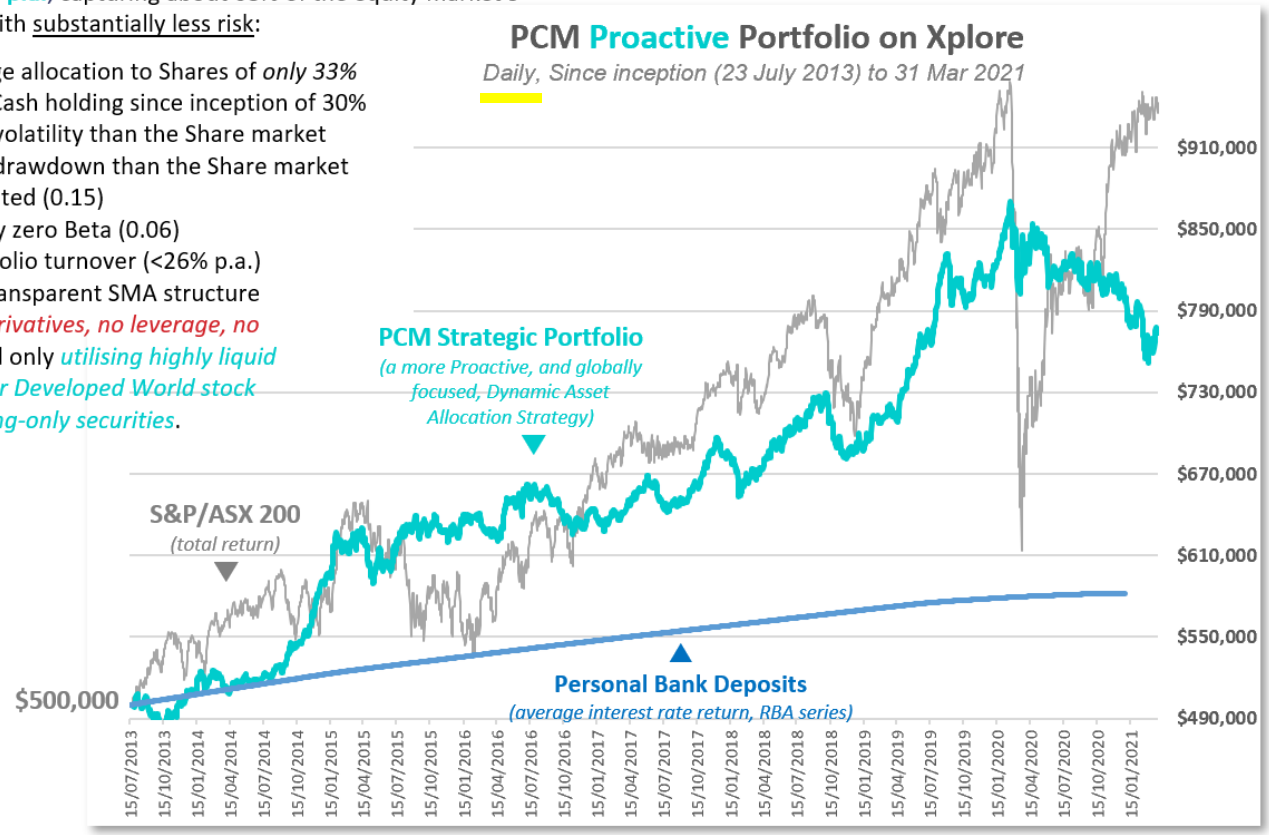
Prerequisite CAPITAL

Over the 7.7 year history of our portfolio, **the Australian Share market** (S&P/ASX 200) has delivered a total return of about **8.4% p.a.**

Our **more proactively managed, Diversified, Dynamic Asset Allocation Portfolio** over the same timeframe has delivered a total return net of fees of about **5.7% p.a.**, capturing about 68% of the equity market's total return, but with substantially less risk:

- ✓ An average allocation to Shares of *only 33%*
- ✓ Average Cash holding since inception of 30%
- ✓ 57% less volatility than the Share market
- ✓ 66% less drawdown than the Share market
- ✓ Uncorrelated (0.15)
- ✓ Effectively zero Beta (0.06)
- ✓ Low portfolio turnover (<26% p.a.)
- ✓ Totally Transparent SMA structure

Whilst using *no derivatives, no leverage, no short positions* and only *utilising highly liquid ASX, NYSE or Major Developed World stock exchange listed long-only securities*.



Over the 7.7 year history of our portfolio, **the Australian Share market** (S&P/ASX 200) has delivered a total return of about **8.4 % p.a.**

Our **Conservatively Managed, Diversified, Dynamic Asset Allocation Portfolio** over the same timeframe has delivered a total return net of fees of about **4.2% p.a.**, capturing about 50% of the equity market's total return, but with substantially less risk:

- ✓ An average allocation to Shares of *only 25%*
- ✓ Average Cash holding since inception of 42%
- ✓ 70% less volatility than the Share market
- ✓ 82% less drawdown than the Share market
- ✓ Uncorrelated (0.36)
- ✓ Effectively zero Beta (0.11)
- ✓ Low portfolio turnover (<27% p.a.)
- ✓ Totally Transparent SMA structure

Whilst using *no derivatives, no leverage, no short positions* and only *utilising highly liquid ASX, NYSE or Major Developed World stock exchange listed long-only securities*.