DECEMBER 2020

JORDI'S JOURNAL

Timely thoughts & musings on the financial markets

WEISS

2020: THE YEAR OF SPEED CHESS & THE BIRTH OF BITCOIN AS AN ASSET

By Jordi Visser, President & CIO

Nothing in life is quite as important as you think it is while you're thinking about it.
-Daniel Kahneman

It has been almost two years since I was able to complete a paper. I enjoy the therapeutic creativity involved with articulating my thoughts on the mystery of the markets. I am reminded by a period like 2020 that sometimes the game moves too fast to allow you the time necessary to go from brain to paper. Hopefully this explains why I have done multiple webinars in 2020. Some environments reward and facilitate contemplative strategy: chess. 2020 has moved too fast for this: speed-chess. This market has forced investors to respond quickly, trust our gut instincts, and most importantly, remember that markets are driven by human behavioral decision making. They are not driven by a mathematical formula which means at times valuations can change dramatically and seem irrational. Violent, quick valuation shifts are one of the reasons many people are skeptical of investing in the stock market at all, requiring an endless pool of "greater fools" willing to pay even higher prices. This creates a fear that you may buy something just before it falls, which prevents you from making the decision. Never in my career do I remember

Jordi Visser
President & CIO
CIO@gweiss.com
+1 212-415-7123

The root problem with conventional currency is all the trust that's required to make it work. The central bank must be trusted not to debase the currency, but the history of fiat currencies is full of breaches of that trust. -Satoshi Nakamoto the word "irrational" or the phrase "this market makes no sense" used more than it has been in 2020. Covid-19 altered the landscape of the world and created a foundation of persistent uncertainty, which has driven human emotions – including disbelief - to extreme levels.

While writing a paper was difficult, trying to come up with a steady valuation mechanism for assets through this uncertainty was also challenging. The world shut down in a way not seen before, leading to US GDP down over 30% in 2Q 2020. Yet despite that collapse in economic output, the stock market rallied 20% in the same quarter and disposable personal income rose by $1.53 trillion dollars (or 42%) while the jobless rate reached almost 15%.This increase in income combined with the dramatic reduction in expenses drove the personal savings rate, as a percent of disposable income, up to record levels during the year. Personal savings rates are currently at the highest level they have been at in over 40 years. We experienced a pandemic forcing a new way of living while the government quickly deployed tools learned and created during the Great Financial Crisis in 2008. It was difficult to put these cross currents together and solidify a game plan. That's why days felt like weeks, weeks like months and the news was useless. Markets always act as a discounting mechanism of the future. 2020 was the clearest evidence of this reality. Even now, as the second wave continues to drive cases well above the highest numbers recorded earlier this year, markets continue to focus on the future because we have vaccines being pushed out with a speed never seen before.

Does this type of trained enhanced perception come from the same place as those wild moments in life when time slows down in the middle of a car crash, or, in my case, when my hand shattered in the ring? The answer is yes and no. The similarity is that a life-or-death scenario kicks the human mind into a very narrow area of focus. Time feels slowed down because we instinctively zero in on a tiny amount of critical information that our processor can then break down as if it is in a huge font. The trained version of this state of mind shares that tiny area of conscious focus. The difference is that, in our disciplines of choice, we cultivate this experience buy converting all the other surrounding information into unconsciously integrated data instead of ignoring it.
– The Art of Learning: An Inner Journey to Optimal Performance by Josh Waitzkin

In 2016, I wrote a paper titled, The Art of Unlearning. The title was in reference to one of the most influential books in my life, The Art of Learning: An Inner Journey to Optimal Performance (2008) by Josh Waitzkin. Josh Waitzkin is the former chess prodigy best known from the movie “Searching for Bobby Fischer”. In the book, he takes us through his personal learning process journey which helped him master chess and eventually succeed in martial arts. This quote is from Chapter 13: Slowing Down Time. It aptly describes the difficulty investors have faced since March in choosing a focus. The speed and magnitude of the daily news highlighting uncertainty around life and death, jobs, the global economy and everyone’s personal financial situation tested our mental resolve. It was alike to living or watching “Groundhog Day” while trapped in your home. It is not a surprise that even the strongest minded and educated investors were forced into a narrow area of focus and incorporated the nightly news into the equation of valuations for future assets. In fact, education and historical training may have been liabilities as the search for an historical analogy or mental model to explain present circumstance proved too rigid an approach to these markets. Much like the word “irrational,” consider how many times you heard the word “unprecedented” in 2020.

In the throes of intense fear, we suddenly find ourselves operating in a different and unexpected way. The psychological tools that we normally use to navigate the world—reasoning and planning before we act—get progressively shut down. In the grip of the brain’s subconscious fear centers, we behave in ways that to our rational mind seem nonsensical or worse. We might respond automatically, with preprogrammed motor routines, or simply melt down. We lose control. In this unfamiliar realm, it can seem like we’re in the grip of utter chaos. But although the preconscious fear centers of the brain are not capable of deliberation and reason, they do have their own logic, a simplified suite of responses keyed to the nature of the threat at hand. There is a structure to panic.
-Extreme Fear by Jeff Wise

To use an analogy related to Josh Waitzkin, when volatility is low and market corrections are limited in price and time, it allows you to patiently think through each decision like a game of chess. Most people were trained for this environment that, in my opinion, no longer exists. In Howard Marks' book, Mastering the Market Cycle, he describes a philosophy built around studying past cycles to understand the origin of those cycles and prepare for the next one. This cycle did not resemble the timing of past cycles. 2020 was much more like a year of speed chess. For many of us, that is difficult. A lightning fast year of speed chess with unprecedented conditions and extreme fear, left many individuals, corporations, governments and central banks in a state of confusion and responding to threat with emotion.

The fast and powerful response of governments and central banks led to what some are calling a new economic regime of Modern Monetary Theory. I have no interest in joining the debate on whether this is a coherent theory or whether it will succeed. Debating individual views and beliefs on politics, religion, or economic philosophies feels like a waste of time in my opinion. However, it is worth the time to think about the decisions made in 2020 and reflect on how these major inflection points will potentially impact the global markets and companies. This is an interesting endeavor and I will summarize my "keep it simple, stupid" view on the changes in monetary rules as a result of Covid-19: Governments are now comfortable creating money out of thin-air to fund expenditures without worrying about debt to GDP or inflation.

In other words, money isn't a material reality – it is a psychological construct. It works by converting matter into mind. But why does it succeed? Why should anyone be willing to exchange a fertile rice paddy for a handful of useless cowry shells? Why are you willing to flip hamburgers, sell health insurance or babysit three obnoxious brats when all you get for your exertions is a few pieces of coloured paper? People are willing to do such things when they trust the figments of their collective imagination. Trust is the raw material from which all types of money are minted. When a wealthy farmer sold his possessions for a sack of cowry shells and travelled with them to another province, he trusted that upon reaching his destination other people would be willing to sell him rice, houses and fields in exchange for the shells. Money is accordingly a system of mutual trust, and not just any system of mutual trust: money is the most universal and most efficient system of mutual trust ever devised. What created this trust was a very complex and long-term network of political, social and economic relations. Why do I believe in the cowry shell or gold coin or dollar bill? Because my neighbours believe in them. And my neighbours

believe in them because I believe in them. And we all believe in them because our king believes in them and demands them in taxes, and because our priest believes in them and demands them in tithes. Take a dollar bill and look at it carefully. You will see that it is simply a colourful piece of paper with the signature of the US secretary of the treasury on one side, and the slogan 'In God We Trust' on the other. We accept the dollar in payment, because we trust in God and the US secretary of the treasury. The crucial role of trust explains why our financial systems are so tightly bound up with our political, social and ideological systems, why financial crises are often triggered by political developments, and why the stock market can rise or fall depending on the way traders feel on a particular morning.
-Sapiens by Yuval Harari

Maybe investors will eventually penalize governments for creating money out of thin air. Debt to GDP ratio has been rising since World War II. Yields have been declining my entire career and now negative yielding debt is at all-time highs near $18 trillion dollars. Given these facts, I am going to continue with the argument I have made for years: Bonds will not exist in a future world of 3D printers, artificial intelligence, nanotechnology, quantum computing, cryptocurrencies and the blockchain. Until we get there, governments will continue trying to inflate their way out of existing debt. In The Art of Unlearning, I made the argument that it was necessary to unlearn what we knew about economic growth (GDP) and focus on the growth in progress from innovation. Post 2020, I think it is now even more necessary to unlearn what we know about debt and to think about the concept of unlimited money flowing into specific areas of the economy. We must consider what that means for investors. After the great financial crisis, this idea was briefly in focus because of "QE Infinity". Post Covid-19, we need to embrace it indefinitely.

As Yuval Harari says, "Money is probably the most successful story ever told. It has no objective value... but then you have these master storytellers: the big bankers, the finance ministers... and they come, and they tell a very convincing story." Embracing unlimited money throws into question monetary frameworks, taxation, capitalism, etc., and will lead economically-literate academics tearing up this paper. However, I believe the line between being provocative and thought provoking is similar to the line between genius and crazy. These are the reactions of chess players without recognition that the game has changed; speed-chess players can embrace and react to the perceived-to-be-irrational and incorporate the notion that perception is reality. In a world of unlimited money, it is easy to explain why a company based on DASHing from door to door during a temporary pandemic could be valued at $60bn dollars or larger than 75% of the companies in the S&P 500. In a world of unlimited money, you can also witness a fall from a similar valuation. WeWork went to near zero in two months.In a world of unlimited money, you can have the range on the SPX P/E be 20 or 30 in a matter of weeks. Let's work with unlimited money as a concept rather than debate it and start to think about the investment opportunities and implications that exist. Unlearning is much more difficult for people than learning something new.

The most important thing to remember is that inflation is not an act of God, that inflation is not a catastrophe of the elements or a disease that comes like the plague. Inflation is a policy.
– Ludwig von Mises

Unlimited money is being provided by elected government officials. Central Bankers are not elected officials and they too are targeting higher inflation. History and economic books want students to focus on currency debasement leading to inflation. The currency debasement story points to the dollar given the 20% broad money increase in 2020. Over the last two years, the two largest global economies have entered a trade war which is breaking down global supply chains and increasing input costs for businesses. Over the last 10 years, investors have been forced into winners from the stock market capitalization race whose underlying assets and business models have been driven by disinflationary trends. This, in turn, has left investors underweight inflationary views and assets in their allocations. Although many strategists and trading oriented investors currently seem to be ready for "reflation" coming out of the crisis, I am surprised that more people are not worried about potential inflation staying higher in the future years. Even if activity slows down due to a worsening Covid-19 outlook or the employment situation takes longer than expected to normalize, the printing press is still ready to fire if deflation fears rise. As a Financial Times article said after the initial printing surge “Giving elected representatives the keys to the printing press is the equivalent of giving a gambling addict the keys to the casino.”

The simplest explanation for why people seem averse to the thought of reflation transitioning to inflation is because they remember a similar story after 2008 QE and inflation never came. Also, much of the doubt on inflation is due to how it is calculated and what the actual definition of high inflation is these days. Another reason is that like the stock market, there will always be some assets that decline in price while others rise - so it matters what you are talking about and how it is weighted. As an example, in 2020 as of December 20th, the SPX is up 15% YTD and yet 200 members of the S&P 500 index were down on the year and over 130 members are down at least 10%. My focus for 2021 and beyond is on two specific areas of inflation risk. These are areas where investors are measured or benchmarked to inflation and on which they would be forced to focus if inflation persists. The first risk is commodity inflation following a 10-year period of deflation. The second risk is a continuation of printing leading to a phenomenon that has occurred since the great financial crisis ended and has forced asset allocation shifts: fiat asset inflation. What makes this a time for the potential rise of inflation so important? It comes at a time where we already have negative real rates around the globe and zero yielding cash.

For commodities, I am going to highlight that many long-term retirement allocators are exposed to headline CPI moving at a time when rates are pegged near zero. I believe we will see further declines in negative real rates in 2021 as the historical relationship between long term yields and inflation breaks down due to unlimited money keeping nominal yields low with headline inflation moving higher on the back of a new cyclical bull market in commodities. As Jeff Currie, Goldman Sachs’ Global Head of Commodities Research, said:

Every single commodity market with the exception of wheat is in a deficit today.....we think the market's going to be in substantial deficit throughout the end of next year and beyond into 2022... You have structural under-investment in supply -- we call it the revenge of the old economy.

DECEMBER 2020

JORDI'S JOURNAL

Timely thoughts & musings on the financial markets

WEISS

It's not just oil, it's metals, mining, the entire old economy has shortages in investment, such broad-based deficits are usually only seen late in the business cycle, underscoring the unique environment markets are in. Given that inventories are drawing this early in the cycle, we see a structural bull market for commodities emerging in 2021.

Whether you agree or not on commodity inflation, it is important to realize that after years of "structural underinvestment in supply" you are not only fighting globally coordinated unlimited money, but also a new massive structural demand for many commodities as part of the globally coordinated move to fight climate change over the next decade. Because of the prevalence of the Environmental Social Governance movement and the poor performance of commodities over the last decade, the asset class has been left for dead which leaves most investors exposed to a secular move higher. The bottlenecks and further under-investment created by trade conflicts and Covid-19 only add to this. Combining these changes with an environment of a weaker dollar and zero rates, investors should – at a minimum - be thinking about hedging headline inflation.Given the lack of liquidity in the space and limited inventories, a large competition between actual end-demand and hedging alone could move prices faster than people anticipate. One thing we have learned this year, the game moves faster and waiting for the exact right time can be dangerous.

The root problem with conventional currency is all the trust that's required to make it work. The central bank must be trusted not to debase the currency, but the history of fiat currencies is full of breaches of that trust.
-Satoshi Nakamoto

When highlighting asset inflation as a risk, investors seem complacent, as it seems to be a positive. It is something central bankers have been using to stabilize the economy since the great financial crisis as they try and execute a "beautiful deleveraging," as Ray Dalio coined it, with a balance between austerity, money printing and debt restructuring. This time though, austerity is nowhere to be found and US broad money supply has grown to levels we have never seen before. The rise of the austere Tea Party following the great financial crisis has been replaced by at least a tacit tolerance for MMT until we adhere to an inflation mentality. Not surprisingly, on the back of the US printing, the dollar has weakened, peaking the same day the SPX bottomed and asset inflation began. The asset that bottomed first and has now appreciated nearly 400% since March 16th is Bitcoin. Yuval Harari's earlier thoughts echo those of bitcoin founder, Satoshi Nakamoto, that unlimited money seems to have people realizing the unprecedented nature of the global currency debasement attempt. Everyone likes to talk about the relative foreign exchange rates in the world versus the dollar but even in a world where almost every currency is rallying against the dollar, the reality is all currencies have fallen versus bitcoin. Across the globe, investors of all types are questioning trust in the story of money and the fiat system.

#Bitcoin days are numbered. It seems like just a matter of time before it suffers the same fate as online gambling.
-Michael Saylor Tweet from 2013

Big Tech will need to integrate their products with #Bitcoin to stay competitive. All companies will need to convert their treasuries to #BTC to stay solvent.
-Michael Saylor Tweet from December 18, 2020

#Bitcoin is an engineered monetary network. The first of its kind. A paradigm shift in the history of money. Everyone needs it, no one can stop it, few understand it. We are still early.
-Michael Saylor Tweet from December 19, 2020

Until this year, I had not focused on bitcoin as mature enough for asset allocation, but now I believe it will be the major story for the coming years as all investors are forced to think about hedging both currency debasement and fiat asset inflation. The quotes above are from the CEO of Microstrategy, Michael Saylor who went through a similar evolution. I recommend listening to a podcast of his story of why Microstrategy decided to make a large asset allocation decision moving $425mm dollars of cash into bitcoin and the work involved in convincing the board of a public company. His fear of sitting on zero yielding cash in a government led fiat asset inflation environment driving irrational valuations is something everyone should be worried about. Combining this cash debasing fear with the increasing technological relevance of this monetary network all made the argument easy for one of the longest standing CEOs for a technology company.

As investors, we are all exposed to fiat asset inflation. All of us have some benchmark or hurdle to beat. As allocators, we choose assets to meet that hurdle and with rates at zero and central banks trying to force some inflation, we are forced out on the fiat asset risk curve to choose the right asset allocation mix to beat the benchmark. Without bonds, where do we find something liquid, trading 24/7, that benefits from asset inflation and in which you can turn gains in stocks, real estate or art into a currency which is not being debased through printing? For Michael Saylor, he had to make a decision on how to compete with his benchmark and cash offered very few liquid alternatives that were out on the risk curve.

While Microstrategy is a small company, Square also recently bought $50mm dollars of bitcoin. The Square company and Twitter's CEO have called the bitcoin whitepaper "one of the most seminal works of computer science in the last 20-30 years. Bitcoin is like poetry." For tech companies loaded with cash who believe bitcoin will be a part of the payment system in the future, fear of missing out is likely to bring others in each month, even if the size is not as big as Microstrategy. In the insurance industry, MassMutual just announced they have purchased 100mm dollars for its general investment account. Over the next 24 months, I believe all investors and allocators, will be in the same position as these companies; faced to decide how to think about bitcoin as an asset.

It was not only a couple anecdotal purchases by companies flushed with cash that has caught my interest. This year, respected legends from the investment world, Stan Druckenmiller, Paul Tudor Jones, Larry Fink and Scott Minerd all publicly discussed positive views of bitcoin. In August, Fidelity launched its first bitcoin fund. In October, PayPal added a new service allowing users to buy, hold and sell cryptocurrencies. "The shift to digital forms of currencies is inevitable, bringing with it clear advantages in terms of financial inclusion and access; efficiency, speed and resilience of the payments system; and the ability for governments to disburse funds to citizens quickly," said Dan Schulman, president and CEO, PayPal.

Bitcoin is not just growing in the US. This is a global trend and for many this is a hedge against global money printing and deficits that are being forgotten by governments. Across the emerging markets Brazil, Argentina, Mexico, Venezuela, Turkey and Africa, bitcoin also continues to grow with individuals who have suffered from hyperinflation, currency devaluations, and the freezing of bank accounts; viewing it as a hedge against not trusting the governments. When I lived in Brazil in the late 1990s, the black market for currency transactions was something we watched daily for information. Today, Bitcoin offers a much easier and safer place for individuals to transact small amounts of currency and transact across borders. Expat remittances also continue to grow in bitcoin for emerging markets with lower fees and avoidance of growing regulations. According to the World Bank, this is a $96bn dollar market for Latin America alone.

Probably the most important data informing the future relevance of bitcoin is the demographic. In a recent report from Bitflyer, the largest crypto exchange in Japan, 60% of account holders in the US and Europe are in their 20s and 30s, while only 18% are 50 and older. Old prefers gold. It is no surprise that millennials have proven to be very quick adopters; they have grown up in the computer age and feel comfortable with new technology, including digital currencies. Young people are also mobile – their sense of ubiquity powered by smartphones – and want to be unfettered in their decisions, facilitated by virtual money. Moreover, the major demographic benefactor of fiat asset inflation to date has been the baby boomers. There is an ongoing tectonic generational wealth transfer occurring across the globe that will continue for years to come. $60 trillion will shift from boomers to millennials through inheritance, although this pace has been slowed through medical innovation and longevity.Pension funds are managing a lot of that $60 trillion and with it, a needed gold to bitcoin rebalance.

As of this weekend, the total size of Bitcoin is $350bn dollars. I will let you do the "if every global pension fund and insurance company added 0.1% allocation to bitcoin" math and see if it is WAY too small given the interest we have seen this year. As a reminder, Michael Saylor made an asset allocation shift from treasuries to bitcoin.Currently there are $18 trillion dollars of negative yielding debt in the world. For the store of value market, the estimate of the total value of all the gold is around $10 trillion dollars. Some people view bitcoin as similar to a technology growth investment. Given we have seen Tesla's market cap start the year at $75bn dollars and close on Friday December 18th at over $650bn dollars, I do not see why the dominant brand of digital currencies cannot see a similar move, even in a compressed time-frame in this "speed chess" environment. This could easily be an order of magnitude. Bitcoin has survived the test that many assets need to pass after a period of euphoria which ended with a crash at the end of 2017. Bitcoin fought off many other digital currency challengers, fears about security, and government attempts against it. Now it is an emerging store of value to compete with gold. It is an emerging medium of exchange which gold never accomplished. Finally, and most importantly, it has become a hedge against fiat asset inflation and currency debasement. The prior decade may have been bitcoin's gestation period, 2020 was its birth as an institutional asset.

It is a mistake to try to look too far ahead. The chain of destiny can only be grasped one link at a time. – Winston Churchill

You can only connect the dots looking backward – Steve Jobs

2020 will be a year we get asked about by our grandchildren. It has been an abrupt change to our lives emotionally and intellectually. Many of the changes will be structural. This year also affected all of us financially in some way. Everyone reading this paper is exposed to both good and bad fiat asset inflation and currency debasement and now governments around the world are using the tools gathered over the years to experiment in the best story ever told: money. The rules of the game changed in 2020. For 2021, I think what stares us directly in the face is a need to think about a repositioning for a world of unlimited money. Some of it will be centered around a continued strong move in commodities. Given the speed seen this year and unexpected events, I would follow the advice of Winston Churchill and Steve Jobs and think in terms of three months at a time rather than annually. Adapting to a speed chess market requires new tools and shorter reaction, decision-making, and measurement periods. This environment creates opportunities for behavioral alpha. Given the tension between growth or value in a world with extreme valuation volatility, expect to see explosive moves one way followed by sharp retracements the other way. This game of speed chess is much faster than the game based on mathematical valuations and is necessary to be present, self-aware, and ready to change your mind – even in the face of seemingly "irrational."

If there is any one asset that symbolizes this speed chess approach and the volatility of valuations while benefitting from hedging against unlimited money, it is bitcoin. Over the last 30 years, most macro people have worried about when this debt to GDP explosion would lead to a collapse in the bond market. With the deflation of exponential innovation offsetting QE, the introduction to negative yields and finally a global printing bonanza, it seems the fight against the printing press is over. If you can't beat them, join them by finding a hedge against fiat asset inflation that also is driven by exponential innovation. Bitcoin, in my opinion, has become that hedge. I would not spend too much time trying to analyze and think about whether it will become the things mentioned or be the long-term winner as a digital currency; it will be volatile but we are now in the "when," not the "if." Watch for the day this newborn institutional asset turns "one," which I believe will be in 2021, and this will mean a "one" trillion market cap. I am not sure the exact size of an asset class at which it is allocable for everyone, but I think one trillion should suffice.

Happy Holidays and all the best in 2021.