Richard Bernstein Advisors

The Leaders In Pactive® Management

Insights

September 2021

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an investment manager focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

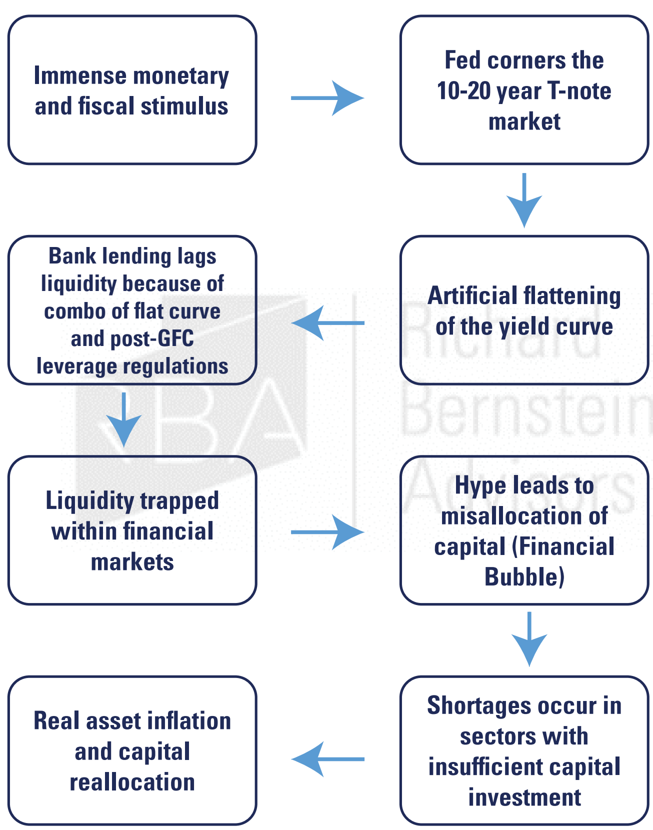
Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

Anatomy of a Bubble

We have become famous (or infamous) regarding our views that there is a bubble in long-duration assets. In a previous report we highlighted the five common characteristics of financial bubbles and how each is currently present within the financial markets ["Bubble? 5 for 5"]. By our reckoning, there should be no doubt there are sizable bubbles inflating.

In this report, we investigate what's causing such widespread bubbles, their potential effects on the overall economy, and the interesting investment opportunities resulting from the bubble's misallocation of capital. The diagram below summarizes the bubble's gestation and the potential investment implications.

Anatomy of a Bubble



CONTACT RBA

Website: RBAdvisors.com

Twitter: @rbadvisors

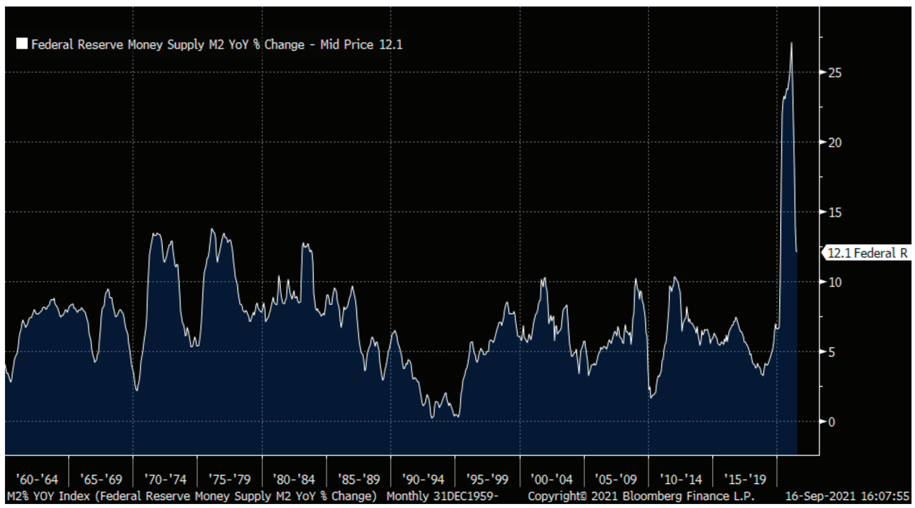
Phone: (212) 692-4088

Immense monetary and fiscal stimulus.

It's well known the Federal Reserve and the government responded to the pandemic with historic levels of stimulus. Some economists have suggested such aggressive policies should remain because of the uncertainty surrounding the future path of the pandemic or of the economy, but there is rarely any certainty about the future economy.

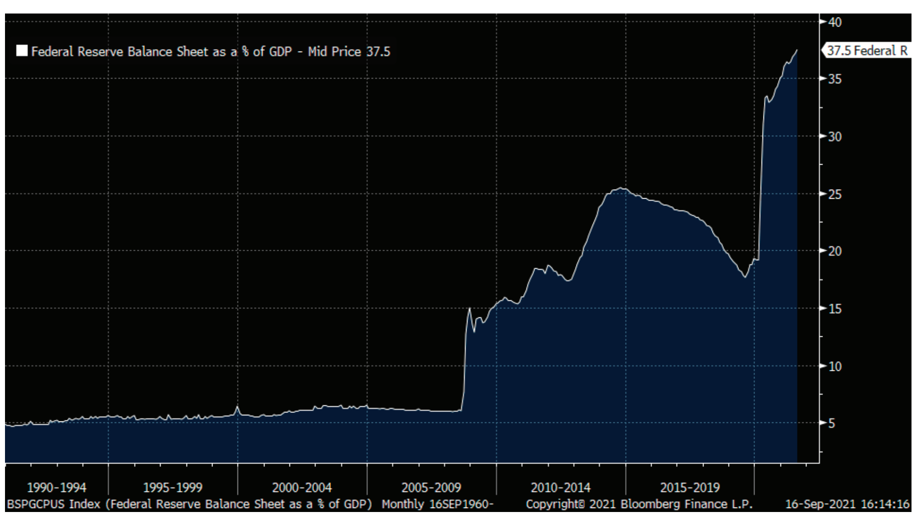
Charts 1, 2, and 3 show the magnitude of the monetary and fiscal stimulus relative to history both in terms of size and longevity. It seems reasonable to suggest the bubble has been inflated by the economy not being able to absorb all the monetary stimulus.

CHART 1:
Money Supply (M2) YoY Percent Change



Source: Bloomberg Finance L.P.

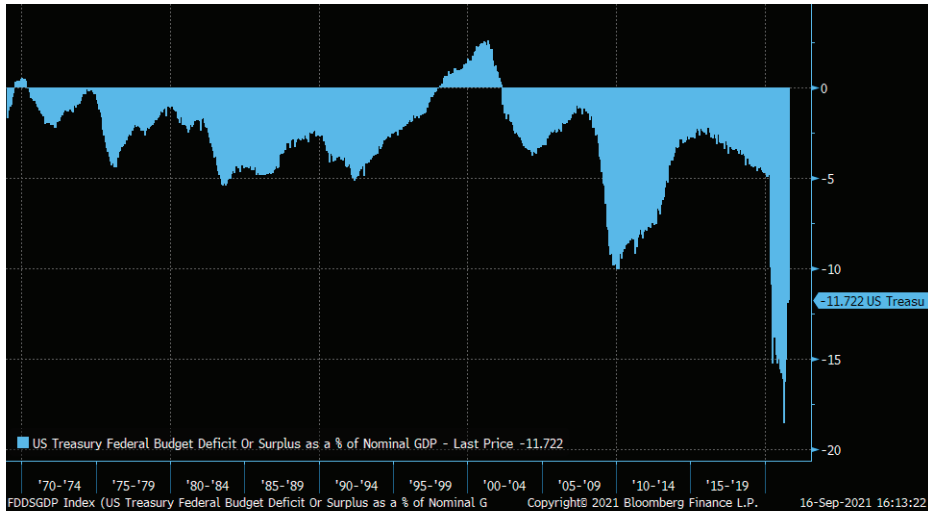
CHART 2:
Federal Reserve Balance Sheet as a Percent of GDP



Source: Bloomberg Finance L.P.

CHART 3:

US Treasury Federal Budget Deficit or Surplus as a Percent of Nominal GDP



Source: Bloomberg Finance L.P.

Fed "corners" the 10–20-year Treasury market

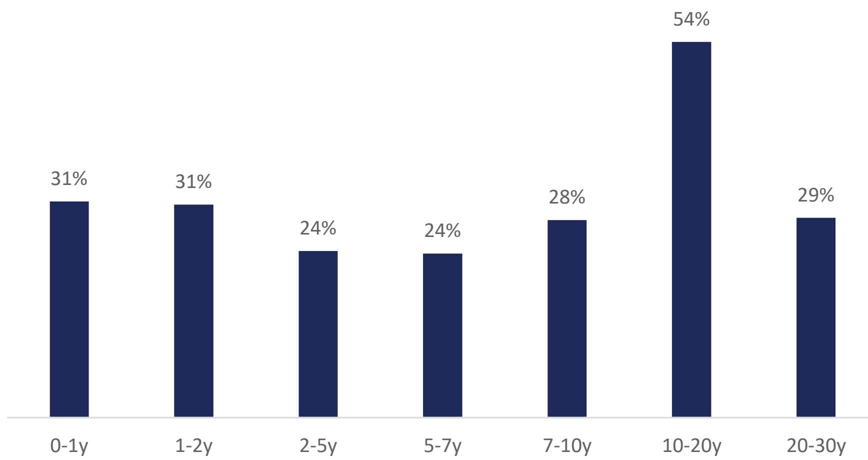
Because short-term interest rates fell to 0% subsequent to the global financial crisis, the Fed chose to inject additional liquidity by purchasing longer-term maturity debt. Typically, the Fed controls the short end of the yield curve by buying and selling short-term T-bills. Their newer strategy of "quantitative easing" was based on the buying of longer-dated Treasury and mortgage bonds.

Because their buying has been sizable and lengthy, the Fed now owns a majority of the 10-20 year Treasury market. They have effectively "cornered" the treasury market. The Corporate Finance Institute defines cornering a market as "obtaining and holding/owning enough stocks, assets, or commodities to effectively control the market price of said items. It involves acquiring the biggest market share without becoming a monopoly."

The Hunt brothers infamously attempted to corner the silver market in the early-1980s by owning about 30-35% of the silver market. The Fed today owns over 50% of the 10-20 year Treasury market! (See Chart 4)

Cornering a market forces artificially high prices or, in the Fed's case today, artificially low yields. The artificially low longer-term Treasury yields have been a primary catalyst to the bubble in long-duration assets.

CHART 4:
Fed Ownership as a Percent of Treasury Market



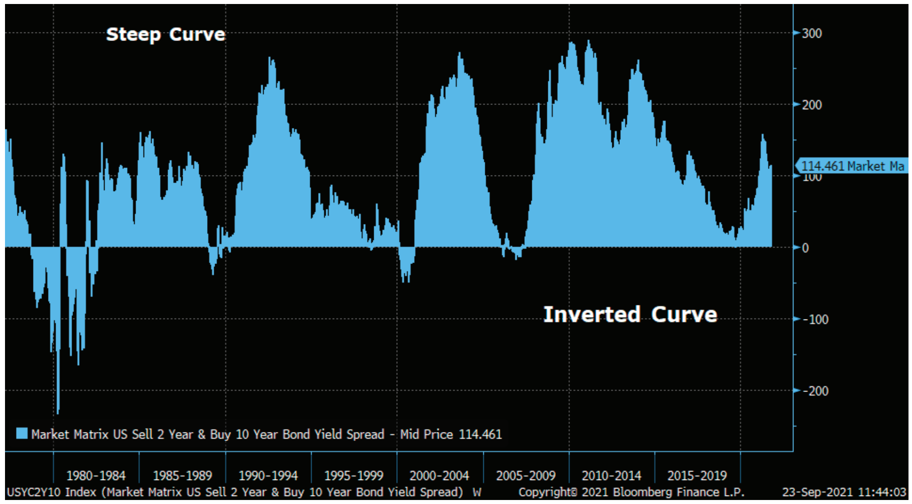
Source: Richard Bernstein Advisors, NY Federal Reserve Bank

Artificial flattening of the yield curve

The slope of the yield curve has historically been a reasonable predictor of future nominal growth (i.e., real growth plus inflation) with steeper curves forecasting stronger growth and inverted curves suggesting recession.

One would think if historic monetary and fiscal stimuli were going to be effective, then the yield curve should be very steep. However, the Fed has artificially flattened the curve by cornering the long-term Treasury market. Chart 5 shows the spread between the 10-year T-note and the 2-year T-bill, and the curve seems remarkably flat relative to historic stimulus. For example, curves after the 2000 and 2008 recessions were much steeper despite there being large, but smaller, stimulus programs.

CHART 5:
Slope of the Yield Curve



Source: Richard Bernstein Advisors, Bloomberg Finance L.P.

Bank lending lags liquidity

The yield curve is also a simple model of the profitability of bank loans, and a flatter curve suggests less attractive lending margins. Banks take in deposits and pay short-term interest rates to depositors, and they make loans with longer terms. Bank margins, therefore, can be approximated by the steepness of the yield curve, i.e., steeper curves suggest higher profitability.

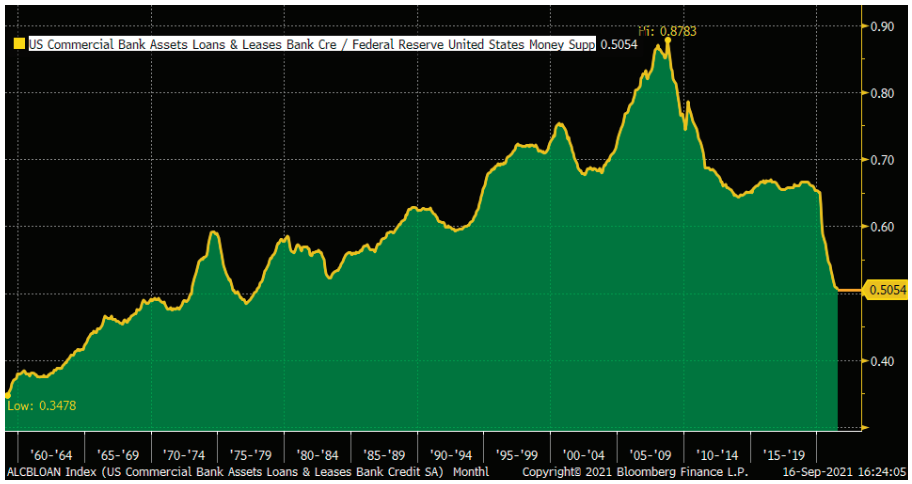
Banks historically often continued to lend during prior cycles despite a flatter yield curve because they would use leverage to improve the profitability of low margin lending. Regulations put in place after the global financial crisis prohibit significant use of leverage, so the margin depicted by the yield curve has become more meaningful.

Because the Fed has cornered the long end of the yield curve and artificially depressed long-term interest rates and artificially flattened the yield curve, bank lending has significantly lagged the liquidity the Fed is attempting to inject into the real economy. The result has been that much of the Fed's liquidity has been trapped within the financial markets and inflated financial assets rather than financing the expansion of the economy.

The Fed can only set the groundwork for incremental lending, but it cannot force banks to lend. The Fed's data show banks have actually been more willing to lend, but their lending is not keeping up with the massive amounts of liquidity the Fed has attempted to inject into the economy. The banks' risk premium associated with riskier lending is simply not large enough to incent broad-based lending.

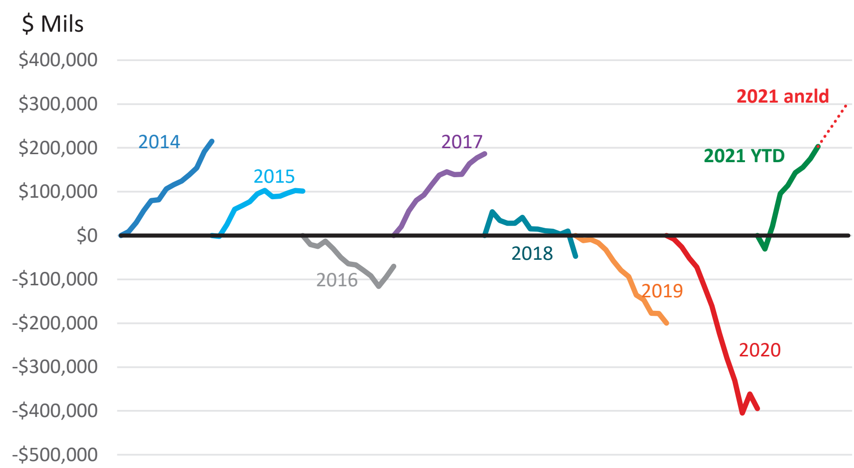
Chart 6 shows bank assets (i.e., lending) relative to the economy's money growth, and the ratio of lending to liquidity has fallen to its lowest level in over 40 years. Chart 7 suggests the excess liquidity is flowing into stocks.

CHART 6:
Ratio of Lending to Liquidity



Source: Richard Bernstein Advisors, Bloomberg Finance L.P.

CHART 7:
Equity Mutual Fund and ETF Annual Net Flows
(12/31/13 thru YTD 8/31/21)



Source: Richard Bernstein Advisors, ICI

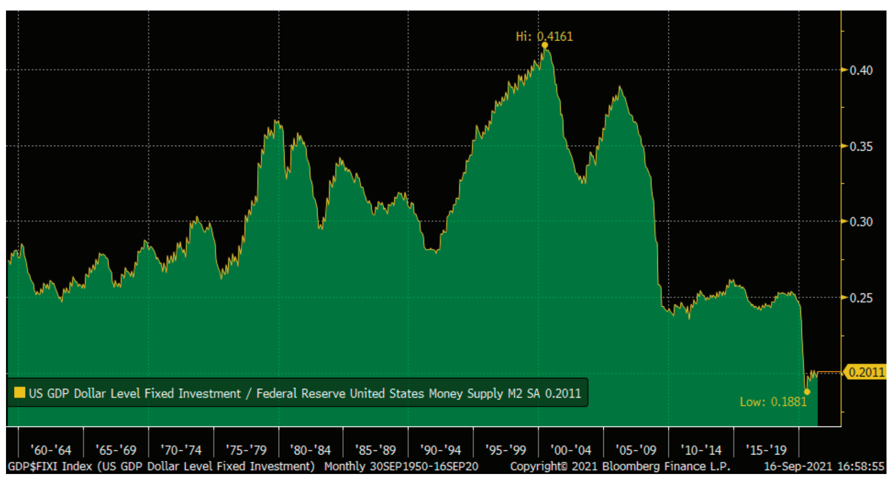
Hype leads to misallocated capital

Bubbles always result in a misallocation of capital. Investors overcapitalize sectors that are "hot", but sectors of the economy that need capital tend to go hungry. It appears as though the current bubble is following that historical precedent.

Chart 8 shows the ratio of real fixed investment to money supply. The Fed may be trying to grow the real economy via excessive money growth, but so far real investment is lagging the growth in the money supply by an historic amount.

Whereas investors are hyped about innovation, disruption, and visions of the future, many industries today are being starved for capital and are significantly underinvesting. Previous under-investment has already resulted in shortages and production bottlenecks in some sectors. One might expect such conditions to last longer than investors currently expect because of the sectors' ongoing underinvestment.

CHART 8:
Ratio of Real Fixed Investment to Money Supply



Source: Richard Bernstein Advisors, Bloomberg Finance L.P

Bubbles create investment opportunities in virtually everything outside the bubble

Perhaps the number one rule of investing is return on investment is highest when capital is scarce. In other words, one should want to be the sole banker in a town of 1,000 borrowers because that one banker will determine the terms and the profitability of every loan. If there are 1,000 bankers and one borrower, then the borrower will get the banks to bid against each other. It's simple supply and demand for capital that ultimately determines expected returns.

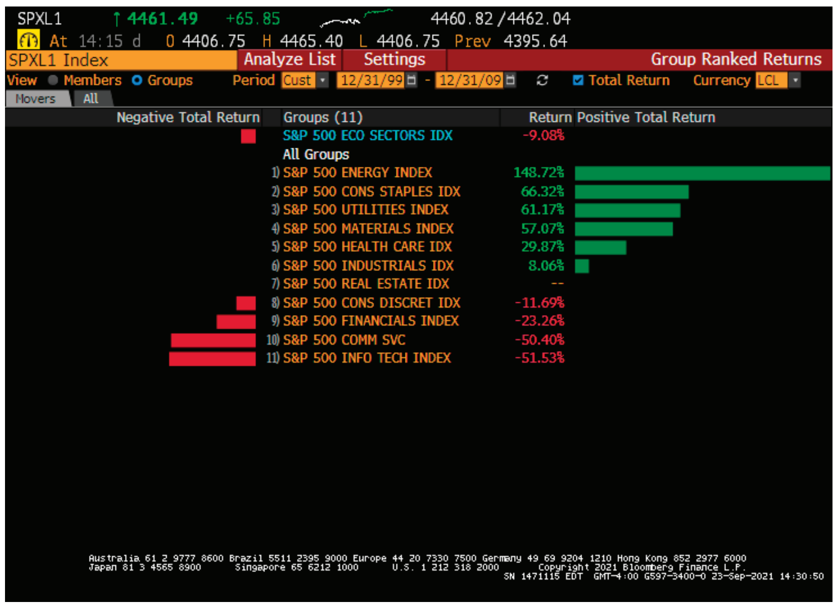
Bubble investors often believe the hype and hot stories about future growth but ignore the valuation of the assets and ultimately over-estimate their expected returns. Asset valuations and not hype determine investment returns regardless of economic development.

For example, there were many stories during the Technology Bubble regarding new technologies changing the economy. Many of those stories came true during the decade after the bubble, but the Technology sector was the worst performing S&P 500® sector and provided negative absolute returns during the decade. (See Chart 9).

CHART 9:

S&P 500® Sector Performance

(12/31/99 thru 12/31/09)



Source: Richard Bernstein Advisors, Bloomberg Finance L.P

The financial markets appear to be at another opportunity similar to that in 1999/2000 in that many sectors around the world outside of the bubble seem attractive. In particular, we favor assets and sectors that outperform as nominal growth accelerates: energy, materials, industrials, smaller capitalization stocks both within and outside the US, non-China emerging markets, lower quality bonds, and commodities/gold.

Investors become very myopic during bubbles, and believe there is little in which to invest other than the bubble assets. To us, such situations present tremendous and broad investment opportunities in sectors that are being relatively denied capital.

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To learn more about RBA's disciplined approach to macro investing, please contact your local RBA representative.

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

S&P 500®: The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

Sector/Industries: Sector/industry references in this report are in accordance with the Global Industry Classification Standard (GICS®) developed by MSCI Barra and Standard & Poor's.

About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an investment manager focusing on long-only, global equity and asset allocation investment strategies. RBA runs ETF asset allocation SMA portfolios at leading wirehouses, independent broker/dealers, TAMPS and on select RIA platforms. Additionally, RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $15.1 billion collectively under management and advisement as of August 31st, 2021. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund and also offers income and unique theme-oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.