The Great Inflation

Revisiting 1969 – 1984 and the Impact of Inflation on Equities

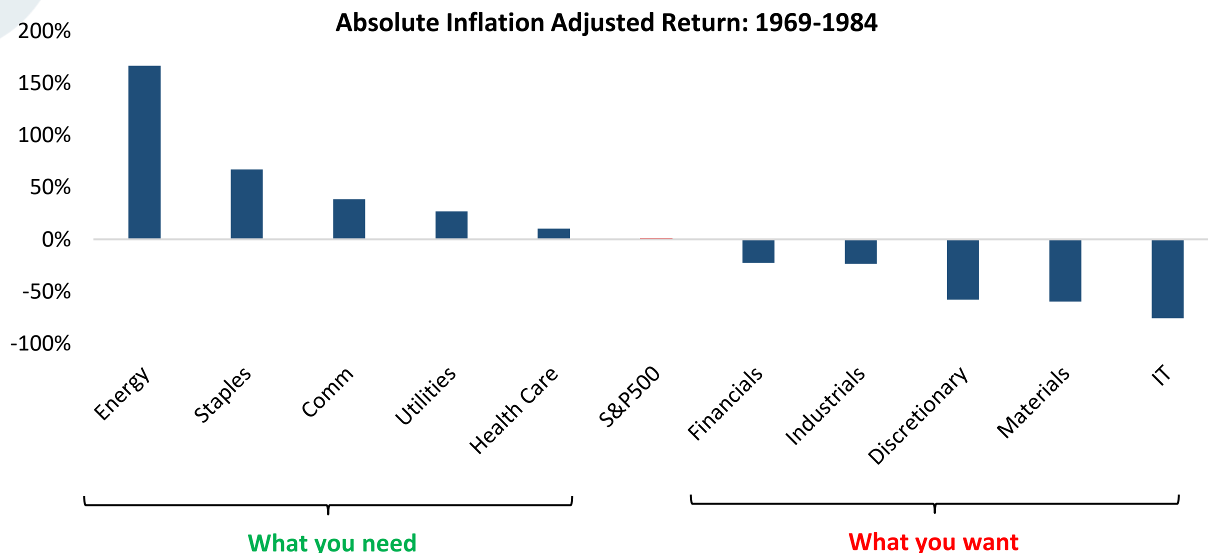
Introduction: A Brief Contemplation of Inflation **Kailash does not make macroeconomic forecasts.**[1]

This newsletter seeks to prove that our prior paper, The Case for Common Sense, represents good investing basics in any environment but also survives the lessons of the Great Inflation. Despite 10-Year Treasury yields having nearly tripled since their lows in August last year, real yields are still negligible, and inflation is topical. Summarily, one could suggest the following are signs that inflation is ***possible*** and hence another powerful reason to buy quality at reasonable prices:

1. **Charlie Munger:** *"…we're in very uncharted waters. Nobody has gotten by with the kind of money printing we are doing now, for a very extended period without some trouble. And, I think we are very near the edge of playing with fire. [The amount of money printing] is astounding. What kind of lunatic would loan money to a European government for 100 years at less than 1%"*[2]
2. **Social Stability & Math:** Thoughtful work by Collaborative Fund shows that the incredible financial health of the average consumer masks a wealth and income disparity that, similar to LBJ's policies in the 1960s, could accelerate government largess to stave off social instability while excellent work by Advocate Capital shows a strong predictive link between GDP growth and Treasury Yields
3. **The Fed Said So:** TD Ameritrade recently noted that the Fed's 2% average inflation guidance is effectively an explicit promise to *overshoot* – an assessment that makes a lot of sense to us
4. **The Market:** With Tesla worth nearly all the energy stocks in the S&P 500[3] and investors applying record valuations to firms that incinerate cash, the market seems very "short" inflation
5. **George A. Roche:** The legendary helmsman of T. Rowe, who started on the New Era fund in 1969 when it was launched as an inflation hedge, instructed investors to look to the 1970s to gauge stock performance during inflationary periods[4]….and so we did

The chart below is stunning in its simplicity. In periods of persistent inflation, investors were well served to own stocks that provided what they needed and avoid investing in companies that sell items they wanted.

Fig. 1: Inflation in Simple Terms – Invest in What you Need Not What You Want



Source: Kailash Capital; Data from 4/30/1969-6/30/1984

[1] Kailash has a forecast allergy, preferring instead to simply combine a robust empirical study of history in the interests of uncovering opportunities.
[2] Charlie Munger, Caltech Interview
[3] A recently famous growth investor told the press she thought Tesla could be worth **$14 trillion** in a few years left us wondering "at what discount rate?"
[4] The New York Times, "Where to Turn When Inflation Roars Again", 2004

A Brief Contemplation of Inflation: The Fatality of Fixed Income

Kailash strongly suggests our readers review a select few pages of *"The Snowball: Warren Buffett and the Business of Life."* Kailash finds pages 1 – 516 to be the most valuable as the remaining 115 pages are dedicated to footnotes.[5,6] As detailed in her biography, against a backdrop of a public increasingly skeptical of government institutions, tensions around civil rights and geopolitical stresses between the US and China[7], in one of his closing sentences to partners in 1969, Buffett wrote.

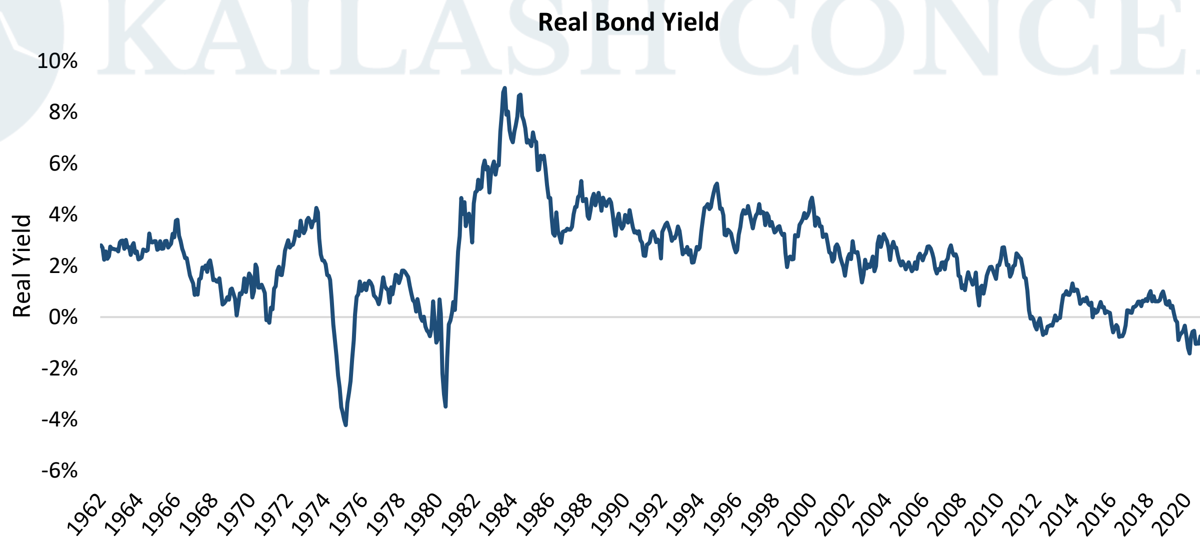
Paradoxically, I have long believed the government should have been doing (in terms of the problem attacked – not necessarily the means utilized) what it finally did – in other words, on an overall basis, I believe the general goal of the activity which has cost us substantial money is socially desirable….[8]
-Warren Buffett, 1969

Listening to his 2020 presentation and reading his Letter to shareholders, Kailash suspects Buffett might harbor similar feelings today. Our government's attempts to instigate social progress are well intended if not, possibly, misguided in their implementation. Kailash believes the summary analogs between 1969 and Today are:

- Real bond yields today are roughly equal to where they were in May of 1969
- Government policy has created an environment of easy money, rampant speculation, high equity prices and sub-optimal managerial behavior today, as it did back in 1969
- If history is a guide, then bonds today might be an even less desirable investment than they were in 1969

Kailash has absolutely no idea if the next 15 years will look like the 15 years following 1969 when a modest amount of social spending triggered severe inflation. **Nonetheless Kailash remains confident that taking on 10, 20 or 30 years of risk for negative to negligible real yields is a terrible decision.** That there might be an inflation of some sort is always in the probability distribution. That there is zero margin for error in today's bond prices makes investing in them that much more precarious.

Fig. 2: Real Bonds Yields Today are Nearly Identical to 1969



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Source: Kailash Capital, Bloomberg; Data from 4/30/1962-2/28/2021

[5] Buffett asked Alice Schroeder to write his biography and in 2003 she went to Omaha to work on the book full time and spent over 2,000 hours reviewing Buffett's personal files and interviewing his family, friends and associates. This resulted in 115 pages of citations.
[6] Similar to our offer regarding "What Works on Wall Street", Kailash offers any paid up subscriber to our Premium service a complimentary copy of ***"The Snowball: Warren Buffett and the Business of Life"*** – please email info@kailashconcepts.com and we will ship it to you promptly
[7] Expressed at the time via the Vietnam War
[8] Buffett Partnership, LTD., May 29, 1969, page 3

A Brief Contemplation of Inflation: The Fatality of Fixed Income

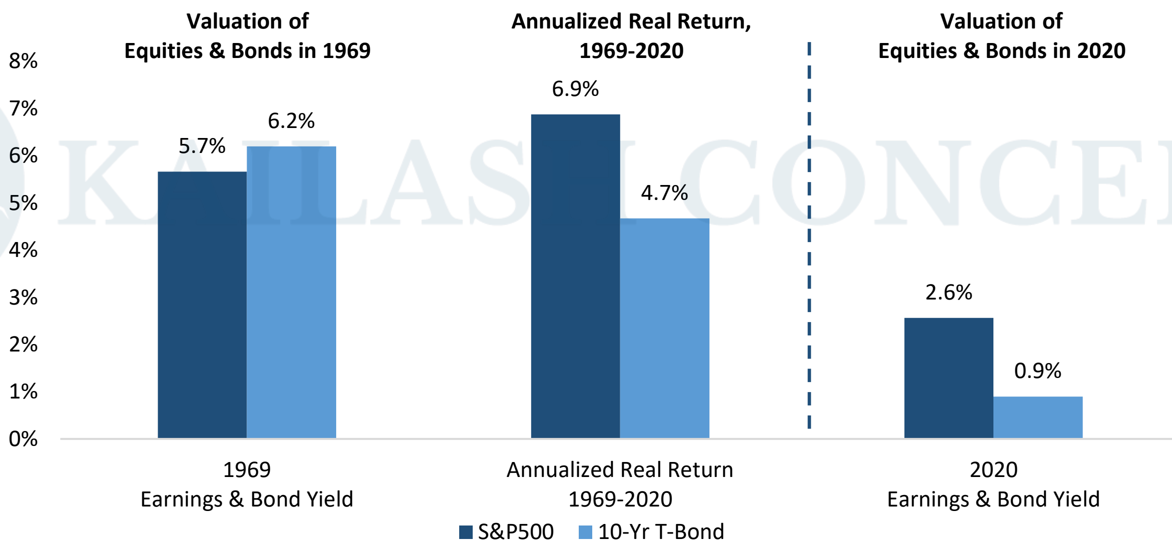
The buyer of money to be used between 1980 and 2020 has been able to obtain a firm price now for each year of its use while the buyer of auto insurance, medical services, newsprint, office space – or just about any other product or service – would be greeted with laughter if he were to request a firm price now to apply through 1985. … our unwillingness to fix a price now for a pound of See's candy … to be delivered in 2010 or 2020 makes us equally unwilling to buy bonds which set a price on money now for use in those years. Overall, we opt for Polonius (slightly restated): "Neither a short-term borrower nor a long-term lender be."[9] -Warren Buffett, 1980

Kailash believes the wisdom of Mr. Buffett is worth heeding any time – but particularly today. When Buffett made the statement above, 10-Year US Government Bonds had a nominal yield of over 10% and a positive real yield. Contrast that with today where 10-year bonds yield ~1.5% and have **negligible** real yields.

The chart below presents:

- The first two bars are the earnings yield of equities (5.7%) and bond yields (6.2%) in 1969 – Bonds offered a higher starting yield and lower valuation than stocks.
- The second two bars are the annualized real returns to equities and bonds between 1969 through 2020
- **Despite bonds starting off cheaper than equities, equities trounced bonds over the ensuing 50+ years (6.9% vs. 4.7%)**
- The third two bars are the earnings yield of equities (2.6%) and bond yields (0.9%) at year end 2020 – **What do you think the next 50 years will look like for bonds vs. equities?**

Fig. 3: Equities Trounced Bonds from 1969 through 2020; The Situation Today Looks Desperate



Source: Kailash Capital, Bloomberg; Data from 12/31/1969-12/31/2020
*Uses annual data

On page 5 of his 2020 letter to shareholders Buffett states:

And bonds are not the place to be these days. Can you believe that the income recently available from a 10-Year U.S. Treasury bond – the yield was 0.93% at year end – had fallen 94% from the 15.8% yield available in 1981? Fixed-income investors worldwide – whether pension funds, insurance companies or retirees – face a bleak future.[10] -Warren Buffett, 2020

DO NOT SAY YOU WERE NOT WARNED: AT THIS POINT BOND INVESTORS ARE FIGHTING ALGEBRA

[9] Warren Buffett, Chairman's Letter, 1980, page 9
[10] Warren Buffett, Chairman's Letter, 2020, page 5

A Brief Contemplation of Inflation: Valuation

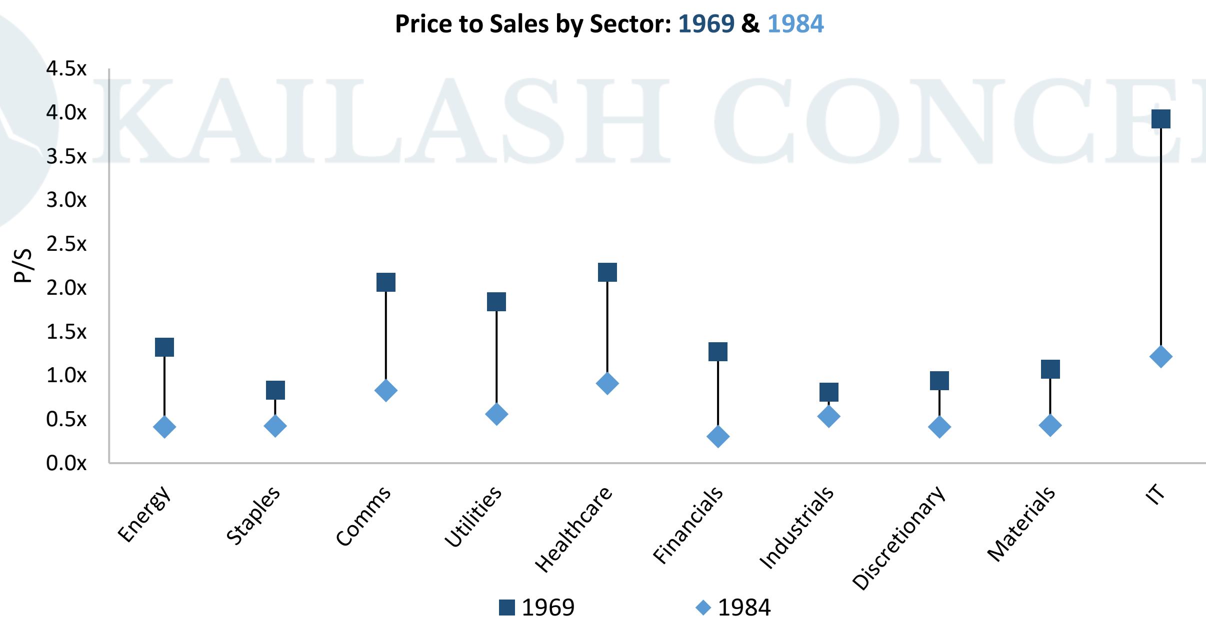
The arithmetic makes it plain that inflation is a far more devastating tax than anything that has been enacted by our legislatures. The inflation tax has a fantastic ability to simply consume capital… If you feel you can dance in and out of securities in a way that defeats the inflation tax, I would like to be your broker – but not your partner. -Warren Buffett, 1977[11]

As longtime readers know, our views are sourced from data and a rigorous review of the historical records. The chart below shows the starting and ending price to sales multiples of the 10 major GICS sectors. They are ordered from the best performing to the worst performing in the great inflation of 1969 – 1984. Looking at the far right, in 1969, technology (IT) shares had become the source of great optimism and commanded immense valuations as investors chased novel stories higher. **This situation would prove unfortunate for those investors as inflation created catastrophic derating as valuations came under crushing pressure.**

Voices wiser than ours have used varying degrees of detail to delve into the reasons why inflation causes severe multiple compression. For those looking to do some surface reading Kailash believes the legendary work done by Modigliani and Cohn[12], the San Francisco Fed[13] and the wonderful record provided by Steven Leuthold in his now out of print "*The Myths of Inflation and Investing*[14]" represent fantastic jumping off points.

Kailash will spare you the untold pages we would love to write sharing our affection for these pieces of research. **Instead, we will revert to the wisdom of Mr. Buffett's experiences managing money during this period: rising hurdle rates and insatiable capital needs make it incredibly difficult to generate real returns for owners[15] creating downward pressure on multiples.**

Fig. 4: During the Great Inflation, Equities in Every Sector Experienced Crushing Multiple Compression



Source: Kailash Capital; Data from 4/30/1969-6/30/1984

[11] https://fortune.com/2011/06/12/buffett-how-inflation-swindles-the-equity-investor-fortune-classics-1977/
[12] "Inflation, Rational Valuation and the Market", Franco Modigliani and Richard A. Cohn, JSTOR, March/April 1979
[13] FRBSF Economic Letter, November 2004-30, October 29, 2004, "Inflation-Induced Valuation Errors in the Stock Market"
[14] "The Myths of Inflation and Investing", Steven C. Leutholv, 1980
[15] Warren Buffett, Chairman's Letter – 1980, page 3

A Brief Contemplation of Inflation: Valuation

This newsletter has urged investors to avoid the rank speculation underway in many money losing tech names. Kailash has now written five papers advocating investors avail themselves of high-quality firms with solid track-records and, often, dividends far in excess of bonds. Our work has identified firms with high returns on invested capital trading at below average prices in the Large, Mid, and Small Cap spaces. Most recently we have specifically advocated for investing in firms that have long and successful operating histories derived from selling investors the goods and services they need.

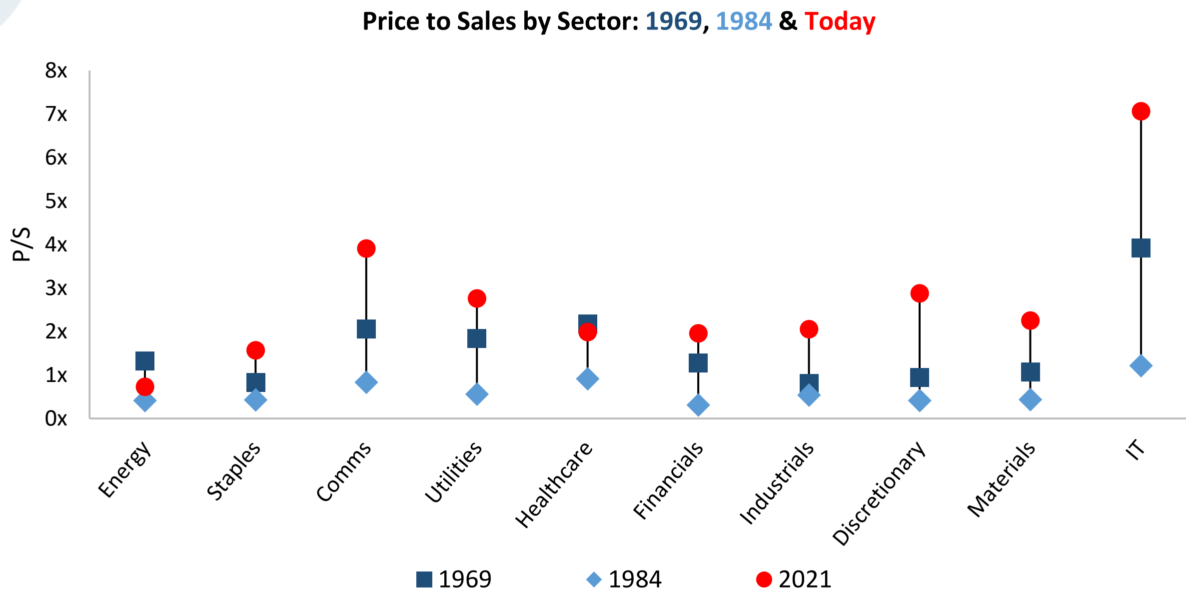
As inflation intensifies, more and more companies find that they must spend all funds they generate internally just to maintain their existing physical volume of business. There is a certain mirage like quality to such operations. However attractive the earnings numbers, we remain leery of businesses that never seem able to convert such pretty numbers into no-strings-attached cash.[16]
– Warren Buffett, 1980

Kailash attaches great importance to the statement above. As we have documented, today's market has trillions of dollars in equity market cap sitting atop firms **that lose money.** It seems almost incredible to hear Buffett complaining that firms' positive ***earnings*** numbers did not generate substantial surplus cash after funding operations. Many of today's most sought after firms are entirely dependent on the kindness of equity and debt investors. **There is no "mirage like quality" to today's story stocks – they are easily seen devices by which equity and bond holders transfer funds into their coffers to subsidize high rates of sales growth.**

Figure 5 below is identical to the one on the prior page with the navy-blue boxes representing the price to sales ratio of various sectors in 1969 and the light blue diamonds showing their multiples by the end of the period. The only difference on this chart is that we added the red dots, which are the valuations of the various sectors today.

Kailash believes the reason Mr. Buffett is sitting on $140bn today is obvious: current prices make those of 1969 look prosaic, negligible real rates on bonds make no sense and the scope for multiple compression has never been greater.

Fig. 5: Should Inflation Break Out, Multiples Today will Face Severe Compression



Source: Kailash Capital; Data from 4/30/1969-6/30/1984

[16] Warren Buffett, Chairman's Letter – 1980, page 14

Conclusion:

Summarily, Kailash believes that the lessons of the Great Inflation have been completely lost by many market participants today. While Kailash does not make macro forecasts and does not invest based on forecasts, we were thrilled to see that our systematic process for identifying statistically advantaged pools of stocks survives the lessons of the 1970s.

Our specific take-aways from this paper are as follows:

- Despite some recent headlines, markets currently provide zero margin of safety in the event of inflation
- This risk may be most severe in bonds where real yields are negligible
- Kailash believes the history books will look back with incredulity at bond investors who slavishly purchased debt instruments at near-zero yields against a backdrop of record deficit spending and a Fed that has ***promised*** to generate 2% average inflation
- **Equally alarming is that while equities may offer relative safety to bonds, they are twice as expensive as they were in 1969**

Kailash believes that a subset of equities offer investors one of the few safe harbors from a possible inflation. In our follow-up piece that will be distributed next week we will also release our Equity Duration tool. Starting from top-flight academic research, Kailash has modified and built what we believe is a rigorous method of estimating the duration of equity portfolios.

By way of preview: the distribution between low and high duration equities has never been wider. The need for investors to begin using varying equity instruments to help mitigate duration risk has never been more pressing. Please reach out to info@kailashconcepts.com or click here for more information.

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