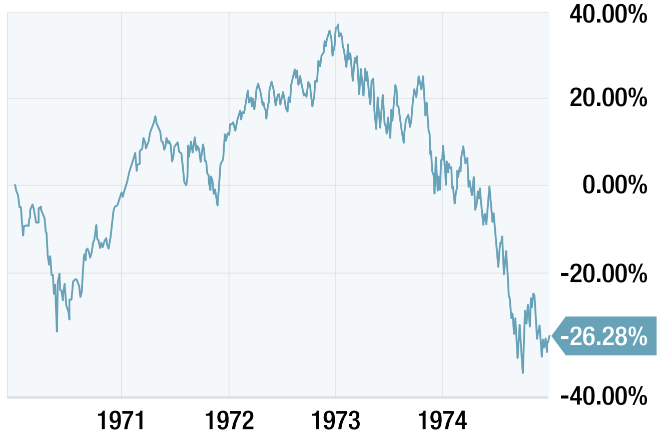
5 Investment Themes for the Future

As so often happens in this perennial and impossible game of market divination, we find ourselves at another threshold. On the horizon, there's nothing but dark clouds. This has to be the most precarious moment we've seen in a long time. Not only are there big unanswered questions for the economy and markets on the stage, but also for history and geopolitics. The war is still raging and with each passing week the stakes get higher and higher. Inflation, which we've long-warned against here in these pages, just won't go away and might even be getting worse. Markets around the world are struggling—so much so that there's almost no place to hide—and as I'm putting the finished touches on this month's edition of Profit, the crypto world is facing yet another serious liquidity crisis, this time with the Celsius network. Look, it's a real question whether we can get through this moment without some serious reckoning. Everything that is rational and logical in me wants to believe that the world evolves from here along one of the two possible paths of reckoning—either some massive deflationary crash (like the 1930's or 2008/9) or an era of stagflation (like the 1970's).

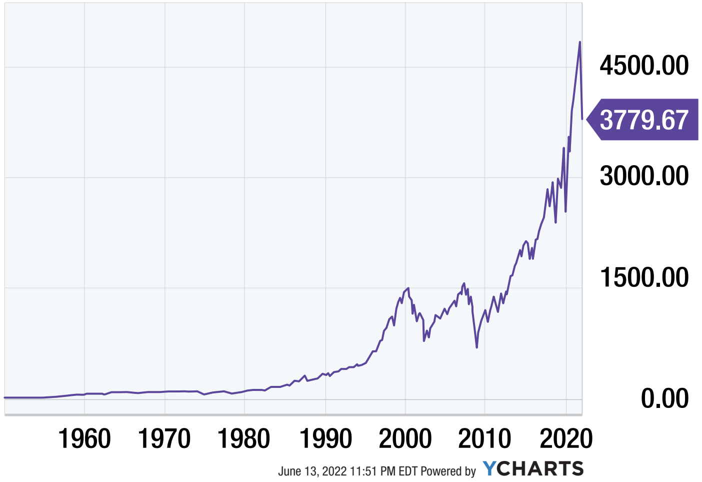
Deflationary Bust
S&P 500 Level % Change

Stagflation
S&P 500 Level % Change



The situation today just doesn't look good. I shudder to even imagine what the world looks like if this chart mean reverts:

S&P 500 Level



However, there's another part of me—call it a feeling or intuition—that thinks we might just muddle through this. I might be totally wrong about this, obviously, but in trying to peer into the future as an investor, I find myself coming to an interesting conclusion: that, even if you find yourself pessimistic and are convinced that one of these two outlier scenarios is coming, it's still better to position your portfolio as if neither happens.

Why? Well, let's say we get a deflationary bust. In this scenario, the market will crash and there will be nowhere to hide. If things get bad enough we'll have a full-scale financial crisis like we did back in 2008. If you knew for certain that this was coming you would want to be 100% in cash. But with inflation raging, this is a very imprudent allocation. So, you cannot really sit 100% in cash unless, of course, you know for sure that a bust is coming. And who knows anything for sure? In the other reckoning scenario—stagflation—most asset prices will get crushed as well but some sectors like precious metals, energy, commodities and certain kinds of real estate could do well. Again, if you knew for sure that stagflation was coming, you'd probably want to sell everything but these inflation-protected type investments. But there's a problem here as well. If you are wrong, not only will you miss out on the opportunities that will do well in the muddle through scenario but you expose yourself to getting wiped out in the deflation scenario, for these types of assets are likely to be the hardest hit there. To make matters worse, in a stagflationary world, there's no guarantee that these assets will even outperform. There's an unpredictability to inflation and the dynamics which made these assets perform well in previous inflationary periods (i.e. where revenues actually increase faster than costs) could easily reverse this time around.

What, then, should we do?

Clearly, today you want to have some decent chunk of your risk portfolio allocated defensively. For me, this means something like 20% in cash, gold and Bitcoin. The rest I'm going to invest based on assumption that we are going to muddle through. Before I go too much farther it probably makes sense to describe what I mean by "muddle through." I think it's clear that the Fed is going to keep raising rates for a while, especially in light of the 8.6% May CPI print. They might even raise rates in an unexpected way—e.g. via a surprise 100bp hike one day. Basically, I think they will do this until the economy breaks and we get a little recession. Why? Because there is simply no other way to stop this inflation.

For the longest time the Fed has been talking about their supposed "dual mandate"—i.e. maximum employment and price stability. Well now they find themselves in the uncomfortable position where they quite literally cannot pursue a dual mandate. They need to sacrifice one to serve the other. While the argument may seem crazy—i.e. that the Fed actually wants to produce a recession and job losses—do they really have another choice? What else could work?

In my mind, this all goes back to the supply chain stuff we talked about several months ago here. Things are just too tight in the world today. Remember, going into COVID, global supply chains were already under pressure. In the wake of the Trump administration's anti-China agenda, companies around the world were already questioning whether it was prudent to keep operating under the same assumptions. De-globalization was essentially well underway for several years when the COVID crisis hit and really shook things up. As if that wasn't enough, then we get this war in Ukraine. Now, as the world is rather quickly reorganizing along the bi-polar lines of the New Cold War, we are in the midst of an absolutely enormous reordering of the channels of supply and production in the economy.

This is happening, of course, at the worst possible historical moment. By itself, COVID was a big enough shock to the system to spark the worst bout of inflation in three decades. And the war has really made things complicated. Maybe Putin really is some super geopolitical genius and he planned this all along. You literally couldn't imagine a worse set of conditions for the big economic powers in the world today, even China—massive public debts, super low interest rates, rising fiscal deficits, aging populations, anti-immigration politics…

We're all, in a sense, backed into a corner where we unfortunately need a recession and a cooling off of demand just to buy some time and space to respond to this global supply-chain and production shock. So, yes, I think the

Fed is definitely pushing for a recession. I think the reason I'm still feeling constructive about the opportunities in the market is that I think a little recession will actually be quite good for the economy. Yeah, we'll get some job losses—never a good thing—but the corresponding fall in demand will ultimately be good for the economy because it'll give some time for this supply-side inflationary pressure to work itself out. That's my theory at least.

By the way, I understand completely that most of what I'm saying here is nonsense. Who can predict the future, right? I will almost certainly be wrong about some or all of this. However, while I recognize the logical futility of the task, I'm still inclined to try. As an investor, you have to be willing to try to live in the future and accept completely the uncertainty involved in such a thing. The investor asks "what will the world look like next year or the year after or a decade from now?" and then makes what amounts to a kind of courageous decision in the moment about what to do. Ultimately, investing is more an act of imagination than anything else.

Well, in the imagined future I'm seeing, we get through this tough period much easier than seems possible by the apparent logic of the moment. Look, the doomsday stuff is always somewhat psychologically appealing. Time and time again, I've found myself drawn to it. There's something about us that craves this kind of thinking—just look at all the disaster, alien invasion, zombie and asteroid movies we keep cranking out. But if you can stomach to look at history, as sordid as it may be, we always get through somehow, don't' we? I'm an optimist at heart and maybe that's clouding my vision here but I cannot help but feel good about our future. We've stared down far darker horizons before, that's for sure.

Anyway, my imagined future world has me excited to invest around 5 big themes:

Innovation

Energy

Housing

Tail Risk

Carbon

Let me close by talking briefly about each.

Innovation. This bear market is cleaning-up some of the speculative excesses which plagued the tech world in recent years, especially in venture and crypto. By the way, in my mind, this is exactly what the market is supposed to be doing. On the way up the market encourages the allocation of capital to innovation and sometimes that invites too much speculative energy to the party. So be it! That's the price of progress in a sense. A good bear market will clean that all out of the system and leave the winners at the table. This is exactly what happened after the tech bubble at the turn of the century. I think something similar is happening today and I'm starting to get very bullish about the potential of the survivors, both in traditional tech and crypto.

Housing. Faithful readers know already that I'm a long-term bull on housing here in the US. I published a whole piece on this last month—"Long Live the Housing Market." While we're going to see some months of bad data as the market adjusts to higher mortgage rates, the market is so fundamentally undersupplied housing is positioned to do well for a very long time. Homebuilders and single-family rental companies are already starting to look interesting here.

Carbon. While the fear of inflation and the war in Ukraine have taken center stage in our collective consciousness, our climate change problem isn't going anyway. In fact, it's probably getting worse. There's still a recognition among all the major powers of the world that we have to do something serious when it comes to CO2 emissions. Ultimately, what this means is that carbon is going to get very expensive. This is a tough space to invest in as it's such a new industry. It's almost as wild as crypto in some sense but there are interesting ways to play this like getting exposure to carbon credit prices and investing in companies focused on producing carbon credits in one way or another. There's also crossover with tech here as there are a bunch of companies working on clean production tech, carbon capture….etc.

Energy. If we've learned anything this year, it's this: energy is still the key to the global economy. While we may all want to transition to clean, renewable energy we are very far from doing so. And now people are thinking a little bit differently about the relationship between national security and energy independence. After years of underperformance, energy companies finally started to catch a bid earlier this year. I expect they will continue to do well and there's a ton of upside from here.

Tail Risk. As I mentioned earlier, this is a crazy time and anything could happen. While I remain optimistic, it's always a good idea to think about risk. Every portfolio needs some meaningful tail risk allocation today—in my mind, some combination of cash, gold and Bitcoin. □