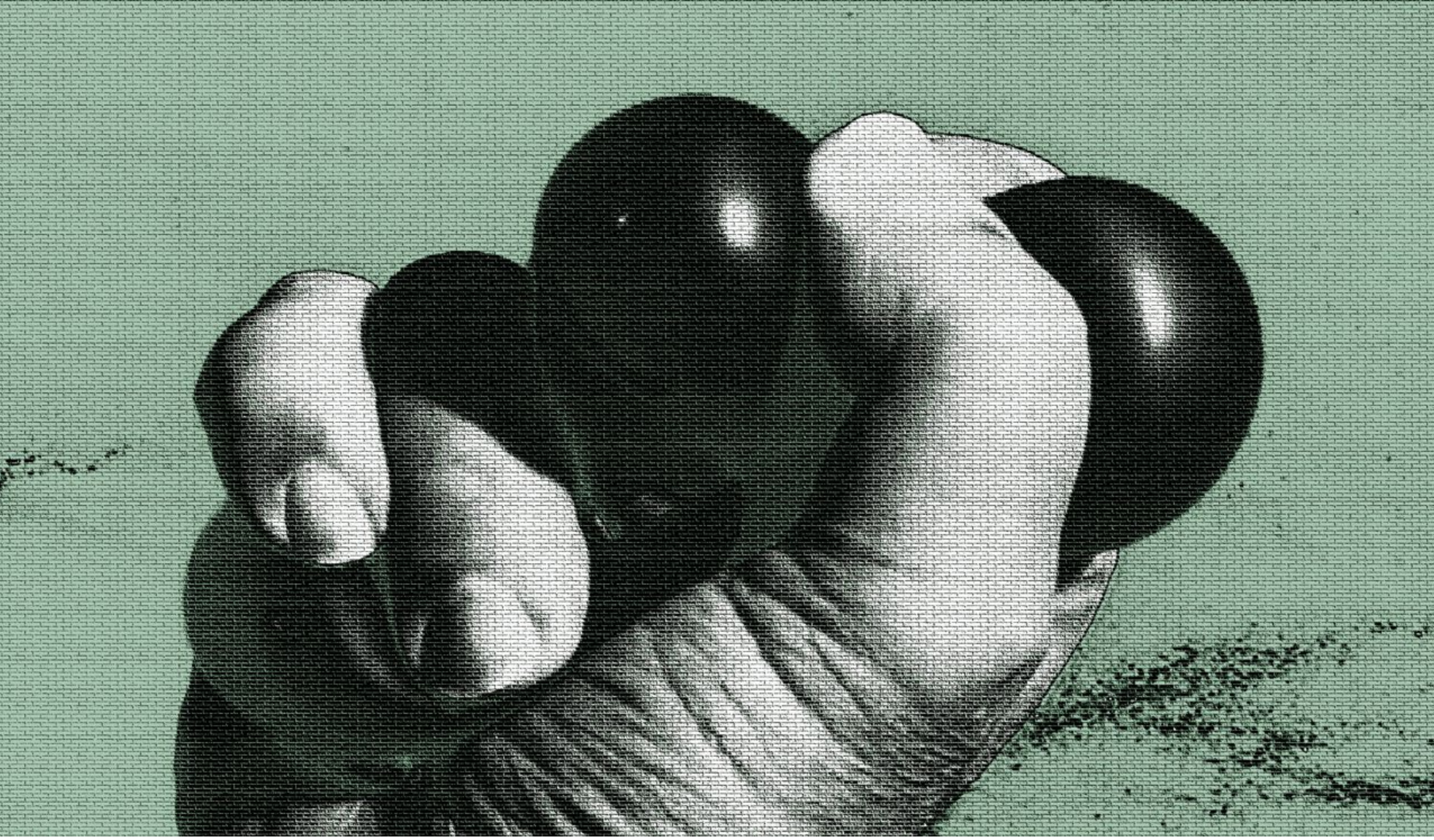
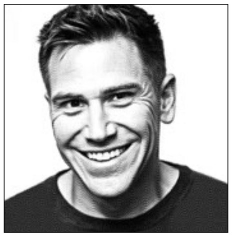


Life After Financial Repression



I am beginning to accept the possibility that market conditions might have actually changed. While my base case forecast remains the same—that the Fed's hiking cycle will ultimately produce an inflation-killing recession and put us right back to where we were in the pre-COVID days—questions keep popping up in my mind. What if I'm wrong about all this? What happens if rates just stay roughly where they are? What does the world look like then?

In times of financial repression inflation doesn't just go away but instead tends to pop-up in more extreme forms in certain segments of the economy.

Much as it pains me to admit, this is a very possible outcome. As a real estate owner, I've got this huge bias pulling my mind in another direction. First of all, there's the whole personal financial part. High rates for longer implies a pretty massive hit to my balance sheet, at least 20% by my calculations. That would suck, right? To make matters worse, there's this whole issue that investing under financial repression is basically all I know how to do! Over the last fifteen years, I've developed this whole set of skills that isn't perfect but works pretty well in the game of investing and developing during times of financial repression. I'd have to figure out some new tricks if meaningful interest rates are back on the table.

Putting my bias aside, let's imagine what the world might look like in this scenario. One thing is for sure, the investing landscape has the chance to get a whole lot more interesting. Investing in financial repression isn't exactly boring but it is rather one directional. The playbook is pretty obvious. Buy as many assets as possible—it almost doesn't matter which ones—and by all means, take advantage of the artificially low rates, get some cheap debt and buy some more. The only thing you have to watch out for is getting caught-up in one of the speculative manias, which inevitably and more frequently form in these times.

By the way, by financial repression I mean this: whenever interest rates aren't allowed to reflect the actual rate of inflation. What we've seen is that in times of financial repression inflation doesn't just go away but instead tends to pop up in more extreme forms in certain segments of the economy. Imagine trying to keep a balloon from expanding just as someone is filling it up with air. The more you press down the more distorted the shape becomes. That's essentially what happens with financial repression. So, for example in the last cycle, while the big CPI contributors were consistently low, like owner's equivalent rent, urban rent growth was out of control. Something similar happened with health care and education costs.

What we've learned from the long, wild history of global finance is that any time markets aren't allowed to express the truth, not only do distortions manifest in asset markets themselves but also, more importantly, they start showing-up in the real economy as well. Essentially, as capital gets over- or under-allocated and prices respond in extreme or unexpected ways to changes in supply and demand, market participants and consumers find themselves increasingly confused. And with confusion comes impaired judgment, misaligned incentives, and unusual outcomes. Look, if you live under financial repression long enough, you might find yourself investing massive amounts of money in a company like dubiously governed FTX, of course without doing any due diligence.

I digress.

As I mentioned above, my base case remains that we get back to a regime of financial repression relatively quickly. And what we've learned in the last decade is that there's a pretty obvious playbook to follow if that's the case. Artificially low interest rates provide this massive tailwind for all assets where:

- Indexing outperforms active management
- Growth outperforms value
&
- Bubble-like dynamics appear more frequently[1].

If the Fed and other central banks around the world do indeed pivot, as everyone seems to be expecting them to do, I see no reason why market dynamics would be any different this time around.

However, if rates go higher or even just stay where they are today, the playbook is going to look a whole lot different. Why? When you have a real interest rate, the whole decision-making analysis for investing changes. All of a sudden, there are options. Why buy the 3% cap rate apartment in Los Angeles when can you earn 4.5% on short-term government bonds? Why buy the altcoin or invest in the Series D 100x revenue valued deal, when you can buy a good multinational corporation with a 5% dividend yield and a history of earnings growth or, better yet, lend money in first position for real estate deals and earn 8%, 10% or even more? The speculative positioning that came to dominate the last cycle, especially during the COVID era, just doesn't feel the same when there is a real cost of capital to contend with.

As you can probably tell, I'm worried about this scenario and not just because it could smash a hole in my business and personal finances but also because it's going to make investing a lot more difficult. What might the world look like with a 5% Fed Funds?

- Indexing probably isn't going to work quite as well

My thesis here is that if indexing works exceedingly well during financial repression, the inverse is true in its absence. Look, it wasn't that long ago when everyone was talking about the end of the hedge fund era. Indexing was all the rage and active management was looked at almost as anachronism. But then the 2022 rate hiking cycle came and hedge funds roared back to life. It was a redemptive year for the active management crowd where many outperformed the indicis. In fact, Citadel, one of the world's biggest funds, posted the largest one-year gain ever ($16B). Crazy what a little rate hiking cycle can do.

- Almost every real estate asset in the world is going to get repriced lower

For real estate, the issue comes down a matter of simple arithmetic. In the previous cycle, assets traded up so much that the underlying cash-flows are not high enough to support new debt priced at the new rates. 3% and 4% cap rate valuations are predicated on rates being at zero. Now with short-term rates at 5%, there's just no way for property level operating fundamentals to improve strong or fast enough to offset the increased costs of the higher rates. Most real estate players have been holding on for dear life but we are seeing the beginnings of what could be a serious downturn in the sector.

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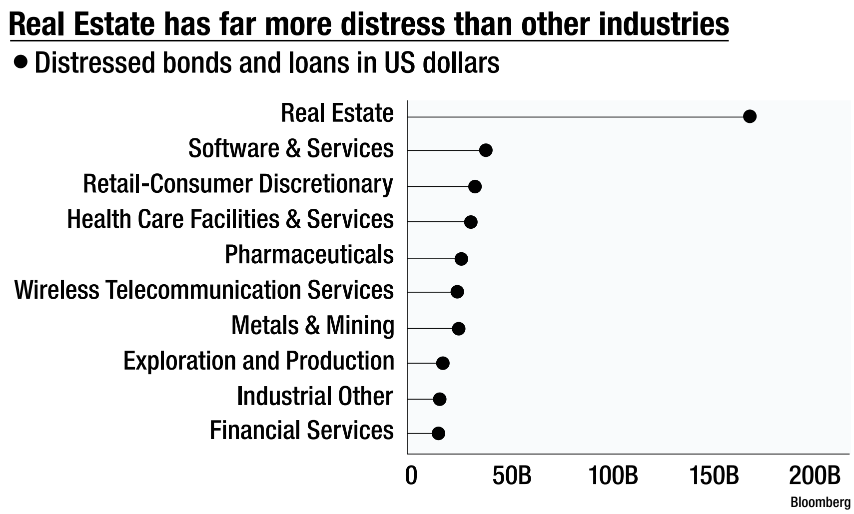
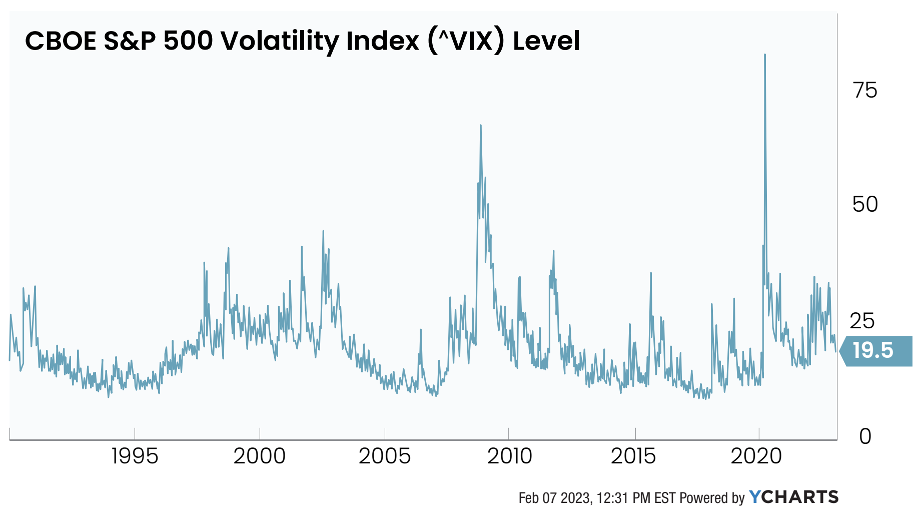
[1]To be clear, it's not that bubbles don't form without financial repression. There are plenty of examples of speculative mania under "normal" market conditions. But when there is financial repression, bubbles tend to form more frequently. Just consider what we've seen over the last 5 or 6 years. We had the altcoins, the FAANG stock run-up, the "Tesla is not a car company" bubble, SPACs, Defi Summer, Meme stocks and the Web 3/Metaverse craze. One after the next in succession, we saw these mini-manias emerge. I suspect we'll see this again if we get back to a world of low rates.



• We are going to see a lot more volatility

One of the things we saw during the decade preceding the COVID crisis was a persistent suppression of volatility in markets. When the Fed becomes the liquidity provider of last resort, it tends to dampen the effect of the normal psychological rhythms of speculation. In a world with non-zero interest rates, I expect we'll see a lot more volatility. Not only will the Fed not be there with the liquidity buffer but investors will once again be able to find and take advantage of interest rate differentials (imagine that!), arbitrage opportunities and valuation anomalies. Interest rates make things interesting in markets because it introduces again the possibility for real choice.



• Finally, investors, especially in venture, are going to have to be a lot more discerning.

My thesis here is all about opportunity cost and investor expectations. When rates are zero, discounted cash-flow models produce useless answers—i.e. everything is worth infinity when there's no discount rate—but when rates are 5%, things start to look a whole lot different. Our models will produce more reasonable results, forcing investors to be more discerning about where they place their bets. 5% rates will bring back the "discipline" part of the art of investing. There will be less tolerance for profitless growth and brash / dubious founders, that's for sure.

While we cannot know for sure how things are going to evolve, the macroeconomic set-up has me convinced that it's one of these two scenarios. We're either going to see a Fed pivot and a return of financial repression or rates are staying higher for longer. The good news is that at least we have an idea of what to do in each scenario. The bad news is that today all that's left to do is to wait and see what happens. ▫