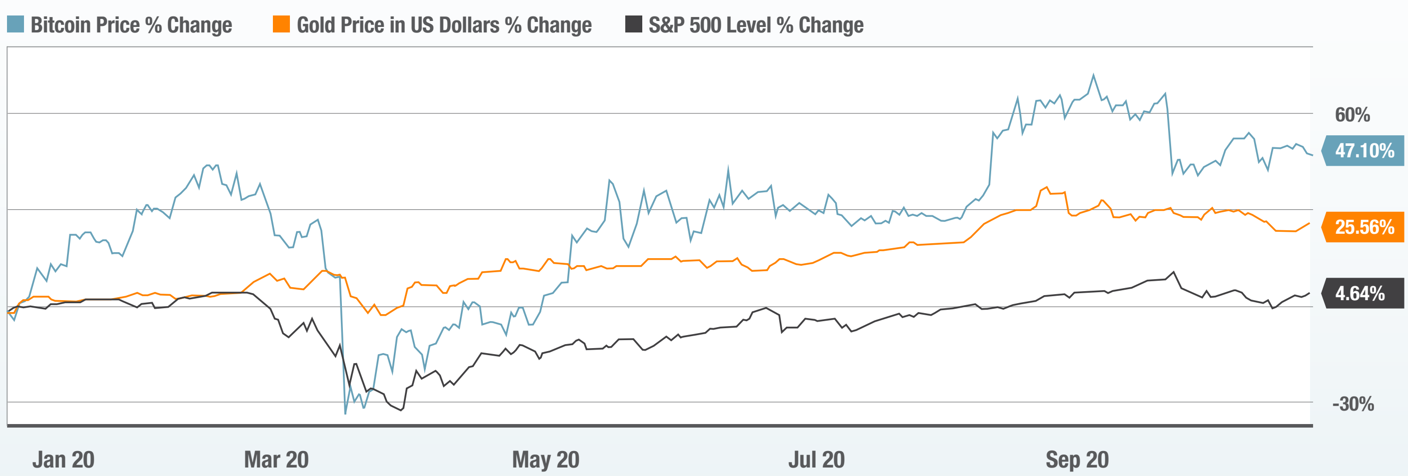
Rational Exuberance?

Photo by Hans Eiskonen

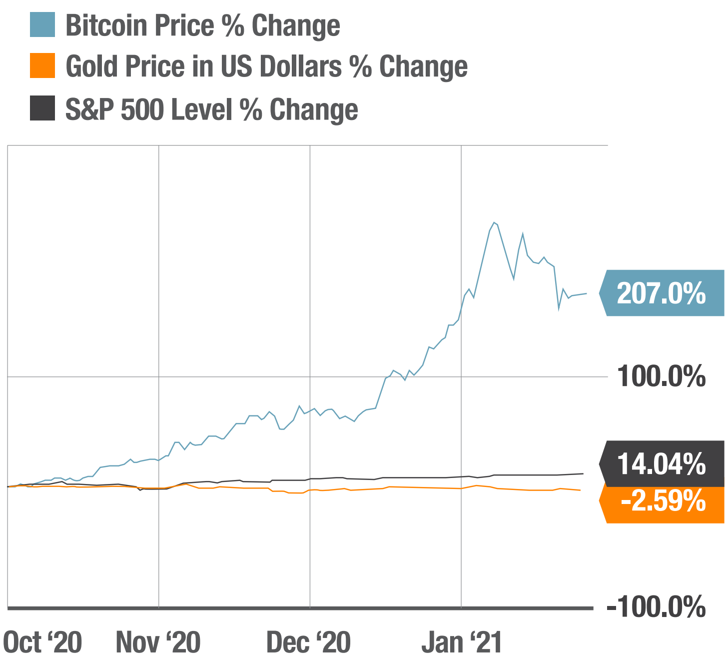
When I first started writing this newsletter—all the way back in those dark, uncertain days of October 2020—there was just a lot that we didn't know. Who was going to be our President? Were we going to get a vaccine? Was Congress ever going to get another stimulus passed? In the face of that uncertainty, I had become bullish on things Bitcoin, gold and gold miners, cautiously optimistic on certain segments of the real estate market and neutral/bearish on the broader equity and fixed income markets. As it stands today, it looks like I was right in my bullish calls and wrong in my bearish ones.

In these past months, it seems like almost everything has done well in the market! The good news (vaccines, stimulus and a new President) has overwhelmed the bad (more lock downs around the world, more and more job losses) and created an unusual dynamic where uncertainty trades (i.e., things like Bitcoin) are trading up alongside risk-on trades (i.e., equities). I did not expect that to happen. Why are risk-off, safe haven assets rallying so hard? Sure, with equities a sharp rally makes sense. But what's going on with Bitcoin? And why is gold holding up?

Here's how markets were trading leading up to the wave of good news:



Things were going well! The market had been going up all year—mostly a response to the more or less explicit guarantee from the Federal Reserve that they will keep enough liquidity in the system to prevent any kind of market crash but also a reaction to the resiliency of the global economy. Things weren't as bad as they could've been. Just think about what the market was signaling back in the scary days of March 2020. Still though there was a fundamental disconnect between the market and the real economy. As the good news started coming in something really interesting (crazy?) started happening with Bitcoin in particular:



What is going on here? We get vaccines, stimulus and normalcy in the White House and the reaction is a massive surge in one of the doomsday crowd's favorite assets! Is this just a sign of how crazy people have gone? Or is something real happening here?

If you want to entertain yourself one afternoon and find yet further evidence that there is absolutely no relationship between maturity/sophistication and financial success, scroll through some of the Twitter conversations and debates on Bitcoin. You'll find adults cursing at each other, gloating, bullying and even proselytizing. While I remain bullish on Bitcoin (even after this rally) and have been for a long time, one of the things that concerns me the most is the nature of this narrative. It's very emotional and almost religious in nature and it has become a mark of a kind of psychological identification—either you believe in Bitcoin or you don't and that belief somehow makes you one kind of person or another. Watch what happens on Twitter when some high-profile investor comes out against Bitcoin or worse when some previously vocal believer announces he or she has sold out of Bitcoin. The Twitter crowd of Bitcoin fanatics absolutely loses its collective mind. You'll see everything from: "Too bad you aren't going to be rich anymore" to "F*ck you Loser." Very strange.

So getting back to the question: just why is Bitcoin doing so well? Bitcoin is like the ultimate story stock. Usually, stocks that go parabolic do so on the basis of some dominant narrative (i.e., Amazon is taking over the world). Investors get excited about the potential of the story and start to pile into it. Well with Bitcoin there is not just one story, there are a whole bunch of them! I think this is why we've seen such dramatic price action over the years. Each one of these stories presents a different kind of hook to grab the attention of investors. The stories range across the entire spectrum of our capacity for belief. There's the rational fundamentalist story ("Bitcoin is the future of currency"), the technologist thesis ("The Bitcoin protocol is designed perfectly, supply is limited and thus Bitcoin will inevitably go up in value"), the anti-government narrative ("This is the perfect way to get my money out of the "system"), the hedge fund story ("Bitcoin is massively under-owned by both individuals and institutions, even a small percentage allocation is enough to cause massive price appreciation")….

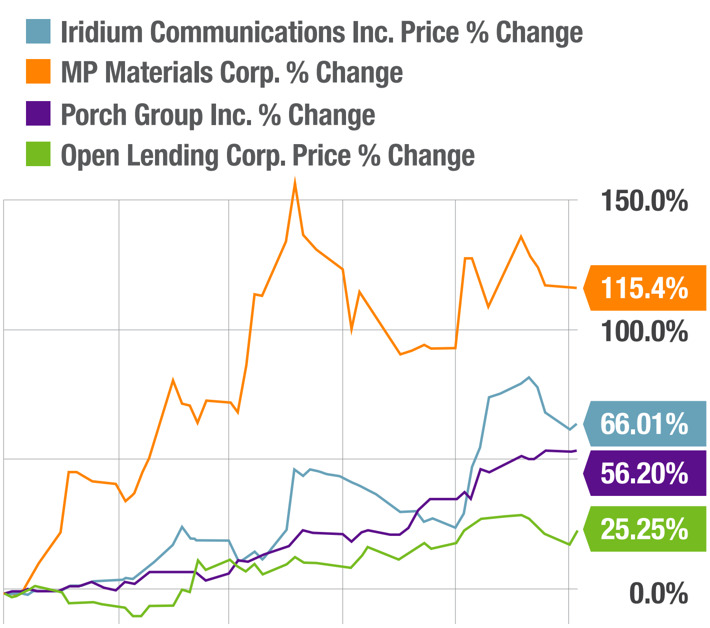
Let's talk for a second about the idea that one day Bitcoin will somehow replace fiat currency altogether. This is a strongly held view, dare I say fanatically, almost religiously, by many in the crypto bull camp. I think what people seem to be forgetting is that Bitcoin can be regulated away very easily. There's historical precedence for this, even here in the United States. On more than one occasion the Federal Government has made owning physical gold illegal. Isn't this a possible outcome for Bitcoin? What happens to the price of Bitcoin if governments around the world even start signaling this might be possible? In recent days, just a hint from Janet Yellen in a speech about the potential for government regulation was enough to derail the incredible bull run and send the price down more than 20% in a short period of time.

With all these narratives floating around, it is really difficult to make sense of Bitcoin. And let's not ignore that there is an obvious alternative explanation here. Maybe none of these stories are "true." Perhaps this is all just another speculative mania, akin to the Tulip bubble. As I've been thinking about this and paying close attention to the market, this is an idea that is not easy to dismiss. The exuberance is there no doubt.

It doesn't take more than a casual observation to see that. And it's not just in Bitcoin. Take, for instance, Tesla:

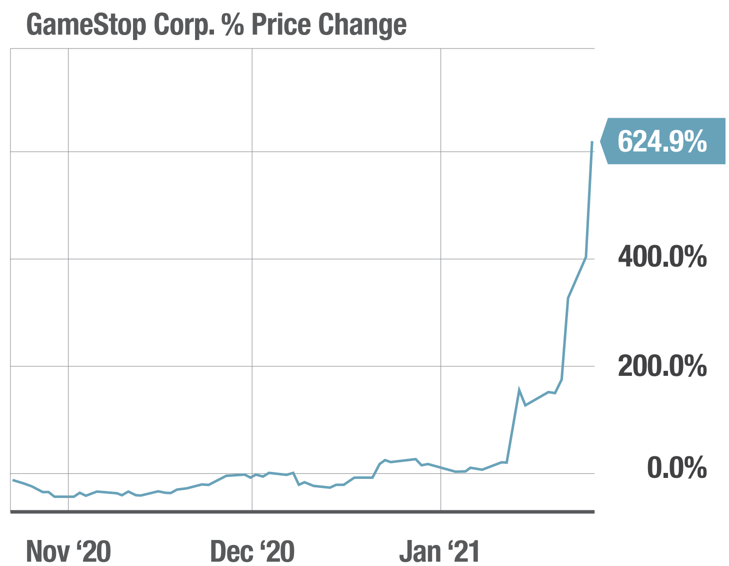
The stock is up sixfold in the past year and has a market capitalization worth more than the combined value of the next 9 largest auto companies in the world! To put this move in perspective, you have to understand that Tesla only sells 500,000 cars per year in a global market of over 60M. Tesla's market capitalization doesn't seem to make any sense.

Similarly, the SPAC market has produced some great returns as well. Note: a SPAC is just a different way to IPO that enables companies to avoid paying hefty investment banker fees. Here's how some of the high-profile SPAC IPO's have been trading:



And the promoters of these SPAC's, arguably some of our generation's best investors, can be found on Twitter bragging about their performance. So that's one end of the spectrum.

At the same time, on the complete opposite side of the investment world, you can find cases of small retail investors herding in and out of stocks to produce some wild price action. In recent days, the most high-profile case involves the company Gamestop:



The story here is that retail investors, using forums like this blog on Reddit called Wall Street Bets and Robinhood, managed to break the backs of some large hedge funds with big short positions on the stock. Somehow they managed to create one of the largest short squeeze rallies in history. If you want to get a good sense for the psychology of the retail speculative mind in today's world, spend ten minutes scrolling through that Reddit blog. There's some crazy stuff on there. You can get investment advice from such well respected thinkers as whoever is behind such usernames as "Suspiciously gives money to children" and "yolo_howla" and my favorites "FatAspirations" and "DeepFuckingValue." You can find screenshots of people who have apparently made enough money to pay off their student loans. Supposedly, DeepFuckingValue turned $50K into over $20M on this Gamestop move.

In observing all this, there's just no denying that it looks and feel like a giant speculative mania. We have clear signs of exuberance. The question is: is this exuberance irrational?

I think my reaction to this question the first time I asked it to myself was something like: "Yes, this is obviously a f@c*ing bubble." Given where the world economy sits today, this price action doesn't make any sense, especially this retail stuff. Even with the vaccines, we are in a massive global recession, we have mass unemployment and governments around the world have absolutely wrecked their balance sheets in an attempt to soften the blow. How can Tesla be worth so much more than all these other auto companies? How can Bitcoin appreciate 3x-4x in such a short time and it not be a mania?

But as I've sat with this question, I think you cannot dismiss so easily the idea—perhaps a radical one—that this type of investment behavior might actually be rational. That's how crazy things have gotten in our modern world. So just what would make what we're seeing today "rational" behavior? Well, here are a couple ideas:

- What if it didn't make sense to keep any liquidity in traditional safe havens like cash and government securities?
- What if you believed that the Fed and other Central Banks around the world would continue their policies of Quantitative Easing and extremely low interest rates and provide an unlimited, never-ending backstop against any significant market declines?
- What if you believed that a huge growth surge, based upon pent up demand in the economy, was on the horizon?
- What if you believed in the underlying business case for some of these high-flying equities?

If you sit down and really try to answer some of these questions you start to realize that it might not be as crazy as it all seems. Perhaps the unintended consequence of radical Central Bank activism is a rational and massive over-allocation to risk assets. If you are going to earn almost nothing in the bank, which actually amounts to a negative interest rate when you take into account inflation, why not buy equities, Bitcoin and gold? At least there, you have a chance to earn a return and stay ahead of inflation. The same is true for government bonds, which yield almost nothing here in America and are negative in many parts of the world already.

I think, for example, that the price action in both Bitcoin and gold over the past year is really just a reaction to the global financial repression we are seeing around the world. The market is essentially forecasting—and I think rightly so—that the consequence of financial repression is yet more financial repression. In other words, extremely low interest rates will lead to extremely low interest rates. And in this self-reinforcing repressive cycle, there is no safe place for liquidity. The price of liquidity used to be at worst, opportunity cost. Now it's opportunity cost plus guaranteed loss in value for not keeping pace with inflation.

At the same time, there's been a lot of talk about a new Roaring 20's on the horizon. The idea is this: once we get through this winter of discontent, once enough people are vaccinated, once the case counts start dropping, the global economy is going to reopen with the force of thunderous applause. Or so the theory goes…

I actually agree with this. Not only is there this tremendous pent-up demand in the system—for everything: travel, dinners, socialization, coffees, concerts, even nice new clothes—there's a new psychology of spending and economic decision-making emerging—the psychology of YOLO. I've experienced this myself. I hadn't bought new work clothes in years but this summer as we were slowly coming out of lockdown I found myself feeling the urge to buy some new clothes, and not just any old stuff, I had the impulse for some really expensive stuff. I justified it to myself with all sorts of crazy reasons—"I've gotten used to nicer things living in this new house." "I need them for my Real Vision and podcast appearances." "It's been a long time." The truth is that I got caught up in this new psychology of spending sweeping across the globe. I'm absolutely convinced of that.

At the same time, here in America at least, we have this pro-growth public policy agenda (at least in the short-term). We're likely to see more stimulus, infrastructure spending and big investments in affordable housing. We're also likely to see immigration reform, which is very pro-growth for America. If the 11M undocumented immigrants in this country can be put on a path to citizenship, a flood of dollars usually sent abroad as remittances will stay instead in our domestic economy and manifest in spending, savings and investment.

So, there's a case to be made for being rationally bullish today. I still believe, though, that it is a time to be cautious about making investment allocation decisions. I'm not ready to jump on the Tesla bandwagon, for example, or chase these SPAC IPO's or join the Reddit crowd. Knowing how Wall Street works (do you really want to mess with hedge funds?) that story is probably going to end really badly for the retail crowd. But I think, more likely than not, equities will do well this year. In fact, we might see more unprecedented market activity in response to the hopeful, optimistic energy of the coming re-openings. I'm currently on the lookout for a way to rationally express a bullish investment on the reopening and the potential for a new roaring 20's and I will share as soon as I find something! And I'm still comfortable being long Bitcoin, gold and gold miners.

Photo by Patrick Li

More Signs of Hope from Multifamily

Let me give you all a quick update on the multifamily space. This one is easy for me because I live and breathe it every day. The space continues to present one of the most confusing signals of the COVID crisis era. When you look at the sector from a wider perspective, you see things like $57B in missed rental payments and the potential for 3.9M evictions in 2021. The big public apartment REITS are still down 30%+. But when you talk to people who actually own apartments or who make a living from the buying and selling of them, you see a different story. Even in hard hit big city markets, prices haven't come down all that much—maybe 10% in LA for example. And in many places, prices are actually up—like with value-add deals in the Southeast. At the same time, the 4th Quarter of 2020 was actually pretty good in terms of rental absorption. The data shows absorption of 77,000 units versus a 5-year Q4 average of less than 45,000. Absorption was still lower on the year but Q4 showed some really optimistic signs.

In our portfolio at Metros Capital we saw continued strength in our assets in the Southeast, even completing some new delivery lease-ups with rents 10%-15% higher than our pre-COVID pro forma. Even here in Los Angeles, after really struggling to fill new deliveries in the summer of 2020 we managed to lease up almost all of our high-end vacancies without having to offer substantial discounts or concessions. One interesting data point from this: every single unit we leased was someone from either New York or San Francisco, all with incredibly high-paying jobs. Might this mean that Los Angeles is going to be a net migration winner as a result of the COVID crisis?

I think what we're seeing in multifamily is just another manifestation of this possibly-rational exuberance that we are finding in the public markets. Here as well, liquidity conditions are enough to overcome any perceived threats from migration, COVID or the economy. There's just too much money chasing few too opportunities. As for risk appetite, even with cap rates as low as they are, apartments present a much, much better return potential than buying government bonds or keeping money in the bank.

I think the market is presenting an interesting opportunity to take advantage of the disconnect between these private market dynamics and what we're seeing with the trading in the big apartment REITs. I think there's a good chance that the REITs that have been punished by the market based on the headlines we're seeing around the death of cities, could rally sharply into the reopening. By the way, most of these beaten-up REITs actually own more suburban assets than urban, have good balance sheets and are still paying solid dividends. And at the property level, they are experiencing the same thing we are at Metros—collections haven't been too bad and absorption is improving. I recommend Equity Residential (EQR) to express this idea.▫