10 THINGS

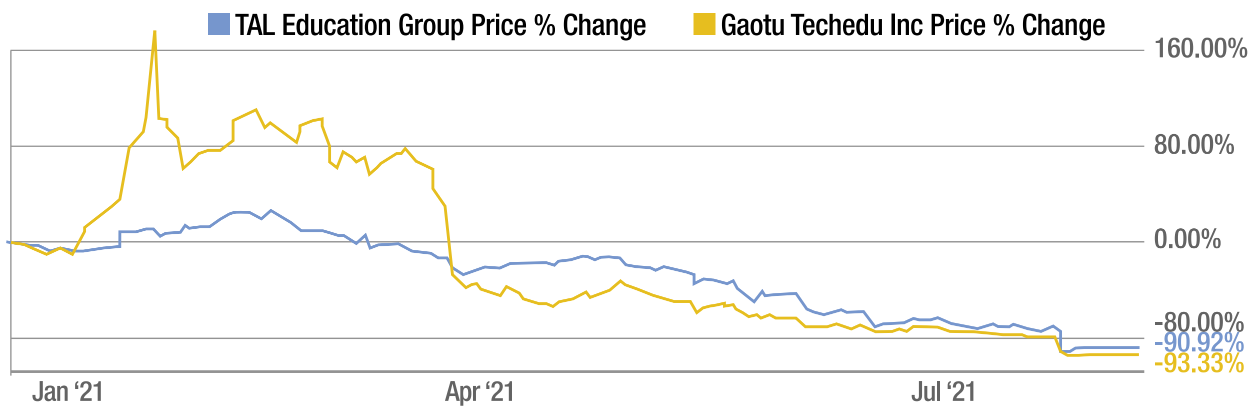
Every Investor Needs to Know Today

I have been at this now for 10 months, some of the most interesting and consequential times in recent history. In writing Profit month-in and month-out, I have learned a lot about the world, about investing, about myself even. It's made me a better investor, that's for sure. Being always on the look out for new writing ideas has lead me to new opportunities and better understanding. There's just something about the process of writing with the intent to publish / share that really challenges and improves your thinking. It brings a different kind of clarity and focus. I'm happy to say that the writing is getting easier at least and, hopefully for you all, better!

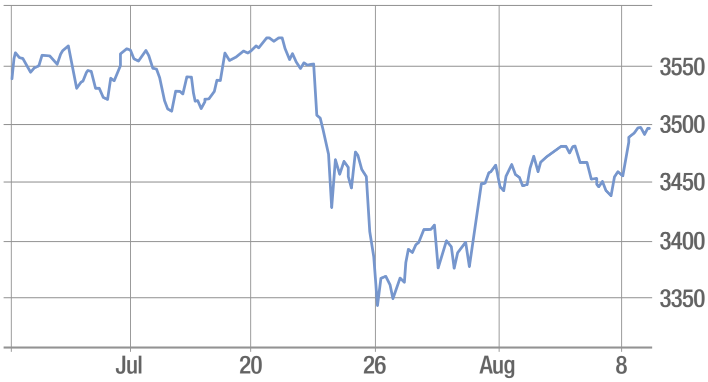
Anyway, I thought I would commemorate this milestone by discussing 10 of the most important themes in the world today. So without further ado, let's get to it:

1. China is Unraveling

As readers will know, I started thinking and writing about this last month. After China so abruptly changed course on Bitcoin and then almost destroyed Didi, one of their own Unicorn success stories, I became convinced that there's something very serious going-on here. True to form, shortly after I wrote last month's article, China made another aggressive move, this time against their $100B private tutoring industry. Again, what they did here is really incredible. Overnight they banned the entire business of "for profit" tutoring, wiping out over $70B in market capitalization from the big players in the industry and causing a broader sell-off in the Chinese market.



Shanghai Stock Exchange Composit Index



Companies like TAL Education and Gaotu Techedu had emerged in response to the increasingly competitive environment for elite education and ultimately for the highly sought after service sector jobs available only for the very best graduates. In recent times, things have gotten so crazy in the world of Chinese University admissions that it makes our college admissions scandal look like the minor leagues. China is suffering from this strange dynamic where youth unemployment, even among the highly educated is significantly higher than in the rest of the population. Chinese youth have already started to revolt against the competitive pressures of the 9,9,6 business culture (9am to 9pm, 6 days a week as the minimum expectation for the "best" jobs) and many are opting out. There's a movement already called "Lying Flat," a powerful metaphor for the idea of seeking fulfillment outside of the rat race.

These dynamics have not escaped the attention of Xi and CCP. I think what we are seeing here with all these anti-business moves is an attempt to shift the focus of the Chinese people away from the narrative of economic growth. And they are doing this for the simple reason that this remarkable pathway is no longer tenable. China is mired in debt and struggling to regain its footing in the post-globalization world. It has bad demographics, rising inequality and structural problems with its labor market. I think Xi is hoping to cast a different narrative of control—something like "focusing on quality of life" or "pushing for social and cultural change." Anyone who remembers what happened the last time "culture" became the focus of the CCP is rightly concerned, if not terrified.

Something serious is happening in China and given its importance in the global economy, we have to monitor this situation carefully.

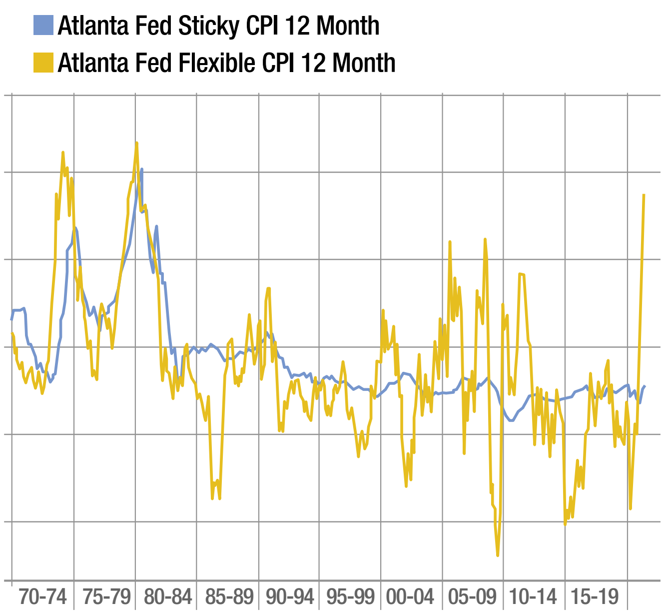
2. The Coronavirus is Here to Stay

Another important thing to keep in mind is that the Coronavirus saga is far from over. Here in Southern California, we are already back wearing masks indoors again and much of the West has hit a wall in vaccination rates just as the delta variant is surging all around the world. We cannot ignore the possibility for yet more mutations. It's hard to tell what kind of impact this might have on the economy and the capital markets but in thinking about the future we cannot ignore the potential for problems. We could see more lockdowns and their resulting supply-chain problems. We could see more government and central bank interventions in the economy (this is a near certainty). With each intervention, well-intentioned as they may be, we open ourselves just a little bit more to Pandora's box of unintended economic, societal and political consequences. We could see geopolitical turmoil as struggling nations compete for coveted vaccines or face inflation or supply shortages in key commodities and components. You get the point here. Don't assume we've seen the end of the pandemic.

3. Inflation is a Problem

I have been writing and thinking about this for some time now. There's really no question anymore whether we have inflation. Clearly, we do. The question now is whether we should believe the Fed, the ECB and other Central Banks that this inflationary pulse is indeed transitory. The optimists are pointing to things like the disinflationary and deflationary impacts of technology and hoping that the supply chain problems causing some of the high-profile issues are indeed "anomalies." The pessimists are pointing to signs from the labor market of rising wages and arguing (correctly, I think) that rising prices tend to be rather sticky. We are seeing this in our business already, where while the lumber futures market has collapsed from the highs, prices to buy actual lumber have come down only by a little bit.

As of now, I think some degree of higher inflation is here to stay. If I am right about this fixed income markets are a dangerous place to be and we should expect more and more volatility in the capital markets.

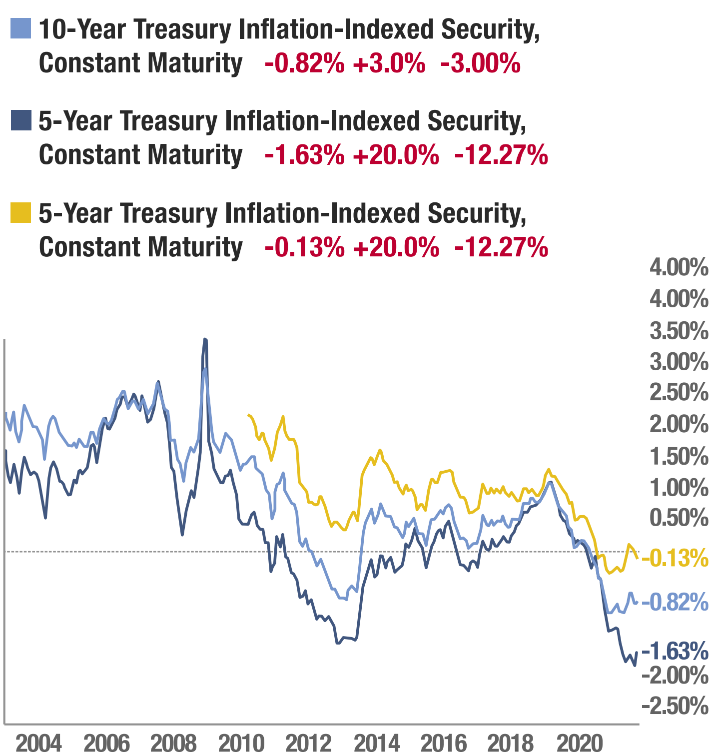


Source: Bloomberg Finance LP

4. Financial Repression Creates Unexpected Results

One of the biggest challenges in investing today is that radical government interventions in the economy and markets are making an already difficult task near impossible. We are living through an era of unprecedented financial repression. For more than a decade now central banks around the world have been taking coordinated action to prevent interest rates from accurately reflecting the rate of inflation in the economy. Now this isn't the first time we've seen financial repression—WWII ushered in a rather lengthy bout actually—but it's certainly the most aggressive. There is a tendency, particularly acute in the financial newsletter space, of looking at these unprecedented actions and forecasting all sorts of hyperbolic doomsday scenarios. "Global hyperinflation is coming! Buy Gold (or Bitcoin)!" Or "The world order is going to collapse. Nothing is safe." These are possible of course, just highly unlikely.

In my view, financial repression is problematic, not because of these extreme possibilities, but rather simply because it distorts economic activity. How do make any sense of a world with negative real interest rates?



Or a world where the entire German Bond market can trade with negative interest rates?

Residual Maturity	Yield Last	Yield Chg 1M	Yield Chg 6M	ZC Price Last	ZC Price Chg 1M
3 Months	-0.665%	-0.9 bp	-2.8 bp		
6 Months	-0.672%	-3.4 bp	-2.6 bp		
9 Months	-0.624%	+2.5 bp	+0.0 bp		
1 Year	-0.665%	-2.4 bp	+1.7 bp	100.67	+0.02%
2 Years	-0.777%	-10.3 bp	-6.1 bp	101.57	+0.21%
3 Years	-0.832%	-12.4 bp	-7.4 bp	102.54	+0.38%
4 Years	-0.829%	-16.5 bp	-7.9 bp	103.39	+0.67%
5 Years	-0.753%	-14.3 bp	-4.5 bp	103.85	+0.72%
6 Years	-0.735%	-19.8 bp	-3.5 bp	104.53	+1.21%
7 Years	-0.652%	-21.9 bp	0.0 bp	104.69	+1.56%
8 Years	-0.630%	-23.1 bp	-2.6 bp	105.19	+1.88%
9 Years	-0.559%	-22.9 bp	-1.7 bp	105.17	+2.09%
10 Years	-0.478%	-23.7 bp	+0.6 bp	104.90	+2.40 %
15 Years	-0.217%	-24.0 bp	+9.0 bp	103.31	+3.66 %
20 Years	-0.255%	-26.1 bp	+0.5 bp	105.24	+5.37 %
25 Years	-0.099%	-27.2 bp	+2.0 bp	102.51	+7.04 %
30 Years	-0.006%	-27.3 bp	+3.4 bp	100.18	+8.53 %

Have investors just gone crazy?

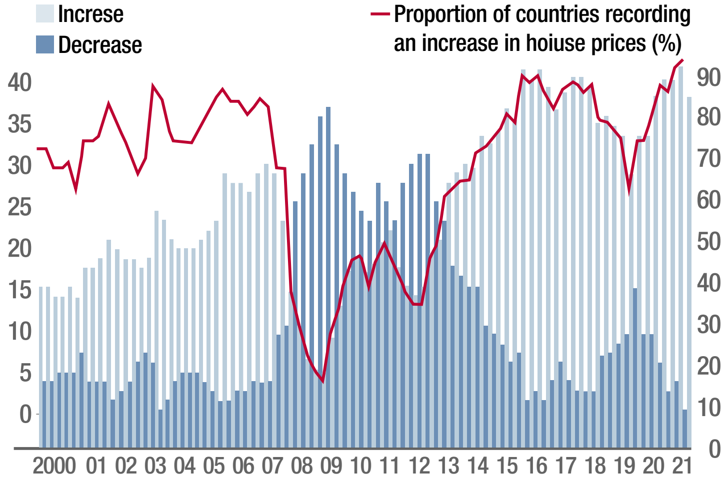
I don't think it's that they've gone crazy, it's just that when interest rates are zero the whole rational incentive structure of the market falls apart. It's not necessarily the case that the price of money is zero—although it kind of is for some people and some companies—it's more that the price cannot be calculated. And this is what causes confusing behavior. Decisions that might look completely irrational, like buying a bond with a negative yield, somehow make sense for certain market participants. On top of this, you get the whole range of garden variety consequences of low interest rates: people are encouraged to speculate rather than save or invest, businesses that would've / should've collapsed stay afloat on the back of easy money and capital often gets misallocated away from productivity enhancing investments.

The problem with financial repression is that it introduces yet more uncertainty into an already incredibly uncertain world. It makes our jobs as investors that much harder.

5. There is a Global Housing Boom

Even though there are a lot of problems in the world economy, it's not all gloom and doom out there. One of the most interesting, and in my view, exciting consequences of the pandemic is the near global reinvigoration of the demand for housing. I think that what happened here is that the whole experience of the pandemic—with the lockdowns, the unrest and the general uncertainty and anxiety of the situation—made people think really seriously and differently about big things like "where am I going to live?" All of a sudden, this question became the most important question of life. And as people started answering this question for themselves a whole new dynamic emerged in the economy.

Total debt-to-GDP ratios in major economies



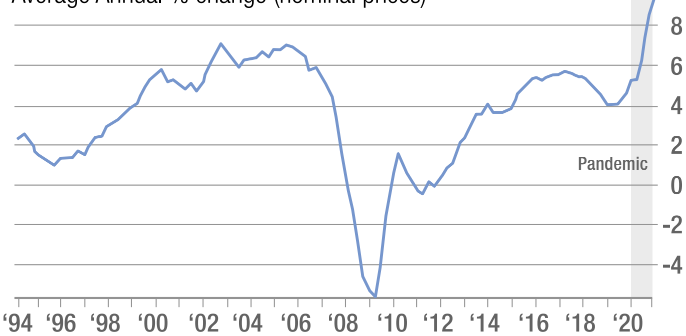
Source: Bloomberg Finance LP

There was a long period of time after the US Housing Bubble collapse where people were generally negative about homeownership. Too many people had been burned in the bust and there was a sort of hangover in the market. People didn't want to stretch financially or take risks in order to be a homeowner. They were content to be renters. Ironically, the pandemic turned out to be the long awaited cure for the hangover.

Now we are seeing tremendous demand for for sale housing all across the world, not just COVID friendly suburban neighborhoods but in urban areas as well. Interestingly, this resurgence in demand is not just about space, which is a very understandable psychological reaction to the pandemic. It's also about ownership. This, I think, is the unexpected consequence. I am not sure why the pandemic made people so much more interested in homeownership but it did. It's like a global, synchronized case of YOLO sentiment. And it kind of makes sense psychologically. I can see how in the face of something like the pandemic, which really introduced a lot of uncertainty into the world and our lives, people would start looking for security wherever they could find it. Homeownership is a great outlet for that.

House prices are rising sharpley across the OECD

Average Annual % change (nominal prices)



Source: OECD

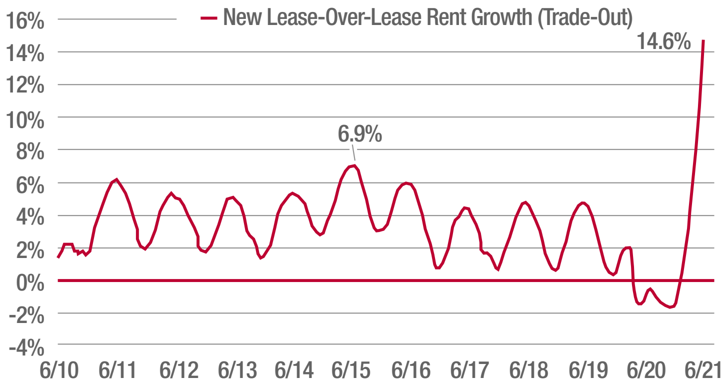
I think this is a good phenomenon for the global economy. Not only will we see very productive economic activity (i.e. New home construction), in a world of radical central bank intervention, the more people that own financial assets, the better. Why? Because it's one of the only ways for households to keep pace with inflation. I think it's good for democracy as well. There's nothing more motivating for civic engagement than owning a home.

6. Cities are Not Dead

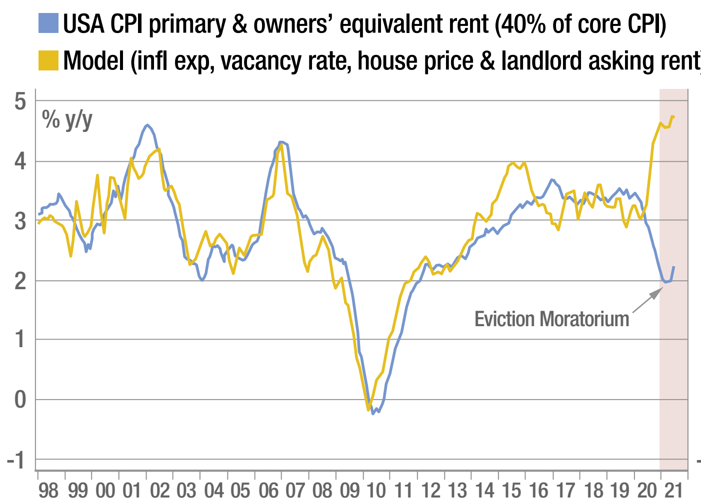
Last summer, as the world struggled through waves of the pandemic and dealt with the unrest and fallout from racially motivated policy brutality in the US, there was a lot of talk in the mainstream media about the "Death of the City." The idea floating around was that the pandemic had really changed things in the world, that people were fed up with city life and willing to give it up for good. At the time I was inclined to think it was yet more hyperbole but as an owner of urban multifamily properties I couldn't ignore completely the disturbing signs in the market. There was a period of time where we couldn't rent some of our best units in LA without reducing pricing by over 20% and what would normally rent in a week took 2 or 3 months to rent out. So we were concerned.

However, as we moved into the Fall of 2020, things quickly changed. Young people started to return to the city (from their parents' house—there's only so long that is tenable right!?)—and market dynamics quickly returned to normal. Now, we are seeing signs that the cities are on fire. Rental pricing trends in many cities look even better than the pre-pandemic trajectory.

True U.S. Apartment Rent Growth surges to another record high in June



Source: Rent rolls for market-rate apartments running on RealPage platform. New leases only.



Source: Macrobond and Nordea

This is true even with urban core for-sale housing. These locations are doing just as well in most cases as the much talked about suburban markets. Here in LA, we've seen some really aggressive condo sales recently, almost $4,500 per sf. This price point, which feels more like a Hong Kong number, is unheard of in LA. You can buy houses in coveted neighborhoods of Beverly Hills and Brentwood for less than ½ that on per sf value.

While you would think that the natural reaction to the pandemic would be a very aggressive move toward suburban living, I think what we're seeing here is a representation of another part of the story: after being starved from normal life for over a year, people are craving experiences and real-life interactions like never before. There's no better place for this than a great city.

I'm convinced that the cities are thriving again and that this trend is here to stay. Don't get me wrong—it's not that the cities are going to do well and the suburbs are going to suffer. I don't think that at all. I think both are poised to thrive. But I expect cities to hold their own in the short-term and almost certainly outperform in the long-term.

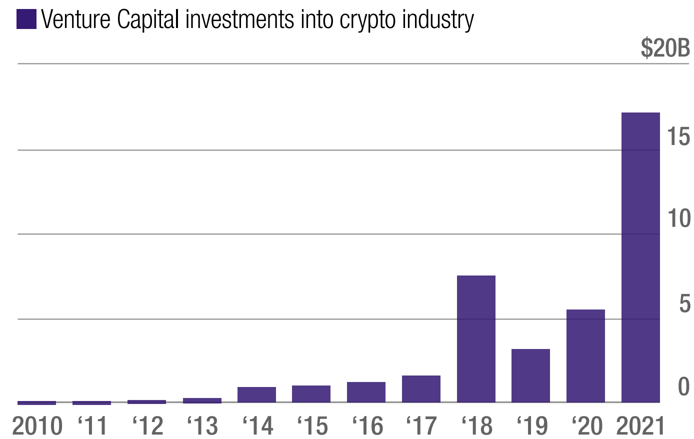
7. The Future is in Crypto, NFT's and the Metaverse

Regular readers know that I'm very excited about the crypto world. I see tremendous opportunity in everything from the applications of decentralized finance to media, gaming and commercial opportunities in the Metaverse to the promise of NFTs and digital art and collectibles. Crypto is another sector that somehow managed to really benefit from the pandemic. The extent to which our digital lives became paramount during lockdown really opened people's eyes and minds to what's been happening here and ultimately accelerated the development of some key innovations in the space like digital collectibles, DeFi and the Metaverse.

Every time I engage with the traditional financial system, whether it's sending a wire or signing loan documents for a deal for Metros Capital, I see so clearly why the crypto movement is getting so much attention from the VC community around the world.

Gold Rush

Venture Capital has piled into crypto companies in 2021



Source: Pitchbook

Conducting the most basic transactions within the established financial system is increasingly frustrating, inefficient and sometimes, asinine. To submit a wire, for example, you have to first call the receiving party and verbally confirm their wiring instructions. Of course, they cannot just send you the instructions via email! Then, using a login and secure ID token, you submit a request to your bank. Then you take a phone call to verbally confirm, which you cannot initiate yourself because it needs to be on a recorded line. Then, if it's a big enough wire, you take another phone call…. By the time you are done you have wasted a half an hour and find yourself logging onto Coinbase to buy some more crypto!

Something similar happens when you need to sign documents for the purchase of a new property. Rather than just handling things electronically, a notary comes to your house or office with hundreds of pages of non-negotiable legalese. You initial and sign a whole bunch of pages without reading a thing. The whole process wastes an hour at least. All of this can be handled digitally with already existing technologies. It's only a matter of time.

I think the crypto opportunity is exciting, not because I believe that Bitcoin and Ethereum are going to replace the US$ as the reserve currency. It's nothing like that. Rather it's a function of the reality that the digital world is going to become the dominant force in our economic system and we just haven't fully developed the infrastructure to operate this brave new world. This is what the opportunity is about: the chance to create the infrastructure of the digital economy.

To be sure, crypto is not without its problems. The elephant in the room—the looming threat of regulation—is real and not going away. We've already seen China basically ban Bitcoin mining overnight and signal that they won't be allowing much crypto, if any. There's also fraud, excessive speculation, hacking and crime. Then there's the environmental issue behind Bitcoin's proof of work protocol. But even with all these headwinds, crypto is going to evolve into a huge part of our economic system. The opportunities of a global digital economy are just too large and the inadequacies of our legacy systems in finance and law, too serious to ignore. It's going to be a wild ride but crypto is the future.

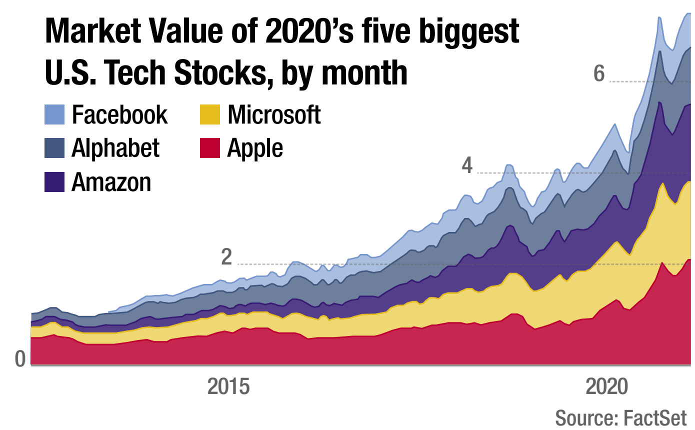
8. The Global Warming Crisis is an Opportunity

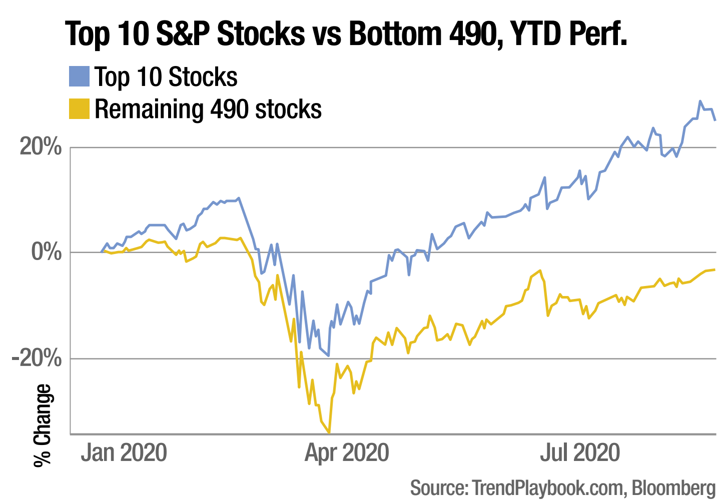
I wrote about this at length last month but suffice it to say for now that the carbon economy represents one of the biggest, most important, most exciting investment opportunities of our age. Whatever you may think about climate change and CO2 emissions, as an investor this whole area is something you simply cannot ignore. There's wide political consensus among global powers that something big must be done to reduce the amount of CO2 in the atmosphere and prevent global average temperatures from rising even more. And the market itself has taken note, rewarding companies that are focused on doing their part in the fight to reduce CO2 with lower cost of capital and penalizing those that don't. This force is so strong in the market already that even Bitcoin, this year's darling asset in some sense, saw its dazzling prospects halted when criticisms emerged about the environmental cost of operating and maintaining the protocol.

With each new extreme weather event, whether it's floods in Europe and China or wildfires all over the world, the stakes go up and up. While there's nothing inevitable in capital markets—except for maybe inflation and fraud—I have to believe that the price of carbon (i.e. carbon offset credits) is going up. In my mind, it has a chance to be the best performing commodity of all time. Even a cursory review of the mathematics behind what it would take to get to Net Zero by 2050 suggest carbon pricing is going to the moon. There are also really compelling opportunities to invest in things like carbon offset projects like reforestation, green technologies like carbon capture and renewable energy investments like wind and solar. I am tracking a few companies here and hope to have some recommendations soon.

9. Big Tech is Eating the World

One of the more interesting and consequential repercussions of the pandemic is the extent to which events of the past year enabled big technology companies to absolutely dominate the market. I don't think we've ever seen anything quite like this, where just a handful of companies (i.e. Apple, Google, Facebook, Microsoft and a few others) have contributed so much to the overall market performance and grown to such titanic market capitalizations. These companies have amassed titanic levels of economic power. In recent times, not owning them has been downright foolish:





This trend was in place before COVID for sure, but the pandemic seems to have accelerated things. The established players—the builders of our current infrastructure for the digital economy—really benefited from the various disruptions in the "normal" economy. We spent more time on our devices doing everything from streaming entertainment to conducting business to running campaigns. We all sort of knew how powerful our technology had become but the pandemic really brought the point home.

I'm not sure whether there is a problem here or an opportunity. Part of me wants to believe that this kind of concentrated economic power just has to be bad news for consumers and the economy. We've already seen some high-profile instances of abuse of power and there's big, on-going debates about things like privacy and what's appropriate to track or not. There's talk even of antitrust actions against these companies, more so in the EU but it's gaining traction in the US. However, it's hard to square this negativity against my own consumer experiences, where things have been overwhelmingly positive. Apple makes incredible products. I won't even consider buying a computer, phone or tablet from another company. And does anyone not use Google for search and email? What about Amazon's customer service? They really have figured some things out. Social media, while sometimes annoying, does help me stay connected to people…

I think that having some exposure to these companies is a good idea. More likely than not the economic conditions that have enabled these companies to become so wildly successful will continue in the future. Then there are the network effects and the winner take all dynamics which make these businesses the envy of the world. And when you realize how financially secure these companies have become, with their pristine balance sheets and enormous cash hoards, it's difficult to imagine a scenario where they don't continue to outperform. Something to watch for sure!

10. Retail Speculation Strikes Back

No list like this would be complete without mentioning the fascinating emergence of the meme stock phenomenon. Just this past week Robinhood, the main tool of meme stock crowd, went public and became itself a meme stock. You cannot make this stuff up! I think it's kind of good that we are seeing a return of retail engagement with the stock market. For too long, the market had come to be dominated by algorithmic trading and big institutional players. And in an inflationary world of financial repression, we do want to encourage more widespread ownership of financial assets. However, what we've seen with stocks like GameStop, AMC and now Robinhood is ultimately problematic because it's an expression of overly speculative behavior. By and large, people haven't been "investing" in these companies they have been gambling on them.

Now, you could argue that there is nothing really all that different between what the Reddit crowd is doing here and what hedge funds do day in and day out. At the highest level of abstraction it is sort of the same thing. I think there is a difference though and this is where the current situation looks dangerous and problematic. After engaging with the meme crowd on Reddit, YouTube and a few other places, I got this feeling that by and large people are gambling with money they cannot really afford to lose and getting used or taken advantage of by people only slightly more sophisticated than they are when it comes to stock market investing. This is a toxic recipe for a bad ending. Most people are going to end up worse off than when they started.